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WEBS

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 27, 2000

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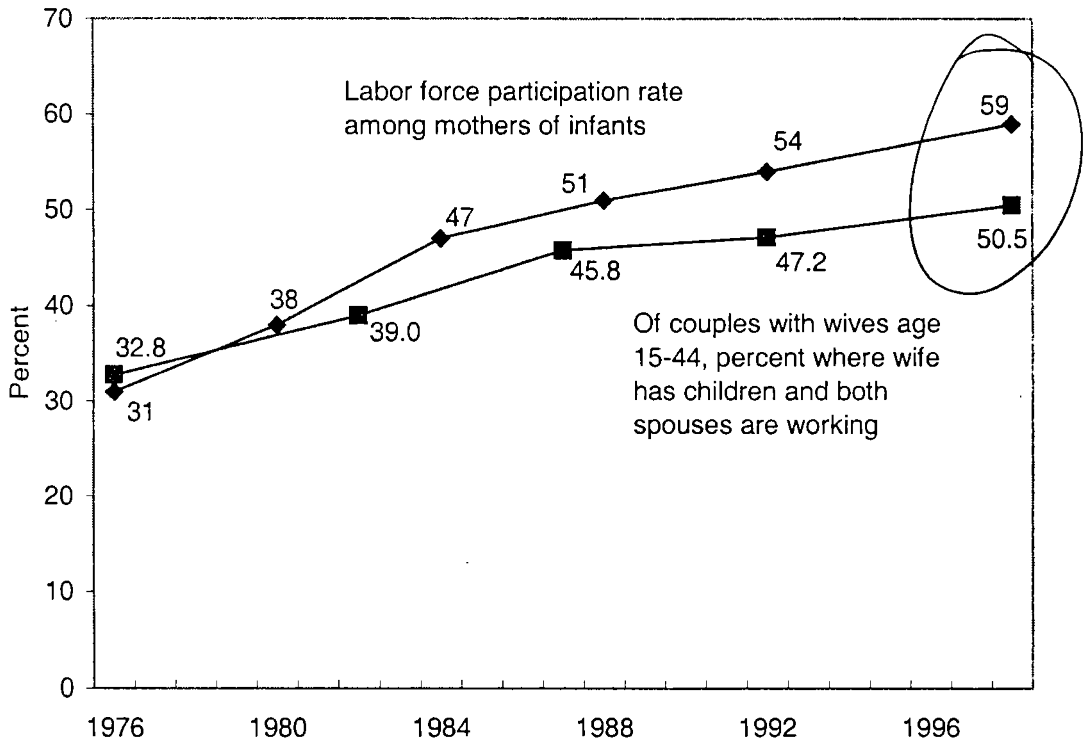
CHART OF THE WEEK

More Women Combining Work and Family



According to a recent Census Bureau report on the fertility of American women, the number of women who both work and have children has increased steadily over the past two decades. Since such indicators were first collected in 1976, the labor force participation rate among mothers of infants (children less than 1 year old) has almost doubled. Additionally, among couples with wives age 15-44, the proportion in which the wife has children and both spouses are working has topped one-half for the first time.

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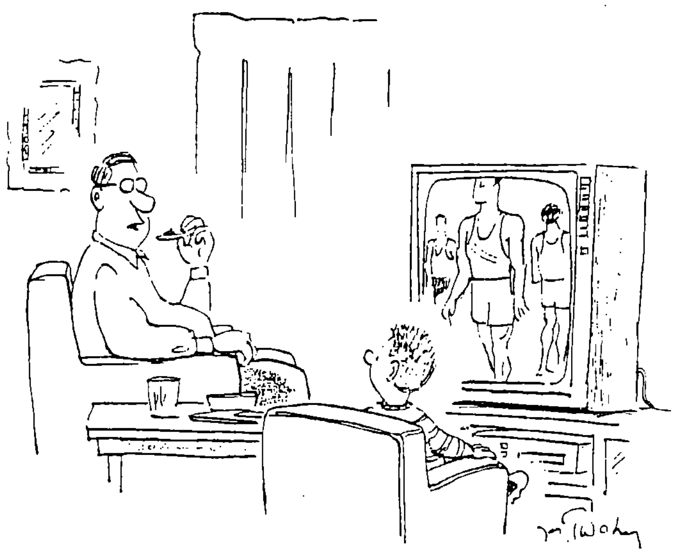

"Daddy is *fiscally* buff."

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CURRENT DEVELOPMENT

GDP Scorecard: Third Quarter 2000

Real GDP is estimated to have increased at a 2.7 percent annual rate in the third quarter of 2000. Exports grew very rapidly. Business investment continued to post strong growth, but growth was not as strong as in the past 2 years. In contrast, Federal purchases dropped sharply, while most of the major categories of construction fell. Inflation, as measured by the price index for GDP, was 2.0 percent, down from the 2.8 percent annual rate in the first half of the year.

Component	Growth*	Comments
Total consumer expenditures	4.5%	Motor vehicle purchases retraced part of their second-quarter decline, while nondurables and services also posted solid rates of growth.
Equipment and software	8.5%	Computer equipment grew at a 55 percent annual rate, but purchases of other forms of business equipment slowed from their recent trend.
Nonresidential structures	1.7%	Almost all the recent growth was accounted for by drilling for oil and natural gas.
Residential investment	-9.2%	The decline had been foreshadowed by a substantial drop in single-family housing starts. Residential investment is likely to fall further in the fourth quarter.
Inventories (change, billions of 1996 dollars)	$79.9	The inventory-to-sales ratio has edged up since March, but remains low nevertheless.
Federal purchases	-10.1%	The 10 percent fall in nondefense purchases partly reflects the completion of the decennial census. Defense purchases have been erratic, and the third-quarter drop retraces part of the second-quarter increase.
State & local purchases	0.0%	Highway building, which had boomed in the fourth and first quarters, fell sharply in the third.
Exports	16.2%	This was the sixth consecutive quarter of strong export growth, and suggests continuing expansion among our trading partners.
Imports	13.8%	About half of the growth in imports is accounted for by capital goods.

*Percent real growth in the quarter at annual rates (except inventories). This advance estimate is subject to substantial revision—especially for exports, imports, and inventories, where the estimates are based on only 2 months of data.

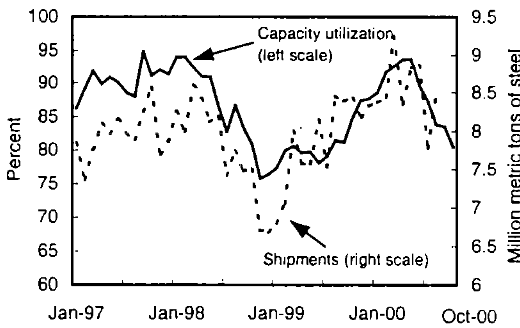
SPECIAL ANALYSIS

Steel Industry Update

After a sharp downturn during the import crisis of 1998 and a tepid recovery in late 1999, the U.S. steel industry rebounded strongly in early 2000. Since June, however, the economy has slowed and domestic steel production and capacity utilization have slackened; imports initially remained high, but then declined sharply in September.

The steel industry boomed in early 2000. For the first half of this year, strong orders from auto manufacturers, the construction sector, and steel distributors fueled an expanding demand for both domestic and imported steel. Monthly domestic production of raw steel averaged 8.9 million metric tons, even higher than levels before the 1998 crisis. Producers shipped over 15 percent more steel than in the first half of 1999, with first-quarter shipments the highest in 26 years. Capacity utilization ran above 90 percent for most of the first half of 2000, peaking at 93.7 percent in May (see chart). Imports grew along with domestic output, rising 21 percent compared with the same period in 1999.

Shipments and Capacity Utilization



Steel output has since declined. Both the construction sector and sales by domestic auto companies slackened in mid-year, contributing to decreased demand. Steel distributors, the largest purchasers of raw steel, also appeared to experience a slowdown. Monthly domestic production of raw steel has fallen since May, dropping to a current level of less than 8 million metric tons. Capacity utilization has likewise declined, from 93.7 percent in May to 80.5 percent in the first 3 weeks of October. Steel mill inventories have begun to creep back up, providing further evidence of slowing demand.

Prices have fallen and employment remains depressed. Prices have also recently turned downward. Producer prices for steel from blast furnaces and steel mills recovered partially from steep drop-offs in 1998 and 1999, rising to around 93 percent of their pre-1998 level. Since May, prices have begun to fall again, averaging a half-percent decline each month.

Blast furnace and steel mill employment at the end of 1997 was 235,100, and then fell by more than 8,000 workers during the 1998 crisis. Employment rose somewhat after October 1999, reaching 228,000 workers in June of this year. The downward trend has since resumed; September employment was 225,300 workers.

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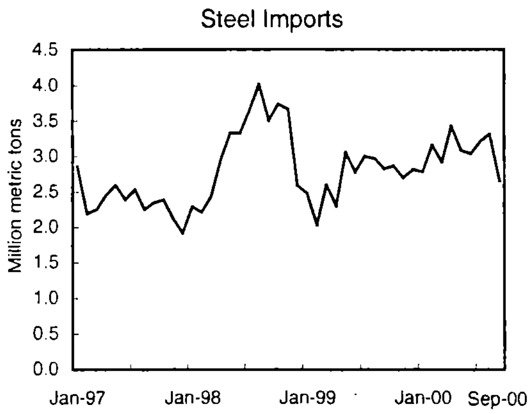
Imports also appear to be moderating. While this year's strong growth in imports continued into the third quarter, even rising slightly, preliminary data show September imports at 2.7 million metric tons, a 14 percent drop from May. Import penetration follows a similar trend: 27 percent in the first two quarters of 2000, rising a bit early in the third quarter, and then likely tapering off in September (see chart). High imports in July and August were possibly due to the filling of orders made during the strong demand of the first half. After an order is placed, it typically takes 2 to 6 months for foreign steel to ~~arrive.~~



The slowdown is potentially rooted in decreased demand. In 1998 a sharp surge in relatively inexpensive imports was followed by a substantial decline in domestic production. Import penetration soared, reflecting a rise in the overall market share of imported steel. The current data are not sufficient to know whether the steel industry is on the verge of a similar experience, but initial evidence indicates that the catalyst is more likely a slowdown in demand rather than an import push. To be sure, imports did increase their share of the U.S. market in July and August, contributing to the domestic industry's difficulties. In September, however, imports fell 15 percent from the March-May average, as domestic production declined 10 percent over the same period.

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ARTICLE

Shifting Composition and Energy Use of Manufacturing

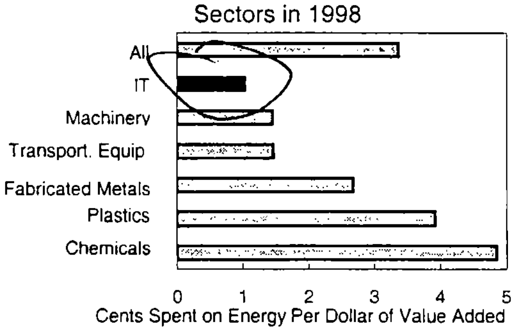
Over the past 50 years, U.S. energy use has on average grown nearly 2/3 percent for every 1 percent increase in GDP. But during the current economic expansion, energy use has grown at a more modest rate of less than 1/2 percent for each 1 percent increase in GDP. This may be due in part to the fact that much of the growth is occurring in sectors that are less energy intensive than those that fueled past expansions.

What determines the energy intensity of the economy? The energy intensity of the economy, or amount of energy consumed per unit of GDP, is a way of describing one facet of the relationship between the amount and type of inputs used in production nationwide and the resulting GDP. One significant determinant of this relationship is the relative size of each sector of the economy. As particular sectors of the economy become more important, the intensity with which they use energy has a greater effect on the overall energy use of the economy. Thus, given the substantial growth of information technology (IT) equipment manufacturing, it is important to understand how this will affect the intensity with which our economy uses energy.

Manufacturing is a big consumer of energy. While manufacturing's share of GDP in the mid-1990s was roughly 17 percent, it was responsible for 31 percent of domestic energy consumption and 26 percent of carbon dioxide emissions. Manufacturing's disproportionate share of energy consumption implies that further growth in typical manufacturing sectors can have significant implications for our future energy consumption and aggregate emissions.

But the share of IT in manufacturing is growing. Since the beginning of this economic expansion, the growth rate of IT-producing industries has far surpassed the observed 5 percent annual growth of the entire manufacturing sector. During this period, the production of computers, communications equipment, and semiconductors has grown at an average annual rate of 32.3 percent. As a result, during the course of this economic expansion, IT-producing industries' share of manufacturing's value added increased from 8.3 percent in 1991 to 11.5 percent in 1998. Consequently, these industries' energy needs have the potential to significantly influence growth in manufacturing's energy demand.

Energy Intensity of Manufacturing Sectors in 1998



The differences between the energy intensity of IT-producing industries and the rest of manufacturing are dramatic (see chart). In 1998, on average, 1 cent was spent on energy

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inputs for every dollar of value added in IT-producing industries, while 3.7 cents were spent in the remaining manufacturing industries. If IT-producing industries had the same energy intensity as the rest of manufacturing, in 1998 their additional energy needs would have been equivalent to 11,100 megawatts of electricity—roughly the residential electricity consumption of Florida.

Not only does the IT industry appear to be less energy intensive currently, but its intensity has also declined faster than that of the manufacturing sector as a whole. Between 1992 and 1997, real energy ~~intensity of all manufacturing dropped at an~~ annual rate of 3.4 percent. In contrast, during the same period, manufacturing sectors that produce IT equipment witnessed a median annual reduction in energy intensity of 7.3 percent, with intensity dropping in the computer production industry by 18.3 percent per year. While this dramatic decline likely reflects actual improvements in energy use, it may be due primarily to the explosive growth in quality-adjusted output and productivity in that sector.

The composition effect on energy intensity will continue, but not indefinitely. Given that IT-producing industries have a much lower energy intensity than other manufacturing sectors, continued growth in those industries will not raise future energy demand to the extent that past periods of manufacturing growth have. But further progress in reducing the impact of future economic growth on energy demand is more likely to be made through improvements in the technologies and practices that determine productivity, or through changes in the price of energy relative to other inputs.

Energy Demand of IT Use

Recently there has been a debate about the contribution to energy demand from the use, rather than the production, of IT. Analyses in this debate suffer from a lack of data describing aggregate energy consumption attributable to IT equipment. They must therefore build "bottom-up" estimates that are based on assumptions about the number of individual units and their energy consumption. One report, which has received press attention, suggests that energy consumption arising from Internet use accounts for 8 percent of the U.S. electricity supply. A recent analysis from Lawrence Berkeley National Laboratory discovered numerous flaws in this analysis, such as overestimation of both the energy use of various types of computer units, and the amount of that use attributable to Internet-related activity. Correcting for these flaws reduces the estimated energy use by at least a factor of 8. Furthermore, the analysis estimates that electricity demand from all office, telecommunications, and network equipment—not just that related to Internet use—accounts for only 2.6 percent of national electricity use.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

More Custodial Parents Receiving Full Child Support Due. In the spring of 1998, there were 14 million "custodial parents"—parents of children under 21 whose other parent is not living with the family—according to a recent Census Bureau report. Mothers represent more than 85 percent of all custodial parents. About 56 percent of custodial parents had some sort of child support agreement (most arranged through the legal system). Of parents with support agreements, the share receiving at least partial payments was unchanged from 1993 to 1997 at about two-thirds. However, the proportion receiving full child support payments rose from 34 percent in 1993 to 41 percent in 1997. Between 1993 and 1997, the proportion of custodial parents with full-time, year-round jobs increased, especially among mothers; the proportion in poverty decreased; and the proportion participating in public assistance programs decreased. However, the poverty rate among custodial-parent families, at 29 percent in 1997, was still much higher than the overall poverty rate among families with children.

Decreasing Employment Rates among the Disabled May be Due to Greater Working-Age Participation in the Disability Insurance Program. During the 1990s, employment rates for the non-disabled population rose, but employment rates for the disabled fell. Critics of the Americans with Disabilities Act have pointed to this as evidence that the law discourages employers from hiring the disabled by requiring reasonable accommodations for disabled employees, which may raise employers' costs. However, a recent study supports an alternative explanation operating through the supply side of the labor market: the decreased employment of the disabled is largely due to growth in the fraction of the working-aged population receiving Disability Insurance benefits. This increase in DI benefits may be a result of 1984 relaxations of various standards for disability benefit eligibility, in particular, increased eligibility of people suffering from mental illness. Growth in DI availability appears to be facilitating the withdrawal of disabled men and women from the work force.

SRW / worth study?

American Families Enjoying Economic Gains Since 1997, But Some Are Not Better Off under Other Measures of Well Being. New data from an Urban Institute survey of American families show improvements in several economic indicators over the 1997-99 period, consistent with recent Census Bureau data on incomes. Employment rates increased for single parents, poverty rates decreased, and fewer families reported having problems affording food. Child poverty rates declined, and the likelihood that low-income children lived in single-parent families decreased. However, other indicators considered by the survey reveal that not all families are better off in all ways. The proportion of middle-income children covered by health insurance declined; the time that higher-income parents spent reading to their children fell; and self-reported stress among parents in higher-income, two-parent families rose. Low-income children continue to fare worse than higher-income children on every measure of child well being.

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INTERNATIONAL ROUNDUP

Cameroon Qualifies for Debt Relief under HIPC. The IMF and World Bank have agreed to support a comprehensive debt-reduction package for Cameroon under the Highly Indebted Poor Countries initiative. Interim debt relief should begin shortly, with more to come after the completion point is reached around the end of 2002. Cameroon is the eleventh country to reach decision point under the enhanced initiative, and still needs to satisfy poverty reduction criteria in order to qualify for the full debt reduction available through HIPC. In the meantime, the interim debt relief will free about $100 million per year for expenditures on health care, primary ~~education,~~ HIV/AIDS prevention, and other critical social services. Debt service as a percentage of government revenue is projected to decline from its current 23 percent to 12 percent in 2001. Cameroon has already implemented economic reforms with support from the IMF's Poverty Reduction and Growth Facility, and ~~has made~~ substantial macroeconomic progress. Real GDP growth has averaged 4.5 percent over the last 4 years, and average consumer price inflation has been lowered to less than 1 percent in 1999-2000.

