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Weekly Economic Briefing of the President of the United States,
Jan 1995

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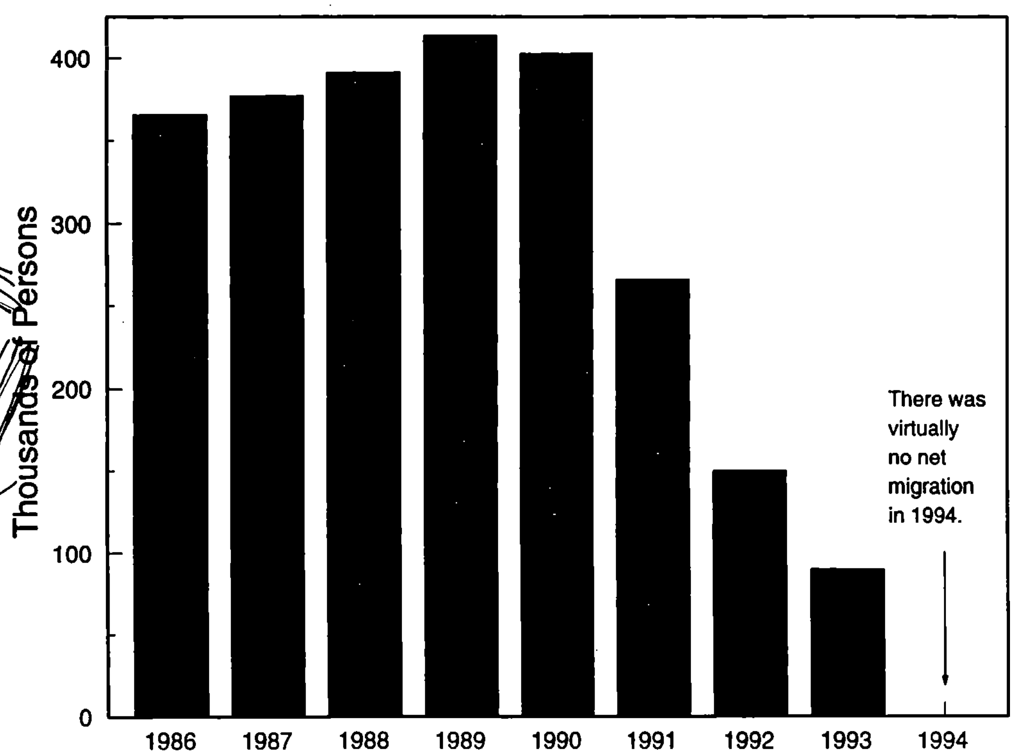
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 19, 1995

CHART OF THE WEEK

Net Migration into California



Bill Hershey

Migration typically plays an important role in helping to return a region's economy to equilibrium following an economic downturn. Eventually, a depressed region's unemployment rate tends to recover to its normal value, but only partly because job growth returns. Net migration into the region tends to slow, as workers move instead to areas where job prospects are more promising. Recent data suggest that this pattern is being repeated in California, where net migration into the state slowed from more than 400,000 in 1989 to essentially nothing in 1994. An item in this issue of the Briefing provides additional information on the economies of the Pacific Rim states.

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"My lawyer says I'm not allowed to guess what's wrong with you until after the tests are complete, and even then I'm supposed to cross my fingers."

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CURRENT DEVELOPMENT

The Tide Rolls Out: States Backtrack on Health Reform

Several states that had pursued comprehensive health care reforms during the last two years are now backtracking. The biggest step backward in state health reform appears to have occurred in the state of Washington. In May, most of the reforms enacted in 1993 were repealed. Although the new law still prohibits denial of coverage for preexisting conditions, it repeals employer and individual mandates, premium caps, and a minimum benefits package. Similar, though less dramatic, setbacks have occurred in Montana, Vermont, and Oregon.

Analysis. What lies behind the turnaround at the state level? Because reform plans were never fully implemented, bad experience with the programs can hardly be the explanation. Hawaii, which is the one state that has had an employer mandate in place for a long time, has not taken any steps backwards.

In large part, the turnaround probably reflects the election of more conservative lawmakers at the state level. In addition, it may reflect the recent deceleration of health benefits costs, which may have served to reduce the sense of urgency felt by state residents about the matter.

Health care reform may be inherently more difficult to enact and sustain at the state level than it is at the Federal level. Employers can easily and credibly threaten that they will move out of a particular state—or never move in—if it implements reforms that prove expensive to firms.

