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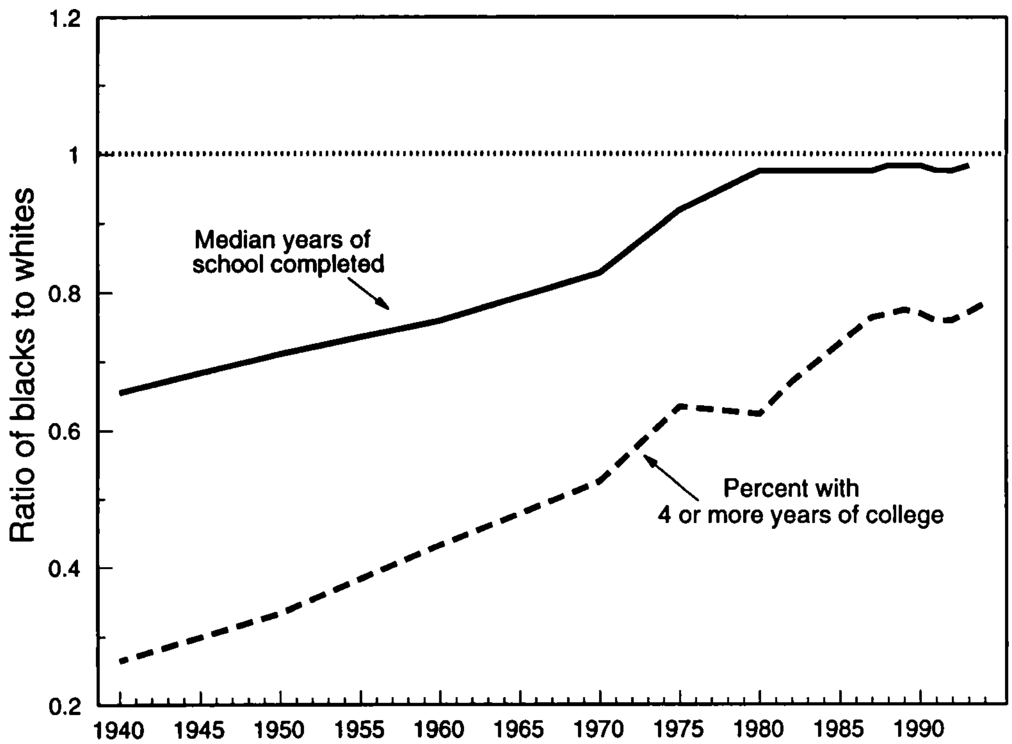
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

September 6, 1996

CHART OF THE WEEK

Educational Attainment of Blacks Relative to Whites



Median years of school completed for blacks and whites has converged. Blacks are still less likely to go to college, but the proportion of blacks with 4 or more years of college has risen relative to that of whites. The impact of these trends on the black-to-white wage ratio is discussed in a Special Analysis in this Weekly Economic Briefing.

