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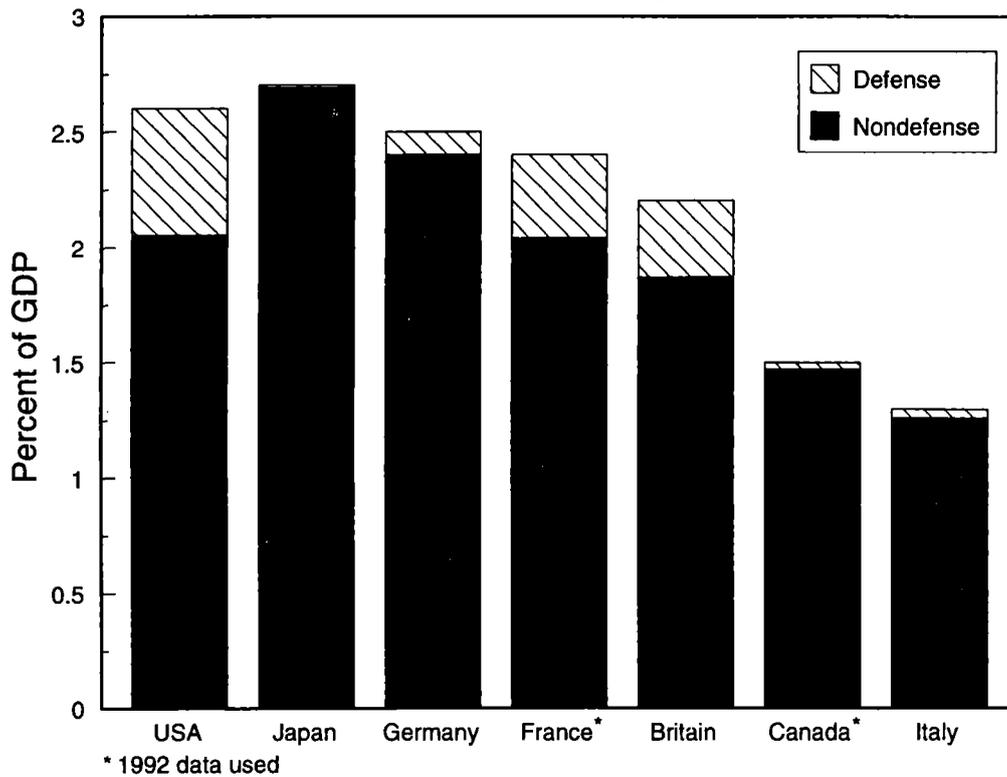
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

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

May 31, 1996

CHART OF THE WEEK

Research and Development Spending as a Share of GDP



Total spending on research and development as a share of GDP was higher in the United States than in all other G-7 countries except Japan in 1993, the latest year for which comparable data are available. The United States lags well behind Japan and Germany, however, when only spending for nondefense purposes is considered. All of the G-7 countries have seen a sharp slowing in the real growth rate of research and development spending in 1990s compared to the 1980s, with real spending falling in Japan, Britain, and Italy, and growing only marginally in the United States and France.

