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THE PRESIDENT HAS SEEN
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WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

BE

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

March 10, 2000

Copied
Daily
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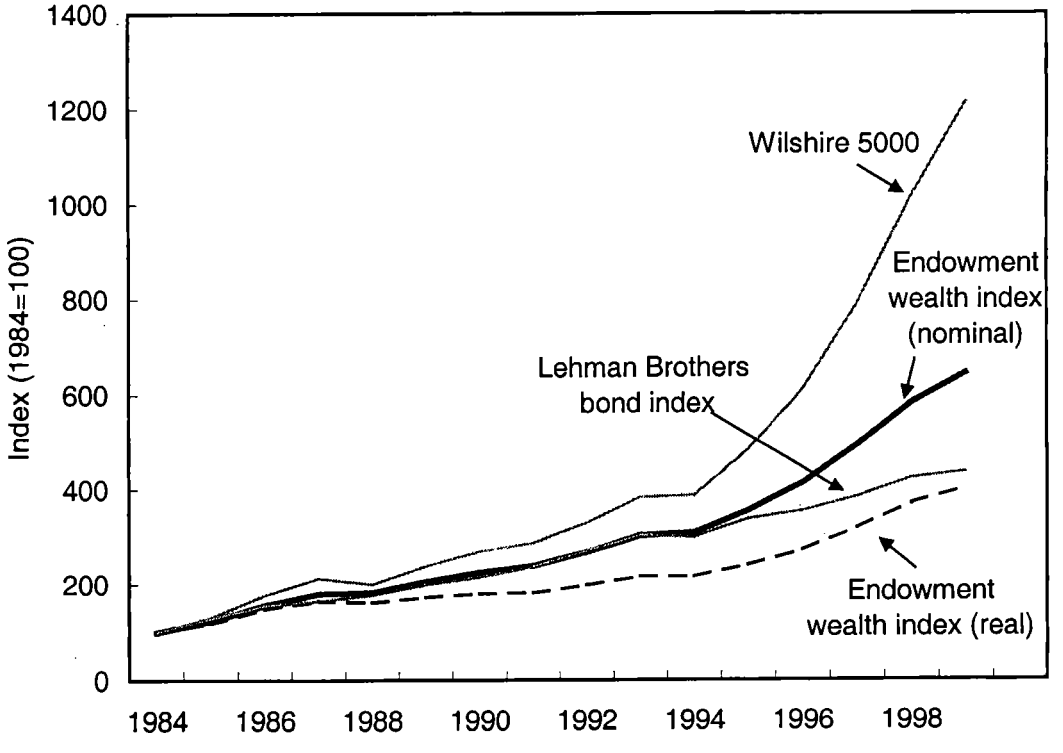
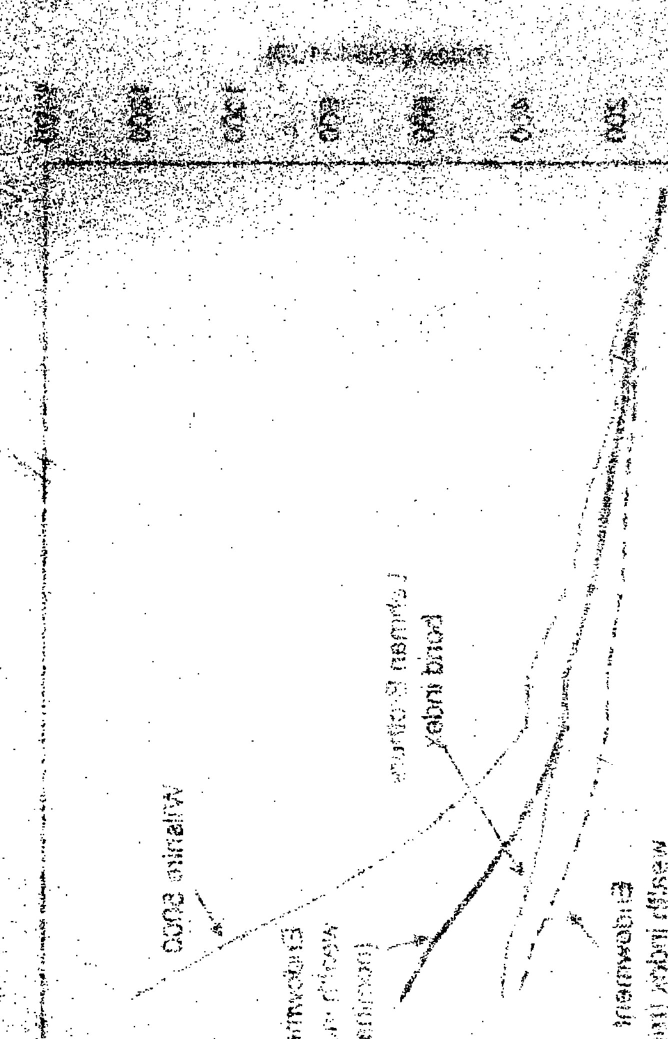
CHART OF THE WEEK

