RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-JAN-1998 12:34:36.00

SUBJECT: Re: (1) Ch.7 & (2) cables

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

TEXT:
---------------------- Forwarded by Jeffrey A. Frankel/CEA/EOP on 01/02/98
12:32 PM ---------------------------

Mark R. Hopkins
01/02/98 12:22:00 PM
Record Type: Record

To: Jeffrey A. Frankel
cc: jon @ HAVEMAN.ORG@LNGTWY@LNGTWY
Subject: Re: 1) Ch.7 & 2) cables

Message Creation Date was at 2-JAN-1998 12:22:00

Jeff,

1) I have a copy of the most recent
(prior to giving control to the editor) version of Chapter 7. I am
attaching
the file to this email.

2) I receive the cables now that I have my temporary clearance. I use
them for
information and fact-checking sources for the WEB roundups, and I will be
happy
to give you copies of any on topics you are interested in. My one
caveat: I
receive several hundred a day, so they have a tendency to pile up quickly
and
not get read whenever the WEB is not priority. I have not read any since
the
last WEB. As you can imagine, January is not likely to be a good month
for
keeping abreast of the cables. When we get a new intern, I hope to
separate
the unclassified ones (about 80% of them) and having him/her help me
process
them. This will make receiving timely updates of SEAsian events much more
of a
possibility.

Mark

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

TEXT:
The following attachments were included with this message:

TYPE : FILE
NAME : GALLEY3.WPD

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

=================== ATTACHMENT 2 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D20]MAIL464754105.026 to ASCII,
The following is a HEX DUMP:

CHAPTER 7

THE BENEFITS OF MARKET OPENING

INTRODUCTION

THE UNITED STATES HAS LONG recognized that open domestic markets, and an open global trading system, are more conducive to broad-based growth and prosperity than are isolationist policies. For decades, our economy's openness and our nation's successful leadership on global trade and investment liberalization have generated important growth and employment benefits for the American people. The opportunity to acquire goods and services from abroad allows us both to stay competitive and to raise our living standards. An open U.S. economy combined with U.S.-led liberalization in world markets, has been essential to U.S. growth in the 1990s, including substantial improvements in employment, productivity and income.

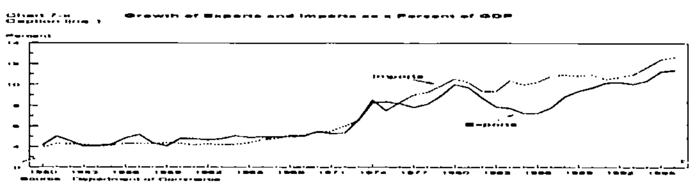
The United States enacted the Reciprocal Trade Agreements Act (RTAA) in 1934. The RTAA ultimately launched an extraordinarily successful campaign to open markets worldwide. In the years since, trading countries have grown and developed at impressive rates. While significant growth might have occurred regardless, it is increasingly clear that strong growth is more likely in economies open to international trade. Bearing this in mind, the Clinton Administration's overall strategy for economic growth includes a campaign to foster the liberalization of international markets worldwide. Although much has been accomplished in the post war period, much remains to be done. Following a discussion of recent trends in U.S. international trade patterns, this chapter spells out the primary elements of the U.S. market opening campaign. Building on the various market opening initiatives, it proceeds with a discussion of the benefits resulting from trade liberalization. This discussion is intended to underscore the need for a stronger commitment to trade liberalization not only by the United States, but by all of our trading partners.

We then turn to the concern that international trade can have a disparate impact on certain sectors of the economy. Particular attention is paid to impact on workers. The chapter finishes with a presentation of recent developments in foreign direct investment and a discussion of the implications for workers stemming from U.S. direct investment abroad and foreign investment in the United States.

TRENDS IN U.S. INTERNATIONAL TRADE

THE GROWING IMPORTANCE OF TRADE

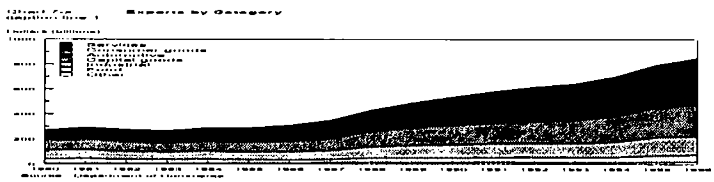
The current role of international trade in the U.S. economy is unprecedented. Until 1970, U.S. exports and imports, combined, amounted to less than 10 percent of GDP (see Chart 7-1). Since 1970, trade has grown by an average rate of [9?] percent per year, nearly double the growth of output, so that by 1996, exports alone were 12 percent of GDP, and imports were 13 percent.



Nevertheless, trade remains a much smaller component of the U.S. economy than in most countries. In 1995, only four countries in the world had a smaller ratio of trade to GDP than the United States. This does not reflect U.S. trade barriers, which are among the lowest in the world, but rather determinants of trade volumes such as the size of our economy, the diversity of our endowments, and geography. Accounting for such factors, one finds that the United States is more open to other countries' exports than are most countries. However, the point remains that as a result of a large internal market and geographical location, the U.S. economy feels the effects of trade and the pressure for "globalization" much less than most countries.

Government policy and technology have combined to facilitate the rapid expansion of global trade. Although the trend towards internationalizing markets is due in part to innovation in transportation and communication technology, there is strong evidence that removing trade barriers and other protectionist policies has had a significant role in the globalization of industry. For instance, between 1920 and 1930, average U.S. tariff rates roughly doubled, and the volume of trade fell from 9 percent to 5 percent of GDP. Technological progress in transportation continued during this period, suggesting that government policies were largely responsible for the decline in trade.

The rapid expansion of U.S. trade that began in 1972 corresponds with the implementation of the Kennedy Round agreement of the GATT, which cut tariffs by 35 percent and, more significantly, increased the number of countries participating in multilateral negotiations from 26 to 62. The two subsequent GATT rounds and bilateral and regional trade agreements have continued to reduce tariffs substantially.



THE SECTORAL COMPOSITION OF TRADE

The composition of U.S. exports and imports have changed significantly over the past decade and a half. Exports of services have enjoyed particularly strong growth, rising from 18 percent of total exports in 1980 to 28 percent in 1996 (see Chart 7-2). Exports of food and other agricultural merchandise has fallen from 16 percent of exports to 8 percent in the same time. In part, these trends reflect the effects of Engel's Law (as world incomes rise, the share devoted to food falls), and the evolution of U.S. comparative advantage to the provision of more skill intensive goods and services.

Nevertheless, the impact of market opening may be evident in these trends as well. Innovations in the global communications infrastructure, the new General Agreement on Trade in Services (GATS) of the Uruguay Round, and the liberalization of financial markets in many countries have also facilitated trade in services. Large tariff reductions in industrial sectors negotiated under the GATT have lowered export costs in those sectors. However, agricultural tariffs and trade barriers continue to be relatively high in most countries.

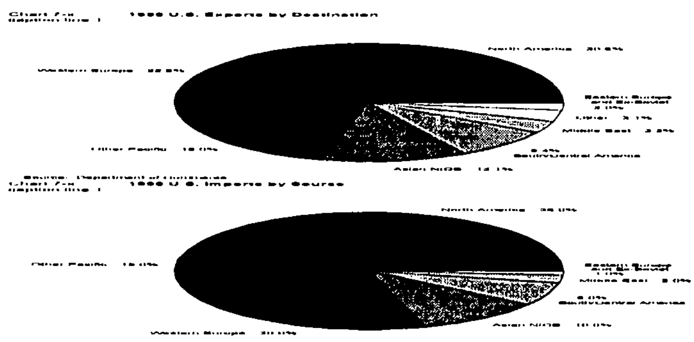
The fastest growth in goods trade has occurred in manufacturing industries. Consumer goods and capital goods have enjoyed high sustained growth in exports since the 1980s. These goods also represent the fastest growing imports. However, growth in exports of these goods tended to occur more evenly across industries relative to imports, which experienced more dramatic increases in specific categories such as computer goods and semiconductors. Industrial goods have also experienced strong growth, even though they have fallen as a share of total exports. Industrial supplies have dropped more significantly as a share of imported goods, as have petroleum products.

The fact that growth is occuring in both imports and exports of consumer and capital goods may seem antithetic to the logic of specialization by comparative advantage. However this reflects the changing nature of trade. In general, imports and exports often grow in tandem even at very disaggregated levels of industry classification, reflecting the increasing share of trade that is *intra*-industry rather than *inter*-industry. Intra-industry trade (e.g., trading Japanese cars for U.S. cars) is thought to arise principally from economies of scale in production and consumer tastes for variety, while inter-industry trade (e.g., trading Japanese silk for U.S. wheat) is more closely associated with traditional notions of comparative advantage. In 1996, 57% of U.S. trade occurred within, rather than between, industries measured at the 4-digit SITC commodity grouping. Over the 1990s, this share has risen at an average rate of over 1 percent per year.

U.S. TRADING PARTNERS

Canada and Japan continue to be the major trading partners of the United States, together accounting for one-third of our exports and imports. In recent years Mexico and China have risen quickly to become our next largest partners, representing about 13 percent of total merchandise trade. The European Union as a whole represents 20 percent of our export market, and supplies 18 percent of our imports. The Asia-Pacific region has experienced an explosion in the growth of both trade and output over the past two decades. U.S. trade with Pacific Rim countries has grown quickly, and now accounts for one-third of total U.S. trade. Trade with Latin and South American countries has grown by [ ] percent per year, and now represents [10] percent of U.S. trade.

Recognizing the export opportunites for U.S. firms in these developing markets, the administration has supported negotiations in two regional initiatives. The countries in the Asia Pacific Economic Cooperation (APEC) forum, the largest regional trade area in the world, currently account for over 65 percent of both U.S. exports and imports. Countries in the proposed Free Trade Area of the Americas (FTAA) account for 39 percent of U.S. exports and 35 percent of imports.

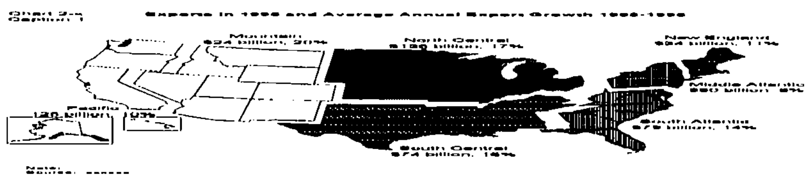


U.S. TRADE BY REGION

In a country as large as the United States, U.S. trade has important economic implications with regard to internal geography. The North Central and Pacific regions of the U.S. remain the largest sources of exports, and both regions continue to enjoy strong export growth (Chart 7-5). However, the highest rates of export growth have been in some of the regions and states in the center of the country. This suggests that the benefits of trade are being realized throughout the country, not only in the coastal and border states. The impact of NAFTA on the regional trends in production and export has no doubt been significant, and may be partly responsible for the high growth in exports from the Mountain and North and

South Central regions.

However, the change is not attributable simply to a shift of exports from eastern and western borders to those of the north and south. Since 1993, the largest share of exports to Mexico has continued to come from Texas and California (over 40 percent of total), but the 20 fastest growing exporters to Mexico during the 1993-1996 period consisted mostly of North Central and Southern Atlantic states. Similarly, exports from Michigan, the largest exporter to Canada, grew by 92 percent from 1993-1996, but Hawaii and Nevada enjoyed some of the highest rates of export growth to Canada over the period. Much of the attention to NAFTA has focused on activities in the border regions. However, it seems that the export opportunities presented by market-opening agreements benefit the nation as a whole.



INITIATIVES IN MARKET OPENING

There is no single recipe for opening foreign markets to U.S. exports. Accordingly, the Administration has pursued an active trade liberalization agenda on several fronts. Although we recognize the importance of a coordinated effort to reduce barriers to trade on a widespread multilateral and reciprocal basis, we are also supplementing the multilateral negotiations with significant regional liberalization efforts. These regional agreements can help reinforce the larger multilateral efforts at liberalization (see box). In addition, market access impediments may be peculiar to a single country and are not of the type traditionally dealt with in a multilateral forum. In such cases, there is a need to pursue bilateral negotiations with the particular country in question. An outline of recent initiatives in each arena follows a brief history of executive branch negotiating authority.

TRADE NEGOTIATING AUTHORITY

The Constitution of the United States places the ultimate authority to regulate international trade with the legislative branch of the government. However, for the better part of this century, Congress has given greater freedom to the executive branch to negotiate trade agreements. In particular, on five occasions between 1974 and 1993, Congress gave the President so-called "fast track" negotiating authority, which allows, under specific circumstances, that Congress will vote on negotiated trade liberalizations without amendment.

This traditional trading authority allows the President to negotiate sensitive and complex trade agreements with other countries, and then requires Congress to take an up or down vote on the *entire* agreement. In other words, in exchange for being involved in the development and implementation of the agreement, Congress agrees not to reopen negotiations by adding or deleting individual provisions during Congressional debate of the agreement. In this way, Congress retains its constitutionally mandated final authority to regulate international trade. Under fast track, the parties to a trade agreement know that the overall package of agreed provisions cannot later be reopened for renegotiation of individual provisions, which in essence would reopen the entire package. Fast track is important because it lends credibility to our trade negotiations.

Fast track authority is crucial to the success of market-opening discussions with representatives of other nations. Agreements such as the NAFTA and the Uruguay Round agreement of the GATT would not have been possible without this authority.

History

The history of Executive Branch trading authority has its roots in the 1930s, a time when international trade flows were heavily restricted by high tariffs throughout much of the world. At that time, President Roosevelt made a compelling plea to Congress to grant him the power to negotiate tariff reductions. Congress subsequently granted him permission, in the form of the Reciprocal Trade Agreements Act (RTAA) of 1934, to reduce U.S. tariffs on a bilateral basis by up to 50% in exchange for reductions in barriers faced by U.S. exports. The RTAA was often used and repeatedly renewed, leading to agreements that subsequently generated large reductions in tariff barriers. After World War II, the RTAA and accompanying agreements formed the basis for the General Agreement on Tariffs and Trade (GATT), and are an integral part of the newly established World Trade Organization (WTO).

Tariffs among RTAA partners and GATT member countries have been reduced from an average of more than 60 percent in the 1930s to about 6.3 percent by the late 1980s. By the 1960s, negotiations had expanded to cover non-tariff barriers (NTBs) as well as tariff barriers. Such NTBs include price, quantity, and quality control measures. Authority to reduce these barriers was not covered by the RTAA, leading to complications in Congressional ratification of the Kennedy Round GATT agreement in the early 1970s. The failure of Congress to implement the entire agreement undermined the credibility of Presidential negotiating efforts. As a consequence, the Europeans refused to negotiate further trade agreements under these conditions with the United States.

For this reason, in 1974, Congress developed and passed legislation providing the President with fast track implementing authority. The primary difference between traditional negotiating authority under the RTAA and this new authority was that it gave the President the requisite credibility to negotiate international trade agreements covering non-tariff barriers in addition to tariff barriers. This new legislation retains for Congress the authority to reject the adoption and implementation of such agreements in their entirety without change. This ensures that the agreement negotiated is not subject to changes as it it considered domestically for approval The legislation has generally called for extensive consultations between the President and both houses of Congress and private-sector advisor communities during the negotiations. Congress must also be notified in advance of the intention to conclude an agreement. In return, Congress provides a commitment to introduce the implementing bill in both Congressional bodies with language unchanged and to vote on the unamended bill within 60 days. Given these stipulations, Congress has historically exerted influence over the negotiations and hence the agreements prior to the submission of the implementing legislation. Fast track has therefore proven successful at facilitating negotiations while not removing Congress from the process.

Since the inception of fast track, a pair of extremely successful rounds of GATT negotiations have taken place: the Tokyo Round which was signed in December of 1979 and the Uruguay Round which was signed in April of 1994. Negotiations outside of the GATT have also been undertaken and passed by Congress under fast track procedures. In 1985, the United States entered into a free trade agreement with Israel, followed in 1989 with the implementation of the Canada-U.S. Free Trade Agreement and in 1994 with the implementation of the North American Free Trade Agreement.

MULTILATERAL INITIATIVES

By the conclusion of the Uruguay Round negotiations, governments recognized that pursuing multilateral liberalization exclusively in the context of negotiating "rounds" was insufficient. Thus, the final Uruguay Round Agreements included a "built-in" agenda. This agenda provides a mandate and opportunity to continue the liberalization process within the regular work program of the WTO. In some cases, the WTO's built-in agenda calls for the review and updating of the rules of the multilateral system; in other areas, it is the further opening of markets and reduction of trade-distorting or -restrictive practices which is the objective. Over the past few years, liberalization negotiations have already occurred -- or are occurring -- in other sectors, either as a result of commitments set forth in existing WTO agreements or as a result of forward-looking initiatives given impetus by the United States and its trading partners within APEC, the WTO, and other international organizations. In what follows, we present recent and future multilateral initiatives including single-sector efforts and completion of the built-in agenda.

The New Success of Single-Sector Initiatives

The success of multilateral negotiations in the two years since the Uruguay Round has in some ways been remarkable. The negotiations have been narrowly focused, concentrating on individual sectors for liberalization. In the past it had generally been thought that only agreements covering many sectors simultaneously could gain enough political support to be viable. For example, if two countries seek trade liberalization, the easiest approach is to find one sector that is heavily protected in one country and another sector that is heavily protected in the other. By agreeing to liberalize both sectors simultaneously, each country can please at least one group of constituent producers.

Recent agreements in the services and information technology sectors represent significant departures from this traditional negotiating format. In each of these sectors, the United States is generally thought to be highly competitive. So, one would have thought that concessions in some other sector might have been necessary. But a common element in each of these sectors is that they are key inputs into production in other sectors, and are necessary for economic development and to profitable participation in the advanced, information-driven global economy. Industrialists in Asian and other emerging-market countries, for example, understand that a modern telecommunications infrastructure is essential to economic development. Hence, domestic support for liberalization is present in most countries and tradeoffs are not necessarily required. As transportation services are also important determinants of success in the modern economy, it is hoped that ongoing negotiations in this area will also experience success. Examples of recent single-sector negotiations include financial services, telecommunications, and information technology. Other single sectors slated for negotiation under the built-in agenda are agriculture and government procurement.

Services

An important contribution of the Uruguay Round was the General Agreement on Trade in Services (GATS). The new agreement provides a solid framework of trading rules and obligations for including services in multilateral negotiations for the first time; most services were omitted from the original GATT. However, the agreement contains pledges from WTO member countries that are fairly narrow in scope. Of some 150 service sectors, most countries have committed to the liberalization of less than 100 sectors. While these may sound like significant concessions, members in most cases have scheduled sectors with either little domestic production or little domestic protection. This is typical of trade negotiations more generally; countries liberalize first in areas where the domestic impact is smallest. Therefore, the agreement, in this case, falls short of more comprehensive liberalization by leaving the most heavily protected sectors untouched.

It was acknowledged in 1994 that commitments under the GATS were unsatisfactory. The agreement therefore includes specific deadlines for future negotiations in key areas: financial services, telecommunications, and maritime services. Some success has been achieved in financial services and telecommunications, while the maritime negotiations have been suspended until more comprehensive service negotiations take place in the year 2000.

Financial Services. Multilateral negotiations on a broad range of financial services were resumed in April of 1997. (An earlier attempt ended in 1995 with an interim solution, as the United States found some other countries' offers as inadequate to complete the negotiations.) In continuing these negotiations, the United States emphasized the need for agreement on four principles: assurances to foreign firms of the rights in markets they have already acquired, a guarantee of the right of establishment, the right of full majority ownership, and the provision of substantially full national treatment. These talks were successfully concluded on December 12 and produced agreement among 71 WTO member countries for broad liberalization of the banking, securities, insurance and financial data services sectors. The commitments apply to about $18 trillion in global securities assets, $38 trillion in global bank lending and about $2.5 trillion in worldwide insurance premiums.

Telecommunications. On February 15, 1997, the United States and 69 other WTO members successfully concluded global negotiations on basic telecommunications services, such as telephone service. The agreement includes a commitment to provide market access and national treatment to service suppliers from WTO members in the provision of all types of basic telecommunications services. Under the agreement, 55 countries have also committed to a specific set of pro-competitive regulatory principles. In all, it eliminates restrictive practices in countries that account for 95% of the world's telecommunications revenues, which are estimated to have been on the order of $600 billion in 1996. Prior to the agreement, only 17% of telecommunications revenues in the top 20 markets were open to U.S. companies. While many economies have telecommunications markets that are served by inefficient government monopolies, these markets in the United States have been largely deregulated. This deregulation, along with a large internal market, has resulted in a position of advantage and technological leadership in this area for U.S. suppliers.

Information Technology

Information technology products are often "enablers" for the efficient production of goods in other sectors. Liberalization of this sector therefore takes on added importance as a source of growth worldwide. Signed in Singapore in December 1996, the Information Technology Agreement (ITA) will bring about the general tariff liberalization of this $1 trillion dollar market. The agreement covers six main categories of products: computers and parts, electronic components, semiconductor manufacturing equipment, software, scientific instruments, and telecommunications equipment with the participation of countries accounting for over 90% of trade in this sector. The agreement also covers office machines and unrecorded electronic media. Each of the 43 participating countries has agreed to eliminate tariffs on some 400 tariff lines by the year 2000, with some countries taking on extended phase-out of tariffs for a limited number of products. While benefitting all parties, this agreement is especially important for the United States as a major exporter of information technology products.

As provided for in the original ITA, negotiations have begun that will extend country and product coverage and eliminate non-tariff barriers to trade under an expanded ITA, dubbed ITA-II. These negotiations are to conclude by the summer of 1998.

Agriculture

Although some specified agricultural tariffs were reduced in the various GATT negotiations, comprehensive agricultural trade barriers, much like those in services, only recently became a central subject of GATT negotiations, i.e., in the Uruguay Round Agreement on Agriculture (Agriculture Agreement). The Agriculture Agreement is thus historic, in being the first comprehensive attempt to address barriers to trade in agriculture. Significant achievements resulted from this initial downpayment on agricultural liberalization. Among other commitments, the Agriculture Agreement specifies cuts in agricultural export subsidies, reduces aggregate support to farmers, converts non-tariff barriers to tariffs, binds and cuts new and previously existing tariffs, as well as providing for minimum access quotas for products whose trade was largely eliminated by past protection. Reflecting a general interest in further liberalization, agricultural negotiations are a part of the built-in agenda, with negotiations scheduled to resume in 1999. Some countries are, however, expected to remain an obstacle in pushing for further liberalization, particularly, Japan, Korea, and the European Union.

Government Procurement and Contracting

Government procurement and contracting, accounting for up to 15 percent of economic activity in much of the industrialized world, is an important target for multilateral negotiations. **Purchases of goods and services by the public sector are often subject to policies that discriminate against foreign suppliers. Many countries maintain an explicit bias in favor of domestic firms in the form of a preference for bids received from domestic firms over those from foreign competitors.** There are many other forms in which such a bias can manifest itself; for instance, in how extensively the bidding process is advertised, whether or not the selection criteria are precisely spelled out in advance, and **requirements that domestic providers be used in the provision of small scale goods and services.**. There is also concern that specifying a certain process or method rather than a product specification, can bias selection toward favored firms. Different firms often develop products that serve the same purpose, but through alternative mechanisms. To the extent that these products differ by country, a government could specify that only a product using the mechanism of the domestic variety would be acceptable. Such a specification represents a barrier to trade as it puts domestic firms in a favorable position.

Government procurement was explicitly exempt from the original GATT (1947) specification of national treatment, but has more recently been addressed. The Agreement on Government Purchasing (AGP) was negotiated alongside the Uruguay Round Agreements. This was an expansion of an earlier agreement in effect since 1981. In each year between 1990 and 1994, this first agreement applied to approximately $30 billion worth of government contracts. The coverage under the new agreement is estimated to be a ten-fold increase, or up to $400 billion annually. Although the AGP was a good start, it has several limitations: too few countries (22 to date) have subscribed and coverage and enforcement are inadequate. Additional negotiations have been scheduled to begin by January of 1999.

REGIONAL INITIATIVES

During the 1980s, the United States turned an eye towards bilateral and regional liberalization. It was not with the purpose of supplanting the multilateral talks, but rather to supplement and spur progress on the multilateral front. Regionalism generates some concerns, generally focused around a discussion of trade creation and diversion. The trade creating tendency is clear. As barriers to trade are reduced, trade between the member countries is likely to increase, leading to a more efficient allocation of resources. However, the favorable effects of this increase in trade may be offset by reduced trade with other countries. If the low cost source of supply is outside of the agreement, the preferential market access may promote trade with a higher cost source inside the bloc. This diversion results in an inefficient allocation of resources in both member and non-member countries. Whether the trade creating benefits outweigh the costs of diversion for insiders depends on the specifics of the agreement. However, regional agreements are more likely to impose a cost on countries outside of the agreement than to provide them with a direct economic benefit.