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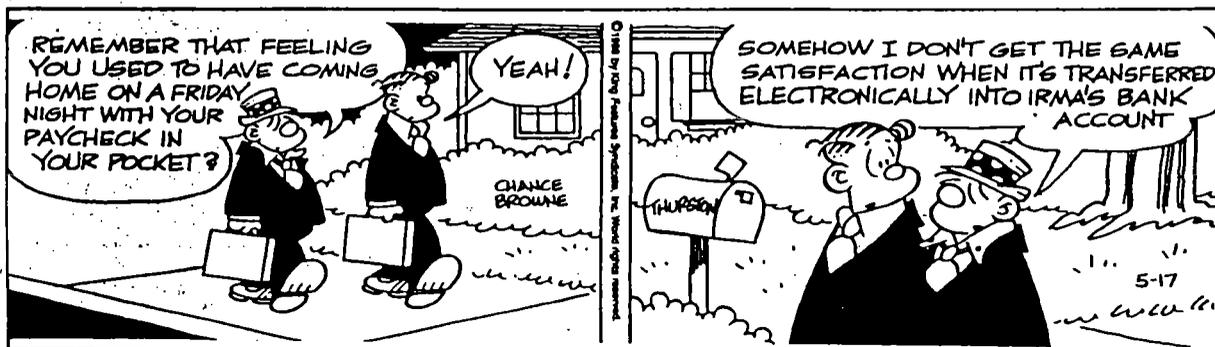
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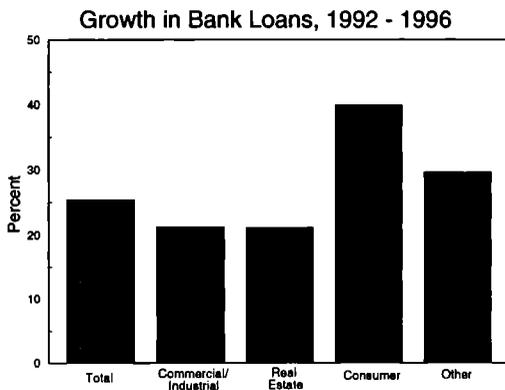
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CURRENT DEVELOPMENT

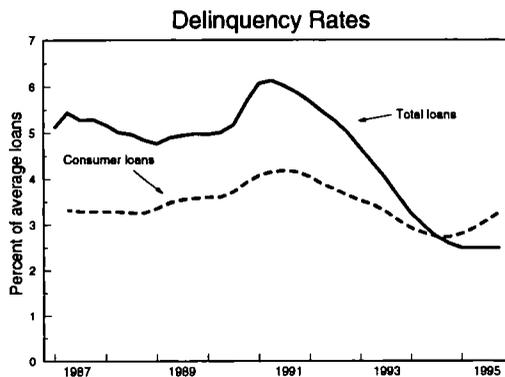
Quality of Bank Loans is High Overall, Despite Rise in Consumer Delinquencies

Banks in recent years have thrived, posting solid loan growth and strong increases in profits. Since 1992, loans outstanding have grown by 25 percent, with gains spread across commercial, consumer, and mortgage lending (see top chart).



Despite the seemingly healthy state of banks, the recent rise in delinquency rates on consumer loans has caused concern that banks may be extending loans to less qualified borrowers. While the quality of consumer loans may well have fallen, delinquency rates on other types of bank loans remain exceptionally low, so that, overall, the quality of bank loans is high.

Analysis. A common measure of loan quality is the delinquency rate—the percent of loans with payments past due 30 days or more, or no longer accruing interest. The delinquency rate for all bank loans fell from mid-1991 through early 1995 before flattening out during the past year (see bottom chart). This rate is now significantly lower than it was during the expansion of the 1980s, prior to its rise in the recession of 1990-91.



Delinquency rates for commercial-industrial loans and real estate loans have declined sharply since the

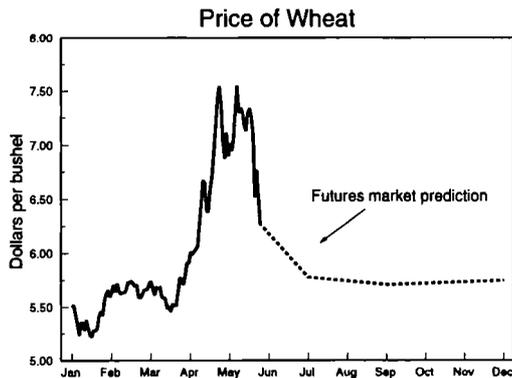
recession, while the delinquency rate for consumer loans fell initially but has ticked up over the past year. This uptick is due mainly to an increase in bad credit-card debts. Because consumer loans represent only about 20 percent of bank loans outstanding, the effect of the recent rise in delinquencies on the overall quality of bank loans has been small. The marked improvement in overall loan quality likely reflects tighter bank lending standards and the strong U.S. economy.