And You Can Take That to the Bank. A new study finds that banking crises in developing countries are primarily caused by rapid ~~domestic~~ credit growth, large bank liabilities relative to reserves, and deposit-rate decontrol. This suggests that bank stability in emerging markets is at ~~risk~~ when macroeconomic and financial policies combine with financial deregulation to create an unsustainable lending boom. Based on 75 developing countries from 1975 to 1997, the authors find a diminishing role for external factors, such as economic growth rates in OECD countries, in explaining banking crises since the early 1990s. They also find that countries with fixed and flexible exchange rates are equally susceptible to banking crises. In addition, the authors find at least as much evidence that deposit insurance has the favorable effect of providing protection from depositor panics, as that it destabilizes banking systems by weakening market discipline in emerging markets.

Global Private Equity and Venture Capital Boomed in 1999. A newly released report finds that global financial investment of private equity and venture capital (PEVC) reached $136 billion in 1999, up 65 percent from 1998. Global investments of this type have shown an average annual growth rate of 36 percent over the last 5 years, with technology companies receiving an increasing share (33 percent in 1999) of total investment. The United States received 71 percent of global PEVC investments, equivalent in 1999 to about 1 percent of GDP. Average venture capital funding for technology-based companies in the United States rose 87 percent in 1999. Venture capital investments in the United States in the first half of 2000 have already outstripped those for all of 1999. Western Europe also saw a significant increase of 65 percent in PEVC investments in 1999, but this still represents only 1/3 of 1 percent of European GDP. The UK received 45 percent of all investments, far ahead of Germany and France, with 13 and 11 percent, respectively. Technology investments in Western Europe grew 84 percent in 1999 and accounted for one-third of total PEVC investment.

EYES ONLY

RELEASES THIS WEEK

Advance Durable Orders

****Embargoed until 10:00 a.m., Friday, October 27, 2000****

Advance estimates show that new orders for durable goods increased 1.8 percent in September, following an increase of 3.5 percent in August.

Gross Domestic Product

****Embargoed until 8:30 a.m., Friday, October 27, 2000****

According to advance estimates, real gross domestic product grew at an annual rate of 2.7 percent in the third quarter of 2000.

Employment Cost Index

The employment cost index for private industry workers increased 4.6 percent for the 12-month period ending in September.

MAJOR RELEASES NEXT WEEK

Consumer Confidence—The Conference Board (Tuesday)
NAPM Report on Business (Wednesday)
Productivity (Thursday)
Leading Indicators (Thursday)
Employment (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	1999	2000:1	2000:2	2000:3
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	5.0	4.8	5.6	**2.7**
GDP chain-type price index	5.2	1.6	3.3	2.4	**2.0**
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	4.1	1.9	5.7	N.A.
Real compensation per hour:					
Using CPI	1.0	2.2	0.0	1.7	N.A.
Using NFB deflator	1.5	3.3	1.1	2.9	N.A.
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.9	13.4	13.7	**13.8**
Residential investment	4.5	4.3	4.3	4.2	**4.1**
Exports	8.2	10.6	10.8	11.0	**11.3**
Imports	9.2	13.4	14.2	14.6	**15.0**
Personal saving	6.6	1.6	0.1	0.2	**-0.2**
Federal surplus	-2.8	1.3	2.4	2.4	N.A.

	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	0.5
PPI-Finished goods	5.0	2.9	0.0	-0.2	0.9

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

New or revised data in **boldface.**
GDP and related data **embargoed until 8:30 a.m., Friday, October 27, 2000**.

EYES ONLY

FINANCIAL STATISTICS

	1998	1999	August 2000	September 2000	Oct. 26, 2000
Dow-Jones Industrial Average	8626	10465	11015	10968	10380
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	6.09	6.00	6.18
10-year T-bond	5.26	5.65	5.83	5.80	5.69
Mortgage rate, 30-year fixed	6.94	7.43	8.03	7.91	7.68
Prime rate	8.35	8.00	9.50	9.50	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level October 26, 2000**	**Percent Change from**	
		Week ago	**Year ago**
Euro (in U.S. dollars)	0.827	-1.6	-21.8
Yen (per U.S. dollar)	108.4	-0.2	3.4
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	103.7	0.8	12.7

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	**5.3** (Q3)	3.9 (Sep)	3.5 (Sep)
Canada	5.3 (Q2)	7.1 (Aug)	3.2 (Sep)
Japan	0.8 (Q2)	4.6 (Aug)	-0.7 (Aug)
France	3.4 (Q2)	9.7 (Aug)	2.2 (Sep)
Germany	3.6 (Q2)	8.3 (Aug)	2.5 (Sep)
Italy	2.6 (Q2)	10.6 (Jul)	2.6 (Sep)
United Kingdom	2.9 (Q3)	5.4 (Jun)	3.3 (Sep)

U.S. GDP data **embargoed until 8:30 a.m., Friday, October 27, 2000.**

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

(WEBS)

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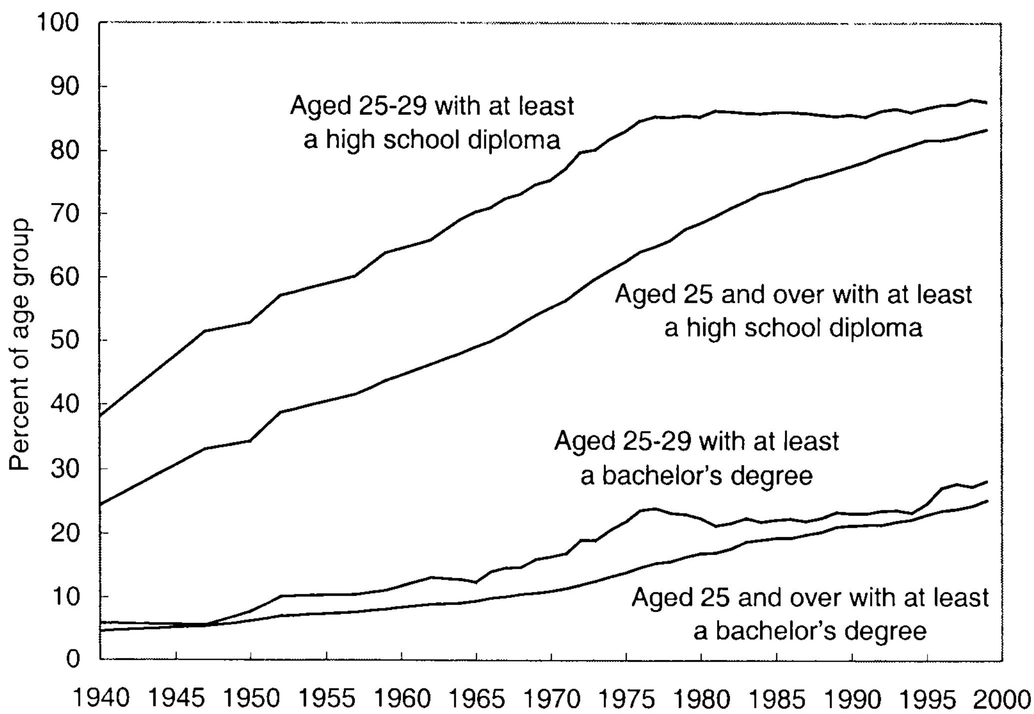
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 22, 2000

CHART OF THE WEEK

Educational Attainment of Adults



The share of Americans aged 25-29 with at least a high school diploma has exceeded 85 percent since 1977. As a result, the share of the population aged 25 and older with at least a high school diploma has increased steadily, reaching 83.4 percent in 1999. The share of young adults with a bachelor's degree or more exceeded its 1977 level in 1995 and reached an all-time high of 28.2 percent in 1999.

EYES ONLY

CONTENTS

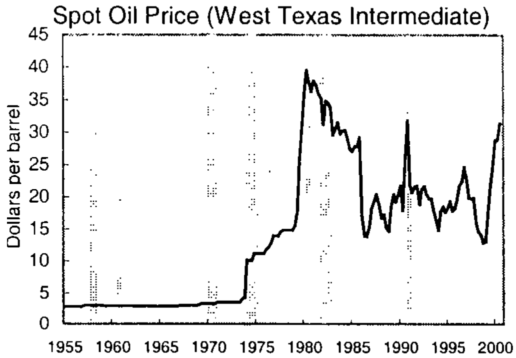
"Anyway, who needs oil? We've got the internet."

EYES ONLY

CURRENT DEVELOPMENT

Oil Prices and the Macroeconomy

Three of the past four recessions have been preceded by a sharp rise in oil prices (see chart), raising legitimate concerns about the possible impact of the latest surge in oil prices. While the economy today is less vulnerable to an oil price shock than it was in the past, a sharp enough rise in oil prices could be disruptive.



Swings in oil prices. At about $31 per barrel, crude oil prices in August were roughly $10 higher than they were a year earlier. Prices this month have surged to $37 per barrel. Oil prices had fallen sharply during the Asian economic crisis in 1998. But over the past 2 years, prices have risen as world economic growth (at 3.6 percent per year) has outpaced growth in world oil production capacity (at 0.9 percent per year). Current high prices should encourage growth in capacity, and futures markets expect prices to fall about $4 by January. Still, uncertainty about how much surplus production capacity can come online and about Iraqi intentions suggest the possibility of further price increases in the near future.

Energy prices and inflation. A $10 per barrel increase in oil prices like the one we experienced through August directly boosts the CPI by 0.6 percentage point. Natural gas prices would also be pushed up as a result of utilities and industry substituting away from oil. The price *level* could be pushed up a bit more in the longer run when higher energy costs feed through to other goods. But if oil prices stabilize, the post-shock *inflation rate* should recede toward earlier levels.

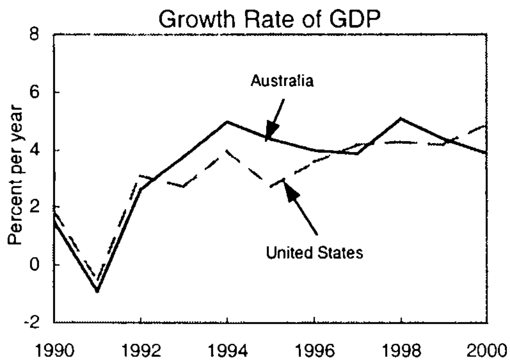
Macroeconomic effects. A $10 per barrel increase in oil prices costs domestic oil consumers about $71 billion annually. Roughly $35 billion of this is a transfer to domestic oil producers, but the remaining $36 billion is transferred to foreign oil producers. Transfers to foreigners represent a drain on purchasing power that reduces aggregate demand. Monetary policy would face a hard choice between supporting aggregate demand and fighting inflation.

Conclusion. This analysis suggests that recent high oil prices will have a moderating effect on U.S. economic growth. However, the economy today is remarkably strong, with high employment, low inflation, and strong productivity growth. In addition, oil is less important to the economy than it once was: the United States consumes only 52 percent as much oil per dollar of real GDP as it did in 1973. Nevertheless, the calculations above suggest that a sustained increase in oil prices to over $40 per barrel, if it should happen, would further increase the danger of some combination of weaker growth and higher inflation.

SPECIAL ANALYSIS

Australia's Olympian Economy

As the eyes of the world turn to Sydney for the Olympic Games, it appears that the United States and Australia share more than athletic prowess in swimming. Like the United States, Australia is experiencing a remarkable and long-lasting economic boom, with growth averaging 4 percent per year over the past 7 years (see chart). Growth continues to be robust this year. This rapid growth stands in stark contrast to the plodding 2.8 percent per year experienced during the 1980s.



Some similarities. Durability is not the only attribute that the Australian expansion shares with ours. Like us, Australia has experienced a drop in its unemployment rate, a shrinking government debt-to-GDP ratio, and low inflation. Moreover, productivity growth has remained high even as the expansion has matured. Australia also has a declining household saving rate and a large current account deficit (nearly 6 percent of GDP).

But some differences. Despite these similarities, Australia has some way to go before attaining the American standard of living: per capita income in 1999 was only 74 percent that of the United States. Some features of Australia's expansion are also different from ours. Perhaps most notably, Australia's surge in productivity and economic growth is not concentrated in the production of information technology equipment, which only accounted for 0.7 percent of GDP in 1997 (compared with 3.1 percent in the United States). Taken together, however, value added in IT and communication equipment production, software, and communications services was not too far away from U.S. levels (3.3 percent of GDP in Australia compared with 4.4 percent in the United States). In other words, Australia does not produce much IT equipment, but it does appear to be a fairly intensive user of the technology.

Policy foundations. Macroeconomic and structural policy changes have been important sources of renewed productivity growth in Australia. The Labour Party undertook extensive reform of the economy during the 1980s, when the financial sector was deregulated and tariff rates were reduced. In the 1990s, state-owned enterprises were privatized, extensive labor market reforms were enacted, and tariffs were reduced further. Over the 1990-97 period, the value of proceeds from privatizations was second only to that of the UK among OECD countries. For instance, the major telecommunications company Telstra is now partially privatized, and Australia is home to a number of vigorously competing mobile telephone companies. The average tariff rate on imports was 4 percent in 1998, down from over 12 percent in the mid-1970s. Floating the Australian dollar proved to be a key macroeconomic policy change, particularly during the East Asian financial crisis. With a floating exchange rate and a sound banking sector, the Australian economy was scarcely affected. even though 57 percent of exports went to East Asia in the quarter before the collapse of the Thai baht.

Prospects. It remains to be seen whether the Australian experience over the past decade signals the beginning of a new era of accelerated growth, or merely a transitional phenomenon associated with the efficiency gains arising from previous policy reforms. However, recent studies conclude that trend productivity growth has risen relative to its lows during the 1980s, suggesting that the recent gains could prove to be enduring.

EYES ONLY

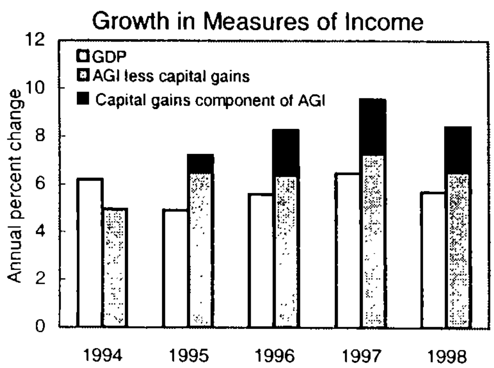
ARTICLE

The Sustainability of the Revenue Boom

Recurring revenue "surprises" have been an important feature of the fiscal landscape in recent years. Personal income tax receipts, in particular, have surged from less than 8 percent of GDP in 1994 to nearly 10 percent most recently, with the "excess" growth contributing an additional $141 billion to deficit reduction over the 1994-98 period, according to Congressional Budget Office calculations.

The faster growth in revenue relative to GDP reflects two main factors: faster growth in taxable income than in income generally; and an increase in effective tax rates (the percentage of income paid in taxes). Uncertainty about how much of this increase is sustainable introduces uncertainty into future surplus estimates.

Strong growth in taxable personal income. CBO estimates that 60 percent of the excess growth in individual income tax receipts arose from rapid growth in adjusted gross income (AGI) relative to GDP. About 17 percentage points of this excess growth occurred because personal income grew faster than the other income components of GDP. The rest reflects strong growth in sources of AGI that are not included in GDP (because they are not earned as a result of current production), such as capital gains realizations and retirement benefits—with capital gains being particularly important (see chart).



A rise in the effective tax rate. Statutory individual income tax rates have not increased since 1993, and some fell as a result of the 1997 Taxpayer Relief Act. Nevertheless, the overall effective tax rate on non-capital gains AGI has increased, accounting for the remaining 40 percent of excess growth in individual income tax receipts. Two factors account for most of this increase in effective tax rates, in roughly equal measure:

- Real bracket creep. For taxpayers in general, income has grown faster than the inflation-indexed adjustments to tax brackets. Because of this, more aggregate taxable income is now taxed at the higher rates.

- More taxable income at the top. Especially strong growth at the top of the income distribution also increased the proportion of aggregate income subject to the top tax rates. Tax return data indicate that the share of taxpayers with AGI above $200,000 (in 1998 dollars) rose over the 1994-98 period, and those taxpayers experienced higher-than-average growth in income. Incomes grew even more for taxpayers with more than $1 million in AGI. As a result, the share of taxes paid by these highest-income groups rose; of course, their after-tax incomes rose substantially as well.

Will excess revenue growth continue? CBO expects that growth in overall real income will continue and that taxable retirement income will pick up in the future, but it anticipates that capital gains relative to GDP will level off. However, revenue estimation remains an inexact science. In January, the CBO forecast that the net effect of these factors would be a slowing in individual tax receipts relative to GDP over the next 5 years, followed by a pick-up that would bring individual income taxes as a share of GDP back to about 10 percent by 2010. By the July update, however, another surprise had raised the 2000 forecast to 10.2 percent, which was projected to remain roughly level before rising slightly in 2009. Thus, the CBO forecast now assumes that the rise in individual income tax revenues as a share of GDP to its current, historically high level was not due to unusual factors that will soon be reversed. But it is fairly conservative in assuming that these revenues cannot grow faster than GDP indefinitely.

Conclusion. Of course, the tremendous uncertainty surrounding economic forecasts and predictions about real GDP, stock market values, and other variables affecting taxable income feeds directly into uncertainty about these revenue forecasts. Since 1986, CBO revenue forecasts for the upcoming budget year have been off by absolute amounts averaging 4 percent of revenues (and 0.8 percent of GDP), with overestimates occurring in the 1986-92 period, and underestimates since then. Moreover, forecast errors grow larger as the forecast horizon lengthens. Nevertheless, the apparent connection of economic growth with higher tax revenues, and hence with higher national saving and lower interest rates, suggests another channel through which a strong economy can be self-sustaining.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Shows Moderating Economy. Economic activity expanded at a moderate pace in August and early September, according to the latest reports from the Federal Reserve districts. Most districts characterized economic conditions as strong, and several said that economic growth continued to be solid. However, reports from Atlanta, Chicago, St. Louis, and Minneapolis indicated a softened overall pace of growth. Consumer spending was flat to modestly higher in most districts in August compared with late spring and early summer. Home sales and construction continued to soften, but several districts reported that commercial real estate activity was robust. In agriculture, crop prices remained low, and yield prospects dimmed in areas of the Southeast and Midwest experiencing prolonged drought conditions. Labor markets remained tight in most districts. Nevertheless, there were few indications that higher wages were being passed to consumers as higher productivity and competitive pressures held prices in check.

