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WEEKLY ECONOMIC BRIEF OF THE PRESIDENT OF THE UNITED STATES

BE

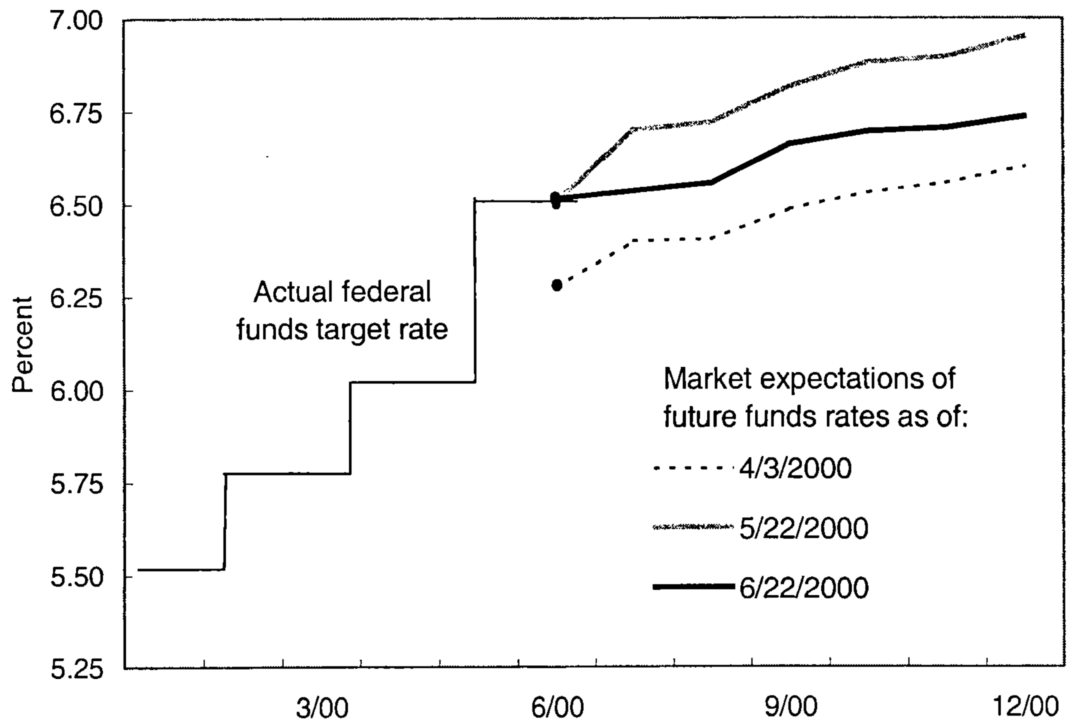
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

June 23, 2000

copied
Baily
Podesta

CHART OF THE WEEK

Market Expects Fed Rate Hikes Nearly Done for the Year



Market sentiment is that the Federal Open Market Committee will not make a move at next week's meeting, but will probably raise the federal funds target by one-quarter percentage point to 6.75 percent sometime later in the year. Recent data showing subdued inflation and slowing growth have soothed earlier concerns of further rate hikes.

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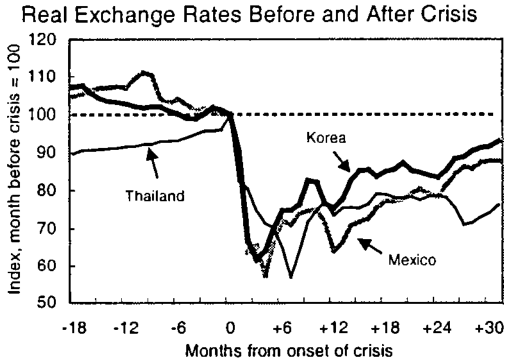
SPECIAL ANALYSIS

The Asian Rebound

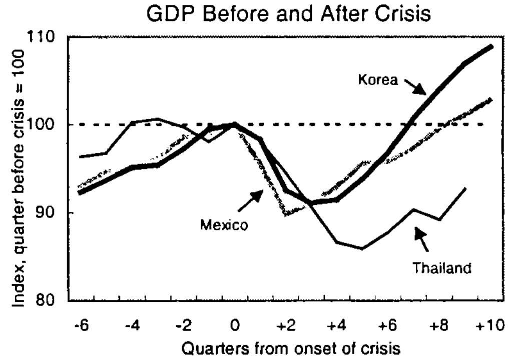
In contrast to the so-called "Tequila crisis" in Mexico in 1994-95, the Asian financial crisis that began in 1997 appeared to be rooted in private sector financial weaknesses rather than public sector financial problems. Nevertheless, the post-crisis responses of the economies have been remarkably similar, particularly in the cases of Mexico and Korea.

