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THE PRESIDENT HAS SEEN
11/11/96

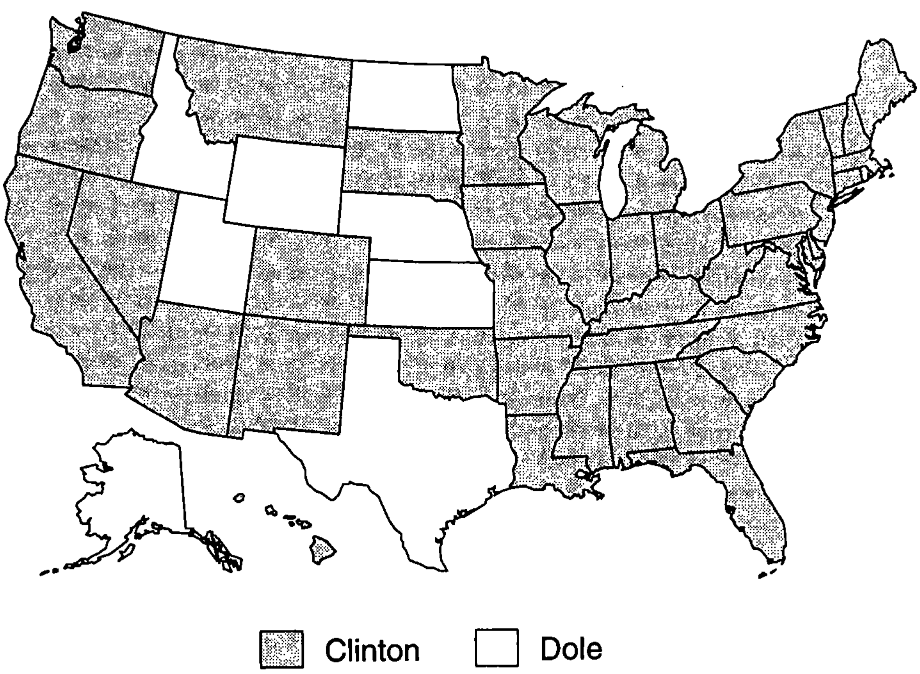
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

November 1, 1996

CHART OF THE WEEK

An Economic Electoral Map



In predicting Presidential election outcomes, all economics may be local. At least one prominent model based on national economic data went badly awry in 1992. A new, improved version, still based on national data, predicts a very narrow Democratic victory. But a model that incorporates state level economic data into this general framework—and gets the 1992 winner right—predicts a Democratic landslide in 1996 (463 electoral votes). A major drawback of the model is that it does not pick up the trend toward Republicans in the South in recent years. And modesty requires economists to admit that non-economic factors may also influence the outcome!

192782

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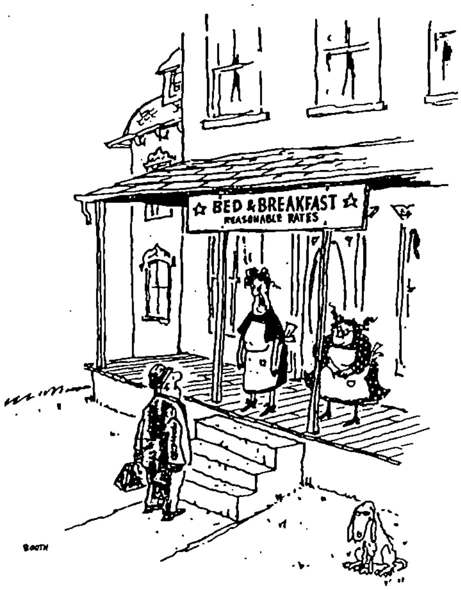


"If you are a Democrat, Mrs. Hooper-Smith does the Macarena during your pancakes."