CURRENT DEVELOPMENT

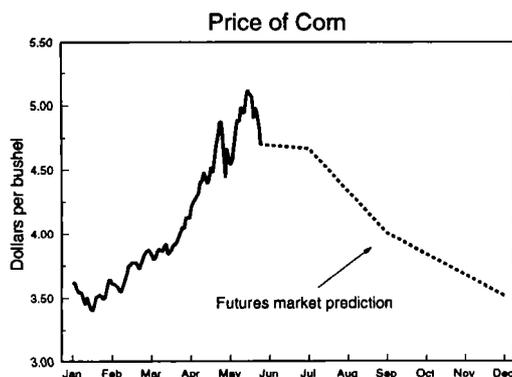
Grain Prices Have Fallen, But Remain Volatile

Prices for wheat and corn have fallen over the past 2 weeks, and futures markets predict additional declines through year-end. Bad weather in the Midwest, poor crops abroad, and strong worldwide demand had combined to push prices up sharply this spring. The price spike now appears to be reversing, as weather conditions look more favorable for this year's crops. Nevertheless, prices likely will remain higher than historical averages, with substantial price swings possible through summer.

Analysis. The price of wheat hit a high of \$7.50 per bushel in late April and has since fallen by more than a dollar (see top chart). The futures price of wheat for December delivery, however, is only a bit below the current price, a sign that the market expects only a modest additional decline later this year.



The price of corn has fallen only slightly from the high of just over \$5 per bushel reached in mid-May (see bottom chart). In contrast to wheat, however, the market for corn futures is anticipating a large price decline later this year. This expected price decline reflects USDA predictions of a large increase in corn acreage, raising the likelihood of a bumper crop.



Although the market currently projects declines in grain prices, several factors could push prices back up, including:

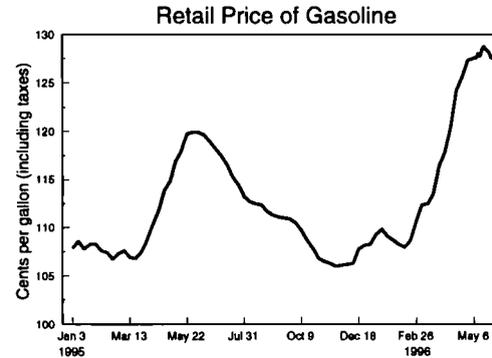
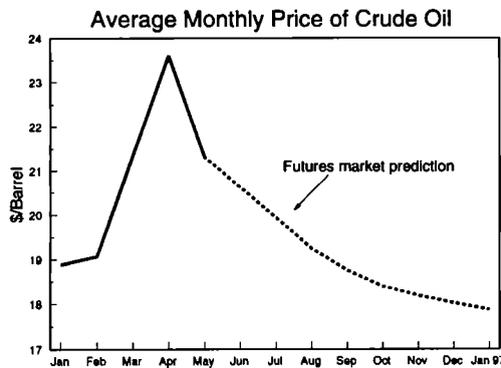
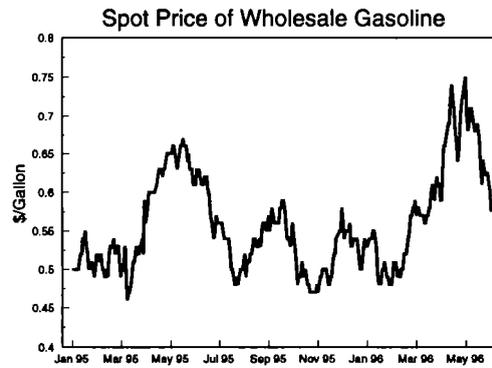
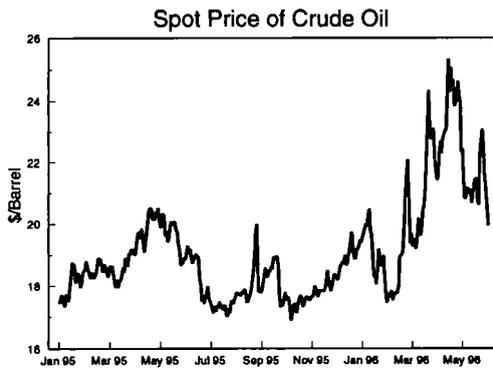
- Adverse weather that lowers expected plantings or yields.
- Announcements of large bulk purchases of U.S. grain by foreign buyers.

