

Withdrawal/Redaction Sheet

Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	R. Lawrence to W. Gillespie, re Uranium Meeting (1 page)	08/10/1999	P3/b(3)
002. email	W. Gillespie to R. Lawrence, re Uranium Meeting (3 pages)	08/10/1999	P3/b(3)

COLLECTION:

Clinton Presidential Records
Automated Records Management System
CEA (Robert Z. Lawrence)
OA/Box Number: 950000

FOLDER TITLE:

[08/06/1999 - 08/12/1999]

2014-0316-F

wr10752

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

- P1** National Security Classified Information [(a)(1) of the PRA]
- P2** Relating to the appointment to Federal office [(a)(2) of the PRA]
- P3** Release would violate a Federal statute [(a)(3) of the PRA]
- P4** Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
- P5** Release would disclose confidential advice between the President and his advisors, or between such advisors [(a)(5) of the PRA]
- P6** Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

- b(1)** National security classified information [(b)(1) of the FOIA]
- b(2)** Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
- b(3)** Release would violate a Federal statute [(b)(3) of the FOIA]
- b(4)** Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
- b(6)** Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
- b(7)** Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
- b(8)** Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
- b(9)** Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Kathryn Shaw <"ks4s+"@andrew.cmu.edu> (Kathryn Shaw <"ks4s+"@andrew.cmu.edu> [UNKNOWN])

CREATION DATE/TIME: 6-AUG-1999 12:21:03.00

SUBJECT: Congratulations

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP [CEA])

READ:UNKNOWN

TEXT:

Hi Robert,

You must be celebrating today! I was stunned to hear that it went through the entire Senate at the last minute.

I have begun to investigate my tax issues, and will keep Martin informed. Thanks for your support.

Congratulations! Wonderful news.

Kathryn

Kathryn Shaw
Professor
GSIA
Carnegie Mellon University
Pittsburgh, PA 15213

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Audrey Choi (CN=Audrey Choi/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 6-AUG-1999 11:15:05.00

SUBJECT: ERP-Sunset

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

just wanted to thank you for your help with the ERP/Sunset memo. I just talked with OMB and they are including the ERP on the list of reports that they are recommending to Congress must continue to be required per statute. thanks

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 6-AUG-1999 19:13:52.00

SUBJECT: Y2K draft

TO: Audrey Choi (CN=Audrey Choi/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

CC: douglas_w._elmendorf@cea.eop.gov (douglas_w._elmendorf@cea.eop.gov [UNKNOWN])
READ:UNKNOWN

TEXT:

hope this is okay ... good luck to all===== ATTACHMENT 1 =====
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D96]ARMS29609591Q.236 to ASCII,
The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

Y2K Draft
Elmendorf, Friday 7 pm

Concerns about Y2K will shift economic activity from next year into this one, but total production and employment will likely be little changed.

- The fundamental Y2K risk is that computer systems – especially in the critical infrastructure of finance, telecommunications, power generation, and transportation – could malfunction on January 1st. Both the government and private sector have devoted substantial effort and expense to overhauling their systems, and major disruptions now seem very unlikely. However, some failures will almost surely occur.
- The anticipation of possible Y2K problems could have significant economic effects even if all computers perform normally. Many firms plan to accumulate extra inventories as a precaution against possible supply disruptions, and households may stockpile extra groceries, prescription drugs, and gasoline. These actions will boost demand this year and depress it by an equal amount next year as the excess inventories are consumed.
- These effects could be accentuated by a concern that other people will deplete available supplies through their own precautions. For example, if we expect our neighbors to fill their gas tanks before year-end, we may try to fill ours first, and our combined actions could create a temporary gasoline shortage or long lines even if the supply is unchanged. Policymakers' efforts to calm excessive fears could diminish these problems.
- Financial markets usually show a higher premium for risk at year-ends, as firms try to improve their published balance sheets by holding safer assets. This year's premium is now unusually high, suggesting greater uncertainty about interest rates or the need for liquidity after January 1st. This uncertainty may affect the timing of some financial transactions but should have little effect on the rest of the economy.
- The Blue Chip consensus of economic forecasts suggests that Y2K effects will boost fourth-quarter GDP growth by ¾ percentage point and depress first-quarter growth equally. One well-known survey of firms' purchasing plans implies much larger effects.

[Notes to CEA Folks:

1. Sorry this is too long, but I figure you can decide where to cut.
2. I didn't cite the Fed forecast directly, because I couldn't find the right wording without mentioning the Fed by name. Instead, I used the survey to highlight the upside risk.
3. I'm not sure the financial-market bit needs to be in there, but I learned about it from a Fed colleague and thought I should write it for your benefits at least.
4. One other inventory example. Suppose that households decided to stock an extra week's worth of groceries, prescription drugs and fuel oil. This would boost q4 demand by about \$35 billion at an annual rate, which would boost GDP growth by about 1-1/2 percent.

5. One other point about inventories: some of them will be satisfied by imports, so the GDP effects will be smaller by the extent of the import elasticity.
6. I will be away until Wednesday evening. In an emergency, I can be reached at 1-800-225-3819, Sebasco Resort in Maine. If I'm not listed, check for my wife, Karen Dynan.]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 6-AUG-1999 15:30:04.00

SUBJECT: Phone Message from Arvind Subramanian

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

Contact: Arvind Subramanian Company: IMF Phone: 623-6232 FAX: Message: REMINDER: He is anxious to discuss teaching position at Harvard.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: ft.com.update@news.ft.com (ft.com.update@news.ft.com [UNKNOWN])

CREATION DATE/TIME: 8-AUG-1999 20:32:21.00

SUBJECT: ft.com Update

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

TEXT:
ft.com.update@news.ft.com
08/09/99 12:12 AM GMT

To:

cc:

Dear ft.com user

This month, while half the world is on holiday somewhere else, we have been busy. We gave our in-depth coverage of the half-year results of some of the biggest companies in the UK and US and followed the consequences of the strong dollar. We increased the number of companies in our company briefing section and for the first time we offered all the articles in the Global Archive FREE of charge.

***** European Performance League *****

The latest assessment on Europe's corporate winners and losers, ranked by total shareholder value, is now available on ft.com. This FT league table also gives analysis and profiles on Europe's best and worst.
http://www.ft.com/cgi-bin/site_track.pl?id=monthly5a&url=/euroleague/

***** Asian tonic for the Pharmaceutical Industry *****

As greater prosperity in Asia fuels the diseases of affluence - diabetes, asthma, cancer, heart conditions, obesity and depression - our Life Sciences survey looks at pharmaceutical industry plans for the region.
http://www.ft.com/cgi-bin/site_track.pl?id=monthly5a&url=/lifesci/index-jul.htm

***** FT-IT Discussion Forum *****

The first internet stocks are being launched in the UK as the market begins to falter in the US. What does this mean for the future of technology investment? Discuss this and other technology-for-business issues on the FT's IT discussion forum:
[http://www.ft.com/cgi-bin/ft/site_track.pl?id=monthly4a&url=/ftit/discuss.h
tm](http://www.ft.com/cgi-bin/ft/site_track.pl?id=monthly4a&url=/ftit/discuss.htm)

*** Cricket ***

Follow our coverage of the Test Series between England and New Zealand including a scoreboard with live updates.

http://www.ft.com/cgi-bin/site_track.pl?id=monthly5a&url=/sport/

*** FREE Global Archive ***

Don't forget to take advantage of our great offer. Until August 23 you can get articles from thousands of business publications free of charge.

http://www.ft.com/cgi-bin/ft/site_track.pl?id=gaoffer&url=virtual-globalarchive

*** FTQuicken: Personal finance e-mail course ***

Due to the overwhelming success of FTQuicken's first personal finance by e-mail course, we are repeating the course for newcomers beginning early in September. If you think you could better manage your money, why not sign up now for the eight-week e-mail course covering debt reduction, mortgages, investments, retirement planning and more.

http://www.ft.com/cgi-bin/site_track.pl?id=monthly5a&url=/splash/signup2.htm

Thanks to all those who submitted "mad" business ideas. We have selected three winners - a truly difficult job considering the volume and quality of responses - and will be notifying them by e-mail over the next week.

Regards,
ft.com

If you no longer wish to receive further e-mails from us please send an e-mail to ft.com.unsubscribe@news.ft.com with the single word "unsubscribe" as the subject of the message. Your name will then be removed from our mailing list.

If you have forgotten your password for ft.com simply visit www.ft.com/utis/register/lostpassword.htm

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 17:00:49.00

SUBJECT: Phone Message from Peter Goesslin

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

Contact: Peter Goesslin Company: Phone: 861-9265 FAX: Message: Discuss getting together with you and Martin for lunch.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jason Furman (CN=Jason Furman/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME: 9-AUG-1999 21:38:47.00

SUBJECT: Revised version -- already

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: david.wilcox@do.treas.gov (david.wilcox@do.treas.gov @ inet [UNKNOWN])
READ:UNKNOWN

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: ted.truman@do.treas.gov (ted.truman@do.treas.gov @ inet [UNKNOWN])
READ:UNKNOWN

TO: maureen.grewe@do.treas.gov (maureen.grewe@do.treas.gov @ inet [UNKNOWN])
READ:UNKNOWN

TEXT:

Attached is a revised version, it includes an updated table from Maureen
Grewe.===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D67]ARMS25845122K.236 to ASCII,
The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

MEMORANDUM TO THE PRESIDENT

FROM: Lawrence Summers, Department of Treasury
Martin Baily, Council of Economic Advisers

DATE: August 9, 1999

RE: Economic Outlook

The United States has enjoyed 99 consecutive months of economic expansion and is on track to achieve the longest economic expansion in its history. Meanwhile, inflation has remained under control, unemployment is exceedingly low compared with other expansions since the early 1970s, and recent gains in productivity have been encouraging. The consensus outlook for the economy is positive. While economic growth is seen as moderating somewhat from the very rapid pace of the past few years, the consensus view is that the U.S. economy should continue to exhibit many of the positive characteristics that have been hallmarks of the expansion thus far.

Overview of uncertainties in the forecast

Although the consensus forecast is positive, the uncertainties surrounding the macroeconomic outlook are considerable—both on the upside and on the downside.

- New Era optimism. On the upside, many commentators have suggested that the economy may have entered a “New Era” in which unemployment can remain low, output growth can remain strong, and wage increases can remain rapid, *without* triggering the kinds of imbalances that have led to the demise of expansions in decades past. If this view is correct, there is no presumption that the current expansion will end in the way that almost all past U.S. expansions have ended, with accelerating inflation leading to higher interest rates.
- An inflation shock. On the downside, some observers point to the risk that the productivity surge of the last few years may prove to be only temporary, and that some of the other factors that have helped keep inflation in check may wane or even go into reverse. The consensus forecast assumes that appropriate policy can achieve a “soft landing” in which the economy slows enough to avoid overheating while avoiding a recession. However, efforts to slow demand with higher interest rates could precipitate a recession.
- A domestic asset market shock. Although the typical end of an expansion is the result of rising inflation, some other possibilities deserve serious consideration. For example, the stock market is at a very high level, overpriced in the eyes of many observers. A precipitous decline in asset prices would likely reduce both household

and business demand—and potentially severely so. How that might play out is itself a matter of uncertainty. The experience with the stock market break in 1987 suggests that, provided the monetary response is swift and vigorous, the macroeconomic damage can be contained, and the expansion sustained. On the other hand, Japan's experience over the decade of the 1990s suggests that with the wrong or timid policies, the fallout can be protracted and painful.

- A dollar shock. The U.S. current account deficit has continued to widen, and now is approaching 4 percent of GDP. A number of commentators have raised the possibility that the U.S. dollar may come under (perhaps intense) downward pressure. Such a development could trigger other adverse events, such as an increase in inflation (because imported goods would have become more expensive), a sharp correction in our asset markets (reflecting a generalized loss of confidence on the part of foreign investors), and a marked step-down in our pace of growth.
- Contagion from the Global Economy. The global economy has stabilized and improved somewhat in the last six months. While this is surely a positive development on net, it is not an unmixed blessing, as it does imply greater global competition for capital. Moreover, it is conceivable that a financial crisis in an emerging market economy could set off another round of economic and financial contagion. Argentina and China are the most obvious "hot spots," but there are other candidates, especially in Latin America which, as you know, is in recession.
- Y2K. A number of voices have sounded the alarm with respect to the so-called Y2K computer bug. Although great strides in preparedness have been made, a risk remains of systemic failure, possibly involving financial systems or other major elements of social and economic infrastructure.

The remainder of this memo first reviews the consensus macroeconomic outlook and then examines each of these risks in greater detail.

The consensus macroeconomic outlook

The following table presents recent history and the Administration, CBO, and Blue Chip consensus economic forecasts for key macroeconomic variables:

Economic Projections: A Comparison

	1998	1999	2000
Real GDP growth (Q4/Q4 %)	4.3		
Administration		3.2	2.1
CBO		3.6	2.1
Blue Chip		3.5	2.5
Unemployment (percent)	4.5		
Administration		4.3	4.5
CBO		4.2	4.3
Blue Chip		4.3	4.4
CPI inflation (percent)	1.5		
Administration		2.4	2.4
CBO		2.5	2.4
Blue Chip		2.4	2.3
Current account def. (\$ current)	221		
Administration		326	376
Consensus Economics		298	314
Capacity Utilization (percent)	81.8		

Like the Blue Chip forecasters, the Administration expects growth of real GDP to continue slowing toward a more sustainable pace—both we and the Blue Chip are anticipating a soft landing. The consensus forecast is that productivity growth will gradually return to its longer run historical trend, rather than remaining at the high rate of the last 3 ½ years. The unemployment rate is expected to rise from its current 4.3 percent to 5.2 percent (the center of the estimated range for the NAIRU).

A major uncertainty in the forecast is whether the current expansion will continue to exhibit a number of characteristics that have distinguished it from previous long expansions:

- Productivity growth has picked up rather than slowed as the expansion has matured.
- Inflation and interest rates have declined rather than risen.

- Investment has been historically strong and industrial capacity has expanded accordingly.
- The stance of fiscal policy has shifted from seemingly terminal deficits to the prospect of an era of surpluses.
- The current account has widened despite an improving trend in national saving, as the demand for investment has outstripped our ability to finance it from domestic savings.
- Interest rates have been rising in recent months. Since the end of April, the rate on ten-year Treasury bonds has risen by about 0.50 percentage point. Spreads of private sector interest rates over Treasury rates have risen as well, so rates paid by corporate borrowers and homeowners have risen by even more. Mortgage rates, for example, have risen by 0.90 percentage point. At the same time that spread have widened, new issues of corporate bonds have been rising, suggesting that the widening of spreads is demand driven. In contrast, when spreads widened last fall, a flight to quality led to a contraction of credit supply in capital markets, the new issues market dried up, and financial markets were destabilized.

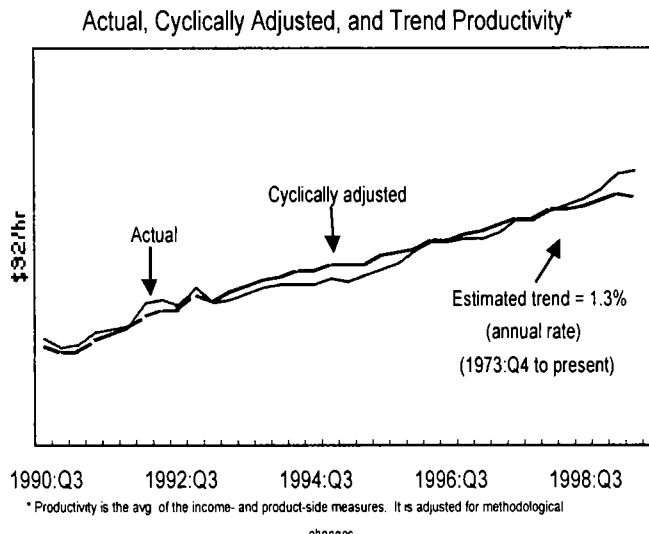
One way to frame the issue of the macroeconomic outlook, therefore, is to ask whether these favorable elements can be sustained

A New Era or the old trade-offs?

The view that the economy has entered a New Era assumes that many of these favorable elements are now permanent features of the economy. The contrary view is that they mainly reflect special factors that will be reversed. Two critical relationships illustrate the debate.

- The NAIRU. Not so many years ago, the consensus view was that the economy risked rising inflation once the unemployment rate dropped below 6 percent, or even 6.5 percent in some economic models. However, the unemployment rate has been below 6 percent for the past NN months, and below 5 percent for the past MM. Although wage inflation has picked up in the past few years, the rise has been far less than one would have predicted based on a NAIRU of 6 percent. To the extent that increased international and domestic competition have created a new environment in which businesses find it hard to raise prices, productivity is growing rapidly, and investment is expanding capacity at a rapid rate, it may be possible to avoid inflation even with a tight labor market and rising wages. In part, however, the favorable inflation situation reflects some transitory factors – including falling prices for imports, and moderate prices for energy goods – that either have already reversed (as in the case of energy) or could plausibly do so in the near future (as in the case of import prices).
- Trend productivity growth. The sustainable rate of economic growth is determined by the rate of growth of the labor force (about 1.1 percent) and the rate of growth of

productivity. Over the past three years, productivity growth has been substantially higher than its longer-term trend of about 1.3 percent per year. A centerpiece of New Era thinking is a belief that information technology and other developments have allowed for substantially faster sustained productivity growth. The contrary view – particularly in the context of a strong cyclical expansion – is that it is premature to conclude from a short period of strong productivity growth that trends that have been evident since the early 1970s have been sharply reversed.



According to the *Economist* (July 24), Alan Greenspan is among those who believe that information technology has contributed to faster productivity growth. He points out that “the accessibility of up-to-date information offered by information technology has allowed substantial improvements in corporate efficiency. Production planning is made easier; inventories can be reduced; delivery lead-times fall; the nature of distribution is altered. All of these factors increase the

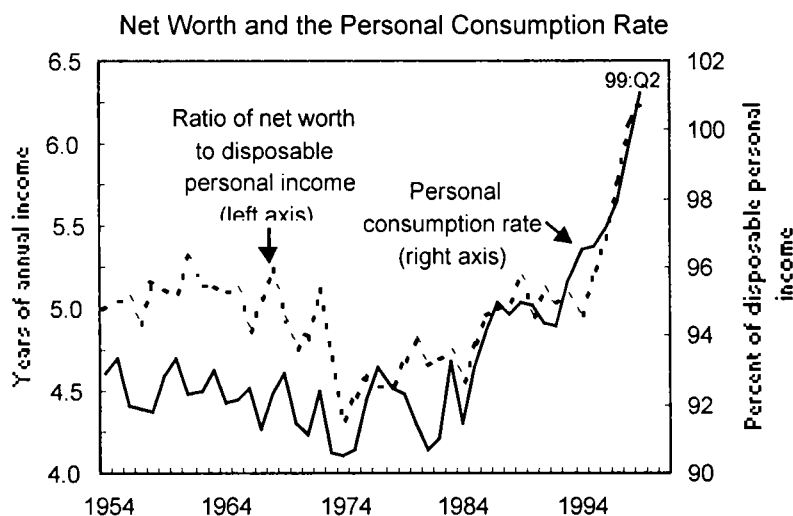
flexibility of capital goods, making capital investment more attractive and productive than it used to be, and encouraging firms to substitute capital for (scarce) labor.”

An extensive study by a US consulting firm looked at the current and potential future effect of the electronics revolution on productivity. They examined a variety of companies in different industries, recording how workers spend their time. They concluded that in US companies, workers spend 51 percent of their time on “interactions,” such as communication, data gathering and collaborative problem-solving. Improvements in communications technologies, such as the Internet, are now allowing reductions in the labor required for such interactions and these gains are expected to continue even more rapidly in the future. Business economist Eric Brynjolfsson of the Sloan School at MIT has estimated that computer capital has a larger impact on productivity than other kinds of capital.

A principal critic of the new economy view is economist Robert Gordon. He notes that the price of a computer of a given quality has recently been declining at an accelerating rate (or equivalently, that every dollar spent buys a rapidly rising quality of computer). This leads to large and accelerating estimates of productivity growth within the manufacturing sector that produces computers. Gordon then tries to separate computer production from the rest of the economy. And when he does so, he finds that virtually all of the acceleration of productivity growth in the nonfarm business sector is coming from

the computer-producing part and almost none from the rest of the economy. We are fantastic at making computers, he concludes, but have not discovered how to use computers to make the rest of the economy more productive.

Gordon's conclusion is hard to believe given extensive case study evidence of businesses using new technologies to improve their operations. Other economists question his method of separating out computer production from the rest of the economy. But the fact remains that there is great uncertainty around estimates of future productivity growth. Chart x shows that labor productivity has only very recently moved above the level that would be expected, given the strong cyclical recovery. This is why the Administration forecast is conservative in the assumed rate of productivity growth that feeds into our budget estimates.



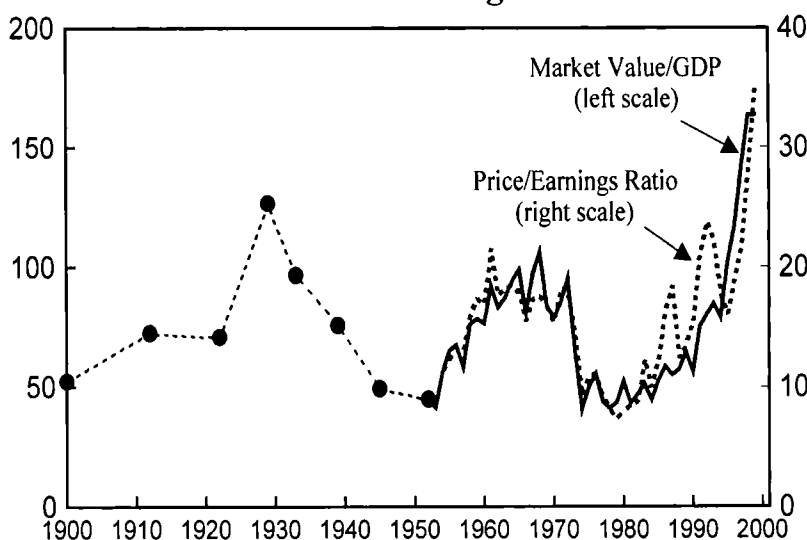
The Stock Market. The stock market has appreciated spectacularly over the past five years, accompanied by a dramatic rise in the market value of young, high-tech companies that employ significantly fewer people than traditional industrial blue chips. While profit growth has been strong, price-earnings ratios and other traditional indicators of valuation are at record levels. Accordingly, the issue of whether the market is “overvalued” has been hotly debated in recent months.

Those who are concerned about the current valuations in the stock market point to evidence of the following type:

- The market value of equities increased from 77 percent of GDP at the end of 1994 to 164 percent of GDP in the first quarter of this year, a value that is well above the previous peaks 127 percent reached in 1929 and 106 percent reached in 1968.

- Similarly, despite strong growth in corporate earnings, the ratio of price to earnings for the 500 largest companies in the stock market has more than doubled, rising from 15 at the end of 1994 to 35.2 in the first quarter of this year.

Market Value of Domestic Corporations and Price/Earnings Ratios



Note: 1999 values are for the first quarter.

- Some private analysts express fears that the United States is currently facing an asset price “bubble” in which asset prices are bid to unrealistic levels, threatening economic stability. They argue that the current combination of low inflation and strong economic growth has been associated with what they view as previous bubble episodes. Investors (and perhaps even policy makers) can get seduced into believing in “new paradigms.” When an overheated economy and a rekindling of inflationary pressures that had been hidden by unusual factors results in rising interest rates, the economy slows and asset prices fall sharply, slowing the economy even more. Slower growth reveals the new paradigm optimism to be misplaced.

- Others who fear that a speculative bubble is emerging in the stock market point to more popular indicators like the rise of day trading and the enormous value placed on some internet startups that have yet to turn a profit.

On the other hand, those who are relatively sanguine about the current state of the market point to the following:

- The economy remains strong and private forecasters have increased their projected growth rates for GDP and corporate profits since the beginning of the year. Prospects for some industries that suffered from the impact of a sluggish world economy last year have improved and several key sectors are viewed as generating impressive results this year. At the same time, views on inflation remain sanguine.
- Not all stocks are going to the sky. On the contrary, a large fraction of the growth in the market's value can be attributed to a small set of companies, most of whom are engaged in some form of high-tech activity. Meanwhile, valuations for many traditional companies remain tame by historical standards. This suggests that the market retains its ability to discriminate among stocks, rewarding those companies that are on the cutting edge of innovation.
- It is possible (with some stretching) to justify current market values, by combining relatively optimistic assumptions about future profit growth, interest rates, and the premium that investors demand for bearing the risks inherent in holding stocks. For example, if the rapid rates of productivity growth experienced since 1995 were to continue unabated and feed continued rapid earnings growth; if long-term interest rates were to return to the lower levels seen earlier this year; and if the premium for bearing stock market risk were to descend to levels that are quite low by historical standards, then the current level of the market could be "justified."

The main macroeconomic risk posed by an overvalued stock market is the prospect of a market reversal, which would reduce aggregate demand.

- A decline in stock values would reduce the net worth of consumers and lead to a decline in consumer spending.
- It also would increase businesses' cost of raising equity capital and thereby reduce investment spending.
- Although banks are currently well capitalized, a recession might lower the quality of banks' loan portfolios.
- The appropriate antidote to a development of this type is a dose of lower interest rates. This type of action proved quite successful in 1987, when the Fed moved promptly and vigorously to reassure markets in the wake of the October crash.

A more remote – but nonetheless real – risk is that the financial system simply seizes up and ceases to function in the wake of a stock market crash.

- Stock market losses could lead to actual or threatened bankruptcies, particularly among highly leveraged institutions with large derivatives positions, and spread

beyond the stock market.

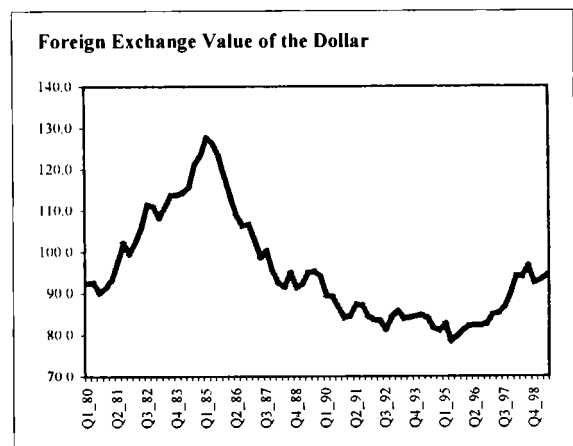
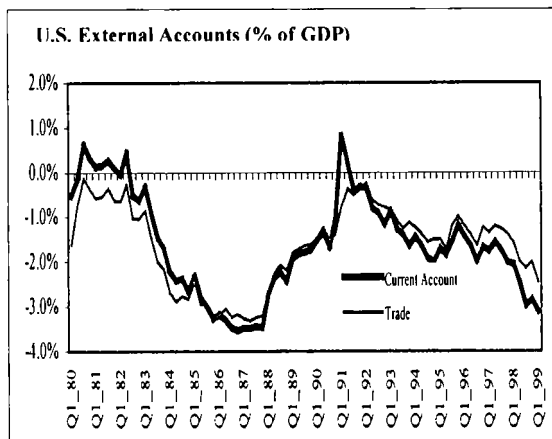
- Concerns about counterparty risk might then cause the clearance and payments systems that are crucial to well-functioning securities markets to freeze.
- Significant steps have been taken to reduce this risk following what some view as a near miss during the 1987 stock market crash, but some risk remains.
- The traditional tools of monetary policy may not be sufficient to prevent a seizing up of markets in the face of widespread panic.

The risk posed by the stock market is compounded by international considerations. A substantial weakening in asset markets here could shake the confidence of foreign investors, thereby causing a substantial drying up of the supply of foreign capital and a free fall of the dollar. This would pose a dilemma for the Federal Reserve, which would be caught between conflicting needs to cushion a recession and contain rising inflation. The implications of such a scenario are potentially more severe than they otherwise would be in light of the fact that we are presently running a large current-account deficit – a topic to which we now turn.

The current account deficit and the dollar

The current account deficit -- already large last year -- is forecast to widen further in 1999 and beyond.

- The widening of the deficit has been exacerbated by temporary factors: the Asian crisis and the faster relative growth of the U.S. economy compared to the rest of the world, as well as the appreciation of the dollar since 1995.
- As the dollar's strength shows, foreigners have been more than willing to finance our external deficits of recent years. The relative attractiveness of U.S. investments and performance of the U.S. economy have pulled in foreign capital.
- The U.S. current account deficit is not likely to be sustainable indefinitely at recent growth rates in the U.S. and abroad and unchanged exchange rates. Based on standard forecasting models, the deficit would continue to widen as a percent of GDP.
- Foreign investors have built up large net (\$1.5 trillion) and gross (\$7.5 trillion) claims on the U.S. Sooner or later they may become less willing to hold an ever increasing share of their wealth in claims on the United States, especially as an upturn in foreign growth provides more competition for U.S. assets.



Federal Reserve Board Real Exchange Rate Index

Repeat of the 1980s? A continuing widening of the deficit could place the dollar under significant downward pressure over the next year as happened in the 1980s, despite differences between now and then:

- U.S. deficits in the 1980s were driven by a fall in national savings associated with large fiscal deficits. Since 1992, our national savings rate has been rising, and our external deficits have been associated with the more rapid rise in investment.
- The dollar has appreciated on average in real (price-adjusted) terms since 1995, but the appreciation has been substantially less than in the mid-1980s.

- Although the U.S. has become a net international debtor, with net income payments now contributing to our current account deficit (as a percent of GDP), our trade deficit has not yet reached the low point (as a percent of GDP) of 1987.

Hard Landing? The external adjustment process in the late 1980s was difficult, but it was not a “hard landing” involving a deep sustained recession and substantially higher inflation.

- The difficulties associated with any prospective adjustment in our external accounts would depend in large part on how it was triggered and what other developments accompanied it, and on policy responses here and abroad.
- Standard macroeconomic models suggest that, under plausible assumptions about policy responses in the U.S. and abroad, an abrupt 25% decline in the dollar would raise U.S. growth by about 1% over the first 1-2 years and eventually reduce the current account deficit by half or two thirds, but it would also boost U.S. inflation by as much as 2%.

The adjustment process in the new millennium could well be less benign:

- The U.S. adjustment process could be triggered or exacerbated by (or could itself trigger) a sharp correction in U.S. asset markets.
- Policy responses in the rest of the world may fail to offset the contractionary effects of the U.S. adjustment on their own growth from reduced exports to and increased imports from the U.S.
- The result could be a U.S. recession, an intensified flight from dollar-denominated assets, further downward pressure on the dollar, and a large increase in inflation.

This potential vicious cycle of sudden and excessive asset price deflation followed by an economic downturn in the U.S. and abroad is the main source of risk from our growing trade and current account deficit and a possible sharp dollar decline.

The likelihood of a “hard landing” scenario is not large, and careful management can help reduce the risk. Maintaining our strong-dollar policy will help sustain confidence in our assets and markets. Policies to enhance our national savings will help cushion the economy against a potential slowdown of inflows of foreign savings. Faster growth abroad should on balance ease our adjustment process as would broad-based trade liberalization and avoidance of protectionist pressures.

Contagion from the Global Economy

The outlook for the global economy has brightened a bit since late last year.

- The mood surrounding prospects in Japan and Europe has improved somewhat.
- Economic activity is recovering in the affected countries in Asia. Although Latin America is in recession, there too the outlook has brightened somewhat recently.

- External investors have substantially reduced their exposure to emerging market economies as they have moved toward external surpluses, and borrowing spreads for emerging market economies are lower than last fall, though still wide.

Evolution of Consensus Forecasts of World Economic Growth					
	1999 Forecasts			2000 Forecasts	
Date of Forecast	Dec 1998	Mar 1999	Jul 1999	Mar 1999	Jul 1999
Euro-11	2.3%	2.1%	2.0%	2.6%	2.6%
Japan	-0.6%	-0.9%	0.1%	0.2%	-0.2%
Asia ex Japan	2.7%	3.3%	4.7%	4.8%	5.3%
Latin America	0.5%	-1.2%	-0.5%	3.1%	3.5%

Japan: The economy may finally have stopped deteriorating, though we have seen false bottoms before. Market sentiment has turned, and the rise in the Nikkei stock index since the beginning of 1999 (24%) and astonishing 7.9% annual rate growth recorded in the first quarter are positive, but record 4.9% unemployment, declining incomes and decreased household spending, and continuing corporate restructuring suggest further pressure on jobs and incomes. Japan's banking sector may have stabilized, following the recapitalization of leading banks, but more progress is needed in disposal of bad assets. Continued government facilitation of economic and financial restructuring along with supportive macro policies are critical to achieve a lasting recovery.

Europe: Although the macroeconomy may be poised for an upturn, the strength of any rebound is uncertain and likely to be export-led, given the euro's depreciation over the first half of the year. Unemployment still remains stubbornly in double digits, underscoring the need for fundamental structural reforms, if European growth is to return output to potential, to say nothing of cutting into high unemployment rates.

This somewhat improved outlook for the industrial countries is on balance good for the U.S. and global economy though, as noted above, it is not an unmixed blessing because of the increased competition from more attractive investment opportunities abroad.

The two emerging market economies that at this point appear to pose the greatest risk to the U.S. and global economy and financial system are Argentina in Latin America and China in Asia.

Argentina: Despite basically sound policies, Argentina's dependence on foreign capital inflows to refinance its large external obligations (about 450% of exports) leaves it vulnerable to the risk that market worries about its exchange rate regime become a self-fulfilling prophecy. Its external accounts have been hit by lower prices on its commodity exports and by devaluation and recession in Brazil. Private capital inflows have declined due to the global crisis, investor nervousness about the October presidential election, and concerns the peso may be overvalued. The result has been sharply higher international and domestic borrowing costs. Argentina is in a severe recession (2½-3% real GDP

contraction expected this year) with rising unemployment (now 14.5%) and growing non-performing loans. Monetary policy is constrained by Argentina's currency board regime. A political-economic crisis in Argentina with its currency board could undermine confidence in Hong Kong, with potential implications throughout Asia.

China: The recent slowdown in growth and contraction of exports in China is a source of risk and increased vulnerability. Fears of rising unemployment and a looming fiscal burden from restructuring the financial system and state-owned enterprises may lead the authorities to try to restore export-led growth and devalue the renminbi. Although current account data are not available for 1999, the recorded trade surplus has basically vanished since late last year. Financial market expectations about a devaluation have recently returned to levels last seen during the global panic of August 1998. With its capital controls and large foreign exchange reserves (\$147 billion), the risk of a successful speculative attack on the renminbi is still low. However, a poorly managed devaluation, if this should be the course chosen by the Chinese authorities, could put pressures on Hong Kong's exchange rate peg and spill over to other Asian currencies and other regions and to the U.S. economy as we saw in 1997-98.

Other country risks: Other large countries with less immediate difficulties that may pose a concern are Brazil, Indonesia, Korea, Mexico, Russia, and Turkey. For example, if Korea mishandles the Daewoo restructuring, its economy could be plunged back into serious recession or crisis. Smaller financial fragile countries that have the potential to trigger a broader crisis include Colombia, Ecuador, Romania, Ukraine, and Venezuela. For example, Ecuador's failure to make its Brady bond payments later this month could trigger a flight from the debt of emerging market economies generally, even though the market should not be surprised.

In contrast to the situation over the past two years when concerns about the outlook for the U.S. economy focused primarily on contagion from the rest of the world, our vulnerability from this source appears to have declined both absolutely and relatively. Conditions abroad are mending slowly and the shocks of the past few years are probably still recent enough to keep even investors with short memories mindful of a repetition.

The Y2K Problem

The Y2K computer problem poses some limited risks from the potential malfunction of computer systems that support critical infrastructure. There is also some anticipated economic impact from hoarding behavior at the end of 1999 in anticipation of Y2K problems.

- Fundamentals. The fundamental risk is of severe and long lasting economic dislocation as computer systems malfunction -- particularly in the critical infrastructure areas of finance, telecommunications, power generation, and transportation. Considerable investment has been made to avoid the fundamental problems that would occur with a system-wide failure. Most large firms and the Federal government have spent large amounts to ensure their systems are Y2K ready. Concerns remain with respect to smaller users, State governments and less-developed countries. Because of the extensive preparation that has taken place, problems among the small users are unlikely to cumulate into a supply shock sufficient to cause a significant macro-economic impact on the United States. Only one of 52 blue-chip forecasters currently projects negative growth for 2000.
- Hoarding. A second set of economic problems could occur even if all computers perform normally, if there is hoarding behavior in anticipation of Y2K problems. This could lead to temporary shortages, soaring prices and long lines. In particular, this could be a problem, if at the last moment firms seek to accumulate extra inventories; households to stockpile supplies such as groceries, prescription drugs, gasoline, and currency; and financial market participants to shift towards highly liquid assets.

Again, many institutions are taking steps to provision for such hoarding. For example, the Federal Reserve plans to boost its currency holdings from \$100 billion to \$300 billion, about \$2,000 per US household of additional cash.

The inventory behavior induced by Y2K is expected to boost growth in the final quarter 1999 by $\frac{3}{4}$ percentage point, and lower it in the first quarter of 2000 by the same amount. Interest rates on assets to be held over year-end indicate a liquidity premium but the effect dissipates after a few months.

A small aggregate impact. Y2K is likely to be to the economy, what a sandstorm is to the desert. A highly visible nuisance for most who are caught in it, quite damaging to a few; but with an impact that is scarcely visible overall once the dust has settled. The key to containing the disruptions from anticipatory behavior is public confidence that the fundamental problems have been dealt with.

Conclusion.

History suggests that in any year, regardless of how long an expansion has run, the chances that it will end are generally about one in four. In the postwar period, for the United States, these terminations have resulted from Federal Reserve responses to

inflation. The lack of inflationary pressures currently, and the belief that if any were to arise, they would be effectively nipped in the bud, provides consensus forecasters with the confidence to project sustained economic growth, at a rate of 2.6 percent in 2000.

But the consensus forecast could be wrong. The recent surge in productivity performance provides plausibility to the view that the benefits of the revolution in information technology are finally coming to fruition. While there is much talk of a new economy, if the US could simply return to the old economy which achieved a 2 percent rate of productivity growth over the century prior to 1973, over the next five years, growth could average over three percent annually. The consensus forecasts could prove to be just another example of the dismal science.

There are, however, a variety of risks facing the economy that could pose some painful choices. There have been other periods in history such as the late 1920s in the US and the late 1980s in Japan, in which apparent prosperity proved to be ephemeral as the collapse of asset market bubbles wreaked financial and economic havoc. Currently, therefore it is prudent to attach concern to the risks we face from an outburst of inflation and both internal and external financial market instability.

However, each of these risks is better faced with a strong fiscal position. Less stimulus would reduce inflation. More national savings allow us to finance domestic investment with less foreign borrowing and lower interest rates reduce the probability of financial distress at home and abroad.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: David.Wilcox@do.treas.gov (David.Wilcox@do.treas.gov [UNKNOWN])

CREATION DATE/TIME: 9-AUG-1999 14:05:49.00

SUBJECT: current version 1:58 pm

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

TEXT:

Date: 08/09/1999 01:58 pm (Monday)

From: David Wilcox

To: baily, lawrence

Subject: current version 1:58 pm

- POTUS3.DOC===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D98]ARMS24975112L.236 to ASCII,
The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

MEMORANDUM TO THE PRESIDENT

FROM: Lawrence Summers, Department of Treasury
Martin Baily, Council of Economic Advisers

DATE: August 9, 1999

RE: Economic Outlook

The U.S. has enjoyed 99 consecutive months of economic expansion and is on track to achieving the longest economic expansion in its history. Meanwhile, inflation has remained under control, unemployment is exceedingly low by recent standards, and recent gains in productivity have been encouraging. The consensus view is that the outlook for the future is positive, and that the U.S. economy should continue to exhibit many of the same characteristics that have been hallmarks of the expansion thus far.

That said, the uncertainties surrounding the macroeconomic outlook are considerable – both on the upside and on the downside.

- On the upside, many commentators have suggested that the economy may have entered a “New Era” in which unemployment can remain low, output growth can remain strong, and wage increases can remain rapid, *without* triggering the kinds of imbalances that have led to the demise of expansions in decades past. Adherents of this view argue that there should be no presumption that the current expansion will meet a traditional fate at the hands of an inflation-fearful Federal Reserve.
- On the downside, some observers point to the risk that the productivity surge of the last few years may prove to be a passing phenomenon, and that some of the other factors that have helped keep inflation in check may wane or even go into reverse. Even in this case, the economy might experience nothing more traumatic than a “soft landing,” but the risks to the expansion would be far greater, and the overall macroeconomic climate (combining upward drift in both inflation and unemployment) would be less appealing than the one we have been experiencing of late.
- Others have argued that the stock market is very richly priced. A precipitous decline in asset prices would likely reduce both household and business demand – and potentially severely so. How that might play out is itself a matter of uncertainty. The experience with the stock market break in 1987 suggests that, provided the monetary response is swift and vigorous, the macroeconomic damage can be contained, and the expansion sustained. On the other hand, Japan’s experience over the decade of the 1990s suggests that with the wrong or timid policies, the fallout can be protracted and

painful.

- The U.S. current account deficit has continued to widen, and now is approaching 4 percent of GDP. A number of commentators have raised the possibility that the U.S. dollar may come under (perhaps intense) downward pressure. Such a development could trigger other adverse events, such as an increase in inflation (because imported goods would have become more expensive), a sharp correction in our asset markets (reflecting a generalized loss of confidence on the part of foreign investors), and a marked step-down in our pace of growth.
- The global economy has stabilized and improved somewhat in the last six months. While this is surely a positive development on net, it is not an unmixed blessing, as it does imply greater global competition for capital. Moreover, it is conceivable that a financial crisis in an emerging market economy could set off another round of economic and financial contagion. Argentina and China are the most obvious “hot spots.”
- Finally, a number of voices have sounded the alarm with respect to the coming change of millennia, and in particular with respect to the so-called Y2K computer bug. Although great strides in preparedness have been made, a risk remains of systemic failure, possibly involving financial systems or other major elements of social and economic infrastructure.

The remainder of this memo first reviews the consensus macro-economic outlook and then provides greater depth on each of the risks sketched above.

The consensus macroeconomic outlook. Thus far, the current expansion has differed in several key respects from previous long expansions in the United States:

- Productivity growth has picked up rather than slowing.
- Inflation and interest rates have declined rather than rising.
- Investment has been historically strong and industrial capacity has expanded accordingly.
- The stance of fiscal policy has shifted from seemingly terminal deficits to the prospect of an era of surpluses.
- The current account has widened despite an improving trend in national saving, as the demand for investment has outstripped our ability to finance it from domestic savings.

One way to frame the issue of the macroeconomic outlook is to ask whether the favorable elements of these trends can be sustained.

