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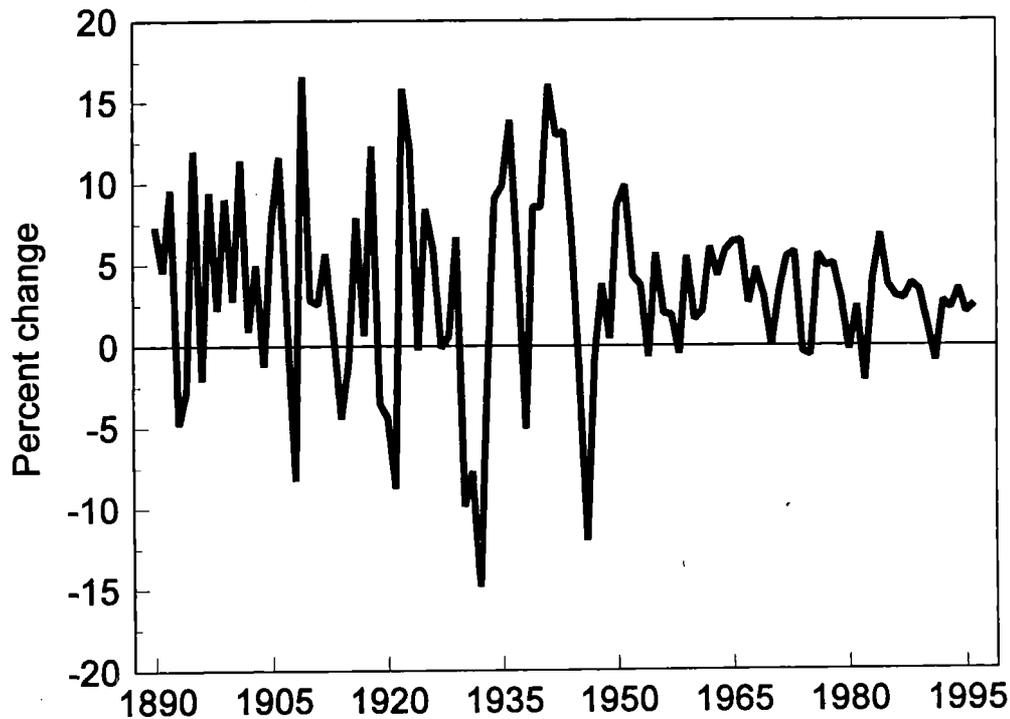
# WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

February 7, 1997

## CHART OF THE WEEK

Fluctuations in Real GNP Growth, 1890-1995



A strong argument against a balanced budget amendment is that it would not only remove discretionary fiscal policy as a weapon to counteract shocks to the economy but also short-circuit the automatic stabilizers that cushion the economy against such shocks and make recessions less severe. Before World War II, fluctuations in economic activity were often quite large. In the postwar period, fluctuations have been substantially more contained, in part because the automatic stabilizers and discretionary policies have become more important. (It should be noted that GNP data are less reliable for years before 1929 than for later years.)



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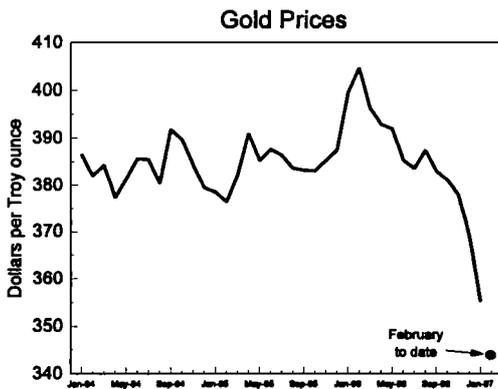


## CURRENT DEVELOPMENT

### Is Gold Losing Its Glitter?

The price of gold has fallen by about 15 percent over the past year, following several years of relative stability (see chart).

**Supply and demand.** The supply of gold is affected by the level of new production and government sales. The demand for gold reflects that of both investors and end users, such as jewelers, dentists, and electronics firms. End-user demand should be fairly stable, but investor demand should respond to changes in expectations about future gold prices and the risks and returns on other assets. In particular, some believe gold provides a useful hedge against inflation. This belief probably led to the very high gold prices of the late 1970s and early 1980s, when inflation fears were also very high.



