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WEEKLY ECONOMIC BRIEFING
OF THE PRESIDENT OF THE UNITED STATES

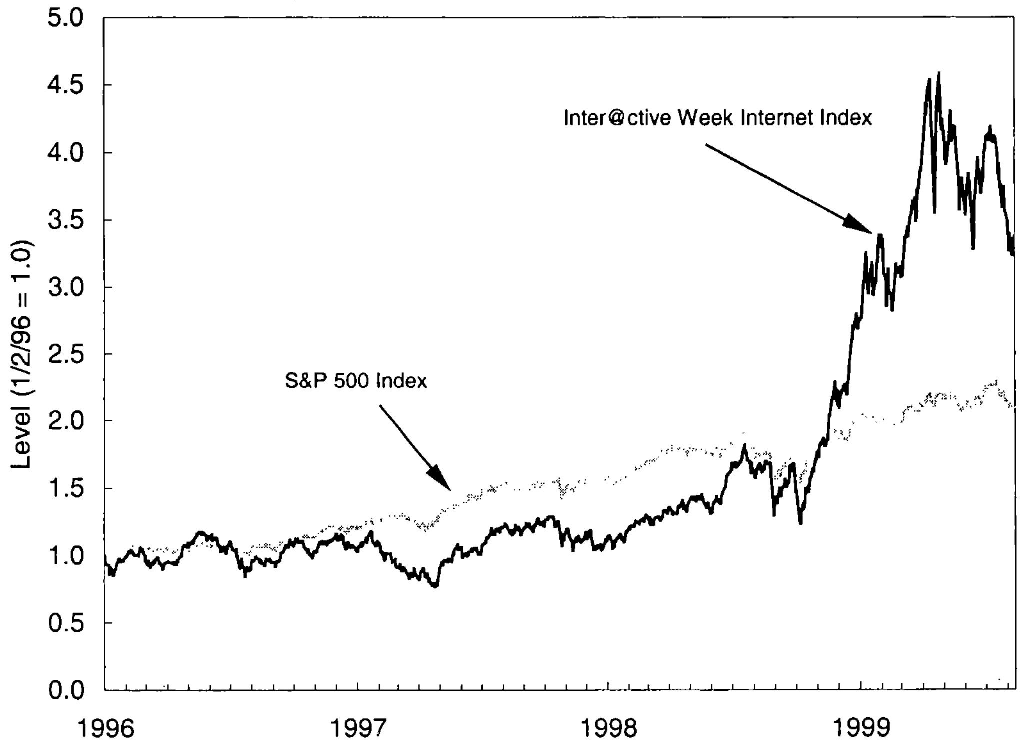
Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

Copied:
Podesta
Baily

August 13, 1999

CHART OF THE WEEK

Internet Stocks and the S&P 500



Between 1996 and late 1998, the Inter@ctive Week index of Internet stocks performed no better than the Standard & Poor's 500 index. Since the beginning of October last year, however, the Internet index has more than doubled in value, despite recent retreats from much higher levels.

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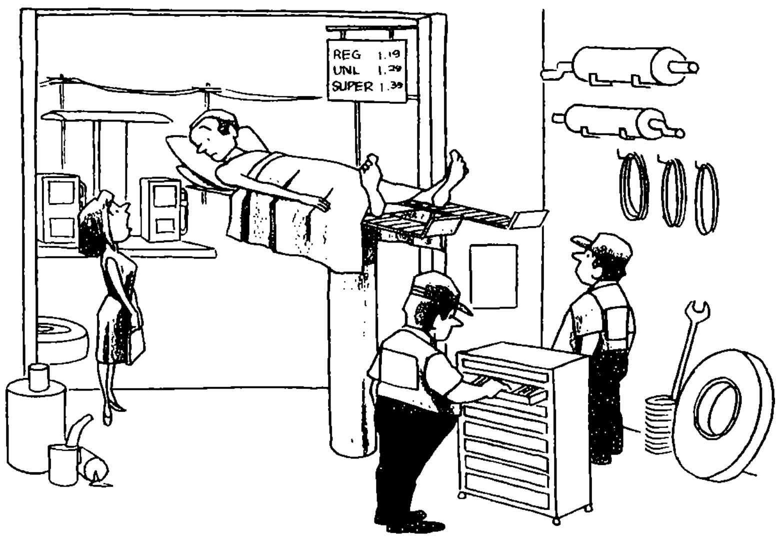

"I checked your company's medical plan again, and these guys *are* authorized through your HMO."

