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Weekly Economic Briefing - July 14, 2000

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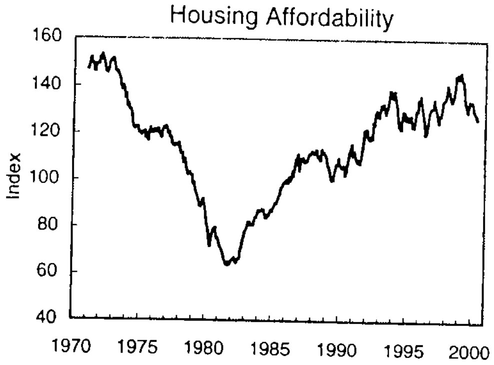
Looking forward, this kind of analysis suggests that interest rates would rise by about ¾ to 1 percentage point if we were merely to maintain the current debt-to-GDP ratio of about 0.35 rather than reducing the debt to zero by 2012.

Impact on households. Each 1-percentage point reduction in interest rates lowers the annual payment on a $100,000 30-year mortgage by about $860, on a $10,000 48-month car loan by about $70, and on a $20,000 10-year student loan by about $140. Based on the current amount of loans outstanding, each percentage point difference in interest rates represents about $39 billion per year on mortgage payments, $3 billion per year on car loans, and $1.5 billion on student loans. Another indicator of a favorable interest rate environment is the housing affordability index, which in the 1990s has been at levels last seen in the early 1970s (see chart, where a value of 100 means that a family with median income can qualify for a mortgage that would allow it to purchase a median-priced home).



Why aren't we seeing lower rates now? Before the Federal Reserve began tightening last summer, the decline in actual interest rates corresponded to the calculation made above about the impact of deficit reduction. Mortgage rates, for example, were about 1½ percentage points below their average 1992 levels, whereas they might have been expected to be a percentage point higher based on the behavior of interest rates in past expansions. As shown in the Chart of the Week, however, consumer interest rates have moved up as the Fed has raised its target for the Federal funds rate. If the pattern following the Fed's tightening in 1994 is repeated, some of the recent increase will be reversed when the Fed stops tightening. Moreover, the calculations reported in this article represent changes in interest rates relative to what they would have been without deficit reduction, not relative to where they were in 1992.

Conclusion. Deficit reduction since 1993 means that households face lower borrowing costs than they otherwise would have. Much of the gain comes from reversing the explosion of debt that would have taken place over the next several years. In addition to substantial savings in Federal interest outlays, each trillion dollars of debt reduction represents an annual direct saving to households of $5-6 billion in mortgage, auto, and student loan payments.

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

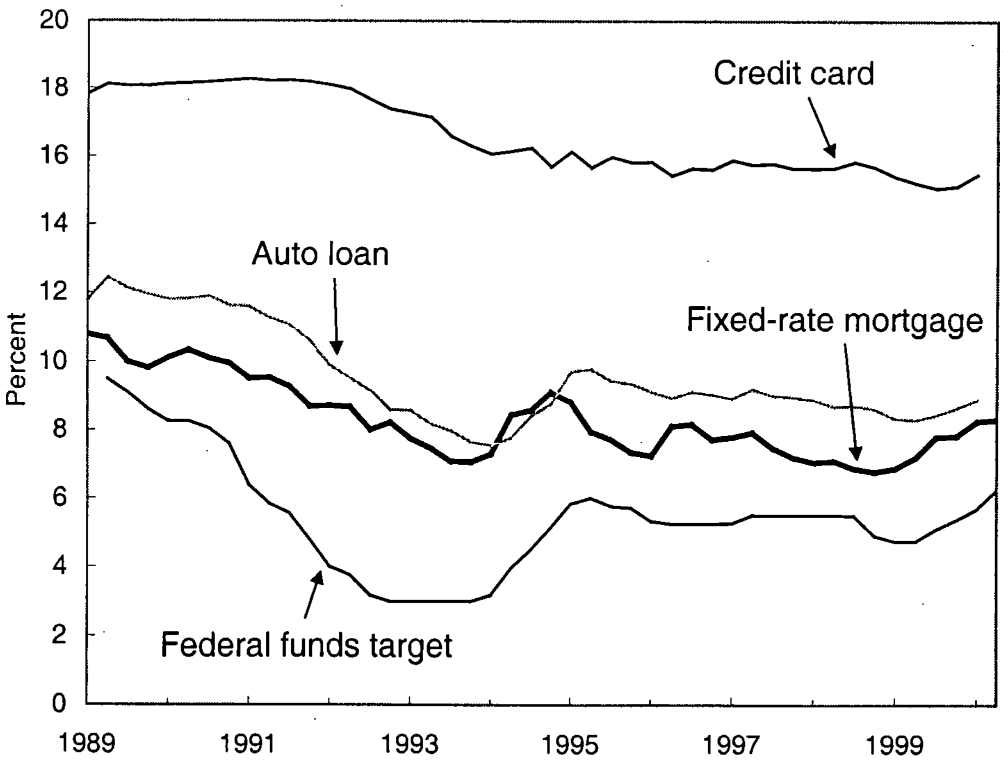
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