**Analysis.** Gold's recent drop could reflect, in part, the Treasury's first auction of inflation-indexed securities in late January. Investors may view them as a rival inflation hedge to gold. Indeed, the price of gold dropped more than 1.5 percent over the 2 days following the auction. But this explanation does not fit with the timing of the longer-term decline in the gold market: The steep fall in gold prices began in November—well after the September announcement that the Treasury would issue indexed securities and well before the first auction.

A related factor is that continued low and stable inflation may have reduced the demand for gold from those looking for a hedge against inflation. Finally, concerns that some European countries may sell gold have reportedly depressed prices. For example, the Netherlands reportedly sold 300 tons of gold in the second half of last year. These sales may reflect European countries' efforts to reduce their debt in order to move closer to compliance with the Economic and Monetary Union convergence criteria.

## SPECIAL ANALYSIS

### **Economic Assumptions and Budget Projections**

During the 1980s and early 1990s, the economic assumptions in the President's budget tended to be too optimistic; Congressional Budget Office predictions usually proved more accurate. In the last 4 years, however, this Administration's forecasts have been consistently conservative. Differences between these forecasts and those of CBO and consensus private forecasts continue to exist, but these differences are much narrower than they used to be.

**Conservative forecasts.** In its first four budgets, this Administration predicted the value of 1996 economic variables 4 times, 1995 variables 3 times, and so forth (each forecast covers several years). This provides 10 observations for assessing the accuracy of our forecasting. In every case, real growth has been higher than forecasted and the unemployment rate lower. In 9 of the 10 cases, CPI inflation came in lower than forecast. This better-than-expected economy, together with substantial technical reestimates (for example, slower-than-expected growth in Medicare and Medicaid outlays) resulted in a lower-than-expected deficit in each of the past 4 years.

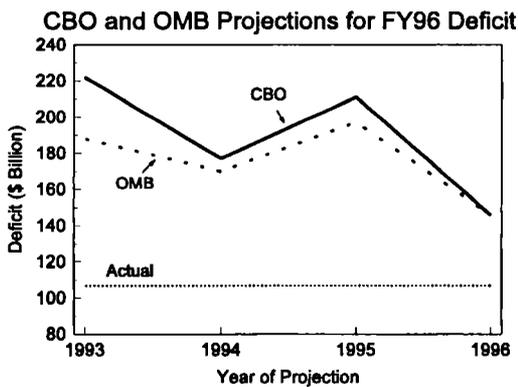
**Comparison to CBO.** The economy has also consistently outpaced CBO's economic forecasts. Because the Administration and CBO have made similar economic assumptions, it is difficult to establish definitively which is a better forecaster. The table shows the average absolute value of the forecast errors made

<b>Comparison of Administration and CBO Forecasts</b>		
Average Absolute Forecast Errors		
	Admin.	CBO
Nominal GDP	0.89	<b><u>0.53</u></b>
Real GDP	<b><u>0.46</u></b>	0.57
CPI	0.32	<b><u>0.18</u></b>
Unemployment	<b><u>0.37</u></b>	0.40
91-day Treasury bill rate	0.61	<b><u>0.59</u></b>
10-year Treasury note rate	0.71	<b><u>0.60</u></b>
Deficit (billions)	<b><u>52</u></b>	58

Notes: Growth rates are annual averages. For real GDP growth, forecasts are compared to actuals measured using a comparable fixed or chain-weighted methodology. The deficit projections assume the President's policy will be implemented.

by the Administration and CBO. It shows that although the Administration has been more accurate than CBO in predicting real growth, CBO has come closer in predicting nominal growth and inflation, both of which are important for the budget. The overall accuracy of the Administration's and CBO's economic and technical forecasts is represented by projections of the deficit. The last line in the table shows that the Administration's deficit projections have been more accurate than CBO's, on average, although the difference between them is dwarfed by the size of the errors both have made.

