

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:15-NOV-1997 13:47:36.00

SUBJECT: Re: college loans

TO: Aaron S. Edlin (CN=Aaron S. Edlin/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

I agree with Jeff. I am happy to see you participate/lead the work on this topic and I agree with your thoughts on the substance, although there may be an angle I haven't thought through sufficiently.

Jeffrey A. Frankel

11/14/97 02:43:44 PM

Record Type: Record

To: Aaron S. Edlin/CEA/EOP

cc: Michele Jolin/CEA/EOP, Janet L. Yellen/CEA/EOP

bcc:

Subject: Re: college loans

Aaron

Sounds like a good thing for you to participate in, or even lead. I also can't think of any objections to your policy slant, offhand. But let me know if Treasury comes back with some plausible arguments.

JF

Aaron S. Edlin

11/14/97 02:32:31 PM

Record Type: Record

To: Michele Jolin/CEA/EOP, Janet L. Yellen/CEA/EOP, Jeffrey A. Frankel/CEA/EOP

cc:

Subject: college loans

please tell me if you have any objections to my planning to participate in and possibly heading up a group that makes the college loan market more of a market, and less of a regulated industry.

Since education is an important concern for this administration, I thought it especially important to apprise you of my ideas and plans in this area to make certain you have no objections, and think this is something worth pursuing.

I started this by attending a meeting on college loans, where a paper from Treasury was presented that tried to calculate an appropriate rate of return for lenders. This seemed like a bad idea, so I sent the email below to Jonathan Gruber and Bob Shireman (NEC).

--Aaron

Jon,

My thoughts on the financial aid meeting on Friday follow. I suspect you will agree with me about what should be done, though you may believe that it is too difficult politically to bother.

I apologize in advance for the fact that some words will be misrecognized by my speech recognition system. In fact, many more will be misrecognized than you see, but I will correct those that seem particularly problematic and Scratch that that I catch.

Rate of return regulation is notoriously difficult. So difficult, that the United States is trying hard to abandon it even in industries long thought to have increasing returns to scale, industries where competition is not viable or involves inefficient replication of fixed costs.

Why, then, should we continue to use rate of return regulation in student loans, an area where there are multiple competing lenders. Instead of spending a huge amount of time trying to find an appropriate rate of return, and probably getting it wrong, shouldn't a system be created in which lenders bid to the government or to students to provide loans at low interest rates? Competition could drive banks toward the break-even point far better than regulation, despite treasury's admirable efforts.

The only real worry that I am able to conjure is a "cream skimming". Lenders might try to only loan to good repayment risks (economizing on debt collection costs and the two percent of the loan that isn't guaranteed). Presumably, this could be regulated easily. Lenders could be required to lend to all eligible borrowers. This wouldn't fully solve the problem, because lenders would try to only amortized to good risks. This problem is also probably controllable, however. Lenders could be required to provide an 800 number, and the department of education or college financial aid officers could provide a list of lenders phone numbers to each eligible student.

Do you know of any sound reason why we shouldn't go the free-market route?

-- Aaron

Email composed using speech recognition software.

Misrecognized words are common.

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

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D30]MAIL45989681U.316 to ASCII,

The following is a HEX DUMP:

Jon,

My thoughts on the financial aid meeting on Friday follow. I suspect you will agree with me about what should be done, though you may believe that it is too difficult politically to bother.

I apologize in advance for the fact that some words will be misrecognized by my speech recognition system. In fact, many more will be misrecognized than you see, but I will correct those that seem particularly problematic and scratch that that I catch.

Rate of return regulation is notoriously difficult. So difficult, that the United States is trying hard to abandon it even in industries long thought to have increasing returns to scale, industries where competition is not viable or involves inefficient replication of fixed costs.

Why, then, should we continue to use rate of return regulation in student loans, an area where there are multiple competing lenders. Instead of spending a huge amount of time trying to find an appropriate rate of return, and probably getting it wrong, shouldn't a system be created in which lenders bid to the government or to students to provide loans at low interest rates? Competition could drive banks toward the break-even point far better than regulation, despite treasury's admirable efforts.

The only real worry that I am able to conjure is a "cream skimming". Lenders might try to only loan to good repayment risks (economizing on debt collection costs and the two percent of the loan that isn't guaranteed). Presumably, this could be regulated easily. Lenders could be required to lend to all eligible borrowers. This wouldn't fully solve the problem, because lenders would try to only amortize to good risks. This problem is also probably controllable, however. Lenders could be required to provide an 800 number, and the department of education or college financial aid officers could provide a list of lenders phone numbers to each eligible student.

Do you know of any sound reason why we shouldn't go the free-market route?

-- Aaron

Email composed using speech recognition software.
Misrecognized words are common.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Peter R. Orszag (CN=Peter R. Orszag/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME:16-NOV-1997 18:06:05.00

SUBJECT: VERY CLOSE HOLD: Rough first draft of surplus memo

TO: alan.cohen (alan.cohen @ treas.sprint.com @ inet [UNKNOWN])

READ:UNKNOWN

TO: Barry B. Anderson (CN=Barry B. Anderson/OU=OMB/O=EOP @ EOP [OMB])

READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Joseph J. Minarik (CN=Joseph J. Minarik/OU=OMB/O=EOP @ EOP [OMB])

READ:UNKNOWN

TO: Jacob J. Lew (CN=Jacob J. Lew/OU=OMB/O=EOP @ EOP [OMB])

READ:UNKNOWN

TEXT:

The attached is a very rough first draft on various options to ensure that projected surpluses do raise national saving (rather than being dissipated through additional spending or tax cuts not linked to private saving). Gene has not reviewed the draft yet, so it should be treated as very preliminary.

Any comments would be most appreciated. We especially need help on some of the budget accounting questions.

The draft may evolve later tonight. If so, I will send a new version tomorrow morning.

I'm sure it's unnecessary to add that this draft should be held extremely tight.

Thanks,

Peter===== ATTACHMENT 1 =====

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D51]MAIL45636691P.316 to ASCII,
The following is a HEX DUMP:

THE UNIFIED BUDGET SURPLUS: OPTIONS TO SECURE INCREASE IN NATIONAL SAVING

The purpose of this memorandum is to present different options for ensuring that the projected unified budget surpluses are translated into higher national saving, rather than being dissipated through additional spending or tax cuts that do not promote private saving. The options thus share the objective of using the unified surpluses in some form to raise saving now, in order to ease the burden on future workers implied by demographic trends.

Background

Current OMB projections suggest a unified surplus will appear in 2002, and grow through the 10-year budget window (see table). As has been noted, these unified surpluses arise initially from surpluses in the trust funds: the non-trust fund component of the budget is projected to remain in deficit through at least 2007. But the *unified* budget balance, not its sub-components, reflects the Federal government's net transactions with the public. All else equal, it also gives an indication of the Federal government's direct impact on national saving.¹

Projected budget balance, \$ billion

	2001	2002	2003	2004	2005	2006	2007
Trust funds	115	123	131	138	153	161	172
Non-trust funds	-122	-60	-69	-55	-46	-25	-5
Unified budget	-7	63	62	83	109	136	167

Options

Three proposals for the surplus would, to a first approximation, have the same effect on saving:

1. Retire debt held by the public;
2. "Donate" the surpluses in some form to the Social Security Trust Fund; or
3. Use the surpluses to fund a set of individual retirement accounts (a la Feldstein)

¹ Technically, the most appropriate budget measure for evaluating the impact of the Federal sector on national saving is probably the net balance of the Federal sector in the NIPA accounts. Among the traditional budget measures (e.g., on-budget, off-budget, and unified), the unified budget balance comes closest in concept to the NIPA measure. Nonetheless, Federal transactions in the NIPAs differ from the unified budget in netting, timing, and coverage. In FY 1997, for example, the unified deficit was \$23 billion while the NIPA deficit was \$67 billion.

Option 1: Retire Debt Held by the Public

Description

This option involves no new policy actions. As the unified surpluses materialize, the excess of revenue over expenditure would be automatically used to retire debt held by the public.

That is, just as a unified budget deficit is generally financed by selling government securities to the public, a unified surplus allows the Federal government to buy down the outstanding stock of government debt held by the public. All else equal, national saving would rise by the amount of the unified surplus.

Pros

- As with all options below, maintains increase in national savings arising from unified budget surpluses.
- Produces reduction in debt outstanding with the public, for first time since 1969. Debt outstanding with the public would fall to less than 1 percent of GDP by approximately 2025.
- Keeps pressure on for Social Security reform.

Cons

- Perpetuates the unified surplus “on the books,” providing a target for new spending or tax cut proposals. Simply buying down debt is unlikely to compete effectively with new spending projects or tax cuts.
- Keeps pressure on for Social Security reform. Does nothing to improve imbalances in Social Security Trust Fund, except through very small and indirect effects on productivity (a 0.1 percent increase in the productivity growth rate reduces the 75-year actuarial imbalance in the Social Security system by approximately 0.1 percent of taxable payroll).

Option 2: Bolster the Social Security Trust Fund

Description

This option involves using the surplus in some form to bolster the Social Security Trust Fund. It has several variants:

- A) Use unified surplus to buy marketable government debt from the public, donate the debt to the Trust Fund.
- B) Use unified surplus to purchase marketable equities for the Social Security Trust Fund.
- C) Use non-Social Security part of the unified surplus to do either of the above.

2(A): Marketable government debt

Description

This option could be implemented in two different ways. The first approach would involve the Treasury purchasing government debt from the public, just as under Option 1 above. Instead of formally retiring the debt, however, the Treasury would then donate it to the Social Security Trust Fund. The second approach would involve the Social Security Trust Fund purchasing marketable government debt directly. We are checking on whether the budgetary treatment of these two approaches would differ.

Pros

- Has same economic effects as retiring government debt (Option 1): what matters is debt outstanding with the public, not how any debt is held *within* the government sector.
- Could provide a more attractive way of selling the reduction in debt held by the public: “saving Social Security” rather than “reducing debt.”
- Would extend the life of the Trust Fund from 2029 to 2050.
- No privatization of the Social Security system -- so popular with Ball camp.
- Uses surpluses in a way consistent with progressivity of current Social Security system.

Cons

- Under first approach, likely to be merely a financing item, and thus perpetuates unified surplus -- leaving a target for spending and tax cut proposals. We are checking on whether the second approach would be scored as an expenditure, and thus eliminate the surplus.
- Has “double counting” problem: The Social Security component of the unified surplus is credited to the Trust Fund twice. In other words, a \$1 of Social Security revenue raises the Social Security Trust Fund by \$2.
- Improves Social Security outlook and thus could reduce pressure for reform.
- No privatization -- so unpopular with supporters of that approach.
- Contrary to precedent, effectively funds Social Security with general revenues.

2(B): Marketable Equities

Description

Under this approach, either the Treasury or the Social Security Administration would purchase marketable equities that would be deposited in the Social Security Trust Fund.

Pros and cons same as 2(A) except:

Pros

- Depletes surplus because purchase of equities is scored as an outlay. Prevents surplus from being spent or used for new tax cuts. (We are still checking on whether 2(A) would achieve the same result.)
- Extends exhaustion date of Trust Fund from 2029 to beyond 75-year forecasting period.
- Lessens “double-counting” criticism because surpluses are depleted by expenditures, and thus double-counting less obvious.
- Still acceptable to Ball camp.

Cons

- U.S. Government investments in private equities raise a series of difficult issues:
 - Trust fund amounts subject to volatility in financial markets
 - Governance issues: how are corporate shares voted or not voted
 - Would investment strategy of the Fund be subject to political influence or interference?
- If Social Security is allowed to invest and disinvest at will, could raise problems for Treasury cash management and monetary policy.
- Still somewhat vulnerable to double-counting charge: Social Security component of unified surplus is transferred to Trust Fund twice.

2(C): Use non-Social Security part of the unified surplus to do either of the above

Description

Same options as above, except that only the non-Social Security component of the unified surplus would be used. Pros and cons as in 2(A) and 2(B) above, except:

Pros

- Avoids double-counting problem.

Cons

- Produces less dramatic improvement in Trust Fund -- no transfers into Fund until 2008.
- Allows Social Security component of unified surplus to be dissipated through new spending or tax cuts -- and thus reduces national saving relative to other options.

Option 3: Fund a set of individual retirement accounts

Description

This option would involve using the unified surplus to fund a set of individual retirement accounts. The effect on national saving would be the same as above, but the split between public and private saving would be different: Federal saving would be lower, but private saving would be higher. Again, there are several alternatives:

- A) The Feldstein proposal: permanent tax cuts linked to deposits into individual retirement accounts
- B) A variety of alternatives broadly similar to the Feldstein proposal: change connection to the surplus, the degree of progressivity, and the governance of the accounts.

3(A): Feldstein proposal

Martin Feldstein has proposed mandating that firms deposit 2 percent of taxable earnings (on top of the current OASDI tax of 12.4 percent) into a Personal Retirement Account for each worker. The individual would then receive a dollar-for-dollar tax credit for the PRA deposits. Feldstein argues that this system would mean a substantial tax cut for taxpayers (it should be noted, however, that it is unclear whether the mandatory “deposits” would be scored as a tax).

It should also be noted that Feldstein proposes permanent tax cuts, and -- as he admits -- his proposal is only tenuously tied to the surplus. Only if the surplus serendipitously turns out to be equal to 2 percent of payroll (about \$65 billion) would his proposal “spend the surplus.”

Pros

- If deposits not scored as revenues and offsetting outlays, reduces taxes. In particular, trades tax cuts (public dissaving) for private saving, and thus reduces the tax-GDP share while achieving the same effect on national saving.
- Could use much or all of unified surplus -- and thus protects against new spending or tax cuts
- Sets up private accounts that belong to individual (privatization):
 - Allows younger individuals to obtain a higher rate of return than Social Security
 - Creates account that belongs to individual, not government, and benefits accumulated by the individual cannot be taken away by the government

Cons

- At some point in the not-too-distant future, Federal surpluses will turn into deficits. The Feldstein proposal exacerbates those deficits. Even though national saving is unaffected relative to Options 1 and 2, large budget deficits may nonetheless be unacceptable and thus force spending cuts.
- Mandatory deposits could be scored as a revenue.
- To the extent that people have “sufficient” net financial assets already, they could offset the deposits into the private accounts by withdrawing from other accounts -- reducing national saving. Empirical evidence is mixed on this topic.
- Does not address the actuarial imbalance in the Social Security Trust Fund, and thus requires either benefit cuts or general revenue financing for benefits in 2029 and after.
- Shares the various cons of privatization:
 - Risk born by the individual
 - Some individuals may be unsophisticated investors
 - Because of risk, Federal Government might be forced to provide a floor under the accounts, adding to Federal cost
 - Problems with either mandatory or voluntary annuitization
 - Creates enormous pressure for ability to withdraw in advance of retirement for special needs, reducing national saving benefit.
 - Administrative costs would be much higher for individual plans than for centralized investment such as occurs or could occur with Social Security
- Administrative burden on whoever has to set up and maintain the IRAs -- employers or the Federal Government. Default options must be created for those who fail to designate a financial institution and investments.
- There are implementation problems with respect to the tax code: Would the tax cut be refundable?
- Taxpayers could perceive mandatory IRA as permanent, but income tax cut as transitory.

3(B): Alternative versions of Feldstein's proposal

Other proposals are similar to the Feldstein proposal, but with several possible twists:

1. The funding could be tied more directly to the unified budget surplus
2. The funding mechanism could involve Federal deposits into the accounts, rather than tax cuts.
3. The funding mechanism could involve more of a matching system, as under the Federal Thrift Savings Plan. The matching could improve the progressivity of the approach.
4. The deposits take the form of a given amount per person, rather than linked to payroll, or be based on some other distributional system.
5. The accounts could be managed by some government body, as under the Thrift Savings Plan.
6. The deposits could be voluntary, rather than mandatory.

1. Funding tied to unified surplus

Description

Feldstein does not link his tax cuts to the unified surplus. One alternative would be to explicitly make that connection: that each year, the deposits and tax cuts would be adjusted to the size of the actual or projected surplus.

Pros and cons as in 3(A) above, except:

Pros

- Does not exacerbate unified deficits after they start re-appearing in 21st century.
- Still provides some seed money for individual accounts, to attenuate tradeoffs involved in transition.

Cons

- Funding for IRAs is not permanent. Could prove hard to terminate funding -- creating pressure on unified deficit after unified surpluses run out.

- Size of deposits and tax cuts could vary from year to year, as the size of the unified surplus varies. In a recession, the tax cuts would be reduced as the surplus fell.

2. Funding provided by Federal outlays into accounts, rather than private deposits/tax cuts

Description

Feldstein's proposal is equivalent to having the Federal government deposit 2 percent of each individual's taxable payroll into a personal retirement account. Especially if the mandatory deposits are scored as a revenue, Feldstein's deposit-and-tax-cut scheme may be easier to implement as a system of Federal outlays.

Pros and cons as in 3(A) above, except:

Pros

- Could simplify structure of program, especially if the program is explicitly tied to the unified surplus: at the end of each fiscal year, the Federal government would make deposits into each account based on the size of the unified surplus.
- Avoids refundability problem with tax cuts.

Cons

- Does not reduce tax/GDP share, and raises outlays/GDP.

3. Funding provided only on a matching basis

Description

Under Feldstein's proposal, the Federal government's tax cuts effectively provide 100 percent funding for the mandatory deposits into individual accounts. An alternative -- regardless of whether the Federal funding is provided indirectly through tax cuts or directly through outlays -- would be to retain the mandatory deposits but provide only a partial match: the U.S. government would put up \$1 for every \$x of the account's value. In other words, the tax credit would be less than dollar-for-dollar, or the outlay would be done only on a matched basis. Specifically, under Feldstein's proposal, the subsidy rate is 100 percent -- the Federal government bears the cost of the entire deposit. The matching function would produce a subsidy rate lower than 100 percent.

Pros and cons as in 3(A) above, except:

Pros

- For a given level of deposits into private accounts, cost to Federal government is lower.
- For given cost to Federal government, more impact on national saving: the reduction in public saving is more than offset by the increased private saving in the specified accounts. Assuming no withdrawals from other private accounts, national saving increases.
- The matching function could be progressive. For example, the Federal government could provide 100 percent of the first \$200 per year, 75 percent of the next \$200, etc.

Cons

- Assuming the mandatory deposits would feed through one-for-one into lower take-home pay, the proposal would not make individuals “whole”: their wages would fall by more than the tax cut or government deposit. The public is likely to lack enthusiasm for any plan that mandates a reduction in their take-home pay.

4. Deposits not linked to payroll

Description

Feldstein’s proposal links the mandatory deposits to taxable payrolls. But the deposits could be made more progressive by cutting the link to payrolls -- instead the deposits could be done on a per capita basis (e.g., \$500 per person). In effect, such a system is a special version of the matching function above, in which the Federal government pays 100 percent of the first \$X for all depositors, and no more.

Pros and cons as in 3(A) above, except:

Pros

- Can easily be made as progressive as desired.

Cons

- Pensions are traditionally linked to compensation. Logic is to replace a certain percentage of income in retirement.

5. Having some government body manage the accounts, as under Thrift Savings Plan

Description

This option would turn Feldstein's accounts, which are similar to the personal security account proposal from one faction of the Gramlich commission, into more of the individual account proposal supported by Gramlich himself. The accounts would be managed by some government board, and would offer individuals some limited choices (e.g., bond fund, equity fund, international fund). The approach is thus similar to the one used in the Thrift Savings Plan for government employees.

Pros and cons as in 3(A) above, except:

Pros

- Reduces investor risks and administrative costs.

Cons

- Raises corporate governance problems similar to the ones noted in 2(B) above.

6. Tax cuts for voluntary deposits

Description

Feldstein's proposal involves mandatory deposits into the private retirement accounts, which could potentially be scored as a revenue and offsetting outlay. Instead of making the deposits mandatory, the system could be made voluntary -- such as through an expansion of existing IRA provisions.

Pros and cons as in 3(A) above, except:

Pros

- Clearly a tax cut.
- No "mandate" involved.

Cons

- More regressive: higher income people more likely to participate.
- Less dramatic -- doesn't break any new ground.
- Not clear that this is optimal use of funds for tax cuts -- plays into tax reform debate.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Peter R. Orszag (CN=Peter R. Orszag/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME:17-NOV-1997 14:32:57.00

SUBJECT: Draft #2 of surplus memo

TO: alan.cohen (alan.cohen @ treas.sprint.com @ inet [UNKNOWN])

READ:UNKNOWN

TO: Russell W. Horwitz (CN=Russell W. Horwitz/OU=OPD/O=EOP @ EOP [OPD])

READ:UNKNOWN

TO: Joseph J. Minarik (CN=Joseph J. Minarik/OU=OMB/O=EOP @ EOP [OMB])

READ:UNKNOWN

TO: Barry B. Anderson (CN=Barry B. Anderson/OU=OMB/O=EOP @ EOP [OMB])

READ:UNKNOWN

TO: Peter A. Weissman (CN=Peter A. Weissman/OU=OPD/O=EOP @ EOP [OPD])

READ:UNKNOWN

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

READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Jacob J. Lew (CN=Jacob J. Lew/OU=OMB/O=EOP @ EOP [OMB])

READ:UNKNOWN

TEXT:

Again, comments welcome...===== ATTACHMENT 1 =====

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D45]MAIL41915502X.316 to ASCII,

The following is a HEX DUMP:

THE UNIFIED BUDGET SURPLUS: OPTIONS TO SECURE INCREASE IN NATIONAL SAVING

The purpose of this memorandum is to present different options for ensuring that the projected unified budget surpluses are translated into higher national saving, rather than being dissipated through additional spending or tax cuts that do not promote private saving. The options thus share the objective of using the unified surpluses in some form to raise saving now, in order to raise productivity in the future and therefore ease the burden on future workers implied by demographic trends. Higher national saving now would also improve both the primary and overall Federal budget balance in the future: it would improve the primary balance by raising future GDP and revenue, while further improving the overall balance by reducing interest rates and the stock of outstanding Federal debt held by the public.

Background

Current OMB projections suggest a unified surplus will appear in 2002, and grow through the 10-year budget window (see table). These unified surpluses are expected to continue through 2026. As has been noted, the unified surpluses arise initially from surpluses in the trust funds: the non-trust fund component of the budget is projected to remain in deficit through 2007, after which it is also expected to move into surplus. But the *unified* budget balance, not its sub-components, reflects the Federal government's net transactions with the public. All else equal, it also gives an indication of the Federal government's direct impact on national saving.¹

On the other hand, the unified surplus does not necessarily provide an insightful summary of inter-generational tradeoffs. In particular, the unified budget does not reflect any sense of generational accounting. To strike a better balance between different generations, it is arguably better to balance the structural non-trust fund component of the budget while also ensuring that the Social Security system is in long-term actuarial balance.

¹ Technically, the most appropriate budget measure for evaluating the impact of the Federal sector on national saving is probably the net balance of the Federal sector in the NIPA accounts. Among the traditional budget measures (e.g., on-budget, off-budget, and unified), the unified budget balance comes closest in concept to the NIPA measure. Nonetheless, Federal transactions in the NIPAs differ from the unified budget in netting, timing, and coverage. In FY 1997, for example, the unified deficit was \$23 billion while the NIPA deficit was \$67 billion.

Projected budget balance, \$ billion

	2001	2002	2003	2004	2005	2006	2007
Trust funds	115	123	131	138	153	161	172
Non-trust funds	-122	-60	-69	-55	-46	-25	-5
Unified budget	-7	63	62	83	109	136	167

Source: OMB

Options

Three proposals for the surplus would, to a first approximation, have the same effect on saving:

1. Retire debt held by the public;
2. “Donate” the surpluses in some form to the Social Security Trust Fund; or
3. Use the surpluses to fund a set of individual retirement accounts.

The second two options have numerous variants, which are explored in more detail below.

Option 1: Retire/Reduce Debt Held by the Public

Description

This option involves no new policy actions. As the unified surpluses materialize, the excess of revenue over expenditure would automatically translate into reduced debt outstanding with the public. Specifically, the excess of revenue over expenditure could be used to retire debt held by the public or, more likely and equivalently, to forgo issuing new debt as existing securities come due. That is, just as a unified budget deficit is generally financed by selling government securities to the public, a unified surplus allows the Federal government to reduce the outstanding stock of government debt held by the public. All else equal, national saving would rise by the amount of the unified surplus.

Pros

- As with all options below, maintains increase in national savings arising from unified budget surpluses.
- Produces reduction in debt outstanding with the public, for first time since 1969. Debt outstanding with the public would fall to less than 1 percent of GDP by approximately 2025.
- Keeps pressure on for Social Security reform because, to a first approximation, the Social Security Trust Fund imbalance is unaffected.

Cons

- Perpetuates the unified surplus “on the books,” providing a target for new spending or tax cut proposals. Simply buying down debt may not be able to compete effectively with new spending projects or tax cuts.
- Keeps pressure on for Social Security reform. Does nothing to improve imbalances in Social Security Trust Fund, except through very small and indirect effects on productivity (a 0.1 percent increase in the productivity growth rate reduces the 75-year actuarial imbalance in the Social Security system by approximately 0.1 percent of taxable payroll).

Option 2: Bolster the Social Security Trust Fund

Description

This option involves using the surplus in some form to bolster the Social Security Trust Fund. It has several variants:

- A) Use unified surplus to buy marketable government debt from the public, donate the debt to the Trust Fund.
- B) Use unified surplus to purchase marketable equities for the Social Security Trust Fund.
- C) Use unified surplus to purchase corporate debt for the Social Security Trust Fund
- D) Allow Social Security to invest *out of existing balances* an amount equal to unified surplus in marketable securities
- E) Use non-Social Security part of the unified surplus to do either of the above.

2(A): Marketable government debt

Description

This option could be implemented in two different ways. The first approach would involve the Treasury purchasing government debt from the public, as is possible under Option 1 above. Instead of formally retiring the debt, however, the Treasury would then donate it to the Social Security Trust Fund. The second approach would involve new purchases of marketable government debt directly by the Social Security Trust Fund, with the amount of purchases tied to the size of the projected unified surplus. We are examining the budgetary treatment of these two approaches, although initial analysis suggests that neither approach would involve a unified budget expenditure.

Pros

- Has same economic effects as retiring government debt (Option 1): what matters is debt outstanding with the public, not how any debt is held *within* the government sector.
- Could provide a more attractive way of selling the reduction in debt held by the public: “saving Social Security” in addition to “reducing publicly held debt.”

- Would extend the life of the Trust Fund from 2029 to 2050.
- No privatization of the Social Security system -- popular with Ball camp and others.
- Uses surpluses in a way consistent with progressivity of current Social Security system.

Cons

- Not scored as an expenditure, and thus perpetuates unified surplus -- leaving a target for spending and tax cut proposals.
- Has “double counting” problem: The Social Security component of the unified surplus is credited to the Trust Fund twice. In other words, \$1 of additional Social Security revenue over outlays raises the Social Security Trust Fund by \$2.
- Improvement in actuarial balance of Social Security comes at the expense of other parts of the budget -- the increase in the Trust Fund does not affect total future revenue, and thus merely shifts revenue across different uses within the budget.
- Improves Social Security outlook and thus could reduce pressure for reform.
- No privatization -- unpopular with supporters of that approach.
- Contrary to precedent, effectively funds Social Security with general revenues.

2(B): Marketable Equities

Description

Under this approach, either the Treasury or the Social Security Administration would purchase marketable equities that would be deposited in the Social Security Trust Fund. OMB is examining the budget scoring involved.

Pros and cons same as 2(A) except:

Pros

- Depending on budget scoring rule: depletes surplus because purchase of equities could be scored as an outlay. Prevents surplus from being spent or used for new tax cuts. (We are still checking on whether 2(A) would achieve the same result.)

- Extends exhaustion date of Trust Fund from 2029 to beyond 75-year forecasting period.
- Lessens “double-counting” criticism because surpluses are depleted by expenditures, and thus double-counting less obvious.
- Acceptable to Ball camp.

Cons

- U.S. Government investments in private equities raise a series of difficult issues:
 - Trust fund amounts subject to volatility in financial markets
 - Governance issues: how are corporate shares voted or not voted
 - Would investment strategy of the Fund be subject to political influence or interference?
- If Social Security is allowed to invest and disinvest at will, could raise problems for Treasury cash management and for monetary policy.
- Still somewhat vulnerable to double-counting charge: Social Security component of unified surplus is transferred to Trust Fund twice.

2(C): Marketable private debt

Description

Under this approach, either the Treasury or the Social Security Administration would purchase marketable private-sector *debt* that would be deposited into the Social Security Trust Fund. Again, OMB is checking on budget scoring rules.

Pros and cons as in 2(B) above, except:

Pros

- Less volatile than equity investments. If bonds are held to maturity, primary risks are default risk and inflation risk.
- Governance issues may be less complicated than with equity investments. No voting rights involved.

Cons

- Extends exhaustion date of Trust Fund to 2050, rather than beyond 75-year horizon, because of lower rate of return to debt.

2(D): Allow Social Security Administration to invest out of existing balances an amount equal to unified surplus into marketable non-governmental securities

Description

This approach is similar to the ones above, except that it does not involve net additions to the Trust Fund. Rather, the Social Security Administration would redeem some of its existing special purpose Treasury securities, and use the funds to purchase marketable non-governmental equity or debt. The immediate impact on the Trust Fund would be zero. But according to initial analysis, the purchase could be scored as an expenditure, while the redemption of the special purpose bond would be treated as an intra-governmental transfer and thus not affect the unified surplus. In other words, the unified surplus would be taken “off the books” through this mechanism.

