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12-30-99

WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

December 17, 1999

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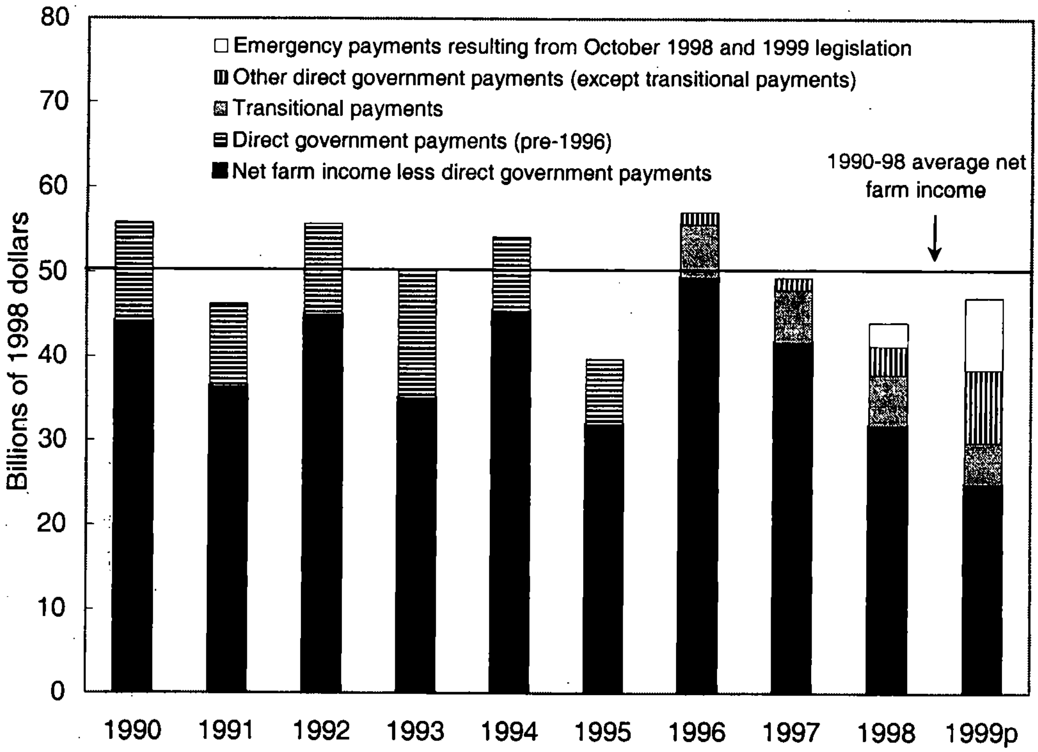
CHART OF THE WEEK

Net Farm Income in the 1990s



In 1999, net farm income excluding direct government payments (the black part of the bars) was well below its average level for the 1990s. However, direct government payments excluding the emergency payments legislated in October 1998 and 1999 would have substantially moderated the effects of the 1998-99 decline in market income. With those emergency payments included, farmers were substantially shielded from the effects of market forces in 1998-99.