**Is the Administration better over a longer time horizon?** Administration and CBO forecasts for 1 or 2 years out tend to be similar. Farther out, however, the forecasts diverge. For example, both the Administration and CBO are forecasting that the unemployment rate will average 5.3 percent this year, close to the current rate of unemployment. Over time, however, CBO projects the unemployment rate will rise to 6.0 percent, while the Administration sees it leveling off at 5.5 percent. Divergences like this compound into large differences in estimates of the deficit 5 years into the future. Although too little time has elapsed to make any confident comparison of the Administration's and CBO's long-term economic forecasting record, the comparative strengths are generally not sensitive to the time period over which the forecasts are compared.



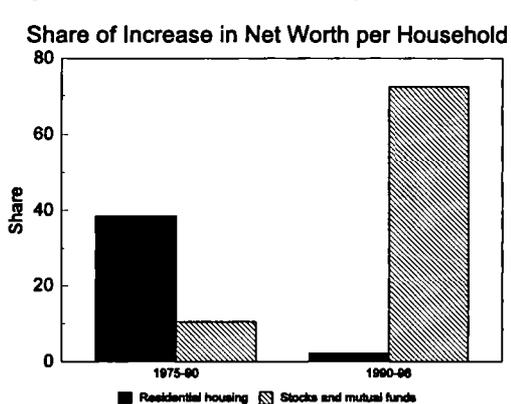
Unfortunately, we have only one observation for testing the Administration's comparative strength at 3-year-ahead deficit forecasting and no observations for 4 or more years. For that one observation, the Administration performed slightly better than CBO. The chart shows Administration and CBO projections of the deficit for fiscal year 1996 made at different points in time. CBO projected a larger deficit than the Administration did at every point in time.

## SPECIAL ANALYSIS

### **Trends in Household Net Worth and Its Distribution**

The average net worth of American households reached an all-time high in 1996. Although earlier gains were driven by increasing home values, more recent gains have been driven by a sharp rise in the value of stocks. Inequality in the distribution of net worth across households may also be on the rise.

**Trends in net worth per household.** In 1996, net worth per household reached its highest level in at least 50 years. More recently, it rose from \$230,000 in 1975 to \$295,000 in 1990 and \$339,000 in 1996



(all measured in 1996 dollars). Between 1975 and 1990, residential housing was a leading contributor to the rise; increases in the value of stocks and mutual funds were less important (see chart). Since 1990, however, rising equity values accounted for roughly three-quarters of the increase in net worth per household. Residential housing made virtually no contribution.

**Inequality in net worth.** Evidence from a periodic survey of consumer finances indicates that the extent of inequality in net worth remained roughly constant between 1983 and 1992. Although inequality statistics are not yet available for 1995, the most recent survey year, recent housing and stock market developments suggest that wealth inequality may be rising.

Roughly two-thirds of all families own their own homes and the value of these assets is large (a median value of \$90,000 for those owning homes). Thus, substantial increases in the value of housing add to the wealth of a broad range of families, probably leaving the distribution of net worth relatively unaffected. The fraction of families owning stocks (either directly or indirectly through mutual funds, IRAs, and the like) is smaller, although it has risen from 32 percent in 1989 to 41 percent in 1995. Moreover, the median value of stocks among those who own them is only \$13,500. Thus, most of any increase in the value of stocks increases the wealth of the relatively few stockholders who have large holdings and makes the distribution of net worth more unequal.

## ARTICLE

### **Risk Adjustment in Medicare: Problems and Progress**

Many HMOs contracting with Medicare have an incentive to recruit relatively healthy people and discourage those who are less healthy from enrolling. This incentive stems from the fact that the payment an HMO receives is not closely tied to expected medical costs, making it possible for the HMO to earn higher profits by enrolling healthy beneficiaries (see *Weekly Economic Briefing*, November 8, 1996).

One solution is for the government to do a better job of matching payments to risk. Medicare currently does this, but only to a limited extent. Efforts are underway to develop better “risk adjusters.” But it is probably impossible to eliminate all opportunities for health plans to gain by “cream-skimming.”

