

Competition, the Economy, and Health Care

Remarks Before
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I would like to share some thoughts with you on why the economy is in such good shape, where we are headed, and what is at stake in the health care industry. My main point is that today's prosperity reflects the emergence about twenty years ago of competitive forces that have become quite significant. As a consequence, the economy and financial markets will continue to perform well as long as this new competitive continues. By "New Era," I do not mean to suggest that the world is operating differently or that the game has changed. The game is the same, and so are the rules. But competition has us playing mainly on the offensive end of the field.

Competition is the Key

First, the economy is in the best shape ever. The unemployment rate is about as low as it gets in peacetime. Incomes are growing steadily. Consumer attitudes are as positive as they have been in thirty years. Corporate profits have doubled in just the last five years and balance sheets of big companies are very strong. Inflation dipped to its lowest pace in a decade this year -- about 2 percent. Interest rates are near long-time lows, and -- despite the recent excitement -- stock prices have been surging. Economic activity is well balanced, with no obvious signs of trouble.

I view this good fortune as sustainable, because it is largely homemade -- the result of five factors that, over the last twenty years or so, have forged the new competitive era: (1) deregulation, (2) globalization, (3) innovation, (4) disinflation, and (5) good luck.

Deregulation dates back to trucking and airlines in the 1970s and includes energy, financial services, and more recently, telecommunications. The electric power generating industry is up next. Deregulation has been beneficial by removing legal or regulatory barriers to competition among firms within the targeted industries and also between those firms and firms from other industries. The result is greater efficiency that translates into better quality goods and services for consumers, stronger corporate balance sheets, and some of the healthiest and most vibrant industries in the world.

Globalization has occurred through technological innovation, and trade-opening agreements. Also important, have been the extended period of peace, which created an environment conducive to free enterprise, and the collapse of Communism, which brought hundreds of millions of people several steps closer to the market. Technology has made it possible to operate far-flung multi-national operations that draw on the comparative advantages of the different regions of the world. The North American Free Trade Agreement and the latest General Agreement on Tariffs and Trade have lowered costs and trade barriers. This process of globalization has added an international dimension to the new competitive era.

The most obvious form of innovation, the third factor, is the technological progress I just mentioned. The widespread adoption of computer-based just-in-time inventory control, for example, saves companies billions each year in overhead costs, reduces their exposure to shifts in demand, and appears to have reduced swings in overall economic activity. Fax machines and, now, the World Wide Web feed competition by quickly and inexpensively disseminating information about products, services, and prices.

The fourth trend is disinflation, or the downward trend inflation, that broke the inflation psychology of the late 1970s and early 1980s. Back then, consumers tried to buy ahead of the next price increase, thereby perpetuating the inflation spiral. Businesses accepted cost increases and were less vigilant about mistakes and missed opportunities, because they could be passed on in the form of higher prices to customers – all to the detriment of efficiency and economic growth.

Since then, the mentality has reversed. Consumers sniff at 30 percent off sales, waiting for the 50 percent markdown or heading to the outlet mall or to discount stores. Because people are no longer willing to pay higher prices without receiving greater value, businesses are forced to deliver quality to maintain market share and wring efficiencies out of operations to sustain profits. As businesses compete for workers, capital, and the best ideas, the fabric of the economy grows stronger.

The last element behind the sound economy is good luck. The economy has adjusted to past bad luck. And we have experienced no new oil embargoes or poisonous economic policies. But we shouldn't attribute our good fortune entirely to chance. Coleman Cox said, "I am a great believer in luck. The harder I work the more of it I seem to have." I think to a significant extent, we have made our own good luck by pursuing economic policies that have fostered competition and made the economy more resilient.

To top it all off, competitive factors feed on each other to make their combined impact greater than the sum of their individual contributions. For example, deregulation feeds disinflation, by forcing companies to hold the line on pricing, which in turn spurs innovation, as businesses strive to maintain profit margins by improving efficiency. Globalization begets more innovation by increasing the number of competitors, which also puts added downward pressure on prices. As long as this virtuous competitive circle remains in motion, we can expect our good fortune to continue, currency devaluations and stock market volatility notwithstanding.

The Forecast

Last year I bragged about the accuracy of my forecast from the year before, and it bit me. It was just a nibble, but it hurt. One year ago, tomorrow, I predicted:

1. The economy would continue growing at 2 percent.
2. Inflation would be 3 percent or less.
3. The Fed would nudge rates down again.
4. Long rates were more likely to go down than up.
5. And this would be a good environment for stocks.

I have to admit, I led you astray on growth. The economy will expand by 3.5 percent this year, not 2 percent. No forecasters saw it coming, but that's no excuse. I also missed on the

Fed. They raised short rates one-quarter point in March instead of reducing them one-half point in the second half, as I predicted. I did revise my forecast about a month ahead of time, though, saying they would raise rates at their March 25 meeting, proving that the secret to successful forecasting is frequent updates.

It gets better from here. I was right on inflation, although it went lower than even I anticipated -- to about 2 percent. And this was a pretty good call. This time last year, there was widespread speculation that rising labor costs would push up inflation this year. Long term rates went up at first, but today are about one-half percentage point lower than one year ago. And, my stock market guess was really good. When many of the experts were saying that a third year of big gains was not likely, our model said to look for a 17 percent rise in the S&P 500 index from fourth quarter to fourth quarter. Even with recent developments, that will still be too low.

That's my confession. Where do we go next year?

