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THE PRESIDENT HAS SEEN

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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

October 4, 1996

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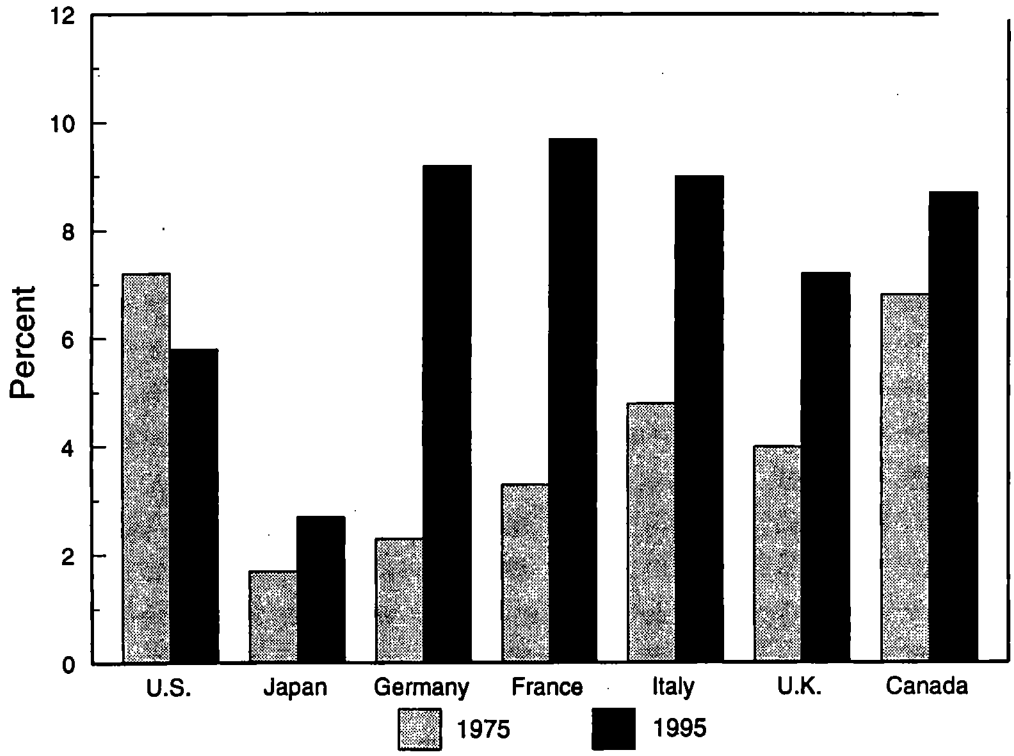
CHART OF THE WEEK

OECD Estimates of the NAIRU for G-7 Countries



According to OECD estimates, the non-accelerating inflation rate of unemployment (NAIRU), sometimes called the "natural" rate of unemployment, is lower today in the United States than it was in 1975. In all other G-7 countries (and many other OECD countries), the NAIRU has risen sharply, often to a higher rate than in the United States. (The OECD estimate for the current U.S. NAIRU is higher than some other estimates.)

