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WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

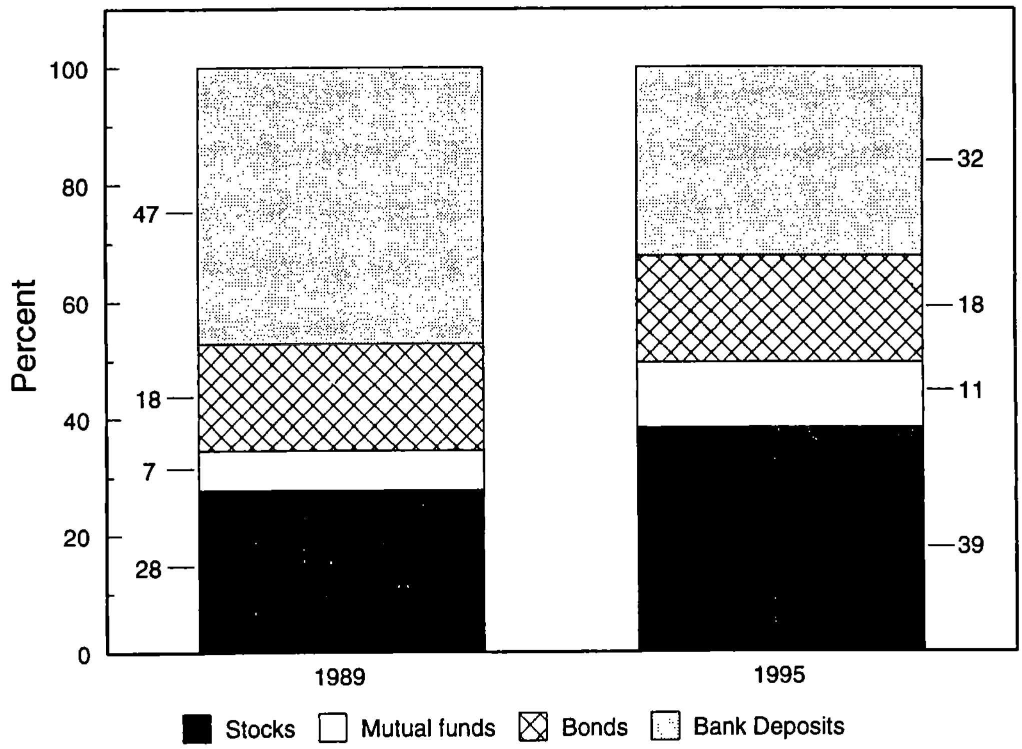
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

June 14, 1996

Copy sent to Stiglitz

CHART OF THE WEEK

Household Financial Assets



Mutual funds and directly held stocks increased from 35 percent to nearly 50 percent of household financial assets between 1989 and 1995. Over the same period, bank deposits fell from 47 percent to 32 percent. Part of the increase in mutual fund and stock holdings reflects a sharp rise in the value of the stock market, which more than doubled over this period. A Special Analysis in this issue of the Weekly Economic Briefing considers how both household assets and debts affect consumer spending.

PHOTOCOPY
WJC HANDWRITING

CONTENTS

CHILDREN ARE WATCHING 18% LESS TV. THAT MAKES IT HARDER FOR ADVERTISERS TO CONVINCE KIDS TO WHINE AT THEIR PARENTS ABOUT BUYING THEM STUFF THEY DON'T NEED. SALES WILL DROP, JOBS WILL DISAPPEAR, THE TRADE DEFICIT WILL SKYROCKET AND THE GNP WILL GO IN THE TANK.
6-11
I'M NOT WATCHING TV. I'M HOLDING THE NATION TOGETHER.
WITH COUCH POTATO GLUE? HOW COMFORTING.

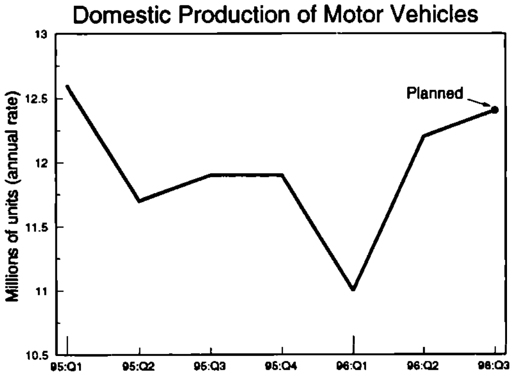
MACROECONOMIC UPDATE

Economy Picking Up the Pace

Brisk gains in employment, a surge in auto sales, and unexpected strength in construction spending suggest that the economy is growing at a robust pace during the current quarter. The pickup in growth reflects in part a bounce back from the bad weather and strikes of the first quarter. Despite the strengthening economy, inflation remains subdued.

