

## Prospects for the Economy and Financial Markets and Health Care Reform

Remarks Before  
Toledo Area Health Care Executives  
Toledo, Ohio  
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### **Introduction**

Good afternoon. I am pleased to be here in Toledo with you today. I was last here to talk about the economy one and a half years ago, in May 1994. How many of you were here then? How many remember what I said? Good. Just enough to back up my story without preventing some creative reminiscing on my part.

### **Previous Forecast**

Actually, things worked out well. My forecast was that the expansion would continue indefinitely – that there was no sign of recession on the horizon – but that growth would peak before year end, falling from near 4 percent in 1994 to 2 percent in the first half of 1995. That proved right on the mark, as the temporary stimulus from the extremely low interest rates in 1992-93, which boosted the economy in 1994, inevitably faded. As the economic rebound in the third quarter of this year indicates, the first half slowdown was a benign lull in an ongoing expansion. The economy is not off to the races, but it will continue to grow at a moderate pace at least well into next year. I will come back to that.

A year and a half ago, I also expected the Federal Reserve to continue raising short term interest rates, which they did on the day I was here. I expected only another half point or so beyond that level – to 4-3/4 or 5 percent. Instead, they took short rates all the way up to 6 percent, but I think now they may wish that they listened to me. They cut the rate to 5-3/4 percent in July, and the consensus is for further reductions by early next year. The Treasury note market is so excited about this prospect that the yield on 2-year notes, which is determined in the open market, is below the overnight rate set by the Fed. As I was walking out the door earlier this afternoon for the trip up to Toledo, there was a ferocious rally underway that had pushed the 2-year yield down to 5-1/2 percent – 25 basis points below the overnight rate!

I also said back in the spring of 1994 that, based on this economic and monetary policy outlook, long term rates would peak before year end near the then current level, which was about 7.5 percent, and fall about a half point in 1995. I got the direction right, but I missed on magnitude. The yield on the government's 30-year bond peaked at just over 8 percent in November and today stands at less than 6.3 percent. My forecast was for 7-1/8 percent.

The reason I missed was that I expected inflation to rise from 2-1/4 percent to 4 percent. It increased to 3-1/4 percent by the spring of this year, but then turned south again. The reason is that the Fed was more successful than I expected – entirely successful, as a matter of fact – in containing the inflationary pressures created by its easy money policy in 1992 and 1993. The traditional warning signs of higher inflation had clearly materialized by early 1994. For example, some commodity prices were up more than 50 percent from a year earlier.

But rather than waiting for inflation to rise before acting as it always has in the past, the Federal Reserve tightened its grip in advance. By all appearances, it has pulled off a soft landing, that is, uninterrupted economic growth without a permanent rise in inflation.

I am here today to brag about my old forecast, but also to discuss the current outlook for the economy and financial markets, and touch briefly on the economics of the health care industry.

## **Current Forecast**

My current forecast is depicted in the charts on the first two pages of the handout and in the table on the last page. I have violated the cardinal rule of forecasting, which is that if you give a number, don't give a date and if you give a date, by all means, don't give a number. But I have attempted to compensate by using very small type.

In a nutshell, the outlook is for (1) uninterrupted economic expansion indefinitely, though not forever, (2) continued low inflation, (3) falling short term interest rates, and (4) flat long term rates. In a broader sense, my forecast has been for some time and remains that we have entered a period in which inflation will be much lower than during the 1980s and therefore that interest rates will fluctuate around a lower average.

Why growth indefinitely? The simple reason is that economic expansions do not die of old age, something has to kill them – usually one or more shocks, such as an oil supply disruption or policy errors, in combination with economic imbalances, such as high debt or inventory levels or inflation. The economy can grow indefinitely, because shocks and imbalances that could derail the expansion are conspicuously absent. The rise in interest rates last year was more than enough to offset the very low rates of 1993, but not so large as to preempt growth. And the economy appears to have weathered the 1990 and 1993 tax rate increases.

Likewise, the economic fundamentals are as sound as in decades. Debt levels are rising, but reflect confidence in the future and are still relatively low. In addition, the abrupt inventory correction that contributed to the slowdown earlier this year was a minor adjustment that will prolong the expansion by preventing the accumulation of a larger and truly threatening inventory overhang.

