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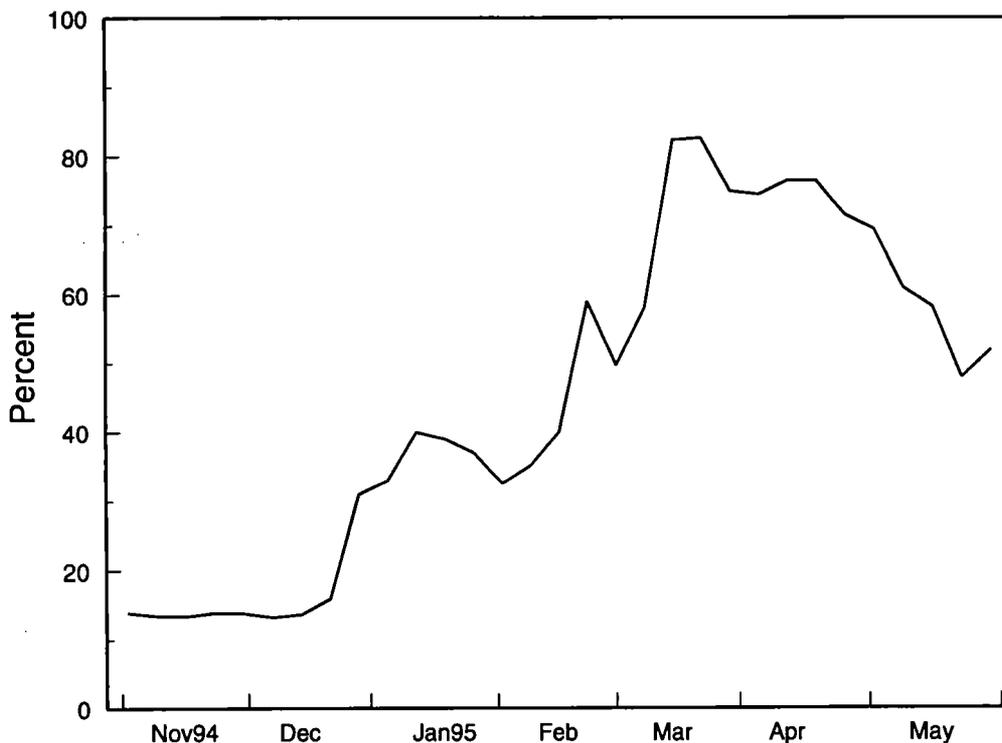
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

June 5, 1995

CHART OF THE WEEK

Interest Rates on 28-Day Mexican Government Securities



During the worst phase of the financial crisis in Mexico, short-term interest rates there climbed to more than 80 percent. More recently, as confidence in the stabilization program has increased, rates have dropped back; by late May, they were about 50 percent. A Current Development in this issue of the Weekly Economic Briefing describes the progress of the stabilization program to date.

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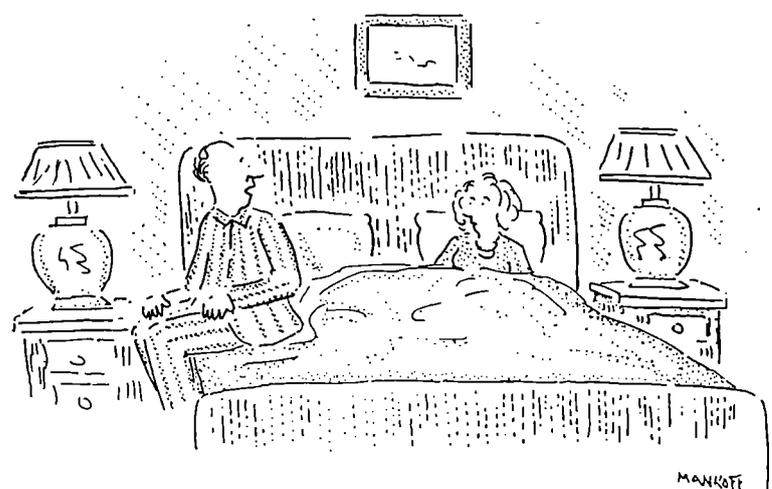
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"I can't sleep. I just got this incredible craving for capital."