CURRENT DEVELOPMENT

GDP Scorecard: Third Quarter 1996

Real GDP rose at a 2.2 percent annual rate in the third quarter of 1996—slower than last quarter's 4.7 percent rate but about the rate forecast for the year as a whole. Most of the growth was accounted for by either equipment investment or inventory building. Consumer spending, by contrast, was very weak. The GDP price index rose at a 2.1 percent annual rate—down from 2.5 percent in 1995. Strong investment, little inflationary pressure, and good prospects for a rebound in consumption bode well for continued expansion.

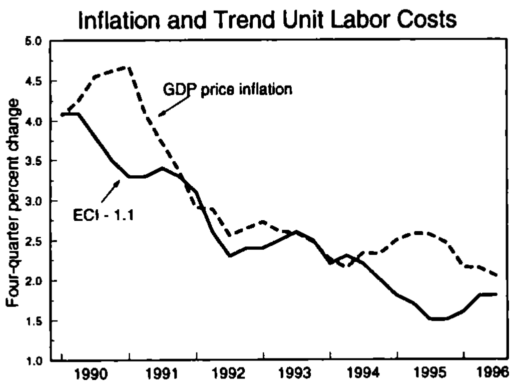
Component	Growth*	Comments
Total consumer expenditures	0.4%	Slowdown had been foreshadowed by weak retail sales, but a number of factors point to a rebound later: consumer confidence is high, income growth is robust, and the net-worth-to-income ratio of households is at its highest level since 1961.
Producers' durable equipment	18.9%	Particularly strong growth in computers and aircraft. PDE has increased at a 12.8 percent annual rate so far this year.
Nonresidential structures	3.3%	Business construction has leveled off and contracts for future construction appear soft.
Housing	-5.8%	Much of the drop was in multi-family housing. A flat housing sector is the best that can be hoped for given the rise in mortgage rates.
Nonfarm inventories (change, billions of 1992 dollars)	$41.2	The jump in second-quarter sales had left inventories very low, and desirable restocking had been expected. Inventories still remain lean in relation to sales.
Federal purchases	-4.0%	A partial offset to above-trend spending in the first and second quarters.
State & local purchases	0.2%	After extensions of the school year to make up for bad-weather closings last winter, school spending fell back to normal.
Exports	0.6%	Exports have been very uneven from quarter to quarter. Over the past year, exports have increased 4.6 percent despite slow growth among major U.S. trading partners. Foreign growth is expected to pick up next year.
Imports	8.3%	Continued domestic growth pulled in imports.

*Percent real growth in the third quarter at annual rates (except inventories). The advance estimate is subject to substantial revision.

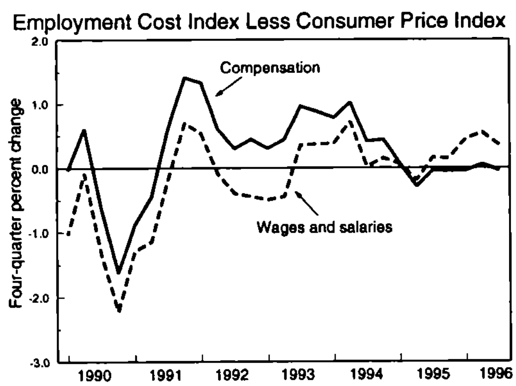
CURRENT DEVELOPMENT

Little Increase in Employment Costs in Third Quarter

Hourly compensation in private industry grew at a moderate 2.5 percent annual pace in the third quarter, as measured by the employment cost index (ECI). Over the past 12 months, ECI compensation rose 2.9 percent, with the wage component rising 3.3 percent and benefits rising 1.8 percent. These increases should not put upward pressure on inflation.



No inflationary pressure. Trend unit labor costs continue to rise more slowly than prices. Subtracting trend productivity growth of 1.1 percent per year from the 2.9 percent increase in hourly compensation over the past year, prices could rise as slowly as 1.8 percent per year with no erosion of profit margins. Prices have risen faster than this over the past year (see upper chart) and profit margins are already high. Thus, firms have a cushion for absorbing faster growth in labor costs without larger price increases.