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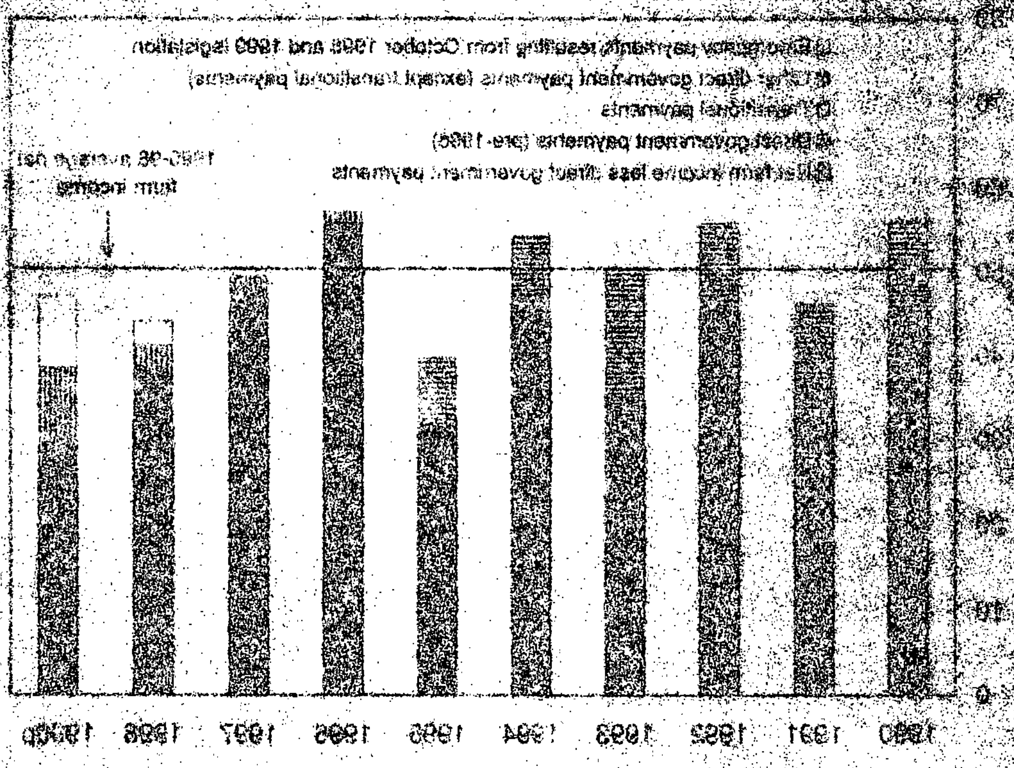

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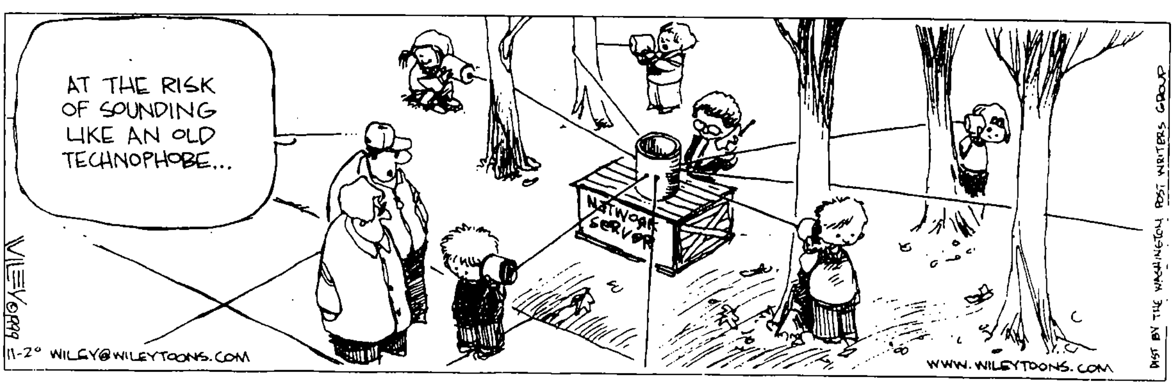
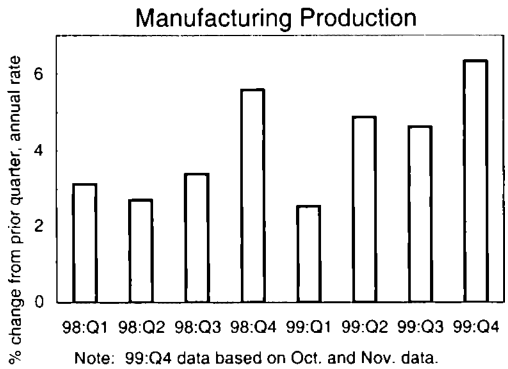


MACROECONOMIC UPDATE

More Strong Growth in the Fourth Quarter

The fourth quarter is shaping up as another of strong growth (around 4¾ percent at an annual rate) with low and stable inflation.