Performance of College and University Endowments



The increase in the aggregate value of college and university endowments in recent years has been better than bonds but not as good as stocks, most likely because few if any endowments are exclusively invested in stocks. In addition, changes in endowments reflect fund raising and withdrawals. Adjusted for inflation, endowments in 1999 were 300 percent higher than they were in 1984. (An article in this briefing describes increases in tuition and financial aid at colleges and universities.)

College and University Endowments



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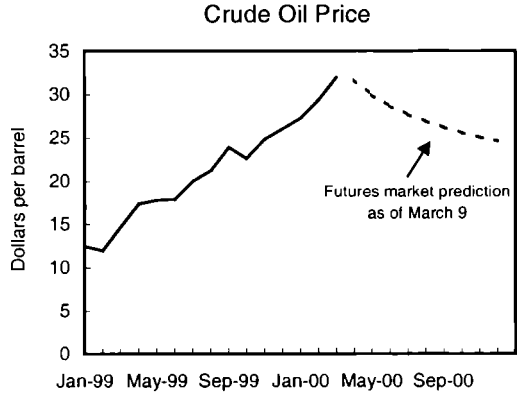
"It's not just me, Dad. Amazon.com has never made a cent, either."

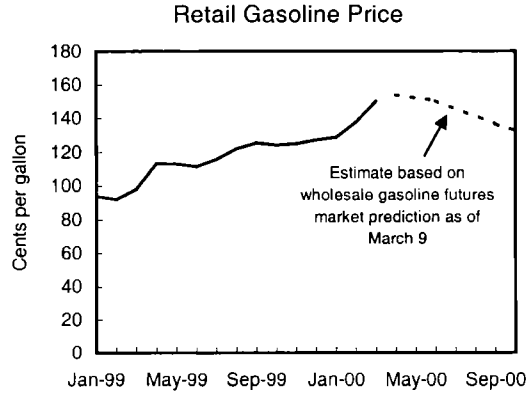
CURRENT DEVELOPMENT

Oil and Gasoline Outlook

Although crude oil prices reached a post-Gulf War high earlier this week before retreating a bit, lower prices in the futures market reflect expectations that OPEC will announce a supply increase at its March 27 meeting. Nevertheless, gasoline prices this summer will be substantially higher than they were last year.

Crude oil. This week's peak price of over $34 per barrel capped a year of increases (see upper chart). However, oil futures prices are signaling a decline to about $25 per barrel by the end of the year. Given current projections for world oil demand, these futures prices imply that markets are expecting an increase in supply of about 1 million barrels per day by this spring, 2 million barrels per day by the end of the summer, and 3 million barrels per day by the end of the year.





Gasoline. Low gasoline inventories and rising crude oil prices have led to rising gasoline prices, with the national average retail price reaching $1.50 per gallon (see lower chart). Since refiner margins historically increase during the spring and summer months because of the summer driving season, gasoline prices may keep rising even as crude oil prices fall. Nevertheless, futures prices suggest that the retail price of gasoline will decline to just above $1.30 per gallon by October. Local prices vary considerably around the national average. For example, in a recent survey, retail prices in Tulsa were about 20 cents per gallon lower than the national average while those in San Francisco were about 25 cents higher.

Risks. The decline in oil and gasoline prices implicit in the futures markets is subject to uncertainty. For example, the Department of Energy's most recent energy market forecast, released this week, estimates that gasoline prices will average about $1.50 per gallon throughout the summer, in part at least because DOE appears to expect less additional world crude supply than the markets. As a rough rule of thumb, each 1 million barrel per day increase in supply above current production and demand growth decreases crude prices by $4 per barrel and gasoline prices by about 10 cents per gallon in the short run. The markets appear to expect OPEC to increase supply by about a million barrels per day. But

in the past 2 weeks, 1-month-out futures prices have shown considerable volatility, based in part on statements by various OPEC members about what will be decided at the March 27 meeting.