July 14, 2000

Copied
Baily
Podesta
p. 2 to Jennings

CHART OF THE WEEK

Consumer Interest Rates and the Target Federal Funds Rate



Consumer interest rates, especially for mortgages, have increased since last summer as the Federal Reserve has tightened monetary policy. A similar sharp increase occurred in 1994 during the last major Fed tightening, but consumer rates subsequently came down once the Fed stopped tightening.

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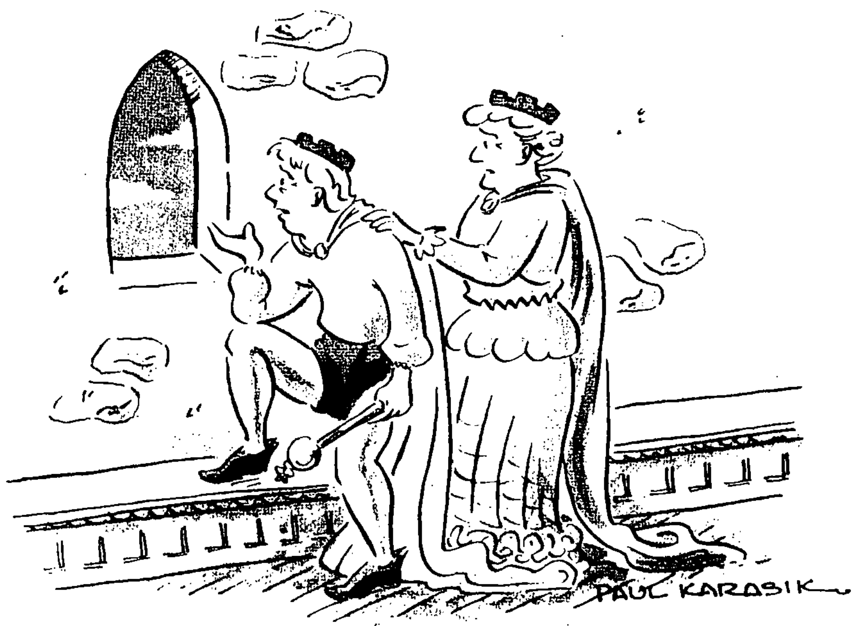


"First, they take my domain, then they take my domain name."

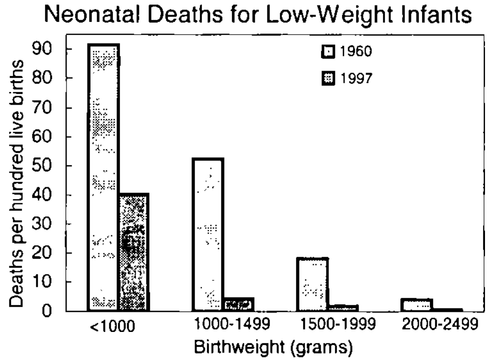
SPECIAL ANALYSIS

Some Economics of Improving Infant Health Outcomes

Prenatal care is currently underutilized, limiting its ability to improve infant health cost-effectively. Innovations in neonatal care technology can offset this problem by increasing life expectancy. But these gains have come with a high price tag. By increasing coverage of prenatal care, we may be able to take advantage of recent medical innovations, resulting in healthier infants at lower costs.