Revised USDA estimates of this year's wheat and corn harvests will be released in mid-June.

CURRENT DEVELOPMENT

Oil and Gasoline Prices Heading Back Down

After rising sharply earlier this year, spot prices of crude oil and wholesale gasoline have fallen in recent weeks (see charts). Futures markets currently predict additional declines in these prices throughout the rest of this year. Because the retail price of gasoline typically lags the wholesale price by several weeks, the recent decline in wholesale prices should translate into lower pump prices in the near future. One indication that the retail price of gasoline has peaked is already apparent in California, where prices have dropped nearly 2 cents per gallon over the past couple of weeks.



SPECIAL ANALYSIS

OECD Ministerial Meeting Highlights Trade and Employment Issues

The annual Ministerial meeting of the Organization for Economic Cooperation and Development (OECD), which was held May 21-22 in Paris, focused on growth and employment, strengthening the multilateral system, and the future of the OECD. In the final communique, the United States was able to advance its multilateral trade agenda as well as its approach to employment issues, while fending off attacks on our sanctions on Cuba. The Ministerial marked a change in leadership for the OECD at a time when it is beginning to grapple with a reduced budget, expanding membership, and its own future.

Trade agenda. The timing of this Ministerial gave it an important role in shaping the agenda of the first World Trade Organization (WTO) Ministerial, to be held in Singapore in December. The United States achieved most of what it sought:

- **Bribery and corrupt practices.** The United States received a commitment to criminalize bribery in international transactions, as well as a reaffirmation that members will deny tax deductibility for bribes.
- **Aviation.** Ministers pledged to further liberalize international air transport, over strong resistance from Japan and France.
- **Investment negotiations.** The OECD negotiations to liberalize foreign investment received a boost as well as a deadline to complete negotiations in 1997. The United States also resisted efforts to move the negotiations to the WTO, which would have diluted potential commitments.
- **Trade and labor standards.** Ministers agreed to work for the promotion of core labor standards around the world. Although British opposition prevented a reference to discussion of trade and labor standards at the WTO Ministerial, what was once an isolated U.S. issue is now widely accepted within the OECD.
- **Encryption.** The ministers endorsed continued work on OECD encryption policy guidelines to enhance security and protect intellectual property rights.

Growth and employment. The communique refers to the importance of enhancing employability and lifelong learning, themes stressed by the United States. As the evidence on U.S. job creation has accumulated, Europeans are now far less apt to draw a distinction between the number of jobs and the quality of jobs, as they did a year ago. Much of the discussion centered on the appropriate macroeconomic policies to encourage growth and employment. The United States and others emphasized the dangers posed by the fiscal contraction that is anticipated as the European countries reduce their budget deficits to meet

requirements for European Monetary Union. Concern was expressed that monetary authorities may not take appropriate steps in time to offset the contractionary effects of deficit reduction. A slowdown in Europe would adversely affect U.S. exports.

Cuba sanctions. The United States came under heavy attack for extending sanctions to third-party firms and individuals in what most members viewed as a bilateral dispute. Although the United States prevented an explicit reference in the communique, the issue of U.S. sanctions dominated the early press.

Future of the OECD. The OECD was originally founded to administer Marshall Plan funds for the postwar reconstruction of Europe. It evolved into a statistical agency and think tank for the advanced industrial countries, as well as a forum for discussion and agreement on rules of behavior in areas such as export credit subsidization, development assistance, shipbuilding supports, and capital market liberalization. With the recent accession of Mexico, the Czech Republic, and Hungary, the OECD has also become a certification of advanced country status for those countries willing to accept its disciplines.

A new Secretary General, Donald Johnston of Canada, takes up his post on June 1. He inherits an organization that is in the process of defining a new role for itself. Several additional countries wait to join, and Russia announced at the Ministerial that it would formally apply for membership.

The United States has pressed for a broader, non-European membership for the OECD, a focus on structural adjustment and reform issues that cut across member countries, and preparatory work on future trade issues. As a part of our trade negotiating strategy in cutting-edge areas such as investment rules and corrupt practices, we have used the OECD to reach high-quality agreements among advanced countries, agreements that can be used as a benchmark for further negotiations within the WTO.

