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11/11/96

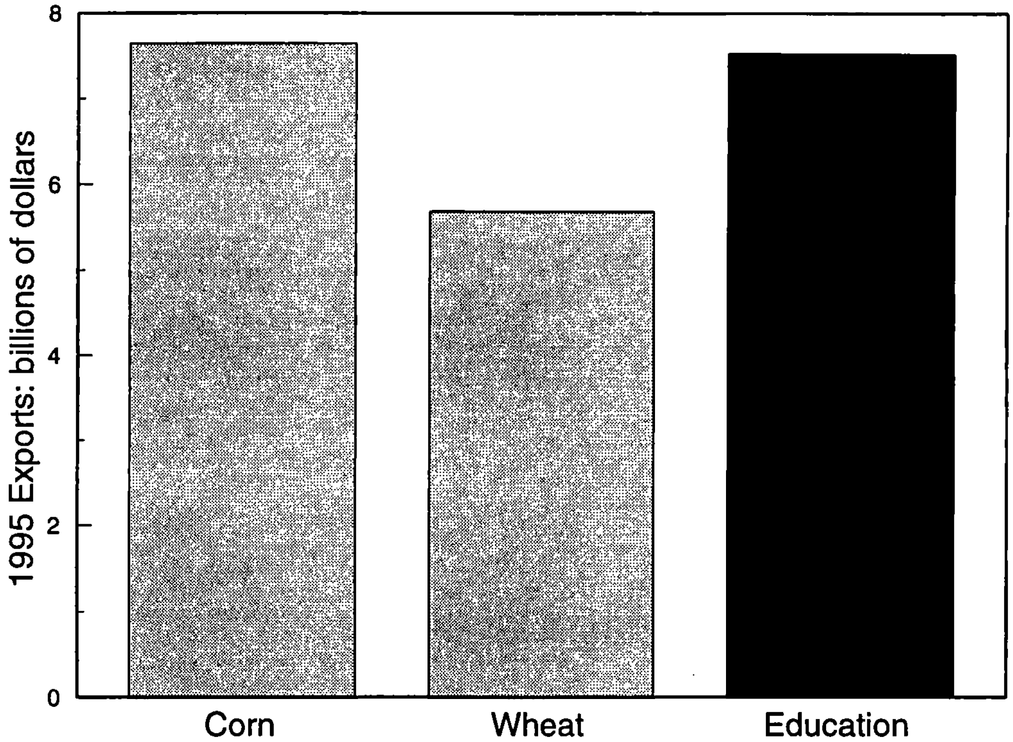
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

November 8, 1996

CHART OF THE WEEK

Food for Thought about What We Export



American institutions of higher learning attract students from all over the world. Spending of foreign students shows up in the U.S. balance of payments accounts as exports of services. The importance of educational services exports now rivals that of corn and wheat, our two most important farm exports.

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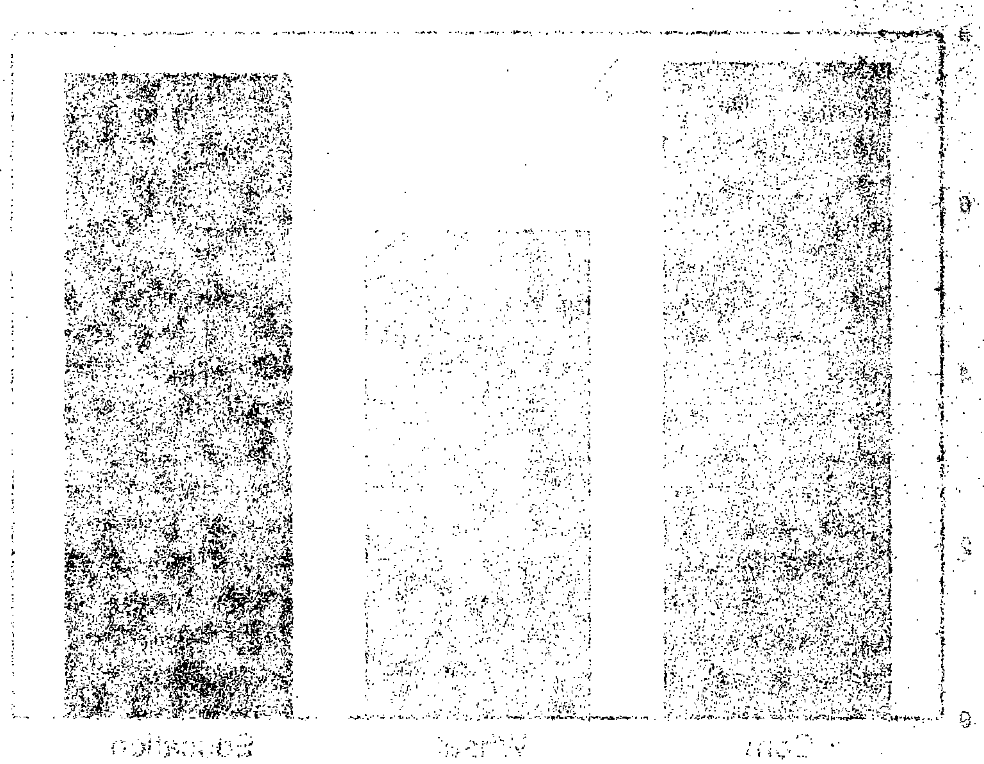