Despite these concerns, there are reasons to believe that the benefits of trade creation may outweigh any negative effects of trade diversion when preferential trading arrangements are drawn along natural geographic lines. Furthermore, there are situations in which regional agreements can generate a positive influence on the multilateral process or support foreign policy positions (see box). In 1985, for instance, the United States negotiated a free trade agreement with Israel. For the United States, the consequences of the agreement were more symbolic than economic. Economic benefits were more important to Israel and the agreement reinforced the political ties between the two countries. Similarly, although economic motivations were significant, a contributing factor in the formation of the European Community was to provide a sense of community in the hopes of reducing the possibility that there would ever be another intra-European war. The promotion of democracy and both economic and political stability is also a factor behind the development of the Free Trade Area of the Americas (FTAA) initiative.

In the last 10 years, the United States has initiated and signed a number of significant regional initiatives. The agenda for the remainder of this century includes laying the foundation for free trade in the Americas as well as moving toward free trade throughout the Pacific Rim.

FTAA

The idea of a Free Trade Area of the Americas (FTAA) was launched in December of 1994, when leaders of 34 Western Hemisphere countries met in Miami for the first hemispheric summit since 1967. At this summit, President Clinton and 33 other leaders committed to conclude the negotiation of a comprehensive free trade agreement no later than 2005, with concrete progress by the end of the century. The United States undertook this regional initiative to foster closer political and economic ties with and further trade liberalization in Western Hemisphere countries. The Miami Summit led to three trade ministerials at which twelve working groups were established to create the foundation and begin preparations for the FTAA negotiations. The United States is actively engaged in this effort.

Building on unilateral liberalizations undertaken in the late 1980s, Latin American countries have negotiated many preferential trading arrangements (e.g., Mercosur, Central american Common Market, and the Andean Community). This dismantling of barriers, both unilateral and regional, reflects a significant shift away from their historic inward-oriented trade policies toward more liberalized regimes. Although generally reflective of progressive policy programes, the preferential nature of these arrangements is of concern for the United States as other countries are gaining greater access to what is naturally our largest export market. As such, the benefits to participation and the cost of spectating are rising. Chile, for example, is now a party to a preferential trading agreement with every major trading partners in the Western Hemisphere except the United States. Therefore, exports from the United States are subject to tariffs that average 11 percent in the Chilean market, while exports from other countries in the Western Hemisphere increasingly have duty free access. Although Chile is only one small country, it is a salient example of a trend that is spreading throughout Latin America.

The formation of an FTAA will bring substantial benefits to all countries in the region, which has a combined GNP of over $9 trillion and a market of 765 million people. These benefits include deeper geopolitical ties and significant reduction of import barriers in the region. The latter will be particularly beneficial to the United States, since its market already is much more open than the other countries' markets. While some of these goals could in principle be achieved through the multilateral process, more immediate and complete liberalization can probably be achieved through regional action.

APEC

Following its formation in 1989, the Asia Pacific Economic Cooperation (APEC) forum took on deeper meaning in November of 1993, when President Clinton suggested elevating it by calling for a meeting of the leaders. This leaders' summit in Seattle set the stage for 1994, when in Bogor, Indonesia, the 18 Pacific Rim leaders announced the goal of achieving "free and open trade and investment in the region," by the year 2010 for developed countries and 2020 for developing countries. In Osaka, Japan the following year, an agenda was laid out for achieving that goal. In 1996, subsequent discussions in Subic Bay, the Phillippines initiated the implementation of the agenda. The most immediate result from the Subic Bay meeting was a call by APEC Leaders to eliminate all tariff barriers to trade in the technology sector; this laid the foundation for the Information Technology Agreement described above. Now accounting for approximately one half of world output and trade, the APEC region has grown in significance for the United States.

Fundamental to APEC is the pledge of "open regionalism." APEC seeks to serve as a building block to the multilateral system of liberalization and not a stumbling block. As a starting point to implementing this vision, APEC members are currently engaged in a process that builds upon the success achieved in the ITA. In November 1997 in Vancouver, Canada, APEC Leaders agreed to expand APEC's role as a catalyst for global market opening, by endorsing liberalization initiatives in 15 sectors. APEC will thus capitalize upon the fact that it collectively accounts for a majority of world trade to leverage multilateral agreements that cut trade barriers globally. The APEC Leaders' decision recognizes the importance of taking APEC sectoral initiatives into the WTO, where appropriate, and including binding global agreements, as was done with the ITA. Which sectors?

BILATERAL INITIATIVES

As successful as regional and multilateral initiatives have been, there are still significant barriers against U.S. exports to individual countries. As the course of development differs from country to country, the institutions and norms that govern economic behavior differ in important ways. As formal barriers to international trade are reduced worldwide, the differences in domestic practices are uncovered. As these domestic practices are country specific, it is sometimes easier to address them on a bilateral rather than multilateral basis. The Administration has a history of actively pursuing remedies to the trade resisting aspects of domestic practices abroad. These efforts are designed not only to liberalize markets specifically for American products, but to provide broad access to the market in question.

China. China is the world's tenth largest trading nation and the United States' fourth largest trading partner. U.S. exports to China have nearly quadrupled in the last decade. However, China's wide array of barriers to trade, and shifts in the location of our imports from other Asian nations to China have resulted in a trade deficit with China of over $39.5 billion in 1996, an increase of more than $5.7 billion from 1995. The latest trade data show that when goods and services are included, our recorded deficit with China now surpasses our deficit with Japan. U.S. exports to China have grown a slight 2% over the last year, compared to the 13% growth in U.S. imports from China. Further opening the Chinese market to our exports is one important goal of our bilateral and multilateral negotiations with China.

Negotiating the terms of China's accession to the World Trade Organization (WTO) is a major part of our effort to address this trade imbalance. The focus of the WTO negotiations rests on opening China's market to U.S. goods and services and bringing China into conformity with international trade rules. Aside from WTO negotiations, the United States pursues an active bilateral agenda with China to resolve outstanding issues ranging from market access for U.S. agriculture exports like citrus, wheat, meat and soybean products, to protection for intellectual property rights in China.

European Union. The trading relationship between the United States and the European Union is important and strong, but it has had frictions. In recent years, longstanding divides have reemerged as have new areas of disagreement. Within the last several months alone, the United States has had to deal with four separate areas of disagreement. The necessity of dealing with these issues was brought about by decisions and deadlines set by the Commission of the European Union. First among these issues is the ban of products that are made with Specified Risk Materials (SRMs). Other issues include restrictions on the imports of furs that were obtained through the use of leghold traps, the biogenetic alteration of corn, and the process by which wine exported to the EU is made. The first issue has been addressed by an agreement to phase out the use of some traps in the United States, while the latter ones remain outstanding.

Japan. Japan is our second largest trading partner after Canada. Between the United States and Japan is a long history of negotiated access to the Japanese market. Structural agreements have sought to address a range of market access barriers, including closed distribution systems, overregulation, lack of transparency in procurement practices, exclusionary business practices, and weak antitrust enforcement.

Since the beginning of the Clinton Administration, the United States and Japan have negotiated 33 bilateral trade agreements. Under the U.S.-Japan Framework for a New Economic Partnership Agreement, reached in 1993, the two countries negotiated sectoral agreements covering such sectors as autos and auto parts, insurance, financial services, telecommunications, medical technology, and flat glass. Objective criteria were included in these agreements to guide the United States and Japan in evaluating their success. Under the Framework Agreement, bilateral agreements on structural issues, including deregulation, investment, and intellectual property rights also were reached. In addition, the two countries have negotiated sectoral agreements on semiconductors, wood products, cellular phones, construction and others.

While noteworthy progress has been made under many of these agreements, progress has fallen short in some areas. The United States places priority on full implementation of our bilateral agreements with Japan and believes that more vigorous enforcement is necessary to ensure that the goals of the agreements are achieved. In addition, the United States continues to seek new market access agreements with Japan to address barriers impeding access to specific sectors. The United States also sees the WTO dispute settlement process and negotiations in multilateral and regional fora, such as the WTO and APEC, as useful in addressing specific Japanese market access barriers and gaining meaningful access to the Japanese market.

More recent U.S. initiatives with Japan reflect a new orientation. Rather than negotiating market access only for commodities, some of our most active negotiations now center around services, such as transportation, that are an input to the processes of production and trade. For example, constraints on air traffic between the United States and Japan have been the subject of intense negotiations. These constraints stem from a 1952 bilateral agreement of the provision of civil air services between the two countries. The goal is to achieve a significant expansion of service. The long-termed goal is an "open skies" agreement similar to those the United States has negotiated with other countries. **The civil aviation agreement will directly benefit the U.S. airline industry and U.S. consumers. American have a cost advantage over Japanese airlines, and so should capture sizeable shares of the growing passenger and cargo markets between the United States and Japan, and in Asia more generally. In the U.S.-Japan market alone, a reasonable estimate of the short-term effect on the balance in passenger services is to increase the surplus by more than $1.5 billion. The increased supply of air services will also be of benefit to businesspeople, tourists, and other travelers, and will have secondary benefits for the U.S. tourist industry and for trade in other goods and services. The liberalization of port services will save U.S. exporters money. But by reducing the costs of trade in all merchandise that moves by sea, it will bring the wider benefits of trade to the Japanese economy, the U.S. economy, and all other trading nations.**

Taken together, these initiatives will work together to free the flow of trade between the United States and Japan. **American negotiators who successfully urge Japan to liberalize services in its ports [and air transportation services] are following in the footsteps of Commodore __ Perry. Perry arrived in Tokyo harbor in 18__ with his "black ships," demanding the opening of Japan to trade** with the West. This event led directly to the end of 250 years of extreme Japanese isolation.

SUMMARY: THE ASYMMETRY OF BARRIER REDUCTIONS

The Administration is pursuing greater market access for U.S. exports in a number of arenas. The importance of doing so is highlighted by the extent to which major portions of the world economy have previously been exempt from formal negotiations. Lowering one's own barriers to trade benefits one's own economy. (As is discussed in the next section, imports provide lower cost goods for consumers and imported inputs for producers, increase competition, and facilitate the transfer of technology.) But they also, of course, benefit one's trading partners.

Although the trade liberalizing initiatives described above are generally reciprocal in nature, they tend to lower foreign barriers to a greater extent than they do U.S. barriers to trade, since U.S. barriers are, on average, much lower to start with than those of our major trading partners. This is the result of the relatively open position taken by the United States throughout most of the post war period. The natural implication is that such agreements raise foreign demand for our products by more than they raise our demand for imports. Hence we are likely to benefit from a positive "terms of trade effect." This just adds to the usual benefits of increased efficiency of production and gains to consumers from international trade.

THE EFFECTS OF MARKET OPENING

Throughout the latter half of this century, the thrust of U.S. international trade policy has been to open markets to international trade. These efforts have been remarkably successful: barriers to international transactions are at a mere fraction of their 1930s level. But it is not enough to measure the extent to which markets have been opened. One desires an assessment of the accompanying benefits. In what follows, we discuss the sources of benefit from international trade and some estimates of the impact of trade on U.S. GNP. This is followed by a discussion of international trade's impact on U.S. workers.

THE BENEFITS OF TRADE LIBERALIZATION

The benefits from international trade can be categorized as those that lead to static gains, that is, a one time increase in income, and dynamic gains, those resulting in an increase in the rate of growth of the economy. Although the former can be significant, the accumulation over time of the latter generates potentially much larger improvements in the standard of living.

Benefits to our Standard of Living

We stand to benefit from trade in three ways. The resulting specialization allows each person to be used efficiently, it also reduces the costs of production through scale economies and it increases the variety of goods available to consumers, and to firms as inputs.

Fundamentally, free trade results in a more efficient allocation of an economy's scarce resources leading to higher living standards. This efficiency gain is brought about by allowing countries to produce according to their relative strength: some countries have many skilled workers or are more advanced technologically, some countries have warm climates, and some have large supplies of natural resources or capital. These differences imply that the cost of producing a particular good will differ from country to country depending on the relative availability of resources. By producing and exporting goods that are relatively cheap to produce in a given country, for instance, wheat in the United States, and importing other goods which would be relatively expensive to produce in that country, for example, coffee, trade can boost the living standards of both countries.

This notion is straightforward when applied to individuals and is well illustrated with the following: President Wilson, they say, could type faster than his secretary. But it made sense to leave the White House correspondence to others so he could concentrate on making the world safe for democracy and other higher-productivity endeavors. The same principle holds true for countries: even if one country is better at producing every good than is its partner, the country can still benefit by concentrating its resources in what it produces relatively better. The partner country is also made better off. By specializing in what is produced relatively efficiently in that country, its resources are put to use where they generate the greatest economic value. Free trade thus is a positive, not negative, or zero, sum game - both partners gain from it.

This resource reallocation benefit has been augmented by the observation that there are economies of scale in the production of some goods. That is, by producing more of a particular good, the cost of producing additional quantities actually falls (for example, automobiles). By concentrating production in the goods that a country produces relatively well, these economies of scale are better exploited. This raises the gains from trade, making it even more efficient to sell in the global market. It also helps explain why the United States trades more with similar countries (Canada and Europe) than dissimilar ones.

The gains from trade due to economies of scale can be understood fairly intuitively. Consider the production of automobiles. If each city in the United States had to produce its own automobiles, the cost would likely be prohibitive. The expense of the design process and building a factory could be very high relative to the number of cars sold in any one city. If, on the other hand, one city can develop and produce a car that it subsequently sells to other cities as well, it is clear that all will benefit. Here, we have a case where trade doesn't just make a consumption good cheaper or better, it is essential to its existence. By spreading the cost of additional varieties of goods across countries, the number of varieties available to any one country is increased.

Benefits to the Growth Rate of Our Economy

By encouraging productivity improvements, international trade can influence an economy's rate of growth of income. Productivity improvements come most directly through the pro-competitive effects of trade. By subjecting domestic firms to competition from foreign suppliers, international trade results in incentives that not only lower prices for consumers, but lead to productivity enhancements, further reducing prices. Increased competition leads to gains from trade that are continuously recurring; that is, although competition is only introduced once, it leads to a cycle of productivity improvements and quality enhancements that continue to benefit the economy. Additionally, trade and or international investment can facilitate the transfer of technology between countries. Although the limiting of this flow in the short term is important for providing the incentive to conduct research and development (by protecting intellectual property rights), over the longer term the free flow of technological advances across borders will encourage a more efficient utilization of the world's scarce resources.

Measuring the Gains From Trade

The difficulty associated with measuring the effects of specific international trade agreements is that changes in the structure of trading arrangements are but one event among many. In an economy the size of the United States, GDP both rises and falls for many reasons, most of which are not associated with trade agreements.

A prime example of the difficulty in evaluating the benefits of trade liberalization was presented in the July 1997 Administration report, in fulfillment of a Congressional mandate, on effects of the North American Free Trade Agreement (Study on the Operation and Effects of the NAFTA). The NAFTA entered into force in January of 1994. In December of that year, Mexico experienced a deep economic and financial crisis that was unrelated to the agreement. The result, in 1995, was a steep fall in output in Mexico, an increase in unemployment and a drop in real wages there. A natural side effect of the crisis was a dramatic decline in Mexican imports. This decline was brought on by greatly reduced domestic income and demand, higher import prices due to Peso devaluation and, to a limited extent higher tariff barriers against non-NAFTA trading partners. Despite this crisis-induced decline in trade with Mexico, it is possible to discuss gains for the U.S. economy derived from the NAFTA. Because of the agreement, Mexico did not raise tariff barriers against the United States or Canada, only against other countries. As a consequence, not only did U.S. exports to Mexico not decline by as much as they might have, but some believe the agreement sped the general recovery of the Mexican economy and of imports from the United States. Seeking to take the extraneous effects of the Peso crisis into account, the July report estimates that the NAFTA increased U.S. income by $13 billion in 1996.

Despite the difficulty associated with disentangling the causes of real national income growth, a large number of studies assess the overall benefits of actual or hypothetical trade liberalization. Some examine the benefits of removing existing measures. A recent study of the costs of protection in the United States suggests that real GDP in 1990 would have been $70 billion or 1.3 percent larger if existing barriers were removed. In the sectors subject to the most restrictive barriers, estimates from the early 1990s put their cost range of $15 billion to $32 billion. A drawback of these studies is their inability to incorporate all the benefits of international trade. While they capture the static costs of the inefficient allocation of resources, and some do this more thoroughly than others, their methodology is incapable of quantifying the value of forgone varieties, quality improvements, or productivity enhancements in the production process that would take place in the absence of these barriers. Thus, studies of this type understate the benefits from trade.

Another approach to understanding the benefits of trade is to examine the statistical correspondence between openness and growth rates among countries. Such cross-country studies hold constant for such well-known determinants of growth as investment in physical capital (plant and equipment) and human capital (education and training). The common empirical finding is that increased international trade results in higher income. One recent study uses data on 100 countries to discern the effect of openness, as measured by the sum of imports and exports as a fraction of GDP. The conclusion is that every percentage point increase in openness was associated with an estimated 0.34 percent increase in 1985 income per capita relative to 1960. Since 1960, U.S. openness has increased by 12.5 percentage points, suggesting that the increase in trade was responsible for an estimated 4 percent increase in U.S. income per capita.

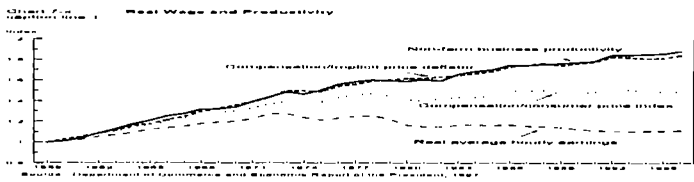
TRADE AND THE AMERICAN WORKER

In public discussions, the controversy surrounding trade liberalization tends not to focus on whether or not there are benefits for the economy as a whole. It is widely conceded that there are. Instead, the greatest concern focuses on the distributional impact of increased international trade. The distributional impact arises from the fact that international trade tends to disadvantage some industries and advantage others. Increased international trade can be expected to contract production in the former and expand production in the latter relative to what they otherwise would be. As export oriented industries expand, they draw resources away from the rest of the economy, resulting in a relative decline in other industries. Resources are drawn not only into the expanding industries, but into sectors supporting those industries as well. This reallocation of resources will, in all likelihood, benefit some groups and injure others. Concern has particularly been expressed over the impacts on workers, including impacts on the average wages of workers, the wages received by low-skilled workers relative to skilled workers, and the extent to which workers suffer from job dislocation due to trade.

Trade and Average Wages

Throughout the first half of the post-WWII era, average hourly real wages increased at a fairly consistent rate of about two percent per year. Between 1974 and 1996, however, measured real wages fell roughly ten percent, to their 1965 levels. In the early 1970s, a dramatic increase in the growth of world trade began; since 1972, the rate of growth in world trade has consistently outpaced that of world income. This trend applies especially to the United States, with growth in trade exceeding growth in output by approximately two percentage points in each year. The coincidence of increasing trade volumes and the downward trend in real wages suggested to many that international forces were the source of this decline. This inference is probably wrong, however. To begin with, it is more appropriate to focus on the level of total compensation rather than just the wages workers receive. Total compensation includes both wages and nonmonetary benefits provided by employers. This non-wage compensation, including health care benefits, pension costs, and other fringe benefits, has grown relative to wages in recent decades. In fact, total compensation has increased in real terms by almost eight percent since 1974. While this does represent slower growth than in the 15 years prior to 1974, this slowdown is more appropriately explained by factors other than international trade.

The compensation of labor is generally believed to be determined by worker productivity. In times of rapid productivity growth, we expect to see rapid growth in real compensation. Conversely, when productivity growth is slow, we expect compensation to grow more slowly. Between 1959 and 1973, output per worker hour -- non-farm business productivity -- grew at a rate of 1.85 percent per year. Productivity growth slowed, however, between 1974 and 1990 to approximately 0.73 percent per year. Given the productivity slowdown, we would expect a slower rate of increase in compensation. In figure 7-?, we find a remarkable correlation between the rate of productivity growth and the rate of growth in compensation. The decline in real wages during this latter period is offset by growing non-wage compensation, as illustrated by the middle line in the chart. Moreover, these measures use the consumer price index to correct for inflation. To producers, the ones making the wage decisions, the real output of their workers must be judged against only the prices of goods they sell, not of all goods and services that consumers buy. After making this correction, real compensation and productivity growth are found to track each other very closely. A policy aimed at increasing the rate of productivity growth, rather than one aimed at reducing international competition, is therefore more likely to increase the growth rate of real compensation.



Although aggregate compensation is driven by overall productivity growth, there is an additional effect related to the industry in which workers are employed. There is strong evidence that industries producing for export generate high paying jobs. A recent report from the Department of Commerce indicates that jobs associated with exports tend to pay wages that are approximately 13 percent higher than other jobs. The differential is reduced, but not eliminated, once the skill composition of the industry and non-monetary compensation are accounted for. Part of the differential is also due to factors associated with higher productivity such as the size of the plant. But again, even after these details are accounted for, a significant compensation differential remains: the adjusted compensation of unskilled workers is approximately 7 percent higher in export-oriented industries and the adjusted compensation of skilled workers is approximately 5 percent higher than in the rest of the economy. Working in export sectors benefits unskilled workers even more than it does skilled workers.

Although standard assumptions of perfectly competitive labor markets would indicate that similar workers should earn comparable compensation even when employed in different industries, such theories are not borne out in reality. There has long been a relationship between industry and compensation. Individuals with similar characteristics tend to earn more in some industries and less in others (see box). Movement of particular workers from one industry to another can result in increased compensation for the individual. The differential is attributable to some combination of enhanced productivity acquired in the new setting and additional "rents." Moreover, a general shift of employment opportunities from one industry to another can bring about significant changes in aggregate compensation because of these inter-industry differentials. The communications and transportation equipment industries are two examples of export oriented industries that have historically provided higher compensation than is provided in other sectors for similar workers.

Trade and Relative Wages

Over the past 18 years, trends in relative wages have been used by some to indict free trade. Between 1972 and 1993, at the same time as rising trade volumes, the wages of skilled workers rose dramatically relative to those of unskilled workers. Over the course of the 1980s, the wages of skilled workers rose between 8 and 15 percent relative to the wages of unskilled workers, depending on the definition of skilled workers used. Given the rough coincidence of these changes, it is tempting to single out international trade as being responsible for the increasing disparity in wages between the skilled and unskilled.

A significant source of increased world trade is the entry into the world marketplace of many Asian economies well endowed with unskilled workers. Thus, the claim that free trade is detrimental to the unskilled is generally supported by casual observation: unskilled workers in the United States are now competing with a greater pool of unskilled workers abroad. Competition with this larger pool of unskilled workers can logically be expected to lower the wages of unskilled workers in the United States.

For a variety of reasons, however, this theory is of limited applicability. First, it assumes that workers of a given skill level are equally productive in different industries, which is unrealistic (except perhaps in the very long run). Second, the model incorporates only the most traditional benefits of trade, those brought about by the exploitation of comparative advantage. Left out are the benefits of increased competition, faster productivity improvements, and increased product variety. The existence of these benefits can in principle raise the lot of all workers so that none need be disadvantaged by international trade. A third, and perhaps most important, qualification is that the model assumes that countries possess identical technologies. This implies that factors will be equally productive in different countries and that their wages will be driven together; that is, that the wages of low-skilled workers in the United States will be reduced to those in less developed countries. There is a great deal of empirical evidence indicating that this is not the case. U.S. workers are more productive than those in most other countries, and this is true even after taking account of the higher levels of capital they have to work with. Thus their real wages will naturally be higher, even when trading with low-wage countries.

In addition, most careful analysis of the direct evidence does not provide strong support for international trade as a major source of increasing wage inequality. Skill biased technological change, in particular the use of computers and robotics, has been a more important source of increased inequality during this period. The nature of technological change has served to reduce the demand for unskilled workers and increase the demand for skilled workers. This phenomenon can be expected to reduce the wages of unskilled workers relative to those of skilled workers, and perhaps absolutely. Current research indicates that international trade is responsible for only perhaps 10 to 20 percent of the observed increase in wage inequality during the 1980s.

