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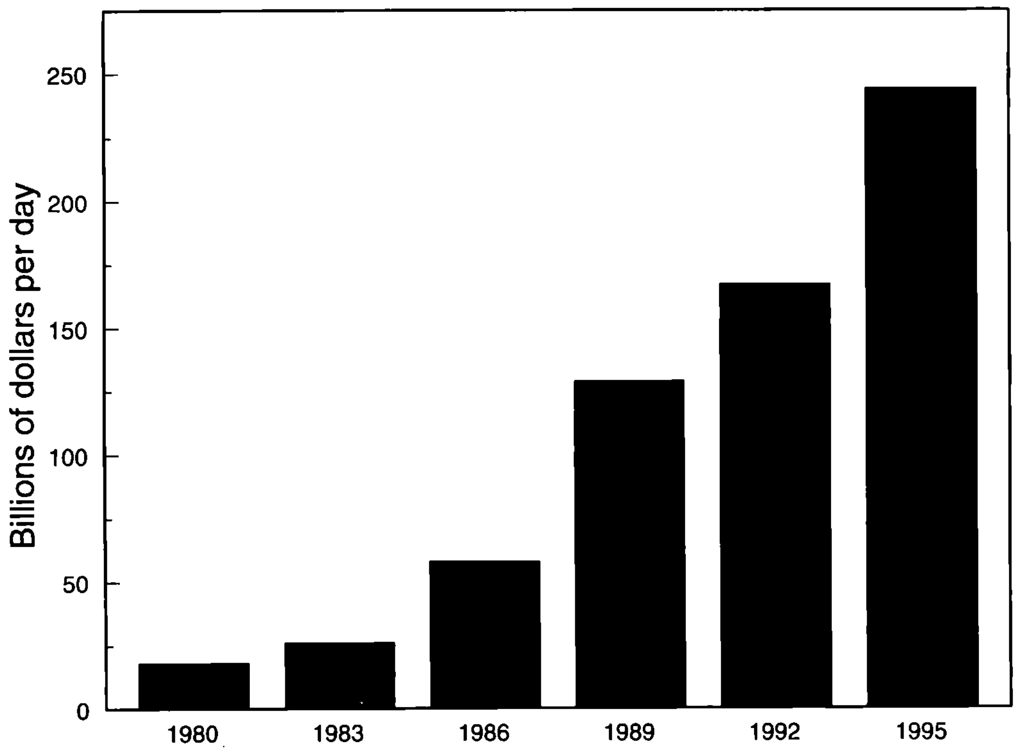
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 22, 1995

CHART OF THE WEEK

Daily Turnover in the U.S. Foreign Exchange Market



Major central bank reports on foreign exchange trading, released this week, indicate much stronger growth in the volume of trading over the past 3 years than many analysts had expected. London remains the world's largest foreign exchange market, with daily trades over $460 billion, followed by New York. The reports also show that transactions in the forward market have grown in importance.

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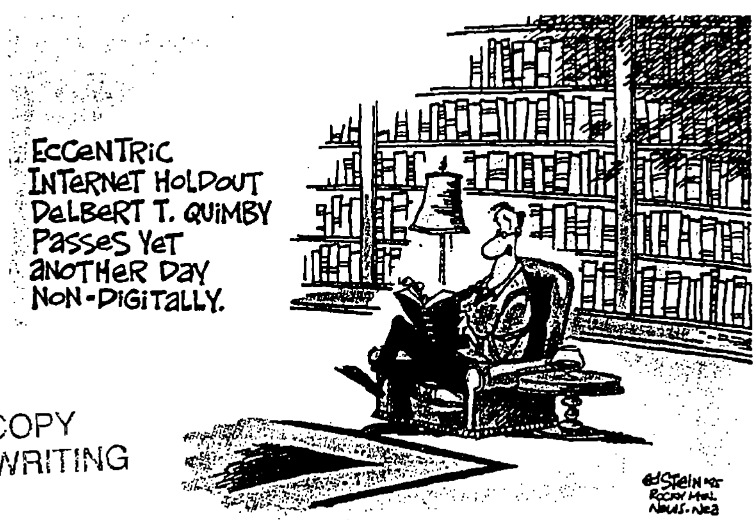