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CONTENTS

CURRENT DEVELOPMENTS

ARTICLE

DEPARTMENTS

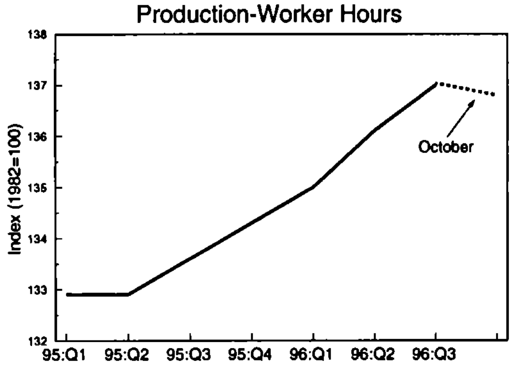
"It's true, Caesar. Rome _is_ declining, but I expect it to pick up in the next quarter."

CURRENT DEVELOPMENT

Fourth Quarter Outlook: Anemic Growth Likely

Fragmentary information on fourth-quarter production suggests further slowing from the 2.2 percent annualized growth estimated for the third quarter.

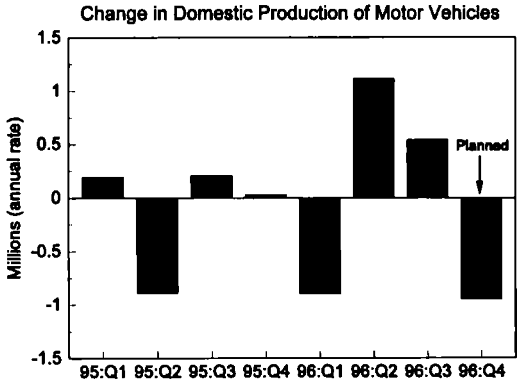
Production-Worker Hours



Note: 96:Q1 adjusted for effects of bad weather in January.

Production hours. Hours worked by production workers dropped in October (see top chart). Although private employment was strong, the length of the workweek shortened considerably. Even if the workweek recovers, the quarterly growth rate of hours is unlikely to exceed a 1 percent annual rate.

Change in Domestic Production of Motor Vehicles



Motor vehicles. Assembly schedules for motor vehicles suggest production will fall about 1 million units at an annual rate (see lower chart). This is enough to subtract a full percentage point from GDP growth. Second- and third-quarter production had been elevated by rebuilding from the strike last March and preparation for a possible strike in the fall. As it turned out, now-settled strikes held down October production at GM and are causing fourth-quarter production to fall below trend.

Consumption. The third-quarter slowdown in consumer expenditures seems to have continued into October as chain-store sales remain weak. A small part of the slowdown may be related to bankers' restraint on consumer loans (see next article), but most seems to be normal volatility. The third-quarter slowing may have only been "the pause that refreshes," because consumer fundamentals remain strong (strong income growth, high consumer confidence, and net worth that is high in relation to income).

Net exports. Net exports, which performed poorly in the third quarter, may rebound. The OECD and foreign governments are forecasting a pickup in growth, which should be good for U.S. exports.