**Risk adjustment: the state of the art.** In a “perfect” risk adjustment system, all of the predictable variation in health expenditures across individuals would be reflected in Medicare payments, so that health plans would not gain financially from enrolling healthier individuals. Higher average expenditures on riskier patients would be covered by higher average payments for these individuals. Substantial variation in expenditures across individuals would remain, but these would not be related in any predictable way to identifiable characteristics of enrollees. Indeed, experts estimate that even a hypothetically perfect risk-adjustment system is unlikely to capture more than 20 to 25 percent of the variation in health costs among individuals, because a large fraction of variation in expenditures is inherently random.

One recent study estimates that risk adjustment based on demographic characteristics alone (similar to what is now done in Medicare) identifies only about 4 or 5 percent of the potentially predictable variation in health expenditures. Taking into account diagnostic information substantially improves predictive power. When information on the principle diagnosis is included, up to one-third of the predictable variation is explained. Including multiple diagnoses raises this to about 45 percent of predictable variation (9 percent of total variation). This last approach is particularly interesting because the Health Care Financing Administration (HCFA) is planning to use a variant of it in its “Medicare Choices” demonstration program.

The critical issue, however, is not how well any particular risk adjustment methodology measures up against a theoretical ideal or how much variation remains even after “perfect” risk adjustment. The issue is whether information remains asymmetric, that is, whether health plans can continue to profit by “cream-skimming,” given the risk adjusters used by Medicare. The problems associated with asymmetric information are minimized as long as private parties are not substantially better than Medicare at identifying risk. This is true whether both are pretty bad or both are pretty good. If the health plan cannot exploit more information than is contained in the risk-adjuster, they cannot cream-skin.

**Inherent problems.** Designing government risk-adjusters that address the asymmetric information problem is difficult. The government will probably be restricted to using indicators that are relatively easy to quantify, whereas an individual health plan may be able to exploit additional information. Even if the government has as much information as the health plan, the plan may still be able to attract healthy beneficiaries (for instance, by offering reduced-price memberships to health clubs).

Any remaining ability to select relatively healthy people from a particular risk class provides opportunities for cream-skimming. Moreover, it is difficult to detect cream-skimming. One cannot simply look to see if costs are low on average in a particular HMO, or for a particular risk class. The HMO can simply claim to have provided efficient, cost-effective care.

Even if a “perfect” risk-adjuster could be designed, its use might have adverse effects on the efficient provision of medical care. For example, although prior expenditures may help to predict future health costs, including them in the risk-adjuster may reduce the incentives for health providers to lower costs, because higher spending in one year increases the risk-adjusted payment in the next. Similarly, if the reimbursement rate depends on previous diagnoses, providers may have incentives to classify individuals as having more medical problems or more severe ailments. On the other hand, this method of risk-adjustment may encourage more complete diagnosis and better record-keeping.

Even with recent improvements in risk adjustment, considerable scope is likely to remain for health plans to profit by cream-skimming. Moreover, to the extent that the designers have not succeeded in eliminating the incentive problems created by the new risk adjusters, health plans may still profit by classifying individuals into more severe diagnoses or practicing more costly medical care.

**Conclusion.** Better risk adjustment is needed to reduce many of the adverse selection problems present in government health programs. But solutions need to be constructed with the understanding that our ability to adjust for risk, while improving, is inherently limited.

## BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

**Law Allows More Americans to Work.** Two years after the Americans with Disabilities Act went into effect in mid-1992, the law was already helping many to become employed, according to recent reports. The number of working disabled Americans aged 21 to 64 rose by almost 1.1 million between 1991 and 1994; most of the increase was among the severely disabled. The total includes over 200,000 workers with limitations requiring help with activities such as walking, bathing, or eating. The fraction of wheelchair-bound adults who are employed rose from 18.4 percent to 22 percent, and the fraction of those using a cane, crutches, or a walker rose from 25.2 percent to 27.5 percent.

**Solid Gains for African-Americans.** In honor of African-American History Month, the Census Bureau has compiled statistics evaluating current trends affecting African-Americans. In 1995, almost 75 percent of African Americans aged 25-and-over had at least a high school diploma and 13 percent held at least a college degree, up from about 50 percent and 8 percent, respectively, in 1980. The younger cohort saw a particularly impressive gain: The proportion of African Americans aged 25-to-29 who had completed high school rose from 81 percent in 1985 to 87 percent in 1995, while the share of whites in the same age group remained constant at about 87 percent. Between 1994 and 1995, the median income of African American households rose 3.6 percent in real terms, while the poverty rate declined 1.3 percentage points to 29.3 percent. And the number of African-American-owned businesses increased 46 percent between 1987 and 1992—nearly 20 percentage points more than U.S. businesses as a whole.