PHOTOCOPY
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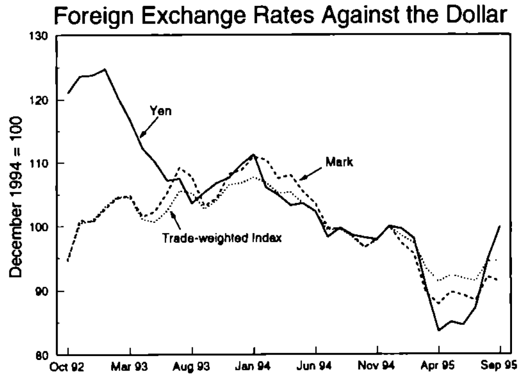
CURRENT DEVELOPMENT

The Rebound of the Dollar

Since early July, the U.S. dollar has rallied strongly on world currency markets. Its rise has been sharpest against the yen, where the gain is about 20 percent, but the dollar has also risen against the deutsche mark and on average against the currencies of our major trading partners (see chart).

Reasons for the dollar's ascent include large interest rate differentials in favor of the dollar. Recent Treasury Department intervention, in coordination with foreign central banks, has been particularly successful in catching traders off-guard, producing relatively large short-run movements.



Effects on the U.S. Economy. The rebound in the dollar reverses its sharp depreciation early this year, and largely restores exchange rates to December 1994 levels. An exchange rate cycle lasting only 9 months would be expected to have only limited short-run effects on the U.S. economy, and essentially no net effects after 1 year. Manufacturers' planning horizons typically extend over a much longer period and are based on longer-term trends in real exchange rates. Thus, little of the depreciation earlier this year showed up in import prices before the dollar rebounded: between December 1994 and July 1995 the prices of imports from Japan rose only 4.8 percent, while those from the European Union rose by 3.7 percent.

Despite the recent appreciation of the dollar, the United States remains a highly competitive economy. U.S. real exchange rates based on unit labor costs today are back to early 1990 levels, while Germany and Japan have seen their costs rise relative to their competitors.

SPECIAL ANALYSIS

Contingent Workers

As reported recently in the New York Times, employers' use of contingent workers is growing, but is not as widespread as some estimates have suggested. Unfortunately, there is no common definition for "contingent worker," and estimates of the number of such workers have varied widely.

In 1995, the Bureau of Labor Statistics established a measure of the number of these workers that includes wage and salary workers who believe their jobs are temporary, as well as self-employed workers and independent contractors who do not expect to be with their client for more than one additional year. Using this definition, the BLS survey in February 1995 found that 4.6 percent of the labor force and 4.9 percent of all employed persons were contingent workers. In other words, in addition to the 5.4 percent of the labor force that were unemployed in that month, another 4.6 percent believed that their jobs were only temporary. Contingent workers were more likely to be young, female, black or hispanic, and part-time workers. They also were less likely to have health insurance.

Is the number growing? The BLS does not have historical data on trends in contingent employment since the new measure was added just this year. But other evidence suggests that the number of contingent workers has grown considerably over time. For instance, the number of persons employed at temporary help agencies—one component of the contingent workforce—grew from 0.9 percent to 1.4 percent of private nonfarm payroll employment between 1985 and 1990 and to 2.2 percent in 1995.

Should we be concerned? Economists disagree as to whether growth in the number of contingent workers signals a weakness or a strength of the U.S. labor market. On one hand, greater uncertainty about future employment is one way in which jobs at the bottom of the labor market have deteriorated. On the other hand, contingent workers can provide greater flexibility for management to tailor its workforce to its needs.

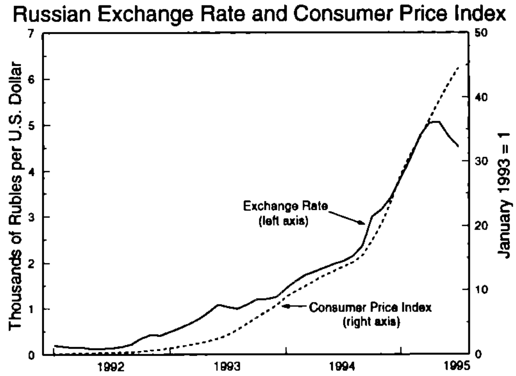
TREND

The Resurgent Russian Ruble

Inflation in Russia averaged 17 percent per month (about 550 percent per year) between January of 1992 and January of this year. This high inflation—the result of monetary credits used to finance large budget deficits—battered the Russian ruble, which fell in value from 180 rubles per dollar in early 1992 to about 4,500 per dollar in the middle of this year (see chart).