Trends in infant health outcomes. Neonatal mortality decreased dramatically for low-birthweight babies between 1960 and 1997 (see upper chart). And underweight infants are not only living longer but also leading relatively healthy lives. Improved medical technology has been important, but the cost of neonatal care is high. Medical expenses for infants less than 1000 grams (about 2 pounds) are 10 to 20 times those of treating a normal-weight infant, and sometimes over $100,000. Why then are people investing so heavily in neonatal care when prenatal care could have the same outcome—healthier infants—at dramatically lower costs?

Neonatal Deaths for Low-Weight Infants



The bad news: efforts to increase prenatal care are often ineffective. Prenatal care is commonly believed to be the best way to improve infant health. At a relatively low cost of about $400-500 per woman, medical screening and appropriate care could reduce the incidence of low birth weight by about 20 percent. However, accessibility to such care is often a problem, especially for women in lower income groups. Evidence suggests that when the income threshold for receiving Medicaid was raised in 1990, the number of women who received prenatal care increased, and fewer women delayed prenatal care beyond the first trimester. However, this increase in prenatal care did not appear to have much effect on birth weights. A likely explanation is that high-risk women continued either not to receive prenatal care or to receive it later into their pregnancy than did others. In addition, smoking and drug use may affect birth weight, especially in the high-risk group. Unfortunately, several studies have found that women who are likely to have unhealthy infants are more likely to go without prenatal care. Thus, despite attempts to increase use of prenatal care, the women who need it are often the least likely to receive it.

The good news: neonatal care is becoming more cost-effective. Gains in life expectancy suggest that improvements in neonatal care partially offset the underutilization of prenatal care. Neonatal technology involves a great deal of

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medical machinery, such as incubators and machines to monitor blood gases, heart rate and rhythm, breathing rate, and blood pressure. In fact, improvements in ventilators allow better treatment for underdeveloped infants, lowering the risk of lung damage. But pharmaceuticals have also played an important role in lowering costs and increasing life expectancy. For example, the increased use of surfactant to treat respiratory distress syndrome, a major cause of death for many low-birthweight infants, has decreased the need for more intrusive medical intervention. Despite the high costs of neonatal care, the value of increased life expectancy produces an enormous benefit. For low-birthweight infants (those between 1000 and 1500 grams), the benefits of improved survival and quality of life are huge compared with the costs. One study that assigned a monetary value to each year of life found that the rate of return for low-birthweight infants was an enormous 1,880 percent.

Implications. The importance and effectiveness of neonatal care in countering the effects of low birth weight does not mean that we should forget about prenatal care. Thus, extending S-CHIP to parents may encourage the use of prenatal care. Because the program targets an increase in coverage to women who are at higher risk of low-weight births, those who most need prenatal care will be more likely to participate. Additionally, improvements in prenatal care allow even late-term intervention to decrease neonatal costs. For example, late-term prenatal steroids speed the development of a fetus in danger of being premature, decreasing the need for costly neonatal intervention. To the extent that cheaper prenatal care can substitute for much more expensive—albeit highly effective—neonatal care, the overall costs of achieving improved infant health outcomes will be reduced.

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SPECIAL ANALYSIS

What's in a Name?

Internet domain names (such as "ibm.com" or "whitehouse.gov") are valuable assets. In many cases, however, organizations and individuals find that names they would like to use have already been registered by other parties. Moreover, Internet domain names have always been issued to individuals, companies, and nonprofit organizations on a first-come-first-served basis. While economic theory suggests that this somewhat arbitrary assignment of domain names need not interfere with the efficient allocation of resources, the issue remains contentious in law and practice.

Ownership of domain names. The way domain names have been issued can lead to confusion and may not initially produce the best allocation. For example, entering "www.delta.com" into a web browser brings up Delta Financial Corporation, not Delta Air Lines ("www.delta-air.com"). Until recently, the popular search engine AltaVista could only be reached at "www.altavista.digital.com" because "altavista.com" was registered to Altavista Technology Inc. People looking for a particular web site might benefit from a different assignment of names, as might site owners seeking to attract visitors.

