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BE

Weekly Economic Briefings – Oct. 1, 1999.

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10-5-99

EYES ONLY

WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

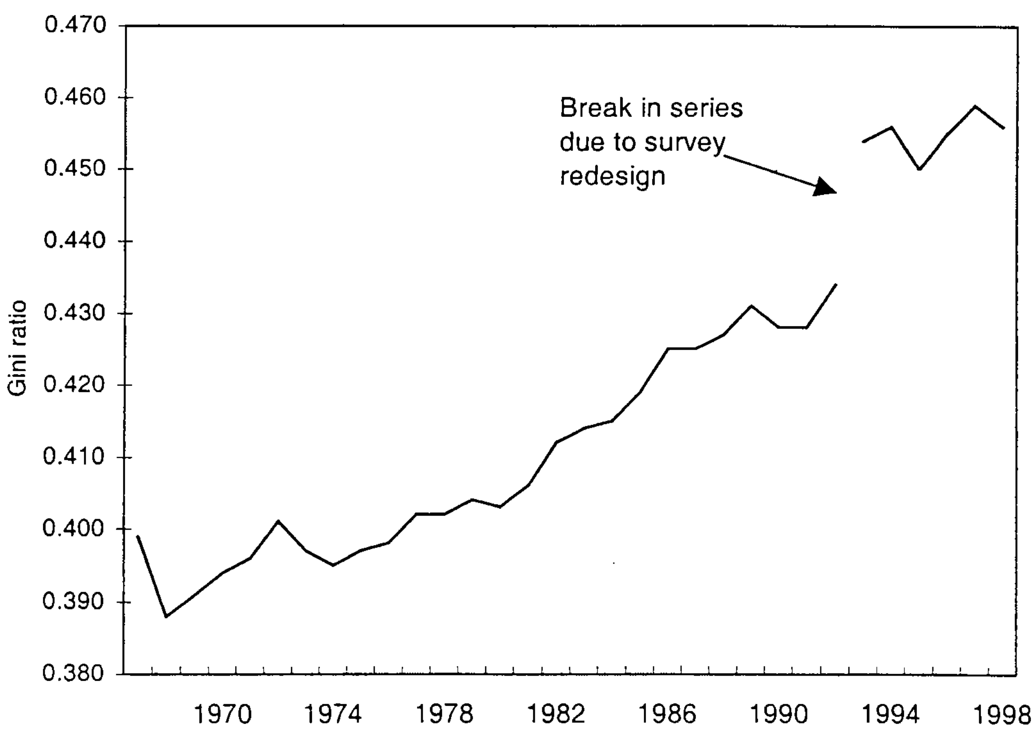
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

copied
Baily
Podesta
Pg 6:
Reed
Podesta
Pg 7:
Sperling
Podesta

October 1, 1999

CHART OF THE WEEK

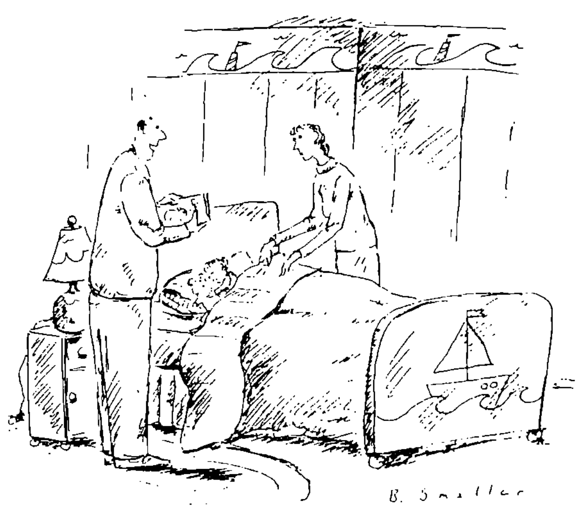
Income Inequality Has Stopped Increasing



The latest income and poverty statistics show that the Gini ratio (a measure of income inequality) fell slightly in 1998. After two decades of rising inequality, this measure has shown no significant change since 1993. (The break in the series reflects a change in data reporting that increased the measured income of the highest income households by substantially more than their actual income increased.)

