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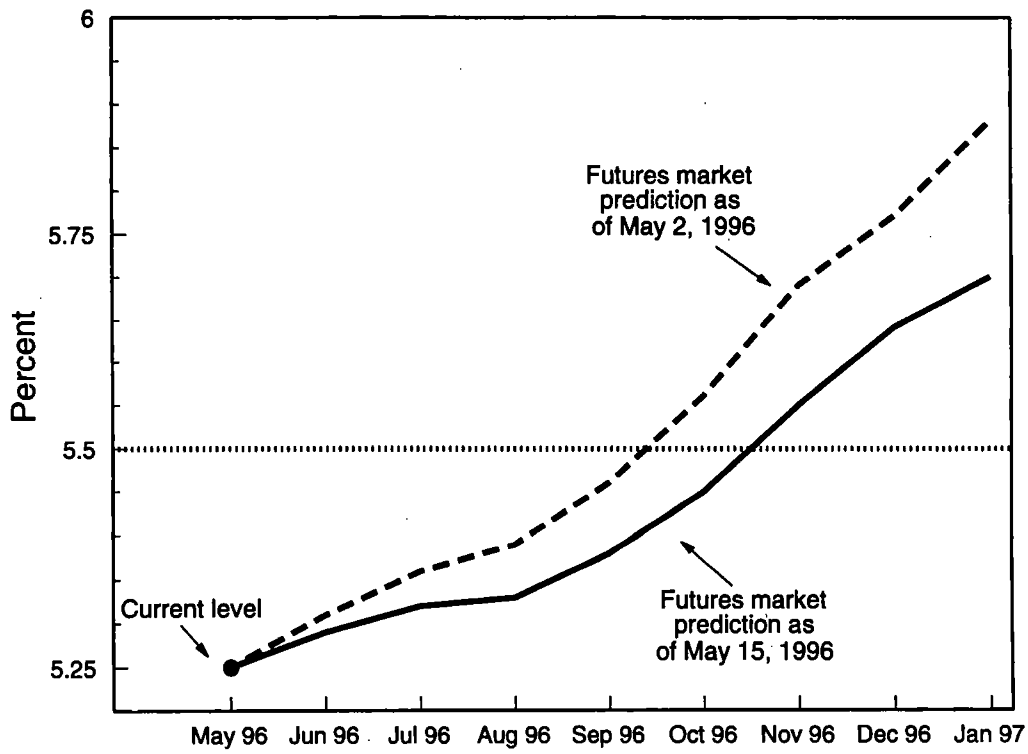
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

May 17, 1996

CHART OF THE WEEK

Rise in Federal Funds Rate Less Likely



The futures market is predicting no change in the federal funds rate at next week's meeting of the Federal Reserve's Open Market Committee and less chance than it had been of an increase through the November election. Following the report on May 2 of strong first-quarter GDP growth, the market predicted that the Fed, which always adjusts the rate in quarter-point increments, would raise it as early as October. Good news on inflation this past week, however, led to a reassessment, and the market now sees less probability of an increase in the rate before November. A Macroeconomic Update in this issue of the Weekly Briefing discusses near-term prospects for the economy.

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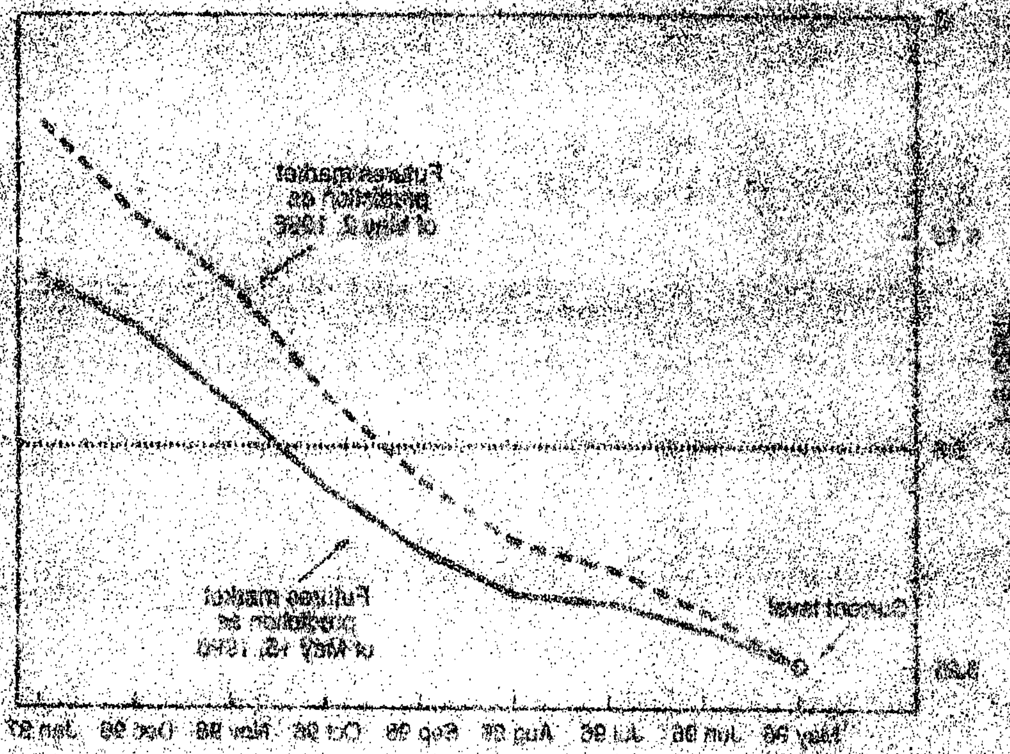