Real Exchange Rates Before and After Crisis



Exchange rates collapsed. The exchange rates of the Asian economies most affected by the crisis fell by around 40 percent at the onset of the Asian crisis, similar to the earlier Mexican experience (see upper chart). Real exchange rates remain well below pre-crisis levels in Korea and Thailand, as they did in Mexico.

GDP Before and After Crisis



Output fell sharply. The decline and subsequent rise in real GDP in Korea closely follows the pattern set by Mexico during its earlier crisis and recovery. In each case, output fell about 10 percent below its pre-crisis peak, and recovered fully within 2 years (see middle chart). Hong Kong and Malaysia have enjoyed rebounds similar to Korea's; in Thailand and Indonesia, however, the recoveries have shown considerably less bounce.

Unemployment Rates Before and After Crisis

Unemployment rose. Monthly unemployment data are available for Mexico and Korea, and show substantial increases after the onset of crisis (see lower chart). The unemployment rate rose more sharply in Korea than in Mexico, and peaked somewhat later. In both countries, unemployment gradually declined over the next few years. In the case of Mexico, the unemployment rate of 2.5 percent in April 2000 (4 1/2 years past the peak shown on the chart) was well below its pre-crisis level, while the Korean unemployment rate is still above its pre-crisis level but continues to decline.

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A cautionary note. The policy response to the Mexican crisis 5 years ago is now generally viewed as having produced satisfactory results. Similarly, the rapid rebound enjoyed by some economies hard hit by the Asian crisis owes much to sound macroeconomic policy and structural reform measures—as well as to a global economic boom that has boosted demand for Asian exports. The reform agenda remains incomplete, however, and the pace of reform needs to be maintained in order to continue improving corporate governance and rehabilitating the financial sector. The ongoing rapid recovery heightens the risk of complacency. While structural reforms can be painful in the short run, without them Asia would remain vulnerable to future economic disruptions.

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SPECIAL ANALYSIS

Measuring the Benefits of Pharmaceutical Innovation

Pharmaceutical research and innovation have been a key part of the increase in longevity discussed in last week's *Weekly Economic Briefing*. Antibiotics and vaccines, for example, have nearly eradicated major diseases like polio, measles, and diphtheria, and improved drug therapies have reduced the effects of epidemics such as AIDS.

Pharmaceutical innovations explain much of the fall in mortality. Today, people are living longer than ever. New drugs are constantly being developed and put to use to decrease mortality. A recent study finds that nearly two-fifths of the drugs in use in 1991 had been approved since 1980, highlighting the rapid rate of pharmaceutical innovation. The same study finds the use of new drugs (approved since 1970) explains over 40 percent of the variation in mortality reduction across 75 diseases between 1970 and 1991. In contrast to the impact of drugs, measures of non-medication therapeutic services, vaccines, and new surgical procedures appear to contribute little to the reduction in mortality from these diseases over this period.

Good argument for our program

Drugs reduce the need for hospitalization. A wide range of evidence supports the view that drug treatments have reduced the need for hospital care. For example, operations for peptic ulcers decreased by 80 percent from 1977 to 1987 after the introduction of H2 antagonists, thus saving hundreds of millions of dollars in annual medical costs. Similarly, one study found that the number of hospital bed-days declined most rapidly when the number of drug prescriptions rose. Data from patient visits, hospital use, and drugs prescribed between 1980 and 1991 show that there is a strong inverse relationship between hospital bed-days and drugs in use: a 10 percent increase in drug prescriptions is associated with a 6.4 percent reduction in hospital bed days. In contrast to the effect of drugs, the availability of new surgical techniques tends to increase hospital use.