EYES ONLY

CONTENTS



"Of course he looks peaceful—he's lived his entire life in a bull market."

10-5-99

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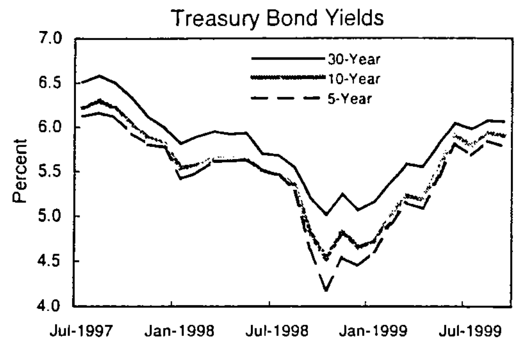
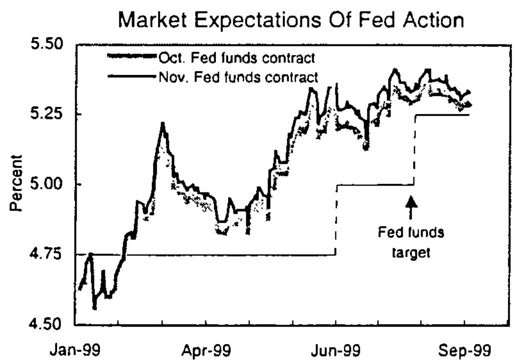
FINANCIAL MARKET UPDATE

Third Quarter, 1999

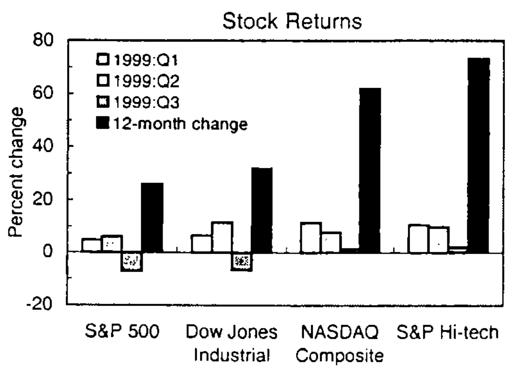
In August the Fed again raised its Federal funds target by ¼ point. Interest rates this quarter have remained near levels reached in June, and growth in stock prices has stalled.



Interest rates. Yields on Treasury securities are at their highest levels since late 1997 (see upper chart). Expectations for future rate hikes at the next FOMC meeting and beyond remain muted, with Fed funds futures contracts trading close to the current target (see middle chart).



There appears to be less apprehension over Y2K issues than earlier this quarter. One measure of the perceived risk is the premium that people are willing to pay to have access to liquidity in early January. One such measure, the spread between December and January Fed funds futures contracts, has recently retreated to under 5 basis points after widening to over 15 in July, suggesting that market anxiety over the availability of liquidity may have eased somewhat. The Fed's decision to make discount window credit readily available from October to April may have also helped dampen any tendency for money markets to tighten.



Stock prices. The major indexes were nearly flat this quarter, following sizeable gains in each of the first two quarters (see lower chart). Technology stocks grew slowly, while the Dow and the S&P 500 actually lost ground. Notwithstanding the stock market's recent sluggishness, the major indexes have all recorded strong growth over the last 12-month period.

EYES ONLY

CURRENT DEVELOPMENT

Y2K Inventory Building Could Make GDP More Volatile

As a precautionary move against possible Y2K disruptions, many businesses may advance their purchases of raw materials. This could cause an uneven pattern of GDP growth over the next few quarters.

Survey evidence. A survey just published by the National Association of Purchasing Management sheds light on how much precautionary inventory building is likely in manufacturing. Of the purchasing managers surveyed, 38 percent plan to acquire extra inventories because of Y2K concerns in commodities comprising 22 percent of their total inventories. Among the managers who anticipated the acquisition of precautionary stocks, an average extra 18-day supply of materials was expected, with the median manager beginning stockbuilding in October.