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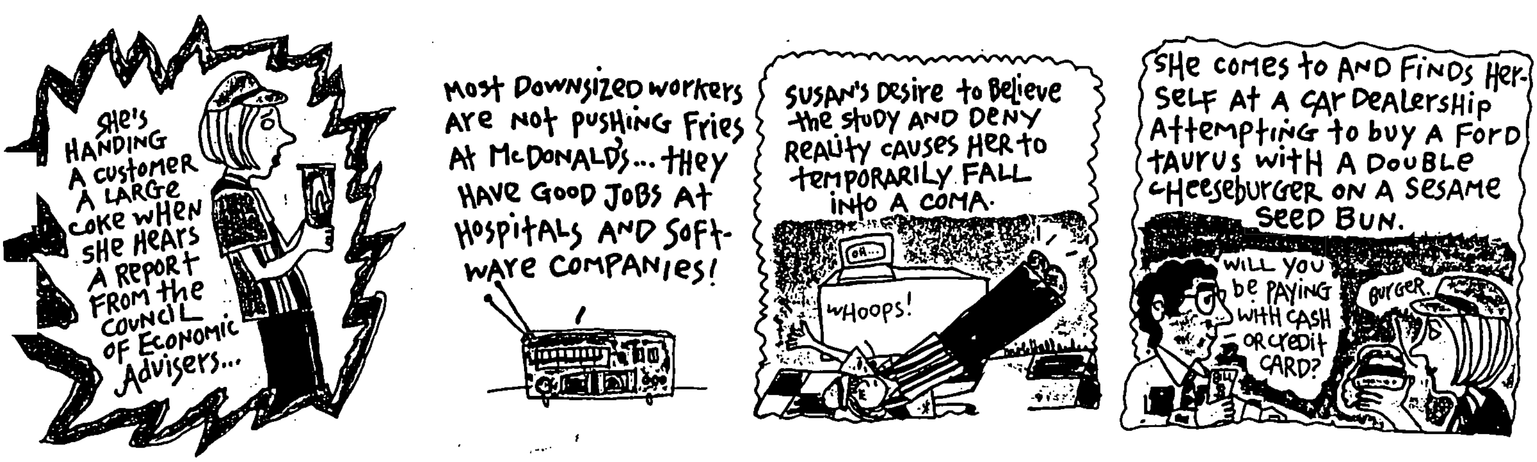


SHE'S HANDING A CUSTOMER A LARGE COKE WHEN SHE HEARS A REPORT FROM THE COUNCIL OF ECONOMIC ADVISERS...
MOST DOWNSIZED WORKERS ARE NOT PUSHING FRIES AT McDONALD'S... THEY HAVE GOOD JOBS AT HOSPITALS AND SOFTWARE COMPANIES!
SUSAN'S DESIRE TO BELIEVE THE STUDY AND DENY REALITY CAUSES HER TO TEMPORARILY FALL INTO A COMA.
WHOOPS!
SHE COMES TO AND FINDS HERSELF AT A CAR DEALERSHIP ATTEMPTING TO BUY A FORD TAURUS WITH A DOUBLE CHEESEBURGER ON A SESAME SEED BUN.
WILL YOU BE PAYING WITH CASH OR CREDIT CARD?
BURGER.

MACROECONOMIC UPDATE

Economy Moderating but Still Strong

Economic growth in the third quarter will likely be about 3.0 percent. This is strong, but less than the very robust 4.8 percent annual rate achieved in the second quarter.

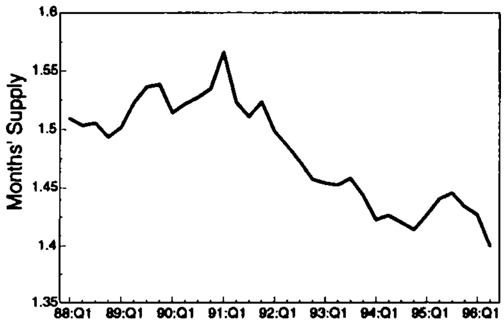
The first official estimate will not be available until the end of October, but 2 months of labor market data are suggestive. Total hours appear to be growing at a 2 percent annual rate. Adding another 1 percent for trend productivity growth produces the 3 percent estimate. More limited data on demand show where the strengths and weaknesses are likely to be:

Plus. Strong second-quarter demand left business with lean inventories and a desire to rebuild (see upper chart).

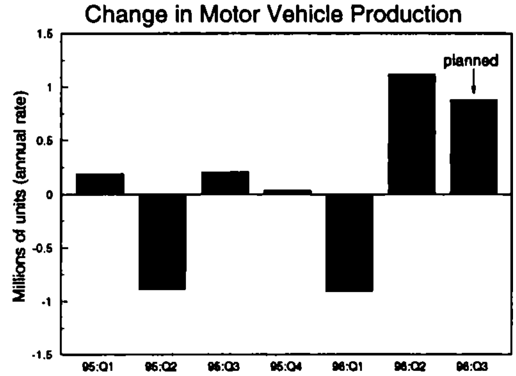
Neutral. Although motor vehicle production is scheduled to increase again in the third quarter, this increase is not as large as in the second (see middle chart). The strong pace of third-quarter production may reflect a desire to build stocks in advance of the expiration of the UAW contract on September 14th.