With gasoline inventories low, there is also uncertainty in the gasoline market over and above that associated with crude oil prices. Local price spikes may occur due to supply shocks such as a refinery or pipeline shutdown for repair. Such short-term price spikes occurred in the gasoline market in California last year due to a refinery fire, as well as in the home heating oil market in New England this winter because of weather-related delivery problems. DOE estimates that unexpected supply shocks could push monthly average gasoline prices up into the $1.75 to $1.80 per gallon range.

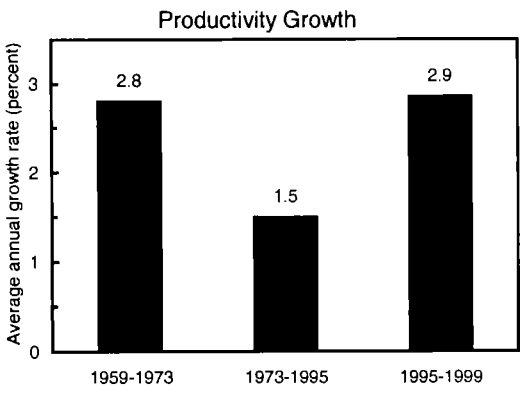
Macroeconomic effects. The higher crude oil prices will likely add an additional 0.2 to 0.3 percentage point to the consumer price index for February, and if gasoline prices remain at their current levels, another 0.2 to 0.3 percentage point in March. (A national average increase of 10 cents per gallon for gasoline increases the CPI by about 0.25 percentage point and the producer price index by about 0.6 percentage point.) However, the drop in oil prices over the rest of the year implied by the futures market would undo these increases.

3-13-00

SPECIAL ANALYSIS

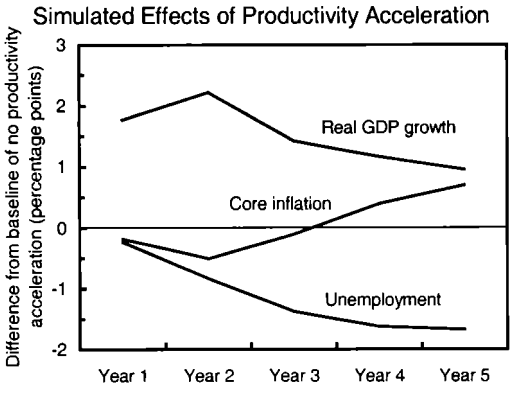
Growing Pains in the New Economy

The sustained increase in productivity growth since 1995 (see chart) bodes well for future growth in real wages. The recent productivity acceleration has also helped lower core inflation. Paradoxically, however, it may also be a source of potential overheating of the economy in the short run. Alan Greenspan pointed to such a possibility in recent testimony, observing that the improvement in productivity trends may be a reason why increases in spending have been outstripping increases in domestic supply, causing unemployment to fall and the current account deficit to widen, and increasing the risk of inflation.



A spending boom. One implication of accelerating productivity is higher expected future corporate profits through the effects of lower costs and increased sales. This improved profit outlook, in turn, justifies higher stock prices. The resulting increase in household wealth encourages greater consumer spending through the wealth effect described in last week's *Weekly Economic Briefing*. But the productivity acceleration also causes wages and incomes to rise faster, and as people come to expect this to continue, they raise their spending patterns accordingly. Together, these effects can cause current spending to increase more than current income, because households might rationally borrow against the income they expect to receive in the future in order to pay for rising standards of living starting today. A further boost to aggregate spending comes from business investment, as firms ramp up capacity to meet growing demand for their products.

An experiment. Record levels of consumer confidence, the booming stock market, and rapid growth in consumer and business spending offer circumstantial evidence of a spending boom fueled by the productivity acceleration. Still, sustained changes in productivity growth are rare, making a careful empirical test of the link between accelerating productivity and spending difficult. An experiment using the Federal Reserve's macroeconomic model provides some indirect support for this hypothesis, however. The experiment involves comparing two simulations: a base case with a constant trend rate of growth of productivity, and a second case with a 1 percentage point higher trend rate of growth of productivity. The Federal Reserve is assumed to hold the real federal funds rate constant in both simulations. The results of the experiment are meant to be illustrative of the linkages between productivity and spending; they are not mean to measure the extent to which productivity increases have contributed to actual economic developments.