CURRENT DEVELOPMENT

Some Pain, Some Gain

The Mexican people are paying a price for the financial crisis that erupted late last year. More than 500,000 people have lost their jobs, and the urban unemployment rate by February had already increased from 3.2 percent to 5.3 percent. Nonetheless, there are some encouraging signs that the adjustment program is taking effect:

- The peso has stabilized at around 6 pesos per dollar, up from a low of about 7-1/2 pesos per dollar in early March.
- Inflation may have peaked. After rising more than 5 percent in the first half of April, consumer prices rose “only” slightly more than 2 percent during the second half (still more than 60 percent at an annual rate).
- Domestic interest rates have fallen from more than 80 percent in March to about 50 percent today (see Chart of the Week).
- More than half of the troublesome dollar-linked short-term government debt due this year has been retired with the help of the financing package from the IMF and the United States. And there appear to be ample resources for dealing with the remaining 40 percent of this debt.
- The fiscal situation has improved dramatically. Excluding interest expense, the federal budget was in surplus to the tune of 7 percent of GDP in the first quarter of this year, up from 3-1/2 percent one year earlier.
- The trade balance has turned around rapidly (see Chart of the Week, Weekly Economic Briefing, May 1, 1995).

Analysis. At this point, the stabilization plan appears to be on track but there remain some risks. In particular, the plan has been tough on the Mexican people, and it remains to be seen whether the program will continue to command their support.

SPECIAL ANALYSIS

Be Prepared

At the summit you will be attending in Halifax later this month, the G-7 countries will agree on recommendations aimed at improving the ability of the International Monetary Fund (IMF) to deal with financial crises of the type that Mexico suffered late last year:

- Enhanced reporting and surveillance. The G-7 will recommend that all IMF members be required to report certain key economic indicators on a more timely basis. The G-7 will also urge the IMF to sharpen its policy advice, especially to countries that appear to be avoiding necessary policy actions. Some observers have speculated that more timely reporting of data might have led to earlier detection of the crisis in Mexico, and provided the basis for stronger warnings from the IMF to Mexico at an earlier stage.
- Beefed-up crisis procedures. The G-7 will recommend that the IMF establish a procedure for providing emergency financing in crisis situations. This procedure could be activated more quickly than existing IMF arrangements, and would be linked to monies to be provided by the G-7 and other countries.

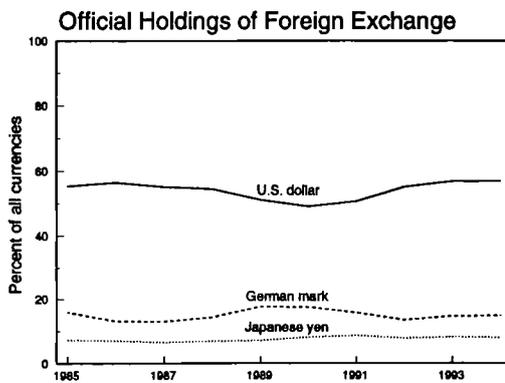
The G-7 may also recommend the study of a more controversial proposal: institutional arrangements permitting a country to suspend payment to creditors temporarily until it can get its fiscal house in order.

Analysis. Some analysts have argued that advance preparations for financial crises may be counter-productive: By reducing the pain associated with financial crises, such actions may also reduce the incentives for countries to avoid those crises. The opposing view—shared by the United States—is that crisis preparation should have little if any adverse impact on incentives because the IMF will have authority not only to disburse aid but also to impose economic reform programs.

TREND

The Role of the Dollar in the International Economy

In the wake of the dollar's recent slide against the Japanese yen and the German mark, some observers have speculated that the U.S. dollar might be in jeopardy of losing its role as the world's principal reserve currency. But the dollar has endured much greater reductions in its value in the past, and yet retained its central role in the international financial system:



Central banks around the world hold the bulk of their foreign-currency reserves in dollar-denominated assets (e.g., U.S. Treasury securities). At the end of 1994, 57 percent (or about \$585 billion) of these holdings were in dollar-denominated assets, compared with only 15 percent for German marks and 8 percent for Japanese yen (see chart). Since at least the mid-1980s, the dollar's share in central bank

portfolios has been broadly stable, despite enormous changes in the exchange value of the dollar.

Many international transactions, both trade-related and purely financial, are executed in terms of dollars. For example, U.S. trade is almost always invoiced in terms of dollars. Worldwide, a good guess is that about half of all international trade in goods and services is invoiced in dollar terms. Furthermore, about 40 percent of the nearly \$1 trillion in foreign exchange transactions conducted daily involve dollars on either the buying or selling side.

