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GOLDMAN SACHS WEEKLY
JANUARY 1997 - APRIL 1998

Asia's Impact on U.S. Growth: A Case of Weak Dominoes

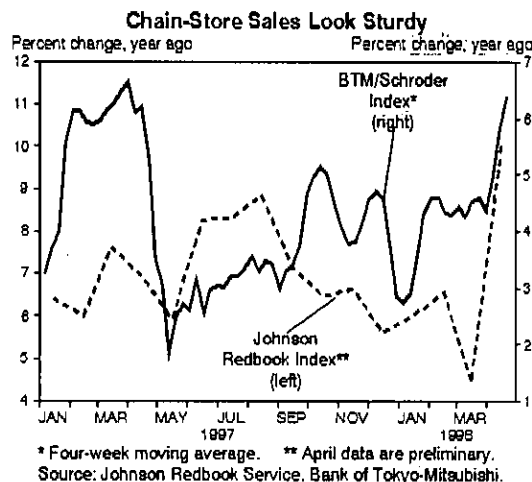
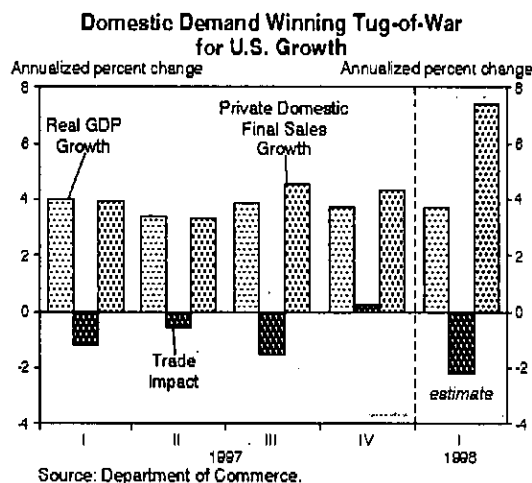
■ Although the Asian crisis has pushed the U.S. trade deficit up and slowed growth in the factory sector, it has had no visible impact on overall growth. Advance estimates for first-quarter real GDP are apt to show no significant change from the 3.7% growth pace of the preceding year.

■ In essence, the Asian crisis has exerted offsetting positive effects on domestic demand by helping reduce inflation and interest rates. Along with warm weather, these factors pushed real private domestic final sales up at what was probably the largest quarterly rise of the expansion (7½% at an annual rate).

■ It is a bit early to conclude that the Asian impact on U.S. growth has been minimal, but such a conclusion would not be inappropriate by the summer if no more shoes drop. Claims that Asian exporters will hurt U.S. growth by dumping goods ignore key mitigating factors, in particular the likelihood that a pickup in export growth would facilitate a rebound in imports.

■ Comments by another group of Federal Reserve officials have reinforced impressions of a shift in thinking at the institution toward more concern about excessive growth and intensifying labor cost pressures. While central bankers remain likely to weigh substantial second-quarter information before reaching conclusions, the risks of a tightening early in the year's second half clearly have risen.

■ Weekly reports on retail spending, mortgage applications, and jobless claims suggest continued firmness in domestic demands.



Trade Recommendations

■ Stay short June '99 Eurodollar futures, lowering stops to a close above 94.27 from 94.35, and maintaining a target of 93.50.

Contributors: Bill Dudley, Ed McKelvey,
John Youngdahl, Alex Patelis (212) 902-6807

E-mail Address: william.dudley@gs.com

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I. Weekly Wrapup

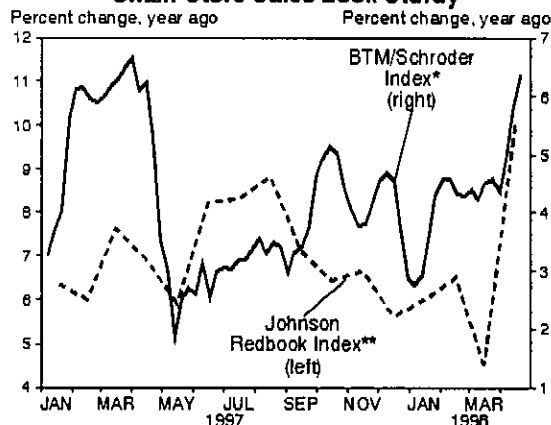
Economic and Market Overview

Further remarks by Federal Reserve officials suggesting increased focus on upside possibilities for economic activity and long-term inflationary pressures have weighed down U.S. bond prices in recent days. The heightened anxiety about monetary policy prospects created a less hospitable market environment for the absorption of relatively heavy new-issue corporate debt supplies.

With no major economic reports on the docket, data-watchers were left with only the usual weekly indicators from which to draw inferences about business conditions. Those series, on balance, continue to point toward strength in demands for retail items, homes, and workers. Both the Johnson Redbook and BTM/Schroder Wertheim surveys of spending at merchandise outlets have displayed appreciable strength this month. The Redbook index is up 3.6% thus far in April from March, and 10% versus a year ago, while the BTM series (which measures same-store sales changes) has posted six consecutive weekly gains and is running 6.4% above last year on a four-week average basis. These gains have probably been inflated by the late timing of Easter, but the degree of momentum is nevertheless impressive, given prior assumptions that weather influences would suppress consumption this quarter.

First-time unemployment insurance claims continue to hover at a low average level, with volatility in the two latest weekly figures (down 24,000 for April 11, up 29,000 for April 18) very likely related to the timing of the Good Friday and Passover holidays.

Chain-Store Sales Look Sturdy



* Four-week moving average. ** April data are preliminary.
Source: Johnson Redbook Service. Bank of Tokyo-Mitsubishi.

The low pace of new filings has gradually eroded the total number of persons receiving state benefits, a development that often presages a decline in the national unemployment rate. Mortgage bankers, meanwhile, also experienced some holiday-related variations in applications for home purchase loans, but this activity has stayed on a solid upward trend, with average year-to-year gains close to 25%.

Federal Reserve Policy

Some more top Fed policy makers have added their voices to the chorus expressing concerns that the U.S. expansion has not slowed enough in the wake of Asian economic adjustments to relieve potentially inflationary strains on resources. The most notable commentary came from relatively new Governor Roger Ferguson, who said that with respect to the economic outlook, "the downside risks are far less likely than the upside risks at this point." These remarks were similar to those made earlier by Governors Meyer, Kelley and Phillips, and this convergence of views about the imbalance of probable outcomes enhances the possibility that the FOMC has already restored a formal policy bias toward tightening. In the same interview, however, Ferguson indicated a willingness to be patient with current monetary conditions until data from the spring emerge, allowing a more complete assessment of impacts from Asia on domestic activity.

Fiscal and Political Developments

Startlingly rapid improvement in the federal budget is persisting, with the March 1998 deficit coming in at \$13.8 billion, steeply lower than the \$21.3-billion

Unemployment Claimants Lead Jobless Rate



Source: Department of Labor.

shortfall a year earlier. Over the first half of this fiscal year, the budget balance has improved by \$41.3 billion, or nearly \$7 billion per month on average. In light of this trend, and relatively firm revenue results from the early days of the key April tax collection period, we regard our forecast of a \$40-billion surplus in fiscal 1998 as somewhat conservative.

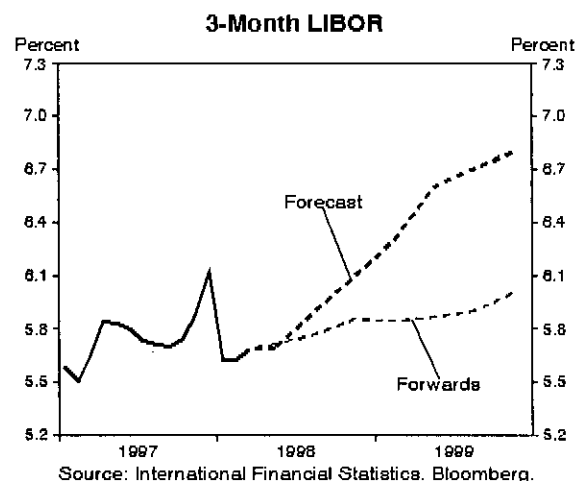
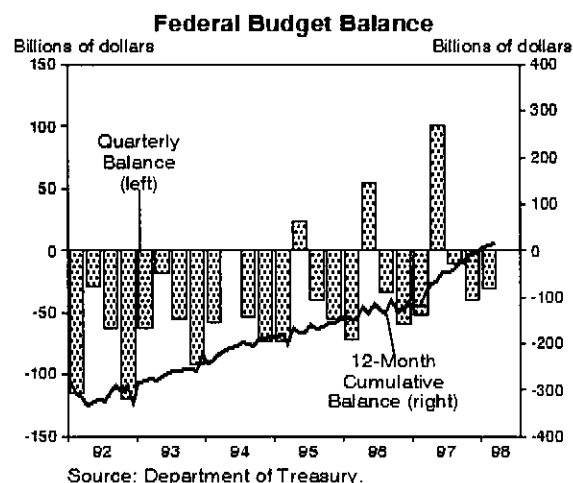
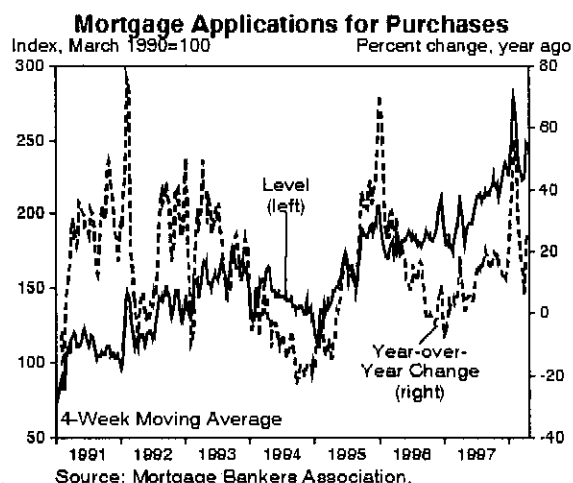
It seems clear that some long-overdue, radical revisions to the government's internal assumptions about the budget are in process. On Tuesday, Senate Budget Committee Chairman Pete Domenici (R-New Mexico) said that his current "best guess" for this year's surplus is in the \$45- to \$55-billion range. One can be fairly confident that he did not conjure up this estimate on his own, but instead was reflecting the views of his staff, who keep in close touch with analysts at the Congressional Budget Office. By next month, it seems probable that official budget forecasts will be adjusted to show large surpluses for each of the next few years, and those changes will have a huge impact on how Treasury debt managers assess their medium-term market borrowing requirements and approach decisions about modifications to the federal funding structure. We continue to anticipate a sizable cutback in Treasury coupon supplies to be implemented by summer, with fresh volumes in the two- to five-year maturity zone particularly ripe for reduction.

Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

Although anxiety about Fed tightening has clearly increased, forward Eurodollar rates still appear to discount a relatively low probability that rates will be hiked anytime in the next 12 months. For example, the June '99 Eurodollar futures, for which we recommended short positions a week ago, are still priced only about 15-20 basis points above the current 3-month LIBOR level. Most or all of that differential could be attributed to a normal risk premium, rather than expectations of more restrictive monetary conditions. Thus, we would advise retaining a short stance heading into key reports next week on GDP and employment costs, lowering buy-stops to a close above 94.27 from 94.35 previously.

We remain neutral on U.S. bond futures at this time. It is probably premature to expect long-duration yields to burst out of their recent range, given that Fed policy will likely hold steady through midyear and domestic demand should decelerate this quarter.



II. Asia's Impact on U.S. Growth: A Case of Weak Dominoes

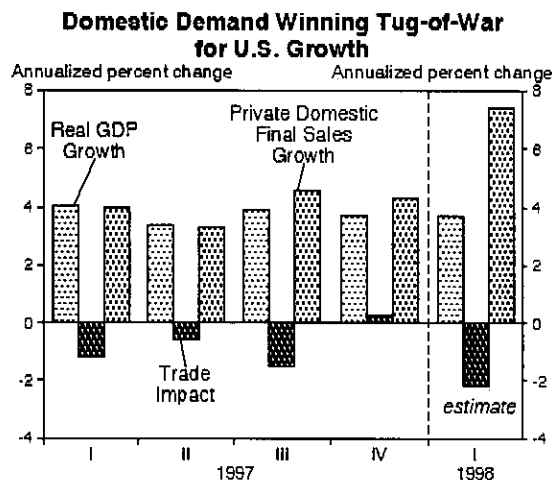
What has become of the Asia-induced slowdown? As one economy toppled another in the area, like falling dominoes, a tidal wave of weakening net exports was supposed to knock U.S. growth for a loop in early 1998. The trade setback has occurred more or less on schedule, and it has caused growth in factory output to slow sharply—to 1.8% at an annual rate in the first quarter from 6.3% during the preceding year. But evidence of broader damage is scant. In a few days, the Commerce Department is likely to report that the entire economy grew at a 3.7% rate last quarter—no different than the average of the four quarters of 1997 despite an estimated 2.2-point setback in net exports.

The lack of a broader impact is due to two factors, both of which had a heavy helping hand from Asia's turmoil. First, the rising dollar and falling oil prices kept U.S. inflation on a downward track, stretching still further the already awesome purchasing power of U.S. households. Second, interest rates fell as money flowed to the safe haven of dollar-based assets and Fed officials refrained from tightening monetary policy. The declines in inflation and interest rates boosted an already strong trend in private domestic demand, effectively neutralizing the trade drag from Asia, at least to this point.

Is it premature to conclude that Asia has had virtually no impact on U.S. growth? Probably. Indirect trade effects, via neighboring countries, have so far not materialized. And there is always the risk that more shoes will drop in Asia, provoking more turmoil. But barring such events, the scale of the damage to U.S. growth should be evident by midyear, and it is highly unlikely to derail the economy from its current above-potential growth track, in our view. In particular, the belief that U.S. growth will suffer as Asian exporters, who are just now regaining access to financing, dump goods into the U.S. markets, ignores several key mitigating factors that should make this yet another small effect.

A Swift and Sizable Trade Adjustment . . .

Trade adjustment in Asia has been swift and sizable, as was inevitable given the enormous loss of international purchasing power imposed on the ASEAN-4 nations and South Korea by the sharp devaluation of their currencies. Weighted by shares of U.S. trade, the currencies of these five nations, now known as the Asian crisis countries (ACC-5), depreciated about 50% against the dollar from mid-



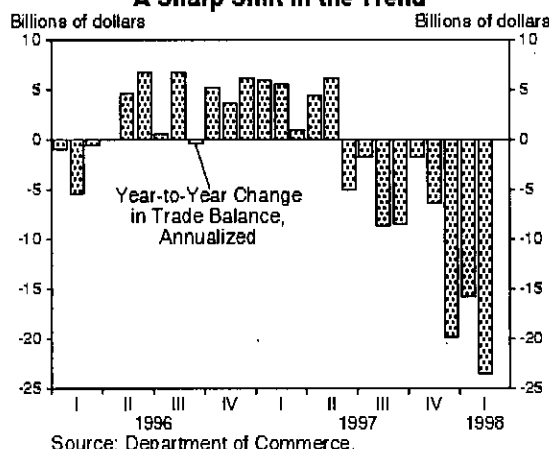
1997 to early 1998. And, as a consequence of the forced cutbacks in imports, all but the Philippines are now reporting current account surpluses. In some cases, these surpluses are quite large relative to the size of the local economy. For example, South Korea booked a surplus of \$7.1 billion in January and February; if this performance were to continue through the year, the current account surplus would balloon to more than 13% of projected GDP for 1998.

Bilateral trade data from both sides of the Pacific also show that the United States has been an active participant in the ACC-5 trade adjustment. In the year prior to June 1997, the U.S. data show that the trade deficit with these five countries was narrowing consistently, to a level \$4.3 billion smaller than in the preceding 12 months, as shown in the chart on the top of page 5. This trend broke abruptly at midyear; as of the latest three months for which data are available (through February), the U.S. deficit with the ACC-5 nations was widening \$17.9 billion, at an annual rate, from its year-earlier levels—a \$22.2-billion swing, or about ¼% of U.S. GDP. Parallel calculations based on data from the Asian trading partners show an even larger \$30-billion (0.35% of U.S. GDP) swing.

Large though these swings seem, they are barely more than half the ½% upper bound we estimated for the Asian trade impact last November.¹ A key reason for this is that the indirect trade effects through neighboring Asian countries have so far been

¹ See the November/December 1997 *Pocket Chartroom* for the details of this estimate.

U.S. Trade Balance with ACC-5 Nations: A Sharp Shift in the Trend



negligible. The trend in the U.S. trade balance with the entire Pacific Rim, including the ACC-5, has deteriorated by only \$22.5 billion on the same basis, implying little net change, on balance, in the trends of U.S. trade vis-à-vis other nations in the region.

... But Significant Offsets to U.S. Growth

Meanwhile, private domestic spending has continued to barrel ahead in the United States. We estimate that consumer spending rose at a brisk 5.5% annual rate in the first quarter, while investment in both the residential and nonresidential sectors surged about three times as fast. If these estimates are accurate, then real private domestic final sales will post the largest quarterly gain in the current expansion—about 7½% at an annual rate. Although unusually warm winter weather has artificially boosted demand, at the likely expense of the second quarter, the untold story about the Asian crisis is that it has played a key supporting role, via its beneficial effects on inflation and interest rates.

In the case of inflation, turmoil in Asia has certainly been the main factor driving the dollar up in recent months, which in turn has kept the prices of U.S. imports falling. And, along with the warm weather and the liberalization of terms on which Iraq could export oil, the Asian crisis has also been a major reason for the weakening in prices of oil as well as other commodities. The resulting decline in inflation, to an estimated 0.4% annual rate in the first quarter from 1½% over the preceding four, freed up about \$14 billion in annualized real disposable personal income. Although it is unclear how much of this was actually spent, it could have been responsible for as much as 0.6 points of last quarter's growth.

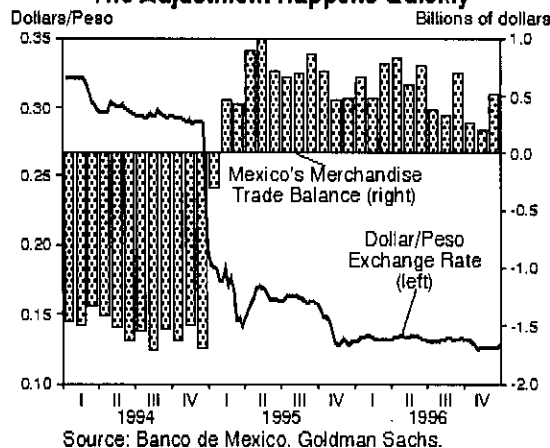
Asia's second contribution to growth has been to help push U.S. interest rates down. In this regard, the crisis clearly provoked a flight to the safe haven of dollar-denominated assets. It also put monetary policy on hold at a time when Fed officials were on the brink of raising their federal funds rate target. Both developments have been instrumental in bringing interest rates down and keeping stock prices high. Although it is hard to say just how much U.S. growth has benefited, given the complicating effect of abnormally warm weather, it is no coincidence that housing starts have reached a new 3-month high for this business expansion and that sales of durable goods, and spending in general, have been robust.

It Ain't Over 'Til It's Over, But . . .

The speed with which the ACC-5 trade adjustment has occurred is reminiscent of Mexico's experience following the peso crisis of late 1994 and early 1995. In that case, the peso's value also dropped by half within a few months, pushing the Mexican trade balance quickly into surplus, as shown in the chart below. The message from the chart seems clear: In the wake of a sharp devaluation and loss of confidence, a country's trade balance will adjust very quickly—within months of the onset of the crisis—and then stabilize.

Even so, many observers say that the main impact of the Asian crisis has yet to be felt. Such claims come in three forms: First, more shoes could drop in Asia, throwing the region back into turmoil. The worries most often voiced are a devaluation of the Chinese renminbi or a free-fall in Japan. Second, the United States has yet to see the indirect deterioration in its trade balance with other countries more affected by the crisis, notably Japan. Third, Asian exporters are

Lessons from the 1995 Peso Crisis: The Adjustment Happens Quickly



just now regaining their access to credit and will soon begin dumping their goods on foreign markets, allegedly forcing a sizable cutback in U.S. growth.

With respect to new shoes, the safest response is to take refuge in the forecaster's motto: "Never say never." If major new disruptions were to occur, we would clearly have to consider revising our outlook for U.S. growth, inflation, and interest rates. That said, we are optimistic that further major disruptions can be avoided. In the case of China, the scope for easing in monetary and fiscal policies to support growth in domestic demand, coupled with a large pile of foreign exchange reserves, makes a devaluation unlikely. Meanwhile, the latest fiscal package announced by the Japanese government, worth more than 2% of GDP, should at a minimum keep that economy from collapsing. And even if another shoe were to drop, the experience to date cautions against giving too much weight to the potential trade impact at the risk of ignoring other effects.

Indirect trade effects are also apt to be small, for two reasons. First, by our reckoning, the United States has already borne a disproportionately large share of the ACC-5 trade adjustment. Whereas historically the United States has accounted for 15%-20% of trade with the ACC-5 nations, its share of the latest trade adjustment appears to have been two to three times as much. Second, any effects on U.S. international trade passing through those countries are diluted by the fact that they account for only a fraction of ACC-5 trade as well as by other factors that might cushion the impact on their domestic demand growth.

Finally, the notion that the dumping of Asian exports onto U.S. markets will slow U.S. growth sharply runs into several difficulties. First, supply is not the only factor that determines how many Asian goods U.S. producers or consumers will buy, nor is it even the main one. The pace of growth in domestic demand is far more important. Although demand has been strengthening, there is no reason to believe that it will strengthen further just because the supply from Asia has come back on line.

This leads directly to the second point: To the extent that U.S. imports from Asia rise, the increase will mainly displace goods supplied by some other source. That source could well be another foreign producer, in which case U.S. output would not suffer; however, regardless of whose goods are displaced, the reason for the displacement will be that the Asian goods are

Lessons from the 1995 Peso Crisis: Export Growth Enables Import Recovery



cheaper, in which case U.S. inflation will remain low and the corresponding growth benefits will persist.

Finally, the dumping theory implicitly presumes that the Asian nations will simply accumulate the foreign exchange earned by growing their exports. However, as already noted, most of these countries are already running large current account surpluses. The 13% of GDP figure cited earlier for Korea, for example, is almost triple the level our Hong Kong economists expect for all of 1998! Under these circumstances, much of the extra income is likely to find its way back into purchases of foreign goods, from the United States and elsewhere.

Once again, Mexico's experience in 1995 provides useful guidance. As shown above, once balance had been achieved via a reduction of imports into Mexico, its solid growth in exports enabled a resumption of growth in imports. We know of no reason why the ACC-5 nations would not follow the same pattern.

Implications for the Outlook

Barring renewed turmoil in Asia, it seems likely that the final reckoning of the crisis in that region on U.S. growth can be made by about midyear, and that it will turn out to have been quite small. In particular, there is no evidence that the Asian crisis has derailed U.S. domestic demand from its strong growth track, which is well above the economy's long-term growth potential. Thus, signs of slower growth in coming months should be seen as a transitory payback for the weather-induced add-on to first-quarter growth, coupled with an effort to curb inventory accumulation modestly, rather than as anything more fundamental.

Ed McKelvey

Key U.S. Economic Data

	Latest Monthly Data				6 Mo Trend	12 Mo Trend	Next Release
	'98 Mar	'98 Feb	'98 Jan	'97 Dec			
Nonfarm Payrolls (ch. thousands)	-36	252	399	354	282	261	May 8
Unemployment Rate (%)	4.7	4.6	4.7	4.7	4.7	4.8	
Index of Hours Worked (% ch)	-0.7	0.6	0.8	-0.3	3.7	2.4	
Average Hourly Earnings (% ch)	0.3	0.6	0.3	0.0	4.6	4.0	
Producer price finished goods index (% ch)	-0.3	-0.1	-0.7	-0.2	-2.7	-1.8	May 13
Excluding food and energy	0.0	0.1	-0.1	0.0	-0.3	-0.1	
Consumer price index (% ch)	0.0	0.1	0.0	0.1	0.9	1.4	May 14
Excluding food and energy (% ch)	0.1	0.3	0.2	0.2	2.4	2.3	
Retail sales (% ch)	-0.1	0.7	1.0	0.5	4.3	3.1	May 13
Excluding motor vehicles (% ch)	0.1	0.6	1.5	-0.1	4.5	3.4	
Industrial Production (% ch)	0.2	-0.2	-0.2	0.3	3.4	4.3	May 15
Manufacturing	-0.2	-0.2	0.1	0.4	3.7	4.4	
Capacity utilization (%)	82.2	82.3	82.8	83.3	82.8	82.7	May 15
Manufacturing	80.9	81.5	82.0	82.3	81.8	81.7	
Housing Starts (annual rate, thousands)	1590	1635	1545	1540	1560	1508	May 19
Single-family	1238	1269	1225	1130	1192	1159	
Trade balance (billions, monthly)	--	-12.1	-11.6	-10.9	-10.6	-9.7	May 20
Merchandise	--	-18.6	-18.3	-17.7	-17.6	-16.7	
Factory Orders (% ch)	--	-0.9	0.6	-2.6	-0.1	2.5	May 6
Durable Goods	--	-1.1	1.6	-5.3	-0.9	3.6	Apr 28
Personal Income (% ch)	--	0.6	0.6	0.4	6.5	5.7	May 1
Wages and Salaries	--	0.9	0.8	0.5	8.9	7.2	
Purchasing Managers' Index (%)	54.8	53.3	52.4	53.1	54.0	54.9	May 1
Consumer Sentiment U Mich (Feb 66=100)	106.5	110.4	106.6	102.1	106.4	105.4	May 1
Conference Board (1985=100)	134.3	137.4	128.3	136.2	131.3	129.0	Apr 28

Note: Percentage changes are month to month for last four months, annualized for 6- and 12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- A further upward move in the year-to-year trend in employment cost increases is almost inevitable, as the quarterly change one year ago was only 0.6%. Recent announcements of sharp increases in healthcare premiums create an upside risk to the heretofore benign performance of benefits inflation (April 30).
- Advance estimates for first-quarter GDP are likely to show that the economy grew at about the same pace as in the preceding four quarters, as a large (2.2% of GDP) trade drag was offset by a 7½% annualized surge in private domestic final sales (April 30).
- Purchasing managers' reports on industrial activity in April are likely to slip a bit from March, but remain firmly in growth territory (April 30 and May 1).

Economic Releases and Other Events

Date	Time	Indicator	Estimate		Last Report
			GS	Consensus	
Mon Apr 27	10:00	Existing Home Sales (Mar)	-4.2%	-3.2%	+8.7%
Tue Apr 28	8:30	Durable Goods Orders (Mar)	+0.6%	+0.6%	-1.1%
	10:00	Consumer Confidence (Apr)	131.0	135.0	134.3
Thu Apr 30	8:30	Employment Cost Index (Q1 '98)	+0.9%	+1.0%	+1.0%
	8:30	Real GDP (Q1 '98—Adv.)	+3.7%	+3.4%	+3.7%
	8:30	Chain-Weight Price Index (Q1 '98—Adv.)	+0.9%	+1.3%	+1.4%
	10:00	Chicago Purchasing Managers Index (Apr)	58.5%	58.2%	59.5%
	10:00	New Home Sales (Mar)	-9.3%	-2.8%	+4.8%
Fri May 1	8:30	Personal Income (Mar)	+0.3%	+0.2%	+0.6%
	8:30	Personal Consumption (Mar)	+0.3%	+0.3%	+0.4%
	10:00	National Purchasing Managers Index (Apr)	54.0%	53.9%	54.8%
	10:00	Construction Spending (Mar)	+0.6%	0.0%	+0.3%
		Domestic Motor Vehicle Sales (Apr)	13.2M	n.a.	13.2M

- Treasury 2-Year Note Auction (Tue, Apr 28)
- Treasury 5-Year Note Auction (Wed, Apr 29)
- APICS Survey (Thu, Apr 30 - 8:30)
- Help-Wanted Index (Thu, Apr 30 - 10:00)
- U. of Michigan Consumer Sentiment—Final (Fri, May 1 - 10:00)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.8%	5.9%	6.2%
Forward	5.8	5.8	5.9
2 Yr T-Note	5.6	5.8	6.2
Forward	5.7	5.7	5.7
10 Yr T-Note	5.7	5.9	6.2
Forward	5.7	5.7	5.8

Key Numbers in the Business Outlook

	1997	1998E		1997	1998E
	Q4	Q1	Q2		
Real GDP	3.7%	3.7%	2.0%	3.8%	3.3%
Ind. Prod., Mfg.	8.1	1.8A	4.8	5.6	5.4
CPI	2.1	0.5A	1.3	2.3	1.5
After-Tax Profits*	8.2	7.7	6.4	9.6	5.3
Unemployment	4.7	4.7A	4.6	5.0	4.5

* Excluding inventory profits; adjusted for depreciation distortions.

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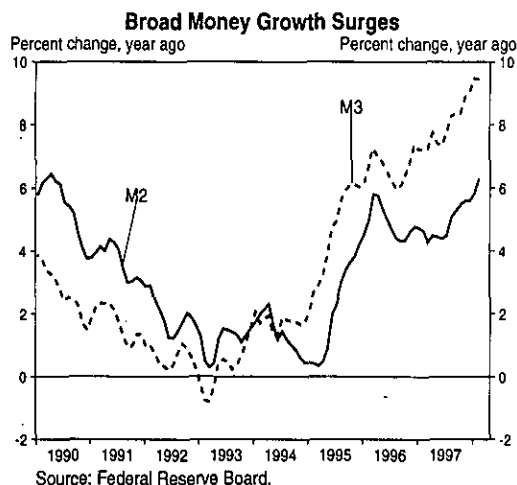
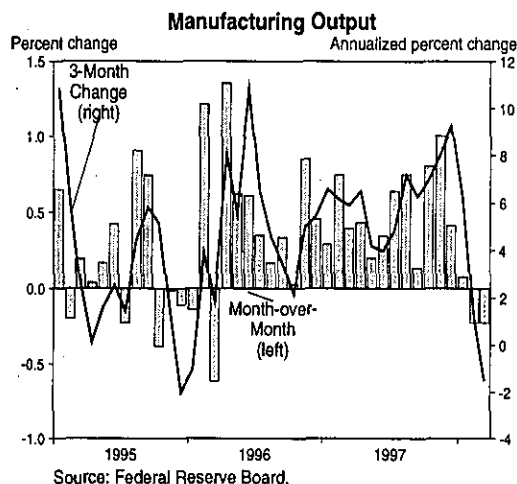
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Money Supply Growth and Its Implications for Inflation

- The trade and industrial production data underscore the impact of the Asian crisis on the U.S. economy. On the trade front, the deficit widened in February due to weakness in exports. Meanwhile, manufacturing output fell in both February and March.
- At the same time, the impact of the weather on consumer spending and housing in March was quite mild. Looking through the weather impact, the trend in both areas still appears to be strongly upward. This highlights the strength of the domestic economy.
- Consumer prices remained well-behaved as dollar strength and lower oil prices continued to dominate.
- Broad money growth is surging, which suggests that monetary policy may be too loose to prevent the economy from overheating. The pickup in the growth rate of the monetary aggregates is worrisome for two reasons: (1) It is precisely the consequence one would expect when the federal funds rate is being pegged and the domestic economy is expanding quickly, and (2) it has been accompanied by a pickup in the growth rate of debt.
- The likelihood that M2 deposits may be temporarily inflated by monies that are now moving to the IRS suggests one reason for patience. Also, the linkage between the broad monetary aggregates and nominal GDP growth has been sufficiently loose in recent years that it has been dangerous to make inferences about the economy's prospective performance on the basis of money supply growth.



Trade Recommendations

- Sell short the June '99 Eurodollar futures contract (currently 94.23), with a target of 93.50 and a stop on a close above 94.35.

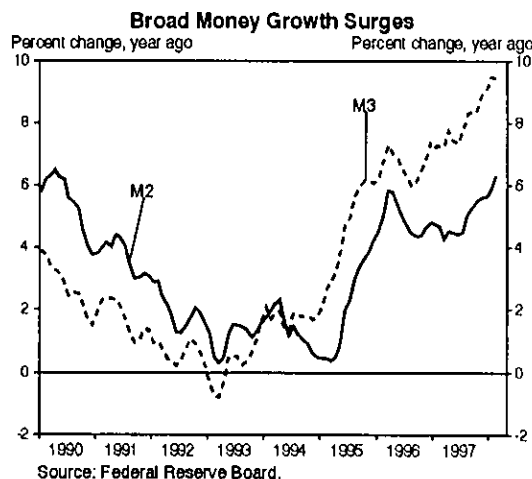
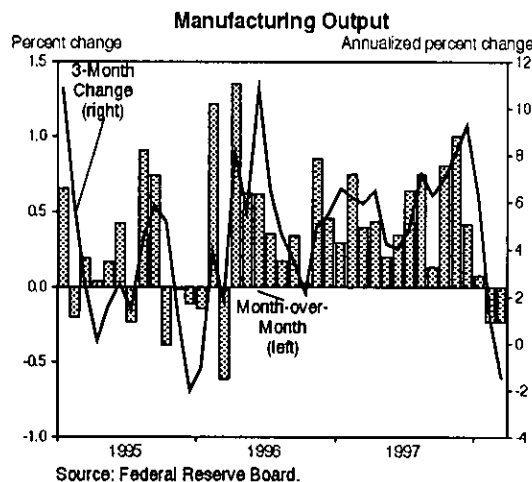
Contributors: Bill Dudley, Ed McKelvey,
John Youngdahl, Alex Patelis (212) 902-6807

Issue No: 98/16
April 17, 1998

E-mail Address: william.dudley@gs.com

Money Supply Growth and Its Implications for Inflation

- The trade and industrial production data underscore the impact of the Asian crisis on the U.S. economy. On the trade front, the deficit widened in February due to weakness in exports. Meanwhile, manufacturing output fell in both February and March.
- At the same time, the impact of the weather on consumer spending and housing in March was quite mild. Looking through the weather impact, the trend in both areas still appears to be strongly upward. This highlights the strength of the domestic economy.
- Consumer prices remained well-behaved as dollar strength and lower oil prices continued to dominate.
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I. Weekly Wrapup

Economic and Market Overview

The bond market remained range-bound as dollar/yen fluctuations were the major focus of the week. On the economic front, the trade and industrial production reports made it clear that the Asian crisis was having a negative impact on economic activity during the first quarter. The overall trade balance widened to a \$12.1-billion deficit in February, from a revised \$11.6-billion deficit in January, as exports declined by 0.8%. The deterioration in the real merchandise trade balance was about twice as great as in the nominal balance as lower oil prices helped to chop about \$0.4 billion from the oil import bill. Although the bilateral trade balance with Pacific Rim countries improved in February to -\$10.6 billion from -\$11.7 billion, this is on a not-seasonally-adjusted basis and means little as this bilateral deficit typically narrows in February.