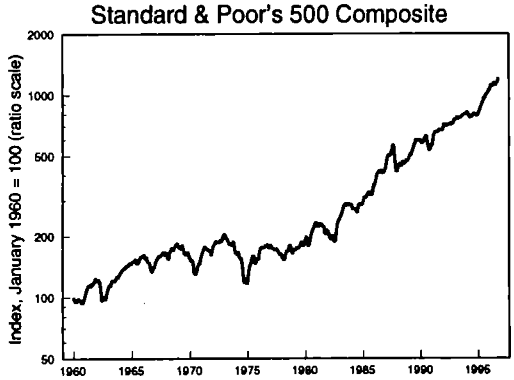
Real wages. Recently, ECI compensation has barely kept pace with the consumer price index (CPI), although the wage component has grown somewhat faster (see lower chart). The ECI is a good measure of the cost to firms of hiring a worker for a particular job, but it may not be the best indicator of how individual workers are doing. In fact, some other measures of wages and compensation have grown a little faster than the ECI, and real disposable personal income grew at a robust 4.9 percent annual rate in the third quarter.

SPECIAL ANALYSIS

Is the Stock Market Too High?

Stock prices have continued to increase dramatically in recent months (see upper chart). Although much of the attention has focused on the Dow Jones average of 30 industrial stocks, which moved past the 6000 mark, other broader indexes, like the Standard and Poor's 500, also touched new highs in October.

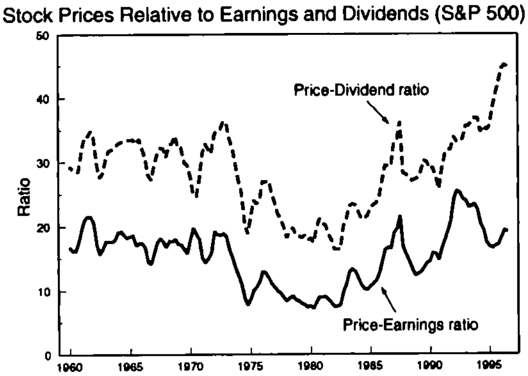
Standard & Poor's 500 Composite



The sharp rise in stocks since early last year has raised concerns that prices no longer rationally reflect the outlook for earnings or interest rates. Some worry that stocks may be ripe for a fall.

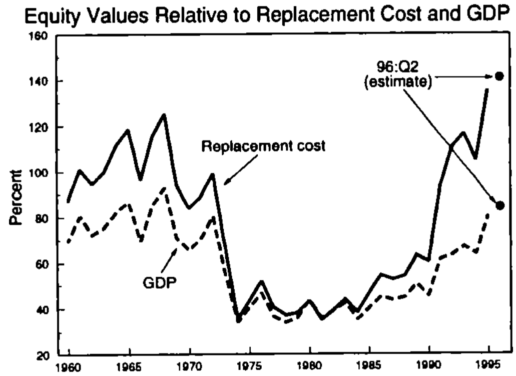
Analysis. In theory, stock prices should reflect "fundamentals" like expected future dividends and interest rates, adjusted to take account of risk and taxation. In practice, these fundamentals are not directly observable and financial economists look at a number of alternative indicators.

Stock Prices Relative to Earnings and Dividends (S&P 500)



Currently, stock prices as measured by the S&P 500 index are only moderately high relative to earnings, based on historical experience. But they are very high relative to dividends (see middle chart). The market value of non-farm non-financial businesses is also quite high relative to an estimate of what it would cost firms to replace their plant and equipment. Finally, this value is also fairly high relative to GDP (see lower chart).