Impact on GDP. These survey results imply that precautionary stockbuilding by manufacturers will add about ½ percentage point to the annual rate of real GDP growth in the third and fourth quarters. The effect on first quarter GDP will depend on whether or not Y2K disruptions appear. If Y2K disruptions become evident after January 1, these buffer stocks of raw materials will prevent output from falling further than would happen otherwise. But if the disruptions do not appear, the overhang of these excess stocks would depress first-quarter GDP growth by about 1½ percentage points at an annual rate.

Conclusion. Although large enough to be noticed, these effects are small relative to normal fluctuations. The effect would be larger, however, if precautionary hoarding occurs elsewhere as well. For example, utilities may advance purchases of coal and oil, and consumers may hoard groceries and gasoline.

SPECIAL ANALYSIS

E-Commerce (Re)discovers the Distribution System

Much has changed in American retailing between the introduction of the mail order catalogue and the electronic commerce (e-commerce) of today. Among large retailers providing an extensive selection of consumer goods, however, one important element of their operations that appears to be unchanged is the need to operate an efficient warehouse distribution system.

Montgomery Ward and Sears. Montgomery Ward began mail order distribution of a wide variety of consumer goods in 1872, but by 1900, mail order sales at Sears exceeded those at Montgomery Ward. As Sears made an increasingly wide variety of consumer goods available through its mail order operation (ranging from jewelry and clothing to hardware and furniture), its sales expanded from less than $1 million in 1895 to more than $37 million by 1905.

Distribution problems caused by success. The increasing success in selling merchandise, however, left Sears with the problem of how to distribute efficiently all of the goods ordered through its catalogue. Initially, Sears had relied on manufacturers to ship orders directly to consumers, but delays and duplicated orders increased costs and hurt the company's reputation with its customers. To solve its distribution problem, Sears built a large, mechanized warehouse designed to centralize shipping in one location.

Centralized distribution and Wal-Mart. A similar approach was adopted by Wal-Mart to lower the distribution costs for consumer goods sold through its stores. Like Sears, Wal-Mart built centralized distribution centers to handle merchandise delivered from factories. Truckload shipments to the distribution center from suppliers are divided up for shipment to individual stores. To determine what needs to be shipped to each store, Wal-Mart uses computerized inventory equipment to keep track of which items need to be reordered, thereby increasing revenues from its shelf space. Attention to the details affecting the cost of distributing goods allowed Wal-Mart to became an effective, low-cost competitor to other mass merchants, including, ironically, the department stores operated by Sears.

E-commerce vendors. Some of the leading firms involved in today's electronic commerce have rediscovered the virtues of centralized distribution centers long employed by traditional merchants. Initially, it might have been thought that e-commerce vendors would be able to use the Internet to avoid investing in the infrastructure of traditional merchants. Recently, however, several prominent e-commerce firms like Amazon.com and Barnesandnoble.com have announced plans to create new warehouse distribution centers to hold inventory and fill the orders they receive over the Internet. Thus, even in the virtual world of Internet retailing, efficient distribution centers appear to be just as important today as they were to earlier large retailing firms at the turn of the century.

EYES ONLY

10-5-99

ARTICLE

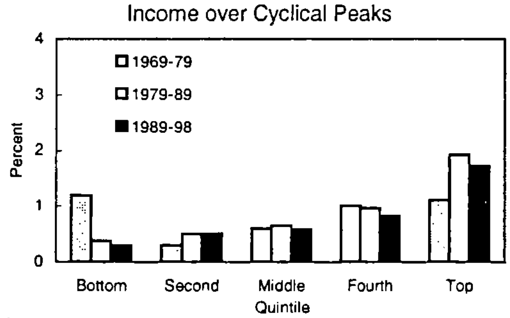
Measuring Income and Poverty

The latest statistics on income and poverty show excellent progress since 1993. Median family income adjusted for inflation is at an all-time high and the poverty rate is lower than it has been at any time since 1979. In some ways, the gains would be even more impressive if the official measures better reflected methodological improvements in measuring inflation and poverty.