Many residents of foreign countries hold dollars as legal tender. Dollars are often used instead of the local currency in high-inflation countries such as Russia. Dollars are also often used to finance illicit activity such as trade in illegal drugs. All holdings of dollars (whether abroad or at home) in effect amount to an interest-free form of financing for the U.S. government. (Both Treasury bonds and dollar bills represent liabilities of the Federal government. But the holder of a Treasury bond receives interest whereas the holder of a dollar bill does not.) This source of financing may be saving the government as much as \$15 billion in debt-servicing charges per year.

Summary. In many respects, the dollar plays a central role in the international economy. History suggests that it will continue to play that role despite the recent decline in the foreign exchange value of the dollar.

ARTICLE

Death and Taxes

If enacted, the tax bill passed by the House earlier this year would ease the terms of the Federal gift and estate tax. Specifically, the bill would increase the lifetime amount of gifts and bequests exempt from tax from \$600,000 to \$750,000 by 1998, and would index it thereafter. Treasury estimates that this change would cut the number of taxable estates by nearly one-half, at a revenue cost of between \$1 billion and \$2 billion per year.

Structure of the tax. The Federal tax code treats gifts and estates on a unified basis (i.e., added together and taxed as a single amount). During an individual's lifetime, he or she may give up to \$10,000 per recipient per year with no tax consequences (married couples are allowed \$20,000). Any excess over \$10,000 per recipient per year is added to a running total, as is any bequest. Taxes must be paid only after the running total exceeds the lifetime exemption amount, currently \$600,000. An important exception is that married individuals are allowed to transfer an unlimited amount to their surviving spouses without incurring any tax. Statutory marginal tax rates for transfers exceeding the lifetime exemption amount vary from 37 percent to 55 percent (applicable to gift-plus-bequest totals of more than \$3 million.)

Who pays the tax? Only 1 percent of adult deaths result in estates subject to taxation. Thus, only the very wealthiest Americans stand to benefit from any relaxation of the estate tax.

How much revenue does the tax raise? Ostensibly, the gift and estate tax raised \$15.2 billion in 1994, about 1 percent of total Federal revenues. However, some analysts believe that this figure overstates the net revenue-producing power of the gift and estate tax, because strategic estate planning has the side-effect of reducing income tax revenues. For example, taxpayers may give assets during their lifetimes to persons in lower tax brackets, or to tax-exempt charities. A cut in estate tax rates might reduce the effort expended in tax avoidance, and so might actually result in an increase in income tax revenues.

Oddly enough, the Federal gift and estate tax provides a substantial amount of revenue to state governments. Currently, the Federal estate tax allows a credit to be taken for estate taxes paid to State governments up to a limit. At this time, all States have enacted estate taxes substantial enough to at least cover or "pick up" the amount of Federal credit. This provision, a form of revenue-sharing between the Federal government and the states, yields the states more than \$3 billion per year.

The "lock-in" effect in the income tax. One provision of the income tax law has profound implications for estate planning. This provision is called the "step-up"

in basis on assets transferred at death; it grants heirs a cost basis on bequeathed assets equal to the fair market value of those assets at time of the donor's death. Effectively, this provision permits any accumulated capital gain on the bequeathed assets to escape income taxation.

The step-up provision will often create a strong incentive for individuals to hold onto their assets until they die. Some analysts believe that this "lock-in" effect distorts economic decisions. For the Federal government, a more pressing concern with the step-up loophole is that it costs the Treasury a great deal of income tax revenue. The Congressional Budget Office estimates that elimination of the step-up in basis might yield as much as \$10 billion per year. As a practical matter, any reform of the step-up in basis would probably have to make some special provisions for small businesses and farms along the lines of those currently contained within the estate tax.

Possible reforms. In the past, piecemeal reform of the step-up in basis has run into Congressional opposition. In principle, it should be possible to craft a tax reform *package* that would close an income tax loophole, modify or eliminate the state tax credit, substantially reduce the number of people subject to the gift and estate tax, reduce marginal rates under the gift and estate tax (thereby reducing the incentive to engage in socially wasteful strategic tax planning), and raise revenue. Alternative approaches to designing such a package are under study within the Administration.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Electric Car Technology Surges Ahead. A four-passenger electric car recently set a new world distance record by going 238 miles in mixed city-highway driving without a recharge. Built by Solectria, a Massachusetts-based company, the Ford Taurus-sized Sunrise is powered by nickel-metal hydride batteries. Although nickel-based auto batteries are not yet in commercial production, a joint venture between the Ovonic Battery Corp. and General Motors plans to begin production soon. In attracting consumers, range matters: Many observers feel that electric vehicles will need to offer a consistent range of 100-200 miles, under more punishing conditions than the Sunrise encountered. Cost will also be a factor, of course. Solectria estimates that if battery prices fall as the firm expects and if it can log 20,000 orders per year, it will be able to market the Sunrise at about \$20,000.