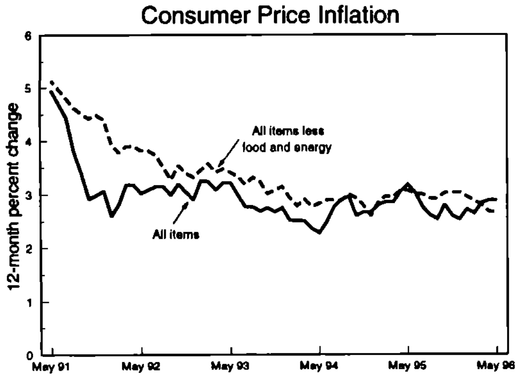
Analysis. Auto producers had planned to step up production this quarter and strong auto sales are validating these plans. While increased auto production will help spur growth in the second quarter, production plans show only a modest rise for the third quarter (see top chart). As a result, the auto sector likely will contribute only marginally to growth later this year.

Domestic Production of Motor Vehicles



The solid report on residential construction spending in April, combined with a rise in housing starts, suggests surprising strength in homebuilding despite recent increases in mortgage rates. This unexpected strength will support growth this quarter, but should wane later in the year as the current higher mortgage rates slow the housing sector.

Consumer Price Inflation



Inflation in May showed no surprises, continuing to run just below 3 percent on a 12-month basis. The recent run-up in energy and grain prices has had relatively little effect on the overall inflation rate this year (see bottom chart). Futures markets predict declines in these prices over coming months.

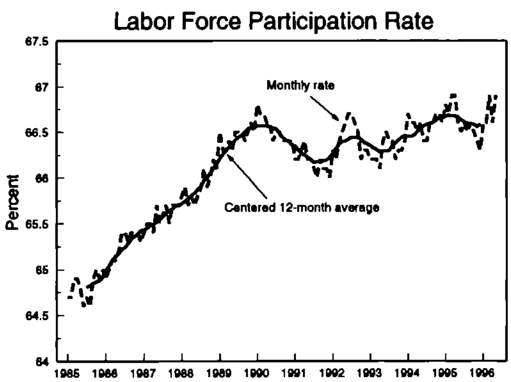
Although economic growth is likely to slow in the third quarter, it is unlikely to fall below its potential rate. Recent job gains should sustain incomes and power consumer spending later this year, helping ensure continued economic expansion.

CURRENT DEVELOPMENT

Rise in Labor Force Participation Boosts Short-term Job Growth, But Longer Term Trend Appears Unchanged

Job growth since December has been well above the 120,000 a month pace that many economists consider sustainable at high employment. Recent strong job growth has resulted from a rise in labor force participation. The increase in participation, however, does not yet provide a compelling reason to revise upward the estimate of sustainable job growth.

Analysis. Most of the estimated 120,000 per month sustainable growth in jobs comes from projected growth in the working-age population. Only a little comes from projected growth in labor force participation. Between 1948 and 1989 labor force participation rose from 58.8 percent to 66.5 percent. Since 1989, however, it has fluctuated in a narrow range between 66 and 67 percent, with no strong upward trend (see the chart). While the labor force participation rate this year has risen to the top of this range, it is still consistent with the post-1989 experience. Until more evidence of a rising trend in the participation rate emerges, 120,000 jobs per month remains a prudent estimate of sustainable job growth.

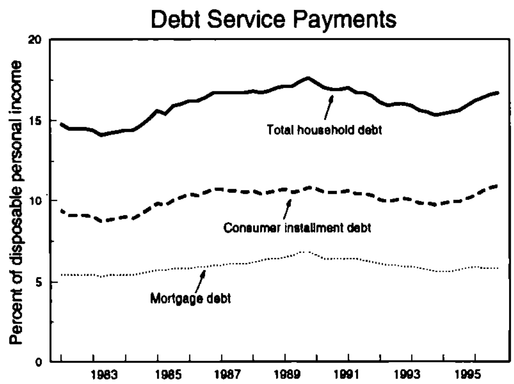


SPECIAL ANALYSIS

Debt Load of Households Continues to Rise, But Gains in Net Worth Should Forestall a Pullback in Spending

Households have continued to add to their debt this year, with both mortgage and consumer loan balances increasing. This mounting pile of debt has caused concern that the recent uptick in interest rates could force households to cut back on spending, slowing the economy later this year.