Adjusting for inflation. The Census Bureau currently uses a variant of the official consumer price index to adjust its historical money income series for inflation. This variant, the CPI-U-X1, incorporates revisions to the treatment of homeownership made by the Bureau of Labor Statistics in 1983 into the CPI for the earlier 1967-82 period. This year the BLS has introduced another experimental variant, the CPI-U-RS, which incorporates most of the other improvements in its methodology made over the 1978-98 period into the CPI for that period. Using this index to adjust for inflation would add 0.2 percentage point to the average annual growth rate of income since 1993.

Trends and cycles in the growth of household income. Officially, real median household income did not surpass its 1989 level until 1998, and the average income of the bottom fifth of the distribution has barely edged above its 1989 level. Using the experimental CPI, median household income is now 5.5 percent higher than it was in 1989 and the average income of each fifth of the distribution has surpassed its 1989 level. Nevertheless, income grew most slowly at the bottom of the distribution in both the 1979-89 and 1989-98 periods (see upper chart).

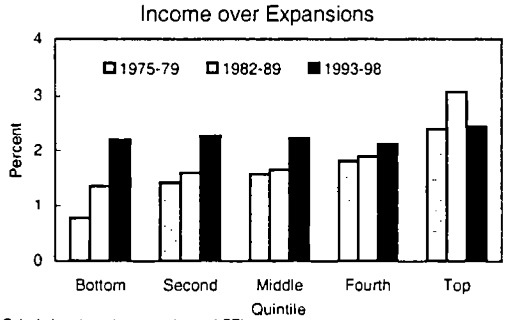
Average Annual Growth in Household Income over Cyclical Peaks



Calculations based on experimental CPI

A hopeful sign that the stagnation of median income and the rise in inequality that characterized the 1973-93 period may be over can be seen in the growth of income since 1993. In each fifth of the distribution, growth in real income exceeded 2 percent per year (using the experimental CPI) and growth was fairly uniform across the distribution (see lower chart). The strength and balance of this expansion surpass those of the other two

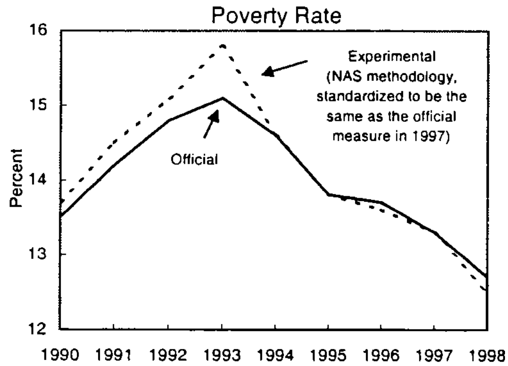
Average Annual Growth in Household Income over Expansions



Calculations based on experimental CPI

expansions shown in the chart (except for the growth in the richest fifth in the 1982-89 expansion).

A better measure of poverty? In addition to its official calculation of the poverty rate, the Census Bureau has begun to publish an experimental measure that incorporates improvements recommended in a 1995 National Academy of Sciences (NAS) report. The chart compares the official poverty rate with the experimental measure based on the NAS methodology (standardized to be the same as the official rate in 1997). The experimental measure shows a larger decline than the official measure both between 1997 and 1998 and since 1993. In part, this reflects the fact that the alternative measure reflects the EITC while the official measure does not.



Conclusion. Improving Federal statistics is an ongoing process, and the statistical agencies are cautious about making changes. However, the incorporation of improved methodologies is critical to achieving an accurate picture of the economy and in the case of the income and poverty numbers would strengthen the evidence that the strong economy is raising income and reducing poverty.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Ethnic Gap in College Graduation. While native-born Hispanics and blacks have increased high school graduation rates, they have made little progress in closing the gap between their college graduation rates and those of non-Hispanic whites and Asians. Moreover, the share of Hispanics in the school-age population is growing. This share is expected to double from 1990 levels, reaching 20.8 percent in 2015. Researchers at the Rand Corporation have estimated that despite the increase in the share of minorities, the educational attainment of those 25 years and older will grow, in part because older, less-educated people will be replaced by younger more-educated cohorts. Nevertheless, the college graduation gap between Hispanics and blacks, on the one hand, and non-Hispanic whites, on the other, is projected to grow between 1990 and 2015. The report argues that the nation as a whole may suffer if this increasingly large population is not provided with the tools needed to succeed in a changing economy.