Educational Attainment Gaps Remain among Young Adults. As has been the case for about a decade, women aged 25-29 are more likely than men in that age group to hold high school diplomas and bachelor's degrees, according to new Census tabulations of 1999 data. The 1999 data are also broadly consistent with past evidence on racial and ethnic differences: the share of blacks aged 25-29 with high school diplomas (89 percent) is just a little below that of whites (93 percent), but the share of Hispanics is a much lower 62 percent. While 51 percent of Asians and 34 percent of whites aged 25-29 have bachelor's degrees, the shares are just 15 percent for blacks and 9 percent for Hispanics. Particularly low educational attainment among the foreign-born Hispanic population pulls down that group's overall attainment. Among all Hispanics aged 25 and over, 44 percent of the foreign-born hold high school degrees, compared with 71 percent of the native-born. The native-born are also more likely than the foreign-born to hold college degrees. This pattern contrasts with that of non-Hispanics aged 25 and over, among whom the foreign-born are more likely than the native-born to hold bachelor's degrees.

Effects of Public School Choice in Chicago. Allowing Chicago high school students to attend a public school other than the one in their neighborhood has not achieved its objective of greater racial integration, according to a recent study. But it has increased the amount of segregation by ability. It also appears to have boosted graduation rates. Overall, the study found that high-ability students were most likely to leave their neighborhood schools. White students were more likely to travel to attend high-achieving schools, while black students were more likely to travel to attend career academies. Controlling for pre-high-school test scores, the study found that students who traveled were more likely to graduate. School characteristics explained the higher graduation rates of those attending career academies, while unobservable characteristics of the students themselves seemed to be most important for those traveling to high-achieving academic high schools. The authors found no evidence that school choice lowered the probability of graduation for the students who remained in their neighborhood schools.

EYES ONLY

INTERNATIONAL ROUNDUP

IMF Projects Strong World Growth. World GDP is projected to grow 4.7 percent in 2000 and 4.2 percent in 2001, according to the latest IMF *World Economic Outlook*. U.S. growth is projected to slow from 5.2 percent in 2000 to 3.2 percent in 2001. The Euro area recovery should continue, with growth of 3.5 and 3.4 percent in 2000 and 2001 respectively, up from 2.4 percent in 1999. Differences in growth rates within the Euro area are projected to narrow. The IMF is somewhat optimistic for Japan, claiming that a modest recovery is gathering momentum and should produce growth rates of 1.4 and 1.8 percent in 2000 and 2001 respectively. Latin America and East Asia are continuing to recover from the 1997-98 crises, with projected growth rates of more than 4 percent in 2000 and 2001 for Latin America and over 6 percent for East Asia. Growth in Africa is expected to rise to 4.5 percent in 2001, spurred by the recovery in South Africa and the oil-exporting countries. However, the poorest countries in Africa have been hit hard by both higher oil prices and declining prices for their commodity exports.

Red Tape for Start-ups Is Severe in Many Countries. A recent study of 75 countries finds substantial variation in the number of procedures that must be followed and the time and costs involved before a new business can open its doors. The number of required procedures varies from a low of 2 in Canada to a high of 20 in Bolivia, with a worldwide average of about 10. The minimum time required to complete these procedures ranges from 2 to 174 business days, with a worldwide average of 63 days. The payments required for a single firm to complete these procedures can surpass 2.6 times per capita GDP. The United States requires 4 procedures that take an average of 7 days to complete at a cost of a little under 1 percent of per capita GDP. The study found that countries with heavier regulation frequently exhibit greater corruption and a larger unofficial economy. Even after controlling for the costs associated with corruption and bureaucratic delay, the study found that starting a business is expensive, especially in poor countries. Moreover, stricter regulation of business start-ups was not found to be associated with higher quality products, less pollution, or more favorable health and safety outcomes.

Who Is the Most Corrupt of Them All? Nigeria is perceived to be the most corrupt economy in the world and Finland the least corrupt, according to Transparency International's latest corruption perceptions index. The index, which ranks countries from least to most corrupt, is calculated using 16 separate surveys from eight independent institutions and gauges the level of corruption perceived by business people, country analysts, and the general public. The United States was ranked 14th least corrupt, trailing several European countries, Singapore, Australia, New Zealand, and Canada. Nigeria received its poor ranking despite recent anti-corruption efforts, but survey respondents were optimistic about future efforts. By contrast Zimbabwe, Ukraine, and the Philippines registered considerable drops from last year. Recent political scandals in Ireland and Germany were also associated with a decline in their rankings.

EYES ONLY

RELEASES THIS WEEK

U.S. International Trade in Goods and Services

The goods and services trade deficit was $31.9 billion in July; the deficit was $29.8 billion in June.

Housing Starts

Housing starts were unchanged in August at 1.53 million units at an annual rate.

MAJOR RELEASES NEXT WEEK

Consumer Confidence—The Conference Board (Tuesday)
Median Income and Poverty Reports (Tuesday)
Advance Durable Shipments and Orders (Wednesday)
Gross Domestic Product (Thursday)

EYES ONLY

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	5.3
GDP chain-type price index	5.2	1.6	1.6	3.3	2.6
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	June 2000	July 2000	August 2000
Unemployment Rate (percent)	6.7**	4.2**	4.0	4.0	4.1
Payroll employment (thousands)					
increase per month			57	-51	-105
increase since Jan. 1993					21989
Inflation (percent per period)					
CPI	5.8	2.7	0.6	0.2	-0.1
PPI-Finished goods	5.0	2.9	0.6	0.0	-0.2

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

EYES ONLY

FINANCIAL STATISTICS

	1998	1999	July 2000	August 2000	Sept. 21, 2000
Dow-Jones Industrial Average	8626	10465	10663	11015	10766
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.96	6.09	5.98
10-year T-bond	5.26	5.65	6.05	5.83	5.88
Mortgage rate, 30-year fixed	6.94	7.43	8.15	8.03	7.90
Prime rate	8.35	8.00	9.50	9.50	9.50

INTERNATIONAL STATISTICS

Exchange Rates	Current level September 21, 2000	Percent Change from Week ago	Percent Change from Year ago
Euro (in U.S. dollars)	0.856	-0.7	-18.2
Yen (per U.S. dollar)	106.5	-0.7	1.6
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	101.3	-0.0	9.5

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	6.0 (Q2)	4.1 (Aug)	3.4 (Aug)
Canada	5.3 (Q2)	6.8 (Jul)	2.5 (Aug)
Japan	0.8 (Q2)	4.7 (Jul)	-0.5 (Jul)
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	3.1 (Q2)	5.5 (May)	3.0 (Aug)

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.

WBBS

EYES ONLY

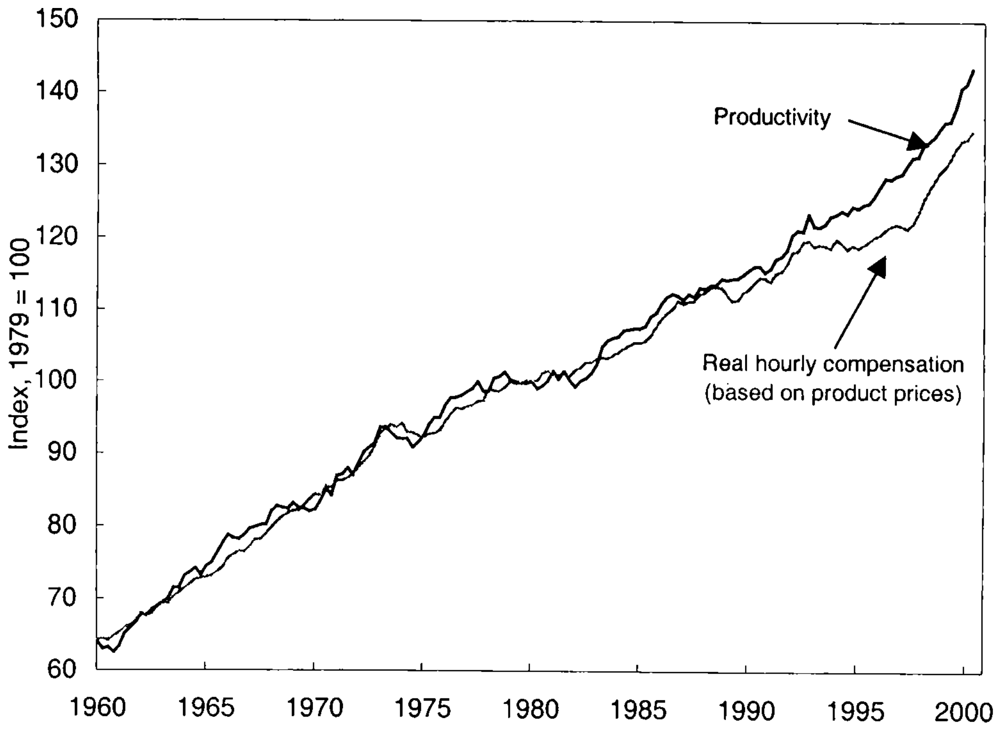
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 8, 2000

CHART OF THE WEEK

Nonfarm Productivity and Real Hourly Compensation



In the long run, real hourly compensation paid by employers (compensation deflated by product prices) tends to track productivity. However, real hourly compensation grew more slowly than productivity for a while in the 1990s, and the resulting gap has not closed despite recent sharp increases in hourly compensation. Unless the resulting widening of the markup of prices over unit labor costs (and concomitant decline in labor's share of national income) is permanent, ongoing productivity gains imply further large gains in compensation.

EYES ONLY

CONTENTS

EYES ONLY

SPECIAL ANALYSIS

Multi-Gas Approaches to Climate Change Mitigation

A recent study by an eminent climate change scientist suggests that global warming observed thus far has been due mostly to emissions of non-CO_2 greenhouse gases. The study does not imply that concern about CO_2 emissions may be misplaced—as some press coverage has suggested that it does. Nonetheless, along with recent economic analysis, it does bring attention to the view that climate change mitigation efforts should consider all six types of greenhouse gases targeted by the Kyoto Protocol.

The emerging impact of CO_2. So far, the effects of CO_2 on the climate have been counteracted by another product of fossil fuel combustion: aerosols such as SO_2. While CO_2 has a warming effect on the climate, aerosol concentrations in the atmosphere have a cooling effect. As a result, the observed climate change may mainly reflect the additional warming effect of the non-CO_2 greenhouse gases: methane, nitrous oxide, SF_6, HFCs, and PFCs. Over time, however, the counteracting effect of aerosols is likely to decline. First, aerosols have a much shorter residence time in the atmosphere than CO_2, hence existing concentrations of aerosols will diminish faster than those of CO_2. Second, many countries are actively reducing aerosol emissions because of their adverse health effects. Thus, the ratio of aerosol emissions to CO_2 emissions will decline in the future, and the observed impact of CO_2 will grow relative to that of other greenhouse gases.

Cost-effective reduction strategies. While the relative importance of non-CO_2 gases will subside over time, the new scientific study complements recent economic analysis emphasizing the importance of considering abatement opportunities for all six greenhouse gases. Most economic analyses have only focused on CO_2 abatement. This is partly because CO_2 accounts for the vast majority of the U.S. greenhouse gas emissions (85 percent in 1995, weighted by warming potential). Furthermore, emissions patterns and abatement opportunities for the other five greenhouse gases are not so well understood. Nevertheless, new evidence indicates that incorporating reductions of other greenhouse gases into a climate change mitigation strategy would be cost-effective. A recent economic analysis, which does not take the possibility of international permit trading into account, finds that a strategy involving all six greenhouse gases could reduce U.S. compliance costs by roughly 50 percent relative to the cost of abatement strategies that only target CO_2. Reductions of non-CO_2 emissions would make up roughly a quarter of overall reductions.

The effects of trading. When international permit trading is allowed, the inclusion of all six gases in abatement strategies would lead to additional savings, compared with focusing just on carbon. However, the magnitude of those savings is unknown. If an international market for carbon permits existed, the United States would pursue all emissions reduction options that cost less per ton of carbon equivalent than the price of a permit and then buy permits for the remaining emissions that exceed its target. Cost savings from considering all six gases could be realized in two ways. First, to the extent that some non-CO_2 gases can be abated at less than the permit price, the United States will need to buy fewer permits. Second, incorporation of all six gases into abatement strategies worldwide could lower the price of the permits we do buy.

Conclusion. Recent scientific and economic evidence has focused attention on the contribution of non-CO_2 greenhouse gases to climate change. But even though a multi-gas strategy may yield significant cost savings, efforts to mitigate CO_2 emissions remain paramount. After all, reductions in CO_2 emissions would most likely still account for a large fraction of overall emissions reductions in a multi-gas strategy.

EYES ONLY

SPECIAL ANALYSIS

Gifts to Children and Estate Tax Avoidance

The majority of parents name their children as beneficiaries in their wills, and for very wealthy parents the amount bequeathed can be reduced substantially by the estate tax. One of the simplest ways to reduce this tax burden is to take advantage of a provision in the tax code that allows certain tax-free transfers while the parents are still alive. Recent studies suggest, however, that this provision is significantly underutilized. Apparently, many wealthy parents are willing to forego substantial tax savings in order to hold on to their wealth until they die.

Tax-saving incentives. Yearly gifts of up to $10,000 per recipient per year to relatives or non-relatives can be made without affecting the lifetime gift and estate tax exemption of $675,000 (scheduled to rise to $1 million in 2006). Aggregated over a number of years such transfers can be substantial. For instance, a married couple with two married children and four grandchildren could each transfer $80,000 per year to these heirs (including their children's spouses) for a total of $160,000. If the combined life expectancy for the couple is 30 person-years (typical for a couple in their late 60s), the potential reduction in their taxable estate is $2.4 million. At a top marginal tax rate of 55 percent, such strategic giving would save $1.32 million in taxes and thus increase transfers to heirs by that amount.

Taxpayer responses. At first glance, the wealthy do seem to respond to these incentives to make "early bequests." One recent study showed, for example, that while 30 percent of parents with wealth below the estate tax limits made a cash transfer to a child in the past year, nearly 60 percent of parents with greater wealth did so. Other work indicates that the magnitude of the transfer increases with the expected tax rate, suggesting that individuals are responding to the cost of leaving a bequest.

However, despite the increased probability of making transfers to children, the vast majority of wealthy parents fail to take full advantage of this tax-savings device. First, as the results above imply, 40 percent of wealthy parents did not make any transfers to their children. Other research has found an even larger fraction of non-givers. Second, only 7 percent of wealthy parents transferred $10,000 to each of their children, and even fewer, just 3 percent, took full advantage of the exclusion and transferred an amount greater than or equal to $10,000 for each child, spouse of a child, and grandchild. Finally, even among those who made some transfer, the fraction transferring an amount at least equal to the tax-exempt limit was only 5 percent.

Why do people voluntarily pay taxes? Assuming that wealthy individuals intend eventually to transfer assets to their heirs, why do they, in effect, voluntarily pay additional taxes by waiting until they die for the transfer to take place? Since nearly one-half of the wealthy parents who are giving less than

$10,000 per child reported that they had used a financial planner, lack of information is unlikely to be an explanation for the shortfall in giving. One reason might be that the elderly enjoy holding wealth for the respect or power it confers; giving up wealth before their deaths could result in a reduction in the position they hold in their family or society. Another explanation might be that some elderly are concerned about giving away "too much," and having insufficient wealth should they live much longer than expected or incur substantial medical bills or other expenses. This second explanation is unlikely to hold for those with extremely large estates, but it could certainly justify the behavior of those with wealth near the taxable limits.

Conclusion. Both early bequests and estate taxes reduce the control the elderly have over the distribution of their assets; in one case the timing of the transfer is affected, in the other, the amount. Perhaps surprisingly, wealthy individuals are willing to forego substantial tax savings in lieu of *inter vivos* giving. One set of projections indicates that the amount of wealth subject to tax could be reduced by 23 percent if the opportunities for tax-free giving to children were fully exploited. Similar estimates show that by maximizing early bequests to children, spouses of children, and grandchildren, the number of estates owing taxes could be reduced by nearly 80 percent and the total amount owed by 65 percent relative to the situation with current giving patterns. Nevertheless, these opportunities go unexploited, suggesting either that the estate tax is less of a concern to many people than current rhetoric would suggest or that wealthy individuals have other reasons for holding on to their wealth that are more important than avoiding taxes.

EYES ONLY

ARTICLE

Third-Generation Wireless Technology

A new wireless technology, "third generation" or 3G, offers exciting possibilities for U.S. consumers and businesses. However, the United States is currently a year or two behind many other countries in the allocation of spectrum to this technology, and delay is costly.

Advantages of 3G. The new technology combines two of the fastest growing technologies of the 1990s, digital wireless telephones and the Internet. Today's digital wireless phones can access the Internet, but at speeds so slow that special software—or complete redesigns of existing websites—are required to make the content accessible. Third-generation devices, by contrast, transmit data at much higher speeds, essentially creating "broadband" connections to the Internet or other communications networks. At these speeds, 3G technology lets consumers access the full power of the Internet through wireless devices such as phones, handheld computers, devices embedded in automobiles, and other as-yet-undeveloped applications.

Quantifying the benefits of new technologies. Like many new technologies, 3G may well bring substantial benefits to its producers and consumers, as well as spillover benefits to sellers and buyers of related goods and services. First, firms producing and distributing 3G devices and applications will likely earn significant profits. The exact size of these profits is uncertain. However, the recently completed auctions for 3G spectrum in Germany and the UK provide a measure of the order of magnitude of possible producer benefits. These auctions raised $46 and $35 billion, respectively, representing total payments in excess of $500 per inhabitant in these two countries. If U.S. firms were to bid as much per capita, a U.S. auction could raise as much as $135 billion.

Consumers of 3G technologies can also reap substantial gains. Economists often measure consumer benefits in terms of "consumer surplus," the difference between the prices consumers actually pay and the maximum amounts they would be willing to pay for particular goods or services. Again, the gains from 3G are unknown, but one prominent economist estimated that the consumer surplus created by the introduction of analog or "first-generation" (1G) cellular service was in the range of $31 billion to $50 billion *per year* in constant 1994 dollars.