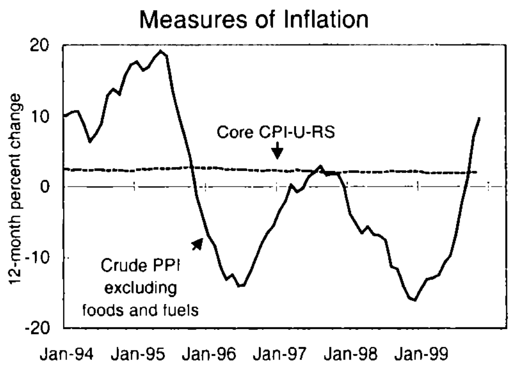
The labor market. Payroll employment grew by an average of 250,000 per month in October and November, and total hours of production workers have increased at a 2½ percent annual pace thus far in the fourth quarter. Adding trend growth in productivity (probably around 2¼ percent at an annual rate), these hours could support GDP growth of about 4¾ percent at an annual rate.



Production. Data on production are also robust. Manufacturing industrial production has grown at a 6¼ percent annual rate so far in this quarter—which promises to be the strongest quarterly increase in 2 years (see upper chart). The acceleration may reflect exports to improving foreign economies.

Spending. Spending data remain fragmentary. Solid data are available for consumer spending—where fourth quarter growth appears to be about 4¾ percent at an annual rate. Consumer sentiment is fluctuating around the high plateau at which it has persisted for most of the year. One worry is that some of the fourth-quarter spending may represent advance hoarding to buffer against potential Y2K disruptions. If so, the first quarter of next year may be weak.

Inflation. With the exception of energy and tobacco prices, consumer inflation remains low and stable. Core consumer prices rose just 2.1 percent during the past 12 months—down slightly from the year-earlier pace. However, some inflationary risk is on the radar screen: the rise in oil prices may get passed through to other goods, and a strengthening world economy may lead to higher import and export prices over the next year. Both influences may be pushing up prices at the earlier stages of processing. For example, the index for crude materials excluding foods and fuels has increased 10 percent over the past year—a dramatic acceleration from a 16 percent decline during the year-earlier period (see lower chart).



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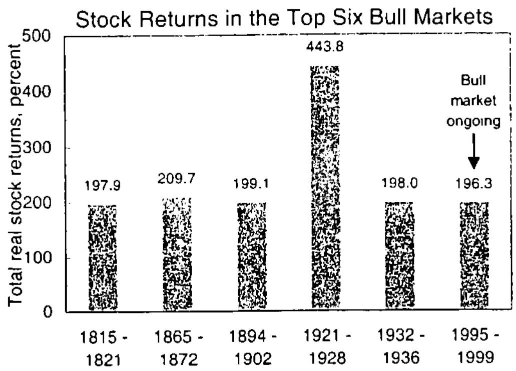
SPECIAL ANALYSIS

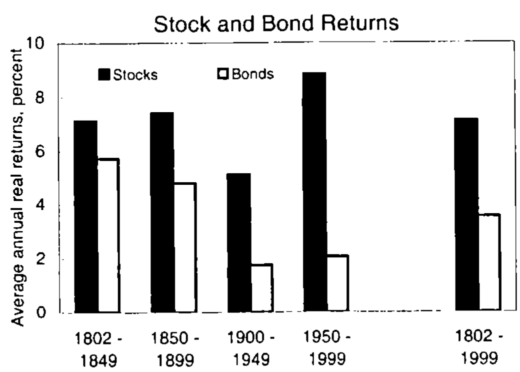
Trying to Make Sense of the Bull Market

In the exceptional stock market of the last 5 years, investors have earned an annual real return of over 24 percent—the highest 5-year average real return since 1936. Already, this market ranks as the sixth best of all U.S. bull markets of the last 200 years, based on the total real return to stocks (see upper chart). Although some economists remain puzzled by the exuberance of markets, others argue that changes in the economy help reconcile the stock market performance with economic theory.