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TREND

Employment Changes in Manufacturing Industries

While the overall economy has performed strongly in this expansion, international factors have retarded manufacturing since 1997. This has led to significant employment declines in many of the durable goods industries that had been growing prior to 1997 and accelerated job losses in most nondurable industries.

1993-97: the durable divide. Between 1993 and 1997, manufacturing output grew at a ~~5.6 percent~~ annual rate—faster than the rest of the economy, despite an increase in the manufacturing trade deficit. Because productivity growth was particularly rapid, employment growth was more sluggish. Nevertheless, manufacturing employment grew at an average annual rate of 0.8 percent and manufacturing employment increased by 769,000 between December 1992 and December 1997.

As might be expected in an expansion with particularly strong growth in investment, manufacturing employment gains were concentrated in durable goods (see chart on next page), with rapid advances over this period in motor vehicles and equipment, lumber and wood products, industrial machinery and equipment, fabricated metal products, and electronic and electrical equipment. Even in this period, however, employment growth in nondurables was sluggish. Indeed, labor-intensive industries heavily engaged in international trade, such as textiles, apparel, and leather and leather products (footwear), experienced significant employment declines.

1997-99: the global divide. More recently, the growth pattern has changed. Weak foreign demand and declining foreign currencies have brought manufacturing export growth to a halt. The volume of U.S. merchandise exports in the second quarter of 1999 was just 0.7 percent higher than it was in the fourth quarter of 1997, while merchandise imports increased by 18 percent. In the first 5 months of this year, the annualized trade deficit in manufactured goods has been $270 billion—almost double the level prior to the Asian crisis.

The most rapid employment declines since 1997 were again in labor-intensive sectors such as leather products, apparel, and textile mill products. In addition, however, many durable goods industries that had been doing well began to experience declining employment (trade-impacted durables in the chart). These include electronic and electrical equipment, industrial machinery and equipment, transportation equipment, and primary metals (including steel). Indeed, even employment in computer manufacturing fell by about 21,000 during this period.

Since machinery accounts for about half of all U.S. manufactured goods exports, durable goods manufacturers and their suppliers have clearly been adversely impacted by the export slump. Not only have they lost export sales directly but they have also been damaged indirectly as the decline in manufacturing capacity

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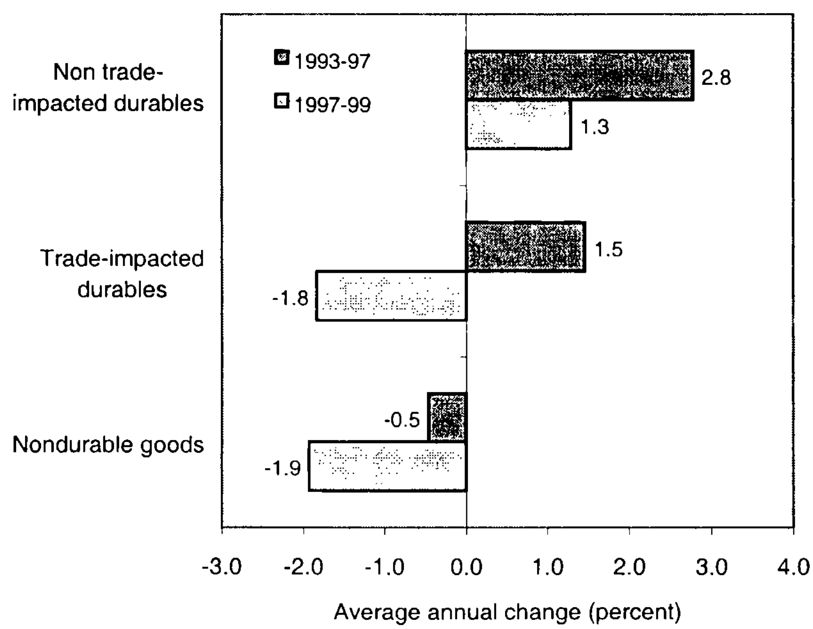
utilization (from 82.5 percent in the fourth quarter of 1997 to 79.4 percent in June) has depressed spending on industrial equipment. (In the second quarter, for example, expenditures on industrial equipment were only 2.6 percent above the level in the fourth quarter of 1997.) This weakness appears to explain why capacity utilization in steel remains low, despite the fact that steel imports have returned to near their pre-surge levels.