Equity Values Relative to Replacement Cost and GDP



Even given their current high value by these measures, however, stocks might not be overvalued. Investors may anticipate rapid growth in earnings and dividends. Alternatively, investors may have reduced the compensation they demand for bearing the risk associated with holding equities. Such a reduction might have occurred in response to research showing that equities have consistently outperformed other financial investments over long holding periods (see *Weekly Economic Briefing*, September 20, 1996). Finally, investors may be expecting improved tax treatment of stocks, such as reduced capital gains taxes. Any of these factors would boost the demand for stocks and could explain the observed rise in stock prices.

Implications. To the extent that stock prices are high relative to fundamentals, they could decline substantially with little or no immediate cause. The markets' reaction to surprises—like a Democratic sweep of the congressional elections next week or a change in leadership in Russia—could be larger than the change in fundamentals would appear to justify.

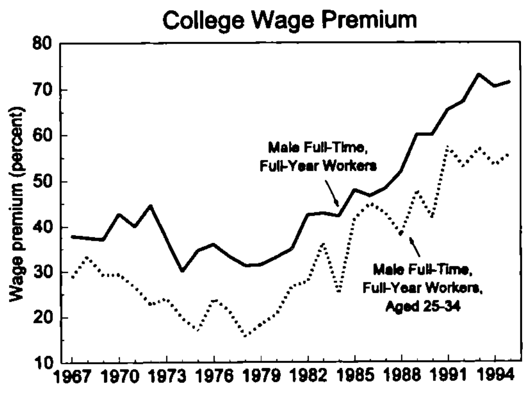
ARTICLE

Income Inequality and the College Wage Premium

After 20 years of almost steady increases, income inequality fell noticeably last year. One reason may be that the earnings of college-educated workers have stopped growing faster than the earnings of less-educated workers.

Trends. The upper chart shows the trend in the "Gini index," one of the most commonly used measures of household income inequality. The lower chart shows the trend in the college wage premium, as measured by the ratio of the median earnings of male full-time, full-year workers with college degrees to the earnings of those with just a high school diploma. Both series show a sharp rise through the 1980s that has stopped abruptly in the last few years. Earnings are an important component of income, hence significant increases in the earnings premium for college graduates are associated with significant changes in income inequality.

Analysis. In 1978, men with college degrees and full-time jobs earned only about 30 percent more than those with just a high school diploma. By 1993, this premium had risen to more than 70 percent, but it has remained roughly constant since. The rise in the college wage premium during the 1980s should have made college more attractive. In fact, the percentage of high school graduates enrolling in college went from about 50 percent in 1980 to over 60 percent in 1994.



Eventually, however, an increase in the supply of college educated workers puts downward pressure on the college wage premium. Although it may take several years for this effect to show up in the overall labor market statistics, it should appear initially in the college wage premium of younger workers. And, indeed, the college wage premium among 25-to-34-year-old men stopped rising in 1991.

Conclusion. It is too early to know conclusively whether the 20-year-long trend of rising income inequality has ended. But reduced income inequality may well be an important side benefit of expanding the number of college-educated workers.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Reports Expansion Is Moderating. The latest regional Federal Reserve survey finds that business activity continues to expand, but at a somewhat slower pace. Although few indications of price increases for raw materials, goods, or services are evident, upward pressure on wages is found in more regions, spanning more occupations and ranges of skill levels. Consumer spending is moderate, with strength in most apparel markets but mixed reports in the automobile and tourism sectors. Crop harvests are turning out better than many anticipated this spring, when the Southwest suffered from drought and the Midwest and Northern Plains had unseasonably cold, wet weather. Manufacturing is largely stable, with inventories reported at generally normal to somewhat below normal levels. Growth is somewhat stronger in the Midwest. And the Boston and San Francisco Districts, which had lagged much of the rest of the nation through the first half of the 1990s, are reporting improved performance.

Intensive Smoking Cessation Efforts Cost-Effective. Smoking cessation programs are among the most cost-effective preventive health measures, according to an unreleased study described in a recent issue of the *Journal of the American Medical Association*. Such programs cost about $2,000 per year-of-life-saved compared to mammographic screening for breast cancer which costs about $50,000. The study found that many interventions work, but intensive ones are more cost-effective than ones like a 3-minute comment to the patient about the hazards of smoking.