Pros and cons same as above, except:

Pros

- Eliminates double-counting problem.
- Could eliminate unified surplus, depending on scoring rules.

Cons

- Reduces long-term Social Security Trust Fund imbalance less than above.
- May seem too much like budgetary legerdemain and may be too confusing.

2(E): Use non-Social Security part of the unified surplus to do either of the above

Description

Same options as above, except that only the non-Social Security component of the unified surplus would be used. Pros and cons as above, except:

Pros

- Avoids double-counting problem.

Cons

- Produces less dramatic improvement in Trust Fund -- no transfers into Fund until 2008.
- Allows Social Security component of unified surplus to be dissipated through new spending or tax cuts -- and thus reduces national saving relative to other options. The trust fund component of the budget accounts for more than the entire unified surplus until 2007.

Option 3: Fund a set of individual retirement accounts

Description

This option would involve using the unified surplus to fund a set of individual retirement accounts. The effect on national saving would be the same as above, but the split between public and private saving would be different: Federal saving would be lower, but private saving would be higher. Again, there are several alternatives:

- A) Permanent tax cuts linked to deposits into individual retirement accounts
- B) Funding tied to unified surplus
- C) Funding provided by Federal outlays into accounts, rather than private deposits/tax cuts
- D) Funding provided only on a partial matching basis
- E) Deposits not linked to payroll
- F) Having some government body manage the accounts, as under Thrift Savings Plan
- G) Tax cuts or matching funds for voluntary deposits

3(A): Permanent tax cuts linked to deposits into individual retirement accounts

Description

Martin Feldstein has proposed mandating that firms deposit 2 percent of taxable earnings (on top of the current OASDI tax of 12.4 percent) into a Personal Retirement Account for each worker. The individual would then receive a dollar-for-dollar individual income tax credit for the PRA deposits. This system would mean a substantial income tax cut for taxpayers, but it is unclear whether the mandatory “deposits” would be scored as a tax (with offsetting outlays).

It should also be noted that this proposal involves permanent tax cuts, which would continue even after Federal budget deficits re-appear, and is only tenuously tied to the surplus. Only if the surplus serendipitously turns out to be equal to 2 percent of payroll (about \$65 billion) would the proposal “spend the surplus.”

Pros

- If deposits not scored as revenues and offsetting outlays, reduces taxes. In particular, trades tax cuts (public dissaving) for private saving, and thus reduces the tax-GDP share while achieving the same effect on national saving.
- Could use much or all of unified surplus -- and thus protects against new spending or tax cuts.
- Sets up private accounts that belong to individual (privatization):

- Allows younger individuals to obtain a higher rate of return than Social Security
- Creates account that belongs to individual, not government, and benefits accumulated by the individual cannot be taken away by the government

Cons

- At some point in the not-too-distant future, Federal surpluses will turn into deficits. The 3(A) proposal exacerbates those deficits. Even though national saving is unaffected relative to Options 1 and 2, large budget deficits may nonetheless be unacceptable and thus force spending cuts -- including cuts in Social Security.
- Mandatory deposits could be scored as a revenue.
- To the extent that people have “sufficient” net financial assets already, they could offset the deposits into the private accounts by withdrawing from other accounts or reducing other non-tax-favored savings. Such offsets would reduce or eliminate the net increase in national saving relative to Option 1. Empirical evidence is mixed on this topic.
- Does not address the actuarial imbalance in the Social Security Trust Fund, and thus requires either benefit cuts or general revenue financing for benefits in 2029 and after.
- Shares the various cons of privatization:
 - Could undermine long-term support for Social Security program.
 - Risk born by the individual.
 - Millions of individuals are unsophisticated investors, and may invest in a manner that is unduly risky or undiversified. May be vulnerable to investor fraud.
 - Might induce some employers to drop retirement plans or reduce existing coverage.
 - Creates enormous pressure for ability to withdraw in advance of retirement for special needs, reducing national saving benefit.
 - Administrative costs would be much higher for individual plans than for centralized investment such as occurs or could occur with Social Security.
 - Generally less progressive than current Social Security system.
 - Problems with either mandatory or voluntary annuitization.
- Administrative burden on whoever has to set up and maintain the IRAs -- employers or the Federal Government. Default options must be created for those who fail to designate a financial institution and investments.

- There are implementation problems with respect to the tax code: Millions of people would be subject to the 2 percent with-holding from their earnings, but do not owe any income tax against which to credit the offset. Would the tax cut be refundable?
- Taxpayers may fear that mandatory 2 percent deposits out of payroll are likely to outlast the offsetting tax cuts, which could be eliminated after budget surpluses disappear.

3(B): Funding tied to unified surplus

Description

The proposal above does not link the tax cuts to the unified surplus. One alternative would be to explicitly make that connection: that each year or on a multi-year basis, the deposits and tax cuts would be adjusted to the size of the actual or projected surplus.

Pros and cons as in 3(A) above, except:

Pros

- Does not exacerbate unified deficits after they start re-appearing in 21st century.
- Still provides significant seed money for individual accounts with tax-free compounding, to inculcate the savings habit and attenuate the tradeoffs involved in transition from pay-as-you-go system.

Cons

- Funding for IRAs is not permanent. Could prove hard to terminate funding -- creating pressure on unified deficit after unified surpluses run out.
- Size of deposits and tax cuts could vary from year to year, as the size of the unified surplus varies. In a recession, the tax cuts would be reduced or eliminated as the surplus fell.

3(C): Funding provided by Federal outlays into accounts, rather than private deposits/tax cuts

Description

The 3(A) proposal is equivalent to having the Federal government deposit 2 percent of each individual's taxable payroll into a personal retirement account. Especially if the mandatory

deposits are scored as a revenue, Feldstein's deposit-and-tax-cut scheme may be easier to implement as a system of Federal outlays.

Pros and cons as in 3(A) above, except:

Pros

- Could simplify structure of program and avoid imposing new payroll deduction and deposit obligations on employers. If the program is explicitly tied to the unified surplus, the Federal government would make deposits at the end of each fiscal year into each account based on the size of the unified surplus.
- Avoids potential public concern that payroll deposit mandate is permanent, while offsetting tax cuts are temporary.
- Avoids refundability problem with tax cuts.

Cons

- Does not reduce tax/GDP share, and raises outlays/GDP.

3(D): Funding provided only on a partial matching basis

Description

Under the 3(A) proposal, the Federal government's tax cuts effectively provide 100 percent funding for the mandatory deposits into individual accounts. An alternative -- regardless of whether the Federal funding is provided indirectly through tax cuts or directly through outlays -- would be to retain the mandatory deposits but provide only a partial match: the U.S. government would put up \$1 for every \$x of the account's value. In other words, the tax credit would be less than dollar-for-dollar, or the outlay would be done only on a matched basis. Specifically, under 3(A), the subsidy rate is 100 percent -- the Federal government bears the cost of the entire deposit. The matching function would produce a subsidy rate lower than 100 percent.

Pros and cons as in 3(A) above, except:

Pros

- For a given level of deposits into private accounts, cost to Federal government is lower.
- For given cost to Federal government, more impact on national saving: the reduction in

public saving is more than offset by the increased private saving in the specified accounts. Assuming no withdrawals from other private accounts, national saving increases.

- The matching function could be progressive. For example, the Federal government could provide 100 percent of the first \$200 per year, 75 percent of the next \$200, etc.

Cons

- Assuming the mandatory deposits would feed through one-for-one into lower take-home pay, the proposal would not make individuals “whole”: their wages would fall by more than the tax cut or government deposit. The public is likely to lack enthusiasm for any plan that mandates a reduction in their take-home pay.

3(E): Deposits not linked to payroll

Description

3(A) links the mandatory deposits to taxable payrolls. But the deposits could be made more progressive by cutting the link to payrolls -- instead the deposits could be done on a per capita basis (e.g., \$500 per person) or some other basis. In effect, such a system is a special version of the matching function above, in which the Federal government pays 100 percent of the first \$X for all depositors, and no more.

Pros and cons as in 3(A) above, except:

Pros

- Can easily be made as progressive as desired.
- Non-payroll based deposits would be further divorced from the Social Security tax system and hence might be slightly less likely to be viewed as a replacement for part of the existing defined benefit Social Security program.

Cons

- Pensions are traditionally linked to compensation. Logic is to replace a certain percentage of income in retirement.

3(F): Having some government body manage the accounts, as under Thrift Savings Plan

Description

This option would turn the 3(A) accounts, which are similar to the personal security account proposal from one faction of the Gramlich commission, into something more closely resembling the individual account proposal supported by Gramlich himself. The accounts would be managed by some government board, and would offer individuals some limited choices (e.g., bond fund, equity fund, international fund). The approach is thus similar to the one used in the Thrift Savings Plan for government employees.

Pros and cons as in 3(A) above, except:

Pros

- Reduces investor risks and administrative costs.

Cons

- Raises corporate governance problems similar to the ones noted in 2(B) above.
- Potential criticism for extensive or unnecessary bureaucracy and government interference.

3(G): Tax cuts or matching funds for voluntary deposits

Description

3(A) involves mandatory deposits into the private retirement accounts, which could potentially be scored as a revenue and offsetting outlay. Instead of making the deposits mandatory, the system could be made voluntary -- such as through an expansion of existing IRA provisions. An alternative could involve Federal government contributions that match voluntary contributions by individuals (as under many corporate 401(k) plans and the Federal government's TSP program):

- For example, for every dollar an individual deposits into his or her account up to \$1,000, the Federal government would also deposit a dollar into the account.
- The matching could be progressive: \$1 for every \$1 up to \$1,000, then 50 cents for every \$1 up to \$2,000.
- Alternatively, the Federal match could apply only after the individual had contributed \$x (e.g., \$500).

Pros and cons as in 3(A) above, except:

Pros

- Unambiguous benefit or tax cut for individuals.
- Does not necessarily commit to Federal deposits or tax cuts beyond duration of unified surpluses.
- No “mandate” involved.

Cons

- Potentially more regressive: higher income people more likely to participate in a voluntary program. Matching function could be designed to improve progressivity.
- Plays more directly into tax reform debate -- and could be confusing given existing tax incentives for savings.
- May not absorb entire surplus.
- May not increase national saving as much as mandatory approach, since those who participate in voluntary program more likely to have other assets with which to offset deposits.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:17-NOV-1997 18:46:45.00

SUBJECT: Monthly Treasury Meetings

TO: Rebecca M. Blank (CN=Rebecca M. Blank/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Randy suggested to me that it might be a good idea to invite OMB (particularly Josh Gotbaum and Joe Minarik) to participate in the monthly meetings. I concur. They are almost always on the same wavelength as CEA and Treasury, are involved in the same set of issues, and have been excellent allies in past battles.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:17-NOV-1997 14:57:05.00

SUBJECT: memo on SEAsia impact on U.S.

TO: Jon D. Haveman (CN=Jon D. Haveman/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: HOPKINS_M (HOPKINS_M @ A1 @ CD @ LNGTWY [UNKNOWN]) (CEA)

READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

I propose to send this one-pager around (at Lael's suggestion). Comments welcome.

Janet: you might find it useful re WEB brief.

Mark: could you please check the shares of US exports and imports (each separately) going to/ coming from (1) ASEAN, and (2) all of East Asia?

Thks.

JF

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

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D62]MAIL40296502M.316 to ASCII,

The following is a HEX DUMP:

Draft memo

November 17, 1997

To:

Charlene Barshevsky

Gene Sperling

Larry Summers

Dan Tarullo

From: Jeff Frankel

Re: Forecasted impact of SE Asian currency crisis on the U.S.

Economic forecasters are busy knocking down their projections for growth. A common estimate is that the loss in net exports due to the Southeast Asian crisis will amount to about ½ per cent of US GDP, based on the countries that have been hit as of mid November. This is the forecasted effect on the trade balance. The ultimate effect on GDP could be greater if there are multiplier effects.

Or it could be less, if one takes into account the likely implication that interest rates will be lower than they otherwise would be. The most recent official Administration forecast for 1998 growth, at the mid-session review, was a conservative 2.0 percent. (The troika is unlikely to reduce the forecast for 1998 much, if at all, going into the upcoming budget process. We are still below private forecasters such as the Blue Chip consensus, at 2.5.) This forecast entails a definite slowdown relative to our growth in the recent past, 4.0 per cent over the last four quarters. We have never specified what would cause the economy to slow down. An increase in interest rates was the most obvious candidate. Now it appears that the slowdown will take the form more of a loss in net exports, and less of a loss in interest-sensitive sectors such as investment and consumer durables. In other words, the effect is on the composition of growth, not the level.

These considerations are reassuring as regards US growth. But they are not reassuring as regards the politically-sensitive trade deficit, particularly vis-a-vis East Asia. The truth is that the rising trade deficit is a natural reflection of our rapid growth rate, and -- with unemployment at 4.7% -- not a cause of economic concern. But the anti-internationalist sentiment that has dealt fast-track a political set-back may feed on a growing trade deficit in 1998. In this regard I would note that some forecasters may be under-estimating the likely effect on US imports from East Asia. Much of the attention has focussed on the likely loss of *exports*. Some solace has been taken, for example, from the fact that the ASEAN countries buy less than 4 % of our exports to begin with. This may be too sanguine. It neglects that these countries are likely to react to their devaluations by increasing the supply of their products (semi-conductors, other electronics, steel, textiles, apparel, etc.), driving down the prices of these goods on world markets. The US of course already imports more from East Asia than it exports. These imports are now likely to increase rapidly.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:17-NOV-1997 21:06:51.00

SUBJECT: file on Global Outlook

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

READ:UNKNOWN

TO: Jeremy B. Rudd (CN=Jeremy B. Rudd/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

I am sending this around in case anybody wants to turn it (the talk I gave at IIF this a.m.) into the last section of the Macro chapter of the ERP, while I am in Vancouver. (Some notes for revisions appear at the end.) If not, I can do it when I get back.

JF===== ATTACHMENT 1 =====

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D90]MAIL42276702F.316 to ASCII,
The following is a HEX DUMP:

Notes on the Global Outlook
Jeffrey A. Frankel, Member, Council of Economic Advisers

To be presented at the Institute of International Finance, Nov. 17, 1997
{and to be the basis for a section of Macro chapter of ERP}

Toward the end of this talk I am going to discuss some broad themes, evaluating a few capsule characterizations of the current outlook that one often hears, and adding one of my own: *overheating, deflation, market clearing, New Economy, and new anti-internationalism*. But I will begin by reviewing recent developments in the global macroeconomy.

During much of the last six years, the United States has been growing faster than its trading partners. At the start of 1997, we expected this pattern to reverse. On the one hand, it seemed unlikely that the rapid U.S. growth rate of 1996 would continue [3.3 on a Q4/Q4 basis]. On the other hand, it seemed likely that growth in Japan and Europe would pick up. And it appeared certain that developing Asia, the new "fourth growth pole" of the world economy, would continue to far exceed our own growth rate.

For example in the IMF WEO forecast of one year ago the U.S. was expected to slow to 2.4%, while Japan was expected to grow at about 2.7% and the developing countries of Asia were expect to continue chugging along at 7.6%. The PECC Ec.Outlook said 8% [May]. As recently as last month's October WEO, when the outlines of the ASEAN problems were known, 1998 growth among Asian developing countries was still forecast at 7.4 %¹.

What happened this year was something quite different than forecasted.

U.S.

- Contrary to the slowing that most [incl. us] expected in 1997, the growth rate in the first three quarters averaged 3.9 %. Employment continues to rise, with over 13 millions jobs created since January 1993.
- The President's plan to cut (by 2/3 > 1/2 during the first term) and then eliminate (by 2002) the budget deficit has proceeded well ahead of schedule, in part due to rapid growth.
- With growth in excess of potential, and unemployment below 5% since April [for the first time since before the 1973 oil shock], and below traditional estimates of the NAIRU as well, one would have expected inflationary pressures to emerge by now. They have not. Inflation remains low. While the most recent statistics suggest higher compensation growth in the 3rd quarter, they also suggest more rapid productivity growth. The implication is that workers are earning their raises, and unit labor costs are still not putting upward pressure on inflation.

The North Atlantic vs. the RoW

- Growth has also been strong in Canada, the British Isles, and the Nordic countries.

¹[and worldwide at 4.3 %, almost the same as for 1997]

- (In many of these countries, recent fiscal consolidation has helped keep interest rates down.)
- In the rest of the world, however, 1997 was a disappointingly weak year.

Europe

- Odds look good for EMU taking place as currently scheduled (participants to be chosen in Spring of 1998, and the euro in place by January 1999). In the early 1990s, as German spending in the re-acquired eastern lander pushed up real interest rates, differences in countries' needs regarding monetary policy led to the 1992-93 ERM crises. Currently, differences in monetary policy needs are not as sharp, as reflected in the convergence of interest rates.
- EMU will be the most important change in the world monetary system since 1973, and an inspiring enterprise -- economically, politically, and historically.
- US has far less stake in EMU than Europe does. But nevertheless, we are following its progress with interest. To the extent that we do have a stake in it, it is congruent with the interests of Europeans. That is, a healthy and growing European economy is in the economic and political interest of the United States
- Growth has been unspectacular on the European continent, particularly among the major countries, and unemployment remains very high (an undiminished 11% in the EU overall). Monetary and fiscal policy are largely constrained by the needs of Maastricht (though of course price stability and budgetary discipline are good for long-term growth, regardless of plans for EMU). Monetary and fiscal policy will probably be equally constrained, after Jan. 1999 as before, by a new credibility-seeking European Central Bank and the Stability and Growth path, respectively.
- Policymakers cannot afford to let EMU distract them from fundamental reforms to reduce rigidities in labor and product markets. National economies need to be able to adjust flexibly to future shocks. Otherwise the loss of countries' monetary independence entailed in EMU will cause problems in the future. Procrustean attempts to address unemployment by reducing the supply of labor rather than letting demand increase (through flexibly-adjusting markets) are not promising [e.g., French ideas on mandating a shorter workweek at unchanged pay].²

Japan

- Bursting of 1980s bubble (1990-95).
- Faltering of recovery in 1997. The US Administration was concerned that Japan's April 97 consumption tax increase (in an understandable desire to move toward long-term fiscal consolidation) might be too much too soon, and would choke off the nascent 1996 recovery. The Japanese government was confident that it would achieve 1.8% growth in 1997. In the event, U.S. concerns turn out to have been justified.
- When one looks around the world for possible threats to the global economy, there are perhaps more grounds for concern in Japan than anywhere else.

² "A recent flood of cross-country mergers and acquisitions shows that the private sector is responding, less by seeking to protect itself from competition, but rather so as to take advantage of European integration. Governments should build on the growing consensus for reform."

- Monetary policy can't push Japan's economy any further (liquidity trap), and the government seems determined not to cut taxes.
- Banking problems linger. Japan's slowness to acknowledge, deal with, and move beyond its bad loans problem has actually managed to make the U.S. record of the 1980s look good by comparison.
- Prime Minister Hashimoto's deregulation initiative is a hopeful sign (deregulation in construction, retail, telecom and transp., e.g., ports, and esp. Big Bang in financial markets). But deregulation is unlikely to provide a large boost to output in the short run.
- The weak Japanese economy, by comparison with the strong US economy, probably explains much of the depreciation of the yen against the dollar over the last two+ years. (Almost the same could be said of continental Europe.)

SE Asia

Origins of the crisis

We all believe that liberalized, open, and international integrated financial markets have many important advantages. Funds will be allocated more efficiently, developing countries can fund their investment at lower costs of capital than if they had to rely on domestic saving alone, investors in wealthy countries can earn higher returns on average than if they were limited to investments in their own countries, and everyone can benefit from diversifying risk and smoothing consumption across time.

It may be time, however, to reconsider the proposition that financial markets always get it right, that if an emerging market country adopts sound policies it can be secure in the knowledge that it is immune from speculative attack. What do we say to those countries who resist opening their financial markets by citing the danger of crisis brought on by successive and excessive waves of speculative inflow and speculative outflow?

- At one time, we said that the key was budget discipline. If the government is not running a deficit, then it is the private sector that is borrowing from abroad, and it can be relied on to use the funds for good purposes. This "Lawson fallacy" was discredited by Chile 1980, Britain 1992, and Mexico pre-1994.
- So we said that the problem in Mexico was other fundamentals, particularly a low private saving rate; consumption was too strong (in part a response to liberalization of consumer credit, retail and imports). [Another fundamental was that a relatively high share of the capital inflow took the form of short-term liabilities denominated (in foreign currency), and not enough in the form of direct investment.] When we looked around for other countries with high current account deficits, and saw that they were in SE Asia [Thailand and Malaysia], we were reassured that fundamentals such as the saving rate and the level of foreign exchange reserves looked much stronger. If the inflows were not going to finance government budget deficits or private consumption, then they must be going to finance investment. So everything must be alright.

Of course the crisis did not take everyone by surprise. Krugman's twin Foreign Affairs articles of three years ago, on the Myth of the East Asian Miracle, and Tulipmania, provided a good early warning. Many of us took note over the last few years of excesses in some Asian countries and flaws in their banking systems, and urged reforms. We also noticed in 1996 the sort of export slowdown (in the global electronics market) to which an overly indebted country is

particularly vulnerable. The IMF duly warned the countries most at risk. But I think it fair to say that most of us were surprised at the depth and breadth of the crisis this Fall.

- What are we to conclude now? One answer is that much of the money went to finance -- not just investment in plant and equipment and infrastructure --but real estate and construction. The former generate the future earnings of foreign exchange from exports necessary to service the debt. Condo construction does not.

But this answer is a bit incomplete. For one thing, investment in plant and equipment was high in some of the countries most affected [T&M]. For another, the crisis has of course spread widely, including to countries with stronger fundamentals [Indonesia, Taiwan and Hong Kong]. Contagion appears to be a genuine phenomenon. As in Latin America two years ago, the breadth and depth of the punishment visited by investors on the debtor countries seems to exceed the magnitude of the policy sins they have committed.

The conclusion I draw is certainly not that financial market liberalization is bad. Overall, the benefits outweigh the costs. But we must be prepared for occasional crises, not all of them fully understandable. If markets sometimes overreact, then countries need even sounder macroeconomic policies to compensate. As Merton said, modern financial markets are like superhighways: they get us where we want to go faster, but the accidents are bigger as well. Extra caution in driving, and airbags, are both appropriate. Public and private saving rates remain important. Strengthening of prudential regulation of banks and other financial institutions in these countries is key to reducing the risk of accidents. Increases in reserve requirements against banks' short-term foreign-currency liabilities may be in order in some cases.

The longer term:

An end to the East Asian miracle, or just a temporary setback? Krugman claimed that there never was an East Asian miracle. (The appropriateness of the word "miracle" lies in the eyes of the beholder. If Krugman had chosen to phrase his conclusion differently: "The miracle of East Asian growth is due to miraculous rates of investment in physical and human capital," most readers would have been less surprised by the article than they were. Yet this is really what the article said.) Nevertheless, he forecasted a marked slowdown in East Asia. An article by Jeff Sachs in the current Foreign Affairs takes the contrary view: that East Asia's current financial troubles are purely transitory, and growth at miracle rates will before long resume. A natural guess is that the truth lies in between.

Yet this is really what the article said.) Nevertheless, he forecasted a marked slowdown in East Asia. An article by Jeff Sachs in the current Foreign Affairs takes the contrary view: that East Asia's current financial troubles are purely transitory, and growth at miracle rates will before long resume. A natural guess is that the truth lies in between.

Japan's growth rate appears to have converged to that of the United States and other industrialized countries, not gradually, but in the course of two sharp kinks. The first occurred in 1973-74, with the world oil shock. The second followed the bursting of the 1987-89 bubble in Japanese financial markets. [Japan's per capita growth rate averaged a remarkable 8 percent during the period 1962-1973, but slowed to 3 percent during 1974-1990 (Table 1). Over the last seven years, it averaged a mere 1 ½ percent.] Presumably Japanese growth will recover from its recent recession, but whether it will go back to the miracle rates of earlier decades seems

dubious. The convergence is complete. Are other East Asian economies now going through a growth-path kink analogous to Japan's 1973 slowdown? There is no necessary connection between transitory shocks such as a sharp increase in the price of oil or a financial crisis and the long-run rate of growth of potential output. With the exception of Japan, Singapore, and Hong Kong, East Asian economies still have a very long way to go before attaining the per capita incomes of the industrialized countries. But for those observers who thought that the miracle rates of growth attained by many East Asian economies over the past several decades were unsustainable, the 1997 episode of instability in financial markets may be interpreted as a signpost indicating that a more moderate and sustainable rate of growth lies ahead.

Other emerging markets

The most encouraging development in the world economy over the last decade was the choice by many countries to adopt the open market-economy model. Faced with the stark examples of the East Asia economic miracle on the one hand, and the economic fiasco of the communist countries on the other, countries in Latin America, the rest of Asia, Eastern Europe, and even Africa, opted for the capitalist model. Recent financial market developments have spread to Latin America, and may have a negative effect on 1998 growth rates. But assuming that this experience doesn't undermine the fundamental "Washington consensus," -- which favors stable monetary and fiscal policies, privatized enterprises and market-determined prices -- the long-term prospects for the emerging economies and transition economies remain excellent.

Possible short-term spillover from the crisis

Economists are busy updating 1998 projections for growth rates. Some that I have seen:			
	Downward revision		including effects via Lat. Am.
[Korea			
a government agency	0.2%-0.4%		-0.6% &
-.15%]			
a Washington agency	0.6% [1 w/ mult.]		
W.Cline, Inst.Int.Fin.			-0.3%
Lipsky, at Chase:	0.5%, to 1.0-1.5%		
Goldman Sachs 9/1 0.1%			
E.Hyman & N.Lazar	0.5 to 2.5%		
A.Sinai, Primark	0.5% to 2.5%		
B.Steinberg, at M.Lynch	0.5% to 2.5%		
Blue Chip		Yr./yr.2.5% 4Q/4Q 2.3%	
("Corporate economists slower to react to fin.mkts. & overseas news than Wall St. forecasters? wsj)			

U.S.

It is easy to see why there would be a wide range of numbers. Aside from the usual variation in models and assumptions, different forecasts refer to different dating, which makes all the difference. Forecasts from the early fall consider only the implications of retrenchment in

the ASEAN countries, which are a relatively small part of US trade (4% of U.S. exports, though the import side is also relevant, more than some analysts appear to realize: price-taking economies react to devaluations by increases in production of traded goods, and decreases in consumption, which can show up as an increase in their exports as easily a decline in their imports). Later numbers look at spillovers farther north in Asia [Korea alone is another 4% of US merchandise exports], and in Latin America and elsewhere. Also, evaluating a statement like “the impact may be a loss as large as 0.5 of GDP” depends on what baseline is being considered. Some who are talking about the biggest negative effects had high estimates to begin with.

Some of these estimates are just the effect on US net exports. The ultimate effect on the U.S. economy could be larger than this, with multiplier effects, or smaller, if one takes into account that the likely effect would be interest rates lower than they otherwise would be, thereby replacing demand lost in the trade sector with output in producers’ durable equipment, construction, and consumer durables.

The CEA makes official growth forecasts only twice a year as part of the government’s budget process. November is the time of year when we begin meeting with Treasury and OMB to prepare the forecast on which the February budget will be based. We have not completed this process. But I think it unlikely that the forecast will differ very greatly from what we called for last time: 2.0 percent in 1998. This was a nice conservative forecast when we made it last January (and when we renewed it at mid-session review). No “rosy scenario” in this Administration’s forecasts. Whatever the negative effects of the developments in emerging markets, we see little reason to believe that they will outweigh the unusual positive momentum that the US economy has shown in 1997.

Japan

The East Asian crisis will have a substantially greater impact on Japan than on the United States. This is true both by virtue of geography (and corresponding trade patterns), and because Japan’s banking sector and economy were already weak. There is an implication for the U.S.: just as Japan loses some of its net exports to East Asia, the U.S. will lose some of its net exports to Japan.

The US trade balance

Just as job-creation is less of a concern once we are close to the constraints of full employment, so the trade balance is less of a concern when we are up against the constraints of potential output. Nevertheless, I will talk a bit about recent external deficits.

The trade deficit on Goods & Services is still well below the 1987 peak of \$153 billion, especially as a share of GDP. But it has been rising since its 1991 low-point [of \$30 billion, and in 1996 reached \$114 billion]. The current account deficit likewise remains slightly below the 1987 peak of \$167 billion, especially as a share of GDP. But it too is well up from its 1991 low-point [of \$10 billion, reaching \$165 billion in 1996].

What have been the causes of these movements over the last ten years? The 1985-87 depreciation of the dollar was a major cause of the subsequent trade balance improvement. The

1990-91 recession was another clear source of "improvement," by depressing imports.

I think that the most important reason why the trade deficit and current account deficit have grown over the last year, or for that matter over the last six years, is that the US has grown more rapidly than our trading partners. Higher income brings higher imports. [See chart.] As I noted at the outset, our expectations that the relative growth rates would reverse have been contradicted by the developments of 1997. Thus the US trade deficit continues to increase.