The table below presents Administration, CBO, and Blue Chip consensus economic forecasts for key macroeconomic variables:

	Administration		CBO		Blue Chip	
	1999	2000	1999	2000	1999	2000
Real GDP growth (percent, Q4/Q4)						
Unemployment (percent)						
Core CPI Inflation (percent, Q4/Q4)						
Current Acct. Def. (percent of GDP)						
Capacity Util. (percent)						

Like outside observers, the Administration expects growth of real GDP to continue slowing toward a more sustainable pace. Although restraint could come from any of several sources, the most likely candidates at this point appear to be business investment spending (capacity utilization has actually been declining *despite* the strong growth of recent quarters), housing (where building activity appears to have been running ahead of the pace that would be justified based on long-term demographic trends) and household spending, which might cool in the wake of some moderation in the strength of the stock market.

A New Economic Era?

Two aspects of the domestic macroeconomic situation will be key in helping to determine how long, and at what pace, the current economic expansion can continue:

- First, what will happen to wage inflation, given the low level of unemployment? Not so many years ago, the consensus view was that the “neutral” point for the unemployment rate (that is, the point at which the labor market would put neither upward nor downward pressure on inflation) was about 6 percent. (This is the infamous NAIRU.) For the last NN months, the unemployment rate has been below that level. Wage inflation has picked up, but much less so than one would have guessed based on a NAIRU of 6 percent.

In its official economic projections, the Administration assumes that the NAIRU is 5.3 percent. Precise evidence on this parameter is frustratingly difficult to amass. Accordingly, it is possible for a few holdouts to continue to hold the torch for a NAIRU of 6 percent (or close to it), and likewise possible for a few radicals to assert that unemployment in the 4’s may be sustainable.

- Second, how much wage inflation can you have without igniting a spiral of price inflation, which is the type of inflation that the Federal Reserve is concerned about preventing? The recent surge in productivity growth has meant that wages could increase relatively rapidly, and yet producers be able to maintain moderate pricing policies, as the difference could be absorbed in productivity gains.

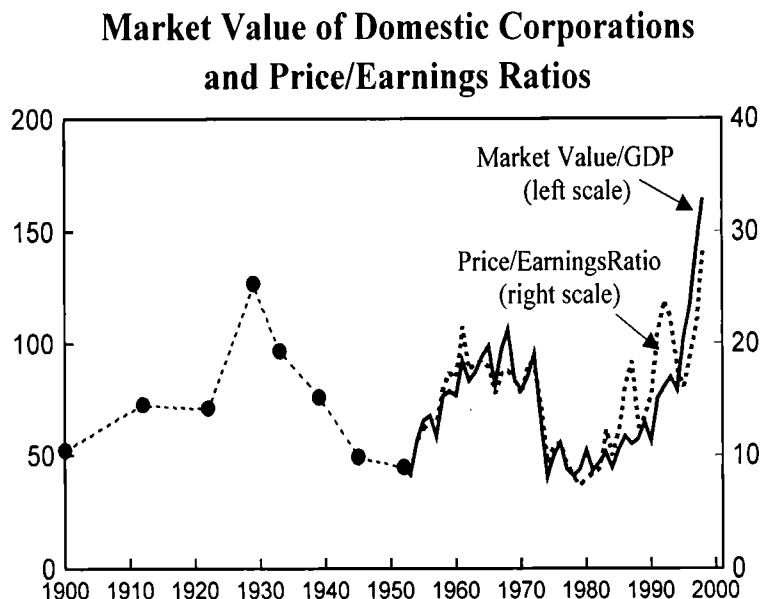
In part, the favorable inflation situation reflects some transitory factors – including falling prices for imports, and moderate prices for energy goods – that either have already reversed (as in the case of energy) or could plausibly do so in the near future (as in the case of import prices).

If either or both of these favorable developments of late (low NAIRU and rapid productivity growth) can be sustained, the positive implications for our economy would be profound. In that case, we could look to a future of lower inflation, fortified budget surpluses, and – most important of all – a reinvigorated pace of increase in the standard of living.

The Stock Market. The stock market has appreciated spectacularly over the past five years, accompanied by a dramatic rise in the market value of young, high-tech companies that employ significantly fewer people than traditional industrial blue chips. While profit growth has been strong, price-earnings ratios and other traditional indicators of valuation are at record levels. Accordingly, the issue of whether the market is “overvalued” has been hotly debated in recent months.

Those who are concerned about the current valuations in the stock market point to evidence of the following type:

- The market value of equities increased from 77 percent of GDP at the end of 1994 to 164 percent of GDP in the first quarter of this year, a value that is well above the previous peaks reached in 1929 and 1968.
- Similarly, despite strong growth in corporate earnings, the ratio of price to earnings for the 500 largest companies in the stock market has more than doubled, rising from 15 at the end of 1994 to 35.2 in the first quarter of this year.



On the other hand, those who are relatively sanguine about the current state of the market point to the following:

- The economy remains strong and private forecasters have increased their projected growth rates for GDP and corporate profits since the beginning of the year. Prospects for some industries that suffered from the impact of a sluggish world economy last year have improved and several key sectors are viewed as generating impressive results this year. At the same time, views on inflation remain sanguine.
- Not all stocks are going to the sky. On the contrary, a large fraction of the growth in the market's value can be attributed to a small set of companies, most of whom are engaged in some form of high-tech activity. Meanwhile, valuations for many traditional companies remain tame by historical standards. This suggests that the market retains its ability to discriminate among stocks, rewarding those companies that are on the cutting edge of innovation.
- It is possible (with some stretching) to justify current market values, by combining relatively optimistic assumptions about future profit growth, interest rates, and the premium that investors demand for bearing the risks inherent in holding stocks. For example, if the rapid rates of productivity growth experienced since 1995 were to continue unabated and feed continued rapid earnings growth; if long-term interest rates were to return to the lower levels seen earlier this year; and if the premium for bearing stock market risk were to descend to levels that are quite low by historical standards, then the current level of the market could be "justified."

The main macroeconomic risk posed by an overvalued stock market is the prospect of a sharp market reversal, which would reduce aggregate demand. A decline in stock values would reduce the net worth of consumers and lead to a decline in consumer spending. It also would increase businesses' cost of raising equity capital and thereby reduce investment spending. The appropriate antidote to a development of this type is a dose of lower interest rates. This type of action proved quite successful in 1987, when the Fed moved promptly and vigorously to reassure markets in the wake of the October crash.

A more remote – but nonetheless real – risk is that the financial system simply seizes up and ceases to function in the wake of a sharp break in stock market values. Significant steps have been taken to reduce this risk following what some view as a near miss during the 1987 stock market crash, but some risk remains. And the traditional tools of monetary policy may not be sufficient to prevent a seizing up of markets in the face of widespread panic.

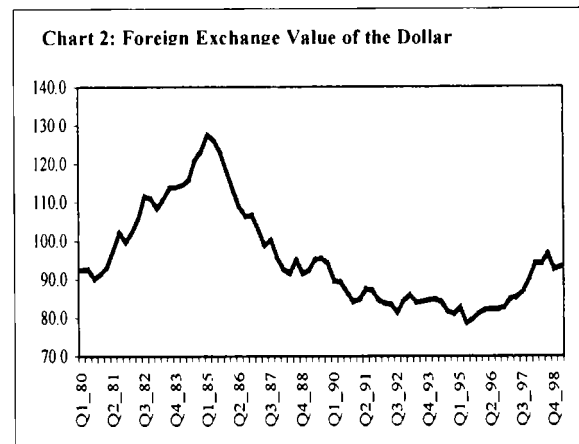
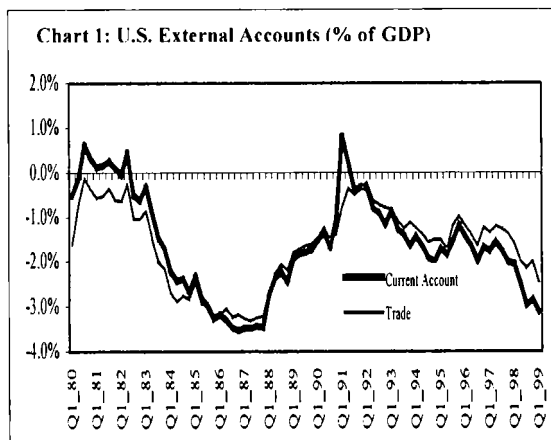
The risk posed by the stock market is compounded by international considerations. A substantial weakening in asset markets here could shake the confidence of foreign investors, thereby causing a substantial drying up of the supply of foreign capital and a free fall of the dollar. This would pose a dilemma for the Federal Reserve, which would be caught between conflicting needs to cushion a recession and contain rising inflation. The implications of such a scenario are potentially more severe than they otherwise

would be in light of the fact that we are presently running a large current-account deficit – a topic to which we now turn.

The Current Account Deficit

The current account deficit -- already large last year -- is forecast to widen further in 1999 and beyond.

- The widening of the deficit has been exacerbated by temporary factors: the Asian crisis and the faster relative growth of the U.S. economy compared to the rest of the world, as well as the appreciation of the dollar since 1995.
- As the dollar's strength shows, foreigners have been more than willing to finance our external deficits of recent years. The relative attractiveness of U.S. investments and performance of the U.S. economy have pulled in foreign capital.
- The U.S. current account deficit is not likely to be sustainable indefinitely at recent growth rates in the U.S. and abroad and unchanged exchange rates. Based on standard forecasting models, the deficit would continue to widen as a percent of GDP.
- Foreign investors have built up large net (\$1.5 trillion) and gross (\$7.5 trillion) claims on the U.S. Sooner or later they may become less willing to hold an ever increasing share of their wealth in claims on the United States, especially as an upturn in foreign growth provides more competition for U.S. assets.



Federal Reserve Broad Real Exchange Rate Index

Repeat of the 1980s? A continuing widening of the deficit could place the dollar under significant downward pressure over the next year as happened in the 1980s, despite differences between now and then:

- U.S. deficits in the 1980s were driven by a fall in national savings associated with large fiscal deficits. Since 1992, our national savings rate has been rising, and our external deficits have been associated with the more rapid rise in investment.
- The dollar has appreciated on average in real (price-adjusted) terms since 1995, but the appreciation has been substantially less than in the mid-1980s.
- Although the U.S. has become a net international debtor, with net income payments now contributing to our current account deficit (as a percent of GDP), our trade deficit has not yet reached the low point (as a percent of GDP) of 1987.

Hard Landing? The external adjustment process in the late 1980s was difficult, but it was not a “hard landing” involving a deep sustained recession and substantially higher inflation.

- The difficulties associated with any prospective adjustment in our external accounts would depend in large part on how it was triggered and what other developments accompanied it, and on policy responses here and abroad.
- Standard macroeconomic models suggest that, under plausible assumptions about policy responses in the U.S. and abroad, an abrupt 25% decline in the dollar would raise U.S. growth by about 1% over the first 1-2 years and eventually reduce the current account deficit by half or two thirds, but it would also boost U.S. inflation by as much as 2%.

The adjustment process in the new millennium could well be less benign:

- The U.S. adjustment process could be triggered or exacerbated by (or could itself trigger) a sharp correction in U.S. asset markets.
- Policy responses in the rest of the world may fail to offset the contractionary effects of the U.S. adjustment on their own growth from reduced exports to and increased imports from the U.S.
- The result could be a U.S. recession, an intensified flight from dollar-denominated assets, further downward pressure on the dollar, and a large increase in inflation.

This potential vicious cycle of sudden and excessive asset price deflation followed by an economic downturn in the U.S. and abroad is the main source of risk from our growing trade and current account deficit and a possible sharp dollar decline.

The likelihood of a “hard landing” scenario is not large, and careful management can help reduce the risk. Maintaining our strong-dollar policy will help sustain confidence in our assets and markets. Policies to enhance our national savings will help cushion the economy against a potential slowdown of inflows of foreign savings. Faster growth abroad should on balance ease our adjustment process as would broad-based trade liberalization and avoidance of protectionist pressures.

Contagion from the Global Economy

The outlook for the global economy has brightened a bit since late last year.

- The mood surrounding prospects in Japan and Europe has improved somewhat.
- Economic activity is recovering in the affected countries in Asia although Latin America is in recession.
- External investors have substantially reduced their exposure to emerging market economies as they have moved toward external surpluses, and borrowing spreads for emerging market economies are lower than last fall, though still wide.

Table 1: Evolution of Consensus Forecasts of World Economic Growth

	<u>Sept 1998</u>	<u>Dec 1998</u>	<u>March 1999</u>		<u>July 99</u>	
	1999	1999	1999	2000	1999	2000
Euro-11	2.6%	2.3%	2.1%	2.6%	2.0%	2.6%
Japan	0.3	-0.6	-0.9	0.2	0.1	-0.2
Asia ex Japan	2.9	2.7	3.3	4.8	4.7	5.3
Latin America	3.5	0.8	-1.2	3.1	-0.5	3.5

Japan: The economy may finally have stopped deteriorating, though we have seen false bottoms before. Market sentiment has turned, and the rise in the Nikkei stock index since the beginning of 1999 (24%) and astonishing 7.9% annual rate growth recorded in the first quarter are positive, but record 4.9% unemployment, declining incomes and decreased household spending, and continuing corporate restructuring suggest further pressure on jobs and incomes. Japan's banking sector may have stabilized, following the recapitalization of leading banks, but more progress is needed in disposal of bad assets. Continued government facilitation of economic and financial restructuring along with supportive macro policies are critical to achieve a lasting recovery.

Europe: Although the macroeconomy may be poised for an upturn, the strength of any rebound is uncertain and likely to be export-led, given the euro's depreciation over the first half of the year. Unemployment still remains stubbornly in double digits, underscoring the need for fundamental structural reforms, if European growth is to return output to potential, to say nothing of cutting into high unemployment rates.

This somewhat improved outlook for the industrial countries is on balance good for the U.S. and global economy though, as noted above, it is not an unmixed blessing because of the increased competition from more attractive investment opportunities abroad.

The two emerging market economies that at this point appear to pose the greatest risk to the U.S. and global economy and financial system are Argentina in Latin America and China in Asia.

Argentina: Despite basically sound policies, Argentina's dependence on foreign capital inflows to refinance its large external obligations (about 450% of exports) leaves it

vulnerable to the risk that market worries about its exchange rate regime become a self-fulfilling prophecy. Its external accounts have been hit by lower prices on its commodity exports and by devaluation and recession in Brazil. Private capital inflows have declined due to the global crisis, investor nervousness about the October presidential election, and concerns the peso may be overvalued. The result has been sharply higher international and domestic borrowing costs. Argentina is in a severe recession (2½-3% real GDP contraction expected this year) with rising unemployment (now 14.5%) and growing non-performing loans. Monetary policy is constrained by Argentina's currency board regime. A political-economic crisis in Argentina with its currency board could undermine confidence in Hong Kong, with potential implications throughout Asia.

China: The recent slowdown in growth and contraction of exports in China is a source of risk and increased vulnerability. Fears of rising unemployment and a looming fiscal burden from restructuring the financial system and state-owned enterprises may lead the authorities to try to restore export-led growth and devalue the renminbi. Although current account data are not available for 1999, the recorded trade surplus has basically vanished since late last year. Financial market expectations about a devaluation have recently returned to levels last seen during the global panic of August 1998. With its capital controls and large foreign exchange reserves (\$147 billion), the risk of a successful speculative attack on the renminbi is still low. However, a poorly managed devaluation, if this should be the course chosen by the Chinese authorities, could put pressures on Hong Kong's exchange rate peg and spill over to other Asian currencies and other regions and to the U.S. economy as we saw in 1997-98.

Other country risks: Other large countries with less immediate difficulties that may pose a concern are Brazil, Indonesia, Korea, Mexico, Russia, and Turkey. For example, if Korea mishandles the Daewoo restructuring, its economy could be plunged back into serious recession or crisis. Smaller financial fragile countries that have the potential to trigger a broader crisis include Colombia, Ecuador, Romania, Ukraine, and Venezuela. For example, Ecuador's failure to make its Brady bond payments later this month could trigger a flight from the debt of emerging market economies generally, even though the market should not be surprised.

In contrast to the situation over the past two years when concerns about the outlook for the U.S. economy focused primarily on contagion from the rest of the world, our vulnerability from this source appears to have declined both absolutely and relatively. Conditions abroad are mending slowly and the shocks of the past few years are probably still recent enough to keep even investors with short memories mindful of a repetition.

Y2K. The Y2K computer problem poses some limited risks from the potential malfunction of computer systems that support critical infrastructure. There is also some anticipated economic impact from hoarding behavior at the end of 1999 in anticipation of Y2K problems.

Fundamentals: The fundamental risk is of severe and long lasting economic dislocation as computer systems malfunction -- particularly in the critical infrastructure areas of finance, telecommunications, power generation, and transportation. Considerable investment has been made to avoid the fundamental problems. Most large firms and the Federal government have spent large amounts to ensure their systems are Y2K ready. Concerns remain with respect to smaller users, State governments and less-developed countries. However, their problems are unlikely to cumulate into a supply shock sufficient to cause a significant macro-economic impact on the US. Only one of 52 blue-chip forecasters currently projects negative growth for 2000.

Hoarding: A second set of economic problems could occur even if all computers perform normally, if hoarding behavior in anticipation of Y2K problems. This could lead to temporary shortages, soaring prices and long lines. In particular, this could be a problem, if at the last moment firms seek to accumulate extra inventories; households to stockpile supplies such as groceries, prescription drugs, gasoline, and currency; and financial market participants to shift towards highly liquid assets.

The inventory behavior induced by Y2K is expected to boost growth in the final quarter 1999 by $\frac{3}{4}$ percentage point, and lower it in the first quarter of 2000 by the same amount. Interest rates on assets to be held over year-end indicate a liquidity premium but the effect dissipates after a few months.

Overall Impact: Y2K is likely to be to the economy, what a sandstorm is to the desert. A highly visible nuisance for most who are caught in it, quite damaging to a few; but with an impact that is scarcely visible overall once the dust has settled. The key to containing the disruptions from anticipatory behavior is public confidence that the fundamental problems have been dealt with.

Conclusion. [Material here from some kind soul.]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 11:34:36.00

SUBJECT: Phone Message from Peter Goesslin

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

Contact: Peter Goesslin Company: Phone: 861-9265 FAX: Message:

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lael Brainard (CN=Lael Brainard/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME: 9-AUG-1999 12:27:20.00

SUBJECT: Comments on draft memo

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: david.wilcox@do.treas.gov (david.wilcox@do.treas.gov @ inet [UNKNOWN])
READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

Memo is heading in very good direction. Generally quite clear.

I did not read previous version but had similar reaction to Gene/Jason/Rob independently. In particular, detail on inflationary scenario is missing. The first two bullet points in the intro (New Era and Declining Productivity Growth/Rising Inflationary Pressures) appear to be conflated in body of memo under single "New Era" heading. Also, need to clarify whether latter is baseline or "soft landing" moderate downside.

----- Forwarded by Lael Brainard/OPD/EOP on 08/09/99
12:18 PM -----

Jason Furman
08/09/99 12:08:15 PM
Record Type: Record

To: Martin N. Baily/CEA/EOP@EOP, Robert Z. Lawrence/CEA/EOP@EOP,
david.wilcox@do.treas.gov
cc: Robert F. Wescott/OPD/EOP@EOP, Lael Brainard/OPD/EOP@EOP
Subject: Comments on draft memo

The following incorporates comments from Rob Wescott and myself. Before getting to that, Gene just called me to say that he felt the memo was not detailed and quantitative enough. In his view the President would already know a lot of what was in there, and that the memo should bring more new material in. One part of a quick fix, he suggested, was to bring back some of the detail from the previous memo. I think he will be calling Martin to discuss this issue.

More specific comments:

I think the framing in the beginning should be specific about the baseline

relative to which you are describing an upside and a downside. The baseline should probably be the Admin/CBO/Blue Chip forecast showing moderation. The upside would be continued GDP growth at 4 percent and GDP inflation at 1-2 percent and the downside would be the hard landing scenarios. As written this isn't clear, and one might infer that you think the upside is an improvement relative to recent past, something like 6 percent growth and 0 percent inflation.

Do you want to provide a preview of what is to come in the initial bullets on risks? Specifically, if the President doesn't finish the memo, would you want him to know that you don't view Y2K as a serious problem? Or that international contagion might be second order relative to dramatic changes in U.S. asset prices?

Consensus macroeconomic outlook

--long-term interest rates have risen 140 basis points in the last 10 or so months. It should probably say that long-term rates have risen less than they would have given the low unemployment rate, or something like that.

A New Economic Era

--Rob points out that the Fed was using a NAIRU of 6.5 percent a few years ago. This provides starker contrast for where we have come.

--What should be on the LHS of a NAIRU equation, wage inflation or rise in unit labor costs? Or specifically, although wage inflation has risen do we think of that as a demand-side confirmation of the NAIRU being higher than 4.3 or do we think of that as a supply-side increase that is consistent with productivity growth? I'm not sure.

--Could you quantify, or draw on other people's work to quantify, perhaps in a table, the other factors holding down inflation?

Stock market

--Gene flagged this as a section with, as written, little value added to the President's current knowledge. One thing Larry Summers discussed on the conference call that was very interesting was the composition of the rise in the stock market, specifically low-employment, high-tech companies. He said it had two implications: it made one think the rise might be sustainable because these companies could have super high productivity growth, without having to believe the economy could have that growth overall; and if the market crashed many firms might be insulated. I don't know if that is right or wrong, but it sounded interesting and is no longer in the draft.

Y2K

--You may want to reverse the order, to have the real point first (the hoarding) and the other concern second (the fundamentals)

--Hoarding is also more general. It includes other preventative steps that cumulate into their own problems. One could imagine, although it does not seem likely, these happening in financial markets with serious consequences.

--Some quantification on the hoarding issues would be interesting. Specifically, what would happen to the money supply, interest rates, etc.

if everyone decided to raise their average cash holdings by \$200. You could then point out that the Fed has printed money for this eventuality and is standing ready, I assume, to smooth out any of these seasonal-like fluctuations. You could then assess whether or not this will be sufficient.

I hope this is helpful,
Jason

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 14:18:34.00

SUBJECT: Re: time on robert's calendar

TO: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:
Tommorrow

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lael Brainard (CN=Lael Brainard/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME: 9-AUG-1999 14:19:49.00

SUBJECT: Edits -- Latin America

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: david.wilcox@do.treas.gov (david.wilcox@do.treas.gov @ inet [UNKNOWN])
READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

CC: Robert F. Wescott (CN=Robert F. Wescott/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

CC: Jason Furman (CN=Jason Furman/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

TEXT:

Might want to include Latin America in international economic outlook
section in response to latest inquiry from our leader.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 16:41:00.00

SUBJECT: Phone Message from Al Larson

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

Contact: Al Larson Company: Phone: 647-7575 FAX: Message:

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: thughes@cfia.harvard.edu (thughes@cfia.harvard.edu [UNKNOWN])

CREATION DATE/TIME: 9-AUG-1999 16:36:15.00

SUBJECT: Another opportunity

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP [CEA])

READ:UNKNOWN

TEXT:

thughes@cfia.harvard.edu

08/09/99 08:37 PM GMT

To:

cc:

Hello again, everyone --

Just in case you weren't intrigued by the first car-for-sale offer I sent this morning, never fear. Another of our Fellows, Federico Molina Soto, is trying to sell his car as well. If you are interested, please contact him at (617) 734-7742 or via e-mail at <molina@cfia.harvard.edu>.

Here are the details:

1990 Oldsmobile Cutlass Calais

Excellent condition

Only 66,000 miles

For sale at \$3100 (Kelly Blue Book value \$4600)

Thanks.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 17:51:14.00

SUBJECT: Travel to Tel Aviv from Newark or JFK

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

There is only one US carrier per day to Tel Aviv from either Newark or JFK:

Fm Newark to Tel Aviv

LV: 5:40pm

AR: 10:05am

Fm JFK to Tel Aviv

LV: 10:30pm

AR: 3:20pm

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 10:22:09.00

SUBJECT: International roundup from Salomon Smith Barney

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D67]ARMS26213702U.236 to ASCII,
The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

ECONOMIC &

MARKET

ANALYSIS

August 6, 1999

International Market Roundup

Global

Kermit L. Schoenholtz
(212) 816-9898
kim.schoenholtz@ssmb.com
New York

Europe

Michael Saunders
(44-171) 721-3950

Japan

Jeffrey D. Young
(81-3) 5574-4730

United States

Robert V. DiClemente
Mitchell J. Held
(212) 816-9893

Emerging Markets

Desmond Lachman
Thomas J. Trebat

Rising Real Yields

- **Improving global growth prospects will continue to lift real bond yields. In Japan, yields are likely to rise much further than elsewhere, as the economy recovers. In the United States, financial conditions already are tightening more than the rise in Treasury yields implies.**
- **Renewed U.S. labor cost pressures and persistently large employment gains are setting the stage for another round of Fed tightening. Rising market interest rates could prove pivotal in limiting the scope of additional monetary restraint.**
- **Profits are likely to climb in Japan this year, despite the yen's advance. As firms cut fixed costs, upside demand surprises create the possibility of a sizable earnings bounce.**
- **Euro-area mutual fund inflows have slowed sharply in recent months. The drop in inflows, together with the recent sharp rise in non-government bond issuance, probably is exacerbating the ongoing bond selloff.**

This Week

Overview: Global Capital Clash?	2
United States: Fed and Markets in Double-Barreled Tightening	4
Japan: Profits to Grow Despite Strong Yen	6
Euro Area — Mutual Fund Boom Leveling Off	7
Notable Quotes	10

Overview: Global Capital Clash?

Kermit L. Schoenholtz
(212) 816-9898
kim.schoenholtz
@ssmb.com

- Improving growth prospects probably will continue to lift global real yields...
- ...but financial conditions already are tightening notably in the United States as the Fed gradually unwinds the 1998 easing.

We expect a further rise in global real yields as growth picks up, especially in Japan.

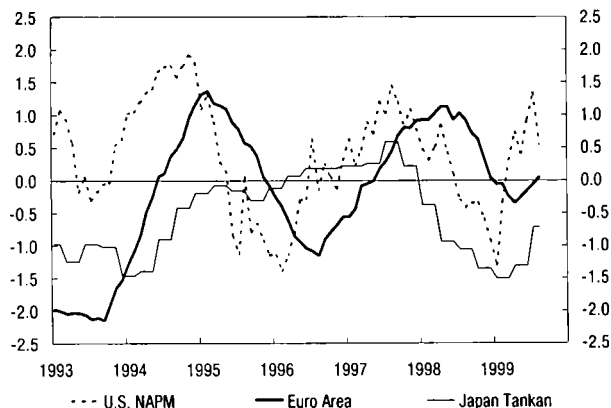
Investors are worried about sizable further increases in *real* yields as improving growth prospects in the global economy risk a clash of demands for capital. On average in the big three government bond markets, real yields have climbed to about 3.6%, up from about 2.6% at the trough in late 1998. However the current level is only roughly consistent with the average of the past 10 years. We continue to expect some upward pressure on key international bond yields in coming months, consistent with the acceleration in activity outside the United States (see Figure 1). Particularly in Japan, where signs are cumulating that a recovery is under way, the outlook is for a substantial rise in yields that would be consistent with the fiscal deterioration of the 1990s.

The prospective rise in Treasury yields is likely to be relatively modest.

However, a new, sustained *leap* in Treasury yields is more doubtful because preemptive Fed action is likely to contain inflation, while widening spreads on other U.S. bonds are tightening financial conditions by more than the Treasury selloff implies. In addition, Treasuries also remain a safe haven against turbulence in the emerging world, where important risks persist.

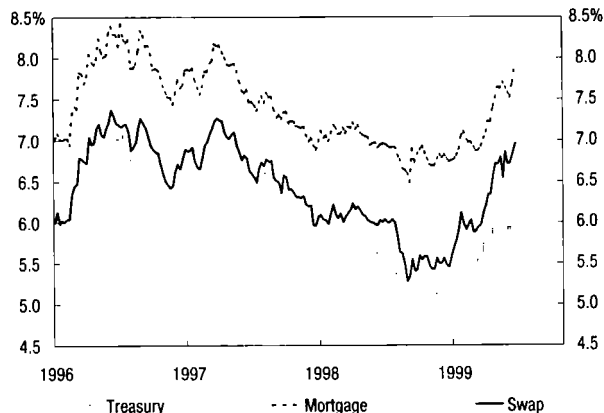
The global growth pickup is gaining ground, with important upside risks in Japan.

Concerns about a global growth pickup are real. U.S. demand remains robust, despite a few hints of moderation. In Europe, low short-term rates and the euro's slide have begun to lift manufacturing confidence, while consumer and construction sentiment remain high. Euro-area growth next year probably will rise to the 2½%-3% range, up from less than 2% in 1999. Moreover, as emerging Asia continues to rebound, recent evidence suggests that Japan already may be expanding again, possibly at a significant pace: Surveys point

Figure 1. Euro Area, Japan and the United States – Business Cycle Confidence Indicators, 1987-99

Note: The figure shows the business confidence indexes in each region measured in units of standard deviations from the 10-year mean.

Sources: Bank of Japan, EU Commission and the U.S. National Association of Purchasing Management.

Figure 2. United States – Long Treasury, Swap and Mortgage Yields, 1996-6 Aug 99

Note: Swap yields are 10-year maturity. The other yields are 30-year maturity.
Source: Federal Reserve Board, FHLMC and Salomon Smith Barney.

to a 4% production rise in July/August, compared to the second quarter. At the same time, Japan's profit outlook is improving as sales grow and firms cut costs (see "Japan: Profits To Grow Despite Strong Yen").

The base case for Japan remains for a moderate turnaround...

Ultimately, arguments for a global capital clash probably depend on a sizable recovery in Japan, which represents about one-seventh of OECD activity. Thus, the acceleration of output in Japan from -3% in 1998 to modest expansion in 1999 already is adding about ½% to OECD output. Looking forward, the base case in Japan is for a moderate upturn, held back in part by lingering weaknesses in the financial system. Recent demand indicators, such as machinery, housing and public works orders, are markedly less favorable than production plans. Moreover, bank loans remain moribund, despite the recapitalization of the banking system. And, of course, rising unemployment and falling wage income — as a result of corporate restructuring — suggest that recent consumption gains remain at risk.

...but upside risks predominate.

Nonetheless, the repeated sequence of upside production surprises this year is consistent with a classic cyclical upturn: If the projected summer production gains are realized without prompting an inventory bulge, growth projections in Japan — including our own — would rise again. In this scenario, JGB yields could meaningfully surpass our projection of 2¼% over the next year: inflation-adjusted JGB yields averaged close to 3% over the past decade, while the fiscal deterioration over that period may warrant a larger risk premium today.

Faster growth in Japan will lift JGB yields substantially, but the impact on Treasuries could prove limited.

Even in this case, however, investors should not assume that faster growth in Japan automatically leads to synchronized global takeoff, or that significantly higher JGB yields would prompt a similar response in U.S. Treasuries. U.S. financial conditions already have tightened substantially this year, and a further modest deterioration — in the context of Fed tightening — may be all that is needed to moderate U.S. economic growth next year and contain inflation risks.

U.S. financial conditions already have tightened by more than Treasury yields or the equity market imply...

Indeed, observers focusing only on Treasury yields or the equity market are likely to underestimate the change of conditions: Widening corporate and mortgage spreads already have lifted yields in these sectors back to two-year highs, while the long Treasury yield remains close to the level that prevailed before last summer's financial crisis (see Figure 2). While these wider yield spreads partly reflect the shift of demand for capital within the United States from the public to the private sector, they also focus restraint in the most sensitive areas: Adjusted for inflation, corporate and mortgage yields are near their highest levels since 1995.

...while Treasuries continue to benefit from their role as a liquid, safe haven.

At the same time, Treasuries remain the global safe haven of choice. Within the United States, Y2K concerns appear to be encouraging acquisition of Treasuries, as investors seek liquidity. Outside the United States, continued distress in parts of Latin America and renewed uncertainty about currency stability in parts of emerging Asia probably will sustain safe-haven concerns in the remainder of 1999.

High equity valuations and good inflation performance should make it difficult to sustain a new U.S. yield surge.

Yield overshooting can hardly be ruled out. Nonetheless, a renewed surge of U.S. Treasury yields probably would be difficult to sustain, unless the underlying trend of inflation unexpectedly turns higher. In particular, high U.S. equity valuations, a key driver of private demand, remain vulnerable to such a yield spike. And, at least in the past, Treasury yields typically peak a few months *before* the last Fed rate hike in a cycle. The more assistance the Fed receives from tighter financial conditions, the earlier it can shift back to neutral.

United States: Fed and Markets in Double-Barreled Tightening

Robert V. DiClemente
(212) 816-7942
robert.diclemente@ssmb.com

- **Renewed labor cost pressures and persistently large employment gains are setting the stage for another round of Fed tightening.**
- **Rising market interest rates could prove pivotal in limiting the scope of additional monetary restraint.**

Labor demand and cost data heightened the chances of renewed Fed tightening this month.

With each week that passes, the case for another round of Fed tightening as anti-inflation insurance grows more compelling. As discussed last week, the prospect of a sharp second-quarter acceleration in hourly compensation and unit labor costs combined with persistent outsized job gains at the start of the third quarter heightened the risks that inflation pressures could resurface soon. In the event, the data were every bit as strong as expected, and this morning's report that hourly earnings shot up by 0.5% in July completed a "hat trick" of rising labor cost proxies, all of which are accelerating again amid intense hiring needs.

Beyond a pending move, additional action will depend in part on the ongoing rise in private sector borrowing costs.

This picture reinforces our expectation of another 25-basis point tightening at the August 24 policy meeting. Although we anticipate still another round of Fed action beyond the pending one — taking the funds rate back to 5½% — both the timing and extent of any additional restraint will need to be judged in the context of changing financial market conditions, which are tightening swiftly again. In particular, the virtual stability in Treasury bond yields masks a significant ongoing rise in other market interest rates that could in turn choke off a rising stock market. Indeed, given limited supply and a lingering global safe-haven bid, there is a fair chance that long Treasuries are at or near a cyclical peak in the 6% to 6¼% range. However, mortgage and corporate yields continue to climb and in real terms are approaching extremes not seen in a decade (see Figure 3).

Increasingly, Treasury yields are decoupling from the underlying outlook, reflecting the unprecedented gap between public and private borrowing.

Moderate further restraint may be enough.

Surveying the latest evidence on the economy and inflation, the outlook appears reasonably on course: some moderation around the edges, but with that, demand remains ahead of even relatively optimistic assessments of the economy's long-run supply potential. The economy will strain to produce 3½% growth in the second half of '99. However, the one-two combination of moderate policy restraint and tighter financial market conditions likely will cool business and household spending sufficiently to keep inflation contained heading into next year.

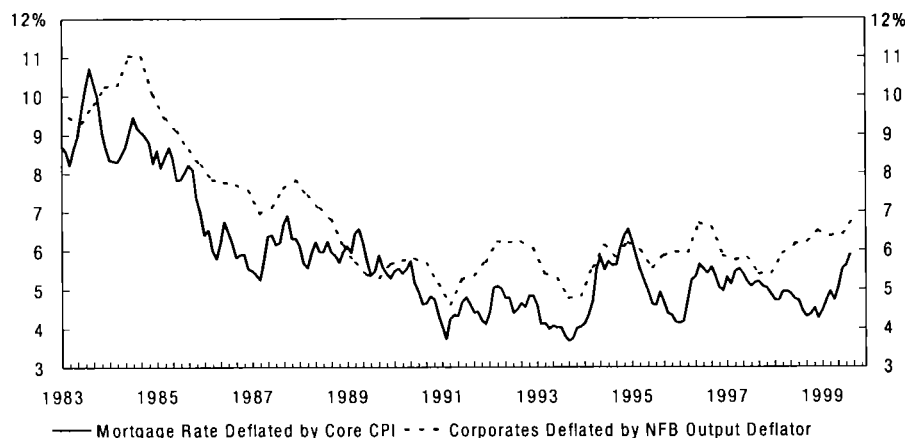
Wealth effects and global recovery are evident in today's robust jobs report..

Today's employment report presented a vivid display of how a wealth-driven expansion buoyed by a recovering global economy manifests itself in the labor markets. The reported payroll gain of 310,000 included massive gains in service-related establishments, particularly among restaurants, but also saw continued strength in construction and related industries as well as in autos and finance areas, all key segments of the "feel-good" economy. Manufacturing payrolls jumped by 31,000, corroborating earlier signs of revival in external demand. The pickup was the first meaningful increase in factory employment in two years. Moreover, the rise in the factory workweek and overtime suggests there is more where that came from.

...which also showed new signs of wage pressure.

Despite the strong employment showing, labor markets apparently did not tighten further in July, but that is not likely to lessen Fed concerns about the risks of inflationary imbalances. While the unemployment rate held steady, year-to-year growth in hourly earnings is inching higher at 3.8%, up from a low of 3.5% earlier this year, while three-month annualized growth has risen to 4.6%. The unemployment rate was held up by an erratic decline in the household survey measure of employment. The larger picture indicates that the divergence between establishment and household employment is narrowing in favor of unsustainably high growth. In the past year, payroll employment growth has edged down from 2.4% to 2.3%, while the household job count has risen 1.6%, up from 1.1%. At either rate, hiring needs will outstrip population growth and tighten labor markets further, barring the onset of meaningful financial restraint, just now beginning to take shape.

Figure 3. United States — Inflation-Adjusted Corporate Bond Yields and Mortgage Rates, 1983-3Q 99E



Note: Corporate yields are deflated by the nonfarm business output deflator and mortgage rates are deflated by core consumer prices.
Sources: Salomon Smith Barney and selected major mortgage lenders. Bureau of Labor Statistics.

Japan: Profits to Grow Despite Strong Yen

Jeffrey D. Young
Tomoko Fujii
 (81-3) 5574-4730
 jeffrey.young
 @nssmb.com

- Profits are likely to rise by about 5% in FY99 and 23% in FY00.
- Improving profits will underpin the yen and eventually point to higher yields as companies increase investment.

Profits should rise this year, with upside surprises likely to dominate.

Corporate profits should rise this year, paving the way for a self-sustaining upturn in private-sector economic activity. We have revised our top-down corporate profit projections modestly upward for fiscal 1999-2000, due to better demand prospects and a broad-based improvement in cost structures. The upward revision is particularly notable because we no longer expect the yen to depreciate sustainably past ¥120/US\$.

The sales outlook has improved, while companies have made progress in cutting costs.

Recurring profits for 969 Tokyo Stock Exchange First Section (TSE-I) nonfinancials¹ are expected to rise by 5.2% in fiscal 1999 (FY99) and by 22.9% in fiscal 2000 (FY00), largely reflecting an upward revision to our forecast for domestic final sales. In addition, companies have made progress in cutting costs, reflecting the record pace of decline in the economy-wide wage bill and ongoing reductions of productive capacity. Both these trends contradict the often-heard view that Japanese firms will shelve their restructuring plans as soon as demand revives. Lower fixed costs highlight the possibility of a profit surge if sales surprise favorably.

The strong yen is a downside risk...

The stronger yen may temper profit gains in some sectors. The direct impact on export sales is the most visible effect of the rising yen, but there are some mitigating factors. First, overseas economic growth is accelerating, with growth in Japan's major trading partners expected to rise by 3.5% in 1999, after a paltry 0.2% in 1998. Second, Japan remains reasonably competitive at current exchange rates: on a real trade-weighted basis, the yen is close to long-term averages, and unit labor costs relative to the United States will remain nearly stable. Reflecting these factors, Japanese export volume turned up in June, even though the peak effects of the yen's early-1999 rise should have been felt at about this time. Finally, the stronger yen brings some benefits in the form of lower input costs. A higher currency may lift profits for nonmanufacturing firms (which have a high import intensity).

...but demand consistently has surprised on the upside this year.

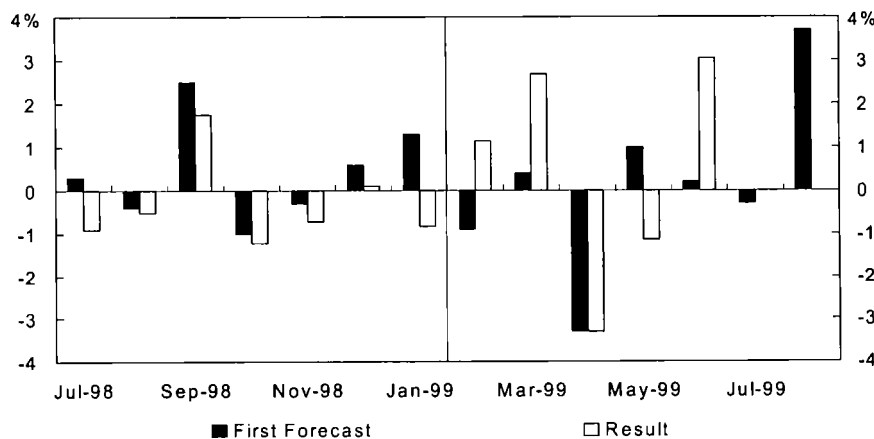
More generally, upside risks for profits currently appear to dominate. Primary among these upside risks is the potential for a surprise demand pop in the near term. Evidence regarding the current quarter is mixed: forward-looking demand-side data (machinery orders, public works orders, and housing orders) have been weak, but companies have reported bullish production plans (manufacturing output is expected to rise by 4% above the second-quarter average in the July-August period). Which figures are correct? This year, it has been wise to trust the production-side data. Since February, production typically has overshoot initial forecasts, reversing the pattern seen for most of 1998 (see Figure 4). Output has managed to beat plans even as inventories have been slashed, suggesting that demand exceeds the volumes in traditional orders data. If bullish summer production plans are realized without a bulge in unwanted inventories, the profit outlook will have improved substantially.

¹ These figures exclude Nippon Telephone and Telegraph (NTT).

Higher profits create the basis for growth, which should underpin the yen and lift bond yields.

A rise in profits would have important market implications. First, this forecast implies that a further yen decline is not necessary for a cyclical recovery. Until now, the primary argument for aggressive policy action to weaken the yen has been to counter the economic downturn. We doubt that the authorities would tolerate a surge past ¥110/US\$, but we also no longer expect that any move into the ¥120/US\$ range would be sustained. Higher profits also will pave the way for a self-sustaining recovery after policy stimulus begins to wear off. In this scenario, business investment probably will stabilize early in 2000, putting some upward pressure on bond yields.

Figure 4. Japan — Manufacturing Output Forecast vs Result, July 1998-August 1999 (Month-to-Month Percentage Change)



Note: Production results available through June; MITI forecasts through August. Vertical line represents February 1999.
Source: Ministry of International Trade and Industry.

Euro Area — Mutual Fund Boom Leveling Off

Michael Saunders
(44 171) 721 3924
michael.saunders
@ssmb.com

Second-quarter mutual fund inflows fell year on year...

...with the sharpest drops in Italy and Spain.