Iowa Electronic Market Update. With less than a week to go until the election, a contract that pays a dollar in the event of a Clinton victory is selling for about 95 cents on the Iowa Electronic Market. That price is up from 80 cents in mid-September, and a little over 30 cents in January 1995. The price of a contract paying a dollar in the event of a Republican victory is now about 5 cents. "Vote-share" contracts, which pay a dollar times the candidate's share of the two-party vote, are selling at 56 cents for Clinton and 42 cents for Dole. The market has been a good predictor in the past—in both 1988 and 1992 the market did a better job than contemporaneous opinion polls in predicting the vote share of each candidate. In the congressional market, contracts paying a dollar if Republicans retain control of both chambers sell for about 55 cents. Other congressional contracts include: Democratic House and Republican Senate, 26 cents; Democratic control of both chambers, 15 cents; and Republican House and Democratic Senate, 4 cents. But the market does not have nearly as good a track record predicting congressional elections. In 1994, the first time such contracts were traded, the market predicted Democrats would retain control of each chamber.

Consumer Sentiment and the Election: an Update. As shown in an earlier Chart of the Week (*Weekly Economic Briefing*, October 18, 1996), the University of Michigan's Consumer Sentiment index has turned out to be an excellent predictor of Presidential electoral outcomes. The index for October has been revised upward, which boosts the predicted incumbent electoral vote from 386 to 413.

INTERNATIONAL ROUNDUP

Mexican Tripartite Consultations Set Out Economic Goals for 1997. Last weekend, representatives of the Mexican government, business, and labor met to review Mexico's economic performance and set goals for the future. During the past year, the Mexican economy has bounced back from a 6 percent contraction in 1995, with 4-quarter growth topping 7 percent in the second quarter. Employment growth was strong enough not only to restore the nearly 500,000 jobs lost during the crisis but also to create an additional 125,000 jobs. The government projected economic growth of 4 percent for next year, supported by a resurgence in both private and public investment. Inflation was forecast to fall to 15 percent. A modest recovery in real wages is expected, assisted by a minimum wage increase of 17 percent. The agreement, which sets out a budget deficit goal of 0.5 percent of GDP, may go some way towards easing pressure on the peso. After trading fairly stably for the last year, the peso fell nearly 6 percent in October, possibly due to concern that the government may be loosening fiscal policy too much.

Pakistan Introduces Emergency Economic Measures. Last week, the government of Pakistan introduced an emergency budget aimed at stabilizing the economy. The government also devalued the rupee's fixed rate against the U.S. dollar by 8.5 percent. Over the preceding 5 months, the threat of a foreign exchange crisis had increased notably in Pakistan: foreign exchange reserves fell from $2 billion in June to $900 million in early October—the equivalent of just 3 weeks of import coverage. (Generally, reserves equal to 3 months worth of imports are considered the minimum necessary to safeguard the stability of a national currency.) Pakistan's business community has reacted sharply to the devaluation, arguing that exports are unlikely to be helped much. In addition to low foreign reserves, a loose fiscal stance and declining market confidence, reflected in a 20 percent drop in stock prices since June, had further unsettled financial markets. Negotiations for the resumption of a stalled $600 million IMF loan are currently underway in Pakistan.

Russian Industrial Giant Makes Its Debut on the World's Equity Stage. On Monday, American Depositary Shares (ADSs) in Gazprom, Russia's natural gas giant, began trading on the London Stock Exchange. (ADSs are specialized financial instruments that allow investors to receive dividends and capital gains from equity in a foreign corporation that does not meet the requirements to be listed on a U.S. stock exchange.) Gazprom's international share issue of 1 percent of its stock, which took place 2 weeks ago, has been valued at roughly $400 million. It was reportedly the largest Russian share sale ever, domestic or foreign. Gazprom is the world's largest producer of natural gas, accounting for one quarter of global gas production. In 1994, its output of nearly 600 billion cubic meters of natural gas was twice the production of Royal Dutch/Shell, Exxon, Mobil, Amoco, BP, Chevron and Texaco combined. Its reserves are estimated at 24 trillion cubic meters, which dwarfs the 1.5 trillion cubic meters claimed by the next largest competitor.