Furthermore, U.S. trading patterns are inconsistent with the notion that trade liberalization is substantially depressing the wages of unskilled workers. Although the surge of imports from some low-wage countries has received tremendous attention, the United States continues to buy the bulk of its imports from advanced countries, whose workers have similar skills and wages. If we define low-wage countries as those countries whose average wages are half that in the United States, trade with such countries in 1990 was roughly the same as it was in

1960 when much of the European Union and Japan qualified as low-wage. Imports from this type of country were 2.2 percent of GDP in 1960 and had risen to only 2.8 percent of GDP by 1990. In addition, the trade-weighted average hourly manufacturing wage of U.S. trade partners was 88 percent of that in the United States in 1990; this seems much too small a difference to have produced the observed changes in relative wages. This is a more subtle point, but no less valid: in order for international trade to result in a decrease in the wages of low skilled workers, the price of low-skill intensive imports must necessarily fall. The price of such imported goods actually rose during the 1980s.

If there were trade induced inequities that were judged not worth the gain in aggregate income, refraining from new trade agreements might seem the natural policy prescription. However, for many of the reasons expressed above, it is not clear that international trade has actually caused injury to less-skilled workers on an absolute scale, which is different from the question of benefits less than those accruing to skilled workers.

Trade and Job Displacement

As reported in last year's Economic Report of the President, public opinion polls continue to reveal a low sense of job security among workers. This is surprising in the respect that, historically, periods of robust economic activity, such as the United States is currently enjoying, are characterized by much less anxiety over job loss. This anxiety is also evidenced by a relatively low propensity for workers to quit their current jobs. Workers are currently associating much of their concern to international trade flows. However, despite substantial liberalization during the 1980s, studies estimate that 80 percent of the loss of production jobs in manufacturing in the United States and most other developed nations was due to technological change. Only the remaining 20 percent is due to business failures and possibly internationally trade.

The extent to which opening markets leads to involuntary job loss depends on the form it takes. If the primary result is expanded access to foreign markets, the reallocation of resources comes from export pull: increased export production pulls labor and other resources out of other industries. Alternatively, the resource reallocation resulting from increased penetration of the U.S. market by foreign firms results in an import push that drives resources out of a particular sector.

In the case of export pull, involuntary job loss need not be substantial. In fact, when unemployment rates are high, the expansion in exporting sectors may be accomplished by providing new job opportunities for unemployed workers. For example, in January 1993 unemployment was still 7.1 percent (even though the recession had technically ended two years earlier). During the subsequent two years, employment supported by exports rose by 446,000. However, currently we are close to full employment. In times when labor markets are relatively tight, opportunities will decrease in some industries and increase in others. The effect of export growth in this circumstance is not to increase the number of jobs. Rather it is to increase the pay of jobs, as in the discussion of trade and average wages above.

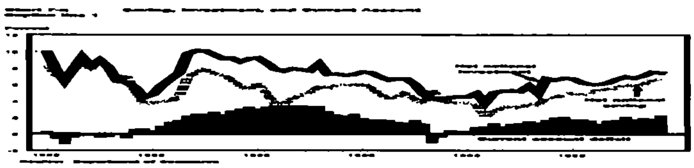
An import push, is likely to displace workers in the competing domestic sectors. However, some recent evidence suggests that, for a variety of reasons, international trade is not a primary contributor to total displacements. First, the U.S. economy is among the largest and most dynamic in the world. As such, it is characterized by a great deal of turnover as new firms go into business and others drop out. Data available from the 1980s reveals that international trade contributed at most ten percent of the observed displacements from manufacturing industries in the worst year and generally contributed significantly less. This is primarily because of the small size of trade-related employment changes relative to those resulting from other forces, such as technological change.

Combining the effects of import push and export pull forces over the course of the 1980s, changing trade patterns over this period left the volume of displacements relatively unchanged. This is possible because over the long run, the effects of an import push will generally be offset by an export push which serves to reduce the number of displacements. The net effect is then only a reshuffling of displacements across industries and time.

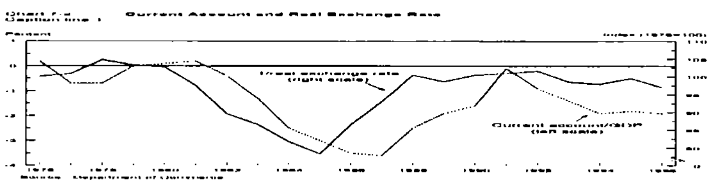
There is a well-established correlation between some characteristics -- education, age, race, among others -- and the consequences of displacement. Older, less educated workers tend to have a more difficult experience once displaced than do younger, more educated individuals. It has been found that trade tends to displace the former individuals and hence workers who experience greater hardship from displacement. In addition, their opportunities are reduced relative to other displaced workers in ways that are directly related to trade. That is, the availability of opportunities for finding employment once displaced depend significantly on the state of the industry. Import push has the tendency, almost by definition, to shift the distribution of displaced workers towards industries that are contracting, and hence towards workers with reduced opportunities for reemployment.

THE U.S. TRADE BALANCE

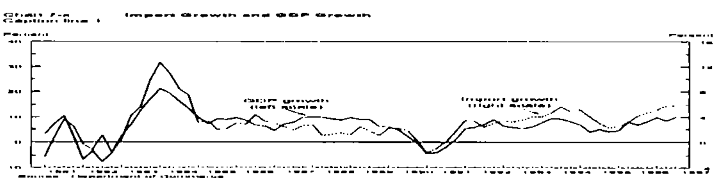
A popular measure of the impact of trade policies is the trade balance, the difference between exports and imports. However, the trade balance as a measure of the success of market opening endeavors is problematic. The overall trade balance need not be related to specific market opening efforts: the trade balance is generally determined by macroeconomic factors, not microeconomic barriers to trade. Specifically, by simple national income accounting identities, net exports must equal the difference between savings and investment (see Chart 7-?). In periods when saving is low, or investment is high, the balance is likely to be in deficit. In the first case, we are effectively borrowing to finance short term consumption; in the second, we are borrowing to finance expanded productive capacity. Such deficits do not represent a failure of market opening policies.



In the 1970s, the current account measure of the balance of payments averaged zero. Small trade deficits tended to be offset by surpluses on investment income. Since then, the U.S. trade and current account balances have been in substantial deficit, as growth of imports has largely exceeded those of exports. However, these deficits have not arisen because of differential changes in market access between the United States and its trading partners. In fact, most countries have substantially reduced their trade barriers over this period. Rather, as shown in Chart 7-?, changes in the trade deficit have usually corresponded with earlier movements in the real exchange rate.



The trade balance also tends to increase when the economy grows quickly.
As revealed in Chart 7-?, when aggregate demand is low, the volume of imports tends to be low. Conversely, during a boom, consumption increases and the volume of imports relative to exports can be expected to increase, resulting in a trade deficit. In times of full employment, an improvement in the trade balance would merely lead to a crowding out of other sectors.



The trade deficit grew in the early 1980s as the government maintained a mix of tight monetary policy and expansionary fiscal policy. As government dissaving grew, domestic capital became more scarce, requiring that investment be financed through borrowing on international capital markets. As the dollar appreciated, imports became cheaper and our export prices rose on world markets. This problem was often referred to as the "twin deficits," emphasizing the role of the government budget deficit in the low national savings rate and resulting trade deficit.

However, the U.S. budget deficit has fallen steadily since 1992, while the trade deficit has once again grown. This is occurring because for seven years U.S. income has been growing steadily, accelerating U.S. demand for imports. In particular, the expansion has been led by investment. **When the current account deficit is rising at the same time that national saving is increasing, it logically follows that investment is increasing even more rapidly than saving.** Arguably, however, a current account deficit is less worrisome when it is accompanied by rising saving and investment.

The deficit also remains susceptible to international forces and events. During 1997, the trade deficit increased more rapidly than forecasted. At the beginning of the year, it seemed likely that the U.S. growth rate would fall behind the growth rate of our trading partners n Asia and elsewhere. Instead, U.S. growth–and import demand– remained unusually strong, while the rest of the world was growing less rapidly (see discussion in the international outlook section of Chapter 2). The currency crisis that hit East Asia in the second half of the year, entailing devaluations and slower growth in many of those developing countries, suggests that the U.S. deficit will continue to grow in 1998.

The trade gap has varied over the past decade. The trade deficit for goods and services was $111 billion in 1996, greater than the 1991 low of $31 billion, but smaller than the 1987 level of $153 billion. At 1.5 percent of GDP, the trade deficit in 1996 was equal to the average from 1976-1996. (There are difficulties in measuring the trade balance precisely, however, and many different statistics are often reported. The trade deficit in goods alone is deceptively larger. This results from the exclusion of services, for which the United States is a large net exporter.)

The current rise in the trade deficit reflects our household decisions, policy choices and the strength of the U.S. economy, particularly in the context of international stagnation and instability. A smaller deficit might be realized with a different mix of fiscal and monetary policy, but it would bring problems of its own. In particular, in current conditions of very low unemployment, an increase in the trade balance would simply crowd out other sectors. The excess demand for U.S. goods would put upward pressure on inflation and interest rates, and other sectors would have to contract to make room for the rising net exports. The trade deficit has acted as a safety valve for the current economic expansion. Imports of goods keep inflation low, while imports of capital keep interest rates low, helping to maintain sustained rapid income growth.

Admittedly, ongoing external deficits do carry some concerns. Because a current account deficit must be financed by capital inflows, the country is incurring greater debt to foreign residents each year. If the international debt were to continue to rise relative to GDP, the deficit could eventually become unsustainable. Additionally, trade deficits often give rise to political support for protectionism, which itself damages the economy. Fortunately, however, in a strongly-expanding full-employment economy, it should be easier to dissuade people from the idea that trade deficits necessarily reduce output and employment.

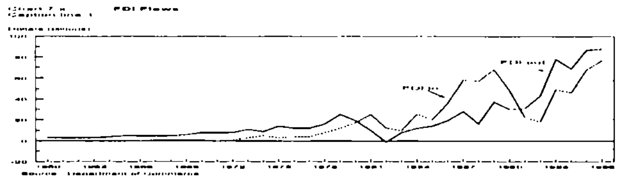
FOREIGN DIRECT INVESTMENT

Growth in the international flow of capital has out-paced even the rapid growth of trade. Between 1976 to 1996, recorded annual capital outflows rose 10 percent a year on average, from $51 billion to $352 billion. Capital inflows rose an average 13 percent a year over the same period, from $38 billion to $548 billion. A significant share of these asset flows is in the form of foreign direct investment (FDI), wherein the investing company maintains operating control over the asset in the foreign country.

As the importance of international capital flows and direct investment has increased in international transactions, there has been a move to negotiate a set of rules for foreign direct investment along the lines of those that exist for trade. To aid in understanding how FDI relates to trade, and the need, the design, and the effects of additional investment policies, this section first addresses three questions: what is the nature of foreign direct investment, why does it occur, and why is it beneficial?

CURRENT TRENDS IN FDI

The United States has been, and continues to be, both the largest source and the largest host to FDI in the world. Throughout most of the post-war period, the United States has generally been a net foreign investor in the world. However, in 1981, the balance of flows turned inward for the first time, led by the large expansion of Japanese overseas investment. Direct investment by foreign firms in the United States grew rapidly throughout the 1980s, peaked in 1987, and then dropped sharply in the early 1990s as Japan's financial sector bubble burst. In the past decade, investment abroad by U.S. firms has increased tremendously, and since 1991 the net balance of FDI flows has been outward once again. These trends continue: in the three quarters of 1997, foreign direct investment outflows in the balance of payments accounts were $88 billion, $10 billion more than inflows, and $31 billion more than the same period last year.



In 1996, the cumulative FDI position of foreign firms in the United Sates on a historical cost basis was $630 billion, an increase of 60 percent since 1990. There are some accepted problems in measuring FDI precisely, and some estimates suggest that historical cost measurements may understate the market value of the stock of FDI by as much as 50 percent. This is because U.S. balance of payments accounting rules define FDI as financial flows from a parent company to an overseas affiliate in which it has more than 10 percent ownership. Thus, investment in foreign affiliates not financed directly by the parent company is excluded, and capital gains (including those due to inflation) are not recorded. However, historical cost measurements do allow us to monitor the distributional changes of FDI across countries and sectors.

More than half of foreign investment has come from three countries: the United Kingdom, Japan, and the Netherlands, in that order. Much FDI is reciprocal: these three countries are also hosts to much of U.S. direct investment abroad. In total, European countries are host to half of the U.S. FDI position. In 1996, U.S. firms directly controlled overseas assets of $797 billion valued at historical cost, of which OECD countries were home to over 61 percent. Much of the remaining 39 percent was in the Caribbean Islands and Asian NIES such as Hong Kong, suggesting the investment predominantly in the financial and service sectors.

Throughout the 1990s, the expansion of U.S. FDI has been most pronounced in South America. However, the stock of FDI in this region is still relatively small, representing less than seven percent of all U.S. direct investment abroad last year, and less than four percent of total U.S. non-bank affiliate assets in 1995. Of the developing countries, Brazil has been the largest recipient of US FDI. In general, the countries that receive the most FDI do not have greater cost advantages in manufacturing (see Chart 7-?). Rather, developing countries like Brazil have been growing rapidly, and are seen as potential sources of future consumption. This suggests that the companies investing in these markets wish to establish market presence in expectation of the profitability of future sales, rather than simply outsourcing production for other markets.

	Outward FDI (millions of dollars)			Inward FDI (millions of dollars		
	1980	1990	1996	1980	1990	1996
All industries	215,375	430,521	796,494	83,046	394,911	630,045
Petroleum	47,591	52,826	75,479	12,200	42,882	42,343
Manufacturing	89,290	170,164	272,564	33,011	152,805	234,323
Food and related	8,278	15,570	36,179	4,869	22,543	28,089
Chemicals and related	18,877	37,988	69,430	10,439	45,746	74,810
Metals	6,322	10,520	13,603	3,576	13,713	18,727
Industrial machinery	16,095	30,875	35,020	2,896	11,527	16,305
Office/Computing	9,305	22,152	21,687	443	2,608	2,672
Electronic and electric equip	7,263	15,550	29,519	4,099	16,099	20,788
Motor vehicles and equipmer	11,831	20,410	31,593	3,276	16,225	12,338
Other manufacturing	19,943	38,140	55,270	7,133	43,176	75,604
Wholesale and retail trade	25,913	50,677	84,344	15,210	60,152	92,945
Banking	7,264	20,670	32,504	4,617	18,442	31,903
Finance, Insurance & Real Estate	27,506	109,657	257,213	13,530	70,421	159,869
Services	5,618	13,446	36,673	1,089	30,592	38,945

Although the public image of FDI in the United States is often based on the large manufacturing multinationals, manufacturing activity now accounts for only one-third of the FDI position in the US and by US firms abroad. FDI in manufacturing occurs predominantly in motor vehicles, electronic equipment, office machines and computers, and chemicals and allied products (see Table 7-?). In 1996, these sectors accounted for over half of the U.S. direct investment position abroad in manufacturing, and the foreign position in the United States.

However, FDI has evolved in accord with changes in the industrial composition of the U.S. economy, as evident in Table 7-?. Much of the initial motivation for FDI was the ability to use U.S. technology in extracting foreign resources such as oil, coal and gas. In 1980, the petroleum industry accounted for roughly 22 percent of the outward FDI position. However, this share has been falling steadily: in 1996 the petroleum industry accounted for only 10 percent of the U.S. FDI position. Between 1980 and 1990, FDI became associated with the relocation of manufacturing activities in part because of the rapid expansion of FDI in the United States manufacturing sector. More recently, a growing share of FDI has been in the finance, insurance, and real estate (FIRE) and other service sectors, corresponding with the evolution of the U.S. economy from manufacturing to services. The FIRE and other service sectors accounted for 37 of the inward FDI position, and 52 percent of the U.S. position abroad in 1996, larger than the entire manufacturing sector.

Employment in foreign owned U.S. affiliates rose from 2 million in 1980 to almost 5 million in 1995, an average annual increase of 6.3 percent. This was over 3 times the rate of growth in non-farm U.S. employment, and represents an increase in the share of jobs in foreign controlled firms from 2.2 to 4.3 percent. An interesting comparison can be made to the [12?] million jobs supported by exports in 1995. Although FDI provides opportunities for less than half as many U.S. workers as trade, the impact of FDI on jobs can be more direct.

WHY FIRMS INVEST ABROAD

The corporate entity encompassing the parent and affiliate is often referred to as a multinational enterprise (MNE). Despite the tendency to speak broadly about FDI, there is no single factor that determines why a firm chooses to become an MNE and operate affiliates in foreign countries. It may be to exploit unique opportunities available overseas (e.g., oil field development in the petroleum sector), to take advantage of lower production costs (e.g., in the manufacturing sector), or to improve access to foreign markets (e.g., in services and retail trade).

In each case, it must be that the benefits of FDI outweigh those of the alternatives the firm has, such as licensing production to foreign firms or exporting the goods directly. In explaining the decision to invest abroad, economists have identified three critical aspects of multinationals that a complete economic theory of FDI must address:
ownership, internalization, and location.

Ownership

Why does it matter who owns a firm, if the inputs to production, and the goods produced can both be freely bought or sold? It stands to reason that in a foreign market, an MNE may operate at a considerable cost disadvantage over a local firm producing the same good. MNEs must operate across borders, dealing with foreign governments and customers, shipping goods and maintaining internal communications over long distances, and possibly paying employees a premium to work away from home. This suggests that a successful MNE has some proprietary asset that confers a unique cost advantage, enabling the MNE to compete in foreign markets. This proprietary asset may be a patented good or process, or be as intangible as a brand name or managerial style.

Internalization

While this might explain how multinationals can exist, it does not explain why they do exist. In particular, it is unclear why directly operating a foreign affiliate is preferable to licensing production to lower cost local firms. Licensing allows the firm to obtain the full value of its proprietary asset without incurring the additional costs associated with multinational activity. One reason firms may choose not to license other firms to produce their goods is because of transaction costs involved in doing so.

Economic theories of the firm recognize that there are costs to having a firm that is either too large or too small. Although the costs of conducting arms-length transactions outside the firm merit the internalization of some operations, maintaining a large operating structure may have costs of its own. These costs include a lack of flexibility, making adjustment more difficult in changing market conditions. This suggests that companies prefer multinational operations to licensing their proprietary assets because of the transaction costs embodied in licensing. These may include possible piracy of patent ideas, the establishment of rival firms using the firm's production processes, or the risk to the reputation of the brand name if licensees have lower quality standards. Transaction costs also help explain why some vertically-integrated multinationals chose to invest in their own foreign supply and distribution networks.

Location

Nothing said above suggests why a firm might need to cross borders in performing its functions, however. The most popular explanation is simply comparative advantage. Wages and returns to capital differ across countries. Thus, if transport costs are minimal, and production of a particular good contains a number of discrete steps, some using capital intensively and some using labor intensively, a firm may choose to locate the capital-intensive activities where capital is cheap, and the labor-intensive activities where labor is cheap.

Transportation can be costly, however, which limits the degree to which outsourcing can be productive. An alternative explanation is that firms see a trade-off between proximity to customers and concentration of production. If there are economies of scale in production, the lowest cost is achieved by concentrating production activities in the home country. However, transport costs and other market access considerations make it attractive to maintain operations closer to the foreign markets that the firm wishes to serve. Firms trade off their desire for proximity to foreign customers with the cost savings of concentration in making their choice between FDI and exporting. In contrast to explanations based on comparative advantage, FDI occurs because it increases foreign sales, not because it yields a higher return on capital or lowers the wage bill.

Additional considerations

Some firms may choose to operate in several markets because they are responding to other firms' actions. For example, if a firm's decision to operate in a third market poses a threat to its competitors' exports in that market, they may establish affiliates in that market. Firms may also follow the leader into other countries if they sell complementary, rather than competing, goods. Alternatively, firms in one country may try to discourage foreign competition by threatening reciprocity to any foreign firms establishing affiliates in their home market. If this regime breaks down, then there will be investment by firms in each country in the others' home market. This may seem unlikely, but it does explain the high degree of reciprocal investment by industrialized countries.

The theoretical arguments suggested above do not explain one aspect of FDI, however. Most foreign direct investment is not for the establishment of new plant and equipment, but is simply the acquisition of existing enterprises. This has led some to focus on asset valuation in explaining why foreign firms would purchase these assets rather than domestic firms. It may be that local firms value the assets less highly than foreign firms, because they discount the expected profit stream of an enterprise more greatly. This might occur because multinationals can borrow on better terms, either because they have access to a wider number of local capital markets, or because they have lower overall risk by diversifying their operations over several economies. An alternative explanation suggests that exchange rate movements that increase the relative wealth of foreign firms and make domestic assets relatively cheaper allow foreign firms to outbid domestic ones. During the rapid rise of foreign direct investment by the Japanese in the late 1980s, as the yen appreciated strongly against the dollar, fears were expressed that U.S. assets were being purchased by the Japanese in a "fire sale".

THE BENEFITS OF FDI

The benefits of trade for the average citizen have been established in previous sections. The benefits of foreign direct investment, however, seem less clear. Indeed, some have suggested the ability of capital to flow freely across borders in contrast to labor has resulted in the suppression of real wage growth and rising wage inequality over the past two decades. But in a world where trade occurs due to differences in relative factor abundance, capital mobility is a substitute for trade. This corresponds with the notion that FDI occurs in response to barriers to trade, and suggests that capital flows and trade may have similar welfare implications. However, the benefits of FDI go beyond merely capital mobility, and may have direct impacts on both the host and the source countries.

Benefits to the host country

These are likely to depend on whether the country is developed or developing, and why FDI is taking place in that country. In the case of developed countries, FDI generally occurs due to market access considerations. The proximity to customers may increase the quality of support services and the ability to match products to local tastes. The presence of multinationals also entails all the traditional benefits of local investment, bringing jobs and fostering demand from local industry suppliers.

When FDI occurs in developing countries, the gains of fostering demand from local industry may be even greater. "Big push" theories of industrialization emphasize that the profitability to a single firm of adopting new technological advances often depends on other firms' decisions to do likewise. In this case, the gap between developed and developing countries occurs because the former have managed to overcome the coordination problem associated with development. By internalizing such transactions, often by using already established global supply networks, multinationals can overcome this coordination problem and provide the first step towards industrialization.

Moreover, by directly controlling firms, multinationals may be crucial links in the international dissemination of technological innovations and best practices. The recent growth literature emphasizes the importance of such international knowledge spillovers in increasing growth in all countries. Evidence suggests that FDI is an important vehicle for the transfer of technology, contributing relatively more to growth than domestic investment, although these benefits may hold only if the host country has a minimum threshold stock of human capital.

FDI may have additional advantages in developing countries, particularly over portfolio investment. The ability to own a foreign firm directly rather than through stock holdings may increase the incentive to invest in countries that offer investment opportunities but little domestic entrepreneurial experience. Furthermore, since the commitments involved in direct ownership imply greater adjustment costs than under stock ownership, FDI can create a more stable overall investment atmosphere by reducing the ease of capital flight and speculation that has plagued developing economies in South East Asia this past year. When investors are forced to weather financial storms, volatility in the country's markets and macroeconomic instability is reduced, which may help the storms to pass more quickly.

Benefits to the source country

Multinationals create trade by moving goods and services between parent and affiliate. This intra-firm trade accounts for a growing share of U.S. trade: in 1995 it accounted for 26 percent of exports and 17 percent of imports. In theory, this need not represent "new" trade: normal firm level transfers would simply be manifest in the balance of payments. However, it appears that on net, foreign direct investment leads to increased trade. In 1977, almost __of affiliate exports were to the parent, and over __ percent of imports were from the parent. By 1995, affiliate exports had grown __ percent, but only __ percent of those affiliate exports were to the parent, suggesting growth in sales overseas. Likewise, imports by overseas affiliates . . . . This can be considered a benefit in itself, by promoting the interchange of goods.

Intra-firm trade also runs a trade surplus, so that U.S. multinationals export more abroad to their affiliates than they import from them. This suggests that, on balance, rather than outsourcing production (which would create an intra-firm trade deficit equal to the value added overseas), shipments to foreign affiliates most likely represent exports that are finished or marketed overseas in the target market. In the rapidly changing world environment, firms hoping to enter foreign markets are increasingly coming to realize that establishing a direct presence in those markets may be the best way compete.

CURRENT INITIATIVES

Evidence has shown that a stable policy environment is a good determinant of the amount of FDI a country attracts. Countries that are prone to nationalization, corruption, and political instability are less likely to receive foreign investment, while those that protect foreign investors and intellectual property rights do better in attracting investment. Multinational activity is more likely the more similar are the home and foreign markets, suggesting benefits to achieving multilateral standards for investment rules.

Under the auspices of the OECD, the United States has joined other countries in beginning negotiations for a Multilateral Agreement on Investment (MAI), with "high standards for the liberalization of investment regimes and investment protection, and with effective dispute settlement procedures." The goal is that the MAI eliminate discrimination in investment by achieving a uniform set of rules for all signatories, thereby removing market-distortions, and facilitating the overall process of foreign investment.