As a share of GDP, the current account deficit is about the same as in 1989, the last time that unemployment was [almost] this low.³ As a matter of pure macroeconomics, I am not too worried about the "deterioration" of the last six years. That it represents rapid growth sucking in imports is a good thing. Better yet, both national saving and investment have increased steadily as shares of GDP. [See chart.] The explanation for the widening current account deficit evidently is that investment is increasing more rapidly than national saving. This too is a good thing. [National saving and investment rates generally rise during expansions, but in this case they have been increasing even on a cyclically adjusted basis.]

The recent situation is very different from the much larger current account deterioration that took place between the 1970s and 1980s. That was a fall in the national saving rate: the famous fiscal profligacy of the first Reagan Administration, and a continued fall in private saving in the 2nd Reagan and Bush Administrations. The declines in National Saving and Investment were grounds for concern.. Our low rates of National Saving and Investment are leading candidates to explain our low rate of productivity growth since 1973, and so the recent improvements are good news. So far in the 1990s we have made up a little of the earlier decline, but only a little. More needs to be done. [See table.]

Capsule diagnoses one hears

overheating? No signs of it yet.

deflation? Yes, in crisis countries, and the goods they sell: textiles, footwear, steel, chips, other electronics. But that's not worldwide or general deflation.

market clearing A natural question: how can it be that half the talk is the danger of overheating (excess demand) and half deflation (excess supply). Surely one concern or the other (or both) must be nonsense? One possible answer is that we are indeed on a knife-edge between excess supply and excess demand, and that is what being in market equilibrium is all about. If it feels different today, perhaps it is because the economist's model -- whereby prices adjust to clear the market every time supply or demand shifts -- is closer to being an accurate description of the world economy than ever before. The volatility, and the risk of excess supply or excess demand if you are too slow to react, feel uncomfortable. But this is the system that gives us the most income growth for the most people.

³ If even a small share of the statistical discrepancy is judged to belong in the current account, then it is currently better than 1989]

New Economy There have been important structural changes in the American economy, most of them good: deregulation, opening, flexible labor markets. But we haven't licked the business cycle.

A new anti-internationalism. The dangers are real. An increase in our trade deficit with Asia is worrisome in this political sense. In the U.S.: Congress turning inward on fast-track, NAB and UN dues. In the developing world: SEAsia backlash, Mercosur raised tariffs. But I remain hopeful.

REVISIONS NEEDED FOR ERP CHAPTER

TAKE OUT REFERENCES TO “I” AND “THIS TALK”

IN SE ASIA SECTION, NEED TO RECOUNT THE DEVELOPMENTS

BEGIN BY RECOUNTING THAT AFTER 1990, CAPITAL BEGAN TO FLOW INTO EMERGING MARKET COUNTRIES ON AN UNPRECEDENTED SCALE, IN RESPONSE TO LIBERALIZATION, OPENING, AND STRONG GROWTH PROSPECTS. 1994-95 STREW SOME TACKS IN THE ROAD FOR LATIN AMERICA, AND NOW 1996-97 IS DOING SO FOR EAST ASIA.

IN EUROPE SECTION, NEED TO ADD A FEW SENTENCES ABOUT EUROPEAN GROWTH PROSPECTS (INDEPENDENT OF EMU)

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Peter R. Orszag (CN=Peter R. Orszag/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME:18-NOV-1997 13:53:40.00

SUBJECT: Draft of surplus memo to be discussed at tomorrow's Special Issues mtg.

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Jacob J. Lew (CN=Jacob J. Lew/OU=OMB/O=EOP @ EOP [OMB])

READ:UNKNOWN

CC: Barry B. Anderson (CN=Barry B. Anderson/OU=OMB/O=EOP @ EOP [OMB])

READ:UNKNOWN

CC: Joseph J. Minarik (CN=Joseph J. Minarik/OU=OMB/O=EOP @ EOP [OMB])

READ:UNKNOWN

CC: Jill M. Blickstein (CN=Jill M. Blickstein/OU=OMB/O=EOP @ EOP [OMB])

READ:UNKNOWN

TEXT:

Here's the latest version. Gene would like to base tomorrow's Special Issues meeting on the issues discussed in the memo. The draft is, of

course, still open for corrections and comments. Thanks.===== ATTACHMENT 1

=====

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D74]MAIL46271512X.316 to ASCII,

The following is a HEX DUMP:

**THE UNIFIED BUDGET SURPLUS:
OPTIONS TO SECURE INCREASE IN NATIONAL SAVING**

The purpose of this memorandum is to present different options for ensuring that the projected unified budget surpluses are translated into higher national saving, rather than being dissipated through additional spending or tax cuts that do not promote private saving. The options thus share the objective of using the unified surpluses in some form to raise saving now, to raise productivity in the future and therefore ease the burden on future workers imposed by demographic trends. Higher national saving now would also improve both the primary and overall Federal budget balance in the future: it would improve the primary balance by raising future GDP and revenue, while further improving the overall balance by reducing interest rates and the stock of outstanding Federal debt held by the public.

Background

Current OMB projections suggest a unified surplus will appear in 2002, and grow through the 10-year budget window (see table). Under OMB's long-term projections, these unified surpluses are expected to continue through 2026. As has been noted, the unified surpluses arise initially from surpluses in the trust funds: the non-trust fund component of the budget is projected to remain in deficit through 2007, after which it is also expected to move into surplus.

There are alternative points of view about which measure of the deficit is the most useful. The unified budget balance reflects the Federal government's net transactions with the public. All else equal, it also gives an indication of the Federal government's direct impact on national saving.¹

On the other hand, balancing the unified budget does not necessarily enforce the most sensible balance between generations. For example, at present, merely balancing the unified budget would fail to impose the full burden on the baby boom generation for pre-funding their own retirement. A better rule-of-thumb may be to balance the structural non-trust fund component of the budget, while achieving pre-funding of public retirement programs.

Projected budget balance, \$ billion

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¹ Technically, the most appropriate budget measure for evaluating the impact of the Federal sector on national saving is probably the net balance of the Federal sector in the NIPA accounts. Among the traditional budget measures (e.g., on-budget, off-budget, and unified), the unified budget balance comes closest in concept to the NIPA measure. Nonetheless, Federal transactions in the NIPAs differ from the unified budget in netting, timing, and coverage. In FY 1997, for example, the unified deficit was \$23 billion while the NIPA deficit was \$67 billion.

	2001	2002	2003	2004	2005	2006	2007
Trust funds	115	123	131	138	153	161	172
Non-trust funds	-122	-60	-69	-55	-46	-25	-5
Unified budget	-7	63	62	83	109	136	167

Source: OMB

Options

Three proposals for the surplus would, to a first approximation, have the same effect on saving:

1. Retire debt held by the public;
2. “Donate” the surpluses in some form to the Social Security Trust Fund; or
3. Use the surpluses to fund individual retirement accounts.

The second two options have numerous variants, which are explored in more detail below.

Option 1: Retire/Reduce Debt Held by the Public

Description

This option involves no new policy actions. As the unified surpluses materialize, the excess of revenue over expenditure automatically translates into reduced debt outstanding with the public. Specifically, the excess of revenue over expenditure could be used to retire debt held by the public or, equivalently, to forgo issuing new debt as existing securities come due. That is, just as a unified budget deficit is generally financed by selling government securities to the public, a unified surplus allows the Federal government to reduce the outstanding stock of government debt held by the public. All else equal, national saving would rise by the amount of the unified surplus.

Pros

- As with all options below, maintains increase in national savings arising from unified budget surpluses.
- Produces reduction in debt outstanding with the public, for first time since 1969. Debt outstanding with the public would fall from its peak level of 50 percent in 1993 to less than 1 percent of GDP by approximately 2025.
- Keeps pressure on for Social Security reform because the Social Security Trust Fund imbalance is basically unaffected. Such pressure may be critical to any reform effort, since Social Security problem is less immediate than Medicare problem.

Cons

- Perpetuates the unified surplus “on the books,” providing a target for new spending or tax cut proposals. Simply buying down debt may not be able to compete effectively with new spending projects or tax cuts.
- Does nothing to improve imbalances in Social Security Trust Fund.

Option 2: Bolster the Social Security Trust Fund

Description

This option involves using the surplus in some form to bolster the Social Security Trust Fund. It has several variants:

- A) Use unified surplus to buy marketable government securities from the public, and donate to the Trust Fund.
- B) Use unified surplus to purchase equities for the Social Security Trust Fund.
- C) Use unified surplus to purchase corporate debt for the Social Security Trust Fund
- D) Allow Social Security to invest *out of existing balances* an amount equal to unified surplus in marketable securities
- E) Use non-Social Security part of the unified surplus to do either of the above.

2(A): Marketable government debt

Description

This option could be implemented in two different ways. The first approach would involve the Treasury purchasing government securities from the public, as is possible under Option 1 above. Instead of formally retiring the securities, however, the Treasury would then donate them to the Social Security Trust Fund. The second approach would involve new purchases of marketable government debt directly by the Social Security Trust Fund, with the additional purchases supplementing the existing Trust Fund balance and tied to the size of the projected unified surplus. Initial analysis suggests that neither approach would involve a unified budget expenditure.

Pros

- Has same economic effects as retiring government debt (Option 1): what matters is debt outstanding with the public, not how any debt is held *within* the government sector.
- Could provide a more attractive way of selling the reduction in debt held by the public: “saving Social Security” in addition to “reducing publicly held debt.”

- Would extend the life of the Trust Fund from 2029 to 2050.
- No privatization of the Social Security system -- therefore popular with Ball camp and others.
- Uses surpluses in a way consistent with progressivity of current Social Security system.

Cons

- Has “double counting” problem: The Social Security component of the unified surplus is credited to the Trust Fund twice. In other words, \$1 of additional Social Security revenue over outlays raises the Social Security Trust Fund by \$2. Similarly, any reform to the Social Security system would have a more than one-for-one impact on reducing the actuarial imbalance, because of the indirect effect through the unified surplus. The Social Security Trust Fund could easily become as much a target for mischief as the unified surplus.
- Improvement in actuarial balance of Social Security comes at the expense of other parts of the budget. In effect, the improvement in the Trust Fund is financed by causing an equal and offsetting deterioration in the net balances of the non-Social Security portion of the government. The increase in the Trust Fund does not affect total future revenue, and thus merely shifts revenue across different uses within the budget.
- Not scored as an expenditure, and thus perpetuates unified surplus -- leaving a target for spending and tax cut proposals.
- Improves Social Security outlook and thus could reduce pressure for reform.
- No privatization -- unpopular with supporters of that approach.
- Contrary to precedent, effectively funds Social Security with general revenues.

2(B): Equities

Description

Under this approach, either the Treasury or the Social Security Administration would purchase marketable equities that would be deposited in the Social Security Trust Fund. OMB is examining the budget scoring involved.

Pros and cons same as 2(A) except:

Pros

- Depending on budget scoring rule: Eliminates surplus because purchase of equities could be scored as an outlay. If so, prevents surplus from being spent or used for new tax cuts.
- Extends exhaustion date of Trust Fund from 2029 to beyond 75-year forecasting period.
- Lessens “double-counting” criticism because surpluses are depleted by expenditures, and thus double-counting less obvious.
- Acceptable to Ball camp.

Cons

- U.S. Government investments in private equities raise a series of difficult issues:
 - Who would decide which shares to purchase? Would investment strategy be subject to political influence or interference?
 - Trust fund amounts subject to volatility in financial markets
 - Governance issues: how are corporate shares voted or not voted
 - Contrary to public opinion, has little or no more effect on availability of capital than purchases of Treasury securities
- Until non-trust fund component of the budget is balanced, outlays to purchase equities (if that is how transactions are scored) could require adjustments to the discretionary caps or a pay-go offset. But if legislation is required to effect the purchases, the legislation could presumably make the necessary adjustments to the Budget Enforcement Act.
- If Social Security is allowed to invest and disinvest at will, could raise problems for Treasury cash management and for monetary policy.
- Still somewhat vulnerable to double-counting charge: Social Security component of unified surplus is transferred to Trust Fund twice.

2(C): Private debt***Description***

Under this approach, either the Treasury or the Social Security Administration would purchase private-sector *debt* that would be deposited into the Social Security Trust Fund. Again, OMB is

checking on budget scoring rules.

Pros and cons as in 2(B) above, except:

Pros

- Less volatile than equity investments. If bonds are held to maturity, primary risks are default risk and inflation risk.
- Governance issues may be less complicated than with equity investments. No voting rights involved.

Cons

- Extends exhaustion date of Trust Fund to about 2050, rather than beyond 75-year horizon, because of lower rate of return to debt.

2(D): Allow Social Security Administration to invest out of existing balances an amount equal to unified surplus into marketable non-governmental securities

Description

This approach is similar to the ones above, except that it does not involve net additions to the Trust Fund. Rather, the Social Security Administration would redeem some of its existing special purpose Treasury securities, and use the funds to purchase marketable non-governmental equity or debt. The immediate impact on the Trust Fund would be zero. But according to initial analysis, the purchase could be scored as an expenditure, while the redemption of the special purpose bond would be treated as an intra-governmental transfer and thus not affect the unified surplus. In other words, the unified surplus would be taken “off the books” through this mechanism.

This proposal is similar to one proposed in the National Debt Repayment Act of 1997, sponsored by Mark Neumann and almost 100 other Congressmen.

Pros and cons same as above, except:

Pros

- Eliminates double-counting problem.
- Could eliminate unified surplus, depending on scoring rules.

Cons

- Reduces long-term Social Security Trust Fund imbalance less than above.
- May seem too much like budgetary legerdemain.

2(E): Use non-Social Security part of the unified surplus to do either of the above

Description

Same options as above, except that only the non-Social Security component of the unified surplus would be used. Pros and cons as above, except:

Pros

- Avoids double-counting problem.

Cons

- Because non-Social Security component of budget does not balance until 2008, this option delays action until after the damage may well be done. Allows Social Security component of unified surplus to be dissipated through new spending or tax cuts -- and thus reduces national saving relative to other options -- if unified surplus remains the focus of budgetary activity.
- Produces less dramatic improvement in Trust Fund -- no transfers into Fund until 2008.

Option 3: Fund individual retirement accounts

Description

This option would involve using the unified surplus to fund individual retirement accounts. If individuals do not reduce other saving to offset the deposits into the accounts, the effect on national saving would be the same as above -- with a different split between public and private saving would be different: Federal saving would be lower, but private saving would be higher. Again, there are several alternatives:

- A) Permanent tax cuts linked to deposits into individual retirement accounts
- B) Funding tied to unified surplus
- C) Funding provided by Federal outlays into accounts, rather than private deposits/tax cuts
- D) Funding provided only on a partial matching basis
- E) Deposits not linked to wages
- F) Having some government body manage the accounts, as under Thrift Savings Plan
- G) Tax cuts or matching funds for voluntary deposits

3(A): Permanent tax cuts linked to deposits into individual retirement accounts

Description

Many people have proposed using the projected surplus to fund some sort of individual accounts.

For example, Martin Feldstein has proposed mandating that firms deposit 2 percent of taxable earnings (on top of the current OASDI tax of 12.4 percent) into a Personal Retirement Account for each worker. The individual would then receive a dollar-for-dollar individual income tax credit for the PRA deposits. This system would mean a substantial income tax cut for taxpayers, but it is unclear whether the mandatory “deposits” would be scored as a tax (with offsetting outlays).

This proposal involves permanent tax cuts, which would continue even after Federal budget deficits re-appear, and is not tied to the surplus. Only if the surplus serendipitously turns out to be equal to 2 percent of payroll (about \$65 billion) would the proposal “spend the surplus.”

Pros

- If deposits not scored as revenues and offsetting outlays, reduces taxes. In particular, trades tax cuts (public dissaving) for private saving, and thus reduces the tax-GDP share while achieving the same effect on national saving.
- Could use much or all of unified surplus -- and thus protects against new spending or tax cuts.

- Sets up private accounts that belong to individual (privatization):
 - Allows younger individuals to obtain a higher rate of return than Social Security
 - Creates account that belongs to individual, not government, and benefits accumulated by the individual cannot be taken away by the government

Cons

- At some point in the not-too-distant future, Federal surpluses will turn into deficits. The 3(A) proposal exacerbates those deficits. Even though national saving is the same as under Options 1 and 2, large budget deficits may nonetheless be unacceptable and thus force spending cuts -- including cuts in Social Security.
- Mandatory deposits could be scored as a revenue.
- To the extent that people have “sufficient” net financial assets already, they could offset the deposits into the private accounts by withdrawing from other accounts or reducing other non-tax-favored savings. Such offsets would reduce or eliminate the net increase in national saving relative to Option 1. Empirical evidence is mixed on the importance of this concern, with studies suggesting that somewhere between 0 and 40 cents of every \$1 deposited into the private accounts could be offset by reduced private saving elsewhere.
- Does not address the actuarial imbalance in the Social Security Trust Fund, and thus requires either benefit cuts or general revenue financing for benefits in 2029 and after.
- Until non-trust fund component of the budget is balanced, tax cuts could require pay-go offsets.
- Shares the various cons of privatization:
 - Could undermine long-term support for Social Security program.
 - Risk born by the individual.
 - Millions of individuals are unsophisticated investors, and may invest in a manner that is unduly risky or undiversified. May be vulnerable to investor fraud.
 - Might induce some employers to drop retirement plans or reduce existing coverage.
 - Creates enormous pressure for ability to withdraw in advance of retirement for special needs, reducing national saving benefit.

- Administrative costs would be much higher for individual plans than for centralized investment such as occurs or could occur with Social Security.
 - Generally less progressive than current Social Security system.
 - Problems with either mandatory or voluntary annuitization.
- Administrative burden on whoever has to set up and maintain the IRAs -- employers or the Federal Government. Default options must be created for those who fail to designate a financial institution and investments.
 - There are implementation problems with respect to the tax code: Millions of people would be subject to the 2 percent with-holding from their earnings, but do not owe any income tax against which to credit the offset. Would the tax cut be refundable?
 - Taxpayers may fear that mandatory 2 percent deposits out of payroll are likely to outlast the offsetting tax cuts, which could be eliminated after budget surpluses disappear.

3(B): Funding tied to unified surplus

Description

The proposal above does not link the tax cuts to the unified surplus. One alternative would be to explicitly make that connection: that each year or on a multi-year basis, the deposits and tax cuts would be adjusted to the size of the actual or projected surplus.

Pros and cons as in 3(A) above, except:

Pros

- Does not exacerbate unified deficits after they start re-appearing in 21st century.
- Still provides significant seed money for individual accounts with tax-free compounding, to inculcate the savings habit and attenuate the tradeoffs involved in transition from pay-as-you-go system.

Cons

- Funding for IRAs is not permanent. Could prove hard to terminate funding -- creating pressure on unified deficit after unified surpluses run out.
- Size of deposits and tax cuts could vary from year to year, as the size of the unified surplus varies. In a recession, the tax cuts would be reduced or eliminated as the surplus

fell -- exacerbating the downturn.

3(C): Funding provided by Federal outlays into accounts, rather than private deposits/tax cuts

Description

The 3(A) proposal is equivalent to having the Federal government deposit 2 percent of each individual's taxable payroll into a personal retirement account. Especially if the mandatory deposits are scored as a revenue, Feldstein's deposit-and-tax-cut scheme may have little advantage over a system of Federal outlays.

Pros and cons as in 3(A) above, except:

Pros

- Could simplify structure of program and avoid imposing new payroll deduction and deposit obligations on employers. If the program is explicitly tied to the unified surplus, the Federal government would make deposits at the end of each fiscal year into each account based on the size of the unified surplus.
- Avoids potential public concern that payroll deposit mandate is permanent, while offsetting tax cuts are temporary.
- Avoids refundability problem with tax cuts.

Cons

- Does not reduce tax/GDP share, and raises outlays/GDP.

3(D): Funding provided only on a partial matching basis

Description

Under the 3(A) proposal, the Federal government's tax cuts effectively provide 100 percent funding for the mandatory deposits into individual accounts. An alternative -- regardless of whether the Federal funding is provided indirectly through tax cuts or directly through outlays -- would be to retain the mandatory deposits but provide only a partial match: the U.S. government would put up \$1 for every \$x of the individual's contributions. In other words, the tax credit would be less than dollar-for-dollar, or the outlay would be done only on a matched basis. Specifically, under 3(A), the subsidy rate is 100 percent -- the Federal government bears the cost of the entire deposit. The matching function would produce a subsidy rate lower than 100 percent.

Pros and cons as in 3(A) above, except:

Pros

- For a given level of deposits into private accounts, cost to Federal government is lower.
- For given cost to Federal government, more impact on national saving: the reduction in public saving is more than offset by the increased private saving in the specified accounts. Assuming no withdrawals from other private accounts and no reduction in other deposits that would have been made, national saving increases.
- The matching function could be progressive. For example, the Federal government could provide 100 percent of the first \$200 per year, 75 percent of the next \$200, etc.

Cons

- Assuming the mandatory deposits would feed through one-for-one into lower take-home pay, the proposal would not make individuals “whole”: their wages would fall by more than the tax cut or government deposit. The public is likely to lack enthusiasm for any plan that mandates a reduction in their take-home pay.

3(E): Deposits not linked to wages

Description

3(A) links the mandatory deposits to taxable wages. But the deposits could be made more progressive by cutting the link to payrolls -- instead the deposits could be done on a per capita basis (e.g., \$500 per person) or some other basis. In effect, such a system is a special version of the matching function above, in which the Federal government pays 100 percent of the first \$X for all depositors, and no more.

Pros and cons as in 3(A) above, except:

Pros

- Can easily be made as progressive as desired.
- Non-payroll based deposits would be further divorced from the Social Security tax system and hence might be slightly less likely to be viewed as a replacement for part of the existing defined benefit Social Security program.

Cons

- Pensions are traditionally linked to compensation. Logic is to replace a certain percentage of income in retirement.
- If people without earnings are eligible, more expensive than the payroll-linked system above. Also, could become administratively complex.

3(F): Having some government body manage the accounts, as under Thrift Savings Plan

Description

This option would turn the 3(A) accounts, which are similar to the personal security account proposal from one faction of the Gramlich commission, into something more closely resembling the individual account proposal supported by Gramlich himself. The accounts would be managed by some government board, and would offer individuals some limited choices (e.g., bond fund, equity fund, international fund). The approach is thus similar to the one used in the Thrift Savings Plan for government employees.

Pros and cons as in 3(A) above, except:

Pros

- Reduces investor risks and administrative costs.

Cons

- Raises corporate governance problems similar to the ones noted in 2(B) above.
- Potential criticism for extensive or unnecessary bureaucracy and government interference.

3(G): Tax cuts or matching funds for voluntary deposits

Description

3(A) involves mandatory deposits into the private retirement accounts, which could potentially be scored as a revenue and offsetting outlay. Instead of making the deposits mandatory, the system could be made voluntary -- such as through an expansion of existing IRA provisions. An alternative could involve Federal government contributions that match voluntary contributions by individuals (as under many corporate 401(k) plans and the Federal government's TSP program):

- For example, for every dollar an individual deposits into his or her account up to \$1,000, the Federal government would also deposit a dollar into the account.
- The matching could be progressive: \$1 for every \$1 up to \$1,000, then 50 cents for every \$1 up to \$2,000.
- Alternatively, the Federal match could apply only after the individual had contributed \$x (e.g., \$500).

Pros and cons as in 3(A) above, except:

Pros

- Unambiguous benefit or tax cut for individuals.
- Does not necessarily commit to Federal deposits or tax cuts beyond duration of unified surpluses.
- No “mandate” involved.

Cons

- Potentially more regressive: higher income people more likely to participate in a voluntary program. Matching function could be designed to improve progressivity.
- Plays more directly into tax reform debate -- and could be confusing given existing tax incentives for savings.
- May not absorb entire surplus.
- May not increase national saving as much as mandatory approach, since those who participate in voluntary program more likely to have other assets with which to offset deposits.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeremy B. Rudd (CN=Jeremy B. Rudd/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:18-NOV-1997 22:31:50.00

SUBJECT: Talking points on economic outlook, &c.

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Here are some draft talking points on the economic outlook. (This might be more than you need...?) I grafted portions of Dr. Frankel's speech on Southeast Asia to a slightly updated version of your old talking points on the economic outlook (the file labelled outlkt2.doc), per your instructions. I focussed on SE Asia and its effects on the U.S. outlook, and did not mention Europe, EMU, &c.

- Jeremy

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

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D54]MAIL44631812C.316 to ASCII,
The following is a HEX DUMP:

Talking points on the economic outlook and deficit reduction (revised 18th November 1997)

Pleasure to join you. As the President's Chief Economist in the White House, one of my major duties involves keeping him informed about how the economy is doing and what problems, if any, we see on the horizon going forward. With this as one of my chief functions, my guess is that I have one of the easiest and most pleasant jobs of anyone in the Administration, since the economy is in extraordinarily good shape. Nevertheless, an important part of my job *does* involve "thinking about the unthinkable"--in this case, trying to identify possible black clouds on the economic horizon. So today I would like to balance my comments on the economy's extraordinary performance to date with a discussion of some of the major risks I think we could face in the future.

But first the good news.

I. Retrospective on the economy (and policy)

The economic expansion has entered its 80th month. This is the second-longest peacetime expansion in history. Unlike the 1980s, economic growth has been driven by private demand, not public--an important difference.

- Real business investment and exports have soared. Over the past four years, real business investment has grown at an average rate of 10 percent per year, while exports have grown at an average rate of 11 percent per year.
- For the first time in 24 years, the unemployment rate has held at or below five percent for seven months, with no sign of inflationary pressure.
- Consumer confidence remains near record-high levels.

The benefits of our strong "high pressure" economy are being extended to all Americans. The unemployment rate among African-Americans, which has historically stayed stuck at double-digit levels, has been hovering near its lowest level in over two decades. The poverty rate for African-Americans is at an historical low. And, the upward trend in inequality that has characterized the past twenty years appears to have stalled.

A sustained return to full employment has profound economic and social significance. A tight labor market encourages participation by those who might otherwise be forced to sit on the sidelines, and makes it easier to absorb less-productive workers--such as those who are less-skilled, or younger workers--into the workforce. This gives labor-market entrants much-needed job training, including the skills required in order to hold down a job successfully in the future. In this way, a high-pressure economy can affect long-term (structural) unemployment--hence, running a high-pressure economy may be one of the surest ways to ensure that we do not consign a large fraction of our citizens to long-term joblessness and economic marginalization. (And, a tight labor market can also improve workers' well-being by giving workers the ability to "trade up" their job by moving to a different job for which they are better

suited.)

The high pressure economy is a substantial benefit in making welfare reform work--in moving current welfare recipients into the workforce. Since August 1996, when the welfare reform legislation was signed, the number of recipients has fallen by nearly 2 million (from 12.2 to 10.5 million). Evidence suggests that a significant fraction, though not all, can be traced to the economy's strength.

How has policy contributed to the economy's strength? There is a natural tendency for policymakers to claim credit for all that is good. Make no mistake, much of the economy's recent performance reflects factors that are beyond policymakers' control. For instance, inflation has been moderate in part because import price inflation has been low. And structural changes in the labor market appear to have lowered the rate of unemployment that is consistent with stable inflation.

That said, I nevertheless believe that a significant share of the credit for the economy's recent performance must go to the government's pursuit of a more responsible fiscal policy. When President Clinton was elected, we were on an unsustainable fiscal course, but the public had lost confidence in the ability of its government to come to grips with the deficit. Had this gridlock continued, it would have created an extremely adverse climate for business investment and growth. The consequence of coming to grips with that problem--reducing the deficit from its record level of \$290 billion in 1992 to near balance now--has been an extraordinary investment boom. By freeing up national savings through a reduction in government borrowing, deficit reduction has created room in the economy for capital investment. Additional capital investment has increased capacity, thus helping to dampen inflationary pressures. And, additional investment creates workplaces that provide workers with the tools they need in order to make them productive and competitive.

In addition, fiscal policy remains on a sustainable course. The recently concluded budget agreement will finish the job that the President set out to do in 1993--namely, to balance the budget. Currently, the deficit is about half a percent of GDP--the lowest it has been since 1974. According to our projections, the budget will move into surplus in 2002; this will be the first balanced budget since 1969, and only the ninth since World War Two.

The purpose of deficit reduction is to create investment. Hence, the Administration has been careful to ensure that deficit reduction does not cut into government's own investment, particularly its investment in people. The recently concluded budget agreement contains increased spending and tax incentives for education and training. Many of these benefits are extended to workers, in recognition of the fact that learning and training must be lifelong activities in a world in which rapid technological change is a commonplace. And we have an unprecedented commitment of new funds to invest in children's health.

Nevertheless, we do face several longer-term challenges for fiscal policy, most importantly in the realm of entitlement reform--Social Security and Medicare. In the case of Social Security, the problem is that the retirement of the "baby-boom" generation will mean that there are more retirees receiving benefits than there are employed workers paying benefits into the system. When this happens (around the year 2012), Social Security will start to place greater demands on the Federal budget. This is not an insurmountable problem--even if the government does absolutely nothing, it will still be able to permanently finance roughly 75 percent of benefits

out of current payroll taxes. If the government wanted instead to finance benefits by raising taxes, it would only have to raise the payroll tax by about two percentage points, which represents less than one percent of GDP. (By way of comparison, the defense build-down after the Cold War represented a much larger share of the economy.)