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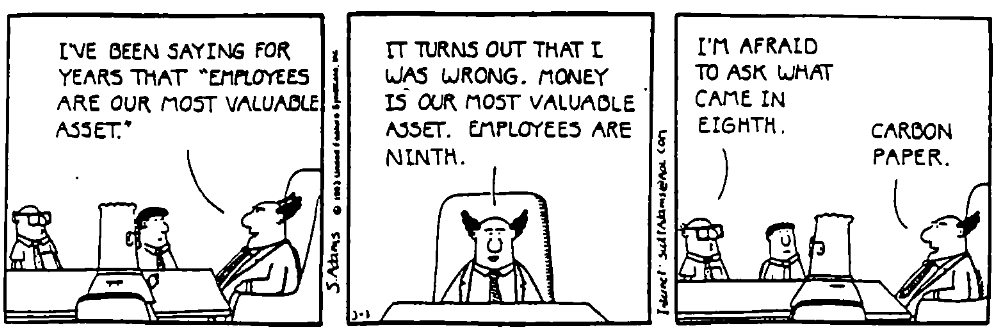


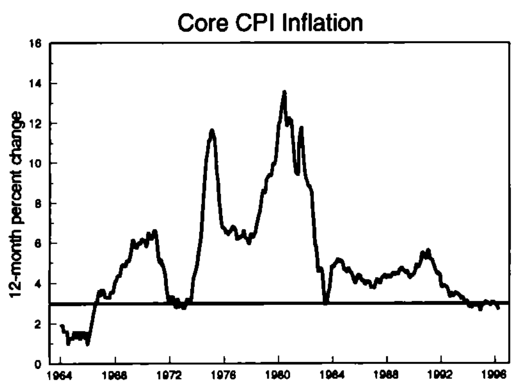
I'VE BEEN SAYING FOR YEARS THAT "EMPLOYEES ARE OUR MOST VALUABLE ASSET."
IT TURNS OUT THAT I WAS WRONG. MONEY IS OUR MOST VALUABLE ASSET. EMPLOYEES ARE NINTH.
I'M AFRAID TO ASK WHAT CAME IN EIGHTH.
CARBON PAPER.

<u>MACROECONOMIC UPDATE</u>

Inflation Subdued as Economy Gathers Momentum

Large employment gains earlier this year coupled with the recent report that real GDP grew by a stronger-than-expected 2.8 percent in the first quarter had raised concern that the economy could overheat. Fear of inflation had driven the 30-year bond yield up more than a percentage point from its January low to over 7 percent by early May. Price data reported in the past week, however, showed an absence of underlying inflation pressures, and led the bond yield to retreat below 7 percent.

Core inflation is low and stable. The core rate of inflation—which omits volatile food and energy prices—has remained steady this year as the economy picked up steam. <u>Core inflation has been at or below 3 percent for the past two and one-half years, the best record in over three decades (see chart).</u> Although the recent jump in energy prices had caused some concern, it is expected to reverse later this year and to have little effect on inflation for the year as a whole. Even if the forecasts are wrong and energy prices stay high, as long as prices do not rise further they would have little continuing effect on the rate of inflation.