Costs of delay. Each year of delay in introducing 3G will deprive consumers of whatever surplus that technology will generate. Other costs of delay may be equally important but even harder to quantify. History suggests that first-mover advantages are important in developing services and applications that use new technologies. Knowledge spillovers among firms and between firms and academic institutions are particularly important in high-technology industries. One recent study used patent citations to show that these spillovers tend to be geographically localized, even after controlling for pre-existing research activity.

In the technology sector much of the relevant knowledge is "tacit" rather than explicit, making close social ties (such as those between entrepreneurs and venture capitalists) all the more important. Consequently, location is often important in the early stages of these industries. Silicon Valley is an obvious example. Moreover, a vibrant cluster of startups devoted to developing commercial applications for 3G and existing digital wireless technologies has emerged in Finland—which allocated its 3G spectrum in March 1999. (The box provides further examples of wireless Internet applications developed outside the United States.) Because location is so important, delays in creating a domestic market for 3G applications can be very costly.

Use of the spectrum by the DoD and other incumbents. Domestic 3G spectrum auctions will not take place until fall 2002 at the earliest. One reason the U.S. lags behind other economies is that portions of the relevant spectrum are currently in use, most notably by the Department of Defense. Other agencies such as the FAA and private firms also use smaller parts of this spectrum. To the extent that it is expensive for the DoD or others to convert equipment to use other communication bands, their concerns would have to be addressed before 3G spectrum auctions could be accelerated.

Conclusion. 3G applications promise substantial benefits, but in the United States, parts of the spectrum suitable for 3G applications are already in use. In judging the costs of delaying 3G development it is important to take into account not only the expected revenues from auctioning spectrum licenses, but also the expected consumer benefits from using the technology.

Innovation in Mobile Services

The following are drawn from recent press accounts:

i-mode. DoCoMo, a subsidiary of Nippon Telephone and Telegraph (NTT) has launched a service known as i-mode in Japan. This service recently surpassed 10 million subscribers. Subscribers receive an i-mode phone with which they can send and receive e-mail as well as access Web sites that have been tweaked to fit on tiny screens. With a thumb-controlled joystick, subscribers can tap into online news, browse through restaurant guides, buy tickets on Japan Airlines, and trade stocks via DLJdirect.

Phones operating as electronic wallets. Using WAP (wireless application protocol), several firms have turned phones into electronic wallets, allowing customers to pay for goods and services via their mobile phone bill rather than via credit cards or cash. Finnish consumers can make vending machine purchases via their mobile phones. A Finnish bank is launching a service that will allow users to pay rent, phone, or electricity bills via their mobile phones. An Estonian firm allows users to pay for parking spaces via their mobile phones.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Flexible Schedules Are Growing More Popular. More than 25 million workers (27.6 percent of all full-time workers) reported keeping flexible hours in 1997, almost double the proportion working flexible schedules in 1991, according to a recent study. White workers were more likely than black or Hispanic workers to have flexible work arrangements, a variation only partially explained by occupational differences. Men and women were about equally likely to have flexible work arrangements. However, men were increasingly likely to have such arrangements the older they were, while women were less likely. The study also looked at work outside traditional business hours, such as evening or night shifts. In 1997 more than 15 million workers (16.8 percent) had such arrangements, which was about the same proportion as in 1985 and 1991. Most said that they did so because of the nature of their work; protective service providers, for example, were the most likely to work alternative shifts. Men were more likely than women, and black workers were more likely than either white or Hispanic workers to work nontraditional hours. For all these groups, the likelihood of maintaining such a work schedule generally declined with age.

Race and Wealth. A new study of wealth holding in 1998 continues to find a sharp racial divide, with the average net worth of blacks only 18 percent that of whites and median black net worth only 12 percent that of whites. These percentages are even lower for financial net worth (which excludes assets like houses and cars). More than a quarter of black households had zero or negative net worth, double the comparable percentage of whites. Growth in the median net worth of blacks between 1983 and 1998 was encouraging, but average net worth fell slightly. Turning to Hispanics, the study found that average net worth in 1998 was higher than that of blacks (but still only 25 percent that of whites), while median net worth was smaller than that of blacks (zero for nonfinancial net worth). This difference suggests sharp disparities in the distribution of net worth among Hispanic households. Indeed, 36 percent of Hispanic households reported zero or negative net worth, and the median net worth of Hispanics stagnated between 1983 and 1998 even though average net worth grew.

In Hollywood, R is for Risk. At least one critic of Hollywood's fascination with trashy movies has suggested that they also are a poor investment. And a recent economic study supports this view. The study finds that a studio executive who wanted to trim the "downside" risk and increase the "upside" possibilities in the studio's film portfolio could do so by shifting production dollars out of R-rated movies and into G, PG, and even PG-13 movies. The study reports that more than half of all movies released in the past decade are R-rated and only 3 percent are G-rated; about a fifth are rated PG and a quarter PG-13. While the number of R-rated movies that are box-office successes is high, this reflects the large number that are made rather than their superior probability of success. In fact, according to the study, only about 6 percent of R-rated movies are financially successful, while the success rate for all other types is twice that high.

INTERNATIONAL ROUNDUP

Countries Still Face Barriers to E-Readiness. Apart from the major developed economies, many countries still face barriers to participating fully in the digital economy, according to a new study. The study assesses 42 countries based on five characteristics: network infrastructure, e-leadership (government and industry commitment to developing the networked world), protection of intellectual property and information security, human capital, and e-business climate. While Latin America has shown improvements in promoting its digital economy and has strong human capital, weak infrastructure and lack of investment incentives are concerns. Similarly, Asia's inadequate information security remains the region's greatest drawback. Also, eight of the ten Asian economies examined received the lowest possible infrastructure rating. Central and Southern Europe is the most e-ready region considered, ranking high in information security but with its strength lying primarily in its human capital. Overall, however, 25 countries, representing 3.6 billion people, still require substantial infrastructure improvements.

Internet Use Increases Trade. A recent study provides formal evidence that the spread of the Internet has led to increased international trade. Poor countries appear to gain more from expanded Internet access than rich countries: doubling the number of Internet hosts in a country raises exports by around 10 percent for a developing economy, somewhat more than the approximate 8 percent gain of an industrial nation, suggesting that access to the Internet can compensate for infrastructure shortcomings that may hinder trade. In other words, bridging the international digital divide between rich and poor countries has measurable economic benefits. The Internet was found to have had no effect on international trade in 1995 or 1996, but increasing effects in each subsequent year. The results cover only trade in goods and do not include items such as financial services, music, computer software, or education, all potentially important components of e-commerce. If anything, then, the effect of the Internet on international trade is likely to be larger than what is suggested by these initial results.

Study Assesses Causes of Low Earnings in the EU. About 15 percent of paid employees in the EU had low monthly earnings (60 percent of their country's median monthly earnings), according to a recent study using 1996 household data. About 37 percent of these employees worked full time (at least 30 hours a week) but earned low wages. Another 43 percent had wages such that that they would not have experienced low earnings if they had worked at least 30 hours a week, but they worked less (some by choice and some because they could not find full-time work). The rest had hourly pay near or below the low-wage threshold and did not work full time. The study also found substantial cross-country differences in the proportions of workers with low earnings and the reasons for those low earnings. The UK, for example, had the highest overall proportion of employees with low earnings (21 percent) but more than half were part-time workers. Belgium and the Netherlands also had high proportions of part-time workers. By contrast, low pay tended to be much more important in "southern" countries.

EYES ONLY

EYES ONLY

WEBS

EYES ONLY

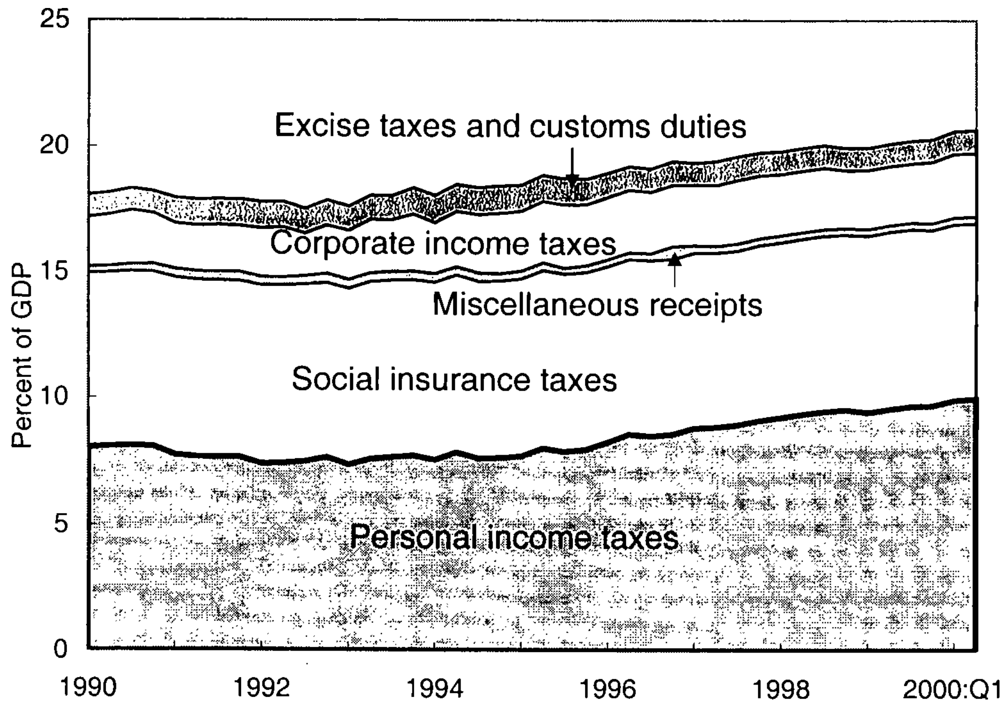
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 15, 2000

CHART OF THE WEEK

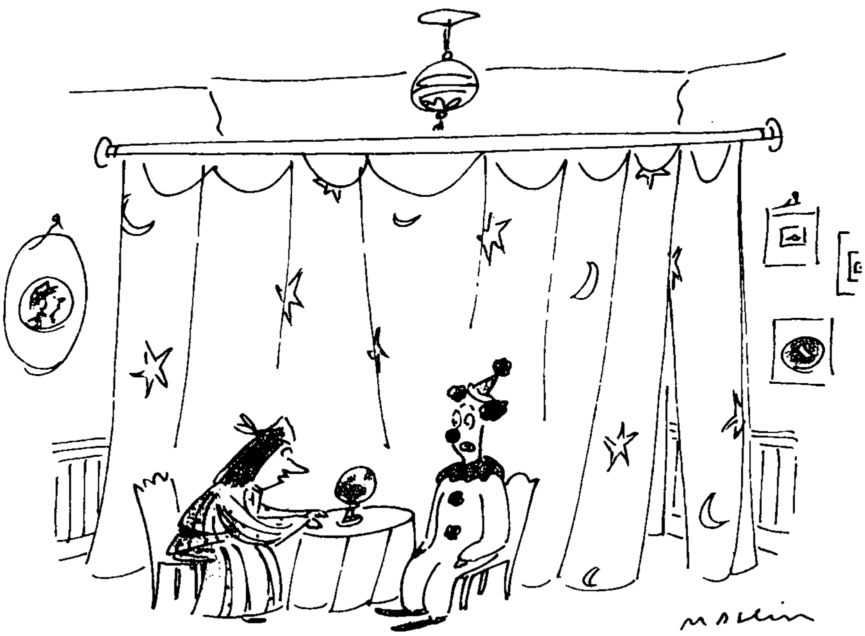
Federal Revenues as Share of GDP



Federal revenues as a share of GDP have reached 20.6 percent this year, a postwar high. The growth in total revenues has been especially pronounced since the mid-1990s, due to the surge in personal income tax receipts, which rose from about 8 percent of GDP in 1995 to nearly 10 percent most recently. The strong growth in the personal tax component is due largely to increases in capital gains realizations, real incomes overall, and the incomes of the highest-income households in particular.

EYES ONLY

CONTENTS



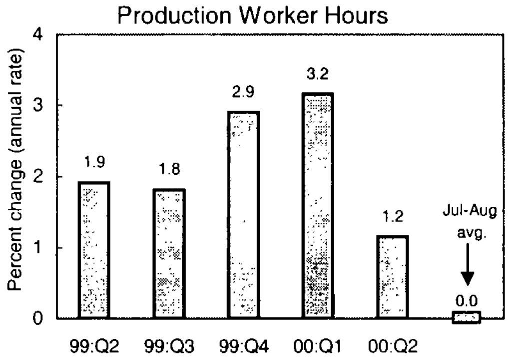
"You will run away from the circus and join a dot-com."

EYES ONLY

MACROECONOMIC UPDATE

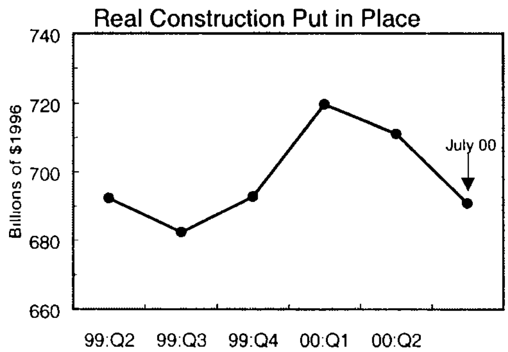
GDP Growth Moderates in the Third Quarter

After growing 6 percent during the past four quarters, evidence is mounting that real GDP slowed in the third quarter to a growth rate in the 2½-to-3½ percent range at an annual rate. The evidence for the slowdown is most apparent in the labor-market data.

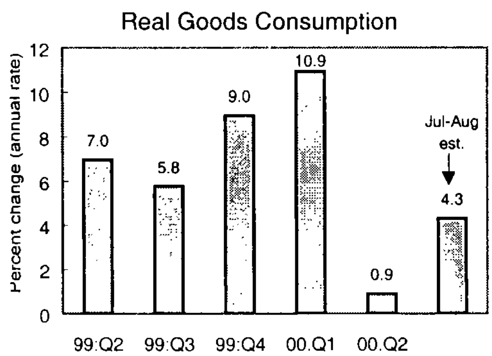


Labor market is slowing. Hours of production workers are flat thus far in the third quarter, a significant deceleration from its earlier pace (upper chart). Initial claims for unemployment insurance, available through September 9th, have risen significantly from the extraordinarily low levels reported earlier in the year.

Construction is falling. Third-quarter data on consumer and business spending remain fragmentary, but point to a slowdown. Construction spending has dropped (middle chart). Homebuilding and public construction account for the decline. Nonresidential construction has plateaued after strong gains early in the year. Although business investment in equipment and software remains robust, early third-quarter data suggest that its growth may not be as strong as previously.



But growth of personal consumption is rebounding. The growth of real goods consumption in the third quarter appears to be rebounding to a 4¼ percent annual rate, after dropping in the second quarter (lower chart). Additionally, consumer sentiment remains in the top 3 percent of its historical range.



Ripples from the world economy.
The strengthening of the world economy has boosted export prospects for American goods, but it may also have caused import prices to accelerate. As a result, the inflation risk has increased. CPI inflation over the past 12 months has increased to 2.5 percent, up from 1.9 percent 1 year ago (but identical to the 2.5 percent of 2 years ago).

SPECIAL ANALYSIS

The Open Source Paradigm in Software Authorship

Many of thousands of Americans are working on open source software programming projects, often receiving little or no monetary compensation for their valuable contributions to the U.S. economy. Instead, these people are motivated by non-pecuniary incentives or expected future benefits.

What is open source? Open source software is software in which source code—the instructions that generate all of the 1s and 0s—is disseminated to users, who are encouraged to make modifications and provide feedback. Users are actively encouraged to share the software with others, with or without modifications, as long as they also share the right to copy and modify the software. Open source software tends to be written for the needs of advanced users, who can understand and contribute to the source code.

Open source software is especially prominent in running the Internet: the open source computer operating system, Linux, powers more than a third of Internet servers; two-thirds of Internet servers use the open source server software Apache; and Sendmail is the most commonly used program for transferring email between mail servers. Proponents of open source software say it is of inherently higher quality than other software, because users can locate and fix problems themselves. Users pass “bug reports” and “patches” on to authors and fellow users, and the best "fixes" are incorporated in future versions of the software. Authors can receive specific feedback from many users, improving the code and directing future improvements.

How many people are involved in authoring open source software? Two estimates made about a year ago suggest that about 50,000 to 100,000 people are working on open source software projects without monetary compensation, and another 5,000 to 20,000 work on open source projects as part of their jobs. Of these people, about one-fourth to one-third are in the United States, and most of the remainder are in Northern and Western Europe. Many contributors are young—about one-tenth are under 18. The vast majority are in their twenties.

Why do people produce “free” software? Some open source development occurs because of ordinary profit-seeking behavior. There are firms developing open source software to earn revenue. For example, one start-up sells services in writing, customizing, and supporting open source software.

Individual programmers may also work on open source projects as part of their jobs, modifying existing open source programs to solve the specific problems faced by their own firms. Such people may share their modifications to reduce the cost of incorporating them in future versions of the software. Programmers working "on their own time" may be motivated by the possibility of future monetary rewards. Open source software is generally distributed with its contributors listed, and so contributing programmers can acquire a reputation for skill, especially if others accept their code as canonical. Reputations for skilled work may translate into better job offers in the future. Such signaling behavior may be particularly important for talented individuals who are young or who lack the certification of a computer science degree.

Developers of open source programs may also do such work because they enjoy writing code and sharing their work with others, as part of a culture of scientists and engineers. Many may simply derive great satisfaction from being part of the "information revolution."

Conclusion. While open source software represents only a small portion of the software industry, its prominence among the software powering one of the most dynamic sectors of the U.S. economy makes the motivations of its authors especially interesting.