The weakness of exports is restraining industrial production. Although industrial output climbed by 0.2% in March, this was solely due to a big jump (+4.8%) in utilities output. Manufacturing output fell by 0.2%. Moreover, industrial output for January and February were revised downward to -0.2% for each month. This helped cut the overall capacity utilization rate to 82.2%, the lowest level since 1996.

In contrast, much of the other economic data indicate a continuation of relatively firm business activity, with only modest negative influences from a return to more normal weather conditions. Retail sales declined 0.1% last month, but this followed gains totaling 1.7% over January and February, when

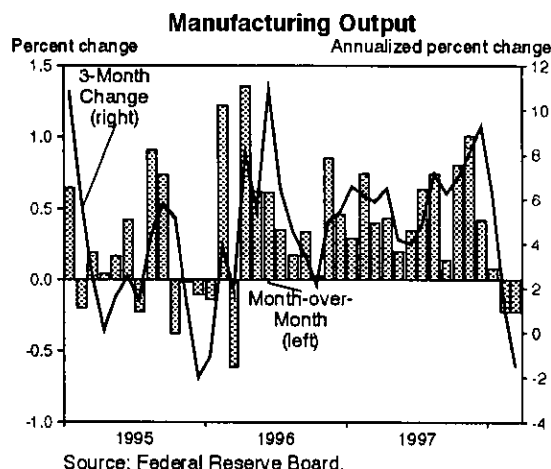
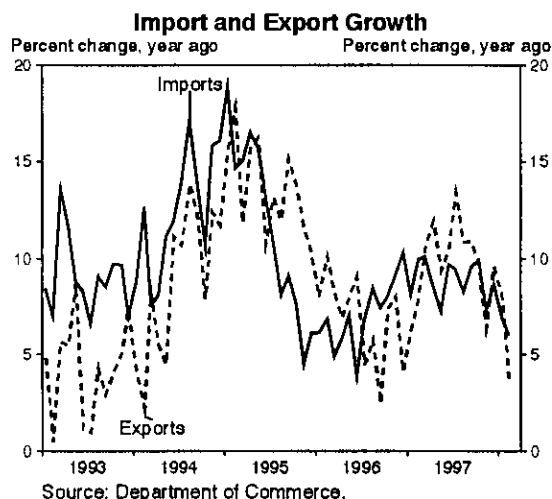
favorable temperatures no doubt pulled forward some purchases. The sales change also was depressed by the ongoing decline in gasoline prices. Excluding motor vehicles, gasoline, and building materials (the latter group is reclassified as intermediate residential construction expenditure), sales actually climbed 0.3% in March and 9.1% at an annual rate for the first quarter as a whole.

Amid buoyant housing demand, low supplies of unsold new dwellings are helping to foster a further pickup in residential construction. Housing starts eased 2.8% last month, giving back less than half the weather-aided gains recorded over the prior two months. At 1.59 million annual units, the average level of total starts last quarter was the highest in more than 10 years, implying that residential investment spending will remain a positive influence on GDP growth for most of this year.

Consumer price inflation remains subdued. The total CPI was flat for March, with prices excluding food and energy up only 0.1% following a 0.3% jump the month before. At 2.3%, the year-to-year rise in the core CPI is down from 2.5% a year ago, in part because of appreciable weakness in import prices (down 3.2% year-to-year excluding petroleum).

Federal Reserve Policy

The next set of economic data with potentially important monetary policy consequences will be released beginning April 30, when first-quarter employment cost index and GDP data are due. In recent days, a few top central bankers have indicated



an erosion of their patience with the brisk trend in domestic spending and a creeping anxiety that labor cost pressures could grow deep roots if joblessness drifts much lower. Although it is doubtful that Chairman Greenspan shares their degree of concern, he too will be very interested in the coming information about the degree and distribution of last quarter's output gains and, particularly, the latest signals about employee compensation developments.

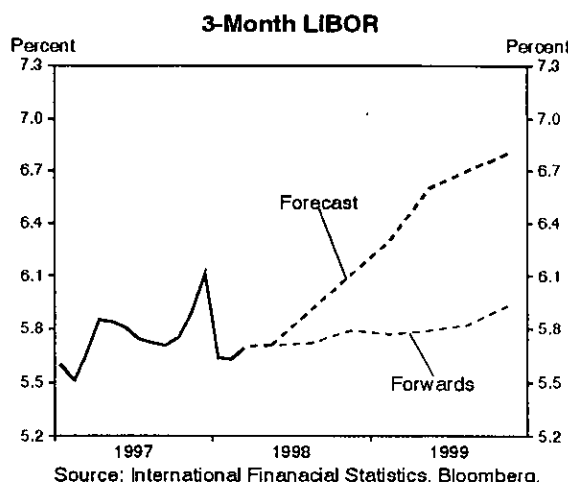
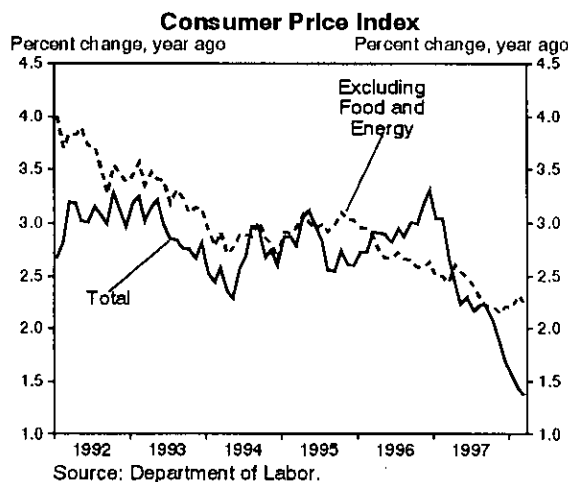
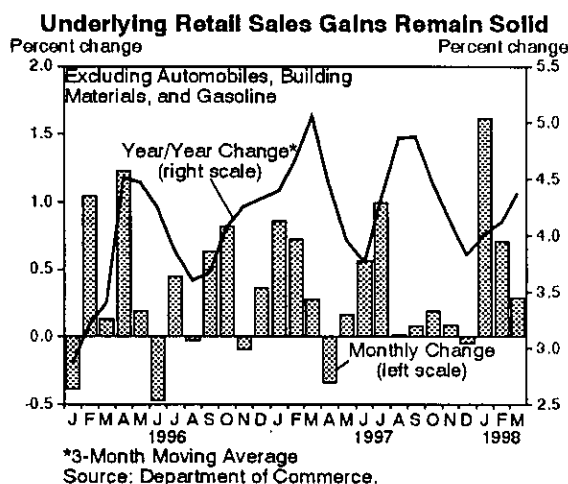
Fiscal and Political Developments

The text of the communiqué issued following the G-7 meeting on April 15 reflects the delicate balancing act that Treasury Secretary Rubin and other U.S. officials must play with respect to Japanese economic policy, which still weighs against concerted international intervention to depress the dollar against the yen. A strong consensus exists within the group that Japan needs to undertake significant fiscal policy stimulus and restructuring in order to pull their domestic demand out of its torpor and relieve downward pressure on the yen's market value. There also is general agreement that the plans announced by Japanese officials to this point are important steps in the proper direction. At the same time, the G-7 members recognize that no enabling legislation has yet been approved, so the group does not wish to relax their persuasive efforts too soon. Thus, while the communiqué expressed agreement that "It is important to avoid excessive depreciation" of the yen, there was reportedly no discussion of joint foreign exchange intervention toward that end. The finance ministers instead chose to stress the importance of following through on the proposed fundamental policy adjustments in Japan as the primary means of achieving and sustaining the desired boosts to that nation's economy and currency.

Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

Most weather-softened March data is now in hand and the impact of Asia on the U.S. economy should soon start to moderate. Given the strength of the domestic economy, we think it is just a matter of time before Chairman Greenspan puts the market on notice again that he may need to tighten monetary policy. We would short the June '99 Eurodollar contract (currently 94.23), with a target of 93.50 and a stop on a close above 94.35. On the long end, our bullish position was stopped out during the past week. With supply shrinking, we would remain neutral for now.



II. Money Supply Growth and Its Implications for Inflation

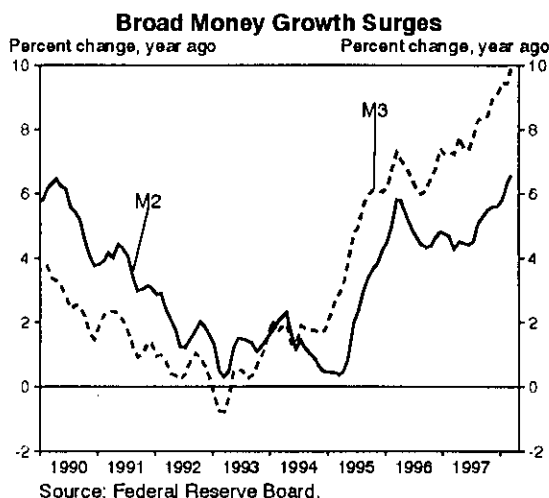
Over the past year, measures of the broad money supply such as M2 and M3 have been growing more quickly. This has raised concerns that U.S. monetary policy is too loose and will prove to be inflationary.

There are good reasons to worry. After all, in the past, a monetary policy conducted by pegging the federal funds rate has often been late in responding to changes in the economy's momentum. When the economy is strengthening at a time that the federal funds rate is pegged, one symptom should be a pickup in money supply growth.

Despite this, it is a leap of faith to conclude that the climb in money supply growth that has occurred over the past year foreshadows a meaningful pickup in inflation. First, the relationship between money supply growth and nominal GDP growth has not been stable. Second, the increase in money supply growth rates may prove to be temporary, boosted by funds earmarked for tax payments to the government that have temporarily been parked in savings deposits and money market funds.

Why Worry?

Broad money growth has climbed over the past year. As shown in the chart below, the year-over-year growth rates of M2 and M3 climbed to 6.6% and 9.9%, respectively, in March, up from 4.3% and 7.2% a year earlier. These are the highest year-over-year growth rates for M2 and M3 since 1987 and 1985, respectively.

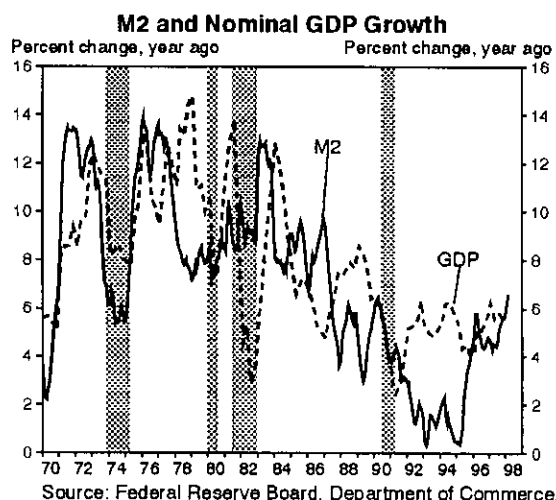


This has created anxiety among market participants for two reasons. First, in the past, rapid money supply growth has often foreshadowed a pickup in nominal GDP growth and inflation. Second, robust growth of the broad monetary aggregates at a time that the Federal Open Market Committee is conducting monetary policy by pegging the federal funds rate suggests that the peg has been set at too low a level to prevent the economy from overheating.

As shown in the chart below, a climb in the growth rate of M2 has often preceded a pickup in nominal GDP growth. When resource constraints have limited the real growth rate, this has translated into a climb in inflation. Noteworthy episodes of faster money growth foreshadowing a quicker pace of economic activity and a rise in inflation include 1967-1969, 1971-1973, 1976-1978, and 1986-1987. In all four cases, the monetary authorities ultimately responded by tightening significantly.

The risk that more rapid money supply growth is foreshadowing faster economic growth and a rise in inflationary pressures is particularly high under the current monetary policy regime in which Fed officials peg the federal funds rate. That is because a pegging policy tends to make monetary policy pro-cyclical. When the economy picks up speed and credit demands rise, the Fed accommodates the rise in money demand by adding reserves to the banking system to prevent the fed funds rate from rising.

Illustrating this point graphically on page 5, when the Federal Reserve targets the nominal federal funds



rate, this means that it adjusts the supply of reserves to match fluctuations in the demand for reserves generated by shifts in the demand for money. For example, when the demand curve shifts from DD to DD', the Fed must increase the supply of reserves to S' from S to keep the federal funds rate steady at i . In contrast, if the monetary authorities do not accommodate the increase in demand but instead keep the supply of reserves fixed at S, then the increase in demand pushes interest rates up to i' .

If the demand for money is increasing because the economy is gaining speed, pegging the fed funds rate causes monetary policy to become too easy. As the demand curve continues to shift towards the right over time, Fed officials respond by adding reserves to keep the federal funds rate steady at i , rather than allowing interest rates to rise. These reserves provide the fuel for banks to expand credit, and monetary policy becomes increasingly stimulative.

Unfortunately, the shifts in the demand for money illustrated above can be generated by other factors than a strengthening economy. In that case, the shifts in demand may have no inflationary consequences. For example, consider what happens if households increase their demand for money because of a shift in portfolio preferences. In such a case, the money supply increases—the Fed satisfies the increase in demand—but there is no inflationary consequence because households are happy to hold the money. The increase in money supply is not associated with increased credit creation or an overly strong economy.

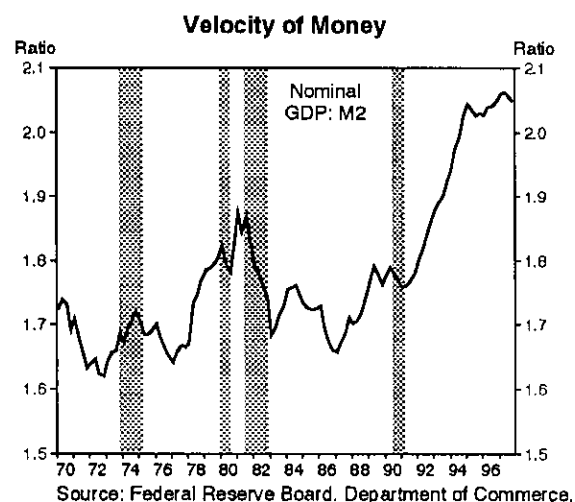
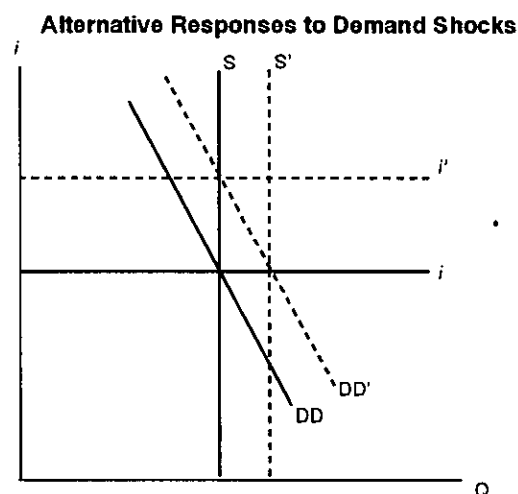
The hard part is that there is no simple way to sort out which increases in the money supply are due to the heightened demand generated by a firm economy and which increases are generated by shifts in portfolio preferences. Empirically, both have been important in influencing the growth rate of the broad monetary aggregates.

This can be shown most simply by plotting the velocity of M2—the ratio of nominal GDP to M2. As shown in the accompanying chart, after being relatively stable during the 1970s and 1980s, the velocity of M2 climbed sharply during the first half of the 1990s—indicating a shift in portfolio preferences away from holding M2 balances—before stabilizing again in recent years. In other words, strong money growth has foreshadowed faster nominal GDP growth at times. But at other times, the relationship has broken down. Given the shifts in

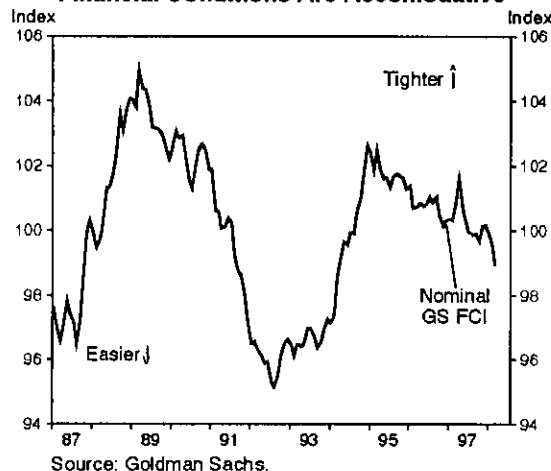
velocity over the past ten years, it is unclear whether the recent stabilization of velocity will persist. Just as possible, M2 growth might exceed nominal GDP growth for awhile, leading to a fall in the velocity of M2 relative to GDP—a reversal of the pattern of the early 1990s.

Most likely, the recent pickup in money supply growth is due to both factors. On the worrisome side of the ledger, there are signs that monetary policy is too easy. The interest-rate sensitive sectors of the economy are buoyant; the stock market has been climbing rapidly; and credit is freely available. In this context, rapid money growth is just another symptom of a stimulative monetary policy.

We have illustrated the lack of monetary stringency formally by the Goldman Sachs financial conditions index (GS FCI). This index, which includes short-



Financial Conditions Are Accommodative



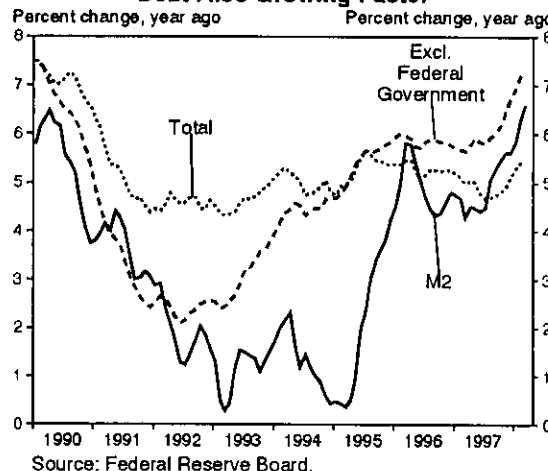
and long-term interest rates, the GS trade-weighted dollar, and the price/earnings ratio for the S&P 500, is in neutral territory and has fallen in recent years, indicating more accommodative financial market conditions.¹

The fact that debt growth has closely followed the pattern of M2 also suggests that the pickup in money supply growth is a sign of an overly accommodative monetary policy. If the pickup in M2 growth were due solely to a shift in portfolio preferences, then credit growth should have been remained subdued.

Still, there are some reasons why some of the rise in M2 growth may partially reflect a shift in portfolio preferences. First, over the past few years, total household financial assets have been growing much faster than M2. This has caused the share of M2 relative to total financial assets to fall sharply. If households respond by rebalancing their portfolios away from equities into M2 assets, then M2 might grow very rapidly for awhile without this growth pickup having any implications for the pace of economic activity or inflation.

Second, some of the bulge in household deposits is likely to prove to be temporary. In 1997, the strength of the stock market and the lowering of the top capital gains tax rate caused households to dramatically increase their capital gains realizations. This, in turn, led to a big increase in tax liabilities on the order of \$15-\$25 billion. Some of these funds have undoubtedly been temporarily parked in saving

Debt Also Growing Faster



deposits and retail money market mutual funds. Now that the April 15 tax date has passed, these monies will soon be drained from checking, savings, and money market mutual funds accounts, causing M2 deposits to drop sharply. If money supply growth does not moderate within the next month, then we will become more worried about what it implies about the stance of monetary policy and the need for higher short-term interest rates.

Proof of the Pudding

In recent years, Federal Reserve officials have deemphasized the importance of the monetary aggregates as an intermediate target of monetary policy for good reason. Until Fed officials can be confident that the relationship between M2 and nominal GDP is stable again, it is risky to make strong inferences about the economy and the appropriateness of monetary policy based upon fluctuations in money supply growth.

With inflation subdued, the costs of placing a low weight on money supply growth and waiting for more information are modest. If the increase does foreshadow a pickup in economic activity and higher inflation, such economic strength will soon be apparent. At that time, Fed officials will have better information on which to base their actions than a money supply signal that may still not be very reliable.

Bill Dudley

¹ For details, see "Equity Price Surge Implies Easier Financial Conditions," *U.S. Economics Analyst*, February 27, 1998.

Key U.S. Economic Data

	Latest Monthly Data				6 Mo Trend	12 Mo Trend	Next Release
	'98 Mar	'98 Feb	'98 Jan	'97 Dec			
Nonfarm Payrolls (ch. thousands)	-36	252	399	354	282	261	May 8
Unemployment Rate (%)	4.7	4.6	4.7	4.7	4.7	4.8	
Index of Hours Worked (% ch)	-0.7	0.6	0.8	-0.3	3.7	2.4	
Average Hourly Earnings (% ch)	0.3	0.6	0.3	0.0	4.6	4.0	
Producer price finished goods index (% ch)	-0.3	-0.1	-0.7	-0.2	-2.7	-1.8	May 13
Excluding food and energy	0.0	0.1	-0.1	0.0	-0.3	-0.1	
Consumer price index (% ch)	0.0	0.1	0.0	0.1	0.9	1.4	May 14
Excluding food and energy (% ch)	0.1	0.3	0.2	0.2	2.4	2.3	
Retail sales (% ch)	-0.1	0.7	1.0	0.5	4.3	3.1	May 13
Excluding motor vehicles (% ch)	0.1	0.6	1.5	-0.1	4.5	3.4	
Industrial Production (% ch)	0.2	-0.2	-0.2	0.3	3.4	4.3	May 15
Manufacturing	-0.2	-0.2	0.1	0.4	3.7	4.4	
Capacity utilization (%)	82.2	82.3	82.8	83.3	82.8	82.7	May 15
Manufacturing	80.9	81.5	82.0	82.3	81.8	81.7	
Housing Starts (annual rate, thousands)	1590	1635	1545	1540	1560	1508	May 19
Single-family	1238	1269	1225	1130	1192	1159	
Trade balance (billions, monthly)	--	-12.1	-11.6	-10.9	-10.6	-9.7	May 20
Merchandise	--	-18.6	-18.3	-17.7	-17.6	-16.7	
Factory Orders (% ch)	--	-0.9	0.6	-2.6	-0.1	2.5	May 6
Durable Goods	--	-1.1	1.6	-5.3	-0.9	3.6	Apr 28
Personal Income (% ch)	--	0.6	0.6	0.4	6.5	5.7	May 1
Wages and Salaries	--	0.9	0.8	0.5	8.9	7.2	
Purchasing Managers' Index (%)	54.8	53.3	52.4	53.1	54.0	54.9	May 1
Consumer Sentiment U Mich (Feb 66=100)	106.5	110.4	106.6	102.1	106.4	105.4	May 1
Conference Board (1985=100)	134.3	137.4	128.3	136.2	131.3	129.0	Apr 28

Note: Percentage changes are month to month for last four months, annualized for 6- and 12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- The magnitude of final income tax settlements will become easier to judge by the end of the coming week. We expect a sizable jump in receipts due to heavy capital-gains-related tax liabilities. If this occurs, then estimates of this year's budget surplus could be revised up significantly.
- In contrast, the March budget balance information should be quite unenlightening, with the deficit narrowing slightly from year-ago levels (April 21).

Economic Releases and Other Events

Date	Time	Indicator	Estimate		Last Report
			GS	Consensus	
Tue Apr 21	2:00	Federal Budget Balance (Mar)	-\$20.0 Bll	-\$15.5 Bll	-\$21.3 Bll

- Fed Chairman Alan Greenspan testifies before the National Bipartisan Commission on the Future of Medicare (Mon, Apr 20 -1:00)
- Treasury Announces 2- and 5-Year Notes (Wed, Apr 22 - 2:30)
- Treasury 1-Year Bill Auction (Thu, Apr 23)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.8%	5.9%	6.2%
Forward	5.7	5.7	5.8
2 Yr T-Note	5.6	5.8	6.2
Forward	5.6	5.6	5.6
10 Yr T-Note	5.7	5.9	6.2
Forward	5.6	5.6	5.7

Key Numbers in the Business Outlook

	1997	1998E		1997	1998E
	Q4	Q1	Q2		
Real GDP	3.7%	4.0%	2.0%	3.8%	3.3%
Ind. Prod., Mfg.	8.1	1.8A	4.8	5.6	5.4
CPI	2.1	0.5A	1.3	2.3	1.5
After-Tax Profits*	8.2	7.7	6.4	9.6	5.3
Unemployment	4.7	4.7A	4.6	5.0	4.5

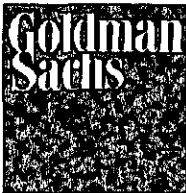
* Excluding inventory profits; adjusted for depreciation distortions.

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Benign Inflation, Less Robust Consumer Spending

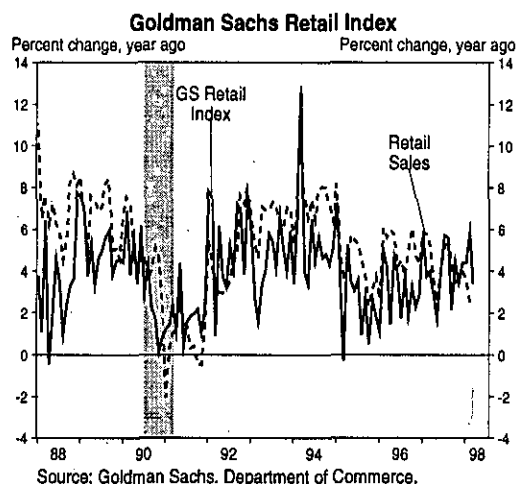
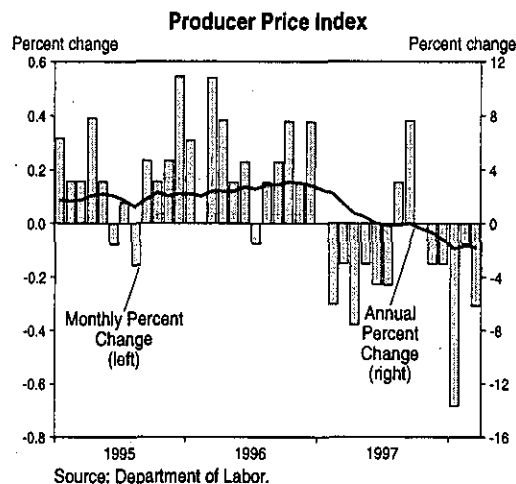
This issue of the U.S. Economics Analyst is in an abridged, four-page format. The center section and the tables of historical and forecast data have been omitted. Our regular format will resume with our next issue, dated April 17, 1998.

■ In the goods arena, deflation, not inflation, remains the watchword, as overall finished producer goods prices fell by 0.3% and core prices were unchanged in March. Moreover, there was no pressure further back in the pipeline. Both core intermediate and crude goods prices declined, which suggests that the favorable news on goods prices is likely to continue.

■ The Goldman Sachs Retail Index (GSRI) posted a 3.4% year-over-year gain in March, down from 5.9% in February. This reflects a return to more typical weather patterns and a late Easter compared to a year ago and foreshadows a soft retail sales report this coming week.

■ Commentary from Fed officials indicates less concern about Asia and a willingness to look through the soft March payroll employment report. Although this does not foreshadow any change in policy anytime soon, it is consistent with our view that the next change in monetary policy will be a tightening, not an easing.

■ The social security debate on privatization is beginning to heat up as a growing budget surplus makes such an option more feasible. However, the difficulty of developing a consensus, combined with congressional elections, makes it extraordinarily unlikely that any breakthrough will occur this year.



Trade Recommendations

- Stay long the June '98 T-bond futures contract, with a target of 124.00 and a stop on a close below 120.24.
- Get short the December '98 Eurodollar futures contract at 94.45 or above, with a stop on a close above 94.60 and a target of 94.00.

Contributors: Bill Dudley, Ed McKelvey,
John Youngdahl, Alex Patelis (212) 902-6807

Issue No: 98/15
April 9, 1998

E-mail Address: william.dudley@gs.com

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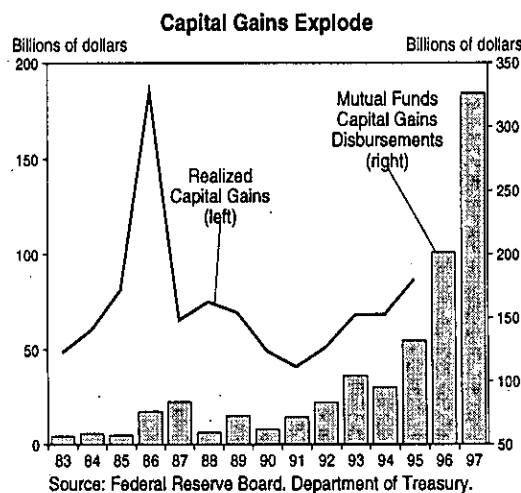
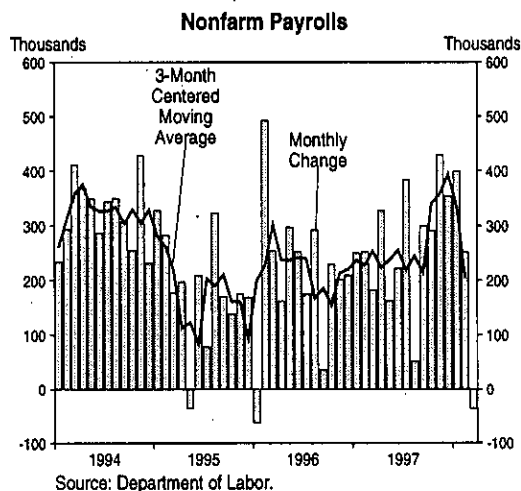
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Budgetary Bliss and Its Policy Portents

- The economic impact of the unseasonably warm winter weather is evident in both directions in the latest indicators. On the positive side, sales of new single-family homes hit an all-time high in February, while real residential construction outlays surged in both January and February.
- On the other side, the 36,000 decline in nonfarm payrolls reported for March reflected a payback of prior weather-inflated gains in both the retail and construction sectors. While last month's job count was lower than expected even setting aside these factors, it does not signify a softening in labor-market conditions given that it followed half a year of upside surprises and has not been joined by a rise in claims for jobless benefits.
- Beyond the vagaries of weather, the evidence that domestic demand is winning the tug-of-war on U.S. growth continues to accumulate. This is most recently evident in the uptick reported by purchasing managers in March.
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Trade Recommendations

- Get short the December '98 Eurodollar futures contract at 94.45 or above, with a stop on a close above 94.60 and a target of 94.00
- Get long the June T-bond futures below 121.16, with a stop on a close below 120.24 and a target of 124.00.

Contributors: Bill Dudley, Ed McKelvey,
John Youngdahl, Alex Patelis (212) 902-6807

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April 3, 1998

E-mail Address: william.dudley@gs.com

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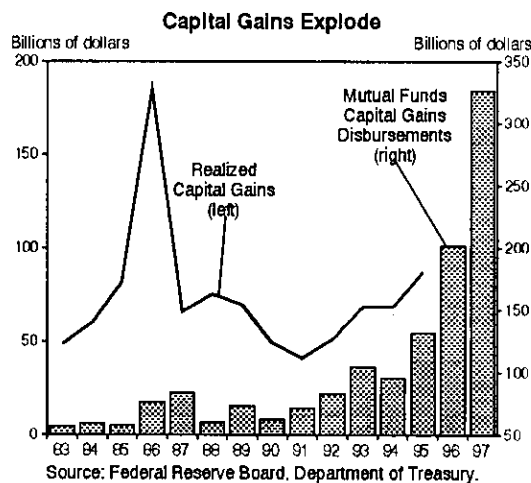
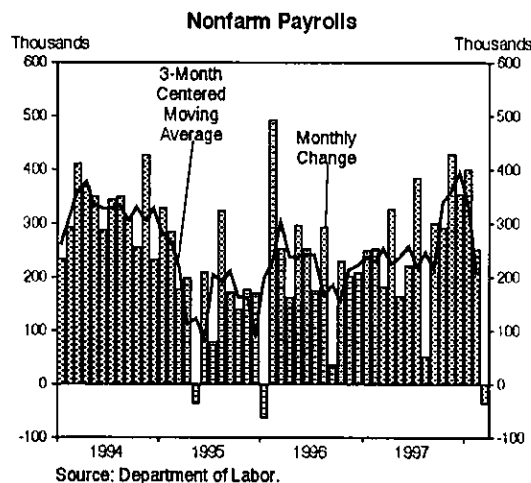
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I. Weekly Wrapup

Economic and Market Overview

The effects of an unseasonably warm winter continue to distort the data on U.S. economic activity, masking the underlying growth trend. On the positive side, indicators of home building and buying were robust in February. Sales of new single-family homes hit an all-time high, as did turnover of existing homes, while real spending on residential projects jumped 1.1% in February on top of an upward-revised 2.1% gain in January. However, total construction outlays have risen much less rapidly in recent months, as the effects of lower interest rates and unseasonably warm winter weather on business and government building projects are less immediate and pronounced.

On the negative side, nonfarm payrolls fell 36,000 in March, pulled down in part by the payback of previous weather-inflated gains. As a rough index of that impact, the number of jobs at construction sites and retail establishments plunged 136,000 in March. Although correction for this setback still implies a smaller-than-expected pace of net hiring, we attach no significance to the surprise given that it followed half a dozen upside surprises in payroll growth. Notably, initial filings for unemployment insurance give no evidence of any shift in the pace of job creation.