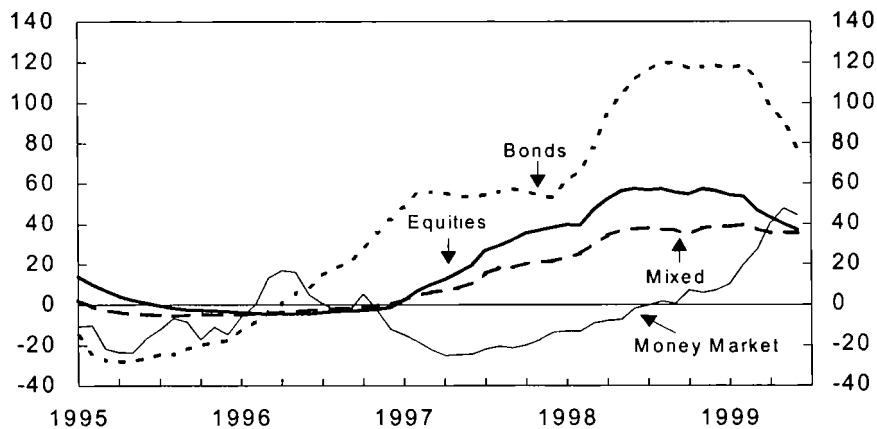
- **Second-quarter retail inflows to mutual funds were down from a year ago, due to lower inflows in Italy after very high 1998 levels...**
- **...while the supply-demand mix was worsened by soaring bond issuance.**

In May, we noted that Europe's mutual fund surge was "leveling off".² This trend now is clearer, with total second-quarter inflows in the major four euro-area countries down 42% year on year, with a 66% drop excluding money market funds. This is the first time since 1995 that inflows (both total inflows and inflows excluding money market funds) over a quarter fell below year-ago levels.

By asset class, the biggest collapse is in bond funds, with net inflows of just below €5 billion in 2Q99 – the lowest three-month total since early 1996 and compared with nearly €40 billion in 2Q98 (an 88% drop). Inflows to equities fell by about 50%, with inflows to mixed funds only slightly down. The biggest drops were in Italy and Spain, which previously had seen the strongest gains. In Italy, inflows (excluding money market funds) in 2Q99 were about €14 billion, compared with about €50 billion in 2Q98, while in Spain inflows totaled about €2 billion in 2Q99 compared with €9.5 billion a year earlier. Inflows in France and Germany were only slightly down from a year earlier.

² See "Mutual Fund Flows Flattening Off," *Euro Weekly*, Salomon Smith Barney, May 13, 1999. Fuller details of the mutual fund data are in *European Funds Flows*, Mark Howdle and Niall Macleod, Salomon Smith Barney, August 5, 1999.

Figure 5. Euro Area — Aggregate Net Retail Mutual Fund Inflows in Germany, France, Italy and Spain (12 Month Total, Billions of Euros), 1995-2Q 99



Source: Salomon Smith Barney.

The second-quarter drop in inflows to equity, bond and hybrid funds — which contrasts with the sharp gains seen over recent years — probably reflects two main factors:

Part of last year's surge may have been a one-off...

- Last year's surge in inflows probably included a sizable "one-off" element, especially in Italy and Spain, as short rates plunged and households moved savings out of deposits and short-term bonds to seek higher returns from equity and bond funds. Italian mutual fund inflows in 2Q98 were 560% up from a year earlier, and inflows in 2Q99 remain about three times the pace of 2Q97.

...and the recent market selloff may have scared investors...

- Recent poor market performance may have made investors more risk averse. Part of the drop in inflows to equity, bond and hybrid funds reflects a shift to money market funds (which are low risk). Second-quarter inflows to money market funds in Germany, France, Italy and Spain were roughly double last year's level and accounted for an unusually high share of total inflows.

...but rapid secular expansion in mutual fund assets still probably is intact.

Despite the recent dip, we still suspect that most euro-area countries will continue to see a sizable shift of assets into mutual funds and other institutionally managed savings, and away from bank deposits and short-term bonds. This trend is being driven by low short rates plus greater awareness among savers that they cannot rely on unfunded state pensions. Compared with U.S. and U.K. households, euro-area households in total have low levels of financial assets, and their asset holdings are heavily biased towards bank deposits and short-term bonds but underweight long-term retirement-type assets (e.g. pension funds, equities, bonds and non-money market mutual funds). Households may be cautious about returning to bond funds for a while but, perhaps after a few months, the recent rise in yields probably will attract higher inflows again.

Reduced mutual fund inflows have been met by greater capital markets issuance...

The dip in mutual fund inflows has coincided with a surge in bond issuance, so that the demand-supply mix has turned bearish. International bond issuance in euros by non-sovereign borrowers this year already roughly equals the 1998 total (for ecu and the individual EMU-area currencies) and exceeds that for 1997. Issuance in U.S. dollars and sterling also is up, but less sharply than for euros. Equity issuance in euros already is near the 1998 total and above the 1997 total.

*...triggered by
pre-emptive
Y2K concerns and
secular trends...*

The surge in issuance partly reflects a shift among euro-area companies away from bank finance (which previously has dominated) and towards capital market finance. Global issuers (both corporations and sovereigns) also probably are aiming to rebalance their liabilities between dollars and euros, whereas previously most issuance was in U.S. dollars. These secular trends have been prompted by (1) greater liquidity in non-government markets post-EMU, and (2) growing shareholder pressure on European banks to raise the return on capital, which implies that margins on corporate loans might rise towards U.S. levels and hence make bond and equity issuance more competitive. Issuance also probably is being front-loaded before possible yearend Y2K-related disruptions. This effect probably will cause very high issuance in September and October, but then fade.

*...so that the short-
run supply-demand
balance may remain
bearish.*

In the long run, the chances are that neither the bullish effect of the shift in household assets to mutual funds and away from bank deposits, nor the bearish effect from higher bond supply will dominate in financial asset pricing. However, over periods of a few months, one or other factor may dominate. Last year, the surge in mutual fund inflows gave a bullish backdrop to European financial assets, while now — with mutual fund inflows leveling off and high issuance — bearish factors set the tone.

Figure 6. Euro Area — Net Retail Mutual Fund Inflows, 1996-2Q99 (Billions of Euros per Quarter)

	Quarterly Average			Quarterly Data		2Q99 Less
	1996	1997	1998	1Q99	2Q99	2Q98
Germany						
Equity Funds	€0.1bn	€2.7bn	€2.9bn	€4.2bn	€2.7bn	-€1.0bn
Bonds Funds	0.8	0.8	-0.1	1.9	1.4	0.8
Mixed Funds	0.0	0.3	0.5	0.0	0.1	-0.6
Total Excl. MM Funds	0.9	3.8	3.3	6.2	4.1	-0.7
Money Market Funds	-0.6	-0.6	0.7	2.1	1.7	1.5
France						
Equity Funds	-0.3	1.3	2.6	2.0	1.4	-1.2
Bond Funds	-1.0	-0.3	0.2	0.7	0.4	-0.9
Mixed Funds	0.2	1.3	2.1	3.2	2.3	-0.4
Total Excl. MM Funds	-1.1	2.3	4.8	5.8	4.1	-2.5
Money Market Funds	-2.4	-5.9	0.0	16.6	5.3	5.0
Italy						
Equity Funds	-0.5	3.9	6.0	1.1	4.3	-4.4
Bond Funds	8.4	10.1	26.4	29.0	5.6	-30.7
Mixed Funds	-0.3	0.8	3.0	3.0	3.9	-0.8
Total Excl. MM Funds	7.5	14.8	35.4	33.1	13.8	-35.9
Money Market Funds	0.0	3.1	3.6	7.3	12.2	8.3
Spain						
Equity Funds	0.3	1.7	2.6	2.1	1.1	-3.3
Bonds Funds	2.4	2.7	3.1	6.7	-2.7	-4.2
Mixed Funds	0.3	2.0	4.0	6.2	3.3	-0.3
Total Excl. MM Funds	3.0	7.4	9.8	15.0	1.7	-7.8
Money Market Funds	0.0	0.0	-2.5	2.0	-1.6	2.3
Euro-4						
Equity Funds	-0.3	9.6	14.1	9.0	9.4	-9.9
Bond Funds	10.6	13.3	29.6	38.4	4.7	-34.9
Mixed Funds	0.1	5.4	9.7	12.4	9.6	-2.1
Total Excl. MM Funds	10.3	28.3	53.3	60.1	23.8	-46.9
Money Market Funds	-3.0	-3.4	1.8	28.0	17.6	17.1
Total	7.3	24.9	55.2	88.1	41.3	-29.8

Note: Figures derived from various sources, and include some estimates. The German data assume that June inflows match flows in May.

Source: Salomon Smith Barney.

Notable Quotes

William Poole, St. Louis Federal Reserve Bank President

"He [Greenspan] can carry the committee with him and that's not because we're a bunch of lemmings but because he is so successful and has good judgment. Should Greenspan's fantastic judgment desert him and if there were a sequence of bad calls, it would start to show up because the fundamentals would not be right. I have every reason to anticipate he will continue to have good judgment."

Bloomberg, August 4, 1999.

Gary Gensler, U.S. Undersecretary of the Treasury for Domestic Finance

"We are now in our second year of budget surpluses. Thus far, we have managed the paydown of our debt by refunding our regularly maturing debt with smaller amounts of new debt. What we are proposing today would enable Treasury to repurchase debt that is not currently maturing."

Office of Public Affairs, U.S. Treasury, August 4, 1999.

Haruhiko Kuroda, Japan Vice Finance Minister for International Affairs

"The Japanese economy may be recovering, but the recovery is not firm. Share prices have risen due to expectations of an economic recovery, but even if stock prices rise, the yen does not necessarily need to rise. (...) Stability in the foreign exchange market and rises in share prices can coexist."

Reuters, August 6, 1999.

Paul Volcker, Former U. S. Federal Reserve Chairman

"I think the basic instinct is right. The ultimate implication of the global economy is fewer national currencies.(...) It simply makes no sense in an integrated world to have so many exchange rates moving so widely without a reasonable relationship to economic fundamentals."

Reuters, August 6, 1999.

Dominique Strauss-Kahn, French Finance Minister

"When the automotive and construction sectors are in good shape, then so is the economy, and that's the case at the moment."

Dow-Jones, August 3, 1999.

Martine Aubry, French Social Affairs Minister

"1998 was a very good year, with an exceptional growth rate, and unemployment fell by 135,000. Now, over the last six months we are around [a decline of] 100,000, that is to say an annual rate of 200,000 which is one and a half times better than last year, even though growth is less strong."

Interview to *France-Inter* radio quoted by *Reuters*, July 30, 1999.

Yves Thibault de Silguy, EU Monetary Affairs Commissioner

"The euro-zone needs a unified agency for government bond issues. I know this could cause controversy and perhaps irritate some member states, who might see it as yielding even more sovereignty. [A single agency] would create a truly single market, more liquidity, and interest rates would certainly be lower."

Interview with *Corriere della Sera*, August 2, 1999.

International Market Indicators

Currency and Market		Yields/Rates					Change Week	a
		30 Jul	2 Aug	3 Aug	4 Aug	5 Aug		
Bellwether Bonds ^b								
US\$ Govt. ^c	5.5% of 08	5.91 %	5.91 %	5.95 %	5.95 %	5.88 %	-3 bp	
A\$ Govt. ^c	8.75% of 08	6.22	6.22	6.30	6.26	6.20	-2	
C\$ Govt. ^c	7.25% of 07	5.74	5.74	5.75	5.72	5.72	-2	
¥ Govt. (Simple)	#182 3% of 05	1.22	1.30	1.34	1.33	1.25	3	
¥ Govt. (Compound) ^c	#182 3% of 05	1.31	1.27	1.35	1.38	1.38	7	
Bfr Govt.	5.75 of 08	5.02	5.08	5.10	5.10	5.20	18	
Dkr Govt.	7% of 07	5.11	5.22	5.23	5.23	5.37	26	
DM Govt Bund	5.25% of 08	4.82	4.89	4.91	4.91	4.99	17	
Dfl Govt.	5.25% of 08	4.89	4.95	4.97	4.97	5.05	17	
Ecu	OAT 5.25% of 08	3.81	3.81	3.81	3.81	3.81	0	
Fim Govt.	6.0% of 08	4.97	5.03	5.05	5.05	5.13	16	
Ffr Govt.	5.25% of 08	4.83	4.89	4.91	4.91	4.99	16	
Itl Govt.	6.0% of 07	5.04	5.11	5.15	5.15	5.25	20	
Pta Govt.	6.0% of 08	4.99	5.06	5.08	5.09	5.18	19	
Pte Govt.	6.625% of 07	4.75	4.85	4.88	4.89	4.99	24	
Skr Govt.	9.0% of 09	5.34	5.42	5.42	5.48	5.62	28	
£ Govt.d	7.25% of 07	5.64	5.60	5.66	5.66	5.72	8	
Representative Money Market Rates								
US\$	Federal Funds	5.07 %	5.18 %	4.98 %	4.94 %	5.00 %	-7 bp	
US\$ Euro	3-Mo. LIBOR	5.34	5.34	5.34	5.34	5.38	3	
A\$	3-Mo. Deposit	4.70	4.62	4.74	4.68	4.68	-2	
C\$	3-Mo. Tbill	4.61	4.63	4.65	4.64	4.61	0	
¥	3-Mo. CDs	0.03	0.03	0.03	0.03	0.03	0	
Bfr	3-Mo. Deposit	2.62	2.64	2.64	2.64	2.64	2	
Dkr	3-Mo. CIBOR	-	-	-	-	-	-	
DM	3-Mo. Interbank ^{2.72}	2.72	2.70	2.74	2.74	2.76	4	
DM	Call Money Rate	2.60	2.59	2.58	2.55	2.55	-5	
Dfl	3-Mo. Interbank	2.72	2.70	2.74	2.74	2.76	4	
Ecu	3-Mo. Interbank	2.72	2.70	2.74	2.74	2.76	4	
Fim	3-Mo. HELIBOR	3.11	3.12	3.12	3.12	3.13	2	
Ffr	3-Mo. PIBOR	3.27	3.27	3.26	3.26	3.26	-1	
Itl	3-Mo. Interbank	2.72	2.70	2.74	2.74	2.76	4	
Pta	3-Mo. Interbank	2.72	2.70	2.74	2.74	2.76	4	
Pte	3-Mo. Interbank	2.60	2.64	2.64	2.64	2.66	6	
Skr	3-Mo. STIBOR	3.25	3.27	3.27	3.24	3.24	-1	
Sfr	3-Mo. Interbank	1.15	1.15	1.16	1.15	1.15	0	
£ Sterling	3-Mo. Interbank	5.27	5.29	5.30	5.30	5.31	4	
Foreign Exchange Rates (versus U.S. Dollar)								
Australian Dollar ^d		0.652	0.650	0.655	0.659	0.654	0.3 %	
Canadian Dollar		1.504	1.505	1.493	1.491	1.496	0.5	
Japanese Yen		114.6	114.2	115.3	114.3	114.3	0.3	
U.K. Sterling ^d		1.623	1.617	1.620	1.622	1.614	-0.5	
Euro ^d		1.071	1.070	1.068	1.077	1.076	0.4	
Foreign Exchange Rates (versus Euro)								
Danish Krone		7.456	7.470	7.469	-	7.432	0.3	
Swedish Krona		8.781	8.790	8.777	-	8.763	0.2	
Swiss Franc		1.600	1.602	1.605	-	1.597	0.2	
U.K. Sterling		0.660	0.661	0.661	-	0.665	0.8	
Stock Market Indexes								
U.S. (S&P 500)		1329	1328	1322	1305	1314	-1.1	
10911		10655	10646	10677	10675	10794	1.3	
Australia (All Ordinaries)		3020	3000	3032	3006	3019	0.0	
Canada (TSE 300)		7081	7055	7033	6963	6907	-2.5	
Japan (TOPIX)		1479	1469	1482	1460	1431	-3.2	
Japan (Nikkei)		17862	17826	17970	17685	17358	-2.8	
U.K. (FT-SE 100)		6232	6288	6251	6235	6102	-2.1	
Germany (DAX)		-	-	-	-	-	-	
France (CAC 40)		4382	4378	4355	4326	4241	-3.2	
Italy MIB-30		32584	32999	32827	32534	31850	-2.3	
Spain (Madrid)		843	845	848	848	829	-1.7	

^a Change between closing on previous Friday and Thursday of this week. ^b Yields are quoted on an annual basis except where indicated. ^c Yields quoted on a semiannual basis. ^d U.S. dollars per unit of foreign currency. bp Basis points. — Data not available due to holiday.

Key International Economic Indicators

United States

Aug 12 8:30am New York Time	Jobless Claims (August 7)	Forecast: 280,000 (+1,000)
	The number of initial claims filed during the week ended August 7 likely remained near its expansionary low, inching just 1,000 higher to 280,000. Meanwhile, the benefit rolls probably continued to shed recipients, falling by 40,000 to 2.207 million during the week reflecting July 31.	
Aug 12 8:30am New York Time	Retail Sales (Jul)	Forecast: 0.6% Excl. Automobiles: 0.5%
	Stepped-up spending across a wide variety of product categories probably propelled retail sales higher in July, after a modest 0.1% uptick in the previous month. Preliminary data from motor vehicle manufacturers indicate that unit purchases likely rebounded to 17.0 million last month, almost matching the expansion-high 17.2 million posted in May. After adjusting for seasonal differences between the unit volume and value series and price effects, automotive dealer receipts probably rose by 1.0% in July, more than offsetting June's 0.9% decline. Net of the anticipated rebound in motor vehicle sales, retail purchases likely rose by 0.5%, narrowly outpacing the consecutive 0.4% increases recorded in May and June. Increased outlays on building materials, gasoline, general merchandise and "other" nondurables probably accounted for a little over two thirds of the projected rise in nonautomotive receipts last month. Our estimates would place total and nonautomotive retail sales in July 4.3% and 3.7% annualized above their respective second-quarter averages.	
Aug 13 8:30am New York Time	Business Inventories (Jun)	Forecast: Unchanged
	The nominal value of business inventories probably was unchanged in June, as projected stockbuilding by merchant wholesalers was neutralized by reductions of manufacturers' and retailers' stores. Although the pace of manufacturing and trade sales slowed from May's pace, the overall inventory-to-sales ratio likely slumped to an all-time low of 1.18.	
Aug 13 8:30am New York Time	Producer Prices (Jul)	Forecast: 0.1% Excl. Food and Energy: 0.1%
	The Producer Price Index (PPI) probably edged a touch higher in July, after a 0.1% dip in the previous month, as gasoline-led surge in energy costs and a modest bounceback in the core wholesale inflation gauge were all but offset by markedly lower quotes for finished consumer foods. Paced by an anticipated 19.0% leap in seasonally adjusted gasoline prices, the PPI finished energy cost barometer likely climbed by 3.2% — the largest jump in three months. Projected rebounds in motor vehicle costs probably triggered a 0.1% uptick in the PPI excluding food and energy components in July, reversing half of the surprising 0.2% decline recorded in the prior month. Sharply lower costs for beef, coffee, fresh fruits, pork products and vegetables, however, likely pared the PPI for finished consumer foods by 1.5% in July, marking the largest decline in 17 years. Our estimates would place the overall and core PPIs 1.3% and 1.4% above their respective year-ago levels.	
Aug 13 10:00am New York Time	University of Michigan Sentiment Index (August Preliminary)	Forecast: 107.0 (+1.0 Point)
	Early-August soundings from the ABC News/ <i>Money</i> magazine poll suggest that the University of Michigan's confidence barometer probably rebounded, essentially matching the average level posted over the May-July span.	
Japan		
Aug 9 8:50 Tokyo Time	Wholesale Prices, Domestic (Jul)	Forecast: -1.8% Yr.-Yr.; -0.1% Mo.-Mo. Previous: -1.7% Yr.-Yr.; 0.0% Mo.-Mo.
	Wholesale Prices, Overall (Jul)	Forecast: -4.1% Yr.-Yr.; -0.1% Mo.-Mo. Previous: -4.0% Yr.-Yr.; -0.1% Mo.-Mo.
	Domestic wholesale prices likely edged down 0.1% month on month in July. Drops in prices of chemical products and agricultural products were greater than a rise in price of nonferrous metal products in the July 1-20 period. Due to further appreciation of the yen, both export and import yen-based prices declined month on month and year on year during the period. Consequently, we expect overall WPI to decline 0.1% month on month and 4.1% year on year in July, from drops of 0.1% month on month and 4.0% year on year in June.	
Aug 10 2:00 p.m. Tokyo Time	Machinery Orders, Private Excl. Ships and Elec. Power (Jun)	Forecast: 2.5% Mo.-Mo.; -10.7% Yr.-Yr. Previous: 3.8% Mo.-Mo.; -7.5% Yr.-Yr.
	Business investment demand remained stagnant, although downward forces appear to be moderating. Core private machinery orders (excluding ships and electric power, both volatile factors) likely rose modestly month on month for the second consecutive month. However, these orders probably dropped by 8% quarter on quarter in April-June following a marginal gain (0.7%) in January-March. The EPA's July-September outlook should show a modest quarter-on-quarter rebound.	
Aug 11-18 8:50 Tokyo Time	Balance of Payments, Current Account (Jun)	Forecast: ¥1,200 Billion NSA; ¥1,220 Billion SA Previous: ¥1,417 Billion NSA; ¥1,297 Billion SA
	The June unadjusted current account surplus likely dropped to ¥1,200 billion from a year ago despite only a slight year-on-year decline in the unadjusted merchandise trade surplus during the month (estimated at ¥1,323 billion). This is partly due to an expected rebound in the services deficit in the wake of some signs of economic strength in the latest indicators. However, June's services deficit growth probably will be lower than April's surge, which was related to May's Golden Week travel. On a seasonally adjusted basis, the current account surplus likely posted a moderate month-on-month decline of about 6%. Meanwhile, patterns of capital inflows are likely to reveal effects on the yen's appreciation during the month.	

Key International Economic Indicators

GermanyAug 11
7:00**Industrial Production (Jun)****Forecast: -0.4% Mo.-Mo.; -2.0% Yr.-Yr.**
Previous: -0.2% Mo.-Mo.; -2.2% Yr.-Yr.

London Time

Based on the preliminary numbers, industrial production probably dropped 0.4% month on month and 2.0% year on year in June, after dropping 0.2% month on month and 2.2% year on year in May. Activity in 2Q99 still is subdued, as the special factors that supported activity in 1Q99 unwind. Over 2Q99 as a whole, we expect industrial production to be roughly flat quarter on quarter. However, the pickup in the economy should lead to an acceleration in industrial production in the second half of the year.

FranceAug 11
7:45**Consumer Prices (Jul)****Forecast: -0.1% Mo.-Mo.; 0.5% Yr.-Yr.**
Previous: 0.0% Mo.-Mo.; 0.3% Yr.-Yr.

London Time

French consumer price inflation probably edged up moderately in July, to 0.5%, from a very low 0.3% in June (only 0.1 percentage point above the record low of February). The mild acceleration in French inflation — similar to what has been seen so far in Germany, Italy and the other countries that have released July data — would be related to the joint effect of higher prices for petroleum products, and unfavorable base effects on the fresh food prices front. By contrast, core inflation is likely to have remained at or about the low 0.7% year-on-year rate seen in June, the lowest of the present cycle, as producer prices have stabilized after last year's decline, wage growth is moderate and manufacturers' selling price expectations have remained downbeat.

Spain

Aug 12

Employment Growth (2Q 99)**Forecast: 3.9% Yr.-Yr.****Previous: 3.9% Yr.-Yr.****Unemployment Rate (2Q 99)****Forecast: 16.5% of Workforce****Previous: 17.0% of Workforce**

Judging from monthly registered unemployment and Social Security data, employment creation remained strong in the second quarter, particularly in the service and building sectors. Assuming that the labor force continued to grow at a similar rate to that of the first quarter (0.6% year on year), the unemployment rate probably dropped further, breaching 17%.

Aug 13

Consumer Prices, Headline (Jul)**Forecast: 2.0% Yr.-Yr.****Previous: 2.2% Yr.-Yr.****Consumer Prices, Ex Food & Energy (Jul)****Forecast: 2.7% Yr.-Yr.****Previous: 2.5% Yr.-Yr.**

A new drop of fresh food prices and lower administrative tariffs partly offset new gains of processed food, gasoline and energy prices, leaving the July CPI 0.2% above the June level. Excluding fresh food and energy, underlying inflation probably was up 0.3%-0.4% month on month, reflecting stubbornly high price gains in the services sector (mainly tourism), and accelerated to 2.7% year on year after remaining stable at 2.5% since March.

United Kingdom

Aug 9

9:30 London Time

Producer Output Prices (Jul)**Forecast: 0.2% Mo.-Mo; 1.2% Yr.-Yr.****Previous: 0.0% Mo.-Mo; 1.0% Yr.-Yr.****Seasonally Adjusted Ex Food, Drink, Tobacco, Petrol (Jul)****Forecast: 0.0% Mo.-Mo; -0.5% Yr.-Yr.****Previous: 0.1% Mo.-Mo; -0.5% Yr.-Yr.****Ex Tax and Seasonally Adjusted (Jul)****Forecast: 0.2% Mo.-Mo; -0.2% Yr.-Yr.****Previous: 0.1% Mo.-Mo; -0.3% Yr.-Yr.**

The recent pickup in oil prices is likely to cause output price inflation to edge up again, and a figure in line with our forecast would put the annual gain in output prices at their highest since August 1997. The ex-tax measure remains down from a year ago, but the six-month annualized rate rose to 0.4% in June (highest since end 1997), and the annual rate will start to turn up in coming months. The other core measure, which excludes products of the food, drink, tobacco and petrol industries, remains softer because the rise in oil prices has less effect on this measure and price pressures (excluding the rise in oil prices) are weak. Surveys suggest that manufacturers' price expectations have rebounded from their lows in the intermediate goods sectors, but remain weak in the consumer and capital goods sector.

Aug 9

9:30

London Time

Producer Input Prices (Jul)**Forecast: 2.0% Mo.-Mo; 1.3% Yr.-Yr.****Previous: 0.6% Mo.-Mo; -1.0% Yr.-Yr.**

The recent sharp gain in oil prices and nonoil commodity prices is likely to be reflected in a sharp jump in input prices. A figure in line with our forecast would be the sharpest jump in prices since January 1995, and put input prices up from a year ago for the first time since April 1996. Oil prices in sterling terms rose by more than 20% in July, and now have doubled since December. A further boost to input prices is likely in coming months.

Aug 11

9:30

London Time

Claimant Count Unemployment (Jul)**Forecast: -5,000 Mo.-Mo; 4.4% of Workforce****Previous: -5,200 Mo.-Mo; 4.4% of Workforce****LFS Unemployment (Apr-Jun)****Forecast: -12,000 Qtr.-Qtr.; +8,000 Yr.-Yr.****Previous: -36,000 Qtr.-Qtr.; -10,000 Yr.-Yr.****Whole Economy Average Earnings (Apr-Jun)****Forecast: 0.3% Mo.-Mo; 4.3% Yr.-Yr.; 4.1% Last 3 Months Yr.-Yr.****Previous: 0.5% Mo.-Mo; 4.1% Yr.-Yr.; 4.3% Last 3 Months Yr.-Yr.****Private Sector Earnings (Apr-Jun)****Forecast: 0.3% Mo.-Mo; 4.5% Yr.-Yr.; 4.1% Last 3 Months Yr.-Yr.****Previous: 0.5% Mo.-Mo; 3.8% Yr.-Yr.; 4.2% Last 3 Months Yr.-Yr.**

Recent data have shown a benign mix of slowing earnings and falling unemployment, and we expect these trends to continue in the latest figures. Figures in line with our forecasts would put the three-month average of earnings growth at its lowest since late 1997, with private sector earnings at their lowest since mid-1996. The annual gain in private sector earnings for the latest month probably will pick up notably due to base effects from a weak figure in June 1998. Unemployment has been roughly stable on the LFS measure over the past year and, with growth remaining fairly sluggish, unemployment probably will remain fairly stable in coming months.

ADDITIONAL INFORMATION AVAILABLE UPON REQUEST

Salomon Smith Barney Inc., a U.S. registered broker-dealer, and the other Salomon Smith Barney entities described below are members of Citigroup Inc and affiliated with Citibank, N.A. and its subsidiaries and branches worldwide (collectively "Citibank"). Despite those affiliations, securities recommended, offered, sold by, or held at, Salomon Smith Barney Inc. or any of the other Salomon Smith Barney entities described below: (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested.

Salomon Smith Barney including its parent, subsidiaries and/or affiliates ("the Firm"), may from time to time perform investment banking or other services for, or solicit investment banking or other business from, any issuer mentioned in this report. Within the past three years, the Firm may have acted as manager or co-manager of a public offering of the securities of, and may currently make a market in, the securities of some of the issuers mentioned in this report. The Firm may sell or buy from customers on a principal basis any of the securities discussed in this report. The Firm, or any of the individuals preparing this report, may at any time have a position in any security of any issuer in this report or in any options on any such security. An employee of the Firm may be a director of an issuer mentioned in this report.

Although the statements of fact in this report have been obtained from and are based upon sources that the Firm believes to be reliable, we do not guarantee their accuracy, and any such information may be incomplete or condensed. All opinions and estimates included in this report constitute the Firm's judgement as of the date of this report and are subject to change without notice. This report is for informational purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security.

This report was prepared by Salomon Smith Barney Inc. This report has been approved for distribution in the United Kingdom by Salomon Brothers International Limited, which is regulated by the Securities and Futures Authority. This report is also being distributed by Nikko Salomon Smith Barney Limited and, in the case of certain equity research, by The Nikko Securities Co., Ltd, under license. The investments and services contained herein are not available to private customers in the United Kingdom. This report does not take into account the investment objectives, financial situation or particular needs of any particular person. Investors should obtain individual financial advice based on their own particular circumstances before making an investment decision on the basis of the recommendations in this report.

The Firm's research opinions may differ from those of The Robinson-Humphrey Company, LLC, a wholly owned brokerage subsidiary of Salomon Smith Barney Inc.

Salomon Smith Barney is a service mark of Salomon Smith Barney Inc. Nikko is a service mark of The Nikko Securities Co., Ltd.

© Salomon Smith Barney Inc., 1999. All rights reserved. Any unauthorised use, duplication or disclosure is prohibited by law and will result in prosecution.

EA08G001

International Financial and Economic Calendar, 16 Aug 99 - 20 Aug 99

United States	Japan	Europe	Europe	United Kingdom	Canada/Australia
MONDAY 16					
1:00 Housing Market Index Jul 74 Aug	(Released This Week) 8:50 Money Supply 8:50 Customs-Clear. Trade Bal. 1:30 Revised Indus. Production 2:00 Machinery Orders	European Union Most Institutions Closed for August (Released This Week) Germany ifo Business Climate, Jul	Finland Consumer Prices, Jul Industrial Output, Jun Denmark Consumer Prices, Jun		Canada 8:30 Auto Sales Jun -3.8% Jul -0.2%*
TUESDAY 17					
8:30 Housing Starts and Permits Jun 1.57M 1.62M Jul 1.64M* 1.63M* 8:30 Consumer Prices Total ExF&E Jun 0.0% 0.1% Jul 0.2%* 0.2%* 9:15 Industrial Production & Capacity Utilization Jun 0.2% 80.3% Jul 0.7%* 80.7%*	BoJ Monthly Financial and Economic Report		Sweden Retail Sales, Jun Unemployment, Jul Finland Employment, Jul	9:30 PSNCR Jun £-5.7B Jul £-5.5B* 9:30 RPI M/M Y/Y Jun 0.0% 1.3% Jul -0.4%* 1.2%* 9:30 RPIX M/M Y/Y Jun 0.0% 2.2% Jul -0.4%* 2.2%*	Canada 8:30 Manufacturing Survey May Jun* Shpmts. 1.0% 0.7%* New Ord. 2.8% 0.4%* Unfill. Ord 0.3% 0.1%* Inv./Ship. 1.26 1.26*
WEDNESDAY 18					
	BoJ Releases Minutes of June 28 Monetary Policy Meeting	Euro Area 11:00 Labor Cost & Earnings 1Q99, 2 nd Release	Spain Retail Sales, Jun Finland Producer Prices, Jul	9:30 Retail Sales M/M Y/Y Jun 0.0% 3.6% Jul 0.4%* 2.7%* 9:30 BoE MPC Minutes (Aug 5)	Canada 8:30 Consumer Prices Total ExF&E Jun 0.1% 0.2% Jul 0.1%* 0.2%* Australia RBA Bulletin
THURSDAY 19					
8:30 Jobless Claims, Aug 14 8:30 International Trade Deficit May \$21.3B Jun \$19.0B* 10:00 Philadelphia Bus. Survey Jul 7.8% Aug 12.0%*		Euro Area 11:00 Harmonized Inflation, Jul France Visible Trade Balance, Jun	Italy 8:00 Nationwide CPI, Jul, Final	9:30 M4 M/M Y/Y Jun -0.5% 5.6% Jul 0.9%* 5.2%* 9:30 M4 Lending M/M Y/Y Jun £9.5B 7.6% Jul £3.0B* 6.9%*	Canada 8:30 Wholesale Trade Jun 1.8% Jul 0.6%* 8:30 International Trade May Jun* Exports 0.5% 0.6%* Imports 0.1% 0.8%* Trade Bal. C\$2.4B C\$2.4B* Australia 11:00 Company Profits, 2Q99 1Q99 5.5%
FRIDAY 20					
2:00 Federal Budget, Jul 99				Business Investment, 2Q99	Canada 8:30 Retail Sales May 0.4% Jun 0.7%* 2099 Financial Statistics for Enterprises

* Salomon Smith Barney estimates.

Times are: GMT -4 for North America; GMT +1 (London Time) for Europe; GMT +9 for Japan; GMT +10 for Australia.

Contributors: Michelle Burns, Stacy Carter, Valérie Destève, Kazue Ishibashi, Ann O'Kelly, Kathy Moloney and Jan Willbourne.

International Financial and Economic Calendar, 9 Aug 99 - 13 Aug 99

United States	Japan	Europe	Europe	United Kingdom	Canada/Australia
MONDAY 9					
10:00 Wholesale Trade May Jun	8:50 Wholesale Prices, Domes. M/M Y/Y Jun 0.0% -1.7% Jul -0.1%* -1.8%* 8:50 Wholesale Prices, Overall M/M Y/Y Jun -0.1% -4.0% Jul -0.1%* -4.1%*	European Union Most Institutions Closed For August	Netherlands Manufacturing Sales, Jun Sweden 12:00 GDP, 2Q99, Preliminary	9:30 Producer Input Prices M/M Y/Y Jun 0.6% -1.0% Jul 2.0%* 1.3%* 9:30 Producer Output Prices M/M Y/Y Jun 0.0% 1.0% Jul 0.2%* 1.2%*	Australia 11:30 Housing Finance May 4.5% Jun -1.5%*
TUESDAY 10					
	2:00 Machinery Orders, Private Excl. Ships & Elec. Power M/M Y/Y May 3.8% -7.5% Jun 2.5%* -10.7%*	Germany 7:00 Trade Balance, Jun Euro Area 11:00 Unemployment, Jun	Sweden Central Government Borrowing Requirement, Jul Denmark Retail Sales, May-Jun Norway Consumer Prices, Jul	00:30 BRC Retail Sales Monitor, Jul	Canada 8:15 Housing Starts (Ann. Rate) May 150K Jun 156K*
WEDNESDAY 11					
2:00 Beige Book	(Released Aug 11-18) 8:50 Balance of Payments, Current Account May ¥1,297B Jun ¥1,220B*	Germany 7:00 Industrial Production M/M Y/Y May -0.2% -2.2% Jun -0.4%* -2.0%* 7:00 Pan-German CPI, Jul France CPI, Preliminary M/M Y/Y Jun 0.0% 0.3% Jul -0.1%* 0.5%*	Europe Solar Eclipse (during morning) Netherlands Manufacturing Output, Jun Sweden Current Account, Jun Denmark Current & Trade Account, May Finland Trade Balance, Jun	9:30 Unemployment (M/M) Jun -5,200 Jul -5,000* 9:30 Average Earnings M/M Y/Y May 0.5% 4.1% Jun 0.3%* 4.3%* 9:30 Bank of England Inflation Report	Canada 8:30 New Housing Price Index (Y/Y) May 0.6% Jun 0.7%* Release of Extracts of Board of Directors Mtg. of 6/17 Australia 11:00 Cons. Confidence, Aug Jul 113.9
THURSDAY 12					
8:30 Jobless Claims (Aug 7) 280 Thous* 8:30 Retail Sales Total ExAuto Jun 0.1% 0.4% Jul 0.6%* 0.5%*		Spain Unemployment Rate 1Q99 17.0% 2Q99 16.5%* Employment Growth (Y/Y) 1Q99 3.9% 2Q99 3.9%*	Sweden CPI, Jul Industrial Production, May Manufacturing Orders, May Riksbank Monetary Policy Mtg. Finland Manufacturing Survey, 2Q99 Norway Labor Force Survey, May		Australia 11:30 Labor Force Emp. Rate Jun 62.4K 7.2% Jul 12.0K* 7.2%*
FRIDAY 13					
8:30 Business Inventories May 3.0% Jun 0.0%* 8:30 Producer Prices Total ExF&E Jun -0.1% -0.2% Jul 0.1%* 0.1%* 10:00 University of Michigan, August Prelim.	BoJ Monetary Policy Meeting (Minutes Released Sep 27)	Germany 7:00 Retail Sales, Jun Euro Area 11:00 Industrial Producer Prices, Jun	Spain Consumer Prices (Y/Y) Headline ExFood Jun 2.2% 2.5% Jul 2.0%* 2.7%* Portugal CPI, Jul		Canada 8:30 Leading Indicators Jun 0.2% Jul 0.3%*

* Salomon Smith Barney estimates.

Times are: GMT -4 for North America; GMT+1 (London Time) for Europe; GMT +9 for Japan; GMT +10 for Australia.

Contributors: Michelle Burns, Stacy Carter, Valérie Destève, Kazue Ishibashi, Ann O'Kelly, Kathy Moloney and Jan Willbourne.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Ronald Minsk (CN=Ronald Minsk/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME: 9-AUG-1999 16:55:26.00

SUBJECT: Oil Dumping Case

TO: Patrick M. Dorton (CN=Patrick M. Dorton/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

TO: Barry J. Toiv (CN=Barry J. Toiv/OU=WHO/O=EOP@EOP [WHO])
READ:UNKNOWN

TO: Lori A. Krauss (CN=Lori A. Krauss/OU=OMB/O=EOP@EOP [OMB])
READ:UNKNOWN

TO: Victoria A. Greenfield (CN=Victoria A. Greenfield/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: D Holly Hammonds (CN=D Holly Hammonds/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

TO: Melissa G. Green (CN=Melissa G. Green/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

TO: Richard L. Siewert (CN=Richard L. Siewert/OU=WHO/O=EOP@EOP [WHO])
READ:UNKNOWN

TO: David W. Beier (CN=David W. Beier/O=OVP@OVP [UNKNOWN])
READ:UNKNOWN

TO: Elwood Holstein (CN=Elwood Holstein/OU=OMB/O=EOP@EOP [OMB])
READ:UNKNOWN

TO: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Matthew P. Schaefer (CN=Matthew P. Schaefer/OU=NSC/O=EOP@EOP [NSC])
READ:UNKNOWN

TO: Sharon H. Yuan (CN=Sharon H. Yuan/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

TO: Gene B. Sperling (CN=Gene B. Sperling/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

CC: Ronald Minsk (CN=Ronald Minsk/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

TEXT:

The Department of Commerce concluded that the petitioners in the oil dumping case did not have standing to proceed. Therefore, Commerce will not initiate an antidumping/countervailing duty investigation of oil imports from Mexico, Venezuela, Saudi Arabia, and Iraq.

Commerce plans to make an announcement at 5:00 pm. It is possible that the petitioners will withdraw the case before then. Either way, I will update you as soon as I know more information.

Ron Minsk

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 14:21:56.00

SUBJECT: Ending.

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D13]ARMS215271128.236 to ASCII,
The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

History suggests that in any year, regardless of its length, an expansion has about a one in four chance of ending. In the postwar period, for the United States, these terminations have resulted from Federal Reserve responses to inflation. The lack of inflationary pressures currently, and the belief that if any were to arise, they would be effectively nipped in the bud, provides consensus forecasters with the confidence to project sustained economic growth, at a rate of 2.6 percent in 2000.

But the consensus forecast could be wrong. The recent surge in productivity performance provides plausibility to the view that the benefits of the revolution in information technology are finally coming to fruition. While there is much talk of a new economy, if the US could simply return to the old economy which achieved a 2 percent rate of productivity growth over the century prior to 1973, over the next five years, growth could average over three percent annually. The consensus forecasts could prove to be just another example of the dismal science.

There are, however, a variety of risks facing the economy, many of which could pose some painful choices. There have been other periods in history such as the late 1920s in the US and the late 1980s in Japan, in which apparent prosperity proved to be ephemeral as the collapse of asset market bubbles wreaked financial and economic havoc. Currently, therefore it is prudent to attach concern to the risks we face from an outburst of inflation and both internal and external financial market instability.

However, each of these risks are better faced with a strong fiscal position. Less stimulus would reduced inflation. More national savings allow us to finance domestic investment with less foreign borrowing and lower interest rates reduces the probability of financial distress at home and abroad. Indeed, the fiscal surplus is just one of several strengths which make the current economy more able to withstand the risks we have outlined: these include a federal reserve with proven credibility, high ratios of household net-worth to income, and strong balance sheets in firms and financial institutions.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jason Furman (CN=Jason Furman/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME: 9-AUG-1999 12:08:21.00

SUBJECT: Comments on draft memo

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: david.wilcox@do.treas.gov (david.wilcox@do.treas.gov [UNKNOWN])
READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

CC: Lael Brainard (CN=Lael Brainard/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

CC: Robert F. Wescott (CN=Robert F. Wescott/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

TEXT:

The following incorporates comments from Rob Wescott and myself. Before getting to that, Gene just called me to say that he felt the memo was not detailed and quantitative enough. In his view the President would already know a lot of what was in there, and that the memo should bring more new material in. One part of a quick fix, he suggested, was to bring back some of the detail from the previous memo. I think he will be calling Martin to discuss this issue.

More specific comments:

I think the framing in the beginning should be specific about the baseline relative to which you are describing an upside and a downside. The baseline should probably be the Admin/CBO/Blue Chip forecast showing moderation. The upside would be continued GDP growth at 4 percent and GDP inflation at 1-2 percent and the downside would be the hard landing scenarios. As written this isn't clear, and one might infer that you think the upside is an improvement relative to recent past, something like 6 percent growth and 0 percent inflation.

Do you want to provide a preview of what is to come in the initial bullets on risks? Specifically, if the President doesn't finish the memo, would you want him to know that you don't view Y2K as a serious problem? Or that international contagion might be second order relative to dramatic changes in U.S. asset prices?

Consensus macroeconomic outlook

--long-term interest rates have risen 140 basis points in the last 10 or so months. It should probably say that long-term rates have risen less than they would have given the low unemployment rate, or something like

that.

A New Economic Era

--Rob points out that the Fed was using a NAIRU of 6.5 percent a few years ago. This provides starker contrast for where we have come.