By contrast, manufacturers experiencing strong domestic demand growth have seen employment growth (non trade-impacted durables in the chart). Strong expenditures on construction have sustained employment growth in lumber and wood products; stone, clay, and glass; and furniture and fixtures. Similarly, buoyant demand for autos and trucks has maintained stable employment levels in motor vehicles and equipment despite strong import growth.

Implications. Manufacturing is an important provider of high-wage jobs, particularly for blue-collar men with a high school education. While rapid productivity growth in this sector is likely to limit the additional opportunities for such employment in the future, other developments can affect job availability. Increased exports, driven by foreign growth, would mitigate these employment declines. By contrast, higher domestic interest rates could depress industrial investment and construction spending and deal another blow to a sector that is already troubled.

Changes in Manufacturing Employment



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SPECIAL ANALYSIS

Can Competition Control Health Care Costs?

In most markets, competition is viewed as a powerful force for encouraging low prices, high quality, and innovation. However, distinctive features of the health care market—particularly differences in what providers and patients know and the diversity of individual health care needs—have led some to question whether more competition is beneficial. While unique features of the health care market may have weighed against the benefits of competition in the past and remain important today, recent developments in the health care industry appear to have shifted the balance in favor of competition.

Concerns about competition in health care. Prior to the mid-1980s, health insurance premiums were typically heavily subsidized by employers, which dampened individuals' sensitivity to cost and price differences. To the extent that employee contributions did not increase in line with costs, employees had an incentive to choose more expensive plans. Among providers, incentives to contain costs were poorly structured and resulted in little restraint on health care spending (encouraging, for example, a "medical arms race" among hospitals to provide more expensive equipment and facilities). Greater competition in such an environment could lead to excess capacity, higher costs, adverse patient health outcomes, and risk selection that isolates high-risk individuals into groups that insurers find prohibitively costly to serve.

The benefits of competition. Dramatic changes in the private health insurance environment have made competition more effective in controlling costs. In the past 15 years, employees have had to pay a larger share of health plan premiums, restoring price sensitivity. In addition, traditional fee-for-service health plans allowing for complete choice have given way to more tightly managed preferred provider organizations, resulting in cost containment. In the current environment greater competition can lower the costs associated with achieving any given quality of health insurance while giving consumers a choice of plans offering different menus of price and quality.

The effect of price on switching among health plans. The projected success of competition as a strategy for controlling health costs depends in part on the willingness of consumers to switch health plans in response to a change in plan premiums. Evidence that consumers are very sensitive to out-of-pocket premiums and are willing to switch health plans in response to small changes comes from a study of what happened at University of California campuses after 1994, when they stopped paying the full premium for most health plans and subsidizing the cost of the most expensive plan. The study found that individuals facing monthly premium increases of as little as $10 were roughly five times as likely to switch plans as those whose premiums remained constant.

Attention to adverse selection remains important. Potentially, the switch to a less expensive plan in response to higher premiums could go too far, given limits on what beneficiaries and insurers know about each other and the diversity of individual health care needs. This is illustrated by what happened when Harvard shifted to a voucher system in 1995, in which beneficiaries were paid a fixed contribution irrespective of which plan they chose. Harvard experienced cost savings of 5 to 8 percent of baseline health spending, due largely to lower insurer profits as a result of increasing plan choice and more stringent bargaining. However, this change increased the price to employees in the most generous plan by over $500 annually. Most individuals switched away from this plan, so that the provider of this policy experienced rising expenses beyond what was projected. Within 3 years, this health care option was driven out of the market.