Looking forward. Growth in the second quarter is likely to match the solid pace of the first quarter, owing in part to a bounce-back in auto production following the strike at General Motors in March.

Factors strengthening the outlook include:

- Recent high readings for consumer confidence combined with hefty gains in disposable income should help sustain the robust first-quarter pace of consumer spending in the near term.
- Inventory accumulation slowed sharply during the first quarter, in large part due to the strike at GM which accelerated planned inventory reduction in the auto sector. With inventories now at more comfortable levels, firms likely will step up production over coming months.
- Orders for durable goods were strong in the first quarter, indicating that the first-quarter surge in business investment likely will continue over coming months.

Risks on the horizon include:

- Consumer debt levels have continued to rise, presenting the possibility that an increase in interest rates could swiftly dampen consumer spending.
- Despite recent gains in housing starts, higher mortgage rates may dampen the sales of new homes, with a deceleration in house construction likely later this year.
- Although exports may benefit from an expected pickup of growth in Japan, they may be restrained by slow growth in Europe.

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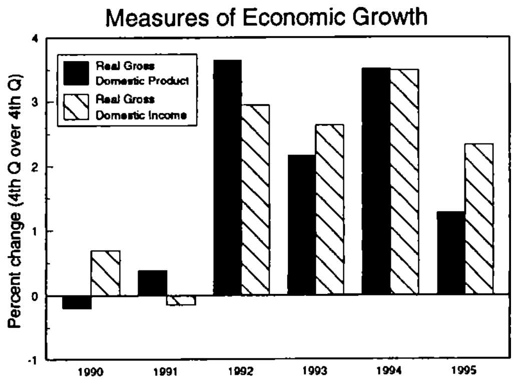
CURRENT DEVELOPMENT

Income and GDP Paint Different Pictures of 1995 Growth

Gross domestic income (GDI) grew more rapidly than gross domestic product (GDP) during 1995, indicating that the economy probably expanded faster than generally believed. Because data on incomes and output are measured separately, the totals do not always agree, sometimes producing a substantial discrepancy.

Analysis. The size of the economy can be measured by adding up either all the output produced or all the income generated in producing that output. Except for a "statistical discrepancy," GDP, which measures total output, must equal GDI, which measures total income. During 1995, the economy grew at an anemic 1.3 percent pace as measured by real GDP, but at a moderate 2.3 percent rate as measured by real GDI (see chart). This difference reflects a swing in the statistical discrepancy of about $75 billion, somewhat larger than in recent years.



Revis'n probably would help a story

1995 GDP likely to be revised up. When the data are revised, the statistical discrepancy often shrinks, with the estimates for GDP and GDI moving toward each other. The stable unemployment rate during 1995 seems more consistent with the relatively stronger growth of GDI. Thus, GDP in 1995 probably will be revised upward, showing that the economy grew a bit faster than current estimates suggest. Income growth, however, is likely to be revised down a bit. Unfortunately, budget cutbacks at the Bureau of Economic Analysis have forced cancellation of this summer's scheduled annual revision. The next annual revision is scheduled for July 1997.

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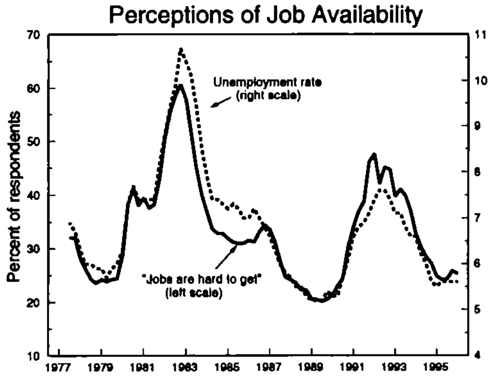
SPECIAL ANALYSIS

With Unemployment Low, Why Are Workers Still Anxious?

Despite several years of strong job creation and moderate economic growth, media reports, focus groups, and anecdotal evidence suggest that workers remain anxious about the future. While much of this anxiety probably has roots in the decades-long stagnation of wages and widening distribution of income, the view that anxiety has not waned as the economy has improved is somewhat puzzling. A careful look at survey evidence on worker sentiment, however, confirms that workers are anxious.