RELEASES THIS WEEK

Employment and Unemployment

****Embargoed until 8:30 a.m., Friday, November 1, 1996****

In October, the unemployment rate was unchanged at 5.2 percent. Nonfarm payroll employment rose by 210,000.

NAPM Report on Business

****Embargoed until 10:00 a.m., Friday, November 1, 1996****

The Purchasing Managers' Index fell to 50.2 percent in October from 51.7 percent in September.

Gross Domestic Product

According to advance estimates, real gross domestic product grew 2.2 percent at an annual rate in the third quarter.

Consumer Confidence

Consumer confidence, as measured by the Conference Board, fell 5.6 index points in October, to 106.2 (1985=100).

Employment Cost Index

The employment cost index for private industry workers rose 2.9 percent for the 12-month period ending in September.

MAJOR RELEASES NEXT WEEK

Productivity (Thursday)

U.S. ECONOMIC STATISTICS

	1970–1993	1995	1996:1	1996:2	1996:3
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	2.0	4.7	**2.2**
GDP chain-type price index	5.3	2.5	2.3	2.2	**1.9**
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.3	1.8	0.5	N.A.
Real compensation per hour:					
Using CPI	0.6	1.4	0.0	–0.1	N.A.
Using NFB deflator	1.3	2.1	2.0	1.6	N.A.
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.4	10.3	**10.5**
Residential investment	4.5	4.0	4.1	4.2	**4.1**
Exports	8.2	11.1	11.3	11.3	**11.1**
Imports	9.2	12.4	12.5	12.6	**12.6**
Personal saving	5.1	3.4	3.6	3.2	**4.0**
Federal surplus	–2.7	–2.2	–2.1	–1.7	N.A.

	1970–1993	1995	Aug. 1996	Sept. 1996	Oct. 1996
Unemployment Rate	6.7**	5.6**	5.1	5.2	**5.2**
Payroll employment (thousands)					
increase per month			**280**	**–35**	**210**
increase since Jan. 1993					**10703**
Inflation (percent per period)					
CPI	5.8	2.5	0.1	0.3	N.A.
PPI-Finished goods	5.0	2.3	0.3	0.2	N.A.

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

New or revised data in **boldface**.
Employment and unemployment data **embargoed until 8:30 a.m., Friday, November 1, 1996**.

FINANCIAL STATISTICS

	1994	1995	Aug. 1996	Sept. 1996	Oct. 31, 1996
Dow-Jones Industrial Average	3794	4494	5686	5804	6029
Interest Rates					
3-month T-bill	4.25	5.49	5.05	5.09	5.03
10-year T-bond	7.09	6.57	6.64	6.83	6.37
Mortgage rate, 30-year fixed	8.35	7.95	8.00	8.23	7.78
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Oct. 31, 1996**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.514	–0.5	7.6
Yen-Dollar	113.8	0.8	11.3
Multilateral $ (Mar. 1973=100)	87.35	–0.5	4.3

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	2.3 (Q3)	**5.2** (Oct)	3.0 (Sept)
Canada	1.2 (Q2)	9.4 (Aug)	1.5 (Sept)
Japan	3.9 (Q2)	3.4 (Aug)	0.0 (Sept)
France	0.5 (Q2)	12.2 (Jul)	1.6 (Sept)
Germany	1.1 (Q2)	7.2 (Aug)	1.4 (Sept)
Italy	0.7 (Q2)	11.9 (Jul)	3.4 (Sept)
United Kingdom	2.3 (Q3)	8.1 (Aug)	2.1 (Sept)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, November 1, 1996.**