EYES ONLY

ARTICLE

Fewer Displaced Workers and Less Traumatic Disruptions

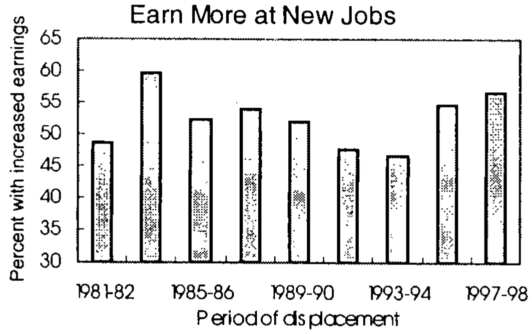
While losing a job because of a plant or company shutdown remains a painful possibility, displaced worker data indicates that the continued growth of the economy has reduced the severity of these disruptions. The data indicate that fewer workers are being displaced, and that many displaced workers are able to obtain new employment at relatively high pay.

Displaced worker data. In 1984 the Census Bureau started collecting data on displaced workers through biannual supplements to the Current Population Surveys. These surveys obtain information on the number and characteristics of people who lost their jobs because their plant or company shut down or was moved, there was insufficient work, or their position or shift was abolished. The Census focuses on long-tenured employees (those who held a job for three or more years), who are more likely to have developed some job-specific skills and attachment to their employer. These employees are more likely to have lost their job due to labor market conditions rather than as a result of a bad match.

The displacement rate for long-tenured employees continues to fall. The data indicate only 2.5 percent of long-tenured workers were displaced in 1997 and 1998, a decline from 2.9 percent in 1995-96 and 3.9 percent in 1991-92. Displacements follow the business cycle, so the continued decline is likely a reflection of the sustained growth of the economy.

Re-employment rates are especially strong. Another feature of the strong economy is that the disruptions caused by displacements are not as traumatic as in the past. About 69 percent of full-time, long-tenured employees displaced in 1997-98 who reported earnings were re-employed in full-time jobs by February 2000. This rate continued an upward trend from about 60 percent re-employment over a comparable period for those displaced in 1991-92. The percent of displaced full-time long-tenured employees who took part-time jobs fell from 9 percent to 4 percent between 1995-96 and 1997-98, possibly because they continued to look for better full-time jobs. This seems to explain the commensurate increase in unemployment (from 5 percent to 10 percent during this period) for these workers. The proportion of full-time displaced workers who leave the labor force is at the lowest level observed since the initial survey period of 1981-82.

Full-Time Displaced Workers Who Earn More at New Jobs



Re-employment earnings are also very good. In addition to faring well at finding new full-time jobs, a majority of the full-time, long-tenured workers displaced in 1997-98 are finding new jobs with higher pay. Almost 57 percent of those reporting their earnings have better paying new jobs than the jobs that were lost. However, one-fourth of those who find full-time employment have earnings reduced by at least 20 percent.

Conclusion. The combination of relatively low displacement rates, high levels of full-time re-employment for displaced full-time long-term employees, and higher earnings for many in their new jobs suggests that the disruption caused by job losses due to plant closures or eliminating shifts may be less traumatic than in the past.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

COPS Program a Success in Increasing Number of Police Officers. A new Urban Institute evaluation of the $9 billion Community Oriented Policing Services Program shows that it has succeeded in increasing the number of police officers on the streets. Funds were targeted to high-crime jurisdictions—the 1 percent of grantee agencies with the highest crime rates received about a third of all program funds. About 80 percent of total grant funds went toward the first 3 years of new officer salaries; the remainder was spent on new technology and civilian hires to free up officer time for community policing. About 90 percent of grantee agencies expect to retain the police officers hired under the program after their COPS grants end, although some expect to be able to pay for the continuing employment of these officers by placing them in positions vacated by retiring officers. Thus, although the COPS grants are only temporary, the study estimates a permanent net increase in police officers nationwide of between 69,000 and 85,000 officers in 2001, and between 63,000 and 84,000 officers in 2003 and thereafter.

Heavier White Women Earn Lower Wages. Among white women, an increase in weight of about 65 pounds lowers wages by about 7 percent, holding intelligence, education, work experience, job tenure, region, year, and local unemployment rates constant, according to a new study. This decrease in wages is equivalent to a year of education, or to three years of work experience. An increase in height of 3 inches raises wages for white women by about 4 percent. Weight does not appear to affect the wages of non-white women, however, and for all women weight does not affect the likelihood of employment or type of occupation. An earlier, related line of research has found that beauty, too, affects labor market outcomes: subjectively measured "plainness" reduces wages about 5 to 10 percent for men as well as women.

EPI Issues Report on Working Americans. *The State of Working America 2000-01* is a biennial compendium and analysis of federal statistics and academic work, produced by the Economic Policy Institute. The report finds that over the 1995-99 period, productivity increases, low unemployment rates, and increases in the minimum wage have led to a rise in wages and incomes, especially for lower-income Americans. Income inequality grew at a slower rate after 1995 than earlier in the decade. Much of the increase in incomes is due to an increasing number of hours worked, some of which is due to greater employment. While wealth has increased this decade, consumer debt has risen almost as much for the typical family, and poverty has declined only slightly.

INTERNATIONAL ROUNDUP

Role of Foreign Banks in Developing Countries is Growing. A new IMF report describes recent developments in emerging market financing, in particular strong foreign direct investment, a rise in portfolio flows, and net repayments to international banks. Emerging market borrowers are relying more on domestic currency financing and longer-term funds, a consequence of the financial crises of the late 1990s. The report documents a growing presence of foreign-owned financial institutions in developing countries. This appears to be due to the ongoing consolidation of banking systems in both mature and developing countries, as well as the desire by developing countries to have banks operating in their markets hold globally diversified portfolios. In Central Europe, foreign control of total bank assets increased from 8 percent in 1994 to 57 percent in 1999. A similar trend was present in Latin America. Evidence indicates that the competitive pressures created by foreign entry in the financial markets have led to lower operating costs and smaller interest rate margins. However, it is less clear whether such foreign presence leads to more stable banking systems and lower volatility in the availability of credit.

International Effects of Duty-Free E-Commerce. New research explores the arguments to make permanent a WTO protocol that exempts electronically delivered items (e.g., digitized media and certain services) from customs duties. Cross-border service trade that could take place in electronic form reached $370 billion in 1995, or 6 percent of total world trade. Trade in media is smaller; total world trade in digitizable media amounted to only $44 billion in 1996. The paper argues that the revenue currently lost from the provision is minimal. Less than one percent of existing tariff revenue would be lost if all current trade in digitizable media were electronic. Furthermore, there are currently no duties on non-electronically traded services. However, the growth rate in trade of media products from 1990 to 1996 was substantially higher than the growth in overall trade. Thus, future revenues lost could become significant over time.

U.S. Ranks First in Economic Creativity and Competitiveness. A new report by the World Economic Forum ranks countries based on their competitiveness. One indicator is "growth competitiveness," which aims to measure the factors that contribute to future growth and is similar to the competitiveness index used in previous years. The U.S. ranks first in this measure, up from last year when it was ranked second to Singapore. Luxembourg, the Netherlands, and Ireland ranked third through fifth, respectively. The "current competitiveness" index aims to identify the factors that support current productivity and hence current economic performance. Finland ranks first in this measure, with the U.S. second, Germany third, and the Netherlands fourth. A new index of "economic creativity" measures the development and the adoption of new technology, and places the U.S. first, followed by Finland and Singapore.

EYES ONLY

RELEASES THIS WEEK

Industrial Production and Capacity Utilization

****Embargoed until 9:15 a.m., Friday, September 15, 2000****

The Federal Reserve's index of industrial production increased 0.3 percent in August following no change in July. Capacity utilization rose 0.1 percentage point to 82.3 percent.

Consumer Price Index

****Embargoed until 8:30 a.m., Friday, September 15, 2000****

The consumer price index fell 0.1 percent in August. Excluding food and energy, consumer prices rose 0.2 percent.

Retail Sales

Advance estimates show that retail sales rose 0.2 percent in August following an increase of 0.9 percent in July. Excluding sales in the automotive group, retail sales rose 0.3 percent following an increase of 0.8 percent.

Producer Price Index

The producer price index for finished goods fell 0.2 percent in August. Excluding food and energy, producer prices rose 0.1 percent.

MAJOR RELEASES NEXT WEEK

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

EYES ONLY

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	5.3
GDP chain-type price index	5.2	1.6	1.6	3.3	2.6
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	June 2000	July 2000	August 2000
Unemployment Rate (percent)	6.7**	4.2**	4.0	4.0	4.1
Payroll employment (thousands)					
increase per month			57	-51	-105
increase since Jan. 1993					21989
Inflation (percent per period)					
CPI	5.8	2.7	0.6	0.2	**-0.1**
PPI-Finished goods	5.0	2.9	0.6	0.0	**-0.2**

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

New or revised data in **boldface**.
CPI data **embargoed until 8:30 a.m., Friday, September 15, 2000.**

EYES ONLY

FINANCIAL STATISTICS

	1998	1999	July 2000	August 2000	Sept. 14, 2000
Dow-Jones Industrial Average	8626	10465	10663	11015	11087
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.96	6.09	5.97
10-year T-bond	5.26	5.65	6.05	5.83	5.79
Mortgage rate, 30-year fixed	6.94	7.43	8.15	8.03	7.88
Prime rate	8.35	8.00	9.50	9.50	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level September 14, 2000**	**Percent Change from** Week ago	Year ago
Euro (in U.S. dollars)	0.862	-1.4	-17.2
Yen (per U.S. dollar)	107.3	2.0	1.8
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	101.4	1.4	9.1

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	6.0 (Q2)	4.1 (Aug)	**3.4** (Aug)
Canada	5.3 (Q2)	6.8 (Jul)	3.0 (Jul)
Japan	0.8 (Q2)	4.7 (Jul)	-0.5 (Jul)
France	3.4 (Q2)	9.6 (Jul) [2]	1.7 (Jul)
Germany	3.6 (Q2)	8.3 (Jul)	1.9 (Jul)
Italy	3.0 (Q1)	10.8 (Apr)	2.7 (Jul)
United Kingdom	3.1 (Q2)	5.5 (May)	3.2 (Jul)

U.S. CPI data **embargoed until 8:30 a.m., Friday, September 15, 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.

Weekly Econ

VIA FAX

TO: WHITE HOUSE

FROM: Bruce Steinberg
Chief Economist
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TIME: Fri Sep 15 14:46:38 2000

9 pages including cover sheet

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15 September 2000

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Weekly Economic & Financial Commentary

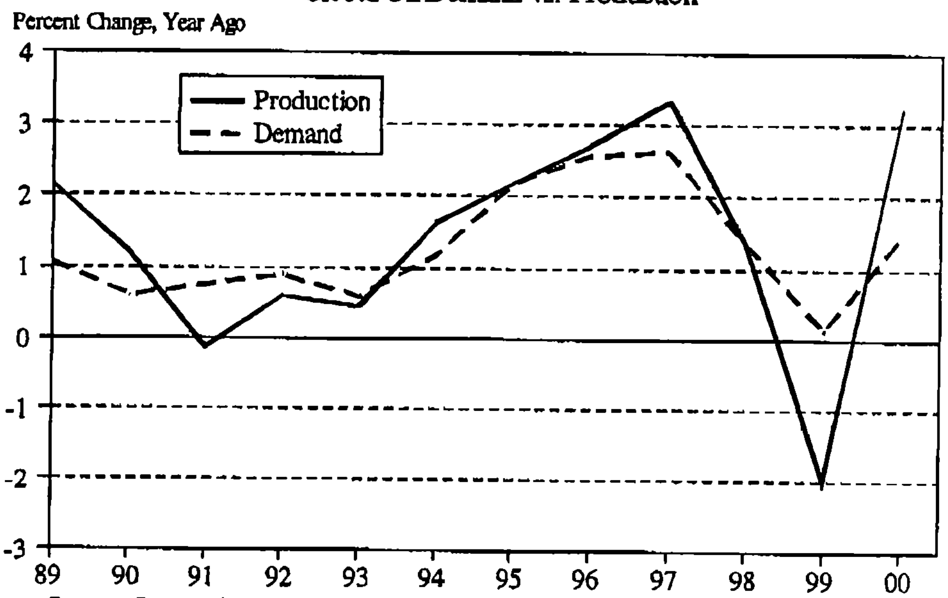
The Mystery of the Missing Barrels

Also: The Euro's Impact on Corporate Earnings

Economics

- **Oil supply is catching up to demand. We still believe that oil prices will move toward $25 a barrel in 2001.**
- **Even if oil prices simply remain where they are, most of the growth-dampening effect has already occurred.**
- **The weak euro will cut S&P 500 operating EPS by roughly one percentage point in 2000. Half that effect occurred in the first half.**
- **Our top-down view remains that S&P 500 operating EPS will be up 16% in 2000, 10% in 2001. But currency effects could negatively impact Q3.**

The Mystery of the Missing Barrels
Global Oil Demand vs. Production



Source: International Energy Agency, Merrill Lynch

Merrill Lynch & Co.
Global Securities Research & Economics Group
Economics Department

The Mystery of the Missing Barrels

Does the world face an oil shock, or is the worst over on the oil front? Though confusion reigns in the oil market, we still believe that oil prices will move toward $25 a barrel in 2001. Even if oil prices simply remain where they are, most of the growth-dampening effect has already occurred. And while a further spike in oil prices can't be ruled out in the very near term, we suspect that a sharp downward break in price is more likely than a sharp upward move over the medium term.

OPEC's ability to manage the oil market clearly leaves a lot to be desired. Since OPEC announced an 800,000 barrel-a-day increase in production quotas, oil prices have moved up and down but are basically unchanged from immediately ahead of the OPEC meeting. Given the confused state of the markets and historically low inventory levels, price volatility is likely to persist.

Yet a mystery hangs over the oil market. During the past year, global oil demand is up about 1% while global oil production is up more than 4%. That should have led to a substantial inventory restocking, yet oil inventories remain way below historic norms. So where did the missing barrels go? No one has a satisfactory answer.

The oil is unlikely to be at sea—tanker rates are just as high as oil prices. In the past, demand has often turned out to be underestimated when such supply-demand anomalies have occurred. But as Mike Rothman, Merrill's Director of Energy Market Research, points outs, it's also hard to believe that demand has been so underestimated this year.

One hint can be found in the minutia of the U.S. oil product balance. Home heating oil inventories are very low, raising fears of shortages and price spikes in the winter. Yet demand for distillate, a good proxy for heating oil, in the year-to-date is up 6% from last year.

Given the weather this year, we doubt that actual oil usage could be up that much. One explanation is that hoarding is going on, with supplies being held by distributors and even homeowners. That makes a spike in home heating oil prices less likely during the winter depending, of course, on the weather. And it's another reason to expect a decline after the winter.

The evidence of hoarding is less apparent for other oil products. But we suspect that the supply-demand balance isn't quite as tight as it seems. Until inventory data start to reflect a stronger inventory build, crude prices will remain elevated. But prices could eventually come down faster than people currently expect.

What about the economic effects of various oil price scenarios? If oil prices merely stabilize, there would be little further negative impact on the economy beyond what has already occurred. Americans are spending about $50 billion more on oil products at present then they were in early 1999. That "tax hike" contributed about half a percentage point of the growth slowdown now underway.

Oil prices would have to spike sharply higher—say above $40 a barrel—on a sustained basis to slow growth much more substantially than has already occurred or to possibly creep into core inflation. And if oil prices fall toward $25 next year, as we expect, it might add a few tenths to GDP growth next year, while trimming headline inflation.

The U.S. and world economies are far less energy dependent than in the past. U.S. oil demand in 2000 has only just now surpassed what it was in 1978, when the economy was half its current size. For that matter, real gasoline prices are actually still lower than their 1990 peak and much lower than their early-1980s peak.

Energy prices certainly have the ability to impact inflation and growth. But because it now takes much less energy to produce a unit of GDP than in the past, it would take a more massive swing in oil prices than has occurred to derail the world economy. Our base case is that oil prices fall back to a higher range than they were in during most of the past fifteen years. If so, sufficient energy supplies will be forthcoming, and world growth will be fine.

Meanwhile, inflation pressures outside the energy complex are barely discernable. The PPI actually fell 0.3% for August, while the core PPI excluding tobacco slipped 0.1%. The CPI fell 0.1%, on temporarily lower energy prices, while the core CPI edged up 0.2%. Aside from things like airline fares, there is no evidence that higher energy prices have had any impact on core inflation.

The Euro's Impact on Earnings

The weak euro is having an on-going impact on corporate earnings. We estimate that currency translation effects cut roughly 35 cents from S&P 500 EPS in the first half of 2000. But since translation had a similar impact in the first half of 1999, year-on-year comparisons were not affected. Operating EPS were up 17% in the first half.

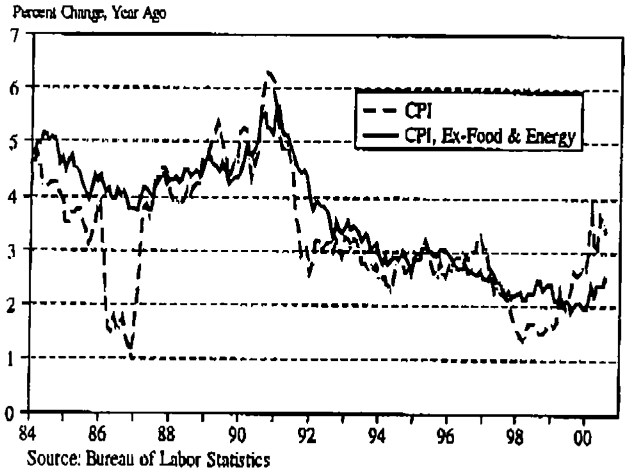
Based on our currency forecast, we expect currency translation to cut about the same amount from second-half EPS, with the effect concentrated in the third quarter. But year-on-year comparisons will suffer because last year currency translation actually added about 30 cents to second-half earnings.

We are sticking with our view that second-half earnings will be up 15% from a year earlier. But there may be up to a percentage point of downside risk to that forecast, with the negative impact concentrated in the current quarter.

In the aggregate, even big swings in exchange rates have fairly minor effects on corporate earnings. But obviously the impact can be more significant for individual companies. Tech is the sector with the highest European exposure, which is presumably one reason the market has been hard on that group of late.