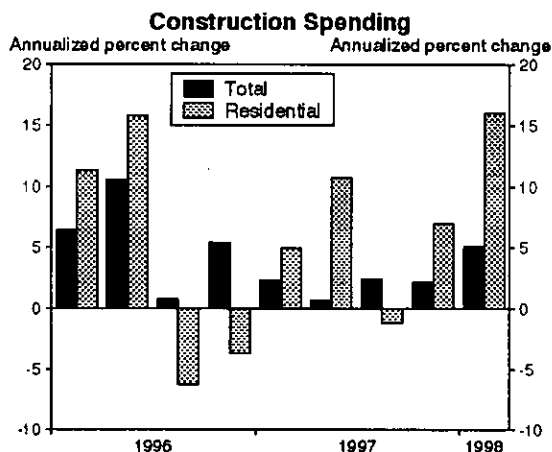
Cutting through the vagaries of weather, the evidence that strength in private domestic demand is winning the tug-of-war for U.S. economic growth continues to accumulate. In particular, the latest national survey of purchasing agents indicates that growth at U.S. factories, the sector of the economy that stood to lose the most from the Asian crisis, is already picking up

after a small sag during the late fall and winter. The NAPM composite index rose to 54.8% in March from 53.3% in February, with indexes of orders, output, and jobs all posting gains and the index of export orders holding steady. Although bookings for factory goods fell 0.9% in February, price weakness in the petroleum and textile industries masked firmer results in other sectors; in the key nondefense capital goods area, the 1.3% gain initially reported for orders in February was revised up to 1.9%.

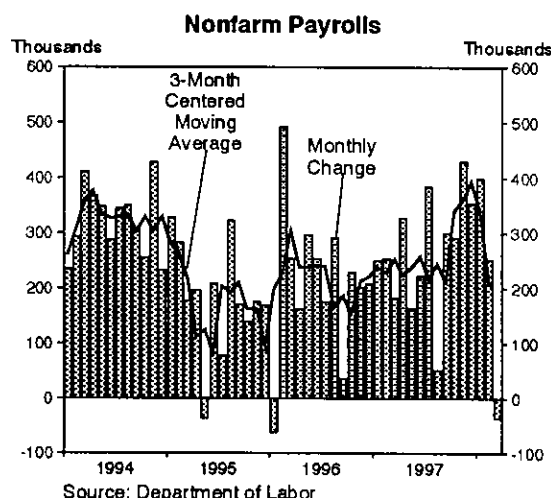
For the most part, the financial markets have taken the evidence of persistent strength in U.S. economic activity in stride, with bond yields moving down in the past few days and major equity indexes advancing to new all-time highs. Key to the market's behavior is the presumption that the strength will not lead to a major tightening in monetary policy, although some market participants have begun to talk about small interest rate increases down the road.

Federal Reserve Policy

Against this backdrop, the focus surrounding the March 31 meeting of the Federal Open Market Committee was not so much about its unsurprising decision to leave rates unchanged, but about whether it would reinstate the tightening bias that had been dropped in December. Although such a shift cannot be firmly ruled out, it seems premature given the high degree of uncertainty expressed by the Committee at its February meeting—uncertainty due mainly to the unknown effects of the Asian crisis. The panel also seemed unfazed by the pickup in labor compensation inflation at yearend, writing it off to “nonrecurring



Note: 1998 Q1 based on January/February.
Source: Department of Commerce.



Source: Department of Labor.

developments in a limited number of industries.” Although the data released since that meeting reveal surprisingly little impact from the Asian crisis, there is comparatively little new information to alter Fed officials’ perceptions of wage and price trends. Thus, while we ultimately expect them to lift rates later this year, we suspect that adoption of a directive tilting in that direction is still a few meetings off.

Fiscal and Political Developments

The highway legislation headed toward House/Senate conference shows how hard it will be for Congress to stick to its budgetary diet now that the zero deficit target has been achieved. The House-passed \$218-billion measure breaches the pay-as-you-go rules by some \$33 billion over a six-year horizon. While this hardly constitutes massive fiscal stimulus, amounting to less than 0.1% of GDP, it could be the camel’s nose in the tent with respect to compromising the rules that were instrumental in getting to balance in the first place.

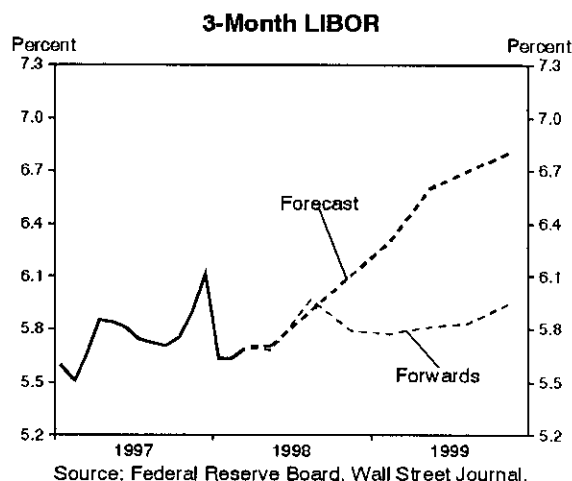
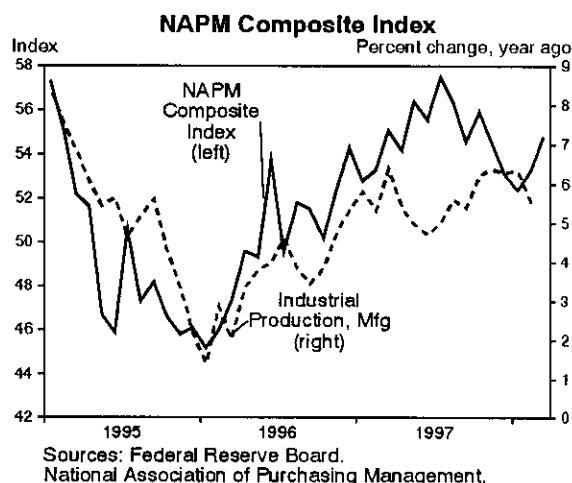
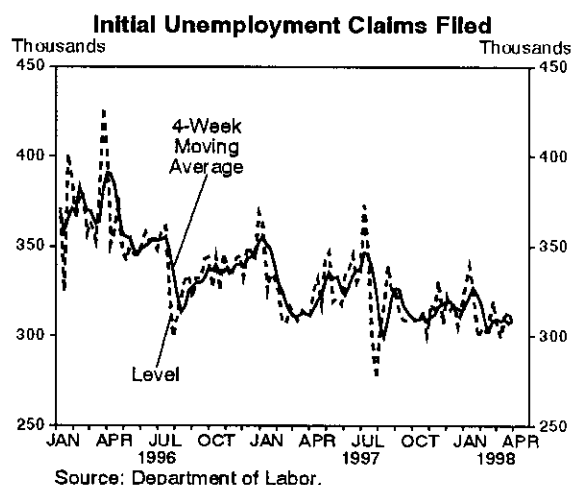
President Clinton received some good news this past Wednesday when a federal district court judge threw out Paula Jones’ sexual harassment suit against him, and financial markets breathed a sigh of relief at the prospect of reduced policy paralysis in Washington. However, this decision does not necessarily spell the end of the president’s problems. The inquiry by special prosecutor Kenneth Starr will continue, and Speaker Gingrich has indicated that the dismissal of the lawsuit will not deter the House from considering whether impeachment proceedings are warranted.

Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

The sharp rally in the front end is already overdone, as the probabilities still favor Fed tightening (though not soon) over easing. However, friendly inflation, consumer spending, and housing data could cause the short end to become even more overextended. As a result, we would look to get short the December ’98 Eurodollar futures contract should it reach 94.45 or higher, with a stop on a close above 94.60 and a target of 94.00.

On the long end, we are more positive, but would not chase the market at its current level. Instead, we would buy the June T-bond future should it pull back to 121.16 or below, with a tight stop on a close below 120.24 and a target of 124.00



II. Budgetary Bliss and Its Policy Portents

Within a question-and-answer format, this article addresses the current status and trends of the federal budget, and identifies some key issues with regard to this subject that financial market participants should bear in mind over the period ahead.

Q: What are the latest federal budget circumstances and forecasts?

Through five months of fiscal 1998 (October to February), the government has recorded a \$56.0-billion deficit, down from \$89.8 billion a year earlier. That amounts to an almost \$7-billion-per-month net improvement since last summer, an unusually rapid pace of change. On a trailing 12-month basis, the budget has been \$11.8 billion in surplus, whereas one year ago it was \$116.7 billion in deficit.

In the past couple of months, estimators at the Congressional Budget Office and the Office of Management and Budget have finally come to acknowledge the likelihood that the budget will be in surplus this year, for the first time in nearly three decades. On March 4, the CBO issued projections that anticipate surfeits in fiscal years 1998 and 1999 of \$8 billion and \$9 billion, respectively. We believe these forecasts are still much too conservative; last month, we further lifted our sights for the surplus, to \$40 billion this year and \$30 billion in 1999.

Q: What is driving the fiscal balance in such a positive direction?

The primary favorable influence on the budget has been a broadly robust pattern of revenues. Each of

the four largest categories of federal receipts, which together comprise more than 90% of the total, has risen sharply on a year-to-year basis over the first five fiscal months. Individual withheld income tax payments are up 10.3% for that interval, while non-withheld personal remittances have climbed 9.3%. Meanwhile, employment taxes and retirement contributions have risen 7.5%, and net corporate income taxes are 14.7% stronger. By contrast, just two months ago the OMB was expecting less than 5% collective growth this year in these categories.

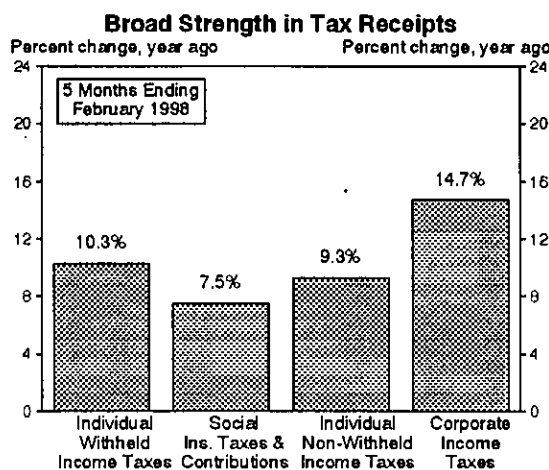
There have also been some unexpected expenditure savings. Last September, the CBO projected that Medicare, Medicaid, and unemployment insurance costs combined would rise more than 6% this fiscal year, yet through 40% of the period they have escalated only 3.5%. If these programs stay on the current path, their full-year spending shortfall relative to forecast would come to about \$9 billion.

Q: How high could the budget surplus grow this year, under best-case assumptions?

If the pace of year-to-year improvement in the October 1997/February 1998 time frame is extended through September, the full-year surplus will total about \$60 billion, or 0.7% of GDP. Another way of addressing this question is with respect to the timing of revenues within the year. In fiscal 1997, only 37.2% of total federal receipts were tallied by the end of February, the lowest percentage since 1981, and down from 38.5% on average in the prior five years. The difference between a repeat of last year's experience of late-arriving revenues and a reversion to the 1992-1996 norm would be almost \$60 billion in extra taxes. Should the result be favorable once again, and if aggregate spending stays on its present trend, we calculate that the surplus could explode to about \$80 billion (1.0% of GDP).

Moreover, there are reasons to suspect that capital gains tax remittances this year will provide a windfall far beyond official expectations. It is very hard to estimate the likely volume of these receipts, since no figures on capital gains realized and taxes paid exist beyond 1995. At least four factors, however, weigh in favor of an upside surprise for these payments:

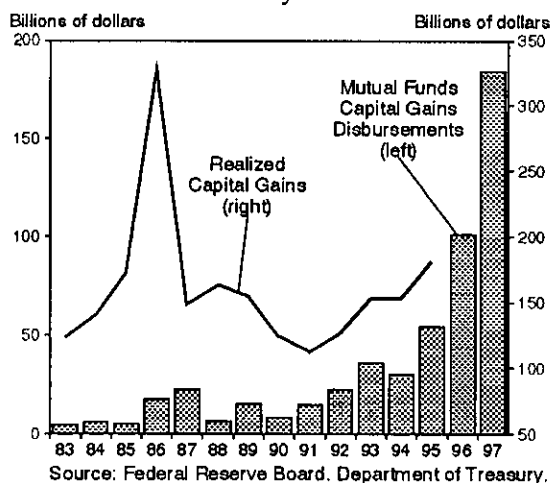
1. **Financial assets have appreciated sharply over the past few years.** The Wilshire 5000 stock-price index rose 105% percent between the end of



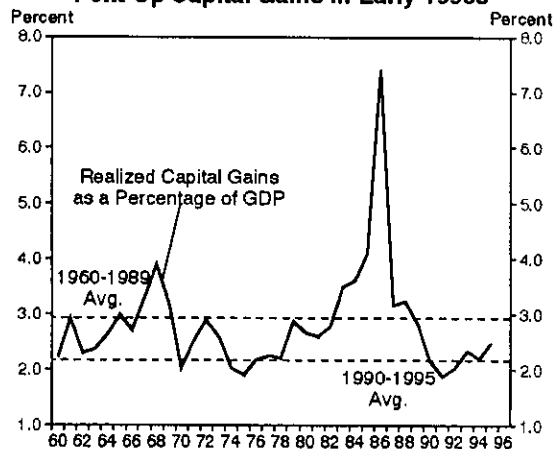
1994 and the end of last year, compared to a 12% cumulative gain in the prior three years.

2. **Realized capital gains as a percent of GDP** were low in 1990-1995, suggesting a potentially high volume of pent-up gains. Over those six years, the percentage averaged only 2.2%, compared to 2.9% in the prior 30 years. Hence, a backlog of unrecognized gains totaling as much as 3%-4% of GDP may have developed in this decade, perhaps as a function of the higher average maximum capital gains tax rate in 1990-1995 (28.9%) versus the prior decade (23.2%).
3. **Tax rates on capital gains were reduced appreciably last May, possibly unleashing some of these unrecognized gains.** The last two times that capital gains tax rates were lowered materially—in the late 1970s and again in the early 1980s—there were notable increases in gain-taking activity relative to GDP.
4. **The shift toward mutual funds as a preferred vehicle of equity ownership among households implies a faster recognition of taxable gains.** Those funds regularly take capital gains and pay them out to shareholders, whereas individuals can and do delay recognition of gains in self-managed portfolios. Data from the Federal Reserve's flow of funds accounts show an explosion in mutual fund capital gains disbursements over the past few years; the 1997 volume (\$184.1 billion) was up 82% from a year earlier and 410% from 1993.

We suspect that realized capital gains last year soared into the \$400-to-\$500-billion range, compared to \$180.1 billion as recently as 1995. That would



Pent-Up Capital Gains in Early 1990s



suggest \$80-\$90 billion of total capital gains tax revenues, approximately \$15-\$25 billion more than we estimate were received in fiscal 1997. Such a prospective windfall, in conjunction with the most optimistic interpretation of other recent revenue and spending trends, gives rise to the possibility of a fiscal 1998 surplus as high as \$100 billion!

Q: Are budget trends likely to remain this favorable beyond the next six months?

Capital gains tax receipts may tail off somewhat next year, given that pent-up gains can only be realized once, and the pace of stock price advances could taper from the break-neck 1995-1997 rate. In other respects, however, the current rosy fiscal environment should persist for a while. Now that the budget is in surplus, a continuation of at least moderate real economic growth will keep total revenues on a solid upward path. Meanwhile, discretionary federal spending is subject to tight annual caps through 2002, and net interest expense may begin to decline as marketable Treasury debt supplies shrink rapidly.

There is another special factor which could generate extra tax revenues in coming fiscal years. Under the Taxpayer Relief Act of 1997, individuals are entitled to roll their existing Individual Retirement Account (IRA) balances into a new "Roth IRA," where contributions are made on an after-tax basis and no taxes are owed on withdrawals taken after age 59½ where the account has been open for more than five years. Rollover transactions, however, are subject to taxation at ordinary income tax rates. For such shifts that occur in 1998, there are special rules allowing the resulting tax liabilities to be spread over four years. At the end of 1996, the total value of IRA and Keogh accounts in the United States was \$1.4 trillion; by the

end of last year, we estimate they topped \$1.7 trillion. This creates the potential for significant extra revenues from rollovers into Roth IRAs; for example, if 20% of all IRA/Keough funds are moved into Roth IRAs this year, then based on an assumed 20% average ordinary income tax rate, \$65-\$70 billion of extra federal revenues will be generated from this source over the next four years.

Q: How will the politicians in Washington deal with these unexpected surpluses?

Up to now, the extra revenues being generated by a booming economy have been retained by the federal government, rather than spent or rebated via tax cuts. Through tactical maneuvering, the president and congressional leaders have boxed each other into preserving what they believe will be a small surplus for the benefit of popular entitlement spending programs with questionable long-range actuarial prospects—Social Security and Medicare. This political standoff has allowed the nation's fiscal position relative to GDP to improve markedly, draining funds from the private sector and thereby providing a damper on what has nonetheless been robust domestic final demand growth.

Whether or not this practice of "saving the surplus" remains in place is a crucial issue for the U.S. economic and interest rate outlook. The larger the surplus grows, the harder it will become for the politicians to resist temptations to enact bigger tax cuts or relax spending constraints, particularly as the mid-term congressional elections in November and the 2000 presidential battles approach. One sign that this is already occurring: the \$218-billion, six-year transportation spending bill now moving through Congress, which would push discretionary outlays well above previously budgeted levels.

Were there to be a significant recycling of surplus funds to the private sector, the economy would lose an important internal braking mechanism at the very time resource margins (particularly for labor) are stretched taut. That would greatly increase pressure on the Federal Reserve to raise interest rates, as monetary policy would become the major—perhaps only—source of restraint on runaway growth and deteriorating inflation. For this reason, financial market participants should be highly sensitive to any signs of a shift in the national political dialogue about budget policy as the impressive magnitude of this year's surplus becomes more widely recognized.

Q: To what extent is recent money supply growth strength related to special tax factors, such as heavy personal refunds?

Two different theories have been advanced as to how tax-related phenomena may be distorting money supply growth rates upward in early 1998. Neither appears to hold up under close scrutiny. Some analysts have asserted that the early-year monetary surge is tied to an acceleration of personal income tax refunds. As of mid-March, however, these refunds year-to-date were running only \$5.7 billion above the same period in 1997, and \$6.8 billion higher than in 1996. Even if all of those extra funds are being held in near-money accounts, they would explain only a small fraction of the recent surges in M2 and M3, which since the fourth quarter have exceeded \$100 billion and \$200 billion, respectively.

Another thought has been that taxpayers may be holding an unusually large portion of their assets in liquid balances due to their anticipation of huge tax liabilities in the spring. Yet, in the last two years during which there were unusual upward spikes in springtime tax payments—1987 and 1997—we did not see such a bulge in monetary growth. Growth rates for both M2 and M3 actually slowed in the first months of both those years from the prior trend.

No Money Growth Spike Before Other Heavy Personal Tax Payment Periods

	1986/1987	1996/1997	1997/1998
Growth in M2:			
September to December	9.3 %	5.6 %	6.9 %
December to March	3.8	4.6	8.6
March to June	3.0	4.1	n.a.
Growth in M3:			
September to December	7.4 %	8.8 %	11.6 %
December to March	4.7	8.1	11.8
March to June	5.8	6.7	n.a.

* Through March 23.

Q: What are the implications of the outstanding budget environment for the supply of U.S. treasury securities going forward?

We continue to believe the Treasury is lagging far behind budgetary developments with respect to its market borrowing activities, and that an overhaul of federal debt management will have to be undertaken before long. An extensive discussion of this topic can be found in "The Case for Less Frequent Treasury Note Sales," *U.S. Economics Analyst*, March 6, 1998.

John Youngdahl

Key U.S. Economic Data

	Latest Monthly Data				6 Mo Trend	12 Mo Trend	Next Release
	'98 Mar	'98 Feb	'98 Jan	'97 Dec			
Nonfarm Payrolls (ch. thousands)	-36	252	399	354	282	261	May 8
Unemployment Rate (%)	4.7	4.6	4.7	4.7	4.7	4.8	
Index of Hours Worked (% ch)	-0.7	0.6	0.8	-0.3	3.7	2.4	
Average Hourly Earnings (% ch)	0.3	0.6	0.3	0.0	4.6	4.0	
Producer price finished goods index (% ch)	--	-0.1	-0.7	-0.2	-1.4	-1.7	Apr 9
Excluding food and energy	--	0.1	-0.1	-0.1	0.4	0.1	
Consumer price index (% ch)	--	0.1	0.0	0.1	1.4	1.4	Apr 14
Excluding food and energy (% ch)	--	0.3	0.2	0.2	2.5	2.3	
Retail sales (% ch)	--	0.5	1.0	0.5	3.5	2.5	Apr 14
Excluding motor vehicles (% ch)	--	0.6	1.3	-0.1	4.4	3.2	
Industrial Production (% ch)	--	0.0	0.1	0.3	4.6	4.9	Apr 17
Manufacturing	--	0.0	0.3	0.4	5.4	5.5	
Capacity utilization (%)	--	82.7	83.0	83.2	83.0	82.8	Apr 17
Manufacturing	--	81.8	82.2	82.3	82.0	81.8	
Housing Starts (annual rate, thousands)	--	1636	1543	1540	1545	1498	Apr 16
Single-family	--	1270	1218	1130	1181	1150	
Trade balance (billions, monthly)	--	--	-12.0	-10.9	-10.1	-9.5	Apr 17
Merchandise	--	--	-18.8	-17.7	-17.3	-16.6	
Factory Orders (% ch)	--	-0.9	0.6	-2.6	-0.1	2.5	May 6
Durable Goods	--	-1.1	1.6	-5.3	-0.9	3.6	Apr 28
Personal Income (% ch)	--	0.6	0.6	0.4	6.5	5.7	May 1
Wages and Salaries	--	0.9	0.8	0.5	8.9	7.2	
Purchasing Managers' Index (%)	54.8	53.3	52.4	53.1	54.0	54.9	May 1
Consumer Sentiment U Mich (Feb 66=100)	106.5	110.4	106.6	102.1	106.4	105.4	May 1
Conference Board (1985=100)	134.3	137.4	128.3	136.2	131.3	129.0	Apr 28

Note: Percentage changes are month to month for last four months, annualized for 6- and 12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- In a replay of last month's producer price report, a sharp (3%) decline in energy prices should be the main factor pulling the overall index down. Food prices appear to have risen modestly. Otherwise, the report offers very little prospect for excitement (April 9).
- Look for March results from major retailers to be off somewhat from the strong year-to-year gains registered in January and February, as weather patterns were less unusual and a late Easter pushes spending into April (April 9).

Economic Releases and Other Events

Date	Time	Indicator	Estimate		Last Report
			GS	Consensus	
Tue Apr 7 7:00		Consumer Credit (Feb)	+\$4.0 Bll	+\$3.8 Bll	+\$2.9 Bll
Thu Apr 9	8:30	Producer Price Index (Mar)	-0.3%	-0.2%	-0.1%
		Excluding Food & Energy	+0.1%	+0.1%	+0.1%

■ Wholesale Trade (Tue, Apr 7 - 10:00)

■ Chain-Store Sales Results (Thu, Apr 9)

■ Treasury Inflation-Index Bond Auction
(Wed, Apr 8)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.8%	5.9%	6.2%
Forward	5.7	5.7	5.6
2 Yr T-Note	5.6	5.8	6.2
Forward	5.4	5.4	5.5
10 Yr T-Note	5.7	5.9	6.2
Forward	5.5	5.5	5.6

Key Numbers in the Business Outlook

	1997	1998E		1997	1998E
	Q4	Q1	Q2		
Real GDP	3.7%	4.0%	2.0%	3.8%	3.3%
Ind. Prod., Mfg.	8.0	4.4	4.8	5.6	5.4
CPI	2.1	0.7	1.9	2.3	1.8
After-Tax Profits*	8.2	7.8	6.2	9.6	5.5
Unemployment	4.7	4.7A	4.6	5.0	4.5

* Excluding inventory profits; adjusted for depreciation distortions.

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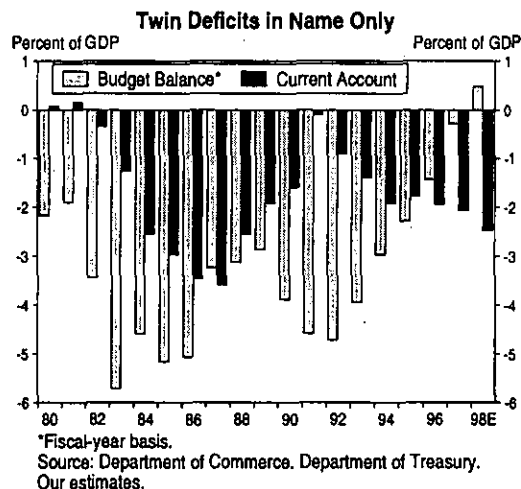
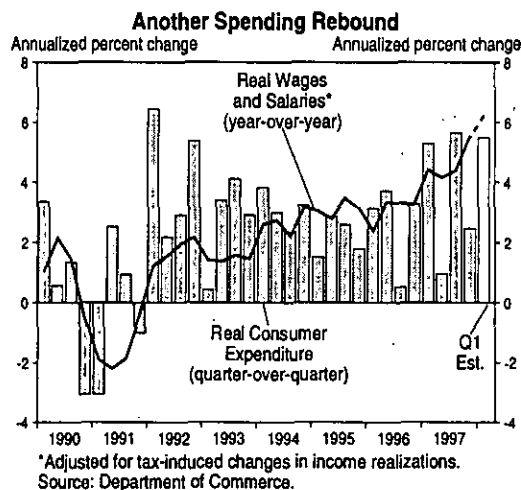
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The Twin Deficits: More Like Distant Relatives

- The U.S. economy continues to barrel ahead in the first quarter. Real consumer spending is on a 5½% annualized growth track, housing turnover has hit an all-time high, and solid gains in bookings for hard goods other than defense equipment and civilian aircraft reveal little effect from the Asian crisis.
- Even so, Fed officials are unlikely to restore the bias toward tightening in their policy directive at the March 31 FOMC meeting given the absence of inflationary pressure and the likelihood that unseasonably warm weather is boosting growth.
- The federal budget is moving into surplus even as the trade deficit widens further. This has confounded some observers, who thought that a balanced budget would lead to a smaller trade deficit and reduced dependence on foreign capital.
- As it turns out, the budget and trade balances are only loosely related. Although the elimination of the budget deficit has helped to raise domestic saving, the need for foreign capital inflows has nevertheless increased. This has occurred because domestic investment has risen even more quickly than saving, with the stock market's rise boosting investment and depressing household saving.
- At present, the U.S. current account deficit is not a problem. The money is coming in freely and the inflows appear well-spent, judging from the rise in domestic investment. However, problems could arise. Most importantly, the bigger the trade deficit, the greater the imbalance between the domestic economy and the external sector, making the U.S. economy vulnerable to a loss of foreign investor confidence.



Trade Recommendations

- At a strike price of 94.00, sell a 78-day put on the June '99 Eurodollar futures contract and buy a 169-day put on the September '99 Eurodollar contract at a net cost of 7 basis points.

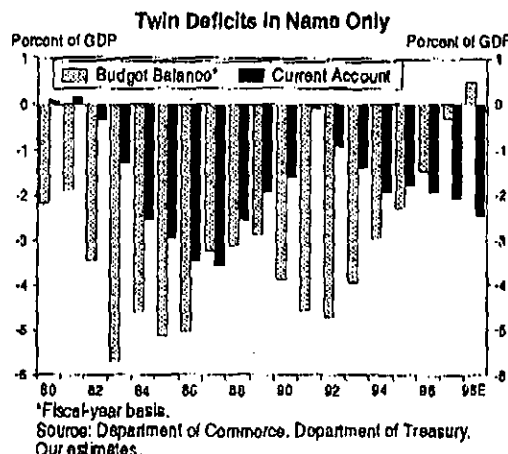
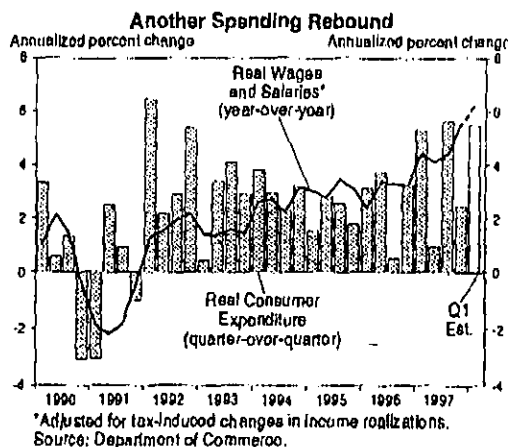
Contributors: Bill Dudley, Ed McKelvey,
John Youngdahl, Alex Patelis (212) 902-6807

E-mail Address: william.dudley@gs.com

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Important disclosures appear on the inside back cover

I. Weekly Wrapup

Economic and Market Overview

An agreement over the weekend among Saudi Arabia, Venezuela, Mexico and other OPEC and non-OPEC producers to cut oil output led to a brief rally in oil prices. However, our commodities analysts believe that these cuts, even if implemented, are not enough to bring the market into balance. Furthermore, this recent rally merely brings oil prices back to their mid-February level. We still believe that the sharp decline in energy prices since last October constitutes a net boost to the U.S. economy in the form of lower headline inflation, higher real wages and lower production costs—benefits that have not yet fully materialized. For all these reasons, we are not overly concerned about the recent bounce-back at this point.

On other fronts, this week's economic news provided further evidence of robust U.S. economic activity. For example, personal consumption rose 0.4% in February from an upward-revised January level, putting real spending on a 5½% annualized path for the first quarter. While unseasonably warm weather has undoubtedly inflated this quarter's spending to some degree, the strong and rising trend in real wage and salary growth—8.2% (at an annual rate) over the past three months and 6.2% over the past twelve—attests to the strength of the fundamentals underlying such spending. Meanwhile, sales of existing homes, aided by falling mortgage rates, warm weather, and a booming stock market, jumped 8.7% to a new all-time high of 4.75 million units annualized. This indicates that monetary policy is currently not restraining the interest-rate sensitive sectors of the economy.

Moreover, although orders for durable goods dropped 1.7% in February, this masked a 1.3% increase in non-defense capital goods orders excluding aircraft and a further increase in related backlogs, a fact that troubled the bond market. With orders continuing to rise four months into the Asian crisis, it is becoming increasingly clear that domestic economic momentum has overwhelmed any order cancellations from Asia.

Final figures for fourth-quarter GDP show that the U.S. economy expanded at a 3.7% annual rate, down only slightly from the previously estimated 3.9% rate. However, after-tax corporate profits (adjusted to remove inventory profits and depreciation distortions) slipped 0.8% to a level 8.2% above the year-earlier reading. For the year as a whole, this profit gauge rose 9.6%, the first single-digit gain since 1992.

Federal Reserve Policy

With the domestic economy seemingly winning the tug-of-war with Asia, the likelihood of Fed easing now appears very low. In fact, we would not be surprised if Fed officials were to begin voicing such an opinion in the weeks ahead. However, Tuesday's FOMC meeting should not bring any changes to monetary policy. A reinstatement of the asymmetric directive biased toward tightening seems premature at this point given both the absence of inflationary pressure and the likelihood that unseasonably warm weather boosted growth in the first quarter.

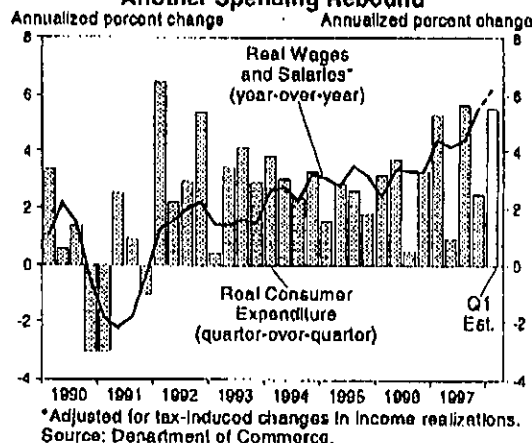
Fiscal and Political Developments

The news on the U.S. federal budget situation just keeps getting better. In February, the Treasury ran a

Despite Recent Uptick, Oil Prices Remain Low



Another Spending Rebound



\$41.8-billion deficit, compared to \$44.0 billion in the same month a year earlier. So far in fiscal 1998, the budget shortfall has totaled \$56 billion, down from \$89.9 billion in the same interval of fiscal 1997.

These figures virtually assure that the latest official estimates for fiscal 1998—a CBO estimate of an \$8-billion surplus as of early March 4 and an OMB estimate of a \$10-billion deficit as of February 2—are too pessimistic. Even under the conservative assumption that the March/September results merely replicate last year's results, the budget would be \$13 billion in the black. At the other extreme, the surplus could more than double our own relatively optimistic \$40-billion estimate if the government receives as high a percentage of its total revenues during the last seven months as it did last year and if current aggregate spending growth patterns persist.

Market Outlook and Comments on Value

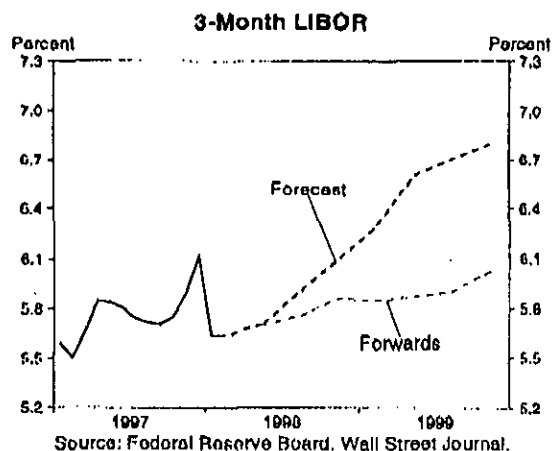
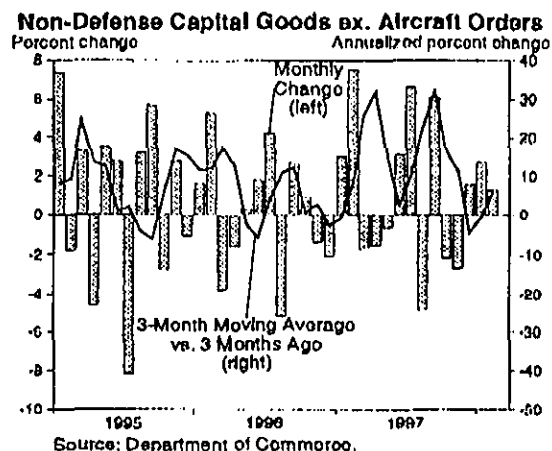
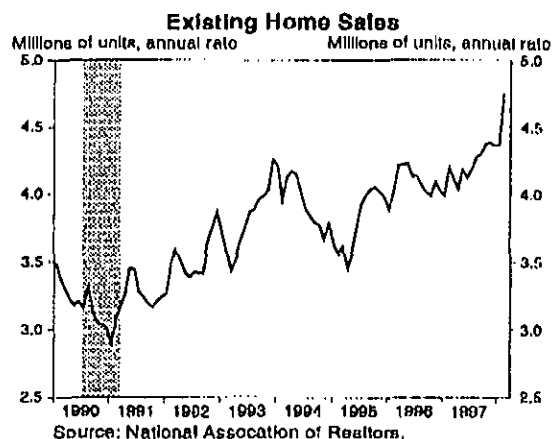
Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

We expect that a slowing of U.S. economic activity will become evident in coming weeks as the weather returns to more normal patterns. With inflation also likely to remain well-behaved over the near-term, this suggests that the long end of the Treasury curve could improve somewhat over this period. For this reason, we are considering going long T-bond futures, but are waiting for the recent sell-off to exhaust itself before initiating a new position.