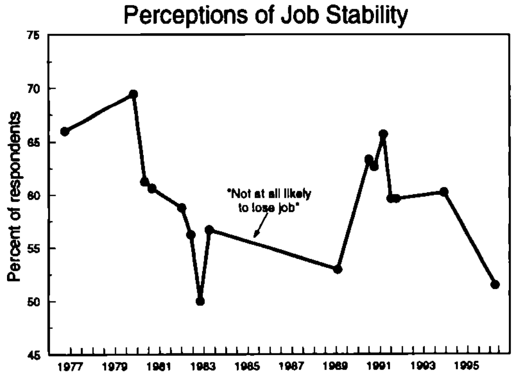
Do perceptions about job availability match the evidence? For many years, the Conference Board has surveyed consumers about the availability of jobs. The pattern of consumer perceptions about job availability has closely matched the pattern of unemployment. When unemployment was high in 1981-83 and again in 1991-92, a larger proportion of respondents reported that "jobs were hard to get" (see top chart). Conversely, as unemployment fell after 1992, an increasing proportion of respondents reported that "jobs were plentiful." A second survey of consumer sentiment conducted by the University of Michigan also shows that consumer perceptions about the job market are consistent with economic conditions.

Perceptions of Job Availability



But worries about job loss have risen. Other surveys, however, show increasing concern about job loss in recent years despite improved economic conditions. For over two decades, the Gallup organization has been asking workers, "How likely is it that you will lose your job over the next 12 months?" Even though the rate of job loss has probably fallen since 1991 and unemployment is lower, <u>fewer</u> workers believe that it is "<u>not at all</u> likely" they will lose their jobs (see bottom chart). In fact, the proportion of workers reporting that it is "not at all likely" they will lose their jobs is similar (at only about 50 percent) to the low reached during 1983 shortly after the unemployment rate peaked at nearly 11 percent during the worst recession since World War II. It is important to note, though, that the decline in share of respondents to the Gallup

Perceptions of Job Stability



poll saying it was "not at all likely" they would lose their job has been mirrored by an increase in the share saying it was "not too likely," with little change in the share saying it was "very or fairly likely." Accordingly, the poll suggests that more people are feeling a moderate, though not high, risk of job loss.

Reconciling perceptions of an improved economy with increased worry. These two impressions reported by consumers—recognition of generally strong job prospects, yet sagging confidence in their own job security—are not inconsistent. Evidence on displaced workers suggests that job displacement is more widely shared than in the past: older, white-collar, and more-educated workers now bear a risk of job loss that in the past was heavily concentrated among blue-collar workers (see Weekly Economic Briefing, February 23, 1996). Thus, more people—perhaps correctly—feel some moderate (but not overwhelming) risk of losing their job even though the overall rate of job loss in recent years probably has fallen.

ARTICLE

Restrictions on Managed Care: Help or Hindrance?

One of the most hotly disputed areas of health insurance reform concerns the oversight of managed care. In the past year, managed care reforms were introduced in over half of all state legislatures, though only a few states actually enacted any significant legislation. Given the increasing importance of managed care in our nation's health care system, pressures to regulate the managed care industry will grow. This Article considers the economics of "any willing provider" laws, which represent one of the more controversial restrictions on managed care.

"Any Willing Provider" Laws. Any willing provider (AWP) laws require managed care organizations to accept into their networks all providers who agree to the terms of the contract and who meet certain minimum standards. To date, 12 states have broad AWP or AWP-like laws. Another 13 states have AWP laws that apply only to pharmacies.

Effects on premiums. Many observers believe that AWP laws significantly reduce the ability of managed care organizations to hold down health insurance costs. Managed care organizations, by choosing which doctors belong to their network, can reduce costs in three main ways:

- **Insurers can contract with only the most efficient providers.** Practicing cost-effective medicine may be one of the best ways to hold down health insurance costs. Most AWP laws allow insurers to specify a broad set of criteria as minimum standards, so insurers could, in theory, specify standards that would ensure the practice of "cost-effective medicine." But writing down such standards is very difficult, and monitoring compliance with them is very costly.
- **Insurers can receive discounts in exchange for guaranteeing a large volume of patients to network providers.** Restricting the number of providers in a network ensures providers a large volume of patients and reduces patient turnover, lowering administrative and patient-search costs.
- **Large insurers may have enough market power to demand discounts from providers.** As more people enroll in managed care health plans, joining a managed care network becomes increasingly important for providers' practices. While this concentration of market power may lead to lower premiums, it may also involve a loss in efficiency as the number of providers is kept artificially low. Fear of being dropped from a network may also limit the investment providers make in developing physician-patient relationships.