Stock valuation in theory. Owning a stock provides an investor with the right to a share in the corporation's future profits. Hence, the stock's price should equal the discounted value of future profits. Future income is discounted to reflect two factors: the opportunity cost of waiting (equal to the return on a safe asset such as a Treasury bond) and the premium that compensates the investor for the greater riskiness of stock returns relative to bond returns. Strong growth in profits paid as dividends and falling real bond rates appear to explain part, but not all, of the nearly 200 percent increase in stock prices over the last 5 years.

A declining equity risk premium? Investors demand a higher return on stocks than on bonds because stocks tend to be riskier than bonds over horizons of a few years or less. What is surprising to economists is how large the equity premium has been, particularly in the last 50 years (see lower chart). The additional volatility of stock returns over that of bond returns does not appear large enough to justify this 7 percentage point premium, unless investors are extraordinarily risk-averse or their investment horizon is very short. One possible explanation for the recent run-up in stock prices, therefore, is that investors have re-evaluated the risks associated with holding stocks and have bid up stock prices until the rate of return on stocks has come down enough to reflect a new, lower equity risk premium.



A new economy? A second possible explanation for the strong performance of the stock market is that investors may have raised their forecasts of future growth in profits, based on an improved outlook for productivity growth. According to

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some models, holding other influences on stock prices constant, a one-half percentage point increase in the expected growth of future profits implies an increase in stock prices of up to 50 percent. Importantly, what is relevant for stock prices is not whether long-run growth trends have in fact changed, but only that investors perceive that they have. In the event that economic developments do not meet these expectations, investors will bid stock prices back down.

Conclusion. The truly exceptional performance of the stock market over the last 5 years is partly attributable to strong increases in profits and a fall in real bond rates. Other factors, including a more tolerant attitude toward risk and an increase in expected productivity growth, may also be boosting stock prices. A remaining question is whether these and other influences that have helped power the bull market have nearly played themselves out, in which case the stock market should cool, or whether we can expect more years of rapid increases in stock prices.

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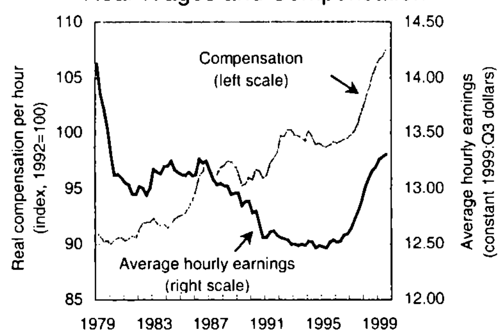
ARTICLE

Inequality in the 1990s: Is the Gini Back in the Bottle?

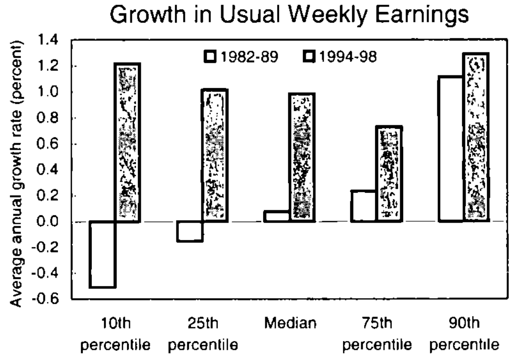
After increasing since the late 1970s or even earlier, many measures of income and wage inequality have remained stable since 1993-94. Interestingly, the usual suspects for the increase in inequality—globalization, technological change, and de-unionization—appear to have proceeded apace even as the rise in inequality has been arrested.

Trends. A range of indicators that showed sluggish wage growth and rising inequality from the early 1970s to the early 1990s appear to have turned around recently.