Minuses. Rising interest rates are expected to hold down residential investment. Housing starts fell in July (see lower chart), and are likely to edge lower in the near term. After providing an unexpected boost to growth in the first half of the year, Federal Government expenditures for consumption and investment are expected to drop, reducing real GDP growth significantly this quarter. With the U.S. economy growing somewhat faster than its trading partners', imports are expected to grow faster than exports this quarter, and negative net exports will continue to be a drag on growth.

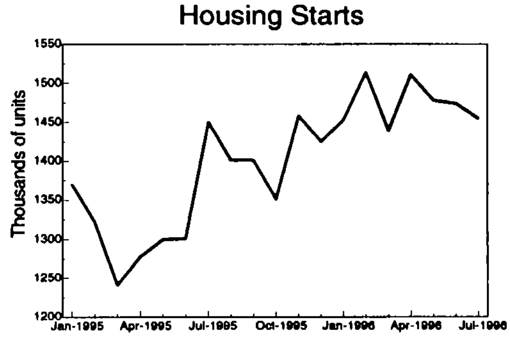
Inventory-to-Sales Ratio



Change in Motor Vehicle Production



Housing Starts



Conclusion. Despite signs of slowing, growth in the third quarter will still be strong.

SPECIAL ANALYSIS

Old McDonald Had a Farm (and an Estate Tax Break)

More than a quarter of all farm owners are at least 65 years old, and half are 55 or older. So it should probably not be surprising that proposals to eliminate the estate tax strike an especially responsive chord in the farm belt. But farms already enjoy special treatment in the estate tax, and a large majority of farmers would be unaffected by further cuts.

Cuts in the estate tax are also favored by some as a means of keeping land in agriculture. A review of how farmers respond to the current estate tax provisions shows that easing these rules further would do little to keep land from being converted to urban uses.

Farm demographics. In 1993, farms were almost 4 times more likely to be owned by someone at least 65 years old than were other sole proprietorships (see chart).

Older farmers tend to have somewhat smaller farms than younger farmers. Nevertheless, in 1993, 43 percent of all farm acres in the United States were operated by someone over 55 and 21 percent by someone over 65. This latter figure implies that almost 200 million acres are farmed by someone at least 65 years old.

Although older farmers are generally in somewhat better financial health than their younger counterparts, close to half are in "financial distress" as determined by negative cash flow and/or a high debt-asset ratio. About 7 percent of farms operated by someone over 65 have net worth less than $50,000 (possibly negative). Thus, many of the 200 million acres operated by older farmers are ripe for acquisition by public or private entities upon the death of the current operator.

Current estate taxes and farmers. As with other individuals, the first $600,000 of the assets of family farmers (as opposed to farming corporations) are exempt from Federal estate taxes. Also, the decedent's gross estate can be reduced by up to $750,000 to reflect the difference between the market value and the "current use" value of the farm. In other words, farmland that might be worth more if it were sold to a developer would be assessed at its value as farmland rather than its market value. If the current use valuation method is employed, the farm must remain in agriculture for 10 years. Finally, farm estate taxes can be paid in installments at a below-market rate. These generous repayment terms lower the effective marginal tax rate by almost half.

Eliminating estate taxes would benefit only a small group of wealthy farmers. In 1995, estate tax returns were filed on only one farm in six that changed hands–the rest were covered by the $600,000 exemption. Less than 40 percent of the farms filing returns paid estate taxes, while the rest escaped liability through the marriage credit, unified credits and other tax provisions. Thus, estate taxes are paid on less than 7 percent of all farms.