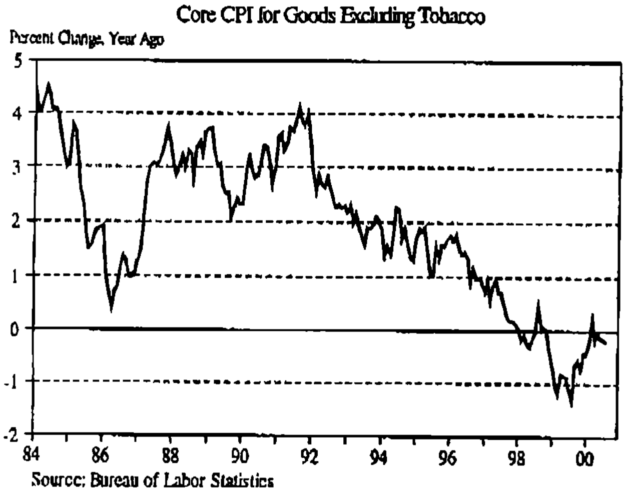
We expect the euro to make some modest gains next year. If so, positive translation effects could give earnings a lift.

Inflation Tame
CPI vs. Core CPI



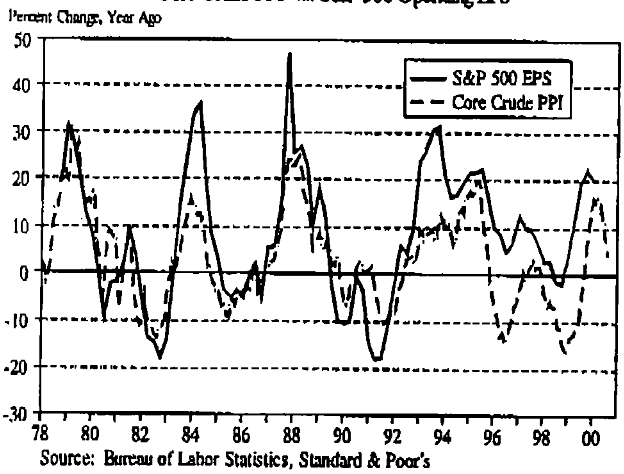
Inflation remains tame. The CPI actually fell 0.1% for August, pulled down by temporarily lower energy prices. That effect will reverse for September. The core CPI edged up 0.2% for August, as expected, but was up 2.5% from a year ago. That was the biggest gain since December 1998. But we believe that will be the peak, and that core inflation will edge at least a couple of tenths lower by the end of the year.

Consumer Goods Deflate
Core CPI for Goods Excluding Tobacco



Consumer goods prices continue to deflate. As of August, the CPI for goods excluding food, energy, and tobacco, was down 0.2% from a year ago. By contrast, in August 1999, the core goods CPI was down 1.3%. That lower rate of goods deflation, by creating less of a negative impulse, accounts for roughly half the pickup in the core CPI during the past twelve months. But as consumer spending slows, goods deflation is intensifying. For the year-to-date, the core goods CPI is down at a 0.6% rate, and for the past three months, it declined at a 1.4% rate. Hence our view that the run rate of the core CPI will edge lower during the next few months.

Earnings Momentum To Slow
Core Crude PPI vs. S&P 500 Operating EPS

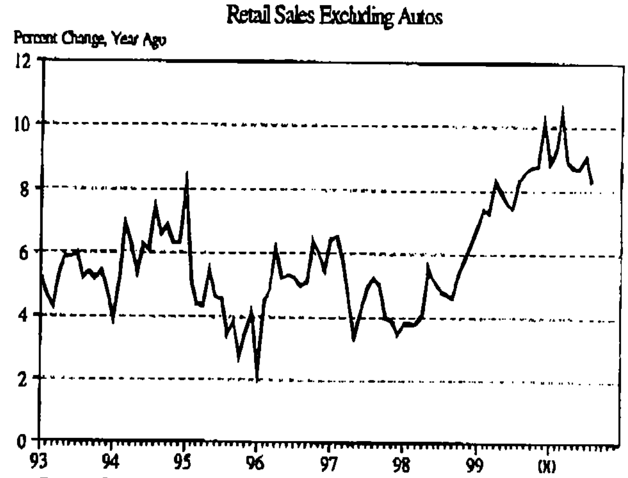


Outside the energy complex, industrial commodity prices have been weakening. The PPI for crude materials other than food and energy declined 1.3% for August, the sixth consecutive monthly decline. Though that still left the index up 4.2% from a year ago, it will probably fall into negative territory before the end of the year. That points to slower earnings momentum ahead, with the slowing concentrated in the most cyclical sectors.

The consumer slowdown that began in early spring continues. Retail sales edged up just 0.2% for August, with non-automotive sales up 0.3%. Consumer spending appears to be rising at about a 3.5% rate in the third quarter, not much stronger than the 2.9% rate of the second quarter, and otherwise the slowest pace in three years. We expect consumer spending to remain at about that 3.5% rate going forward, because income is also rising at roughly the same pace.

Retail Sales Moderate

Retail Sales Excluding Autos

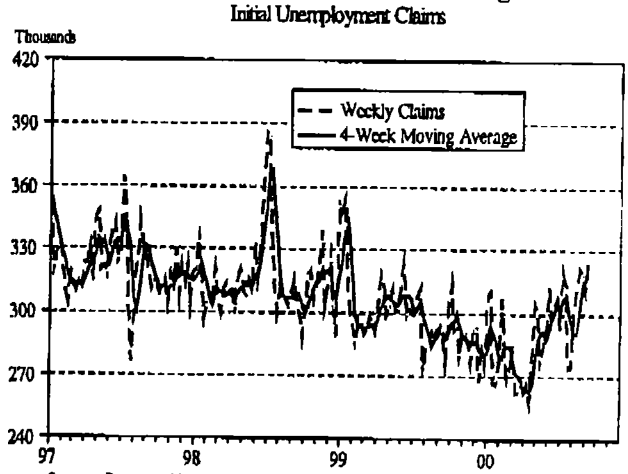


Source: Census Bureau

A slowdown in job growth is the main cause of a slowdown in income growth. The labor market continues to soften around the edges, though it still remains tight. Initial unemployment claims rose by 13,000 to 324,000, the highest level in twenty months. The four-week moving average of claims rose to 319,000, also a twenty-month high. The Fed's primary objective in tightening policy has been to stabilize the labor market. It has succeeded.

Jobless Claims At 20-Month High

Initial Unemployment Claims

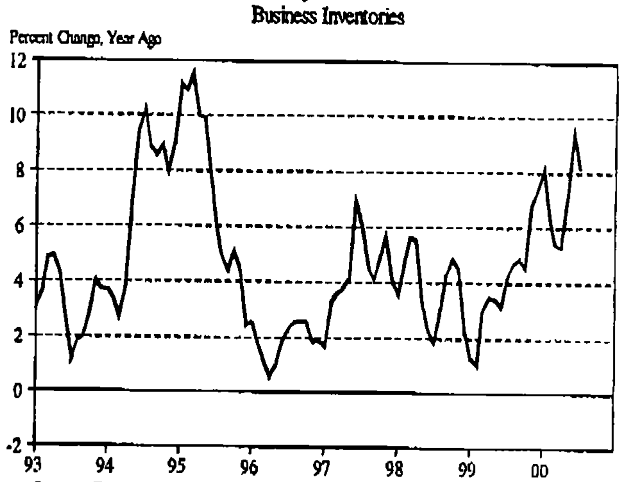


Source: Bureau of Labor Statistics

Business inventories edged up just 0.2% for July, the slowest pace in fifteen months. Retail inventories edged up 0.2%, with non-auto inventories actually down 0.1%. Wholesale inventories also slowed, though factory inventories picked up in July. We expect the slowdown in inventory building to cut third-quarter GDP growth by a percentage point.

Inventory Build Slows

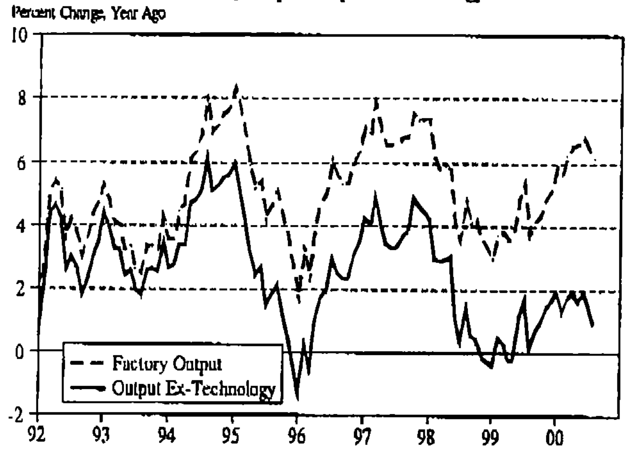
Business Inventories



Source: Commerce Department

Tech Drives Production

Factory Output, Output Ex-Technology

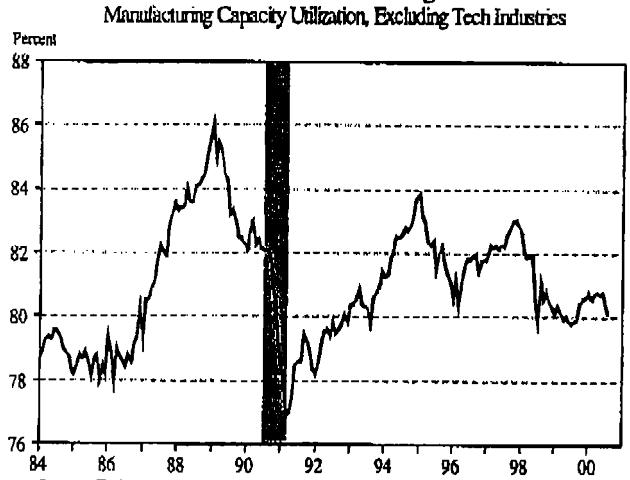


Source: Federal Reserve Board

Industrial production rose 0.3% for August, but most of the gain was due to a 4% jump in utility usage. Manufacturing production eked out a 0.1% gain, though it was up 6.2% from a year ago. But that is misleading. Excluding technology, factory output actually declined 0.3% for August, and was up only 0.9% from a year ago. And for the year-to-date, non-tech output is actually falling at a 0.5% rate. Earnings for basic industry, which were very strong during the first half, are likely to be considerably less so in the second half.

Utilization Falling

Manufacturing Capacity Utilization, Excluding Tech Industries

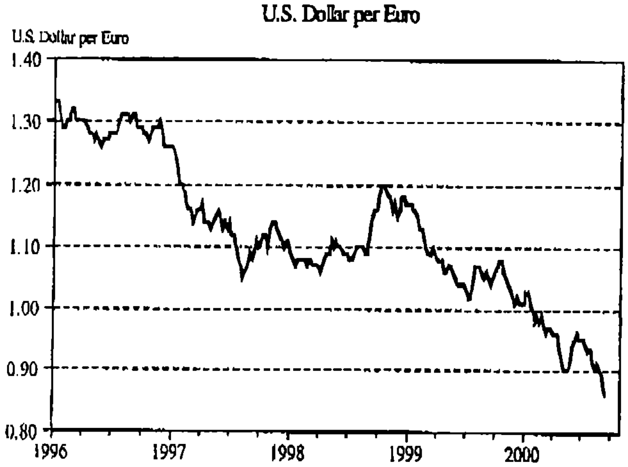


Source: Federal Reserve Board

Declining utilization rates will further diminish pricing power. Manufacturing utilization slipped to 81.2% for August and is headed lower. But utilization in the tech sector is 90%. Outside of tech, the utilization rate is only 80.1% and will probably soon fall below the post-Asia crisis low of 79.8%.

Euro Struggles

U.S. Dollar per Euro



Source: Federal Reserve Board

The euro continues to hover just above its lifetime low. The declining euro is reducing S&P 500 operating EPS probably by about one percentage point in 2000. Half that effect occurred in the first half. But the rest of that effect will be concentrated in the third quarter. We are sticking with our estimate that S&P 500 operating EPS will rise 16% this year. But there is a downside risk to third-quarter earnings as a result of currency translation. Next year a firmer euro could result in small translation gains.

Merrill Lynch Economic Forecast Summary
(As of September 1, 2000)

	2000.2	2000.3F	2000.4F	2001.1F	2001.2F	2001.3F	2001.4F	1999	2000F	2001F
Economic Activity										
Real GDP (Bil 96$), % SAAR	5.3	3.0	3.7	3.7	3.8	3.8	3.8	4.2	5.2	3.8
% Change, Year Ago	6.0	5.3	4.2	3.9	3.5	3.8	3.8			
Nominal GDP, % SAAR	8.0	4.8	4.9	5.5	5.0	5.2	5.1	5.8	7.4	5.3
% Change, Year Ago	8.2	7.7	6.5	5.8	5.1	5.2	5.2			
Industrial Production, FRB, % SAAR	7.3	3.8	3.2	3.7	3.7	3.7	3.7	3.5	5.6	3.8
% Change, Year Ago	6.0	5.7	5.2	4.5	3.6	3.6	3.7			
Civilian Unemployment Rate (%)	4.0	4.1	4.1	4.1	4.1	4.1	4.1	4.2	4.1	4.1
Key Sectors										
Real Final Sales, % SAAR	3.5	4.2	4.0	4.1	3.9	4.0	4.0	4.6	5.1	4.0
% Change, Year Ago	5.3	5.2	4.6	3.9	4.1	4.0	4.0			
Inventory Change (Bil 96$)	79.3	55.0	49.0	42.0	38.0	35.0	32.0	45.3	55.0	36.8
Real Consumption, % SAAR	2.9	3.5	3.3	3.3	3.3	3.3	3.3	5.3	5.1	3.3
% Change, Year Ago	5.4	5.0	4.3	3.3	3.4	3.3	3.3			
Real Disp. Personal Inc. % SAAR	3.3	2.5	3.9	3.8	3.7	3.7	3.6	3.2	3.0	3.6
% Change, Year Ago	3.0	3.1	2.9	3.4	3.4	3.7	3.7			
Personal Savings Rate (%)	0.2	0.0	0.1	0.2	0.3	0.4	0.4	2.2	0.1	0.3
Light Vehicle Sales (Millions SAAR)	17.2	17.1	16.8	16.5	16.5	16.5	16.5	16.8	17.3	16.5
Housing Starts (Millions SAAR)	1.60	1.58	1.58	1.58	1.58	1.58	1.58	1.68	1.62	1.58
Real Non-Res. Fixed Inv., % SAAR	14.6	11.5	9.3	8.8	8.9	9.0	9.0	10.1	13.8	9.6
% Change, Year Ago	14.1	14.1	14.0	11.1	9.6	9.0	8.9			
Corporate Profits and Earnings										
Corp. Profits After Tax (Bil $)	649.3	661.5	664.2	691.0	703.6	723.3	739.7	567.1	652.3	714.4
% Change, Year Ago	17.3	17.1	10.7	8.9	8.4	9.3	11.4	10.4	15.0	9.5
S&P 500 Earnings Per Share ($)	13.92	14.56	14.20	15.21	15.51	16.25	15.55	48.17	56.41	62.52
% Change, Year Ago	11.3	22.0	11.2	10.8	11.4	11.6	9.5	27.7	17.1	10.8
S&P 500 Operating EPS ($)	15.21	15.06	15.76	15.45	16.80	16.70	17.05	51.68	60.00	66.00
% Change, Year Ago	15.1	16.1	14.5	10.6	10.5	10.9	8.2	16.7	16.1	10.0
S&P Ind. Earnings Per Share ($)	15.96	14.95	15.10	16.16	17.71	16.46	16.20	50.25	60.32	66.53
% Change, Year Ago	19.6	27.2	7.0	12.9	11.0	10.1	7.3	31.0	20.0	10.3
S&P Ind. Operating EPS ($)	15.50	15.45	16.65	16.25	17.25	17.00	17.50	53.70	62.00	68.00
% Change, Year Ago	12.3	20.2	10.3	12.8	11.3	10.0	5.1	17.4	15.5	9.7
Inflation										
GDP Price Index, % SAAR	2.6	1.5	1.2	1.7	1.2	1.4	1.2	1.5	2.1	1.5
% Change, Year Ago	2.1	2.2	2.1	1.7	1.4	1.4	1.4			
CPI, Consumer Prices, % SAAR	3.6	3.0	2.3	1.6	1.8	2.0	1.7	2.2	3.3	2.1
% Change, Year Ago	3.2	3.4	3.2	2.6	2.2	1.9	1.8			
CPI Ex Food & Energy, % SAAR	2.8	2.1	1.9	2.1	2.1	2.4	2.1	2.1	2.3	2.2
% Change, Year Ago	2.3	2.4	2.3	2.2	2.1	2.2	2.2			
International Trade and the Dollar										
Real Net Exports (Bil 96$)	-408.6	-405.2	-404.2	-406.3	-408.4	-410.5	-412.6	-322.4	-398.7	-409.5
Euro (U.S.$/€)	0.93	0.91	0.93	0.98	1.01	1.05	1.06	1.06	0.94	1.03
Japanese Yen (¥/$)	106	108	110	116	118	118	118	115	108	118
Interest Rates										
Fed Funds (%)	6.27	6.50	6.50	6.50	6.50	6.50	6.50	4.97	6.25	6.50
Treasury Bills (3 Mos.) (%)**	5.71	6.05	6.00	5.95	5.95	5.95	5.95	4.64	5.80	5.95
Prime Rate (%)	9.25	9.50	9.50	9.50	9.50	9.50	9.50	7.99	9.25	9.50
2-Year Treasury Note (%)	6.57	6.25	6.20	6.15	6.15	6.15	6.15	5.43	6.40	6.15
5-Year Treasury Note (%)	6.42	6.10	6.05	6.00	6.00	6.00	6.00	5.54	6.30	6.00
10-Year Treasury Note (%)	6.18	5.90	5.85	5.80	5.75	5.75	5.75	5.64	6.10	5.75
30-Year Treasury Bond (%)	5.97	5.80	5.75	5.70	5.65	5.65	5.60	5.87	5.95	5.65

** Quoted on a discount-rate basis. All figures are period averages.
For more details see **Forecast Addendum**
Can be found on **Bloomberg** under **MLY** <Go> 1 <GO> 12 <GO>