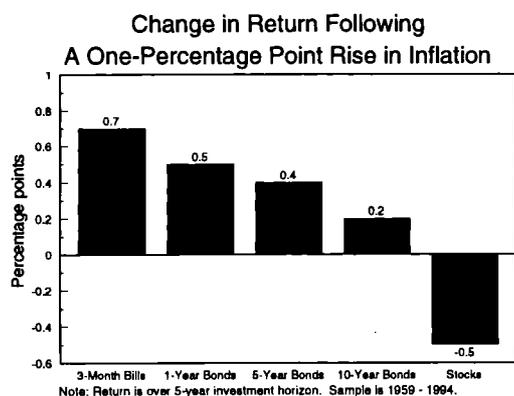
ARTICLE

Can Investors Hedge the Risk of Inflation?

With prices rising less than 3 percent each year since 1992, Americans today are far less concerned about inflation than they were during the 1970s, when prices rose at a double-digit clip for several years. Despite the good performance of inflation and its fading presence as a public concern, inflation remains a threat to investors seeking to maintain the purchasing power of their savings over long periods of time.

With inflation so low, why is it a threat to investors? If inflation were constant and never changed, then returns on investments would be set by the market to adequately compensate investors for the use of their money. In such a world, inflation would not be a threat to investors. When inflation is uncertain, however, the market sets returns on the basis of expected inflation, which can often be different from actual inflation. For example, an investor who purchases a bond paying 6 percent at a time when inflation is expected to remain at 3 percent will lose one-third of the real gain if inflation instead turns out to be 4 percent. Thus, low inflation by itself does not remove the risk that changes in inflation pose for investors. Some investments, however, help dampen this risk by providing returns that adjust with changes in inflation.

How much protection do existing financial investments offer against inflation? Financial investments currently available to investors offer differing degrees of protection against inflation. None, however, offers anything near complete

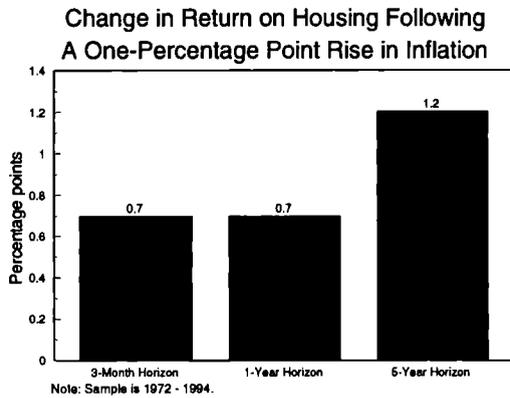


protection, with most offering very little protection. For example, the average nominal return to stocks over a 5-year investment horizon actually declines when inflation rises, while the average return on 10-year Treasury bonds increases only slightly (see chart). Returns on 5-year and 1-year bonds perform somewhat better, increasing in response to higher inflation, but only by roughly half as much. Not surprisingly, the best (though still incomplete)

protection comes from periodically rolling over 3-month Treasury bills (which allows the interest rate to adjust frequently for inflation), but here the investor sacrifices substantial returns for lower inflation risk.

The examples above considered investments over a period of 5 years. Returns over investment horizons of less than 5 years generally do an even poorer job of keeping up with inflation, while returns over longer horizons do a little bit better. Protection against inflation, however, is only one of the criteria for selecting

investments. The rate of return is also important. In that regard, average returns historically have been substantially higher for stocks and long-term bonds than for short-term securities, so investors seeking to maximize their return over the long haul still would do best to invest in stocks and long-term bonds. But, as a hedge against inflation, these investments have done poorly.



What about real estate investments?

When measured over a 5-year investment horizon, the average price of existing homes has kept pace with inflation. Real estate investments, however, are much less liquid than financial assets, preventing them from being easily tapped (although increased use of reverse mortgages could help alleviate the illiquidity problem, see Weekly Economic Briefing, December 1, 1996). Furthermore, over very short

horizons, real estate has not afforded much protection against inflation (see chart).