In the area of Medicare reform, the budget agreement acts to address the pressing short-term problems facing Medicare, thus ensuring the viability of the system for at least another decade. The agreement also calls for the establishment of a bipartisan commission to assess and recommend the structural changes that will have to be implemented in the future in order to ensure Medicare's continued viability. But the need for broad entitlement reform does mean that policymakers will face some tough choices ahead.

2. Risks to the outlook

Now for some bad--or, at least, not-so-good--news about the economy's prospects. First, the question that is on everyone's mind these days, namely, *will the expansion continue?*

Contrary to popular belief, there is no support for the view that expansions "die of old age." Rather, in the past expansions have ended because of a sustained increase in core inflation--either because of an unforeseen external shock (like an oil shock) or overheating. It is this last risk--the prospect for overheating--that worries me the most (given my former post as a Fed Governor, this comes naturally). Inflation today is lower than it has been since the 1960s. However, as I mentioned earlier, part of this inflation performance reflects a special factor that need not continue, namely, the fact that import price inflation has been remarkably low.

Inflation has also been held down by another factor, namely, declines in the measured prices of medical care and computers. How long this can continue is anyone's guess.

Finally, wage inflation has also been unusually muted inasmuch as total compensation has shown little sign of acceleration. Given recent productivity gains, this means that unit labor costs have grown sufficiently slowly that there has been little or no upward pressure on prices. However, the subdued growth in overall worker compensation also reflects a somewhat special situation, namely, slow growth in the health insurance component of benefits. Whether compensation growth will begin to creep up depends in large part on the degree to which medical insurance costs remain in check.

As for an "unforeseen external shock," we are currently seeing one unfold in the form of the recent turmoil in the Southeast Asian economies. Of course, the crisis did not take everyone by surprise (even discounting the accuracy of hindsight). Paul Krugman's *Foreign Affairs* article three years ago on the "Myth of the East Asian Miracle," provided a good early warning, and many of us took note over the last few years of excesses in some Asian countries and flaws in their banking systems, urging that reforms be made. Some also noticed in 1996 the sort of export slowdown (in the global electronics market) to which an overly indebted country is particularly vulnerable. And the IMF duly warned the countries most at risk. But I think it fair to say that most of us were surprised at the depth and breadth of the crisis this autumn.

Is this an end to the East Asian miracle, or just a temporary setback? Some observers--most notably Paul Krugman--claimed that there never was an East Asian miracle.

(Note, though, that the appropriateness of the word “miracle” lies in the eyes of the beholder: If Krugman had chosen to phrase his conclusion differently, say as: “The miracle of East Asian growth is due to miraculous rates of investment in physical and human capital,” then most readers probably would have been less surprised by the article than they actually were. Nevertheless, this is really what the article said.) And, he forecasted a marked slowdown in East Asia. An article by Jeff Sachs in the current issue of *Foreign Affairs* takes the contrary view, namely, that East Asia’s current financial troubles are purely transitory, and growth at miracle rates will resume before long. A natural guess is that the truth lies in between.

What about the effects on other emerging-market countries? A very encouraging development in the world economy over the last decade was the choice by many countries to adopt the open market-economy model. Faced with the stark examples of the East Asia economic miracle on the one hand, and the economic fiasco of the communist countries on the other, countries in Latin America, the rest of Asia, Eastern Europe, and even Africa, opted for the capitalist model. Recent financial market developments have spread to Latin America, and may have a negative effect on 1998 growth rates. But assuming that this experience doesn’t undermine the fundamental “Washington consensus,” which favors stable monetary and fiscal policies, privatized enterprises and market-determined prices, then the long-term prospects for the emerging economies and transition economies remain excellent.

Economists are busy updating 1998 projections for growth rates based on events in Southeast Asia. Some estimates that I have seen include:

[NOTE TO DR. YELLEN: You might check these numbers against Dr. Frankel’s printed copy; also, the top two figures might be confidential...? Maybe you could just quote a general range...?]

	<u>Downward revision</u>	<u>Including effects via</u> <u>Lat. Am.</u> <u>Korea</u>	
a government agency	0.2%-0.4%	-0.6%	extra -.15%
a Washington agency	0.6% [1.0 w/ mult.]		
W.Cline, Inst.Int.Fin.		-0.3%	
Lipsky, at Chase:	0.5% to 1.0-1.5%		
Goldman Sachs (9/1)	0.1%		
E.Hyman & N.Lazar	0.5 to 2.5%		
A.Sinai, Primark	0.5% to 2.5%		
B.Steinberg, at M.Lynch	0.5% to 2.5%		
Blue Chip	Yr./yr.2.5% 4Q/4Q 2.3%		

It is easy to see why there would be a wide range of numbers. Aside from the usual variation in models and assumptions, different forecasts refer to different dating, which makes all the difference. Forecasts from the early fall consider only the implications of retrenchment in the ASEAN countries, which comprise a relatively small part of U.S. trade (four percent of U.S.

exports, although the import side is also relevant--perhaps more than some analysts appear to realize--considering that price-taking economies react to devaluations by increases in production of traded goods and decreases in consumption, which can show up as an increase in their exports as easily as a decline in their imports). Later projections consider spillovers farther north in Asia (Korea alone accounts for another four percent of US merchandise exports), as well as in Latin America and elsewhere. Also, evaluating a statement like "the impact may be a loss as large as 0.5 of GDP" depends on what baseline is being considered. Some who are talking about the biggest negative effects had high estimates to begin with.

Furthermore, some of these estimates are just the effect on U.S. net exports. The ultimate effect on the U.S. economy could be larger than this, with multiplier effects, or smaller, if one takes into account that the likely effect would be to lower interest rates below where they otherwise would be, thereby replacing demand lost in the trade sector with output in producers' durable equipment, construction, and consumer durables.

The CEA makes official growth forecasts only twice a year as part of the government's budget process; this is the time of year when we begin meeting with Treasury and OMB to prepare the forecast on which the February budget will be based. We have just begun this process; however, I think it unlikely that the forecast will differ very much from what we predicted last time: two percent real GDP growth in 1998. This was a nice conservative forecast when we made it last January (and when we reaffirmed it during the mid-session review). The specter of the "rosy scenario" that haunted other Administrations' forecasts has been thoroughly exorcized from the forecasts of this Administration. So, whatever negative effects materialize as a result of the recent developments in emerging markets, we see little reason to believe that they will outweigh the strong positive momentum that the U.S. economy has shown in 1997.

Finally--and somewhat paradoxically--a slowdown in Southeast Asia might even be beneficial to the U.S. economy. First, to the extent that affected Asian countries attempt to "export their way out" of their current straits, there could continue to be downward pressure on import prices, thus helping the domestic inflation prospect. Second, the U.S. economy is at present growing at a rate in excess of potential. Hence, as some have suggested recently [FRB Chairman Greenspan], checking the momentum of the economy slightly will reduce the risk of eventual overheating, and thus act to prolong this already historic expansion.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

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

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Notes on the Global Outlook
Jeffrey A. Frankel, Member, Council of Economic Advisers

To be presented at the Institute of International Finance, Nov. 17, 1997
{and to be the basis for a section of Macro chapter of ERP}

Toward the end of this talk I am going to discuss some broad themes, evaluating a few capsule characterizations of the current outlook that one often hears, and adding one of my own: *overheating, deflation, market clearing, New Economy, and new anti-internationalism*. But I will begin by reviewing recent developments in the global macroeconomy.

During much of the last six years, the United States has been growing faster than its trading partners. At the start of 1997, we expected this pattern to reverse. On the one hand, it seemed unlikely that the rapid U.S. growth rate of 1996 would continue [3.3 on a Q4/Q4 basis]. On the other hand, it seemed likely that growth in Japan and Europe would pick up. And it appeared certain that developing Asia, the new "fourth growth pole" of the world economy, would continue to far exceed our own growth rate.

For example in the IMF WEO forecast of one year ago the U.S. was expected to slow to 2.4%, while Japan was expected to grow at about 2.7% and the developing countries of Asia were expect to continue chugging along at 7.6%. The PECC Ec.Outlook said 8% [May]. As recently as last month's October WEO, when the outlines of the ASEAN problems were known, 1998 growth among Asian developing countries was still forecast at 7.4 %¹.

What happened this year was something quite different than forecasted.

U.S.

- Contrary to the slowing that most [incl. us] expected in 1997, the growth rate in the first three quarters averaged 3.9 %. Employment continues to rise, with over 13 millions jobs created since January 1993.
- The President's plan to cut (by 2/3 > 1/2 during the first term) and then eliminate (by 2002) the budget deficit has proceeded well ahead of schedule, in part due to rapid growth.
- With growth in excess of potential, and unemployment below 5% since April [for the first time since before the 1973 oil shock], and below traditional estimates of the NAIRU as well, one would have expected inflationary pressures to emerge by now. They have not. Inflation remains low. While the most recent statistics suggest higher compensation growth in the 3rd quarter, they also suggest more rapid productivity growth. The implication is that workers are earning their raises, and unit labor costs are still not putting upward pressure on inflation.

The North Atlantic vs. the RoW

- Growth has also been strong in Canada, the British Isles, and the Nordic countries.

¹[and worldwide at 4.3 %, almost the same as for 1997]

- (In many of these countries, recent fiscal consolidation has helped keep interest rates down.)
- In the rest of the world, however, 1997 was a disappointingly weak year.

Europe

- Odds look good for EMU taking place as currently scheduled (participants to be chosen in Spring of 1998, and the euro in place by January 1999). In the early 1990s, as German spending in the re-acquired eastern lander pushed up real interest rates, differences in countries' needs regarding monetary policy led to the 1992-93 ERM crises. Currently, differences in monetary policy needs are not as sharp, as reflected in the convergence of interest rates.
- EMU will be the most important change in the world monetary system since 1973, and an inspiring enterprise -- economically, politically, and historically.
- US has far less stake in EMU than Europe does. But nevertheless, we are following its progress with interest. To the extent that we do have a stake in it, it is congruent with the interests of Europeans. That is, a healthy and growing European economy is in the economic and political interest of the United States
- Growth has been unspectacular on the European continent, particularly among the major countries, and unemployment remains very high (an undiminished 11% in the EU overall). Monetary and fiscal policy are largely constrained by the needs of Maastricht (though of course price stability and budgetary discipline are good for long-term growth, regardless of plans for EMU). Monetary and fiscal policy will probably be equally constrained, after Jan. 1999 as before, by a new credibility-seeking European Central Bank and the Stability and Growth path, respectively.
- Policymakers cannot afford to let EMU distract them from fundamental reforms to reduce rigidities in labor and product markets. National economies need to be able to adjust flexibly to future shocks. Otherwise the loss of countries' monetary independence entailed in EMU will cause problems in the future. Procrustean attempts to address unemployment by reducing the supply of labor rather than letting demand increase (through flexibly-adjusting markets) are not promising [e.g., French ideas on mandating a shorter workweek at unchanged pay].²

Japan

- Bursting of 1980s bubble (1990-95).
- Faltering of recovery in 1997. The US Administration was concerned that Japan's April 97 consumption tax increase (in an understandable desire to move toward long-term fiscal consolidation) might be too much too soon, and would choke off the nascent 1996 recovery. The Japanese government was confident that it would achieve 1.8% growth in 1997. In the event, U.S. concerns turn out to have been justified.
- When one looks around the world for possible threats to the global economy, there are perhaps more grounds for concern in Japan than anywhere else.

² "A recent flood of cross-country mergers and acquisitions shows that the private sector is responding, less by seeking to protect itself from competition, but rather so as to take advantage of European integration. Governments should build on the growing consensus for reform."

- Monetary policy can't push Japan's economy any further (liquidity trap), and the government seems determined not to cut taxes.
- Banking problems linger. Japan's slowness to acknowledge, deal with, and move beyond its bad loans problem has actually managed to make the U.S. record of the 1980s look good by comparison.
- Prime Minister Hashimoto's deregulation initiative is a hopeful sign (deregulation in construction, retail, telecom and transp., e.g., ports, and esp. Big Bang in financial markets). But deregulation is unlikely to provide a large boost to output in the short run.
- The weak Japanese economy, by comparison with the strong US economy, probably explains much of the depreciation of the yen against the dollar over the last two+ years. (Almost the same could be said of continental Europe.)

SE Asia

Origins of the crisis

We all believe that liberalized, open, and international integrated financial markets have many important advantages. Funds will be allocated more efficiently, developing countries can fund their investment at lower costs of capital than if they had to rely on domestic saving alone, investors in wealthy countries can earn higher returns on average than if they were limited to investments in their own countries, and everyone can benefit from diversifying risk and smoothing consumption across time.

It may be time, however, to reconsider the proposition that financial markets always get it right, that if an emerging market country adopts sound policies it can be secure in the knowledge that it is immune from speculative attack. What do we say to those countries who resist opening their financial markets by citing the danger of crisis brought on by successive and excessive waves of speculative inflow and speculative outflow?

- At one time, we said that the key was budget discipline. If the government is not running a deficit, then it is the private sector that is borrowing from abroad, and it can be relied on to use the funds for good purposes. This "Lawson fallacy" was discredited by Chile 1980, Britain 1992, and Mexico pre-1994.
- So we said that the problem in Mexico was other fundamentals, particularly a low private saving rate; consumption was too strong (in part a response to liberalization of consumer credit, retail and imports). [Another fundamental was that a relatively high share of the capital inflow took the form of short-term liabilities denominated (in foreign currency), and not enough in the form of direct investment.] When we looked around for other countries with high current account deficits, and saw that they were in SE Asia [Thailand and Malaysia], we were reassured that fundamentals such as the saving rate and the level of foreign exchange reserves looked much stronger. If the inflows were not going to finance government budget deficits or private consumption, then they must be going to finance investment. So everything must be alright.

Of course the crisis did not take everyone by surprise. Krugman's twin Foreign Affairs articles of three years ago, on the Myth of the East Asian Miracle, and Tulipmania, provided a good early warning. Many of us took note over the last few years of excesses in some Asian countries and flaws in their banking systems, and urged reforms. We also noticed in 1996 the sort of export slowdown (in the global electronics market) to which an overly indebted country is

particularly vulnerable. The IMF duly warned the countries most at risk. But I think it fair to say that most of us were surprised at the depth and breadth of the crisis this Fall.

- What are we to conclude now? One answer is that much of the money went to finance -- not just investment in plant and equipment and infrastructure --but real estate and construction. The former generate the future earnings of foreign exchange from exports necessary to service the debt. Condo construction does not.

But this answer is a bit incomplete. For one thing, investment in plant and equipment was high in some of the countries most affected [T&M]. For another, the crisis has of course spread widely, including to countries with stronger fundamentals [Indonesia, Taiwan and Hong Kong]. Contagion appears to be a genuine phenomenon. As in Latin America two years ago, the breadth and depth of the punishment visited by investors on the debtor countries seems to exceed the magnitude of the policy sins they have committed.

The conclusion I draw is certainly not that financial market liberalization is bad. Overall, the benefits outweigh the costs. But we must be prepared for occasional crises, not all of them fully understandable. If markets sometimes overreact, then countries need even sounder macroeconomic policies to compensate. As Merton said, modern financial markets are like superhighways: they get us where we want to go faster, but the accidents are bigger as well. Extra caution in driving, and airbags, are both appropriate. Public and private saving rates remain important. Strengthening of prudential regulation of banks and other financial institutions in these countries is key to reducing the risk of accidents. Increases in reserve requirements against banks' short-term foreign-currency liabilities may be in order in some cases.

The longer term:

An end to the East Asian miracle, or just a temporary setback? Krugman claimed that there never was an East Asian miracle. (The appropriateness of the word "miracle" lies in the eyes of the beholder. If Krugman had chosen to phrase his conclusion differently: "The miracle of East Asian growth is due to miraculous rates of investment in physical and human capital," most readers would have been less surprised by the article than they were. Yet this is really what the article said.) Nevertheless, he forecasted a marked slowdown in East Asia. An article by Jeff Sachs in the current Foreign Affairs takes the contrary view: that East Asia's current financial troubles are purely transitory, and growth at miracle rates will before long resume. A natural guess is that the truth lies in between.

Yet this is really what the article said.) Nevertheless, he forecasted a marked slowdown in East Asia. An article by Jeff Sachs in the current Foreign Affairs takes the contrary view: that East Asia's current financial troubles are purely transitory, and growth at miracle rates will before long resume. A natural guess is that the truth lies in between.

Japan's growth rate appears to have converged to that of the United States and other industrialized countries, not gradually, but in the course of two sharp kinks. The first occurred in 1973-74, with the world oil shock. The second followed the bursting of the 1987-89 bubble in Japanese financial markets. [Japan's per capita growth rate averaged a remarkable 8 percent during the period 1962-1973, but slowed to 3 percent during 1974-1990 (Table 1). Over the last seven years, it averaged a mere 1 ½ percent.] Presumably Japanese growth will recover from its recent recession, but whether it will go back to the miracle rates of earlier decades seems

dubious. The convergence is complete. Are other East Asian economies now going through a growth-path kink analogous to Japan's 1973 slowdown? There is no necessary connection between transitory shocks such as a sharp increase in the price of oil or a financial crisis and the long-run rate of growth of potential output. With the exception of Japan, Singapore, and Hong Kong, East Asian economies still have a very long way to go before attaining the per capita incomes of the industrialized countries. But for those observers who thought that the miracle rates of growth attained by many East Asian economies over the past several decades were unsustainable, the 1997 episode of instability in financial markets may be interpreted as a signpost indicating that a more moderate and sustainable rate of growth lies ahead.

Other emerging markets

The most encouraging development in the world economy over the last decade was the choice by many countries to adopt the open market-economy model. Faced with the stark examples of the East Asia economic miracle on the one hand, and the economic fiasco of the communist countries on the other, countries in Latin America, the rest of Asia, Eastern Europe, and even Africa, opted for the capitalist model. Recent financial market developments have spread to Latin America, and may have a negative effect on 1998 growth rates. But assuming that this experience doesn't undermine the fundamental "Washington consensus," -- which favors stable monetary and fiscal policies, privatized enterprises and market-determined prices -- the long-term prospects for the emerging economies and transition economies remain excellent.

Possible short-term spillover from the crisis

Economists are busy updating 1998 projections for growth rates.			Some that I have seen: including effects via Lat. Am.	
		Downward revision		
[Korea				
a government agency		0.2%-0.4%	-0.6%	&
-.15%]				
a Washington agency		0.6% [1 w/ mult.]		
W.Cline, Inst.Int.Fin.			-0.3%	
Lipsky, at Chase:		0.5%, to 1.0-1.5%		
Goldman Sachs	9/1	0.1%		
E.Hyman & N.Lazar		0.5	to 2.5%	
A.Sinai, Primark		0.5%	to 2.5%	
B.Steinberg, at M.Lynch		0.5%	to 2.5%	
Blue Chip			Yr./yr.2.5%	4Q/4Q 2.3%
("Corporate economists slower to react to fin.mkts. & overseas news than Wall St. forecasters? wsj)				

U.S.

It is easy to see why there would be a wide range of numbers. Aside from the usual variation in models and assumptions, different forecasts refer to different dating, which makes all the difference. Forecasts from the early fall consider only the implications of retrenchment in

the ASEAN countries, which are a relatively small part of US trade (4% of U.S. exports, though the import side is also relevant, more than some analysts appear to realize: price-taking economies react to devaluations by increases in production of traded goods, and decreases in consumption, which can show up as an increase in their exports as easily a decline in their imports). Later numbers look at spillovers farther north in Asia [Korea alone is another 4% of US merchandise exports], and in Latin America and elsewhere. Also, evaluating a statement like “the impact may be a loss as large as 0.5 of GDP” depends on what baseline is being considered. Some who are talking about the biggest negative effects had high estimates to begin with.

Some of these estimates are just the effect on US net exports. The ultimate effect on the U.S. economy could be larger than this, with multiplier effects, or smaller, if one takes into account that the likely effect would be interest rates lower than they otherwise would be, thereby replacing demand lost in the trade sector with output in producers’ durable equipment, construction, and consumer durables.

The CEA makes official growth forecasts only twice a year as part of the government’s budget process. November is the time of year when we begin meeting with Treasury and OMB to prepare the forecast on which the February budget will be based. We have not completed this process. But I think it unlikely that the forecast will differ very greatly from what we called for last time: 2.0 percent in 1998. This was a nice conservative forecast when we made it last January (and when we renewed it at mid-session review). No “rosy scenario” in this Administration’s forecasts. Whatever the negative effects of the developments in emerging markets, we see little reason to believe that they will outweigh the unusual positive momentum that the US economy has shown in 1997.

Japan

The East Asian crisis will have a substantially greater impact on Japan than on the United States. This is true both by virtue of geography (and corresponding trade patterns), and because Japan’s banking sector and economy were already weak. There is an implication for the U.S.: just as Japan loses some of its net exports to East Asia, the U.S. will lose some of its net exports to Japan.

The US trade balance

Just as job-creation is less of a concern once we are close to the constraints of full employment, so the trade balance is less of a concern when we are up against the constraints of potential output. Nevertheless, I will talk a bit about recent external deficits.

The trade deficit on Goods & Services is still well below the 1987 peak of \$153 billion, especially as a share of GDP. But it has been rising since its 1991 low-point [of \$30 billion, and in 1996 reached \$114 billion]. The current account deficit likewise remains slightly below the 1987 peak of \$167 billion, especially as a share of GDP. But it too is well up from its 1991 low-point [of \$10 billion, reaching \$165 billion in 1996].

What have been the causes of these movements over the last ten years? The 1985-87 depreciation of the dollar was a major cause of the subsequent trade balance improvement. The

1990-91 recession was another clear source of "improvement," by depressing imports.

I think that the most important reason why the trade deficit and current account deficit have grown over the last year, or for that matter over the last six years, is that the US has grown more rapidly than our trading partners. Higher income brings higher imports. [See chart.] As I noted at the outset, our expectations that the relative growth rates would reverse have been contradicted by the developments of 1997. Thus the US trade deficit continues to increase.

As a share of GDP, the current account deficit is about the same as in 1989, the last time that unemployment was [almost] this low.³ As a matter of pure macroeconomics, I am not too worried about the "deterioration" of the last six years. That it represents rapid growth sucking in imports is a good thing. Better yet, both national saving and investment have increased steadily as shares of GDP. [See chart.] The explanation for the widening current account deficit evidently is that investment is increasing more rapidly than national saving. This too is a good thing. [National saving and investment rates generally rise during expansions, but in this case they have been increasing even on a cyclically adjusted basis.]

The recent situation is very different from the much larger current account deterioration that took place between the 1970s and 1980s. That was a fall in the national saving rate: the famous fiscal profligacy of the first Reagan Administration, and a continued fall in private saving in the 2nd Reagan and Bush Administrations. The declines in National Saving and Investment were grounds for concern.. Our low rates of National Saving and Investment are leading candidates to explain our low rate of productivity growth since 1973, and so the recent improvements are good news. So far in the 1990s we have made up a little of the earlier decline, but only a little. More needs to be done. [See table.]

Capsule diagnoses one hears

overheating? No signs of it yet.

deflation? Yes, in crisis countries, and the goods they sell: textiles, footwear, steel, chips, other electronics. But that's not worldwide or general deflation.

market clearing A natural question: how can it be that half the talk is the danger of overheating (excess demand) and half deflation (excess supply). Surely one concern or the other (or both) must be nonsense? One possible answer is that we are indeed on a knife-edge between excess supply and excess demand, and that is what being in market equilibrium is all about. If it feels different today, perhaps it is because the economist's model -- whereby prices adjust to clear the market every time supply or demand shifts -- is closer to being an accurate description of the world economy than ever before. The volatility, and the risk of excess supply or excess demand if you are too slow to react, feel uncomfortable. But this is the system that gives us the most income growth for the most people.

³ If even a small share of the statistical discrepancy is judged to belong in the current account, then it is currently better than 1989]

New Economy There have been important structural changes in the American economy, most of them good: deregulation, opening, flexible labor markets. But we haven't licked the business cycle.

A new anti-internationalism. The dangers are real. An increase in our trade deficit with Asia is worrisome in this political sense. In the U.S.: Congress turning inward on fast-track, NAB and UN dues. In the developing world: SEAsia backlash, Mercosur raised tariffs. But I remain hopeful.

REVISIONS NEEDED FOR ERP CHAPTER

TAKE OUT REFERENCES TO “I” AND “THIS TALK”

IN SE ASIA SECTION, NEED TO RECOUNT THE DEVELOPMENTS

BEGIN BY RECOUNTING THAT AFTER 1990, CAPITAL BEGAN TO FLOW INTO EMERGING MARKET COUNTRIES ON AN UNPRECEDENTED SCALE, IN RESPONSE TO LIBERALIZATION, OPENING, AND STRONG GROWTH PROSPECTS. 1994-95 STREW SOME TACKS IN THE ROAD FOR LATIN AMERICA, AND NOW 1996-97 IS DOING SO FOR EAST ASIA.

IN EUROPE SECTION, NEED TO ADD A FEW SENTENCES ABOUT EUROPEAN GROWTH PROSPECTS (INDEPENDENT OF EMU)

Talking points on the economic outlook and deficit reduction

Pleasure to join you. As the President's Chief Economist in the White House, one of my major duties is to keep him informed about how the economy is doing and what problems, if any, we see on the horizon going forward. With this as one of my chief functions, my guess is that I have one of the easiest and most pleasant jobs of any one in the Administration since the economy is in extraordinarily good shape and it is really hard to spot any black clouds on the horizon.

1. Retrospective and prospective on the economy

The economic expansion has entered its 79th month. This is the second-longest peacetime expansion in history. Unlike the 1980s, economic growth has been driven by private demand, not public--an important difference.

- Real business investment and exports have soared. Over the past four years, real business investment has grown at an average rate of nine percent per year, while exports have grown at an average rate of 10 percent per year.
- For the first time in 24 years, the unemployment rate has held at or below five percent for six months, with no sign of inflationary pressure.
- Consumer confidence remains near record-high levels.

The benefits of our strong "high pressure" economy are being extended to all Americans. The unemployment rate among African-Americans, which has historically stayed stuck at double-digit levels, has been hovering near its lowest level in over two decades. The poverty

rate for African-Americans is at an historical low. And, the upward trend in inequality that has characterized the past twenty years appears to have stalled.

A sustained return to full employment has profound economic and social significance. A tight labor market encourages participation by those who might otherwise be forced to sit on the sidelines, and makes it easier to absorb less-productive workers--such as those who are less-skilled, or younger workers--into the workforce. This gives labor-market entrants much-needed job training, including the skills required in order to hold down a job successfully in the future. In this way, a high-pressure economy can affect long-term (structural) unemployment--hence, running a high-pressure economy may be one of the surest ways to ensure that we do not consign a large fraction of our citizens to long-term joblessness and economic marginalization. (And, a tight labor market can also improve workers' well-being by giving workers the ability to "trade up" their job by moving to a different job for which they are better suited.)

The high pressure economy is a substantial benefit in making welfare reform work--in moving current welfare recipients into the workforce. Since August 1996, when the welfare reform legislation was signed, the number of recipients has fallen by nearly 2 million (from 12.2 to 10.5 million). Evidence suggests that a significant fraction, though not all, can be traced to the economy's strength.

Will the expansion continue? Contrary to popular belief, there is no support for the view

that expansions “die of old age.” Rather, in the past expansions have ended because of a sustained increase in core inflation--either because of an unforeseen external shock (like an oil shock) or overheating. Although recent strong growth might make us cautious about the prospect for overheating, (given my former post as a Fed Governor this comes naturally) inflation today is lower than it has been since the 1960s, and shows no signs of picking up. And there are no signs of the kind of financial fragilities that could make the economy vulnerable in the event of a shock.

2. Retrospective and prospective on policy

How has policy contributed to the economy's strength? There is a natural tendency for policymakers to claim credit for all that is good. Make no mistake, much of the economy's recent performance reflects factors that are beyond policymakers' control. For instance, inflation has been moderate in part because import price inflation has been low. And structural changes in the labor market appear to have lowered the rate of unemployment that is consistent with stable inflation.

That said, I nevertheless believe that a significant share of the credit for the economy's recent performance must go to the government's pursuit of a more responsible fiscal policy. When President Clinton was elected, we were on an unsustainable fiscal course, but the public had lost confidence in the ability of its government to come to grips with the deficit. Had this gridlock continued, it would have created an extremely adverse climate for business investment and growth. The consequence of coming to grips with that problem--reducing the deficit from its record level of \$290 billion in 1992 to near balance now and locking in balance and even a

surplus through 2002 has been an extraordinary investment boom. By freeing up national savings through a reduction in government borrowing, deficit reduction has created room in the economy for capital investment. Additional capital investment has increased capacity, thus helping to dampen inflationary pressures. And, additional investment creates workplaces that provide workers with the tools they need in order to make them productive and competitive.

The purpose of deficit reduction is to create investment. Hence, the Administration has been careful to ensure that deficit reduction does not cut into government's own investment, particularly its investment in people. The recently concluded budget agreement contains increased spending and tax incentives for education and training. Many of these benefits are extended to workers, in recognition of the fact that learning and training must be lifelong activities in a world in which rapid technological change is a commonplace. And we have an unprecedented commitment of new funds to invest in children's health.

What is the policy outlook?