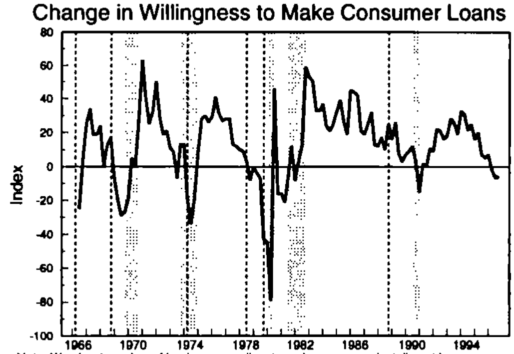
CURRENT DEVELOPMENT

Banks Less Eager to Provide Consumer Credit

On balance, loan officers at large commercial banks are a little less willing to make consumer installment loans than they were 3 months ago, according to preliminary results from a Federal Reserve survey. This is the third consecutive quarterly decline.

Analysis. In the past, reduced willingness by banks to extend installment loans has been associated with slower growth in consumer credit and consumer durables expenditures, and with weaker economic growth. Indeed, past reductions have generally either accompanied or been followed by recessions (shaded regions in the chart).

Change in Willingness to Make Consumer Loans



Note: Weighted number of banks more willing to make consumer installment loans this quarter less the weighted number less willing.

This simple correlation, however, is misleading. In the past, decreases in banks' willingness to make consumer loans generally followed Fed decisions to combat inflation with aggressive monetary policy tightening (these times are marked by dashed lines on the chart). Thus, the economic slowdowns reflected the effects of tighter monetary policy on businesses and households, while the reduced willingness to lend was a side effect of the policy.

With inflation low, the Fed has not tightened this year. Banks instead may be reacting to an unexpectedly large increase in loan losses. Between 1992 and 1995 some banks may have eased underwriting standards excessively, and now they may be moving standards back toward more prudent levels. Overall, however, banks are not likely to cut consumer lending sharply since it remains a profitable activity, and bank profits and capital are both robust.

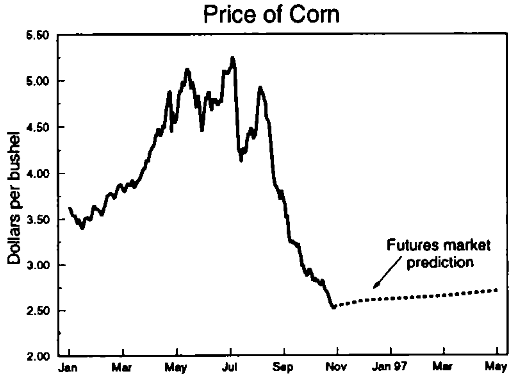
Implication. So long as the current shift to more conservative consumer lending terms reflects only a modest correction of earlier excesses, it should not impose a significant drag on the economy.

CURRENT DEVELOPMENT

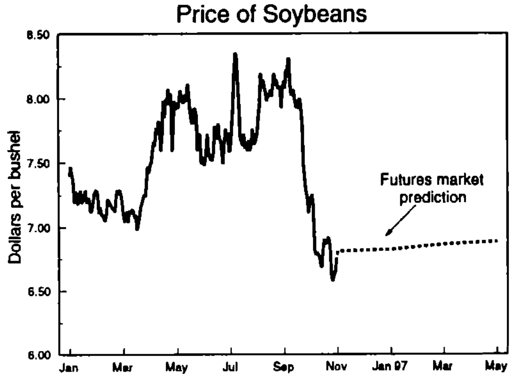
Crop Prices Drop

The price of corn has fallen by over 50 percent and the price of soybeans has declined by over 20 percent since their summer peaks (see charts). Futures markets expect grain prices to stay close to their current levels through the spring.

Price of Corn



Price of Soybeans



Analysis. Corn and soybean plantings were high this spring, setting the stage for large harvests. Cool, rainy weather in the summer, coupled with the low stocks with which farmers began production this year, drove up prices. Better weather the past few weeks increased farm output and brought prices down.