Conclusion. In the current health care environment, increasing price sensitivity and requiring providers to bid competitively for contracts to provide health care should prove beneficial. While issues such as adverse selection cannot be ignored, recent research suggests that the cost savings from increased competition are likely to be enough to generate net benefits. In the case of competitive bidding, reductions in the cost of providing care are transferred to the organization soliciting the bids, with some of these savings passed on to patients. Such an incentive structure should lead to shifts away from costly plans and create additional savings. With the right structuring of incentives, competition can achieve desired cost objectives without unduly sacrificing quality.

SPECIAL ANALYSIS

Labor Market Explanations for a Lower NAIRU

[This material was discussed at Wednesday's economic briefing, but was not contained in the written material for that briefing.]

One of the most notable features of the current expansion is how long the unemployment rate has remained below 5 percent without triggering rising inflation. A new study highlights four changes in the labor market that may have lowered the unemployment rate consistent with stable inflation (the NAIRU).

Demographics. The maturing of the baby boom and rising educational attainment of the labor force could reduce the amount of unemployment associated with frequent job changes by younger and less-educated workers (because they represent a smaller fraction of the labor force) and hence lower the aggregate unemployment rate. The study estimates that the changing age composition of the labor force can account for an estimated 0.4 percentage point of the decline in the overall unemployment rate since the mid-1980s. Because it has been going on for decades, increasing average educational attainment appears to be a less plausible explanatory factor for *recent* changes in the NAIRU.

Growth in the prison population. The study notes that nearly 2 percent of the adult male population is currently incarcerated and that the prison population has almost doubled in the past decade. To the extent that convicted criminals had weak employment histories (and hence high unemployment rates) prior to their arrest, their removal from the labor force would lower the unemployment rate without much impact on labor market tightness. The study estimates that the increase in the incarcerated population can account for roughly a 0.3 percentage point decline in the male unemployment rate, and a 0.17 percentage point decline in the overall unemployment rate, since 1985.

Improved matching. The rise of the temporary help industry and, since 1993, the expanded provision of job search assistance (JSA) to unemployed workers could have reduced frictional unemployment by matching unemployed workers to job vacancies more quickly and more efficiently. The study finds that JSA is unlikely to affect a large enough number of workers to significantly affect the aggregate unemployment rate. By contrast, it finds that the rise of the temporary help industry may account for as much of the decline in unemployment since the mid-1980s as do demographic shifts.

Weak unions and worker anxiety. Finally, the study examines the "weak backbone hypothesis," which holds that workers have become more reluctant to press for wage gains. It points to declining union membership and the watershed Professional Air Traffic Controllers Organization (PATCO) strike in 1981 as evidence that the threat of unionization is now so low in many industries that the labor market has passed a "tipping point" beyond which unions and the threat of unionization have very little influence on wage setting. Although worker anxiety is frequently advanced as a source of wage restraint, the study concludes that worker surveys do not reveal widespread insecurity and there is little evidence of a link between insecurity and wage growth.

Implications. Demographic shifts and the rise of the temporary help industry appear to be the major labor market developments that have allowed the economy to achieve sustained low unemployment rates. While it remains an open question whether they are the main reason for the improved inflation-unemployment trade-off during the current expansion, they are unlikely to be reversed in the near future. Thus, they would be a force operating to maintain the high-pressure labor markets of this expansion that have begun to bring benefits to low-wage workers and disadvantaged families as well as the rest of the labor force.

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Do Local Communities Benefit from Foreign Direct Investment? Investment by foreign manufacturing firms in American communities raises wages by more than an equivalent amount of domestic investment, but that investment may come at a cost to government budgets, according to a recent study. The study found that attracting a representative foreign manufacturing firm increased wages for all jobs in the industry in the same county by 2.3 percent, compared with 0.3 percent for a new domestic firm. However, state and local governments often offer incentives to attract firms, and the study finds that attracting foreign firms is associated with larger reductions in real per capita local government revenues and expenditures than attracting new domestic firms. Also, increased foreign investment is associated with lower public school enrollment and a shift in spending away from education toward public safety and transportation.