Rolling Calendar of Business Indicators

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
Sep 18 **NAHB Builders** Survey—September	**Sep 19** **Housing Starts** Jun .... 1.56M Jul .... 1.51M Aug .... 1.50M* **Housing Permits** Jun .... 1.53M Jul .... 1.51M Aug 1.60M*	**Sep 20** **International Trade** May .... -$30.3B Jun .... -$30.6B Jul .... -$31.4B* **Fed's Beige Book Released** **Announce Buyback Operation**—$1.5B* **Announce 2-year Note**—$10.0B*	**Sep 21** **Initial Unemployment Claims** (week ending 9/16/00)—320,000* **Philadelphia FRB Index** Jul .... 0.7 Aug .... 14.1 Sep .... 10.0* **U.S. Treasury Balance** Aug 99 .... -$2.8B Aug 00 .... -$11.0B* **Buyback Operation**—$1.5B*	**Sep 22**
Sep 25 **Existing Home Sales** Jun .... 5.31M Jul .... 4.79M Aug 4.90M*	**Sep 26** **Consumer Confidence** (Conference Board) Jul .... 143.0 Aug .... 141.1 Sep 140.0*	**Sep 27** **Durable Goods Orders** Jun .... 9.5% Jul .... -12.4% Aug .... 2.0%* **Ex-Transportation Orders** Jun .... 0.5% Jul .... -4.9% Aug .... 0.8%* **Auction 2-Yr Note**—$10.0B* **Announce Buyback Operation**—$1.5B*	**Sep 28** **Initial Unemployment Claims** (week ending 9/23/00) **GDP**—00Q2 Final Revision 00Q1 .... 4.8% 00Q2 .... 5.3% **Corporate Profits**—00Q2 **Help-Wanted Index**—August **Agricultural Prices**—September **Buyback Operation**—$1.5B*	**Sep 29** **Personal Income** Jun .... 0.4% Jul .... 0.3% Aug .... 0.3%* **Personal Spending** Jun .... 0.4% Jul .... 0.8% Aug .... 0.4%* **Chicago PMI**—September Jul .... 52.0 Aug .... 46.5 **Consumer Sentiment** (University of Michigan)—September **APICS Index**—September
Oct 2 **NAPM Survey**—September Jul .... 51.8 Aug .... 49.5 **Construction Spending** Jun .... -1.3% Jul .... -1.6% Aug .... -0.5%* **New Domestic Car Sales**—September Jul .... 6.8M Aug .... 6.8M **New Light Truck Sales**—September Jul .... 7.5M Aug 8.0M	**Oct 3** **New Home Sales**—August Jun .... 823,000 Jul .... 944,000 **Leading Indicators** Jun .... -0.1% Jul .... -0.1% Aug 0.2%*	**Oct 4** **Factory Orders**—August Jun .... 5.2% Jul .... -7.5% **NAPM Non-Manufacturing Survey** Jul .... 55.6 Aug .... 60.0 Sep .... 59.0* **Announce 30-Yr TIPS**—$6.0B*	**Oct 5** **Initial Unemployment Claims** week ending 9/30/00) **Chain Store Sales**—September **Challenger Layoffs**—September	**Oct 6** **Payroll Employment** Jul .... -51,000 Aug .... -105,000 Sep .... 280,000* **Unemployment Rate** Jul .... 4.0% Aug .... 4.1% Sep .... 4.1%* **Average Hourly Earnings** Jul .... 0.4% Aug .... 0.3% Sep .... 0.3%* **Average Workweek** Jul .... 34.4H Aug .... 34.4H Sep .... 34.4H* **Consumer Credit** Jun .... $14.7B Jul .... $9.4B Aug .... $8.7B* **Treasury Stripping**—September

* Projections – Subject to revision as additional data become available during the month.

The calendar is on bloomberg under MLY <GO> 1 <GO> 12 <GO>
Look for "US Economic Indicators Calendar"

Forthcoming Indicators

Tuesday, September 19

Housing Starts & Permits. (Released at 8:30 a.m.) We project both housing starts and building permits to edge lower to a 1.50 million-unit rate in August (consensus: starts 1.53 mil) from a 1.51 rate in July. While mortgage rates continue to drift lower, the survey of homebuilders on homebuyers' traffic and buying prospects remains well below the pace witnessed last winter. Furthermore, the modest gains in the U.S. stock market during the past year constrains the financing of home purchasers.

Wednesday, September 20

International Trade. (Released at 8:30 a.m.) The trade deficit should widen to $31.4 billion in July (consensus: $31.0 bil) from $30.6 billlion in June. The drop in factory shipments suggests that merchandise exports fell around 3%. Modest declines for merchandise imports should offset some of that weakness. Soft retail sales, a drop in customs duties, and some unintended inventory accumulation over the last few months indicate that merchandise imports excluding petroleum products should drop by over 1%. Petroleum imports should fall as crude oil prices fell over 5% in July. The net service balance should be essentially unchanged.

Thursday, September 21

Initial Unemployment Claims. (Released at 8:30 a.m.) The job market continues to soften. We expect jobless claims will decline to 320,000 for the week ending September 16. Following the jump in continuing benefits last week to 2.245 million, we anticipate that they will drop to 2.225 million for the week ending September 9.

U.S. Treasury Statement. (Released at 8:30 a.m.) The August budget balance is expected to record a deficit of $11 billion (consensus: $0.0 bil), an $8 billion deterioration from August 1999's balance. Nevertheless, this would place the cumulative budget surplus for the eleven months spanning October 1999 through August 2000 at $170 billion, a $104 billion improvement from the analogous period a year ago. With just one month remaining in fiscal year 2000, it appears that the total year budget surplus will be around $235 billion, compared to the $124 billion surplus recorded in fiscal year 1999. So far this year federal revenues have increased by 11%, the strongest pace in over a decade, surpassing $2 trillion for the first time. Outlays have been running 4.8% higher this year.

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Weekly Econ

VIA FAX

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9 pages including cover sheet

Merrill Lynch

United States

8 September 2000

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Weekly Economic & Financial Commentary

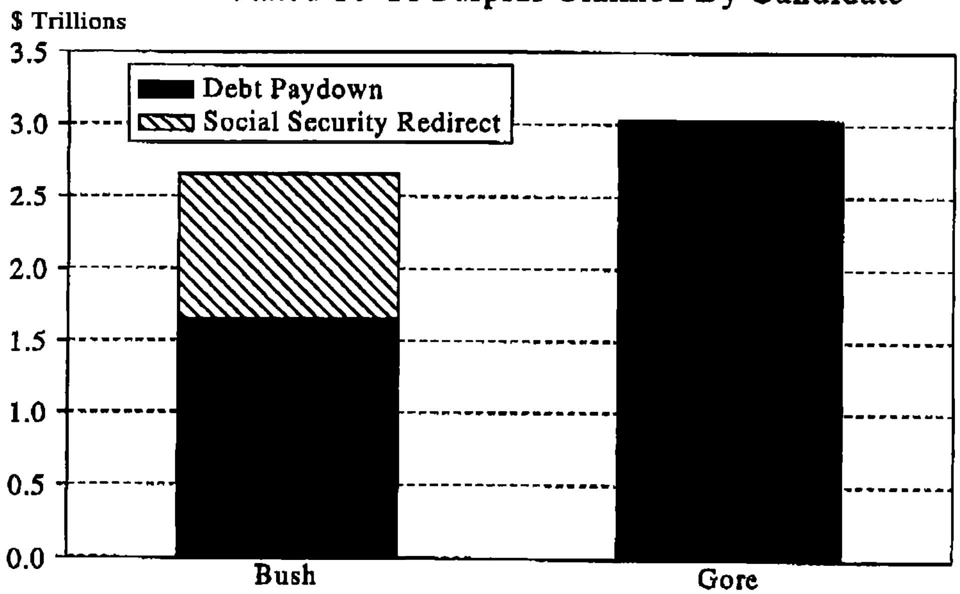
Will They Blow The Surplus?

Economics

- **Will they blow the surplus? Probably not, but federal spending will undoubtedly rise faster than either candidate allows for.**
- **Revenues are also likely to rise faster because the economy is likely to perform better than they assume.**
- **Gore's plan could pay down $2.8 trillion of public debt. Bush's plan could result in accumulated surpluses of $2.4 trillion.**
- **The net economic stimulus of either plan is tiny and unlikely to worry the Fed too much.**

How Much Debt They Claim To Pay

Accumulated 10-Yr Surplus Claimed By Candidate



Source: Bush and Gore Budget Plans

Merrill Lynch & Co.
Global Securities Research & Economics Group
Economics Department

Will They Blow The Surplus?

Will they blow the surplus? As the Presidential campaign heats up, both candidates have released broad outlines of their fiscal plans. Taken at face value, both the Bush and Gore budget plans would drastically reduce federal debt during the next decade. Even after making a very liberal allowance for a more realistic federal spending path than the candidates assume, their fiscal goals can still largely be achieved because the economy will probably perform better, rather than worse, than they assume.

Furthermore, the net economic stimulus of either plan is tiny and not likely to worry the Fed too much. Indeed, if the candidates stuck to their tax and spending plans, fiscal policy would actually grow ever more restrictive during the next decade, because Federal spending as a share of GDP would continuously shrink. We doubt spending will end up being quite that restrictive.

Both Bush and Gore use the budget baseline developed by the Congressional Budget Office in costing out their respective plans. On that CBO baseline, accumulated surpluses over the next decade come to nearly $4.6 trillion, more than sufficient to pay off the existing Federal debt of $3.5 trillion. Roughly half of those projected surpluses, $2.4 trillion, reflects the Social Security surplus.

Both parties say they will "lock up" the Social Security surplus, leaving them the other $2.2 trillion to play with. Gore would leave the current Social Security system intact, so all of the accumulated Social Security surpluses would result in debt reduction. Bush would redirect 2% of the Social Security payroll tax into individual self-directed accounts, reducing the debt paydown by about $1 trillion.

As we know, Bush tilts toward tax cuts and Gore toward spending. In judging the candidate's ten-year projections, keep in mind that cumulative GDP will amount to $130 trillion, and maybe more, over the next decade. Bush would reduce taxes by $1.3 trillion and increase spending by $470 billion. In addition, interest costs would be $310 billion more than under the CBO baseline, costing out the Bush plan at about $2.1 trillion.

Gore would reduce taxes by only $480 billion, while increasing spending by $1 trillion. Interests costs would be $240 billion more than under the CBO baseline, costing out the Gore plan at about $1.7 trillion. Both Bush and Gore claim gains in government efficiency of roughly $200 billion, which we ignore.

If we accept the candidates' figures, excluding their "efficiency" gains, Gore's proposals would pay down about $2.8 trillion of Federal debt by 2010, eliminating 80% of the existing debt by that time. Bush's proposals would pay down about $1.4 trillion of debt, eliminating 40% of the existing debt, plus accumulating $1 trillion in self-directed Social Security accounts.

Of course, candidates have a habit of being unduly optimistic about budget effects. There are two sets of issues in judging the realism of the candidates' budget proposals. First, are their proposals costed out adequately? Second, is the CBO baseline on which both Gore and Bush base their analyses sufficiently realistic?

Both candidates have undoubtedly underestimated the cost of their spending programs. More than half of the extra spending in both plans is for healthcare, an area of notorious cost overruns. Gore proposes to spend $490 billion on healthcare, including $340 billion for a prescription drug plan. Bush proposes $330 billion for healthcare, including $160 billion for prescription drugs. Our guess is that any prescription drug plan will end up costing at least twice what they assume.

Beyond the specifics of their policy proposals, both Bush and Gore use a CBO baseline that assumes real discretionary spending is flat for the next ten years. Somehow we don't believe that will happen. If real discretionary spending grew 2% a year, the pattern of the past few years, it would add about $850 billion to long-term spending projections.

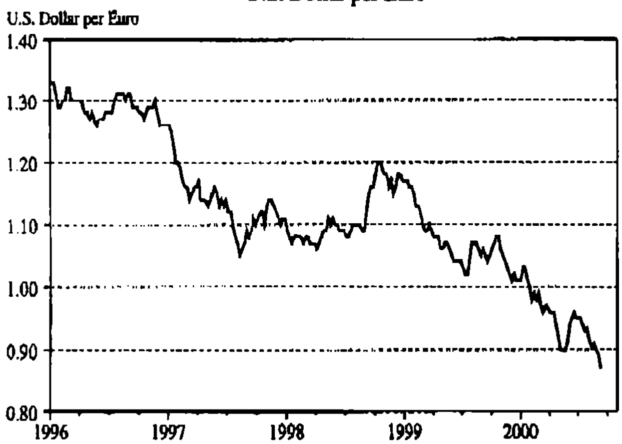
But the economy will probably bail them out. Economic assumptions are the main driver behind any set of long-term budget projections, and the CBO baseline is unduly pessimistic. The CBO assumes that GDP growth will average 2.75% during the next decade. Yet the Fed now believes that non-inflationary growth potential is 4% a year and we think it's even faster.

If growth averaged 3.5% a year—still less than the Fed's estimate of potential, leaving room for a recession to occur—Federal revenues would be roughly $1.5 trillion more than assumed in the CBO baseline. So higher revenues resulting from stronger economic growth are likely to offset even very sizeable cost overruns in the candidates' spending plans. In short, the fiscal goals held by Bush and Gore may actually be achievable, at least over the ten-year horizon used in their budget planning.

The fiscal stimulus resulting from these proposals is minimal, at least over the next decade. If the CBO baseline were actually carried out, fiscal policy would become ever more restrictive over time, with budget surpluses growing to 4.4% of GDP by 2010 vs. 2.3% of GDP in 2000. Even adding the extra spending discussed above, the Gore plan would still leave the surplus around 2% of GDP in 2010, while the Bush plan would leave it at about 1.5% of GDP.

Because tax cuts are backloaded, the fiscal situation begins to deteriorate in the next decade, particularly in the Bush program. And Bush has made no allowance for the transition costs of moving from a pay-as-you-go Social Security system to a defined-contribution system. Those costs can be ignored for the next ten years or so, but will come back to bite in the middle of the next decade. However, that's a tale for another day.

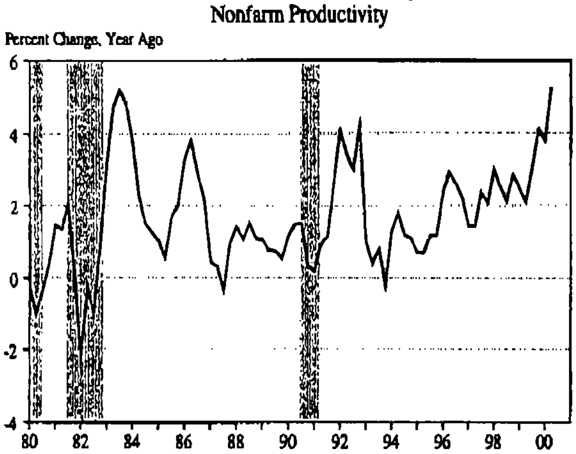
Euro Struggles
U.S. Dollar per Euro



Source: Federal Reserve Board

The euro continues to hit new lows. The problem is simple. As good as Europe is doing—and it's doing very well indeed—the U.S. is doing better still. As a result, capital keeps hemorrhaging out of Europe, heading for the U.S. In light of the euro's profound weakness, we have revised our euro/dollar forecast. We still expect the euro to eventually bottom and head higher. But it could hit new lows in the very short run and may not reach parity until the end of 2001. Until recently, we expected parity by the end of 2000.

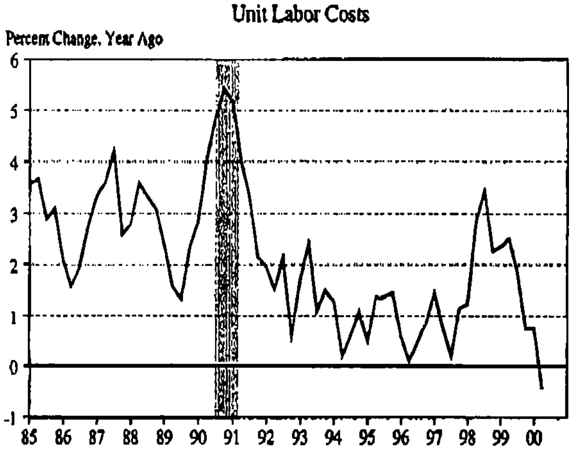
Awesome Productivity
Nonfarm Productivity



Source: Bureau of Labor Statistics

U.S. productivity is simply awesome, up 5.2% during the past year. We expect productivity growth to average around 3.5% through the end of 2001, implying that the growth potential of the U.S. economy is 4.5% a year. By contrast, while European growth has picked up, it has been labor intensive, drawing down high European unemployment. That's as it should be in an early cycle period, but European productivity gains are significantly lagging U.S. gains. As the new economy takes hold in Europe, productivity will also pick up, supporting the euro.

No Labor Cost Pressure
Unit Labor Costs

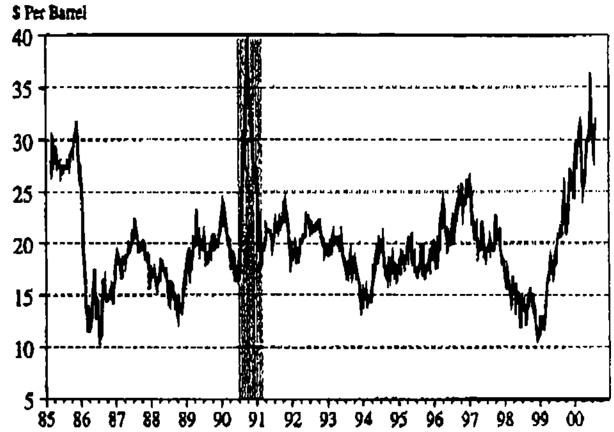


Source: Bureau of Labor Statistics

Strong productivity is reducing unit labor costs, permitting profit margins to widen. If productivity can grow at a 3.5% rate through next year, as we expect, unit labor costs should rise no more than 1% during that period. Profit margins should then widen slightly, consistent with our forecast the S&P 500 operating EPS will rise 10% in 2001.

Oil prices rose above $35 a barrel before retreating slightly, just ahead of OPEC's meeting on September 10. Saudi Arabia's oil minister said OPEC would act to move oil prices into a target range of $22-to-28 a barrel. But it would take a production increase of at least one million barrels a day to move oil prices below $30 a barrel in the near term.