The MAI is being negotiated principally among the 29 OECD countries that account for [a lot] of worldwide FDI flows. However, the MAI is designed as a free-standing international treaty, to which other nations may accede. Currently, over 600 bilateral investment treaties (BITs) exist, primarily between developed and developing countries. To date, the United States has signed 40 of these (see Box). By doing so, the United States has been able to establish deeper agreements more quickly with more countries than it could by negotiating a single agreement with all countries. Even negotiation of the MAI, among similar countries with similar objectives, has been difficult at times. However, once the MAI is completed, it is likely that many other countries will be able to join the MAI as well.

Another recent initiative has been the international effort to combat corruption. Corruption is a particular problem in many developing countries, and may offset the other benefits to multinationals associated with locating in those countries. One recent estimate equated the effects of corruption to as much as a 20 percent point increase in the marginal tax rate for foreign investors. Given the benefits of FDI to both source and host country, this significant disincentive to investment is likely to have a negative impact on the welfare of both countries. It has had important legal ramifications for U.S. investors abroad, since under the Foreign Corrupt Practices Act it is already illegal to bribe foreign officials, making it even more difficult to legally establish and maintain businesses in countries with pervasive corruption.

This past December, the member countries of the OECD finalized a draft treaty to outlaw bribery of foreign public officials. Holding multinational corporations of all nationalities to similar standards will put pressure on individuals in foreign governments to abide by legal and transparent procedures in doing business with foreign companies, rather than allowing them to promote a "race to the ethical bottom" among companies seeking government contracts or licensing. It is hoped that establishing a common set of rules, and reducing the corruption abroad, will act as an incentive to foreign direct investment, bringing increased benefits to both host and source country.

Box: Fears and Facts about Foreign Direct Investment

In the 1980s there was concern that the rapid increase of foreign direct investment in the United States would have adverse effects on employment, as foreign controlled affiliates in the United States displaced U.S. firms and workers. Ironically, during the 1990s, when net FDI flows turned outward, there was equal concern that U.S. companies would begin "outsourcing" much of their production to other countries, at the expense of jobs at home. This seeming contradiction—that inward and outward FDI might each affect U.S. employment the same way—reflects how little was actually known about the effect of FDI.

Unlike trade, which has been the subject of study and speculation for hundreds of years, there has been little rigorous study of foreign direct investment until recently. However, as more studies have been performed, and more learned about FDI, many of these initial fears have subsided. The following are some fears that have been recently expressed about how FDI may undermine the U.S. economy, and the facts that we now know.

Fear: *Won't U.S. industries leave for low wage developing countries?* During the NAFTA debate, there was concern that lowering the barriers to investment with Mexico would result in a large movement of U.S. industry to Mexico, as firms exploited the low wages in that country in production.
Fact: There has been no rapid movement of U.S. industry to Mexico, or to any other low wage countries. This is because of a very simple rule: "there is no free lunch." Wages may vary significantly across countries, but studies show that cross-country real wage differences are tightly linked to productivity differences, just as economic theory would predict. There is no reason for a firm to move production to a country with lower wages if there is corresponding lower productivity. The vast majority of U.S. FDI continues to be with other OECD countries, so it is likely that market access considerations, and not low-wage "outsourcing," is behind the majority of FDI.

Fear: *Are U.S. firms investing abroad exporting jobs?* Even if firms are not leaving the United States for developing countries, FDI is becoming increasingly commonplace. It seems reasonable that a firm that hires workers in an overseas affiliate is contributing to U.S. unemployment, since they could be hiring a U.S. worker to do the same job here.
Fact: Evidence shows that generally this is not the case: increases in employment in U.S. foreign affiliates are most often associated with increases in domestic employment in the parent as well. Employment substitution seems to occur offshore between countries competing for FDI, and not between the U.S. and the affiliate country. Rather than exporting jobs, it appears that creating jobs overseas creates jobs at home as well.

Fear: *Isn't U.S. FDI abroad lost domestic investment?* A similar argument suggests that the capital invested abroad by firms increases foreign production and competitiveness and reduces the total amount of investment in the U.S.
Fact: This argument is flawed theoretically because the decision by firms whether to invest is not independent of their choice of location. The fact that the firm is not investing in the U.S. indicates that it might not invest at all if FDI were not an option. Moreover, the capital outflows associated with FDI seem to have little effect on the aggregate level of U.S. investment: Over the past [ ] years, the correlation of outward FDI with net investment in the U.S. is only [ ]. In any case,
FDI outflows account for only about 1 percent of U.S. gross investment, and are largely compensated by investment inflows from abroad. In fact, evidence suggests that an increase in FDI raises total investment more than one for one, implying a complementarity between the investment decisions of domestic and foreign firms. As most direct investment occurs reciprocally between the U.S. and other OECD countries, this suggests exchanging direct investment increases the total level of investment in all countries.

In short, opponents of FDI have framed it as a zero-sum venture, where one country gains only at the expense of another. However, both the theoretical arguments of the benefits of FDI, and the light of evidence now available, suggest that foreign direct investment can represent a net gain for all parties.

Box: Differences in Wages Related to Industry

Economic theory tells us that workers who possess the same productive characteristics ought to receive equivalent compensation. However, there is a long, fairly stable pattern of differences in compensation across industries. The following table illustrates some of these differences.

Industry Compensation Premia
(% by which industry compensation - wages plus benefits - exceed the national average, accounting for worker characteristics)

Top 10		Bottom 10	
Petroleum	53.3	Leather	-11.8
Tobacco	42.6	Repair services	-12.3
Communications	37.1	Entertainment	-14.9
Public Utilities	34.2	Apparel	-15.0
Transportation Equip	28.2	Other retail trade	-17.3
Mining	27.7	Education services	-19.4
Primary Metals	26.2	Personal services	-22.3
Chemical	23.1	Eating and Drinking	-28.3
Paper	19.9	Welfare services	-32.8
Machinery, excl elec.	18.2	Private household	-50.8

This table implies that a worker in the petroleum industry with a given set of characteristics (for instance, education, race, location) will receive compensation that is about 53 percent higher than would the average workers with similar characteristics. Similarly, workers engaged in the provision of private household services will receive compensation that is 51 percent below the national average for similar workers.

Sources

There is no single reason for these wage differences. However, a number of possible explanations do present themselves:

- *Unobserved productivity differences*: the extent to which we are able to assess the productive characteristics of workers is limited in survey data. If firms provide their workers with training that makes them more productive on the job, their wages would likely be higher than the average

- *Compensating wage differentials*: the work environment tends to vary across industries. It may be more pleasant to work in some industries and less so in others. Workers in unhealthy or dangerous environments, for instance, may receive compensation that exceeds the average.

- *Efficiency wages*: paying higher wages can increase worker productivity on the job. It can also reduce the probability that workers will quit. To the extent that the benefits of higher wages differ across industries, compensation levels will differ.

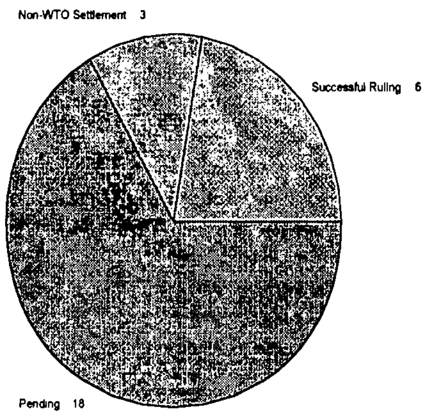
- *Monopoly rents*: the degree of competition varies across industries and consequently so does the profitability of firms in different industries. Workers may be able to obtain some fraction of the profits in the form of higher compensation. Differences in both the profitability of firms and the bargaining power of workers can give rise to differences in compensation across industries.

It is possible that the higher wages received in export-oriented jobs are due to unobserved skills that these workers possess. However, if these skills are acquired through on-the-job training and experience in the industry, the higher wages still represent a benefit to employment in export related industries relative to employment in other industries.

Box: U.S. Trade Policy and the WTO Dispute Settlement Body

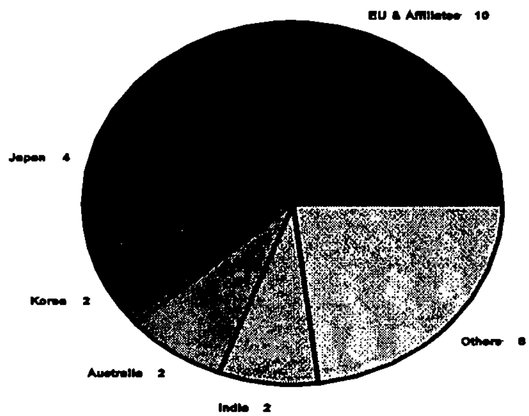
The introduction of a strengthened multilateral dispute settlements system in the WTO and new WTO agreements covering the protection of intellectual property rights and trade in services has brought about a shift in U.S. tactics for resolving trade disputes. During the 1980s, the United States resorted to the unilateral Section 301 provisionsof U.S. trade law to resolve differences with other countries. Beginning in 1995, however, the DSU has displaced the unilateral process for ensuring appropriate access to foreign markets for U.S. exports. Since early 1995, the United States has requested WTO action in 27 cases, as compared to ?? independent Section 301 cases. As displayed below, the process has been very effective with the United States being handed only one negative ruling among eight rulings to date. The use of Section 301 is now closely tied to multilateral dispute settlement, at least for disputes with WTO members and in areas subject to WTO commitments. With the exception of a dispute with China, a non-WTO member, all seven Section 301 actions initiated by the U.S. during 1996, as well as two earlier investigations, have been referred to the WTO dispute settlement body.

Chart 7-x caption line 1 **Status of WTO Disputes**



Source USTR

Chart 7-x caption line 1 **Target Countries in U.S.-Initiated Dispute Settlement Proceedings**



Source: USTR

The WTO Dispute Settlement Understanding (DSU) expedites decision making, institutes an appeals process, and establishes procedures to facilitate the implementation of panel rulings, an important aspect of which is the acceptance of cross-sector retaliation by WTO members. In the three years since its institution, many countries have made efficient use of the DSU, largely to the satisfaction of everybody involved.

Box: Bilateral Investment Treaties

For much of the last decade, the United States has been actively pursuing the negotiation of Bilateral Investment Treaties (BITs) with emerging markets around the world. These BITs provide for U.S. investments the better of national or most favored nation treatment with respect to the following:

- prompt, adequate, and effective compensation in the event of an expropriation;
- freedom to transfer all funds associated with an investment;
- access to international arbitration for investment disputes;
- the right to hire top managerial personnel of the investor's choice; and
- limitations on performance requirements.

By negotiating national or most favored nation treatment for investments, the treaty ensures, in the case of national treatment, that U.S. investors are treated in a manner equivalent to domestic investors, in the case of most favored nation treatment, U.S. investors are assured treatment no worse than investors from any third country. To date, the United States has successfully negotiated investment treaties with some 37 countries and is actively engaged in pursuing a multilateral version of the treaty under the auspices of the OECD.

Countries with whom the U.S. has a B.I.T.

Year in which B.I.T. approved

Argentina	1994	Mongolia	1997
Azerbaijan	1993	Morocco	1991
Bangladesh	1989	Panama	1991
Bulgaria	1994	Poland	1994
Cameroon	1989	Romania	1994
Congo	1994	Senegal	1990
Czech Republic	1992	Slovakia	1992
Egypt	1992	Sri Lanka	1993
Estonia	1996	Trinidad & Tobago	1996
Granada	1989	Tunisia	1993
Kazakstan	1994	Turkey	1990
Kyrgyzstan	1994	Ukraine	1996
Latvia	1996	Zaire	1989
Moldova	1994		

Pending B.I.T.s

Albania	Honduras
Belarus	Jamaica
Croatia	Nicaragua
Ecuador	Russia
Georgia	Uzbekistan

Box: APEC Members and Initiatives

Although formal regional negotiations over tariff reductions have not yet taken place, many countries within the APEC forum have already implemented dramatic reductions in tariff levels. Between 1988 and 1996, the average applied tariff in the APEC region fell by more than one third, from 15.4% to 9.1%.

Country	Tariff Rate (%) (Simple Average)	
	1988	1996
Australia	15.6	6.1
Brunei	3.9	2.0
Canada	9.1	6.7
Chile	19.9	10.9
China	40.3	23.0
Hong Kong	0.0	0.0
Indonesia	20.3	13.1
Japan	7.2	9.0
Korea, South	19.2	7.9
Malaysia	13.0	9.0
Mexico	10.6	12.5
New Zealand	15.0	7.0
Philippines	27.9	15.6
Singapore	0.4	0.0
Taiwan	12.6	8.6
Thailand	40.8	17.0
United States	6.6	6.4
Average	**15.4**	**9.1**

The progressive lowering of tariff barriers is but one aspect of the APEC Action Agenda. This Agenda details steps that APEC members will follow to promote greater international interaction throughout the region. Other aspects include reducing barriers to competition in the fast-growing air transport market and a variety of measures designed to reduce the cost of doing business in the region: the development of an infrastructure opportunity database, the promotion of uniform customs classifications and procedures, and the development of more significant standards harmonization.

Box: Building Blocks or Stumbling Blocks

Does regionalism generate greater momentum for multilateral liberalization or less. There are compelling arguments that regionalism can build either stumbling or building blocks to the multilateral process.

Stumbling Blocks

- *Optimal Tariff.* Perhaps the most compelling theoretical force for protectionism is the optimal tariff argument. This argument is basically that by imposing tariffs, a country may be able to achieve more favorable terms of trade with the rest of the world. By acting together, a set of countries may be more successful at generating more favorable terms of trade than if they were to act alone. The reason is that they have greater market power when acting together than when acting independently. Fortunately, Article 24 of the GATT governing regional trading arrangements, prohibits increases in tariffs against non-members. The Uruguay Round extended the same principle to services as well as goods under the GATS.

- *Special Interests.* Special interests may be able to manipulate technical aspects of a free trade area (such as exemptions, phase-outs, and rules of origin) to their advantage. This manipulation may be inconsistent with broader multilateral negotiations.

Building Blocks

- *Locked-in Reforms.* By entering into the NAFTA, Mexico's President hoped to prevent future regimes from undoing the unilateral liberalization of the 1980s. Mexico's reaction to the Peso crisis of 1994-95 bore out this lock-in effect. In contrast to the 1982 debt crisis when Mexico raised barriers against all its trading barriers, in 1995, Mexico continued to reduce its import barriers for its NAFTA partners.

- *Smaller Numbers of Negotiating Units.* Negotiating among 150 countries, over dozens of sectors, can be inefficient and difficult. It is more efficient if smaller countries can join into customs unions and thus negotiate as a larger unit. Also, it may be easier to test out agreements in special areas -- such as services, investment, dispute settlement, and competition policy-- among a subset of countries prior to their introduction into multilateral negotiations.

- *Competitive Liberalizations.* In 1993, President Clinton is said to have made a triple play. By pushing NAFTA through Congress, the President revealed a political will that, combined with the upgrading of APEC negotiations to a high profile leaders' meeting, signaled to the Europeans that the United States may have found liberalization sufficient to obviate the need for a conclusion to the Uruguay Round of GATT negotiations. German policymakers have reportedly confirmed that this was part of their motivation for concluding the negotiations in December of 1993.

There are both positive and negative links between regionalism and multilateral negotiations. Every regional bloc will have its share of each. In the end, however, the evidence suggests that the recent growth of regionalism has served to foster progress toward liberalization more generally. Those groups of countries that ahve participated in regional liberalization have often tended to reduce their barriers against non-members at the same time that they do so internally.

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CHAPTER ONE
Promoting Prosperity in a High Employment Economy

The economic expansion entered its 82nd month in January 1998, making it the second-longest peacetime expansion in history. Moreover, growth and job creation remained vigorous without triggering higher inflation. Over the past year, real gross domestic product (GDP) grew 3.x percent and the number of jobs rose by an average of 2xx,000 per month. The unemployment rate dropped below 5 percent for the first time in 24 years, yet core inflation (measured by the consumer price index excluding the volatile food and energy components) averaged only 2.x percent in 1997—its lowest rate in over 30 years.

At the beginning of 1998, the prospects for continued growth with high employment and low inflation remain excellent. The economy is remarkably free of the kinds of imbalances that often presage an economic downturn. One of the most common danger signs is rising inflation, whether due to an overheating of the economy or a foreign price shock, such as the oil price increases of the 1970s. But inflation fell in 1997, and the most likely external price shock would be a reduction in inflation due to developments in East Asia. Turmoil in East Asia does represent a cloud on the horizon, but the main effect of events there may be to bring U.S. growth down to a more sustainable rate without a rise in interest rates. Another sign that an expansion may be nearing its end is a sudden accumulation of inventories as businesses find their sales falling short of production. But sales were strong in 1997 and inventories do not appear excessive. In terms of potential financial imbalances, banks and other financial institutions do not appear overextended, as they did in the late 1980s and early 1990s. And the stock market shrugged off a nasty one-day plunge in October—though its continuing high valuation relative to earnings is a source of concern to some observers. It would be foolish to assume from the current sunny economic outlook that the business cycle has been vanquished forever. But it is appropriate to regard the economy as in fundamentally sound shape and well-equipped to handle unexpected bouts of rougher weather.

One major reason the economy is in good shape for the future is that the Federal budget deficit has been reduced substantially. The length and strength of the current expansion have played an important role in reducing the deficit. But the possible effects of policies taken to reduce the deficit on the character of the expansion should not be overlooked. It is noteworthy, for example, how much the current expansion reflects growth in private—rather than public—demand for goods and services, particularly investment. Almost none of the growth in GDP since 1991 has come from increased government purchases, whereas more than two-fifths has come from greater gross private domestic investment. The contribution of government spending is much lower than in previous postwar expansions and the contribution of private investment has been much higher.

It is tempting for policymakers to take all the credit for the economy's recent successes. And a case certainly can be made that policies such as deficit reduction have contributed toward creating an investment-led recovery and a climate conducive to sustained economic growth. But the lion's share of the credit for the economy's performance must go—as it always must—to American workers and firms, who have risen to the challenges of a new global economy driven by competition and technology. The role of government in such an economy is not to provide the direct spending impetus for economic growth, but, more subtly, to provide individuals and businesses with the tools they need in order to thrive and flourish through their own efforts. The range of appropriate government policies in such an economy includes promoting private investment, encouraging the formation of skills through training and education, securing opportunity for marginalized members of our society, and—where necessary—providing assistance to those who, through no fault of their own, are unable to maintain a standard of living that is a basic right of all Americans. Using government to complement—not replace—the market and the private sector has been a fundamental, guiding principle of this Administration's economic strategy from the very beginning. And it is this strategy that has borne fruit in

It is also tempting to conclude that having achieved high employment, policymakers can rest on their laurels. In fact, a host of challenges remain despite the economy's recent performance. This Chapter considers in greater detail what needs to be done next in order to ensure that the economy's success is built upon and continued, and presents the Administration's proposals for achieving its two basic, overarching goals—securing high and rising living standards now and in the future, and ensuring that the benefits of a higher standard of living are extended to all Americans.

THE ADMINISTRATION'S ECONOMIC STRATEGY

The enactment of the Employment Act of 1946, which created the Council of Economic Advisers, gave the Federal government responsibility for stabilizing short-run economic fluctuations and promoting strong, noninflationary economic growth and low unemployment in the long run. This Administration's pursuit of this mandate has been based on a strategy that has focused on getting the fundamentals right—reducing the budget deficit, investing in technology, infrastructure, and the American people, and opening markets at home and abroad. These were the right policies for encouraging the job creation needed to move the economy to full employment, and they are the right policies for attacking the longer-term problems that have plagued the economy since the early 1970s—sluggish productivity growth and widening income inequality.

But there is more to the Administration's policy agenda than can be measured by aggregate economic statistics alone. Getting the fundamentals right means removing barriers that block individuals from realizing their potential; it means promoting their sense of individual responsibility and giving them the tools to succeed. Getting the fundamentals right also means promoting a sense of community, which includes racial harmony and a sense of responsibility for our children. It means fostering personal commitment to helping others, and ensuring national prosperity.

A Credible Plan for Deficit Reduction

The key economic milestones reached in 1997 vindicate the policy course that was set in 1993. At that time, the economy was just beginning to recover from the 1990-91 recession, but labored under the burden of a Federal budget deficit that had ballooned to $290 billion, its highest level ever. The linchpin of the Administration's strategy for recovery was a credible deficit reduction plan that was large enough to achieve substantial fiscal retrenchment over the longer term, yet balanced and gradual enough to allow the economy to gather strength and move toward full employment in the shorter term. The success of this program rested on achieving an interest rate environment conducive to investment that would allow the economy to grow in the face of an otherwise contractionary fiscal policy. This, in turn, required that financial markets be forward looking and (correctly) anticipate an appropriately accommodative monetary policy. In large measure, that is exactly what happened. Long-term interest rates fell to 25-year lows in 1993, spurring a pickup in economic growth. Since 1993, business fixed investment has grown at an average rate of #xx# percent per year, and has been responsible for roughly #xx# percent of overall GDP growth.

A key component of the Administration's deficit reduction plan was its credibility. A credible and realistic program for deficit reduction--one that observers and financial markets judged likely to be fully implemented--was a precondition for the reduction in interest rates that helped spur investment-led growth. A fundamental source of the plan's credibility involved predicating budgets on a set of economic projections that represented conservative, mainstream forecasts of future growth and inflation. These projections eschewed the "rosy scenarios" of previous budgets that invariably fell short of reality; they were not meant to indicate the best that the economy could do, but rather how the economy was most likely to perform given past experience. In fact, the economy's actual performance has been somewhat stronger than past Administration predictions.

The net result of deficit reduction has been the promotion of a more salubrious mix of fiscal and monetary policy. In the 1980s, expansive fiscal policy required relatively tight monetary policy in the form of high interest rates in order to prevent the economy from overheating. Even simple textbook models of the economy point out that this is the least favorable policy combination for the long term, however, since high interest rates impede capital formation, while burgeoning government deficits depress national savings and contribute to a larger current account deficit. And, deficit reduction has also had an important collateral benefit, namely, a restoration of Americans' confidence in the ability of their government to manage its own affairs.

Investing in People, Technology, and Public Capital

The purpose of deficit reduction is to encourage investment. Hence, the Clinton Administration recognized from the outset that a plan that balanced the budget at the expense of the government's own investments would be ultimately self-defeating. To that end, the Administration has given investment in people, technology, and public capital a major role in its economic agenda.

The government invests in people by promoting public health and safety, encouraging opportunity and individual responsibility, and assisting in the formation of human capital through education and training. This last function--investment in education and training--is especially vital today. In today's high-technology economy, having a skilled workforce is an essential condition for future economic growth. And, education and training programs are of particular importance in today's economic environment as a way of promoting greater income equality.

The return to education have risen dramatically since the late 1970s; today, highly skilled workers command a far greater premium in the labor market than their less-skilled counterparts. This has been an important contributing factor to the overall rise in earnings inequality that has occurred since the late 1970s. Today, investment in education is one that pays particularly high returns, and the government has an important role to play in ensuring that all Americans have the opportunity to accumulate the skills that are necessary for economic success. This requires initiatives to improve public education at the primary and secondary levels, as well as programs to make higher education accessible. It also requires recognition of the fact that learning must be a lifelong activity in an economy where rapid technological change is a commonplace.

Investing in basic research and the development of new technologies is another important function of government. The private sector spends billions every year on research and development. But economic theory suggests that private-sector spending in these areas will be too low--the benefits of a new scientific discovery, for example, are not merely enjoyed by the discoverer, but by society as a whole. Moreover, new theories of economic growth place a special emphasis on advances in knowledge through research and development as the motive force behind long-run increases in living standards. If this is true, an implication is that the return to government investment in research and technology is likely to be especially high.

Finally, government investment can take the form of investment in physical capital. The government creates and maintains a network of infrastructure--roads, bridges, waterworks, and suchlike--that is a critical input to private-sector production. The returns on infrastructure investment need not be higher than the returns on private capital in order to give it an important claim on government resources, since infrastructure investment is the particular province and responsibility of government. In addition, maintaining the Nation's existing stock of infrastructure may well yield large benefits for each dollar of expenditure. Promoting Federal and state investment in infrastructure--and ensuring that each dollar of infrastructure investment is well spent--must be a priority for policymakers.