The drop in grain prices will affect other commodities. Dairy prices, particularly cheese prices, are already starting to decline and are expected to continue to fall throughout the year. Livestock prices dropped this summer as ranchers slaughtered large numbers of cattle rather than pay high feed costs; the recent grain price decrease should help stabilize the livestock industry.

Price volatility and the Farm Act. Price volatility is affected by the level of grain stocks and the ability of farmers to respond to price changes. Domestic grain stocks today are only a small fraction of their levels 10 years ago, and their low level increases price volatility. The 1996 Farm Act, however, decoupled program payments from planting decisions, thereby giving farmers the freedom to plant the crops with the highest market returns. This flexibility should help reduce grain price variability over the longer term by increasing production of crops that would otherwise be in tight supply.

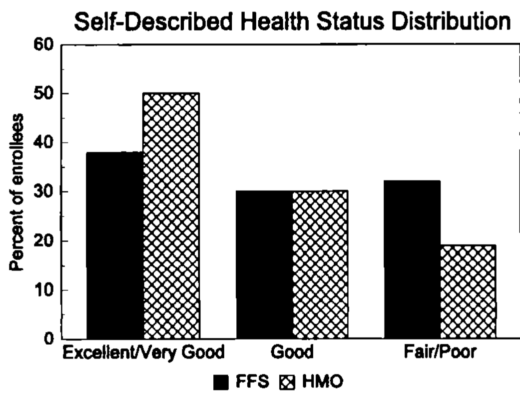
ARTICLE

Improving Medicare Managed Care

Opportunities for substantial Medicare savings from managed care are limited by small enrollments and a flawed approach to paying HMOs for Medicare beneficiaries.

Background. The private sector has shifted dramatically toward managed care and away from fee-for-service (FFS) reimbursement of medical expenses. In 1995, for example, 69 percent of workers in large companies (those with more than 200 employees) received their insurance coverage from some type of managed care provider—up from 29 percent in 1988. By contrast, less than 10 percent of Medicare beneficiaries are enrolled in HMOs or other kinds of managed care plans. HMOs with Medicare enrollees receive a payment equal to 95 percent of the per capita Medicare spending in FFS plans in the same county, adjusted for a limited number of risk factors. This formula provides few incentives for cost savings and may actually increase Medicare expenditures.

Selection bias. HMOs tend to enroll relatively healthy people with low risk of requiring expensive care (see chart). The per capita payment to HMOs for Medicare patients should reflect the lower costs associated with serving this relatively healthy population. To the extent it does not, Medicare payments may be higher than if the patients were in FFS plans. One study indicates that the medical expenses of seniors shifting into HMOs were 25 to 30 percent lower than those of the average Medicare FFS enrollee in the year or so immediately prior to their enrollment in the plan. Another analysis estimates that the introduction of managed care has increased Medicare costs by 7 percent per HMO beneficiary.



The selection problem is exacerbated by three additional factors:

- Migration of healthier individuals into managed care leads to higher average costs in the FFS sector, which drives up the HMO per capita payment.
- HMOs have an incentive to offer coverage in counties with high payment rates and to avoid counties in which the per capita payment is low.
- Individuals are allowed to switch between plan types as often as monthly. Hence they have an incentive to move from a managed care to an FFS plan if their health deteriorates. (Evidence on the significance of this is weak. Only 12 percent of those newly enrolled in HMOs in 1990 returned to FFS plans within a year and the percentage of switches has been falling over time.)

Weak incentives for cost savings. HMOs are not allowed to earn higher profit margins on their Medicare enrollees than they earn on their private sector enrollees. In cases where the allowed per capita payment would generate too high a rate of profit, HMOs have the option of covering some or all of enrollees' mandatory Medicare premiums or providing coverage not normally included in Medicare (like prescription drugs). But unless HMOs are allowed to keep some of the profit resulting from increased efficiency, they have little incentive to develop more cost-effective methods of providing care.

Scope for improvement. The Administration has a number of proposals that would address some of these selection bias and cost-incentive issues. The use of more uniform payment rates, for example, should help to remove the incentive for HMOs to locate mainly in high-cost areas. The Administration has also proposed testing new risk-adjustment methodologies. But the likelihood of classifying medical risks accurately enough to eliminate the remaining selection bias is poor. The best currently available risk-adjustment mechanisms, which use information on prior claims as well as on observable characteristics, only account for about one-eighth of the individual variation in annual health care spending. Furthermore, using information on previous claims to set the payment rate could give providers an incentive to increase medical expenses in one period in order to receive more generous payments subsequently.