Model results. In the experiment, the spending boom outlined above causes real GDP to grow faster than potential GDP for the first 4 years (see chart). The shortfall in supply is made up by hiring additional labor (which causes the unemployment rate to fall by 1.7 percentage points) and a widening of the current account deficit (not shown in chart) as imports make up for the share of demand not met by domestic producers.

The productivity acceleration has two competing effects on inflation. Because it takes several years for wage increases to catch up with the rise in productivity, unit labor costs initially fall, putting downward pressure on inflation. This impulse for falling inflation diminishes over time. If it were not for increased labor market tightness, the inflation rate would eventually stabilize at a lower level. This outcome could be accomplished if the Federal Reserve were to raise interest rates sufficiently to keep spending in line with potential GDP. Without such rate increases, however, the tighter labor markets resulting from the spending boom put upward pressure on wages and prices, eventually leading to a pickup in core inflation.

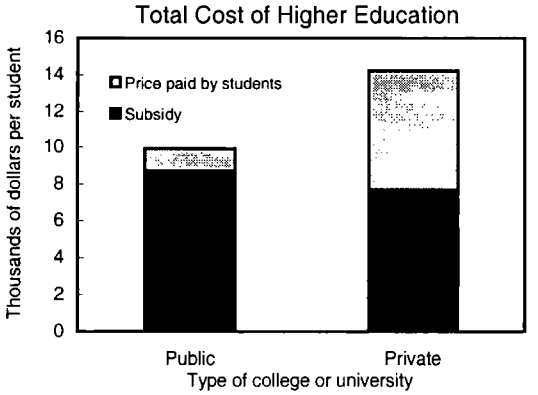
Conclusion. This model-based experiment provides one basis of support for Chairman Greenspan's contention that the productivity acceleration may be a key factor behind the recent spending boom and fall in unemployment. Other models might produce different results. But as long as the inflationary pressure from tight labor markets outweighs the dampening effect of lower unit labor costs, a policy tightening is needed to forestall rising inflation.

ARTICLE

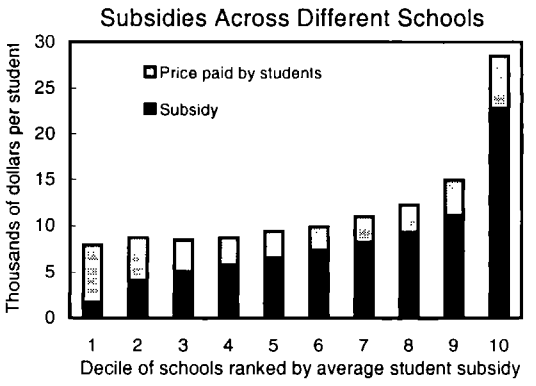
The Market for Higher Education

Tuition has been rising faster than inflation at many colleges, but a significant proportion of the increase in the "list" price of a college education has been offset by increases in financial aid. Many colleges use aid to compete for students, and such competition appears to have increased the likelihood that well-qualified applicants from financially disadvantaged backgrounds will attend good schools.

Subsidies for higher education. Most colleges and universities are non-profit institutions that subsidize the cost of educating their students. Those subsidies come in two forms: subsidies targeted at individual students through financial aid grants, and general subsidies received by all students because even the full tuition price does not cover the total cost of a student's education. On average, financial aid accounts for only about 25 percent of the total subsidy across all types of schools. A study of educational costs and net payments by students during the 1994-1995 school year found that the average subsidy (from both financial aid and general subsidies) was about $8,700 per year at public universities and colleges, and about $7,700 at private schools (see upper chart). Student payments make up the difference between the subsidy and the total cost of a college education, and these payments averaged $1,200 per year in the public sector and $6,500 per year at private institutions.



Subsidy differences across institutions. These averages conceal wide differences among individual institutions. When institutions are grouped according to subsidy levels, those in the upper 10 percent look very different from the rest (see lower chart). Among these institutions, which include both private schools like Harvard, Stanford, and Williams and public schools like Berkeley, UCLA, and the University of Minnesota, the average subsidy per student was $22,800 during the 1994-1995 school year. Students at these institutions paid an average of $5,700, which is also higher than at most other schools. The institutions with the highest subsidy level are also the most selective, and they attract students with better academic credentials. Students at these institutions are paying more for a more expensive (and presumably higher quality) education than most students at



less well subsidized schools. As the subsidy level declines, however, so does school selectivity and student quality.