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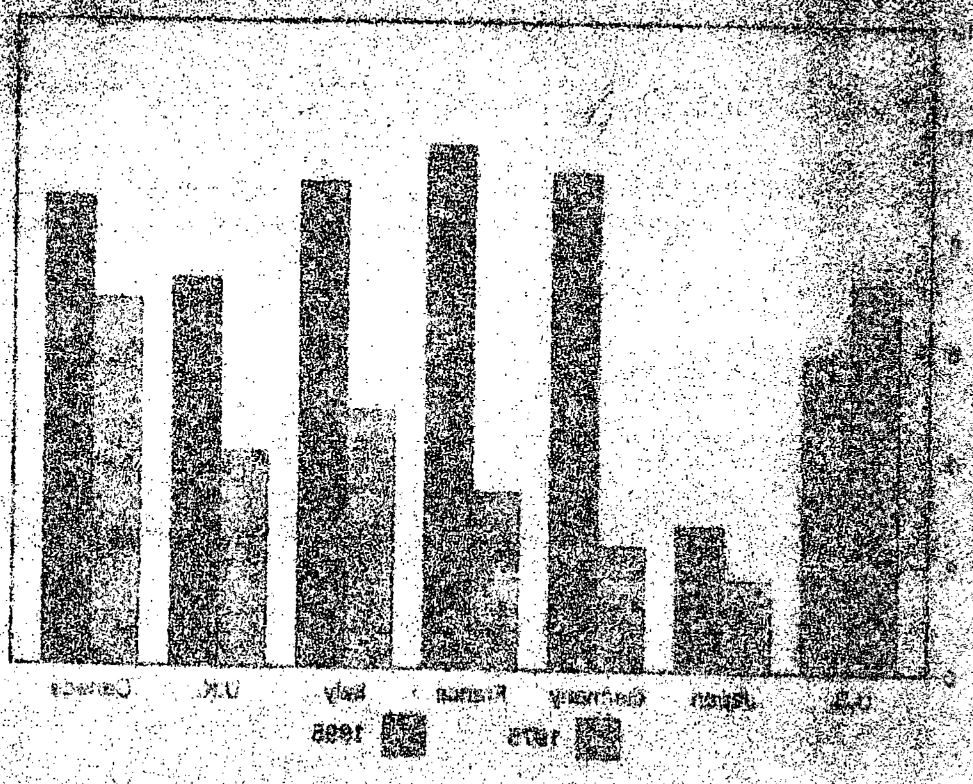

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CONTENTS

THE WALL STREET JOURNAL

CURRENT DEVELOPMENT

Measures for International Development and Stability Emerge from World Bank and IMF Annual Meetings

The World Bank and International Monetary Fund annual meetings have concluded with important progress on at least three issues.

Debt relief. The Bank and the Fund have committed to a program of debt relief for low-income countries with substantial debt overhang. Twenty countries, including 16 in Africa, have already been identified as having debt burdens considered "possibly stressed" or "unsustainable." A trust fund will be set up, to which the Bank has already committed $500 million. Proposals to finance part of the IMF's contribution through gold sales have been shelved for now.

A new fund for financial crises. A new emergency funding source, the New Arrangements to Borrow (NAB), will be able to provide additional funds for international financial emergencies like the Mexican peso crisis. Through the NAB, the funds already available through the General Agreements to Borrow (established in 1962) would be roughly doubled, to $50 billion. When finalized, the NAB will, for the first time, bring some newly prosperous Asian countries in to share some responsibility for managing the global system.

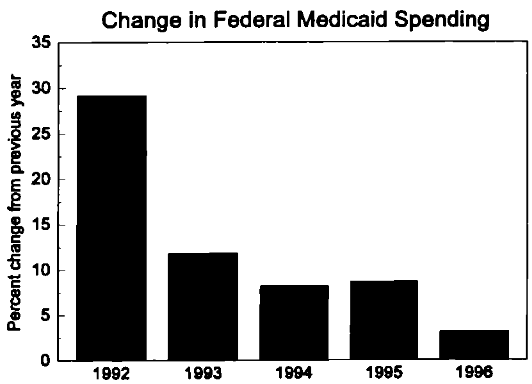
Transparency and surveillance. Efforts to enhance transparency and surveillance of member economies also moved forward. A data dissemination initiative works to reduce the likelihood that Mexico-type crises will occur by improving the quality and timeliness of economic data released by countries with access to international capital markets. (At the time of the peso crisis, many investors complained that some key indicators, particularly reserve levels, had been suppressed for several months by the Mexican authorities.) Thirty-four countries are currently covered. The IMF also launched a public access Internet bulletin board with information on the data practices of subscribing countries.

CURRENT DEVELOPMENT

Growth in Medicaid Costs Slows Dramatically

Although growth in Medicaid expenditures has been slowing in recent years (see chart), the 3 percent growth now estimated for FY 1996 is below previous Congressional Budget Office and Office of Management and Budget projections. Information on growth in expenditures per beneficiary, which is more useful for some purposes, is not yet available. But that too may have slowed considerably last year. Three factors may be important for explaining the slowdown.

Managed care. Increasing use of managed care may have reduced the growth in Medicaid costs per beneficiary. The fraction of beneficiaries covered by managed care arrangements increased from 12 percent of recipients in 1993 to 28 percent in 1995. This effect may be reinforced by a general slowdown in the growth of medical costs in managed care programs. For instance, costs in HMOs rose by 31 percent between 1989 and 1991 but by just 6 percent between 1992 and 1994.