Summary. Even with low and stable inflation, investors today continue to face the risk that the inflation rate could rise in the future. The existing array of assets available to investors does a relatively poor job of protecting against inflation, particularly when the investment horizon is short.

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

IRS Moves to Paperless Age. With the income tax season coming to a close (the Internal Revenue Service (IRS) has to start making interest payments to taxpayers on refunds paid after June 1), indications are that recent efforts by the IRS to streamline the tax filing process have been a success. Payouts have been made easier as over 10 million taxpayers (roughly 14 percent of all refunds) opted for their refunds to be deposited directly into their bank accounts—an option offered for the first time this year to those filing paper returns. Not only is direct deposit quicker, easier, and safer for taxpayers, but it also is less costly for the IRS because no refund check has to be issued. In another innovation, TeleFile (filing by telephone) was expanded into nationwide service after 4 years of pilot testing. About 3 million of the 23 million taxpayers eligible for TeleFile used it, roughly in line with projections. In total, about 20 percent of returns have made use of the IRS's electronic, PC, or telephone filing alternatives, up from 13 percent last year.

Century Conversion Confuses Computers. As the year 2000 rapidly approaches, a hot new (albeit short-lived) employment opportunity is “Century Conversion Expert.” Currently, most computer systems—especially older mainframe systems and software packages used by many companies for billing, payroll and inventory control—are not equipped to handle the turn of the century. As a result, if the problem is not corrected in time, after December 31, 1999 the computers will roll over to January 1, 1900 wreaking havoc on billing and payment schedules. Around 10,000 new positions for technical experts are expected to be created in 1996 to facilitate the transition to dating systems capable of handling years beyond 1999.

Charitable Giving Up in 1995. Americans gave nearly \$145 billion to charities in 1995, up more than 10 percent over 1994 according to the annual report of the American Association of Fund-Raising Counsel Trust for Philanthropy. The gain was especially welcome after a relatively meager 3 percent rise in charitable giving during 1994. Corporate giving, which rose 7.5 percent, failed to keep pace with the 11 percent increase in personal giving. The increase in personal giving, which historically accounts for about 80 percent of contributions, was driven by a strong rise in personal income and by soaring stock prices as the market rose roughly one-third during the year. Charitable contributions have represented about 2 percent of GDP for the past 4 decades.

INTERNATIONAL ROUNDUP

Russia's Communist Party Announces Economic Platform. This week presidential hopeful Gennady Zyuganov outlined his party's economic agenda in the document "From Destruction to Creation: Russia's Road to the 21st Century," which calls for an increased role of government in business and banking over a 15-year period. The program condemns the Yeltsin government's tight monetary policy and trade liberalization, blaming these policies for devastating Russia's industrial base and exposing manufacturers prematurely to international competition. While not explicitly advocating renationalization, the program does come out in favor of a multi-layered economy in which the state maintains a leading role in strategic enterprises and sectors. In the fashion of the Soviet planners of yesteryear, the program calls for a three-stage development program that includes controlling energy prices, hiking import tariffs to protect domestic producers, creating state-directed investment banks, and putting the brakes on capital flight.

Mexican Economy Experiences Healthy Growth in First Quarter of 1996. During the first quarter of this year, Mexico's real GDP grew at an annual rate of 2.2 percent, marking the third consecutive quarter of positive economic growth. However, GDP in the first quarter of 1996 was still 1 percent lower than in the same period last year. Inflation ran at an annual rate of 38 percent in the first quarter of 1996, down somewhat from 1 year earlier, but still considerably higher than in 1994. Improved trade performance has supported Mexico's return to growth. Exports reached a record \$21.8 billion in the first quarter, while imports rose to \$19.9 billion, resulting in a widening trade surplus of \$1.8 billion. In the category of merchandise trade, U.S. exports to Mexico grew 12 percent over the past year, reaching \$13 billion during the first quarter, while U.S. imports from Mexico also expanded 12 percent, hitting a record \$16.7 billion.