--What should be on the LHS of a NAIRU equation, wage inflation or rise in unit labor costs? Or specifically, although wage inflation has risen do we think of that as a demand-side confirmation of the NAIRU being higher than 4.3 or do we think of that as a supply-side increase that is consistent with productivity growth? I'm not sure.

--Could you quantify, or draw on other people's work to quantify, perhaps in a table, the other factors holding down inflation?

Stock market

--Gene flagged this as a section with, as written, little value added to the President's current knowledge. One thing Larry Summers discussed on the conference call that was very interesting was the composition of the rise in the stock market, specifically low-employment, high-tech companies. He said it had two implications: it made one think the rise might be sustainable because these companies could have super high productivity growth, without having to believe the economy could have that growth overall; and if the market crashed many firms might be insulated. I don't know if that is right or wrong, but it sounded interesting and is no longer in the draft.

Y2K

--You may want to reverse the order, to have the real point first (the hoarding) and the other concern second (the fundamentals)

--Hoarding is also more general. It includes other preventative steps that cumulate into their own problems. One could imagine, although it does not seem likely, these happening in financial markets with serious consequences.

--Some quantification on the hoarding issues would be interesting. Specifically, what would happen to the money supply, interest rates, etc. if everyone decided to raise their average cash holdings by \$200. You could then point out that the Fed has printed money for this eventuality and is standing ready, I assume, to smooth out any of these seasonal-like fluctuations. You could then assess whether or not this will be sufficient.

I hope this is helpful,
Jason

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jason Furman (CN=Jason Furman/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME: 9-AUG-1999 21:10:35.00

SUBJECT: Revised copy of POTUS memo

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: david.wilcox@do.treas.gov (david.wilcox@do.treas.gov [UNKNOWN])
READ:UNKNOWN

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: ted.truman@do.treas.gov (ted.truman@do.treas.gov [UNKNOWN])
READ:UNKNOWN

TO: maureen.grewe@do.treas.gov (maureen.grewe@do.treas.gov [UNKNOWN])
READ:UNKNOWN

TEXT:
Attached is a copy of the POTUS memo. All I have done so far is to cut
and past Bob Cumby's section on the stock market into the document and to
implement David's edits. I will be faxing a copy of this to Treasury
Watch for Summers and Eizenstat. I will also be making more, minor
changes over the course of the night. I'll send the next version when it
is ready.

If you have any concerns please e-mail me, call me (456-5358), or page me
through signal (757-5000).

Jason===== ATTACHMENT 1 =====
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D43]ARMS26805122W.236 to ASCII,
The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

MEMORANDUM TO THE PRESIDENT

FROM: Lawrence Summers, Department of Treasury
Martin Baily, Council of Economic Advisers

DATE: August 9, 1999

RE: Economic Outlook

The United States has enjoyed 99 consecutive months of economic expansion and is on track to achieve the longest economic expansion in its history. Meanwhile, inflation has remained under control, unemployment is exceedingly low compared with other expansions since the early 1970s, and recent gains in productivity have been encouraging. The consensus outlook for the economy is positive. While economic growth is seen as moderating somewhat from the very rapid pace of the past few years, the consensus view is that the U.S. economy should continue to exhibit many of the positive characteristics that have been hallmarks of the expansion thus far.

Overview of uncertainties in the forecast

Although the consensus forecast is positive, the uncertainties surrounding the macroeconomic outlook are considerable—both on the upside and on the downside.

- New Era optimism. On the upside, many commentators have suggested that the economy may have entered a “New Era” in which unemployment can remain low, output growth can remain strong, and wage increases can remain rapid, *without* triggering the kinds of imbalances that have led to the demise of expansions in decades past. If this view is correct, there is no presumption that the current expansion will end in the way that almost all past U.S. expansions have ended, with accelerating inflation leading to higher interest rates.
- An inflation shock. On the downside, some observers point to the risk that the productivity surge of the last few years may prove to be only temporary, and that some of the other factors that have helped keep inflation in check may wane or even go into reverse. The consensus forecast assumes that appropriate policy can achieve a “soft landing” in which the economy slows enough to avoid overheating while avoiding a recession. However, efforts to slow demand with higher interest rates could precipitate a recession.
- A domestic asset market shock. Although the typical end of an expansion is the result of rising inflation, some other possibilities deserve serious consideration. For example, the stock market is at a very high level, overpriced in the eyes of many observers. A precipitous decline in asset prices would likely reduce both household

and business demand—and potentially severely so. How that might play out is itself a matter of uncertainty. The experience with the stock market break in 1987 suggests that, provided the monetary response is swift and vigorous, the macroeconomic damage can be contained, and the expansion sustained. On the other hand, Japan's experience over the decade of the 1990s suggests that with the wrong or timid policies, the fallout can be protracted and painful.

- A dollar shock. The U.S. current account deficit has continued to widen, and now is approaching 4 percent of GDP. A number of commentators have raised the possibility that the U.S. dollar may come under (perhaps intense) downward pressure. Such a development could trigger other adverse events, such as an increase in inflation (because imported goods would have become more expensive), a sharp correction in our asset markets (reflecting a generalized loss of confidence on the part of foreign investors), and a marked step-down in our pace of growth.
- Contagion from the Global Economy. The global economy has stabilized and improved somewhat in the last six months. While this is surely a positive development on net, it is not an unmixed blessing, as it does imply greater global competition for capital. Moreover, it is conceivable that a financial crisis in an emerging market economy could set off another round of economic and financial contagion. Argentina and China are the most obvious "hot spots," but there are other candidates, especially in Latin America which, as you know, is in recession.
- Y2K. A number of voices have sounded the alarm with respect to the so-called Y2K computer bug. Although great strides in preparedness have been made, a risk remains of systemic failure, possibly involving financial systems or other major elements of social and economic infrastructure.

The remainder of this memo first reviews the consensus macroeconomic outlook and then examines each of these risks in greater detail.

The consensus macroeconomic outlook

The following table presents recent history and the Administration, CBO, and Blue Chip consensus economic forecasts for key macroeconomic variables:

Economic Projections: A Comparison

	1998	1999	2000
Real GDP growth (Q4/Q4 %)	4.3		
Administration		3.2	2.1
CBO		3.6	2.1
Blue Chip		3.5	2.5
Unemployment (percent)	4.5		
Administration		4.3	4.5
CBO		4.2	4.3
Blue Chip		4.3	4.4
CPI inflation (percent)	1.5		
Administration		2.4	2.4
CBO		2.5	2.4
Blue Chip		2.4	2.3
Current account def. (\$ current)	221		
Administration		326	376
Consensus Economics		298	314
Capacity Utilization (percent)	81.8		

Like the Blue Chip forecasters, the Administration expects growth of real GDP to continue slowing toward a more sustainable pace—both we and the Blue Chip are anticipating a soft landing. The consensus forecast is that productivity growth will gradually return to its longer run historical trend, rather than remaining at the high rate of the last 3 ½ years. The unemployment rate is expected to rise from its current 4.3 percent to 5.2 percent (the center of the estimated range for the NAIRU).

A major uncertainty in the forecast is whether the current expansion will continue to exhibit a number of characteristics that have distinguished it from previous long expansions:

- Productivity growth has picked up rather than slowed as the expansion has matured.
- Inflation and interest rates have declined rather than risen.

- Investment has been historically strong and industrial capacity has expanded accordingly.
- The stance of fiscal policy has shifted from seemingly terminal deficits to the prospect of an era of surpluses.
- The current account has widened despite an improving trend in national saving, as the demand for investment has outstripped our ability to finance it from domestic savings.
- Interest rates have been rising in recent months. Since the end of April, the rate on ten-year Treasury bonds has risen by about 0.50 percentage point. Spreads of private sector interest rates over Treasury rates have risen as well, so rates paid by corporate borrowers and homeowners have risen by even more. Mortgage rates, for example, have risen by 0.90 percentage point. At the same time that spread have widened, new issues of corporate bonds have been rising, suggesting that the widening of spreads is demand driven. In contrast, when spreads widened last fall, a flight to quality led to a contraction of credit supply in capital markets, the new issues market dried up, and financial markets were destabilized.

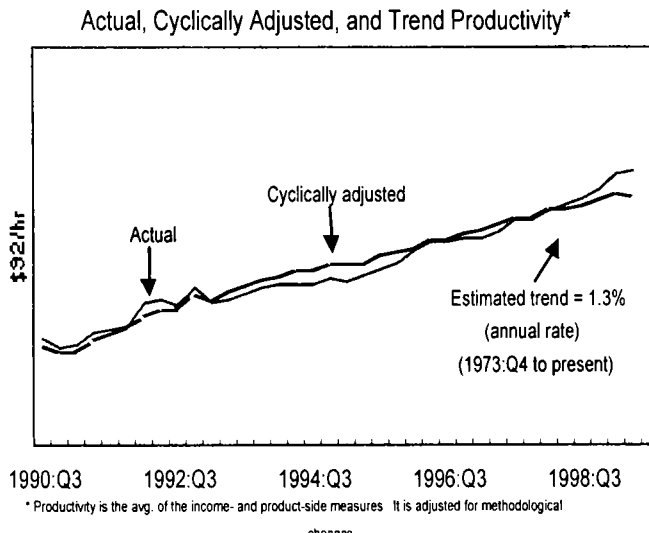
One way to frame the issue of the macroeconomic outlook, therefore, is to ask whether these favorable elements can be sustained

A New Era or the old trade-offs?

The view that the economy has entered a New Era assumes that many of these favorable elements are now permanent features of the economy. The contrary view is that they mainly reflect special factors that will be reversed. Two critical relationships illustrate the debate.

- The NAIRU. Not so many years ago, the consensus view was that the economy risked rising inflation once the unemployment rate dropped below 6 percent, or even 6.5 percent in some economic models. However, the unemployment rate has been below 6 percent for the past NN months, and below 5 percent for the past MM. Although wage inflation has picked up in the past few years, the rise has been far less than one would have guessed based on a NAIRU of 6 percent. To the extent that increased international and domestic competition have created a new environment in which businesses find it hard to raise prices, productivity is growing rapidly, and investment is expanding capacity at a rapid rate, it may be possible to avoid inflation even with a tight labor market and rising wages. In part, however, the favorable inflation situation reflects some transitory factors – including falling prices for imports, and moderate prices for energy goods – that either have already reversed (as in the case of energy) or could plausibly do so in the near future (as in the case of import prices).
- Trend productivity growth. The sustainable rate of economic growth is determined by the rate of growth of the labor force (about 1.1 percent) and the rate of growth of

productivity. Over the past three years, productivity growth has been substantially higher than its longer-term trend of about 1.3 percent per year. A centerpiece of New Era thinking is a belief that information technology and other developments have allowed for substantially faster sustained productivity growth. The contrary view – particularly in the context of a strong cyclical expansion – is that it is premature to conclude from a short period of strong productivity growth that trends that have been evident since the early 1970s have been sharply reversed.



According to the *Economist* (July 24), Alan Greenspan is among those who believe that information technology has contributed to faster productivity growth. He points out that “the accessibility of up-to-date information offered by information technology has allowed substantial improvements in corporate efficiency. Production planning is made easier; inventories can be reduced; delivery lead-times fall; the nature of distribution is altered. All of these factors increase the

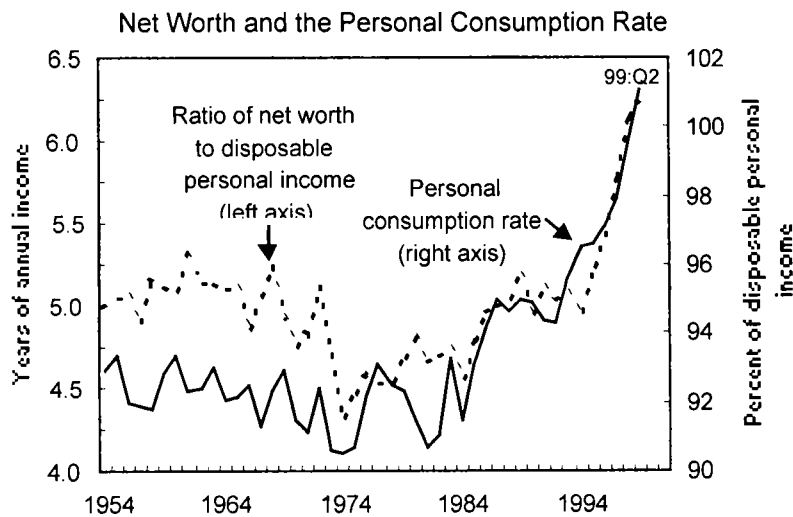
flexibility of capital goods, making capital investment more attractive and productive than it used to be, and encouraging firms to substitute capital for (scarce) labor.”

An extensive study by a US consulting firm looked at the current and potential future effect of the electronics revolution on productivity. They examined a variety of companies in different industries, recording how workers spend their time. They concluded that in US companies, workers spend 51 percent of their time on “interactions,” such as communication, data gathering and collaborative problem-solving. Improvements in communications technologies, such as the Internet, are now allowing reductions in the labor required for such interactions and these gains are expected to continue even more rapidly in the future. Business economist Eric Brynjolfsson of the Sloan School at MIT has estimated that computer capital has a larger impact on productivity than other kinds of capital.

A principal critic of the new economy view is economist Robert Gordon. He notes that the price of a computer of a given quality has recently been declining at an accelerating rate (or equivalently, that every dollar spent buys a rapidly rising quality of computer). This leads to large and accelerating estimates of productivity growth within the manufacturing sector that produces computers. Gordon then tries to separate computer production from the rest of the economy. And when he does so, he finds that virtually all of the acceleration of productivity growth in the nonfarm business sector is coming from

the computer-producing part and almost none from the rest of the economy. We are fantastic at making computers, he concludes, but have not discovered how to use computers to make the rest of the economy more productive.

Gordon's conclusion is hard to believe given extensive case study evidence of businesses using new technologies to improve their operations. Other economists question his method of separating out computer production from the rest of the economy. But the fact remains that there is great uncertainty around estimates of future productivity growth. Chart x shows that labor productivity has only very recently moved above the level that would be expected, given the strong cyclical recovery. This is why the Administration forecast is conservative in the assumed rate of productivity growth that feeds into our budget estimates.



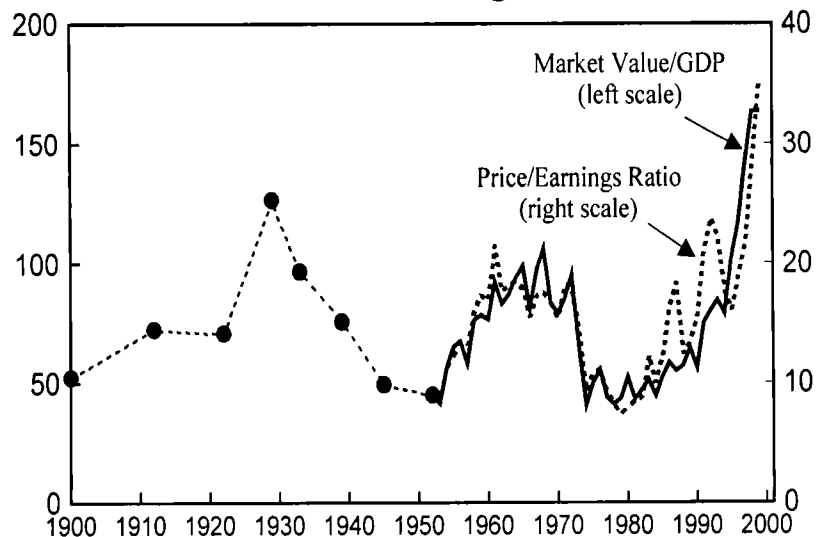
The Stock Market. The stock market has appreciated spectacularly over the past five years, accompanied by a dramatic rise in the market value of young, high-tech companies that employ significantly fewer people than traditional industrial blue chips. While profit growth has been strong, price-earnings ratios and other traditional indicators of valuation are at record levels. Accordingly, the issue of whether the market is “overvalued” has been hotly debated in recent months.

Those who are concerned about the current valuations in the stock market point to evidence of the following type:

- The market value of equities increased from 77 percent of GDP at the end of 1994 to 164 percent of GDP in the first quarter of this year, a value that is well above the previous peaks 127 percent reached in 1929 and 106 percent reached in 1968.

- Similarly, despite strong growth in corporate earnings, the ratio of price to earnings for the 500 largest companies in the stock market has more than doubled, rising from 15 at the end of 1994 to 35.2 in the first quarter of this year.

Market Value of Domestic Corporations and Price/Earnings Ratios



Note: 1999 values are for the first quarter.

- Some private analysts express fears that the United States is currently facing an asset price “bubble” in which asset prices are bid to unrealistic levels, threatening economic stability. They argue that the current combination of low inflation and strong economic growth has been associated with what they view as previous bubble episodes. Investors (and perhaps even policy makers) can get seduced into believing in “new paradigms.” When an overheated economy and a rekindling of inflationary pressures that had been hidden by unusual factors results in rising interest rates, the economy slows and asset prices fall sharply, slowing the economy even more. Slower growth reveals the new paradigm optimism to be misplaced.

- Others who fear that a speculative bubble is emerging in the stock market point to more popular indicators like the rise of day trading and the enormous value placed on some internet startups that have yet to turn a profit.

On the other hand, those who are relatively sanguine about the current state of the market point to the following:

- The economy remains strong and private forecasters have increased their projected growth rates for GDP and corporate profits since the beginning of the year. Prospects for some industries that suffered from the impact of a sluggish world economy last year have improved and several key sectors are viewed as generating impressive results this year. At the same time, views on inflation remain sanguine.
- Not all stocks are going to the sky. On the contrary, a large fraction of the growth in the market's value can be attributed to a small set of companies, most of whom are engaged in some form of high-tech activity. Meanwhile, valuations for many traditional companies remain tame by historical standards. This suggests that the market retains its ability to discriminate among stocks, rewarding those companies that are on the cutting edge of innovation.
- It is possible (with some stretching) to justify current market values, by combining relatively optimistic assumptions about future profit growth, interest rates, and the premium that investors demand for bearing the risks inherent in holding stocks. For example, if the rapid rates of productivity growth experienced since 1995 were to continue unabated and feed continued rapid earnings growth; if long-term interest rates were to return to the lower levels seen earlier this year; and if the premium for bearing stock market risk were to descend to levels that are quite low by historical standards, then the current level of the market could be "justified."

The main macroeconomic risk posed by an overvalued stock market is the prospect of a market reversal, which would reduce aggregate demand.

- A decline in stock values would reduce the net worth of consumers and lead to a decline in consumer spending.
- It also would increase businesses' cost of raising equity capital and thereby reduce investment spending.
- Although banks are currently well capitalized, a recession might lower the quality of banks' loan portfolios.
- The appropriate antidote to a development of this type is a dose of lower interest rates. This type of action proved quite successful in 1987, when the Fed moved promptly and vigorously to reassure markets in the wake of the October crash.

A more remote – but nonetheless real – risk is that the financial system simply seizes up and ceases to function in the wake of a stock market crash.

- Stock market losses could lead to actual or threatened bankruptcies, particularly among highly leveraged institutions with large derivatives positions, and spread

beyond the stock market.

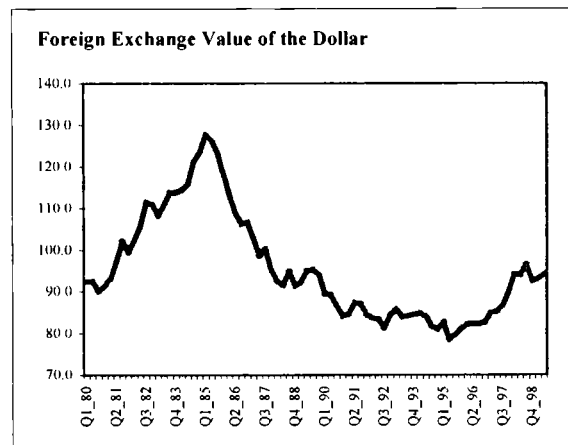
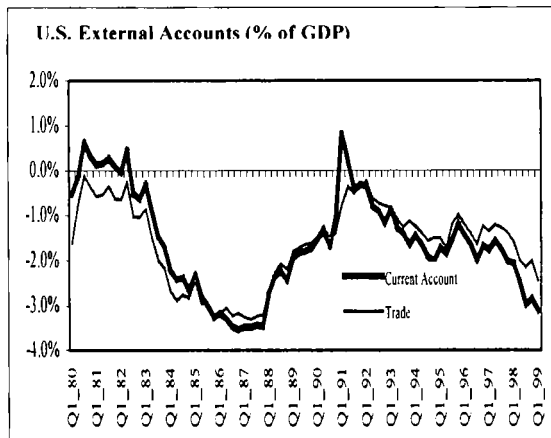
- Concerns about counterparty risk might then cause the clearance and payments systems that are crucial to well-functioning securities markets to freeze.
- Significant steps have been taken to reduce this risk following what some view as a near miss during the 1987 stock market crash, but some risk remains.
- The traditional tools of monetary policy may not be sufficient to prevent a seizing up of markets in the face of widespread panic.

The risk posed by the stock market is compounded by international considerations. A substantial weakening in asset markets here could shake the confidence of foreign investors, thereby causing a substantial drying up of the supply of foreign capital and a free fall of the dollar. This would pose a dilemma for the Federal Reserve, which would be caught between conflicting needs to cushion a recession and contain rising inflation. The implications of such a scenario are potentially more severe than they otherwise would be in light of the fact that we are presently running a large current-account deficit – a topic to which we now turn.

The current account deficit and the dollar

The current account deficit -- already large last year -- is forecast to widen further in 1999 and beyond.

- The widening of the deficit has been exacerbated by temporary factors: the Asian crisis and the faster relative growth of the U.S. economy compared to the rest of the world, as well as the appreciation of the dollar since 1995.
- As the dollar's strength shows, foreigners have been more than willing to finance our external deficits of recent years. The relative attractiveness of U.S. investments and performance of the U.S. economy have pulled in foreign capital.
- The U.S. current account deficit is not likely to be sustainable indefinitely at recent growth rates in the U.S. and abroad and unchanged exchange rates. Based on standard forecasting models, the deficit would continue to widen as a percent of GDP.
- Foreign investors have built up large net (\$1.5 trillion) and gross (\$7.5 trillion) claims on the U.S. Sooner or later they may become less willing to hold an ever increasing share of their wealth in claims on the United States, especially as an upturn in foreign growth provides more competition for U.S. assets.



Federal Reserve Board Real Exchange Rate Index

Repeat of the 1980s? A continuing widening of the deficit could place the dollar under significant downward pressure over the next year as happened in the 1980s, despite differences between now and then:

- U.S. deficits in the 1980s were driven by a fall in national savings associated with large fiscal deficits. Since 1992, our national savings rate has been rising, and our external deficits have been associated with the more rapid rise in investment.
- The dollar has appreciated on average in real (price-adjusted) terms since 1995, but the appreciation has been substantially less than in the mid-1980s.

- Although the U.S. has become a net international debtor, with net income payments now contributing to our current account deficit (as a percent of GDP), our trade deficit has not yet reached the low point (as a percent of GDP) of 1987.

Hard Landing? The external adjustment process in the late 1980s was difficult, but it was not a “hard landing” involving a deep sustained recession and substantially higher inflation.

- The difficulties associated with any prospective adjustment in our external accounts would depend in large part on how it was triggered and what other developments accompanied it, and on policy responses here and abroad.
- Standard macroeconomic models suggest that, under plausible assumptions about policy responses in the U.S. and abroad, an abrupt 25% decline in the dollar would raise U.S. growth by about 1% over the first 1-2 years and eventually reduce the current account deficit by half or two thirds, but it would also boost U.S. inflation by as much as 2%.

The adjustment process in the new millennium could well be less benign:

- The U.S. adjustment process could be triggered or exacerbated by (or could itself trigger) a sharp correction in U.S. asset markets.
- Policy responses in the rest of the world may fail to offset the contractionary effects of the U.S. adjustment on their own growth from reduced exports to and increased imports from the U.S.
- The result could be a U.S. recession, an intensified flight from dollar-denominated assets, further downward pressure on the dollar, and a large increase in inflation.

This potential vicious cycle of sudden and excessive asset price deflation followed by an economic downturn in the U.S. and abroad is the main source of risk from our growing trade and current account deficit and a possible sharp dollar decline.

The likelihood of a “hard landing” scenario is not large, and careful management can help reduce the risk. Maintaining our strong-dollar policy will help sustain confidence in our assets and markets. Policies to enhance our national savings will help cushion the economy against a potential slowdown of inflows of foreign savings. Faster growth abroad should on balance ease our adjustment process as would broad-based trade liberalization and avoidance of protectionist pressures.

Contagion from the Global Economy

The outlook for the global economy has brightened a bit since late last year.

- The mood surrounding prospects in Japan and Europe has improved somewhat.
- Economic activity is recovering in the affected countries in Asia. Although Latin America is in recession, there too the outlook has brightened somewhat recently.

- External investors have substantially reduced their exposure to emerging market economies as they have moved toward external surpluses, and borrowing spreads for emerging market economies are lower than last fall, though still wide.

Evolution of Consensus Forecasts of World Economic Growth

	<u>Sept 1998</u>	<u>Dec 1998</u>	<u>March 1999</u>		<u>July 99</u>	
	1999	1999	1999	2000	1999	2000
Euro-11	2.6%	2.3%	2.1%	2.6%	2.0%	2.6%
Japan	0.3	-0.6	-0.9	0.2	0.1	-0.2
Asia ex Japan	2.9	2.7	3.3	4.8	4.7	5.3
Latin America	3.5	0.8	-1.2	3.1	-0.5	3.5

Japan: The economy may finally have stopped deteriorating, though we have seen false bottoms before. Market sentiment has turned, and the rise in the Nikkei stock index since the beginning of 1999 (24%) and astonishing 7.9% annual rate growth recorded in the first quarter are positive, but record 4.9% unemployment, declining incomes and decreased household spending, and continuing corporate restructuring suggest further pressure on jobs and incomes. Japan's banking sector may have stabilized, following the recapitalization of leading banks, but more progress is needed in disposal of bad assets. Continued government facilitation of economic and financial restructuring along with supportive macro policies are critical to achieve a lasting recovery.

Europe: Although the macroeconomy may be poised for an upturn, the strength of any rebound is uncertain and likely to be export-led, given the euro's depreciation over the first half of the year. Unemployment still remains stubbornly in double digits, underscoring the need for fundamental structural reforms, if European growth is to return output to potential, to say nothing of cutting into high unemployment rates.

This somewhat improved outlook for the industrial countries is on balance good for the U.S. and global economy though, as noted above, it is not an unmixed blessing because of the increased competition from more attractive investment opportunities abroad.

The two emerging market economies that at this point appear to pose the greatest risk to the U.S. and global economy and financial system are Argentina in Latin America and China in Asia.

Argentina: Despite basically sound policies, Argentina's dependence on foreign capital inflows to refinance its large external obligations (about 450% of exports) leaves it vulnerable to the risk that market worries about its exchange rate regime become a self-fulfilling prophecy. Its external accounts have been hit by lower prices on its commodity exports and by devaluation and recession in Brazil. Private capital inflows have declined due to the global crisis, investor nervousness about the October presidential election, and concerns the peso may be overvalued. The result has been sharply higher international and domestic borrowing costs. Argentina is in a severe recession (2½-3% real GDP contraction expected this year) with rising unemployment (now 14.5%) and growing non-performing loans. Monetary policy is constrained by Argentina's currency board regime.

A political-economic crisis in Argentina with its currency board could undermine confidence in Hong Kong, with potential implications throughout Asia.

China: The recent slowdown in growth and contraction of exports in China is a source of risk and increased vulnerability. Fears of rising unemployment and a looming fiscal burden from restructuring the financial system and state-owned enterprises may lead the authorities to try to restore export-led growth and devalue the renminbi. Although current account data are not available for 1999, the recorded trade surplus has basically vanished since late last year. Financial market expectations about a devaluation have recently returned to levels last seen during the global panic of August 1998. With its capital controls and large foreign exchange reserves (\$147 billion), the risk of a successful speculative attack on the renminbi is still low. However, a poorly managed devaluation, if this should be the course chosen by the Chinese authorities, could put pressures on Hong Kong's exchange rate peg and spill over to other Asian currencies and other regions and to the U.S. economy as we saw in 1997-98.

Other country risks: Other large countries with less immediate difficulties that may pose a concern are Brazil, Indonesia, Korea, Mexico, Russia, and Turkey. For example, if Korea mishandles the Daewoo restructuring, its economy could be plunged back into serious recession or crisis. Smaller financial fragile countries that have the potential to trigger a broader crisis include Colombia, Ecuador, Romania, Ukraine, and Venezuela. For example, Ecuador's failure to make its Brady bond payments later this month could trigger a flight from the debt of emerging market economies generally, even though the market should not be surprised.

In contrast to the situation over the past two years when concerns about the outlook for the U.S. economy focused primarily on contagion from the rest of the world, our vulnerability from this source appears to have declined both absolutely and relatively. Conditions abroad are mending slowly and the shocks of the past few years are probably still recent enough to keep even investors with short memories mindful of a repetition.

The Y2K Problem

The Y2K computer problem poses some limited risks from the potential malfunction of computer systems that support critical infrastructure. There is also some anticipated economic impact from hoarding behavior at the end of 1999 in anticipation of Y2K problems.

- Fundamentals. The fundamental risk is of severe and long lasting economic dislocation as computer systems malfunction -- particularly in the critical infrastructure areas of finance, telecommunications, power generation, and transportation. Considerable investment has been made to avoid the fundamental problems that would occur with a system-wide failure. Most large firms and the Federal government have spent large amounts to ensure their systems are Y2K ready. Concerns remain with respect to smaller users, State governments and less-developed countries. Because of the extensive preparation that has taken place, problems among the small users are unlikely to cumulate into a supply shock sufficient to cause a significant macro-economic impact on the United States. Only one of 52 blue-chip forecasters currently projects negative growth for 2000.
- Hoarding. A second set of economic problems could occur even if all computers perform normally, if there is hoarding behavior in anticipation of Y2K problems. This could lead to temporary shortages, soaring prices and long lines. In particular, this could be a problem, if at the last moment firms seek to accumulate extra inventories; households to stockpile supplies such as groceries, prescription drugs, gasoline, and currency; and financial market participants to shift towards highly liquid assets.

Again, many institutions are taking steps to provision for such hoarding. For example, the Federal Reserve plans to boost its currency holdings from \$100 billion to \$300 billion, about \$2,000 per US household of additional cash.

The inventory behavior induced by Y2K is expected to boost growth in the final quarter 1999 by $\frac{3}{4}$ percentage point, and lower it in the first quarter of 2000 by the same amount. Interest rates on assets to be held over year-end indicate a liquidity premium but the effect dissipates after a few months.

A small aggregate impact. Y2K is likely to be to the economy, what a sandstorm is to the desert. A highly visible nuisance for most who are caught in it, quite damaging to a few; but with an impact that is scarcely visible overall once the dust has settled. The key to containing the disruptions from anticipatory behavior is public confidence that the fundamental problems have been dealt with.

Conclusion.

History suggests that in any year, regardless of how long an expansion has run, the chances that it will end are generally about one in four. In the postwar period, for the United States, these terminations have resulted from Federal Reserve responses to

inflation. The lack of inflationary pressures currently, and the belief that if any were to arise, they would be effectively nipped in the bud, provides consensus forecasters with the confidence to project sustained economic growth, at a rate of 2.6 percent in 2000.

But the consensus forecast could be wrong. The recent surge in productivity performance provides plausibility to the view that the benefits of the revolution in information technology are finally coming to fruition. While there is much talk of a new economy, if the US could simply return to the old economy which achieved a 2 percent rate of productivity growth over the century prior to 1973, over the next five years, growth could average over three percent annually. The consensus forecasts could prove to be just another example of the dismal science.

There are, however, a variety of risks facing the economy that could pose some painful choices. There have been other periods in history such as the late 1920s in the US and the late 1980s in Japan, in which apparent prosperity proved to be ephemeral as the collapse of asset market bubbles wreaked financial and economic havoc. Currently, therefore it is prudent to attach concern to the risks we face from an outburst of inflation and both internal and external financial market instability.

However, each of these risks is better faced with a strong fiscal position. Less stimulus would reduce inflation. More national savings allow us to finance domestic investment with less foreign borrowing and lower interest rates reduces the probability of financial distress at home and abroad.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 10:50:33.00

SUBJECT: Today's Meeting

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

FYI.

----- Forwarded by Lisa D. Branch/CEA/EOP on 08/09/99

10:50 AM -----

Melissa G. Green

08/09/99 10:37:49 AM

Record Type: Record

To: See the distribution list at the bottom of this message

cc:

Subject: Today's Meeting

Sorry for all of the confusion.

Today's meeting at 6:30pm is to discuss the Economic Risk presentation.

Gene promises that this meeting will start promptly at 6:30 and will end before 7:30pm. And he is very sorry about the late start for the meeting, it was the only time we were able to gather the necessary people.

Tomorrow's meeting at 9:30am will be a regular Budget strategy meeting to help prepare for Thursday's meeting with the President.

Call melissa with any questions. Thanks 6-2807

Message Sent

To:

Jason Furman/OPD/EOP@EOP

Sandra L. Via/OMB/EOP@EOP

Mindy E. Myers/WHO/EOP@EOP

Janet L. Graves/OMB/EOP@EOP

Robert L. Nabors/OMB/EOP@EOP

Adrienne C. Erbach/OMB/EOP@EOP

Alice H. Williams/CEA/EOP@EOP

Dominique L. Cano/WHO/EOP@EOP

Andrew F. Schneider/OVP@OVP

Cathy R. Mays/OPD/EOP@EOP

Sharon H. Yuan/OPD/EOP
Lisa D. Branch/CEA/EOP@EOP

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 14:19:37.00

SUBJECT: Phone Message from Al Larson

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

Contact: Al LarsonCompany: State DeptPhone: 647-7575FAX: Message:

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 14:17:18.00

SUBJECT: time on robert's calendar

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

Per the attached, when do you want me to schedule Joe and Audrey?

----- Forwarded by Lisa D. Branch/CEA/EOP on 08/09/99

02:16 PM -----

Audrey Choi

08/09/99 02:14:08 PM

Record Type: Record

To: Lisa D. Branch/CEA/EOP@EOP

cc:

Subject: time on robert's calendar

lisa - can joe aldy and i get a slot of about 20 minutes on robert's calendar sometime today or tomorrow (or wednesday, if he's too booked up today and tomorrow with preps for the wednesday meeting). thanks

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 17:27:35.00

SUBJECT: new economy

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TO: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TO: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

Please edit/shorten as appropriate

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D77]ARMS29093412Z.236 to ASCII,

The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

Paragraphs on Is there a new economy?

According to the *Economist* (July 24), Alan Greenspan is among those who believe that information technology has contributed to faster productivity growth. He points out that "the accessibility of up-to-date information offered by information technology has allowed substantial improvements in corporate efficiency. Production planning is made easier; inventories can be reduced; delivery lead-times fall; the nature of distribution is altered. All of these factors increase the flexibility of capital goods, making capital investment more attractive and productive than it used to be, and encouraging firms to substitute capital for (scarce) labor."

An extensive study by a US consulting firm looked at the current and potential future effect of the electronics revolution on productivity. They examined a variety of companies in different industries recording how workers spend their time. They concluded that in US companies workers spend 51 percent of their time on "interactions," such as communication, data gathering and collaborative problem-solving. Improvements in communications technologies, such as the Internet, are now allowing reductions in the labor required for such interactions and these gains are expected to continue even more rapidly in the future. Business economist Eric Brynjolfsson of the Sloan School at MIT has estimated that computer capital has a larger impact on productivity than other kinds of capital.

A principal critic of the new economy view is economist Robert Gordon. He notes that the price of a computer of a given quality has recently been declining at an accelerating rate (or equivalently, that every dollar spent buys a rapidly rising quality of computer). This leads to large and accelerating estimates of productivity growth within the manufacturing sector that produces computers. Gordon then tries to separate out computer production from the rest of the economy. And when he does so, he finds that virtually all of the acceleration of productivity growth in the nonfarm business sector is coming from the computer-producing part and almost none from the rest of the economy. We are fantastic at making computers, he concludes, but have not discovered how to use computers to make the rest of the economy more productive.

Gordon's conclusion is hard to believe given extensive case study evidence of businesses using new technologies to improve their operations. Other economists question his method of separating out computer production from the rest of the economy. But the fact remains that there is great uncertainty around estimates of future productivity growth. Chart x shows that labor productivity has only very recently moved above the level that would be expected, given the strong cyclical recovery. This is why the Administration forecast is conservative in the assumed rate of productivity growth that feeds into our budget estimates.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 10:15:18.00

SUBJECT: Morning Meeting for 08/09/99

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

----- Forwarded by Steven N. Braun/CEA/EOP on 08/09/99
10:15 AM -----

Medley_Global_Advisors@medleyadvisors.com
08/09/99 10:07:35 AM

Record Type: Record

To:
cc:
Subject: Morning Meeting for 08/09/99

NOTICE: Forwarding this proprietary email report constitutes violation of
United States and international copyright laws, and will be pursued to the
full extent of the law.

Medley Global Advisors 212-219-9096

(See attached file: mmaug9.pdf)

- mmaug9.pdf

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D56]ARMS27232702F.236 to ASCII,
The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

MEDLEY GLOBAL ADVISORS

Morning Meeting

August 9, 1999

Emerging Markets:

Russia: Installing revolving doors at the PM's office

Korea: Who needs the PM?

EMERGING MARKETS

RUSSIA

IN THE END, WILL YELTSIN "LOSE RUSSIA"?

The sacking of Russian PM Sergei Stepashin illustrates how difficult the transition to the post-Yeltsin era will be. Just three months after the presidential administration and Yeltsin's personal entourage deemed Yevgeni Primakov too much of a threat to bear, they **concluded that Stepashin was incapable of securing a transition favorable to Yeltsin's survival-obsessed extended family**. Stepashin proved too weak to push through several cherished administration goals -- most notably wresting control of Gazprom from its all-too-independent board -- but was also rising in the presidential polls. The alliance of Luzhkov's Fatherland party with the regional All Russia party was the final straw -- a direct challenge by the regions to the presidential patronage system and to Yeltsin's family.

Today Moscow received Yeltsin's answer to these challenges: Stepashin sacked, and reassertion of direct government control of its 35% stake of Gazprom. Memo to Primakov: cross us, and you're next on the hit list. **These actions, however, do not settle all the issues.** First of all, Yeltsin's assertions that Putin is his preferred successor are hogwash. Given the family's distrust of Interior Minister Rushailo (recently seen negotiating with Luzhkov) as well as Aksyonenko, the most loyal (and beholden) person they could come up with was Putin. Don't be surprised to see other presidential favorites emerge in the months ahead.

Critical in the upcoming days, however, will be the reactions of three key players: Moscow Mayor Luzhkov, electricity boss Chubais, and ex-PM Primakov. Luzhkov, currently under government assault on a number of fronts, can choose to retaliate through the media -- setting the stage for a messy public slanging match, complete with the inevitable kompromat. Chubais' reaction will also be important, for, although acting PM Putin is seen as a Chubais protege, the latter is actually far more beholden to Yeltsin's family than his former mentor. A move by Chubais to "opposition" could also significantly raise the risk of instability. Finally, Primakov has received his loudest warning from Yeltsin not to run for president. Will he heed the warning, or will he push Russia closer to a disorderly showdown?

This government change is an intensification of the previous one. Primakov was sacked, not just because of his popularity, but also because of his working alliance with the Duma majority. In May, Yeltsin felt he had to neutralize the Duma. Yeltsin is Russia's biggest problem today and **this action demonstrates the lengths to which his Family will go in order to keep hold of the reins of power even after the Y2K presidential elections.** Bad news for World Bank's Wolfensohn, by the way: any bets where the proceeds of his most recent loan to Russia goes? The last true believer has probably supported Russian "democracy" unintentionally, through an involuntary campaign contribution.

For Russian debt negotiations, needless to say, change is bad. The London Club might take some solace in seeing Kasyanov's smiling face in September (it's a bit early to predict, but we'll go out on a limb and say he'll still be in charge of negotiations at the next meeting). In addition, the West can look forward to continuity in economic policy, and delude itself that this has anything to do with Russian debt policy. But some **German banks might be less than pleased when they see the government's attitude to pricing further privatizations of slices of Gazprom. The bigger picture is not clear, but this event puts a dent in the positive euro story, because the odds of a disorderly election cycle in Russia have risen... again.**

KOREA

DJ STILL IN CHARGE, EITHER WAY

Korean President Kim Dae Jung's ruling coalition is scrambling to block a timely no-confidence motion submitted by the opposition GNP against Prime Minister Kim Jong Pil. While technically the coalition of DJ's NCNP and JP's ULD control the 299-seat Assembly with their 160 votes, party discipline has broken down in recent months. Now ULD party sources tell us that a dozen ULD Assembly members, led by the faction from anti-DJ Choong-chung province, are moving towards the formation of their own party. If this group sides with the GNP in the no-confidence vote, scheduled for Tuesday, JP's days as Prime Minister would be over. In the end, DJ will spare no efforts to prevent his PM from falling. **But at the same time, Kim Jong Pil does need to be put back in his box, and a close no-confidence vote will remind folks that DJ is still in charge and is not planning to give up any time soon.**

The GNP's excuse for the no confidence vote, the failure of JP to carry out the change to a parliamentary system of government, is a red herring. GNP leader Lee Hoi Chang has separately called for the proposal to be dropped completely, rather than merely postponed. But many in the ULD rank and file did want the change to go through, and fault JP for caving in to the President.

Korea remains the epitome of a presidential power system, and the money follows the power. The fall of the Prime Minister and disintegration of the ULD would allow DJ to accelerate the expansion of his own party that JP tried to block last month. **The political distractions leave little room for concerted efforts on restructuring.** DJ has already had to back down before Daewoo Chairman Kim Woo Chong (who knows very well where the campaign finance skeletons are buried) and allow Daewoo to manage its own restructuring. Other initiatives, including Korea Life Insurance, Samsung Motors are also on the skids.

QUOTE OF THE DAY

"[Government interference in the Duma elections] would be the collapse of Russia 's efforts to become a modern, prosperous country. The biggest banana republic in the world, and one without bananas at that -- that is not an enviable fate."

-- Sergei Stepashin, in an Izvestia interview published today.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 16:02:15.00

SUBJECT: Sarbanes

TO: Audrey Choi (CN=Audrey Choi/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

I called Sen S.'s office in response to his call to us. I did not speak to him, but left a message thanking him for his help and saying we would be happy to interact with him anytime on issues of interest to him.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 11:00:28.00

SUBJECT: budget simulations with alt. GDP growth

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D63]ARMS28768702A.236 to ASCII,
The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

Clinton Presidential Records Automated Records Management System [EMAIL]

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

Hex Dump file is not in a recognizable format, has been incorrectly decoded or is damaged.