Finally, inflation is so low that economists are arguing over whether there is any, rather than what to do about it. The rate of increase in the consumer price level has been 3 percent or less in each of the last four years. It was 2.5 percent during the year ending in September, and this may overstate actual inflation by a full percentage point. 1995 will be the fifth year in a row of sub-3 percent inflation, and the prospects are good for a sixth straight year in 1996.

Low inflation is a key to achieving the best possible rate of economic growth.

- People incur costs to protect against inflation, and inflation interacts with the tax code to transfer resources away from the private sector.
- Inflation obscures critical information about supply and demand that is transmitted by fluctuations in individual prices.
- And inflation can lead to recession by inducing the Federal Reserve to tighten monetary conditions; the Fed is implicated in this way in just about every post-war downturn.

The absence of an inflation problem raises the economy's potential and reduces the risk of recession. (For those of you interested in further information on this subject, the handout contains a scintillating newspaper column on this topic.)

None of this is to say, however, that the economy will grow forever. It won't. Something will cause a recession at some point. That something has not yet occurred and is not on the radar screen, and the economy is not especially vulnerable right now. The stock market keeps hitting new highs, which is a good leading economic indicator. Stock prices have declined significantly in mid-expansion before, but no recession has begun without a large stock decline. By this logic, a stock market decline is a necessary (though not sufficient) indicator of recession, which is notably missing right now.

Corporate profits are also at an all-time high and investment is surging. Purchases of equipment in the third quarter were 16 percent higher than a year ago, 36 percent higher than two years ago, and 71 percent higher than four years ago. Strong investment is a response to the sound economic fundamentals and is laying the foundation for solid growth in the future.

The consumer sector is also in reasonably good shape, albeit the big burst of activity is behind us for this cycle and some cracks are beginning to show. Total employment is at its highest-ever level and the unemployment rate is as low as it gets. Consumer confidence is back to its pre-recession level. Auto and home sales and housing construction have fully recovered from the 1990-91 recession to sustainable rates, but there is little prospect of further significant gains. The chart on page 2 shows auto sales at around 15 million units next year and housing starts of close to 1.4 million units.

The level of activity is quite high throughout the economy, but the rate of improvement has slowed. Month-to-month gains in employment have been about 100 thousand during the last six months, versus almost 300 thousand last year. The ratio of installment debt to income has surpassed the record level reached just prior to the last recession. Debt service payments relative to income, which are a better measure of the debt burden, have turned up yet remain below the last peak. A corresponding development is the rise in consumer loan delinquency in each of the last three quarters. Though still not widespread, the trend toward slower payment indicates some deterioration in consumer finances.

The Toledo economy has done quite well in this environment. This year will be the fourth straight year of stronger employment growth in Toledo than in the nation and the third year in a row of a lower unemployment rate than at the national level. The Toledo economy is finally starting to benefit from the many advantages of the region:

- the large pool of skilled labor,
- the vast transportation network,
- relatively low production costs, and
- proximity to much of the nation's manufacturing base.

Again, the major gains are behind us for this expansion, but the Toledo economy, like the national economy, can continue to perform well indefinitely . . .

. . . but not forever. What could upset the apple cart? I could be wrong about monetary policy. The Fed could be slower to adjust than I expect or policy could be tighter than it appears. Monetarist economists are making noises about recession next year, based on the large, abrupt slowdown in narrow measures of the money supply.

Fiscal policy might also be more restrictive than it appears. The budget deficit is still \$165 billion, which is supposedly stimulative. But the primary budget deficit (the deficit, excluding interest payments), which is what influences aggregate demand, is actually in surplus, just as it has been prior to most recent recessions.

There are risks abroad, as well. Political and economic uncertainties in both Japan and Mexico are potential sources of trouble for the U.S. economy. The Japanese economy is flirting with a "liquidity trap" in which the outlook is so dim that no level of interest rates can spark a revival. The crisis in Mexico may also be far from over. The banking system is on uncertain ground and the unprecedented \$50 billion bailout package has not clearly arrested the crisis. The size of the package is itself a concern. The international community pledged \$1.2 billion in 1982 and \$3.5 billion in 1988. It appears that the lesson Mexican officials and foreign investors learned from past mistakes is that irresponsible behavior has limited negative consequences – the U.S. and international agencies will come to the rescue. The Mexican government did make an early payment on its U.S. loan a few weeks ago, but the money was borrowed from Europe. The crisis in Mexico is not over yet.