Economic Growth. Strong income growth and a falling unemployment rate act to reduce the number of Medicaid recipients. For example, one important group eligible for Medicaid is AFDC recipients. Families receiving AFDC fell from 5.0 million in September 1994 to 4.7 million in September 1995 and then to 4.4 million in June 1996. Many families leaving AFDC lose Medicaid eligibility as well.

State policy changes. States may have budgeted less for Medicaid in response to Congressional proposals to change Medicaid into a block grant program (which would have placed states at risk for all expenditures above the grant amount). The proposal was not enacted. Instead, the Federal Government continued to reimburse a percentage of Medicaid costs (between 50 and 80 percent, depending on per capita incomes in the state). Reductions in state Medicaid budgets translate into reduced Federal matching expenditures. Some states may have also shifted claims payments from FY 1996 to FY 1995 in order to increase the base level of the expected block grant. This would further reduce the measured growth rate of Medicaid spending.

The future? It is too soon to know whether the slowdown in Medicaid spending will continue. The switch to managed care, for example, may merely provide a one-time reduction in costs. Also, if unemployment goes up or income growth slows, the number of beneficiaries may increase.

SPECIAL ANALYSIS

Indexed Bonds Should Attract Interest

Beginning in January, the Treasury will issue inflation-indexed bonds with a 10- year maturity. For households, this means a better inflation hedge than previously was available. The introduction of the new bonds has broader budget and monetary policy implications as well.

A better inflation hedge. Historically, the returns on most assets held by households have not fully reflected changes in the inflation rate (see Weekly Economic Briefing, May 31, 1996). Homes have been an exception, but real estate investments are not very liquid. Thus, families looking for a flexible and low-cost way to save for long-term expenditures like retirement or a child's education should find inflation-indexed bonds a valuable new option. The availability of indexed Treasury bonds may also allow private firms to develop other desirable financial instruments, such as indexed annuities.

Savings Outcomes after 10 Years under Different Inflation Assumptions (initial investment of $10,000)

	Conventional Bond (Subject to Real Risk)		Indexed Bond (Not Subject to Real Risk)	
If inflation turns out to be 1 percent	Total Savings:	18,771	Total Savings:	14,845
	College Cost:	14,728	College Cost:	14,728
	Net:	**4,043**	**Net:**	**117**
If inflation turns out to be 5 percent	Total Savings:	18,771	Total Savings:	21,891
	College Cost:	21,718	College Cost:	21,718
	Net:	**-2,947**	**Net:**	**173**

Notes: Initial investment of $10,000; real rate of return of 3 percent on indexed bond; nominal rate of 6.5 percent on conventional bond (3 percent expected inflation plus 0.5 percent inflation risk premium); current college cost of $13,333, assumed to grow at the same rate as the CPI; returns are assumed to accumulate tax free.

The box uses a hypothetical example to illustrate the advantage of an indexed bond in reducing the risk of meeting a future expenditure, in this case the cost of a year of college for a child who is currently 8 years old and will be attending college in 10 years. If the cost of a year of college grows at the same rate as the CPI, an indexed bond guarantees there will be enough money to cover that cost, no matter how high the inflation rate is.

Although an indexed bond reduces risk by providing a guaranteed real return, it does not necessarily outperform a conventional bond. If inflation turns out to be lower than had been anticipated when the conventional bond was issued, the holder of the conventional bond will end up with a larger net return than the holder of the indexed bond. If inflation is higher than had been expected, the conventional bondholder ends up with a smaller net return than the indexed bond holder and cannot meet the cost of college with the bond and its accumulated interest.

Implications for the budget and monetary policy. Much of the attention surrounding the introduction of indexed bonds has, correctly, focused on their likely impact on households. But questions have also been raised concerning how the budget and monetary policy would be affected if a large volume of indexed bonds were to be issued.

- Some concern has been expressed that indexed bonds would increase the risk to the Treasury of having to meet high interest payments if inflation were high. But indexed bonds carry a known real (inflation-adjusted) interest cost. An increase in inflation would increase nominal interest costs, but it would also increase nominal GDP growth and hence tax revenue. Thus, even though apparent (nominal) risk goes up, true (real) risk goes down.