File Name: p_92078677_cea_html_1.xls

Attachment Number: [ATTACH.D63]ARMS28768702A.236

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 18:34:11.00

SUBJECT: current electronic version

TO: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TO: David.Wilcox@do.treas.gov (David.Wilcox@do.treas.gov @ inet [UNKNOWN])

READ:UNKNOWN

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TO: Alice H. Williams (CN=Alice H. Williams/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TO: Jason Furman (CN=Jason Furman/OU=OPD/O=EOP@EOP [OPD])

READ:UNKNOWN

TO: Robert.Cumby@do.treas.gov (Robert.Cumby@do.treas.gov @ inet [UNKNOWN])

READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

I am bowing out of the process for now. This is the latest electronic version (excluding Bob Cumby's stock market material). I am sending it to the group because I do not know who will take the pen next. ===== ATTACHMENT 1
=====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D20]ARMS24859022D.236 to ASCII,
The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

MEMORANDUM TO THE PRESIDENT

FROM: Lawrence Summers, Department of Treasury
Martin Baily, Council of Economic Advisers

DATE: August 9, 1999

RE: Economic Outlook

The United States has enjoyed 99 consecutive months of economic expansion and is on track to achieve the longest economic expansion in its history. Meanwhile, inflation has remained under control, unemployment is exceedingly low compared with other expansions since the early 1970s, and recent gains in productivity have been encouraging. The consensus outlook for the economy is positive. While economic growth is seen as moderating somewhat from the very rapid pace of the past few years, the consensus view is that the U.S. economy should continue to exhibit many of the positive characteristics that have been hallmarks of the expansion thus far.

Overview of uncertainties in the forecast

Although the consensus forecast is positive, the uncertainties surrounding the macroeconomic outlook are considerable—both on the upside and on the downside.

- New Era optimism. On the upside, many commentators have suggested that the economy may have entered a “New Era” in which unemployment can remain low, output growth can remain strong, and wage increases can remain rapid, *without* triggering the kinds of imbalances that have led to the demise of expansions in decades past. If this view is correct, there is no presumption that the current expansion will end in the way that almost all past U.S. expansions have ended, with accelerating inflation leading to higher interest rates.
- An inflation shock. On the downside, some observers point to the risk that the productivity surge of the last few years may prove to be only temporary, and that some of the other factors that have helped keep inflation in check may wane or even go into reverse. The consensus forecast assumes that appropriate policy can achieve a “soft landing” in which the economy slows enough to avoid overheating while avoiding a recession. However, efforts to slow demand with higher interest rates could precipitate a recession, such as the one that took place in 1990.
- A domestic asset market shock. Although the typical end of an expansion is the result of rising inflation, some other possibilities deserve serious consideration. For example, the stock market is at a very high level, overpriced in the eyes of many observers. A precipitous decline in asset prices would likely reduce both household

and business demand—and potentially severely so. How that might play out is itself a matter of uncertainty. The experience with the stock market break in 1987 suggests that, provided the monetary response is swift and vigorous, the macroeconomic damage can be contained, and the expansion sustained. On the other hand, Japan's experience over the decade of the 1990s suggests that with the wrong or timid policies, the fallout can be protracted and painful.

- A dollar shock. The U.S. current account deficit has continued to widen, and now is approaching 4 percent of GDP. A number of commentators have raised the possibility that the U.S. dollar may come under (perhaps intense) downward pressure. Such a development could trigger other adverse events, such as an increase in inflation (because imported goods would have become more expensive), a sharp correction in our asset markets (reflecting a generalized loss of confidence on the part of foreign investors), and a marked step-down in our pace of growth.
- Trouble in emerging markets. The global economy has stabilized and improved somewhat in the last six months. While this is surely a positive development on net, it is not an unmixed blessing, as it does imply greater global competition for capital. Moreover, it is conceivable that a financial crisis in an emerging market economy could set off another round of economic and financial contagion. Argentina and China are the most obvious “hot spots,” but there are other candidates, especially in Latin America which, as you know, is in deep recession.
- Y2K. A number of voices have sounded the alarm with respect to the coming change of millennia, and in particular with respect to the so-called Y2K computer bug. Although great strides in preparedness have been made, a risk remains of systemic failure, possibly involving financial systems or other major elements of social and economic infrastructure.

The remainder of this memo first reviews the consensus macroeconomic outlook and then examines each of these risks in greater detail.

The consensus macroeconomic outlook

The following table presents recent history and the Administration, CBO, and Blue Chip consensus economic forecasts for key macroeconomic variables:

Economic Projections: A Comparison

	1998	1999	2000
Real GDP growth (Q4/Q4 %)	4.3		
Administration		3.2	2.1
CBO		3.6	2.1
Blue Chip		3.5	2.5
Unemployment (percent)	4.5		
Administration		4.3	4.5
CBO		4.2	4.3
Blue Chip		4.3	4.4
CPI inflation (percent)	1.5		
Administration		2.4	2.4
CBO		2.5	2.4
Blue Chip		2.4	2.3
Current account def. (\$ current)	221		
Administration		326	376
Consensus Economics		298	314
Capacity Utilization (percent)	81.8		

Like the Blue Chip forecasters, the Administration expects growth of real GDP to continue slowing toward a more sustainable pace—both we and the Blue Chip are anticipating a soft landing. The consensus forecast is that productivity growth will gradually return to its longer run historical trend, rather than remaining at the high rate of the last 3 ½ years. The unemployment rate is expected to rise from its current 4.3 percent to 5.2 percent (the center of the estimated range for the NAIRU).

A major uncertainty in the forecast is whether the current expansion will continue to exhibit a number of characteristics that have distinguished it from previous long expansions:

- Productivity growth has picked up rather than slowed as the expansion has matured.
- Inflation and interest rates have declined rather than risen.

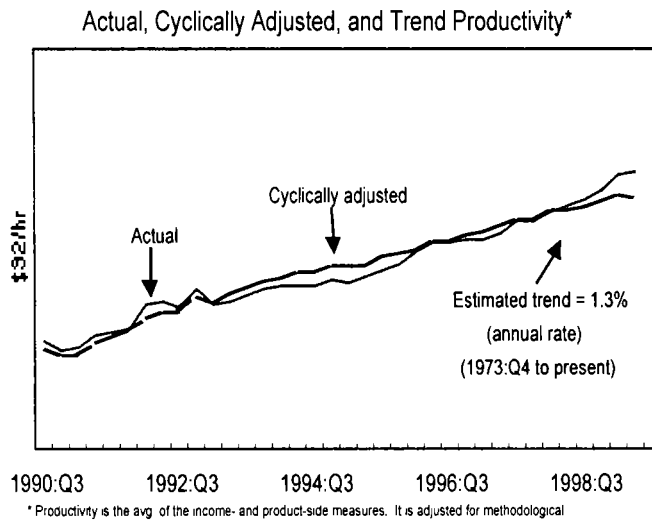
- Investment has been historically strong and industrial capacity has expanded accordingly.
- The stance of fiscal policy has shifted from seemingly terminal deficits to the prospect of an era of surpluses.
- The current account has widened despite an improving trend in national saving, as the demand for investment has outstripped our ability to finance it from domestic savings.

One way to frame the issue of the macroeconomic outlook, therefore, is to ask whether these favorable elements can be sustained

A New Era or the old trade-offs?

The view that the economy has entered a New Era assumes that many of these favorable elements are now permanent features of the economy. The contrary view is that they mainly reflect special factors that will be reversed. Two critical relationships illustrate the debate.

- The NAIRU. Not so many years ago, the consensus view was that the economy risked rising inflation once the unemployment rate dropped below 6 percent, or even 6.5 percent in some economic models. However, the unemployment rate has been below 6 percent for the past NN months, and below 5 percent for the past MM. While wage inflation has picked up in the past few years, it has not translated into the kind of price inflation that would trigger a substantial tightening by the Fed that could threaten the expansion. To the extent that increased international and domestic competition have created a new environment in which businesses find it hard to raise prices, productivity is growing rapidly, and investment is expanding capacity at a rapid rate, it may be possible to avoid inflation even with a tight labor market and rising wages. In part, however, the favorable inflation situation reflects some transitory factors – including falling prices for imports, and moderate prices for energy goods – that either have already reversed (as in the case of energy) or could plausibly do so in the near future (as in the case of import prices). Without such factors, the unemployment rate consistent with stable inflation may well be as much as a point higher than the current rate of 4.3 percent.
- Trend productivity growth. The sustainable rate of economic growth is determined by the rate of growth of the labor force (about 1.1 percent) and the rate of growth of productivity. Over the past three years, productivity growth has been substantially higher than its longer-term trend of about 1.3 percent per year. A centerpiece of New Era thinking is a belief that information technology and other developments have allowed for substantially faster sustained productivity growth. The contrary view is that it is premature to conclude from a short period of strong productivity growth that trends that have been evident since the early 1970s have been sharply reversed.



According to the *Economist* (July 24), Alan Greenspan is among those who believe that information technology has contributed to faster productivity growth. He points out that “the accessibility of up-to-date information offered by information technology has allowed substantial improvements in corporate efficiency. Production planning is made easier; inventories can be reduced; delivery lead-times fall; the nature of distribution is altered. All of these factors increase the

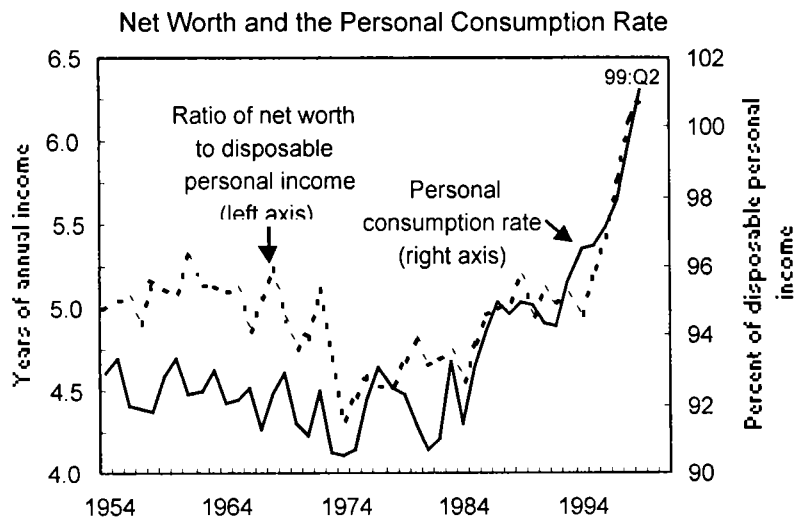
flexibility of capital goods, making capital investment more attractive and productive than it used to be, and encouraging firms to substitute capital for (scarce) labor.”

An extensive study by a US consulting firm looked at the current and potential future effect of the electronics revolution on productivity. They examined a variety of companies in different industries recording how workers spend their time. They concluded that in US companies workers spend 51 percent of their time on “interactions,” such as communication, data gathering and collaborative problem-solving. Improvements in communications technologies, such as the Internet, are now allowing reductions in the labor required for such interactions and these gains are expected to continue even more rapidly in the future. Business economist Eric Brynjolfsson of the Sloan School at MIT has estimated that computer capital has a larger impact on productivity than other kinds of capital.

A principal critic of the new economy view is economist Robert Gordon. He notes that the price of a computer of a given quality has recently been declining at an accelerating rate (or equivalently, that every dollar spent buys a rapidly rising quality of computer). This leads to large and accelerating estimates of productivity growth within the manufacturing sector that produces computers. Gordon then tries to separate out computer production from the rest of the economy. And when he does so, he finds that virtually all of the acceleration of productivity growth in the nonfarm business sector is coming from the computer-producing part and almost none from the rest of the economy. We are fantastic at making computers, he concludes, but have not discovered how to use computers to make the rest of the economy more productive.

Gordon’s conclusion is hard to believe given extensive case study evidence of businesses using new technologies to improve their operations. Other economists question his method of separating out computer production from the rest of the economy. But the fact remains that there is great uncertainty around estimates of future productivity growth.

Chart x shows that labor productivity has only very recently moved above the level that would be expected, given the strong cyclical recovery. This is why the Administration forecast is conservative in the assumed rate of productivity growth that feeds into our budget estimates.

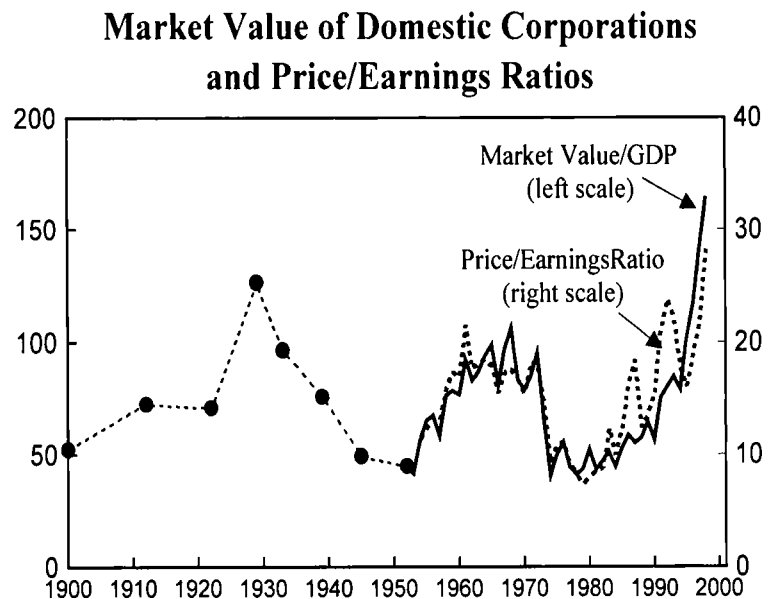


The Stock Market

The stock market has appreciated spectacularly over the past five years, accompanied by a dramatic rise in the market value of young, high-tech companies that employ significantly fewer people than traditional industrial blue chips. While profit growth has been strong, price-earnings ratios and other traditional indicators of valuation are at record levels. Accordingly, the issue of whether the market is “overvalued” has been hotly debated in recent months.

Those who are concerned about the current valuations in the stock market point to evidence of the following type:

- The market value of equities increased from 77 percent of GDP at the end of 1994 to 164 percent of GDP in the first quarter of this year, a value that is well above the previous peaks reached in 1929 and 1968.
- Similarly, despite strong growth in corporate earnings, the ratio of price to earnings for the 500 largest companies in the stock market has more than doubled, rising from 15 at the end of 1994 to 35.2 in the first quarter of this year.



On the other hand, those who are relatively sanguine about the current state of the market point to the following:

- The economy remains strong and private forecasters have increased their projected growth rates for GDP and corporate profits since the beginning of the year. Prospects for some industries that suffered from the impact of a sluggish world economy last year have improved and several key sectors are viewed as generating impressive results this year. At the same time, views on inflation remain sanguine.
- Not all stocks are going to the sky. On the contrary, a large fraction of the growth in the market's value can be attributed to a small set of companies, most of whom are engaged in some form of high-tech activity. Meanwhile, valuations for many traditional companies remain tame by historical standards. This suggests that the market retains its ability to discriminate among stocks, rewarding those companies

that are on the cutting edge of innovation.

- It is possible (with some stretching) to justify current market values, by combining relatively optimistic assumptions about future profit growth, interest rates, and the premium that investors demand for bearing the risks inherent in holding stocks. For example, if the rapid rates of productivity growth experienced since 1995 were to continue unabated and feed continued rapid earnings growth; if long-term interest rates were to return to the lower levels seen earlier this year; and if the premium for bearing stock market risk were to descend to levels that are quite low by historical standards, then the current level of the market could be “justified.”

The main macroeconomic risk posed by an overvalued stock market is the prospect of a sharp market reversal, which would reduce aggregate demand. A decline in stock values would reduce the net worth of consumers and lead to a decline in consumer spending. It also would increase businesses' cost of raising equity capital and thereby reduce investment spending. The appropriate antidote to a development of this type is a dose of lower interest rates. This type of action proved quite successful in 1987, when the Fed moved promptly and vigorously to reassure markets in the wake of the October crash.

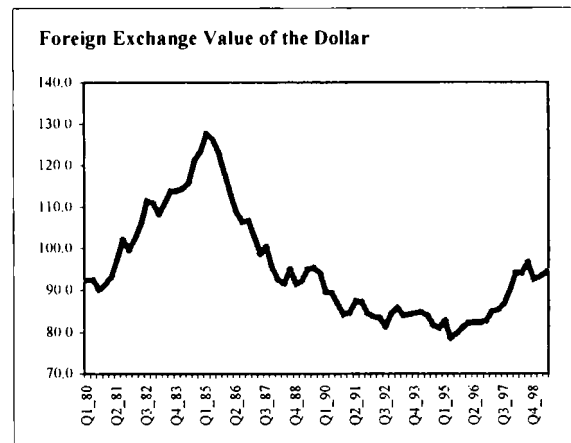
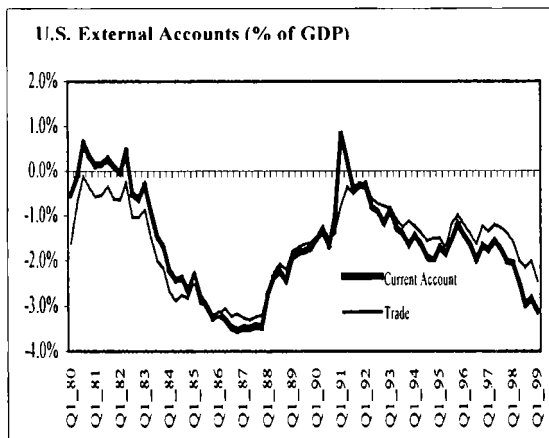
A more remote – but nonetheless real – risk is that the financial system simply seizes up and ceases to function in the wake of a sharp break in stock market values. Significant steps have been taken to reduce this risk following what some view as a near miss during the 1987 stock market crash, but some risk remains. And the traditional tools of monetary policy may not be sufficient to prevent a seizing up of markets in the face of widespread panic.

The risk posed by the stock market is compounded by international considerations. A substantial weakening in asset markets here could shake the confidence of foreign investors, thereby causing a substantial drying up of the supply of foreign capital and a free fall of the dollar. This would pose a dilemma for the Federal Reserve, which would be caught between conflicting needs to cushion a recession and contain rising inflation. The implications of such a scenario are potentially more severe than they otherwise would be in light of the fact that we are presently running a large current-account deficit – a topic to which we now turn.

The current account deficit and the dollar

The current account deficit -- already large last year -- is forecast to widen further in 1999 and beyond.

- The widening of the deficit has been exacerbated by temporary factors: the Asian crisis and the faster relative growth of the U.S. economy compared to the rest of the world, as well as the appreciation of the dollar since 1995.
- As the dollar's strength shows, foreigners have been more than willing to finance our external deficits of recent years. The relative attractiveness of U.S. investments and performance of the U.S. economy have pulled in foreign capital.
- The U.S. current account deficit is not likely to be sustainable indefinitely at recent growth rates in the U.S. and abroad and unchanged exchange rates. Based on standard forecasting models, the deficit would continue to widen as a percent of GDP.
- Foreign investors have built up large net (\$1.5 trillion) and gross (\$7.5 trillion) claims on the U.S. Sooner or later they may become less willing to hold an ever increasing share of their wealth in claims on the United States, especially as an upturn in foreign growth provides more competition for U.S. assets.



Federal Reserve Board Real Exchange Rate Index

Repeat of the 1980s? A continuing widening of the deficit could place the dollar under significant downward pressure over the next year as happened in the 1980s, despite differences between now and then:

- U.S. deficits in the 1980s were driven by a fall in national savings associated with large fiscal deficits. Since 1992, our national savings rate has been rising, and our external deficits have been associated with the more rapid rise in investment.
- The dollar has appreciated on average in real (price-adjusted) terms since 1995, but the appreciation has been substantially less than in the mid-1980s.

- Although the U.S. has become a net international debtor, with net income payments now contributing to our current account deficit (as a percent of GDP), our trade deficit has not yet reached the low point (as a percent of GDP) of 1987.

Hard Landing? The external adjustment process in the late 1980s was difficult, but it was not a “hard landing” involving a deep sustained recession and substantially higher inflation.

- The difficulties associated with any prospective adjustment in our external accounts would depend in large part on how it was triggered and what other developments accompanied it, and on policy responses here and abroad.
- Standard macroeconomic models suggest that, under plausible assumptions about policy responses in the U.S. and abroad, an abrupt 25% decline in the dollar would raise U.S. growth by about 1% over the first 1-2 years and eventually reduce the current account deficit by half or two thirds, but it would also boost U.S. inflation by as much as 2%.

The adjustment process in the new millennium could well be less benign:

- The U.S. adjustment process could be triggered or exacerbated by (or could itself trigger) a sharp correction in U.S. asset markets.
- Policy responses in the rest of the world may fail to offset the contractionary effects of the U.S. adjustment on their own growth from reduced exports to and increased imports from the U.S.
- The result could be a U.S. recession, an intensified flight from dollar-denominated assets, further downward pressure on the dollar, and a large increase in inflation.

This potential vicious cycle of sudden and excessive asset price deflation followed by an economic downturn in the U.S. and abroad is the main source of risk from our growing trade and current account deficit and a possible sharp dollar decline.

The likelihood of a “hard landing” scenario is not large, and careful management can help reduce the risk. Maintaining our strong-dollar policy will help sustain confidence in our assets and markets. Policies to enhance our national savings will help cushion the economy against a potential slowdown of inflows of foreign savings. Faster growth abroad should on balance ease our adjustment process as would broad-based trade liberalization and avoidance of protectionist pressures.

Contagion from the Global Economy

The outlook for the global economy has brightened a bit since late last year.

- The mood surrounding prospects in Japan and Europe has improved somewhat.
- Economic activity is recovering in the affected countries in Asia. Although Latin America is in recession, there too the outlook has brightened somewhat recently.

- External investors have substantially reduced their exposure to emerging market economies as they have moved toward external surpluses, and borrowing spreads for emerging market economies are lower than last fall, though still wide.

Evolution of Consensus Forecasts of World Economic Growth

	<u>Sept 1998</u>	<u>Dec 1998</u>	<u>March 1999</u>		<u>July 99</u>	
	1999	1999	1999	2000	1999	2000
Euro-11	2.6%	2.3%	2.1%	2.6%	2.0%	2.6%
Japan	0.3	-0.6	-0.9	0.2	0.1	-0.2
Asia ex Japan	2.9	2.7	3.3	4.8	4.7	5.3
Latin America	3.5	0.8	-1.2	3.1	-0.5	3.5

Japan: The economy may finally have stopped deteriorating, though we have seen false bottoms before. Market sentiment has turned, and the rise in the Nikkei stock index since the beginning of 1999 (24%) and astonishing 7.9% annual rate growth recorded in the first quarter are positive, but record 4.9% unemployment, declining incomes and decreased household spending, and continuing corporate restructuring suggest further pressure on jobs and incomes. Japan's banking sector may have stabilized, following the recapitalization of leading banks, but more progress is needed in disposal of bad assets. Continued government facilitation of economic and financial restructuring along with supportive macro policies are critical to achieve a lasting recovery.

Europe: Although the macroeconomy may be poised for an upturn, the strength of any rebound is uncertain and likely to be export-led, given the euro's depreciation over the first half of the year. Unemployment still remains stubbornly in double digits, underscoring the need for fundamental structural reforms, if European growth is to return output to potential, to say nothing of cutting into high unemployment rates.

This somewhat improved outlook for the industrial countries is on balance good for the U.S. and global economy though, as noted above, it is not an unmixed blessing because of the increased competition from more attractive investment opportunities abroad.

The two emerging market economies that at this point appear to pose the greatest risk to the U.S. and global economy and financial system are Argentina in Latin America and China in Asia.

Argentina: Despite basically sound policies, Argentina's dependence on foreign capital inflows to refinance its large external obligations (about 450% of exports) leaves it vulnerable to the risk that market worries about its exchange rate regime become a self-fulfilling prophecy. Its external accounts have been hit by lower prices on its commodity exports and by devaluation and recession in Brazil. Private capital inflows have declined due to the global crisis, investor nervousness about the October presidential election, and concerns the peso may be overvalued. The result has been sharply higher international and domestic borrowing costs. Argentina is in a severe recession (2½-3% real GDP contraction expected this year) with rising unemployment (now 14.5%) and growing non-performing loans. Monetary policy is constrained by Argentina's currency board regime.

A political-economic crisis in Argentina with its currency board could undermine confidence in Hong Kong, with potential implications throughout Asia.

China: The recent slowdown in growth and contraction of exports in China is a source of risk and increased vulnerability. Fears of rising unemployment and a looming fiscal burden from restructuring the financial system and state-owned enterprises may lead the authorities to try to restore export-led growth and devalue the renminbi. Although current account data are not available for 1999, the recorded trade surplus has basically vanished since late last year. Financial market expectations about a devaluation have recently returned to levels last seen during the global panic of August 1998. With its capital controls and large foreign exchange reserves (\$147 billion), the risk of a successful speculative attack on the renminbi is still low. However, a poorly managed devaluation, if this should be the course chosen by the Chinese authorities, could put pressures on Hong Kong's exchange rate peg and spill over to other Asian currencies and other regions and to the U.S. economy as we saw in 1997-98.

Other country risks: Other large countries with less immediate difficulties that may pose a concern are Brazil, Indonesia, Korea, Mexico, Russia, and Turkey. For example, if Korea mishandles the Daewoo restructuring, its economy could be plunged back into serious recession or crisis. Smaller financial fragile countries that have the potential to trigger a broader crisis include Colombia, Ecuador, Romania, Ukraine, and Venezuela. For example, Ecuador's failure to make its Brady bond payments later this month could trigger a flight from the debt of emerging market economies generally, even though the market should not be surprised.

In contrast to the situation over the past two years when concerns about the outlook for the U.S. economy focused primarily on contagion from the rest of the world, our vulnerability from this source appears to have declined both absolutely and relatively. Conditions abroad are mending slowly and the shocks of the past few years are probably still recent enough to keep even investors with short memories mindful of a repetition.

The Y2K Problem

The Y2K computer problem poses some limited risks from the potential malfunction of computer systems that support critical infrastructure. There is also some anticipated economic impact from hoarding behavior at the end of 1999 in anticipation of Y2K problems.

- Fundamentals. The fundamental risk is of severe and long lasting economic dislocation as computer systems malfunction -- particularly in the critical infrastructure areas of finance, telecommunications, power generation, and transportation. Considerable investment has been made to avoid the fundamental problems that would occur with a system-wide failure. Most large firms and the Federal government have spent large amounts to ensure their systems are Y2K ready. Concerns remain with respect to smaller users, State governments and less-developed countries. Because of the extensive preparation that has taken place, problems among the small users are unlikely to cumulate into a supply shock sufficient to cause a significant macro-economic impact on the United States. Only one of 52 blue-chip forecasters currently projects negative growth for 2000.
- Hoarding. A second set of economic problems could occur even if all computers perform normally, if there is hoarding behavior in anticipation of Y2K problems. This could lead to temporary shortages, soaring prices and long lines. In particular, this could be a problem, if at the last moment firms seek to accumulate extra inventories; households to stockpile supplies such as groceries, prescription drugs, gasoline, and currency; and financial market participants to shift towards highly liquid assets.

Again, many institutions are taking steps to provision for such hoarding. For example, the Federal Reserve plans to boost its currency holdings from \$100 billion to \$300 billion, about \$2,000 per US household of additional cash.

The inventory behavior induced by Y2K is expected to boost growth in the final quarter 1999 by $\frac{3}{4}$ percentage point, and lower it in the first quarter of 2000 by the same amount. Interest rates on assets to be held over year-end indicate a liquidity premium but the effect dissipates after a few months.

A small aggregate impact. Y2K is likely to be to the economy, what a sandstorm is to the desert. A highly visible nuisance for most who are caught in it, quite damaging to a few; but with an impact that is scarcely visible overall once the dust has settled. The key to containing the disruptions from anticipatory behavior is public confidence that the fundamental problems have been dealt with.

Conclusion.

History suggests that in any year, regardless of how long an expansion has run, the chances that it will end are about one in four. In the postwar period, for the United States, these terminations have resulted from Federal Reserve responses to inflation.

The lack of inflationary pressures currently, and the belief that if any were to arise, they would be effectively nipped in the bud, provides consensus forecasters with the confidence to project sustained economic growth, at a rate of 2.6 percent in 2000.

But the consensus forecast could be wrong. The recent surge in productivity performance provides plausibility to the view that the benefits of the revolution in information technology are finally coming to fruition. While there is much talk of a new economy, if the US could simply return to the old economy which achieved a 2 percent rate of productivity growth over the century prior to 1973, over the next five years, growth could average over three percent annually. The consensus forecasts could prove to be just another example of the dismal science.

There are, however, a variety of risks facing the economy that could pose some painful choices. There have been other periods in history such as the late 1920s in the US and the late 1980s in Japan, in which apparent prosperity proved to be ephemeral as the collapse of asset market bubbles wreaked financial and economic havoc. Currently, therefore it is prudent to attach concern to the risks we face from an outburst of inflation and both internal and external financial market instability.

However, each of these risks is better faced with a strong fiscal position. Less stimulus would reduced inflation. More national savings allow us to finance domestic investment with less foreign borrowing and lower interest rates reduces the probability of financial distress at home and abroad.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 14:48:52.00

SUBJECT: Cache of cash

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Jason Furman (CN=Jason Furman/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

CC: david.wilcox@do.treas.gov@inet (david.wilcox@do.treas.gov@inet [UNKNOWN])
READ:UNKNOWN

TEXT:

I just spoke with Don Kohn at the Fed.

The Federal Reserve normally has about \$100 billion of currency in its vaults, but expects to have \$300 billion on October 1st.

For comparison purposes,

The normal seasonal spike of currency holdings in December is about \$10 billion.

Total currency outstanding was \$484 billion in June 1999. (About 2/3 of which is thought to be overseas.)

With 103 million households in the U.S. the \$200 billion Federal reserve cash hords amounts to about \$2000 per household.

Don thought the cash reserve was more than adequate, but problems are expected for getting the cash to banks.

1) the armored car industry is small; its seasonal peak is already in December; and its capacity may be inadequate. Efforts are being made to coax banks to build up their cash horde early, but because holding cash is not profitable, this effort is meeting some resistance. There have been some conversations about using the national guard for this purpose.

2) As a partial fix, efforts are being made to pre-position cash at 85 "Strategic Inventory Locations" around the country, often at military bases.

3) The period of cash re-collection when the Y2K problem is over also worries banks. Both the pre- and post-crisis hordes might be magnets for robbers.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: David.Wilcox@do.treas.gov (David.Wilcox@do.treas.gov [UNKNOWN])

CREATION DATE/TIME: 9-AUG-1999 14:06:17.00

SUBJECT: current version 1:58 pm

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP [CEA])

READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP [CEA])

READ:UNKNOWN

TEXT:

Date: 08/09/1999 01:58 pm (Monday)

From: David Wilcox

To: baily, lawrence

Subject: current version 1:58 pm

- POTUS3.DOC===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D17]ARMS29485112P.236 to ASCII,

The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

MEMORANDUM TO THE PRESIDENT

FROM: Lawrence Summers, Department of Treasury
Martin Baily, Council of Economic Advisers

DATE: August 9, 1999

RE: Economic Outlook

The U.S. has enjoyed 99 consecutive months of economic expansion and is on track to achieving the longest economic expansion in its history. Meanwhile, inflation has remained under control, unemployment is exceedingly low by recent standards, and recent gains in productivity have been encouraging. The consensus view is that the outlook for the future is positive, and that the U.S. economy should continue to exhibit many of the same characteristics that have been hallmarks of the expansion thus far.

That said, the uncertainties surrounding the macroeconomic outlook are considerable – both on the upside and on the downside.

- On the upside, many commentators have suggested that the economy may have entered a “New Era” in which unemployment can remain low, output growth can remain strong, and wage increases can remain rapid, *without* triggering the kinds of imbalances that have led to the demise of expansions in decades past. Adherents of this view argue that there should be no presumption that the current expansion will meet a traditional fate at the hands of an inflation-fearful Federal Reserve.
- On the downside, some observers point to the risk that the productivity surge of the last few years may prove to be a passing phenomenon, and that some of the other factors that have helped keep inflation in check may wane or even go into reverse. Even in this case, the economy might experience nothing more traumatic than a “soft landing,” but the risks to the expansion would be far greater, and the overall macroeconomic climate (combining upward drift in both inflation and unemployment) would be less appealing than the one we have been experiencing of late.
- Others have argued that the stock market is very richly priced. A precipitous decline in asset prices would likely reduce both household and business demand – and potentially severely so. How that might play out is itself a matter of uncertainty. The experience with the stock market break in 1987 suggests that, provided the monetary response is swift and vigorous, the macroeconomic damage can be contained, and the expansion sustained. On the other hand, Japan’s experience over the decade of the 1990s suggests that with the wrong or timid policies, the fallout can be protracted and

painful.

- The U.S. current account deficit has continued to widen, and now is approaching 4 percent of GDP. A number of commentators have raised the possibility that the U.S. dollar may come under (perhaps intense) downward pressure. Such a development could trigger other adverse events, such as an increase in inflation (because imported goods would have become more expensive), a sharp correction in our asset markets (reflecting a generalized loss of confidence on the part of foreign investors), and a marked step-down in our pace of growth.
- The global economy has stabilized and improved somewhat in the last six months. While this is surely a positive development on net, it is not an unmixed blessing, as it does imply greater global competition for capital. Moreover, it is conceivable that a financial crisis in an emerging market economy could set off another round of economic and financial contagion. Argentina and China are the most obvious “hot spots.”
- Finally, a number of voices have sounded the alarm with respect to the coming change of millennia, and in particular with respect to the so-called Y2K computer bug. Although great strides in preparedness have been made, a risk remains of systemic failure, possibly involving financial systems or other major elements of social and economic infrastructure.

The remainder of this memo first reviews the consensus macro-economic outlook and then provides greater depth on each of the risks sketched above.

The consensus macroeconomic outlook. Thus far, the current expansion has differed in several key respects from previous long expansions in the United States:

- Productivity growth has picked up rather than slowing.
- Inflation and interest rates have declined rather than rising.
- Investment has been historically strong and industrial capacity has expanded accordingly.
- The stance of fiscal policy has shifted from seemingly terminal deficits to the prospect of an era of surpluses.
- The current account has widened despite an improving trend in national saving, as the demand for investment has outstripped our ability to finance it from domestic savings.

One way to frame the issue of the macroeconomic outlook is to ask whether the favorable elements of these trends can be sustained.

The table below presents Administration, CBO, and Blue Chip consensus economic forecasts for key macroeconomic variables:

	Administration		CBO		Blue Chip	
	1999	2000	1999	2000	1999	2000
Real GDP growth (percent, Q4/Q4)						
Unemployment (percent)						
Core CPI Inflation (percent, Q4/Q4)						
Current Acct. Def. (percent of GDP)						
Capacity Util. (percent)						

Like outside observers, the Administration expects growth of real GDP to continue slowing toward a more sustainable pace. Although restraint could come from any of several sources, the most likely candidates at this point appear to be business investment spending (capacity utilization has actually been declining *despite* the strong growth of recent quarters), housing (where building activity appears to have been running ahead of the pace that would be justified based on long-term demographic trends) and household spending, which might cool in the wake of some moderation in the strength of the stock market.

A New Economic Era?

Two aspects of the domestic macroeconomic situation will be key in helping to determine how long, and at what pace, the current economic expansion can continue:

- First, what will happen to wage inflation, given the low level of unemployment? Not so many years ago, the consensus view was that the “neutral” point for the unemployment rate (that is, the point at which the labor market would put neither upward nor downward pressure on inflation) was about 6 percent. (This is the infamous NAIRU.) For the last NN months, the unemployment rate has been below that level. Wage inflation has picked up, but much less so than one would have guessed based on a NAIRU of 6 percent.

In its official economic projections, the Administration assumes that the NAIRU is 5.3 percent. Precise evidence on this parameter is frustratingly difficult to amass. Accordingly, it is possible for a few holdouts to continue to hold the torch for a NAIRU of 6 percent (or close to it), and likewise possible for a few radicals to assert that unemployment in the 4’s may be sustainable.

- Second, how much wage inflation can you have without igniting a spiral of price inflation, which is the type of inflation that the Federal Reserve is concerned about preventing? The recent surge in productivity growth has meant that wages could increase relatively rapidly, and yet producers be able to maintain moderate pricing policies, as the difference could be absorbed in productivity gains.

In part, the favorable inflation situation reflects some transitory factors – including falling prices for imports, and moderate prices for energy goods – that either have already reversed (as in the case of energy) or could plausibly do so in the near future (as in the case of import prices).

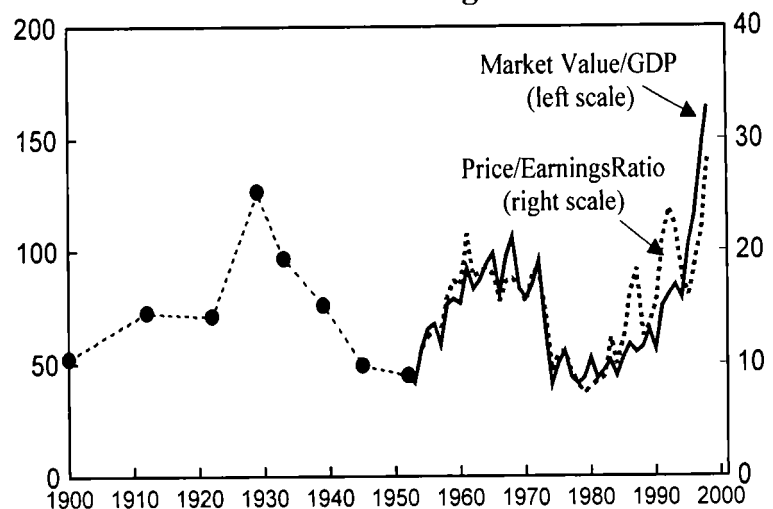
If either or both of these favorable developments of late (low NAIRU and rapid productivity growth) can be sustained, the positive implications for our economy would be profound. In that case, we could look to a future of lower inflation, fortified budget surpluses, and – most important of all – a reinvigorated pace of increase in the standard of living.

The Stock Market. The stock market has appreciated spectacularly over the past five years, accompanied by a dramatic rise in the market value of young, high-tech companies that employ significantly fewer people than traditional industrial blue chips. While profit growth has been strong, price-earnings ratios and other traditional indicators of valuation are at record levels. Accordingly, the issue of whether the market is “overvalued” has been hotly debated in recent months.

Those who are concerned about the current valuations in the stock market point to evidence of the following type:

- The market value of equities increased from 77 percent of GDP at the end of 1994 to 164 percent of GDP in the first quarter of this year, a value that is well above the previous peaks reached in 1929 and 1968.
- Similarly, despite strong growth in corporate earnings, the ratio of price to earnings for the 500 largest companies in the stock market has more than doubled, rising from 15 at the end of 1994 to 35.2 in the first quarter of this year.

**Market Value of Domestic Corporations
and Price/Earnings Ratios**



On the other hand, those who are relatively sanguine about the current state of the market point to the following:

- The economy remains strong and private forecasters have increased their projected growth rates for GDP and corporate profits since the beginning of the year. Prospects for some industries that suffered from the impact of a sluggish world economy last year have improved and several key sectors are viewed as generating impressive results this year. At the same time, views on inflation remain sanguine.
- Not all stocks are going to the sky. On the contrary, a large fraction of the growth in the market's value can be attributed to a small set of companies, most of whom are engaged in some form of high-tech activity. Meanwhile, valuations for many traditional companies remain tame by historical standards. This suggests that the market retains its ability to discriminate among stocks, rewarding those companies that are on the cutting edge of innovation.
- It is possible (with some stretching) to justify current market values, by combining relatively optimistic assumptions about future profit growth, interest rates, and the premium that investors demand for bearing the risks inherent in holding stocks. For example, if the rapid rates of productivity growth experienced since 1995 were to continue unabated and feed continued rapid earnings growth; if long-term interest rates were to return to the lower levels seen earlier this year; and if the premium for bearing stock market risk were to descend to levels that are quite low by historical standards, then the current level of the market could be "justified."

The main macroeconomic risk posed by an overvalued stock market is the prospect of a sharp market reversal, which would reduce aggregate demand. A decline in stock values would reduce the net worth of consumers and lead to a decline in consumer spending. It also would increase businesses' cost of raising equity capital and thereby reduce investment spending. The appropriate antidote to a development of this type is a dose of lower interest rates. This type of action proved quite successful in 1987, when the Fed moved promptly and vigorously to reassure markets in the wake of the October crash.

A more remote – but nonetheless real – risk is that the financial system simply seizes up and ceases to function in the wake of a sharp break in stock market values. Significant steps have been taken to reduce this risk following what some view as a near miss during the 1987 stock market crash, but some risk remains. And the traditional tools of monetary policy may not be sufficient to prevent a seizing up of markets in the face of widespread panic.

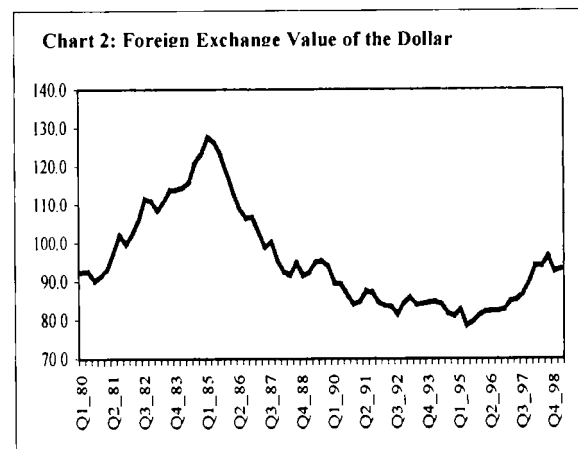
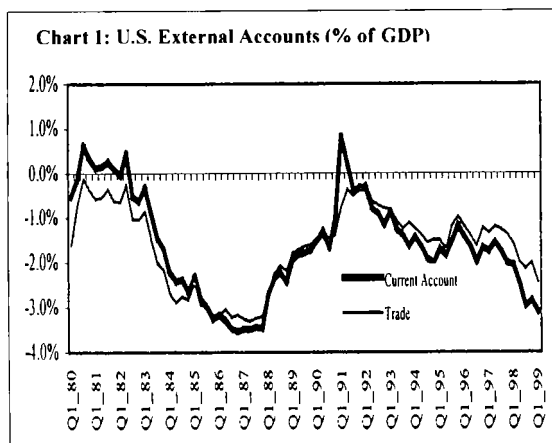
The risk posed by the stock market is compounded by international considerations. A substantial weakening in asset markets here could shake the confidence of foreign investors, thereby causing a substantial drying up of the supply of foreign capital and a free fall of the dollar. This would pose a dilemma for the Federal Reserve, which would be caught between conflicting needs to cushion a recession and contain rising inflation. The implications of such a scenario are potentially more severe than they otherwise

would be in light of the fact that we are presently running a large current-account deficit – a topic to which we now turn.

The Current Account Deficit

The current account deficit -- already large last year -- is forecast to widen further in 1999 and beyond.