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BC

Transactions Services Compose a Significant Portion of Banks' Revenue. A substantial percentage of banks' revenue comes from transactions services, according to a study by the Federal Reserve Bank of New York. Transactions services include the safekeeping, administering, reporting on and transferring of money in deposit accounts, the transfer of money related to credit cards, as well as securities processing. Revenue from transactions services comes from fees (such as ATM surcharge fees, deposit account and credit card fees, and hidden fees such as the fee the merchant pays for accepting a debit or credit card). But it also comes from foregone interest on deposit accounts and high interest rates on credit cards, which substitutes for higher explicit fees. All told, transactions services contribute as much as $59.2 billion, or 42.2 percent, to the combined operating revenue of the 25 largest bank holding companies. The study concludes that transactions services constitute a significant activity of banks, and that lending activities contribute less revenue than is commonly believed.

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A Shrinking Portion of the Safety Net. General Assistance (GA) programs, which are financed by states and localities, provide income or in-kind support to people ineligible for Federal cash assistance (such as SSI or TANF). A recent study notes that these programs have contracted considerably over the last decade, continuing a trend that began in the 1980s. State GA programs for able-bodied adults without dependent children, which traditionally provide the only source of cash support for these individuals, have suffered the sharpest cutbacks. In 1989, 25 states provided GA for this group, while in 1998 only 13 states provided such assistance. In Michigan, for example, 82,000 recipients lost benefits when the state terminated its GA program for able-bodied adults without dependent children in 1991. GA programs for disabled, elderly, and unemployed individuals suffered moderate cutbacks between 1989 and 1998, and states have also restricted benefits to immigrants.

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WJC HANDWRITING

THE PRESIDENT HAS SEEN
10-8-99

EYES ONLY

INTERNATIONAL ROUNDUP

Mergers Drive FDI in 1999. Cross-border mergers and acquisitions (M&As) were the driving force behind a record volume of foreign direct investment (FDI) by the developed countries in 1998, according to UNCTAD's *World Investment Report 1999*. FDI outflows from developed nations rose 46 percent to $595 billion in 1998, as cross-border M&As shot up 74 percent to $411 billion. These developments underscore the emergence of an international production system through FDI with transnational corporations (TNCs) at its core. 60,000 TNCs account for an estimated 25 percent of global output. Sales by foreign affiliates of TNCs grew by 17.5 percent to reach $11 trillion in 1998, and such sales have consistently exceeded the value of world exports ($7 trillion in 1998), making international production globally more important than trade in delivering goods and services to foreign markets. The large FDI outflows by developed countries did not translate into commensurate FDI inflows for developing countries, as inflows declined 4 percent in 1998, compared with a 68 percent increase in inflows to developed countries.

*

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Gene ?

Investment in Knowledge Increasing in OECD. OECD countries spend roughly as much on intangible, knowledge-based investments as on machinery and equipment, according to the new OECD report, *OECD Science, Technology, and Industry Scoreboard 1999*. Knowledge-based investment, defined as spending on research and development, software, and public education, averaged 8 percent of GDP across the OECD in 1995. Between 1985 and 1995, investment in knowledge grew 2.8 percent per year on average in OECD countries (slightly higher than GDP growth), with growth the highest in Nordic countries, Japan, and the United States. U.S. investment in knowledge grew 3.1 percent per year, far outpacing physical investment, which grew 1.9 percent per year. Knowledge-based industries, which include high and medium technology manufacturing, finance, insurance, communications, and some other services, composed more than 50 percent of OECD business value-added in the mid-1990s, up from 45 percent in the mid-1980s. The U.S. knowledge-based industry had the second highest relative share of real business value-added of all OECD countries (after Germany) in 1996, although its growth was actually slightly below the OECD average from 1985 through 1996.