Who should own a particular domain name? Economic theory teaches that resources, when freely tradable in markets, tend to flow to their highest valued users. This is the rationale behind spectrum auctions, the creation of tradable SO_2 permits, and other market-based solutions to resource-allocation problems. Rather than deciding who should own a particular resource, courts and regulatory authorities often focus instead on assuring that the relevant property rights are clearly defined and protected, relying on exchange to determine ownership patterns. Nobel Prize winner Ronald Coase famously elaborated this insight in 1960. The "Coase Theorem" implies that the initial allocation of property rights need not affect the eventual allocation of rights, as long as such rights can be bought and sold. Of course, initial allocations do affect the distribution of wealth, and transaction costs can impede the efficient transfer of rights to their highest-valued uses. Nonetheless, Coase's approach provides a powerful framework for understanding liability and property issues.

A market for domain names? The Coase Theorem suggests a simple way for individuals and organizations to obtain the domain names they desire: buy them. (Compaq, AltaVista's parent, did just that, purchasing the "altavista.com" domain for a reported $3.35 million in 1998). But what about "cybersquatting," the practice by which speculators register previously unregistered domain names merely to hold and then sell to the highest bidder? Some cybersquatters have been successful: according to *Web Developer's Journal*, the domain name "business.com" was recently sold for $7.5 million; "loans.com" for $3 million; "wine.com" for $2.9 million; "autos.com" for $2.2 million; and "drugs.com" for $830,000. In other cases, however, domain name holders have been sued for trademark infringement, particularly following passage of the Trademark Cyberpiracy Prevention Act, and the Courts have shown some sympathy (see box).

Conclusion. While cybersquatting has enriched a few individuals and consequently appears unfair to many, alternatives to the present system of assigning names have problems of their own. Domain names cannot be allocated by public auction, as with electromagnetic spectrum, because the number of potentially valuable names is effectively infinite. Resolving domain-name disputes by litigation also imposes substantial costs. Besides the administrative costs of the actual legal proceedings, it is difficult for courts to distinguish between opportunistic and legitimate use of domain names that may be similar to the trademarked names of companies and nonprofit organizations. The social costs of "wrong" decisions by courts can be particularly disruptive to individuals and small, startup companies who find themselves targets of a trademark infringement suit.

Cybersquatting Goes to Court

In December 1999 the New York Yankees filed suit against Brian McKiernan, owner of "newyorkyankees.com" since 1997. Citing the Trademark Cyberpiracy Prevention Act, the suit charges McKiernan with illegal cybersquatting, trademark infringement, false representation, and trademark dilution. (McKiernan's attorney claims the Yankees offered his client $450 million for the name before filing the suit.) In a similar suit, People for the Ethical Treatment of Animals (PETA), owner of "peta.com," sued Michael Doughney for using his legally registered domain, "peta.org," to host a PETA parody site. In June 2000, a U.S. District Court judged ruled in favor of PETA and ordered Doughney to turn over the domain name to PETA.

Recent court rulings in this area suggest that individuals may register and use domain names that are similar to company and organization names, but only if the domains are intended for artistic or political parody, not merely the expected gains from selling the domain. In the PETA case, for example, the court ruled that Doughney's primary purpose was to mislead and confuse potential visitors to PETA's site, and possibly to intimidate PETA into buying the domain name.

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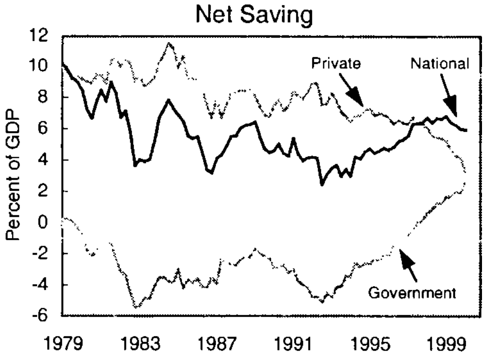
ARTICLE