The recently concluded budget agreement will finish the job that the President set out to do in 1993--namely, to balance the budget. Currently, the deficit is about half a percent of GDP--the lowest it has been since 1974. According to our projections, the budget will move into surplus in 2002; this will be the first balanced budget since 1969, and only the ninth since World War Two.

And where do we go from here?

I would point to two of the economic policy challenges facing the Administration now.

The first involves the renewal of the Administration's "fast track" authority for negotiating international trade agreements. And the second concerns entitlements.

From his first days in office, President Clinton has believed in the importance of promoting free and fair trade. He has adopted an outward-looking, internationalist trade policy concluding over 200 trade agreements during his first four years in office. The President intends to extend and build upon this record during the Administration's next four years.

To do this, he needs fast track authority from Congress. "Fast track" is a provision whereby the Congress is required to vote on trade agreements in their entirety, without amendment. It gives the U.S. needed credibility in trade talks, by signalling to our partners that we have come to the table ready to deal.

Every President since 1974 has received fast track authority from Congress. It was started after Congress failed to ratify the Kennedy Round of trade talks in their entirety, which led Europe to refuse to negotiate any further trade agreements with the U.S.

The pace with which preferential trade agreements are being negotiated is fast--so fast that the U.S. risks being left behind if it does not act. For example, since 1992 other countries have negotiated 20 preferential trade agreements in Latin America and Asia that exclude the United States.

The Administration would use fast track in connection with three key trade initiatives:

1. We want to complete the agenda that was established in the Uruguay Round

of GATT negotiations. This year, we will begin negotiations in the sphere of government procurement, which represents a trillion-dollar market for the U.S. in Asia alone over the next decade. Talks in areas such as intellectual property rights, agriculture, and services are scheduled to follow.

2. We want to extend the information technology agreement (ITA), which lowers tariffs on information technology products to zero, to related classes of goods. The U.S. is particularly competitive in information technology, and its tariffs on these types of goods were already much lower than those of our partners in the agreement. And there are other sectors where we are very competitive but global barriers tend to be high--areas like environmental equipment and services, medical equipment and technology, and transportation equipment where we need fast track to reduce trade barriers.

3. And, we want to negotiate more comprehensive market access agreements with individual countries. Chile is an example--today, every major economy in this hemisphere save the U.S. has a preferential trade agreement with Chile. This puts the U.S. at a serious competitive disadvantage.

The second policy challenge facing the Administration involves *long-term Social Security and Medicare reform*.

- In the case of Social Security, the problem is that the retirement of the "baby-boom" generation will mean that there are more retirees receiving benefits than there are

employed workers paying benefits into the system. When this happens (around the year 2012), Social Security will start to place greater demands on the Federal budget.

The problem is not insurmountable, however. Even if the government does absolutely nothing, it will still be able to permanently finance roughly 75 percent of benefits out of current payroll taxes. If the government wanted instead to finance benefits by raising taxes, it would only have to raise the payroll tax by about two percentage points, which represents less than one percent of GDP. By way of comparison, the defense build-down after the Cold War represented a much larger share of the economy.

- In the area of Medicare reform, the budget agreement acts to address the pressing short-term problems facing Medicare, thus ensuring the viability of the system for at least another decade. The agreement also calls for the establishment of a bipartisan commission to assess and recommend the structural changes that will have to be implemented in the future in order to ensure Medicare's continued viability.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeremy B. Rudd (CN=Jeremy B. Rudd/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:21-NOV-1997 17:14:40.00

SUBJECT:

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Statement and talking points for OECDpress conference

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

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

TEXT:

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The following is a HEX DUMP:

Opening statement:

I would like to begin by thanking the OECD Secretariat, the Economic Review and Development Committee, and Dr. Jarrett for their excellent job in preparing this year's economic survey of the United States. The OECD consistently produces extremely high-quality work, and it is very useful for us as policymakers to have an opportunity to obtain the international community's perspective on the current state of the U.S. economy and U.S. economic policy. This year's special chapters on entrepreneurship and immigration were especially interesting and useful from this standpoint.

In general, we broadly concur with the *Survey*'s assessment of and recommendations for the U.S. economy. Needless to say, there are, of course, a few topics on which our views diverge--particularly in the context of the OECD's assessment of several specific policies--but these typically represent areas in which reasonable people can find much room for debate. Indeed, one of the strengths of the OECD is that it provides a forum for such discussion, in which policymakers from industrialized nations can compare their experiences and exchange views on recent policy developments.

Let me now turn to the *Survey* itself. To quote from the *Survey*'s opening text, "the United States has enjoyed a year of exceptional economic performance." I couldn't agree more.

The current economic expansion has entered its 80th month; this is the second-longest peacetime expansion in history. As the OECD's *Survey* makes clear, economic growth has been strong and balanced, and driven by private demand--not public. This situation contrasts very favorably with that which prevailed in the 1980s.

Real business investment and exports have soared. Over the past four years, real

business investment has grown at an average rate of 10 percent per year, while exports have grown at an average rate of 11 percent per year. For the first time in 24 years, the unemployment rate has held at or below five percent for seven months, with no sign of inflationary pressure. Consumer confidence remains near record-high levels. And inflation today is lower than it has been since the 1960s.

The *Survey* comments extensively on a topic that has been on the minds of the Administration's policymakers more and more in recent months; namely, to what extent the combination of strong growth and low inflation reflects transitory special factors, as opposed to permanent structural changes. The OECD makes a reasonable case for the point that, in part, special factors have been at work, and I would tend to be somewhat sympathetic to this view. For example, import price inflation has been remarkably low recently; inflation has also been held down by another factor, in the form of declines in the measured prices of medical care and computers. Wage inflation has also been unusually muted inasmuch as total compensation has shown little sign of acceleration--but the subdued growth in overall worker compensation also reflects a somewhat special situation, namely, slow growth in the health insurance component of benefits. Of course, predicting how long these factors will last is extremely difficult.

As far as the role played by long-term structural change in affecting the current situation, there is strong evidence that the rate of unemployment consistent with stable inflation--the NAIRU--has dropped in recent years as a result of changes in the structure of the labor market. This has helped to keep inflation in check in the face of a sustained return to full employment. I agree with the OECD that whether other long-term changes are at work remains an open question; and I second the notion that, as policymakers, we should be somewhat conservative in

this regard.

The OECD predicts that the current expansion will continue, and forecasts GDP growth in 1998 equal to 2¾ percent. However, given recent economic performance, the *Survey* flags the possibility for overheating as a possible risk. To some extent, I believe that this prediction has been overtaken by events, as the recent turmoil in the Southeast Asian economies should help to check the momentum of the economy slightly, thus reducing the risk of eventual overheating. And, to the extent that affected Asian countries attempt to “export their way out” of their current straits, there could continue to be downward pressure on import prices, thus helping the domestic inflation prospect. Time will tell.

I would now like to comment briefly on the portion of the *Survey* that addresses institutional and policy concerns. The *Survey* singles out several praiseworthy aspects of the U.S. economy that contribute to its positive performance, including labor market flexibility, structural reform (deregulation), and an economic system that fosters entrepreneurship. I also believe that a significant share of the credit for the economy’s recent performance must go to the government’s pursuit of a more responsible fiscal policy. When President Clinton was elected, we were on an unsustainable fiscal course, but the public had lost confidence in the ability of its government to come to grips with the deficit. Had this gridlock continued, it would have created an extremely adverse climate for business investment and growth. The consequence of coming to grips with that problem--reducing the deficit from its record level of \$290 billion in 1992 to near balance now--has been an extraordinary investment boom. By freeing up national savings through a reduction in government borrowing, deficit reduction has created room in the economy for capital investment. Additional capital investment has increased capacity, thus helping to

dampen inflationary pressures. And, additional investment creates workplaces that provide workers with the tools they need in order to make them productive and competitive.

Today, fiscal policy remains on a sustainable course. The recently concluded budget agreement will finish the job that the President set out to do in 1993--namely, to balance the budget. Currently, the deficit is about half a percent of GDP--the lowest it has been since 1974. According to our projections, the budget will move into surplus in 2002; this will be the first balanced budget since 1969, and only the ninth since World War Two.

Perhaps my biggest quibble with the OECD's assessment of U.S. economic policy concerns its characterization of the steps that we have taken to achieve a balanced budget. The OECD criticizes the recent budget agreement on two points: first, on the grounds that more rapid deficit reduction would have been desirable in order to slow the expansion slightly and reduce the risk of overheating; and second, on the grounds that little has been done to deal with long-term entitlement reform. Regarding the first point, I believe it important to recognize that policymakers in the U.S. have essentially eschewed using fiscal policy for stabilization purposes in favor of more flexible tools such as monetary policy. Instead, the principal goal of fiscal policy at present involves advancing investment--both public and private.

It is, however, undeniable that we face several longer-term challenges in the realm of entitlement reform--Social Security and Medicare. In the area of Medicare reform, the budget agreement acts to address the pressing short-term problems facing Medicare, thus ensuring the viability of the system for at least another decade. The agreement also calls for the establishment of a bipartisan commission to assess and recommend the structural changes that will have to be implemented in the future in order to ensure Medicare's continued viability.

Similarly, Social Security faces long-term problems--which are also far from insurmountable. However, the need for broad entitlement reform does mean that policymakers will face some tough choices ahead.

Backloading, &c.

The OECD *Survey* argues that the deficit reduction agreement is unambitious, as well as backloaded (though not in so many words), since “nearly three-quarters” of the savings come in the last two years (under a program of constant deficit reduction, 60 percent of the savings would fall in the last two years). It also argues that the tax cuts are wasteful, add to complexity, and do not reduce marginal tax rates.

Talking points:

- The U.S. has made progress in fiscal consolidation that would have been inconceivable as recently as five years ago. Relatively little remains to be done to balance the budget. To argue that the current plan lacks credibility ignores the credibility that has already been gained by our progress to date. And, taken as a ten-year deficit reduction plan, there is no backloading.

- Ignoring tax cuts and looking at spending reductions--arguably the more difficult part of deficit reduction--reveals that there is essentially no backloading.

- The degree of “backloading” is overstated because the budget is moving into a surplus. If you take the goal as being a zero deficit--that is, look at the savings required in order to balance the budget, as opposed to moving the budget into surplus--then there is no backloading.

[See the attached figures that Steve presented at the EDRC.]

Education

I suggest that you not bring this topic up unilaterally. The OECD argues that the education initiatives in the budget agreement are misguided in that they apply to college-level education, whereas the real problem is in primary (elementary and high-school) education. The OECD does point out that primary education is mainly a state and local concern, however.

Talking points:

- Enclosed are remarks on education made by the President at a recent bill signing. These include a discussion of initiatives oriented toward primary-level education.
- Enclosed also are talking points on the 1998 education budget.
- Note that the OECD supports the Administration's support of charter schools.

Miscellaneous items

Electricity: This is still being worked on within the Administration; we are nearing the end of our deliberations but have made no hard and fast decisions and no firm date for completion. [By the way, the President announced his support for electricity restructuring when he gave his global climate change speech.]

Telecom: The Administration's position is that the FCC must vigorously enforce last year's Telecommunications Act. [Attached are some remarks made by the Vice President at the FCC swearing-in ceremony earlier this month; these aren't very useful but are the only talking points available.]

Financial Services Reform: See the enclosed letters by Secretary Rubin and Jerry Hawke on this topic.

OECD Shipbuilding Agreement: The Senate is considering this, and we appreciate and encourage their efforts [USTR]. [The Administration supports the shipbuilding agreement.]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:21-NOV-1997 18:42:08.00

SUBJECT: paper on growth for Vancouver mtg.

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Jeremy B. Rudd (CN=Jeremy B. Rudd/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Jon D. Haveman (CN=Jon D. Haveman/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Our paper on determinants of long-term growth, background for the APEC Economic Advisers meeting, got rave reviews there. Several participants asked if I was going to publish it. What would you think of issuing it as a CEA "White Paper," (whatever that entails)?

JF===== ATTACHMENT 1 =====

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

TEXT:

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The following is a HEX DUMP:

Draft , November 10, 1997

Determinants of Long Term Growth

Council of Economic Advisers, United States Government

Background Paper for the Morning Session of the Meeting of the Asia-Pacific Economic Cooperation Economic Advisers, Vancouver, Canada, November, 20, 1997

1 Introduction

1.1 The last 20 years have seen wide-ranging research, both theoretical and empirical, on the determinants of long term growth. "Old growth models" of closed economies have given way to "new growth models" of open economies in concert with "new trade" theories.

1.2 The resurgence in research is partly the result of interest in the explanation of the rapid growth in many East Asian economies. The record of growth in this part of the world had been so spectacular, at least until recently, that it was claimed as supporting evidence by *both* sides in *each* of three debates (at least). First is the debate on whether the East Asians' success is proof of the superiority of protectionist policies on the one hand, or of outward-oriented policies on the other. Second is the broad debate whether the East Asian phenomenon is evidence of the virtues of government intervention in general, or of laissez-faire market-oriented policies.¹ Third is the debate over whether the statistics support growth based on simple accumulation of the factors of production (labor, education, and especially physical capital), or growth based on improvements in technology and efficiency (measured as an increase in total factor productivity, or the "Solow residual"). Young (1992, 1994, 1995), Kim and Lau (1994), and Krugman (1994) have upset conventional wisdom by arguing that growth among the four East Asian dragons, especially Singapore, can be explained by simple factor accumulation, with no important residual left over in most cases.²

1.3 Finally, to the extent that growth rates do take the form of increases in total factor productivity, there would also be the question whether this increase in technical efficiency is due:

- (i) to superior government policies, in which case East Asia may have valuable lessons for other countries,
- (ii) to some superior mode of social organization, perhaps some exogenous aspect of "Confucian culture",

¹ Examples include Krueger (1990) vs. Pack and Westphal (1986), or the controversy surrounding World Bank (1993), including Rodrik (1994a). Laissez-faire is not the same as outward-orientation, of course, because some governments deliberately use subsidies or an undervalued currency to promote outward orientation.

² Sarel (1995) reviews the state of play. The appropriateness of the word "miracle" lies in the eyes of the beholder. If Krugman had chosen to phrase his conclusion differently: "The miracle of East Asian growth is due to miraculous rates of investment in physical and human capital," most readers would have been less surprised by the article than they were. Yet this is really what the article said.

(iii) to simple catch-up with the technologically more advanced industrialized economies, or
(iv) to chance.³

1.4 A central hypothesis in the growth literature is that incomes across countries tend to converge to a common level.⁴ In other words, lower-income countries will tend to grow more rapidly than countries at a higher level of income. There are two important kinds of catch-up. First, given the right economic structure and environment, poor countries tend to have high rates of return to capital. The accumulation of physical and human capital, whether financed by domestic saving or capital inflows, leads to rapid growth. Second, they tend to have rapid rates of growth of total factor productivity. They can emulate the technologies and “best practice” management innovations of the more advanced economies that have gone before them. Growth can therefore be facilitated as much through the accumulation of factors as through increases in the efficiency of the use of these factors.

1.5 There is reason to think that the process of catching up has natural limits. As Krugman and Young have pointed out, to the extent that growth is based on high rates of factor accumulation, economies eventually run into diminishing returns to capital. Rural-urban migration is an important source of growth in many countries that eventually runs its course. Furthermore, improvements in total factor productivity, to the extent they constitute emulation of front-runners, also run into natural limits, as the followers draw nearer to the front-runners.

1.6 An important question is whether the process of convergence is a gradual one, or occurs with bumps and kinks. Japan’s growth rate appears to have converged to that of the United States and other industrialized countries, not gradually, but in the course of two sharp kinks. The first occurred in 1973-74, with the world oil shock. The second followed the bursting of the 1987-89 bubble in Japanese financial markets. Japan’s per capita growth rate averaged a remarkable 8 percent during the period 1962-1973, but slowed to 3 percent during 1974-1990 (Table 1). Over the last seven years, it averaged a mere 1 ½ percent. Presumably Japanese growth will soon recover from its recent recession, but whether it will go back to the miracle rates of earlier decades seems dubious. The convergence is complete.

1.7 This paper will not explicitly address the question of whether some other East Asian economies may now be going through a growth-path kink analogous to Japan’s 1973 slowdown. There is no necessary connection between transitory shocks such as a sharp increase in the price of oil or a financial crisis and the long-run rate of growth of potential output. With the

³ Easterly (1995) and Easterly, Kremer, Pritchett, and Summers (1993). The main problem with the chance argument is that the East Asian success stories are all located in the same region. These authors provocatively point out that this ex post reasoning has some pitfalls.

⁴ This is the famous convergence hypothesis: Barro (1991), Barro and Sala-i-Martin (1992), and Mankiw, Romer, and Weil (1992).

exception of Japan--and Singapore and Hong Kong--East Asian economies still have a very long way to go before attaining the per capita incomes of the industrialized countries. But for those observers who thought that the miracle rates of growth attained by many East Asian economies over the past several decades were unsustainable, the 1997 episode of instability in financial markets may be interpreted as a signpost indicating that a more moderate and sustainable rate of growth lies ahead.

1.8 In what follows, we present a discussion of factors that researchers have identified as possible determinants of a country's long-term economic performance. The purpose is merely to outline some of the main currents of thought that define the contemporary literature on growth. It is intended to be a representative survey of recent theoretical and empirical growth research. The factors to be examined include:

- investment in private and public capital
- education and training
- financial intermediation
- macroeconomic stability
- openness with respect to trade and investment
- equality of income distribution and
- stability of political and social conditions.

2 Investment in private and public capital

2.1 Capital accumulation is perhaps the most easily identified determinant of future living standards. What is less clear, however, is whether capital accumulation--or the accumulation of any factor of production--can drive growth in per capita terms for an indefinite period of time. In neoclassical theory (the Solow-Swan growth model), differential rates of investment across countries induce permanent differences in the *level* of per capita output, as opposed to its growth rate. Intuitively, the presence of diminishing returns implies that if the capital stock becomes very large, at some point additional investment is not sufficient to make up for depreciation of the existing capital stock, so higher rates of investment do not lead to increases in the net capital stock or output.⁵

2.2 This view of the role investment plays in driving long-run growth was challenged in the early 1980s in a series of articles by Paul Romer and others. Romer argued that higher rates of investment might induce higher rates of innovation, and thus faster economic growth. Hence economies with higher saving rates will grow faster, and so convergence in the neoclassical sense

⁵. A corollary of neoclassical growth theory is that all countries with access to a common production technology should converge to a level of output per capita that is identical once one has controlled for countries' differential rates of saving and population growth.

need not obtain. The new view drew support from two sets of empirical evidence. The first indicated that countries' output levels do not seem to converge in a manner consistent with the neoclassical model. The gap between the poorest and richest economies is at least as wide now as it was 50 years ago. The second contrary empirical finding was that higher rates of investment are correlated with future long-term growth rates, not merely with the level of GDP.

2.3 Economists have also identified a role for public capital, particularly infrastructure capital, in economic growth. This includes transports--highways, bridges, ports, airports, railways--and, under broader definitions, telecommunications, electric power, water and sanitation networks.⁶ Some rapidly-developing economies have run head-on into overloaded infrastructures and congested transport networks, and severe environmental damage to air and water. At low levels of income, most people are willing to put up with some congestion and pollution as the side-effect of growth. When incomes pass a certain intermediate level, people tend to demand better environments as an important component of their standard of living. Even in narrowly-defined economic terms, infrastructure and environment are important. The costs shows up in GDP when workers must spend hours in commute traffic to get to their jobs, when mail and shipments are delayed for days, or when extreme air pollution scares off tourists and businessmen.

2.4 While it is intuitive that infrastructure accumulation should raise output, it has been difficult to determine whether spending in this area has a greater pay-off than other forms of investment. Some authors have pointed out that, as with any capital investment, changes in the stock of public capital should be less important than changes in the flow of productive services that obtain from that stock. Hence, infrastructure *maintenance* can have a large impact on output.⁷ One strand of the new growth literature identifies another channel through which infrastructure investment can affect the growth *rate* of output: if transportation infrastructure increases the extent of the market in a country, it can foster a faster rate of technical innovation (and hence of productivity growth).⁸

3 *Investment in human capital*

⁶ Easterly and Rebelo (1994) find that investment in transport and communication infrastructure have a strong effect on countries' growth.

⁷ Hulten (1993) presents some suggestive evidence along these lines.

⁸ See Romer (1990), who cites work by Sokoloff indicating that the rate of patenting activity in the United States in the early nineteenth century tended to increase in a region when it gained access to a navigable waterway (*e.g.*, as a result of canal construction).

3.1 The term “human capital” is applied to acquisition of skills and know-how through education, training, experience and research. It is difficult to measure education in internationally comparable ways. Nevertheless, enrollment rates in primary and secondary school, adult literacy rates, and cognitive test scores have been found to be higher in high-growth economies in general, and East Asia in particular.⁹ Human capital, together with trade and other international interactions, is apparently a necessary condition to absorb knowledge from other countries.

3.2 Countries that over-invest in higher education relative to basic education, before the economy has reached the stage of development at which graduates with college and higher degrees can be usefully employed, have not necessarily been successful. Nevertheless, as some East Asian economies move rapidly up the ladder, they may find that they run into shortages of skilled workers. Such education bottlenecks mean that increases in years of schooling are a prerequisite for the next stage of economic development.

4 *Financial intermediation and financial structure*

4.1 Funds for investment must be raised through saving (leaving aside borrowing from abroad). Hence the identity between national saving and national investment. Because financial institutions mediate the transformation of savings into physical capital, the presence or absence of a stable and well-developed financial system can profoundly influence a country’s long-term growth. Early writers such as Schumpeter and Gerschenkron emphasized this point in their writings on economic development, although it was debated whether the presence or absence of a financial system mattered to an economy before it had attained some threshold level of development.

4.2 Broadly speaking, economists identify four distinct channels by which financial institutions influence economic growth.

- First, the financial system promotes saving and investment by reducing the need for self-finance. It allows savers, by lending their funds to others, to earn higher rates of return than they otherwise would earn, while simultaneously allowing firms to borrow at low rates than the opportunity cost they would face if they had to raise the funds internally.
- Second, the risk-sharing or risk-bearing function of financial intermediaries or securities markets permits the implementation of high-risk (but high-return) investment projects.
- Third, the presence of a banking sector or securities markets allows the accumulation of

⁹ E.g., Helliwell (1994, 1995), World Bank (1993), and Frankel, Romer and Cyrus (1996). Of course, the correlation between education and growth could result from a tendency for the demand for education to rise as income rises, rather than the reverse.

large sums of capital. These sums might be necessary in order to finance increasing-returns-to-scale projects with large fixed costs.

- Finally, the development of a financial system, particularly a market-oriented one, allows for more efficient allocation of investment across competing uses.

4.3 Note that the first three channels relate to the mobilization of saving and the *quantity* of investment, while the fourth influences the *quality* of investment.¹⁰ The literature on “financial repression” has emphasized that a liberalized, market-oriented system can better mobilize and allocate funds, as compared to a system where the government keeps real rates of return to savers artificially low and allocates the available savings based on political considerations or bureaucratic judgments as to investment priorities.

4.4 An interesting line of research involves studies that attempt to quantify empirically the influence of financial intermediation on growth. An early study by Goldsmith identified in a number of developed and developing countries a correlation between the relative size of the financial sector and output. As Goldsmith himself acknowledged, however, the direction of causality is unclear in this case: does greater financial intermediation drive development, or *vice-versa*? More recently, King and Levine (1993) demonstrate a correlation between various measures of financial development and the rate of GDP growth, capital accumulation, and multifactor productivity growth in a large cross section of countries; these authors argue that the correlation reflects a causal relationship between intermediation and growth.¹¹

4.5 Another issue regards the specific institutional structure of the financial sector. A distinction has been drawn between a so-called “Anglo-Saxon” model of financial structure and an Asian one. The former relies relatively heavily on securities markets (including venture capital markets) and other “arm’s length” transactions, even in the case of transactions that involve the banking sector. On the other hand, the institutional structure of the financial sector in many Asian economies often involves closer ties between intermediaries and the firms to

¹⁰. Some recent research has sought to formalize these rather intuitive arguments. For example, Bencivenga and Smith (1991) present a model where agents’ need for liquidity discourages long-term investment, and Greenwood and Jovanovic (1990) consider a model in which the presence of a banking sector allows agents to undertake more profitable investment. This latter model is noteworthy for two reasons. First, it posits the existence of a feedback effect in that a well-developed financial system raises output, while higher-income economies are in turn better able to invest in a “financial superstructure.” Second, the dynamics of the model imply that development induces an increase in income inequality that decelerates and eventually reverses--the famous “Kuznets curve” [see below].

¹¹ De Gregorio and Guidotti (1995) refine this analysis, and suggest that the data support two conclusions: first, that financial development promotes growth by affecting the efficiency of investment (rather than its quantity), with larger effects for poorer countries; and second, that unregulated financial liberalization can induce a negative correlation between economic performance and the extent of the banking sector. They view this as a description of Latin America’s experience in the 1970s and 1980s.

which they lend, as

well as a greater role for government allocation of capital, including what sometimes amounts to government subsidization of the banking sector relative to securities markets.¹²

4.6 While generalizations are difficult across a wide class of disparate economies, the Asian model of finance tends to feature:

- high debt/equity ratios
- greater reliance on bank loans than on securities markets
- closer relationships between banks and borrowers
- extensive corporate cross-shareholding
- greater guidance from the government in credit allocation

4.7 Five to ten years ago, economists were wondering if the Japanese system might be superior to the Anglo-Saxon one. Research took both theoretical and empirical forms. The theoretical models assumed “asymmetric information” (between borrowers and lenders). The idea is that, from the viewpoint of a firm seeking to finance an investment project, the typical investor in the securities markets is a stranger, who has no way of knowing whether to expect your project to have as high a return as you claim. Such investors will demand a premium to compensate them. The empirical tests confirmed that firms were better able to finance their investment projects internally, than when they had to go to the securities markets and convince strangers of the worthiness of their projects. Thus relationship banking was thought to be a possible way around the asymmetric information problems that impede capital markets. It was said that American financial markets had excessively short horizons, and would cut a worthy firm off from funds when it was experiencing temporary losses. A Japanese main bank, by comparison, would be sufficiently familiar with the firm’s business that it would continue to furnish the necessary resources to see it through setbacks.

4.8 The question ultimately was an empirical one. The financial systems in Japan, Korea and other East Asian economies seemed to work very well. They had produced very high rates of saving and investment. In doing so, they seemed arguably the key to these economies’ high rates of growth.

4.9 Now aspects of these financial systems are looking somewhat tarnished. Every country has its bumps in the road; one does not want to conclude too much from a single episode. But

¹² Frankel (1995) reviews issues concerning Asian financial systems, with an emphasis on the notion that different structures may be appropriate at different stages of development.

recent developments have called into question various aspects of the model: close relationships between banks and corporate borrowers, heavy government involvement in resource allocation, and special priority to industrial sectors that were once thought key to industrial development or strategic in export markets (e.g., steel). The admired attribute of the Asian system, the readiness

of banks to lend to loss-making firms, proved precisely to be a source of difficulty, as many banks continued to lend to borrowers that should in fact have been cut off.

5 Macroeconomic stability

5.1 Macroeconomic stability, particularly low and stable inflation, is typically viewed as a precondition for--though not a guarantee of--economic growth. Consider inflation first. One theoretical description of how high inflation might retard productivity growth can be found in Milton Friedman's Nobel lecture (Friedman, 197x), the intellectual antecedents of which can in turn be traced to Hayek's description of the coordinative role played by the price system in a capitalist economy. Since prices signal vital information regarding the optimal allocation of resources, any disruption of the price system causes misallocation of resources, with a corresponding loss of efficiency. While it is less clear that high (as opposed to variable) inflation will induce such distortions, there is a general belief that the volatility of inflation, or at least its unpredictability, rises with its level. Other mechanisms by which inflation might affect growth have also been advanced; for example, it has been argued that unexpected inflation discourages saving by transferring income from lenders to borrowers.

5.2 Several studies, including Barro (1995) and Fischer (1993) have sought to quantify the effect of inflation on economic growth.¹³ These studies find that higher inflation reduces growth by a small, though meaningful, amount: each percentage point of inflation depresses a country's growth rate by 0.02 to 0.05 percentage point. Hence, a country with a five percent inflation rate sacrifices anywhere from 0.10 to 0.25 percentage point of growth per year relative to a country with no inflation.

5.3 While most attention has focused on inflation, some authors have identified other macroeconomic factors as having an impact on growth. One such factor is government fiscal policy. It is easy to postulate a mechanism through which large budget deficits or heavy tax burdens might retard growth; for instance, government borrowing can crowd out private capital accumulation. Also, unbalanced government fiscal policy might be a symptom of other, related problems--such as an overall lack of good governance--that could adversely affect a country's productivity growth [see below]. Fischer also finds that distortions in foreign exchange markets reduce economic growth, perhaps by discouraging foreign direct investment and/or trade more

¹³. In addition, X and Wilcox (1994) find evidence in U.S. data that even moderate inflation depresses productivity growth.

generally.

5.4 It is worth stressing that low inflation and/or low budget deficits do not ensure that a country will enjoy healthy macroeconomic performance. As Fischer himself points out, several franc-zone economies in Africa have had low inflation over the 1980s and 1990s, but have

nonetheless grown slowly. However, he emphasizes that high inflation appears incompatible with sustained economic growth. In other words, monetary stability is necessary but not sufficient.

