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Weekly Economic Briefing - Oct. 15, 1999

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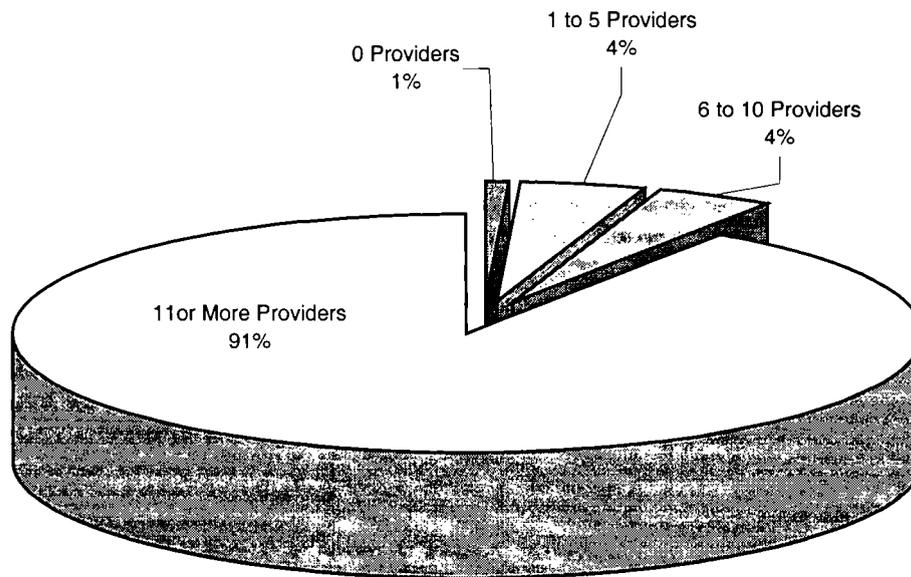
# WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

October 15, 1999

## CHART OF THE WEEK

Percent of Population with Local Internet Access



Over 90 percent of the U.S. population live in counties that have access to 11 or more local Internet Service Providers (ISP), while less than 1 percent have no local access to an ISP. Without regard to population, 247 mostly rural counties, nearly 8 percent of the total, have no local ISPs while 55 percent of all counties have 11 or more.

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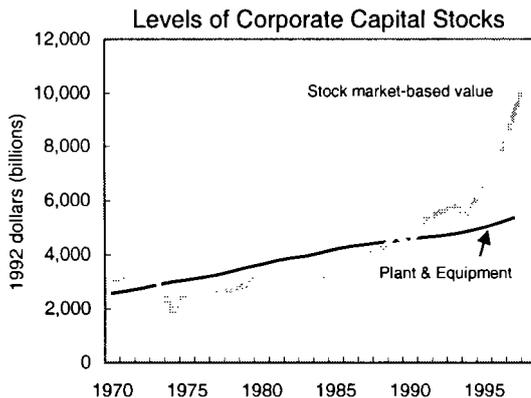
*"I've consolidated all our bills into one missed payment."*

## SPECIAL ANALYSIS

### **Intangible Capital and the Stock Market**

Recent research based on stock market valuations suggests that over the last decade U.S. businesses have accumulated large quantities of intangible capital that raise productive capacity but are not accounted for in standard measures of the capital stock. Intangible capital includes the value of intellectual property, organizational structure, management expertise, and past investments in job training. According to a measure of capital based on stock market valuation, growth in the total capital stock including intangible capital has been more rapid than that in plant and equipment alone. Such rapid growth in the capital stock would imply faster trend labor productivity growth than one would expect based on the more limited measure of capital. However, the stock market-based method of measuring business capital has yet to be the subject of careful study and remains controversial.

**The stock market as a measuring stick.** The premise of this research is that the stock market accurately measures the true productive capacity of businesses, and therefore provides a better yardstick for capital accumulation than standard



measures based on past investments in plant and equipment. Economic theory argues that, at least over longer periods of time, the market value of a business should equal its replacement cost—including the cost of replacing its intangible capital. One implication of this theory is that the doubling of the stock market value of nonfinancial corporate businesses over 1990-1997 implies an equally large increase in their productive capital stock, well above

the 17 percent increase based on investments in plant and equipment alone (see chart). If total capital accumulation has in fact been faster than previously thought, this should have a positive effect on labor trend productivity growth.