Implications for land use. Eliminating the estate tax would have little impact on land use patterns. Of the approximately 5,000 farms filing estate tax returns in 1995, only 365 were assessed under the use value provisions in spite of its large tax advantages. The principal reason for such a small participation rate is that many heirs wish to sell the land at its market value rather than keep it in agriculture for the 10 years necessary for current use assessment. That is, when offered a substantial tax break in return for keeping their land in agriculture, these farmers would rather preserve the option to convert their land.

One additional effect of lowering the estate tax on farms is that it would increase the price of farmland, even if there is only a small impact on land allocation. Reducing the estate tax on farmland makes it more attractive relative to other assets, thus increasing the demand for farmland and raising its price. An increase in the price of farmland would harm the 45 percent of American farmers who rent at least a portion of their land, and young people trying to enter farming.

Conclusion. The graying of the farm population is an important demographic development, suggesting that a substantial amount of farmland will change hands over the next several years. Although estate tax relief may be popular politically, only a few wealthy farm families would be affected by abolishing estate taxation. Further, eliminating estate taxes would do little to slow the pace at which agricultural land is converted to other uses.

Older Farmers and Land Retirement Programs

Older farmers are far more likely than younger farmers to participate in temporary land retirement programs like the Conservation Reserve Program (CRP), which offers a way for them to stay in their rural communities without the hard work of planting and harvesting. CRP, in other words, may function as a supplementary retirement income program as well.

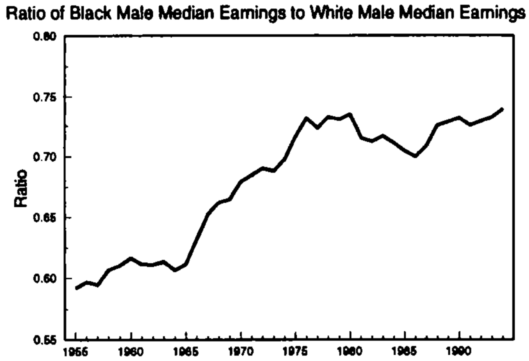
SPECIAL ANALYSIS

Earnings Inequality and the Black-to-White Wage Ratio

This look at trends in the earnings of black men relative to white men is the last in a series of Weekly Economic Briefing analyses of wage trends. After a tremendous surge in the ratio of black-to-white wages over the 1965-75 period, subsequent progress has been grudging at best. A general trend towards greater earnings inequality appears to be a significant contributor to this stagnation.

Civil rights and wages. During the 1950s and early 1960s, black earnings rose modestly relative to white earnings (see chart). This slight upward trend is generally attributed to the migration of blacks from the South to the North, where wages were higher, and to increases in the level and quality of education among blacks. In the decade following passage of the Civil Rights Act of 1964, by contrast, wages of black men increased dramatically relative to those of whites.

Ratio of Black Male Median Earnings to White Male Median Earnings



Note: Data before 1967 are estimated based on trends for nonwhites versus whites.

Although accumulated gains in educational attainment and reduced labor force participation among lower-wage blacks played some role, the evidence suggests the link to civil rights legislation is the dominant explanation. During this period, for example, older black men, who had completed their education prior to 1964, experienced a significant wage increase relative to their white counterparts.

Over the past two decades, the relative earnings of black men have leveled off. Although some have blamed the lack of further progress on Reagan administration policies, black wage gains had stopped well before 1980, suggesting that other explanations for this phenomenon are required.

Why has the ratio stopped rising? Black workers are more likely to be found in lower-paying, less skilled jobs either because of differences in their characteristics, like education, or because of discrimination. Thus, all else equal, the two-decades long trend towards greater penalties to employment in a low-skilled job should have reduced blacks' wages. Working to counteract that trend, however, is the increasing educational attainment of blacks. As shown in the Chart of the Week, median years of education among blacks and whites are now virtually identical and college graduation rates of blacks continue to rise relative to whites. Therefore, the trend towards greater earnings inequality and blacks' educational advancement may have had offsetting effects leading to stagnant relative wages for blacks. Additional increases in education or a reduction in earnings inequality should contribute to furthering the economic advancement of blacks.