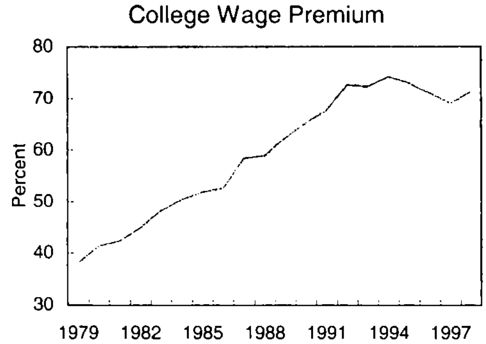
Real Wages and Compensation



Growth in Usual Weekly Earnings



College Wage Premium



Real wages and labor's share. Both average hourly earnings and nonfarm real compensation per hour have increased sharply in the past few years (see upper chart). The share of income received by workers in the form of compensation has shown no long-term trend relative to capital's share (and has increased some since 1996).

Income and earnings inequality. Various measures of income inequality (including the index of income concentration known as the Gini coefficient) rose substantially between the mid-1970s and the early 1990s. But inequality has changed little since then. In this expansion, both wages and household income have increased roughly in the same proportion at different points in the income distribution. This contrasts with the 1980s expansion, when the gains were concentrated among higher income households and higher wage workers (see middle chart).

The college wage premium. After shooting up sharply in the 1980s, the wage premium earned by workers with a college degree has stabilized (see lower chart). The average weekly earnings of full-time workers with

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college degrees, which in 1979 were about 40 percent higher than those of workers with a high school diploma, have been about 70 percent higher in the 1990s.

The paradox. The apparent trend shift in measures of inequality might not be surprising if the major forces adduced to explain the rise in inequality in the 1980s were not still operating in the 1990s. But they appear to be.

- Globalization. In the 1980s the increase in trade, particularly with developing countries, was seen as reducing demand for relatively less-skilled workers. Yet in the 1990s globalization has increased even more rapidly. For example, the sum of imports and exports as a share of GDP averaged under 19 percent in the 1980s and over 22 percent in the 1990s.

- Technological change. According to many, an even more important source of the increased relative demand for skilled workers in the 1980s was technological change, such as the broader application of computers and new management approaches emphasizing leaner and more flexible production. Yet in the 1990s, technological change seems to be even more rapid, as evidenced by the strong investment in computers and information technology, and the surge in productivity growth.

- Institutional and structural changes. In the 1980s, de-unionization and deregulation weakened the bargaining power of workers and the declining share of manufacturing in employment reduced high-wage opportunities for less-skilled blue-collar workers. Yet in the 1990s, union membership has continued to decline and, after rising through 1997, manufacturing employment has fallen.

Analysis. There are several plausible reasons why inequality has not been affected by these forces in the same way recently as it was in the 1980s.

- The high pressure economy. Tight labor markets generate increased employment opportunities for less skilled workers and may also launch a virtuous circle in which new opportunities lead to new skills and higher productivity, which in turn may allow for labor markets to operate at higher levels without upward pressure on prices.

- Feedback from globalization and technology to the economy. Ironically, the forces that were seen as working toward increased inequality may have helped to achieve a high pressure economy. First, lower import prices help keep inflation low; imports also reduce pressures on domestic capacity. Second, positive shocks to productivity from technological change allow firms to pay higher wages without having to raise prices. And third, it could be that a more competitive economy is less inflation-prone.

- The trends themselves may have been brought to a halt by offsetting microeconomic forces. Skill bias is not divinely ordained, and firms may increasingly find ways to employ relatively less-educated workers more effectively as their relative wages decline. Second, the pressure on employment patterns and wages from globalization may diminish as U.S. firms either exit from low-wage activities or learn how to compete using competitive strategies that offset cheaper foreign labor costs. Similarly, declining union membership may mean that those who remain are in areas with continued bargaining strength.

Conclusion. The halt to rising inequality is surprising in light of the usual explanations for why inequality increased in the first place. However, there are some plausible explanations for this development. While the macroeconomic explanation implies that inequality could reverse in the face of higher unemployment, the microeconomic considerations suggest that we may have a more resilient economy and may finally be reaping the benefits of having adjusted to some major structural challenges. Claims that globalization and rapid technological change inevitably increase inequality need to be re-appraised.