- Many economists believe the Treasury pays an inflation risk premium of between 0.5 and 1.0 percentage point on nominal bonds. By issuing indexed bonds, the Treasury should, on average, be able to reduce borrowing costs by this amount.

- Some have worried that widespread acceptance of indexed bonds might reduce the incentive to fight inflation because it would reduce political pressure from bondholders anxious for inflation to remain low in order to preserve the real value of their assets. Others have argued that indexed bonds would increase the incentive to fight inflation because it would no longer be possible to inflate away the value of outstanding government debt.

- Regardless of the effect on incentives, the existence of a substantial market for indexed bonds will provide valuable information about real interest rates and investors' expectations of future inflation rates. Currently, this information can only be estimated from nominal interest rates and survey data on expected inflation.

ARTICLE

Inflation: How Low is Low Enough?

Although inflation has remained remarkably tame during the current economic expansion, low inflation is still not the same as zero inflation. This article explores the costs and benefits of trying to achieve price stability rather than just low inflation.

What is price stability? For consumers, price stability is a situation in which the cost of maintaining a given standard of living stays the same from year to year. This does not require that all prices remain the same, only that the adverse consequences of price increases in some areas be offset by the benefits of price decreases or quality improvements in others. Because many experts believe changes in the consumer price index (CPI) overstate true increases in the cost of living, the objective of price stability might be consistent with a measured CPI inflation rate in the range of 0.5 to 2 percent per year.

Benefits of price stability. Economists argue that price stability would eliminate several adverse economic consequences of inflation:

- People have trouble distinguishing relative price changes from general inflation, which reduces the effectiveness of the price system in producing an efficient allocation of resources.
- People undertake costly efforts to avoid holding cash and to delay making payments for as long as possible.
- Taxation of nominal capital gains and interest income may distort saving and investment decisions in an inflationary environment.
- Unanticipated inflation exposes people to unwanted risks. Lenders lose money from higher-than-expected inflation because they are repaid in dollars that are worth less; similarly, borrowers lose from lower-than-expected inflation. Also, the time and effort devoted to reducing this risk are socially wasteful.

How large are these benefits? Some economists have estimated that the benefits of eliminating inflation could be quite large. But reasons exist for thinking that the benefits of zero inflation may be relatively modest and might even be mitigated by other costs.

- Although the argument for price stability implies that the elimination of inefficiencies associated with inflation should raise growth rates, economic studies almost unanimously find a weak or nonexistent link between economic growth and inflation in low-inflation countries like the United States. (Inflation rates above 20 percent, however, are widely recognized as detrimental to growth).

- Maintaining price stability might have its own costs, including a permanent increase in unemployment and corresponding decrease in the level of GDP. Some evidence exists, for example, that workers are more resistant to nominal wage cuts than they are to an equivalent erosion in their real wage due to inflation. In a moderate inflation environment, firms can adjust to shocks by letting real wages fall without resorting to layoffs. In a zero inflation world, layoffs might be more common.

- Another cost might be that unemployment and output would fluctuate more over the business cycle. Maintaining high employment could get less attention from policymakers concerned with maintaining price stability. And their tools for stabilizing demand might be less effective. For example, reducing real interest rates is an important way of stimulating the economy out of a recession. With zero inflation, nominal interest rates would already be quite low, leaving little room for further reduction (although monetary policy could still have some effect through other channels, including changes in credit availability).

Transition costs and distributional issues. Weighing the permanent benefits and permanent costs of being at zero inflation still leaves out what might be the biggest cost of all: the cost of lowering the inflation rate. On this issue the evidence is strong: deliberately lowering the inflation rate requires inducing a recession. Even if the economy eventually returns to its trend growth path after inflation has been squeezed out, the short-term losses in output could easily be as much as 5 percent of GDP.

Distributional consequences of achieving zero inflation are also significant. The unemployment burdens of a zero inflation policy will fall disproportionately on those who are already economically disadvantaged. The incidence of benefits is less easy to pin down. To the extent that price stability leads to faster productivity growth, benefits are widely dispersed. Otherwise, bondholders are the main beneficiaries. Many of these are wealthy, but many in the middle class have bond holdings in their pension plans. People with large cash holdings (some of whom are engaged in illegal activities) would also benefit from price stability.