Opening Markets at Home and Abroad

A third major component of the Administration's economic agenda is its efforts to promote freer and more competitive markets at home and abroad. Domestically, this has involved the pursuit of initiatives directed not only toward fostering competition, but also toward reducing the burden of government regulation and ensuring that new regulations meet their goals in as cost-effective a manner as possible. It has also meant addressing market failures in such areas as the provision of health care and pollution and other forms of environmental degradation. In some cases, the effect of these policies is to raise the *level* of output by promoting greater efficiency and reducing costs. But these policies can also lead to faster economic growth. For example, past experience provides evidence that sensible deregulation policies have not only helped raise efficiency, but have spurred innovation through greater competition.

Much government regulation affects industries in which technological change causes the nature of market competition to change rapidly. A key precept of this administration's approach to regulation, therefore, is the notion that the regulatory process must be a dynamic one, in which regulatory policies are constantly reviewed in order to minimize their burden on consumers and businesses. Another important precept involves eschewing policies that rely on regulation through government fiat in favor of policies that use market-based incentive structures in order to attain a desired outcome. Experience with such policies as permit trading for sulfur-dioxide emissions suggests that this method can provide a powerful means for ensuring that compliance with socially beneficial goals is obtained efficiently and cost-effectively.

This Admininstration has also worked hard to open markets abroad, by encouraging fairer and freer international trade. From his earliest days in office, President Clinton has advocated an outward-looking, "internationalist" trade policy. During the first four years of the Clinton Administration, over 200 trade agreements were implemented, some relatively large in scope--such as NAFTA and the Uruguay Round of GATT--others relatively small, but all vital to the Nation's competitive future.

Economists generally recognize two broad classes of benefits from an open economy, the first being static, the second dynamic. First, trade helps an economy by allowing it to specialize in what it does best--a point that economists have made since the 18th century. Even if a country is more efficient than its neighbors at producing *every* good it consumes, it can still benefit from trade by specializing in the production of goods in which it is *relatively* more efficient, and then trading its surplus production for whatever else it wants to consume. In addition, a new view of international trade has recently emerged which argues that increased trade actually raises an economy's *rate of growth* (Box 1-x). If this is in fact true, it makes the case for trade liberalization even more compelling, since raising the economy's growth rate--even by a few tenths of a percentage point per year--has vastly more significance for long-run living standards than even a relatively large one-off increase in the level of output.

Box 1-x: *New Trade Theory and the Benefits of International Trade*

Economists have long realized that economic growth has two sources. An economy can either increase the amount of inputs (capital, labor, and raw materials) that it feeds into the productive process, or it can make those inputs more productive, through innovations in technology, better education and training, and so on. In fact, this latter factor is necessary if the economy is to grow in per-capita terms in the long run, as ooner or later simply accumulating more inputs will run uip against the law of diminishing returns.

The classical theory of free trade emphasizes the *one-time* gains that obtain from an increase in this latter factor: specialization lets an economy allocate labor and capital to the productions of goods that it is relatively good at producing, making a given amount of labor and capital more productive in a manner that is not unlike an improvement in managerial technique. Hence, moving from a situation in which there less trade (or no trade) raises the level of output--though it might take a number of years for the benefits from trade to be fully felt. These static gains from trade can be quite significant: for example, one economic historian argued that most of the economic growth that occurred in the classical world was rooted in the expansion of markets that resulted from increased sea trade around the Mediterranean.

The new view of international trade also focusses on this second factor, but argues that freer international trade can actually increase the rate of innovation and technological change. One economist has summarized this argument with the following catena:

International trade leads to greater competition;
Competition induces greater innovation; and,
Innovation (*i.e.*, technological change) drives economic growth.

In a sense, the emphasis of the new trade theory on the dynamic benefits of international trade comes full circle to Adam Smith, who is recognized as one of the fathers of classical trade theory. Smith pointed out that the specialization that results from free trade could foster innovation by acquainting workers with a specific productive process, thus giving them insight into how such processes could be improved. New trade theory also incorporates elements of Joseph Schumpter's theory of "creative destruction," in which competition serves as a motive force for the economy's progress.

New trade theory represents a valuable contribution to academic economics. Recently, it has received empirical confirmation as well. Studies that examine what drives economic growth across countries have found that an economy's degree of openness--as proxied, say, by the amount that it imports and exports relative to its overall output--has an effect on its rate of growth.

A RECORD OF ACCOMPLISHMENT

Focussing on the fundamentals in shaping economic policy has paid off by helping to produce an economy that is stronger than it has been in years. This past year alone saw the unemployment rate drop to its lowest level in a generation, the forging of a budget agreement that promises to bring the deficit under control for the first time in decades, and significant advances in this Administration's economic agenda along other fronts.

Returning to a High-Pressure Economy

The expansion in output and employment that characterized the second half of 1993 persisted and strengthened in 1994, with very strong growth in business fixed investment serving as a key factor in driving the expansion. This robust growth led to a series of monetary policy tightenings over the course of 1994, which were reflected in more moderate growth in 1995.

In retrospect, 1995 may have been the pause that refreshes. As 1994 opened, a number of observers had begun to express concern that continued strong economic growth might soon overheat the economy, even though inflation was relatively quiescent. Prevailing wisdom about the relationship between inflation and the unemployment rate suggested that inflation would begin to rise if the unemployment rate dropped below 6 percent, and it had already fallen to 6.4 percent by the end of 1993. Thus, the increase in short-term interest rates over the course of 1994 and early 1995 could be seen as an attempt to restrain demand pressures and hold growth close to its long-term potential. After falling to 5.4 percent by the end of 1994, the unemployment rate remained relatively flat through 1995. Economic growth picked up in 1996, exceeding expectations, and strong growth has continued through 1997. This strong growth has produced a high-pressure economy conducive to overcoming the longer-term problems of growth and distribution that built up in the 1970s and 1980s.

Returning the economy to full employment yields a direct benefit by ensuring that the economy's resources--human and material--are not squandered by needless cyclical unemployment. On average, reducing the unemployment rate by a percentage point raises output by approximately two percent; in 1997, two percent of GDP equalled $160 billion, or roughly $600 for every American--man, woman, and child. Wasted resources from not producing at potential--together with the human cost of unemployment--are intolerable, and the elimination of this waste is the principal benefit of a sustained return to full employment.

But a high-pressure economy also yields benefits that exceed these significant gains in aggregate employment and output. It also seems plausible that short-term economic conditions can affect long-term structural unemployment, and although the idea that the natural rate of unemployment can increase as a result of a recession is generally used to explain labor-market conditions in European countries, the same phenomenon might well exist in the United States (albeit perhaps in a less widespread and more hidden form). 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. Running a high-pressure economy, therefore, 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.

The need today is greater than ever. For years, the ability of the economy to reduce poverty through growth alone has been hampered by the presence of a significant headwind: sustained declines in wages at the lowest end of the earnings distribution over the past two decades have acted to offset the benefits of an expanding economy for the poorest Americans. Over the 1980s, for example, real wages at the lowest decile of the earnings distribution actually *declined*, while .It is no longer the case that holding a job ensures that a less-skilled worker will be able to exit poverty.

Keeping the economy at full employment is also necessary if we are to be successful in moving current welfare recipients into the workforce. Early, indirect evidence here is encouraging: employment and participation rates among women who maintain families--about 61 percent of whom have children under 18--have increased in the past few years. This is partially the result of policy, namely, the recent institution of welfare-reform measures: the greatest acceleration in employment rates occurred among those single women who were most likely to be affected by welfare reform, namely, single mothers with young children. Nevertheless, it is obvious that an economy in which job opportunities are plentiful plays a crucial part in aiding the transition from welfare to work.

We have begun to see heartening signs that this expansion is distributing overall gains in living standards to all Americans, especially those at the bottom of the income distribution. The pretax poverty rate fell to 13.7 percent in 1996, down from 15.1 percent in 1993. Similarly, the poverty rate for African-Americans is at an historical low, while unemployment among African-Americans fell to its lowest rate in 24 years in 1997. In 1996, income grew in each quintile of the income distribution, with the largest percentage increase going to the poorest members of our society. Maintaining a full-employment economy is essential if this progress is to continue.

Deficit Reduction: Completing the Task

The most significant policy event of 1997 was the passage of a deficit reduction package that ensures that the Federal budget will be in surplus no later than 2002. This will be the first balanced budget since 1969, and only the ninth since World War Two.

An important component of the balanced budget agreement is the institution of a tax cut for middle class families. The Taxpayer Relief Act of 1997, which the President signed into law on August 5th, will provide a reduction in taxes for 27 million families in the form of a $500 per child tax credit. This credit will benefit 45 million children under age 17, and is targetted to the middle class and poor--the credit is phased out for couples making more than $110,000 and single-parent families making more than $75,000. Importantly, the child tax credit is "stacked" before the Earned Income Tax Credit, which means that 7.5 million children in working families with incomes below $30,000 and no post-EITC tax liability will benefit from the credit. And, the credit can be applied to the post-EITC tax liability of families with two children or more.
[Talk more about distributional effects?]

Some have claimed that the economy deserves all of the credit for vanquishing the deficit. It is certainly true that business-cycle fluctuations have an important effect on government revenues and outlays, leading to short-term fluctuations in the deficit. Economists therefore consider the "full-employment," or "structural" budget deficit--which corrects for the cyclical position of the economy--to be a more useful guide to the underlying state of fiscal policy. But even when these cyclical factors are accounted for, it is evident that policy has played a major role in bringing the deficit under control. In January of 1993, before the deficit reduction package was adopted, the Federal defict was projected to remain well in excess of $200 billion even after it was assumed that the economy was at full employment. Likewise, calculations that take actual history into account indicate that the deficit in fiscal year 1997 would have been $347 billion had there been no change in policy. While improvements in economic conditions have definitely played a part in reducing the deficit, we would not now be within striking range of a balanced budget had we stayed on the fiscal course that was set in 1992.

Considering the structural deficit also drives home an important point regarding surpluses. If economic activity rises in excess of its long-run trend, then the actual deficit will fall below its structural level, as a result of a transitory increase in receipts and decrease in outlays. Responding to this short-run improvement in the deficit with a change in policy--such as a tax cut--may not be sensible if the government's goal is long-term budget balance. Estimates indicate that the unadjusted structural deficit will not vanish until 2002, the same year that the budget enters surplus. Any surpluses that arise over the next several years, therefore, should not be treated as permanent.

Policies to Raise Growth, Reduce Inequality, and Increase Opportunity

The recent success that the Administration has enjoyed in advancing its economic agenda has not been confined to the sphere of deficit reduction. As described above, a significant component of the Administration's economic agenda involves investment in people--in a broad sense, that encompasses education and training, health, and extending opportunity to all Americans. A number of policies have been put in place in order to ensure that these goals are met.

<u>Education</u>

The budget that the President signed into law in the Fall of 1997 made funds available for initiatives that, together, comprise the largest investment in education in 30 years. These initiatives attempt to improve the quality and accessibility of primary, secondary, *and* higher education.

Higher education is a particular priority. The earnings of a college graduate have risen sharply relative to those of a worker with a high-school education. In today's economy, a college degree has become as vital for success as a high-school diploma was a generation ago. Even post-high school education that does not lead to a bachelor's degree (such as an associate's degree or vocational or technical training) boosts earnings by nearly as much (in percentage terms) as does completing high school.

Moreover, learning must be a life-long process. A fundamental characteristic of our economy is rapid technological change. While this holds the promise of greater living standards for all, it reqires workers to adopt to employers' demands for well-trained, skilled workers. It is therefore critical to ensure that all individuals--including those not traditionally thought of as "school age"--have access to additional educaiton or training.

The President's higher education initiatives, which were enacted into law as a part of the recent budget agreement, reflect these principles. Specific measures include:

° *The largest Pell Grant increase in 20 years:* The maximum Pell grant is increased by over 10 percent, to $3,000. Approximately 3.7 million students will receive the increase, and close to a quarter of a million families will become eligible for the grant.

° *HOPE Scholarships for post-high school education:* In his State of the Union speech on February 14, 1997, the President called for making the 13th and 14th years of education as universal as a high school education is today. The HOPE scholarship accomplishes this by providing a tax credit for higher education expenses of as much as $1,500, which is enough to cover tuition at a typical community college.

° *A Tuition Tax Credit for all Americans:* A 20 percent tax credit for post-high school tuition expenses will be available for the first $5,000 of qualified educational expenses. (After 2002, the credit can be applied to the first $10,000 in expenses.) Importantly, this tax credit is made available to school-age Americans as well as those already working, in order to permit workers to upgrade their skills at any time during their life.

° *Tax exemptions for employer-provided education benefits:* Section 127 of the tax code is extended for three years, allowing workers to exclude up to $5,250 of employer-provided educational benefits from their taxable income.

° *A tax deduction for student loan interest:* Up to $2,500 of interest payments on loans for higher education expenses will be tax deductible in any given tax year.

Because public education in the United States is largely administered by local authorities, the Federal government's ability to influence primary and secondary education is somewhat less direct. Nevertheless, this Administration recognizes that there is much that the Federal government *can* do in order to influence the quality of our public schools, and has worked for the passage of programs which will ensure that our children have access to the best possible primary and secondary education. These initiatives include:

° *Establishing national standards:* Research shows that students in countries that have standardized, mandatory examination programs do better than students in countries that do not. The Administration's voluntary national testing program has received full funding, which will allow for the development and pilot testing of national fourth-grade reading and eighth-grade mathematics examinations.

° *Expansion of Head Start:* Funding for Head Start was raised by $374 million, to $4.4 billion, in order to reach the Administration's goal of having one million children in the Head Start program by 2002. Since 1993, funding for Head Start has increased by 57 percent; the program will serve over 800,000 children and their families in 1998.

° *A comprehensive literacy strategy ("America Reads"):* Every child should be able to read by the third grade. In order to ensure that this basic goal can be met, the President's comprehensive literacy strategy will receive nearly $300 million in new funding. State teacher training and family literacy efforts will receive an additional $41 million, while $210 million will be earmarked for prending legislation based on the President's America Reads Initiative.

° *Increased funding for charter schools:* The President set a goal of having 3,000 locally designed public charter schools in operation by early next century. Funding for charter schools has been increased by over 50 percent, which will allow the Department of Education to support nearly 1,000 charter schools by the end of 1998.

Health

Promoting the health of our citizens is a moral duty, but also represents an investment that pays off handsomely in that small interventions--particularly at young ages--can lead to significant reductions in future healthcare expenditures. Under President Clinton's Children's Health Initiative, up to five million currently uninsured children will receive healthcare coverage, including pharmaceuticals, vision and hearing screening, and mental health services. This represents the single largest investment in child health care since Medicaid was begun in 1965.

In addition, this Administration has overseen the reform of the Food and Drug Administration ...

Finally, the Administration has taken the first steps toward ensuring that Medicare remains viable. Structural reforms--such as extended choice among health care plans, changes to annual Medigap enrollment, and the restructure of certain payment systems--will help save $115 billion over five years. Recently passed legislation also provides additional funding for preventative measures, such as expanded coverage for mammograms, that can help to keep healthcare expenses down by catching and treating health problems before they become serious. These and other measures will keep the Medicare trust fund solvent for at least the next decade; meanwhile, a commission has been set up in order to examine long-term solutions to the problem of Medicare viability.

Welfare Reform and Poverty Alleviation

Welfare reform presents an ongoing challenge: to ensure that our neediest citizens can maintain the basic standard of living that is the right of all Americans without creating incentives that in turn encourage a life of dependency. This Administration has committed itself to a policy that combines work incentives and community efforts in order to move people off the welfare rolls and into employment. The result has been the largest reduction in welfare rolls in history.

Any attempt at welfare reform must recognize that long-term changes in the wage structure imply that some will be unable to raise themselves out of poverty even with a full-time job. Moreover, if we are to make work pay, we must guarantee workers a minimum level of earnings. The Administration has therefore made an expansion of the Earned Income Tax Credit, which raises the pay of low-income workers who have children--together with an increase in the minimum wage--a cornerstone of its antipoverty strategy (Box 1-x).

Although the welfare rolls have shrunk significantly since this Administration began its plan to "end welfare as we know it," much remains to be done. President Clinton has called for further reducing the number of people on welfare by two million over the next two years. To that end, two additional initiatives have been put in place in order to advance this Administration's strategy for welfare reform. First, a tax credit for employers that hire long-term welfare recipients has been established; this rebates up to $3,500 in wages in the first year and up to $5,000 in the second, thus encouraging businesses to hire and retain former welfare recipients. Second, $3 billion has been earmarked for the Welfare to Work Job Challenge Fund, which will assist states and communities in moving long-term welfare recipients into lasting, unsubsidized employment. A hallmark of this fund is that it is targetted to areas

Box 1-x: *Poverty Alleviation, the Earned Income Tax Credit, and the Minimum Wage*

A typical cash assistance program guarantees a given amount of money to those who receive no income, and then phases out this benefit as income--that is, labor income--rises. Such a program discourages work, and these work disincentives have been a major concern--perhaps *the* major concern--of policymakers. Today, policymakers have concluded that there is really no way to correct these disincentives *so long as we confine ourselves to considering policies that are similar to the cash assistance program just outlined.* We therefore have to broaden the menu of policies that are up for consideration.

One way to avoid the work disincentive effects of the canonical cash assistance program involves constructing a program that subsidizes the wages of low-income workers. This type of program has recently been expanded as part of the government's current welfare reform initiative, and is known as an "earned income tax credit," or EITC. Under the EITC, low-wage workers with children receive a credit against their earned-income tax liability; this credit is rebated in cash if the worker's tax liability is zero.

An EITC-style program differs from a typical cash assistance program in that benefits are zero under the EITC for those who do not work and rise as earnings increase (up to some threshold earnings level). The EITC therefore largely eliminates the disincentive effects that face low-wage workers in the standard cash assistance program.

The minimum wage complements and interacts with an EITC-style program in an important way. Using the minimum wage by itself in order to guarantee a subsistence level of income is problematic in that it requires the minimum wage to be very high, which discourages employment. On the other hand, using the EITC alone in order to guarantee an income floor requires payment of a large subsidy that must then be phased out slowly in order to minimize disincentive effects. This makes the program much more costly. Hence, the minimum wage and the EITC must be employed jointly in designing an optimal assistance package.

that are most in need of poverty alleviation.

Policies to Strengthen Our Cities and Communities

Finally, this Administration has ensured that the Federal government invests in our cities and communities with:

° *A threefold increase in the number of empowerment zones:* Twenty new empowerment zones (15 urban and 5 rural) are added, bringing the total number to 31.

° *Additional funding for Community Development Banks:* Community Development Financial Institutions make investment capital and other financial products available to low-and moderate-income communities. Recent legislation adds $80 million in additional funding for CDFIs.

° *Establishment of the "brownfields" tax incentive program:* The Brownfields program creates tax incentives for the restoration of contaminated urban land. These incentives will leverage more than $6 billion for nationwide private-sector cleanups and the redevelopment of 14,000 contaminated, abandoned sites in economically distressed urban communities.

Strengthening the Performance of Markets

During the past year, the Administration also implemented a number of policies that advance its goal of more open and competitive markets.
[describe highlights of antitrust and micro chapter, e.g. five principles from tobacco settlement]

Promoting an Environmental Agenda That Is Economically Sound

International trade

Progress was also made over the past year in opening foreign markets to U.S. goods as a number of important international trade initiatives were finalized. First, the Information Technology Agreement (ITA) was concluded; this will completely eliminate tariffs on a large array of information technology products in which U.S. firms tend to be highly competitive. While domestic tariffs on these products were low or zero, Asian tariffs averaged around 30 percent, implying that the ITA will significantly advance American firms' competitiveness in Asian markets. The United States also concluded an agreement covering financial services that will foster broad liberalization of banking, securities, and insurance, along with a key agreement to liberalize basic telecommunications sectors (telephone services).

[N.B.: I would prefer not to discuss China MFN; also, it's more of a foreign policy area than an economic one...]

FACING THE CHALLENGES AHEAD

In many ways, the U.S. economy today is very different from the economy in which our parents and grandparents found themselves. Today, #xx# percent of families are headed by a single parent, as compared to #zz# percent #yy# years ago. The nature of the labor market has changed significantly; few today expect to be working for the same employer--or even to be in the same career--when they retire. Industry has also changed radically: in the 1950s, the information technology industry barely existed; today, it employs a larger share of the labor force than the auto industry did at its height **[check this]**. And, our population is aging, implying that there will be fewer workers for every retiree in the next century.

Hence, this Administration's economic agenda is an open one, in recognition of the fact that change is the only constant of economic life. If the American economy is to maintain its preeminence as the strongest and most dynamic economy in the world, policymakers and citizens will have to meet and overcome a number of challenges in the 21st century.

Two specific challenges currently face this Administration and Congress. First, the new balanced-budget act left two long-run issues largely unaddressed, namely, Social Security and Medicare reform. In the case of Medicare, some progress was made in addressing the program's immediate problems. But, necessity and time considerations dictated a delay of the comprehensive reforms that are required in order to ensure Medicare's long-term viability.

Likewise, Social Security reform remains an open issue.

Beginning in 2012, the government will be unable to pay for current Social Security benefits out of currently collected payroll taxes. The government then faces several options, singly or in combination: It can reduce benefits until they are in line with current collections; it can raise payroll taxes in order to cover an unchanged level of benefits; and/or it can finance Social Security from other parts of the budget, by raising other taxes besides the payroll tax, cutting expenditures on other programs, or allowing the budget deficit to increase--*i.e.*, borrowing in order to make up for the shortfall. The Social Security "crisis" that so many refer to simply refers to the fact that one or more of these situations will occur absent any changes to the present system.

The seriousness of the problem facing the Social Security system should not be downplayed. However, it is worth noting that the problem is far from insurmountable. First, even if the government were to do absolutely nothing, it would still be able to permanently finance roughly 75 percent of benefits out of currently received payroll taxes after the Social Security Trust Fund is exhausted. Second, if the government wanted to maintain existing benefits by raising taxes, it could do so indefinitely by increasing the current payroll tax by roughly 4.7 percentage points. This would represent an increase in the share of total payroll taxes in GDP of less than two percentage points, phased in over a very long period of time--about 40 years. By way of comparison, the reduction in defense expenditures that took place after the Cold War ended represented a larger share of GDP and took place over a much shorter period of time. Finally, the situation is much better in the United States than in most other industrialized countries, particularly Japan, where a much larger fraction of the population is heading for retirement. While it will not be easy to find a solution to the problems facing Social Security, the facts suggest that these problems will admit of eventual solution.

Medicare reform presents a somewhat thornier problem, both in terms of its complexity and its scale. Unlike Social Security, Medicare promises the delivery of a service--health insurance--as opposed to the provision of benefits in the form of a fixed payment of money. An additional complicating factor is that government has little influence in practice over the rate of increase of the cost of providing this service, which has largely been driven by technological advances in medical care. Higher costs for medical care are projected to account for the bulk of the increase in Medicare expenditures for the next 25 years or so, after which the aging of the baby-boom generation will act to raise expenditures through increases in program enrollment. Hence, any long-term reform will have to involve slowing the growth of health care prices as well as the volume and intensity of use of covered services, neither of which can be done easily.

The recently concluded budget legislation acted to address the pressing short-term problems facing Medicare. Prior to this legislation, the trust fund for the component of Medicare that covers hospital costs was projected to fall to zero in 2001. The current reforms will delay the trust fund's depletion until fiscal year 2007. The legislation also calls for the establishment of a bipartisan commission to assess and recommend the structural changes that will need to be implemented in order to ensure Medicare's continued viability.

A second major policy challenge involves continuing the drive for more open international markets. The pace with which preferential trade agreements are being negotiated between and among countries around the world is fast, and the United States could easily be left behind through inaction. Since 1992, other nations have negotiated 20 preferential trade agreements in Latin America and Asia that exclude the United States. The European Union has begun a process that will culminate in a free trade agreement with Brazil, Argentina, and other MERCOSUR nations; the President of one European nation has even gone so far as to declare that he economic interests of Latin America lie with Europe, and not the United States. Within South America itself, the four MERCOSUR nations are attempting to extend their preferential trade arrangements to encompass the entire continent. It is clear that now, more than ever, continued engagement will require an active effort on the part of the United States.

In 1997, the President's authority to negotiate trade agreements on a "fast track" basis was temporarily postponed. This reflects a more general backlash against free trade that traces its roots to several factors, including perhaps the perception that free trade hurts American workers and contributes to the U.S. trade deficit.

It is true that some will be hurt by more open markets. in an ideal world--the world in which economists live--free trade unambiguously benefits the economy *taken as a whole*. This is true in the real world as well, although the ideal case masks the fact that some will gain from freer trade, but others may lose--even though on net the winners could compensate the losers and still have something left over. In practice, increased globalization will induce reallocations of labor and capital across sectors as the focus of American industry moves to the production of those goods and services which we are relatively good at producing. Because our economy is not frictionless, these adjustments sometimes involve lengthy periods of dislocation until the reallocation of labor and capital across industries is complete.