ARTICLE

Generating Cooperation in a Competitive Industry: Prospects in Electricity Markets

This summer's power blackouts in the West were widely characterized as portents of trouble for an electric power industry that is moving towards greater competition and less regulation. This conclusion is wrong, but the blackouts do highlight the critical importance of establishing effective coordination among competing electric utilities linked together in large regional grids.

The importance of coordination. Historically, the production and delivery of electricity in a given geographical area was seen as a natural monopoly. Both the generation of electricity and its distribution to customers over high-voltage transmission lines took place within a single vertically integrated utility. Experience since the late 1970s has shown, however, that generation can be unbundled from transmission. Electricity generated by one company can be delivered over lines owned by another, opening up opportunities to shop for the best deal among competing generators.

But maintaining a reliable grid of transmission facilities is a daunting task. Unlike many other energy sources, electricity once produced cannot be cheaply stored in substantial quantity. Consequently, the amount of power being produced must match, on virtually a minute-by-minute basis, the amount of power being consumed. A failure to balance inflows and outflows can result in a rapid, serious deterioration of system operation and widespread damage to equipment. Through interconnected regional "power pools," utilities with currently excess generation capacity can meet the needs of other utilities experiencing surges in demand or network failures, to keep supplies and loads in balance.

Cooperation among utilities is particularly important in the event of a severe and unexpected loss in the ability to supply power. The very interconnectedness of transmission lines that allows utilities to share power can, without a broad, coordinated response, lead to rapid spreading of a technical failure's effects. For example, press reports attribute the initial cause of the west coast blackout to the failure of a single 500 kilovolt transmission line in northern Oregon.

Does increasing competition threaten reliability? Over the last 20 years or so, a combination of antitrust cases, congressional statutes, and most recently, the Federal Energy Regulatory Commission's Order 888 have paved the way for introducing competition in electricity generation by opening up utility transmission grids to independent generators. This competition is still in its very early stages, and thus is not responsible for the recent west coast blackout. But the blackout has led some to ask whether utilities will continue to cooperate as they change from being geographically distinct monopolies to companies that compete against one another for customers. For example, when Utility X experiences an unexpected surge in demand, would Utility Y be willing to sell it power, or would it consider it more strategically advantageous to refuse to sell, increasing the likelihood that Utility X would be seen as an unreliable supplier?

Can we have competition and coordination? One way to promote reliability in a competitive environment would be to control or eliminate conflicts of interest between the transmission grid manager and the generation side of the business. Historically, policy makers have addressed this conflict using two general approaches.

- The first is regulation, where firms are allowed to continue to operate in multiple markets, but under rules requiring nondiscriminatory treatment of competitors and, sometimes, mandating "arms-length" treatment and separate subsidiaries within a common corporate umbrella.

- The second is divestiture, so that the businesses at the root of the conflict–here, generation and transmission–are in totally separate companies.

The history of the telephone industry exemplifies both approaches and some of the considerations influencing the choices between them. Fourteen years ago, the Antitrust Division found that regulation was an inadequate remedy for AT&T's discrimination in favor of its long distance and equipment subsidiaries. Accordingly, it obtained AT&T's divestiture of local telephone companies and rules to keep those divested companies out of related markets. Since then, with new technologies opening a door to local telephone competition, the 1996 Telecommunications Act reflects a judgment that appropriate regulatory solutions, while perhaps imperfect, are preferable to rigid corporate separations.