Conclusion. Eliminating inflation would provide some economic efficiency benefits. But the size and distribution of those benefits is very uncertain. The costs of achieving and maintaining zero inflation are likely to be substantial and fall on the less well-off.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Health of Elderly and Poor Found to Suffer Under HMOs. Elderly and poor patients treated by HMOs had worse physical health outcomes than those treated by fee-for-service doctors, according to a 4-year study of chronically ill adults in Boston, Chicago and Los Angeles. Over half of HMO patients aged 65 and over reported deteriorating health over the 4-year period, compared to 28 percent of elderly fee-for-service patients. Patients who were neither elderly nor poor, however, had slightly better health outcomes in HMOs than in fee-for-service plans. While elderly patients and poor patients suffered worse health outcomes under HMOs, individuals who were poor and elderly and enrolled in an HMO were more than twice as likely (68 percent) to experience a decline in health than similar fee-for-service patients (27 percent). The study did not determine the reason for the findings, but HMO patients may receive less hospital and specialist care, or they may wait longer for treatment. Since the study focused on three large cities, its conclusions may not necessarily apply to other cities or to rural areas. It is also possible that chronically ill patients who remained in an HMO over the entire study period have different characteristics from patients in fee-for-service plans.

Crucial other variables eg. income health age

Corporate Downsizing May Be Harder on Women. Women often fare worse than their male counterparts do after a corporate downsizing, according to new data from the Department of Labor. Women who were displaced after holding their jobs for at least 3 years are less likely to be re-employed than men. By February 1996, only 76 percent of such women who lost full-time wage and salary jobs in 1993-94 had become re-employed, compared to almost 82 percent of men. And women were more likely to be working only part-time. While nearly 40 percent of workers were re-employed at jobs that paid less than the jobs they lost, the average wage loss for women was slightly higher than the loss for men. Part of the explanation for the disparity may be that women may be less able to relocate to find another job, or that women may be more likely to not seek re-employment after being displaced.

Symphonies Silent This Season. Three symphonies have started the Fall season off on a sour note. In Philadelphia, orchestra musicians have been on strike all season for a 23 percent raise over 3 years. Management is offering 10 percent, which would raise the minimum starting pay to $83,200 in 1999. The Atlanta Symphony went on strike on September 20, after 3 weeks of "play and talk" negotiations. The musicians are seeking 5 percent raises each of the next 3 years and extended pension benefits, while management wants to freeze both salaries and pensions. But the dissonance in the Oregon Symphony has been resolved. After canceling 6 shows during the first strike in its 100-year history, the symphony is making music again under a 4-year contract that ultimately boosts salaries 10 percent. The deal also includes performance-based incentives, so more ticket sales could yield bonuses for the players.

INTERNATIONAL ROUNDUP

Japan's Prime Minister Proposes Leaner Government. Partly in response to criticism that his party is beholden to bureaucrats, Prime Minister Hashimoto (who faces an election this Fall) recently floated a radical plan to reorganize Japan's central government, which would reduce the number of ministries from 22 to 14. The most striking part of the proposal is the elimination of both the Ministry of Finance and the Ministry of International Trade and Industry. MOF's monetary and exchange rate functions would be combined with the activities of the Economic Planning Agency (EPA) to create a new Economics Ministry. MOF's fiscal functions (both budget and taxation) would form a new Treasury Ministry. These reforms would also increase the independence of the Bank of Japan (BOJ), which is currently subject to heavy influence from the MOF. For example, the MOF appoints the executive director of the BOJ, and can dismiss him at any time.

Budget Cuts Lead Canadian Public TV To Drop All U.S. Programming. The Canadian Broadcasting Corporation (CBC), Canada's state-owned radio and television company, recently announced that as part of deep cost-cutting measures, it would accelerate its policy of "Canadianizing" the English language television schedule. Starting this season, prime time English Television will be made up of Canadian material, supplemented with some international shows. By September 1998, the daytime schedule, which includes U.S. soap operas and U.S. situation comedy repeats, will also be fully Canadian. A recent public survey found that 78 percent of Canadian respondents agreed that the CBC should be all Canadian indicates some support for the move. Canadians will not completely lose access to their favorite shows from south of the border, however, because three private networks now operate in Canada.