... and So Does Boeing. Even before making its first commercial flight, Boeing's new twin-engine 777 scored a significant victory. The Federal Aviation Administration (FAA) ruled in late May that the plane can immediately begin flying routes that take it up to 3 hours away from the nearest landing strip. In practice, this means that the 777 is cleared right off the bat to fly all major transoceanic routes. In the past, the FAA has required twin-engine jets to stay close to airports during their first 2 years of commercial flights, while they accumulate safety records under actual flying conditions. But Boeing put its new jet through an extensive pre-launch testing program aimed at winning early approval from the FAA. Wall Street reacted well to news of Boeing's success. The firm's stock rose \$1.75 per share, to \$58.25, after the announcement.

Poverty's Toll. In its first annual World Health Report, the World Health Organization identifies "extreme poverty" as the world's most ruthless killer. After adjusting for age and sex, the Report found that an inhabitant of the developing world is nearly twice as likely as his/her developed-world counterpart to die in any given year. (In large part, the difference is due to communicable diseases, which cause half of Third World deaths but are generally prevented or treated in wealthier countries.) Children disproportionately bear the health consequences of poverty. For young children in the developing world, the mortality rate from all causes is 10 times the developed-world rate. Each year, 3 million young children in the Third World die of diarrhoeal diseases, 4 million die for lack of inexpensive antibiotics, and more than 2 million because they have not been immunized against measles, tetanus, and other diseases. In most of these cases, the child's life could have been saved with only a small expenditure on drugs or treatments. And history supports the view that efforts in this area can make a difference. The Report estimates that between 1985 and 1993, the number of children dying from vaccine-preventable deaths fell by 1.3 million (more than one-third).

RELEASES LAST WEEK**Employment and Unemployment******Embargoed until 8:30 a.m., Friday, June 2, 1995****

In May, the unemployment rate declined to 5.7 percent from 5.8 percent in April. Nonfarm payroll employment decreased by 101,000, to 116.2 million.

Leading Indicators****Embargoed until 8:30 a.m., Friday, June 2, 1995****

The index of leading economic indicators fell 0.6 percent in April, following decreases of 0.5 percent in March and 0.3 percent in February.

Personal Income and Expenditures

Personal income increased 0.3 percent in April (monthly rate). Disposable personal income decreased 0.7 percent. Personal consumption expenditures increased 0.3 percent.

Gross Domestic Product

According to revised estimates for the first quarter, real gross domestic product grew at an annual rate of 2.7 percent.

Consumer Confidence

Consumer confidence, as measured by the Conference Board, decreased 3.0 index points in May, to 101.6 (1985=100).

MAJOR RELEASES THIS WEEK**Producer Prices (Friday)**

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	2.0	3.2	4.0	0.7
Manufacturing (1978-93)	2.1	4.7	3.5	3.4	3.6
Real compensation per hour	0.6	0.7	-0.4	1.2	1.0
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.					
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	N.A.
PPI-Finished goods	5.0	1.7	0.0	0.5	N.A.

New or revised data in **boldface**.

Employment and unemployment data **embargoed until 8:30 a.m., Friday, June 2, 1995.**

FINANCIAL STATISTICS

	1993	1994	April 1995	May 1995	June 1, 1995
Dow-Jones Industrial Average	3522	3794	4231	4392	4473
Interest Rates					
3-month T-bill	3.00	4.25	5.65	5.67	5.50
10-year T-bond	5.87	7.09	7.06	6.63	6.20
Mortgage rate, 30-year fixed	7.33	8.36	8.32	7.91	7.71
Prime rate	6.00	7.15	9.00	9.00	9.00

INTERNATIONAL STATISTICS

Exchange Rates	Current level June 1, 1995	Percent Change from	
		Week ago	Year ago
Deutschemark-Dollar	1.414	0.7	-14.0
Yen-Dollar	84.80	-0.2	-18.9
Multilateral (Mar. 1973=100)	82.65	0.1	-10.6

International Comparisons	Real GDP growth (last 4 quarters)	Unemployment rate	CPI inflation (last 12 months)
	United States	4.0 (Q1)	5.7 (May)
Canada	5.6 (Q4)	9.7 (Mar)	2.4 (Apr)
Japan	0.9 (Q4)	3.0 (Feb)	-0.4 (Mar)
France	3.7 (Q4)	12.1 (Feb)	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 (Mar)	3.4 (Apr)