Competition in higher education. This disparity in subsidy levels reflects the fact that at the upper end of the distribution, schools place a high value on their academic reputation and compete aggressively for the top caliber students necessary to maintain that reputation. By setting a price below the market clearing level, these schools can increase the pool of applicants and thereby select among applicants with better academic credentials.

Trends in tuition increases in higher education. Competition has led to changes in how schools price their services. Between the 1986-87 school year and the 1994-95 school year, real tuition "list" prices increased by 34 percent. As a result of increases in financial aid, however, the amount students actually paid increased only about half as much.

Effects on student access to college. The increasing competition for high quality students has helped students from disadvantaged financial backgrounds. One study found that in 1972 students from low income families who scored well on the SAT and who were in the top quarter of their high school class had a 6 percent probability of not going to college at all, and a 33 percent probability of going to one of the most expensive colleges. In 1992 students with the same background had a zero percent chance of not going to college, and a 43 percent chance of ending up at one of the top schools.

Conclusion. The cost of providing a college education varies widely among institutions, as does the amount of that cost which is subsidized. At the most selective schools with the largest subsidies, however, competition for students through financial aid awards appears to be helping those from financially disadvantaged backgrounds.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Beige Book Reports Growth Continuing in First Quarter. Reports from the twelve Federal Reserve Districts indicated appreciable expansion of economic activity during late January and February. The majority of districts reported strong growth, with the remaining reports pointing to moderate growth or continued high levels of activity. Retail sales expanded significantly over their year-earlier levels. Gains in manufacturing output were widespread. Providers of services to businesses and consumers continued to expand output and employment substantially. Real estate market activity and construction were at high levels, although slight cooling was evident in some areas. Conditions in the agricultural and resource extraction sectors were mixed. Demand for bank loans generally was strong, but several districts reported slower activity in some loan categories, especially consumer loans and residential mortgages. Constraints on the availability of labor and other production inputs were apparent in many areas. Most districts reported tight supplies and upward wage pressure for various types of labor, both skilled and entry level. Despite faster wage growth for some workers, increases in the prices of final goods and services were limited overall, although the prices of transportation services and some industrial commodities rose noticeably.

Class Size Research: a Critique of the Critics. A critical question in the economics of education policy is whether changes in school spending such as reductions in class size affect student performance. Evaluations of Tennessee's STAR experiment provide some of the strongest evidence that reducing class size has a positive effect on student performance, but other studies are less conclusive. In fact, one influential scholar who conducted a quantitative summary of the literature concluded that there is no strong or consistent relationship between school inputs and student performance. But this agnostic conclusion has been called into question by one of the leading proponents of the view that class size matters, who argues in a new study that once the quality of individual estimates is taken into account the weight of the evidence supports the conclusion that class size is systematically related to student achievement. In addition, the new study performs a cost-benefit analysis of class size reduction, based on the STAR experiment. The key finding is that the present value of the benefits of class size reduction in terms of increased student income is greater than, or roughly equal to, the costs, depending upon assumptions about the discount rate and productivity growth.

INTERNATIONAL ROUNDUP

Education Access Improving in Developing Countries. A new OECD report measuring educational performance in 18 non-OECD developing countries finds that most have achieved universal primary education and are closing the gap at the lower secondary level. In most countries, the percentage of the population that has completed at least a lower secondary education is significantly higher in the 25-34 year old age group than in the 55-64 year old age group, indicating broad progress in increasing education access over time. However, of the countries studied, only Argentina, Brazil, and Chile have participation rates higher than 75 percent for the final year of compulsory schooling, indicating that most countries still have not met the objective of universal compulsory education. Interestingly, all but one of the countries in the study invest a higher proportion of their public budgets in education than the average OECD country, indicating that education is a high priority. However, expenditure per student in these countries still lags far behind the OECD average at both the primary and secondary levels.

EC Endorses Emissions Trading. As a stepping stone to help the EU achieve its internationally agreed emission reduction targets, the European Commission launched the European Climate Change Program this week and released a Green Paper advocating greenhouse gas emissions trading. The latest data show that CO_2 emissions are increasing in the EU, and the Commission emphasized that without additional measures, the EU will not meet its Kyoto Protocol target of cutting greenhouse gas emissions by 8 percent between 1990 and 2008-12. Besides reducing emissions from specific sources, the EC advocates the adoption of an internal EU emissions trading scheme that will allow the energy sector and big industrial installations to buy and sell pollution permits.