6 *The role of openness to trade and investment*

6.1 There is a positive relationship between a country's growth rate and the extent to which it is open to trade and investment. Until fairly recently this relationship was understood in relatively simple terms. Trade was understood to facilitate specialization in the production of goods that a country is best able to produce--the principle of comparative advantage. This specialization brings about a more efficient use of existing resources and raises the level of real income on a per capita basis, but doesn't permanently alter the rate of growth. The marriage of the "new" growth theory, which accounts for the endogeneity of technological change, and the "new" international trade theory, which incorporates the notion of imperfect competition, yields insight into the ability of openness to facilitate permanently higher growth rates, rather than merely a small increase in the level of income.

6.2 Openness to trade and or investment can facilitate the transfer of technology from rich/high technology countries to poor/low technology countries. The mechanism through which the technology can be transferred can take on any of a number of forms. A high rate of economic interaction with the rest of the world speeds the absorption of frontier technologies and global management best practices, spurs innovation and cost-cutting, and competes away monopoly.

6.3 As emphasized by Grossman and Helpman (1991a,b), technological spillovers could come via imports as easily as exports. One source of technology transfer is the ability of a poorer country to imitate the production of higher quality goods that have been developed in the rich country. Another important channel is through the importation of higher quality intermediate inputs. By incorporating higher quality inputs into the production process, the extent of domestic value added per unit of domestically added inputs can be enhanced.

6.4 In addition to trade, direct investment can also facilitate the transfer of technology from one country to another. In this context, "technology" can include managerial practices and worker skills, in addition to the physical process of production and the characteristics of the product. Foreign firms will train employees who may subsequently transfer to a domestically owned firm and bring with them the knowledge that they have acquired.

6.5 The process whereby late-comers catch up to the productivity and income levels of those that have gone before has some special attributes in the East Asian case, which sometimes go under the name “flying geese pattern of development.”¹⁴ Countries adopt the commodity composition previously exhibited by those that are one step ahead of them on the ladder. Direct investment into the follower country is an important component of the process of transferring knowledge and production characteristics. One interesting aspect of the flying geese pattern is that it suggests that a country with a high ratio of unskilled labor to capital, such as Indonesia, the Philippines, or China, might have more to learn from a country that made the transition to more advanced products relatively recently, such as Korea, than from a country at the frontier, such as Japan or the United States. [By analogy, a worker has more to learn from a colleague recently promoted to foreman than from a company executive.]¹⁵

6.6 A qualification to the benefits of foreign direct investment is the so-called headquarters effect. This is the alleged tendency of high-income, skill-worker-abundant countries, to take a substantial ownership position in a foreign firm and subsequently transfer the research and development efforts back to the rich country. The effect is to concentrate low-skill intensive activities in the poor country.

6.7 A prime example of the transfer of superior management practices is in the automobile industry. Prior to the 1980s, Japan’s just-in-time inventory methods ran contrary to common practice in the United States for example. This practice has now achieved wide acceptance. Firms in the United States have now attained historically low levels inventories.

6.8 Other schools of thought include “import substituting industrialization” (IS) and “export oriented industrialization.” The first in the past has been pursued extensively in African and South American countries with little success. The rationale behind this approach is related to infant industry arguments. By closing off domestic markets from international competition, domestic manufacturing is encouraged. These new industries will then receive protection until they are capable of competing on world markets. The fundamental flaw has generally been that such domestic industries rarely reach a level of efficiency that matches that in more competitive

¹⁴ The inverted “V” pattern was intended by the originators of the flying geese metaphor--Akamatsu (1962) and Yamazawa (1990)--simply to describe the rise and fall of a given Asian economy’s comparative advantage in a given industry (say, textiles or toys, followed by radios, chemicals, steel, autos and high-tech). The same metaphor can be made more vivid by envisioning Japan as the lead goose in a horizontal “V,” flanked by Singapore and Hong Kong, then Korea and Taiwan, followed by Malaysia and Thailand, and Indonesia and the Philippines, and finally China and Indochina. The lead goose ascertains which economic territory is the most rewarding to enter, and the others in sequence follow the lead of those that went before. See Kwan (1994).

¹⁵ Frankel and Wei (1996) examine direct investment in the context of ASEAN, and give references.

markets, and thus the barriers are seldom reduced. Export-oriented industrialization, on the other hand, prescribes a complex of policies intended to make exports a leading sector. The notion is to exploit opportunities presented by trading with the rest of the world on market terms, rather than adopting a strategy that deliberately tries to limit imports. This approach further relies on the exploitation of increasing returns to scale.

6.9 There is a substantial and growing empirical literature investigating the relationship between openness and growth. Quite a few empirical studies of growth rates across countries find that the ratio of exports to GDP, or some other measure of openness, is a significant determinant of growth,¹⁶ and often that it is an important determinant for East Asian economies in particular.¹⁷ A typical specification begins with the standard determinants of GDP suggested by neoclassical growth theory, and adds a variable for trade as a share of GDP. For example, Feder (1982) regresses growth rates for 31 semi-industrialized countries over the period 1964-1973 against three variables: investment as a share of income, the rate of growth of the labor force, and the rate of growth of exports (times exports as a share of income). The coefficient on the last variable is highly significant statistically. Similarly, Edwards (1993, pp.9-11) regresses the rate of growth of total factor productivity on two measures of openness--total trade as a percent of GDP and total tariff revenue as a per cent of trade--along with some other variables, and finds that "in every regression the proxies for trade distortions and openness are highly significant." Some, such as Harrison (1996), look to the policy determinants that underlie openness. Frankel, Romer, and Cyrus (1996) wrestle with the endogeneity problem: Does openness lead to growth, or does growth lead to openness? The effect of openness on growth turns out even stronger when correcting for the simultaneity, as compared to standard estimates. Each additional percentage point in openness (expressed as imports plus exports, divided by GDP), raises income per capita between 1960 and 1986 by an estimated 0.34 percent.

6.10 The broad evidence on openness and growth is consistent with effects coming via a variety of channels in addition to trade. Coe and Helpman (1995) find that countries' productivity levels are positively affected by domestic as well as bilateral import share measures of foreign research and developments: ie, intermediate goods that embody technology. Keller (1997) looks at individual industries and finds that foreign R&D is between 7 and 17% percent as effective as local research and development. Harrison and Revenga (1995) find a significant correlation between trade policy reform and increased investment flows. They suggest, however, that other factors may be more important; such as the general macroeconomic environment and macro-conditionality imposed by international organizations.

¹⁶ Examples include Michael (1977), Krueger (1978), Feder (1982), Kohli and Singh (1989), Romer (1989), Quah and Rauch (1990), de Melo and Robinson (1991), DeLong and Summers (1991), Dollar (1992), Edwards (1993), van den Berg and Schmidt (1994), Sachs and Warner (1995, p.35-37), Harrison (1995), and Eusufzai (1996). Edwards (1993b) and Rodrik (1993) survey the literature.

¹⁷ Five examples are Helliwell (1992, 1995), Page (1994), Pack and Page (1994), and Fukuda and Toya (1995). Pack and Page find that manufactured exports, in particular, are important in the growth equation, and that this variable explains part of the East Asian success (and that its coefficient is the same as for other parts of the world). Bradford (1994) surveys the literature.

7 *Income distribution*

7.1 The notion that inequality is in some way linked to economic development dates back at least to Kuznets, who argued that inequality should rise during the early stages of economic development, stabilize, and then decline as a country becomes more wealthy (a pattern that was dubbed the “Kuznets curve”). One mechanism that was suggested as the cause of this process is the increasing degree of urbanization that typically accompanies industrialization, the argument being that inequality is lower in rural areas.

7.2 Under the Kuznets process, development drives changes in inequality. A more recent view holds that inequality itself affects development. An oft-invoked example (which is attributed to Lucas, 1988) compares the development experiences of Korea and the Philippines: both countries were virtually equivalent in 1965 in terms of GDP per capita, population, urbanization, school enrollment, and so on, but income inequality was substantially higher in the Philippines. The subsequent growth of the Korean economy was far greater than that of the Philippines: six percent per year on average as compared with two percent. This example is confirmed by more extensive empirical studies; in virtually all cross-country growth regressions, income inequality is negatively correlated with future economic growth. In the case of Korea and some other East Asian economies, land redistribution after World War II is credited with creating initial conditions for growth. A distinction is drawn with Latin American countries, where conflicts arising from distributional concerns have at times in the past interfered with growth.

7.3 A number of theoretical models generate this negative correlation between inequality and growth. Bénabou (1996) groups these models into three general categories. In the first class of models, higher levels of inequality increase the electorate’s demand for redistributive policies by government. To the extent that these policies involve distortionary taxation, it follows that subsequent growth is impeded.¹⁸ A second broad class of models argues that a high concentration of wealth exacerbates the credit constraints that poorer producers face in developing countries. Finally, yet another category of theoretical work involves models in which inequality breeds social unrest, which has an adverse impact on development by reducing the security of property rights.

7.4 While equality might initially be good for development, it is nevertheless possible that subsequent increases in inequality may occur during the course of industrialization--and, in fact, may be necessary for industrialization to progress. For example, an increase in inequality might reflect a greater return to education or skill, which in turn induces greater accumulation of human capital. Regional income disparities within an industrializing country can also develop as

¹⁸. This requires poorer agents to have some sort of access to the political process. An implication of this type of model is therefore that the effects of inequality tend to be more pronounced in a democracy. See Alesina and Rodrik (1994).

better-endowed or better-situated provinces reap the rewards. On the other hand, the rise of a middle class (which typically reduces measured inequality) is sometimes seen as being necessary for industrialization in that it provides a demand for domestic production and acts a source of entrepreneurial capital and talent.

7.5 A negative relationship between inequality and growth does not necessarily imply that a developing country should engage in disruptive redistributive policies, for example, forced redistribution of land. However, it is easily seen that such a relationship strengthens the case for a policy measure such as subsidized education, which itself can augment growth through human capital formation [see above], in addition to any effects that work via the promotion of greater income equality.

8 *Political and social conditions*

8.1 Researchers have also attempted to quantify the effect of political and social institutions on long-term growth. Some of the factors that have been considered include: the form of a country's political system (*e.g.*, democratic *versus* autocratic¹⁹), its degree of economic freedom and/or lack of government interference in the economy, and its degree of political and economic stability (measured, say, in terms of the risk of collapse of its political or economic institutions). It is difficult *not* to believe that these factors matter for growth; and, unsurprisingly, proxy measures of political and social stability are often correlated with economic performance. Barro (1991), for example, finds that the frequencies of revolutions, coups, and assassinations have significant negative effects on growth. Economic freedom--the right to property and choice--is observed to have a strong positive correlation with growth.²⁰

8.2 It is somewhat less certain that these correlations are meaningful in a causal sense. We might expect, for instance, that poor economic conditions would tend to induce civil unrest, or that demand for access to the political system would increase as living standards improve. But Alesina, Ozler, Roubini, and Swagel (1992) find that political instability has a significant negative effect on growth, even when controlling for the simultaneous effect of growth back on stability.

8.3 One aspect of the political/social structure has received particular interest from students of economic development, namely, the sources and effects of corruption (or rent-seeking more generally) on the part of government. Corruption, while not unknown in developed countries, is

¹⁹ A review of empirical studies of the effect of democracy on growth finds some positive and some negative (Borner, Brunetti and Weder, 1995). Logically, authoritarianism can be used either in pursuit of good economic policies or in pursuit of bad. Democracy and freedom, whatever their economic effects, are, of course, highly prized for non-economic reasons as well.

²⁰ Gwartney, Lawson, and Block, 1996.

particularly common in many developing countries. Some researchers have argued that high returns to rent-seeking behavior can adversely affect the allocation of human capital in an economy, with obvious ramifications on economic performance. In addition, as Shleifer and Vishny (1993) have pointed out, “the illegality of corruption [and corresponding need for secrecy] make it much more distortionary and costly than its sister activity, taxation.” Finally, Wei (1997) finds that economies where corruption is more pervasive tend to receive less foreign direct investment on average.

9 Concluding Remarks

9.1 To summarize, statistical studies find that the strongest determinants of countries’ long-term growth rates are investment in physical and human capital (especially investment in infrastructure and education), openness with respect to international trade and investment, and economic freedom. Also important are macroeconomic stability, financial structure, and political and social stability.

9.2 Many East Asian economies have many of these characteristics in abundance. This observation helps explain the miracle growth rates of the past, and helps reassure us of strong performance in the future as well. On the other hand, some slowdown seems likely, in three ways:

- as the gap separating these economies from the front-runners narrows,
- as they run into diminishing marginal returns to investment
- and as they encounter bottlenecks created by shortages of highly skilled labor, outdated financial structures, overloaded infrastructures, congested cities, and unacceptable environmental damage.

While the first two eventual limitations to continued miracle-growth are probably inevitable, the bottlenecks are not. The aim should be to emulate what industrialized countries have done right, and avoid what they have done wrong. Countries have it within their power to facilitate their movement up to the next stages of development, by further investments in physical and educational infrastructures, reform of their financial systems, and proper pricing of scarce environmental resources such as air, water, and roadways.

Appendix: A technical note on empirical studies of economic growth

The preceding discussion has cited a number of empirical studies that typically attempt to assess the contribution of some factor--say inflation or human capital accumulation--to observed growth in output or productivity. This empirical strategy has come under serious criticism on at least two grounds: first, it is often impossible to assign causality convincingly (for example, it could well be the case that growth induces greater human capital accumulation--say if education is a consumption good--rather than *vice-versa*); and second, the statistical correlations are rather fragile.

Levine and Renelt (1992) provide a comprehensive critique of the empirical growth literature. They define a coefficient in a cross-country growth regression as “robust” if the coefficient keeps its sign and remains statistically significant no matter what other variables are included in the regression. Levine and Renelt find that “...the broad array of fiscal-expenditure variables, monetary-policy indicators, and political stability indicators considered by the profession are not robustly correlated with growth; and a huge assortment of new indicators...constructed to capture exchange rate, trade, tax, and fiscal-expenditure policies are also not robustly correlated with growth.” In fact, the only truly robust correlation that Levine and Renelt find is between growth and the share of capital investment in GDP.

Levine and Renelt’s definition of what comprises a robust correlation has been seen as too strict by some authors, notably Sala-I-Martin (1997). Sala-I-Martin points out that even a factor that truly matters will occasionally show a contrary result, if one experiments with a large number of tests, and thus will fail the Levine-Renelt definition of robustness. He proposes an alternate test in which, essentially, distributions are generated for the coefficient estimates *across specifications*; this in turn allows him to assess the “strength” of a variable’s correlation with growth performance. He finds that a relatively large number of variables are robustly correlated with economic growth, including investment’s share in GDP, a number of political and social indicators, and openness.

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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:24-NOV-1997 11:18:15.00

SUBJECT: letter to WSj in reply to Bhagwati

TO: HOPKINS_M (HOPKINS_M @ A1 @ CD @ LNGTWY [UNKNOWN]) (CEA)
READ:UNKNOWN

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

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

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

CC: Rebecca M. Blank (CN=Rebecca M. Blank/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

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

TEXT:

I propose to send the attached letter to the WSJ, in reply to today's
op-ed by Bhagwati. Comments preferred by COB please?

JF===== ATTACHMENT 1 =====

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D64]MAIL42072472J.316 to ASCII,
The following is a HEX DUMP:

To the editors:

Professor Bhagwati is correct that unilateral trade liberalization generally raises the aggregate real income of the liberalizing country [*Free Trade Without Treaties*, Nov. 24]. It allows the country to specialize in production, and to import what can more cheaply be produced abroad. But there are losers as well, in the less competitive sectors, whom we don't want to leave behind.

Moreover, the interests of those who benefit from the cheap imports are generally not voiced with sufficient clarity or clout to prevail unaided politically. Thus U.S.-led internationally-negotiated liberalization -- whether bilateral, regional or multilateral -- will continue to be a more potent force in the world than U.S.-led unilateral liberalization. This is one reason why the Administration needs from Congress traditional (or fast-track) trade-negotiating authority.

When other countries agree to reduce their barriers at the same time that we lower ours, their demand for our products increases at the same time that our demand for theirs increases. This is all the more true when the partner eliminates previously existing high barriers, while the U.S. eliminates low barriers, as has been the case in past, current, and prospective negotiations. There is an increase in relative demand for our products, which improves our terms of trade, on top of all the other benefits of trade liberalization. Successful negotiations in telecommunications, information technology [and, we hope, now financial services] are only the most recent major examples where foreign markets have been opened.

Negotiated market-opening abroad leads to enhanced U.S. export opportunities, which in turn lead to higher-wage jobs for American workers. This effect remains the most powerful argument we have for maintaining political support for free trade. We need businessmen and workers from such sectors as telecommunications and information technology to be able to weigh in to the ongoing national debate over trade. It is not enough for liberalization to benefit a majority of Americans. We need to benefit a very heavy majority of Americans. Negotiated liberalization will do this.

Professor Bhagwati argues, correctly, that the President needs to explain the case for free trade to the American public. President Clinton's powers of exposition and persuasion are impressive. But the case for unilateral liberalization is patently more difficult to make than the case for mutual liberalization. Professor Bhagwati is almost alone, politically, in arguing that the problem with our current fast-track plans is that they are not sufficiently unilateral or pro-free trade. If the inspiration of U.S. presidential leadership is crucial to advancing free trade in the world, and I agree that it is, then persuading Congress to grant fast-track authority is a key component of that leadership.

Jeffrey A. Frankel, Member, Council of Economic Advisers

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Peter R. Orszag (CN=Peter R. Orszag/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME:25-NOV-1997 21:24:40.00

SUBJECT: Handout for tomorrow's 11:30 POTUS meeting

TO: Sylvia M. Mathews (CN=Sylvia M. Mathews/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: Ron Klain (CN=Ron Klain/O=OVP @ OVP [UNKNOWN])
READ:UNKNOWN

TO: Michael Waldman (CN=Michael Waldman/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

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

TO: Franklin D. Raines (CN=Franklin D. Raines/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

TO: DAVID.WILCOX (DAVID.WILCOX @ MS01.DO.treas.sprint.com @ INET @ LNGTWY [UNKNOWN])
READ:UNKNOWN

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

TO: Alan.Cohen (Alan.Cohen @ MS01.DO.treas.sprint.com @ INET @ LNGTWY [UNKNOWN])
READ:UNKNOWN

TO: Paul E. Begala (CN=Paul E. Begala/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

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

TO: Jacob J. Lew (CN=Jacob J. Lew/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

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

CC: Russell W. Horwitz (CN=Russell W. Horwitz/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

CC: Jill M. Blickstein (CN=Jill M. Blickstein/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

TEXT:

This draft incorporates the comments from tonight's meeting. If you have any further corrections or comments, please let me know by 9:30 tomorrow

morning. Thanks.===== ATTACHMENT 1 =====
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D78]MAIL400577824.316 to ASCII,
The following is a HEX DUMP:

Social Security and the Unified Budget Surplus
November 26, 1997

Overview

Projected budget balance, \$ billion

	2001	2002	2003	2004	2005	2006	2007
Trust funds	115	123	131	138	153	161	172
Non-trust funds	-122	-60	-69	-55	-46	-25	-5
Unified budget	-7	63	62	83	109	136	167

Source: OMB, Mid-Session Review cycle

- Unified surplus projected for 2002 to 2026. Between 2002 and 2007, unified surplus is “working man” surplus. In 2008, non-trust component of budget shifts to surplus.
- The surpluses raise national saving, which helps to raise productivity in the future and therefore ease the burden on future workers imposed by demographic trends.

Options

1. Bolster the Social Security Trust Fund

A) Alternatives:

- Purchase Treasury securities
 - Has same economic effects as retiring government debt
 - Would extend the life of the Trust Fund
 - Under current scoring rules, leaves surplus on the books
- Purchase private securities
 - Would extend the life of the Trust Fund significantly
 - Market risks and “social” investing concerns
 - Would eliminate the surplus

B) Key issues

- Whether elite leaders would view as increase in national saving, or as accounting maneuver.
- Could emphasize down-payment, not complete solution. Present plan (e.g., commission or high-level group to report by January 1999) for effecting other steps.

2: Fund individual retirement accounts

This option would use the unified surplus to fund a set of mandatory individual retirement accounts. If creating private accounts does not affect individuals' behavior any differently than bolstering Social Security, the effect on national saving would be the same as above -- but private saving would be higher and public saving would be lower.

A) Key elements:

- Funding tied to surplus
- Progressive as possible -- progressive match or system not linked to wages. For example: 1 percent of wages, plus lump sum per person depending on size of surplus (e.g., 1 percent of wages, plus \$500 per person).

B) Policy issues:

- Administrative costs
- Market risk: Risk borne by individuals, not shared by society as a whole
- Pressures that could reduce national saving:
-- Withdraw early for special needs?
-- For employers to reduce pensions?
- Pressure to reduce future role of government
- Support for Social Security: Will private accounts undermine support for S.S.?
- Government involvement: Should some government entity manage the accounts, as under Thrift Savings Plan?

C) Political issues

- Will approach be seen as partial privatization and split Democrats?
- How closely should the approach be tied to "Social Security"? Separation could reduce problem for Dems. But Social Security "problem" then remains.

D) Allow withdrawals for layoffs

- Could define a new type of social security
- Pressure to be expanded for medical care, home purchases, etc.

3. Social Security and retirement needs exclusively

- A) 100 percent of surplus for Social Security Trust Fund, but leave open Treasury versus private securities. 100 percent of surplus as down-payment on Social Security, with commission or bipartisan process to decide split between Treasury securities and private securities. Could be linked with broader Social Security reform effort, with reporting date by January 1999.
- B) Leave split between Trust Fund and individual accounts undecided at this point. Declare that 100 percent of the surplus would be used for helping to address demographic and retirement challenges, but leave split between Trust Fund and individual accounts to be decided by commission or bipartisan process.
- C) 50 percent Social Security, 50 percent individual accounts. Specify now that 50 percent of the surplus would be used for the Trust Fund, and 50 percent for individual accounts. Decide now or later the details of both.

4. Mix Social Security with other priorities

Another approach would be to expand the potential uses of the surplus beyond Social Security and retirement. The advantage of such a broader approach is that it allows us to address other priorities; the cost is that it blurs the message.

Illustrative example: One illustrative example would be to use 50 percent of the surplus for the Social Security Trust Fund, 25 percent for tax reform (which could include individual accounts), and 25 percent for an Investment in the Future fund.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Rebecca M. Blank (CN=Rebecca M. Blank/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:25-NOV-1997 08:58:06.00

SUBJECT: micro chapter

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

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

READ:UNKNOWN

CC: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Janet and Jeff --

I read through the revised version of the micro chapter last night. I made a few minor editorial changes, but as far as I'm concerned, this is ready to be sent out to agencies. It's a vast improvement over the draft we received last week, and much more tightly and clearly written.

Becky

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 1-DEC-1997 19:48:17.00

SUBJECT: Attached

TO: Janet L. Yellen (CN=Janet L. Yellen/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.D55]MAIL42971743Q.316 to ASCII,
The following is a HEX DUMP:

USA-ROC Economic Council Plenary Session

Remarks by Dr. Janet Yellen Chairman, Council of Economic Advisers

December 2, 1997

It is a pleasure to be here today. In preparing for my presentation today, I looked back at addresses given by some of my predecessors at the US-ROC Business Council. One common theme was a kind of homage paid to the "East Asian Economic Miracle," with analyses of what produced it. In the last few weeks, we have read numerous analyses that often begin by using the term "East Asian Economic miracle" ironically, as if the achievements of the last 20 years have somehow been obliterated by the turmoil in Asian financial markets and the devaluations of the last several months.

Well, today may not be another day for homage, but it is not the day for a eulogy either. It's rather a time for a sober-minded look at the policies the East Asian economies have pursued that have laid a foundation for future growth and strength and the continued importance of openness and economic integration.

I do not need to remind this group why this all matters to Taiwan. The linkages of the economies of the region are extensive and intensive. Taiwan is a major investor in Southeast Asia, in China, in the Hong Kong Special Administrative Region. Changes in the value of Taiwan's currency immediately proceeded a sharp downturn in Hong Kong's stock market. Problems that began in Thailand have spread out of Southeast Asia into Northeast Asia. While each economy in the region has its own unique characteristics -- and certainly Taiwan does -- the

interrelationships of the region's economies require each to pay attention to the successes, and the failures, of its neighbors.

So, this afternoon I will briefly discuss the current economic situation in East Asia and the economic outlook for the region, and then turn to the importance of continued economic integration and engagement between the United States and the Asia Pacific Community.

OUTLOOK FOR ECONOMIC GROWTH IN EAST ASIA

As you know the East Asian economies have faced serious challenges in recent months. We have seen financial market problems arise -- first in Thailand, then Indonesia -- that could have had a potentially important impact on other emerging markets in Asia and around the world.

President Clinton's economic team has been working closely with our partners in the region and with the international financial institutions, the IMF and the World Bank, to help re-establish financial stability in Southeast Asia. And, in Vancouver, building on the Finance Ministers' work in Manila, the leaders of the APEC nations established a cooperative policy approach to compliment IMF efforts through surveillance, technical assistance, and cooperative financing arrangements.

All along, President Clinton has emphasized that it is critical that economies affected by

financial market turmoil help themselves by establishing sound policy regimes. The President has affirmed the U.S. commitment to sound macroeconomic policies for the region, to transparency -- publishing economic statistics regularly, frequently and accurately -- and to solid financial regulation. The United States firmly believes that sound policy regimes will generate confidence and calm financial markets.

During these months of turmoil, it has been clear that each of the East Asian countries has faced its own unique set of circumstances. But, it is also clear that there are common strengths which have fueled rapid growth the past and which make these economies well-placed for a rapid return to growth once stability has been restored.

These common strengths include:

First, a stable business environment. This included macroeconomic stability -- low inflation and realistic exchange rates -- but also stable and predictable rules of the game for business.

Second, high rates of saving and investment. And, there's no miracle here -- these economies grew because they invested heavily. And, governments contributed by running balanced budgets, or budget surpluses, and by raising the returns to private saving. But it was not only that governments had sound budgets--they made choices that about how to spend their limited money in ways which enhanced economic growth.

They had a clear sense of priorities. For instance, they invested heavily in education, the returns to which have proved to be enormous. This is a lesson which some in Washington need to take to heart.

Third, an **emphasis on education**. There was a particular emphasis on primary and secondary education, but there was also a strong concern to make sure that there was widespread access to education, for females as well as males. The countries of East Asia showed that egalitarian policies could enhance growth. One didn't need to rely on trickle down economics.

Fourth, there was a basic **openness to technology**, and strong efforts to learn from, and adapt, foreign best practice.

And, finally, many of the **East Asian governments** demonstrated an ability to know when government should get in and where government should stay out. Achieving that delicate balance between doing what supports growth -- such as investing in infrastructure and R&D -- and not intervening too heavily is a very difficult task. And the most successful East Asian governments were able to find that appropriate middle ground, a middle ground which so many countries, both developed and less developed, have found difficult to find.

To be sure, East Asian governments have made some mistakes. In particular, where

they have protected uncompetitive industries from competition; where they have excluded foreign investment; and, where they have failed to protect intellectual property.

But, the most successful governments reversed course when they saw their policies were having the wrong effect.

These strengths in the East Asian economies have laid a foundation upon which these nations can build and return to solid growth and healthy development when stability has been restored to their nation's financial markets. To achieve this return to growth, however, it is critical for the East Asian nations to first work to address the common vulnerabilities which have helped fuel and prolong the financial crises -- namely, the large volumes of mismatched borrowing, the weakness of the domestic financial system in many of the East Asian economies, and the presence of an increasingly unsustainable exchange rate regime.

IMPORTANCE OF CONTINUED INTEGRATION

With the recent financial market turmoil, some in East Asia may have been tempted to turn inward, to retreat in the face of these economic challenges. Instead, at the recent AEC Summit in Vancouver, the APEC Leaders agreed to open trade in nine new areas covering \$1.5 trillion in goods and services -- everything from chemicals to environmental technology to medical equipment.

It is critical for the East Asian economies to continue this progress: increased economic

integration is necessary for the continuation of growth and development in East Asia. .

Over the past few years, the economies of East Asia -- as well as the APEC region more broadly -- have become increasingly integrated. Intra-regional investment, subcontracting, and trade in finished goods occupy a growing share of the total trade for these economies, and, at the same time, trade with APEC as a whole has grown rapidly.

Today's economic changes and challenges all point to the importance of larger and more integrated markets: larger markets provide necessary economies of scale; intra-regional investment provides the presence that is so often necessary for the delivery of modern services; and, greater integration makes possible those instantaneous communications that are the heart and core of our most dynamic, creative industries.

Trade was once largely a transatlantic phenomenon for the United States. Today, successful American businesses turn to markets in the East in ever increasing numbers. The statistics are telling:

- * The 14 Asian APEC economies accounted for almost two-thirds of merchandise trade last year -- this is larger than any other single regional grouping. And -- even more notable -- it was nearly 3 times larger than U.S. trade with Europe.

* Taiwan is a key player in this ever expanding trade relationship.

Taiwan is our 7th largest trading partner, with two-way trade amounting to \$49 billion. Taiwan is also our 6th largest export market.

The Clinton Administration has recognized and responded to this dramatic change in the international business environment. We welcome the growth in our economic ties with Taiwan and East Asia. And, we are committed to the APEC process for achieving free trade in the region by the year 2020.