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

The Impact of Changes in Financial Services Industries on Cities. Financial services firms have been an important source of jobs, income, and tax revenue in cities, especially in central business districts. A recent study observes that, as of 1996, 8.5 percent of employment and 14.5 percent of earnings in 88 of the largest central cities were in financial services. Some cities, such as Hartford, Wilmington, and Jersey City, are highly specialized in financial services, with approximately 20 to 30 percent of city employment in this sector. In many larger cities—including New York City, Chicago, Boston, and San Francisco—over 10 percent of the jobs and 20 to 30 percent of the residents' earnings are found in financial services. The study finds that, especially in banking, heavy investments in information technology such as the automated teller machine, telephone calling centers, on-line banking and the in-store supermarket branch have led to decreases in employment, especially for lower-skilled workers. Mergers and acquisitions have concentrated banking assets in a number of core banking metropolitan areas, with Charlotte and New York currently in dominant positions. Geographic concentration is less noticeable in other sectors. For example, mutual fund assets have actually become less concentrated, with New York's share falling from 40 to 24 percent between 1986 and 1996.

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Racial Digital Divide Extends Beyond Income Differences. The latest digital divide data from the Commerce Department show that in 1998 African American and Hispanic households were approximately half as likely to have computers at home and roughly two-fifths as likely to have Internet access than white households. While computer ownership and Internet access for all groups have soared, the racial/ethnic divide has also grown. Because computer and Internet use are correlated with income and education, some of the divide reflects lower average household income and lower average educational attainment among African Americans and Hispanics. However, a recent RAND analysis of the 1997 survey data finds that a digital divide persists even after controlling for education, income, location of residence, sex, and age. In other words, racial and ethnic characteristics appear to exert an independent and important influence on home computer access and network use.

c Ben Johnson
Maria E.

Assessing the Costs of Student Loans. A recent report from the Department of Education demonstrates how budget rules mandated by the Credit Reporting Act of 1990 tend to obscure program costs for student loans. Under such rules, estimates of subsidy costs for student loans are calculated on a present value basis while estimates of Federal administrative costs reflect actual spending in a given year. When both subsidy and administrative costs are calculated on a net present value basis, the report concludes that providing a student with a $10,000 subsidized loan costs $1,407 whereas the government makes $411 when the same loan is provided directly to the student. This difference reflects the interest received on repayments of the direct loans, which more than offsets the higher administrative expenses of direct loans.

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INTERNATIONAL ROUNDUP

Japan's Tenuous Recovery. Although output grew at an annual rate of around 5 percent in the first half of the year, recent data suggest that Japan's economic recovery has not yet fully taken hold. Last week, preliminary data showed that real GDP fell at a 3.8 percent annual rate in the third quarter. This week, the Bank of Japan's quarterly Tankan survey showed that while business sentiment improved somewhat, companies still had excess inventories and planned to further reduce investment in plant and equipment. Large enterprises, for example, planned to cut capital spending by 11 percent in the 1999 fiscal year; furthermore, many of these enterprises reported that they had too many workers, which bodes poorly for a revival in consumer confidence. Japan's Economic Planning Agency also cautions that high unemployment, weak private demand, and a sustained decline in business fixed investment remain obstacles to full economic recovery, despite recent improvement in exports, industrial production, and company profits.

Trade Unions to Unite. On January 1, 2000, a new international organization of trade unions will be launched, incorporating 16 million members in 800 unions from 140 countries. The organization, called Union Network International (UNI), will be the world's largest grouping of individual trade unions, and will cover a range of non-manufacturing sectors, including commerce, electricity, finance, media, entertainment, postal, private health care, telecommunications, and tourism. The organization is pressing for an overhaul of the WTO and for trade agreements to incorporate international core labor standards, including the right to organize into unions. UNI intends to use the latest communications technology to build networks with affiliates and to give union members a more effective voice with governments, multinational corporations, and international institutions.