Deficit Reduction and Interest Rates

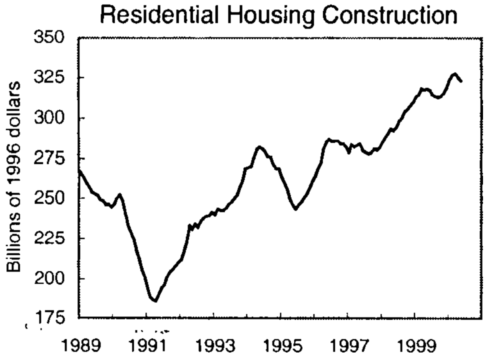
The swing from Federal deficits to surpluses has boosted national saving and investment and contributed to the remarkable performance of the economy over the past several years. While consumer interest rates have increased since last summer (see Chart of the Week), economic analysis suggests that the longer-term impact of paying off the debt by 2012 has been mortgage, car loan, and other interest rates that are 2½ to 3 percentage points lower than they would have been based on pre-OBRA-1993 deficit projections.

Trends in saving and investment. Deficit reduction has increased government saving, which has translated into increases in net national saving (see upper chart). However, increases in government saving do not translate dollar-for-dollar into increases in national saving. As shown in the chart, private saving tends to move in the opposite direction from government saving, including a decline in private saving that has partly offset the increase in government saving since 1993. In addition, some of the increase in national saving goes into investment abroad (or reduced borrowing from abroad) rather than into domestic investment.

Net Saving



Residential Housing Construction

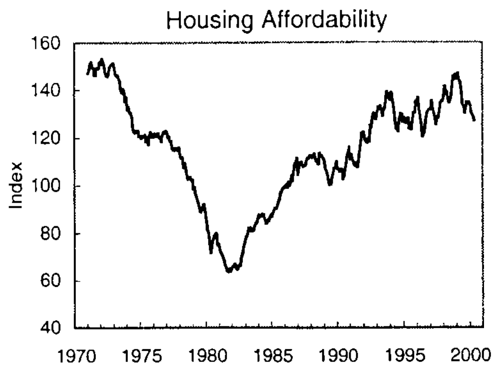


A reasonable estimate is that each $1 of increased government saving from deficit reduction translates into an additional 40-50 cents of increased domestic saving available to finance domestic investment such as housing and business equipment. The increase in business equipment in this expansion has been widely noted, and housing construction has surged as well (see lower chart).

Lower interest rates. The net increase in domestic saving and investment resulting from deficit reduction leads to increased capital formation, a lower return to capital, and lower interest rates. OMB calculations predicted a national debt of nearly $20 trillion (in 1993 dollars) in 2012 assuming pre-OBRA-1993 deficits, or a debt-to-GDP ratio of about 1.3. Based on a standard economic model, the elimination of such a debt by 2012 implies a reduction in interest rates of 2½ to 3 percentage points relative to what they would have been under that baseline (or about 12½ to 15 basis points per trillion dollars of deficit reduction).

Looking forward, this kind of analysis suggests that interest rates would rise by about ¾ to 1 percentage point if we were merely to maintain the current debt-to-GDP ratio of about 0.35 rather than reducing the debt to zero by 2012.

Impact on households. Each 1-percentage point reduction in interest rates lowers the annual payment on a $100,000 30-year mortgage by about $860, on a $10,000 48-month car loan by about $70, and on a $20,000 10-year student loan by about $140. Based on the current amount of loans outstanding, each percentage point difference in interest rates represents about $39 billion per year on mortgage payments, $3 billion per year on car loans, and $1.5 billion on student loans. Another indicator of a favorable interest rate environment is the housing affordability index, which in the 1990s has been at levels last seen in the early 1970s (see chart, where a value of 100 means that a family with median income can qualify for a mortgage that would allow it to purchase a median-priced home).



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Why aren't we seeing lower rates now? Before the Federal Reserve began tightening last summer, the decline in actual interest rates corresponded to the calculation made above about the impact of deficit reduction. Mortgage rates, for example, were about 1½ percentage points below their average 1992 levels, whereas they might have been expected to be a percentage point higher based on the behavior of interest rates in past expansions. As shown in the Chart of the Week, however, consumer interest rates have moved up as the Fed has raised its target for the Federal funds rate. If the pattern following the Fed's tightening in 1994 is repeated, some of the recent increase will be reversed when the Fed stops tightening. Moreover, the calculations reported in this article represent changes in interest rates relative to what they would have been without deficit reduction, not relative to where they were in 1992.