Effect on consumer choice. Restricting the number of providers in a managed care network restricts patient choice. This can be particularly difficult for patients whose providers are dropped from a list of network providers: they either have to switch providers or pay substantially more out-of-pocket.

Effect on quality of care. The effect of AWP laws on quality of care is ambiguous. AWP laws may make it more difficult to exclude low-quality providers. On the other hand, some observers feel that managed care organizations often drop the higher quality providers who accept the most difficult cases because they are too costly, and reward those providers who are cheaper, rather than better.

Analysis. Over the past year, coalitions of insurers and employers have generally been successful at convincing state legislatures that restrictions on managed care could lead to increases in health insurance premiums. But, managed care is a growing and largely unregulated industry, and calls for increased regulation are likely to continue. While some degree of regulation may be warranted, it is very important that the "managed care revolution," which has successfully contained growth in health care costs, not be unduly restrained. The Administration recognized this in the proposed Health Security Act, which would have precluded ~~states~~ from enforcing AWP laws and required insurers to disclose what procedures were used to control utilization and costs.

In the long run quality needs to be part of the cost containment —

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cc: Bill Meany

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Skill Deficiencies Among Job Applicants High but Falling. One third of job applicants tested by major U.S. companies in 1995 lacked sufficient reading or math skills to perform the jobs they sought, according to a survey by the American Management Association. While the one-third finding is distressing, the deficiency rate fell from 39 percent in 1994 and now stands at its lowest level since 1990. The survey also found that more companies test for math than for literacy skills. Deficiency rates varied widely by industrial category, with manufacturers reporting a whopping 46 percent of applicants were deficient but wholesalers and retailers reporting just 16 percent. The survey found that 43 percent of firms test job applicants for basic skills, a sharp increase over 33 percent in 1990.

Agriculture Department Releases Crop Forecasts. The Agriculture Department has released its first official forecasts of grain production and consumption for the 1996-97 crop year. The world coarse grain crop (mainly corn) is forecast to be the largest in history, while the world wheat crop is expected to be the second largest on record. Despite projections that global consumption will also reach a new record, crops of this size would allow world grain stocks to rise after 3 years of decline. World stocks, however, would still remain low by historical standards. U.S. supplies and stocks of wheat are expected to remain low in 1996-97 as the winter wheat crop is forecast to fall 12 percent below last year. Domestic wheat consumption is forecast to rise slightly, while wheat exports are forecast to fall 25 percent. U.S. corn production is forecast to rise 27 percent. The estimated increase in corn production is in part based on the expectation that many farmers will plant corn to replace their winter wheat crop which was damaged due to bad weather in the Midwest.

President's Economic Report Receives Favorable Review. The 1996 Economic Report of the President received a positive review in the latest issue of Challenge magazine, whose audience is economists concerned with public policy. The reviewer writes "fair-minded readers will recognize that the latest report contains a thorough, dispassionate, and professional statement of the Administration's economic views." The Report's emphasis on the role of deficit reduction as a means of raising overall living standards, rather than as an end in itself, was singled out for particular praise. The review also highlights the Report's defense of progressive taxation and its "indictment" of flat tax proposals. While the review did argue that policy responses to income inequality were accorded insufficient attention, it concludes with an affirmation of "the sincerity of the present Administration's economists" on the topic, emphasizing the Report's role in creating "a worthwhile hope that [inequality] could change."

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INTERNATIONAL ROUNDUP

Vietnam Set to Receive $1.5 Billion in World Bank Loans. In a recent visit to Hanoi, World Bank President Wolfensohn praised Vietnam's progress toward a market economy and recommended that the Bank lend $1.5 billion on concessionary terms to Vietnam over 1997-99, which would more than double its previous lending. President Wolfensohn focused on the challenges faced by Vietnam in addressing widespread poverty—Vietnam was the fifth poorest country in the world in 1993, with a per capita income of just $170—while reducing a substantial foreign debt burden that equaled $25 billion (160 percent of GDP) at the end of 1994. This week, Vietnam began talks with international bankers to restructure its commercial debt. The Vietnamese economy expanded at a rapid rate of over 9 percent last year, buoyed by strong exports and foreign investment, which has surged in recent years with approved foreign investment projects totalling $6.2 billion by 1995.