Can New York Bank on Wall Street? A recent study by the Federal Reserve Bank of New York addresses concerns that a future downturn in the securities industry would be quite disruptive to the New York City economy. The study reports that the securities industry is disproportionately large in New York City. It accounts for 4.7 percent of total employment (roughly 10 times the national average) and generates 19 percent of total earnings. In some way, 14 percent of all New York City employment depends on the securities industry. The study also notes that Wall Street was a large factor in New York City's two major downturns in the 1970s and early 1990s. However, it finds that other factors might soften the blow of a decline in securities market employment. Specifically, several sectors that were hard hit in earlier downturns (including manufacturing and real estate) appear to be on more solid footing in this expansion. Other fast-growing industries not tied to the financial sector might also cushion the effects of securities industry job losses.

State Regulators Highlight Problems with Day Trading. This week, state securities regulators issued a report based on a 7-month investigation of the day-trading industry. Day trading is a strategy in which individuals make numerous small stock trades each day trying to exploit small movements in share prices. The day-trading industry consists of specialty firms where customers go to make such trades using proprietary software. The report, released by the North American Securities Administrators Association (NASAA), concluded that day-trading firms are misleading in their advertising and ought to screen potential customers better. It also questioned the practice at some firms of arranging inter-customer loans to meet margin calls. These practices seem to be aimed at evading legal restrictions on investment firms' lending to customers—restrictions that are meant to prevent customers from investing beyond their means. The report contained an independent analysis of accounts at one Massachusetts firm where at least 70 percent of traders lost money and only 11.5 percent showed the ability to conduct profitable short-term trading. However, this firm had been shut down last year by state authorities and may not be representative of the industry.

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INTERNATIONAL ROUNDUP

IEA Sees Tighter Oil Markets. With supply constrained and a recovery in demand underway, oil markets are set to tighten, according to the International Energy Agency (IEA). Demand is expected to grow beginning in the second half of this year, and oil demand in 2000 is forecast to be about 1.8 million barrels per day, or 2.4 percent, higher than 1999 levels. On the supply side, OPEC ministers have been quoted in the press saying that they do not anticipate raising output quotas at their next meeting in September. OPEC compliance with recent cutback agreements was 91 percent in July, and continued compliance will keep OPEC supplies constrained. Meanwhile, non-OPEC oil supply is expected to increase much less than demand, following a small decrease this year.

World Bank Sees Commodity Markets Vulnerable to Y2K Bug. Anticipation of the Y2K technology bug could disrupt global commodity markets, according to the World Bank's most recent *Global Commodity Markets* report. Demand for essential commodities is expected to increase as consumers stockpile basic staples such as fuels and foods and speculators buy in anticipation of higher prices—though some producer response should be expected as well. Stocks of most commodities appear to be sufficiently large to prevent significant price increases, but oil markets may be vulnerable, not only because of the supply considerations discussed above but also because oil production is highly technology intensive, which heightens the risk of production disruptions, especially for producers like Russia and Nigeria that might lack the resources to fix problems. The report also warns that Y2K-related transportation disruptions could lead to local imbalances. For example, efforts by importers to stockpile goods before the end of 1999 could put strains on shipping capacity. Also, low-valued or bulky commodities such as grains and timber may be crowded out by high-valued commodities and manufactures, leading to price volatility as surpluses build in exporting countries and shortages develop in importing countries.

OECD Reviews Mexico's Regulatory Restructuring. In its new report *Regulatory Reform in Mexico,* the OECD praises the regulatory reforms that have helped transform Mexico from an inward-looking economy to an open and market-based economy over the last 15 years. The report emphasizes that reforms have produced major benefits by reducing prices and increasing quality and choice for Mexican consumers and businesses. It notes that privatization and the elimination of red tape have encouraged firms to invest in new technologies. The report finds that the Mexican economy is now more adaptable, allowing it to rebound more quickly and at lower cost from major economic crises. However, it observes that further reform is needed in some sectors, notably telecommunications, where prices remain very high. It recommends improving regulation of dominant firms after privatization, enhancing the efficiency and coherence of regulations at state and local levels, and increasing regulatory transparency to boost investment, market entry, and innovation. And it stresses the importance of securing the benefits of the program through sustained policy stability and strengthened public administration.