We favor trades that sell short-end volatility over the next few months and buy forward volatility over the following few months. That is because we anticipate no change in monetary policy at least through June, but beyond that, the likelihood of a shift in monetary policy increases sharply.

We also favor trades that have a bearish medium-term bias because we do not think that the Asian shock will be large enough to derail the strong momentum of the domestic economy. In this regard, the next round of Humphrey-Hawkins testimony in late July may be very important in changing the market's mood that Fed policy is locked on hold forever.

One trade that combines these two ideas is the following: At a strike price of 94.00, sell a 78-day put option on the June '99 Eurodollar futures contract (11 basis points) and buy a 169-day put option on the September '99 Eurodollar futures contract (18 basis points) at a net cost of 7 basis points.



II. The Twin Deficits: More Like Distant Relatives

In 1998, the federal budget deficit will vanish as strong growth and high capital gains receipts generate a substantial surplus. Yet the current account deficit will widen as the Asian crisis and the strong dollar lead to a wider trade deficit. This has surprised many who anticipated that the elimination of the federal deficit would lead to reduced dependence on foreign capital inflows and a smaller current account deficit. Why is the United States becoming increasingly dependent on foreign capital despite the sharp improvement in its fiscal position?

The divergence between the paths of the budget balance and the current account deficit has a simple explanation. Although the elimination of the federal deficit has increased the supply of domestic saving available for investment, the need for foreign capital inflows has nevertheless increased because domestic investment has risen faster than domestic saving.

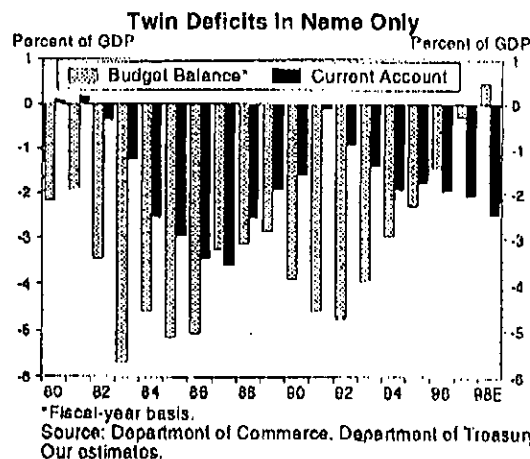
At this point, the increasing dependence on foreign saving should not create alarm. The capital is coming in freely. This can be seen by the appreciation of the dollar. Moreover, the money appears to have been put to good use, judging from the high return on capital in the U.S. relative to most other countries.

However, this does not mean one should be complacent either. If the confidence of foreign investors in the United States were to flag, then the capital would not flow into the United States so readily and the dollar would weaken. In that case, the inflation suppressed by dollar strength would become more visible, leading to a more hostile financial market environment.

The Rise of the Twin Deficits

The idea of budget and trade deficits whose fates were forever intertwined had its genesis in the 1980s. The massive shift in fiscal policy toward stimulus, reflecting a 23% cut in personal income tax rates between 1981 and 1983 and a sharp increase in defense spending, led to rapid economic growth, high real interest rates, and a rising trade deficit.

The increase in the federal deficit reduced the supply of domestic saving available for investment. Interest rates rose as the supply of saving fell short of the ex ante demand for investment. Foreign investors were attracted by the higher yields, but initially this just drove the dollar higher. It took time for the current



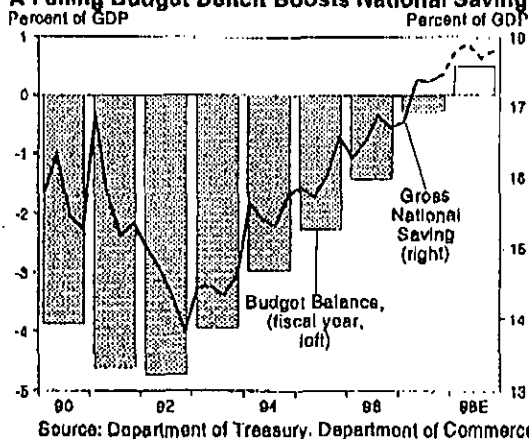
account deficit to widen to accommodate the increase in the demand by foreigners for U.S. assets. But eventually, the rise in the dollar caused a sufficient loss of competitiveness to create a large current account deficit. By the late 1980s, the U.S. seemed stuck with large, chronic budget and trade deficits.

Policymakers were unhappy about this dependence on foreign capital inflows, with the seminal event being the sharp drop in foreign confidence in the United States in 1987, which caused the dollar to weaken sharply and contributed to the stock market crash. In response, they came up with what appeared to be a straight-forward solution. If the federal budget deficit could be eliminated, then the pool of domestic saving available for investment would increase, reducing the need for large foreign capital inflows. U.S. interest rates would moderate, the dollar would fall, and the trade deficit would shrink, reducing the nation's reliance on foreign capital.

Why the Trade Deficit Persists

The policymakers have been successful in eliminating the budget deficit. But this has had no observable impact on the size of the trade deficit. In fact, the current account deficit is likely to reach a record level in dollar terms this year. As a percentage of GDP, the federal budget deficit has moved sharply lower since 1992, yet over this same time period, the current account deficit has widened significantly (see chart above). In recent years, the two deficits have moved in opposite directions, rather than behaved like twins. At best, they seem to be only distant relatives.

A Falling Budget Deficit Boosts National Saving

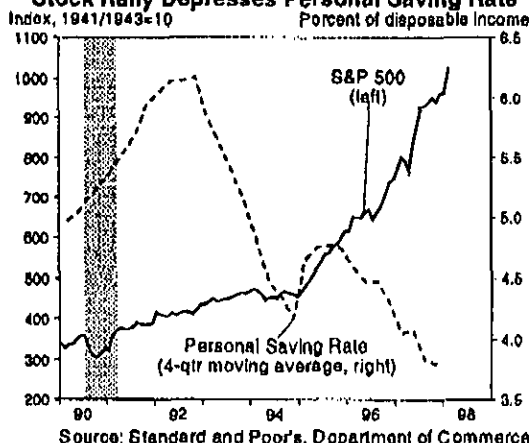


The elimination of the federal budget deficit has increased the supply of domestic saving available for investment (see chart above). The government's move into a surplus position should help push the gross national saving rate up to about 18% of GDP this year, compared to about 14% in the fourth quarter of 1992.

Despite this, the need for foreign capital has increased for two reasons. First, some of the fall in government dissaving has been offset by a lower personal saving rate. Second, gross private domestic investment has climbed sharply over the past few years. As a result, gross domestic investment continues to outstrip domestic saving, requiring large foreign capital inflows to plug the gap.

But why did the personal saving rate fall and domestic investment rise during this period? There are two explanations. First, the remarkable rise in the

Stock Rally Depresses Personal Saving Rate



U.S. equity market has led to a lower personal saving rate. The appreciation of equity prices has generated a sharp rise in household net worth. Now richer—at least on paper—households have responded by saving less out of current income, which has led to a decline in the personal saving rate (see chart below).

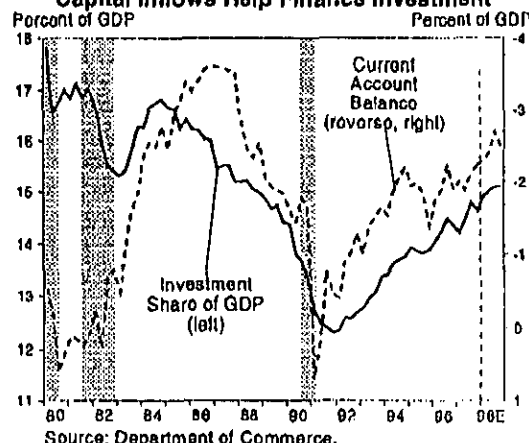
Second, the U.S. trade deficit has climbed because the U.S. economy has been growing quickly, relative to those of its major trading partners. Rapid growth has led to strong investment demand, which has outstripped the rise in domestic saving. This has necessitated a rise in capital inflows. As shown in the chart below, the 1990s have seen both a wider current account deficit and a rising investment share of nominal GDP. The foreign capital inflows have been needed to facilitate greater investment.

Is the Wide Trade Deficit a Problem?

In our view, the widening of the trade deficit should be no great cause for alarm for three reasons:

1. The capital is being supplied freely at a level of interest rates that is not too high for the domestic economy to operate effectively. This is evident by the high rate of resource utilization in the U.S. Moreover, the level of the current account deficit relative to the size of the economy is not particularly high—about 2½% of GDP in 1998.
2. The foreign capital inflows—while fungible—appear to be funding increased investment. Unlike the 1980s, when the investment share of GDP fell as the current account deficit was rising, during the 1990s, both the current account balance and the investment share of GDP have been moving in tandem (see chart).

Capital Inflows Help Finance Investment



3. The rise in the U.S. trade deficit reflects an excess of saving relative to investment abroad as much as it does a shortfall of saving relative to investment at home. The ability of the global economy to reallocate saving flows to economies with higher returns should be encouraged, not resisted.

Despite this relatively upbeat view, there are also a few dangers. First, as we have seen in Asia recently, economies that are dependent on foreign capital inflows are vulnerable should foreign investors lose confidence. If there were such a loss of confidence in the United States, then the dollar could weaken sharply. This could, in turn, lead to more inflation as the price pressures now suppressed by the dollar's strength resurfaced. In such a situation, the financial market environment could turn more hostile quickly.

Second, it is conceivable that foreign capital inflows could facilitate overinvestment in the United States. This would occur if there were an excess of global saving relative to investment and that excess were channeled into the United States. Under such circumstances, the outcome would be declining returns on U.S. capital, weaker earnings growth, and, eventually, a decline in the U.S. equity market.

Be Careful What You Wish For

The U.S. trade deficit is wide, in part, because the U.S. economy is healthy. The strength of the economy has led to strong investment demand, which has outstripped the domestic supply of saving. With this in mind, a narrower trade deficit may not be something to wish for.

Worrying about the trade deficit directly is barking up the wrong tree. If policymakers want to curb the trade deficit, they should take steps to increase domestic saving. In this regard, reducing the federal budget deficit was a sensible step in the right direction. The fact that it did not work in curbing the trade deficit does not mean that the policy was a failure. Instead, other factors intervened that were more powerful in pushing up the gap between domestic saving and investment. If a large budgetary imbalance had been allowed to persist, the trade deficit would almost certainly have been even larger and/or U.S. interest rates would have been higher.

Will the Gap Between the Trade and Budget Balances Narrow?

This depends mainly on how the gap between private domestic saving and investment evolves. If the gap

widens, then there will be more need for foreign capital. If the gap narrows, then the trade deficit is likely to shrink over time.

The performance of the U.S. equity market is likely to be the most important factor influencing the gap between domestic saving and investment. For example, a sharp stock market decline would probably lead to a much smaller imbalance between domestic saving and investment. Domestic saving would tend to rise as the household sector saved more out of income in response to the decline in net worth. Domestic investment would tend to fall as the economy slowed and the equity cost of capital rose. As the gap between domestic saving and investment narrowed, interest rates would fall. This would probably cause the dollar to weaken. Over time, the combination of slower growth and a weaker dollar would lead to a smaller trade deficit and reduced foreign capital inflows.

In contrast, as long as the stock market can bull ahead, a large imbalance between domestic saving and investment is likely to persist. Under such circumstances, U.S. interest rates need to be relatively high to keep the dollar propped up at a level that generates a sufficiently wide trade deficit to generate the foreign capital inflows to plug the gap.

Whether Congress and the Clinton administration continue to practice fiscal rectitude or respond to this year's surplus by cutting taxes and increasing spending will also be important. If fiscal rectitude ends this year, tax cuts and/or higher spending would tend to stimulate domestic activity in 1999. The federal government would also contribute less to the domestic saving pool. The gap between domestic saving and investment would widen. The result would probably be higher interest rates, a stronger dollar, and an even wider current account deficit.

Under this scenario, the gap between the budget balance and the trade balance probably would not change that much. But with the trade deficit widening further, the economy would be even more vulnerable to a loss in confidence. Put simply, the bigger the trade deficit gets, the harder it will be to unwind the imbalance later without precipitating a hard landing.

Bill Dudley

Key U.S. Economic Data

	Latest Monthly Data				6 Mo Trend	12 Mo Trend	Next Release
	'98 Mar	'98 Feb	'98 Jan	'97 Dec			
Nonfarm Payrolls (ch. thousands)	--	310	375	354	343	282	Apr 3
Unemployment Rate (%)	--	4.6	4.7	4.7	4.7	4.8	
Index of Hours Worked (% ch)	--	0.6	0.8	-0.3	5.3	3.2	
Average Hourly Earnings (% ch)	--	0.6	0.3	0.0	4.8	4.1	
Producer price finished goods index (% ch)	--	-0.1	-0.7	-0.2	-1.4	-1.7	Apr 8
Excluding food and energy	--	0.1	-0.1	-0.1	0.4	0.1	
Consumer price index (% ch)	--	0.1	0.0	0.1	1.4	1.4	Apr 14
Excluding food and energy (% ch)	--	0.3	0.2	0.2	2.5	2.3	
Retail sales (% ch)	--	0.5	1.0	0.5	3.5	2.5	Apr 14
Excluding motor vehicles (% ch)	--	0.6	1.3	-0.1	4.4	3.2	
Industrial Production (% ch)	--	0.0	0.1	0.3	4.6	4.9	Apr 17
Manufacturing	--	0.0	0.3	0.4	5.4	5.5	
Capacity utilization (%)	--	82.7	83.0	83.2	83.0	82.8	Apr 17
Manufacturing	--	81.8	82.2	82.3	82.0	81.8	
Housing Starts (annual rate, thousands)	--	1636	1543	1540	1545	1498	Apr 16
Single-family	--	1270	1218	1130	1181	1160	
Trade balance (billions, monthly)	--	--	-12.0	-10.8	-10.1	-9.5	Apr 17
Merchandise	--	--	-18.8	-17.7	-17.3	-16.6	
Factory Orders (% ch)	--	--	0.5	-2.6	3.0	4.2	Apr 2
Durable Goods	--	-1.7	1.5	-5.3	-2.3	2.9	Apr 28
Personal Income (% ch)	--	0.6	0.6	0.4	6.5	5.7	May 1
Wages and Salaries	--	0.9	0.8	0.5	8.9	7.2	
Purchasing Managers' Index (%)	--	63.3	52.4	53.1	54.0	54.9	Apr 1
Consumer Sentiment U Mich (Feb 88=100)	106.5	110.4	108.8	102.1	106.4	105.4	May 1
Conference Board (1985=100)	--	135.3	128.3	136.2	130.7	127.8	Mar 31

Note: Percentage changes are month to month for last four months, annualized for 6- and 12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- New home sales for February should weaken following January's surge. Despite this, the underlying trend in housing remains positive (March 30).
- The Federal Open Market Committee will almost certainly keep monetary policy unchanged at its upcoming meeting. Although there may be some discussion about whether to move back to an asymmetric policy directive biased towards tightening, most likely the meeting will not result in such a tilt to policy (March 31).
- The National Association of Purchasing Management's (NAPM) index is likely to decline slightly in March. The export orders component (47.9% in February) will also be closely scrutinized for evidence of the impact of the Asian crisis (April 1).
- Payroll employment growth should slow, reflecting more seasonal weather patterns in March, which should signal a correction in construction job growth. However, slower labor force growth is likely to cause the unemployment rate to fall slightly. The "day-count" bias limits growth in average hourly earnings (April 3).

Economic Releases and Other Events

Date	Time	Indicator	Estimate		Last Report
			GS	Consensus	
Mon Mar 30	10:00	New Home Sales (Feb)	-5.9%	-1.4%	+10.3%
Tue Mar 31	10:00	Chicago Purchasing Managers Index (Mar)	57.0%	n.a.	57.8%
	10:00	Consumer Confidence (Mar)	136.0	136.2	138.3
Wed Apr 1	10:00	NAPM Index (Mar)	52.5%	53.0%	53.3%
	10:00	Construction Spending (Feb)	+0.8%	+0.5%	+0.7%
	10:00	Leading Indicators (Feb)	+0.3%	+0.2%	0.0%
		Domestic Motor Vehicle Sales (Mar)	13.3M	13.1M	13.1M
Thu Apr 2	10:00	Factory Orders (Feb)	-0.6%	-0.2%	+0.6%
Fri Apr 3	8:30	Civilian Unemployment Rate (Mar)	4.5%	4.6%	4.6%
	8:30	Nonfarm Payroll Employment (Mar)	+250,000	+250,000	+310,000
	8:30	Average Hourly Earnings (Mar)	+0.1%	+0.2%	+0.6%

- FOMC Meeting (Tue, Mar 31)
- February FOMC Minutes (Thu, Apr 2 - 2:00)
- Treasury Announces Inflation-Indexed Bond (Wed, Apr 1 - 2:30)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.8%	5.9%	6.2%
Forward	5.7	5.8	5.8
2 Yr T-Note	5.6	5.8	6.2
Forward	5.7	5.7	5.7
10 Yr T-Note	5.7	5.9	6.2
Forward	5.7	5.7	5.8

Key Numbers in the Business Outlook

	1997	1998E		1997	1998E
	Q4	Q1	Q2		
Real GDP	3.7%	4.0%	1.3%	3.8%	3.1%
Ind. Prod., Mfg.	8.0	5.2	3.9	5.6	5.4
CPI	2.1	0.7	1.9	2.3	1.8
After-Tax Profits*	8.2	9.5	4.6	9.6	4.4
Unemployment	4.7	4.6	4.6	5.0	4.5

* Excluding inventory profits; adjusted for depreciation distortions.

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The Case of the Missing Inflation

■ Contrary to conventional economic wisdom, a drop in the unemployment rate has failed to spark inflationary pressures. In this week's center section we attempt to solve the case of the missing inflation. We find that a traditional output gap model would have failed to predict the decline in inflation over the past three years, and that well-behaved unit labor costs are not the culprit either.

■ The sharp decline in oil prices and the rise in the dollar do seem to be able to explain the current inflation puzzle—however, they create new ones in the past. We would need a reversal of these trends, at a minimum, for the inflationary clouds to start amassing again.

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■ Tactical budget policy maneuvering between the White House and Congress has strengthened the probability that large fiscal surpluses will be permitted to accumulate in fiscal years 1998-1999.

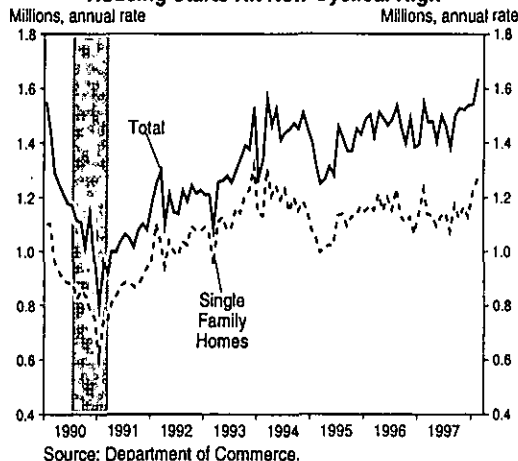
The Stars Would Have to Align for Inflation to Rise

	Oil	Dollar	Capacity Utilization	Unemployment Rate	Core Inflation
1992	*		*		
1993			*	*	
1994	*	*	*	*	
1995	*	*			*
1996	*		*	*	
1997			*	*	
1998				*	

A "star" indicates that the column variable is working in the direction of higher inflation.

Source: Department of Labor, Federal Reserve Board, WEFA, Goldman Sachs.

Housing Starts Hit New Cyclical High



Trade Recommendations

■ We continue to recommend neutral postures in both T-bond and Eurodollar futures for the time being.

Contributors: Bill Dudley, Ed McKelvey,
John Youngdahl, Alex Patelis (212) 902-6807

E-mail Address: william.dudley@gs.com

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March 20, 1998

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U.S.
Economic
Research

The Brave New Business Cycle: *Seven Years Old and Still Counting*

- The Best Economic Environment Ever
- Steady Growth, without Inflation and Still No Recession in Sight
- Structural Changes Important and Should Persist
- Good Policy and Luck Also Have Helped
- But Both Could Slip

William C. Dudley
Edward F. McKelvey

March 17, 1998

The Case of the Missing Inflation

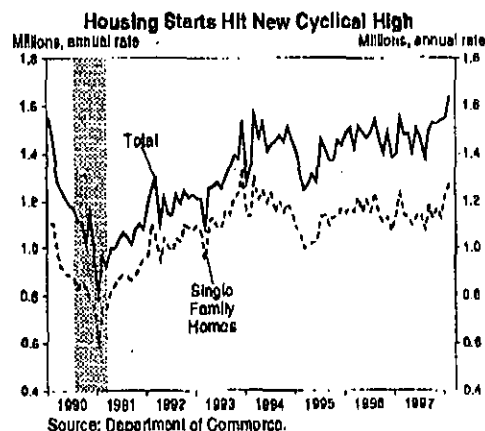
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	Oil	Dollar	Capacity Utilization	Unemploy- ment Rate	Core Inflation
1992	*		*		
1993			*	*	
1994	*	*	*	*	
1995	*	*			*
1996	*		*	*	
1997			*	*	
1998				*	

A "star" indicates that the column variable is working in the direction of higher inflation.

Sources: Department of Labor, Federal Reserve Board, WELFA, Goldman Sachs.



Trade Recommendations

- We continue to recommend neutral postures in both T-bond and Eurodollar futures for the time being.



I. Weekly Wrapup

Economic and Market Overview

While U.S. bond yields have stayed within a tight range over recent days, major stock price indexes have repeatedly set new records. Economic reports, meanwhile, continue to depict sturdy trends in domestic demands with mitigating influences from international trade and a slow pace of price increases.

Low mortgage interest rates, lean stocks of unsold new houses, and an abnormally mild winter in the northern tier of the country helped to fuel a surge in homebuilding last month. Starts jumped 6.0% to a nine-year high, and building permits kept pace with a 6.5% increase. Through February, single-family home starts are running 9.5% (not annualized) above the average for the second half of last year, which bodes for appreciable gains in residential construction outlays over the spring and summer months. Consumer demand, meanwhile, continues to appear well-supported by high levels of income growth and consumer sentiment, both of which are products of brisk business hiring and an upward tilt in annual wage awards. As first-time jobless insurance claims slipped below 310,000 in seven of the past eight weeks, the ABC/Money Magazine poll of household sentiment scaled new heights.

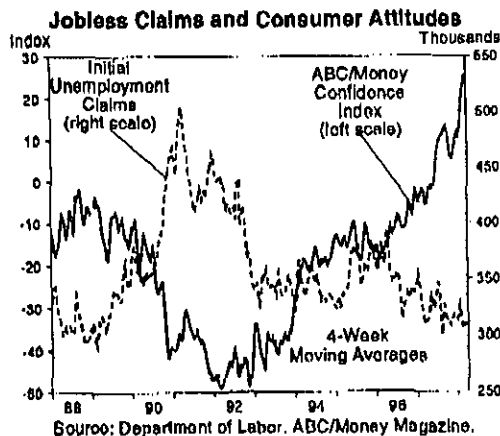
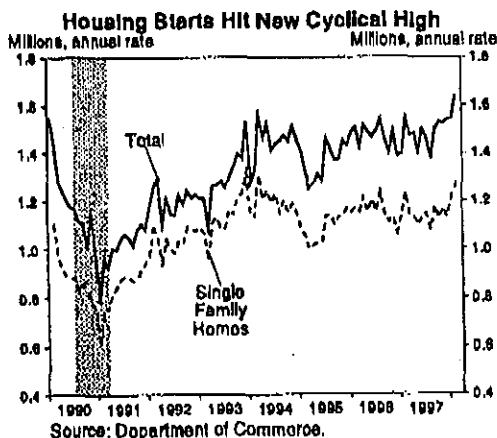
A sharp drop in exports of civilian aircraft from an inflated yearend volume was the main factor that widened the overall trade deficit to \$12 billion in January. The shortfall with Pacific Rim countries continues to expand rapidly, growing \$2.2 billion versus January 1997. On an inflation-adjusted basis, the January deficit in goods trade was \$3.5 billion

wider than the fourth-quarter average, which is consistent with the substantial degree of net exports deterioration we have been expecting for the first quarter. Reduced export momentum has combined with heightened inventory restraint to brake the previously robust factory growth pattern. Total industrial production failed to advance in February for the first time in 17 months; however, this partly reflected the vagaries of short-term changes in auto and truck assembly schedules. Excluding autos and trucks, factory output so far this quarter is still rising more than 4% annualized, but this marks a moderation from the vigorous pace in prior periods.

A steep energy price decline held the total CPI to a 0.1% increase last month; excluding food and energy, however, the CPI rose 0.3%, the most since last April. Higher airline fares contributed to a relatively firm 0.3% price rise for non-energy services.

Federal Reserve Policy

As they ponder the possible dangers that could arise from a protracted steady-hand interest rate strategy, Fed officials remain especially attentive to the increasing scarcity of labor and the related pickup in private wage growth. For that reason, the results of the Fed's latest anecdotal surveys, as presented in the March 17 "beige book," are cause for concern. According to the report, worker supplies are "stretched to the limit in many areas," leading to increased reliance on personnel supply service firms and, in some cases, limits on production schedules. This extraordinary labor market tightness "appears to have increased the degree of wage pressures



compared with recent reports," with some regions reporting "rather large wage increases," running as high as 15% at some temporary employment agencies. While it is highly doubtful that central bankers will choose to tighten credit to cool down employment demands anytime soon, this sort of information certainly sets the bar very high for the amount of weak economic data that would be needed to foster significant thoughts about easing.

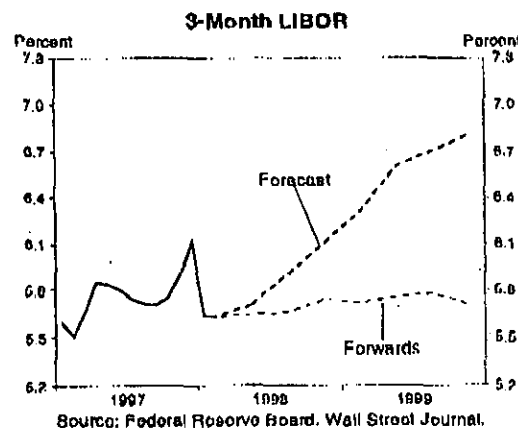
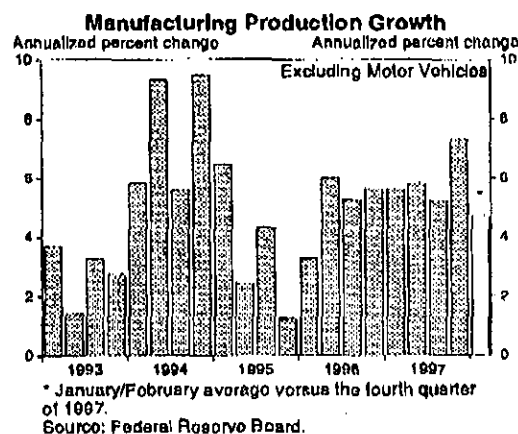
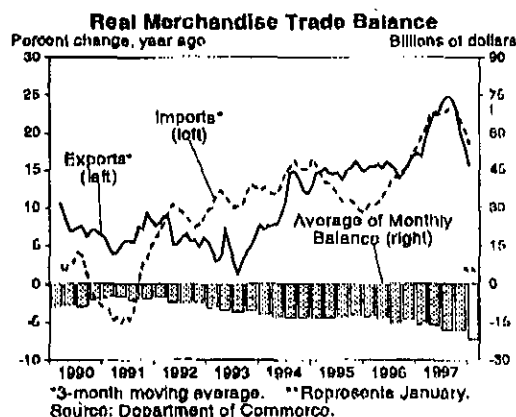
Fiscal and Political Developments

More by accident than design, Congress and the Administration appear to have tactically boxed themselves into a status quo federal fiscal policy for the next year, which would allow sizable surpluses to be realized. Pressure from GOP lawmakers for big tax cuts was blunted when the president called for all surpluses to be dedicated to enhancing Social Security program resources. Now, the Senate budget panel has drafted a plan that maintains the tight discretionary outlay caps negotiated last year, and also requires all extra revenues from tobacco tax increases to be held in reserve for Medicare, another highly popular entitlement program. This approach has frustrated Democratic advocates for enhanced domestic spending. With both sides blocked from moving forward on their main budget initiatives, there is a growing probability that matters will be allowed to drift throughout the year, and that burgeoning tax payments on higher incomes and capital gains will simply be permitted to overflow the federal coffers.

Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

We remain skeptical that either T-bond or Eurodollar futures prices will break out of their fairly narrow trading ranges in the very near term. The likelihood of an appreciable second-quarter GDP slowdown amid substantial Treasury debt redemptions and energy-depressed headline inflation data suggests little risk of a sharp upward yield spike anytime soon. At the same time, the progressive slimming of labor availability and upward-creeching wage growth serve as huge deterrents to consideration of Fed monetary easing, and that would appear to constrain the room for a further fixed income market rally. For now, we believe the best course is to stay neutral while awaiting signals of how these powerful competing forces will evolve during the spring.



II. The Case of the Missing Inflation

In spite of the gathering clouds in the form of extraordinarily tight labor markets, the inflation outlook remains stunningly positive as we enter the eighth year of the current economic expansion. Contrary to conventional economic wisdom, a drop in the unemployment rate has failed to spark inflationary pressures. In this week's center section, we attempt to solve the case of the missing inflation. We find that a traditional output gap model would have failed to predict the decline in inflation over the past three years, and that well-behaved unit labor costs are not the culprit either. The sharp decline in oil prices and the rise in the dollar do seem to be able to explain the current inflation puzzle—however, they create new ones in the past. We would need a reversal of these trends, at a minimum, for the inflationary clouds to start amassing again.

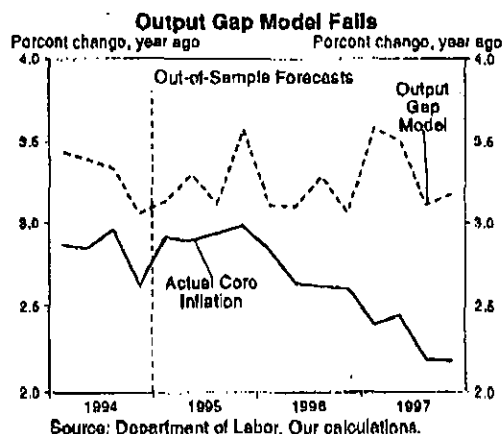
Strong Growth = Higher Inflation?

The knee-jerk reaction of a fixed income trader to a report showing strong growth is to sell bonds, since strong growth is presumed to lead to higher inflation. Economics 101 students learn that, as an economy expands beyond its "potential," excess demand creates strains on productive resources, thus bidding up their price and leading to inflation. Since the end of 1994 the economy has grown by an average rate of 2.9% annually, while creating nearly 5 million jobs, yet core inflation has fallen from 2.6% to 2.3%. Have the laws of economics been repealed?

1. A traditional output gap model would have failed to predict the decline in inflation.

To check whether there has been a favorable inflation surprise, we estimate a traditional output gap model. Such a model postulates that the inflation rate should be a function of the degree of tightness in the labor and capital markets (measured by the unemployment rate and the rate of capacity utilization, respectively), past inflation rates (since inflation exhibits a lot of inertia), as well as the speed at which those variables are changing over time. (The idea being that the faster capacity utilization is rising, the more likely that this will create bottlenecks in the economy.) We estimate this model for the period 1969Q2-1994Q4 using quarterly data and up to eight lags per variable¹ (the precise lag structure is selected

¹ We also estimated a full-fledged vector-autoregressive (VAR) model, but the results were similar, so we opted for the simpler, more intuitive approach. Also the

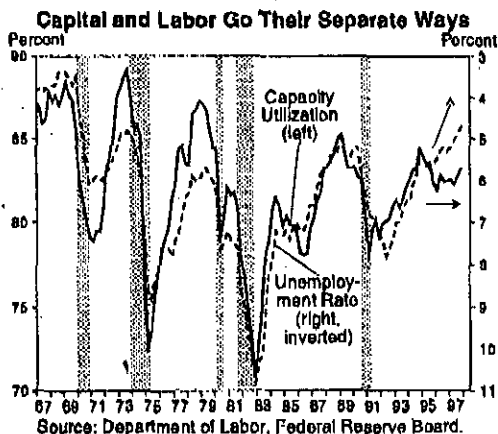


to maximize the regression's fit). We then use the fitted model to predict inflation over the following three years. Lo and behold, as the dotted line in the graph above shows, the model overpredicts inflation by about 1%: Despite a drop in the unemployment rate and a mostly flat capacity utilization rate, core inflation has managed to decline. With the employment report having cried wolf one too many times in the recent past, no wonder traders have begun to ignore it!

One reason for the model's error is the fact that the Bureau of Labor Statistics (BLS) has recently made changes to the way it calculates inflation. These changes have shaved over 0.3% from the annual inflation rate during the 1995-1997 period. This means that of the 1% inflation surprise, only 0.7% is in fact unaccounted for by our model.

Another explanation may be that labor and capital markets have gone their separate ways during the current economic expansion. As the graph at the top of the next page shows, tightness in labor has occurred without accompanying tightness in capital. The divergence in these paths is only likely to become more pronounced in the months ahead, as the Asian crisis impacts on the manufacturing sector.