- The widening of the deficit has been exacerbated by temporary factors: the Asian crisis and the faster relative growth of the U.S. economy compared to the rest of the world, as well as the appreciation of the dollar since 1995.
- As the dollar's strength shows, foreigners have been more than willing to finance our external deficits of recent years. The relative attractiveness of U.S. investments and performance of the U.S. economy have pulled in foreign capital.
- The U.S. current account deficit is not likely to be sustainable indefinitely at recent growth rates in the U.S. and abroad and unchanged exchange rates. Based on standard forecasting models, the deficit would continue to widen as a percent of GDP.
- Foreign investors have built up large net (\$1.5 trillion) and gross (\$7.5 trillion) claims on the U.S. Sooner or later they may become less willing to hold an ever increasing share of their wealth in claims on the United States, especially as an upturn in foreign growth provides more competition for U.S. assets.



Federal Reserve Broad Real Exchange Rate Index

Repeat of the 1980s? A continuing widening of the deficit could place the dollar under significant downward pressure over the next year as happened in the 1980s, despite differences between now and then:

- U.S. deficits in the 1980s were driven by a fall in national savings associated with large fiscal deficits. Since 1992, our national savings rate has been rising, and our external deficits have been associated with the more rapid rise in investment.
- The dollar has appreciated on average in real (price-adjusted) terms since 1995, but the appreciation has been substantially less than in the mid-1980s.
- Although the U.S. has become a net international debtor, with net income payments now contributing to our current account deficit (as a percent of GDP), our trade deficit has not yet reached the low point (as a percent of GDP) of 1987.

Hard Landing? The external adjustment process in the late 1980s was difficult, but it was not a “hard landing” involving a deep sustained recession and substantially higher inflation.

- The difficulties associated with any prospective adjustment in our external accounts would depend in large part on how it was triggered and what other developments accompanied it, and on policy responses here and abroad.
- Standard macroeconomic models suggest that, under plausible assumptions about policy responses in the U.S. and abroad, an abrupt 25% decline in the dollar would raise U.S. growth by about 1% over the first 1-2 years and eventually reduce the current account deficit by half or two thirds, but it would also boost U.S. inflation by as much as 2%.

The adjustment process in the new millennium could well be less benign:

- The U.S. adjustment process could be triggered or exacerbated by (or could itself trigger) a sharp correction in U.S. asset markets.
- Policy responses in the rest of the world may fail to offset the contractionary effects of the U.S. adjustment on their own growth from reduced exports to and increased imports from the U.S.
- The result could be a U.S. recession, an intensified flight from dollar-denominated assets, further downward pressure on the dollar, and a large increase in inflation.

This potential vicious cycle of sudden and excessive asset price deflation followed by an economic downturn in the U.S. and abroad is the main source of risk from our growing trade and current account deficit and a possible sharp dollar decline.

The likelihood of a “hard landing” scenario is not large, and careful management can help reduce the risk. Maintaining our strong-dollar policy will help sustain confidence in our assets and markets. Policies to enhance our national savings will help cushion the economy against a potential slowdown of inflows of foreign savings. Faster growth abroad should on balance ease our adjustment process as would broad-based trade liberalization and avoidance of protectionist pressures.

Contagion from the Global Economy

The outlook for the global economy has brightened a bit since late last year.

- The mood surrounding prospects in Japan and Europe has improved somewhat.
- Economic activity is recovering in the affected countries in Asia although Latin America is in recession.
- External investors have substantially reduced their exposure to emerging market economies as they have moved toward external surpluses, and borrowing spreads for emerging market economies are lower than last fall, though still wide.

Table 1: Evolution of Consensus Forecasts of World Economic Growth

	<u>Sept 1998</u>	<u>Dec 1998</u>	<u>March 1999</u>		<u>July 99</u>	
	1999	1999	1999	2000	1999	2000
Euro-11	2.6%	2.3%	2.1%	2.6%	2.0%	2.6%
Japan	0.3	-0.6	-0.9	0.2	0.1	-0.2
Asia ex Japan	2.9	2.7	3.3	4.8	4.7	5.3
Latin America	3.5	0.8	-1.2	3.1	-0.5	3.5

Japan: The economy may finally have stopped deteriorating, though we have seen false bottoms before. Market sentiment has turned, and the rise in the Nikkei stock index since the beginning of 1999 (24%) and astonishing 7.9% annual rate growth recorded in the first quarter are positive, but record 4.9% unemployment, declining incomes and decreased household spending, and continuing corporate restructuring suggest further pressure on jobs and incomes. Japan's banking sector may have stabilized, following the recapitalization of leading banks, but more progress is needed in disposal of bad assets. Continued government facilitation of economic and financial restructuring along with supportive macro policies are critical to achieve a lasting recovery.

Europe: Although the macroeconomy may be poised for an upturn, the strength of any rebound is uncertain and likely to be export-led, given the euro's depreciation over the first half of the year. Unemployment still remains stubbornly in double digits, underscoring the need for fundamental structural reforms, if European growth is to return output to potential, to say nothing of cutting into high unemployment rates.

This somewhat improved outlook for the industrial countries is on balance good for the U.S. and global economy though, as noted above, it is not an unmixed blessing because of the increased competition from more attractive investment opportunities abroad.

The two emerging market economies that at this point appear to pose the greatest risk to the U.S. and global economy and financial system are Argentina in Latin America and China in Asia.

Argentina: Despite basically sound policies, Argentina's dependence on foreign capital inflows to refinance its large external obligations (about 450% of exports) leaves it

vulnerable to the risk that market worries about its exchange rate regime become a self-fulfilling prophecy. Its external accounts have been hit by lower prices on its commodity exports and by devaluation and recession in Brazil. Private capital inflows have declined due to the global crisis, investor nervousness about the October presidential election, and concerns the peso may be overvalued. The result has been sharply higher international and domestic borrowing costs. Argentina is in a severe recession (2½-3% real GDP contraction expected this year) with rising unemployment (now 14.5%) and growing non-performing loans. Monetary policy is constrained by Argentina's currency board regime. A political-economic crisis in Argentina with its currency board could undermine confidence in Hong Kong, with potential implications throughout Asia.

China: The recent slowdown in growth and contraction of exports in China is a source of risk and increased vulnerability. Fears of rising unemployment and a looming fiscal burden from restructuring the financial system and state-owned enterprises may lead the authorities to try to restore export-led growth and devalue the renminbi. Although current account data are not available for 1999, the recorded trade surplus has basically vanished since late last year. Financial market expectations about a devaluation have recently returned to levels last seen during the global panic of August 1998. With its capital controls and large foreign exchange reserves (\$147 billion), the risk of a successful speculative attack on the renminbi is still low. However, a poorly managed devaluation, if this should be the course chosen by the Chinese authorities, could put pressures on Hong Kong's exchange rate peg and spill over to other Asian currencies and other regions and to the U.S. economy as we saw in 1997-98.

Other country risks: Other large countries with less immediate difficulties that may pose a concern are Brazil, Indonesia, Korea, Mexico, Russia, and Turkey. For example, if Korea mishandles the Daewoo restructuring, its economy could be plunged back into serious recession or crisis. Smaller financial fragile countries that have the potential to trigger a broader crisis include Colombia, Ecuador, Romania, Ukraine, and Venezuela. For example, Ecuador's failure to make its Brady bond payments later this month could trigger a flight from the debt of emerging market economies generally, even though the market should not be surprised.

In contrast to the situation over the past two years when concerns about the outlook for the U.S. economy focused primarily on contagion from the rest of the world, our vulnerability from this source appears to have declined both absolutely and relatively. Conditions abroad are mending slowly and the shocks of the past few years are probably still recent enough to keep even investors with short memories mindful of a repetition.

Y2K. The Y2K computer problem poses some limited risks from the potential malfunction of computer systems that support critical infrastructure. There is also some anticipated economic impact from hoarding behavior at the end of 1999 in anticipation of Y2K problems.

Fundamentals: The fundamental risk is of severe and long lasting economic dislocation as computer systems malfunction -- particularly in the critical infrastructure areas of finance, telecommunications, power generation, and transportation. Considerable investment has been made to avoid the fundamental problems. Most large firms and the Federal government have spent large amounts to ensure their systems are Y2K ready. Concerns remain with respect to smaller users, State governments and less-developed countries. However, their problems are unlikely to cumulate into a supply shock sufficient to cause a significant macro-economic impact on the US. Only one of 52 blue-chip forecasters currently projects negative growth for 2000.

Hoarding: A second set of economic problems could occur even if all computers perform normally, if hoarding behavior in anticipation of Y2K problems. This could lead to temporary shortages, soaring prices and long lines. In particular, this could be a problem, if at the last moment firms seek to accumulate extra inventories; households to stockpile supplies such as groceries, prescription drugs, gasoline, and currency; and financial market participants to shift towards highly liquid assets.

The inventory behavior induced by Y2K is expected to boost growth in the final quarter 1999 by $\frac{3}{4}$ percentage point, and lower it in the first quarter of 2000 by the same amount. Interest rates on assets to be held over year-end indicate a liquidity premium but the effect dissipates after a few months.

Overall Impact: Y2K is likely to be to the economy, what a sandstorm is to the desert. A highly visible nuisance for most who are caught in it, quite damaging to a few; but with an impact that is scarcely visible overall once the dust has settled. The key to containing the disruptions from anticipatory behavior is public confidence that the fundamental problems have been dealt with.

Conclusion. [Material here from some kind soul.]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Audrey Choi (CN=Audrey Choi/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-AUG-1999 16:21:19.00

SUBJECT: REQUEST FOR DOCUMENTS

TO: Leigh L. Linden (CN=Leigh L. Linden/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: John L. Goldie (CN=John L. Goldie/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: John G. Fernald (CN=John G. Fernald/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Brian A. Amorosi (CN=Brian A. Amorosi/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Francine P. Obermiller (CN=Francine P. Obermiller/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Stephen F. Lin (CN=Stephen F. Lin/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Victoria A. Greenfield (CN=Victoria A. Greenfield/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Catherine H. Furlong (CN=Catherine H. Furlong/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Michael J. Brien (CN=Michael J. Brien/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Douglas V. Almond (CN=Douglas V. Almond/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

can you please check your files for any documents as requested below? if
you do not have any documents please send me an email noting that you have
checked your files and do not have any responsive documents.

i need to send a certification to the counsel's office that every staff

person at cea has checked their files and has produced any responsive documents or has confirmed that they do not have responsive documents.
thank you.

----- Forwarded by Audrey Choi/CEA/EOP on 08/09/99 04:15 PM -----

Audrey Choi
08/06/99 10:55:36 AM
Record Type: Record

To: All CEA Users
cc:
Subject: REQUEST FOR DOCUMENTS

for those of you who have not already done so, please read the request for documents below and see whether you have any responsive documents. if you do, please bring them to me. if you do not, please send me an email confirming that you do not have any responsive documents. thank you.

----- Forwarded by Audrey Choi/CEA/EOP on 08/06/99 10:54 AM -----

PostMaster 08/06/99 08:26:57 AM

Record Type: Record

To: All EOP Users, All USTR Users
cc:
Subject: REQUEST FOR DOCUMENTS

MEMORANDUM TO: All EOP Staff

FROM: Charles F.C. Ruff Counsel to the President

SUBJECT: REQUEST FOR DOCUMENTS

Congressman Bob Barr has filed a lawsuit alleging that the White House maintains files on him in violation of the Privacy Act. To allow us to respond to these allegations, please conduct a thorough and complete search of all your records -- whether in hard copy, computer form, or any other form -- for any of the following material:

Any and all files identified as pertaining to Congressman Barr by his name or any other identifying number, symbol or other information that is particular to him, and which contains any item, collection or grouping of information about Congressman Barr. Individual documents that are not maintained in a file identifiable by Representative Barr's name or other information particular to him need not be provided. To the extent that the file is responsive, please provide a copy of the file jacket as well

as all the contents of the file.

Every employee is responsible for searching his or her own files and records to ensure a comprehensive search. Each office head or Assistant to the President must certify that his or her staff has done a complete and thorough search.

In addition, if you believe that files from your office that have been sent to the Office of Records Management may contain responsive information, please advise us so that we may ensure that all responsive documents have been located.

All materials must be provided to Shelli Peterson (OEOP Room 482) by noon on Thursday, August 12, 1999. If you have any questions, Shelli can be reached at 456-7804.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-AUG-1999 12:33:39.00

SUBJECT: final final

TO: david.wilcox@do.treas.gov (david.wilcox@do.treas.gov @ inet [UNKNOWN])
READ:UNKNOWN

TO: Jason Furman (CN=Jason Furman/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: maureen.grewe@do.treas.gov (maureen.grewe@do.treas.gov @ inet [UNKNOWN])
READ:UNKNOWN

TO: ted.truman@do.treas.gov (ted.truman@do.treas.gov @ inet [UNKNOWN])
READ:UNKNOWN

TO: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D45]ARMS22787712H.236 to ASCII,
The following is a HEX DUMP:

MEMORANDUM TO THE PRESIDENT

FROM: Lawrence Summers, Department of Treasury
Martin Baily, Council of Economic Advisers

DATE: August 10, 1999

RE: Economic Outlook

The United States has enjoyed 100 consecutive months of economic expansion and is on track to achieve the longest economic expansion in its history. Meanwhile, inflation has remained under control, unemployment is exceedingly low compared with other expansions since the early 1970s, and recent gains in productivity have been encouraging. The consensus outlook for the economy is positive. While economic growth is seen as moderating somewhat from the very rapid pace of the past few years, the consensus view is that the U.S. economy should continue to exhibit many of the positive characteristics that have been hallmarks of the expansion thus far.

Overview of Uncertainties in the Forecast

Although the consensus forecast is positive, the uncertainties surrounding the macroeconomic outlook are considerable—both on the upside and on the downside.

- New Era optimism. On the upside, many commentators have suggested that the economy may have entered a “New Era” in which unemployment can remain low, output growth can remain strong, and wage increases can remain rapid, *without* triggering the kinds of imbalances that have led to the demise of expansions in decades past. If this view is correct, there is no presumption that the current expansion will end in the way that almost all past U.S. expansions have ended, with increasing inflation leading to higher interest rates.
- An inflation shock. On the downside, some observers point to the risk that the productivity surge of the last few years may prove to be only temporary, and that some of the other factors that have helped keep inflation in check may wane or even go into reverse. The consensus forecast assumes that appropriate policy can achieve a “soft landing” in which the economy slows enough to avoid overheating while avoiding a recession. However, efforts to slow demand with higher interest rates could precipitate a recession.
- A domestic asset market shock. Although the typical end of an expansion is the result of rising inflation, some other possibilities deserve serious consideration. For example, the stock market is at a very high level, overpriced in the eyes of many

observers. A precipitous decline in asset prices would likely reduce both household and business demand—and potentially severely so. How that might play out is itself a matter of uncertainty. The experience with the stock market break in 1987 suggests that, provided the monetary response is swift and vigorous, the macroeconomic damage can be contained, and the expansion sustained. On the other hand, Japan's experience over the decade of the 1990s suggests that with the wrong or timid policies, the fallout can be protracted and painful.

- A dollar shock. The U.S. current account deficit has continued to widen, and now exceeds 3 percent of GDP. A number of commentators have raised the possibility that the U.S. dollar may come under downward pressure. Such a development could trigger other adverse events, such as an increase in inflation (because imported goods would have become more expensive), a sharp correction in our asset markets (reflecting a generalized loss of confidence on the part of foreign investors), and a marked step-down in our pace of growth.
- Contagion from the global economy. The global economy has stabilized and improved somewhat in the last six months. While this is surely a positive development on net, it is a mixed blessing, as it does imply greater global competition for capital. Moreover, it is conceivable that a financial crisis in an emerging market economy could set off another round of economic and financial contagion. Argentina and China are the most obvious “hot spots,” but there are other candidates, especially in Latin America, which is in recession.
- Y2K. A number of voices have sounded the alarm with respect to the so-called Y2K computer bug. Although great strides in preparedness have been made, a risk remains of systemic failure, possibly involving financial systems or other major elements of social and economic infrastructure.

The remainder of this memo first reviews the consensus macroeconomic outlook and then examines each of these risks in greater detail.

The Consensus Macroeconomic Outlook

The following table presents recent history and the Administration, CBO, and Blue Chip consensus economic forecasts for key macroeconomic variables:

Economic Projections: A Comparison

	1998	1999	2000
Real GDP growth (Q4/Q4 percent)	4.3		
Administration		3.2	2.1
CBO		3.6	2.1
Blue Chip		3.3	2.5
Unemployment (percent)	4.5		
Administration		4.3	4.5
CBO		4.2	4.3
Blue Chip		4.3	4.4
CPI inflation (Q4/Q4 percent)	1.5		
Administration		2.4	2.4
CBO		2.5	2.4
Blue Chip		2.3	2.3
Current account def. (\$bil current)	221		
Administration		326	376
Consensus Economics		298	314
Capacity Utilization (percent)	81.8	80.3 (June)	

Like the Blue Chip forecasters, the Administration expects growth of real GDP to continue slowing toward a more sustainable pace—both we and the Blue Chip are anticipating a soft landing. The consensus forecast is that GDP growth will gradually return toward its longer-run historical trend, rather than remaining at the high rate of the last 3½ years. In the Administration forecast, the unemployment rate is expected to rise from its current 4.3 percent to 5.2 percent (the center of the estimated range for the NAIRU). The Blue Chip consensus shows a similar rise.

A major uncertainty in the forecast is whether the current expansion will continue to exhibit the characteristics that have distinguished it from previous long expansions:

- Productivity has picked up rather than slowed as the expansion has matured.

- Inflation and interest rates have generally declined rather than risen.
- Investment has been historically strong and industrial capacity has expanded accordingly.
- The stance of fiscal policy has shifted from seemingly interminable deficits to the prospect of an era of surpluses.
- The current account has widened despite an improving trend in national saving, as the demand for investment has outstripped our ability to finance it from domestic saving.
- Interest rates have been rising in recent months. Since April, the rate on ten-year Treasury bonds has risen by 0.8 percentage point. Spreads of private sector interest rates over Treasury rates have risen as well, so rates paid by corporate borrowers and homeowners have risen by even more. Mortgage rates, for example, have risen by a percentage point. The widening of spreads seems to be demand driven insofar as new issues of corporate bonds have been rising at the same time that spreads have widened. In contrast, when spreads widened last fall, a flight to quality led to a contraction of credit supply in capital markets, the new issues market dried up, and financial markets were destabilized.

One way to frame the issue of the macroeconomic outlook, therefore, is to ask whether these favorable elements can be sustained

A New Era or the Old Trade-offs?

The view that the economy has entered a New Era assumes that many of these favorable elements are now permanent features of the economy. The contrary view is that they mainly reflect special factors that will be reversed. Two critical relationships illustrate the debate.

- The NAIRU. Not so many years ago, the consensus view was that the economy risked rising inflation once the unemployment rate dropped below 6 percent, or even 6.5 percent in some economic models. However, the unemployment rate has been below 6 percent for the past 59 months, and at or below 5 percent for the past 28 months. Although wage inflation has picked up in the past few years, the rise has been far less than one would have predicted based on a NAIRU of 6 percent. To the extent that increased international and domestic competition have created a new environment in which businesses find it hard to raise prices, productivity is growing rapidly, and investment is expanding capacity at a rapid rate, it may continue to be possible to avoid inflation even with a tight labor market and rising wages. In part, however, the favorable inflation situation of the past few years reflects some transitory factors – including falling prices for imports, and moderate prices for energy goods – that either have already reversed (as in the case of energy) or could plausibly do so in the near future (as in the case of import prices).

- Trend productivity growth. The sustainable rate of economic growth is determined by the rate of growth of the labor force (about 1.2 percent) and the rate of growth of productivity. Over the past three years, productivity growth has been substantially higher than its longer-term trend of about 1.3 percent per year. A centerpiece of New Era thinking is a belief that information technology and other developments have allowed for substantially faster sustained productivity growth. The contrary view – particularly in the context of a strong cyclical expansion – is that it is premature to conclude from a short period of strong productivity growth that trends that have been evident since the early 1970s have been sharply reversed.

Alan Greenspan is among those who believe that information technology has contributed to faster productivity growth. He points out that “the accessibility of up-to-date information offered by information technology has allowed substantial improvements in corporate efficiency. Production planning is made easier; inventories can be reduced; delivery lead-times fall; the nature of distribution is altered. All of these factors increase the flexibility of capital goods, making capital investment more attractive and productive than it used to be, and encouraging firms to substitute capital for (scarce) labor.”

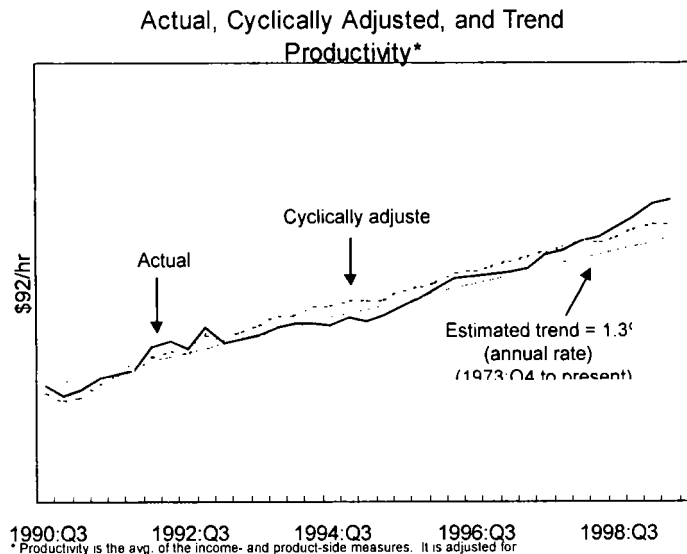
An extensive study by a U.S. consulting firm looked at the current and potential future effect of the electronics revolution on productivity. They examined a variety of companies in different industries, recording how workers spend their time. They concluded that in U.S. companies, workers spend 51 percent of their time on “interactions,” such as communication, data gathering and collaborative problem-solving. Improvements in communications technologies, such as the Internet, are now allowing reductions in the labor required for such interactions and these gains are expected to continue even more rapidly in the future. Business economist Eric Brynjolfsson of the Sloan School at MIT has estimated that computer capital has a larger impact on productivity than other kinds of capital.

A principal critic of the new economy view is economist Robert Gordon. He notes that the price of a computer of a given quality has recently been declining at an increasing rate (or equivalently, that every dollar spent buys a rapidly rising quality of computer). This leads to large and increasing estimates of productivity growth within the manufacturing sector that produces computers. Gordon then tries to separate computer production from the rest of the economy. And when he does so, he finds that virtually all of the acceleration of productivity growth in the nonfarm business sector is coming from the computer-producing part and almost none from the rest of the economy. We are fantastic at making computers, he concludes, but have not discovered how to use computers to make the rest of the economy more productive.

Gordon’s conclusion is hard to believe given extensive case study evidence of businesses using new technologies to improve their operations. Other economists question his method of separating out computer production from the rest of the economy. But the fact remains that there is great uncertainty around estimates of future productivity growth. Chart 1 shows that labor productivity has only very recently moved above the level that

would be expected, given the strong cyclical recovery. This is why the Administration forecast is conservative in the assumed rate of productivity growth that feeds into our budget estimates.

Chart 1



The Stock Market and Its Consequences for the Economy

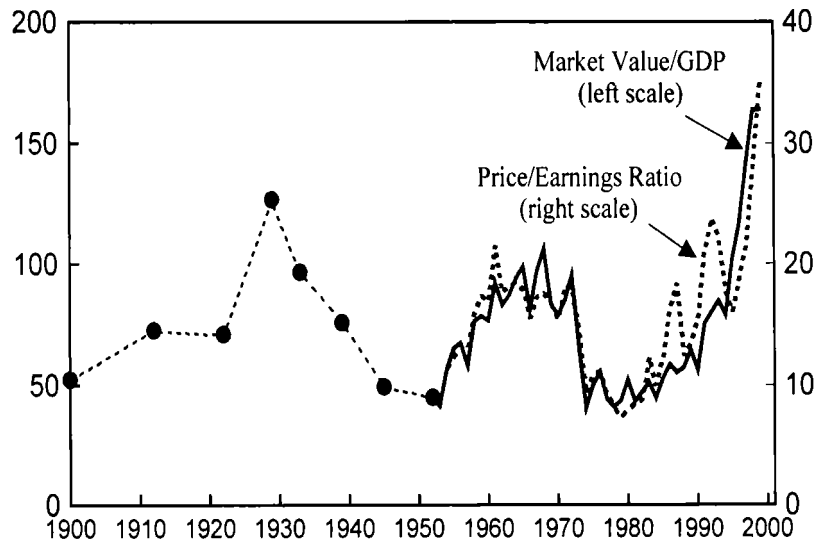
The stock market has appreciated spectacularly over the past five years, accompanied by a dramatic rise in the market value of young, high-tech companies that employ significantly fewer people than traditional industrial blue chips. While profit growth has been strong, price-earnings ratios and other traditional indicators of valuation are at record levels. Accordingly, the issue of whether the market is “overvalued” has been hotly debated in recent months.

Those who are concerned about the current valuations in the stock market point to evidence of the following type:

- The market value of equities increased from 77 percent of GDP at the end of 1994 to 164 percent of GDP in the first quarter of this year, a value that is well above the previous peaks of 127 percent reached in 1929 and 106 percent reached in 1968 (Chart 2 on next page).

Chart 2

Market Value of Domestic Corporations and Price/Earnings Ratios



Note: 1999 values are for the first quarter.

- Similarly, despite strong growth in corporate earnings, the ratio of price to earnings for the 500 largest companies in the stock market has more than doubled, rising from 15 at the end of 1994 to 33 in the first quarter of this year.
- Some private analysts express fears that the United States is currently facing an asset price “bubble” in which asset prices are bid to unrealistic levels, threatening economic stability. They argue that the current combination of low inflation and strong economic growth has been associated with what they view as previous bubble episodes. Investors (and perhaps even policy makers) can get seduced into believing in “new paradigms.” When an overheated economy and a rekindling of inflationary pressures that had been hidden by unusual factors results in rising interest rates, the economy slows and asset prices fall sharply, slowing the economy even more. Slower growth reveals the new paradigm (or new era) optimism to be misplaced.
- Others who fear that a speculative bubble is emerging in the stock market point to more popular indicators like the rise of day trading and the enormous value placed on some Internet startups that have yet to turn a profit.

On the other hand, those who are relatively sanguine about the current state of the market point to the following:

- The economy remains strong and private forecasters have increased their projected growth rates for GDP and corporate profits since the beginning of the year. Prospects

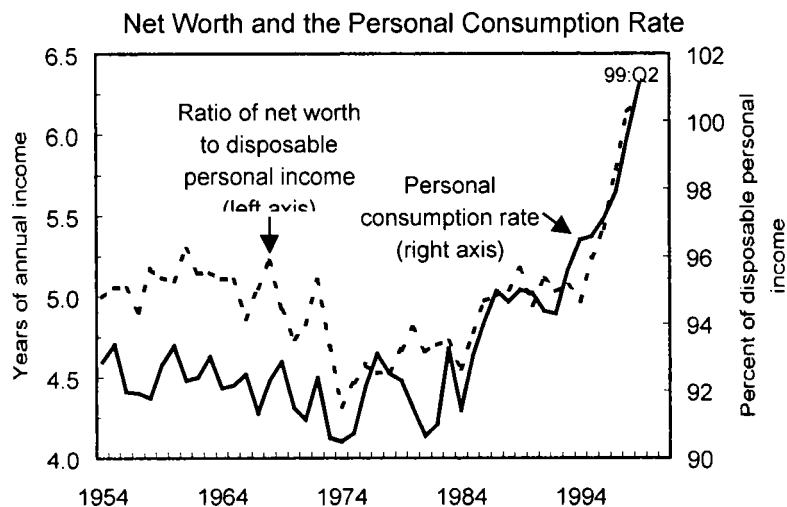
for some industries that suffered from the impact of a sluggish world economy last year have improved and several key sectors are viewed as generating impressive results this year. At the same time, views on inflation remain sanguine.

- Not all stocks are going to the sky. On the contrary, a large fraction of the growth in the market's value can be attributed to a small set of companies, most of whom are engaged in some form of high-tech activity. Meanwhile, valuations for many traditional companies remain tame by historical standards. This suggests that the market retains its ability to discriminate among stocks, rewarding those companies that are on the cutting edge of innovation.
- It is possible (with some stretching) to justify current market values, by combining relatively optimistic assumptions about future profit growth, interest rates, and the premium that investors demand for bearing the risks inherent in holding stocks. For example, if the rapid rates of productivity growth experienced since 1995 were to continue unabated and feed continued rapid earnings growth; if long-term interest rates were to return to the lower levels seen earlier this year; and if the premium for bearing stock market risk were to descend to levels that are quite low by historical standards, then the current level of the market could be "justified."

The main macroeconomic risk posed by an overvalued stock market is the prospect of a market reversal, which would reduce aggregate demand. Recent stock gains have boosted consumption.

- A decline in stock values would reduce the net worth of consumers and lead to a decline in consumer spending, reversing the consumption increases that have accompanied the run-up in wealth (Chart 3).

Chart 3



- It also would increase businesses' cost of raising equity capital and thereby reduce investment spending.
- Although banks are currently well capitalized, a recession might lower the quality of banks' loan portfolios.
- The appropriate antidote to a development of this type is a dose of lower interest rates. This type of action proved quite successful in 1987, when the Fed moved promptly and vigorously to reassure markets in the wake of the October crash.

A more remote – but nonetheless real – risk is that the financial system simply seizes up and ceases to function in the wake of a stock market crash.

- Stock market losses could lead to actual or threatened bankruptcies, particularly among highly leveraged institutions with large derivatives positions, and spread beyond the stock market.
- Concerns about counterparty risk might then cause the clearance and payments systems that are crucial to well-functioning securities markets to freeze.
- Significant steps have been taken to reduce this risk following what some view as a near miss during the 1987 stock market crash, but some risk remains.
- The traditional tools of monetary policy may not be sufficient to prevent a seizing up of markets in the face of widespread panic.

The risk posed by the stock market is compounded by international considerations. A substantial weakening in asset markets here could shake the confidence of foreign investors, thereby causing a substantial drying up of the supply of foreign capital and a free fall of the dollar. This would pose a dilemma for the Federal Reserve, which would be caught between conflicting needs to cushion a recession and contain rising inflation. The implications of such a scenario are potentially more severe than they otherwise would be in light of the fact that we are presently running a large current-account deficit—a topic to which we now turn.

The Current Account Deficit and the Dollar

The current account deficit—already large last year (Chart 4 on next page)—is forecast to widen further in 1999 and beyond.

- The widening of the deficit has been exacerbated by temporary factors: the Asian crisis and the faster relative growth of the U.S. economy compared with the rest of the world, as well as the appreciation of the dollar since 1995 (Chart 5 on next page).

Chart 4

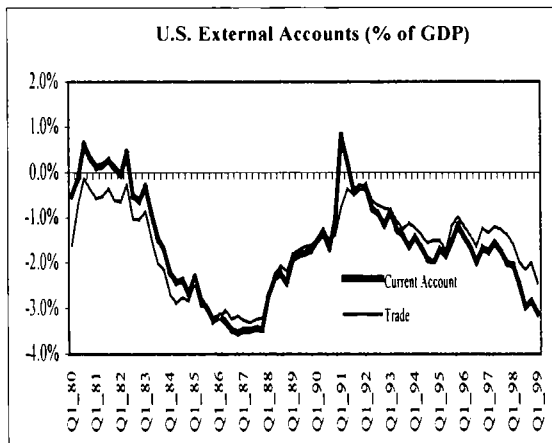
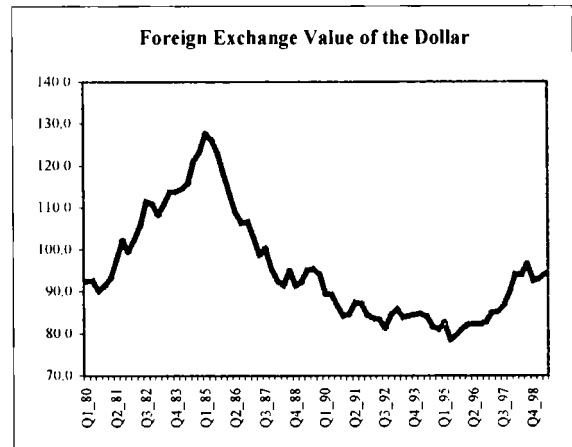


Chart 5



Federal Reserve Board Real Exchange Rate Index

- As the dollar's strength shows, foreigners have been more than willing to finance our external deficits of recent years. The relative attractiveness of U.S. investments and the performance of the U.S. economy have pulled in foreign capital.
- The U.S. current account deficit is not likely to be sustainable indefinitely at recent growth rates in the United States and abroad and unchanged exchange rates. Based on standard forecasting models, the deficit would continue to widen as a percent of GDP.
- Foreign investors have built up large net (\$1.5 trillion) and gross (\$7.5 trillion) claims on the United States. Sooner or later they may become less willing to hold an ever increasing share of their wealth in claims on the United States, especially as an upturn in foreign growth provides more competition for investment in U.S. assets.

Repeat of the 1980s? A continuing widening of the deficit could place the dollar under significant downward pressure over the next year as happened in the 1980s, despite differences between now and then:

- U.S. deficits in the 1980s were driven by a fall in national saving associated with large fiscal deficits. Since 1992, our national saving rate has been rising, and our external deficits have been associated with the more rapid rise in investment.
- The dollar has appreciated on average in real (price-adjusted) terms since 1995, but the appreciation has been substantially less than in the mid-1980s.
- Although the United States has become a net international debtor, with net income payments now contributing to our current account deficit (as a percent of GDP), our trade deficit has not yet reached the low point (as a percent of GDP) of 1987.

Hard Landing? The external adjustment process in the late 1980s was difficult, but it was not a “hard landing” involving a deep sustained recession and substantially higher inflation.

- The difficulties associated with any prospective adjustment in our external accounts would depend in large part on how it was triggered and what other developments accompanied it, and on policy responses here and abroad.
- Standard macroeconomic models suggest that, under plausible assumptions about policy responses in the United States and abroad, an abrupt 25 percent decline in the dollar, if it occurred smoothly, which would be unlikely, would raise U.S. growth by about 1 percent over the first 1-2 years and eventually reduce the current account deficit by half or two thirds, but it would also boost U.S. inflation by as much as 2 percent.

The adjustment process in the new millennium may well not be benign:

- The U.S. adjustment process could be triggered or exacerbated by (or could itself trigger) a sharp correction in U.S. asset markets.
- Policy responses in the rest of the world may fail to offset the contractionary effects of the U.S. adjustment on their own growth from reduced exports to and increased imports from the United States.
- The result could be a U.S. recession, an intensified flight from dollar-denominated assets, further downward pressure on the dollar, and a large increase in inflation.

This potential vicious cycle of sudden and excessive asset price deflation followed by an economic downturn in the United States and abroad is the main source of risk from our growing trade and current account deficit and a possible sharp dollar decline.

The likelihood of a “hard landing” scenario is not large, and careful management can help reduce the risk. Maintaining our strong-dollar policy will help sustain confidence in our assets and markets. Policies to enhance our national saving, like continued budget surpluses, will help cushion the economy against a potential slowdown of inflows of foreign savings. Faster growth abroad should on balance ease our adjustment process as would broad-based trade liberalization and avoidance of protectionist pressures.

Contagion From the Global Economy

The outlook for the global economy has brightened a bit since late last year (see table).

- The mood surrounding prospects in Japan and Europe has improved somewhat.

- Economic activity is recovering in the affected countries in Asia. Although Latin America is in recession, there too the outlook has brightened somewhat recently.
- External investors have substantially reduced their exposure to emerging market economies as these economies have moved toward external surpluses, and borrowing spreads for emerging market economies are lower than last fall, though still wide.

Evolution of Consensus Forecasts of World Economic Growth					
	1999 Forecasts			2000 Forecasts	
Date of Forecast	Dec 1998	Mar 1999	Jul 1999	Mar 1999	Jul 1999
Euro-11	2.3%	2.1%	2.0%	2.6%	2.6%
Japan	-0.6%	-0.9%	0.1%	0.2%	-0.2%
Asia ex Japan	2.7%	3.3%	4.7%	4.8%	5.3%
Latin America	0.5%	-1.2%	-0.5%	3.1%	3.5%

Japan: The economy may finally have stopped deteriorating, though we have seen false bottoms before. Market sentiment has turned with a 24 percent rise in the Nikkei stock index since the beginning of 1999 and an astonishing 7.9 percent annual rate of growth recorded in the first quarter. But record 4.9 percent unemployment, declining incomes and decreased household spending, and continuing corporate restructuring suggest further pressure on jobs and incomes. Japan's banking sector may have stabilized, following the recapitalization of leading banks, but more progress is needed in disposal of bad assets. Continued government facilitation of economic and financial restructuring along with supportive macro policies are critical to achieve a lasting recovery.

Europe: Although the macroeconomy may be poised for an upturn, the strength of any rebound is uncertain and likely to be export-led, given the euro's depreciation over the first half of the year. Unemployment still remains stubbornly in double digits, underscoring the need for fundamental structural reforms if European growth is to return output to potential, to say nothing of cutting into high unemployment rates.

This somewhat improved outlook for the industrial countries is, on balance, good for the U.S. and global economy though, as noted above, it is a mixed blessing because of the increased competition from more attractive investment opportunities abroad.

The two emerging market economies that at this point appear to pose the greatest risk to the U.S. and the global economy and financial system are Argentina and China.

Argentina: Despite basically sound policies, Argentina's dependence on foreign capital inflows to refinance its large external obligations (about 450 percent of exports) leaves it vulnerable to the risk that market worries about its exchange rate regime become a self-fulfilling prophecy. Its external accounts have been hit by lower prices of its commodity exports and by devaluation and recession in Brazil. Private capital inflows have declined due to the global crisis, investor nervousness about the October presidential election, and

concerns the peso may be overvalued. The result has been sharply higher international and domestic borrowing costs. Argentina is in a severe recession (2½-3 percent real GDP contraction expected this year) with rising unemployment (now 14.5 percent) and growing non-performing loans. Monetary policy is constrained by Argentina's currency board regime. A political-economic crisis in Argentina with its currency board could undermine confidence in Hong Kong, with potential implications throughout Asia.

China: The recent slowdown in growth and contraction of exports in China is a source of risk and increased vulnerability. Fears of rising unemployment and a looming fiscal burden from restructuring the financial system and state-owned enterprises may lead the authorities to try to restore export-led growth and devalue the renminbi. Although current account data are not available for 1999, the recorded trade surplus has basically vanished since late last year. Financial market expectations about a devaluation have recently returned to levels last seen during the global panic of August 1998. With its capital controls and large foreign exchange reserves (\$147 billion), the risk of a successful speculative attack on the renminbi is still low. However, a poorly managed devaluation, if this should be the course chosen by the Chinese authorities, could put pressures on Hong Kong's exchange rate peg and spill over to other Asian currencies and other regions and to the U.S. economy as we saw in 1997-98.

Other country risks: Other large countries with less immediate difficulties that may pose a concern are Brazil, Indonesia, Korea, Mexico, Russia, and Turkey. For example, if Korea mishandles the Daewoo restructuring, its economy could be plunged back into serious recession or crisis. Smaller financially fragile countries that have the potential to trigger a broader crisis include Colombia, Ecuador, Romania, Ukraine, and Venezuela. For example, Ecuador's failure to make its Brady bond payments later this month could trigger a flight from the debt of emerging market economies generally, even though the market should not be surprised.

In contrast to the situation over the past two years when concerns about the outlook for the U.S. economy focused primarily on contagion from the rest of the world, our vulnerability from this source appears to have declined both absolutely and relatively. Conditions abroad are mending slowly and the shocks of the past few years are probably still recent enough to keep even investors with short memories mindful of a repetition.

The Y2K Problem

The Y2K computer problem poses some limited risks from the potential malfunction of computer systems that support critical infrastructure. There is also some anticipated economic impact from hoarding behavior at the end of 1999 in anticipation of Y2K problems.

- Fundamentals. The fundamental risk is of severe and long lasting economic dislocation as computer systems malfunction—particularly in the critical infrastructure areas of finance, telecommunications, power generation, and

transportation. Considerable investment has been made to avoid the fundamental problems that would occur with a system-wide failure. Most large firms and the Federal government have spent large amounts to ensure their systems are Y2K ready. Concerns remain with respect to smaller users, State governments and less-developed countries. Because of the extensive preparation that has taken place, problems among the small users are unlikely to cumulate into a supply shock sufficient to cause a significant macroeconomic impact on the United States. Only one of 52 blue-chip forecasters currently projects negative growth for 2000.

- Hoarding. A second set of economic problems could occur even if all computers perform normally, if there is hoarding behavior in anticipation of Y2K problems. This could lead to temporary shortages, soaring prices, and long lines. In particular, this could be a problem if at the last moment firms seek to accumulate extra inventories; households seek to stockpile supplies such as groceries, prescription drugs, gasoline, and currency; and financial market participants seek to shift their portfolios toward highly liquid assets.

Again, many institutions are taking steps to provision for such hoarding. For example, the Federal Reserve plans to boost its currency holdings from \$100 billion to \$300 billion, about \$2,000 of additional cash per U.S. household.

The inventory behavior induced by Y2K is expected to boost growth in the final quarter 1999 by $\frac{3}{4}$ percentage point, and lower it in the first quarter of 2000 by the same amount. Interest rates on assets to be held over year-end indicate a liquidity premium but the effect dissipates after a few months.

A small aggregate impact. Y2K is likely to be to the economy, what a sandstorm is to the desert: a highly visible nuisance for most who are caught in it, quite damaging to a few; but with an impact that is scarcely visible overall once the dust has settled. The key to containing the disruptions from anticipatory behavior is public confidence that the fundamental problems have been dealt with.

Conclusion

History suggests that in any year, regardless of how long an expansion has run, the chances that it will end are generally about one in four. In the postwar period, for the United States, these terminations have resulted from Federal Reserve responses to inflation. The lack of inflationary pressures currently, and the belief that, if any were to arise, they would be effectively nipped in the bud, provides consensus forecasters with the confidence to project sustained economic growth, at a rate of 2.6 percent in 2000.

But the consensus forecast could be wrong. The recent surge in productivity performance provides plausibility to the view that the benefits of the revolution in information technology are finally coming to fruition. While there is much talk of a new economy, if the United States could simply return to the old economy, which achieved a 2 percent rate

of productivity growth over the century prior to 1973, then over the next five years growth could average over three percent annually. The consensus forecasts could prove to be just another example of the dismal science.

There are, however, a variety of risks facing the economy that could pose some painful choices. There have been other periods in history such as the late 1920s in the United States and the late 1980s in Japan, in which apparent prosperity proved to be ephemeral as the collapse of asset market bubbles wreaked financial and economic havoc. Currently, therefore it is prudent to attach concern to the risks we face from an outburst of inflation and both internal and external financial market instability.