Case study: drug treatment for heart attacks. The effects of new drug treatments in reducing mortality rates from heart attacks stands out as a particularly valuable example because, as noted in last week's *Weekly Economic Briefing*, improved cardiovascular care has been the dominant source of increased longevity in the United States. The heart attack mortality rate fell by about 30 percent between 1975 and 1995. During this period, several key drugs were introduced and widely adopted. For example, Heparin (a blood thinning drug) use rose quickly following its introduction in the 1980s to 53 percent of all cases, and settled at 70 percent by the mid-1990s. According to one estimate, improved medical treatment explains about half of the fall in heart attack mortality between 1975 and 1995, with virtually all of this attributable to pharmaceuticals. In fact, these numbers underestimate the total effect of drug therapy, because they do not include the effect of drugs in reducing the probability of having a heart attack in the first place.

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The social return to research on pharmaceuticals. According to one estimate, the return to society in the form of increased longevity of pharmaceutical research and innovation is well above the rates of return to overall investment in the economy. Moreover, such estimates of the value of pharmaceutical research ignore the positive effect of new drugs on the quality of life, implying an even larger benefit to society.

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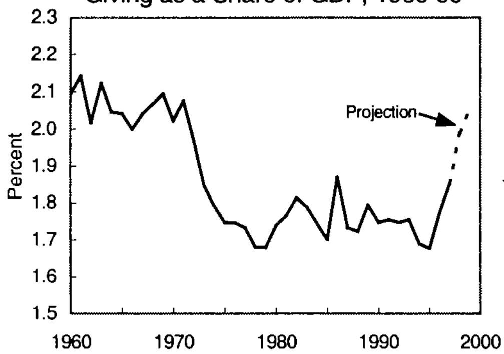
ARTICLE

Wealth and Giving

Philanthropic giving is estimated to have reached a record $190.2 billion in 1999 and has grown faster than GDP since 1995. The strong stock market and substantial increases in income and wealth among the wealthiest Americans appear to be important reasons for the recent surge.

Trends in giving. Between 1975 and 1995, total charitable giving fluctuated in a range around 1.75 percent of GDP (see chart). Sharp increases in giving in 1995 and 1996 outpaced growth in GDP, and the AAFRC Trust for Philanthropy (the organization that compiles these data) estimates that giving continued to be strong in 1998 and 1999, based on growth in income and the stock market. As a result, giving as a share of GDP in 1999 is estimated to be back near the levels of the 1960s.

Giving as a Share of GDP, 1960-99



Economic determinants of giving. Individuals provide about three-fourths of all giving, with the rest coming from foundations, bequests, and corporations. Economists analyzing the determinants of individual giving focus on ability to give (income and wealth) and the "price" of giving (based on the marginal tax rate for those who itemize deductions).

- Income and wealth. The average contribution through most of the income range averages about 1½ to 2 percent of family income, but this percentage rises for the small share of families with incomes above $100,000. Thus, strong growth in income and wealth has probably contributed to the recent growth in individual giving and bequests. In addition, private foundations are required by law to distribute a minimum share of their assets to charity each year, and the rise in the stock market has boosted these assets substantially.

- Taxes. Cuts in income tax rates in the 1980s raised the after-tax cost of making tax-deductible charitable contributions, and this increase was only partly reversed by subsequent changes in tax.law. Thus, tax changes are probably not the primary cause of recent increases in giving. However, economic studies generally find that giving is at least somewhat responsive to tax incentives, especially for higher income taxpayers. The Treasury estimates, for example, that repeal of the estate tax would reduce charitable giving by about $5-6 billion per year, partly through reduced bequests and partly through reduced lifetime giving.

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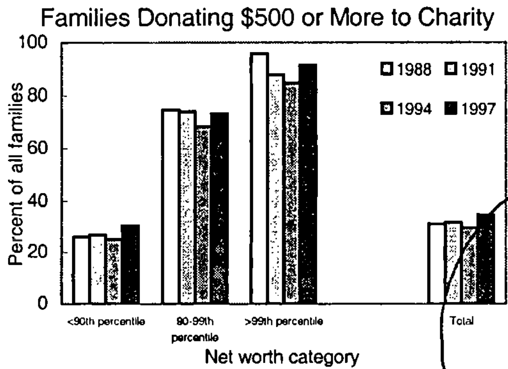
Wealth effects. Evidence on how giving varies with wealth comes from the Federal Reserve's Survey of Consumer Finances (SCF), which gathers detailed information about wealth and also asks about charitable contributions of $500 or more. Because of the $500 exclusion, the SCF data do not reflect smaller contributions. While this exclusion may produce a distorted pattern of participation among less wealthy households, it appears to exclude only about 5-10 percent of total contributions.