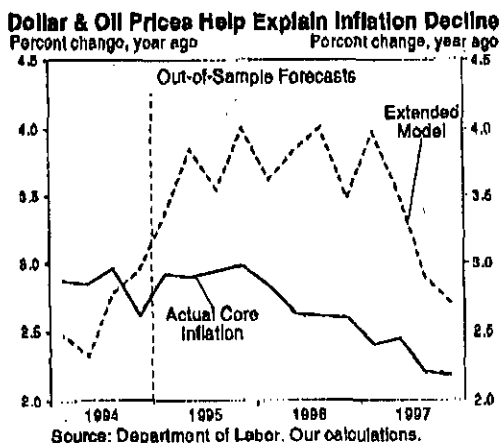
results did not change when we used the output gap directly as a right-hand side variable, instead of capacity utilization and the unemployment rate as separate variables.



In fact when we re-estimate our model to include the full 1969-1997 sample, we find that the regression coefficients now place a greater emphasis on capacity utilization and past inflation and a smaller emphasis on the unemployment rate compared to the pre-1995 coefficients. Furthermore, the model is now able to fit the behavior of inflation. This indicates that something has changed between the two periods. What could that be? We now add two more variables to our modeling efforts.

2. The sharp decline in oil prices and the rise in the dollar can explain the current inflation puzzle—however, they create new ones in the past.

So what if labor markets have been tightening? Other analysts point to falling oil prices and a booming dollar as possible solutions to the current inflation puzzle. To examine the validity of these claims we



extend our traditional output gap model to include changes in the real trade-weighted Goldman Sachs dollar index (which has the advantage of including emerging market currencies) and the price of oil.

The dotted line in the graph below plots the out-of-sample fitted values of such an extended model: It tells us that the rise in the dollar since mid-1995 and the decline in the price of oil go a long way in explaining the current rate of inflation. This model would have predicted an inflation rate of 2.7% in 1997, merely a half-percent above the actual recorded rate. Adjusted for the changes in BLS methodology, the model error is just 0.2%.

Although energy prices and the dollar are useful in explaining the current low rates of inflation, such a model cannot account for the experience of 1995-1996. Core inflation remained subdued during that period despite a run-up in oil prices and a decline in the dollar.

3. Well-behaved unit labor costs are not the culprit.

A recent paper by Cara S. Lown and Robert W. Rich, both of the Federal Reserve Bank of New York², finds that well-behaved unit labor costs can account for the drop in inflation since 1992.

Along those lines we extended our model to include changes in nonfarm business unit labor costs (which depend on changes in both compensation and labor productivity). We find that such a model does worse than both original models. Since 1994, unit labor costs have been increasing at about the same rate that they were increasing earlier on, whereas inflation has declined. So, contrary to the findings of Lown & Rich, we conclude that unit labor costs are not the culprit in the mystery of the missing inflation.³

Beyond Econometrics

A couple of additional observations are in order:

² Lown S. Cara, and Robert W. Rich, 1997, Is there an inflation puzzle? *FBNY Economic Policy Review*, pp. 51-69.

³ The difference in the conclusions is probably a result of the different time periods examined, as well as the difference in methodologies. Lown & Rich (1997) look at the post-1992 period, which was preceded by a sharp decline in unit labor costs. We are looking at the post-1994 period, which is not.



The Stars Would Have to Align for Inflation to Rise

	Oil	Dollar	Capacity Utilization	Unemployment Rate	Core Inflation
1992	*		*		
1993			*	*	
1994	*	*	*	*	
1995	*	*			*
1996	*		*	*	
1997			*	*	
1998				*	

A "star" indicates that the column variable is working in the direction of higher inflation.

Sources: Department of Labor, Federal Reserve Board, WEFA, Goldman Sachs.

1. The anemic nature of the economic recovery in its early stages is probably a factor behind the absence of inflationary pressures.

One of the most remarkable features of the current economic expansion is in fact how *weak* it has been! This might sound counterintuitive given the recent sharp increases in non-farm payrolls, and other indicators of robust economic growth. Yet people often forget that both the recession and the subsequent recoveries of the early 1990s were characterized by their anemic nature. This means that the current economic expansion has been very well-balanced, lacking the lopsided nature of past booms. This is an argument in favor of looking beyond "averages" into more microeconomic data, and we will be working along those lines in a future *U.S. Economics Analyst*. For example, our conjecture would be that the average capacity utilization rate is not a sufficient statistic in describing inflationary pressures (and we would make a similar argument for other indicators too). An economy can lack inflationary pressures, even at a high capacity utilization rate, if most sectors exhibit the same average capacity utilization rate. Similarly an economy can face inflationary pressures at lower average capacity utilization rates, if bottlenecks are present in some, but not all, sectors. The point is that bottlenecks are either binding (in which case inflation rises) or not (in which case the actual level of capacity utilization is irrelevant). The current economy is one in which, anecdotally, there are very few imbalances between different sectors, and can therefore exhibit an absence of inflationary pressures even at very fast growth rates.

2. Furthermore, inflation tends to exhibit a lot of inertia.

Or, to put it another way, the ride is long both on the way up, and on the way down. In the 1970s, higher oil prices, a weaker dollar, and higher inflation fed into each other, creating what became to be known as "stagflation." In the 1990s so far, we have experienced the reverse of such a vicious circle. Lower oil prices, a stronger dollar and lower inflation have fed into each other, creating what has come to be known as the "Brave New Business Cycle." At the end of the day, inflation and inflationary expectations exhibit a lot of inertia. This means that long-term trends in inflation, once established, are difficult to break.

3. For inflation to rise you need the stars to align, and, so far in 1998, this is not happening.

Just because our estimated models are not complete and exhaustive descriptions of reality does not mean they are useless! After all, the included variables are all statistically significant, and therefore worth paying attention to. The table above provides a useful checklist of inflationary pressures. How would you know when to start getting worried about inflation? This would require a drop in the unemployment rate, a rise in capacity utilization, a rise in oil prices, and a drop in the dollar. Such an alignment of the stars in 1994 led to a slight re-emergence of inflationary pressures. The situation is quite different today: So far in 1998, except for the low and declining unemployment rate, all other indicators remain tame.

Implications for the Inflation Outlook

Our commodities and currency analysts are expecting a rebound in oil prices and dollar weakness as the year unfolds. Such developments would put upward pressure on prices, and, indeed, our central forecast is for an increase in the headline inflation rate to 2.1% year-over-year by yearend. However, even under such a scenario, core consumer prices are unlikely to drift up much, given that core inflation tends to exhibit a lot of inertia. Thus, we think that the inflationary outlook remains favorable throughout 1998. However, if 1998 evolves as we expect and compensation costs keep drifting higher with the dollar and oil prices no longer dampening inflationary pressures, core prices could begin to move up more meaningfully in 1999.

Alex Patellis



Key U.S. Economic Data

	Latest Monthly Data				6 Mo	12 Mo	Next
	98 Feb	98 Jan	97 Dec	97 Nov	Trend	Trend	Release
Nonfarm Payrolls (ch. thousands)	310	376	354	429	343	282	Apr 3
Unemployment Rate (%)	4.6	4.7	4.7	4.6	4.7	4.8	
Index of Hours Worked (% ch)	0.6	0.6	-0.3	1.2	5.3	3.2	
Average Hourly Earnings (% ch)	0.6	0.3	0.0	0.6	4.8	4.1	
Producer price finished goods index (% ch)	-0.1	-0.7	-0.2	-0.1	-1.4	-1.7	Apr 8
Excluding food and energy	0.1	-0.1	-0.1	0.0	0.4	0.1	
Consumer price index (% ch)	0.1	0.0	0.1	0.1	1.4	1.4	Apr 14
Excluding food and energy (% ch)	0.3	0.2	0.2	0.1	-2.5	2.3	
Retail sales (% ch)	0.5	1.0	0.5	0.1	9.5	2.5	Apr 14
Excluding motor vehicles (% ch)	0.6	1.3	-0.1	-0.1	4.4	3.2	
Industrial Production (% ch)	0.0	0.1	0.3	0.8	4.8	4.9	Apr 17
Manufacturing	0.0	0.3	0.4	1.0	5.4	5.5	
Capacity utilization (%)	82.7	83.0	83.2	83.3	83.0	82.8	Apr 17
Manufacturing	81.8	82.2	82.3	82.3	82.0	81.8	
Housing Starts (annual rate, thousands)	1636	1543	1540	1523	1545	1498	Apr 16
Single-family	1270	1216	1130	1167	1181	1180	
Trade balance (billions, monthly)	-	-12.0	-10.9	-8.9	-10.1	-9.5	Apr 17
Merchandise	-	-18.8	-17.7	-15.7	-17.3	-16.6	
Factory Orders (% ch)	-	0.5	-2.6	2.4	3.8	4.2	Apr 2
Durable Goods	-	1.8	-5.3	4.7	6.4	6.6	Mar 25
Personal Income (% ch)	-	0.8	0.4	0.7	6.5	5.9	Mar 27
Wages and Salaries	-	0.7	0.4	1.2	8.8	7.4	
Purchasing Managers' Index (%)	53.3	52.4	53.1	54.5	54.0	54.9	Apr 1
Consumer Sentiment U Mich (Feb 98=100)	110.4	106.6	102.1	107.2	108.3	104.0	Mar 27
Conference Board (1995=100)	138.3	128.3	138.2	128.1	130.7	127.8	Mar 31

Note: Percentage changes are month to month for last four months, annualized for 6- and 12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- Declines during February in bookings for capital items, particularly in the volatile defense and aircraft sectors, will likely overwhelm a rebound in demand for consumer hardgoods, causing a moderate drop in overall durable goods orders (March 25).
- Strong employment and hourly earnings gains last month imply another solid expansion of personal incomes. Household consumption also should have posted a sizable advance, aided in part by favorable weather conditions (March 27).
- High levels of mortgage applications around the turn of the year point toward a further rise in the volume of existing home sales (March 25).

Economic Releases and Other Events

Date	Time	Indicator	Estimate		
			GS	Consensus	Last Report
Wed Mar 25	8:30	Durable Goods Orders (Feb)	-1.0%	-0.2%	+1.6%
	10:00	Existing Home Sales (Feb)	+0.5%	+0.2%	+0.7%
Thu Mar 26	8:30	Real GDP (Q4—Revised)	+3.9%	+3.9%	+3.9%
	8:30	Chain-Weight Price Index (Q4—Revised)	+1.4%	+1.4%	+1.4%
Fri Mar 27	8:30	Personal Income (Feb)	+0.5%	+0.6%	+0.6%
	8:30	Personal Consumption (Feb)	+0.5%	+0.5%	+0.4%

- Treasury 2-Year Note Auction (Tue, Mar 24 - 1:00)
- Treasury 5-Year Note Auction (Wed, Mar 25 - 1:00)
- APICS Survey (Thu, Mar 26 - 8:30)
- Help-Wanted Index (Thu, Mar 26 - 10:00)
- Treasury 1-Year Bill Auction (Thu, Mar 26 - 1:00)
- Consumer Sentiment—Final (Fri, Mar 27 - 10:00)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.8%	5.9%	6.2%
Forward	5.7	5.7	5.7
2 Yr T-Note	5.8	5.8	6.2
Forward	5.5	5.5	5.6
10 Yr T-Note	5.7	5.9	6.2
Forward	5.6	5.6	5.7

Key Numbers in the Business Outlook

	1997			1998E	
	Q4	Q1	Q2	1997	1998E
Real GDP	3.9%	4.0%	1.3%	3.8%	3.1%
Ind. Prod., Mfg.	8.0	5.2	3.9	6.6	5.4
CPI	2.1	0.7	1.9	2.3	1.8
After-Tax Profits*	12.6E	9.5	4.6	10.8E	4.4
Unemployment	4.7	4.6	4.6	5.0	4.5

* Excluding inventory profits; adjusted for depreciation distortions.

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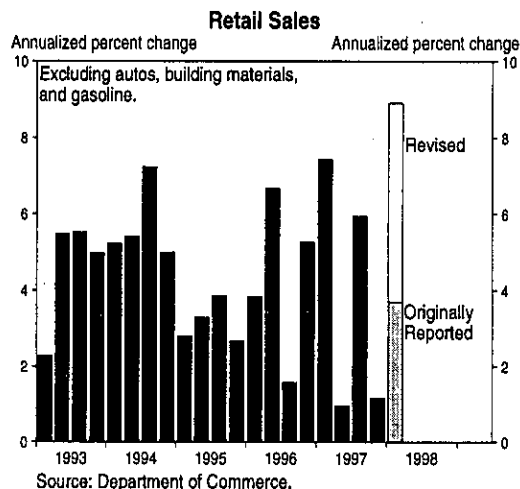
Warm Weather Heats Up Growth

■ We have raised our estimate for first-quarter real GDP growth to 4.0%, at an annual rate, from 2.5% as recently as one week ago. Significant gains in retail sales in February, coming on top of sharp upward revisions to preliminary data for January, imply that real consumer spending is on a 5½% growth track.

■ We estimate that about 1 percentage point of this growth is due to unseasonably warm winter weather, which has softened the (not seasonally adjusted) declines in construction activity and retail sales that normally occur at this time of the year. Individually, January and February ranked close to the top of the warmest such months on record; together, they have no precedent, at least in the last 104 years.

■ Although the winter has also been unusually wet, a factor that normally inhibits economic activity, the fact that much of this precipitation has fallen as rain rather than snow has probably made this less of a deterrent.

■ Weather's impact on growth should soon turn from positive to negative, as the completion of transactions forwarded into the first part of the year causes activity to fall from above its long-term trend to below that trend. Last year, for example, a warmer-than-normal winter followed by a cooler-than-normal spring caused spending growth to slow from 5.3% in the first quarter to 0.9% in the second. Even if this spring's weather is normal, we currently expect the pay-back of current strength to push real GDP growth temporarily into the 1%-1½% range.



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Southwest	94	57	82	7
Northwest	98	87	31	49
West	101	47	15	1
National	101	99	8	2

*1 = coldest or wettest.

Source: National Climatic Data Center.

Trade Recommendations

■ We would stay on the sidelines for the time being.

Contributors: Bill Dudley, Ed McKelvey,
John Youngdahl, Alex Patelis (212) 902-6807

E-mail Address: william.dudley@gs.com

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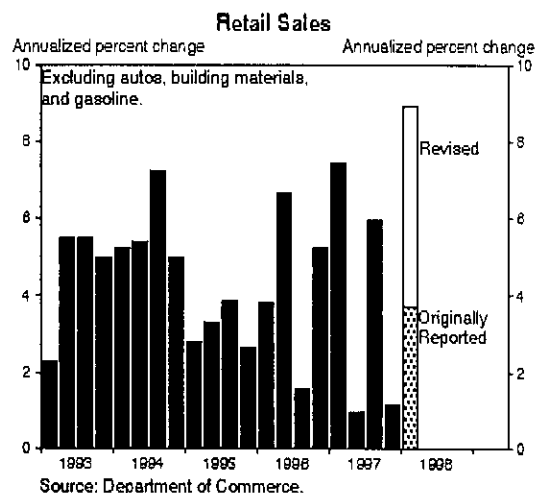
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I. Weekly Wrapup

Economic and Market Overview

Prices of U.S. equities and bonds have risen sharply in recent trading sessions despite signs of larger-than-expected gains in U.S. domestic demand. Investors either believe that these signs are merely a reflection of warmer-than-normal weather or are quite confident that the strength will not lead to higher inflation.

Retail outlays climbed briskly last month, rising 0.5% overall and 0.6% outside the motor vehicle sector. Moreover, sharp upward revisions substantially lifted the platform from which these spending gains were achieved. Sales of items other than vehicles, building materials, and gasoline were up 2.2% in January and February combined, and are rising at nearly a 9% annual rate thus far this quarter. Essentially all of this increase reflects higher volumes, given the virtual absence of price inflation in the retail goods sector. In light of these surprisingly robust results, we have sharply boosted our estimates for first-quarter growth in real GDP and consumer spending. We now reckon that real GDP is rising at a 4.0% annual rate (up from 2.5% just one week ago), with consumer spending up 5.5% (vs. 3.3%). Unusually warm winter weather has no doubt contributed to this strength; its effects are discussed in the center section on pages 4-6.

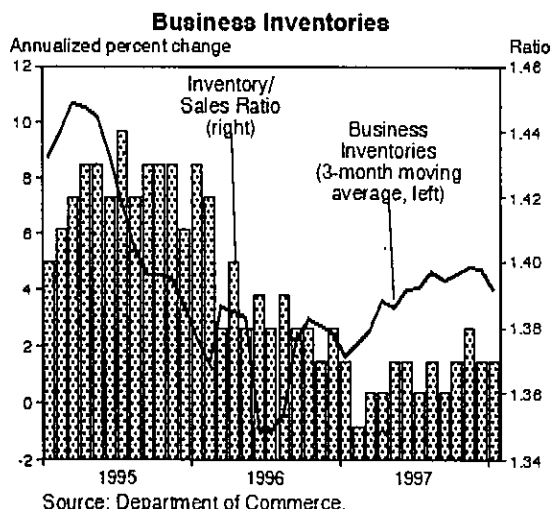
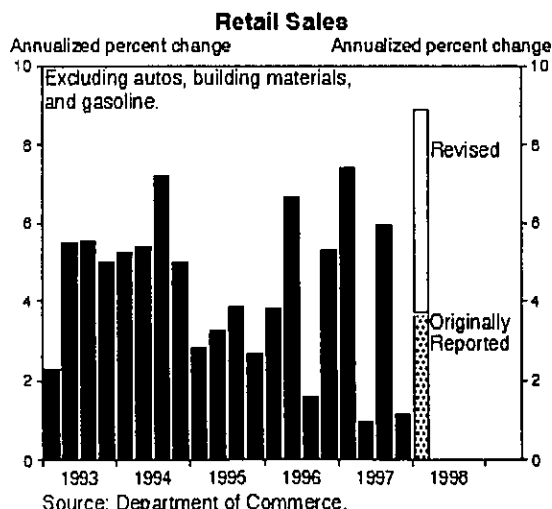
Aided by the pickup in final demand, businesses were successful in substantially slowing the growth of their inventories at the outset of 1998; in book value terms, stocks were flat in January, compared to a 0.4% monthly average rise from September to December. The breadth and speed of this stocking slowdown enhances the potential for required adjustments to last

quarter's rapid stockpiling to be completed without an abrupt downshift in domestic production.

Despite robust consumer activity and relatively lean inventory levels, prices of goods in the United States have remained very soft, especially for items purchased from abroad. Import quotes slumped 0.8% in February, bringing the year-to-year drop to 6.1%. Even when the big drop in petroleum costs is removed, import prices eased 0.3% last month and 3.3% over the past year. These declines have helped quell domestic producer prices also, by reducing materials costs and capping pricing flexibility for tradable goods. Thus, the core producer price index for finished goods edged up only 0.1% in February, while prices of partly processed goods other than food and energy slipped 0.1% for the third month in a row.

Federal Reserve Policy

Less than three weeks after Chairman Greenspan delivered his semiannual report on monetary policy to Congress, participants in the fixed income securities market seem to be disregarding or downplaying some of the more cautionary aspects of his commentary. Yields for many Treasury issues today are back down to or through the levels that prevailed before the Fed chairman-spoke on February 24. Yet, in the interim, there have been numerous signs that the concerns he voiced at that time about the potential for persistent above-trend growth to cause a further tightening in labor supplies and stiffer cost pressures are justified. Specifically, in this year's first two months there have been out-sized increases in payrolls (3.4% annual



pace), hours worked (8.7%), hourly earnings (5.9%), and retail outlays (9.1%), as well as improvement in a variety of manufacturing surveys. With stock and real estate prices surging and broad monetary aggregates soaring well above their target ranges, it is an open question just how long senior Fed officials will let their anxieties about instability in Asia override more traditional worries that domestic financial conditions are fostering behavior which, if unchecked, could undermine the long-term health of the economy.

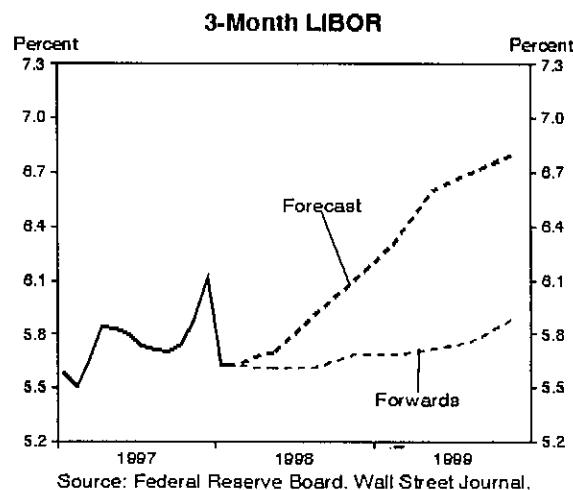
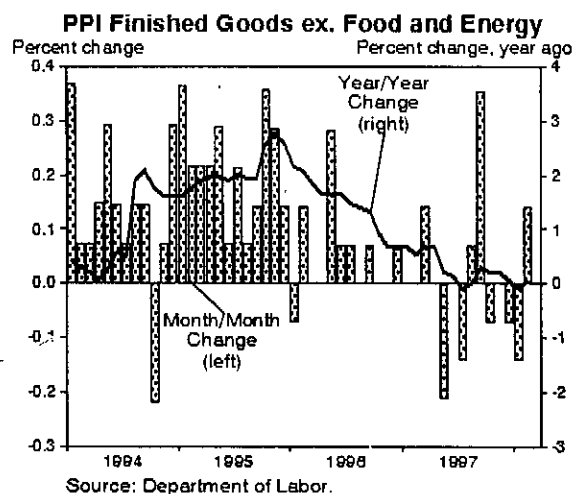
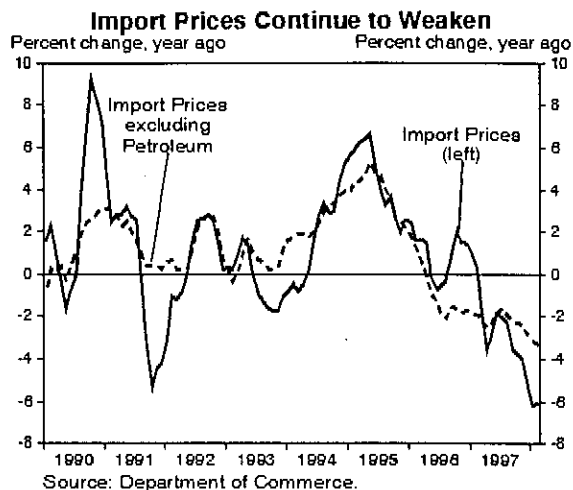
Fiscal and Political Developments

It is very unlikely that Congress will adopt a joint budget resolution for fiscal 1999 prior to the April 15 statutory deadline. Chairman Pete Domenici (R-NM) of the Senate Budget Committee has indicated that his panel will take up consideration of a plan sometime next week, less than one month before the targeted completion date. This framework will probably include only a slim reduction in taxes, with offsetting provisions that mitigate or offset its impact. In the House, by contrast, there is considerable sentiment in favor of deeper tax cuts. Reconciling the two visions will not be easy, particularly when lawmakers have an incentive to delay final agreements until they get a clearer sense of this year's projected fiscal results after April tax collections are counted. Therefore, this year's budget process will probably drift along at a leisurely pace well into the spring, with little in the way of new initiatives to distract the electorate from the favorable performance of the U.S. economy.

Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

It is hard to get enthusiastic about the market given the strength of domestic demand and the flatness of the yield curve. At the same time, a sharp sell-off appears unlikely. After all, the inflation news will remain excellent for at least a few more months as lower oil and import prices restrain prices more generally and the growth pace slows sharply as the weather effects, which have boosted activity in January and February, fade. Also, technically, the market should be in good shape as the Treasury pays down about \$100 billion of debt during the second quarter. As a result, a neutral posture seems appropriate for now. If the market rallies sharply, we would consider resetting shorts in the short end.



II. Warm Weather Heats Up Growth

Unusual weather is once again playing havoc with the U.S. economy. Although the fundamental factors underpinning U.S. economic growth remain solidly intact, the 4.0% annualized increase in real GDP we now estimate for the first quarter of 1998 (which we recently revised up from 2.5%) is getting a big boost from the fact that January and February were the warmest such period on record. These conditions have softened the sharp drops in construction activity and retail sales that normally occur at this time of the year, producing significant gains in both sectors on a seasonally adjusted basis.

Based on partial data, we estimate that the unusually warm weather will tack about 1 percentage point onto this quarter's annualized growth in real GDP. The ultimate effect could be larger, given that last year's unseasonably warm weather, which was obviously less extreme than this year's, appears to have added a similar amount to real GDP growth in the first quarter of 1997.

However, when it comes to meteorological influences on economic activity, the rule is that what goes around comes around. The fact that unusually warm weather is artificially boosting economic activity at the present time means that growth will fall below its underlying rate in the very near future, as activity returns to a level more in line with its fundamental determinants. In fact, it should drop below that level for a while, given that much of the added spending and construction spurred by warm weather has simply been pulled forward into the current quarter. Thus, above-trend growth should shortly be followed by below-trend growth, which could buoy financial markets to the extent that their willingness to ignore the strength does not already factor in the full effects of unusual weather in producing a downswing in growth.

Warm Weather Boosts Economic Activity

A few days ago, the National Climatic Data Center confirmed what we all have known for some time: This winter has been the mildest on record. In terms of average temperature across the nation, January was the fourth warmest in the last 104 years, while February was the sixth, as shown in the table above; taken as a whole, the two-month stretch apparently topped the list for such periods. Ranked by

Temperature and Precipitation Ranking, 1895-1998

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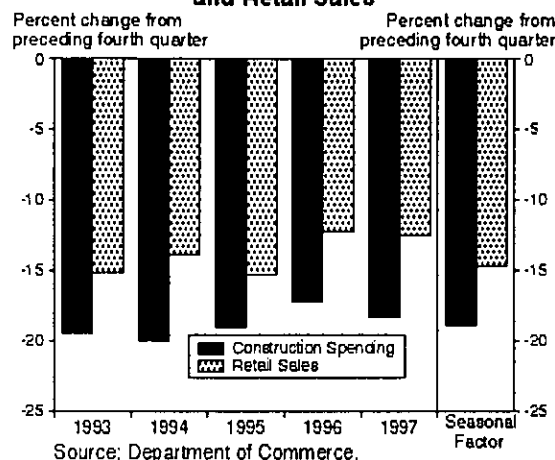
Source: National Climatic Data Center.

precipitation, January was eighth and February was second, making this winter also one of the wettest.

An unusually warm winter affects economic activity in three ways. First, it reduces the normal tendency for construction activity to drop sharply at this time of the year. Second, consumers are more inclined to get out and shop, go out to dinner, etc., if the weather is comparatively warm. Although heavier-than-normal precipitation often dampens both spending and construction activity, the fact that more of it came down as rain rather than snow probably made it less of a deterrent. Finally, warm weather cuts utility bills. This depresses output of electricity and natural gas and reduces demand for heating oil and coal, but it also frees up income for spending on other items. Thus, on balance, the net effect of this year's unusual weather is likely to be a boost to growth this quarter.

Moreover, the effects on seasonally adjusted data can be substantial because the (unadjusted) declines in construction activity and retail spending tend to be large and systematic at this time of the year, as shown in the chart at the top of page 5. Over the past five years, for example, real construction outlays have fallen consistently between 17.3% (not at an annual rate, in 1996) and 20.0% (in 1994). The seasonal factors used to remove this regular pattern from the data thus assume an average decline of about 19%. In the case of retail sales, the seasonal factors "expect" about a 15% drop. Therefore, declines that fall just 2½ percentage points short of these norms would imply an annualized gain on the order of 10%.

First-Quarter Declines in Construction Spending and Retail Sales



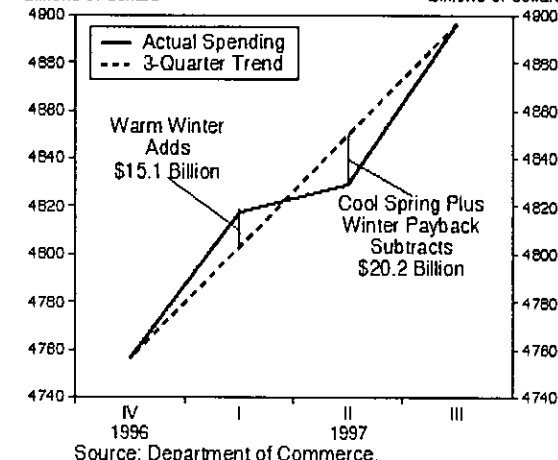
1997: A Case Study

Last year, the winter was also warmer than normal. That period therefore offers a case study of how an unusually warm winter can affect economic activity. As we noted in the July 11, 1997 issue of the *U.S. Economics Analyst*, the warmer-than-normal winter was followed by a cooler-than-normal spring. This caused key indicators to overstate strength in the first quarter and to understate it in the second.

Most of this distortion showed up in retail sales and spending on other items, as shown in the chart above and to the right. Relative to its underlying 4% growth trend during the first three quarters of 1997, growth in real spending was 1.3 percentage points higher in the first quarter and 2.9 points lower in the second quarter despite small swings in the opposite direction in utility usage. The second-quarter effect was large because it included both a payback from first-quarter strength as well as postponements of activity that would normally have occurred during the spring. Somewhat surprisingly, construction activity did not exhibit a similar pattern, perhaps because increases in interest rates during the winter and early spring were working in the opposite direction.

Given that consumer spending accounts for four-fifths of private domestic final sales, its 4.2-point swing more than accounts for the 2-point slowdown in the growth rate of this gauge of aggregate demand—from 5.0% down to 2.9%—obscuring what was really a pickup in the economy's underlying strength. Sure enough, real private domestic final sales surged at a 7.1% rate in the third quarter, with only about one-fifth of the gain (1.4 points) due to the rebound in spending from its weather-depressed second-quarter level.

Weather's Effect on Real Consumer Outlays in '97



In theory, the effect on total output might have been muted by offsetting effects on the rate of inventory accumulation. In practice, we could find no such offsets. Thus, we need only add in the government and trade sectors to derive a rough estimate of the impact of last year's weather swings. They appear to have added about 0.9 point to real GDP growth in the first quarter of 1997, sliced about 2.0 points from the second quarter, and added back about 1.1 point in the third.

Where We Stand in Early 1998

Although the returns are far from complete for the current quarter, the data do appear to be setting up for another overstatement of first-quarter growth, this time including construction, as detailed in the table at the top of page 6. This should not be surprising, as the current winter is even milder than its predecessor. As things now stand, the key developments are these:

1. In January, real construction spending was 1.0% (\$5.1 billion in annualized 1992 dollars) above its fourth-quarter average. This increase is about \$1½ billion above the average gain of the preceding four quarters. However, the 1.0% gain seems grossly understated given that hours worked in this sector during January and February surged 6.2% above their fourth-quarter average. In the past, surges of this magnitude have signaled construction spending gains on the order of 3½%-4%. Thus, an upward revision to the January figure seems likely. The strength of retail sales of building materials certainly points in this direction: They rose 3.6% in January (in nominal terms) and 2.0% further in February. Based on these indications, we reckon that the structures component of real GDP will post a

Key U.S. Economic Data

	Latest Monthly Data				6 Mo	12 Mo	Next
	'98 Feb	'98 Jan	'97 Dec	'97 Nov	Trend	Trend	Release
Nonfarm Payrolls (ch. thousands)	310	375	354	429	343	282	Apr 3
Unemployment Rate (%)	4.6	4.7	4.7	4.6	4.7	4.8	
Index of Hours Worked (% ch)	0.6	0.8	-0.3	1.2	5.3	3.2	
Average Hourly Earnings (% ch)	0.6	0.3	0.0	0.6	4.8	4.1	
Producer price finished goods index (% ch)	-0.1	-0.7	-0.2	-0.1	-1.4	-1.7	Apr 9
Excluding food and energy	0.1	-0.1	-0.1	0.0	0.4	0.1	
Consumer price index (% ch)	--	0.0	0.1	0.1	1.6	1.6	Mar 19
Excluding food and energy (% ch)	--	0.2	0.2	0.1	2.0	2.2	
Retail sales (% ch)	0.5	1.0	0.5	0.1	3.5	2.5	Apr 14
Excluding motor vehicles (% ch)	0.6	1.3	-0.1	-0.1	4.4	3.5	
Industrial Production (% ch)	--	0.0	0.4	0.7	5.5	5.5	Mar 17
Manufacturing	--	0.3	0.4	1.0	6.9	6.3	
Capacity utilization (%)	--	83.0	83.3	83.2	83.0	82.8	Mar 17
Manufacturing	--	82.1	82.3	82.3	82.0	81.8	
Housing Starts (annual rate, thousands)	--	1534	1538	1523	1501	1490	Mar 17
Single-family	--	1196	1118	1167	1143	1144	
Trade balance (billions, monthly)	--	--	-10.8	-8.7	-9.8	-9.5	Mar 19
Merchandise	--	--	-17.6	-15.7	-17.0	-16.6	
Factory Orders (% ch)	--	0.5	-2.6	2.4	3.8	4.2	Apr 2
Durable Goods	--	1.6	-5.3	4.7	6.4	6.6	Mar 25
Personal Income (% ch)	--	0.6	0.4	0.7	6.5	5.9	Mar 27
Wages and Salaries	--	0.7	0.4	1.2	8.6	7.4	
Purchasing Managers' Index (%)	53.3	52.4	53.1	54.5	54.0	54.9	Apr 1
Consumer Sentiment U Mich (Feb 66=100)	110.4	106.6	102.1	107.2	106.3	104.9	Mar 27
Conference Board (1985=100)	138.3	128.3	136.2	128.1	130.7	127.8	Mar 31

Note: Percentage changes are month to month for last four months, annualized for 6- and 12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- January's trade report could register the widest trade deficit ever, driven by weakness in exports to Asia, a seasonal adjustment problem, and a drop-off in aircraft exports (March 19).
- Strong sales of new homes, coupled with low inventories of unsold units, point to a sharp increase in housing starts in February, with unseasonably weather a supporting factor despite heavy rains in Florida and California (March 17).
- The Federal Reserve's beige book, summarizing economic conditions through the end of February, is likely to have a strong-side bias given the warm weather that prevailed throughout much of the nation (March 18).
- The February report on consumer prices should echo the basic themes of the producer price report, with little net upward pressure on the 2% annualized trend in the core index and energy pulling the headline rate down (March 19).