With this increase in trade and the rapid growth of the East Asian economies, there has been a maturing of our trade relations with the region. Although some disputes remain, the United States welcomes the co-operation it has received from Taiwan on tariff reductions, protection of endangered species, and intellectual property protection.

The progress on intellectual property issues -- in Taiwan and elsewhere in the Pacific Rim -- has yielded enormous benefits for Taiwan -- in terms of increased innovative activity and increased access to cutting edge foreign technologies. And, that progress has come as a result of our strong and growing economic ties.

President Clinton is strongly committed to active engagement in the Asia-Pacific. Four years ago at Blake Island he articulated his vision of a Pacific community based on shared

prosperity and values. Three years ago, along with 17 other Asia-Pacific leaders, President Clinton committed to achieving free and open trade and investment in the region by 2020. Last year, President Clinton joined the other Pacific leaders in setting a concrete agenda for more open trade. And, this year, President Clinton worked with other Pacific leaders in setting an agenda to help us meet the challenges of the international financial system in the 21st century.

It is people like you who will be the driving force for future integration in the APEC region. You -- the business men and women of America and East Asia -- are the source and the energy for the changes and developments in our economies. You are the source of the economic changes that are forcing governments to respond and change. And you can help ensure that the East Asian economies continue to look outward and move forward.

Increased integration and economic engagement between the United States and the East Asian nations is important now more than ever. Support and encouragement from the private sector has been crucial in establishing APEC as a framework for advancing integration and co-operation in the Asia-Pacific region. We hope and encourage -- and, indeed, challenge -- you to continue your strong participation in the future.

* * *

[Automated Records Management System Hex-Dump Conversion]

But this answer is a bit incomplete. For one thing, investment in plant and equipment was high in some of the countries most affected [T&M]. For another, the crisis has of course spread widely, including to countries with stronger fundamentals [Indonesia, Taiwan and Hong Kong]. Contagion appears to be a genuine phenomenon. As in Latin America two years ago, the breadth and depth of the punishment visited by investors on the debtor countries seems to exceed the magnitude of the policy sins they have committed.

The conclusion I draw is certainly not that financial market liberalization is bad. Overall, the benefits outweigh the costs. But we must be prepared for occasional crises, not all of them fully understandable. If markets sometimes overreact, then countries need even sounder macroeconomic policies to compensate. As Merton said, modern financial markets are like superhighways: they get us where we want to go faster, but the accidents are bigger as well. Extra caution in driving, and airbags, are both appropriate. Public and private saving rates remain important. Strengthening of prudential regulation of banks and other financial institutions in these countries is key to reducing the risk of accidents. Increases in reserve requirements against banks' short-term foreign-currency liabilities may be in order in some cases.

The longer term:

An end to the East Asian miracle, or just a temporary setback? Krugman claimed that there never was an East Asian miracle. (The appropriateness of the word "miracle" lies in the eyes of the beholder. If Krugman had chosen to phrase his conclusion differently: "The miracle of East Asian growth is due to miraculous rates of investment in physical and human capital," most readers would have been less surprised by the article than they were. Yet this is really what the article said.) Nevertheless, he forecasted a marked slowdown in East Asia. An article by Jeff Sachs in the current Foreign Affairs takes the contrary view: that East Asia's current financial troubles are purely transitory, and growth at miracle rates will before long resume. A natural guess is that the truth lies in between.

Japan's growth rate appears to have converged to that of the United States and other industrialized countries, not gradually, but in the course of two sharp kinks. The first occurred in 1973-74, with the world oil shock. The second followed the bursting of the 1987-89 bubble in Japanese financial markets. [Japan's per capita growth rate averaged a remarkable 8 percent during the period 1962-1973, but slowed to 3 percent during 1974-1990 (Table 1). Over the last seven years, it averaged a mere 1 ½ percent.] Presumably Japanese growth will recover from its recent recession, but whether it will go back to the miracle rates of earlier decades seems dubious. The convergence is complete. Are other East Asian economies now going through a growth-path kink analogous to Japan's 1973 slowdown? There is no necessary connection between transitory shocks such as a sharp increase in the price of oil or a financial crisis and the long-run rate of growth of potential output. With the exception of Japan, Singapore, and Hong

Kong, East Asian economies still have a very long way to go before attaining the per capita incomes of the industrialized countries. But for those observers who thought that the miracle rates of growth attained by many East Asian economies over the past several decades were unsustainable, the 1997 episode of instability in financial markets may be interpreted as a signpost indicating that a more moderate and sustainable rate of growth lies ahead.

Other emerging markets

The most encouraging development in the world economy over the last decade was the choice by many countries to adopt the open market-economy model. Faced with the stark examples of the East Asia economic miracle on the one hand, and the economic fiasco of the communist countries on the other, countries in Latin America, the rest of Asia, Eastern Europe, and even Africa, opted for the capitalist model. Recent financial market developments have spread to Latin America, and may have a negative effect on 1998 growth rates. But assuming that this experience doesn't undermine the fundamental "Washington consensus," -- which favors stable monetary and fiscal policies, privatized enterprises and market-determined prices -- the long-term prospects for the emerging economies and transition economies remain excellent.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-DEC-1997 21:21:39.00

SUBJECT: Taiwan Speech

TO: Janet L. Yellen (CN=Janet L. Yellen/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.D21]MAIL46827743W.316 to ASCII,
The following is a HEX DUMP:

USA-ROC Economic Council Plenary Session

Remarks by Dr. Janet Yellen Chairman, Council of Economic Advisers

December 2, 1997

INTRODUCTION

It is a pleasure to be here today.

In preparing for my presentation today, I looked back at addresses given by some of my predecessors at the US-ROC Business Council. One common theme was a kind of homage paid to the “East Asian Economic Miracle,” with analyses of what produced it. In the last few weeks, we have read numerous analyses that often begin by using the term “East Asian Economic miracle” ironically, as if the achievements of the last 20 years have somehow been obliterated by the turmoil in Asian financial markets and the devaluations of the last several months.

Well, today may not be another day for homage, but it is not the day for a eulogy either. It’s rather a time for a sober-minded look at the policies the East Asian economies have pursued that have laid a foundation for future growth and strength and the continued importance of openness and economic integration.

I do not need to remind this group why this all matters to Taiwan. The linkages among the economies of the region are extensive. Taiwan is a major investor in Southeast Asia, in China, in the Hong Kong Special Administrative Region. Changes in the value of Taiwan’s

currency immediately proceeded a sharp downturn in Hong Kong's stock market. Problems that began in Thailand have spread out of Southeast Asia into Northeast Asia. While each economy in the region has its own unique characteristics -- and certainly Taiwan does -- the interrelationships of the region's economies require each to pay attention to the successes, and the failures, of its neighbors.

So, this afternoon I will briefly discuss the fundamental economic conditions that I believe have been -- and will continue to be -- the foundations for growth in East Asia, and then turn briefly to some of the corrective policies that will be necessary to put Asian economies back on track to solid growth.

THE FOUNDATIONS OF EAST ASIA'S GROWTH "MIRACLE"

As you know the East Asian economies have faced serious challenges in recent months. We have seen financial market problems arise -- first in Thailand, then Indonesia -- that could have a potentially important impact on other emerging markets in Asia and around the world.

During these months of turmoil, it has been clear that each of the East Asian countries has faced its own unique set of circumstances. But, it is also clear that there are common strengths which have fueled rapid growth in the past and which will provide the foundations for solid growth once financial stability has been restored.

These common strengths include:

First, a **stable business environment**. This included low inflation and realistic exchange rates in many cases, but also stable and predictable rules of the game for business.

Second, **high rates of saving and investment**. There's no miracle here: many economies grew rapidly in large part because they invested heavily. And, governments contributed by running sustainable budgets and by raising the returns to private saving. But it was not only that successful governments had sound budgets--they made choices that about how to spend their limited money in ways which enhanced economic growth. They had a clear sense of priorities.

For instance, and this is really the third ingredient, the most successful governments placed a high priority on investing in **education**. There was a particular emphasis on primary and secondary education, but there was also a strong concern to make sure that there was widespread access to education, for females as well as males. This experience showed that egalitarian policies could enhance growth. One didn't need to rely on trickle down economics.

Fourth, the most successful economies were characterized by a basic **openness to technology**, and strong efforts to learn from, and adapt, foreign best practice. And, finally, policy makers in the most successful East Asian economies demonstrated an

ability to know when government should get in and where government should stay out.

Achieving that delicate balance between doing what supports growth -- such as investing in infrastructure and R&D and providing appropriate banking system supervision -- and not intervening too heavily is a very difficult task. The most successful East Asian governments were able to find that appropriate middle ground, a middle ground which so many countries, both developed and less developed, have found difficult to find.

To be sure, East Asian governments have made some mistakes. In particular, where they have protected uncompetitive industries from competition; where they have excluded foreign investment or foreign competition; and, where they have failed to protect intellectual property. But on balance the five strengths that I just described have laid a foundation upon which these nations can build and return to solid growth and healthy development when stability has been restored to their nation's financial markets. To achieve this return to growth, however, it is critical for the East Asian economies to first work to address the vulnerabilities which have helped fuel and prolong the financial crises.

RESTORING SOUND FINANCIAL CONDITIONS

Just last week in Vancouver, leaders from the 18 economies of the Asia-Pacific Economic Cooperation forum -- or APEC -- embraced a common approach to restoring financial market stability. They agreed to strengthen the three lines of defense that protect a country from the type of financial market instability that we have seen in recent months.

An economy's first line of defense is sound domestic policies; sound policy regimes are a necessary precondition to restore confidence and calm financial markets. That includes the basics: a sustainable exchange rate regime, sound fiscal policy, and sensible and consistent monetary policy. But it also includes adequate supervision of banks and other financial institutions and timely, accurate reporting of government economic statistics to gain the trust of investor both at home and abroad. For that reason, APEC leaders recommended that technical assistance on banking and financial regulation should be expanded and strengthened.

The second line of defense is provided by the international financial institutions. President Clinton's economic team has been working closely with our partners in the region and with international financial institutions such as the IMF and the World Bank to help re-establish financial stability in Southeast Asia. Building on the "Manila Framework" developed by Deputy Finance Ministers, APEC leaders agreed that the IMF must continue to be the centerpiece of any international response to financial crises. For that reason, they recommended strengthening the capacity of the IMF to respond rapidly and effectively to financial crises, for instance by establishing a new short-term financing facility.

But the regional reverberations of the financial turmoil in Asia has also pointed to the importance of a third line of defense: regional cooperation. Recognizing that neighbors have a disproportionate interest in each others' financial soundness, APEC leaders agreed to establish a regional surveillance forum to provide a mechanism for expressing concerns frankly and openly.

They also agreed to a rapid-response mechanism for identifying additional resources to supplement IMF programs on a case-by-case basis as needed.

Together, these three lines of defense -- if implemented rapidly and steadfastly -- should help to restore confidence and stability to the region's financial markets, creating conditions for the restoration of growth.

Finally, there is one last ingredient that has been a central part of the region's past recipe for success that I believe will continue to figure prominently.

IMPORTANCE OF CONTINUED INTEGRATION

Perhaps more than any other region in the world, East Asia has benefitted from close trade ties with other economies in the region and in the world. Over the past few years, the economies of East Asia -- as well as the APEC region more broadly -- have become increasingly integrated. Intra-regional investment, subcontracting, and trade in finished goods occupy a growing share of the total trade for these economies, and, at the same time, trade with APEC as a whole has grown rapidly.

Today's economic changes and challenges all point to the importance of larger and more integrated markets: larger markets provide necessary economies of scale; intra-regional investment provides the presence that is so often necessary for the delivery of modern services;

and, greater integration makes possible those instantaneous communications that are the heart and core of our most dynamic, creative industries.

And trade ties between East Asia and America are deep and growing fast. The statistics are telling:

- * The 14 Asian APEC economies accounted for almost two-thirds of America's merchandise trade last year -- this is larger than any other single regional grouping. And -- even more notable -- it was nearly 3 times larger than U.S. trade with Europe.

- * Taiwan is a key player in this ever expanding trade relationship. Taiwan is our 7th largest trading partner, with two-way trade amounting to \$49 billion. Taiwan is also our 6th largest export market.

With the recent financial market turmoil, some in East Asia may have been tempted to turn inward, to retreat from international markets. Instead, at the recent meeting in Vancouver, APEC Leaders agreed to embrace increased integration -- opening trade in nine new areas covering \$1.5 trillion in goods and services -- everything from chemicals to environmental technology to medical equipment.

It is critical for the East Asian economies to continue this progress: increased economic

integration is necessary for the continuation of growth and development in East Asia. .

CONCLUSION

It is people like you who will be the driving force for future integration in the APEC region. You -- the business men and women of America and East Asia -- are the source and the energy for the changes and developments in our economies. You are the source of the economic changes that are forcing governments to respond and change. And you can help ensure that the East Asian economies continue to look outward and move forward.

* * *

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Sandra F. Daigle (CN=Sandra F. Daigle/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 1-DEC-1997 13:08:21.00

SUBJECT: Speeches attached

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

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USA-ROC Economic Council Plenary Session

Remarks by Dr. Janet Yellen Chairman, Council of Economic Advisers

December 2, 1997

It is a pleasure to be here today. I want to thank

This afternoon I'd like to discuss the reasons for the economic successes of Taiwan and other countries of East Asia and the lessons we can draw from these successes as we face new challenges in our dynamic, changing economies.

By any measure, Taiwan and other East Asian economies have achieved extraordinary successes. Strong economic growth, strong growth of exports and ready adaptation of technological developments. This a record that is rightfully admired around the world.

So, the question is: how did it happen? Is there a secret behind this success? A magic ingredient that is the source of the East Asian "miracle?"

These questions are important in informing future debates about strategies for economic growth. And, they are important in informing policy discussions as we face the challenges. This afternoon, I'd like to address the following: What were the true sources of East Asian growth? What role did government and public policy play? And, finally what role should government play with the new and exciting changes and challenges in our industries and our economic environment? An environment, I might add, that you in this room are creating and fostering.

But, first, I think it is important to take stock of the changes in the U.S. economic relationship with Taiwan and other East Asian nations.

While trade was once largely a transatlantic phenomenon for the United States, today, successful American businesses turn to markets in the East in ever increasing numbers. The statistics are telling:

- * The 14 Asian APEC economies accounted for over one-third of our trade last year -- this is larger than any other single regional grouping. And -- even more notable -- it was 60 percent larger than U.S. trade with Europe.
- * Taiwan is a key player in this ever expanding trade relationship. Taiwan is our 7th largest trading partner, with two-way trade amounting to \$44 billion. Taiwan is also our 6th largest export market, the largest of any country outside the OECD.

The Clinton Administration has recognized and responded to this dramatic change in the international business environment. We welcome the growth in our economic ties with Taiwan and East Asia. And, we are committed to the APEC process for achieving free trade in the region by the year 2020.

With this increase in trade and the rapid growth of the East Asian economies, there has been a maturing of our trade relations with the region. Although some disputes remain, the United States welcomes the co-operation it has received from Taiwan on tariff reductions, protection of endangered species, and intellectual property protection.

The progress on intellectual property issues -- in Taiwan and elsewhere in the Pacific Rim -- has yielded enormous benefits for Taiwan -- in terms of increased innovative activity and increased access to cutting edge foreign technologies. And, that progress has come as a result of our strong and growing economic ties.

So, now let me turn to the important questions I want to address. First, how did the East Asian miracle happen?

The bottom line is: there are no simple and magic answers. No recipe that can be translated into easy success for other developing countries.

Instead, the East Asian "miracle" was a result of a combination of strong successes in certain basic areas. Let me list them:

First, a **stable business environment**. This included macroeconomic stability -- low inflation and realistic exchange rates -- but also stable and predictable rules of the game for business.

There were also **high rates of saving and investment**. And, there's no miracle here -- these economies grew because they invested heavily. And, governments contributed by running balanced budgets, or budget surpluses, and by raising the returns to private saving. But it was not only that governments had sound budgets--they made choices that about how to spend their limited money in ways which enhanced economic growth. They had a clear sense of priorities. For instance, they invested heavily in education, the returns to which have proved to be enormous. This is a lesson which some in Washington need to take to heart.

Indeed, not only was there a strong **emphasis on education**, particularly a high level of primary and secondary education, but there was a strong concern to make sure that there was widespread access to education, for females as well as males. The countries of East Asia showed that egalitarian policies could enhance growth. One didn't need to rely on trickle down economics.

And, finally, there was a basic **openness to technology**, and strong efforts to learn from, and adapt, foreign best practice.

A more controversial element of the East Asian "miracle" is the role of industrial policy -- the combination of intervention, promotion and direction that characterized many of the East Asian countries. There is among academic circles still some controversy about whether these policies made a difference -- whether they raised growth or changed the industrial structure. My study of the countries of East Asia convinced me that at least some of them did have significant positive effects.

But from some perspectives, the more interesting question, I think, is not whether industrial policy worked, but rather why it did not fail. Government intervention can -- and has been -- a major retarding factor in so many other countries. So, why not in East Asia?

The answer is: the most successful East Asian governments were able to craft economic policies and build relationships between business and government that employed market forces rather than blunted them. The most successful East Asian governments actively consulted the business community and assisted industry, but they also maintained domestic competition.

In a word, industries obtained the benefits of economic cooperation both among the firms within the industry and between industry and government without society having to pay the price of economic collusion and--at least up to a point--without the marked disadvantages that result from what economists refer to as capture, where government simply serves the interests of industry without keeping paramount the broader societal perspective of national interest

Success in competing on world markets through exports was strongly emphasized. And the benefits that government bestowed -- credit, foreign exchange, investment approvals -- were based on performance, on the outcomes of market-based contests among domestic firms.

Many of the East Asian governments demonstrated a ready ability to know when government should get in and where government should stay out. Achieving that delicate balance between doing what supports growth -- such as investing in infrastructure and R&D -- and not intervening too heavily is a very difficult task. And the most successful East Asian governments were able to find that appropriate middle ground, a middle ground which so many countries, both developed and less developed, have found difficult to find.

To be sure, East Asian governments have made some mistakes. In particular, where they have protected uncompetitive industries from competition; where they have excluded foreign investment; and, where they have failed to protect intellectual property. But, the most successful governments reversed course when they saw their policies were having the wrong effect.

As a result, the East Asian successes have shaped thinking about development policy.

These successes have had a strong and important influence on views about the appropriate relationship between business and government. (A relationship that is -- and will be in the future -- central to all of our economic debates.)

Making government work more effectively and less intrusively has been a top priority for the Clinton Administration. And, the proper role of government is now at the core of the debate between the major political parties in the United States.

But this is not just an issue for the American political debate. Economic changes and developments in the past few years will force all of us -- in the United States and across the world -- to re-examine what is the most effective role that government can play.

Let me give you one example: services industries -- finance, information and communications.

These dynamic industries are the industries of our economies' future growth and strength. Intellectual creativity is the primary input -- and this input knows no bounds.

Change in these industries is happening like rapid-fire. Competition is springing up in industries once viewed as monopolies. And, trade is taking place in industries once viewed as purely local. I believe that we in the United States are rising to the challenge. Evidence of efficiency increases, improvements in the quality of the services provided and decreases in the costs of providing those services abound. Some of the countries of East Asia, while they have led the way in improvements in efficiency in manufacturing, have lagged in these vital sectors, and as a result, improvements in standards of living--which is, after all, the ultimate objective of all of this economic activity--have lagged.

Governments -- in East Asia and elsewhere -- have tended to be more heavily involved in these industries than they have been in manufacturing. And there is now a pressing need to reassess government's proper role.

Achieving the proper balance in government policy is now more important than ever. The goal is to dismantle unnecessary government regulations and interventions while creating a framework of rules that allows the private sector to flourish and -- at the same time -- protect the public interest. This task--again a careful balancing act--has been one of the foundations of this Administration's economic policy. I can speak proudly of some of the reforms that we have already accomplished, such as in the banking sector, and I can speak warily of some of those upon which we are embarking, such as telecommunications, where the Administration has been working hard for a bill which promotes long run competition while it provides adequate safeguards during the transition period in which there remain significant imperfections of competition.

In the financial sector, the reassessment of government's role means liberalization of

existing rules the main effect of which is to impede competition while strengthening prudential supervision. I cannot overemphasize the importance of the delicate balance--the failure to achieve such a balance during the previous Administrations in the United States, with inadequate prudential supervision, was a major contributing factor to the S & L debacle, which not only cost taxpayers billions and billions of dollars, but led to massive misallocation of resources and, in my judgment, was a major contributing factor to the economic slowdown that we have had to work so hard during the last two years to recover. In communications it means allowing freer rein to market forces and new entrants, while at the same time addressing monopolies or access barriers where they still exist.

These issues are particularly important for Taiwan, given its ambition to become a regional center in finance, transportation, and communications. The reasons for formation of economic centers -- or "clusters" -- are interesting. Often centers are the product of historical accident. But sometimes they have developed because of official efforts--the careful balancing of which I spoke earlier, a balancing which includes, as a central ingredient, a willingness to tolerate new entrants and activities.

This requires both a cosmopolitan attitude and a willingness to take risks. Those who can -- and do -- move fastest to address the new competitive challenges are the ones who will be most likely to create and foster successful regional and international centers.

THE FUTURE

Finally, I'd like to conclude with a few remarks about the future.

Over the past few years, the economies of East Asia -- as well as the APEC region more broadly -- have become increasingly integrated. Intra-regional investment, subcontracting, and trade in finished goods occupy a growing share of the total trade for these economies, and, at the same time, trade with APEC as a whole has grown rapidly.

These interweavings are welcome. And, in fact, their continuation may be necessary for the continuation of the Asian miracle--or the beginning of the next Asian -- or Asian-Pacific -- miracle.

Today's economic changes and challenges all point to the importance of larger and more integrated markets: larger markets provide necessary economies of scale; intra-regional investment provides the presence that is so often necessary for the delivery of modern services; and, greater integration makes possible those instantaneous communications that are the heart and core of our most dynamic, creative industries.

But, further integration of the economies of the region will require a number of other things. I want to emphasize two:

First, **political and economic stability**. This is critical to fostering the confidence necessary for the large-scale private sector investments that are so necessary for future growth. This in turn requires that disputes among parties be settled amicably, something that is strongly supported by the United States. It also requires a recognition that some of the modus vivendi that have evolved over recent decades may provide the most constructive framework for the continuation of the political and economic stability which have served the region so well.

And, second, is **further steps in economic liberalization and deregulation**. These now often stand as barriers to domestic competition and innovation, as well as to trade.

President Clinton is strongly committed to active engagement in the Asia-Pacific. Four years ago at Blake Island he articulated his vision of a Pacific community based on shared prosperity and values. Three years ago, along with 17 other Asia-Pacific leaders, President Clinton committed to achieving free and open trade and investment in the region by 2020. Two years ago, President Clinton joined the other Pacific leaders in taking the first concrete steps to making that vision a reality. And, again this year, ...

But, U.S. interests go beyond economic and commercial. We are by our heritage and our character interested in individual rights and the spread of democracy. This would be true even if democratization and the expansion of individual and human rights had no bearing on economic and income growth.

But, in fact, the spread of democracy is both supported by economic development, and plays a strong role in fostering continued economic growth. This is increasingly true as our businesses and our economies demand greater and greater individual creativity.

It is people like you who will be the driving force for future integration in the APEC region. You -- the business men and women of America and East Asia -- are the source and the energy for the changes and developments in our economies. You are the source of the economic changes that are forcing governments to respond and change.

The fact that increased integration now seems desirable -- even inevitable -- is largely due to the explosive growth in private sector activity in the Asia-Pacific region. Support and encouragement from the private sector has been crucial in establishing APEC as a framework for advancing integration and co-operation in the Asia-Pacific region. We hope and encourage -- and, indeed, challenge -- you to continue your strong participation in the future.

* * *

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 1-DEC-1997 13:36:05.00

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Notes on the Global Outlook
Jeffrey A. Frankel, Member, Council of Economic Advisers

To be presented at the Institute of International Finance, Nov. 17, 1997
{and to be the basis for a section of Macro chapter of ERP}

Toward the end of this talk I am going to discuss some broad themes, evaluating a few capsule characterizations of the current outlook that one often hears, and adding one of my own: *overheating, deflation, market clearing, New Economy, and new anti-internationalism*. But I will begin by reviewing recent developments in the global macroeconomy.

During much of the last six years, the United States has been growing faster than its trading partners. At the start of 1997, we expected this pattern to reverse. On the one hand, it seemed unlikely that the rapid U.S. growth rate of 1996 would continue [3.3 on a Q4/Q4 basis]. On the other hand, it seemed likely that growth in Japan and Europe would pick up. And it appeared certain that developing Asia, the new "fourth growth pole" of the world economy, would continue to far exceed our own growth rate.

For example in the IMF WEO forecast of one year ago the U.S. was expected to slow to 2.4%, while Japan was expected to grow at about 2.7% and the developing countries of Asia were expect to continue chugging along at 7.6%. The PECC Ec.Outlook said 8% [May]. As recently as last month's October WEO, when the outlines of the ASEAN problems were known, 1998 growth among Asian developing countries was still forecast at 7.4 %¹.

What happened this year was something quite different than forecasted.

U.S.

- Contrary to the slowing that most [incl. us] expected in 1997, the growth rate in the first three quarters averaged 3.9 %. Employment continues to rise, with over 13 millions jobs created since January 1993.
- The President's plan to cut (by 2/3 > 1/2 during the first term) and then eliminate (by 2002) the budget deficit has proceeded well ahead of schedule, in part due to rapid growth.
- With growth in excess of potential, and unemployment below 5% since April [for the first time since before the 1973 oil shock], and below traditional estimates of the NAIRU as well, one would have expected inflationary pressures to emerge by now. They have not. Inflation remains low. While the most recent statistics suggest higher compensation growth in the 3rd quarter, they also suggest more rapid productivity growth. The implication is that workers are earning their raises, and unit labor costs are still not putting upward pressure on inflation.

The North Atlantic vs. the RoW

- Growth has also been strong in Canada, the British Isles, and the Nordic countries.

¹[and worldwide at 4.3 %, almost the same as for 1997]

- (In many of these countries, recent fiscal consolidation has helped keep interest rates down.)
- In the rest of the world, however, 1997 was a disappointingly weak year.

Europe

- Odds look good for EMU taking place as currently scheduled (participants to be chosen in Spring of 1998, and the euro in place by January 1999). In the early 1990s, as German spending in the re-acquired eastern lander pushed up real interest rates, differences in countries' needs regarding monetary policy led to the 1992-93 ERM crises. Currently, differences in monetary policy needs are not as sharp, as reflected in the convergence of interest rates.
- EMU will be the most important change in the world monetary system since 1973, and an inspiring enterprise -- economically, politically, and historically.
- US has far less stake in EMU than Europe does. But nevertheless, we are following its progress with interest. To the extent that we do have a stake in it, it is congruent with the interests of Europeans. That is, a healthy and growing European economy is in the economic and political interest of the United States
- Growth has been unspectacular on the European continent, particularly among the major countries, and unemployment remains very high (an undiminished 11% in the EU overall). Monetary and fiscal policy are largely constrained by the needs of Maastricht (though of course price stability and budgetary discipline are good for long-term growth, regardless of plans for EMU). Monetary and fiscal policy will probably be equally constrained, after Jan. 1999 as before, by a new credibility-seeking European Central Bank and the Stability and Growth path, respectively.
- Policymakers cannot afford to let EMU distract them from fundamental reforms to reduce rigidities in labor and product markets. National economies need to be able to adjust flexibly to future shocks. Otherwise the loss of countries' monetary independence entailed in EMU will cause problems in the future. Procrustean attempts to address unemployment by reducing the supply of labor rather than letting demand increase (through flexibly-adjusting markets) are not promising [e.g., French ideas on mandating a shorter workweek at unchanged pay].²

Japan

- Bursting of 1980s bubble (1990-95).
- Faltering of recovery in 1997. The US Administration was concerned that Japan's April 97 consumption tax increase (in an understandable desire to move toward long-term fiscal consolidation) might be too much too soon, and would choke off the nascent 1996 recovery. The Japanese government was confident that it would achieve 1.8% growth in 1997. In the event, U.S. concerns turn out to have been justified.
- When one looks around the world for possible threats to the global economy, there are perhaps more grounds for concern in Japan than anywhere else.

² "A recent flood of cross-country mergers and acquisitions shows that the private sector is responding, less by seeking to protect itself from competition, but rather so as to take advantage of European integration. Governments should build on the growing consensus for reform."

- Monetary policy can't push Japan's economy any further (liquidity trap), and the government seems determined not to cut taxes.
- Banking problems linger. Japan's slowness to acknowledge, deal with, and move beyond its bad loans problem has actually managed to make the U.S. record of the 1980s look good by comparison.
- Prime Minister Hashimoto's deregulation initiative is a hopeful sign (deregulation in construction, retail, telecom and transp., e.g., ports, and esp. Big Bang in financial markets). But deregulation is unlikely to provide a large boost to output in the short run.
- The weak Japanese economy, by comparison with the strong US economy, probably explains much of the depreciation of the yen against the dollar over the last two+ years. (Almost the same could be said of continental Europe.)