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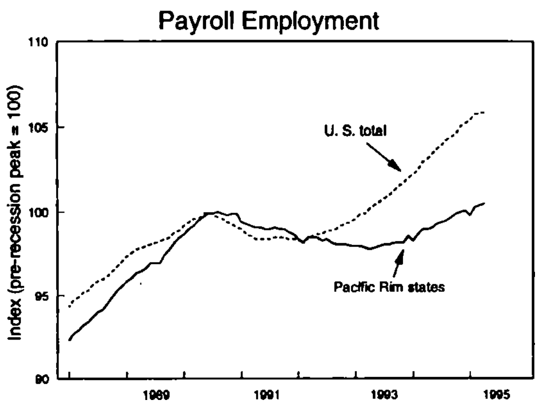
TREND

Weathering the Economic Storms on the Pacific Rim

During the early 1990s, the Pacific Rim region of the United States (defined to include Alaska, Washington, Oregon, California, and Hawaii) suffered a recession that was 60 percent longer and 30 percent deeper than the recession endured by the nation as a whole. Whereas total employment in the nation fell 1.7 percent from peak to trough, in the Pacific Rim states it fell 2.2 percent (see chart). And whereas the turnaround in employment was only 21 months in coming in the rest of the country, on the Rim the turnaround took 33 months to arrive. Since early 1993, employment on the Rim has risen steadily, but there has still been no "rebound" period of rapid job growth. As a result, the Pacific states' employment now exceeds its pre-recession peak by only 0.5 percent; for the nation as a whole, the comparable figure is 5.8 percent.



Not all parts of the region have suffered equally. Job loss and sluggish growth have been most pronounced in southern California and Hawaii. In California, the unemployment rate has stagnated for the past six months at around 7-3/4 percent—2 percentage points above the national average. And Hawaii now has fewer employed workers than it did two years ago. By contrast, job growth in the Pacific Northwest has been strong over the past year.

Key factors shaping the regional economy in the recent past and influencing its prospects include:

- Defense conversion. The cutback in defense spending has cost California hundreds of thousands of jobs in aerospace alone. But according to one recent study, the downsizing of California's aerospace industry is now 80 percent complete. Furthermore, other industries are picking up the slack. In 1994, Hollywood and the recreation industry together created as many California jobs as were lost in aerospace in that year. This year, labor markets should continue to strengthen: In southern California, two to three times as many firms plan to add workers as plan to cut jobs in 1995. Washington state, which has suffered layoffs at Boeing and at the Hanford nuclear plant, has managed to keep employment growing by adding more jobs in other manufacturing industries.
- Natural-resource conversion. Oregon has made great progress in diversifying away from the declining timber industry. Thanks largely to growth in high-technology industries—which now employ more workers

than the timber and wood-products industries—Oregon has outpaced the nation in job creation throughout the 1990s. Alaska, however, remains heavily dependent on natural resources; with only about 5 percent of its jobs in manufacturing, Alaska's economy remains vulnerable to booms and busts in the oil industry.

- Natural disasters. After suffering more than its share of natural disasters over the past several years, California may see a silver lining. Only a small fraction of available insurance and relief money has been spent thus far on rebuilding from the Northridge earthquake. According to one recent study, another $10 billion or more will be pumped into southern California's economy before reconstruction is complete. Similarly, this year's heavy rains are not all bad news. Although they did damage fruit and nut crops in flooded areas, they may boost agricultural production elsewhere in the state. With reservoirs filled, farmers will receive their full water allotment for the first time in years.

- Foreign trade and tourism. On net, foreign trade has contributed less than expected to the region's growth in recent months. The devaluation of the peso and the collapse of the Mexican economy have reduced demand for the region's exports to Mexico. The strength of the yen should have increased demand for the region's exports, but any such stimulus has probably been at least partly offset by the fact that the Japanese economy has been so sluggish. Nonetheless, tourist arrivals in Hawaii rose substantially last year, and they should increase further if and when Japan's economy revives.

ARTICLE

Designing Environmental Policies for a More Competitive Electricity Industry

Although the electricity industry produces less than 3 percent of the output of the economy, it accounts for more than one-third of both greenhouse gas emissions and nitrogen dioxide emissions (a precursor of ozone smog). It also accounts for three-fourths of the nation's sulfur dioxide emissions (although these emissions will fall sharply in the future due to limits imposed by the Clean Air Act).

Federal and state regulators have responded to this environmental impact by attempting to influence the type of generating capacity that is built, and by promoting energy conservation through a variety of programs collectively known as demand-side management programs. For example, a state regulator may mandate that utilities under its jurisdiction subsidize the purchase of fluorescent light bulbs, or offer rebates on the installation of energy-efficient windows. Demand-side management programs are one way of addressing the problem that many households fail to invest in cost-effective energy-saving technology. Such programs have also probably helped redress the fact that, under the prevailing regulatory regime (which is based on a cost-plus-type approach), utilities have a financial incentive to build too much capacity.