Economic Releases and Other Events

Date	Time	Indicator	Estimate		
			GS	Consensus	Last Report
Tue Mar 17	8:30	Housing Starts (Feb)	+4.5%	+1.0%	-0.3%
	9:15	Industrial Production (Feb)	+0.1%	-0.1%	0.0%
	9:15	Capacity Utilization (Feb)	82.8%	82.8%	83.0%
Thu Mar 19	8:30	Consumer Price Index (Feb)	+0.1%	+0.1%	0.0%
		Excluding Food & Energy	+0.2%	+0.2%	+0.2%
	8:30	Trade Balance (Jan)	-\$13.0 Bil	-\$10.4 Bil	-\$10.8 Bil
	10:00	Philadelphia Fed Survey (Mar)	+10.0%	n.a.	+12.8%
Fri Mar 20	2:00	Federal Budget Balance (Feb)	-\$41.0 Bil	-\$38.0 Bil	-\$44.0 Bil

- Home Builders' Survey (Mon, Mar 16)
- Fed "Beige Book" (Wed, Mar 18 - 2:00)
- Treasury Announces 2- and 5-Year Notes (Wed, Mar 18 - 2:30)
- Treasury Announces 1-Year Bill (Fri, Mar 20 - 2:30)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.8%	5.9%	6.2%
Forward	5.6	5.6	5.7
2 Yr T-Note	5.6	5.8	6.2
Forward	5.5	5.6	5.6
10 Yr T-Note	5.7	5.9	6.2
Forward	5.6	5.7	5.7

Key Numbers in the Business Outlook

	1997			1998E	
	Q4	Q1	Q2	1997	1998E
Real GDP	3.9%	4.0%	1.3%	3.8%	3.1%
Ind. Prod., Mfg.	8.0	5.2	3.9	5.6	5.4
CPI	2.1	0.7	1.9	2.3	1.8
After-Tax Profits*	12.6E	9.5	4.6	10.8E	4.4
Unemployment	4.7	4.6	4.6	5.0	4.5

* Excluding inventory profits; adjusted for depreciation distortions.

Weather's Impact on Real GDP Growth in Early 1998

Outlays on	Net Change in Q1 (in billions of 1992 \$)		Impact on Real GDP Growth %	
	Q1	Q4/Q1 Trend	Total	Weather-Related
Structures	+\$15.0	+\$12.6	+0.7%	+0.3%
Energy				
Heating	-8.7	-9.1	-0.5	-0.5
Transportation	+3.0	+2.4	+0.1	+0.1
Other Consumer				
Goods & Services	+70.1	+26.7	+1.5	+1.2
Total	+\$79.4	+\$32.6	+1.8%	+1.1%

Source: Department of Commerce. Our calculations.

\$15-billion (10.4% annualized) increase this quarter, adding 0.7 points more to real GDP growth than it did over the preceding year. Not all of this can be attributed to weather, given declines in interest rates. But if even half of it is, then real GDP growth is getting a 0.3-0.4 point weather-induced lift from construction spending this quarter.

2. Outlays for electricity, natural gas, heating oil, and coal in January were about \$8.7 billion, in real terms, below their fourth-quarter average. By a comparable calculation, this reduction in real heating outlays, if maintained through the quarter, would reduce first-quarter growth in real GDP by about 0.5 points (\$9 billion). Nearly one-third of the reduced usage of these energy sources in January was offset by a \$2½-billion jump in purchases of gasoline and motor oil above their modest upward trend, presumably reflecting a greater inclination on the part of consumers to drive when the weather is warmer than normal.
3. Retail sales of items other than motor vehicles, building materials, and gasoline surged in January and February to a level 1.5% above their fourth-quarter average. Based on these data, as well as on more complete (though still preliminary) figures on total spending in January, we estimate that total real spending is rising at a 5.5% annual rate and about 6% excluding energy. Relative to changes over the prior four quarters, these growth rates are about 1¼ and 2¼ points higher, respectively, adding an estimated 1.5 points to this quarter's real GDP growth. But as with construction spending, part of this stepup is probably due to a fundamental strengthening in real income growth, reflecting lower inflation and faster net hiring; one indication of this is that

consumer confidence indexes, which exhibited no particular sensitivity to weather last year, have risen sharply in recent weeks. Taking the 4.1% 12-month trailing growth rate in real disposable income as a benchmark of the higher trend, we estimate that weather-induced outlays for goods and services other than energy is boosting real GDP growth by 1.2 points.

What Goes Around Comes Around

On balance, the record-breaking warm winter appears to be adding about 1 point to real GDP growth this quarter, about as much as it did a year ago. Indeed, it would not be too surprising to see this estimate rise as more information comes to light, given that this year's winter has been even milder than last year's.

However, one lesson from our analysis of the 1997 experience is that, when it comes to weather, what goes around comes around. Even if the weather this spring turns out to be normal, growth in the second quarter should suffer as activity drops back to its trend line. In fact, the damage to second-quarter growth should be even larger than the boost to first-quarter growth, because some—perhaps most—of this quarter's weather-induced activity is simply an acceleration of events that would have occurred later (e.g., building projects started ahead of schedule, or purchases of spring apparel). Thus, we have slightly reduced our already low estimate of second-quarter growth, to 1.3% from 1.5%, despite evidence that the fundamentals underlying growth are improving and the Asian flu is not having quite the negative impact we had previously built into our forecast.

What does this mean for financial markets? It would be easier to answer this question if the bond market had sold off on employment and retail sales reports that were both stronger than consensus expectations. Perhaps market participants are discounting the unexpected strength because they attribute it to unusually warm weather. If so, then the payback of soft second-quarter growth should come as no surprise. But to the extent that the impact of this quarter's weather on next quarter's growth rate is not fully appreciated, the bond market may strengthen further during the spring months, as it sees second quarter real GDP growth shaping up to be well below trend.

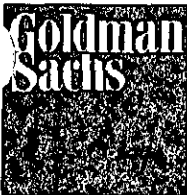
Ed McKelvey

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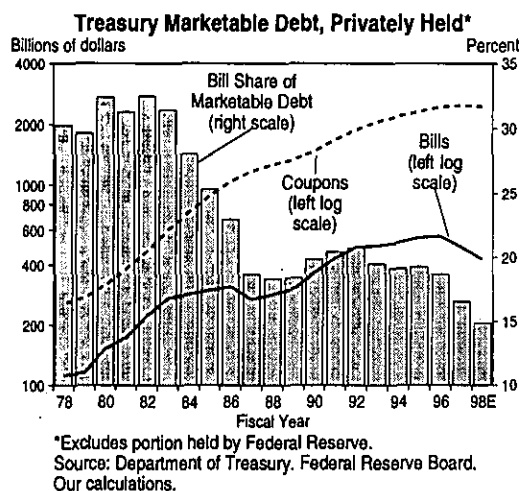
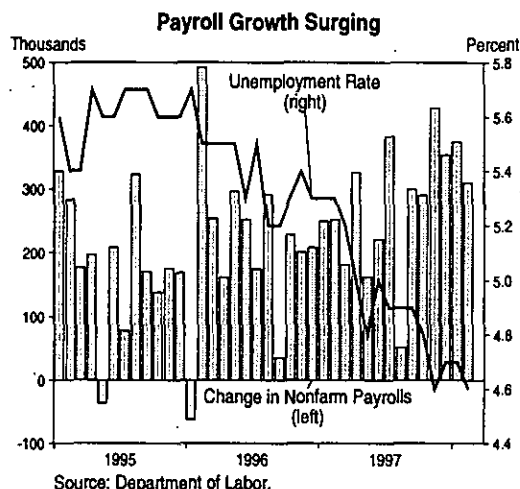


U.S. Economics Analyst

Our Views Have Changed (Slightly)

The Case for Less Frequent Treasury Note Sales

- This week provided additional evidence that the impact of the Asian flu on the U.S. economy is not likely to be as large as had been originally expected. With a fifth strong employment report in a row pointing toward solid first-quarter GDP growth, and a slew of data indicating strong retail sales, a solid housing market, and no drop-off in factory orders, the arguments in favor of Fed easing have weakened significantly.
- For this reason, we are adjusting our current range for Treasury bond yields upward to 5¾%-6¼% from 5½%-6% earlier. A larger adjustment appears unwarranted given that the return of more normal weather and trade drag exerted by Asia should cause the economic growth pace to slow considerably soon. Bond prices should also gain support from further good news on inflation for awhile longer.
- Despite exceptionally favorable developments in the federal budget, Treasury debt management practices have not evolved in a manner consistent with lasting reductions in market borrowing requirements. To the contrary, the number of annual coupon debt offerings has actually grown in recent years, causing a material decline in average note and bond issue sizes and a notable loss of liquidity in the short-term T-bill market.
- To avoid potentially costly erosions of market participation as the consequence of spreading illiquidity, we recommend that Treasury officials promptly and substantially reduce the number of annual coupon debt sales. If the inflation-protection debt cycle must be maintained, then we would favor elimination of four or five note sales per year from the current monthly 2- and 5-year cycles, as their timing generally coincides with periods of less onerous cash needs.



Trade Recommendations

- We would stay on the sidelines for now.

Contributors: Bill Dudley, Ed McKelvey,
John Youngdahl, John Simpson, Alex Patelis. (212) 902-6807.

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E-mail Address: william.dudley@gs.com

SUBJECT : U. S. ECONOMIC ANALYST

ATTENTION: GENE SPERLING
WHITE HOUSE

FAX: 12024562878

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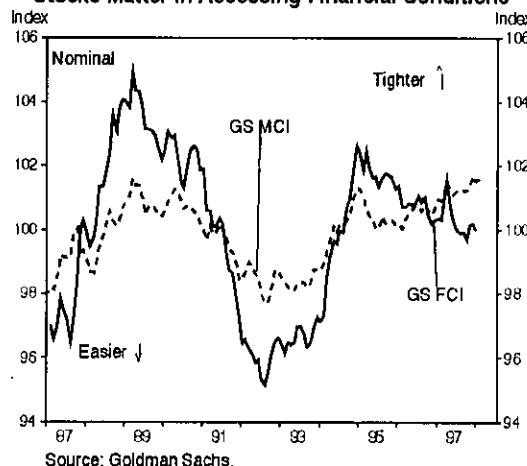
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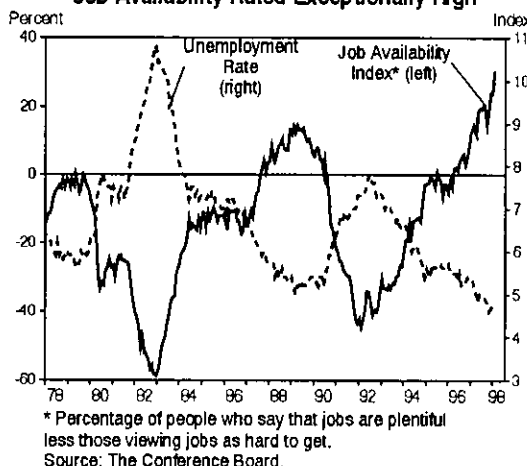
Equity Price Surge Implies Easier Financial Conditions

- Chairman Greenspan had three major messages for market participants: 1) No easing is likely anytime soon; 2) Fed officials are very uncertain about how the tug-of-war between the strong domestic economy and the trade drag from Asia will be resolved; 3) Lenders and investors may be too optimistic about the economic outlook.
- The notion that the FOMC was not close to easing was underscored by Greenspan's observation that the rise in real interest rates resulting from the decline in inflation was "by no means inadvertent." He pointed out that financial conditions were actually quite supportive of the domestic economy and cited the importance of the strong stock market.
- We reach the same conclusion. When the Goldman Sachs monetary conditions index (GS MCI) is transformed into a financial conditions index (GS FCI) by including the S&P 500 price/earnings ratio, the pattern traced out by the resulting index changes sharply. In contrast to the GS MCI, which indicates that conditions are tighter, the GS FCI has drifted lower over the past year, indicating easier financial market conditions. The strength of the stock market has caused the price/earnings ratio to widen, and this has more than offset the impact of a stronger dollar.
- The economic news continues to underscore the nirvana state of the U.S. economy—a strong domestic economy without inflation pressures. This wonderful combination has caused consumer confidence to surge, suggesting that the domestic economy may be strong enough to shrug off the trade shock from Asia.

Stocks Matter In Assessing Financial Conditions



Job Availability Rated Exceptionally High



Trade Recommendations

- We closed out our short September '98 Eurodollar futures position on the close on Tuesday (94.30).
- We would stay neutral for now, awaiting the NAPM and employment data for February.

Contributors: Bill Dudley, Ed McKelvey,
John Youngdahl, John Simpson, Alex Patelis (212) 902-6807

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E-mail Address: william.dudley@gs.com

I. Weekly Wrapup

Economic and Market Overview

Bond prices have fallen in response to a Fed policy report and statistical news that, on the whole, implied a reduced potential for monetary easing. Downward revisions to fourth-quarter growth in real GDP (to a 3.9% annual rate from 4.3%) and final sales (2.5% versus 3.6%) reflected the poor December trade report, which showed a significant widening in the deficit with the Pacific Rim. Despite this evidence of a trade impact from deterioration in Asian economic activity, there has been no visible damage as yet to domestic job creation, which in fact has lifted consumer spirits to new heights. Paralleling results from other recent surveys, the Conference Board's consumer confidence index jumped 10 points in February to 138.3, a 30-year high. The exceptional degree of household optimism stems from similarly exuberant perceptions of hiring conditions, as the gap between the percentage of respondents seeing jobs as plentiful versus hard to get hit +30.3%, versus +14% just one year ago. Over the years, this job availability index has been a useful indicator of labor market tightness; the last time it was in this territory the jobless rate stood more than a point lower than recent levels, at around 3½%.

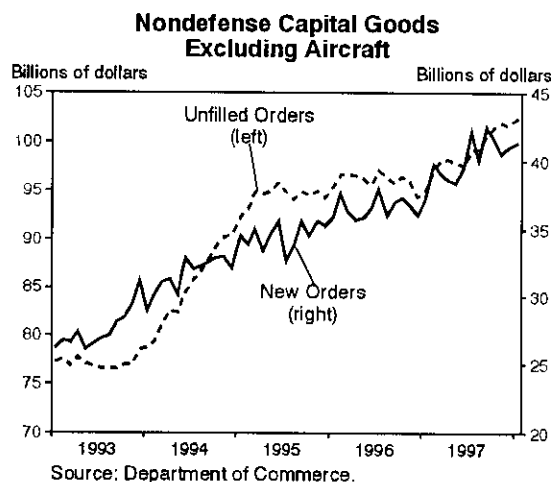
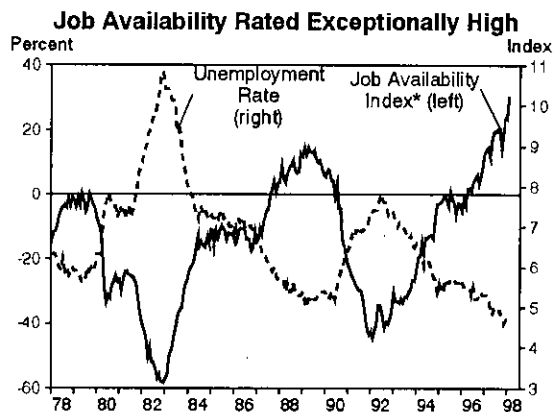
Meanwhile, new orders for durable goods rose 0.7% last month, although bookings outside the volatile defense and aircraft sectors were down 1.6%, to the lowest level since June. This falloff was entirely in orders for durable consumer goods and materials, with a drop in motor vehicle assemblies—which also tend to bounce up and down from month to month—apparently part of the story. For nondefense capital

goods other than aircraft, by contrast, both new and unfilled orders rose modestly. This suggests that the impact of Asian distress on U.S. factories has thus far been small, as foreign entities would have had ample opportunity by January to reduce or cancel equipment orders.

The latest consumer price data (flat overall in January, up 0.2% excluding food and energy) sustains the pattern of divergent pricing of goods and services. On a year-to-year basis, excluding food and energy, goods prices are up only 0.4% whereas service quotes have climbed 3.0%. This gap could widen further in coming months, as retail distributors pass along cost savings for many items imported from Asia, while service firms face growing labor-cost pressures.

Federal Reserve Policy

Chairman Greenspan's latest monetary policy report to Congress indicated clearly that the FOMC's decision in December to drop the long-standing bias toward tightening in the formal open-market directive was not a way station to lower short-term interest rates. This is clear in the panel's "central tendency" forecast that real GDP growth, at 2%-2¾% during 1998, will be firm enough to keep the jobless rate below 5%, and it is also evident from Greenspan's statement that the firming in monetary conditions implied by the rise in the real federal funds rate over the past year, while passive, "was by no means inadvertent." The FOMC has no doubt been impressed by evidence of continued vigorous income growth and consumer confidence, as well as by the buoyancy of stock and other asset prices. Indeed, Mr.



Greenspan voiced some concern, reminiscent of his famed "irrational exuberance" comment, that asset prices could suffer setbacks in 12-18 months' time.

At the same time, Fed officials remain nervous that the negative domestic impulses from Asia could turn out to be greater than are now apparent. Unusually low inflation provides plenty of breathing room for them to stay neutral while they wait to see how the conflict between domestic spending strength and deteriorating trade plays out in the months ahead.

Fiscal and Political Developments

Following the report of a \$25.4-billion federal budget surplus in January, it is becoming impossible even for normally cautious government estimators to deny the likelihood of a surplus for this fiscal year. The recent results have been particularly striking with regard to revenue trends. In the four months ending January, the four largest categories of tax receipts—individual withheld, individual nonwithheld, social insurance, and corporate—are all sharply above year-earlier levels. If these trends persist through September, then the net federal tax take this year would exceed last month's official forecasts (which anticipated approximate fiscal balance) by \$80 billion or more.

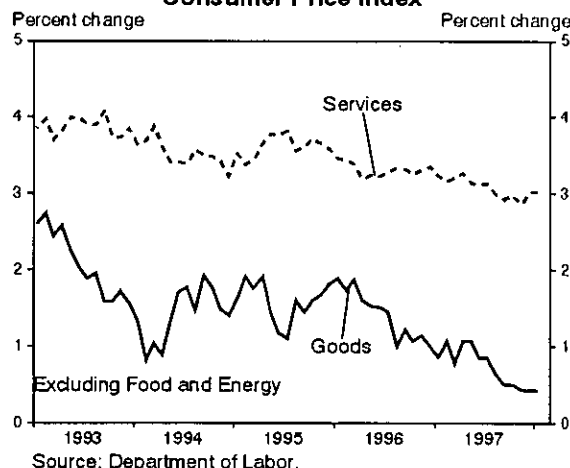
These developments are quite likely to influence this year's congressional budget process. For now, senior lawmakers are reluctant to discuss more than tiny tax cuts, because they are not confident that a surplus is nigh and don't wish to be perceived as raiding the Social Security surplus. By late April or May, however, when the budget-writing effort kicks into high gear, the prospect of a large surfeit should give rise to heightened scrutiny of proposals for more substantial personal tax relief.

Market Outlook and Comments on Value

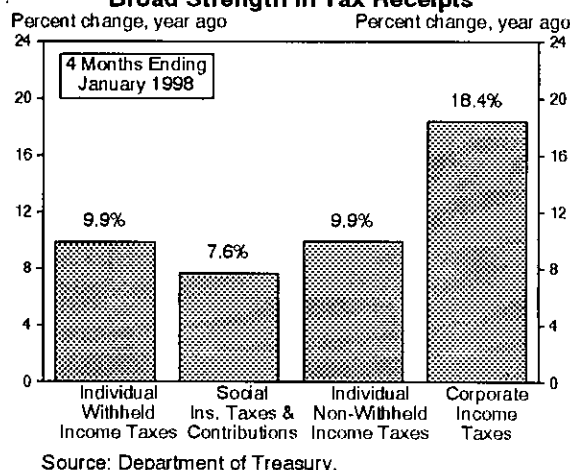
Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

We closed out our long-standing short stance in September 1998 Eurodollar futures on Tuesday afternoon, at 94.30, following Chairman Greenspan's policy report. With the forward short-term rate structure now much more consistent with an expectation of Fed neutrality through summer, our preference is to wait for key economic data from February—specifically, the NAPM and payroll reports—before undertaking any fresh position recommendations.

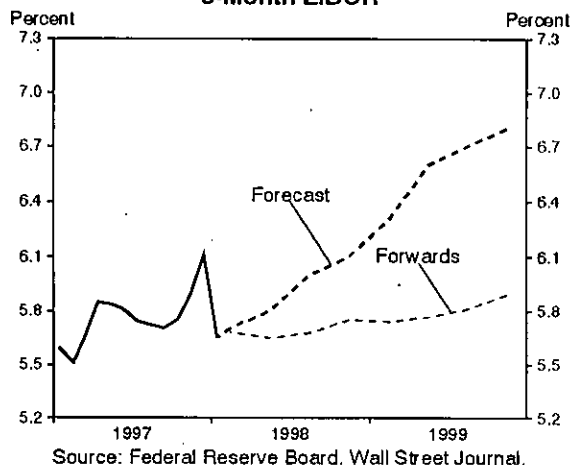
Consumer Price Index



Broad Strength in Tax Receipts



3-Month LIBOR



II. Equity Price Surge Implies Easier Financial Conditions

In assessing the appropriate stance of monetary policy, the behavior of the equity market matters. This was highlighted this past week in Chairman Greenspan's Humphrey-Hawkins testimony. He noted that "... financial markets remained quite accommodative and, indeed, judging by the rise in equity prices, were providing additional impetus to domestic spending." The U.S. economy has continued to barrel ahead despite an appreciating currency and above-average real interest rates because the equity market has surged, providing support to both consumer spending and business fixed investment.

In this brief, we formally demonstrate the importance of the equity market by transforming the Goldman Sachs monetary conditions index (GS MCI) into a financial conditions index (GS FCI). We do this by including the S&P 500 price/earnings ratio in our construction of the index. The results are striking. In contrast to our GS MCI measure, which shows tighter monetary conditions, the GS FCI indicates an easing of financial conditions over the past year. This helps to explain the vibrancy of the domestic economy and suggests that as long as the U.S. equity market remains buoyant, Federal Reserve officials are unlikely to ease monetary policy over the next year.

The Goldman Sachs Financial Conditions Index

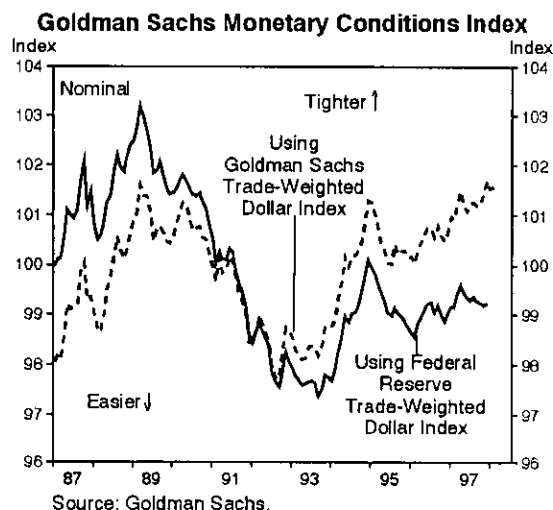
One way to assess the stance of monetary policy is to construct a monetary conditions index. In the past, we have tracked monetary conditions through the GS MCI.¹ For a given country, the GS MCI is constructed by relating three monetary factors—short-term interest rates, long-term interest rates, and the value of the currency—to changes in real GDP growth. The three factors are weighted to maximize their collective role in explaining fluctuations in real activity. The index is scaled to an index value of 100 and constructed so that a basis-point change in the index is equivalent to a basis-point change in all three of the factors used in constructing the model. For the U.S. version of the GS MCI, the three factors are the 3-month LIBOR, 10-year Treasury note yield, and the trade-weighted exchange rate. Recently, we modified this index to use the Goldman Sachs trade-weighted dollar index (GS TWI) rather than the Federal

Reserve trade-weighted dollar index (FED TWI) in order to capture the impact of the dollar's abrupt appreciation against many of the Asian currencies that are not incorporated in the Fed's measure.²

As shown below, the monetary conditions index is sensitive to the dollar index used. In the index using the FED TWI, the dollar has a very low weight of 2.5%. As a result, the impact of the rise in the dollar has been fully offset by the drop in long-term interest rates over the past year. In contrast, the revised GS MCI, which uses the broader GS TWI, has risen sharply for two reasons. First, the dollar has a much higher weight in this index (7.5%). Second, the GS TWI has risen more sharply over the past year than the FED TWI. If the revised GS MCI measure is the appropriate standard, then the conclusion is clear: Monetary conditions have tightened significantly over the past year, implying that a slowdown in the U.S. economy lies ahead, all else equal.

But all else is not equal. The other striking feature of the financial landscape is the strength of the U.S. equity market. In assessing the outlook for the economy, this should also be included because equity prices affect economic performance through their impact on the cost of capital incurred by business and on households' spending/saving decisions.

Equity valuation affects business investment because it determines the equity cost of capital, an important



¹ See the *International Economics Analyst*, July/August 1996 for more details.

² See the *Weekly Analyst*, February 10, 1998 for details.

component in the investment spending decision. When equity prices climb and price/earnings ratios expand, the cost of equity capital falls, reducing the hurdle rate for new investment. A buoyant equity market also helps spur initial public offerings that can allow young firms to rapidly increase investment.

Equity prices also influence consumer spending because equities are an important component of the household balance sheet. Household net worth has been growing rapidly over the past few years, bolstered by the strong stock market, and this has caused households to reduce their aggregate saving rate. When the equity market appreciates sharply, the rise in wealth causes households to save less out of income. The result is more consumer spending and a stronger economy.

To incorporate the impact of the equity market, we transformed the revised GS MCI into a financial conditions index (GS FCI) by adding the price/earnings ratio of the S&P 500 to the other variables—3-month LIBOR, 10-year T-note yield, and the Goldman Sachs trade-weighted dollar—included in the revised GS MCI.³ In the construction of the index, we actually use the reciprocal of the P/E ratio (*i.e.*, E/P) so that a lower value equates to a lower cost of equity capital. In the resulting GS FCI, the P/E ratio receives a weight of 9.3% in the index compared to a weight of 7.5% for the trade-weighted dollar and an aggregate weight of 83.3% for interest rates, split five parts to four between short- and long-term rates, respectively.

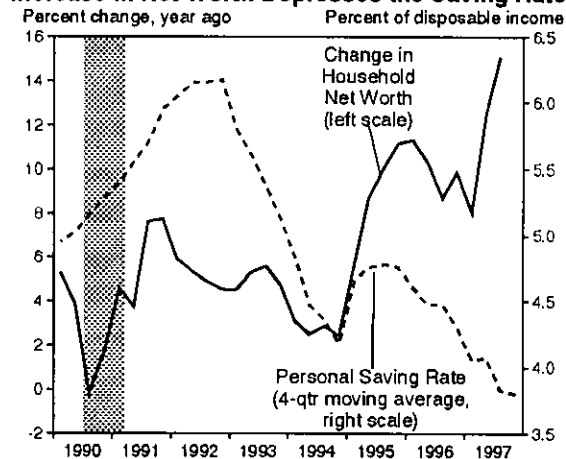
As can be seen in the chart to the right, inclusion of the equity market valuation variable, the price/earnings ratio for the S&P 500, causes the behavior of the GS FCI to diverge sharply from the revised GS MCI. This occurs because the P/E ratio has expanded dramatically over the past few years as prices have risen faster than earnings and because the P/E ratio receives a significant weight in the index.⁴

In comparing the two indexes, two differences are particularly noteworthy. First, the strength of the

equity market has caused the GS FCI to trend generally lower since its peak in early 1995. The rise in the P/E ratio—which has widened to about 25.8 at the end of 1997 from about 17.0 at yearend 1994—has swamped the impact of the rise in the GS TWI, which has appreciated by about 20% over the same time frame.

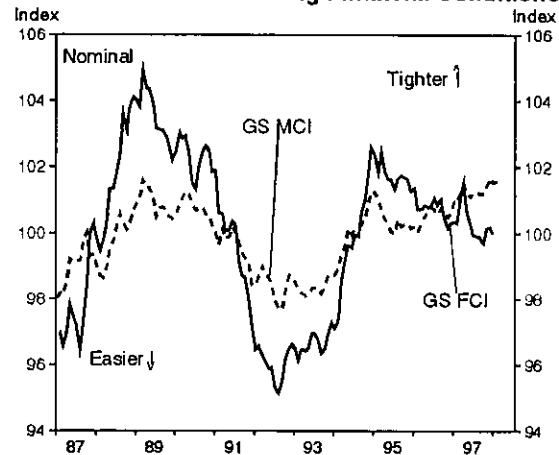
Second, the GS FCI appears to provide a much more sensible reading in terms of the current looseness or stringency of financial conditions. As can be seen, the GS FCI is in the middle of its range over the past decade, indicating that financial conditions are not unusually tight or loose. In contrast, the revised GS MCI index recently reached its highest reading since 1989, suggesting that monetary conditions are very tight.

Increase in Net Worth Depresses the Saving Rate



Source: Federal Reserve Board, Department of Commerce.

Stocks Matter in Assessing Financial Conditions



Source: Goldman Sachs.

³ We also tried using a cyclically adjusted price/earnings ratio to strip out the impact of economic performance on the aggregate P/E ratio. However, we did not follow this approach because it made little difference to our results as the two series are highly correlated.

⁴ We also looked at inflation-adjusted (real) measures of both indexes. The differences were small and the conclusions unaffected.

Using the GS FCI as a guide to financial conditions appears much more sensible than using the revised GS MCI for two reasons. First, the behavior of the GS FCI appears much more consistent with other indicators of financial market conditions than the revised GS MCI. For example, over the past few years, credit spreads have generally been narrowing and the growth rates of the broad monetary aggregates, M2 and M3, have been picking up. Although it is difficult to incorporate these variables formally into a GS FCI, their behavior suggests that the GS FCI is sending out the right signal.

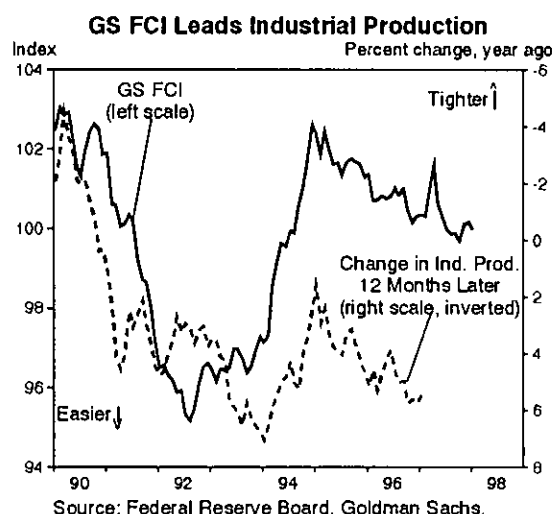
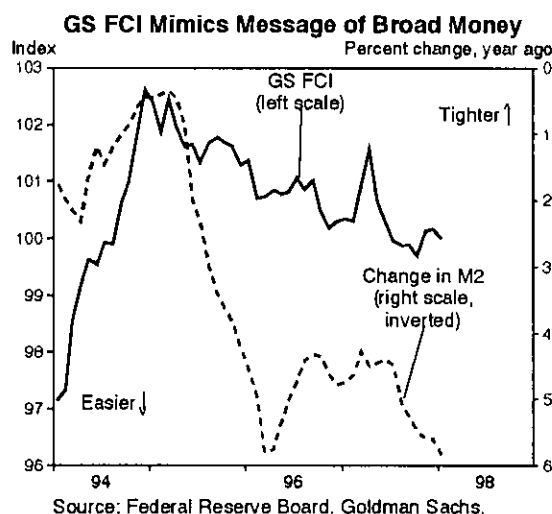
Second, the GS FCI has done a better job than the revised GS MCI in anticipating subsequent changes in the real economy. Since 1987, the correlation between the revised GS FCI and the year-over-year change in industrial production 12 months ahead has been 0.64, compared to 0.55 for the GS MCI. As shown in the chart to the right, the GS FCI has done a particularly good job in anticipating changes in industrial production 12 months ahead over the past few years. This has been the period in which the P/E ratio has widened sharply and the GS FCI has diverged from the path of the revised GS MCI.

A Strong, But Fragile Economy

The GS FCI can also be used as a tool to assess the vulnerability of the economy to a stock market decline. For example, if the stock market dropped by 10% (without any change in earnings), this would push the GS FCI index up by almost 1 index point. Based upon the historical relationship between the GS FCI and real GDP, such a change implies about a 0.2 percentage point fall in the growth of real GDP over the following four quarters.

This suggests that the economy remains vulnerable to a stock market reversal. If the stock market were to decline sharply, this would dramatically tighten financial conditions. If interest rates and the dollar did not adjust in an offsetting manner, then a material slowdown in GDP growth would likely occur. Although we do not anticipate a stock market decline, the economy is clearly vulnerable should equity prices fall significantly.

⁵ We also experimented with including credit spread measures in the GS FCI. We found this did not work well. The collinearity of the variables generated index weights that were unstable and not very sensible.



Implications for Markets

The behavior of the GS FCI helps to explain why higher real interest rates and a stronger dollar have not yet been sufficient to slow the U.S. economy. Put simply, the strength of the stock market has been the more powerful influence. This suggests that the stock and bond markets may now be out of whack. The strength of the stock market implies relatively accommodative financial conditions. But the flatness of the Treasury yield curve implies that market participants still expect that Fed officials will ease monetary policy. If the stock market remains buoyant, the economy is likely to remain relatively robust. Under such circumstances, Fed officials would stay on the sidelines, disappointing bond investors.