Policymakers advocating freer trade must be aware of this fact, and the Clinton Administration has realized from the beginning that it is the government's duty to minimize the impact of this dislocation by speeding up the adjustment process however it can. For example, one of the key provisions of NAFTA involved monitoring those industries that were in danger of being adversely affected by the free trade agreement, and the Administration committed itself early on to providing for dislocated workers through retraining programs. And, more generally, the Administration's commitment to investing in people through education and training serves as a strong complement to its policy of trade liberalization: since freer trade tends to benefit skilled workers most, the United States enjoys greater benefits from trade to the extent that more of its workers are highly skilled.

In addition, the benefits of free trade do not, as is sometimes supposed, manifest themselves as an improved overall current account or trade balance. Economic policies do indeed affect the current account, but it is budget, saving, and investment policies, not trade liberalization policies, that do so. The current account is a macroeconomic phenomenon that reflects the gap between what we as a nation invest and what we save. The large budget deficits of the 1980s and early 1990s reduced the amount of saving that was available to cover the nation's investment in plant and equipment (investment was reduced as well, but not by as much), and this shortfall had to be filled by importing goods from abroad. In an important sense, the nation was overconsuming in the 1980s, financing its consumption binge by borrowing output from foreigners. The result was a large and persistent trade deficit.

Today, we still face a trade deficit, but for a very different reason. Reducing the government's budget deficit has left more room for investment in plant and equipment by the private sector. And invest it has: since 1993, real business fixed investment has grown nearly nine percent per year on average, a much faster rate than that of the preceding ten years. This rate of investment is above the rate at which Americans save--even with the federal government dissaving less by virtue of its smaller budget deficit. So, once again the shortfall is made up for by borrowing output from abroad, with the result being a current account deficit. But there is a big difference between borrowing in order to invest--as the economy is doing now--and borrowing in order to consume, as we did in the 1980s. In fact, running a trade deficit in order to expand the nation's productive capacity is not new to American history--in the 1800s, we did much the same thing in order to build up the nation's infrastructure, most notably during the railroad construction boom a century ago. Ironically, therefore, the trade deficit reflects the economy's current success in growing more rapidly than our trading partners and investing so much--and *not* our free trade policies.

We face more general challenges as well in shaping economic policies for the 21st century. First, we must act to help families address the problems that they face in today's economy. More families are faced with the need to juggle the demands of the workplace with the demands of home. We must act to ease this burden by ensuring that families have access to quality childcare and healthcare. Policymakers must also ensure that policies are in place to support working families when they are forced to change jobs or occupations as a result of economic change. We must also continue to invest in our children. This, of course, means investing in education, but it also means investing in a broader sense. Today, far too many children--roughly one in five--are in families that are below the poverty line. The consequences of this for these children's future development--and, therefore, for the future of the Nation--are profound. Chapter # of this year's *Economic Report* considers these issues in greater detail. **[add more on families/children chapter?]**

Finally, this country's long-standing goal of achieving racial equality has not yet been reached. Trends in racial equality are influenced by long-term adverse economic trends, such as the increase in income inequality across workers with different skills. (Chapter # of this *Report* provides **[fill in short description of race chapter]**.) But it is still the case that, on average, a white worker will receive a wage that is 13 percent higher than an identically skilled nonwhite. This means that more is needed to promote racial equality; to that end, this Administration has pledged itself toward furthering a dialogue on race in America.

CONCLUSION

The United States economy currently enjoys the best of both worlds: high growth and low unemployment combined with low and stable inflation. And the success of Americans in adapting to the new economy in which they find themselves has been truly remarkable. But that success--and the economy's present strong condition--cannot be taken for granted. Recent developments do not herald the end of inflation, the conquest of the business cycle, or the complete reversal of such secular trends as weak productivity growth or rising income inequality that have been in place for over a generation. Rather, there will still be ups and downs and long-term changes that will demand action by individuals and governments alike. This Administration has put in place a set of policies that has allowed the economy to grow and flourish—in particular by putting the Nation's fiscal house in order. But we must continue to pursue sound policies aimed at opening markets at home and abroad, promoting private and public investment, and ensuring that all Americans, regardless of age or origin, have the skills they need to prosper in a world of change and opportunity.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 5-JAN-1998 09:54:45.00

SUBJECT: Chapter 1

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

TEXT:
Attached is a first draft of Chapter 1 by Jeremy and Chad. I have given a first round of comments and there are some holes. It would be good to have your reactions. We need to get out a draft for comments by the end of the week.=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
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The following is a HEX DUMP:

CHAPTER ONE
Promoting Prosperity in a High Employment Economy

The economic expansion entered its 82nd month in January 1998, making it the second-longest peacetime expansion in history. Moreover, growth and job creation remained vigorous without triggering higher inflation. Over the past year, real gross domestic product (GDP) grew 3.x percent and the number of jobs rose by an average of 2xx,000 per month. The unemployment rate dropped below 5 percent for the first time in 24 years, yet core inflation (measured by the consumer price index excluding the volatile food and energy components) averaged only 2.x percent in 1997—its lowest rate in over 30 years.

At the beginning of 1998, the prospects for continued growth with high employment and low inflation remain excellent. The economy is remarkably free of the kinds of imbalances that often presage an economic downturn. One of the most common danger signs is rising inflation, whether due to an overheating of the economy or a foreign price shock, such as the oil price increases of the 1970s. But inflation fell in 1997, and the most likely external price shock would be a reduction in inflation due to developments in East Asia. Turmoil in East Asia does represent a cloud on the horizon, but the main effect of events there may be to bring U.S. growth down to a more sustainable rate without a rise in interest rates. Another sign that an expansion may be nearing its end is a sudden accumulation of inventories as businesses find their sales falling short of production. But sales were strong in 1997 and inventories do not appear excessive. In terms of potential financial imbalances, banks and other financial institutions do not appear overextended, as they did in the late 1980s and early 1990s. And the stock market shrugged off a nasty one-day plunge in October—though its continuing high valuation relative to earnings is a source of concern to some observers. It would be foolish to assume from the current sunny economic outlook that the business cycle has been vanquished forever. But it is appropriate to regard the economy as in fundamentally sound shape and well-equipped to handle unexpected bouts of rougher weather.

One major reason the economy is in good shape for the future is that the Federal budget deficit has been reduced substantially. The length and strength of the current expansion have played an important role in reducing the deficit. But the possible effects of policies taken to reduce the deficit on the character of the expansion should not be overlooked. It is noteworthy, for example, how much the current expansion reflects growth in private—rather than public—demand for goods and services, particularly investment. Almost none of the growth in GDP since 1991 has come from increased government purchases, whereas more than two-fifths has come from greater gross private domestic investment. The contribution of government spending is much lower than in previous postwar expansions and the contribution of private investment has been much higher.

It is tempting for policymakers to take all the credit for the economy's recent successes. And a case certainly can be made that policies such as deficit reduction have contributed toward creating an investment-led recovery and a climate conducive to sustained economic growth. But the lion's share of the credit for the economy's performance must go—as it always must—to American workers and firms, who have risen to the challenges of a new global economy driven by competition and technology. The role of government in such an economy is not to provide the direct spending impetus for economic growth, but, more subtly, to provide individuals and businesses with the tools they need in order to thrive and flourish through their own efforts. The range of appropriate government policies in such an economy includes promoting private investment, encouraging the formation of skills through training and education, securing opportunity for marginalized members of our society, and—where necessary—providing assistance to those who, through no fault of their own, are unable to maintain a standard of living that is a basic right of all Americans. Using government to complement—not replace—the market and the private sector has been a fundamental, guiding principle of this Administration's economic strategy from the very beginning. And it is this strategy that has borne fruit in

It is also tempting to conclude that having achieved high employment, policymakers can rest on their laurels. In fact, a host of challenges remain despite the economy's recent performance. This Chapter considers in greater detail what needs to be done next in order to ensure that the economy's success is built upon and continued, and presents the Administration's proposals for achieving its two basic, overarching goals—securing high and rising living standards now and in the future, and ensuring that the benefits of a higher standard of living are extended to all Americans.

THE ADMINISTRATION'S ECONOMIC STRATEGY

The enactment of the Employment Act of 1946, which created the Council of Economic Advisers, gave the Federal government responsibility for stabilizing short-run economic fluctuations and promoting strong, noninflationary economic growth and low unemployment in the long run. This Administration's pursuit of this mandate has been based on a strategy that has focused on getting the fundamentals right—reducing the budget deficit, investing in technology, infrastructure, and the American people, and opening markets at home and abroad. These were the right policies for encouraging the job creation needed to move the economy to full employment, and they are the right policies for attacking the longer-term problems that have plagued the economy since the early 1970s—sluggish productivity growth and widening income inequality.

But there is more to the Administration's policy agenda than can be measured by aggregate economic statistics alone. Getting the fundamentals right means removing barriers that block individuals from realizing their potential; it means promoting their sense of individual responsibility and giving them the tools to succeed. Getting the fundamentals right also means promoting a sense of community, which includes racial harmony and a sense of responsibility for our children. It means fostering personal commitment to helping others, and ensuring national prosperity.

A Credible Plan for Deficit Reduction

The key economic milestones reached in 1997 vindicate the policy course that was set in 1993. At that time, the economy was just beginning to recover from the 1990-91 recession, but labored under the burden of a Federal budget deficit that had ballooned to $290 billion, its highest level ever. The linchpin of the Administration's strategy for recovery was a credible deficit reduction plan that was large enough to achieve substantial fiscal retrenchment over the longer term, yet balanced and gradual enough to allow the economy to gather strength and move toward full employment in the shorter term. The success of this program rested on achieving an interest rate environment conducive to investment that would allow the economy to grow in the face of an otherwise contractionary fiscal policy. This, in turn, required that financial markets be forward looking and (correctly) anticipate an appropriately accommodative monetary policy. In large measure, that is exactly what happened. Long-term interest rates fell to 25-year lows in 1993, spurring a pickup in economic growth. Since 1993, business fixed investment has grown at an average rate of #xx# percent per year, and has been responsible for roughly #xx# percent of overall GDP growth.

A key component of the Administration's deficit reduction plan was its credibility. A credible and realistic program for deficit reduction--one that observers and financial markets judged likely to be fully implemented--was a precondition for the reduction in interest rates that helped spur investment-led growth. A fundamental source of the plan's credibility involved predicating budgets on a set of economic projections that represented conservative, mainstream forecasts of future growth and inflation. These projections eschewed the "rosy scenarios" of previous budgets that invariably fell short of reality; they were not meant to indicate the best that the economy could do, but rather how the economy was most likely to perform given past experience. In fact, the economy's actual performance has been somewhat stronger than past Administration predictions.

The net result of deficit reduction has been the promotion of a more salubrious mix of fiscal and monetary policy. In the 1980s, expansive fiscal policy required relatively tight monetary policy in the form of high interest rates in order to prevent the economy from overheating. Even simple textbook models of the economy point out that this is the least favorable policy combination for the long term, however, since high interest rates impede capital formation, while burgeoning government deficits depress national savings and contribute to a larger current account deficit. And, deficit reduction has also had an important collateral benefit, namely, a restoration of Americans' confidence in the ability of their government to manage its own affairs.

Investing in People, Technology, and Public Capital

The purpose of deficit reduction is to encourage investment. Hence, the Clinton Administration recognized from the outset that a plan that balanced the budget at the expense of the government's own investments would be ultimately self-defeating. To that end, the Administration has given investment in people, technology, and public capital a major role in its economic agenda.

The government invests in people by promoting public health and safety, encouraging opportunity and individual responsibility, and assisting in the formation of human capital through education and training. This last function--investment in education and training--is especially vital today. In today's high-technology economy, having a skilled workforce is an essential condition for future economic growth. And, education and training programs are of particular importance in today's economic environment as a way of promoting greater income equality.

The return to education have risen dramatically since the late 1970s; today, highly skilled workers command a far greater premium in the labor market than their less-skilled counterparts. This has been an important contributing factor to the overall rise in earnings inequality that has occurred since the late 1970s. Today, investment in education is one that pays particularly high returns, and the government has an important role to play in ensuring that all Americans have the opportunity to accumulate the skills that are necessary for economic success. This requires initiatives to improve public education at the primary and secondary levels, as well as programs to make higher education accessible. It also requires recognition of the fact that learning must be a lifelong activity in an economy where rapid technological change is a commonplace.

Investing in basic research and the development of new technologies is another important function of government. The private sector spends billions every year on research and development. But economic theory suggests that private-sector spending in these areas will be too low--the benefits of a new scientific discovery, for example, are not merely enjoyed by the discoverer, but by society as a whole. Moreover, new theories of economic growth place a special emphasis on advances in knowledge through research and development as the motive force behind long-run increases in living standards. If this is true, an implication is that the return to government investment in research and technology is likely to be especially high.

Finally, government investment can take the form of investment in physical capital. The government creates and maintains a network of infrastructure--roads, bridges, waterworks, and suchlike--that is a critical input to private-sector production. The returns on infrastructure investment need not be higher than the returns on private capital in order to give it an important claim on government resources, since infrastructure investment is the particular province and responsibility of government. In addition, maintaining the Nation's existing stock of infrastructure may well yield large benefits for each dollar of expenditure. Promoting Federal and state investment in infrastructure--and ensuring that each dollar of infrastructure investment is well spent--must be a priority for policymakers.

Opening Markets at Home and Abroad

A third major component of the Administration's economic agenda is its efforts to promote freer and more competitive markets at home and abroad. Domestically, this has involved the pursuit of initiatives directed not only toward fostering competition, but also toward reducing the burden of government regulation and ensuring that new regulations meet their goals in as cost-effective a manner as possible. It has also meant addressing market failures in such areas as the provision of health care and pollution and other forms of environmental degradation. In some cases, the effect of these policies is to raise the *level* of output by promoting greater efficiency and reducing costs. But these policies can also lead to faster economic growth. For example, past experience provides evidence that sensible deregulation policies have not only helped raise efficiency, but have spurred innovation through greater competition.

Much government regulation affects industries in which technological change causes the nature of market competition to change rapidly. A key precept of this administration's approach to regulation, therefore, is the notion that the regulatory process must be a dynamic one, in which regulatory policies are constantly reviewed in order to minimize their burden on consumers and businesses. Another important precept involves eschewing policies that rely on regulation through government fiat in favor of policies that use market-based incentive structures in order to attain a desired outcome. Experience with such policies as permit trading for sulfur-dioxide emissions suggests that this method can provide a powerful means for ensuring that compliance with socially beneficial goals is obtained efficiently and cost-effectively.

This Admininstration has also worked hard to open markets abroad, by encouraging fairer and freer international trade. From his earliest days in office, President Clinton has advocated an outward-looking, "internationalist" trade policy. During the first four years of the Clinton Administration, over 200 trade agreements were implemented, some relatively large in scope--such as NAFTA and the Uruguay Round of GATT--others relatively small, but all vital to the Nation's competitive future.

Economists generally recognize two broad classes of benefits from an open economy, the first being static, the second dynamic. First, trade helps an economy by allowing it to specialize in what it does best--a point that economists have made since the 18th century. Even if a country is more efficient than its neighbors at producing *every* good it consumes, it can still benefit from trade by specializing in the production of goods in which it is *relatively* more efficient, and then trading its surplus production for whatever else it wants to consume. In addition, a new view of international trade has recently emerged which argues that increased trade actually raises an economy's *rate of growth* (Box 1-x). If this is in fact true, it makes the case for trade liberalization even more compelling, since raising the economy's growth rate--even by a few tenths of a percentage point per year--has vastly more significance for long-run living standards than even a relatively large one-off increase in the level of output.

Box 1-x: *New Trade Theory and the Benefits of International Trade*

Economists have long realized that economic growth has two sources. An economy can either increase the amount of inputs (capital, labor, and raw materials) that it feeds into the productive process, or it can make those inputs more productive, through innovations in technology, better education and training, and so on. In fact, this latter factor is necessary if the economy is to grow in per-capita terms in the long run, as ooner or later simply accumulating more inputs will run uip against the law of diminishing returns.

The classical theory of free trade emphasizes the *one-time* gains that obtain from an increase in this latter factor: specialization lets an economy allocate labor and capital to the productions of goods that it is relatively good at producing, making a given amount of labor and capital more productive in a manner that is not unlike an improvement in managerial technique. Hence, moving from a situation in which there less trade (or no trade) raises the level of output--though it might take a number of years for the benefits from trade to be fully felt. These static gains from trade can be quite significant: for example, one economic historian argued that most of the economic growth that occurred in the classical world was rooted in the expansion of markets that resulted from increased sea trade around the Mediterranean.

The new view of international trade also focusses on this second factor, but argues that freer international trade can actually increase the rate of innovation and technological change. One economist has summarized this argument with the following catena:

International trade leads to greater competition;
Competition induces greater innovation; and,
Innovation (*i.e.*, technological change) drives economic growth.

In a sense, the emphasis of the new trade theory on the dynamic benefits of international trade comes full circle to Adam Smith, who is recognized as one of the fathers of classical trade theory. Smith pointed out that the specialization that results from free trade could foster innovation by acquainting workers with a specific productive process, thus giving them insight into how such processes could be improved. New trade theory also incorporates elements of Joseph Schumpter's theory of "creative destruction," in which competition serves as a motive force for the economy's progress.

New trade theory represents a valuable contribution to academic economics. Recently, it has received empirical confirmation as well. Studies that examine what drives economic growth across countries have found that an economy's degree of openness--as proxied, say, by the amount that it imports and exports relative to its overall output--has an effect on its rate of growth.

A RECORD OF ACCOMPLISHMENT

Focussing on the fundamentals in shaping economic policy has paid off by helping to produce an economy that is stronger than it has been in years. This past year alone saw the unemployment rate drop to its lowest level in a generation, the forging of a budget agreement that promises to bring the deficit under control for the first time in decades, and significant advances in this Administration's economic agenda along other fronts.

Returning to a High-Pressure Economy

The expansion in output and employment that characterized the second half of 1993 persisted and strengthened in 1994, with very strong growth in business fixed investment serving as a key factor in driving the expansion. This robust growth led to a series of monetary policy tightenings over the course of 1994, which were reflected in more moderate growth in 1995.

In retrospect, 1995 may have been the pause that refreshes. As 1994 opened, a number of observers had begun to express concern that continued strong economic growth might soon overheat the economy, even though inflation was relatively quiescent. Prevailing wisdom about the relationship between inflation and the unemployment rate suggested that inflation would begin to rise if the unemployment rate dropped below 6 percent, and it had already fallen to 6.4 percent by the end of 1993. Thus, the increase in short-term interest rates over the course of 1994 and early 1995 could be seen as an attempt to restrain demand pressures and hold growth close to its long-term potential. After falling to 5.4 percent by the end of 1994, the unemployment rate remained relatively flat through 1995. Economic growth picked up in 1996, exceeding expectations, and strong growth has continued through 1997. This strong growth has produced a high-pressure economy conducive to overcoming the longer-term problems of growth and distribution that built up in the 1970s and 1980s.

Returning the economy to full employment yields a direct benefit by ensuring that the economy's resources--human and material--are not squandered by needless cyclical unemployment. On average, reducing the unemployment rate by a percentage point raises output by approximately two percent; in 1997, two percent of GDP equalled $160 billion, or roughly $600 for every American--man, woman, and child. Wasted resources from not producing at potential--together with the human cost of unemployment--are intolerable, and the elimination of this waste is the principal benefit of a sustained return to full employment.

But a high-pressure economy also yields benefits that exceed these significant gains in aggregate employment and output. It also seems plausible that short-term economic conditions can affect long-term structural unemployment, and although the idea that the natural rate of unemployment can increase as a result of a recession is generally used to explain labor-market conditions in European countries, the same phenomenon might well exist in the United States (albeit perhaps in a less widespread and more hidden form). 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. Running a high-pressure economy, therefore, 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.

The need today is greater than ever. For years, the ability of the economy to reduce poverty through growth alone has been hampered by the presence of a significant headwind: sustained declines in wages at the lowest end of the earnings distribution over the past two decades have acted to offset the benefits of an expanding economy for the poorest Americans. Over the 1980s, for example, real wages at the lowest decile of the earnings distribution actually *declined*, while .It is no longer the case that holding a job ensures that a less-skilled worker will be able to exit poverty.

Keeping the economy at full employment is also necessary if we are to be successful in moving current welfare recipients into the workforce. Early, indirect evidence here is encouraging: employment and participation rates among women who maintain families--about 61 percent of whom have children under 18--have increased in the past few years. This is partially the result of policy, namely, the recent institution of welfare-reform measures: the greatest acceleration in employment rates occurred among those single women who were most likely to be affected by welfare reform, namely, single mothers with young children. Nevertheless, it is obvious that an economy in which job opportunities are plentiful plays a crucial part in aiding the transition from welfare to work.

We have begun to see heartening signs that this expansion is distributing overall gains in living standards to all Americans, especially those at the bottom of the income distribution. The pretax poverty rate fell to 13.7 percent in 1996, down from 15.1 percent in 1993. Similarly, the poverty rate for African-Americans is at an historical low, while unemployment among African-Americans fell to its lowest rate in 24 years in 1997. In 1996, income grew in each quintile of the income distribution, with the largest percentage increase going to the poorest members of our society. Maintaining a full-employment economy is essential if this progress is to continue.

Deficit Reduction: Completing the Task

The most significant policy event of 1997 was the passage of a deficit reduction package that ensures that the Federal budget will be in surplus no later than 2002. This will be the first balanced budget since 1969, and only the ninth since World War Two.

An important component of the balanced budget agreement is the institution of a tax cut for middle class families. The Taxpayer Relief Act of 1997, which the President signed into law on August 5th, will provide a reduction in taxes for 27 million families in the form of a $500 per child tax credit. This credit will benefit 45 million children under age 17, and is targetted to the middle class and poor--the credit is phased out for couples making more than $110,000 and single-parent families making more than $75,000. Importantly, the child tax credit is "stacked" before the Earned Income Tax Credit, which means that 7.5 million children in working families with incomes below $30,000 and no post-EITC tax liability will benefit from the credit. And, the credit can be applied to the post-EITC tax liability of families with two children or more. **[Talk more about distributional effects?]**

Some have claimed that the economy deserves all of the credit for vanquishing the deficit. It is certainly true that business-cycle fluctuations have an important effect on government revenues and outlays, leading to short-term fluctuations in the deficit. Economists therefore consider the "full-employment," or "structural" budget deficit--which corrects for the cyclical position of the economy--to be a more useful guide to the underlying state of fiscal policy. But even when these cyclical factors are accounted for, it is evident that policy has played a major role in bringing the deficit under control. In January of 1993, before the deficit reduction package was adopted, the Federal defict was projected to remain well in excess of $200 billion even after it was assumed that the economy was at full employment. Likewise, calculations that take actual history into account indicate that the deficit in fiscal year 1997 would have been $347 billion had there been no change in policy. While improvements in economic conditions have definitely played a part in reducing the deficit, we would not now be within striking range of a balanced budget had we stayed on the fiscal course that was set in 1992.

Considering the structural deficit also drives home an important point regarding surpluses. If economic activity rises in excess of its long-run trend, then the actual deficit will fall below its structural level, as a result of a transitory increase in receipts and decrease in outlays. Responding to this short-run improvement in the deficit with a change in policy--such as a tax cut--may not be sensible if the government's goal is long-term budget balance. Estimates indicate that the unadjusted structural deficit will not vanish until 2002, the same year that the budget enters surplus. Any surpluses that arise over the next several years, therefore, should not be treated as permanent.

Policies to Raise Growth, Reduce Inequality, and Increase Opportunity

The recent success that the Administration has enjoyed in advancing its economic agenda has not been confined to the sphere of deficit reduction. As described above, a significant component of the Administration's economic agenda involves investment in people--in a broad sense, that encompasses education and training, health, and extending opportunity to all Americans. A number of policies have been put in place in order to ensure that these goals are met.

Education

The budget that the President signed into law in the Fall of 1997 made funds available for initiatives that, together, comprise the largest investment in education in 30 years. These initiatives attempt to improve the quality and accessibility of primary, secondary, *and* higher education.

Higher education is a particular priority. The earnings of a college graduate have risen sharply relative to those of a worker with a high-school education. In today's economy, a college degree has become as vital for success as a high-school diploma was a generation ago. Even post-high school education that does not lead to a bachelor's degree (such as an associate's degree or vocational or technical training) boosts earnings by nearly as much (in percentage terms) as does completing high school.