Many regulators; many approaches. Like the 1996 Telecommunications Act, FERC's Order 888 embodies a regulatory approach, requiring "functional unbundling" within integrated utilities to prevent discrimination. But Order 888 recognizes the potential need for stronger solutions, such as the creation of "independent system operators" (ISOs) that would manage power grids and work out cooperative arrangements with adjacent systems to maintain reliability.

Various states, particularly California and New York, are evaluating alternative methods for ISO design and implementation. Whether FERC's functional unbundling rules or an ISO as developed by the states will suffice for minimizing blackouts, or whether full divesting of generation from transmission is necessary, remains an important and open issue.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Vacationers Boost California Economy. Finally shaking off the effects of earthquakes, urban unrest, and recession, the California tourism industry is experiencing a banner year. Tourism in California is projected to increase 6 percent this summer–three times the national average. This comes on the heels of a strong 1995, when 197 million American tourists added over $55 billion to the state economy. Foreign tourism, especially from Japan and Germany, is also the strongest it has been in years. The travel industry has become an increasingly important economic force in California; its 685,000 jobs make it the state's third-largest employer. Experts say that the new wave of tourism is being fueled by the many low-cost airlines operating to California. Tourists are flocking to national parks and theme parks; attendance at Universal Studios is up 40 percent over last year as thrill-seekers come to experience its new $100 million "Jurassic Park" ride.

New Guidelines Promote Innovative Health Care Arrangements. Physician groups that want to offer health coverage plans to employers will be better able to compete with insurance companies and health maintenance organizations due to new guidelines released last week by the Federal Trade Commission and the Justice Department. Previously, doctors had been dissuaded from forming joint ventures in fear of violating antitrust law. Once a network is formed, doctors within the same network usually want to agree to charge the same prices to their patients, but this was viewed as price fixing. The new guidelines recognize that despite the "price fixing," joint venture physician networks may, in fact, be pro-competitive in many circumstances. According to the Justice Department, physician joint ventures may expand consumer choice and help meet demand for high-quality health care services.

Aircraft Industry Takes Off Again. The aircraft industry is experiencing a strong rebound after the deep recession of the early 1990s. This week, Boeing announced orders for 70 aircraft worth $6.3 billion. It also said it would consider building larger versions of its 747 jumbo jet. Boeing has been testing airline responses to two new versions that would cost up to $200 million each: one that would carry up to 550 people rather than the current 415 and another that would have a greater range of more than 10,000 miles. McDonnell Douglas, hoping to bounce back from its recent decline in market share, also announced orders for new planes worth more than $2 billion. With airlines filling their seats and piling up profits, orders for new airplanes are expected to soar into the next century.

INTERNATIONAL ROUNDUP

Japan's Recovery Slower than Expected. The August Bank of Japan quarterly survey of business sentiment suggested that Japan's recovery is weaker than many analysts had predicted based on strong growth earlier in the year. The news quieted speculation that the central bank might raise interest rates and the yen weakened against the dollar. One key index of business sentiment worsened for the first time since August 1995. The report attributes the slowing recovery to a 4.3 percent drop in industrial production during June, rising inventories, a decline in the semiconductor market, and weaknesses in markets for other exports. Additionally, the recent outbreak of food poisoning has hurt food and retail companies. On the positive side, confidence among companies outside the manufacturing sector and smaller companies rose, and capital investment plans were revised upward.

Canada Reports Disappointing Second Quarter. Canadian GDP rose at a seasonally adjusted, annualized rate of 1.3 percent in the second quarter. Inflation has remained below 2.0 percent for the year. The weaker-than-expected performance and low inflation have fostered expectations that an August 22 central bank rate cut may be followed by future easing. Inventories and business investment fell in the second quarter while personal disposable income and consumer demand flattened. Sluggish domestic demand contributed to falling imports and a second-quarter trade surplus of $7.4 billion (Canadian), the largest since 1985. The combination of strong growth in the United States and weak Canadian demand for U.S. goods contributed to a 35 percent rise in the Canadian trade surplus with the United States.