Policy measures. In March of this year, the Russian government and central bank announced a new program to combat inflation. The program, which was devised with the assistance of the International Monetary Fund, limits the budget deficit and credit growth. It seems quite successful thus far. The Federal budget deficit in the first half of this year was 3.2 percent of GDP, down from 9.2 percent a year earlier. And monthly inflation fell from 18 percent in January to 5 percent in July.

Russian Exchange Rate and Consumer Price Index



Building on their initial success in reducing inflation, the authorities issued a promise in July to maintain the exchange rate within a zone of 4,300 to 4,900 rubles to the dollar. Since then, the demand for rubles has surged: the Central Bank has been forced to sell rubles (and buy dollars) in order to ensure that the ruble does not gain too much value. As a result, Russia's foreign exchange reserves rose from $2 billion in January to $10 billion in June.

Analysis. Very high inflation causes significant and often unexpected costs. A target for the exchange rate can help to reduce high inflation by anchoring some domestic prices to those abroad and by serving to bolster the government's credibility. Many stabilization programs (such as the ones implemented by Israel in 1985 and Argentina in 1991) have used exchange rate targets.

Pegging the exchange rate is not a panacea. The exchange rate target is likely to collapse relatively quickly unless it is accompanied by other fundamental policy changes, such as reductions in the budget deficit. And maintaining an exchange rate target for a long time—even if it were feasible—might not be desirable. Unless inflation falls rapidly, exporters will be squeezed between rising domestic costs (driven up by the domestic inflation rate) and roughly constant revenues (held down by the fixed exchange rate). While policymakers must ensure that these costs do not become excessive, temporarily pegging the exchange rate can be an important tool in stopping very high inflation and its associated distortions.

ARTICLE

The Advisory Commission on the CPI: Interim Report

The Advisory Commission to Study the Consumer Price Index last week released its interim report, in which it estimates that the CPI as presently calculated overstates changes in the true cost of living by about 1.5 percentage points per year. Of this bias, the Commission believes 0.5 percentage point will be eliminated by changes in the formula used to compute the CPI when its next update occurs in 1998. The remaining bias of 1.0 percentage point, which actually may range from 0.7 to 2.0, will be more difficult to eliminate. The Commission, which was appointed earlier this year by the Senate Finance Committee, consists of five experts in the fields of economics and statistics. All of these experts were on record prior to appointment as believing that the bias in the CPI is large. The Commission will present its final report in June 1996.

Analysis. Although the CPI is a good measure of the price of a fixed market basket of consumer goods and services over time, it tends to overstate changes in the cost of living. Both the Bureau of Labor Statistics and the Commission have identified the reasons for this bias.

- **Technical problems.** The CPI suffers from problems in the way it combines the prices of thousands of products and services into the aggregate index. For example, its formula exaggerates the effect of price increases after a sale. The BLS is aware of these problems and will reduce them when the CPI is updated in 1998. <u>These corrections are estimated by the Commission to account for a 0.5 percentage point overstatement of the cost of living</u>.

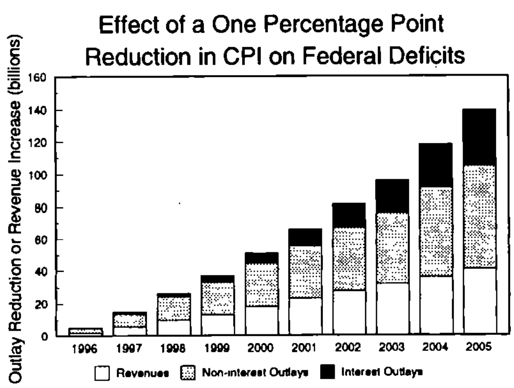
- **Substitution toward low-priced products.** Because the market basket used to create weights for constructing the CPI is updated only about once every 10 years, the fixed weights do not allow for substitution by consumers away from those goods and services whose prices are rising faster than others. For this reason, the CPI overweights products whose prices are rising rapidly and underweights products whose prices are rising more slowly, biasing the overall index upward. This bias tends to increase slightly over time as the base period recedes further into the past. <u>The Commission estimates that substitution bias causes the CPI to overstate changes in the cost of living by about 0.3 percentage point per year</u>.