Moreover, learning must be a life-long process. A fundamental characteristic of our economy is rapid technological change. While this holds the promise of greater living standards for all, it reqires workers to adopt to employers' demands for well-trained, skilled workers. It is therefore critical to ensure that all individuals--including those not traditionally thought of as "school age"--have access to additional educaiton or training.

The President's higher education initiatives, which were enacted into law as a part of the recent budget agreement, reflect these principles. Specific measures include:

° *The largest Pell Grant increase in 20 years:* The maximum Pell grant is increased by over 10 percent, to $3,000. Approximately 3.7 million students will receive the increase, and close to a quarter of a million families will become eligible for the grant.

° *HOPE Scholarships for post-high school education:* In his State of the Union speech on February 14, 1997, the President called for making the 13th and 14th years of education as universal as a high school education is today. The HOPE scholarship accomplishes this by providing a tax credit for higher education expenses of as much as $1,500, which is enough to cover tuition at a typical community college.

° *A Tuition Tax Credit for all Americans:* A 20 percent tax credit for post-high school tuition expenses will be available for the first $5,000 of qualified educational expenses. (After 2002, the credit can be applied to the first $10,000 in expenses.) Importantly, this tax credit is made available to school-age Americans as well as those already working, in order to permit workers to upgrade their skills at any time during their life.

° *Tax exemptions for employer-provided education benefits:* Section 127 of the tax code is extended for three years, allowing workers to exclude up to $5,250 of employer-provided educational benefits from their taxable income.

° *A tax deduction for student loan interest:* Up to $2,500 of interest payments on loans for higher education expenses will be tax deductible in any given tax year.

Because public education in the United States is largely administered by local authorities, the Federal government's ability to influence primary and secondary education is somewhat less direct. Nevertheless, this Administration recognizes that there is much that the Federal government *can* do in order to influence the quality of our public schools, and has worked for the passage of programs which will ensure that our children have access to the best possible primary and secondary education. These initiatives include:

° *Establishing national standards:* Research shows that students in countries that have standardized, mandatory examination programs do better than students in countries that do not. The Administration's voluntary national testing program has received full funding, which will allow for the development and pilot testing of national fourth-grade reading and eighth-grade mathematics examinations.

° *Expansion of Head Start:* Funding for Head Start was raised by $374 million, to $4.4 billion, in order to reach the Administration's goal of having one million children in the Head Start program by 2002. Since 1993, funding for Head Start has increased by 57 percent; the program will serve over 800,000 children and their families in 1998.

° *A comprehensive literacy strategy ("America Reads"):* Every child should be able to read by the third grade. In order to ensure that this basic goal can be met, the President's comprehensive literacy strategy will receive nearly $300 million in new funding. State teacher training and family literacy efforts will receive an additional $41 million, while $210 million will be earmarked for prending legislation based on the President's America Reads Initiative.

° *Increased funding for charter schools:* The President set a goal of having 3,000 locally designed public charter schools in operation by early next century. Funding for charter schools has been increased by over 50 percent, which will allow the Department of Education to support nearly 1,000 charter schools by the end of 1998.

Health

Promoting the health of our citizens is a moral duty, but also represents an investment that pays off handsomely in that small interventions--particularly at young ages--can lead to significant reductions in future healthcare expenditures. Under President Clinton's Children's Health Initiative, up to five million currently uninsured children will receive healthcare coverage, including pharmaceuticals, vision and hearing screening, and mental health services. This represents the single largest investment in child health care since Medicaid was begun in 1965.

In addition, this Administration has overseen the reform of the Food and Drug Administration ...

Finally, the Administration has taken the first steps toward ensuring that Medicare remains viable. Structural reforms--such as extended choice among health care plans, changes to annual Medigap enrollment, and the restructure of certain payment systems--will help save $115 billion over five years. Recently passed legislation also provides additional funding for preventative measures, such as expanded coverage for mammograms, that can help to keep healthcare expenses down by catching and treating health problems before they become serious. These and other measures will keep the Medicare trust fund solvent for at least the next decade; meanwhile, a commission has been set up in order to examine long-term solutions to the problem of Medicare viability.

Welfare Reform and Poverty Alleviation

Welfare reform presents an ongoing challenge: to ensure that our neediest citizens can maintain the basic standard of living that is the right of all Americans without creating incentives that in turn encourage a life of dependency. This Administration has committed itself to a policy that combines work incentives and community efforts in order to move people off the welfare rolls and into employment. The result has been the largest reduction in welfare rolls in history.

Any attempt at welfare reform must recognize that long-term changes in the wage structure imply that some will be unable to raise themselves out of poverty even with a full-time job. Moreover, if we are to make work pay, we must guarantee workers a minimum level of earnings. The Administration has therefore made an expansion of the Earned Income Tax Credit, which raises the pay of low-income workers who have children--together with an increase in the minimum wage--a cornerstone of its antipoverty strategy (Box 1-x).

Although the welfare rolls have shrunk significantly since this Administration began its plan to "end welfare as we know it," much remains to be done. President Clinton has called for further reducing the number of people on welfare by two million over the next two years. To that end, two additional initiatives have been put in place in order to advance this Administration's strategy for welfare reform. First, a tax credit for employers that hire long-term welfare recipients has been established; this rebates up to $3,500 in wages in the first year and up to $5,000 in the second, thus encouraging businesses to hire and retain former welfare recipients. Second, $3 billion has been earmarked for the Welfare to Work Job Challenge Fund, which will assist states and communities in moving long-term welfare recipients into lasting, unsubsidized employment. A hallmark of this fund is that it is targetted to areas

Box 1-x: *Poverty Alleviation, the Earned Income Tax Credit, and the Minimum Wage*

A typical cash assistance program guarantees a given amount of money to those who receive no income, and then phases out this benefit as income--that is, labor income--rises. Such a program discourages work, and these work disincentives have been a major concern--perhaps *the* major concern--of policymakers. Today, policymakers have concluded that there is really no way to correct these disincentives *so long as we confine ourselves to considering policies that are similar to the cash assistance program just outlined.* We therefore have to broaden the menu of policies that are up for consideration.

One way to avoid the work disincentive effects of the canonical cash assistance program involves constructing a program that subsidizes the wages of low-income workers. This type of program has recently been expanded as part of the government's current welfare reform initiative, and is known as an "earned income tax credit," or EITC. Under the EITC, low-wage workers with children receive a credit against their earned-income tax liability; this credit is rebated in cash if the worker's tax liability is zero.

An EITC-style program differs from a typical cash assistance program in that benefits are zero under the EITC for those who do not work and rise as earnings increase (up to some threshold earnings level). The EITC therefore largely eliminates the disincentive effects that face low-wage workers in the standard cash assistance program.

The minimum wage complements and interacts with an EITC-style program in an important way. Using the minimum wage by itself in order to guarantee a subsistence level of income is problematic in that it requires the minimum wage to be very high, which discourages employment. On the other hand, using the EITC alone in order to guarantee an income floor requires payment of a large subsidy that must then be phased out slowly in order to minimize disincentive effects. This makes the program much more costly. Hence, the minimum wage and the EITC must be employed jointly in designing an optimal assistance package.

that are most in need of poverty alleviation.

Policies to Strengthen Our Cities and Communities

Finally, this Administration has ensured that the Federal government invests in our cities and communities with:

° *A threefold increase in the number of empowerment zones:* Twenty new empowerment zones (15 urban and 5 rural) are added, bringing the total number to 31.

° *Additional funding for Community Development Banks:* Community Development Financial Institutions make investment capital and other financial products available to low-and moderate-income communities. Recent legislation adds $80 million in additional funding for CDFIs.

° *Establishment of the "brownfields" tax incentive program:* The Brownfields program creates tax incentives for the restoration of contaminated urban land. These incentives will leverage more than $6 billion for nationwide private-sector cleanups and the redevelopment of 14,000 contaminated, abandoned sites in economically distressed urban communities.

Strengthening the Performance of Markets

During the past year, the Administration also implemented a number of policies that advance its goal of more open and competitive markets.
[describe highlights of antitrust and micro chapter, e.g. five principles from tobacco settlement]

Promoting an Environmental Agenda That Is Economically Sound

International trade

Progress was also made over the past year in opening foreign markets to U.S. goods as a number of important international trade initiatives were finalized. First, the Information Technology Agreement (ITA) was concluded; this will completely eliminate tariffs on a large array of information technology products in which U.S. firms tend to be highly competitive. While domestic tariffs on these products were low or zero, Asian tariffs averaged around 30 percent, implying that the ITA will significantly advance American firms' competitiveness in Asian markets. The United States also concluded an agreement covering financial services that will foster broad liberalization of banking, securities, and insurance, along with a key agreement to liberalize basic telecommunications sectors (telephone services).

[N.B.: I would prefer not to discuss China MFN; also, it's more of a foreign policy area than an economic one...]

FACING THE CHALLENGES AHEAD

In many ways, the U.S. economy today is very different from the economy in which our parents and grandparents found themselves. Today, #xx# percent of families are headed by a single parent, as compared to #zz# percent #yy# years ago. The nature of the labor market has changed significantly; few today expect to be working for the same employer--or even to be in the same career--when they retire. Industry has also changed radically: in the 1950s, the information technology industry barely existed; today, it employs a larger share of the labor force than the auto industry did at its height **[check this]**. And, our population is aging, implying that there will be fewer workers for every retiree in the next century.

Hence, this Administration's economic agenda is an open one, in recognition of the fact that change is the only constant of economic life. If the American economy is to maintain its preeminence as the strongest and most dynamic economy in the world, policymakers and citizens will have to meet and overcome a number of challenges in the 21st century.

Two specific challenges currently face this Administration and Congress. First, the new balanced-budget act left two long-run issues largely unaddressed, namely, Social Security and Medicare reform. In the case of Medicare, some progress was made in addressing the program's immediate problems. But, necessity and time considerations dictated a delay of the comprehensive reforms that are required in order to ensure Medicare's long-term viability.

Likewise, Social Security reform remains an open issue.

Beginning in 2012, the government will be unable to pay for current Social Security benefits out of currently collected payroll taxes. The government then faces several options, singly or in combination: It can reduce benefits until they are in line with current collections; it can raise payroll taxes in order to cover an unchanged level of benefits; and/or it can finance Social Security from other parts of the budget, by raising other taxes besides the payroll tax, cutting expenditures on other programs, or allowing the budget deficit to increase--*i.e.*, borrowing in order to make up for the shortfall. The Social Security "crisis" that so many refer to simply refers to the fact that one or more of these situations will occur absent any changes to the present system.

The seriousness of the problem facing the Social Security system should not be downplayed. However, it is worth noting that the problem is far from insurmountable. First, even if the government were to do absolutely nothing, it would still be able to permanently finance roughly 75 percent of benefits out of currently received payroll taxes after the Social Security Trust Fund is exhausted. Second, if the government wanted to maintain existing benefits by raising taxes, it could do so indefinitely by increasing the current payroll tax by roughly 4.7 percentage points. This would represent an increase in the share of total payroll taxes in GDP of less than two percentage points, phased in over a very long period of time--about 40 years. By way of comparison, the reduction in defense expenditures that took place after the Cold War ended represented a larger share of GDP and took place over a much shorter period of time. Finally, the situation is much better in the United States than in most other industrialized countries, particularly Japan, where a much larger fraction of the population is heading for retirement. While it will not be easy to find a solution to the problems facing Social Security, the facts suggest that these problems will admit of eventual solution.

Medicare reform presents a somewhat thornier problem, both in terms of its complexity and its scale. Unlike Social Security, Medicare promises the delivery of a service--health insurance--as opposed to the provision of benefits in the form of a fixed payment of money. An additional complicating factor is that government has little influence in practice over the rate of increase of the cost of providing this service, which has largely been driven by technological advances in medical care. Higher costs for medical care are projected to account for the bulk of the increase in Medicare expenditures for the next 25 years or so, after which the aging of the baby-boom generation will act to raise expenditures through increases in program enrollment. Hence, any long-term reform will have to involve slowing the growth of health care prices as well as the volume and intensity of use of covered services, neither of which can be done easily.

The recently concluded budget legislation acted to address the pressing short-term problems facing Medicare. Prior to this legislation, the trust fund for the component of Medicare that covers hospital costs was projected to fall to zero in 2001. The current reforms will delay the trust fund's depletion until fiscal year 2007. The legislation also calls for the establishment of a bipartisan commission to assess and recommend the structural changes that will need to be implemented in order to ensure Medicare's continued viability.

A second major policy challenge involves continuing the drive for more open international markets. The pace with which preferential trade agreements are being negotiated between and among countries around the world is fast, and the United States could easily be left behind through inaction. Since 1992, other nations have negotiated 20 preferential trade agreements in Latin America and Asia that exclude the United States. The European Union has begun a process that will culminate in a free trade agreement with Brazil, Argentina, and other MERCOSUR nations; the President of one European nation has even gone so far as to declare that he economic interests of Latin America lie with Europe, and not the United States. Within South America itself, the four MERCOSUR nations are attempting to extend their preferential trade arrangements to encompass the entire continent. It is clear that now, more than ever, continued engagement will require an active effort on the part of the United States.

In 1997, the President's authority to negotiate trade agreements on a "fast track" basis was temporarily postponed. This reflects a more general backlash against free trade that traces its roots to several factors, including perhaps the perception that free trade hurts American workers and contributes to the U.S. trade deficit.

It is true that some will be hurt by more open markets. in an ideal world--the world in which economists live--free trade unambiguously benefits the economy *taken as a whole*. This is true in the real world as well, although the ideal case masks the fact that some will gain from freer trade, but others may lose--even though on net the winners could compensate the losers and still have something left over. In practice, increased globalization will induce reallocations of labor and capital across sectors as the focus of American industry moves to the production of those goods and services which we are relatively good at producing. Because our economy is not frictionless, these adjustments sometimes involve lengthy periods of dislocation until the reallocation of labor and capital across industries is complete.

Policymakers advocating freer trade must be aware of this fact, and the Clinton Administration has realized from the beginning that it is the government's duty to minimize the impact of this dislocation by speeding up the adjustment process however it can. For example, one of the key provisions of NAFTA involved monitoring those industries that were in danger of being adversely affected by the free trade agreement, and the Administration committed itself early on to providing for dislocated workers through retraining programs. And, more generally, the Administration's commitment to investing in people through education and training serves as a strong complement to its policy of trade liberalization: since freer trade tends to benefit skilled workers most, the United States enjoys greater benefits from trade to the extent that more of its workers are highly skilled.

In addition, the benefits of free trade do not, as is sometimes supposed, manifest themselves as an improved overall current account or trade balance. Economic policies do indeed affect the current account, but it is budget, saving, and investment policies, not trade liberalization policies, that do so. The current account is a macroeconomic phenomenon that reflects the gap between what we as a nation invest and what we save. The large budget deficits of the 1980s and early 1990s reduced the amount of saving that was available to cover the nation's investment in plant and equipment (investment was reduced as well, but not by as much), and this shortfall had to be filled by importing goods from abroad. In an important sense, the nation was overconsuming in the 1980s, financing its consumption binge by borrowing output from foreigners. The result was a large and persistent trade deficit.

Today, we still face a trade deficit, but for a very different reason. Reducing the government's budget deficit has left more room for investment in plant and equipment by the private sector. And invest it has: since 1993, real business fixed investment has grown nearly nine percent per year on average, a much faster rate than that of the preceding ten years. This rate of investment is above the rate at which Americans save--even with the federal government dissaving less by virtue of its smaller budget deficit. So, once again the shortfall is made up for by borrowing output from abroad, with the result being a current account deficit. But there is a big difference between borrowing in order to invest--as the economy is doing now--and borrowing in order to consume, as we did in the 1980s. In fact, running a trade deficit in order to expand the nation's productive capacity is not new to American history--in the 1800s, we did much the same thing in order to build up the nation's infrastructure, most notably during the railroad construction boom a century ago. Ironically, therefore, the trade deficit reflects the economy's current success in growing more rapidly than our trading partners and investing so much--and *not* our free trade policies.

We face more general challenges as well in shaping economic policies for the 21st century. First, we must act to help families address the problems that they face in today's economy. More families are faced with the need to juggle the demands of the workplace with the demands of home. We must act to ease this burden by ensuring that families have access to quality childcare and healthcare. Policymakers must also ensure that policies are in place to support working families when they are forced to change jobs or occupations as a result of economic change. We must also continue to invest in our children. This, of course, means investing in education, but it also means investing in a broader sense. Today, far too many children--roughly one in five--are in families that are below the poverty line. The consequences of this for these children's future development--and, therefore, for the future of the Nation--are profound. Chapter # of this year's *Economic Report* considers these issues in greater detail. **[add more on families/children chapter?]**

Finally, this country's long-standing goal of achieving racial equality has not yet been reached. Trends in racial equality are influenced by long-term adverse economic trends, such as the increase in income inequality across workers with different skills. (Chapter # of this *Report* provides **[fill in short description of race chapter]**.) But it is still the case that, on average, a white worker will receive a wage that is 13 percent higher than an identically skilled nonwhite. This means that more is needed to promote racial equality; to that end, this Administration has pledged itself toward furthering a dialogue on race in America.

CONCLUSION

The United States economy currently enjoys the best of both worlds: high growth and low unemployment combined with low and stable inflation. And the success of Americans in adapting to the new economy in which they find themselves has been truly remarkable. But that success--and the economy's present strong condition--cannot be taken for granted. Recent developments do not herald the end of inflation, the conquest of the business cycle, or the complete reversal of such secular trends as weak productivity growth or rising income inequality that have been in place for over a generation. Rather, there will still be ups and downs and long-term changes that will demand action by individuals and governments alike. This Administration has put in place a set of policies that has allowed the economy to grow and flourish—in particular by putting the Nation's fiscal house in order. But we must continue to pursue sound policies aimed at opening markets at home and abroad, promoting private and public investment, and ensuring that all Americans, regardless of age or origin, have the skills they need to prosper in a world of change and opportunity.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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CREATION DATE/TIME: 5-JAN-1998 17:58:18.00

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TO: Jeremy B. Rudd (CN=Jeremy B. Rudd/OU=CEA/O=EOP @ EOP [CEA])
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CHAPTER ONE
Promoting Prosperity in a High Employment Economy

The economic expansion entered its 82nd month in January 1998, making it the second-longest peacetime expansion in history. Moreover, growth and job creation remained vigorous without triggering higher inflation. Over the past year, real gross domestic product (GDP) grew 3.x percent and the number of jobs rose by an average of 2xx,000 per month. The unemployment rate dropped below 5 percent for the first time in 24 years, yet core inflation (measured by the consumer price index excluding the volatile food and energy components) averaged only 2.x percent in 1997—its lowest rate in over 30 years.

At the beginning of 1998, the prospects for continued growth with high employment and low inflation remain excellent. The economy is remarkably free of the kinds of imbalances that often presage an economic downturn. One of the most common danger signs is rising inflation, whether due to an overheating of the economy or a foreign price shock, such as the oil price increases of the 1970s. But inflation fell in 1997, and developments in East Asia, by reducing U.S. import prices, are likely to exert additional downward pressure on U.S. inflation in 1998. Turmoil in East Asia does represent a cloud on the horizon, but the main effect of events there may be to moderate U.S. growth to a more sustainable rate without a rise in interest rates. Another sign that an expansion may be nearing its end is a sudden accumulation of inventories as businesses find their sales falling short of production. But sales were strong in 1997 and inventories do not appear excessive. In terms of potential financial imbalances, banks and other financial institutions do not appear overextended, as they did in the late 1980s and early 1990s. And the stock market shrugged off a nasty one-day plunge in October—though its continuing high valuation relative to earnings is a source of concern to some observers. It would be foolish to assume from the current sunny economic outlook that the business cycle has been vanquished forever. But it is appropriate to regard the economy as in fundamentally sound shape and well-equipped to handle unexpected bouts of rougher weather.

One major reason the economy is in good shape for the future is that the Federal budget deficit has been reduced substantially, permitting private spending, particularly on investment, rather than public spending to fuel the expansion. Almost none of the growth in GDP since 1991 has come from increased government purchases, whereas more than two-fifths has come from greater gross private domestic investment. The contribution of government spending is much lower than in previous postwar expansions and the contribution of private investment has been much higher. Indeed, the U.S. economy enjoyed the fastest growth in industrial capacity over the last n years since 196x.

It is tempting for policymakers to take all the credit for the economy's recent successes. And a case certainly can be made that policies such as deficit reduction have contributed toward creating an investment-led recovery and a climate conducive to sustained economic growth. But the lion's share of the credit for the economy's performance must go—as it always must—to American workers and firms, who have risen to the challenges of a new global economy driven by competition and technology. The role of government in such an economy is not to provide the direct spending impetus for economic growth, but, more subtly, to provide individuals and businesses with the tools they need in order to thrive and flourish through their own efforts. The range of appropriate government policies in such an economy includes promoting private investment, encouraging the formation of skills through training and education, securing opportunity for marginalized members of our society, and—where necessary—providing assistance to those who, through no fault of their own, are unable to maintain a standard of living that is a basic right of all Americans. Using government to complement—not replace—the market and the private sector has been a fundamental, guiding principle of this Administration's economic strategy from the very beginning. And it is this strategy that has borne fruit over the last five years.

It is also tempting to conclude that having achieved high employment, policymakers can rest on their laurels. In fact, a host of challenges remain despite the economy's recent performance. This Chapter considers in greater detail what needs to be done next in order to ensure that the economy's success is built upon and continued, and presents the Administration's proposals for achieving its two basic, overarching goals—securing high and rising living standards now and in the future, and ensuring that the benefits of a higher standard of living are extended to all Americans.

THE ADMINISTRATION'S ECONOMIC STRATEGY

The enactment of the Employment Act of 1946, which created the Council of Economic Advisers, gave the Federal government responsibility for stabilizing short-run economic fluctuations, promoting strong, noninflationary economic growth and low unemployment. This Administration's pursuit of this mandate has been based on a strategy that has focused on getting the fundamentals right—reducing the budget deficit, investing in technology, infrastructure, and the American people, and opening markets at home and abroad. These were the right policies for encouraging the job creation needed to move the economy to full employment, and they are the right policies for attacking the longer-term problems that have plagued the economy since the early 1970s—sluggish productivity growth and widening income inequality.

But there is more to the Administration's policy agenda than can be measured by aggregate economic statistics alone. Getting the fundamentals right means removing barriers that block individuals from realizing their potential; it means promoting their sense of individual responsibility and giving them the tools to succeed. Getting the fundamentals right also means promoting a sense of community, which includes racial harmony and a sense of responsibility for our children. It means fostering personal commitment to helping others, and ensuring national prosperity.

A Credible Plan for Deficit Reduction

The key economic milestones reached in 1997 vindicate the policy course that was set in 1993. At that time, the economy was just beginning to recover from the 1990-91 recession, but labored under the burden of a Federal budget deficit that had ballooned to $290 billion, its highest level ever. The linchpin of the Administration's strategy for recovery was a credible deficit reduction plan that was large enough to achieve substantial fiscal retrenchment over the longer term, yet balanced and gradual enough to allow the economy to gather strength and move toward full employment in the shorter term. The success of this program rested on achieving an interest rate environment conducive to investment that would allow the economy to grow in the face of an otherwise contractionary fiscal policy. This, in turn, required that financial markets be forward looking and (correctly) anticipate an appropriately accommodative monetary policy. In large measure, that is exactly what happened. Long-term interest rates fell to 25-year lows in 1993, spurring a pickup in economic growth. Since 1993, business fixed investment has grown at an average rate of #xx# percent per year, and has been responsible for roughly #xx# percent of overall GDP growth.

A key component of the Administration's deficit reduction plan was its credibility. A credible and realistic program for deficit reduction--one that observers and financial markets judged likely to be fully implemented--was a precondition for the reduction in interest rates that helped spur investment-led growth. A fundamental source of the plan's credibility involved predicating budgets on a set of economic projections that represented conservative, mainstream forecasts of future growth and inflation. These projections eschewed the "rosy scenarios" of previous budgets that invariably fell short of reality; they were not meant to indicate the best that the economy could do, but rather how the economy was most likely to perform given past experience. In fact, the economy's actual performance has been somewhat stronger than past Administration predictions.

The net result of deficit reduction has been the promotion of a more salubrious mix of fiscal and monetary policy. In the 1980s, expansive fiscal policy required relatively tight monetary policy in the form of high interest rates in order to prevent the economy from overheating. Even simple textbook models of the economy point out that this is an unfavorable policy combination from the standpoint of fostering longer term growth, however, since high interest rates impede capital formation, while burgeoning government deficits depress national savings and contribute to a larger current account deficit. And, deficit reduction has also had an important collateral benefit, namely, a restoration of Americans' confidence in the ability of their government to manage its own affairs.