**Many Immigrants' Stays Are Short.** Mexican immigrants to the United States return to Mexico in large numbers, often relatively soon after arriving here, according to a recent study. About 50 percent of immigrants in the sample returned to Mexico within 2 years, and 70 percent returned within 10 years. Because many immigrants do not stay long enough to qualify for most public assistance programs under current waiting periods (typically 5 years), the recent increase in the waiting period to 10 years is expected to have little effect on immigration patterns. Furthermore, those who do stay are the least likely to need services; they tend to be better educated, more attached to the labor force, and have higher wages. The study concludes that economic factors and education are far more important than public assistance programs in determining immigration and return migration patterns.

## INTERNATIONAL ROUNDUP

**United States Expands and Augments Textile Trade With China.** Sunday's textiles agreement builds on a 1994 agreement with China to extend current U.S. import quota arrangements; augment enforcement against transshipment (the export of Chinese produced goods through an intermediary country such as Hong Kong or Canada); and increase access to the Chinese market for U.S. exporters. In 1996, U.S. textile and apparel imports from China—our third largest supplier after Mexico and Canada—were \$5.9 billion; U.S. textile and apparel exports to China were \$55.2 million. Under the new agreement, China has promised to reduce tariffs, set them at fixed rates, and reduce non-tariff barriers. To the extent that trade barriers have restricted access to Chinese markets, the agreement will help U.S. exporters of high-quality cotton and knit apparel such as T-shirts and sweatshirts who claim to be competitive in China. Given its lower wages, however, China has an overall comparative advantage in the production of textiles. Thus, China probably will continue to run a large bilateral trade surplus with the United States in textiles and apparel.

**Russia's Growing Trade Surplus Relieves Protectionist Pressures.** A preliminary estimate that Russia's trade surplus was \$23 billion in 1996—up almost 14 percent from 1995—is credited with helping to alleviate protectionist pressures that erupted in the run-up to the 1996 presidential election. Counteracting any surplus-reducing effects from a strong ruble, high prices for fuel products (45 percent of Russian exports) and low demand for imports have been the most important factors in generating a larger surplus. Despite slowing imports, Russians continued to buy U.S. products, especially poultry and cigarettes; U.S. exports to Russia were up nearly 20 percent for the first 11 months of 1996. Meanwhile, U.S. imports from Russia, mainly metals and inorganic chemicals, fell by over 18 percent. Russia hopes to join the WTO and APEC and has announced that it intends to reduce average custom tariffs 20 percent by the year 2000.

**Pakistan's Prime Minister-Elect to Continue IMF Reforms.** Pakistan's new Prime Minister, Nawaz Sharif, is expected to further reforms and stabilization policies advanced by Pakistan's interim government, ensuring the continued support of the IMF and other donors. Although GDP grew 6 percent in 1995-96, then-Prime Minister Bhutto failed to meet IMF commitments of keeping the budget deficit under control, and the IMF suspended its support. Market confidence weakened; reserves declined; and the trade deficit grew, forcing Bhutto to adopt new stabilization measures at the end of October. Citing corruption and economic mismanagement, President Leghari fired Bhutto in November and appointed an interim government to oversee the stabilization measure. With Pakistan's per capita GNP at only \$473, tariff barriers still high, and inflation in double digits, the new government faces many challenges. Yet, growth is estimated to remain a fairly strong 5 percent for 1996-97. In December, the IMF expressed confidence in Pakistan's future by extending and augmenting its credit to the country.

## RELEASES THIS WEEK

### **Employment and Unemployment**

**\*\*Embargoed until 8:30 a.m., Friday, February 7, 1997\*\***

In January, the unemployment rate was 5.4 percent; it was 5.3 percent in December. Nonfarm payroll employment rose by 271,000.