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Food Gap to Increase in Low-Income Countries. For 67 low-income developing countries, the food gap—defined as the shortfall between a) domestic food production plus commercial imports and b) the level required to meet minimum nutritional requirements—is estimated to be 15 million tons in 1999, according to a new USDA report. Global food aid shipments for 1998/99 are estimated at roughly 9.5 million tons, almost two-thirds of the shortfall. However, the distribution of this aid is not necessarily based on nutritional need; for example, only 23 percent of food aid goes to Sub-Saharan Africa, covering just 20 percent of the region's food shortfall. Distribution is likely to become more important over the next decade. The food gap for the 67 countries is expected to increase 54 percent to 23 million tons, with Sub-Saharan Africa accounting for 70 percent of the gap in 2009. The total number of people whose food consumption fails to meet nutritional requirements is projected to grow 13 percent to nearly 1 billion; however, the growth in Sub-Saharan Africa will be 40 percent, so that 60 percent of the region's population will be food deficient in 2009.

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Gene/Sandy
Shouldn't we ask for more $ in budget for this - better way to help farmers - to keep prices up
BC

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Gene/Sandy
Should we ask for more $ in budget for this — better way to help farmers — to keep prices up
BC

RELEASES THIS WEEK

Housing Starts

****Embargoed until 8:30 a.m., Friday, December 17, 1999****

Housing starts decreased 2 percent in November to 1.600 million units at an annual rate.

U.S. International Trade in Goods and Services

The goods and services trade deficit rose to $25.9 billion in October from $24.2 billion in September.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production increased 0.3 percent in November. Capacity utilization was unchanged at 81.0 percent.

Retail Sales

Advance estimates show that retail sales rose 0.9 percent in November following an increase of 0.3 percent in October. Excluding sales in the automotive group, retail sales rose 0.4 percent following an increase of 0.8 percent.

Consumer Price Index

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

MAJOR RELEASES NEXT WEEK

Gross Domestic Product (Wednesday)
Advance Durable Shipments and Orders (Thursday)

U.S. ECONOMIC STATISTICS

	1970-1993	1998	1999:1	1999:2	1999:3
Percent growth (annual rate)					
Real GDP (chain-type)	3.0	4.6	3.7	1.9	5.5
GDP chain-type price index	5.2	1.1	2.0	1.3	1.1
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	3.1	2.7	0.6	4.9
Real compensation per hour:					
Using CPI	1.0	3.9	2.8	1.2	2.1
Using NFB deflator	1.5	4.7	2.9	2.9	4.4
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.5	12.6	12.6	12.8
Residential investment	4.5	4.2	4.4	4.5	4.4
Exports	8.2	11.0	10.7	10.7	10.9
Imports	9.2	12.7	12.9	13.4	13.8
Personal saving	6.6	2.6	2.2	1.8	1.5
Federal surplus	-2.8	0.5	1.1	1.3	1.4

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

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

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1997	1998	October 1999	November 1999	Dec. 16, 1999
Dow-Jones Industrial Average	7441	8626	10397	10810	11245
Interest Rates (percent per annum)					
3-month T-bill	5.06	4.78	4.86	5.07	5.23
10-year T-bond	6.35	5.26	6.11	6.03	6.31
Mortgage rate, 30-year fixed	7.60	6.94	7.85	7.74	7.86
Prime rate	8.44	8.35	8.25	8.37	8.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level December 16, 1999**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	1.017	0.1	N.A.
Yen (per U.S. dollar)	103.0	0.5	-10.9
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	93.26	0.2	1.1

International Comparisons [1]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	4.2 (Q3)	4.1 (Nov)	2.6 (Nov)
Canada	4.2 (Q3)	7.2 (Oct)	2.3 (Oct)
Japan	1.0 (Q3)	4.7 (Oct)	-0.7 (Oct)
France	3.0 (Q3)	11.0 (Sep)	0.8 (Oct)
Germany	1.2 (Q3)	9.0 (Oct)[2]	0.8 (Oct)
Italy	0.8 (Q2)	12.1 (Apr)	1.8 (Oct)
United Kingdom	1.8 (Q3)	5.9 (Aug)	1.2 (Oct)

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