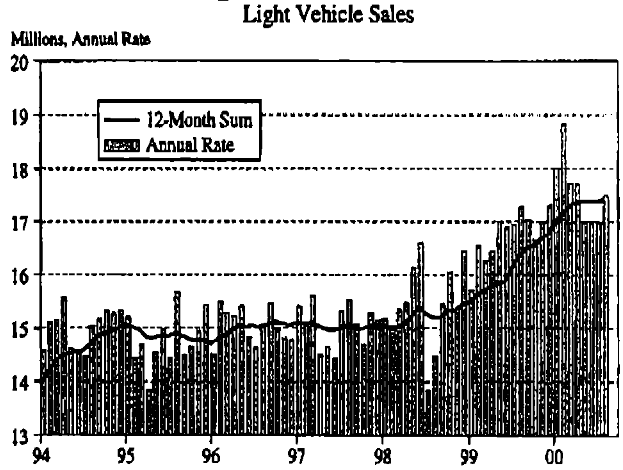
Where Do Oil Prices Go Next?
West Texas Intermediate



Source: Dow Jones

While consumer spending has moderated, consumers are still out there shopping. Vehicle sales rose to a 17.5 million-unit rate for August, above the pace of the prior three months, though well behind the pace of the first four of the year. On the other hand, chain-store sales were weak in August. Consumer spending appears to be rising at about a 3.5% rate in the third quarter, consistent with GDP growth at roughly the same pace.

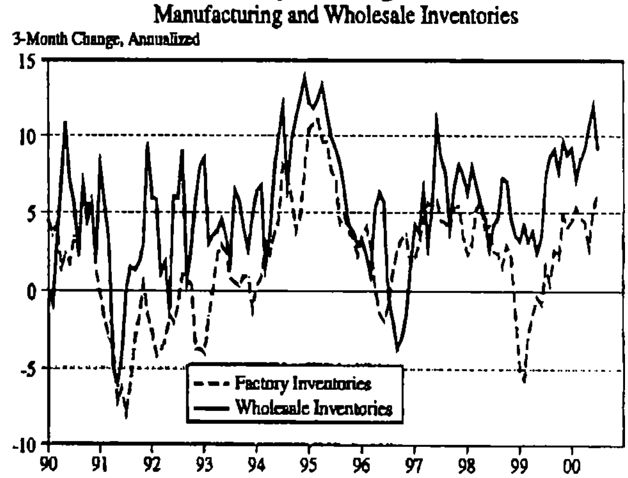
August Vehicle Sales Rise
Light Vehicle Sales



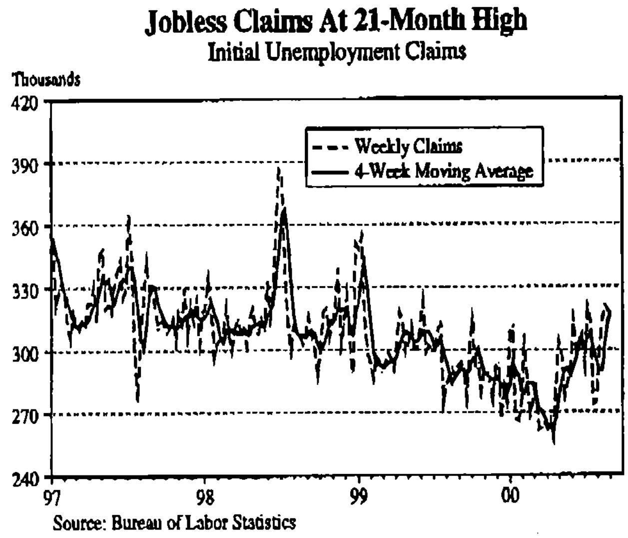
Source: Bureau of Economic Analysis, Merrill Lynch

Wholesale inventory building slowed in July, while factory inventory building picked up. While there is still a lot more inventory data to be released for the current quarter, we assume that a slowdown in inventory building will cut about .75 percentage point from third-quarter GDP growth. In the second quarter, inventories added about two percentage points to growth.

Inventory Building To Slow
Manufacturing and Wholesale Inventories

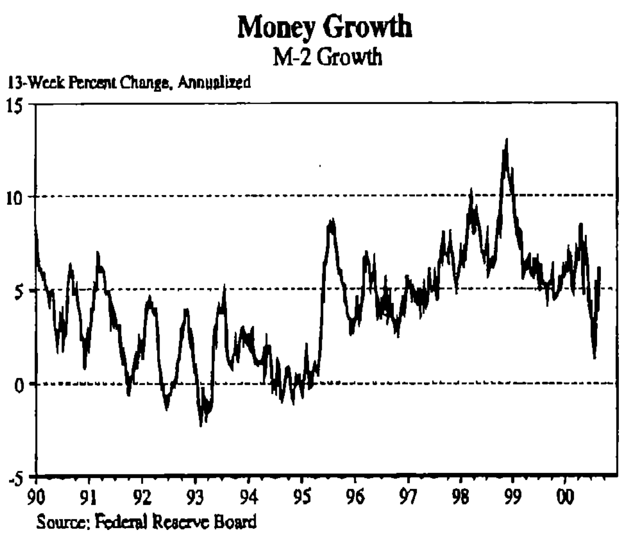


Source: Census Bureau



The labor market remains tight, but not quite as tight as it has been. Jobless claims slipped 3,000 to 316,000 for the week ending September 2. But the four-week moving average rose to 318,000, a 21-month high.

The Fed has succeeded in its primary objective of stabilizing the labor market. The unemployment rate has been within 0.1 percentage point of its current level for the past eleven months. The employment rate—the share of the working age population with jobs—has actually come down slightly since early 2000 and is no higher than it was 18 months ago.



M2 growth slowed sharply through mid-summer and has since rebounded, when measured on a 13-week rate of change basis. We don't read much into those wiggles. On a year-to-year basis, M2 is up 5.7% from a year ago and has been running at about that pace for the past nine months.

Merrill Lynch Economic Forecast Summary
(As of September 1, 2000)

	2000.2	2000.3F	2000.4F	2001.1F	2001.2F	2001.3F	2001.4F	1999	2000F	2001F
Economic Activity										
Real GDP (Bil 96$), % SAAR	5.3	3.0	3.7	3.7	3.8	3.8	3.8	4.2	5.2	3.8
% Change, Year Ago	6.0	5.3	4.2	3.9	3.5	3.8	3.8			
Nominal GDP, % SAAR	8.0	4.8	4.9	5.5	5.0	5.2	5.1	5.8	7.4	5.3
% Change, Year Ago	8.2	7.7	6.5	5.8	5.1	5.2	5.2			
Industrial Production, FRB, % SAAR	7.3	3.8	3.2	3.7	3.7	3.7	3.7	3.5	5.6	3.8
% Change, Year Ago	6.0	5.7	5.2	4.5	3.6	3.6	3.7			
Civilian Unemployment Rate (%)	4.0	4.1	4.1	4.1	4.1	4.1	4.1	4.2	4.1	4.1
Key Sectors										
Real Final Sales, % SAAR	3.5	4.2	4.0	4.1	3.9	4.0	4.0	4.6	5.1	4.0
% Change, Year Ago	5.3	5.2	4.6	3.9	4.1	4.0	4.0			
Inventory Change (Bil 96$)	79.3	55.0	49.0	42.0	38.0	35.0	32.0	45.3	55.0	36.8
Real Consumption, % SAAR	2.9	3.5	3.3	3.3	3.3	3.3	3.3	5.3	5.1	3.3
% Change, Year Ago	5.4	5.0	4.3	3.3	3.4	3.3	3.3			
Real Disp. Personal Inc. % SAAR	3.3	2.5	3.9	3.8	3.7	3.7	3.6	3.2	3.0	3.6
% Change, Year Ago	3.0	3.1	2.9	3.4	3.4	3.7	3.7			
Personal Savings Rate (%)	0.2	0.0	0.1	0.2	0.3	0.4	0.4	2.2	0.1	0.3
Light Vehicle Sales (Millions SAAR)	17.2	17.1	16.8	16.5	16.5	16.5	16.5	16.8	17.3	16.5
Housing Starts (Millions SAAR)	1.60	1.58	1.58	1.58	1.58	1.58	1.58	1.68	1.62	1.58
Real Non-Res. Fixed Inv., % SAAR	14.6	11.5	9.3	8.8	8.9	9.0	9.0	10.1	13.8	9.6
% Change, Year Ago	14.1	14.1	14.0	11.1	9.6	9.0	8.9			
Corporate Profits and Earnings										
Corp. Profits After Tax (Bil $)	649.3	661.5	664.2	691.0	703.6	723.3	739.7	567.1	652.3	714.4
% Change, Year Ago	17.3	17.1	10.7	8.9	8.4	9.3	11.4	10.4	15.0	9.5
S&P 500 Earnings Per Share ($)	13.92	14.56	14.20	15.21	15.51	16.25	15.55	48.17	56.41	62.52
% Change, Year Ago	11.3	22.0	11.2	10.8	11.4	11.6	9.5	27.7	17.1	10.8
S&P 500 Operating EPS ($)	15.21	15.06	15.76	15.45	16.80	16.70	17.05	51.68	60.00	66.00
% Change, Year Ago	15.1	16.1	14.5	10.6	10.5	10.9	8.2	16.7	16.1	10.0
S&P Ind. Earnings Per Share ($)	15.96	14.95	15.10	16.16	17.71	16.46	16.20	50.25	60.32	66.53
% Change, Year Ago	19.6	27.2	7.0	12.9	11.0	10.1	7.3	31.0	20.0	10.3
S&P Ind. Operating EPS ($)	15.50	15.45	16.65	16.25	17.25	17.00	17.50	53.70	62.00	68.00
% Change, Year Ago	12.3	20.2	10.3	12.8	11.3	10.0	5.1	17.4	15.5	9.7
Inflation										
GDP Price Index, % SAAR	2.6	1.5	1.2	1.7	1.2	1.4	1.2	1.5	2.1	1.5
% Change, Year Ago	2.1	2.2	2.1	1.7	1.4	1.4	1.4			
CPI, Consumer Prices, % SAAR	3.6	3.0	2.3	1.6	1.8	2.0	1.7	2.2	3.3	2.1
% Change, Year Ago	3.2	3.4	3.2	2.6	2.2	1.9	1.8			
CPI Ex Food & Energy, % SAAR	2.8	2.1	1.9	2.1	2.1	2.4	2.1	2.1	2.3	2.2
% Change, Year Ago	2.3	2.4	2.3	2.2	2.1	2.2	2.2			
International Trade and the Dollar										
Real Net Exports (Bil 96$)	-408.6	-405.2	-404.2	-406.3	-408.4	-410.5	-412.6	-322.4	-398.7	-409.5
Euro (U.S.$/€)	0.93	0.91	0.93	0.98	1.01	1.05	1.06	1.06	0.94	1.03
Japanese Yen (¥/$)	106	108	110	116	118	118	118	115	108	118
Interest Rates										
Fed Funds (%)	6.27	6.50	6.50	6.50	6.50	6.50	6.50	4.97	6.25	6.50
Treasury Bills (3 Mos.) (%)**	5.71	6.05	6.00	5.95	5.95	5.95	5.95	4.64	5.80	5.95
Prime Rate (%)	9.25	9.50	9.50	9.50	9.50	9.50	9.50	7.99	9.25	9.50
2-Year Treasury Note (%)	6.57	6.25	6.20	6.15	6.15	6.15	6.15	5.43	6.40	6.15
5-Year Treasury Note (%)	6.42	6.10	6.05	6.00	6.00	6.00	6.00	5.54	6.30	6.00
10-Year Treasury Note (%)	6.18	5.90	5.85	5.80	5.75	5.75	5.75	5.64	6.10	5.75
30-Year Treasury Bond (%)	5.97	5.80	5.75	5.70	5.65	5.65	5.60	5.87	5.95	5.65

** Quoted on a discount-rate basis. All figures are period averages.
For more details see **Forecast Addendum**
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Rolling Calendar of Business Indicators

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
Sep 11	***Sep 12*** **Richmond FRB Index**—August	***Sep 13*** **Import Price Index** Jun 1.2% Jul 0.0% Aug 0.2%* **Export Price Index** Jun -0.2% Jul 0.0% Aug 0.1%* **Current Account (BOP)** 99Q4 -$96.2B 00Q1 -$102.3B 00Q2 -$106.8B*	***Sep 14*** **Initial Unemployment Claims** (week ending 9/9/00) —310,000* **Retail Sales** Jun 0.4% Jul 0.7% Aug -0.2%* **Retail Sales Ex-Auto** Jun 0.3% Jul 0.6% Aug 0.3%* **Producer Price Index** Jun 0.6% Jul 0.0% Aug 0.2%* **Core PPI** Jun -0.1% Jul 0.1% Aug 0.3%*	***Sep 15*** **Consumer Price Index** Jun 0.6% Jul 0.2% Aug 0.1%* **Core CPI** Jun 0.2% Jul 0.2% Aug 0.2%* **Business Inventories** May 0.9% Jun 0.9% Jul 0.6%* **Industrial Production** Jun 0.2% Jul 0.4% Aug 0.0%* **Capacity Utilization**—August Jun 82.2% Jul 82.3% Aug 82.0%* **Real Earnings**—August **Consumer Sentiment (Univ. of Michigan)**—Early September
Sep 18 **NAHB Builders Survey**—September	***Sep 19*** **Housing Starts** Jun 1.56M Jul 1.51M Aug 1.50M* **Housing Permits** Jun 1.53M Jul 1.51M Aug 1.50M*	***Sep 20*** **International Trade** May -$30.3B Jun -$30.6B Jul -$31.4B* **Fed's Beige Book Released** **Announce Buyback Operation**—$1.5B* **Announce 2-year Note Auction**—$10.0B*	***Sep 21*** **Initial Unemployment Claims** (week ending 9/16/00) **Philadelphia FRB Index** Jul 0.7 Aug 14.1 Sep 10.0* **U.S. Treasury Balance**—August Aug 99 -$2.8B Jul 00 4.8B **Buyback Operation**—$1.5B*	***Sep 22***
Sep 25 **Existing Home Sales** Jun 5.31M Jul 4.79M Aug 4.90M*	***Sep 26*** **Consumer Confidence** (Conference Board)—September Jul 143.0 Aug 141.1	***Sep 27*** **Durable Goods Orders**—August Jun 9.5% Jul -12.4% **Ex-Transportation Orders**—August Jun 0.5% Jul -4.8% **Auction 2-yr Note**—$10.0B* **Announce Buyback Operation**—$1.5B*	***Sep 28*** **Initial Unemployment Claims** (week ending 9/23/00) **GDP**—00Q2 Final Revision 00Q1 4.9% 00Q2 5.3% **Corporate Profits**—00Q2 **Help-Wanted Index**—August **Agricultural Prices**—September **Buyback Operation**—$1.5B*	***Sep 29*** **Personal Income** Jun 0.4% Jul 0.3% Aug 0.3%* **Personal Spending** Jun 0.4% Jul 0.6% Aug 0.3* **APICS Index**—September

* Projections – Subject to revision as additional data become available during the month.

The calendar is on **bloomberg** under **MLY <GO> 1 <GO> 12 <GO>**
Look for **"US Economic Indicators Calendar"**

Forthcoming Indicators

Wednesday, September 13

Import and Export Prices. (Released at 8:30 a.m.) We estimate that import prices rose 0.2% in August (consensus: 0.4%) as crude oil prices rose over 2%. Excluding petroleum products, import prices should be unchanged. Export prices, which are up 2.0% during the past year, should advance just 0.1% in August.

Current Account (BOP). (Released at 10:00 a.m.) The current account balance should widen further in the second quarter to -$106.8 billion (consensus: -$108.0 bil) from -$102.3 billion in the first quarter. The goods and service balance deteriorated by $5.4 billion. The other components of the current account should be essentially neutral. For this year, we project that the current account deficit should widen to $425 billion from $331 billion in 1999.

Thursday, September 14

Initial Unemployment Claims. (Released at 8:30 a.m.) Jobless claims should drift lower to 310,000 for the week ending September 9 from 316,000 in the prior week. Continuing jobless benefits should climb 46,000 to 2.23 million for the week ending September 2. The job market is not as robust as it was six months ago.

Retail Sales. (Released at 8:30 a.m.) Retail sales should fall 0.2% in August (consensus: 0.3%) and retail sales excluding automobile dealers should climb 0.3% (consensus: 0.3%). Motor vehicle sales rose to 17.5 million units from 17.0 in July. However, large seasonal factors within the retail sales report should depress that gain and dampen overall sales gains. Furthermore, the monthly chain store data was weak and gasoline prices fell in August. It appears that real consumer spending advanced at a moderate 3.5% pace in the third quarter.

Producer Price Index. (Released at 8:30 a.m.) We project that the PPI rose 0.2% in August (consensus: 0.1%) and the core PPI increased 0.3% (consensus: 0.2%). Gasoline prices appear to have dipped 5% in August, but should rebound sharply in September. Tobacco companies announced sharp price increases of 5%. Excluding tobacco prices, we estimate that the core PPI should advance only 0.1%. Deflation remains prevalent for technology, capital goods and selected consumer household durable goods.

Friday, September 15

Consumer Price Index. (Released at 8:30 a.m.) The CPI should advance just 0.1% in August (consensus: 0.2%) as a decline in gasoline prices and a jump in tobacco prices will largely offset each other. Various surveys suggest that the retail price of gasoline fell 5.3% in August, however, it should rebound in September. Other energy prices were probably not as weak in August. Tobacco prices should jump 5% as tobacco companies announced substantial prices increases in order to pay for the legal settlement. We estimate that the core CPI climbed 0.2% in August (consensus: 0.2%) and excluding tobacco prices advanced just 0.1%.

Industrial Production and Capacity Utilization. (Released at 9:15 a.m.) Industrial production should be unchanged in August (consensus: 0.0%) after a 0.4% gain in July. Manufacturing aggregate hours worked fell sharply in August. However, other weekly and monthly indicators of factory production suggest somewhat better performance. Motor vehicle production was strong in preparation for the new model year. We estimate that motor vehicle production should climb 2.5%. Excluding the motor vehicle sector, factory production probably fell about 0.5%. Technology production, while still strong, probably slowed from the 3.6% gain witnessed in July. Capacity utilization should fall to 82.0 in August (consensus: 82.0) from 82.3 in July.

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