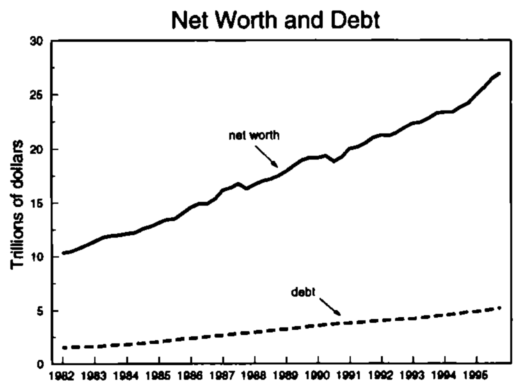
Analysis. The ongoing debt buildup has led to an increase over the past 2 years in the percent of income households are paying to service their debt (see chart). Almost all of this increase in the debt service burden has come from a surge in payments on consumer loans (mainly credit cards and auto loans), while payments on mortgage loans have risen only slightly. Although total debt service as a share of income at 16.7 percent is still a bit below the peak of 17.6 percent reached in 1989, payments on consumer loans as a share of income has now reached 10.9 percent, surpassing its recent high. Thus, with the income-share of debt payments already quite high, households might feel pressured to reduce their spending if higher interest rates cause payments to rise further.



Does debt really matter for consumer spending? Basic models of consumer behavior predict that household indebtedness should have no direct effect on consumer spending. These models predict that lifetime earnings are the principal determinant of spending and that indebtedness itself has no separate effect on spending. Econometric evidence, however, suggests otherwise. One reason debt may matter for consumer spending is that banks and other lenders may view households as greater credit risks when their debt load rises, and, in response, tighten lending standards. Faced with tighter lending standards either in the form of more costly credit or outright rationing, households may be less able to borrow additional amounts to finance current spending out of future earnings.

On the other hand, net worth (assets less debt) is also an important determinant of consumer spending. A rise in net worth signals to lenders that a household remains a good credit risk even if it has taken on substantial debt. Higher net worth also means that a household has more resources to spend. Econometric analysis shows that an increase in household net worth as a share of income raises consumer spending even after accounting for the separate tendency of higher debt to reduce spending.

Net worth shows strong gains in 1995. Although households are paying an increasingly larger share of their income to service their debts, their assets have recently risen faster than their debts, improving net worth (see chart). This gain in net worth is likely to help support consumer spending for the economy as a whole, despite the increase in household debt. But, because much of the growth in assets reflects the extraordinary surge in stock prices last year, the gain in net worth likely has been concentrated among upper income households who invest in stocks, with little of the gain going to lower income households who tend not to own stocks. Thus, to the extent that households at the bottom of the income scale are taking on debt without an offsetting increase in assets, these households may be increasingly credit-constrained and find that they must restrain their spending.



ARTICLE

New Study Finds Little Effect of Medical Savings Accounts on Health Spending

The RAND Corporation recently released a study of the likely effects of Medical Savings Accounts (MSAs) on health expenditures by the nonelderly population. MSAs would provide favorable tax treatment for the out-of-pocket health expenditures of those who choose insurance plans with large deductibles. Advocates claim that MSAs would create incentives to economize on health care and significantly reduce health spending. Critics charge that introducing high-deductible plans would have little effect on overall health spending, and that only the healthy and the wealthy would choose MSAs, pushing up premium costs for everyone else.

The RAND study. The authors used the results of the 1975-1982 RAND Health Insurance Experiment and a model of consumer insurance-plan choice to simulate what would happen if currently insured workers were given a choice of three plans: a standard fee-for-service plan, an HMO, and an MSA. They studied two different types of MSAs: one with a relatively low deductible of $1,500 per individual (the minimum required under the House-passed bill), and one with a high deductible of $2,500 per individual. Their findings showed that:

- If everyone switched to an MSA, total health spending would decline by 0 to 13 percent, depending upon the MSA design.
- But many people would not choose an MSA. When likely plan choices were taken into account, the change in aggregate health spending was negligible.