Comprehensive changes in the FFS program may well be needed to achieve the full benefits of Medicare managed care. Currently, beneficiaries enrolled in the traditional program have limited incentives to switch into managed care and, particularly for those with Medigap policies, little reason to economize on medical spending. Moreover, FFS providers have strong incentives to increase expenditures beyond what would be cost-effective.

THE PRESIDENT HAS SEEN
11-12-96

CR / G Jennings / B Reed

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Illegal Immigration Affected by Relative U.S./Mexican Wages. Efforts to enter the United States illegally from Mexico are very sensitive to changes in wages, a recent study finds. A 10 percent decrease in real (inflation-adjusted) Mexican wages leads to about an 8 percent increase in apprehensions at the U.S.-Mexico border. Increases in apprehensions also are correlated with increases in U.S. real wages. Moreover, the study finds that overall attempts to cross the border illegally are at least as sensitive as apprehensions to changes in U.S. and Mexican wages. The increase in attempted entry seems to be driven by the purchasing power of U.S. wages in Mexico more than the purchasing power of U.S. wages in the United States. This suggests that prospective migrants intend to maintain links with Mexico, either by planning to return someday or by supporting family members who remain behind.

Managed Competition Controls Health Insurance Costs. A recent case study of Harvard University's employee health insurance system provides evidence that competition and incentives can help cut health costs. Competition also produces considerable adverse selection, however, highlighting the need for good risk-adjustment methods. To encourage employees to choose less-costly plans and to encourage insurers to lower premiums, the University switched from a traditional cost-sharing arrangement, in which the employer paid 80 percent of premiums, to a "fixed-contribution" system, in which employees bear the full extra cost of more expensive policies. Many employees did respond to the change in out-of-pocket premiums by switching to lower cost health maintenance organizations; and premiums charged to Harvard fell by about 10 percent compared to the same plans offered to other employers in the Boston area. The findings also suggest that traditional plans may be threatened by adverse selection in a managed-competition environment. So many relatively healthy people shifted out of the high cost traditional plan that it had to be replaced because of rising premiums after just 2 years under the new policy.

Low Used-Car Prices May Threaten Detroit's Profits. After rising by an average of 7 to 8 percent a year since 1992, used-car prices this year have leveled off. Weaker used-car prices may hurt auto makers' profits by forcing them to offer competitive deals on new cars. Some industry analysts are attributing the price slow-down to the growing number of previously leased cars that are coming on the used-car market. A reported 3 million cars are scheduled to come out of leases by the end of 1996, and that number is expected to rise again in 1997. Industry experts are already projecting slowing new-car sales next year, and the expanding supply and lower prices of used cars may undermine the new-car market even more than expected.

INTERNATIONAL ROUNDUP

Researchers Pessimistic about German Budget Plan. A new forecast by the six leading German research institutes raises questions about whether the current German budget plan is adequate to meet the fiscal requirements for European Monetary Union in 1997. The EU will decide who can enter the currency union in 1999 using 1997 data. Although the German Finance Minister insists the government's 1997 budget will meet the Maastricht criteria, the economic institutes believe the combined deficits of the Federal, state and local governments and the publicly funded health and pension plans, will total 3.4 percent of GDP (the criterion is 3.0 percent), bringing Germany's debt to 61 percent of GDP (the criterion is 60 percent). The institutes presented a more sanguine outlook for the economy than in their spring report, forecasting growth of 1.3 percent this year and 2.4 percent in 1997. Their picture for eastern Germany is somewhat less favorable, with unemployment expected to rise to 16 percent next year, compared to 9 percent in western Germany.