**Intangible capital and the IT revolution.** Why might the stock of intangible capital have grown so rapidly in the 1990s? A number of explanations have been put forward. One is that businesses have intensified efforts at increasing efficiency and productivity. A second is that the explosion in information technologies has led to a surge in investment in intangible capital—including investments in computer software (not currently counted as business capital), the creation of new products and services, and the redesign of production processes and management strategies. In this view, businesses have invested considerable resources in order to take advantage of the opportunities provided by the IT revolution. Investors perceive that these investments will pay off and this is

showing up in stock market valuations. One piece of evidence supporting the connection between information technologies and the accumulation of intangible capital is the fact that stock price gains in high tech firms have outpaced those in the rest of the economy, suggesting that these firms have been accumulating intangible capital at a rapid rate.

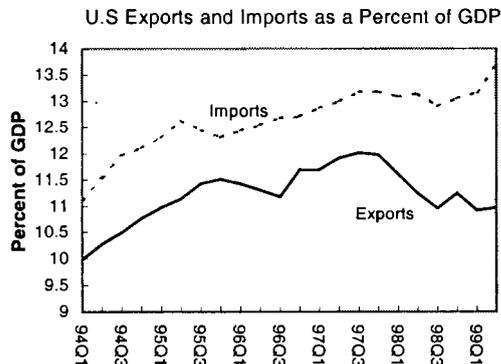
**Intangible capital or a market bubble?** There have doubtless been sizable increases in intangible capital over the last decade, but there remains considerable controversy over whether the huge increase in stock market valuation over this period implies a one-for-one increase in the capital stock. At least a portion of the runup in stock prices may reflect changes in perceptions of risk or excessive optimism on the part of investors regarding future earnings, with no positive implications for the capital stock and productivity growth. It is difficult to measure and evaluate the different variables—including perceptions of risk and profitability—that factor into stock market prices. Indeed, economists have a mixed record of perceiving the underlying determinants of stock values. Irving Fisher, one of the founders of financial economics, claimed that “Stock prices have reached what looks like a permanently high plateau,” just 2 weeks before the stock market crash of 1929. For 1999, a balanced view of the stock market and intangible capital is likely somewhere between the two extremes, with some but not all of the increase in stock market valuation representing real gains to productive capacity.

## SPECIAL ANALYSIS

### Recent Patterns of Trade and Growth

Between the onset of the Asia crisis in the third quarter of 1997 and the second quarter of this year, the U.S. trade deficit widened from 1.2 percent of GDP to 2.7 percent of GDP. Most of this increase reflects depressed export growth.

**Recent trends.** From 1994 through 1997, the trade deficit remained fairly constant as a percentage of GDP (see upper chart). The trade deficit has widened substantially over the last year and a half. About two-thirds of this widening



owes to export sluggishness, with only a third attributable to increases in imports.

**Are U.S. exports competitive?** If export weakness reflects weak demand abroad, then it is reasonable to expect that it can be reversed as the rest of the world recovers. A longer-term decline in competitiveness, by contrast, could be more difficult to reverse.

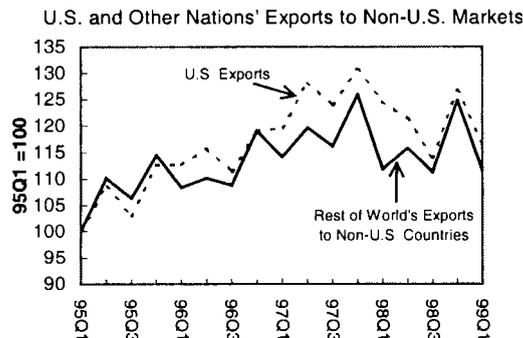
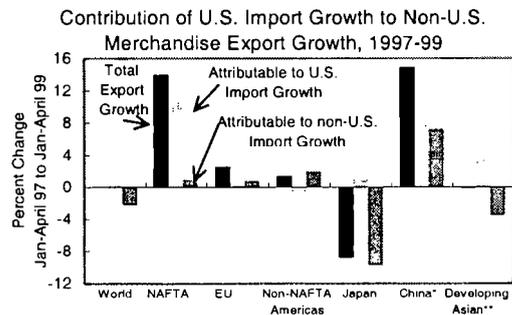


Chart derived from Import data

The middle chart compares the performances of U.S. exports with the rest of the world's exports to all non-U.S. markets. U.S. exports appear to have tracked global market movements rather closely. U.S. exports were indeed hit hard in 1998, but so were those of other countries. Despite the contraction in exports in 1998, the market share of U.S. exports in the first quarter of 1999 remained higher than in the mid-1990s.