The challenge of industry reorganization. The advent of competition to the electrical utility industry will render many current conservation and clean technology programs impossible to implement. Requirements for the use of certain types of generating technology will become more difficult to enforce as unregulated electricity generators take a larger share of the market, and in any event, these requirements work contrary to the goal of restructuring. Mandates for financing customer conservation and the use of cleaner technologies could be maintained by imposing them on the distribution network, which will in all likelihood remain a regulated monopoly, but this would concentrate costs on a smaller share of the industry. It is an indication of the complexity of these issues that California, which has been a forerunner both in mandating conservation and alternative technologies and in proposing a restructuring of the industry, has not yet developed a clear plan for how environmental issues associated with restructuring should be addressed.

However, in many respects, the demise of current conservation and clean technology programs would represent an opportunity for achieving improved efficiency while protecting the environment. In many cases, these programs are excessively costly, even taking account of the environmental benefits they deliver. For example, many states effectively mandate the purchase of electricity from alternative suppliers at inflated prices even though this is contrary to the intent of the relevant authorizing legislation. There also are debates about the cost-effectiveness of conservation programs under the current regulatory regime.

Critics argue that these programs may be much more costly than is commonly thought. It may also be that the capacity such programs displace is new, clean generating plant rather than older, dirtier plant.

Appropriate pricing is crucial. Fortunately, the environmental goals of Federal and state conservation and technology programs can be achieved in other (often more efficient) ways even as the restructuring of the industry goes forward. Appropriate supply and demand decisions can be encouraged by ensuring that consumers pay prices that reflect the full cost to society of generating electricity, including the cost of environmental damage. One efficient means of achieving full-cost pricing is to create regional emissions trading programs that cover all relevant generation sources (as EPA and the states are attempting to do in a number of locations). Emissions trading programs represent a market-oriented mechanism for rewarding utilities that invest in cleaner technology. These programs can be complemented with information campaigns and state conservation subsidies that are targeted, for example, to lower-income households that are less likely to make energy-efficient purchases. They can also be complemented by continued support for research on renewable energy technologies (a program targeted for severe cuts in the Republican budget proposals).

Policy issues. At the Federal level, the most immediate issue is the fate of the 1978 Public Utilities Regulatory Policies Act (PURPA). The original objectives of this Act were to guarantee more open access to the utility grid system and to promote the development of environmentally friendly alternative energy sources (such as waste heat industrial cogenerators and plants operated with renewable resources like solar energy and municipal waste). The Act attempts to accomplish these objectives by requiring utilities to purchase the electrical output of certain "qualifying facilities" (mainly cogenerators and renewables users) at a certain price known in the trade as "full avoided cost" (roughly speaking, a price that reflects both the capital and operating costs the utility would have to pay in order to produce the electricity itself from a new plant).

Critics of PURPA argue that under the new competitive regime, access will not be a problem, and full-cost pricing and technology R&D represent more cost-effective mechanisms for encouraging the development and adoption of environmentally friendly approaches to electricity generation than does PURPA. However, many supporters of PURPA, while acknowledging problems of implementation that have caused economic distortions, argue that the basic requirements set out by the Act should be retained until restructuring of the industry is more advanced, environmental concerns have been addressed, and support for renewable energy technologies has been assured.

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BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Orange County Returns to the Well, but Finds It Half-Empty. For the first time since declaring bankruptcy last December, Orange County returned to the bond market. The sale of "recovery bonds" raised $279 million, which will be used to repay the school districts and municipalities that had invested in Orange County's infamous investment pool. The county attempted to reassure investors who were still nervous about its finances by purchasing insurance on all principal and interest payments. With the insurance, the bonds received a AAA rating, leading observers to predict that Orange County would have to pay an interest-rate premium of only about 10 basis points over the yield on comparably rated bonds issued by other counties. But in the event, the market priced the bonds at a premium of 15 to 25 basis points. Even with the higher yield, many large investors refused to bite, and Orange County fell $16 million short of its reported original sales target of $295 million.

Privatization Sputters in Slovakia—or Does It? Slovakia's government has thrown investors for a loop with its eleventh-hour cancellation of a mass privatization plan. Until just recently, Slovakia was scheduled to privatize companies with a combined value of more than $1 billion later this summer through a mass auction. But Prime Minister Meciar cancelled plans to distribute share-purchase coupons to 3.5 million Slovak citizens, raising doubts that the auction will take place at all. Does this change spell trouble for Slovakia's transition to a market economy? Not necessarily. Some observers see these developments in a benign light, and point out that Meciar has previously declared a preference for achieving privatization through sales to small groups of investors (such as a firm's managers or workers) rather than through mass auctions. Moreover, drawing on the experiences of other Central European countries, these analysts argue that direct privatization may result in a more decisive change of ownership and corporate control than mass privatization. But even these optimists await further evidence that the government will follow through with its preferred form of privatization.