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RELEASES THIS WEEK

Producer Price Index

****Embargoed until 8:30 a.m., Friday, August 13, 1999****

The producer price index for finished goods rose 0.2 percent in July. Excluding food and energy, producer prices were unchanged.

Retail Sales

Advance estimates show that retail sales rose 0.7 percent in July. Excluding sales in the automotive group, retail sales rose 0.3 percent.

MAJOR RELEASES NEXT WEEK

Consumer Prices (Tuesday)
Housing Starts (Tuesday)
Industrial Production and Capacity Utilization (Tuesday)
U.S. International Trade in Goods and Services (Thursday)

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U.S. ECONOMIC STATISTICS

	1970-1993	1998	1998:4	1999:1	1999:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	4.3	6.0	4.3	2.3
GDP chain-type price index	5.4	0.9	0.8	1.6	1.6
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	2.6	4.1	3.6	1.3
Real compensation per hour:					
Using CPI	0.6	2.5	2.0	2.9	1.5
Using NFB deflator	1.3	3.7	3.4	3.0	3.3
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	11.0	11.0	11.0	11.2
Residential investment	4.5	4.3	4.5	4.6	4.6
Exports	8.2	11.3	11.3	10.9	10.9
Imports	9.2	13.0	13.1	13.2	13.5
Personal saving	5.2	0.3	-0.0	-0.5	-0.8
Federal surplus	-2.7	0.9	0.8	1.4	N.A.

	1970-1993	1998	May 1999	June 1999	July 1999
Unemployment Rate (percent)	6.7**	4.5**	4.2	4.3	4.3
Payroll employment (thousands)					
increase per month			28	273	310
increase since Jan. 1993					19243
Inflation (percent per period)					
CPI	5.8	1.6	0.0	0.0	N.A.
PPI-Finished goods	5.0	0.0	0.2	-0.1	**0.2**

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

New or revised data in **boldface**.
PPI data **embargoed until 8:30 a.m., Friday, August 13, 1999**.

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FINANCIAL STATISTICS

	1997	1998	June 1999	July 1999	August 12, 1999
Dow-Jones Industrial Average	7441	8626	10704	11052	10808
Interest Rates (percent per annum)					
3-month T-bill	5.06	4.78	4.57	4.55	4.66
10-year T-bond	6.35	5.26	5.90	5.79	6.08
Mortgage rate, 30-year fixed	7.60	6.94	7.55	7.63	8.15
Prime rate	8.44	8.35	7.75	8.00	8.00

INTERNATIONAL STATISTICS

Exchange Rates	**Current level August 12, 1999**	**Percent Change from Week ago**	**Percent Change from Year ago**
Euro (in U.S. dollars)	1.064	−1.5	N.A.
Yen (per U.S. dollar)	115.8	1.6	−20.8
Major currencies index (Mar. 1973=100) (trade-weighted value of the U.S. $)	95.01	0.8	−5.6

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	4.1 (Q2)	4.3 (Jul)	2.0 (Jun)
Canada	3.2 (Q1)	7.6 (Jun)	1.5 (Jun)
Japan	0.1 (Q1)	4.9 (Jun)	0.0 (Jun)
France	2.3 (Q1)	11.3 (Jun)	0.5 (Apr)
Germany	0.8 (Q1)	7.2 (May) [2]	0.4 (Jun)
Italy	0.9 (Q1)	12.1 (Apr)	1.4 (Jun)
United Kingdom	1.2 (Q2)	6.2 (Apr)	1.4 (Jun)

1/ For unemployment data, rates approximating U.S. concepts as calculated by the U.S. Department of Labor, Bureau of Labor Statistics.
2/ Rate for former West Germany. Using OECD standardized unemployment data, the unemployment rate for unified Germany for May was 9.1 percent.