Brazilian Reforms Continue With New Telecom Law. After receiving a cool reception from the United States on its telecom policies at the recent round of World Trade Organization (WTO) negotiations, Brazil's lower house of congress approved new laws this week that will liberalize its state-controlled telecommunications sector. Senate approval is expected. The first sectors to be opened will be cellular and satellite telecommunications, for which the government will be tendering concession offers later this year. The new law allows the government to limit foreign ownership of telecom firms to 49 percent for the first 3 years. Congress also approved the establishment of a regulatory agency to oversee the telecom sector. A comprehensive intellectual property law was signed by President Cardoso this week, bringing Brazil into conformity with the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights.

Growth Projections Sharply Reduced for Europe. The European Commission recently announced a major downward revision in forecasts for European growth this year, from 2.6 percent to 1.5 percent. With the unemployment rate still in double digits, concerns remain that the additional budget cuts needed to meet the Maastricht criteria for monetary union may further increase joblessness. The European Commission is planning more talks with trade unions in order to garner support for these budget cuts. The Commission remains optimistic that by 1997, France and Germany, the two pillar economies of a future European Monetary Union, will meet the 3 percent deficit-to-GDP target set by the Maastricht Treaty. Although in 1995 only three member countries achieved the deficit target (Luxembourg, Ireland and Denmark), the EC expects seven countries to meet the target by the 1997 deadline.

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RELEASES THIS WEEK

U.S. International Trade in Goods and Services
****Embargoed until 8:30 a.m., Friday, May 17, 1996****

The goods and services trade deficit rose to $8.9 billion in March from $7.0 billion in February.

Productivity

Nonfarm business productivity rose 2.6 percent at an annual rate in the first quarter of 1996. Manufacturing productivity increased 6.3 percent.

Housing Starts

Housing starts rose 6 percent in April to 1.52 million units at an annual rate. For the first four months of 1996, starts are up 16 percent over the same period a year ago.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production increased 0.9 percent in April, following a decline of 0.5 percent in March. Capacity utilization increased 0.5 percentage point, to 83.0 percent.

Retail Sales

Advance estimates show that retail sales decreased 0.3 percent in April following an increase of 0.5 percent in March. Excluding sales in the automotive group, retail sales increased 0.4 percent in April following an increase of 0.5 percent in March.

Consumer Price Index

The consumer price index increased 0.4 percent in April. Excluding food and energy, consumer prices increased 0.1 percent.

MAJOR RELEASES NEXT WEEK

Advance Durable Shipments and Orders (Friday)

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	2.8
GDP chain-type price index	5.3	2.6	2.2	2.2	2.5
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	10.3
Residential investment	4.5	4.0	4.0	4.0	4.0
Exports	8.2	11.1	11.1	11.3	11.2
Imports	9.2	12.5	12.5	12.4	12.5
Personal saving	5.1	3.3	3.2	3.6	3.6
Federal surplus	−2.7	−2.2	−2.2	−2.1	N.A.

	1970–1993	1995	Feb. 1996	March 1996	April 1996
Unemployment Rate	6.7**	5.6**	5.5	5.6	5.4
Payroll employment (thousands)					
increase per month			631	178	2
increase since Jan. 1993					8545
Inflation (percent per period)					
CPI	5.8	2.5	0.2	0.4	**0.4**
PPI-Finished goods	5.0	2.3	−0.2	0.5	0.4

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

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1994	1995	March 1996	April 1996	May 16, 1996
Dow-Jones Industrial Average	3794	4494	5612	5580	5635
Interest Rates					
3-month T-bill	4.25	5.49	4.96	4.95	5.01
10-year T-bond	7.09	6.57	6.27	6.51	6.70
Mortgage rate, 30-year fixed	8.35	7.95	7.62	7.93	8.08
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level May 16, 1996**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.535	+1.2	+6.9
Yen-Dollar	106.7	+1.8	+23.7
Multilateral $ (Mar. 1973=100)	88.39	+0.9	+5.6

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	1.8 (Q1)	5.4 (Apr)	2.9 (Apr)
Canada	0.6 (Q4)	9.3 (Mar)	1.5 (Mar)
Japan	2.2 (Q4)	3.1 (Mar)	0.1 (Mar)
France	0.3 (Q4)	12.5 (Jan)	2.3 (Mar)
Germany	0.8 (Q4)	7.0 (Feb)	1.5 (Mar)
Italy	2.3 (Q4)	12.0 (Jan)	4.5 (Mar)
United Kingdom	1.9 (Q1)	8.3 (Mar)	2.7 (Mar)