Congressional Commission Recommends Contraction of Fund and Bank. This week, the International Financial Institution Advisory Commission, established by Congress in 1998, released a report advocating major reductions in the activities of the International Monetary Fund and the World Bank. The report recommends that the IMF restrict its lending to providing short-term liquidity and stop extending long-term loans in exchange for member countries' agreeing to abide by IMF-imposed conditions. The emergency loans would be made at a penalty (above-market) rate and have a limited maturity. The report suggests that the Bank end all resource transfers to countries that enjoy access to private capital markets (the bulk of current Bank lending) or that have per capita incomes exceeding $4,000. It recommends replacing loans and guarantees for physical infrastructure and social service projects with grants. It also calls for the World Bank to transfer primary responsibility for Latin America and Asia to these regions' development banks. The commission also proposes that both the IMF and the World Bank write off all their claims against heavily-indebted poor countries that implement an effective economic and social development strategy.

RELEASES THIS WEEK

Productivity

According to revised estimates, nonfarm business productivity rose 6.4 percent at an annual rate in the fourth quarter of 1999. Manufacturing productivity rose 10.3 percent.

MAJOR RELEASES NEXT WEEK

Advance Retail Sales (Tuesday)
Industrial Production and Capacity Utilization (Wednesday)
Producer Prices (Thursday)
Housing Starts (Thursday)
Consumer Prices (Friday)

U.S. ECONOMIC STATISTICS

	1970-1993	1999	1999:2	1999:3	1999:4
Percent growth (annual rate)					
Real GDP (chain-type)	3.0	4.5	1.9	5.7	6.9
GDP chain-type price index	5.2	1.6	1.3	1.1	2.0
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	**3.6**	0.6	5.0	**6.4**
Real compensation per hour:					
Using CPI	1.0	**1.7**	**1.4**	**2.1**	**0.8**
Using NFB deflator	1.5	**3.0**	2.9	4.0	**2.1**
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.6	12.6	12.7	12.5
Residential investment	4.5	4.4	4.5	4.4	4.4
Exports	8.2	10.8	10.7	10.8	10.9
Imports	9.2	13.5	13.4	13.8	14.0
Personal saving	6.6	1.7	1.8	1.5	1.3
Federal surplus	-2.8	N.A.	1.3	1.4	N.A.

	1970-1993	1999	December 1999	January 2000	February 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	4.0	4.1
Payroll employment (thousands)					
increase per month			309	384	43
increase since Jan. 1993					20823
Inflation (percent per period)					
CPI	5.8	2.7	0.2	0.2	N.A.
PPI-Finished goods	5.0	3.0	0.1	0.0	N.A.

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

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1998	1999	January 2000	February 2000	March 9, 2000
Dow-Jones Industrial Average	8626	10465	11281	10542	10011
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.32	5.55	5.66
10-year T-bond	5.26	5.65	6.66	6.52	6.35
Mortgage rate, 30-year fixed	6.94	7.43	8.21	8.33	8.23
Prime rate	8.35	8.00	8.50	8.73	8.75

INTERNATIONAL STATISTICS

Exchange Rates	**Current level March 9, 2000**	**Percent Change from Week ago**	**Year ago**
Euro (in U.S. dollars)	0.968	0.7	-10.9
Yen (per U.S. dollar)	106.5	-0.9	-12.3
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	95.44	-0.5	-0.1

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	4.5 (Q4)	4.1 (Feb)	2.7 (Jan)
Canada	4.7 (Q4)	6.8 (Jan)	2.3 (Jan)
Japan	1.0 (Q3)	4.7 (Dec)	-0.9 (Jan)
France	3.2 (Q4)	10.4 (Dec)	1.6 (Jan)
Germany	2.3 (Q4)	8.7 (Jan)	1.7 (Jan)
Italy	1.2 (Q3)	11.1 (Oct) [2/]	2.2 (Jan)
United Kingdom	2.9 (Q4)	5.9 (Nov)	1.9 (Jan)

1/ For unemployment data, rates approximating U.S. concepts as calculated by the U.S. Department of Labor, Bureau of Labor Statistics, except as noted in footnote 2.

2/ Data from OECD standardized unemployment rates and reflects new series for Italy.