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Conclusion. Deficit reduction since 1993 means that households face lower borrowing costs than they otherwise would have. Much of the gain comes from reversing the explosion of debt that would have taken place over the next several years. In addition to substantial savings in Federal interest outlays, each trillion dollars of debt reduction represents an annual direct saving to households of $5-6 billion in mortgage, auto, and student loan payments.

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To Bill Daley
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VP must use this
it's dynamite

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Homeownership Gains Are Widespread. The increase in homeownership rates since 1989 has been particularly notable among minority and low-income families, according to a recent study. While the homeownership rate among white families headed by someone aged 22-60 rose by 2.7 percentage points between 1989 and 1998, the comparable increases were 4.7 percentage points for black families and 3.7 percentage points for Hispanic families. Nevertheless, white families in this age group still had homeownership rates more than 50 percent higher than minority families. The study found that homeownership rates increased across all income quintiles, with the largest gains in the middle. In the upper income quintiles, the rise reflected family circumstances, such as increasing age, educational qualifications, and income, as well as changes in the number of adults and children per family. For families in the lower income quintiles, homeownership rates increased, even though they would have been expected to decline based on changes in these same factors. The authors suggest that the rise was due to two factors: the refocusing of the Community Reinvestment Act and Home Mortgage Disclosure Act; and changes in bank lending, such as the increase in the extension of higher-cost mortgages to "risky" borrowers and the rise of remote mortgage lenders. A strong economy has no doubt helped as well.

Small Businesses Appear to Have Greater Access to Credit. Changes in the information available to lenders appear to have increased small business's access to credit, according to a recent study. In particular, the study points to the rise of "infomediaries" such as credit bureaus, which collect information on firm payment and default histories that used to be available to a lender only after a long relationship with the borrower. As evidence of this greater access to credit, the study shows that the distance between small firms (those with fewer than 500 employees) and their lenders grew from an average of 51 miles for lending relationships that began in the 1970s to 161 miles for lending relationships that began in the early 1990s. Using data collected in 1993, before the rise of Internet transactions between businesses, the study found that some of the rise in distance was due to an increasing reliance on non-bank lenders. But small firms were also getting loans from banks whose nearest branches were increasingly far away. Methods of transacting loans also increasingly changed from personal contact to telephone or mail contact. The authors provide suggestive evidence that loans to distant firms are no longer limited to those with the highest credit quality, and thus that a wider and more distant cross-section of firms can now obtain funding.

Higher Minimum Wage Would Have Modest Effect on Food Prices. The food processing and restaurant businesses employ many minimum-wage workers. Nevertheless, current proposals to raise the minimum wage by $1 per hour would raise the processed food prices paid by consumers by less than 1 percent, according to a recent study by the Department of Agriculture. Restaurant prices might increase by 2.27 percent. The study notes that these one-time price increases are smaller than the 2.8 percent annual increase in food prices observed between 1989 and 1999.

INTERNATIONAL ROUNDUP

Study Develops a New Warning System for Financial Crises. A small set of leading indicators, such as appreciation of the real exchange rate, decline in stock prices, and a fall in exports, perform well in anticipating countries' susceptibility to banking and currency crises, according to a book just released by the Institute for International Economics. Based on 1970-95 data for a sample of 25 large emerging economies, the authors use a weighted average of the better-performing indicators to create a composite vulnerability index. Applied to the 1996-97 period, the ordinal ranking of countries derived from this index is effective at identifying the countries hit by currency crises, with only Indonesia being misclassified as not highly vulnerable. The out-of-sample performance was less impressive for banking crises, however, with only two of the five countries classified as most vulnerable actually experiencing a crisis. Banking crises were also found to be more costly than currency crises, requiring more than 3 years for recovery compared with 2 years for a currency crisis. The study found that changes in sovereign credit ratings and interest rate differentials—two commonly used indicators—turned out not to be in the best performing group of leading indicators.