1. Growth: The consensus is for a major slowdown, from close to 4 percent this year to closer to 2 percent next year. The inventory cycle will subtract and the devaluation in Asian currencies will draw a larger share of production out of the U.S. to that region. But labor markets and investment remain strong. I think the economy can do closer to 3 percent, in line with trend of 2.7 percent since spring 1991. At 6-1/2 years, the expansion is the fourth oldest. It will be the third if it lasts to December, second by next December, and the longest in February 2000. To put that into perspective, the expansion is 118 years old in human terms, based on the average length of post-war expansions and the average life expectancy of humans in 1991, when the expansion started. It has to make it to 162 years old to be the oldest. Fortunately, expansions don't die of old age, and this is a pretty spry 118 year old, showing no signs of infirmity.

2. Inflation: Strong growth will keep pressure on labor costs, but won't force up inflation, because most businesses can't raise prices. The result will be a narrowing of profit margins.

3. Fed: Regarding monetary policy, it is possible that the Fed will raise rates again -- although that is looking increasingly unlikely for this year. But whatever they do, I think the next big move -- more than a half point -- will be down. And the reason is that the Fed appears to be holding short rates on the high side right now. After adjusting for inflation, short-term interest rates are half-again their long-term average. Short-term credit growth has decelerated quite a bit in the past two years. The dollar has been strengthening. Commodity prices remain in a downtrend -- especially gold. [See chart on third page.] In the meantime, though, policy makers are in the grip of "Fed-lock." Concern about the potential inflationary implications of low unemployment are balanced by exceptional performance on inflation. They won't raise rates while inflation is low and falling and in the midst of international financial market turmoil. And they won't lower rates while unemployment is so low. So we are stuck here for now.

4. Long Rates: Stay in 6-7 percent range, with slight downward trend. Breach low end when talk of recession. Breach high end when fear of inflation. Yields are headed 100 basis points lower, as inflation expectations catch up to low inflation, but that takes time.

5. Stock Market: I look for low double-digit percentage gains in 1998 and 1999, but barely. That's based on stable-to-falling long term rates and profit growth of 10 percent. No one really knows which way stock prices will zig or zag next. But history tells us that the single greatest threat to the stock market over a long period is inflation. During the 86 years since 1870, when inflation was 3 percent or less, the total return to large-cap stocks averaged 13.0 percent. During the other 40 years, when inflation was above 3 percent, the average return was 6.4

percent. So I think we can say with some confidence that as long as inflation stays down, bull markets will last longer and be larger than the inevitable bear markets, whenever they occur.

But remember, as Mark Twain wrote: "October. This is one of the peculiarly dangerous months to speculate in stocks in. The others are July, January, September, April, November, May, March, June, December, August, and February."

Health Care Can't Hide from the Market

The changes made to Medicare last summer were aimed at temporarily improving the cashflow of the federal program. They amount mainly to more price controls and accounting changes that will only make the situation worse over time, because they do not address the fundamental flaw of the system. That is the separation of payment for medical goods and services from the procurement of those goods and services. A largely overlooked cost of third-party payment is the resulting misallocation of resources that, over time, can become significant enough to impede the economy's ability to grow.

The situation is like a luncheon at which a group of ten people agrees in advance to split the bill evenly. Each person has an incentive to order a more expensive lunch than he personally wants to pay for, because others in the group will bear part of the added cost. When each person is paying his own bill, he will demand more or better food until the marginal dollar ordered is expected to produce one dollar of enjoyment. In contrast, when each person is responsible for one-tenth of the total bill, he will continue to increase his order until the marginal dollar ordered is expected to return only ten cents in extra enjoyment. As a result, the total bill will be larger under an agreement to divide it equally than if each is paying for his own lunch individually.

The same rules apply to the market for health care, because demand is sensitive to price. People want more or better medical care when the price to them is lower. The visible results of splitting the supply and demand decision are rising prices and program budget deficits. Less obvious, but more far-reaching, consequences are overconsumption of medical goods and services and the attendant misallocation of resources.

For Medicare recipients, the only precondition for purchasing medical goods and services is that private benefits exceed private costs. When private costs are reduced below social costs -- as in the luncheon example -- people overconsume. That is, they will demand more to a point at which the value of the goods and services produced is less than the value of the resources used to produce them. This lowers the overall level of economic activity by diverting scarce resources from more highly valued uses. In other words, the resources used to produce the excess medical goods and services could have been used to produce more highly valued non-medical goods and services that are valued more highly. The result is lost economic output and a lower overall standard of living than would otherwise prevail.

What to do about it? Well, as Richard Epstein points out in his new book on health care, *Mortal Peril*, which I recommend very heavily, it is easier to avoid screwing something up than it is to fix it. Unfortunately, would-be health care reformers do not have that luxury. At least the objective is clear: reconstruct a market for medical goods and services by dismantling government programs, laws, and regulations that prevent the price system from efficiently allocating scarce resources between the medical and non-medical sectors and within the medical sector.

But this prescription is not new. The problem is overcoming political obstacles to the necessary changes. As the failure of President Clinton's massive health care plan in 1994 demonstrated, it is difficult to impose sweeping reform. I think the answer is to promote measures that will, over time, restore a competitive market for medical goods and services. No matter how elaborate, schemes to prop up the current system amount to sticking more fingers into a crumbling dike. Beware. Even benign meddling invites more meddling, which might not be benign. And that's how we got here in the first place. The choice is between dwindling control at the hospital, doctor, and patient level, on the one hand, and changes that turn patients into consumers, on the other. Although the new law is a mixed bag on this score, it might turn out to be a small step in the right direction.