- **Substitution toward discount outlets.** In recent years, consumers have been shopping more and more at discount warehouse stores. The BLS presently attributes the lower prices at these new discount stores primarily to differences in the quality of service compared with older traditional retail outlets, and not to an actual decline in price. While some of the price differences may well be due to the lower level of service at discount stores, these stores are gaining market share, indicating that consumers do not believe the price differences are offset entirely by differences in the quality of service. The Commission estimates that outlet bias causes the CPI to overstate changes in the cost of living by about 0.2 percentage point per year.

- **Changes in the quality of products.** An increase in the price of a product that reflects an increase in quality should not be recorded as a rise in the cost of living. The BLS accounts for some of these quality changes; for example, automobile price increases that are judged to reflect improvements in quality (e.g., airbags or anti-lock brakes) are not passed through into the CPI. But BLS does not attempt to correct for quality improvements in many other areas. The reason, in part, is that methods for measuring changes in quality require large amounts of data that often cannot be collected and analyzed within the monthly time frame for producing the CPI. The Commission estimates that quality-change bias causes the CPI to overstate changes in the cost of living by about 0.2 percentage point per year.

- **New products.** The BLS includes new products in the index only with a substantial time lag. For example, the microwave oven was first included in 1978, and the VCR and personal computer in 1987, several years after these products first appeared in the marketplace. Thus, much of the usual rapid decline in the price of new products, particularly electronic ones, is missed because of the delay in introducing new products into the market basket. The Commission estimates that new-product bias causes the CPI to overstate changes in the cost of living by about 0.3 percentage point per year.

Assessment. Most economists agree about the significance of the first two types of bias, but there is wide disagreement about the magnitudes of the three other types. For instance, difficulty in estimating the value of quality changes is one reason that such changes frequently are not reflected in the CPI. Recent budget cuts proposed in the Republican-sponsored appropriation bill funding the BLS likely will limit on-going efforts to improve the CPI.



Budgetary Implications. According to estimates from the Congressional Budget Office, a reduction of 1 percentage point in the annual rate of inflation used to index Federal government programs and the income tax system starting in fiscal 1996 would reduce the deficit for fiscal year 2005 by $140 billion (see chart). Roughly $41 billion of this reduction would come from higher Federal revenues, $64 billion from lower outlays, and $34 billion from lower interest payments. The cumulative reduction in the Federal deficit amounts to $634 billion by the end of fiscal year 2005, which is more than half of the total in the Administration's 10-year plan to balance the budget.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Study Finds EITC Increases Labor Force Participation. A recent National Bureau of Economic Research study finds that the 1987 expansion of the Earned Income Tax Credit, together with other features of the Tax Reform Act of 1986, increased the rate of labor force participation among female household heads from 73.1 percent to 74.5 percent. The increase was statistically significant and largest among low-educated and low-income women with children. Interestingly, the study found no evidence of reduced hours of work among people whose incomes were in the phase-out range and thus were subject to positive marginal tax rates, even though economic theory would predict that such people would respond to the EITC expansion by working less. The study's authors conclude that compared to other government antipoverty efforts, the EITC appears to produce little distortion of work incentives. While these findings are encouraging, it is important to keep in mind that the 1987 expansion was significantly smaller than the 1993 expansion, and data allowing similar study of that expansion are not yet available.

Survey Examines Americans' Views on Retirement and Savings. In a new survey of full-time workers aged 25 to 64, Merrill Lynch reports that about half of respondents fear they will outlive their nest eggs. While about seven in ten expect to be better off in the next 5 years, most believe they will have to stretch their savings further in retirement than their parents did. Few Americans believe that Social Security benefits will be sufficient for their retirement years, yet Merrill Lynch reported in April that baby-boomers (ages 31-49) currently save too little to meet their retirement goals. Moreover, 86 percent believe that Social Security and Medicare will be cut back. At the same time, 85 percent of respondents believe the government does not do enough to encourage Americans to save for the future.

New Book Touts Empowering of Employees. A recently released book, titled Open-Book Management: The Coming Business Revolution and written by a senior writer at Inc. magazine, argues that a company can tap the creativity and intelligence of its workforce by giving employees the information they need to understand the company's overall performance and their own contribution to it. According to the author, numerous companies have found that employees who are informed and aware of the company's financial situation are motivated to seek solutions to problems and assume a greater degree of responsibility for the company's performance. The author points to several principles of open-book management: timely sharing of crucial financial information with employees; educating employees to understand that information and empowering them to apply it to their own work; and offering employees a stake in the successful implementation of their ideas. The book has received favorable reviews from readers in business and academia.