Bill Dudley

John Simpson

Key U.S. Economic Data

	Latest Monthly Data				6 Mo Trend	12 Mo Trend	Next Release
	'98 Feb	'98 Jan	'97 Dec	'97 Nov			
Nonfarm Payrolls (ch. thousands)	--	358	355	429	298	276	Mar 6
Unemployment Rate (%)	--	4.7	4.7	4.6	4.8	4.9	
Index of Hours Worked (% ch)	--	0.6	-0.3	1.2	4.6	3.8	
Average Hourly Earnings (% ch)	--	0.3	-0.1	0.6	4.5	3.8	
Producer price finished goods index (% ch)	--	-0.7	-0.2	-0.2	-0.9	-1.9	Mar 13
Excluding food and energy	--	-0.1	-0.1	-0.1	0.3	-0.1	
Consumer price index (% ch)	--	0.0	0.1	0.1	1.6	1.6	Mar 19
Excluding food and energy (% ch)	--	0.2	0.2	0.1	2.0	2.2	
Retail sales (% ch)	--	0.1	0.3	0.1	1.1	2.4	Mar 12
Excluding motor vehicles (% ch)	--	0.5	-0.1	-0.1	1.1	2.4	
Industrial Production (% ch)	--	0.0	0.4	0.7	5.5	5.5	Mar 17
Manufacturing	--	0.3	0.4	1.0	6.9	6.3	
Capacity utilization (%)	--	83.0	83.3	83.2	83.0	82.8	Mar 17
Manufacturing	--	82.1	82.3	82.3	82.0	81.8	
Housing Starts (annual rate, thousands)	--	1534	1538	1523	1501	1490	Mar 17
Single-family	--	1196	1118	1167	1143	1144	
Trade balance (billions, monthly)	--	--	-10.8	-8.7	-9.8	-9.5	Mar 19
Merchandise	--	--	-17.6	-15.7	-17.0	-16.6	
Factory Orders (% ch)	--	--	-2.5	2.4	4.1	6.1	Mar 5
Durable Goods	--	0.7	-5.5	4.7	4.1	5.4	Mar 25
Personal Income (% ch)	--	--	0.4	0.7	5.6	5.8	Mar 2
Wages and Salaries	--	--	0.4	1.2	7.3	6.7	
Purchasing Managers' Index (%)	--	52.4	53.1	54.5	54.5	54.9	Mar 2
Consumer Sentiment U Mich (Feb 66=100)	110.4	106.6	102.1	107.2	106.3	104.9	Mar 13
Conference Board (1985=100)	138.3	128.3	136.2	128.1	130.7	127.8	Mar 27

Note: Percentage changes are month to month for last four months, annualized for 6- and 12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- Personal income and consumption were robust in January, with income boosted by strong job gains and consumption by good weather and a high level of consumer confidence (March 2). Chain store reports for February should indicate a continuation of spending strength (March 5).
- The NAPM index is likely to tick up slightly in February. So far, the U.S. economy is showing only a scant impact from the Asian crisis. The behavior of the export component, which fell sharply in January, will also be closely scrutinized (March 2).
- New home sales in January are likely to rise sharply, spurred by lower mortgage rates and mild weather (March 3).
- Factory orders should post modest gains as nondurable goods orders are restrained by falling gasoline prices (March 5).
- Payroll employment growth should remain quite robust in February, judging from the low level of initial unemployment claims and the high level of consumer confidence. The unemployment rate is likely to move lower as labor force growth slows. Gains in average hourly earnings should be moderate (March 6).

Economic Releases and Other Events

Date	Time	Indicator	Estimate		
			GS	Consensus	Last Report
Mon Mar 2	8:30	Personal Income (Jan)	+0.6%	+0.5%	+0.4%
	8:30	Personal Consumption (Jan)	+0.5%	+0.6%	+0.3%
	10:00	Purchasing Managers Index (Feb)	53.0%	52.0%	52.4%
	10:00	Construction Spending (Jan)	+1.1%	+0.6%	+0.1%
		Domestic Motor Vehicle Sales (Feb)	13.0M	n.a.	13.2M
Tue Mar 3	10:00	New Home Sales (Jan)	+6.2%	+3.5%	-9.3%
	10:00	Leading Indicators (Jan)	-0.1%	0.0%	0.0%
Thu Mar 5	10:00	Factory Orders (Jan)	+0.3%	+0.8%	-2.5%
Fri Mar 6	8:30	Civilian Unemployment Rate (Feb)	4.6%	4.7%	4.7%
	8:30	Nonfarm Payroll Employment (Feb)	+250,000	+250,000	+358,000
	8:30	Average Hourly Earnings (Feb)	+0.3%	+0.4%	+0.3%
	3:00	Consumer Credit (Jan)	+\$2.5 Bll	+\$4.8 Bll	+\$3.9 Bll

■ Chain-Store Sales Results (Thu, Mar 5)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.8%	5.9%	6.2%
Forward	5.6	5.7	5.8
2 Yr T-Note	5.6	5.8	6.2
Forward	5.6	5.7	5.7
10 Yr T-Note	5.7	5.9	6.2
Forward	5.7	5.8	5.8

Key Numbers in the Business Outlook

	1997			1998E	
	Q4	Q1	Q2	1997	1998E
Real GDP	3.9%	2.5%	1.5%	2.8%	2.9%
Ind. Prod., Mfg.	7.4	4.9	3.2	5.0	4.9
CPI	2.1	1.5	1.9	2.3	1.9
After-Tax Profits*	11.2E	7.3	4.9	10.4E	3.7
Unemployment	4.7	4.7	4.7	5.0	4.6

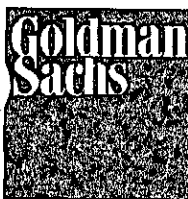
* Excluding inventory profits; adjusted for depreciation distortions.

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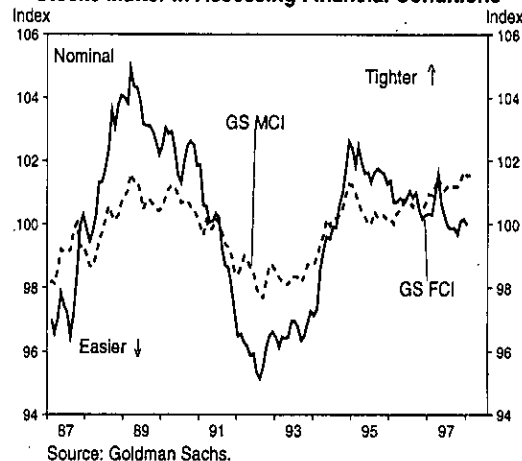
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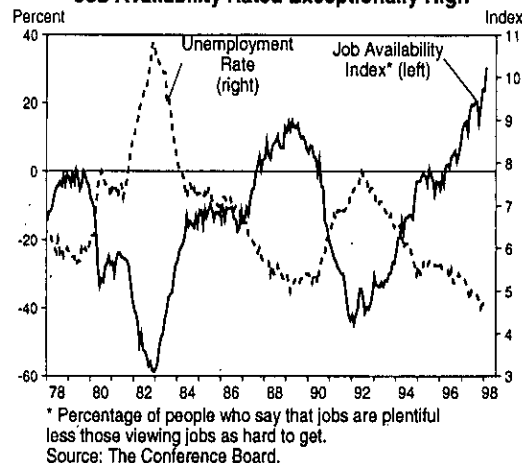
Equity Price Surge Implies Easier Financial Conditions

- Chairman Greenspan had three major messages for market participants: 1) No easing is likely anytime soon; 2) Fed officials are very uncertain about how the tug-of-war between the strong domestic economy and the trade drag from Asia will be resolved; 3) Lenders and investors may be too optimistic about the economic outlook.
- The notion that the FOMC was not close to easing was underscored by Greenspan's observation that the rise in real interest rates resulting from the decline in inflation was "by no means inadvertent." He pointed out that financial conditions were actually quite supportive of the domestic economy and cited the importance of the strong stock market.
- We reach the same conclusion. When the Goldman Sachs monetary conditions index (GS MCI) is transformed into a financial conditions index (GS FCI) by including the S&P 500 price/earnings ratio, the pattern traced out by the resulting index changes sharply. In contrast to the GS MCI, which indicates that conditions are tighter, the GS FCI has drifted lower over the past year, indicating easier financial market conditions. The strength of the stock market has caused the price/earnings ratio to widen, and this has more than offset the impact of a stronger dollar.
- The economic news continues to underscore the nirvana state of the U.S. economy—a strong domestic economy without inflation pressures. This wonderful combination has caused consumer confidence to surge, suggesting that the domestic economy may be strong enough to shrug off the trade shock from Asia.

Stocks Matter in Assessing Financial Conditions



Job Availability Rated Exceptionally High



Trade Recommendations

- We closed out our short September '98 Eurodollar futures position on the close on Tuesday (94.30).
- We would stay neutral for now, awaiting the NAPM and employment data for February.

Contributors: Bill Dudley, Ed McKelvey,
John Youngdahl, John Simpson, Alex Patellis (212) 902-6807

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E-mail Address: william.dudley@gs.com

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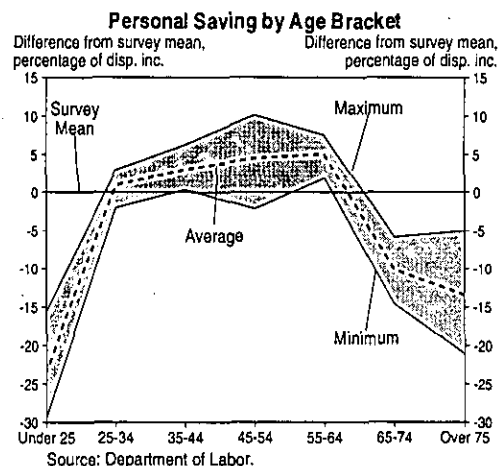
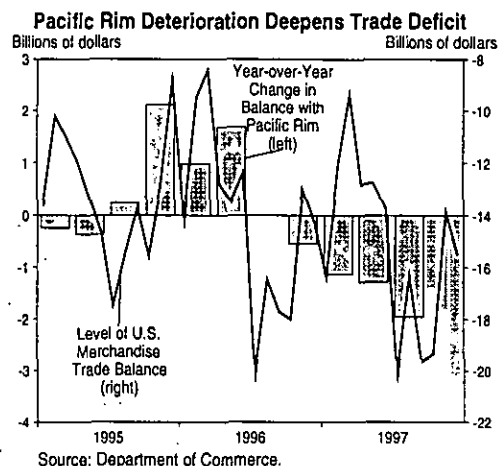
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Demographics Redux: Do New Dogs Learn Old Tricks?

- The latest U.S. trade data now show clear effects from the Asian crisis, most prominently in the fact that the deficit with Pacific Rim countries widened to \$10.6 billion in December from \$7.5 billion in December 1996. The Asian crisis is also partly responsible for ongoing weakness in producer prices, which fell 0.7% in January.
- However, the unfolding weakness in net exports has yet to infect domestic activity in a noticeable way. Factory output rose a sturdy 0.4% outside the motor vehicle industry in January, offsetting a weather-related plunge in utility usage, and claims for jobless benefits remain quite low. Housing starts, while off slightly in January, also remain robust.
- Chairman Greenspan treks to Capitol Hill for his semiannual "Humphrey-Hawkins" testimony on February 24 and 25. His message is likely to reinforce the carefully balanced tone of his latest comments on U.S. economic activity, with the clear implication that monetary policy is on hold pending a clearer reading on the impact of Asia.
- In a detailed review of demographic spending and saving patterns, we find that U.S. families boost their saving at a younger age than assumed in long-standing forecasts of a secular surge in saving. But, while this pattern comports with more recent calls for a demographically driven recession, the process is too glacial to produce a cyclical downturn. Moreover, the associated spending cutback does not occur in outlays for big-ticket items, as assumed. Finally, while the life-cycle model on which these forecasts are based appears dominant for aggregate spending, it breaks down somewhat for finer categories.



Trade Recommendations

- Stay short September '98 Eurodollar futures, but raise target to 94.25 from 94.10 and tighten stop to a close above 94.55, from 94.64 earlier.

Contributors: Bill Dudley, Ed McKelvey,
John Youngdahl, Alex Patelis (212) 902-6807

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E-mail Address: william.dudley@gs.com

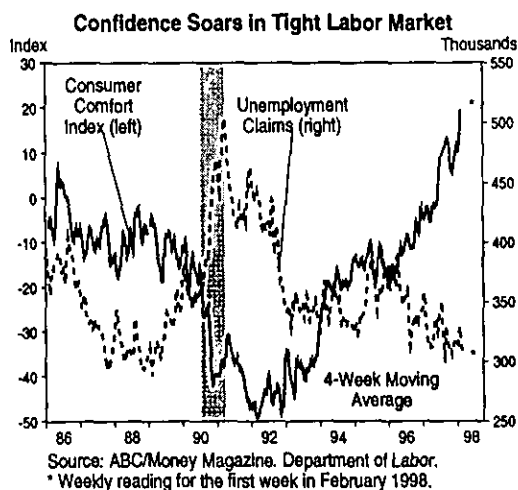
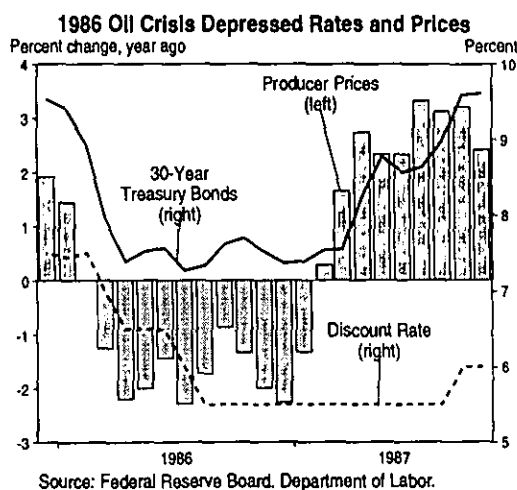
Lessons From the Past

■ In this week's center section we look at three events from the economic history of the United States to draw clues about the likely impact of the Asian crisis and any future shocks. Our look at the Great Depression tells us that the policy errors of the time taught the Fed to take financial crises very seriously, and that a prolonged period of deflation would not have happened without the accompanying dramatic collapse in domestic demand.

■ The 1986 oil crisis teaches us that interest rates can remain subdued for an extended long period of time, even if a deflationary shock is ultimately only temporary. The experience of the Crash of 1987 tells us that although financial crises do not always translate into economic crises, the initial reaction of both the Fed and the market is to focus on the negative short-term impact and ignore any long-term positive effects.

■ Extraordinarily high levels of confidence and low levels of jobless benefit claims continue to paint a bright picture of consumer spending fundamentals. Preliminary retail sales figures for January do show a solid increase in spending outside the motor vehicle area, although revisions also show that spending in the fourth quarter of 1997 was a bit less buoyant than first estimated.

■ Indexes of U.S. import and export prices both fell sharply last month, confirming that the crisis in Asia is suppressing inflation in the United States. Productivity also posted larger-than-expected gains in the fourth quarter, although some of last year's impressive performance in this area reflects a puzzling decline in hours worked by self-employed individuals.



Trade Recommendations

■ Stay short September '98 Eurodollar futures, with a target of 94.10 and a stop on a close above 94.64.

Contributors: Bill Dudley, Ed McKelvey,
John Youngdahl, Alex Patelis (212) 902-6807

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E-mail Address: william.dudley@gs.com

I. Weekly Wrapup

Economic and Market Overview

Prices of U.S. equities moved higher as fresh data continued to indicate moderate growth in the U.S. economy with little apparent upward pressure on inflation. Bond yields, on the other hand, were little changed on balance.

Early in the week, the financial markets were treated to yet another surprisingly strong set of figures on labor productivity. Output per hour was reported to have risen at a 2.0% annual rate last quarter in the nonfarm business sector, maintaining the pattern of firm gains that have allowed increases in unit labor costs to drift slightly lower over the past two years. However, on closer inspection, last year's strength in productivity growth owes much to a puzzling decline in hours worked by self-employed workers, raising suspicions that the labor-cost picture may not be quite as bright as currently painted in the official data.

Other price pressures, on the other hand, continue to abate unambiguously in response to the Asian crisis. U.S. import prices fell 1.3% in January, with about half of this drop coming from weaker oil prices. Whether oil is included or excluded, year-to-year changes in import prices are the weakest in the 13-year history of the series (-6.1% and -3.1%, respectively). Competitive pressures have also kept export prices weak. They were down 0.6% overall in January and 0.3% excluding agricultural products.

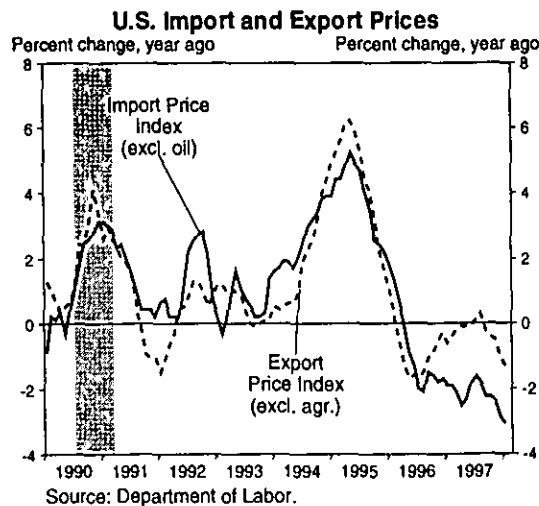
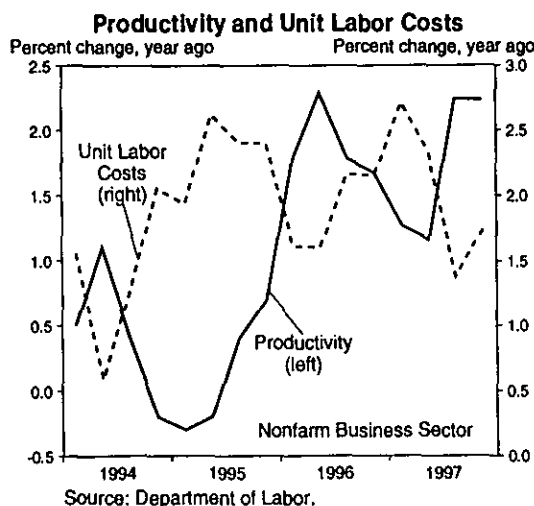
Meanwhile, retail sales inched up 0.1% in January but posted a more solid 0.5% gain when receipts of motor

vehicle dealers are excluded—a figure in line with the firmness in weekly sales indexes. However, the latest report also revealed that spending was less buoyant during the holiday season than previously thought. Downward revisions to the component of retail sales on which estimates of personal spending are based (which exclude building materials as well as motor vehicles) suggest that the Commerce Department's preliminary estimate that real outlays rose at a 3.2% annualized rate could be revised down ¼ to ½ point.

That said, consumer spending is unlikely to slow in any meaningful way, judging from the latest reports on confidence and labor-market conditions. In the first week of February, the composite index from the ABC/Money poll posted another new record, driven by soaring assessments of economic prospects, while initial filings for jobless benefits remained quite low.

Federal Reserve Policy

With an FOMC meeting just behind them and the semiannual Humphrey/Hawkins hearings just ahead, Fed officials have been fairly quiet in recent days. Although Chairman Greenspan was quoted by wire services as saying that the impact of the Asian crisis on U.S. growth might not be very large, his actual testimony did not convey any different impression from his earlier appearances in late January—namely, that it is too soon to tell how big a toll this crisis will exact. In all likelihood, he will strike a balanced and noncommittal tone about this issue, as well as future policy moves, when he appears before the House Banking Committee on February 24.



Fiscal and Political Developments

The ruling by a federal district court judge that the line-item veto is unconstitutional was neither a surprise nor an event of serious consequence for near-term budget trends. Assuming that the decision is upheld on appeal, it would restore about \$1.9 billion in spending over the next five years—a trivial sum when set against the \$8.9 trillion in federal outlays projected over the same period. The maintenance of strict “pay-as-you-go” caps on federal spending and tax cuts will be far more important to maintaining budget discipline in coming years.

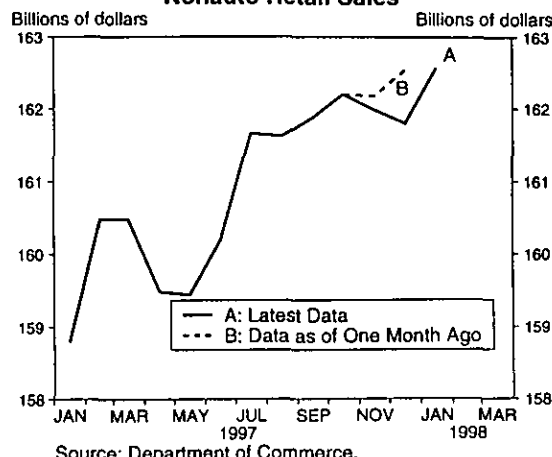
In that regard, the bigger threat that has emerged in recent days is the recognition by the Congressional Budget Office that the federal budget will probably end the current year in surplus. This marks the first official recognition that the federal government's drought of black ink will disappear this year instead of next. And, notwithstanding President Clinton's plea to apply surpluses first to putting Social Security on a sounder financial footing, an earlier-than-expected surplus is likely to tempt Republicans and Democrats into a compromise featuring tax cuts as mid-term elections approach, especially if economic growth softens this spring.

Market Outlook and Comments on Value

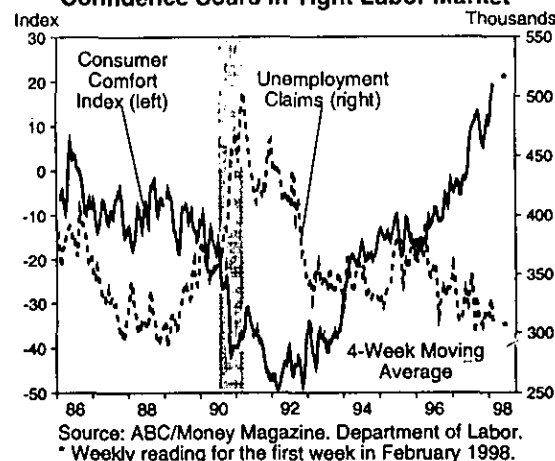
Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

Not much has happened to change our cautious posture on the U.S. fixed-income market. We still believe firmly that Fed officials will frustrate market expectations of an easing later this year; hence, we continue to recommend short positions in September Eurodollar futures, with a target of 94.10 and a stop on a close above 94.64. However, in the near term, the prospective softening trend of economic data over the next few months suggests to us that it is far too early to act on our judgment that long-term rates at current levels are inconsistent with our view that monetary policy will remain unchanged for the foreseeable future.

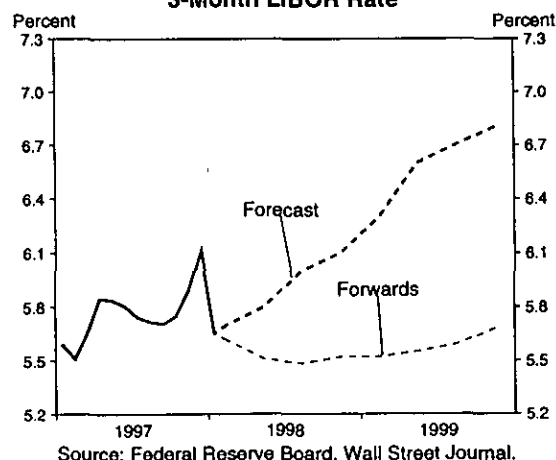
Nonauto Retail Sales



Confidence Soars in Tight Labor Market



3-Month LIBOR Rate



II. Lessons From the Past

When unexpected shocks hit the economy, it is often useful to turn to the past for clues about the future. The U.S. economy is in the process of being hit by a shock from Asia, which has brought back talk of deflation and has rattled financial markets.

The talk about deflation invites references to the Great Depression, which was the last time persistent price declines were a problem for the U.S. economy. From more recent economic history, the collapse in the price of oil in 1986 is an example of a less severe deflationary shock. Finally, the resurgence of financial market volatility amidst a booming economy resembles the experience of the stock market crash of 1987. These are the three historical experiences we look at in this week's center section.

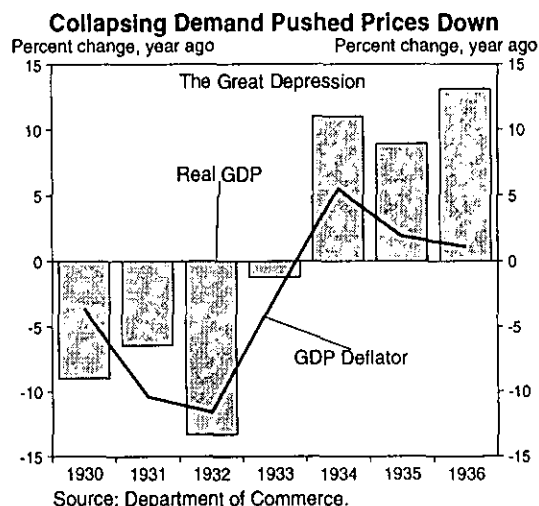
We find that the policy errors of the Great Depression taught the Fed to take financial crises very seriously, and that a prolonged period of deflation would not have happened without the accompanying dramatic collapse in domestic demand. The 1986 oil crisis teaches us that interest rates can remain subdued for a long time, even if a deflationary shock is temporary. The experience of the Crash of 1987 tells us that although financial crises do not always translate into economic crises, the initial reaction of both the Fed and the market is to focus on the negative short-term impact and ignore any long-term positive effects.

Case Study #1: The Great Depression

There has been a lot of talk lately of the U.S. economy entering a period of deflation, *i.e.*, a period during which there is a sustained decline in the prices of goods and services. Such talk of the "D" word inevitably brings to mind the experience of the Great Depression, when consumer prices declined by about one third from 1930 through 1933. If it happened in the past, could it not happen again? It could, but at this point we think this is highly unlikely:

1. Remember it was called the Great Depression, not the Great Deflation.

The main reason the Great Depression has remained so firmly rooted in the national psyche is the incredibly steep decline in economic activity and the pervasive unemployment that it spurred, not the accompanying decline in prices! One cannot overstate the severity of the collapse in domestic demand. Without this collapse, prices would not have declined as persistently



and as steeply as they did. As the graph above shows, real GDP fell by about a third during 1930-1933. This would be equivalent to about \$2.5 trillion in today's economy. At the worst of the Great Depression, almost one third of the labor force was unemployed.

Whatever the shortcomings of the U.S. economy today, insufficient domestic demand is not one of them. With the U.S. consumer registering solid gains in jobs, wages, and wealth, it is difficult to envision a situation of persistent price declines brought about by insufficient demand.

2. The Fed worsened the situation by essentially tightening monetary policy.

It is difficult to explain the Fed's behavior during the Great Depression using today's economic thinking. The Fed's failure to assume its role as a lender of last resort allowed over one third of the commercial banks in the United States to fail. The resulting unprecedented decline in the money supply is thought by many economists to have been the major contributing factor to the severity of the depression. Should signs of deflation emerge today, the Fed could literally print money in order to avoid deflation. Ultimately, deflation is a monetary phenomenon and can be easily counteracted as such.

3. The Great Depression changed economic thinking and Fed policy forever.

Before the Great Depression, economic thinking had been dominated for over a century by

neoclassical economists, who stressed the self-equilibrating nature of economies and did not see a role for government intervention to control economic crises. A 30% unemployment rate was enough to change those beliefs! The Great Depression was followed by the theoretical dominance of Keynesianism, which preached that economies would not always reach their full employment levels, and therefore government intervention was sometimes necessary. The Fed essentially operates under such an environment today, standing by to loosen credit should economic activity slow down substantially.

4. Ultimately, the main difference between the 1930s and today is . . . the Great Depression itself.

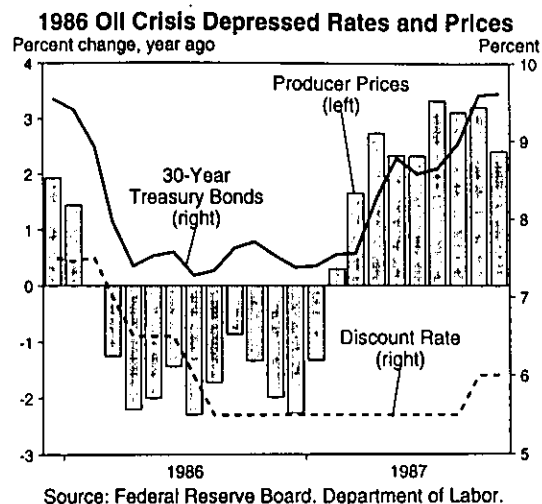
For over half a century, students of economics have been learning about the Fed's policy errors during the Great Depression and the arguments in favor of active monetary policy. The experience of the Great Depression partly explains why the Fed has been so responsive to financial and economic crises over the past 60 years.

Implications for financial asset prices: Though we do not believe that a prolonged period of deflation is currently likely, the Great Depression teaches us that bonds and cash tend to outperform stocks during such periods. This is because fixed income securities offer income which is fixed in nominal terms, but rising in real terms when the price level is falling. On the other hand, stocks offer the promise of dividends, which could be declining in nominal terms, should deflation kick in.

Case Study #2: The 1986 Oil Price Collapse

Although the Great Depression was the last time the U.S. economy experienced a period of persistent deflation, milder deflationary shocks have also hit the U.S. economy in the past. One such example is the oil price collapse of 1986. From \$31 per barrel in November 1985, the price of West Texas Intermediate crude oil dropped to a low of approximately \$10 in July 1986. This dramatic plunge in the price of oil was sudden and unexpected. As shown in the graph above, it led to a period of declining producer prices and somewhat slower economic activity. Here are some lessons to be learned from this experience:

1. Although the shock proved to be temporary, it suppressed bond yields for a full year.



With PPI inflation in negative territory throughout most of 1986 and economic activity subdued, the Fed reduced the discount rate twice that year. This easing in monetary policy helped push bond yields lower. What is interesting, however, is that yields remained low for quite a while—until early 1987, when inflation popped up again. Even though core inflation was largely unaffected by the oil price collapse, and oil prices quickly regained some of their early losses, the Fed remained on hold until April 1987 when it embarked on a series of tightening moves that were interrupted by the Crash of October 1987.

2. The market and the Fed often put more emphasis on the short-term negative rather than any long-term positive effects of a shock.

The 1986 oil price collapse had beneficial long-term economic effects, because cheaper oil lowered production costs and boosted real incomes, and also because the resulting drop in interest rates spurred economic activity. However, in the short term, the oil price collapse fueled a decline in investment in the energy sector, accelerating a slowdown that was already under way following the 1986 tax reform. By the time the long-term positive effects started kicking in and the Fed tightened policy, a full year had gone by.

A similar situation is playing out with the Asian shock to the U.S. economy today. The recent decline in long-term interest rates, as well as the boost in real incomes from falling inflation, will spur economic activity in the medium term. However, in the short term, both the markets and

the Fed are caught by day-to-day uncertainties regarding the size of the shock from Asia.

Case Study #3: The Crash of 1987

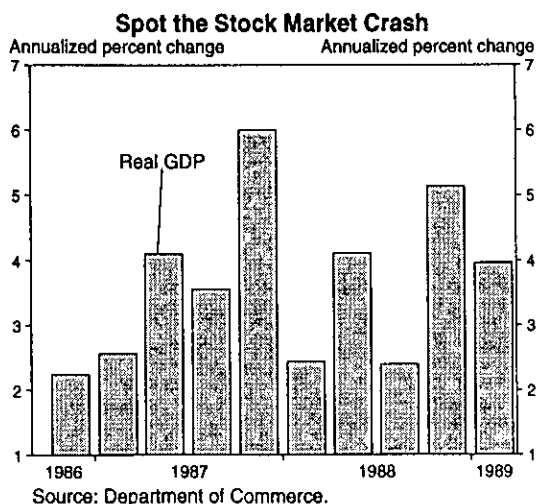
1. The Fed takes financial crises very seriously.

The stock market crash of October 1987 brought Fed officials painful memories of the crash of 1929, which heralded the beginning of the Great Depression. Rather than making the same mistake twice, the Fed pumped liquidity into the financial system in the aftermath of the crash, and lowered interest rates by a total of 100 basis points through January 1988.

A similar situation is playing out during the Asian crisis. Although the Fed hasn't lowered rates, the fact that it removed its tightening bias as early as last December despite a clear tightening in labor markets, illustrates how seriously the FOMC is taking the Asian financial crisis. Even a very small probability of a collapse in the world financial system is sufficient to trigger an immediate reaction by the Fed.

2. A financial crisis does not automatically translate into an economic crisis.

The Crash of 1987 was clearly one of the biggest U.S. financial crises of this century. And yet it did not lead to a recession, as many had feared (see graph below), nor would it figure prominently in a list of major economic crises. Had you not known that the stock market crashed in October 1987, it would have been virtually impossible to have guessed that a major financial crisis hit the U.S. economy during that period, just from looking at the path of economic growth.



Federal Reserve Monetary Policy After the Crash of 1987

Date	Policy Change	From	To
10/23/87	Easing	7.50%	7.00%-7.125%
10/28/87	Easing	7.00%	6.875%
11/3/87	Easing	6.875%	6.75%
1/28/88	Easing	6.75%	6.50%-6.625%
3/29/88	Tightening	6.50%-6.625%	6.75%
5/9/88	Tightening	6.75%-6.875%	7.00%-7.125%
5/25/88	Tightening	7.00%-7.125%	7.375%
6/22/88	Tightening	7.375%	7.50%
6/30/88	Tightening	7.50%	7.75%
11/23/88	Tightening	8.375%	8.50%-8.625%
12/14/88	Tightening	8.625%	8.75%-8.875%
1/5/89	Tightening	8.875%	9.00%-9.125%
2/14/89	Tightening	9.125%	9.25%-9.375%

Source: Federal Reserve Board.

Of course, part of the reason why the U.S. economy managed to withstand the Crash of 1987 was that the negative effect from a temporary stall in consumer spending was counteracted by a dramatic improvement in the trade picture. Ironically, we could be in exactly the reverse situation today! That is, a sharp deterioration in the U.S. trade deficit brought about by the Asian crisis could end up being counteracted by the spending patterns of a buoyant U.S. consumer.

3. The Fed was swift in changing course again, once financial market volatility subsided.

The Fed has often been criticized for overreacting to the Crash of 1987 by loosening credit amidst a booming economy. Yet given the painful memories of the Great Depression, this was a reasonable strategy at the time. And the Fed should be given credit for being quick to revert to a restrictive monetary policy stance once it became obvious that the U.S. economy was not collapsing. As the table above shows, interest rates were jacked up as early as March 1988, two months after they were last lowered, and just five months after the stock market crash.