Ukraine Introduces New Currency. In an attempt to slow inflation, increase investment, and reverse the downward trend in GDP, Ukraine has replaced its currency for the third time in 4 years. The latest currency, the hryvna, replaces the karbovanet, which experienced annual inflation of 10,000 percent in 1993. Recently, inflation has fallen to 0.1 percent a month, and Ukraine is negotiating a $1.5 billion currency stabilization fund with the International Monetary Fund which could lend further credibility to the new foreign exchange regime. Hoping to prevent the activation of inflation, the Cabinet of Ministers passed a decision to freeze all prices for the first month after the introduction of the new currency. Despite some shortages of hryvna, the first day of transition was relatively smooth, according to the Deputy Prime Minister. Extra security measures were implemented at currency exchange points, and measures are being taken to catch counterfeiters.

RELEASES THIS WEEK

Employment and Unemployment

****Embargoed until 8:30 a.m., Friday, September 6, 1996****

In August, the unemployment rate fell to 5.1 percent from 5.4 percent in July. Nonfarm payroll employment rose by 250,000.

Leading Indicators

The composite index of leading indicators increased 0.2 percent in July.

NAPM Report on Business

The Purchasing Managers' Index rose to 52.6 percent in August from 50.2 percent in July.

MAJOR RELEASES NEXT WEEK

Productivity (Tuesday)
Producer Prices (Thursday)
Consumer Prices (Friday)
Retail Sales (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1995	1995:4	1996:1	1996:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	0.3	2.0	**4.8**
GDP chain-type price index	5.3	2.5	2.1	2.3	**2.2**
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.3	−1.1	1.8	-0.1
Real compensation per hour:					
Using CPI	0.6	1.4	1.6	0.0	-0.1
Using NFB deflator	1.3	2.1	2.8	2.0	2.0
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.2	10.4	**10.3**
Residential investment	4.5	4.0	4.0	4.1	4.2
Exports	8.2	11.1	11.4	11.3	**11.2**
Imports	9.2	12.4	12.3	12.5	**12.6**
Personal saving	5.1	3.4	3.8	3.6	3.2
Federal surplus	−2.7	−2.2	−2.1	−2.1	**−1.7**

	1970–1993	1995	June 1996	July 1996	August 1996
Unemployment Rate	6.7**	5.6**	5.3	5.4	**5.1**
Payroll employment (thousands)					
increase per month			**219**	**228**	**250**
increase since Jan. 1993					**10508**
Inflation (percent per period)					
CPI	5.8	2.5	0.1	0.3	N.A.
PPI-Finished goods	5.0	2.3	0.2	0.0	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, September 6, 1996.**

FINANCIAL STATISTICS

	1994	1995	July 1996	Aug. 1996	Sept. 5, 1996
Dow-Jones Industrial Average	3794	4494	5496	5686	5607
Interest Rates					
3-month T-bill	4.25	5.49	5.15	5.05	5.20
10-year T-bond	7.09	6.57	6.87	6.64	6.98
Mortgage rate, 30-year fixed	8.35	7.95	8.25	8.00	8.34
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level Sept. 5, 1996**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.485	0.2	1.5
Yen-Dollar	109.1	0.5	11.6
Multilateral $ (Mar. 1973=100)	86.64	0.1	1.2

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	2.7 (Q2)	**5.1** (Aug)	3.0 (Jul)
Canada	1.2 (Q2)	10.0 (Jun)	1.2 (Jul)
Japan	5.5 (Q1)	3.6 (Jun)	0.0 (Jun)
France	0.4 (Q2)	12.1 (May)	2.2 (Jul)
Germany	1.1 (Q2)	7.1 (May)	3.5 (Jul)
Italy	1.6 (Q1)	12.5 (Apr)	4.0 (Jun)
United Kingdom	1.8 (Q2)	8.3 (Jun)	2.2 (Jul)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, September 6, 1996**.