RELEASES THIS WEEK

Housing Starts

Housing starts rose slightly in August to 1.40 million units at a seasonally adjusted annual rate. For the first 8 months of 1995, housing starts were down 8 percent compared with the same period a year ago.

U.S. International Trade in Goods and Services

The goods and services trade deficit was $11.5 billion in July; it was $11.3 billion in June.

MAJOR RELEASES NEXT WEEK

Consumer Confidence—Conference Board (Tuesday)
Advance Durable Orders (Wednesday)
Gross Domestic Product (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:4	1995:1	1995:2
Percent growth (annual rate)					
Real GDP:					
Fixed weights	2.5	4.1	5.1	2.7	1.1
Chain weights	2.7	3.7	4.0	1.7	0.5
GDP implicit price deflator:					
Fixed weights	5.5	2.3	1.3	2.2	1.6
Chain weights*	5.4	2.7	2.5	2.8	2.2
Productivity, nonfarm business (NFB):					
Fixed weights	1.2	1.8	4.3	2.5	4.8
Chain weights	1.4	0.9	1.4	0.2	2.9
Real compensation per hour (NFB):					
Using CPI	0.6	0.6	1.5	1.0	0.1
Using NFB deflator:					
Fixed weights*	1.1	1.1	2.9	2.9	2.1
Chain weights*	1.2	0.7	2.2	1.8	1.4

* CEA estimates.

	1970–1993	1994	1994:4	1995:1	1995:2
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	13.0	13.6	13.9
Residential investment	4.7	4.3	4.3	4.2	4.0
Exports	8.0	12.3	12.8	12.9	13.1
Imports	9.2	14.4	14.8	15.1	15.4
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.4	3.8	2.9
Federal surplus	−2.8	−2.4	−2.3	−2.1	−1.8

	1970–1993	1994	June 1995	July 1995	August 1995
Unemployment Rate	6.7**	6.1**	5.6	5.7	5.6

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

	1970–1993	1994	June 1995	July 1995	August 1995
Payroll employment (thousands)					
increase per month			299	6	249
increase since Jan. 1993					7325
Inflation (percent per period)					
CPI	5.8	2.7	0.1	0.2	0.1
PPI-Finished goods	5.0	1.7	−0.1	0.0	−0.1

FINANCIAL STATISTICS

	1993	1994	July 1995	Aug. 1995	Sept. 21, 1995
Dow-Jones Industrial Average	3522	3794	4685	4639	4767
Interest Rates					
3-month T-bill	3.00	4.25	5.42	5.40	5.24
10-year T-bond	5.87	7.09	6.28	6.49	6.21
Mortgage rate, 30-year fixed	7.33	8.36	7.61	7.84	7.57
Prime rate	6.00	7.15	8.80	8.75	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Sept. 21, 1995**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.435	−3.4	−7.3
Yen-Dollar	100.1	−2.4	+2.2
Multilateral $ (Mar. 1973=100)	84.74	−2.5	−3.3

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	3.2 (Q2)	5.6 (Aug)	2.6 (Aug)
Canada	2.5 (Q2)	9.8 (Jul)	2.5 (Jul)
Japan	0.6 (Q2)	3.2 (Jun)	0.3 (Jun)
France	2.8 (Q2)	12.4 (Apr)	1.4 (Jul)
Germany	2.1 (Q2)	6.5 (May)	2.3 (Jul)
Italy	4.0 (Q1)	12.2 (Apr)	5.7 (Jul)
United Kingdom	2.8 (Q2)	8.8 (Jul)	3.5 (Jul)

EYES ONLY

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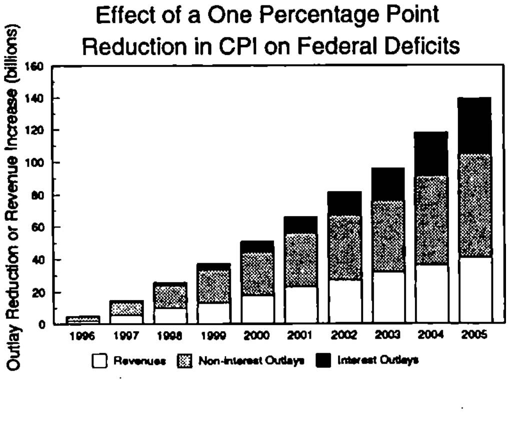

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