\* Includes Hong Kong, \*\* Thailand, Korea, Indonesia, Malaysia, Philippines  
Chart derived from import data

**Support for growth.** As shown in the lower chart, the United States has been a critical source of support for the rest of the world's exports since 1997. Total non-U.S. exports were virtually unchanged over this period. However, excluding the growth in U.S. trade, world exports fell by 2.3 percent: Increases in U.S. imports completely

offset decreases in imports in the rest of the world. As seen in the chart, growth in U.S. imports were particularly important for export growth in the other NAFTA

countries, the European Union, China, and other developing Asian countries. In contrast, U.S. imports contributed little to export growth in the non-NAFTA Americas and Japan.

## ARTICLE

### **From Learning to Earning**

It has long been debated how schooling improves economic well-being. Is it because students who are smart to begin with get more schooling, and employers are willing to pay for such “smarts?” Or do employers value what students learn in school? Three recent studies provide new evidence on the relative contribution of “aptitude” (the ability to learn) and “achievement” (what people learn in school) to economic well-being. The studies, combined with earlier research, provide strong evidence that how much students learn in school affects how much they earn.

**Background.** Starting in the late 1950s, economists developed the theory of human capital, which is a function of both endowments (e.g., genetic factors) and investment (e.g., schooling and student effort). Empirical research using data on identical twins, along with other methods, supported the importance of investment in education by showing that higher levels of schooling lead to higher wages, controlling for initial aptitude. But other research argued that aptitude was the primary determinant of economic success. The 1966 “Coleman Report,” for example, found that school quality (as measured by factors such as school expenditures) had little effect on the amount students learn—and so presumably little effect on future earnings. Others have argued that educational credentials are “signals” that enable employers to sort job applicants by ability, but that ability is largely determined by heredity or by very early environmental influences. In this vein, the 1994 book *The Bell Curve* claimed that innate aptitude largely determines economic outcomes.

**New research.** Because so much controversy remains about the relative importance of aptitude and achievement, the new studies reexamine the issue using new methods. These studies take special care to separate the effects of aptitude and achievement when estimating the effect of schooling on test scores and economic outcomes. Together, they suggest that an additional year of schooling raises future wages by 2 to 4 percent, after controlling for aptitude.

- Using national survey data, one study finds, surprisingly, that gains in students’ test scores between the 10<sup>th</sup> and 12<sup>th</sup> grades are almost uncorrelated with students’ 10<sup>th</sup> grade scores. This implies that increases in cognitive ability (measured by test scores) are likely to reflect learning rather than initial aptitude. The study then uses data on the students’ wages 10 years later to estimate the effect of test-score gains on future earnings.
- A second study finds that—holding education level constant—those who score higher on the Armed Forces Qualification Test (AFQT), a test of cognitive skills, earn higher wages. On the other hand, holding AFQT scores constant, those with more education also earn higher wages. This implies that employers care about worker’s aptitude and their achievement.

- A third study uses the fact that most states require children to enter first grade when they reach a certain age by a particular date. This has the effect of dividing children of the same general age, and presumably the same cognitive ability, into two groups. One group, born in the months before the cut-off date, starts school earlier, while the group born in the months after the cut-off date begins school at a later age. Using national data, the study finds that those in the earlier-starting group actually earn higher average wages as adults (2.7 percent higher). Part of the reason for the difference in wages may be that early exposure to schooling increases cognitive skills which in turn translates into higher wages. This is evidence that schooling (and school timing) affects outcomes—not just innate ability.

**Implications.** The studies present new evidence that enhancing student achievement can yield significant benefits, regardless of aptitude. This evidence highlights the potential impact of policies that increase the quantity or quality of schooling. It also casts doubt on the claim made in *The Bell Curve* that “For many people, there is nothing they can learn that will repay the cost of the teaching.” It should be noted, however, that cognitive test scores explain only a modest amount of the overall variation in wages. Most of the variation can be attributed to factors other than cognitive skills or to cognitive skills not measured by conventional tests. For example, employers say they want workers who are not only skilled, but are also reliable, creative, confident, and honest.

## BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

**Job Loss among Older Americans.** A report based on the Health and Retirement Study finds that a late-career job loss has large and lasting effects on subsequent employment. Nearly 40 percent of American men who lose their jobs at age 55 do not return to work within a year and over 25 percent do not return to work after 2 years. Of those who do return to work after suffering a late career job loss, roughly 20 percent will no longer be working after 1 year, with this figure rising to about 30 percent after 2 years. Combining the difficulties in finding and keeping a job, the report estimates that among 55-year-old job losers, only half are working at age 56, compared to 95 percent of 56-year olds who have not suffered a recent job loss.