SE Asia

Origins of the crisis

We all believe that liberalized, open, and international integrated financial markets have many important advantages. Funds will be allocated more efficiently, developing countries can fund their investment at lower costs of capital than if they had to rely on domestic saving alone, investors in wealthy countries can earn higher returns on average than if they were limited to investments in their own countries, and everyone can benefit from diversifying risk and smoothing consumption across time.

It may be time, however, to reconsider the proposition that financial markets always get it right, that if an emerging market country adopts sound policies it can be secure in the knowledge that it is immune from speculative attack. What do we say to those countries who resist opening their financial markets by citing the danger of crisis brought on by successive and excessive waves of speculative inflow and speculative outflow?

- At one time, we said that the key was budget discipline. If the government is not running a deficit, then it is the private sector that is borrowing from abroad, and it can be relied on to use the funds for good purposes. This "Lawson fallacy" was discredited by Chile 1980, Britain 1992, and Mexico pre-1994.
- So we said that the problem in Mexico was other fundamentals, particularly a low private saving rate; consumption was too strong (in part a response to liberalization of consumer credit, retail and imports). [Another fundamental was that a relatively high share of the capital inflow took the form of short-term liabilities denominated (in foreign currency), and not enough in the form of direct investment.] When we looked around for other countries with high current account deficits, and saw that they were in SE Asia [Thailand and Malaysia], we were reassured that fundamentals such as the saving rate and the level of foreign exchange reserves looked much stronger. If the inflows were not going to finance government budget deficits or private consumption, then they must be going to finance investment. So everything must be alright.

Of course the crisis did not take everyone by surprise. Krugman's twin Foreign Affairs articles of three years ago, on the Myth of the East Asian Miracle, and Tulipmania, provided a good early warning. Many of us took note over the last few years of excesses in some Asian countries and flaws in their banking systems, and urged reforms. We also noticed in 1996 the sort of export slowdown (in the global electronics market) to which an overly indebted country is

particularly vulnerable. The IMF duly warned the countries most at risk. But I think it fair to say that most of us were surprised at the depth and breadth of the crisis this Fall.

- What are we to conclude now? One answer is that much of the money went to finance -- not just investment in plant and equipment and infrastructure --but real estate and construction. The former generate the future earnings of foreign exchange from exports necessary to service the debt. Condo construction does not.

But this answer is a bit incomplete. For one thing, investment in plant and equipment was high in some of the countries most affected [T&M]. For another, the crisis has of course spread widely, including to countries with stronger fundamentals [Indonesia, Taiwan and Hong Kong]. Contagion appears to be a genuine phenomenon. As in Latin America two years ago, the breadth and depth of the punishment visited by investors on the debtor countries seems to exceed the magnitude of the policy sins they have committed.

The conclusion I draw is certainly not that financial market liberalization is bad. Overall, the benefits outweigh the costs. But we must be prepared for occasional crises, not all of them fully understandable. If markets sometimes overreact, then countries need even sounder macroeconomic policies to compensate. As Merton said, modern financial markets are like superhighways: they get us where we want to go faster, but the accidents are bigger as well. Extra caution in driving, and airbags, are both appropriate. Public and private saving rates remain important. Strengthening of prudential regulation of banks and other financial institutions in these countries is key to reducing the risk of accidents. Increases in reserve requirements against banks' short-term foreign-currency liabilities may be in order in some cases.

The longer term:

An end to the East Asian miracle, or just a temporary setback? Krugman claimed that there never was an East Asian miracle. (The appropriateness of the word "miracle" lies in the eyes of the beholder. If Krugman had chosen to phrase his conclusion differently: "The miracle of East Asian growth is due to miraculous rates of investment in physical and human capital," most readers would have been less surprised by the article than they were. Yet this is really what the article said.) Nevertheless, he forecasted a marked slowdown in East Asia. An article by Jeff Sachs in the current Foreign Affairs takes the contrary view: that East Asia's current financial troubles are purely transitory, and growth at miracle rates will before long resume. A natural guess is that the truth lies in between.

Yet this is really what the article said.) Nevertheless, he forecasted a marked slowdown in East Asia. An article by Jeff Sachs in the current Foreign Affairs takes the contrary view: that East Asia's current financial troubles are purely transitory, and growth at miracle rates will before long resume. A natural guess is that the truth lies in between.

Japan's growth rate appears to have converged to that of the United States and other industrialized countries, not gradually, but in the course of two sharp kinks. The first occurred in 1973-74, with the world oil shock. The second followed the bursting of the 1987-89 bubble in Japanese financial markets. [Japan's per capita growth rate averaged a remarkable 8 percent during the period 1962-1973, but slowed to 3 percent during 1974-1990 (Table 1). Over the last seven years, it averaged a mere 1 ½ percent.] Presumably Japanese growth will recover from its recent recession, but whether it will go back to the miracle rates of earlier decades seems

dubious. The convergence is complete. Are other East Asian economies now going through a growth-path kink analogous to Japan's 1973 slowdown? There is no necessary connection between transitory shocks such as a sharp increase in the price of oil or a financial crisis and the long-run rate of growth of potential output. With the exception of Japan, Singapore, and Hong Kong, East Asian economies still have a very long way to go before attaining the per capita incomes of the industrialized countries. But for those observers who thought that the miracle rates of growth attained by many East Asian economies over the past several decades were unsustainable, the 1997 episode of instability in financial markets may be interpreted as a signpost indicating that a more moderate and sustainable rate of growth lies ahead.

Other emerging markets

The most encouraging development in the world economy over the last decade was the choice by many countries to adopt the open market-economy model. Faced with the stark examples of the East Asia economic miracle on the one hand, and the economic fiasco of the communist countries on the other, countries in Latin America, the rest of Asia, Eastern Europe, and even Africa, opted for the capitalist model. Recent financial market developments have spread to Latin America, and may have a negative effect on 1998 growth rates. But assuming that this experience doesn't undermine the fundamental "Washington consensus," -- which favors stable monetary and fiscal policies, privatized enterprises and market-determined prices -- the long-term prospects for the emerging economies and transition economies remain excellent.

Possible short-term spillover from the crisis

Economists are busy updating 1998 projections for growth rates.			Some that I have seen: including effects via Lat. Am.	
		Downward revision		
[Korea				
a government agency		0.2%-0.4%	-0.6%	&
-.15%]				
a Washington agency		0.6% [1 w/ mult.]		
W.Cline, Inst.Int.Fin.			-0.3%	
Lipsky, at Chase:		0.5%, to 1.0-1.5%		
Goldman Sachs	9/1	0.1%		
E.Hyman & N.Lazar		0.5	to 2.5%	
A.Sinai, Primark		0.5%	to 2.5%	
B.Steinberg, at M.Lynch		0.5%	to 2.5%	
Blue Chip			Yr./yr.2.5%	4Q/4Q 2.3%
("Corporate economists slower to react to fin.mkts. & overseas news than Wall St. forecasters? WSJ)				

U.S.

It is easy to see why there would be a wide range of numbers. Aside from the usual variation in models and assumptions, different forecasts refer to different dating, which makes all the difference. Forecasts from the early fall consider only the implications of retrenchment in

the ASEAN countries, which are a relatively small part of US trade (4% of U.S. exports, though the import side is also relevant, more than some analysts appear to realize: price-taking economies react to devaluations by increases in production of traded goods, and decreases in consumption, which can show up as an increase in their exports as easily a decline in their imports). Later numbers look at spillovers farther north in Asia [Korea alone is another 4% of US merchandise exports], and in Latin America and elsewhere. Also, evaluating a statement like “the impact may be a loss as large as 0.5 of GDP” depends on what baseline is being considered. Some who are talking about the biggest negative effects had high estimates to begin with.

Some of these estimates are just the effect on US net exports. The ultimate effect on the U.S. economy could be larger than this, with multiplier effects, or smaller, if one takes into account that the likely effect would be interest rates lower than they otherwise would be, thereby replacing demand lost in the trade sector with output in producers’ durable equipment, construction, and consumer durables.

The CEA makes official growth forecasts only twice a year as part of the government’s budget process. November is the time of year when we begin meeting with Treasury and OMB to prepare the forecast on which the February budget will be based. We have not completed this process. But I think it unlikely that the forecast will differ very greatly from what we called for last time: 2.0 percent in 1998. This was a nice conservative forecast when we made it last January (and when we renewed it at mid-session review). No “rosy scenario” in this Administration’s forecasts. Whatever the negative effects of the developments in emerging markets, we see little reason to believe that they will outweigh the unusual positive momentum that the US economy has shown in 1997.

Japan

The East Asian crisis will have a substantially greater impact on Japan than on the United States. This is true both by virtue of geography (and corresponding trade patterns), and because Japan’s banking sector and economy were already weak. There is an implication for the U.S.: just as Japan loses some of its net exports to East Asia, the U.S. will lose some of its net exports to Japan.

The US trade balance

Just as job-creation is less of a concern once we are close to the constraints of full employment, so the trade balance is less of a concern when we are up against the constraints of potential output. Nevertheless, I will talk a bit about recent external deficits.

The trade deficit on Goods & Services is still well below the 1987 peak of \$153 billion, especially as a share of GDP. But it has been rising since its 1991 low-point [of \$30 billion, and in 1996 reached \$114 billion]. The current account deficit likewise remains slightly below the 1987 peak of \$167 billion, especially as a share of GDP. But it too is well up from its 1991 low-point [of \$10 billion, reaching \$165 billion in 1996].

What have been the causes of these movements over the last ten years? The 1985-87 depreciation of the dollar was a major cause of the subsequent trade balance improvement. The

1990-91 recession was another clear source of "improvement," by depressing imports.

I think that the most important reason why the trade deficit and current account deficit have grown over the last year, or for that matter over the last six years, is that the US has grown more rapidly than our trading partners. Higher income brings higher imports. [See chart.] As I noted at the outset, our expectations that the relative growth rates would reverse have been contradicted by the developments of 1997. Thus the US trade deficit continues to increase.

As a share of GDP, the current account deficit is about the same as in 1989, the last time that unemployment was [almost] this low.³ As a matter of pure macroeconomics, I am not too worried about the "deterioration" of the last six years. That it represents rapid growth sucking in imports is a good thing. Better yet, both national saving and investment have increased steadily as shares of GDP. [See chart.] The explanation for the widening current account deficit evidently is that investment is increasing more rapidly than national saving. This too is a good thing. [National saving and investment rates generally rise during expansions, but in this case they have been increasing even on a cyclically adjusted basis.]

The recent situation is very different from the much larger current account deterioration that took place between the 1970s and 1980s. That was a fall in the national saving rate: the famous fiscal profligacy of the first Reagan Administration, and a continued fall in private saving in the 2nd Reagan and Bush Administrations. The declines in National Saving and Investment were grounds for concern.. Our low rates of National Saving and Investment are leading candidates to explain our low rate of productivity growth since 1973, and so the recent improvements are good news. So far in the 1990s we have made up a little of the earlier decline, but only a little. More needs to be done. [See table.]

Capsule diagnoses one hears

overheating? No signs of it yet.

deflation? Yes, in crisis countries, and the goods they sell: textiles, footwear, steel, chips, other electronics. But that's not worldwide or general deflation.

market clearing A natural question: how can it be that half the talk is the danger of overheating (excess demand) and half deflation (excess supply). Surely one concern or the other (or both) must be nonsense? One possible answer is that we are indeed on a knife-edge between excess supply and excess demand, and that is what being in market equilibrium is all about. If it feels different today, perhaps it is because the economist's model -- whereby prices adjust to clear the market every time supply or demand shifts -- is closer to being an accurate description of the world economy than ever before. The volatility, and the risk of excess supply or excess demand if you are too slow to react, feel uncomfortable. But this is the system that gives us the most income growth for the most people.

³ If even a small share of the statistical discrepancy is judged to belong in the current account, then it is currently better than 1989]

New Economy There have been important structural changes in the American economy, most of them good: deregulation, opening, flexible labor markets. But we haven't licked the business cycle.

A new anti-internationalism. The dangers are real. An increase in our trade deficit with Asia is worrisome in this political sense. In the U.S.: Congress turning inward on fast-track, NAB and UN dues. In the developing world: SEAsia backlash, Mercosur raised tariffs. But I remain hopeful.

REVISIONS NEEDED FOR ERP CHAPTER

TAKE OUT REFERENCES TO “I” AND “THIS TALK”

IN SE ASIA SECTION, NEED TO RECOUNT THE DEVELOPMENTS

BEGIN BY RECOUNTING THAT AFTER 1990, CAPITAL BEGAN TO FLOW INTO EMERGING MARKET COUNTRIES ON AN UNPRECEDENTED SCALE, IN RESPONSE TO LIBERALIZATION, OPENING, AND STRONG GROWTH PROSPECTS. 1994-95 STREW SOME TACKS IN THE ROAD FOR LATIN AMERICA, AND NOW 1996-97 IS DOING SO FOR EAST ASIA.

IN EUROPE SECTION, NEED TO ADD A FEW SENTENCES ABOUT EUROPEAN GROWTH PROSPECTS (INDEPENDENT OF EMU)

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 2-DEC-1997 18:25:39.00

SUBJECT: Tues. budget meeting

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

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

READ:UNKNOWN

CC: Rebecca M. Blank (CN=Rebecca M. Blank/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Janet,

I attended budget meeting[s] in your place in Erskine's office Tuesday [and Wednesday]. They are as you described them last time: political calculations and allusions that fly over one's head. It's hard for me to judge what's important, or what you don't already know.

In the Tuesday meeting, OMB proposed a "concept change" called "CapGo." Erskine eventually pronounced that this proposal seemed without much support.

Gene said we want to emphasize a few popular policies, like using tobacco money for NIH (one "surgical move" to create room under the caps in this one area) and freeing up money for health and kids, and let the Congress be the ones perceived as process-oriented, or keeping money from kids.

Everyone seemed to agree that the Congress was going to get more money for highways whatever we did, but that the President should nonetheless be seen to say "No, no" as the highway steamroller passes over him.

There seemed to be a division between those (Hilley...) who thought that the amount of stringency contained in OMB's passback to the agencies was fine, but who hadn't actually seen the details, vs. those (Bowles...) who had seen the details of what was being cut and thought that "people are going to go crazy, even in this room [let alone in the cabinet]."

Response from the agencies on the passbacks is due by Thursday, and I am sure you will hear a lot about it in the budget meeting that day.

I will leave you some papers, and my handwritten notes (which you may not be able to read).

JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Rebecca M. Blank (CN=Rebecca M. Blank/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 3-DEC-1997 15:22:00.00

SUBJECT: Social Security meeting

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Christopher D. Carroll (CN=Christopher D. Carroll/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

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

READ:UNKNOWN

CC: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Janet --

Chris Carroll and I attended Wednesday's social security meeting in Gene Sperling's office. Treasury presented a set of three options to allocate some amount of the surplus to individual accounts retirement accounts. The resulting discussion largely dismissed this approach, with Frank Raines speaking most forcefully. The primary points (which appeared to receive wide agreement among others present):

- * The message should be "Use the surplus to solve Social Security problems first." Exactly how this is done should be secondary.

- * Any attempt to establish additional payments using money from the surplus should be run through the Social Security system, not used to set up separate entities or programs.

- * Proposals that utilize the surplus to provide additional retirement benefits but which are not closely linked to a larger plan to fix Social Security are not going to be viewed as credible.

- * Preparing plans for individual accounts may be premature. The Administration is sitting uncomfortably between the Republicans who want to cut taxes and provide individual retirement accounts, and the Democrats who reject all types of privatization. The question is what the Administration can propose that will avoid the worse-case Republican proposals but respond to the (in the opinion of at least a few at the meeting) almost impossible-to-resist appeal of individual accounts. The proposals presented at the meeting today were far more progressive than the Republican proposals, and hence an improvement. But a number of those

present suggested that rather than presenting a detailed plan on this front, the Administration may want to propose larger restructuring, and negotiate over the individual accounts issue.

I thought it was a useful meeting, which clearly established consensus on some important issues (and also came down in the right place, as well.) There's evidently another meeting scheduled for tomorrow.

I'll leave the materials from today's meeting with Alice. Feel free to talk with myself or Chris about this further.

Becky

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 3-DEC-1997 13:41:00.00

SUBJECT:: GCC: questions from Treasury for Gruber's trip to Kyoto

TO: Randall W. Lutter (CN=Randall W. Lutter/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Adele C. Morris (CN=Adele C. Morris/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Last night, Ray Squitieri asked me to look into a couple of GCC issues for Gruber (since he will be going to Kyoto this weekend). Treasury had questions on 4 issues:

1) including sinks in accounting for T&T -- We don't have much on this, so I gave some qualitative answers (U.S. good, Australia bad, NZ good, EU roughly neutral) and suggested that Ray contact OSTP.

2) Japanese proposal -- Ray is getting a paper from EPA that evaluates the effects of this T&T (I think EPA had Battelle do some SGM runs of the Japanese proposal)

3) borrowing across budget periods -- Ray asked if borrowing from the next 5 year budget period (e.g., 2013-2017) helps us much, and I told him I didn't think so, especially if in the future budget periods we have an even tighter cap.

4) Effects of trading and JI constraints -- What would be the impact on permit prices if the U.S. was allowed to buy only X% of its emissions reductions abroad through international permit trading and JI? They wanted something based on model runs, so I took what we had from SGM and estimated the effects of 10% from abroad, 25% from abroad, and 50% from abroad constraints. The attached WP6.1 file is a short memo summarizing the results that I sent to Ray last night.

Ray and I are supposed to talk again later today to follow up on this memo and to deal with any other issues that may come up. Any input or suggestions from you are welcome.

Joe

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

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D56]MAIL48780563J.316 to ASCII,
The following is a HEX DUMP:

MEMORANDUM

TO: Ray Squitieri
FROM: Joe Aldy
DATE: December 2, 1997
RE: The Effects of Trading Constraints on Permit Prices and Income Flows

To assess the effects of trading constraints on U.S. permit prices and income flows, I reviewed several model runs from SGM. While unconstrained trading would result in minimizing the compliance costs with binding targets, some have proposed constraining the amount of emissions reductions allowed to be achieved through international permit trading and joint implementation.

The following table presents the permit prices and the quantity of permits purchased abroad under various percentage-based constraints.

U.S. Permit Prices for Meeting 1990 in 2010 under Various Trading Constraints

% of Reductions Allowed to be Purchased from Other Countries	Annex I Trading Only (permits purchased abroad)	Annex I Trading + Joint Implementation (permits purchased abroad)
100% (no constraint)	\$41/ton (202 MMTCE)	\$16/ton (312 MMTCE)
0% (no trading, no JI)	\$108/ton (0 MMTCE)	\$108/ton (0 MMTCE)
10%	\$93/ton (38 MMTCE)	\$93/ton (38 MMTCE)
25%	\$72/ton (95 MMTCE)	\$72/ton (95 MMTCE)
50%	\$45/ton (190 MMTCE)	\$45/ton (190 MMTCE)

model: SGM

Constraints on Trade

This analysis provides four interesting points. First, in an unconstrained world, the U.S. buys 53% of its emissions reductions abroad with Annex I trading and 82% of reductions with JI and Annex I trading. Note in the second table that the U.S. buys less as a share of reductions than other Annex I countries (however, EEFSU countries are sellers). Second, any split between JI and Annex I trading (e.g., no more than 5% through trading, no more than 5% through JI) is irrelevant to the U.S. permit price so long as the total constraint (e.g., 10%) is less than the percentage of emissions reductions the U.S. would buy under no constraints. Third, Russia sells more permits than China under JI (but less than it would with an Annex I trading only world) because it has so many paper tons. Fourth, any constraint less than 60% implies that EEFSU countries would not be able to sell all of their paper tons.

Percent of Emissions Reductions Purchased Abroad with No Constraints on Trading and JI

Country/Region	Annex I Trading Only	Annex I Trading + Joint Implementation
Canada	75%	88%
Japan	78%	91%
Western Europe	65%	86%
Australia	58%	81%
U.S.	53%	82%

model: SGM

Income Flows

Not only do constraints on trade negatively impact the buyers of permits by increasing permit prices, but they also decrease the flows of income to countries that sell. In a no-constraint world, the sellers of permits would receive \$20 billion in 2010 under Annex I trading and more than \$10 billion in 2010 under Annex I trading and JI. However, a constraint of 10% emissions reduction through foreign purchases would result in income transfers of only \$600 million under Annex I trading and \$200 million under Annex I trading plus JI. This 10% constraint results in EIT and developing countries receiving only 2-3% of the income they would have received without the constraint.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 3-DEC-1997 17:21:40.00

SUBJECT: USA_Taiwan speech draft

TO: Alice H. Williams (CN=Alice H. Williams/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.D74]MAIL48164663A.316 to ASCII,
The following is a HEX DUMP:

USA-ROC Economic Council Plenary Session

**Remarks by Dr. Janet Yellen
Chairman, Council of Economic Advisers**

December 2, 1997

INTRODUCTION

It is truly a pleasure to be here with you in San Diego representing the people of the United States. It is an honor to share the podium with my fellow Keynote Speakers--Richard Rosenberg, former Chairman and CEO of Bank of America; P.K. Chiang, Chairman of the Council for Economic Planning and Development and a former Agricultural economist; and Minister Chih-Kang Wang, a former Business School professor like myself. I also want to thank our two Chairmen, Jeffrey Koo and Bill Clark. They personify the dynamism which has been the hallmark of these Councils and of the relationship between the United States and Taiwan.

In preparing for my presentation today, I looked back at addresses given by some of my predecessors at the US-ROC Business Council. One common theme was that all them paid homage to the "East Asian Economic Miracle," and offered analyses of what produced it. Over the last several months, however, as the shadow of financial problems has spread over the Asian region, a new cottage industry of commentators and critics has developed based solely on reinterpretations of the economic model which has been the basis of the remarkable growth in East and Southeast Asia. While some seem sure that the recent financial problems in the Region mean that the Asian Model has been eclipsed, I am not prepared to join that Guild. In my view,

the achievements of the last 20 years have not been obliterated by the turmoil in Asian financial markets and the devaluations of the last several months.

Today is neither a time to pay homage nor a time for eulogies. Rather it's a time for a sober-minded review of the policies that the East Asian economies have pursued that have laid the foundation for recovery and future growth, and it is a time to stress the continued importance of openness and economic integration.

I do not need to remind this group why this all matters to Taiwan. The linkages among the economies of the region are extensive. Taiwan is a major investor in Southeast Asia, in China, in the Hong Kong Special Administrative Region. Changes in the value of Taiwan's currency immediately preceded a sharp downturn in Hong Kong's stock market. Problems that began in Thailand have spread out of Southeast Asia into Northeast Asia. While each economy in the region has its own unique characteristics -- and certainly Taiwan does -- the interrelationships of the region's economies require each to pay attention to the successes, and the failures, of its neighbors.

So, this afternoon I will briefly discuss the fundamental economic conditions that I believe have been -- and will continue to be -- the foundations for growth in East Asia, and then turn briefly to some of the corrective policies that will be necessary to put Asian economies back on track to solid growth.

THE FOUNDATIONS OF EAST ASIA'S GROWTH "MIRACLE"

As you know the East Asian economies have faced serious challenges in recent months. We have seen financial market problems arise -- first in Thailand, then Indonesia -- that could have a potentially important impact on other emerging markets in Asia and around the world.

During these months of turmoil, it has been clear that each of the East Asian countries has faced its own unique set of circumstances. But, it is also clear that there are common strengths which have fueled rapid growth in the past and which will provide the foundations for solid growth once financial stability has been restored.

These common strengths include:

First, a **stable business environment**. This included low inflation and sound fiscal policy in many cases, but also stable and predictable rules of the game for business.

Second, **high rates of saving and investment**. There's no miracle here: many economies grew rapidly in large part because they invested heavily. And, governments contributed by running sustainable budgets and by raising the returns to private saving. But it was not only that successful governments had sound budgets--they made choices about how to spend their limited money in ways which enhanced economic growth. They had a clear sense of priorities.

For instance, and this is really the **third** ingredient, the most successful governments placed a high priority on investing in **education**. There was a particular emphasis on primary and secondary education, but there was also a strong concern to make sure that there was widespread access to education, for women as well as men. This experience showed that egalitarian policies could enhance growth. One didn't need to rely on trickle down economics.

Fourth, the most successful economies were characterized by a basic **openness to technology**, and strong efforts to learn from, and adapt, foreign best practice.

And, **finally**, policy makers in the most successful East Asian economies demonstrated an ability to know when government should get in and where government should stay out. Achieving that delicate balance between doing what supports growth -- such as investing in infrastructure and R&D and providing appropriate banking system supervision -- and not intervening too heavily is a very difficult task. The most successful East Asian governments were able to find that appropriate middle ground, a middle ground which so many countries, both developed and less developed, have found difficult to locate.

To be sure, East Asian governments have made some mistakes. In particular, where they have protected uncompetitive industries from competition; where they have excluded foreign investment or foreign competition; and, where they have failed to protect

intellectual property. But on balance the five strengths that I just described have laid a foundation upon which these nations can build and return to solid growth and healthy development when stability has been restored to their nation's financial markets. To achieve this return to growth, however, it is critical for the East Asian economies to first work to address the vulnerabilities which have helped fuel and prolong the financial crises.

RESTORING SOUND FINANCIAL CONDITIONS

Just last week in Vancouver, leaders from the 18 economies of the Asia-Pacific Economic Cooperation forum -- or APEC -- embraced a common approach to restoring financial market stability. They agreed to strengthen the three lines of defense that protect a country from the type of financial market instability that we have seen in recent months.

An economy's first line of defense is sound domestic policies; sound policy regimes are a necessary precondition to restore confidence and calm financial markets. That includes the basics: a sustainable exchange rate regime, sound fiscal policy, and sensible and consistent monetary policy. But it also includes adequate supervision of banks and other financial institutions and timely, accurate reporting of government economic statistics to gain the trust of investor both at home and abroad. For that reason, APEC leaders recommended that technical assistance on banking and financial regulation should be expanded and strengthened.

The second line of defense is provided by the international financial institutions. President Clinton's economic team has been working closely with our partners in the region and

with international financial institutions such as the IMF and the World Bank to help re-establish financial stability in Southeast Asia. Building on the "Manila Framework" developed by Deputy Finance Ministers, APEC leaders agreed that the IMF must continue to be the centerpiece of any international response to financial crises. For that reason, they recommended strengthening the capacity of the IMF to respond rapidly and effectively to financial crises, for instance by establishing a new short-term financing facility.

But the regional reverberations of the financial turmoil in Asia have also pointed to the importance of a third line of defense: regional cooperation. Recognizing that neighbors have a disproportionate interest in each others' financial soundness, APEC leaders agreed to establish a regional surveillance forum to provide a mechanism for expressing concerns frankly and openly. They also agreed to a rapid-response mechanism for identifying additional resources to supplement IMF programs on a case-by-case basis as needed.

Together, these three lines of defense -- if implemented rapidly and steadfastly -- should help to restore confidence and stability to the region's financial markets, creating conditions for the restoration of growth.

Finally, there is one last ingredient that has been a central part of the region's past recipe for success that I believe will continue to figure prominently.

IMPORTANCE OF CONTINUED INTEGRATION

Perhaps more than any other region in the world, East Asia has benefitted from close trade ties with other economies in the region and in the world. Over the past few years, the economies of East Asia -- as well as the APEC region more broadly -- have become increasingly integrated. Intra-regional investment, subcontracting, and trade in finished goods occupy a growing share of the total trade for these economies, and, at the same time, trade with APEC as a whole has grown rapidly.

Today's economic changes and challenges all point to the importance of larger and more integrated markets: larger markets provide necessary economies of scale; intra-regional investment provides the presence that is so often necessary for the delivery of modern services; and, greater integration makes possible those instantaneous communications that are the heart and core of our most dynamic, creative industries.

And trade ties between East Asia and America are deep and growing fast. The statistics are telling:

- * The 14 Asian APEC economies accounted for almost two-thirds of America's merchandise trade last year -- this is larger than any other single regional grouping. And -- even more notable -- it was nearly 3 times larger than U.S. trade with Europe.

* Taiwan is a key player in this ever expanding trade relationship.

Taiwan is our 7th largest trading partner, with two-way trade amounting to \$49 billion. Taiwan is also our 6th largest export market.

With the recent financial market turmoil, some in East Asia may have been tempted to turn inward, to retreat from international markets. Instead, at the recent meeting in Vancouver, APEC Leaders agreed to embrace increased integration -- opening trade in nine new areas covering \$1.5 trillion in goods and services -- everything from chemicals to environmental technology to medical equipment.

It is critical for the East Asian economies to continue this progress: increased economic integration is necessary for the continuation of growth and development in East Asia. .

CONCLUSION

It is the people in this room and others like you who will be the driving force for future integration in the APEC region. You -- the business men and women of America and East Asia -- are the source and the energy for the changes and developments in our economies. You are the source of the economic changes that are forcing governments to respond and change. And you can help ensure that the East Asian economies continue to look outward and move forward.

We hope and encourage--and indeed, challenge--the members of the US-ROC and

ROC-USA Business Councils to continue your strong participation that has contributed so much to the economic vitality of the Region. For 21 years you have understood the importance of the economic and commercial relationship between the United States and Taiwan. Together business men and women from Taiwan and the U.S. have forged an important link between our two peoples. The Joint Councils have been the anvil where that link has been cast. I salute you for your accomplishments and look forward to your continued leadership and success.

* * *