Russian Government Approves Funds to Repay Consumer Goods Bonds. In the last days of the Soviet Union, the cash-strapped government of the USSR issued some unusual bonds. The so-called "consumer goods bonds", worth nearly $4 billion (roughly 20 trillion rubles), promised future access to a variety of consumer goods that were scarce at the time. The most famous of these is the auto bond, which entitles the bearer to a new Moskvich car from the troubled Moscow automaker AZLK. The Russian government recently re-committed itself to repaying the bonds by earmarking 5.3 trillion rubles of the 1997 budget for this purpose. Apart from this unusual financing technique, Russia has developed a healthy government securities market since introducing short-term Treasury bills in 1993. Currently, the government offers a variety of maturities through short-term T-bills (GKOs) and longer-term Federal Loan Bonds (OFZs). Foreign investors have had expanded access to Russia's government securities market since February this year.

RELEASES THIS WEEK

Employment and Unemployment

****Embargoed until 8:30 a.m., Friday, October 4, 1996****

In September, the unemployment rate was 5.2 percent; it was 5.1 percent in August. Nonfarm payroll employment was about unchanged at 120 million.

Leading Indicators

The composite index of leading indicators increased 0.2 percent in August.

NAPM Report on Business

The Purchasing Managers' Index edged down to 51.7 percent in September from 52.6 percent in August.

MAJOR RELEASES NEXT WEEK

Producer Prices (Friday)
Retail Sales (Friday)

U.S. ECONOMIC STATISTICS

	1970–1993	1995	1995:4	1996:1	1996:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	0.3	2.0	4.7
GDP chain-type price index	5.3	2.5	2.1	2.3	2.2
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	0.3	−1.1	1.8	0.5
Real compensation per hour:					
Using CPI	0.6	1.4	1.6	0.0	-0.1
Using NFB deflator	1.3	2.1	2.8	2.0	1.6
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.2	10.4	10.3
Residential investment	4.5	4.0	4.0	4.1	4.2
Exports	8.2	11.1	11.4	11.3	11.3
Imports	9.2	12.4	12.3	12.5	12.6
Personal saving	5.1	3.4	3.8	3.6	3.2
Federal surplus	−2.7	−2.2	−2.1	−2.1	−1.7

	1970–1993	1995	July 1996	Aug. 1996	Sept. 1996
Unemployment Rate	6.7**	5.6**	5.4	5.1	**5.2**
Payroll employment (thousands)					
increase per month			**235**	**241**	**-40**
increase since Jan. 1993					**10466**
Inflation (percent per period)					
CPI	5.8	2.5	0.3	0.1	N.A.
PPI-Finished goods	5.0	2.3	0.0	0.3	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, October 4, 1996**.

FINANCIAL STATISTICS

	1994	1995	Aug. 1996	Sept. 1996	Oct. 3, 1996
Dow-Jones Industrial Average	3794	4494	5686	5804	5933
Interest Rates					
3-month T-bill	4.25	5.49	5.05	5.09	4.91
10-year T-bond	7.09	6.57	6.64	6.83	6.61
Mortgage rate, 30-year fixed	8.35	7.95	8.00	8.23	8.06
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	**Current level**	**Percent Change from**	
	Oct. 3, 1996	**Week ago**	**Year ago**
Deutschemark-Dollar	1.529	0.4	6.1
Yen-Dollar	111.5	0.9	9.7
Multilateral $ (Mar. 1973=100)	88.09	0.2	3.7

International Comparisons	**Real GDP growth (last 4 quarters)**	**Unemployment rate**	**CPI inflation (last 12 months)**
United States	2.7 (Q2)	**5.2** (Sept)	2.9 (Aug)
Canada	1.2 (Q2)	9.8 (Jul)	1.4 (Aug)
Japan	3.9 (Q2)	3.4 (Jul)	0.2 (Aug)
France	0.4 (Q2)	12.2 (Jun)	1.6 (Aug)
Germany	1.1 (Q2)	7.1 (Jun)	1.4 (Aug)
Italy	1.6 (Q1)	12.5 (Apr)	3.4 (Aug)
United Kingdom	2.2 (Q2)	8.1 (Jul)	2.2 (Aug)

U.S. unemployment data **embargoed until 8:30 a.m., Friday, October 4, 1996.**