**Internet Economy Flying High.** In 1998, Internet-related businesses generated over \$300 billion of revenues and 1.2 million jobs in the United States, as estimated by one study. While the Internet economy has created thousands of startups, major firms still play a significant role, with employment in the top 15 companies accounting for nearly one-third of the jobs. Many of these jobs, such as web design and Internet consulting, did not exist just 5 years ago and companies have had to design jobs to meet the challenges of the Internet economy. Although online companies engaging in commerce are expected to operate with fewer employees, the study found that the ratio of revenues to employees was about the same for online companies and their "brick-and-mortar" counterparts selling similar products in 1998. Evidently, Internet commerce, which is estimated to make up about one-third of all Internet revenues, has yet to yield sizable gains in efficiency over more traditional methods.

**Good and Bad News in Housing.** The physical adequacy of the housing stock has improved significantly over the past few decades, particularly for households in the lowest income quintile, according to a recent study by the Federal Reserve Bank of New York. Today, with only around 2 to 3 percent of housing units rated "severely inadequate" there is little difference in the physical adequacy of the units occupied for different income quintiles. This contrasts with 1975, when 12 percent of the lowest income quintile's housing stock was rated severely inadequate. However, housing affordability remains a problem. The lowest income quintile is spending an average of 60 percent of family income on housing, compared to about 40 percent in the mid-1970s. This increase can be attributed to slow growth in family income compared with that of housing costs. Additionally, as discussed in a recent HUD report, the number of rental units affordable to struggling households (those with income at or below 30 percent of the area median) has decreased by 5 percent between 1991 and 1997. Because the number of renters who are struggling has increased, the gap between struggling families and the number of affordable units has grown since 1991.

## INTERNATIONAL ROUNDUP

**Market Incentives for Developing an AIDS Vaccine.** Although developing an effective HIV vaccine now appears scientifically feasible, a recent World Bank paper argues that privately funded investment in developing such a vaccine remains far too low. Of the \$300 million spent worldwide on R&D on HIV vaccines in 1998, less than \$50 million was privately funded. In contrast, some \$2 billion annually is spent on research for AIDS *treatment*, much of it by the private sector. A forthcoming World Bank study finds that most biotechnology firms and vaccine makers do not consider the potential developing country market in making R&D investment decisions regarding an AIDS vaccine, despite the fact that 90 percent of HIV infections are in the developing world. The firms cited lower-than-expected uptake of other vaccines since the 1970s as evidence that there may not be an adequate market for an HIV vaccine. A possible mechanism for encouraging vaccine development is long-term market assurances, whereby governments and other donors would establish a fund dedicated to purchasing an AIDS vaccine satisfying specific medical criteria.

**Mundell Wins Nobel.** Columbia University Professor Robert A. Mundell won the Nobel Prize in Economic Sciences this week. The Royal Swedish Academy of Sciences cited Mundell's research on optimal currency zones, which was influential in the establishment of the European Monetary Union. This work showed that regional economic disturbances may require movement of labor from high- to low-unemployment regions. In other work, Mundell analyzed how the potency of monetary and fiscal policy depended on the degree of international capital mobility and whether exchange rates are fixed. For example, if capital moves easily, then a fiscal expansion has less effect on output with floating exchange rates than with a fixed exchange rate because in the former case the resulting appreciation of the exchange rate causes net exports to fall.

**Reforming the International Financial Architecture.** A report sponsored by the Council on Foreign Relations analyzes the factors that lead to banking, currency, and debt crises, and proposes recommendations for crisis prevention and resolution. The report emphasizes market-based incentives and fair burden-sharing across and within economies as guiding principles for financial reforms. For emerging economies with fragile financial structures, the report recommends adopting nondiscriminatory taxes to discourage short-term capital inflows and argues against pegged exchange rates. Collective-action clauses on sovereign bond contracts should be implemented to promote private-sector burden-sharing. The report calls for leaner agendas and a clearer division of labor between the IMF and the World Bank, and recommends that the IMF avoid large-scale lending during crises and provide more favorable lending terms to countries adopting "good" policies. The major themes are reasonably consistent with recent G-7 proposals, although this report focuses more on restructuring international lending institutions.

## RELEASES THIS WEEK

### **Industrial Production and Capacity Utilization**

**\*\*Embargoed until 9:15 a.m., Friday, October 15, 1999\*\***

The Federal Reserve's index of industrial production decreased 0.3 percent in September. Capacity utilization fell 0.4 percentage point to 80.3 percent.