Another threat is oil. Peace talks are moving forward and the region has been relatively quiet, but turmoil is never far below the surface. Saddam Hussein is still in power and rival factions remain at odds. Oil shocks played a role in each of the last three recessionary periods – the mid-1970s, early 1980s, and early 1990s – and renewed hostilities would sour the economic outlook.

A positive risk to the forecast is the potential for far-reaching tax reform in 1997. Integrating the corporate and personal tax systems, broadening the base, and lowering marginal rates would remove many of the costly distortions created by the current tax code and substantially raise the potential growth rate of the economy. In the meantime, capital gains tax reform is a good bet to pass this year. It could give the economy a boost by reducing the multiple-taxation of corporate income and unlocking vast resources trapped by the tax code in under-performing investments.

The economic outlook, then, can be characterized as smooth sailing for the foreseeable future, with turbulence waiting for us out there somewhere.

## **Health Care**

Now what about health care? I admit that I do not know if I am preaching to the choir or if I have jumped into the lion's den. Either way, the principles of economics shed some important light on developments in the health care industry that may be helpful as reinforcement or as constructive criticism.

The changes now taking place in health care are the inescapable result of the set of laws, regulations, and institutions established over decades that have separated payment from treatment. In 1990, 95 percent of hospital charges were paid by someone other than the person receiving treatment. More than 80 percent of physician charges were paid by third parties. Ultimately, most patients bear close to the full cost of treatment, but not in a way that affects the decision to acquire a medical good or service. In fact, the incentives are just the opposite: to consume as many medical goods and services as possible.

As a result, demand is not sensitive to the inflated prices that are caused in large part by artificially strong demand and the only effective check on the demand for medical goods and

services is the budget constraint – of individuals, companies, and the country. A driving force behind changes taking place in the health care industry is that demand has finally brushed up against these budget constraints, requiring change.

Reforms can go one of two ways: non-price rationing in some managed care framework or the relinking of payment and treatment by allowing the price system to allocate medical goods and services. One principle of the market-based approach is that there is no fundamental difference between medical goods and services and non-medical goods and services that precludes the price system from working just as effectively in health care as in other sectors. Another principle is that the most efficient way to help those who cannot help themselves is to give them money or vouchers.

Two prerequisites for a market-based health care system are (1) a functioning insurance system and (2) acceptance of different levels of medical care for different people. In its current form, health insurance is more pre-payment with pre-tax dollars for an unspecified quantity of medical goods and services than it is insurance. In fact, the focus on payment processing (in addition to mandated coverage) has crowded out insurance, making it impossible to purchase affordable, portable, non-cancelable, high-deductible protection against unmanageable medical loss. For the price system to work, individuals need real insurance for their health like they have for their cars and homes.

Secondly, we must accept that, just as everyone cannot drive a new Lexus, not everyone can receive the best medical treatment. That sounds harsh, but it is the current reality, and ignoring it only impedes necessary reforms. A market-based system does not mean not caring for people who cannot care for themselves. Whether our society wishes or is obligated to support its less fortunate members, but that support has a limit. A market-based system should include provisions for a certain minimum level of medical care for everyone, through some combination of cash payments, vouchers, and/or high-deductible insurance.

What can be done? On the demand side, broadening the tax base to include total worker compensation would remove the incentive to purchase first-dollar coverage with pre-tax income – the inefficient system we have now with the perverse incentives that boost demand and inflate prices. Medical Savings Accounts are a partial fix that offers a major step in the right direction. Supply side reforms include liability reform and changes in mandated coverage.

As leaders in the health care industry, you will be more successful by embracing market-based reforms than by seeking legal and regulatory protection. The changes taking place in health care today are not unlike those underway for some time in the financial services industry. Bankers once thought that laws and regulations could protect them from competition among themselves and from outside the industry. We learned, I think just in time, that protection from the marketplace is like a jetty built to protect a beach, it ultimately worsens the deterioration. The surf is up. It is time to catch a wave or be left behind.

## **Conclusion**

In closing, we are often reminded how much of our income "goes for health care." It is important to note that income is the mirror image of output. The exact same portion of our national output "comes from health care." How the ongoing adjustments take shape means as much for the economy as it does for the health care industry.

Finally, John Kenneth Galbraith, the Nobel Prize winning economist, once said that there are two classes of forecasters: those who don't know and those who don't know they don't know. I want to assure you that I consider myself a first-class forecaster in this respect. I will look forward to seeing you again next year and reviewing developments in the economy and financial markets.