However, each of these risks is better faced with a strong fiscal position. Less stimulus would reduce inflation. More national saving allows us to finance domestic investment with less foreign borrowing and lower interest rates, reducing the probability of financial distress at home and abroad.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: John L. Goldie (CN=John L. Goldie/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-AUG-1999 14:48:58.00

SUBJECT: IRUPs

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

CC: Yu-Chin Chen (CN=Yu-Chin Chen/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

CC: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

Here are some potential IRUP topics for this week:

1) OECD Review of Regulatory Reform in Mexico. Report highlights the fact that regulatory reforms have already produced major benefits in terms of lower prices and increased quality and choice for Mexican consumers and businesses. Chronicles transformation of Mexican economy from a closed, inward-looking economy to an open, market-based model. Notes that further reform is needed in some some sectors (telecommunications), and that regulatory weaknesses in some sectors need to be corrected in order to encourage effective competition.

2) OECD Health Data 1999- comparison of 29 countries. Reports some new statistics comparing health care sectors in OECD countries. U.S. has highest average health spending as a proportion of GDP, and outspends other OECD countries on average per capita basis by 2.5 to 1. Premature mortality has fallen over past 3 decades, although there are still considerable differences across OECD countries.

3) Y2K Glitch Could Affect Commodities - World Bank Report. Y2K tech problems are expected to lead to increased demand as consumers stockpile essential commodities. Supplies of most commodities are adequate to accomodate such increases, but crude oil supplies are tight and prices could rise on Y2K fears.

4) Japan Ministry of Labor said last week that it was considering revisions from October to labor policies that would end support for industries where there was little chance of recovery or profitability. Would be the first significant curtailment of labor benefits to industry. Sectors that could be affected include textiles, fibres, rubber manufacturing. May be difficult to find official source for this one.

5) UK institutes stricter penalties for companies caught fixing prices in defiance of new competition act. Fines will now be up to 30% of turnover. According to FT, this is "biggest shake up in competition law for 25 years."

6) Singapore upgrades full-year growth forecasts. Singapore reported that its economic growth jumped from .6% to 6.7% in the second quarter, leading it to upgrade its full-year growth forecast to 4-5% from 0-2% previously.

7) Chile's consumer confidence is at one of its lowest points this decade, according to figures released by Chilean Central Bank. Imports of capital goods have fallen 36%, while imports of consumer goods fell 32%.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jason Furman (CN=Jason Furman/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME:10-AUG-1999 01:19:23.00

SUBJECT: Latest version of the memo

TO: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: david.wilcox@do.treas.gov (david.wilcox@do.treas.gov [UNKNOWN])
READ:UNKNOWN

TO: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: maureen.grewe@do.treas.gov (maureen.grewe@do.treas.gov [UNKNOWN])
READ:UNKNOWN

TO: ted.truman@do.treas.gov (ted.truman@do.treas.gov [UNKNOWN])
READ:UNKNOWN

CC: Melissa G. Green (CN=Melissa G. Green/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

TEXT:

The attached is the latest version of the memo. It has changes from Truman/Summers, Braun, and myself. Most of these were cosmetic or, in a few cases, some wordsmithing. The memo needs to get into the President by 1:30 pm (apologies to Treasury folks if you thought the deadline was at midnight). I think it is vastly improved from the first, second, and third drafts and the main work that needs to be done is standardizing the appearance of the charts.

I am now giving up the electronic pen. I think it makes most sense to return it to CEA, but if this does not work you can all arrange otherwise..

Jason===== ATTACHMENT 1 =====
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D52]ARMS25608122J.236 to ASCII,
The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

MEMORANDUM TO THE PRESIDENT

FROM: Lawrence Summers, Department of Treasury
Martin Baily, Council of Economic Advisers

DATE: August 10, 1999

RE: Economic Outlook

The United States has enjoyed 99 consecutive months of economic expansion and is on track to achieve the longest economic expansion in its history. Meanwhile, inflation has remained under control, unemployment is exceedingly low compared with other expansions since the early 1970s, and recent gains in productivity have been encouraging. The consensus outlook for the economy is positive. While economic growth is seen as moderating somewhat from the very rapid pace of the past few years, the consensus view is that the U.S. economy should continue to exhibit many of the positive characteristics that have been hallmarks of the expansion thus far.

Overview of Uncertainties in the Forecast

Although the consensus forecast is positive, the uncertainties surrounding the macroeconomic outlook are considerable—both on the upside and on the downside.

- New Era optimism. On the upside, many commentators have suggested that the economy may have entered a “New Era” in which unemployment can remain low, output growth can remain strong, and wage increases can remain rapid, *without* triggering the kinds of imbalances that have led to the demise of expansions in decades past. If this view is correct, there is no presumption that the current expansion will end in the way that almost all past U.S. expansions have ended, with increasing inflation leading to higher interest rates.
- An inflation shock. On the downside, some observers point to the risk that the productivity surge of the last few years may prove to be only temporary, and that some of the other factors that have helped keep inflation in check may wane or even go into reverse. The consensus forecast assumes that appropriate policy can achieve a “soft landing” in which the economy slows enough to avoid overheating while avoiding a recession. However, efforts to slow demand with higher interest rates could precipitate a recession.
- A domestic asset market shock. Although the typical end of an expansion is the result of rising inflation, some other possibilities deserve serious consideration. For example, the stock market is at a very high level, overpriced in the eyes of many

observers. A precipitous decline in asset prices would likely reduce both household and business demand—and potentially severely so. How that might play out is itself a matter of uncertainty. The experience with the stock market break in 1987 suggests that, provided the monetary response is swift and vigorous, the macroeconomic damage can be contained, and the expansion sustained. On the other hand, Japan's experience over the decade of the 1990s suggests that with the wrong or timid policies, the fallout can be protracted and painful.

- A dollar shock. The U.S. current account deficit has continued to widen, and now is approaching 4 percent of GDP. A number of commentators have raised the possibility that the U.S. dollar may come under downward pressure. Such a development could trigger other adverse events, such as an increase in inflation (because imported goods would have become more expensive), a sharp correction in our asset markets (reflecting a generalized loss of confidence on the part of foreign investors), and a marked step-down in our pace of growth.
- Contagion from the global economy. The global economy has stabilized and improved somewhat in the last six months. While this is surely a positive development on net, it is not an unmixed blessing, as it does imply greater global competition for capital. Moreover, it is conceivable that a financial crisis in an emerging market economy could set off another round of economic and financial contagion. Argentina and China are the most obvious “hot spots,” but there are other candidates, especially in Latin America which, as you know, is in recession.
- Y2K. A number of voices have sounded the alarm with respect to the so-called Y2K computer bug. Although great strides in preparedness have been made, a risk remains of systemic failure, possibly involving financial systems or other major elements of social and economic infrastructure.

The remainder of this memo first reviews the consensus macroeconomic outlook and then examines each of these risks in greater detail.

The Consensus Macroeconomic Outlook

The following table presents recent history and the Administration, CBO, and Blue Chip consensus economic forecasts for key macroeconomic variables:

Economic Projections: A Comparison

	1998	1999	2000
Real GDP growth (Q4/Q4 %)	4.3		
Administration		3.2	2.1
CBO		3.6	2.1
Blue Chip		3.3	2.5
Unemployment (percent)	4.5		
Administration		4.3	4.5
CBO		4.2	4.3
Blue Chip		4.3	4.4
CPI inflation (Q4/Q4% percent)	1.5		
Administration		2.4	2.4
CBO		2.5	2.4
Blue Chip		2.3	2.3
Current account def. (\$bil current	221		
Administration		326	376
Consensus Economics		298	314
Capacity Utilization (percent)	81.8		

Like the Blue Chip forecasters, the Administration expects growth of real GDP to continue slowing toward a more sustainable pace—both we and the Blue Chip are anticipating a soft landing. The consensus forecast is that GDP growth will gradually return to its longer-run historical trend, rather than remaining at the high rate of the last 3½ years. The unemployment rate is expected to rise from its current 4.3 percent to 5.2 percent (the center of the estimated range for the NAIRU).

A major uncertainty in the forecast is whether the current expansion will continue to exhibit a number of characteristics that have distinguished it from previous long expansions:

- Productivity has picked up rather than slowed as the expansion has matured.

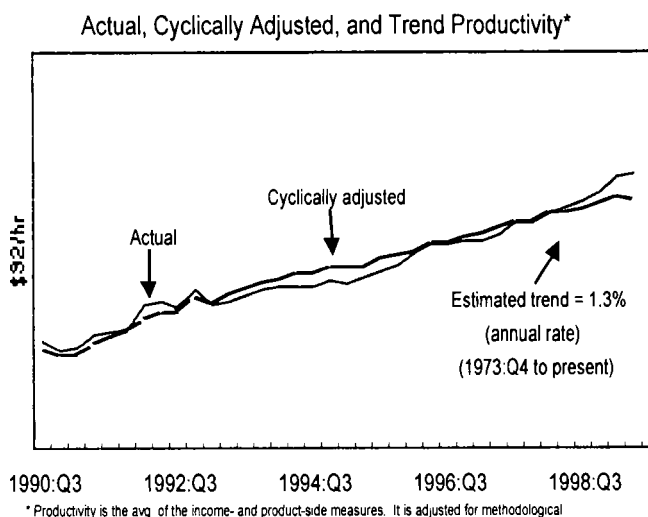
- Inflation and interest rates have declined rather than risen.
- Investment has been historically strong and industrial capacity has expanded accordingly.
- The stance of fiscal policy has shifted from seemingly terminal deficits to the prospect of an era of surpluses.
- The current account has widened despite an improving trend in national saving, as the demand for investment has outstripped our ability to finance it from domestic savings.
- Interest rates have been rising in recent months. Since the end of April, the rate on ten-year Treasury bonds has risen by about 0.50 percentage point. Spreads of private sector interest rates over Treasury rates have risen as well, so rates paid by corporate borrowers and homeowners have risen by even more. Mortgage rates, for example, have risen by 0.90 percentage point. The widening of spreads seems to be demand driven insofar as new issues of corporate bonds have been rising at the same time that spreads have widened. In contrast, when spreads widened last fall, a flight to quality led to a contraction of credit supply in capital markets, the new issues market dried up, and financial markets were destabilized.

One way to frame the issue of the macroeconomic outlook, therefore, is to ask whether these favorable elements can be sustained

A New Era or the Old Trade-offs?

The view that the economy has entered a New Era assumes that many of these favorable elements are now permanent features of the economy. The contrary view is that they mainly reflect special factors that will be reversed. Two critical relationships illustrate the debate.

- The NAIRU. Not so many years ago, the consensus view was that the economy risked rising inflation once the unemployment rate dropped below 6 percent, or even 6.5 percent in some economic models. However, the unemployment rate has been below 6 percent for the past 59 months, and at or below 5 percent for the past 28 months. Although wage inflation has picked up in the past few years, the rise has been far less than one would have predicted based on a NAIRU of 6 percent. To the extent that increased international and domestic competition have created a new environment in which businesses find it hard to raise prices, productivity is growing rapidly, and investment is expanding capacity at a rapid rate, it may be possible to avoid inflation even with a tight labor market and rising wages. In part, however, the favorable inflation situation reflects some transitory factors – including falling prices for imports, and moderate prices for energy goods – that either have already reversed (as in the case of energy) or could plausibly do so in the near future (as in the case of import prices).
- Trend productivity growth. The sustainable rate of economic growth is determined by the rate of growth of the labor force (about 1.2 percent) and the rate of growth of productivity. Over the past three years, productivity growth has been substantially higher than its longer-term trend of about 1.3 percent per year. A centerpiece of New Era thinking is a belief that information technology and other developments have allowed for substantially faster sustained productivity growth. The contrary view – particularly in the context of a strong cyclical expansion – is that it is premature to conclude from a short period of strong productivity growth that trends that have been evident since the early 1970s have been sharply reversed.



According to the *Economist* (July 24), Alan Greenspan is among those who believe that information technology has contributed to faster productivity growth. He points out that “the accessibility of up-to-date information offered by information technology has allowed substantial improvements in corporate efficiency. Production planning is made easier; inventories can be reduced;

delivery lead-times fall; the nature of distribution is altered. All of these factors increase the flexibility of capital goods, making capital investment more attractive and productive than it used to be, and encouraging firms to substitute capital for (scarce) labor.”

An extensive study by a U.S. consulting firm looked at the current and potential future effect of the electronics revolution on productivity. They examined a variety of companies in different industries, recording how workers spend their time. They concluded that in U.S. companies, workers spend 51 percent of their time on “interactions,” such as communication, data gathering and collaborative problem-solving. Improvements in communications technologies, such as the Internet, are now allowing reductions in the labor required for such interactions and these gains are expected to continue even more rapidly in the future. Business economist Eric Brynjolfsson of the Sloan School at MIT has estimated that computer capital has a larger impact on productivity than other kinds of capital.

A principal critic of the new economy view is economist Robert Gordon. He notes that the price of a computer of a given quality has recently been declining at an increasing rate (or equivalently, that every dollar spent buys a rapidly rising quality of computer). This leads to large and increasing estimates of productivity growth within the manufacturing sector that produces computers. Gordon then tries to separate computer production from the rest of the economy. And when he does so, he finds that virtually all of the acceleration of productivity growth in the nonfarm business sector is coming from the computer-producing part and almost none from the rest of the economy. We are fantastic at making computers, he concludes, but have not discovered how to use computers to make the rest of the economy more productive.

Gordon’s conclusion is hard to believe given extensive case study evidence of businesses using new technologies to improve their operations. Other economists question his method of separating out computer production from the rest of the economy. But the fact remains that there is great uncertainty around estimates of future productivity growth. Chart x shows that labor productivity has only very recently moved above the level that would be expected, given the strong cyclical recovery. This is why the Administration forecast is conservative in the assumed rate of productivity growth that feeds into our budget estimates.

The Stock Market and Its Consequences for the Economy

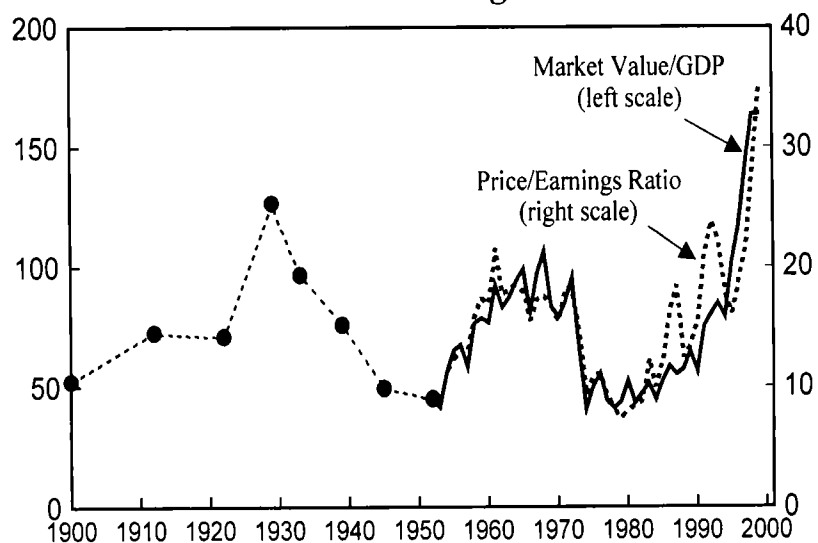
The stock market has appreciated spectacularly over the past five years, accompanied by a dramatic rise in the market value of young, high-tech companies that employ significantly fewer people than traditional industrial blue chips. While profit growth has been strong, price-earnings ratios and other traditional indicators of valuation are at record levels. Accordingly, the issue of whether the market is “overvalued” has been hotly debated in recent months.

Those who are concerned about the current valuations in the stock market point to evidence of the following type:

- The market value of equities increased from 77 percent of GDP at the end of 1994 to 164 percent of GDP in the first quarter of this year, a value that is well above the previous peaks 127 percent reached in 1929 and 106 percent reached in 1968.

- Similarly, despite strong growth in corporate earnings, the ratio of price to earnings for the 500 largest companies in the stock market has more than doubled, rising from 15 at the end of 1994 to 35.2 in the first quarter of this year.

**Market Value of Domestic Corporations
and Price/Earnings Ratios**



Note: 1999 values are for the first quarter.

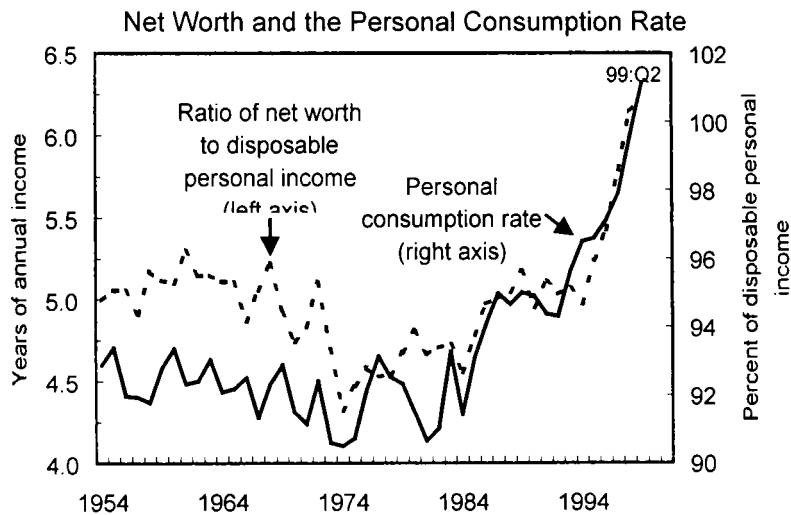
- Some private analysts express fears that the United States is currently facing an asset price “bubble” in which asset prices are bid to unrealistic levels, threatening economic stability. They argue that the current combination of low inflation and strong economic growth has been associated with what they view as previous bubble episodes. Investors (and perhaps even policy makers) can get seduced into believing in “new paradigms.” When an overheated economy and a rekindling of inflationary pressures that had been hidden by unusual factors results in rising interest rates, the economy slows and asset prices fall sharply, slowing the economy even more. Slower growth reveals the new paradigm optimism to be misplaced.

- Others who fear that a speculative bubble is emerging in the stock market point to more popular indicators like the rise of day trading and the enormous value placed on some internet startups that have yet to turn a profit.

On the other hand, those who are relatively sanguine about the current state of the market point to the following:

- The economy remains strong and private forecasters have increased their projected growth rates for GDP and corporate profits since the beginning of the year. Prospects for some industries that suffered from the impact of a sluggish world economy last year have improved and several key sectors are viewed as generating impressive results this year. At the same time, views on inflation remain sanguine.
- Not all stocks are going to the sky. On the contrary, a large fraction of the growth in the market's value can be attributed to a small set of companies, most of whom are engaged in some form of high-tech activity. Meanwhile, valuations for many traditional companies remain tame by historical standards. This suggests that the market retains its ability to discriminate among stocks, rewarding those companies that are on the cutting edge of innovation.
- It is possible (with some stretching) to justify current market values, by combining relatively optimistic assumptions about future profit growth, interest rates, and the premium that investors demand for bearing the risks inherent in holding stocks. For example, if the rapid rates of productivity growth experienced since 1995 were to continue unabated and feed continued rapid earnings growth; if long-term interest rates were to return to the lower levels seen earlier this year; and if the premium for bearing stock market risk were to descend to levels that are quite low by historical standards, then the current level of the market could be "justified."

The main macroeconomic risk posed by an overvalued stock market is the prospect of a market reversal, which would reduce aggregate demand. Recent stock gains have boosted consumption.



- A decline in stock values would reduce the net worth of consumers and lead to a decline in consumer spending, reversing the consumption increases that have accompanied the run-up in wealth (see Chart).
- It also would increase businesses' cost of raising equity capital and thereby reduce investment spending.
- Although banks are currently well capitalized, a recession might lower the quality of banks' loan portfolios.
- The appropriate antidote to a development of this type is a dose of lower interest rates. This type of action proved quite successful in 1987, when the Fed moved promptly and vigorously to reassure markets in the wake of the October crash.

A more remote – but nonetheless real – risk is that the financial system simply seizes up and ceases to function in the wake of a stock market crash.

- Stock market losses could lead to actual or threatened bankruptcies, particularly among highly leveraged institutions with large derivatives positions, and spread beyond the stock market.
- Concerns about counterparty risk might then cause the clearance and payments systems that are crucial to well-functioning securities markets to freeze.
- Significant steps have been taken to reduce this risk following what some view as a near miss during the 1987 stock market crash, but some risk remains.
- The traditional tools of monetary policy may not be sufficient to prevent a seizing up of markets in the face of widespread panic.

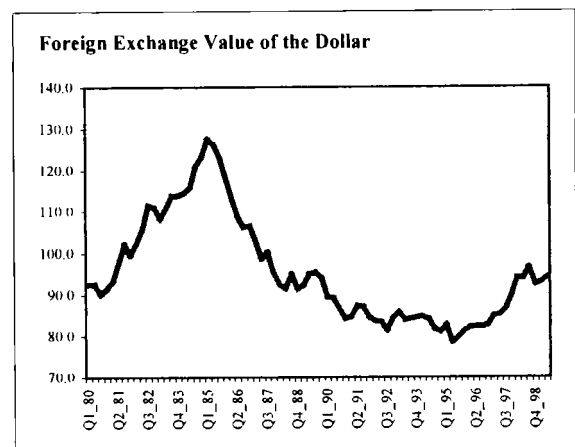
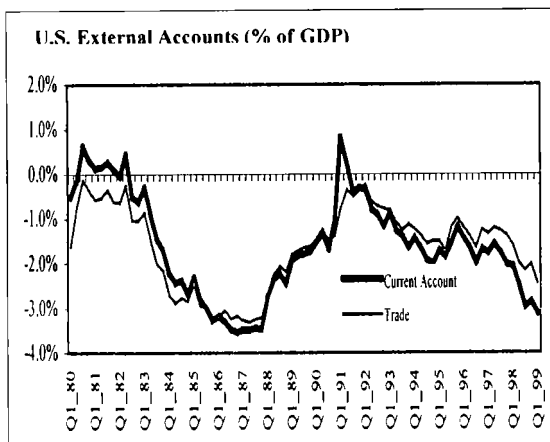
The risk posed by the stock market is compounded by international considerations. A substantial weakening in asset markets here could shake the confidence of foreign investors, thereby causing a substantial drying up of the supply of foreign capital and a free fall of the dollar. This would pose a dilemma for the Federal Reserve, which would be caught between conflicting needs to cushion a recession and contain rising inflation.

The implications of such a scenario are potentially more severe than they otherwise would be in light of the fact that we are presently running a large current-account deficit – a topic to which we now turn.

The Current Account Deficit and the Dollar

The current account deficit -- already large last year -- is forecast to widen further in 1999 and beyond.

- The widening of the deficit has been exacerbated by temporary factors: the Asian crisis and the faster relative growth of the U.S. economy compared to the rest of the world, as well as the appreciation of the dollar since 1995.
- As the dollar's strength shows, foreigners have been more than willing to finance our external deficits of recent years. The relative attractiveness of U.S. investments and performance of the U.S. economy have pulled in foreign capital.
- The U.S. current account deficit is not likely to be sustainable indefinitely at recent growth rates in the United States and abroad and unchanged exchange rates. Based on standard forecasting models, the deficit would continue to widen as a percent of GDP.
- Foreign investors have built up large net (\$1.5 trillion) and gross (\$7.5 trillion) claims on the United States. Sooner or later they may become less willing to hold an ever increasing share of their wealth in claims on the United States, especially as an upturn in foreign growth provides more competition for investment in U.S. assets.



Federal Reserve Board Real Exchange Rate Index

Repeat of the 1980s? A continuing widening of the deficit could place the dollar under significant downward pressure over the next year as happened in the 1980s, despite differences between now and then:

- U.S. deficits in the 1980s were driven by a fall in national savings associated with large fiscal deficits. Since 1992, our national savings rate has been rising, and our external deficits have been associated with the more rapid rise in investment.
- The dollar has appreciated on average in real (price-adjusted) terms since 1995, but the appreciation has been substantially less than in the mid-1980s.
- Although the United States has become a net international debtor, with net income payments now contributing to our current account deficit (as a percent of GDP), our trade deficit has not yet reached the low point (as a percent of GDP) of 1987.

Hard Landing? The external adjustment process in the late 1980s was difficult, but it was not a “hard landing” involving a deep sustained recession and substantially higher inflation.

- The difficulties associated with any prospective adjustment in our external accounts would depend in large part on how it was triggered and what other developments accompanied it, and on policy responses here and abroad.
- Standard macroeconomic models suggest that, under plausible assumptions about policy responses in the United States and abroad, an abrupt 25 percent decline in the dollar, if it occurred smoothly, which would be unlikely, would raise U.S. growth by about 1 percent over the first 1-2 years and eventually reduce the current account deficit by half or two thirds, but it would also boost U.S. inflation by as much as 2 percent.

The adjustment process in the new millennium may well not be benign:

- The U.S. adjustment process could be triggered or exacerbated by (or could itself trigger) a sharp correction in U.S. asset markets.
- Policy responses in the rest of the world may fail to offset the contractionary effects of the U.S. adjustment on their own growth from reduced exports to and increased imports from the United States.
- The result could be a U.S. recession, an intensified flight from dollar-denominated assets, further downward pressure on the dollar, and a large increase in inflation.

This potential vicious cycle of sudden and excessive asset price deflation followed by an economic downturn in the United States and abroad is the main source of risk from our growing trade and current account deficit and a possible sharp dollar decline.

The likelihood of a “hard landing” scenario is not large, and careful management can help reduce the risk. Maintaining our strong-dollar policy will help sustain confidence in our assets and markets. Policies to enhance our national savings, like continued budget surpluses, will help cushion the economy against a potential slowdown of inflows of

foreign savings. Faster growth abroad should on balance ease our adjustment process as would broad-based trade liberalization and avoidance of protectionist pressures.

Contagion From the Global Economy

The outlook for the global economy has brightened a bit since late last year.

- The mood surrounding prospects in Japan and Europe has improved somewhat.
- Economic activity is recovering in the affected countries in Asia. Although Latin America is in recession, there too the outlook has brightened somewhat recently.
- External investors have substantially reduced their exposure to emerging market economies as these economies have moved toward external surpluses, and borrowing spreads for emerging market economies are lower than last fall, though still wide.

Evolution of Consensus Forecasts of World Economic Growth					
	1999 Forecasts			2000 Forecasts	
Date of Forecast	Dec 1998	Mar 1999	Jul 1999	Mar 1999	Jul 1999
Euro-11	2.3%	2.1%	2.0%	2.6%	2.6%
Japan	-0.6%	-0.9%	0.1%	0.2%	-0.2%
Asia ex Japan	2.7%	3.3%	4.7%	4.8%	5.3%
Latin America	0.5%	-1.2%	-0.5%	3.1%	3.5%

Japan: The economy may finally have stopped deteriorating, though we have seen false bottoms before. Market sentiment has turned with a 24 percent rise in the Nikkei stock index since the beginning of 1999 and an astonishing 7.9 percent annual rate growth recorded in the first quarter. But record 4.9 percent unemployment, declining incomes and decreased household spending, and continuing corporate restructuring suggest further pressure on jobs and incomes. Japan's banking sector may have stabilized, following the recapitalization of leading banks, but more progress is needed in disposal of bad assets. Continued government facilitation of economic and financial restructuring along with supportive macro policies are critical to achieve a lasting recovery.

Europe: Although the macroeconomy may be poised for an upturn, the strength of any rebound is uncertain and likely to be export-led, given the euro's depreciation over the first half of the year. Unemployment still remains stubbornly in double digits, underscoring the need for fundamental structural reforms, if European growth is to return output to potential, to say nothing of cutting into high unemployment rates.

This somewhat improved outlook for the industrial countries is on balance good for the U.S. and global economy though, as noted above, it is a mixed blessing because of the increased competition from more attractive investment opportunities abroad.

The two emerging market economies that at this point appear to pose the greatest risk to the U.S. and global economy and financial system are Argentina and China.

Argentina: Despite basically sound policies, Argentina's dependence on foreign capital inflows to refinance its large external obligations (about 450 percent of exports) leaves it vulnerable to the risk that market worries about its exchange rate regime become a self-fulfilling prophecy. Its external accounts have been hit by lower prices on its commodity exports and by devaluation and recession in Brazil. Private capital inflows have declined due to the global crisis, investor nervousness about the October presidential election, and concerns the peso may be overvalued. The result has been sharply higher international and domestic borrowing costs. Argentina is in a severe recession (2½-3 percent real GDP contraction expected this year) with rising unemployment (now 14.5 percent) and growing non-performing loans. Monetary policy is constrained by Argentina's currency board regime. A political-economic crisis in Argentina with its currency board could undermine confidence in Hong Kong, with potential implications throughout Asia.

China: The recent slowdown in growth and contraction of exports in China is a source of risk and increased vulnerability. Fears of rising unemployment and a looming fiscal burden from restructuring the financial system and state-owned enterprises may lead the authorities to try to restore export-led growth and devalue the renminbi. Although current account data are not available for 1999, the recorded trade surplus has basically vanished since late last year. Financial market expectations about a devaluation have recently returned to levels last seen during the global panic of August 1998. With its capital controls and large foreign exchange reserves (\$147 billion), the risk of a successful speculative attack on the renminbi is still low. However, a poorly managed devaluation, if this should be the course chosen by the Chinese authorities, could put pressures on Hong Kong's exchange rate peg and spill over to other Asian currencies and other regions and to the U.S. economy as we saw in 1997-98.

Other country risks: Other large countries with less immediate difficulties that may pose a concern are Brazil, Indonesia, Korea, Mexico, Russia, and Turkey. For example, if Korea mishandles the Daewoo restructuring, its economy could be plunged back into serious recession or crisis. Smaller financial fragile countries that have the potential to trigger a broader crisis include Colombia, Ecuador, Romania, Ukraine, and Venezuela. For example, Ecuador's failure to make its Brady bond payments later this month could trigger a flight from the debt of emerging market economies generally, even though the market should not be surprised.

In contrast to the situation over the past two years when concerns about the outlook for the U.S. economy focused primarily on contagion from the rest of the world, our vulnerability from this source appears to have declined both absolutely and relatively. Conditions abroad are mending slowly and the shocks of the past few years are probably still recent enough to keep even investors with short memories mindful of a repetition.

The Y2K Problem

The Y2K computer problem poses some limited risks from the potential malfunction of computer systems that support critical infrastructure. There is also some anticipated economic impact from hoarding behavior at the end of 1999 in anticipation of Y2K problems.

- **Fundamentals.** The fundamental risk is of severe and long lasting economic dislocation as computer systems malfunction -- particularly in the critical infrastructure areas of finance, telecommunications, power generation, and transportation. Considerable investment has been made to avoid the fundamental problems that would occur with a system-wide failure. Most large firms and the Federal government have spent large amounts to ensure their systems are Y2K ready. Concerns remain with respect to smaller users, State governments and less-developed countries. Because of the extensive preparation that has taken place, problems among the small users are unlikely to cumulate into a supply shock sufficient to cause a significant macro-economic impact on the United States. Only one of 52 blue-chip forecasters currently projects negative growth for 2000.
- **Hoarding.** A second set of economic problems could occur even if all computers perform normally, if there is hoarding behavior in anticipation of Y2K problems. This could lead to temporary shortages, soaring prices and long lines. In particular, this could be a problem, if at the last moment firms seek to accumulate extra inventories; households to stockpile supplies such as groceries, prescription drugs, gasoline, and currency; and financial market participants to shift towards highly liquid assets.

Again, many institutions are taking steps to provision for such hoarding. For example, the Federal Reserve plans to boost its currency holdings from \$100 billion to \$300 billion, about \$2,000 of additional cash per U.S. household.

The inventory behavior induced by Y2K is expected to boost growth in the final quarter 1999 by $\frac{3}{4}$ percentage point, and lower it in the first quarter of 2000 by the same amount. Interest rates on assets to be held over year-end indicate a liquidity premium but the effect dissipates after a few months.

A small aggregate impact. Y2K is likely to be to the economy, what a sandstorm is to the desert. A highly visible nuisance for most who are caught in it, quite damaging to a few; but with an impact that is scarcely visible overall once the dust has settled. The key to containing the disruptions from anticipatory behavior is public confidence that the fundamental problems have been dealt with.

Conclusion

History suggests that in any year, regardless of how long an expansion has run, the chances that it will end are generally about one in four. In the postwar period, for the United States, these terminations have resulted from Federal Reserve responses to inflation. The lack of inflationary pressures currently, and the belief that if any were to arise, they would be effectively nipped in the bud, provides consensus forecasters with the confidence to project sustained economic growth, at a rate of 2.6 percent in 2000.

But the consensus forecast could be wrong. The recent surge in productivity performance provides plausibility to the view that the benefits of the revolution in information technology are finally coming to fruition. While there is much talk of a new economy, if the US could simply return to the old economy which achieved a 2 percent rate of productivity growth over the century prior to 1973, and over the next five years, growth could average over three percent annually. The consensus forecasts could prove to be just another example of the dismal science.

There are, however, a variety of risks facing the economy that could pose some painful choices. There have been other periods in history such as the late 1920s in the United States and the late 1980s in Japan, in which apparent prosperity proved to be ephemeral as the collapse of asset market bubbles wreaked financial and economic havoc. Currently, therefore it is prudent to attach concern to the risks we face from an outburst of inflation and both internal and external financial market instability.

However, each of these risks is better faced with a strong fiscal position. Less stimulus would reduce inflation. More national savings allow us to finance domestic investment with less foreign borrowing and lower interest rates, reducing the probability of financial distress at home and abroad.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jason Furman (CN=Jason Furman/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME:10-AUG-1999 01:22:54.00

SUBJECT: Comments (minor)

TO: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

You will have the latest draft from my previous e-mail. It includes comments from Treasury, including final comments from Larry Summers. (They thought the memo was due at midnight. You will probably want to give them the option of vetting any additional changes, but I leave that to you. You could use the compare document function to show them what has changed since version 5).

I included all of Steve's changes with the exception of one in the paragraph about the 25 percent slide in the dollar. Larry Summers (via Truman) extensively wordsmithed this paragraph and I did not think it made sense to make any alterations. In making changes I suggest you leave the level of the dollar alone, unless you find a grammatical error.

I made various other changes and standardizations. The only remaining work I see, other than a careful readthrough, is:

1. I didn't fix up the charts. They should look standardized. The references to charts in the text ("chart x") should be standardized.
2. I would add numbers to the discussion of the productivity growth chart, probably the real and predicted growth rates since that time a few years ago when they were roughly the same. I also think (sorry Steve) that the linear trend either needs to go or the look needs to be otherwise improved.

Jason

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-AUG-1999 18:18:14.00

SUBJECT: Re: Reunion

TO: jalewis@hardfarm.freemove.co.uk (jalewis@hardfarm.freemove.co.uk [UNKNOWN])
READ:UNKNOWN

TEXT:

Jeff, I'm in. I'll try to get in Friday evening and plan to come back here on Monday. I still need to look into flights.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-AUG-1999 15:59:09.00

SUBJECT: Phone Message from Peter Goesslin

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

Contact: Peter GoesslinCompany: Phone: 861-9265FAX: Message:

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Sandra F. Daigle (CN=Sandra F. Daigle/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-AUG-1999 13:50:03.00

SUBJECT: Phone Message from Emily Schwartz

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

CC: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

Audrey Choi (CN=Audrey Choi/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

TEXT:

Contact: Emily Schwartz
Company: Bloomberg News
Phone: 202-624-1927
FAX: Message: Has just read a synopsis of your book and has some questions she would like to ask you.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lael Brainard (CN=Lael Brainard/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME:10-AUG-1999 18:28:54.00

SUBJECT: Economic Outlook Agenda

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Sylvia M. Mathews (CN=Sylvia M. Mathews/OU=OMB/O=EOP@EOP [OMB])
READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

Agenda revised per 4:30 meeting for your review and clearance. Thanks!===== ATTACHMENT
1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D29]ARMS283521326.236 to ASCII,
The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

MEETING ON THE ECONOMIC OUTLOOK

August 11, 1999; 1:00 – 2:00 p.m.

OUTLINE OF ISSUES

THE OUTLOOK

I. THE NEW ECONOMY VS. THE TRADITIONAL INFLATIONARY TRADEOFF

- Prospects for Continued Productivity Growth
- Labor Market Constraints on Non-Inflationary Growth
- Inflationary Pressures from International Commodity Prices and Growth Abroad

II. OUTLOOK FOR THE DOMESTIC ASSET MARKETS

- Stock Market Correction
 - Recent Trends in Stock Market Pricing
 - The Wealth Effect and Recent Personal Savings Trends
 - Effects on Domestic Consumption, Employment and the Economy
 - Effects on the Domestic Financial System
- Developments in Broader Asset Markets
- Federal Reserve Response

III. CURRENCY OUTLOOK

- Current Account Trends
- Currency Outlook

IV. CONTAGION FROM THE GLOBAL ECONOMY

- Growth Prospects in Japan and Europe
- Uncertainties in Argentina and Prospects for Latin America
- Economic and Currency Outlook for China

BUDGET SENSITIVITY

I. THE RANGE OF UNCERTAINTY FROM ECONOMIC & TECHNICAL FORECASTING ERROR

- Historical Forecasting Error
- Changes in Receipts
- Interest Rates
- Growth

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-AUG-1999 12:36:42.00

SUBJECT: Phone Message from Nicole

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

Contact: NicoleCompany: Phone: FAX: Message:

Withdrawal/Redaction Marker

Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	R. Lawrence to W. Gillespie, re Uranium Meeting (1 page)	08/10/1999	P3/b(3)

COLLECTION:

Clinton Presidential Records
Automated Records Management System
CEA (Robert Z. Lawrence)
OA/Box Number: 950000

FOLDER TITLE:

[08/06/1999 - 08/12/1999]

2014-0316-F
wr10752

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

- P1 National Security Classified Information [(a)(1) of the PRA]
- P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
- P3 Release would violate a Federal statute [(a)(3) of the PRA]
- P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
- P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [(a)(5) of the PRA]
- P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

- b(1) National security classified information [(b)(1) of the FOIA]
- b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
- b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
- b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
- b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
- b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
- b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
- b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-AUG-1999 18:45:29.00

SUBJECT: Phone Message from Peter Goesslin

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

Contact: Peter Goesslin Company: Phone: 861-9265 FAX: Message: I talked to Peter about our inability to arrange lunch anytime soon on both calendars; however, he wants to talk to you tomorrow re a story.

Withdrawal/Redaction Marker

Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
002. email	W. Gillespie to R. Lawrence, re Uranium Meeting (3 pages)	08/10/1999	P3/b(3)

COLLECTION:

Clinton Presidential Records
Automated Records Management System
CEA (Robert Z. Lawrence)
OA/Box Number: 950000

FOLDER TITLE:

[08/06/1999 - 08/12/1999]

2014-0316-F

wr10752

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

- P1 National Security Classified Information [(a)(1) of the PRA]
- P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
- P3 Release would violate a Federal statute [(a)(3) of the PRA]
- P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
- P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [(a)(5) of the PRA]
- P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

- b(1) National security classified information [(b)(1) of the FOIA]
- b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
- b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
- b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
- b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
- b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
- b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
- b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-AUG-1999 15:48:57.00

SUBJECT:

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D5]ARMS26397322G.236 to ASCII,
The following is a HEX DUMP:

===== END ATTACHMENT 1 =====

SPECIAL ANALYSIS

Manufacturing Matters

While the overall economy has performed strongly in this expansion, international factors have retarded manufacturing since 1997. This has led to significant employment declines throughout the sector. Textiles, apparel, and capital goods have all been affected.

1993-97: the durable divide. Between 1993 and 1997, manufacturing output grew at a 5.7 percent annual rate—faster than the rest of the economy, despite an increase in the manufacturing trade deficit. Because productivity growth was particularly rapid, employment growth was more sluggish. Nevertheless, manufacturing employment grew at an average annual rate of 0.8 percent, and manufacturing employment increased by 600,000.

As might be expected in an expansion with particularly strong growth in investment, manufacturing employment gains were concentrated in durable goods manufacturing, with rapid advances over this period in Motor vehicles and parts, lumber and wood products, industrial machinery and equipment, fabricated metal products, and electronic and electrical equipment. Even in this period, however, employment growth in non-durables was sluggish. Indeed, in the labor-intensive industries heavily engaged in international trade such as textiles apparel and footwear significant employment declines were recorded.

1997-99: the global divide. More recently, however, the growth pattern has changed. Weak foreign demand and declining foreign currencies have brought manufacturing export growth to a halt. The volume of U.S. merchandise exports in the second quarter of 1999 was no higher than in the fourth quarter of 1997, while merchandise imports increased by 18 percent. In the first 5 months of this year, the annualized trade deficit in manufactured goods has been \$280 billion—almost double the level prior to the Asian crisis.

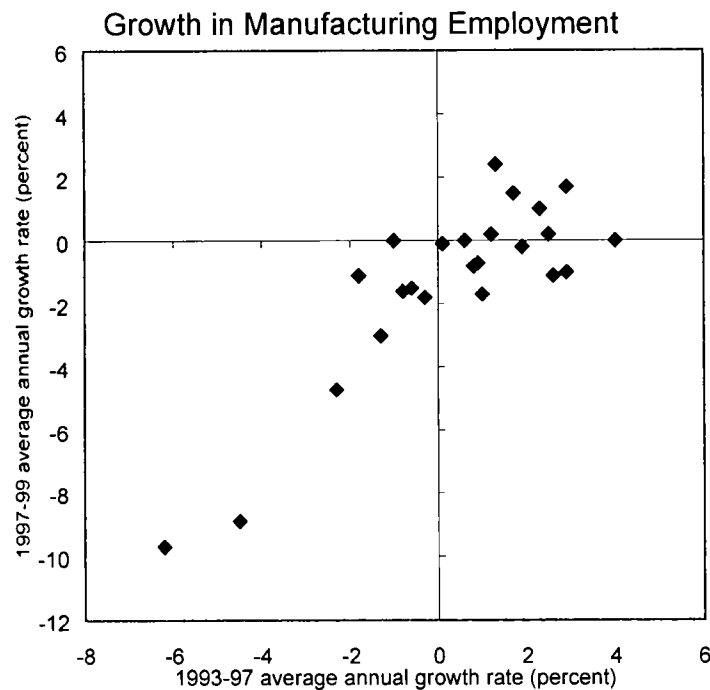
The most rapid employment declines since 1997 were again in labor-intensive sectors such as leather products, apparel, and textile mill products (see chart on next page). In addition, however, there was a noteworthy weakness in durable goods industries such as electronic equipment, industrial machinery and equipment, and primary metals. Indeed, even employment in computer manufacturing has fallen by about 15,000 during this period.

Since machinery accounts for about half of all U.S. manufactured goods exports, durables goods manufacturers and their suppliers have clearly been adversely impacted by the export slump. Not only have they lost export sales directly but they have also been damaged indirectly as the decline in manufacturing capacity utilization (from 82.5 percent in the fourth quarter of 1997 to 79.4 percent in June) has depressed spending on industrial equipment. (In the 2nd quarter, for example, expenditures on industrial equipment were only 2.5 percent above the

levels in the fourth quarter of 1997.) It is this weakness that appears to explain why capacity utilization in steel remains low, despite the fact that steel imports have returned to their pre-surge levels.