### **Producer Price Index**

**\*\*Embargoed until 8:30 a.m., Friday, October 15, 1999\*\***

The producer price index for finished goods rose 1.1 percent in September. Excluding food and energy, producer prices rose 0.8 percent.

### **Retail Sales**

Advance estimates show that retail sales rose 0.1 percent in September following an increase of 1.5 percent in August. Excluding sales in the automotive group, retail sales rose 0.6 percent following an increase of 0.9 percent.

## MAJOR RELEASES NEXT WEEK

Consumer Prices (Tuesday)

Housing Starts (Tuesday)

U.S. International Trade in Goods and Services (Wednesday)

## U.S. ECONOMIC STATISTICS

	<b>1970- 1993</b>	<b>1998</b>	<b>1998:4</b>	<b>1999:1</b>	<b>1999:2</b>
<b>Percent growth</b> (annual rate)					
Real GDP (chain-type)	2.7	4.3	6.0	4.3	1.6
GDP chain-type price index	5.4	0.9	0.8	1.6	1.3
<u>Nonfarm business (NFB) sector:</u>					
Productivity (chain-type)	1.5	2.6	4.1	3.6	0.6
Real compensation per hour:					
Using CPI	0.6	2.5	2.0	2.9	1.5
Using NFB deflator	1.3	3.7	3.4	3.0	3.7

### **Shares of Nominal GDP** (percent)

Business fixed investment	10.9	11.0	11.0	11.0	11.2
Residential investment	4.5	4.3	4.5	4.6	4.7
Exports	8.2	11.3	11.3	10.9	11.0
Imports	9.2	13.0	13.1	13.2	13.7
Personal saving	5.2	0.3	-0.0	-0.5	-0.9
Federal surplus	-2.7	0.9	0.8	1.4	1.6

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	<b>1970- 1993</b>	<b>1998</b>	<b>July 1999</b>	<b>August 1999</b>	<b>September 1999</b>
<b>Unemployment Rate</b> (percent)	6.7**	4.5**	4.3	4.2	4.2
<b>Payroll employment</b> (thousands)					
increase per month			373	103	-8
increase since Jan. 1993					19409
<b>Inflation</b> (percent per period)					
CPI	5.8	1.6	0.3	0.3	N.A.
PPI-Finished goods	5.0	0.0	0.2	0.5	1.1

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

New or revised data in **boldface**.

PPI data **embargoed until 8:30 a.m., Friday, October 15, 1999.**

## FINANCIAL STATISTICS

	1997	1998	August 1999	September 1999	Oct. 14, 1999
<b>Dow-Jones Industrial Average</b>	7441	8626	10935	10714	10287
<b>Interest Rates</b> (percent per annum)					
3-month T-bill	5.06	4.78	4.72	4.68	4.88
10-year T-bond	6.35	5.26	5.94	5.92	6.17
Mortgage rate, 30-year fixed	7.60	6.94	7.94	7.82	7.85
Prime rate	8.44	8.35	8.06	8.25	8.25

## INTERNATIONAL STATISTICS

<b>Exchange Rates</b>	<b>Current level</b>	<b>Percent Change from</b>	
	<b>October 14, 1999</b>	<b>Week ago</b>	<b>Year ago</b>
Euro (in U.S. dollars)	1.080	0.7	N.A.
Yen (per U.S. dollar)	107.0	-0.7	-10.3
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. \$)	92.33	-0.2	-0.9

<b>International Comparisons</b> <sup>1/</sup>	<b>Real GDP growth</b>	<b>Unemployment rate</b>	<b>CPI inflation</b>
	(percent change last 4 quarters)	(percent)	(percent change in index last 12 months)
United States	3.9 (Q2)	4.2 (Sep)	2.3 (Aug)
Canada	3.7 (Q2)	7.8 (Aug)	2.1 (Aug)
Japan	1.1 (Q2)	4.7 (Aug)	0.2 (Aug)
France	2.1 (Q2)	11.3 (Aug)	0.5 (Aug)
Germany	0.6 (Q2)	7.1 (Aug) <sup>2/</sup>	0.6 (Aug)
Italy	0.8 (Q2)	12.1 (Apr)	1.7 (Aug)
United Kingdom	1.4 (Q2)	6.0 (Jun)	1.1 (Aug)

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 former West Germany. Using OECD standardized unemployment data, the unemployment rate for unified Germany for August was 9.2 percent.