Is the Bank of Japan Looking to Raise Interest Rates? Recent data has increased speculation that the Bank of Japan will abandon its zero-interest-rate stance and raise the inter-bank-lending rate at its regular monetary policy meeting on July 17. First, the most recent Tankan Survey revealed that while perceptions of business conditions remained unfavorable overall, the net percentage of respondents reporting "favorable" conditions rose across all sectors in June. Large manufacturing enterprises led the shift, with a majority responding positively for the first time in 3 years. Smaller enterprises and non-manufacturing sectors remained more pessimistic. Second, the Bank may interpret recent price data as showing incipient inflation. After close to 3 years of deflation, domestic wholesale prices remained stable from May to June, and are 0.3 percent higher than a year ago, with petroleum and coal products rising 2.9 percent from the previous month. There appears to be a concern among outsiders that the Bank may be looking for a reason to raise rates in order to assert its independence.

RELEASES THIS WEEK

Industrial Production and Capacity Utilization
****Embargoed until 9:15 a.m., Friday, July 14, 2000****

The Federal Reserve's index of industrial production increased 0.2 percent in June following an increase of 0.5 percent in May. Capacity utilization fell 0.1 percentage point to 82.1 percent.

Retail Sales
****Embargoed until 8:30 a.m., Friday, July 14, 2000****

Advance estimates show that retail sales rose 0.5 percent in June following an increase of 0.3 percent in May. Excluding sales in the automotive group, retail sales rose 0.2 percent following an increase of 0.5 percent.

Producer Price Index
****Embargoed until 8:30 a.m., Friday, July 14, 2000****

The producer price index for finished goods increased 0.6 percent in June. Excluding food and energy, producer prices fell 0.1 percent.

MAJOR RELEASES NEXT WEEK

Consumer Prices (Tuesday)
U.S. International Trade in Goods and Services (Wednesday)
Housing Starts (Thursday)

U.S. ECONOMIC STATISTICS

	1970-1993	1999	1999:3	1999:4	2000:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.9	4.6	5.7	7.3	5.5
GDP chain-type price index	5.2	1.6	1.1	2.0	3.0
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.7	3.7	5.0	6.9	2.4
Real compensation per hour:					
Using CPI	1.0	1.7	2.0	0.9	0.2
Using NFB deflator	1.5	2.9	4.0	1.8	1.8
Shares of Nominal GDP (percent)					
Business fixed investment	11.4	12.6	12.7	12.5	13.0
Residential investment	4.5	4.4	4.4	4.4	4.4
Exports	8.2	10.8	10.8	10.9	10.9
Imports	9.2	13.5	13.8	14.0	14.3
Personal saving	6.6	1.7	1.5	1.3	0.2
Federal surplus	-2.8	1.2	1.4	1.2	2.1

	1970-1993	1999	April 2000	May 2000	June 2000
Unemployment Rate (percent)	6.7**	4.2**	3.9	4.1	4.0
Payroll employment (thousands)					
increase per month			410	171	11
increase since Jan. 1993					22099
Inflation (percent per period)					
CPI	5.8	2.7	0.0	0.1	N.A.
PPI-Finished goods	5.0	2.9	-0.3	0.0	**0.6**

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

New or revised data in **boldface**.
PPI data **embargoed until 8:30 a.m., Friday, July 14, 2000**.

FINANCIAL STATISTICS

	1998	1999	May 2000	June 2000	July 13, 2000
Dow-Jones Industrial Average	8626	10465	10580	10583	10789
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.79	5.69	6.00
10-year T-bond	5.26	5.65	6.44	6.10	6.01
Mortgage rate, 30-year fixed	6.94	7.43	8.52	8.29	8.09
Prime rate	8.35	8.00	9.24	9.50	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level July 13, 2000**	**Percent Change from**	
		Week ago	**Year ago**
Euro (in U.S. dollars)	0.934	-2.0	-8.2
Yen (per U.S. dollar)	108.3	0.8	-10.8
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	97.97	0.9	0.7

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	5.1 (Q1)	4.0 (Jun)	3.1 (May)
Canada	4.9 (Q1)	6.6 (May)	2.4 (May)
Japan	0.7 (Q1)	4.9 (Apr)	-0.7 (May)
France	3.4 (Q1)	9.5 (Apr)	1.5 (May)
Germany	2.3 (Q1)	8.3 (May)	1.4 (May)
Italy	3.0 (Q1)	10.8 (Apr)	2.4 (May)
United Kingdom	3.0 (Q1)	5.7 (Mar)	3.1 (May)

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