- Participation. The proportion of families making charitable contributions is much higher in the top 10 percent of the wealth distribution than in the bottom 90 percent (see chart). In 1997, 35 percent of all households made charitable contributions of $500 or more, a higher rate than in 1988, 1991, and 1994. The participation rate was 30 percent among the least wealthy 90 percent of families, and over 90 percent in the ~~richest 0.5 percent of families.~~



- Amount given. About half of all contributions come from the wealthiest 10 percent of families, and a substantial fraction of that from the wealthiest 0.5 percent. Even so, giving as a proportion of net worth is higher in the bottom 90 percent of the distribution than it is at the top.

Conclusion. Strong growth in income and wealth, especially among richer families, appear to be important reasons why charitable giving has grown faster than GDP since 1995. There is some evidence that the rich are more likely to support education, health, and art and cultural institutions and less likely to support religious institutions and social services than the less wealthy. Thus changes in the distribution of wealth or changes in taxes that affect charitable giving may alter the composition of giving as well as its level.

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Payroll and Income Taxes. Although average Federal income taxes have declined since 1979 across all income classes, payroll taxes have increased so that the average family's combined Federal income ~~and payroll tax~~ liability is roughly the same as it was in 1979, according to a recent study. As a result of the payroll tax increase of the early 1980s coupled with the expansion of the EITC in the late 1980s and early 1990s, payroll tax liabilities now exceed income tax liabilities for nearly two-thirds of all families, compared with 42 percent of families in 1979. Families with adjusted AGI below $10,000 have seen their total Federal tax liabilities decline by roughly one-third between 1979 and 1999. For families in all income categories between $10,000 and $200,000, the combined tax burden in 1999 was nearly unchanged from 1979, but, for the small set of families with adjusted AGI in excess of $200,000, the Federal tax burden has fallen.

Tightening Bank Lending Standards May Cut Down Loan Growth. Nearly a quarter of domestic banks reported tightening standards on commercial and industrial loans in the past quarter, according to the Federal Reserve's quarterly Senior Loan Officer Opinion Survey. Recent research suggests that such a tightening in loan standards may lead to lower aggregate loan growth, supporting the view that bankers allocate loans not only by raising and lowering interest rates, but by changing non-price terms as well. Researchers at the Federal Reserve Bank of New York find that during the past two decades commercial lending by U.S. banks slowed substantially following reports of tighter standards, even after controlling for other factors. To the extent that credit availability depends on lenders' standards, a tightening of standards could cause a decline in spending by firms that depend on bank credit. A tightening of standards may also signal that lenders are reacting to other factors that cause the economy to slow.

Housing Vouchers Improve Outcomes for the Poor. Offering residents of distressed inner-city housing projects vouchers for private housing can improve their well-being, according to a recent study of the Moving to Opportunity program in Boston. Housing project residents were randomly offered either a restricted Section 8 certificate valid only in low-poverty areas (together with mobility counseling), unrestricted Section 8 assistance (and no counseling), or continued project residence. Those with restricted certificates were more likely to move to suburban, low-poverty neighborhoods than their counterparts. However, fewer families offered restricted certificates managed to move out of public housing as compared to those receiving unrestricted assistance (48 and 62 percent, respectively). Both types of movers experienced large improvements in personal safety, health, and a decline in behavior problems among boys, as compared to public housing residents offered no vouchers. The children of families that moved to the suburbs also experienced a decline in injuries, asthma attacks, and personal crime victimization.