U.S. Garners Joint Recognition for Competitive Economy. The United States recently took home high honors in two reports on international competitiveness. The International Institute for Management Development (IMD) ranked the United States first worldwide, while the World Economic Forum (WEF) ranked it fourth overall—behind Singapore, Hong Kong, and New Zealand—but first among the major economies. In previous years, the IMD and WEF collaborated in producing the worldwide rankings, and for the past 2 years, ranked the United States first in the world. The differences in this year's results can be attributed to the different criteria now used by the two organizations. The World Economic Forum judges economies on the basis of a few key growth variables such as openness to trade, government spending, the flexibility of labor markets, and the strength of civil institutions. The IMD, on the other hand, uses a much larger, more varied set of criteria, including stock market capitalization, size of companies, total expenditure on research and development, and number of Nobel Prizes. The differences in criteria can produce significant differences in results: New Zealand, for example, is ranked third on the WEF list and eleventh on the IMD list.

RELEASES THIS WEEK

Gross Domestic Product

According to revised estimates, real gross domestic product grew at an annual rate of 2.3 percent in the first quarter.

Consumer Confidence

Consumer confidence, as measured by the Conference Board, declined 3.6 index points in May, to 101.2 (1985=100).

MAJOR RELEASES NEXT WEEK

Leading Indicators (Monday)

National Association of Purchasing Managers' Report (Monday)

Employment (Friday)

U.S. ECONOMIC STATISTICS

	1970– 1993	1995	1995:3	1995:4	1996:1
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	1.3	3.6	0.5	2.3
GDP chain-type price index	5.3	2.6	2.2	2.2	2.4
<u>Nonfarm business (NFB) sector:</u>					
Productivity (chain-type)	1.5	0.7	1.7	-1.0	2.6
Real compensation per hour:					
Using CPI	0.6	1.3	2.2	0.4	0.0
Using NFB deflator	1.3	2.2	2.4	2.4	1.6
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.2	10.2	10.2	10.4
Residential investment	4.5	4.0	4.0	4.0	4.1
Exports	8.2	11.1	11.1	11.3	11.3
Imports	9.2	12.5	12.5	12.4	12.6
Personal saving	5.1	3.3	3.2	3.6	3.4
Federal surplus	-2.7	-2.2	-2.2	-2.1	-2.1
<hr/>					
	1970– 1993	1995	Feb. 1996	March 1996	April 1996
Unemployment Rate	6.7**	5.6**	5.5	5.6	5.4
Payroll employment (thousands)					
increase per month			631	178	2
increase since Jan. 1993					8545
Inflation (percent per period)					
CPI	5.8	2.5	0.2	0.4	0.4
PPI-Finished goods	5.0	2.3	-0.2	0.5	0.4

**Figures beginning 1994 are not comparable with earlier data.

New or revised data in **boldface**.

FINANCIAL STATISTICS

	1994	1995	March 1996	April 1996	May 30, 1996
Dow-Jones Industrial Average	3794	4494	5612	5580	5693
Interest Rates					
3-month T-bill	4.25	5.49	4.96	4.95	5.04
10-year T-bond	7.09	6.57	6.27	6.51	6.78
Mortgage rate, 30-year fixed	8.35	7.95	7.62	7.93	8.03
Prime rate	7.15	8.83	8.25	8.25	8.25

INTERNATIONAL STATISTICS

Exchange Rates	Current level May 30, 1996	Percent Change from Week ago	Year ago
Deutschemark-Dollar	1.533	-0.5	+10.4
Yen-Dollar	107.7	+0.8	+29.7
Multilateral \$ (Mar. 1973=100)	88.26	-0.5	+8.2

International Comparisons	Real GDP growth (last 4 quarters)	Unemployment rate	CPI inflation (last 12 months)
United States	1.7 (Q1)	5.4 (Apr)	2.9 (Apr)
Canada	0.6 (Q4)	9.3 (Mar)	1.5 (Apr)
Japan	2.2 (Q4)	3.1 (Mar)	0.1 (Mar)
France	0.3 (Q4)	12.5 (Jan)	2.4 (Apr)
Germany	0.8 (Q4)	7.0 (Feb)	1.5 (Apr)
Italy	2.3 (Q4)	12.0 (Jan)	4.5 (Apr)
United Kingdom	1.9 (Q1)	8.3 (Mar)	2.4 (Apr)