According to the RAND model of plan choice:

- About half of the population would choose an MSA. This is much higher than the projected take-up rates in other MSA studies.
- Contrary to popular wisdom, in the RAND model, both low-income and high-income people would choose MSAs. The median MSA user would have only slightly higher income than people choosing a conventional fee-for-service or HMO plan. (While high-wage workers are attracted to MSAs because of the substantial tax breaks, low-wage workers may be attracted to MSAs because the ability to "cash out" an MSA allows these workers to take more of their compensation in cash than in the form of health services.)
- The size of the MSA deductible has a large impact on the amount of market segmentation, with the premiums for healthy people decreasing at the expense of the unhealthy. For the low-deductible MSA plan, RAND finds that the average health expenditures of those selecting MSAs are

only slightly below the average health expenditures of those in conventional insurance plans. For the high-deductible MSA plan, however, the average health expenditures of those with MSAs are well below the average expenditures of those in HMO and fee-for-service plans.

Some caveats. While the study points out a number of factors that influence the effectiveness and desirability of MSAs, these results should be not be viewed as definitive.

- The characteristics of MSAs that actually would be marketed are critical in determining the impact of MSAs. For example, the low-deductible MSA plan considered in the study turns out to be more attractive to the very sick than the conventional fee-for-service plan. In both plans, the very sick expect to hit their $1,500 out-of-pocket maximum. Under the fee-for-service plan the $1,500 is paid in after-tax dollars, but it would be tax-favored under the MSA plan.
- Many of the projections in the RAND study are based on data from a relatively old experiment. Changes in the health insurance market in the past decade, such as increasing cost awareness on the part of doctors and patients, may call some of these results into question.
- The RAND study does not estimate the overall revenue loss from tax-favored MSAs, but it could be large given the high take-up rate they project.

Conclusion. The effects of MSAs on health expenditures are difficult to assess without a direct experiment. Questions about what type of MSAs would be popular and how many employers would offer them remain to be answered. The RAND results do show that some types of MSAs could lead to segmentation of the health insurance market without any significant reduction in health expenditures.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

USDA Updates Crop Projections. The Department of Agriculture released its updated crop forecasts this week. Wheat and corn stock estimates for the end of this crop year rose slightly from last month's forecast, in part because higher prices are expected to reduce demand below earlier projections. USDA continues to project that grain stocks will remain low by historical standards. Grain futures prices generally fell following release of the update. USDA also revised its forecast of U.S. sugar stocks downward. To ease pressures on sugar prices, USDA has announced an increase in the amount of sugar that can be imported under the tariff rate quota for this fiscal year, but has yet to announce plans for 1997 imports.

Support for Science is Strong. Public support for science and technology is high, according to poll results recently released by the National Science Foundation. The poll found that 72 percent of Americans believe that the benefits to society of scientific research outweigh the costs. In separate polls in Texas, Florida, and California, about three-quarters of those surveyed agreed that basic scientific research is necessary even if it brings no immediate benefits, and should be supported by the Federal government. Analysts interpret the strong public support as a sign Americans are convinced that investing in science delivers tangible benefits. Despite their overwhelming support for science, the public does not consider itself well-informed about science discoveries or new technologies: only one in nine thinks of himself or herself as well-informed, and 64 percent have "no understanding" of the nature of scientific inquiry.

Cost of a Ball Game is Up in 1996. Families that take Dad out to the ball game this Father's Day will have to pay more to do so. The average that a family of four might spend at a major league game—including tickets, hot dogs, sodas and parking (but no peanuts or Cracker Jacks)—increased at twice the rate of inflation in 1996. Now the major league average is up to $103. The World Champion Atlanta Braves have the steepest prices, totaling $122. That's 50 percent more than the most affordable outing—$81 to watch the Cincinnati Reds. Sixteen of the 28 teams have a total cost of over $100. Fans have yet to balk, however. Average attendance in the majors is running at 25,452 per game, up more than 1,000 from last year.

INTERNATIONAL ROUNDUP

Global Military Spending Continues to Fall. Global military spending fell to 2.4 percent of world GDP in 1995, down from roughly 5 percent in 1985 and 3.6 percent in 1990. Reasons cited for the decline included a slowdown in world economic activity, increased democratization, improvements in military security, and a fall in military aid. The fall in spending since the end of the Cold War has been broad-based. Industrial countries reduced their military spending by $14 billion in the first half of the decade, to 2.4 percent of GDP in 1995. Developing countries spent 2.6 percent of GDP on their military in 1995, but have cut back substantially from 1990, when military spending was 4.9 percent of GDP. The transition economies (including the former Soviet Union) registered the most dramatic decline of all, from nearly 8 percent of GDP in 1990 to 3 percent last year.