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INTERNATIONAL ROUNDUP

Study Links Civil Wars to Economic Factors. A new study finds that the occurrence of civil war is more strongly related to economic and geographical factors than to measures of objective grievance, such as lack of rights. The study analyzes the pattern of civil wars in 161 countries from 1965-99, covering 73 conflicts. It finds that greater geographical dispersion of the population, faster population growth, less access to education, and a lower rate of GDP growth are all associated with higher incidence of internal conflict. The most powerful risk factor, however, is having a substantial share of primary commodity exports in GDP, perhaps because they can be easily looted and thus provide a potential source of finance for rebellion. Surprisingly, inequality (of income or assets), does not have a discernible effect on the probability of conflict, nor does a lack of democratic rights. Statistical analysis also reveals that countries with *more diverse* religious and ethnic populations have a lower incidence of conflict, while countries with one dominant group have a higher risk of conflict.

WTO Says Trade Promotes Growth and Fights Poverty. A new WTO Secretariat study provides evidence that trade liberalization helps poorer countries catch up with richer ones and that this faster economic growth may help alleviate poverty. While income per capita in developing countries has in general *not* been catching up with that in developed countries, the report—looking at the experiences of various middle- to high-income countries—finds that a country that formally enacted trade liberalization policies did tend to close the income gap. Interestingly, countries that trade extensively with one another tend to converge in income, with both trading partners moving to higher and steeper growth paths. Of course, other factors beyond trade are also important for long-run growth. For the poorest countries, trade liberalization on its own may not have large effects in the absence of other changes that improve capacity to participate effectively in the global market.

WHO Ranks U.S Health System Performance 37th in World. Although the United States has the highest health expenditures per capita, it is only 15th best in terms of health goal attainment, placing it in 37th position for overall performance per health care dollar, according to a World Health Organization study of 191 countries. The report measured health system goal attainment using indicators of disability-adjusted life expectancy across the population, responsiveness to patients, and the distribution of the financial burden of health costs. Japan scored best in overall goal attainment and France was best in terms of performance per dollar spent. The United States ranked first in overall responsiveness of care, based on respect for patients and quality of service, but was 24th in average life expectancy and fared poorly on the equitable distribution of costs and responsiveness for different groups of society.

RELEASES THIS WEEK

U.S. International Trade in Goods and Services

The goods and services trade deficit was $30.4 billion in April; the deficit was $30.6 billion in March.

MAJOR RELEASES NEXT WEEK

Consumer Confidence—The Conference Board (Tuesday)
Advance Durable Shipments and Orders (Wednesday)
Gross Domestic Product (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	5.4
GDP chain-type price index	5.2	1.6	1.1	2.0	2.7
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	0.4
Federal surplus	-2.8	1.2	1.4	1.2	1.9

	1970-1993	1999	March 2000	April 2000	May 2000
Unemployment Rate (percent)	6.7**	4.2**	4.1	3.9	4.1
Payroll employment (thousands)					
increase per month			527	414	231
increase since Jan. 1993					22152
Inflation (percent per period)					
CPI	5.8	2.7	0.7	0.0	0.1
PPI-Finished goods	5.0	2.9	1.0	-0.3	0.0

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

FINANCIAL STATISTICS

	1998	1999	April 2000	May 2000	June 22, 2000
Dow-Jones Industrial Average	8626	10465	10944	10580	10376
Interest Rates (percent per annum)					
3-month T-bill	4.78	4.64	5.66	5.79	5.67
10-year T-bond	5.26	5.65	5.99	6.44	6.12
Mortgage rate, 30-year fixed	6.94	7.43	8.15	8.52	8.14
Prime rate	8.35	8.00	9.00	9.24	9.50

INTERNATIONAL STATISTICS

Exchange Rates	**Current level June 22, 2000**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	0.940	-1.4	-9.0
Yen (per U.S. dollar)	104.4	-2.0	-14.2
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	96.59	-0.1	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	5.0 (Q1)	4.1 (May)	3.1 (May)
Canada	4.9 (Q1)	6.8 (Apr)	2.1 (Apr)
Japan	0.7 (Q1)	4.9 (Apr)	-0.8 (Apr)
France	3.3 (Q1)	9.8 (Mar)	1.3 (Apr)
Germany	2.3 (Q1)	8.4 (Apr)	1.6 (Apr)
Italy	3.0 (Q1)	11.3 (Jan)	2.3 (Apr)
United Kingdom	3.1 (Q1)	5.8 (Feb)	3.0 (Apr)

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