BT Announces Historic Transatlantic Merger with MCI. The proposed $20 billion merger between U.K.-based British Telecommunications (BT) and MCI, the second largest U.S. telecommunications company and the world's third largest international carrier, would reportedly be the largest foreign takeover in U.S. corporate history. The combined company, which will be called Concert, is projected to have over $42 billion in revenues, 183,000 employees, and 43 million business and residential customers in 72 countries. The new company will provide an integrated set of local, long distance and international services including voice, data, wireless, internet and intranet, information technologies and outsourcing. BT and MCI now await the FCC's approval of the merger, which could take up to a year. It is noteworthy that after BT acquired a 20 percent stake in MCI in 1993, the Department of Justice imposed certain conditions on the purchase in order to reduce anticipated anti-competitive effects on the international telephony market.

Difficult Reforms Still on the Agenda in Transition Economies. This week, the European Bank for Reconstruction and Development (EBRD) released its 1996 *Transition Report*. Overall, the EBRD finds that key reforms like price and trade liberalization and the privatization of small-scale enterprises have been undertaken relatively quickly. By contrast, more lengthy processes—like enterprise restructuring, the rehabilitation and rebuilding of infrastructure, and the building of strong financial and legal institutions—are only now being addressed. The critical task of overhauling the region's underdeveloped infrastructure has probably been hampered by tariffs on services such as electricity and water which are still set below the true costs of delivery. The financial sector continues to be a laggard in the reform process, and several transition economies, including the Czech Republic, Lithuania, and Russia, have experienced banking troubles in the past year. In order to increase savings to meet the transition economies' demand for investment capital, the EBRD endorses reducing government deficits to increase public savings, and reforming social security systems and public pensions to boost private savings.

RELEASES THIS WEEK

Productivity

Nonfarm business productivity increased 0.2 percent at an annual rate in the third quarter of 1996. Manufacturing productivity increased 6.3 percent.

MAJOR RELEASES NEXT WEEK

Producer Prices (Wednesday)
Consumer Prices (Thursday)
Retail Sales (Thursday)
Industrial Production and Capacity Utilization (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1995	1996:1	1996:2	1996:3
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	2.0	4.7	2.2
GDP chain-type price index	5.3	2.5	2.3	2.2	1.9
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.3	**1.7**	0.5	**0.2**
Real compensation per hour:					
Using CPI	0.6	1.4	0.0	**0.0**	**1.6**
Using NFB deflator	1.3	2.1	2.0	**2.0**	**2.7**
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.4	10.3	10.5
Residential investment	4.5	4.0	4.1	4.2	4.1
Exports	8.2	11.1	11.3	11.3	11.1
Imports	9.2	12.4	12.5	12.6	12.6
Personal saving	5.1	3.4	3.6	3.2	4.0
Federal surplus	–2.7	–2.2	–2.1	–1.7	N.A.

	1970–1993	1995	Aug. 1996	Sept. 1996	Oct. 1996
Unemployment Rate	6.7**	5.6**	5.1	5.2	5.2
Payroll employment (thousands)					
increase per month			280	–35	210
increase since Jan. 1993					10703
Inflation (percent per period)					
CPI	5.8	2.5	0.1	0.3	N.A.
PPI-Finished goods	5.0	2.3	0.3	0.2	N.A.

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

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1994	1995	Sept. 1996	Oct. 1996	Nov. 7, 1996
Dow-Jones Industrial Average	3794	4494	5804	5996	6206
Interest Rates					
3-month T-bill	4.25	5.49	5.09	4.99	5.02
10-year T-bond	7.09	6.57	6.83	6.53	6.26
Mortgage rate, 30-year fixed	8.35	7.95	8.23	7.92	7.67
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level**	**Percent Change from**	
	Nov. 7, 1996	**Week ago**	**Year ago**
Deutschemark-Dollar	1.507	−0.5	6.3
Yen-Dollar	111.5	−2.0	8.1
Multilateral $ (Mar. 1973=100)	86.83	−0.6	3.1

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	2.3 (Q3)	5.2 (Oct)	3.0 (Sept)
Canada	1.2 (Q2)	9.9 (Sept)	1.5 (Sept)
Japan	3.9 (Q2)	3.3 (Sept)	0.0 (Sept)
France	0.5 (Q2)	12.3 (Aug)	1.6 (Sept)
Germany	1.1 (Q2)	7.3 (Sept)	1.4 (Sept)
Italy	0.7 (Q2)	11.9 (Jul)	3.4 (Sept)
United Kingdom	2.3 (Q3)	8.0 (Sept)	2.1 (Sept)