Yeltsin's Campaign Spending Threatens Anti-Inflation Policy. As the June 16 presidential election draws near, Russian President Boris Yeltsin has opened the spending spigots. Last week he ordered the Central Bank of Russia to transfer $1 billion to the federal budget in order to meet campaign promises, violating the federal budget law. This move complicates the Central Bank's tight money strategy, which has succeeded in bringing inflation down to less than 2 percent per month in May, from 18 percent in January 1995. In an effort to counterbalance the effect of new spending, the Central Bank has raised the reserve requirements it imposes on commercial banks. The requirement on short-term ruble deposits, for example, was raised from 18 to 20 percent. Interestingly, the reserve requirement for hard currencies such as the dollar, which is much lower, was doubled to 2.5 percent. Interest rates rose following reports that the Central Bank had expressed concern about a growing budgetary crisis. Higher interest rates, in turn, will raise the cost of financing the deficit.

Business Outlook Improving in Japan. The latest quarterly reading of the "Tankan" survey of business conditions in Japan shows improvement. The proportion of manufacturing enterprises with an unfavorable view of business conditions fell substantially. The survey, which provides information similar to that of the National Association of Purchasing Management report on U.S. manufacturing firms, now reveals a rough balance between enterprises viewing business conditions as favorable and those viewing conditions as unfavorable.

RELEASES THIS WEEK

Industrial Production and Capacity Utilization

****Embargoed until 9:15 a.m., Friday, June 14, 1996****

The Federal Reserve's index of industrial production increased 0.7 percent in May, the same as in April. Capacity utilization rose 0.3 percentage point, to 83.2 percent.

Retail Sales

Advance estimates show that retail sales increased 0.8 percent in May following a decrease of 0.1 percent in April. Excluding sales in the automotive group, retail sales increased 0.3 percent in May following an increase of 1.1 percent in April.

Consumer Price Index

The consumer price index increased 0.3 percent in May. Excluding food and energy, consumer prices increased 0.2 percent.

Producer Price Index

The producer price index for finished goods decreased 0.1 percent in May. Excluding food and energy, producer prices were unchanged.

MAJOR RELEASES NEXT WEEK

Housing Starts (Tuesday)
Productivity (Tuesday)
U.S. International Trade in Goods and Services (Thursday)

U.S. ECONOMIC STATISTICS

	1970–1993	1995	1995:3	1995:4	1996:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	3.6	0.5	2.3
GDP chain-type price index	5.3	2.6	2.2	2.2	2.4
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.7	1.7	−1.0	2.6
Real compensation per hour:					
Using CPI	0.6	1.3	2.2	0.4	0.0
Using NFB deflator	1.3	2.2	2.4	2.4	1.6
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.2	10.2	10.4
Residential investment	4.5	4.0	4.0	4.0	4.1
Exports	8.2	11.1	11.1	11.3	11.3
Imports	9.2	12.5	12.5	12.4	12.6
Personal saving	5.1	3.3	3.2	3.6	3.4
Federal surplus	−2.7	−2.2	−2.2	−2.1	−2.1

	1970–1993	1995	March 1996	April 1996	May 1996
Unemployment Rate	6.7**	5.6**	5.6	5.4	5.6
Payroll employment (thousands)					
increase per month			158	163	348
increase since Jan. 1993					9724
Inflation (percent per period)					
CPI	5.8	2.5	0.4	0.4	**0.3**
PPI-Finished goods	5.0	2.3	0.5	0.4	**−0.1**

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

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1994	1995	April 1996	May 1996	June 13, 1996
Dow-Jones Industrial Average	3794	4494	5580	5617	5658
Interest Rates					
3-month T-bill	4.25	5.49	4.95	5.02	5.10
10-year T-bond	7.09	6.57	6.51	6.74	7.01
Mortgage rate, 30-year fixed	8.35	7.95	7.93	8.07	8.39
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level June 13, 1996**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.533	0.0	+9.0
Yen-Dollar	108.9	−0.4	+29.1
Multilateral $ (Mar. 1973=100)	88.46	+0.1	+7.2

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	1.7 (Q1)	5.6 (May)	2.9 (May)
Canada	0.2 (Q1)	9.4 (Apr)	1.5 (Apr)
Japan	2.2 (Q4)	3.5 (Apr)	0.1 (Mar)
France	1.0 (Q1)	12.6 (Mar)	2.4 (Apr)
Germany	0.8 (Q4)	7.1 (Mar)	1.5 (Apr)
Italy	1.1 (Q1)	12.0 (Jan)	4.5 (Apr)
United Kingdom	1.9 (Q1)	8.5 (Apr)	2.4 (Apr)