By contrast, manufacturers able to find shelter at home have seen employment growth. Strong expenditures on construction have sustained employment growth in lumber and wood products; stone, clay, and glass; and furniture and fixtures. Similarly, buoyant demand for autos and trucks has maintained stable employment levels in motor vehicles and parts despite strong import growth.

Implications. Manufacturing is an important provider of high-wage jobs, particularly for blue-collar men with high-school education. While rapid productivity growth in this sector is likely to limit the additional opportunities for such employment in the future, other developments can affect the jobs that are available. Increased exports, driven by foreign growth, would mitigate these employment declines. On the other hand, higher domestic interest rates could depress industrial investment and construction spending and deal another blow to a sector which is already troubled



RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jason Furman (CN=Jason Furman/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME:10-AUG-1999 01:32:36.00

SUBJECT: One other minor comment

TO: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TO: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

I forgot to include in my previous e-mail: I don't think you need to hide behind The Economist in stating that Greenspan thinks productivity growth is higher. I would just assert this and quote directly from one of his recent speeches.

Jason

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Audrey Choi (CN=Audrey Choi/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-AUG-1999 16:29:26.00

SUBJECT: afl-cio?

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

robert - just thought i'd check in to see whether you thought we need to try to schedule the next afl-cio meeting anytime soon now that martin's here-- or whether david smith et al are no longer in a particular hurry.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-AUG-1999 16:30:41.00

SUBJECT: 5:00 edit meeting today in Martin's office

TO: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TO: Robin L. Lumsdaine (CN=Robin L. Lumsdaine/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

For changes that come out of tonight's edit meeting===== ATTACHMENT 1
=====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D85]ARMS28154432H.236 to ASCII,
The following is a HEX DUMP:

SPECIAL ANALYSIS

An International Perspective on U.S. Productivity Growth

Labor productivity appears to have accelerated recently in the United States—from an average annual growth rate of 1.3 percent in 1973-95 to one of 2.1 percent in 1995-99. But unscrambling the trend from the cycle is always uncertain, and these preliminary data could be revised substantially.

Understanding whether productivity has accelerated is of the highest importance because it supports real wages, suppresses inflation, and is a key variable in the economic and budget outlook. One might hope to gather more evidence by observing productivity data from other industrialized countries. If new technologies were responsible for the U.S. productivity pickup, then we might expect to observe a similar pickup in foreign economies that used the same technology.

Acceleration in the 1990s? The acceleration in productivity growth in the past 4 years from the rate during the 1973-95 period is compared across countries in the chart. Across these periods, U.S. productivity accelerates as does that of Western Germany and Australia. However, productivity slows in Japan, Italy, France, UK, and Canada.

What to think. An international productivity comparison shows a wide array of productivity accelerations or decelerations and neither confirms nor refutes the idea that the productivity acceleration in the U.S. represents a new path for technological progress.

SPECIAL ANALYSIS

Is Competition Best in Health Care Markets?

Whether greater competition would ameliorate or exacerbate the current state of health care markets is the focus of much recent speculation. Competition advocates cite evidence from other markets that increased competition leads to improved social welfare. Competition critics argue that health care markets are quite different from standard markets, in large part due to information asymmetries between providers and patients and the uncertainty inherent in the nature of medical care. While it is important to recognize the unique features of the health care market, recent developments in market structure have shifted the balance in favor of competition.

The concern about competition in health care. Having insurance inherently dampens individuals' sensitivity to cost and price differences and therefore leads to overconsumption, an observation that also characterizes health insurance. Research based on data from prior to the mid-1980s has largely found increased competition to have negative consequences, encouraging a "medical arms race", where providers compete for patients through the provision of medically unnecessary services. This research generally argues that competition could lead to excess capacity, higher costs, and adverse patient health outcomes. Additionally the problem of risk selection, where insurance ownership appeals only to those who most need it, creates a resulting pool of only high-risk individuals, leading to either prohibitive costs or an inability to attract potential insurers.

The benefits of competition. Counterbalancing earlier concern, however, is evidence based on more recent data which finds that competition among hospitals leads to reductions in excess capacity, costs, and prices. Much of this advantage is attributed to the higher levels and growth of managed care in the recent decade, which is associated with lower growth in medical expenditures.

The effect of price on switching among health plans. The recent success of competition as a strategy for controlling health costs depends in part on the willingness of consumers to switch health plans in response to a change in plan premiums. A 1994 policy change by the University of California, which previously had paid the full premium for most plans and subsidized the cost of the most expensive plans, indicates that consumers are very sensitive to out-of-pocket premiums and are willing to switch health plans in response to small changes. Individuals facing monthly premium increases of less than \$10 were roughly 5 times as likely to switch plans as those whose premiums remained constant.

Competition versus adverse selection. Potentially, the response of switching to less expensive plans may go too far. A second study considered the case of a voucher system for health care, as implemented by Harvard University in 1995, where beneficiaries are paid a fixed contribution independent of plan choice. This

policy change increased the price to employees of the most generous policy by over \$500 annually. As noted above, the potential for adverse selection in this setting could ultimately render expensive plans even more expensive and drive up average costs for individuals remaining in this plan beyond what price differences would dictate. For example, the study estimates that a 1 percent increase in the premiums reduces plan enrollment by 2 percent. In addition, within 3 years of the change, adverse selection drove the more generous insurance entirely out of the market. These negative consequences were offset by cost savings of 5 to 8 percent of baseline health spending, resulting largely from lower insurer profits as a result of increasing plan choice and more stringent bargaining.

Conclusion. Recent evidence suggests that forcing providers to competitively bid for contracts to provide health care is welfare enhancing. Reductions on costs of providing care are transferred to the organization soliciting the bids, with some of these savings passed on to patients. Patients also appear to be very sensitive to small changes in price, leading to shifts away from costly plans and creating additional savings. While some of the benefits of expanded competition are offset due to adverse selection, evidence suggests that the benefits outweigh these costs.

SPECIAL ANALYSIS

Manufacturing Matters

While the overall economy has performed strongly in this expansion, international factors have retarded manufacturing since 1997. This has led to significant employment declines throughout the sector. Textiles, apparel, and capital goods have all been affected.

1993-97: the durable divide. Between 1993 and 1997, manufacturing output grew at a 5.7 percent annual rate—faster than the rest of the economy, despite an increase in the manufacturing trade deficit. Because productivity growth was particularly rapid, employment growth was more sluggish. Nevertheless, manufacturing employment grew at an average annual rate of 0.8 percent, and manufacturing employment increased by 600,000.

As might be expected in an expansion with particularly strong growth in investment, manufacturing employment gains were concentrated in durable goods manufacturing, with rapid advances over this period in Motor vehicles and parts, lumber and wood products, industrial machinery and equipment, fabricated metal products, and electronic and electrical equipment. Even in this period, however, employment growth in non-durables was sluggish. Indeed, in the labor-intensive industries heavily engaged in international trade such as textiles apparel and footwear significant employment declines were recorded.

1997-99: the global divide. More recently, however, the growth pattern has changed. Weak foreign demand and declining foreign currencies have brought manufacturing export growth to a halt. The volume of U.S. merchandise exports in the second quarter of 1999 was no higher than in the fourth quarter of 1997, while merchandise imports increased by 18 percent. In the first 5 months of this year, the annualized trade deficit in manufactured goods has been \$280 billion—almost double the level prior to the Asian crisis.

The most rapid employment declines since 1997 were again in labor-intensive sectors such as leather products, apparel, and textile mill products (see chart on next page). In addition, however, there was a noteworthy weakness in durable goods industries such as electronic equipment, industrial machinery and equipment, and primary metals. Indeed, even employment in computer manufacturing has fallen by about 15,000 during this period.

Since machinery accounts for about half of all U.S. manufactured goods exports, durables goods manufacturers and their suppliers have clearly been adversely impacted by the export slump. Not only have they lost export sales directly but they have also been damaged indirectly as the decline in manufacturing capacity utilization (from 82.5 percent in the fourth quarter of 1997 to 79.4 percent in June) has depressed spending on industrial equipment. (In the 2nd quarter, for example, expenditures on industrial equipment were only 2.5 percent above the

levels in the fourth quarter of 1997.) It is this weakness that appears to explain why capacity utilization in steel remains low, despite the fact that steel imports have returned to their pre-surge levels.

By contrast, manufacturers able to find shelter at home have seen employment growth. Strong expenditures on construction have sustained employment growth in lumber and wood products; stone, clay, and glass; and furniture and fixtures. Similarly, buoyant demand for autos and trucks has maintained stable employment levels in motor vehicles and parts despite strong import growth.

Implications. Manufacturing is an important provider of high-wage jobs, particularly for blue-collar men with high-school education. While rapid productivity growth in this sector is likely to limit the additional opportunities for such employment in the future, other developments can affect the jobs that are available. Increased exports, driven by foreign growth, would mitigate these employment declines. On the other hand, higher domestic interest rates could depress industrial investment and construction spending and deal another blow to a sector which is already troubled

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-AUG-1999 14:54:08.00

SUBJECT: Thankyou.

TO: Gene B. Sperling (CN=Gene B. Sperling/OU=OPD/O=EOP@EOP [OPD])
READ:UNKNOWN

TEXT:

I just wanted to let you know that I really appreciated your including me in the meeting today and your graciousness in introducing me. While the process was not flawless, I also felt that your guidance in the preparation of the memo and the meeting were really helpful to us. Thanks!

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-AUG-1999 16:31:58.00

SUBJECT: Re: afl-cio?

TO: Audrey Choi (CN=Audrey Choi/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

I think we should call to talk about a meeting in the second week in
September in the week after labor day just to let them know we are still
interested.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-AUG-1999 11:18:35.00

SUBJECT: Loy's Mtg on Safety Valves, Mon, 8/16

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

CC: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

Frank Loy has asked that you attend a small mtg re the above on Mon, 8/16,
at 2:15pm, in Rm. 7250 @ State. Other attendees are : Roger Ballantine,
Brook Holmes.

Reminder: Grp of Thirty luncheon is from 12 - 2pm at the Hudson Institute.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Yu-Chin Chen (CN=Yu-Chin Chen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-AUG-1999 09:39:02.00

SUBJECT: duration

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

I am waiting for 2 phone calls to find out whether we can get the duration statistics on foreign-held US securities. the Fed monthly bulletin doesn't have this info. We do have the info from the issuers' side, e.g. Treasury breaks down its liabilities by the length of maturity, but perhaps because bonds are pretty liquid and are traded frequently, data on the shares of each maturity held by domestic vs. foreign owners doesn't seem to be available.

I will let you know if I hear otherwise from the Fed or the BEA

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Martin N. Baily (CN=Martin N. Baily/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-AUG-1999 16:23:27.00

SUBJECT: Fact Sheet: White House Drought Task Force

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

fyi

----- Forwarded by Martin N. Baily/CEA/EOP on 08/11/99

04:23 PM -----

Audrey Choi
08/11/99 04:20:20 PM
Record Type: Record

To: Martin N. Baily/CEA/EOP@EOP, Victoria A. Greenfield/CEA/EOP@EOP
cc:
Subject: Fact Sheet: White House Drought Task Force

FYI - thought you might want to see this on droughts.

----- Forwarded by Audrey Choi/CEA/EOP on 08/11/99 04:20

PM -----

Anne W. Bovaird
08/11/99 04:08:22 PM
Record Type: Record

To: See the distribution list at the bottom of this message
cc:
Subject: Fact Sheet: White House Drought Task Force

----- Forwarded by Anne W. Bovaird/WHO/EOP on 08/11/99
04:08 PM -----

Jason H. Schechter
08/11/99 03:31:56 PM
Record Type: Record

To: See the distribution list at the bottom of this message
cc:
Subject: Fact Sheet: White House Drought Task Force

THE WHITE HOUSE

Office of the Press Secretary

For Immediate

Release

11, 1999

August

FACT SHEET

WHITE HOUSE DROUGHT TASK FORCE

August 11, 1999

Interagency Task Force on Drought and Heat

The President directed the establishment of a task force to coordinate the federal response to the crippling drought problem that continues to grip much of the nation. White House Deputy Chief of Staff Maria Echaveste convened the task force representatives on Monday morning. The task force began cataloguing the extensive federal efforts undertaken thus far to address the crisis. In addition, the task force identified potential additional federal responses to assist communities in planning for and responding to breaking emergencies, some of which are described below. The task force also commenced work on assessing the impact of these droughts so as to identify further needs and possible federal responses. Lastly, the task force will help coordinate federal input into the National Drought Policy Commission created by Congress in 1998.

The Department of Commerce

Web Based Heat Advisory:

Starting immediately, Commerce Secretary William Daley has instructed the National Oceanic and Atmospheric Administration (NOAA) to make available to managers, planners and the public the a weekly assessment of potential heat threats. These assessments are now posted and updated weekly at <http://www.drought.noaa.gov>. Previously, these assessments had been available only on a local basis. This action will now it possible any official or citizen anywhere to access this vital information. It also integrates the heat assessments with assessments of other weather-related threats. With this action, there is a one-stop shop for all of NOAA,s weather threat data.

Called the Threats Assessment, it consists of maps that show where extreme conditions such as temperature, precipitation, wind, and drought are forecast over the coming three to ten days. It is updated weekly or more frequently as events require. The Threats Assessment targets emergency managers, local officials, and forecasters. It provides information that communities and individuals can use to take precautionary steps to mitigate the impacts of extreme events. This product has been in development for nearly two years. NOAA worked with a wide range of

stakeholders to create a tool that is useful at the state and local levels.

Drought Mapping and Forecast Service:

Also starting immediately, Commerce, working in conjunction with the Department of Agriculture and the National Drought Mitigation Center, has launched a drought monitoring and forecast service. This service, which had been available only in experimental form, summarizes the extent and intensity of drought nationwide and forecasts whether droughts will strengthen or weaken. Like the Threat Assessment, the Drought Monitor is on the Internet at <http://www.drought.noaa.gov>.

The three-way partnership is responding to the need for accurate, centralized drought information by developing a map that summarizes information from numerous drought indices and indicators on a single, easy-to-read color map.

The map displays general areas where drought is occurring as well as dry areas where drought threatens. To create the map, the partnership blends information from numerous sources, including the departments of Commerce, Agriculture and Interior.

The map uses a new classification system to show drought intensity and type, similar to the schemes currently in use for hurricanes and tornadoes. The map combines key indices of rainfall and drought to produce the final drought intensity rating. Since drought often affects various activities differently, the map indicates if drought is affecting agriculture, fire danger, or water supplies. State-of-the-art forecast tools are being used to indicate whether drought will strengthen or weaken significantly over the next two weeks.

Two Week Warning For Extreme Heat Events:

Finally, for next summer, the NOAA will extend extreme heat forecasts for up to two weeks in advance. The predictions will be in the form of probabilities of the number of consecutive days heat indices will exceed critical values. The forecasts will be included in the newly operational weekly Threats Assessment. For the first time, these forecasts will provide officials and leaders from organizations like the American Red Cross with a "heads-up" for potentially life threatening conditions well in advance. Local NOAA weather service offices will then work with health officials and communities to highlight the impacts to the area. This information should help the public to take informed, life saving actions.

The Department of Agriculture

Today, Secretary Glickman announced that the entire state of Connecticut, 19 counties in Maryland, six additional counties in New York, five counties in Virginia, and one county in New Mexico will be declared agricultural disaster areas. Such declarations make those areas eligible for emergency, low-interest loans because of the excessive heat and drought. The Secretary's declaration triggers low interest SBA loans for agriculture dependent businesses.

USDA has approved nearly \$4.9 million for 11 states for the Emergency Conservation Program (ECP) funds for the drought. The ECP provides emergency cost-share funding for water conservation measures, federal crop insurance, and the Non-insured Crop Disaster Assistance Program, which provides compensation for crops for which crop insurance is unavailable.

###

Message Sent

To: _____
Christine A. Stanek/WHO/EOP@EOP
Anne M. Edwards/WHO/EOP@EOP
David E. Kalbaugh/WHO/EOP@EOP
Julie E. Mason/WHO/EOP@EOP
Cheryl D. Mills/WHO/EOP@EOP
G. Timothy Saunders/WHO/EOP@EOP
Laura D. Schwartz/WHO/EOP@EOP
Douglas B. Sosnik/WHO/EOP@EOP
Barry J. Toiv/WHO/EOP@EOP
Michael Waldman/WHO/EOP@EOP
Dorian V. Weaver/WHO/EOP@EOP
Catherine T. Kitchen/WHO/EOP@EOP
Brenda M. Anders/WHO/EOP@EOP
Richard Socarides/WHO/EOP@EOP
Dag Vega/WHO/EOP@EOP
Barbara D. Woolley/WHO/EOP@EOP
Cynthia M. Jasso-Rotunno/WHO/EOP@EOP
Sara M. Latham/WHO/EOP@EOP
Andrew J. Mayock/WHO/EOP@EOP
Beverly J. Barnes/WHO/EOP@EOP
Megan C. Moloney/WHO/EOP@EOP
Laura S. Marcus/WHO/EOP@EOP
Virginia N. Rustique/WHO/EOP@EOP
Thomas D. Janenda/WHO/EOP@EOP
Brian D. Smith/WHO/EOP@EOP
Leanne A. Shimabukuro/OPD/EOP@EOP
Kim B. Widdess/WHO/EOP@EOP
I=US @ 2=WESTERN UNION @ 5=ATT.COM @ *ELN\62955104 @ MRX @ LNGTWY
62955104@eln.attmail.com @ inet
BARBUSCHAK_K@A1 @ CD @ LNGTWY
INFOMGT@A1 @ CD @ LNGTWY
JOHNSON_WC@A1 @ CD @ LNGTWY
SUNTUM_M@A1 @ CD @ LNGTWY
WOZNAK_N@A1 @ CD @ LNGTWY
backup@wilson.ai.mit.edu @ inet
newsdesk@usnewswire.com @ inet
usnwire@access.digex.com @ inet
GRAY_W@A1 @ CD @ LNGTWY
NAPLAN_S@A1 @ CD @ LNGTWY
WEINER_R@A1 @ CD @ LNGTWY
GRIBBEN_J@A1 @ CD @ LNGTWY

tnewell@ostp.eop.gov @ INET @ LNGTWY
Elizabeth R. Newman/WHO/EOP@EOP
Jordan Tamagni/WHO/EOP@EOP
HEMMIG_M@A1 @ CD @ LNGTWY
Peter A. Weissman/OPD/EOP@EOP
Douglas J. Band/WHO/EOP@EOP
Edwin R. Thomas III/WHO/EOP@EOP
Sherman A. Williams/WHO/EOP@EOP
William W. McCathran/WHO/EOP@EOP
Julia M. Payne/WHO/EOP@EOP
Robin J. Bachman/WHO/EOP@EOP
Nicole R. Rabner/WHO/EOP@EOP
June Shih/WHO/EOP@EOP
Brooks E. Scoville/WHO/EOP@EOP
Sarah S. Knight/WHO/EOP@EOP
Tracy F. Sisser/WHO/EOP@EOP
Woyneab M. Wondwossen/WHO/EOP@EOP
Patrick E. Briggs/WHO/EOP@EOP
Debra S. Wood/WHO/EOP@EOP
Daniel W. Burkhardt/WHO/EOP@EOP
Maureen A. Hudson/WHO/EOP@EOP
Lana Dickey/WHO/EOP@EOP
Carmen B. Fowler/WHO/EOP@EOP
Lynn G. Cutler/WHO/EOP@EOP
Walker F. Bass/WHO/EOP@EOP
Michael V. Terrell/CEQ/EOP@EOP
Elliot J. Diringer/CEQ/EOP@EOP
Nanda Chitre/WHO/EOP@EOP
Melissa M. Murray/WHO/EOP@EOP
Katharine Button/WHO/EOP@EOP
Eli G. Attie/OVP@OVP
wh-outbox-distr@pub.pub.whitehouse.gov @ inet
Sean P. Maloney/WHO/EOP@EOP
Marsha Scott/WHO/EOP@EOP
Linda Ricci/OMB/EOP@EOP
Mark D. Neschis/WHO/EOP@EOP
Jeffrey A. Shesol/WHO/EOP@EOP
Heather M. Riley/WHO/EOP@EOP
McGavock D. Reed/OMB/EOP@EOP
Janelle E. Erickson/WHO/EOP@EOP
Delia A. Cohen/WHO/EOP@EOP
Maureen T. Shea/WHO/EOP@EOP
RUNDLET_P@A1 @ CD @ VAXGTWY
BUDIG_N@A1@CD@VAXGTWY
Fred DuVal/WHO/EOP@EOP
Pubs_Backup
William C. Haymes/OA/EOP@EOP
Jason H. Schechter/WHO/EOP@EOP
Sheyda Jahanbani/NSC/EOP@EOP
Marty J. Hoffmann/WHO/EOP@EOP
Dorinda A. Salcido/WHO/EOP@EOP
dmilbank@tnr.com
Sarah E. Gegenheimer/WHO/EOP@EOP
kyle.mckinnon@kcrw.org

Thomas M. Rosshirt/OVP@OVP
Minyon Moore/WHO/EOP@EOP
Charles M. Brain/WHO/EOP@EOP
Dario J. Gomez/WHO/EOP@EOP
Carolyn T. Wu/WHO/EOP@EOP
Edward F. Hughes/WHO/EOP@EOP
Rajiv Y. Mody/WHO/EOP@EOP
Robin Leeds/WHO/EOP@EOP
Deborah B. Mohile/WHO/EOP@EOP
Sondra L. Seba/WHO/EOP@EOP
Tania I. Lopez/WHO/EOP@EOP
Jena V. Roscoe/WHO/EOP@EOP
Jocelyn A. Bucaro/WHO/EOP@EOP
Kelley L. O'Dell/WHO/EOP@EOP
Jonathan M. Young/WHO/EOP@EOP
Jackson T. Dunn/WHO/EOP@EOP
Robert B. Johnson/WHO/EOP@EOP
Charles H. Cole/WHO/EOP@EOP
drosen@newsweek.com
Jennifer Ferguson/OMB/EOP@EOP
Joshua S. Gottheimer/WHO/EOP@EOP
Carrie A. Street/WHO/EOP@EOP
mhall@usatoday.com
spage@usatoday.com
bnichols@usatoday.com
Paul D. Glastris/WHO/EOP@EOP
Maria E. Soto/WHO/EOP@EOP
Alejandro G. Cabrera/OVP@OVP
Christopher K. Scully/WHO/EOP@EOP
kara.gerhardt@ost.dot.gov
Mindy E. Myers/WHO/EOP@EOP
meglynn@usia.gov @ INET @ LNGTWY
Larry.mcquillan@reuters.com
Deborin@aol.com
Jonathan A. Kaplan/OPD/EOP@EOP
Karen Tramontano/WHO/EOP@EOP
Skye S. Philbrick/WHO/EOP@EOP
Toby C. Graff/WHO/EOP@EOP
Samuel O. Spencer/WHO/EOP@EOP
Caroline R. Fredrickson/WHO/EOP@EOP
Matt Gobush/NSC/EOP@EOP
James.gerstenzang@latimes.com
scott.barancik@americanbanker.com
IGCP@usia.gov
Evan Ryan/WHO/EOP@EOP
rsimoncol@aol.com
Brian S. Mason/OMB/EOP@EOP
Marty J. Hoffmann/WHO/EOP@EOP
Matthew W. Pitcher/WHO/EOP@EOP
David R. Goodfriend/WHO/EOP@EOP
photo@upi.com
kenneth.prewitt@ccMail.census.gov
Jeffrey M. Smith/OSTP/EOP@EOP
Jodi Enda <jenda @ krwashington.com>

Jeffrey L. Farrow/WHO/EOP@EOP
marhast@aol.com @ inet
mpena@efeamerica.com @ inet
mgarcia@pacifica.org @ inet
info@elsoldetexas.com @ inet
durph@aol.com @ inet
Linda L. Moore/WHO/EOP@EOP
Orson C. Porter/WHO/EOP@EOP
Bridget T. Leininger/WHO/EOP@EOP
Craig Hughes/WHO/EOP@EOP
Simeona F. Pasquil/WHO/EOP@EOP
bob.davis@news.wsj.com
Victoria L. Valentine/WHO/EOP@EOP
jeanne.cummings@news.wsj.com
bob.davis@news.wsj.com
patricia.peart@MSNBC.COM
Jordan D. Matyas/OVP@OVP
Sean P. O'Shea/WHO/EOP@EOP
Abigail C. Smith/WHO/EOP@EOP
Veronica DeLaGarza/WHO/EOP@EOP
Richard L. Siewert/WHO/EOP@EOP
jorszag@doc.gov
Jennifer H. Smith/WHO/EOP@EOP
mmaacdonald1@doc.gov
gary_cohen@metronetworks.com
Shannon M. Hinderliter/WHO/EOP@EOP
Michael J. Sullivan/WHO/EOP@EOP
James E. Kennedy/WHO/EOP@EOP
Erica S. Lepping/WHO/EOP@EOP
ssaukas@nbc.com
Mae E. Haney/WHO/EOP@EOP
Jeffrey H. Oakman/WHO/EOP@EOP
edwin.chen@latimes.com
RATCLIFF_M@AI @ CD @ VAXGTWY
Mark A. Kitchens/WHO/EOP@EOP
Ann C. Hertelendy/WHO/EOP@EOP
Deborah Akel/WHO/EOP@EOP
Debra D. Alexander/WHO/EOP@EOP
philippe.debeusscher@afp.com
gretchen.cook@afp.com
Lindsey E. Huff/NSC/EOP@EOP
David Vandivier/OMB/EOP@EOP
carolmast@aol.com
Carl Haacke/OPD/EOP@EOP
Leslie Bernstein/WHO/EOP@EOP
amy_weiss@bm.com
Erica R. Morris/WHO/EOP@EOP
Kathleen K. Ahn/WHO/EOP@EOP
Ruby Shamir/OPD/EOP@EOP
William Hadley/OA/EOP@EOP
Melissa J. Prober/WHO/EOP@EOP
martinez-elizabeth@dol.gov
Sylvia Bolivar/WHO/EOP@EOP
David Vandivier/OMB/EOP@EOP

john.longbrake@do.treas.gov
pcaplan@fbr.com
Dawn M. Chirwa/WHO/EOP@EOP
Setti D. Warren/WHO/EOP@EOP
Michele Ballantyne/WHO/EOP@EOP
Julia A. DiGangi/WHO/EOP@EOP
Laura Efurd/WHO/EOP@EOP
John H. Corcoran III/WHO/EOP@EOP
Courtney C. Crouch/WHO/EOP@EOP
Renee Sagiv/WHO/EOP@EOP
Patrick M. Dorton/OPD/EOP@EOP
Edward W. Correia/WHO/EOP@EOP
Karen C. Burchard/WHO/EOP@EOP
Denver R. Peacock/WHO/EOP@EOP
Jenni R. Engebretsen/WHO/EOP@EOP
jaret.seiberg@almdc.com
Brian A. Reich@OVP@INET@LNGTWY
Hildy Kuryk/WHO/EOP@EOP
Sharon H. Yuan/OPD/EOP@EOP
Michael K. Gehrke/WHO/EOP@EOP
Mark J. Bernstein/WHO/EOP@EOP
Daniel E. O'Brien/WHO/EOP@EOP
johnparker@economist.com
nbendavid@tribune.com
fletcher@nlc.org
Brooke B. Livingston/WHO/EOP@EOP
Nancy Mathis <Nancy.Mathis@chron.com>
John.Henry@chron.com
Lisel Loy/WHO/EOP@EOP
Irma L. Martinez/WHO/EOP@EOP
Anne W. Bovaird/WHO/EOP@EOP
Eric P. Liu/OPD/EOP@EOP
Charles J. Payson/WHO/EOP@EOP
Fern Mechlowitz/WHO/EOP@EOP
Michele Ballantyne/WHO/EOP@EOP
Adrienne K. Elrod/WHO/EOP@EOP
Jane T. Schaffner/WHO/EOP@EOP

Message Sent

To:

Eric.Dodds@gsa.gov
David Vandivier/OMB/EOP@EOP
Elwood Holstein/OMB/EOP@EOP
gfrazier@usda.gov
davidlane@doc.gov
satterfield-lee@dol.gov
gary.falle@hq.doe.gov@inet
Jon_J._Cowan@hud.gov
leslie_thornton@ed.gov

Jane.bullock@fema.gov
lmshein@opm.gov
Jkravitz@usia.gov
Brian.Coyne@ssa.gov
leamond_nancy@ustr.gov
kris.swedin@sba.gov
William A. Halter/OMB/EOP@EOP
Janet L. Crist/ONDCP/EOP@EOP
wilson.reid@epamail.epa.gov
mehunker@opm.gov
Audrey Choi/CEA/EOP@EOP
Robert L. Nabors/OMB/EOP@EOP
Anne_Shields@ios.doi.gov
janice.joyner@mail.va.gov
jcbua@opm.gov
maria.fernandez@mail.va.gov
manson.brown@ost.dot.gov
Susan_Kaslow@ios.doi.gov
LeeAnn.Inadomi@hq.doe.gov
maya.seiden@hq.doe.gov
Mike.Derian@usda.gov@inet
Jose.Venzor_Jr@usda.gov@inet
jdoyle@doc.gov
ebloom1@doc.gov
dblank1@doc.gov
jdorskind@doc.gov
eric.dodds@gsa.gov
drossi@ed.gov@INET
tbish@ios.doi.gov@INET
valdez-suzanna@dol.gov@inet
gardenswartz-craig@dol.gov@inet
sottenst@os.dhhs.gov
rwerbel@os.dhhs.gov
michael_n_cohen@hud.gov
judi.gold@ost.dot.gov@INET
patrick_mcdermott@ed.gov
debra.silimeo@sba.gov@INET
allison_balderston@ed.gov
Walter L. Holton/ONDCP/EOP@EOP
berkowsky.pamela@osd.pentagon.mil
martinez-elizabeth@dol.gov
ruskc@fca.gov
Kenneth_L_Smith@ios.doi.gov
dweinste@usia.gov
Ryan M. Morse/ONDCP/EOP@EOP
wildman.teresa@epamail.epa.gov
jacquie_m._lawing@hud.gov
bsmith@ustr.gov
rhoda_j._glickman@hud.gov
elisabeth.steele@fema.gov
ba.rudolph@ost.dot.gov
brenda.daniels@ost.dot.gov
Mcmahone@fca.gov
Justin.Paschal@usda.gov

davis.gail@epamail.epa.gov
Jon.P.Jennings@usdoj.gov
Michele.Kreiss@sba.gov
Maxie.Hollingsworth@sba.gov
Lisa.O.Monaco@usdoj.gov
Jeffery T. Christiansen/ONDCP/EOP@EOP
myron.l.marlin@usdoj.gov
Tamontree@usda.gov
hwaddell@dol.gov
MSkolfie@os.dhhs.gov
edahl@os.dhhs.gov
Ginny_Terzano@hud.gov
William.Schulz@ost.dot.gov
David_Frank@ed.gov
John.Hansonx@mail.va.gov
James.Holleyx@mail.va.gov
mgoodman@doc.gov
mcowart@usia.gov
Joan.E.Wainwright@ssa.gov
Phil.Gambino@ssa.gov
saltz-david@dol.gov@inet
brooke.anderson@hq.doe.gov
afridi-samir@dol.gov@inet
george.haddow@fema.gov
Rubey.Kim@epamail.epa.gov
Linda Ricci/OMB/EOP@EOP
Lisa.Cutler@hq.doe.gov
Tim_Ahern@ios.doi.gov
Terry_Bish@ios.doi.gov
bob.klear@mail.va.gov
michelle.a.smith@do.treas.gov
carole.florman@usdoj.gov
mtildonl@doc.gov
julie_green@ed.gov
pauljane95@aol.com
HKlasky@ustr.gov
beth.newburger@gsa.gov
Stephen_M._Tankel@hud.gov
cortez.corina@epamail.epa.gov
Cheryl.Montgomery@usdoj.gov
Mary_Beth.Schultheis@usda.gov
howard-elaine@dol.gov@inet
Jose.Vazquez@ost.dot.gov
SCHWARZ.DENISE@epamail.epa.gov
robert.nickerson@ssa.gov@inet
Rolf_A._Olson@hud.gov
Roger_J._Chiang@hud.gov
michael.coen@fema.gov
fantasia_kari@ustr.gov
mluzzatto@doc.gov
Christi A. Schneeberger/ONDCP/EOP@EOP
Natalie M. Garcia/ONDCP/EOP@EOP
jana.Carter@DO.Treas.gov
Ben.Handford@sba.gov

Sandra L. Via/OMB/EOP@EOP
Daniel S. Morgan/ONDCP/EOP@EOP
GStreett@doc.gov
Courtenay_Miller@ios.doi.gov
Rachel_Samuels@ios.doi.gov

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-AUG-1999 15:39:59.00

SUBJECT: Re: do you have a new draft?

TO: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

No, just use the old one and then I'll revise it.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-AUG-1999 15:41:11.00

SUBJECT: Re: Reunion

TO: jalewis@hardfarm.freemove.co.uk (jalewis@hardfarm.freemove.co.uk [UNKNOWN])
READ:UNKNOWN

TEXT:

I can get to Chicago Friday night. When should I plan to leave? I am thinking about Monday morning, but when is Kalw coming in?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-AUG-1999 15:06:45.00

SUBJECT: Travel to and from Chicago In/Out of Dulles, 9/3-6

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])

READ:UNKNOWN

TEXT:

To obtain...

Roundtrip fare of \$159:

Sep 3: (choose)

LV: 11:20am or 9:45pm

Roundtrip fare of \$195:

Sep 3

LV: 5:20 pm; AR Chicago: 6:18pm

Sep 6: Is this return okay?

LV: 10:40am

AR: 1:24pm

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-AUG-1999 10:21:03.00

SUBJECT: Dets Room for Tonight

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:
FYI. NOTE DIFFERENT ROOM #.
----- Forwarded by Lisa D. Branch/CEA/EOP on 08/11/99
10:20 AM -----

LESLIE
BERNSTEIN
08/11/99 09:50:59 AM

Record Type: Record

To: See the distribution list at the bottom of this message
cc:
Subject: Dets Room for Tonight

Tonight's Deputies Meeting will take place in 476 OEOP at 5:30pm.

Thanks
----- Forwarded by Leslie Bernstein/WHO/EOP on 08/11/99
09:49 AM -----

LESLIE
BERNSTEIN
08/10/99 07:20:28 PM

Record Type: Record

To: See the distribution list at the bottom of this message
cc:
Subject: Before You Email Me

Yes, there will be a Deputies Meeting tomorrow at 5:30pm.
It will not be held in the Roosevelt Room. I will let you know
what room it will be in tomorrow.

Thanks

Message Sent

To:

Sara M. Latham/WHO/EOP@EOP
Barry J. Toiv/WHO/EOP@EOP
Jennifer M. Palmieri/WHO/EOP@EOP
Anne F. Donovan/WHO/EOP@EOP
Linda Ricci/OMB/EOP@EOP
Sharon H. Yuan/OPD/EOP@EOP
Kris M Balderston/WHO/EOP@EOP
Tracey E. Thornton/WHO/EOP@EOP
Dario J. Gomez/WHO/EOP@EOP
Linda L. Moore/WHO/EOP@EOP
Dorian V. Weaver/WHO/EOP@EOP
Beverly J. Barnes/WHO/EOP@EOP
Christopher C. Jennings/OPD/EOP@EOP
John Dankowski/WHO/EOP@EOP
Susan L. Hazard/WHO/EOP@EOP
Lisa D. Branch/CEA/EOP@EOP
Fred DuVal/WHO/EOP@EOP
Shirley S. Sagawa/WHO/EOP@EOP
Donna Dejbani/NSC/EOP@EOP
Francine P. Obermiller/CEA/EOP@EOP
Cathy L. Millison/NSC/EOP@EOP
Jennifer M. Luray/WHO/EOP@EOP
Kelley L. O'Dell/WHO/EOP@EOP
Jeffrey M. Smith/OSTP/EOP@EOP
Todd A. Bledsoe/WHO/EOP@EOP
Janis F. Kearney/WHO/EOP@EOP
Cheryl D. Mills/WHO/EOP@EOP
Skye S. Philbrick/WHO/EOP@EOP
Patricia Solis-Doyle/WHO/EOP@EOP
Martha Foley/WHO/EOP@EOP
Douglas J. Band/WHO/EOP@EOP
Beth A. Viola/CEQ/EOP@EOP
Paul D. Glastris/WHO/EOP@EOP
Anne Whitworth/WHO/EOP@EOP
June G. Turner/WHO/EOP@EOP
Devorah R. Adler/OPD/EOP@EOP
Richard L. Siewert/WHO/EOP@EOP
David R. Goodfriend/WHO/EOP@EOP
Adrienne C. Lavalley/WHO/EOP@EOP
Thomas D. Janenda/WHO/EOP@EOP
Erica R. Morris/WHO/EOP@EOP
Mary M. Chuckerel/OMB/EOP@EOP
Sylvia L. Parsons/WHO/EOP@EOP
Joshua Gotbaum/OMB/EOP@EOP
Courtney O. Gregoire/OPD/EOP@EOP
Laura Efurd/WHO/EOP@EOP
Mark F. Lindsay/WHO/EOP@EOP
Paul J. Weinstein Jr./OPD/EOP@EOP

David Vandivier/OMB/EOP@EOP
Michele Ballantyne/WHO/EOP@EOP
Shannon Mason/OMB/EOP@EOP
Daniel Sakura/CEQ/EOP@EOP
Mara E. Rudman/NSC/EOP@EOP
Wendy E. Gray/NSC/EOP@EOP
Laura S. Marcus/WHO/EOP@EOP
Lisel Loy/WHO/EOP@EOP
Laura K. Demeo/WHO/EOP@EOP

Message Sent

To:

Sara M. Latham/WHO/EOP@EOP
Barry J. Toiv/WHO/EOP@EOP
Jennifer M. Palmieri/WHO/EOP@EOP
Anne F. Donovan/WHO/EOP@EOP
Linda Ricci/OMB/EOP@EOP
Sharon H. Yuan/OPD/EOP@EOP
Kris M Balderston/WHO/EOP@EOP
Tracey E. Thornton/WHO/EOP@EOP
Dario J. Gomez/WHO/EOP@EOP
Linda L. Moore/WHO/EOP@EOP
Dorian V. Weaver/WHO/EOP@EOP
Beverly J. Barnes/WHO/EOP@EOP
Christopher C. Jennings/OPD/EOP@EOP
John Dankowski/WHO/EOP@EOP
Susan L. Hazard/WHO/EOP@EOP
Lisa D. Branch/CEA/EOP@EOP
Fred DuVal/WHO/EOP@EOP
Shirley S. Sagawa/WHO/EOP@EOP
Donna Dejban/NSC/EOP@EOP
Francine P. Obermiller/CEA/EOP@EOP
Cathy L. Millison/NSC/EOP@EOP
Jennifer M. Luray/WHO/EOP@EOP
Kelley L. O'Dell/WHO/EOP@EOP
Jeffrey M. Smith/OSTP/EOP@EOP
Todd A. Bledsoe/WHO/EOP@EOP
Janis F. Kearney/WHO/EOP@EOP
Cheryl D. Mills/WHO/EOP@EOP
Skye S. Philbrick/WHO/EOP@EOP
Patricia Solis-Doyle/WHO/EOP@EOP
Martha Foley/WHO/EOP@EOP
Douglas J. Band/WHO/EOP@EOP
Beth A. Viola/CEQ/EOP@EOP
Paul D. Glastris/WHO/EOP@EOP
Anne Whitworth/WHO/EOP@EOP
June G. Turner/WHO/EOP@EOP
Devorah R. Adler/OPD/EOP@EOP
Richard L. Siewert/WHO/EOP@EOP

David R. Goodfriend/WHO/EOP@EOP
Adrienne C. Lavalley/WHO/EOP@EOP
Thomas D. Janenda/WHO/EOP@EOP
Erica R. Morris/WHO/EOP@EOP
Mary M. Chuckerel/OMB/EOP@EOP
Sylvia L. Parsons/WHO/EOP@EOP
Joshua Gotbaum/OMB/EOP@EOP
Courtney O. Gregoire/OPD/EOP@EOP
Laura Efurd/WHO/EOP@EOP
Mark F. Lindsay/WHO/EOP@EOP
Paul J. Weinstein Jr./OPD/EOP@EOP
David Vandivier/OMB/EOP@EOP
Michele Ballantyne/WHO/EOP@EOP
Shannon Mason/OMB/EOP@EOP
Daniel Sakura/CEQ/EOP@EOP
Mara E. Rudman/NSC/EOP@EOP
Wendy E. Gray/NSC/EOP@EOP
Laura S. Marcus/WHO/EOP@EOP
Lisel Loy/WHO/EOP@EOP
Laura K. Demeo/WHO/EOP@EOP

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-AUG-1999 11:57:51.00

SUBJECT: Sue Esserman's Mtg on WTO, Thurs, 8/12

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

CC: Victoria A. Greenfield (CN=Victoria A. Greenfield/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

Apologize for the short notice, but Sue and Dave Walters ask that you attend a meeting tomorrow (8/12) at 9:30am re WTO. The mtg will be at USTR, Rm. 201 Winder bldg.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-AUG-1999 15:25:22.00

SUBJECT: do you have a new draft?

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

TEXT:

If you want me to circulate anything different from what we had yesterday
please send me a new draft relatively quickly

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:12-AUG-1999 18:19:56.00

SUBJECT: Phone Message from Lee Price

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP@EOP [CEA])
READ:UNKNOWN

Records Management@EOP (Records Management@EOP [UNKNOWN])
READ:UNKNOWN

TEXT:

Contact: Lee PriceCompany: Phone: 482-4885FAX: Message: Contact: Lee PriceCompany: Phone: 482-4885FAX:

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Michel Fouquin <FOUQUIN@CEPII.FR> (Michel Fouquin <FOUQUIN@CEPII.FR> [UNKNOWN])

CREATION DATE/TIME:12-AUG-1999 03:57:36.00

SUBJECT: meeting in Paris

TO: Robert Z. Lawrence (CN=Robert Z. Lawrence/OU=CEA/O=EOP [CEA])

READ:UNKNOWN

TEXT:

**** High Priority ****

**** Reply Requested When Convenient ****

Dear Professor Lawrence,

I have been informed that you will attend a conference in Paris on September 13-14. I guess that you will be very busy, but the CEPII would be very happy to meet you again.

Would you have time, we could organise a meeting in cooperation with the Planning Commission and IFRI. If there is such an opportunity may I suggest you to address the following topics on trade issues : the new round of negotiations launched in Seattle for example.

It would last 1 h.30, approximately 30/45 minutes to present your speech, and then 30/45 minutes for questions.

It would gather approximately 40 participants, economists and decision-makers from the government, companies, and academic institutions.

We are open to other options.

We would organize it in the most convenient way for you, regarding your schedule and where you'll stay in Paris ; it could be for example a breakfast early in the morning.

Looking forward to hearing from you,

Michel Fouquin
Deputy Director
CEPII
9 rue Georges Pitard
75015 paris
France
phone: 331 53 68 55 44
Fax: 331 53 68 55 03
E-mail: Fouquin@cepii.fr