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The WTO and Developing Countries. At a joint conference on "Developing Countries and the Millennium Round" held by the WTO and the World Bank in Geneva last week, economists and policymakers pointed to significant gains for developing countries from further liberalization of trade in agriculture, manufactured goods, and services. However, they also emphasized that the gains are not automatic, and that full realization of the potential gains requires that the next WTO round reflect the capacities and concerns of these countries. More progress should be made in areas where many developing countries have a special interest, such as agriculture and construction services, and negotiations should be sensitive to the special needs of the developing countries, as they might not have the technical capacity or regulatory framework to implement WTO commitments.

EYES ONLY

RELEASES THIS WEEK

NAPM Report on Business

****Embargoed until 10:00 a.m., Friday, October 1, 1999****

The Purchasing Managers' Index rose 3.6 percentage points in September to 57.8 percent. (A reading above 50 percent indicates that the manufacturing economy is generally expanding.)

Gross Domestic Product

According to revised estimates, real gross domestic product grew at an annual rate of 1.6 percent in the second quarter.

Advance Durable Orders

Advance estimates show that new orders for durable goods rose 0.9 percent in August, following an increase of 4.0 percent in July.

Consumer Confidence

Consumer confidence, as measured by The Conference Board, fell 1.8 index points in September, to 134.2 (1985=100).

MAJOR RELEASES NEXT WEEK

Leading Indicators (Tuesday)
Employment (Friday)

EYES ONLY

U.S. ECONOMIC STATISTICS

	1970-1993	**1998**	**1998:4**	**1999:1**	**1999:2**
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	4.3	6.0	4.3	**1.6**
GDP chain-type price index	5.4	0.9	0.8	1.6	**1.3**
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	2.6	4.1	3.6	0.6
Real compensation per hour:					
Using CPI	0.6	2.5	2.0	2.9	1.5
Using NFB deflator	1.3	3.7	3.4	3.0	3.7
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	11.0	11.0	11.0	11.2
Residential investment	4.5	4.3	4.5	4.6	4.7
Exports	8.2	11.3	11.3	10.9	11.0
Imports	9.2	13.0	13.1	13.2	13.7
Personal saving	5.2	0.3	-0.0	-0.5	-0.9
Federal surplus	-2.7	0.9	0.8	1.4	1.6

	1970-1993	**1998**	**June 1999**	**July 1999**	**August 1999**
Unemployment Rate (percent)	6.7**	4.5**	4.3	4.3	4.2
Payroll employment (thousands)					
increase per month			281	338	124
increase since Jan. 1993					19403
Inflation (percent per period)					
CPI	5.8	1.6	0.0	0.3	0.3
PPI-Finished goods	5.0	0.0	-0.1	0.2	0.5

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

New or revised data in **boldface**.

EYES ONLY

FINANCIAL STATISTICS

	1997	1998	August 1999	September 1999	Sept. 30, 1999
Dow-Jones Industrial Average	7441	8626	10935	10714	10337
Interest Rates (percent per annum)					
3-month T-bill	5.06	4.78	4.72	4.68	4.74
10-year T-bond	6.35	5.26	5.94	5.92	5.90
Mortgage rate, 30-year fixed	7.60	6.94	7.94	7.82	7.70
Prime rate	8.44	8.35	8.06	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level September 30, 1999**	**Percent Change from**	
		Week ago	**Year ago**
Euro (in U.S. dollars)	1.064	2.2	N.A.
Yen (per U.S. dollar)	106.8	2.5	-21.8
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	92.56	-0.2	-4.4

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	3.9 (Q2)	4.2 (Aug)	2.3 (Aug)
Canada	3.7 (Q2)	7.7 (Jul)	2.1 (Aug)
Japan	1.1 (Q2)	4.9 (Jul)	-0.1 (Jul)
France	2.1 (Q2)	11.3 (Jun)	0.5 (Aug)
Germany	0.6 (Q2)	7.1 (Jul)[2/]	0.6 (Aug)
Italy	0.8 (Q2)	12.1 (Apr)	1.7 (Aug)
United Kingdom	1.4 (Q2)	6.1 (May)	1.1 (Aug)

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

2/ Rate for former West Germany. Using OECD standardized unemployment data, the unemployment rate for unified Germany for July was 9.1 percent.