The Corporate 109 Line Up to Meet the G-7. In keeping with its commitment to fiscal austerity, Canadian Prime Minister Jean Chretien's government found some creative ways to defray the costs of hosting the Halifax summit. Taking a cue from the Olympics, the government persuaded corporate sponsors to chip in $4 million—or about 20 percent of the total cost of hosting the summit. In return for payments of up to $360,000, sponsors were allowed to display their corporate logos at the summit. Among the 109 firms that took advantage of this opportunity were Air Canada, General Motors of Canada, Moosehead Breweries, and Northern Telecom. One other penny-pinching measure: Rather than buy a new conference table, the government borrowed the table used at last year's Naples summit.

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RELEASES LAST WEEK

Consumer Price Index

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

Retail Sales

Advance estimates show that retail sales rose 0.2 percent in May following a 0.3 percent decrease in April. Excluding sales in the automotive group, retail sales rose 0.1 percent.

Productivity

Nonfarm business productivity increased 2.7 percent at an annual rate in the first quarter. Manufacturing productivity increased 3.4 percent.

Industrial Production and Capacity Utilization

The Federal Reserve's index of industrial production fell 0.2 percent in May. Capacity utilization fell 0.5 percentage point to 83.7 percent.

MAJOR RELEASES THIS WEEK

Housing Starts (Tuesday)
U.S. International Trade in Goods and Services (Wednesday)
Advance Durable Orders (Friday)

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U.S. ECONOMIC STATISTICS

	1970–1993	1994	1994:3	1994:4	1995:1
Percent growth (annual rate)					
Real GDP	2.5	4.1	4.0	5.1	2.7
GDP deflator	5.5	2.3	1.9	1.3	2.2
Productivity					
Nonfarm business	1.2	**1.8**	**2.7**	**4.3**	**2.7**
Manufacturing (1978-93)	**2.0**	**4.2**	**3.4**	**3.7**	**3.4**
Real compensation per hour	0.6	**0.6**	**–0.8**	**1.5**	**1.2**
Shares of Real GDP (percent)					
Business fixed investment	11.0	12.6	12.7	13.0	13.6
Residential investment	4.7	4.3	4.3	4.3	4.2
Exports	8.0	12.3	12.4	12.8	12.8
Imports	9.2	14.4	14.6	14.8	15.0
Shares of Nominal GDP (percent)					
Personal saving	4.9	3.0	3.0	3.4	3.8
Federal surplus	–2.8	–2.4	–2.3	–2.3	–2.2
			March 1995	**April 1995**	**May 1995**
Unemployment Rate	6.7*	6.1*	5.5	5.8	5.7

*Figures beginning 1994 are not comparable with earlier data.

	1970–1993	1994	March 1995	April 1995	May 1995
Payroll employment (thousands)					
increase per month			179	–7	–101
increase since Jan. 1993					6717
Inflation (percent per period)					
CPI	5.8	2.7	0.2	0.4	0.3
PPI-Finished goods	5.0	1.7	0.0	0.5	0.0

New or revised data in **boldface**.

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FINANCIAL STATISTICS

	1993	1994	April 1995	May 1995	June 15, 1995
Dow-Jones Industrial Average	3522	3794	4231	4392	4496
Interest Rates					
3-month T-bill	3.00	4.25	5.65	5.67	5.48
10-year T-bond	5.87	7.09	7.06	6.63	6.18
Mortgage rate, 30-year fixed	7.33	8.36	8.32	7.91	7.55
Prime rate	6.00	7.15	9.00	9.00	9.00

INTERNATIONAL STATISTICS

Exchange Rates	**Current level June 15, 1995**	**Percent Change from**	
		Week ago	**Year ago**
Deutschemark-Dollar	1.411	0.2	−13.7
Yen-Dollar	84.70	0.1	−17.4
Multilateral (Mar. 1973=100)	82.58	0.3	−10.2

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	4.0 (Q1)	5.7 (May)	3.2 (May)
Canada	4.2 (Q1)	9.4 (Apr)	2.4 (Apr)
Japan	0.9 (Q4)	3.0 (Mar)	−0.4 (Mar)
France	3.6 (Q1)	12.1 (Mar)	1.6 (Apr)
Germany	3.3 (Q4)	6.4 (Mar)	2.2 (Apr)
Italy	2.7 (Q4)	12.2 (Jan)	5.0 (Mar)
United Kingdom	3.7 (Q1)	8.6 (Apr)	3.4 (Apr)