### **NAPM Report on Business**

The Purchasing Managers' Index declined to 52.0 percent in January from 53.8 percent in December.

### **Leading Indicators**

The composite index of leading indicators increased 0.1 percent in December.

## MAJOR RELEASES NEXT WEEK

Productivity (Tuesday)

Advance Retail Sales (Thursday)

Producer Prices (Friday)

Industrial Production and Capacity Utilization (Friday)

## U.S. ECONOMIC STATISTICS

	<b>1970– 1993</b>	<b>1996</b>	<b>1996:2</b>	<b>1996:3</b>	<b>1996:4</b>
<b>Percent growth</b> (annual rate)					
Real GDP (chain-type)	2.7	3.4	4.7	2.1	4.7
GDP chain-type price index	5.3	2.1	2.2	2.0	1.8
<b>Nonfarm business (NFB) sector:</b>					
Productivity (chain-type)	1.5	N.A.	0.6	-0.3	N.A.
Real compensation per hour:					
Using CPI	0.6	N.A.	0.1	1.1	N.A.
Using NFB deflator	1.3	N.A.	2.0	2.0	N.A.
<b>Shares of Nominal GDP</b> (percent)					
Business fixed investment	10.9	10.4	10.3	10.6	10.5
Residential investment	4.5	4.1	4.2	4.1	4.0
Exports	8.2	11.3	11.3	11.1	11.5
Imports	9.2	12.6	12.6	12.7	12.7
Personal saving	5.1	3.6	3.2	3.9	3.8
Federal surplus	-2.7	N.A.	-1.7	-1.6	N.A.
<hr/>					
	<b>1970– 1993</b>	<b>1996</b>	<b>Nov. 1996</b>	<b>Dec. 1996</b>	<b>Jan. 1997</b>
<b>Unemployment Rate</b>	6.7**	5.4**	5.3	5.3	5.4
<b>Payroll employment</b> (thousands)					
increase per month			<b>181</b>	<b>261</b>	<b>271</b>
increase since Jan. 1993					<b>11500</b>
<b>Inflation</b> (percent per period)					
CPI	5.8	3.3	0.3	0.3	N.A.
PPI-Finished goods	5.0	2.8	0.4	0.5	N.A.

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

New or revised data in **boldface**.

Employment and unemployment data **embargoed until 8:30 a.m., Friday, February 7, 1997.**

## FINANCIAL STATISTICS

	1995	1996	Dec. 1996	Jan. 1997	Feb. 6, 1997
<b>Dow-Jones Industrial Average</b>	4494	5743	6436	6707	6773
<b>Interest Rates</b>					
3-month T-bill	5.49	5.01	4.91	5.03	5.01
10-year T-bond	6.57	6.44	6.30	6.58	6.49
Mortgage rate, 30-year fixed	7.95	7.80	7.60	7.82	7.74
Prime rate	8.83	8.27	8.25	8.25	8.25

## INTERNATIONAL STATISTICS

<b>Exchange Rates</b>	<b>Current level</b>	<b>Percent Change from</b>	
	<b>Feb. 6, 1997</b>	<b>Week ago</b>	<b>Year ago</b>
Deutschemark-Dollar	1.652	0.9	12.1
Yen-Dollar	123.8	1.9	17.3
Multilateral \$ (Mar. 1973=100)	93.63	0.7	8.1

<b>International Comparisons</b>	<b>Real GDP growth (last 4 quarters)</b>	<b>Unemployment rate</b>	<b>CPI inflation (last 12 months)</b>
United States	3.4 (Q4)	5.4 (Jan)	3.3 (Dec)
Canada	1.6 (Q3)	10.0 (Nov)	2.2 (Dec)
Japan	3.2 (Q3)	3.3 (Nov)	0.5 (Nov)
France	1.4 (Q3)	12.8 (Oct)	1.7 (Dec)
Germany	1.9 (Q3)	7.5 (Nov)	1.4 (Dec)
Italy	0.7 (Q3)	11.9 (Jul)	2.6 (Dec)
United Kingdom	2.6 (Q4)	7.4 (Nov)	2.4 (Dec)

U.S. unemployment data embargoed until 8:30 a.m., Friday, February 7, 1997.