The experience of the Crash of 1987 tells us that the Fed is swift in reacting to a changing world. Being traumatized by the severity of the Great Depression, it stands by as a lender of last resort to contain financial market crises. At the same time, in 1988 it was willing to change course quickly, once financial market volatility subsided and the economic picture became clear again.

Alex Patelis

Key U.S. Economic Data

	Latest Monthly Data				6 Mo Trend	12 Mo Trend	Next Release
	'98 Jan	'97 Dec	'97 Nov	'97 Oct			
Nonfarm Payrolls (ch. thousands)	358	355	429	291	298	276	Mar 6
Unemployment Rate (%)	4.7	4.7	4.6	4.8	4.8	4.9	
Index of Hours Worked (% ch)	0.6	-0.3	1.2	0.2	4.6	3.8	
Average Hourly Earnings (% ch)	0.3	-0.1	0.6	0.4	4.5	3.8	
Producer price finished goods index (% ch)	--	-0.2	-0.2	0.1	0.9	-1.3	Feb 18
Excluding food and energy	--	-0.1	-0.1	0.0	0.3	0.0	
Consumer price index (% ch)	--	0.1	0.1	0.2	2.0	1.7	Feb 18
Excluding food and energy (% ch)	--	0.2	0.1	0.2	2.0	2.2	
Retail sales (% ch)	0.1	0.3	0.1	-0.1	1.1	2.4	Mar 12
Excluding motor vehicles (% ch)	0.5	-0.1	-0.1	0.2	1.1	2.4	
Industrial Production (% ch)	--	0.5	0.8	0.7	7.6	5.9	Feb 17
Manufacturing	--	0.5	1.2	0.7	8.1	6.5	
Capacity utilization (%)	--	83.4	83.3	83.0	83.0	82.7	Feb 17
Manufacturing	--	82.5	82.4	81.8	81.9	81.7	
Housing Starts (annual rate, thousands)	--	1519	1531	1527	1491	1478	Feb 18
Single-family	--	1092	1161	1122	1133	1139	
Trade balance (billions, monthly)	--	--	-8.0	-9.1	-9.2	-9.4	Feb 19
Merchandise	--	--	-15.1	-16.5	-16.5	-16.5	
Factory Orders (% ch)	--	-2.5	2.4	0.1	4.1	6.1	Mar 5
Durable Goods	--	-5.2	4.7	-0.1	3.3	8.5	Feb 26
Personal Income (% ch)	--	0.4	0.7	0.5	5.6	5.8	Mar 2
Wages and Salaries	--	0.4	1.2	0.7	7.3	6.7	
Purchasing Managers' Index (%)	52.4	53.1	54.5	55.9	54.5	54.9	Mar 2
Consumer Sentiment U Mich (Feb 66=100)	106.6	102.1	107.2	105.6	105.3	104.0	Feb 24
Conference Board (1985=100)	127.3	136.2	128.1	123.4	128.8	126.1	Feb 27

Note: Percentage changes are month to month for last four months, annualized for 6- and 12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- The trade deficit probably returned to double-digit levels in December, as the trade drag from Asia started kicking in, and exporters lost some of their pricing power (February 19).
- Significant declines in both food and energy prices should drag the overall producer price index down. Outside these two sectors, prices are stable on average (February 18).
- A potentially large increase in auto assemblies, coupled with indications of further gains in output from the data on hours worked in other sectors, should have offset last month's decline in utility output (February 17).
- Lower interest rates and lean supplies of unsold homes suggest continued buoyancy in housing starts (February 18).

Economic Releases and Other Events

Date	Time	Indicator	Estimate		Last Report
			GS	Consensus	
Tue Feb 17	9:15	Industrial Production (Jan)	+0.4%	+0.3%	+0.5%
	9:15	Capacity Utilization (Jan)	83.4%	83.3%	83.4%
Wed Feb 18	8:30	Producer Price Index (Jan)	-0.3%	-0.2%	-0.2%
		Excluding Food & Energy	0.0%	0.0%	-0.1%
	8:30	Housing Starts (Jan)	+3.5%	-1.3%	-0.8%
Thu Feb 19	8:30	Trade Balance (Dec)	-\$10.5 Bil	-\$8.9 Bil	-\$8.0 Bil
	10:00	Philadelphia Fed Survey (Feb)	+10.0%	+13.5%	+17.3%

- Home Builders' Survey (Tue, Feb 17 - 1:00)
- Kansas City Fed Survey (Wed, Feb 18 - 11:00)
- Treasury Announces 2- and 5-Year Notes (Wed, Feb 18 - 2:30)
- G7 Meeting (Sat, Feb 21 - Sun, Feb 22)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.8%	5.9%	6.2%
Forward	5.6	5.6	5.5
2 Yr T-Note	5.6	5.8	6.2
Forward	5.4	5.4	5.4
10 Yr T-Note	5.7	5.9	6.2
Forward	5.5	5.6	5.6

Key Numbers in the Business Outlook

	1997	1998E		1997	1998E
	Q4	Q1	Q2		
Real GDP	4.3%	2.5%	1.5%	3.8%	2.9%
Ind. Prod., Mfg.	7.4	4.9	3.2	5.0	4.9
CPI	2.1	1.5	1.9	2.3	1.9
After-Tax Profits*	11.2E	7.3	4.9	10.4E	3.7
Unemployment	4.7	4.7	4.7	5.0	4.6

* Excluding inventory profits; adjusted for depreciation distortions.

SUBJECT : U. S. ECONOMIC ANALYST

ATTENTION: GENE SPERLING
WHITE HOUSE

FAX: 12024562878

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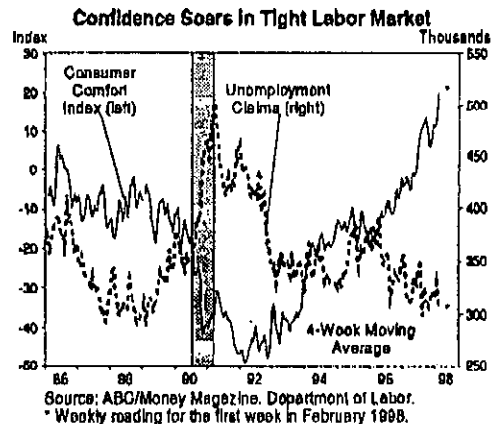
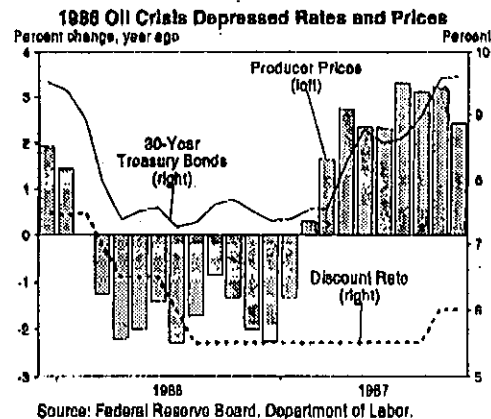
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U.S. Economics Analyst

Lessons From the Past

- In this week's center section we look at three events from the economic history of the United States to draw clues about the likely impact of the Asian crisis and any future shocks. Our look at the Great Depression tells us that the policy errors of the time taught the Fed to take financial crises very seriously, and that a prolonged period of deflation would not have happened without the accompanying dramatic collapse in domestic demand.
- The 1986 oil crisis teaches us that interest rates can remain subdued for an extended long period of time, even if a deflationary shock is ultimately only temporary. The experience of the Crash of 1987 tells us that although financial crises do not always translate into economic crises, the initial reaction of both the Fed and the market is to focus on the negative short-term impact and ignore any long-term positive effects.
- Extraordinarily high levels of confidence and low levels of jobless benefit claims continue to paint a bright picture of consumer spending fundamentals. Preliminary retail sales figures for January do show a solid increase in spending outside the motor vehicle area, although revisions also show that spending in the fourth quarter of 1997 was a bit less buoyant than first estimated.
- Indexes of U.S. import and export prices both fell sharply last month, confirming that the crisis in Asia is suppressing inflation in the United States. Productivity also posted larger-than-expected gains in the fourth quarter, although some of last year's impressive performance in this area reflects a puzzling decline in hours worked by self-employed individuals.



Trade Recommendations

- Stay short September '98 Eurodollar futures, with a target of 94.10 and a stop on a close above 94.64.

Contributors: Bill Dudley, Ed McKelvey,
John Youngdahl, Alex Patelis (212) 902-6807

E-mail Address: william.dudley@gs.com

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February 13, 1998

Important disclosures appear on the inside back cover.



I. Weekly Wrapup

Economic and Market Overview

Prices of U.S. equities moved higher as fresh data continued to indicate moderate growth in the U.S. economy with little apparent upward pressure on inflation. Bond yields, on the other hand, were little changed on balance.

Early in the week, the financial markets were treated to yet another surprisingly strong set of figures on labor productivity. Output per hour was reported to have risen at a 2.0% annual rate last quarter in the nonfarm business sector, maintaining the pattern of firm gains that have allowed increases in unit labor costs to drift slightly lower over the past two years. However, on closer inspection, last year's strength in productivity growth owes much to a puzzling decline in hours worked by self-employed workers, raising suspicions that the labor-cost picture may not be quite as bright as currently painted in the official data.

Other price pressures, on the other hand, continue to abate unambiguously in response to the Asian crisis. U.S. import prices fell 1.3% in January, with about half of this drop coming from weaker oil prices. Whether oil is included or excluded, year-to-year changes in import prices are the weakest in the 13-year history of the series (-6.1% and -3.1%, respectively). Competitive pressures have also kept export prices weak. They were down 0.6% overall in January and 0.3% excluding agricultural products.

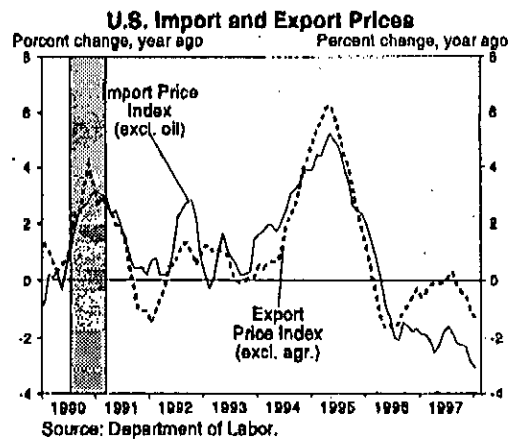
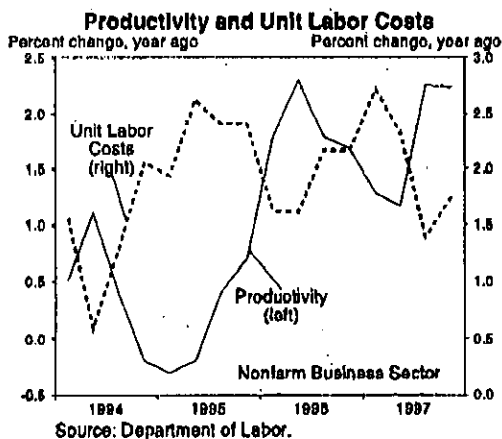
Meanwhile, retail sales inched up 0.1% in January but posted a more solid 0.5% gain when receipts of motor

vehicle dealers are excluded—a figure in line with the firmness in weekly sales indexes. However, the latest report also revealed that spending was less buoyant during the holiday season than previously thought. Downward revisions to the component of retail sales on which estimates of personal spending are based (which exclude building materials as well as motor vehicles) suggest that the Commerce Department's preliminary estimate that real outlays rose at a 3.2% annualized rate could be revised down $\frac{1}{4}$ to $\frac{1}{2}$ point.

That said, consumer spending is unlikely to slow in any meaningful way, judging from the latest reports on confidence and labor-market conditions. In the first week of February, the composite index from the ABC/Money poll posted another new record, driven by soaring assessments of economic prospects, while initial filings for jobless benefits remained quite low.

Federal Reserve Policy

With an FOMC meeting just behind them and the semiannual Humphrey/Hawkins hearings just ahead, Fed officials have been fairly quiet in recent days. Although Chairman Greenspan was quoted by wire services as saying that the impact of the Asian crisis on U.S. growth might not be very large, his actual testimony did not convey any different impression from his earlier appearances in late January—namely, that it is too soon to tell how big a toll this crisis will exact. In all likelihood, he will strike a balanced and noncommittal tone about this issue, as well as future policy moves, when he appears before the House Banking Committee on February 24.





Fiscal and Political Developments

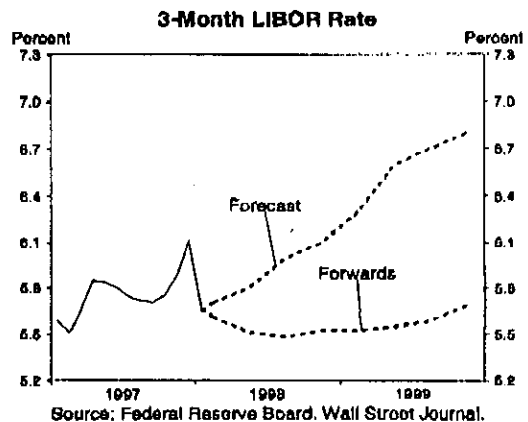
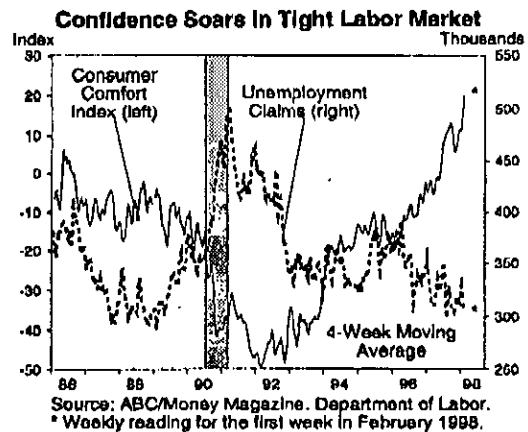
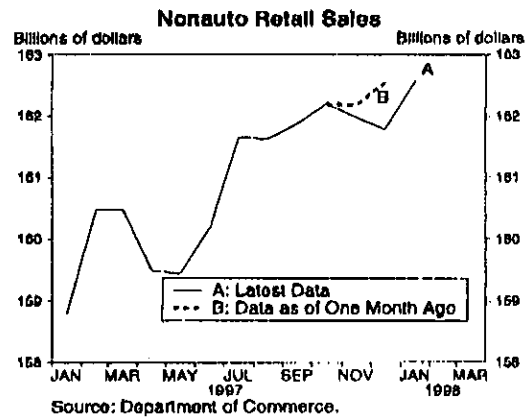
The ruling by a federal district court judge that the line-item veto is unconstitutional was neither a surprise nor an event of serious consequence for near-term budget trends. Assuming that the decision is upheld on appeal, it would restore about \$1.9 billion in spending over the next five years—a trivial sum when set against the \$8.9 trillion in federal outlays projected over the same period. The maintenance of strict "pay-as-you-go" caps on federal spending and tax cuts will be far more important to maintaining budget discipline in coming years.

In that regard, the bigger threat that has emerged in recent days is the recognition by the Congressional Budget Office that the federal budget will probably end the current year in surplus. This marks the first official recognition that the federal government's drought of black ink will disappear this year instead of next. And, notwithstanding President Clinton's plea to apply surpluses first to putting Social Security on a sounder financial footing, an earlier-than-expected surplus is likely to tempt Republicans and Democrats into a compromise featuring tax cuts as mid-term elections approach, especially if economic growth softens this spring.

Market Outlook and Comments on Value

Note: The following comments reflect trading views and may differ from our longer-term interest rate forecast.

Not much has happened to change our cautious posture on the U.S. fixed-income market. We still believe firmly that Fed officials will frustrate market expectations of an easing later this year; hence, we continue to recommend short positions in September Eurodollar futures, with a target of 94.10 and a stop on a close above 94.64. However, in the near term, the prospective softening trend of economic data over the next few months suggests to us that it is far too early to act on our judgment that long-term rates at current levels are inconsistent with our view that monetary policy will remain unchanged for the foreseeable future.





II. Lessons From the Past

When unexpected shocks hit the economy, it is often useful to turn to the past for clues about the future. The U.S. economy is in the process of being hit by a shock from Asia, which has brought back talk of deflation and has rattled financial markets.

The talk about deflation invites references to the Great Depression, which was the last time persistent price declines were a problem for the U.S. economy. From more recent economic history, the collapse in the price of oil in 1986 is an example of a less severe deflationary shock. Finally, the resurgence of financial market volatility amidst a booming economy resembles the experience of the stock market crash of 1987. These are the three historical experiences we look at in this week's center section.

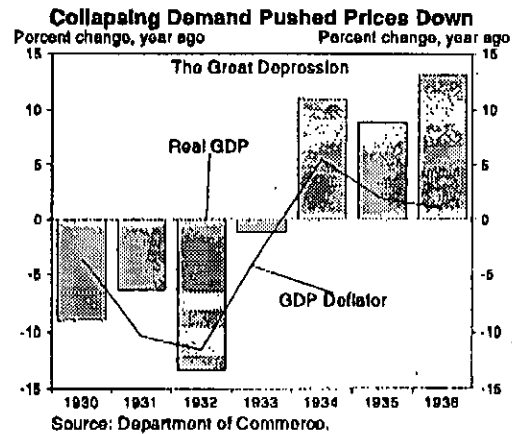
We find that the policy errors of the Great Depression taught the Fed to take financial crises very seriously, and that a prolonged period of deflation would not have happened without the accompanying dramatic collapse in domestic demand. The 1986 oil crisis teaches us that interest rates can remain subdued for a long time, even if a deflationary shock is temporary. The experience of the Crash of 1987 tells us that although financial crises do not always translate into economic crises, the initial reaction of both the Fed and the market is to focus on the negative short-term impact and ignore any long-term positive effects.

Case Study #1: The Great Depression

There has been a lot of talk lately of the U.S. economy entering a period of deflation, *i.e.*, a period during which there is a sustained decline in the prices of goods and services. Such talk of the "D" word inevitably brings to mind the experience of the Great Depression, when consumer prices declined by about one third from 1930 through 1933. If it happened in the past, could it not happen again? It could, but at this point we think this is highly unlikely:

1. Remember it was called the Great Depression, not the Great Deflation.

The main reason the Great Depression has remained so firmly rooted in the national psyche is the incredibly steep decline in economic activity and the pervasive unemployment that it spurred, not the accompanying decline in prices! One cannot overstate the severity of the collapse in domestic demand. Without this collapse, prices would not have declined as persistently



and as steeply as they did. As the graph above shows, real GDP fell by about a third during 1930-1933. This would be equivalent to about \$2.5 trillion in today's economy. At the worst of the Great Depression, almost one third of the labor force was unemployed.

Whatever the shortcomings of the U.S. economy today, insufficient domestic demand is not one of them. With the U.S. consumer registering solid gains in jobs, wages, and wealth, it is difficult to envision a situation of persistent price declines brought about by insufficient demand.

2. The Fed worsened the situation by essentially *tightening* monetary policy.

It is difficult to explain the Fed's behavior during the Great Depression using today's economic thinking. The Fed's failure to assume its role as a lender of last resort allowed over one third of the commercial banks in the United States to fail. The resulting unprecedented decline in the money supply is thought by many economists to have been the major contributing factor to the severity of the depression. Should signs of deflation emerge today, the Fed could literally print money in order to avoid deflation. Ultimately, deflation is a monetary phenomenon and can be easily counteracted as such.

3. The Great Depression changed economic thinking and Fed policy forever.

Before the Great Depression, economic thinking had been dominated for over a century by



neoclassical economists, who stressed the self-equilibrating nature of economies and did not see a role for government intervention to control economic crises. A 30% unemployment rate was enough to change those beliefs! The Great Depression was followed by the theoretical dominance of Keynesianism, which preached that economies would not always reach their full employment levels, and therefore government intervention was sometimes necessary. The Fed essentially operates under such an environment today, standing by to loosen credit should economic activity slow down substantially.

4. Ultimately, the main difference between the 1930s and today is . . . the Great Depression itself.

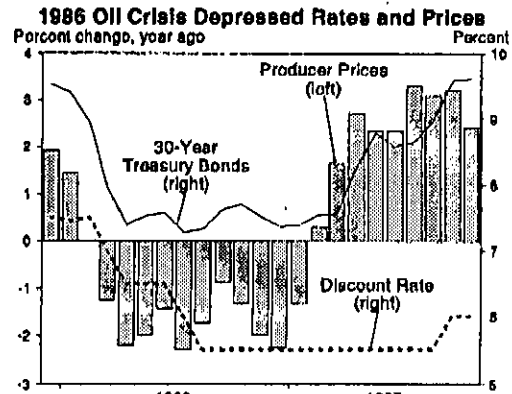
For over half a century, students of economics have been learning about the Fed's policy errors during the Great Depression and the arguments in favor of active monetary policy. The experience of the Great Depression partly explains why the Fed has been so responsive to financial and economic crises over the past 60 years.

Implications for financial asset prices: Though we do not believe that a prolonged period of deflation is currently likely, the Great Depression teaches us that bonds and cash tend to outperform stocks during such periods. This is because fixed income securities offer income which is fixed in nominal terms, but rising in real terms when the price level is falling. On the other hand, stocks offer the promise of dividends, which could be declining in nominal terms, should deflation kick in.

Case Study #2: The 1986 Oil Price Collapse

Although the Great Depression was the last time the U.S. economy experienced a period of persistent deflation, milder deflationary shocks have also hit the U.S. economy in the past. One such example is the oil price collapse of 1986. From \$31 per barrel in November 1985, the price of West Texas Intermediate crude oil dropped to a low of approximately \$10 in July 1986. This dramatic plunge in the price of oil was sudden and unexpected. As shown in the graph above, it led to a period of declining producer prices and somewhat slower economic activity. Here are some lessons to be learned from this experience:

1. Although the shock proved to be temporary, it suppressed bond yields for a full year.



Source: Federal Reserve Board, Department of Labor.

With PPI inflation in negative territory throughout most of 1986 and economic activity subdued, the Fed reduced the discount rate twice that year. This easing in monetary policy helped push bond yields lower. What is interesting, however, is that yields remained low for quite a while—until early 1987, when inflation popped up again. Even though core inflation was largely unaffected by the oil price collapse, and oil prices quickly regained some of their early losses, the Fed remained on hold until April 1987 when it embarked on a series of tightening moves that were interrupted by the Crash of October 1987.

2. The market and the Fed often put more emphasis on the short-term negative rather than any long-term positive effects of a shock.

The 1986 oil price collapse had beneficial long-term economic effects, because cheaper oil lowered production costs and boosted real incomes, and also because the resulting drop in interest rates spurred economic activity. However, in the short term, the oil price collapse fueled a decline in investment in the energy sector, accelerating a slowdown that was already under way following the 1986 tax reform. By the time the long-term positive effects started kicking in and the Fed tightened policy, a full year had gone by.

A similar situation is playing out with the Asian shock to the U.S. economy today. The recent decline in long-term interest rates, as well as the boost in real incomes from falling inflation, will spur economic activity in the medium term. However, in the short term, both the markets and



the Fed are caught by day-to-day uncertainties regarding the size of the shock from Asia.

Case Study #3: The Crash of 1987

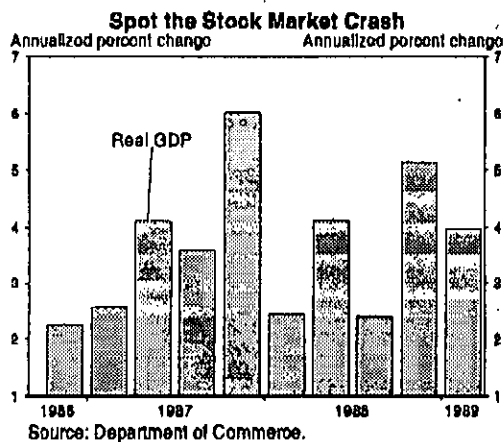
1. The Fed takes financial crises very seriously.

The stock market crash of October 1987 brought Fed officials painful memories of the crash of 1929, which heralded the beginning of the Great Depression. Rather than making the same mistake twice, the Fed pumped liquidity into the financial system in the aftermath of the crash, and lowered interest rates by a total of 100 basis points through January 1988.

A similar situation is playing out during the Asian crisis. Although the Fed hasn't lowered rates, the fact that it removed its tightening bias as early as last December despite a clear tightening in labor markets, illustrates how seriously the FOMC is taking the Asian financial crisis. Even a very small probability of a collapse in the world financial system is sufficient to trigger an immediate reaction by the Fed.

2. A financial crisis does not automatically translate into an economic crisis.

The Crash of 1987 was clearly one of the biggest U.S. financial crises of this century. And yet it did not lead to a recession, as many had feared (see graph below), nor would it figure prominently in a list of major economic crises. Had you not known that the stock market crashed in October 1987, it would have been virtually impossible to have guessed that a major financial crisis hit the U.S. economy during that period, just from looking at the path of economic growth.



Federal Reserve Monetary Policy After the Crash of 1987

Date	Policy Change	From	To
10/23/87	Easing	7.50%	7.00%-7.125%
10/28/87	Easing	7.00%	6.875%
11/3/87	Easing	6.875%	6.75%
1/28/88	Easing	6.75%	6.50%-6.625%
3/29/88	Tightening	6.50%-6.625%	6.75%
5/8/88	Tightening	6.75%-6.875%	7.00%-7.125%
5/25/88	Tightening	7.00%-7.125%	7.375%
6/22/88	Tightening	7.375%	7.50%
6/30/88	Tightening	7.50%	7.75%
11/23/88	Tightening	8.375%	8.50%-8.625%
12/14/88	Tightening	8.625%	8.75%-8.875%
1/5/89	Tightening	8.875%	9.00%-9.125%
2/14/89	Tightening	9.125%	9.25%-9.375%

Source: Federal Reserve Board.

Of course, part of the reason why the U.S. economy managed to withstand the Crash of 1987 was that the negative effect from a temporary stall in consumer spending was counteracted by a dramatic improvement in the trade picture. Ironically, we could be in exactly the reverse situation today! That is, a sharp deterioration in the U.S. trade deficit brought about by the Asian crisis could end up being counteracted by the spending patterns of a buoyant U.S. consumer.

3. The Fed was swift in changing course again, once financial market volatility subsided.

The Fed has often been criticized for overreacting to the Crash of 1987 by loosening credit amidst a booming economy. Yet given the painful memories of the Great Depression, this was a reasonable strategy at the time. And the Fed should be given credit for being quick to revert to a restrictive monetary policy stance once it became obvious that the U.S. economy was not collapsing. As the table above shows, interest rates were jacked up as early as March 1988, two months after they were last lowered, and just five months after the stock market crash.

The experience of the Crash of 1987 tells us that the Fed is swift in reacting to a changing world. Being traumatized by the severity of the Great Depression, it stands by as a lender of last resort to contain financial market crises. At the same time, in 1988 it was willing to change course quickly, once financial market volatility subsided and the economic picture became clear again.

Alex Patells



Key U.S. Economic Data

	Latest Monthly Data				6 Mo Trend	12 Mo Trend	Next Release
	'88 Jan	'87 Dec	'87 Nov	'87 Oct			
Nonfarm Payrolls (ch. thousands)	358	355	429	281	298	278	Mar 8
Unemployment Rate (%)	4.7	4.7	4.8	4.8	4.8	4.9	
Index of Hours Worked (% ch)	0.6	-0.3	1.2	0.2	4.6	3.8	
Average Hourly Earnings (% ch)	0.3	-0.1	0.6	0.4	4.5	3.8	
Producer price finished goods index (% ch)	--	-0.2	-0.2	0.1	0.9	-1.3	Feb 18
Excluding food and energy	--	-0.1	-0.1	0.0	0.3	0.0	
Consumer price index (% ch)	--	0.1	0.1	0.2	2.0	1.7	Feb 18
Excluding food and energy (% ch)	--	0.2	0.1	0.2	2.0	2.2	
Retail sales (% ch)	0.1	0.3	0.1	-0.1	1.1	2.4	Mar 12
Excluding motor vehicles (% ch)	0.5	-0.1	-0.1	0.2	1.1	2.4	
Industrial Production (% ch)	--	0.5	0.6	0.7	7.6	5.9	Feb 17
Manufacturing	--	0.5	1.2	0.7	8.1	6.5	
Capacity utilization (%)	--	83.4	83.3	83.0	83.0	82.7	Feb 17
Manufacturing	--	82.6	82.4	81.8	81.8	81.7	
Housing Starts (annual rate, thousands)	--	1519	1531	1527	1491	1476	Feb 18
Single-family	--	1092	1101	1122	1133	1139	
Trade balance (billions, monthly)	--	--	-8.0	-8.1	-9.2	-9.4	Feb 18
Merchandise	--	--	-15.1	-16.5	-16.5	-16.5	
Factory Orders (% ch)	--	-2.6	2.4	0.1	4.1	6.1	Mar 5
Durable Goods	--	-5.2	4.7	-0.1	3.3	6.5	Feb 26
Personal Income (% ch)	--	0.4	0.7	0.5	5.6	5.8	Mar 2
Wages and Salaries	--	0.4	1.2	0.7	7.3	6.7	
Purchasing Managers' Index (%)	52.4	53.1	54.5	55.9	54.5	54.9	Mar 2
Consumer Sentiment U Mich (Feb 88=100)	106.6	102.1	107.2	105.6	105.3	104.0	Feb 24
Conference Board (1985=100)	127.3	136.2	128.1	123.4	128.8	120.1	Feb 27

Note: Percentage changes are month to month for last four months, annualized for 6- and 12-month trends. 6- and 12-month figures for levels (e.g., unemployment rate) are averages over those periods.

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U.S. Calendar

Focus for the Week Ahead

- The trade deficit probably returned to double-digit levels in December, as the trade drag from Asia started kicking in, and exporters lost some of their pricing power (February 19).
- Significant declines in both food and energy prices should drag the overall producer price index down. Outside these two sectors, prices are stable on average (February 18).
- A potentially large increase in auto assemblies, coupled with indications of further gains in output from the data on hours worked in other sectors, should have offset last month's decline in utility output (February 17).
- Lower interest rates and lean supplies of unsold homes suggest continued buoyancy in housing starts (February 18).

Economic Releases and Other Events

Date	Time	Indicator	Estimate		Last Report
			Q8	Consensus	
Tue Feb 17	9:15	Industrial Production (Jan)	+0.4%	+0.3%	+0.5%
	9:15	Capacity Utilization (Jan)	83.4%	83.3%	83.4%
Wed Feb 18	8:30	Producer Price Index (Jan)	-0.3%	-0.2%	-0.2%
		Excluding Food & Energy	0.0%	0.0%	-0.1%
	8:30	Housing Starts (Jan)	+3.5%	-1.3%	-0.8%
Thu Feb 19	8:30	Trade Balance (Dec)	-\$10.5 Bll	-\$8.9 Bll	-\$8.0 Bll
	10:00	Philadelphia Fed Survey (Feb)	+10.0%	+13.5%	+17.3%

- Home Builders' Survey (Tue, Feb 17 - 1:00)
- Kansas City Fed Survey (Wed, Feb 18 - 11:00)
- Treasury Announces 2- and 5-Year Notes (Wed, Feb 18 - 2:30)
- G7 Meeting (Sat, Feb 21 - Sun, Feb 22)

Interest Rates: Forecast vs. Forward Yields

	3 mo	6 mo	12 mo
LIBOR 3 mo	5.8%	5.9%	6.2%
Forward	5.6	5.6	5.5
2 Yr T-Note	5.6	6.8	6.2
Forward	5.4	5.4	5.4
10 Yr T-Note	5.7	5.9	6.2
Forward	5.5	5.6	5.6

Key Numbers in the Business Outlook

	1997	1998E		1997	1998E
	Q4	Q1	Q2		
Real GDP	4.3%	2.5%	1.5%	3.8%	2.9%
Ind. Prod., Mfg.	7.4	4.9	3.2	5.0	4.9
CPI	2.1	1.8	1.9	2.3	1.9
After-Tax Profits*	11.2E	7.3	4.9	10.4E	3.7
Unemployment	4.7	4.7	4.7	5.0	4.6

* Excluding inventory profits; adjusted for depreciation distortions.

FAX**Date** 2/13/98**Number of pages including cover sheet** 2**TO:** Jennifer Klein**Phone** 202-456-1906
fax 202-456-1121**REMARKS:** ☐ Urgent ☒ For your review ☐ Reply ASAP ☐ Please Comment

Here's the letter to Elena that I mentioned. Looking forward to speaking with you soon. Marcy

February 11, 1998

National Center
for the
Early Childhood
Work Force

*formerly the Child Care
Employee Project*

Elena Kagan, Deputy Director
Domestic Policy Council
Second Floor, West Wing
The White House
Washington, D.C. 20502

Dear Ms. Kagan,



I have recently spoken with Karen Tramontano and Jennifer Klein to let them know that we are just completing an update of our 1989 National Child Care Staffing Study, which will give us a ten-year overview of child care worker salaries and job turnover, how many of the centers in the original study are still in operation, and how many are currently employing TANF recipients as part of welfare reform.

We will be releasing the study update this spring, and would like very much for this data to be helpful to the President's comprehensive child care initiative. I will be in Washington March 4-8, and would very much appreciate the opportunity to meet with you to discuss the findings and their policy implications, as well as the best approaches for talking about the findings with the media and the general public. We are currently writing a summary report and I will send you a draft copy before my trip to Washington.

I would also welcome the opportunity to talk in more depth about the policy proposals on child care staff retention and compensation strategies, and how the Early Learning Fund might be used to support them, that I mentioned in my letter of January 14. I look forward to hearing from you soon.

Sincerely,

Marcy Whitebook

Marcy Whitebook
Co-Director

cc: Karen Tramontano; Jennifer Klein

733 15th Street, NW
Suite 1037
Washington, DC
20005-2112

202/737-7700
202/737-0370 FAX
Worthy Wage Campaign:
1-800-U-R-WORTHY

2625 Alcatraz Ave.
Suite 199
Berkeley, CA
94705

510/654-1778
510/654-0877 FAX

VIA FAX

TO: WHITE HOUSE

FROM: Susan Petrosini
Merrill Lynch
Economics
(212) 449-1061

ATTN: GENE SPERLING

TO: FAX PHONE#: 2024562878

Job Number: 16054909-008-167-0014

TIME: Fri Feb 13 13:31:00 1998

9 pages including cover sheet