Investing in People, Technology, and Public Capital

The purpose of deficit reduction is to encourage investment. Hence, the Clinton Administration recognized from the outset that a plan that balanced the budget at the expense of the government's own investments would be ultimately self-defeating. To that end, the Administration has given investment in people, technology, and public capital a major role in its economic agenda.

The government invests in people by promoting public health and safety, encouraging opportunity and individual responsibility, and assisting in the formation of human capital through education and training. This last function--investment in education and training--is especially vital today. In today's high-technology economy, having a skilled workforce is an essential condition for future economic growth. And, education and training programs are of particular importance in today's economic environment as a way of promoting greater income equality. Education is critical to insure than individuals can capitalize on the opportunities that are created by new technologies and more open global markets. The return to education has risen dramatically since the late 1970s; today, highly skilled workers command a far greater premium in the labor market than their less-skilled counterparts. This has been an important contributing factor to the overall rise in earnings inequality that has occurred since the late 1970s. Today, investment in education is one that pays particularly high returns, and the government has an important role to play in ensuring that all Americans have the opportunity to accumulate the skills that are necessary for economic success. This requires initiatives to improve public education at the primary and secondary levels, as well as programs to make higher education accessible. It also requires recognition of the fact that learning must be a lifelong activity in an economy where rapid technological change is a commonplace.

Investing in basic research and the development of new technologies is another important function of government. The private sector spends billions every year on research and development. But economic theory suggests that private-sector spending in these areas will be too low--the benefits of a new scientific discovery, for example, are not merely enjoyed by the discoverer, but by society as a whole. Moreover, new theories of economic growth place a special emphasis on advances in knowledge through research and development as the motive force behind long-run increases in living standards. If this is true, an implication is that the return to government investment in research and technology is likely to be especially high.

Finally, government investment can take the form of investment in physical capital. The government creates and maintains a network of infrastructure--roads, bridges, waterworks, and mass transit--that is a critical input to private-sector production. The returns on infrastructure investment need not be higher than the returns on private capital in order to give it an important claim on government resources, since infrastructure investment is the particular province and responsibility of government. In addition, maintaining the Nation's existing stock of infrastructure may well yield large benefits for each dollar of expenditure. Promoting Federal and state investment in infrastructure--and ensuring that each dollar of infrastructure investment is well spent--must be a priority for policymakers.

Opening Markets at Home and Abroad

A third major component of the Administration's economic agenda is its efforts to promote freer and more competitive markets at home and abroad. Domestically, this has involved the pursuit of initiatives directed at fostering competition, particularly a vigorous approach to antitrust enforcement and policies to enhance competitive forces in such industries as telecommunications, electricity, financial services and health care. It has also meant addressing market failures in such areas as the provision of health care and pollution and other forms of environmental degradation. In some cases, the effect of these policies is to raise the *level* of output by promoting greater efficiency and reducing costs. But these policies can also lead to faster economic growth. For example, past experience provides evidence that sensible deregulation policies have not only helped raise efficiency, but have spurred innovation through greater competition.

The Administration is also committed to reducing the burden of government regulation and ensuring that the benefits of new regulations justify their costs. Much government regulation affects industries in which technological change causes the nature of market competition to change rapidly. A key precept of this administration's approach to regulation, therefore, is the notion that the regulatory process must be a dynamic one, in which regulatory policies are constantly reviewed in order to minimize their burden on consumers and businesses. Another important precept involves eschewing policies that rely on regulation through government fiat in favor of policies that use market-based incentive structures in order to attain a desired outcome. Experience with such policies as permit trading for sulfur-dioxide emissions suggests that this method can provide a powerful means for ensuring that compliance with socially beneficial goals is obtained efficiently and cost-effectively.

This Admininstration has also worked hard to open markets abroad, by encouraging fairer and freer international trade. From his earliest days in office, President Clinton has advocated an outward-looking, "internationalist" trade policy. During the first four years of the Clinton Administration, over 200 trade agreements were implemented, some relatively large in scope--such as NAFTA and the Uruguay Round of GATT--others relatively small, but all vital to the Nation's competitive future.

Economists generally recognize two broad classes of benefits from an open economy, the first being static, the second dynamic. First, trade helps an economy by allowing it to specialize in what it does best--a point that economists have made since the 18th century. Even if a country is more efficient than its neighbors at producing *every* good it consumes, it can still benefit from trade by specializing in the production of goods in which it is *relatively* more efficient, and then trading its surplus production for whatever else it wants to consume. In addition, a new view of international trade has recently emerged which argues that increased trade actually raises an economy's *rate of growth* (Box 1-x). If this is in fact true, it makes the case for trade liberalization even more compelling, since raising the economy's growth rate--even by a few tenths of a percentage point per year--has vastly more significance for long-run living standards than even a relatively large one-off increase in the level of output.

Box 1-x: *New Trade Theory and the Benefits of International Trade*

Economists have long realized that economic growth has two sources. An economy can either increase the amount of inputs (capital, labor, and raw materials) that it feeds into the productive process, or it can make those inputs more productive, through innovations in technology, better education and training, and so on. In fact, productivity improvements are necessary if the economy is to grow in per-capita terms in the long run, as sooner or later simply accumulating more inputs will run up against the law of diminishing returns.

The classical theory of free trade emphasizes the *one-time* productivity gains that obtain through trade-induced specialization: trade permits labor and capital to be redeployed in the production of goods in which the economy is particularly efficient, allowing a given amount of labor and capital to more productive in a manner that is not unlike an improvement in managerial technique. Hence, moving from a situation in which there less to more trade raises the level of real income--though it might take a number of years for the benefits from trade to be fully felt. These static gains from trade can be quite significant: for example, one economic historian argued that most of the economic growth that occurred in the classical world was rooted in the expansion of markets that resulted from increased sea trade around the Mediterranean.

The new view of international trade also focusses on this second factor, but argues that freer international trade can actually increase the rate of innovation and technological change. One economist has summarized this argument with the following catena:

International trade leads to **??larger markets and??**greater competition;
??Larger markets and increased?? Competition induces greater innovation; and,
Innovation (*i.e.*, technological change) drives economic growth.

In a sense, the emphasis of the new trade theory on the dynamic benefits of international trade comes full circle to Adam Smith, who is recognized as one of the fathers of classical trade theory. Smith pointed out that the specialization that results from free trade could foster innovation by acquainting workers with a specific productive process, thus giving them insight into how such processes could be improved. New trade theory also incorporates elements of Joseph Schumpter's theory of "creative destruction," in which competition serves as a motive force for the economy's progress.

New trade theory represents a valuable contribution to academic economics. Recently, it has received empirical confirmation as well. Studies that examine what drives economic growth across countries have found that an economy's degree of openness--as proxied, say, by the amount that it imports and exports relative to its overall output--has an effect on its rate of growth.

A RECORD OF ACCOMPLISHMENT

Focussing on the fundamentals in shaping economic policy has paid off by helping to produce an economy that is stronger than it has been in years. This past year alone saw the unemployment rate drop to its lowest level in a generation, the forging of a budget agreement that promises to bring the deficit under control for the first time in decades, and significant advances in this Administration's economic agenda along other fronts.

Returning to a High-Pressure Economy

The expansion in output and employment that characterized the second half of 1993 persisted and strengthened in 1994, with very strong growth in business fixed investment serving as a key factor in driving the expansion. This robust growth led to a series of monetary policy tightenings over the course of 1994, which were reflected in more moderate growth in 1995.

In retrospect, 1995 may have been the pause that refreshes. As 1994 opened, a number of observers had begun to express concern that continued strong economic growth might soon overheat the economy, even though inflation was relatively quiescent. Prevailing wisdom about the relationship between inflation and the unemployment rate suggested that inflation would begin to rise if the unemployment rate dropped below 6 percent, and it had already fallen to 6.4 percent by the end of 1993. Thus, the increase in short-term interest rates over the course of 1994 and early 1995 could be seen as an attempt to restrain demand pressures and hold growth close to its long-term potential. After falling to 5.4 percent by the end of 1994, the unemployment rate remained relatively flat through 1995. Economic growth picked up in 1996, exceeding expectations, and strong growth has continued through 1997. This strong growth has produced a high-pressure economy conducive to overcoming the longer-term problems of growth and distribution that built up in the 1970s and 1980s.

The economic and social benefits of a high employment economy are difficult to overstate. An obvious prerequisite for personal economic security is the knowledge that work is available to those who seek it to support themselves and their families. Tight labor markets increase the confidence of job losers that they will be able to regain work, lure discouraged workers back into the labor force, enhance the prospects of those already at work to get ahead, enable those who want or need to switch jobs to do so without a long spell of joblessness, and lowers the duration of a typical unemployment spell. Returning the economy to full employment yields a direct benefit by ensuring that the economy's resources--human and material--are not squandered by needless cyclical unemployment. On average, reducing the unemployment rate by a percentage point raises output by approximately two percent; in 1997, two percent of GDP equalled $160 billion, or roughly $600 for every American--man, woman, and child. Wasted resources from not producing at potential--together with the human cost of unemployment--are intolerable, and the elimination of this waste is the principal benefit of a sustained return to full employment.

But a high-pressure economy also yields benefits that exceed these significant gains in aggregate employment and output. It also seems plausible that short-term economic conditions can affect long-term structural unemployment, and although the idea that the natural rate of unemployment can increase as a result of a recession is generally used to explain labor-market conditions in European countries, the same phenomenon might well exist in the United States (albeit perhaps in a less widespread and more hidden form). 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. Running a high-pressure economy, therefore, may be one of the surest ways to ensure that we do not consign an unacceptably large fraction of our citizens to long-term joblessness and economic marginalization.

The need today is greater than ever. For years, the ability of the economy to reduce poverty through growth alone has been hampered by the presence of a significant headwind: sustained declines in wages at the lowest end of the earnings distribution over the past two decades have acted to offset the benefits of an expanding economy for the poorest Americans. Over the 1980s, for example, real wages at the lowest decile of the earnings distribution actually *declined*, while those at the 90th percentile rose x percent. It is no longer the case that holding a job ensures that a less-skilled worker will be able to exit poverty.

Keeping the economy at full employment is also necessary if we are to be successful in moving current welfare recipients into the workforce. Early, indirect evidence here is encouraging: employment and participation rates among women who maintain families--about 61 percent of whom have children under 18--have increased in the past few years. This is partially the result of policy, namely, the recent institution of welfare-reform measures: the greatest acceleration in employment rates occurred among those single women who were most likely to be affected by welfare reform, namely, single mothers with young children. Nevertheless, it is obvious that an economy in which job opportunities are plentiful plays a crucial part in aiding the transition from welfare to work.

We have begun to see heartening signs that this expansion is distributing overall gains in living standards to all Americans, especially those at the bottom of the income distribution. The pretax poverty rate fell to 13.7 percent in 1996, down from 15.1 percent in 1993. Similarly, the poverty rate for African-Americans is at an historical low, while unemployment among African-Americans fell to its lowest rate in 24 years in 1997. In 1996, income grew in each quintile of the income distribution, with the largest percentage increase going to the poorest members of our society. Maintaining a full-employment economy is essential if this progress is to continue.

Deficit Reduction: Completing the Task

The most significant policy event of 1997 was the passage of a deficit reduction package that ensures that the Federal budget will be in surplus no later than 2002. This will be the first balanced budget since 1969, and only the ninth since World War Two.

Some have claimed that the economy deserves all of the credit for vanquishing the deficit. It is certainly true that business-cycle fluctuations have an important effect on government revenues and outlays, leading to short-term fluctuations in the deficit. Economists therefore consider the "full-employment," or "structural" budget deficit--which corrects for the cyclical position of the economy--to be a more useful guide to the underlying state of fiscal policy. But even when these cyclical factors are accounted for, it is evident that policy has played a major role in bringing the deficit under control. In January of 1993, before the deficit reduction package was adopted, the Federal defict was projected to remain well in excess of $200 billion even after it was assumed that the economy was at full employment. Likewise, calculations that ??take actual history into account?? indicate that the deficit in fiscal year 1997 would have been $347 billion had there been no change in policy. While improvements in economic conditions have definitely played a part in reducing the deficit, we would not now be within striking range of a balanced budget had we stayed on the fiscal course that was set in 1992.

Considering the structural deficit also drives home an important point regarding surpluses. If economic activity rises in excess of its long-run trend, then the actual deficit will fall below its structural level, as a result of a transitory increase in receipts and decrease in outlays. Responding to such short-run improvements in the deficit with permanent changes in tax or spending policies may not be sensible if the government's goal is long-term budget balance. Estimates indicate that the unadjusted structural deficit will not vanish until ??check:2002??, although the maintenance of unusally strong economic conditions could result in surpluses even before then. However, such surpluses should not be treated as permanent.

Perhaps we could craft a careful paragraph stating that from an economic standpoint, there is nothing magic about even a balanced structural budget--that in the longrun, a case can be made for a surplus based on the high return to savings, or to smooth tax rates over time. Perhaps we could show the Debt/GDP and/or net interest/Outlays ratios, showing that these have all risen and will constrain fiscal policy in the future, when the population ages.

Policies to Raise Growth, Reduce Inequality, and Increase Opportunity

The recent success that the Administration has enjoyed in advancing its economic agenda has not been confined to the sphere of deficit reduction. As described above, a significant component of the Administration's economic agenda involves investment in people--in a broad sense, that encompasses education and training, health, and extending opportunity to all Americans. A number of policies have been put in place in order to ensure that these goals are met.

Child Tax Credit

An important component of the balanced budget agreement is the institution of a tax cut to help working families with the expense of raising their children. The Taxpayer Relief Act of 1997, which the President signed into law on August 5th, will provide a reduction in taxes for 27 million families in the form of a $500 per child tax credit. This credit will benefit 45 million children under age 17. Importantly, the child tax credit will benefit 13 million children from working families with incomes below $30,000. Because the credit is partially refundable, large families who paid significant out-of-pocket payroll taxes can benefit even if they have little income tax liability.

Education

The budget that the President signed into law in the Fall of 1997 made funds available for initiatives that, together, comprise the largest investment in education in 30 years. These initiatives attempt to improve the quality and accessibility of primary, secondary, *and* higher education.

Higher education is a particular priority. The earnings of a college graduate have risen sharply relative to those of a worker with a high-school education. In today's economy, a college degree has become as vital for success as a high-school diploma was a generation ago. Even post-high school education that does not lead to a bachelor's degree (such as an associate's degree or vocational or technical training) boosts earnings by nearly as much (in percentage terms) as does completing high school.

Moreover, learning must be a life-long process. A fundamental characteristic of our economy is rapid technological change. While this holds the promise of greater living standards for all, it reqires workers to adopt to employers' demands for well-trained, skilled workers. It is therefore critical to ensure that all individuals--including those not traditionally thought of as "school age"--have access to additional educaiton or training.

The President's higher education initiatives, which were enacted into law as a part of the recent budget agreement, reflect these principles. Specific measures include:

° *The largest Pell Grant increase in 20 years:* The maximum Pell grant is increased by over 10 percent, to $3,000. Approximately 3.7 million students will receive the increase, and close to a quarter of a million families will become eligible for the grant.

° *HOPE Scholarships for post-high school education:* In his State of the Union speech on February 14, 1997, the President called for making the 13th and 14th years of education as universal as a high school education is today. The HOPE scholarship accomplishes this by providing a tax credit for higher education expenses of as much as $1,500, which is enough to cover tuition at a typical community college.

° *A Tuition Tax Credit for all Americans:* A 20 percent tax credit for post-high school tuition expenses will be available for the first $5,000 of qualified educational expenses. (After 2002, the credit can be applied to the first $10,000 in expenses.) Importantly, this tax credit is made available to school-age Americans as well as those already working, in order to permit workers to upgrade their skills at any time during their life.

° *Tax exemptions for employer-provided education benefits:* Section 127 of the tax code is extended for three years, allowing workers to exclude up to $5,250 of employer-provided educational benefits from their taxable income.

° *A tax deduction for student loan interest:* Up to $2,500 of interest payments on loans for higher education expenses will be tax deductible in any given tax year.

Because public education in the United States is largely administered by local authorities, the Federal government's ability to influence primary and secondary education is somewhat less direct. Nevertheless, this Administration recognizes that there is much that the Federal government *can* do in order to influence the quality of our public schools, and has worked for the passage of programs which will ensure that our children have access to the best possible primary and secondary education. These initiatives include:

° *Establishing national standards:* Research shows that students in countries that have standardized, mandatory examination programs do better than students in countries that do not.

The Administration's voluntary national testing program has received full funding, which will allow for the development and pilot testing of national fourth-grade reading and eighth-grade mathematics examinations.

° *Expansion of Head Start:* Funding for Head Start was raised by $374 million, to $4.4 billion, in order to reach the Administration's goal of having one million children in the Head Start program by 2002. Since 1993, funding for Head Start has increased by 57 percent; the program will serve over 800,000 children and their families in 1998.

° *A comprehensive literacy strategy ("America Reads"):* Every child should be able to read by the third grade. In order to ensure that this basic goal can be met, the President's comprehensive literacy strategy will receive nearly $300 million in new funding. State teacher training and family literacy efforts will receive an additional $41 million, while $210 million will be earmarked for prending legislation based on the President's America Reads Initiative.

° *Increased funding for charter schools:* The President set a goal of having 3,000 locally designed public charter schools in operation by early next century. Funding for charter schools has been increased by over 50 percent, which will allow the Department of Education to support nearly 1,000 charter schools by the end of 1998.

Health

Promoting the health of our citizens is a moral duty, but also represents an investment that pays off handsomely in that small interventions--particularly at young ages--can lead to significant reductions in future healthcare expenditures. Under President Clinton's Children's Health Initiative, up to five million currently uninsured children will receive healthcare coverage, including pharmaceuticals, vision and hearing screening, and mental health services. This represents the single largest investment in child health care since Medicaid was begun in 1965. **@@@Add something about tobacco: This program was financed by the proceeds from a higher tobacco tax. Cigarette use amont children has increased and the President has supported an agreement with the tobacco companies that would diminish teen smoking@@ worked to**

???In addition, this Administration has overseen the reform of the Food and Drug Administration ...???

There will probably be several health initiatives in the budget including a buy in for people 62-65. Do we want to mention these?

Finally, the Administration has taken the first steps toward ensuring that Medicare remains viable. Structural reforms--such as extended choice among health care plans, changes to annual Medigap enrollment, and the restructuring of payment systems--will help save $115 billion over five years. Recently passed legislation also provides additional funding for preventative measures, such as expanded coverage for mammograms, that can help to keep healthcare expenses down by catching and treating health problems before they become serious. These and other measures will keep the Medicare trust fund solvent for at least the next decade;

meanwhile, a commission has been set up in order to examine long-term solutions to the problem of Medicare viability.

Welfare Reform and Poverty Alleviation

Welfare reform presents an ongoing challenge: to ensure that our neediest citizens can maintain the basic standard of living that is the right of all Americans without creating incentives that in turn encourage a life of dependency. This Administration has committed itself to a policy that combines work incentives and community efforts in order to move people off the welfare rolls and into employment. The result has been the largest reduction in welfare rolls in history.

Any attempt at welfare reform must recognize that long-term changes in the wage structure imply that some will be unable to raise themselves out of poverty even with a full-time job. Moreover, if we are to make work pay, we must guarantee workers a minimum level of earnings. The Administration has therefore made an expansion of the Earned Income Tax Credit, which raises the pay of low-income workers who have children--together with an increase in the minimum wage--a cornerstone of its antipoverty strategy (Box 1-x). **During 1997 the minimum wage rose, in two steps, from 4.xx to 5.xx benefitting n million low wage workers.**

Although the welfare rolls have shrunk significantly since this Administration began its plan to "end welfare as we know it," much remains to be done. President Clinton has called for further reducing the number of people on welfare by two million over the next two years. To that end, two additional initiatives have been put in place in order to advance this Administration's strategy for welfare reform. First, a tax credit for employers that hire long-term welfare recipients has been established; this rebates up to $3,500 in wages in the first year and up to $5,000 in the second, thus encouraging businesses to hire and retain former welfare recipients. Second, $3 billion has been earmarked for the Welfare to Work Job Challenge Fund, which will assist states and communities in moving long-term welfare recipients into lasting, unsubsidized employment. A hallmark of this fund is that it is targetted to areas that are most in need of poverty alleviation.

Box 1-x: *Poverty Alleviation, the Earned Income Tax Credit, and the Minimum Wage*

A typical cash assistance program guarantees a given amount of money to those who receive no income, and then phases out this benefit as income--that is, labor income--rises. Such a program discourages work, and these work disincentives have been a major concern--perhaps *the* major concern--of policymakers. Today, policymakers have concluded that there is really no way to correct these disincentives *so long as we confine ourselves to considering policies that are similar to the cash assistance program just outlined.* We therefore have to broaden the menu of policies that are up for consideration.

One way to avoid the work disincentive effects of the canonical cash assistance program involves constructing a program that subsidizes the wages of low-income workers. This type of program has recently been expanded as part of the government's current welfare reform initiative, and is known as an "earned income tax credit," or EITC. Under the EITC, low-wage workers with children receive a credit against their earned-income tax liability; this credit is rebated in cash if the worker's tax liability is zero.

An EITC-style program differs from a typical cash assistance program in that benefits are zero under the EITC for those who do not work and rise as earnings increase (up to some threshold earnings level). The EITC therefore largely eliminates the disincentive effects that face low-wage workers in the standard cash assistance program.

The minimum wage complements and interacts with an EITC-style program in an important way. Using the minimum wage by itself in order to guarantee a subsistence level of income is problematic in that it requires the minimum wage to be very high, which discourages employment. On the other hand, using the EITC alone in order to guarantee an income floor requires payment of a large subsidy that must then be phased out slowly in order to minimize disincentive effects. This makes the program much more costly. Hence, the minimum wage and the EITC must be employed jointly in designing an optimal assistance package.

Policies to Strengthen Our Cities and Communities

We need to strengthen this section with an overview of policies including the overall logic and some description of EC/EZs, CDFIs, CRA and a discussion of the success of the policy.
Finally, this Administration has ensured that the Federal government invests in our cities and communities with:

° *A threefold increase in the number of empowerment zones:* Twenty new empowerment zones (15 urban and 5 rural) are added, bringing the total number to 31.

° *Additional funding for Community Development Banks:* Community Development Financial Institutions make investment capital and other financial products available to low-and moderate-income communities. Recent legislation adds $80 million in additional funding for CDFIs.

° *Establishment of the "brownfields" tax incentive program:* The Brownfields program creates tax incentives for the restoration of contaminated urban land. These incentives will leverage more than $6 billion for nationwide private-sector cleanups and the redevelopment of 14,000 contaminated, abandoned sites in economically distressed urban communities.

Strengthening the Performance of Markets

During the past year, the Administration also implemented a number of policies that advance its goal of more open and competitive markets.
[describe highlights of antitrust and micro chapter, e.g. five principles from tobacco settlement]

Promoting an Environmental Agenda That Is Economically Sound

Need some discussion of Clean Air and Global Warming

<u>International trade</u>

Progress was also made over the past year in opening foreign markets to U.S. goods as a number of important international trade initiatives were finalized. First, the Information Technology Agreement (ITA) was concluded; this will completely eliminate tariffs on a large array of information technology products in which U.S. firms tend to be highly competitive. While domestic tariffs on these products were low or zero, Asian tariffs averaged around 30 percent, implying that the ITA will significantly advance American firms' competitiveness in Asian markets. The United States also concluded an agreement covering financial services that will foster broad liberalization of banking, securities, and insurance, along with a key agreement to liberalize basic telecommunications sectors (telephone services).

FACING THE CHALLENGES AHEAD

In many ways, the U.S. economy today is very different from the economy in which our parents and grandparents found themselves. Today, #xx# percent of families are headed by a single parent, as compared to #zz# percent #yy# years ago. And #xx# percent of married women work, including #xx# percent of those with young children. As a consequence, affordable, quality childcare is a pressing concern for most families. The nature of the labor market has changed significantly; few today expect to be working for the same employer--or even to be in the same career--when they retire. Industry has also changed radically: in the 1950s, the information technology industry barely existed; today, it employs a larger share of the labor force than the auto industry did at its height **[check this]**. And, our population is aging, implying that there will be fewer workers for every retiree in the next century.

Hence, this Administration's economic agenda is an open one, in recognition of the fact that change is the only constant of economic life. If the American economy is to maintain its preeminence as the strongest and most dynamic economy in the world, policymakers and citizens will have to meet and overcome a number of challenges in the 21st century.

Several challenges currently face this Administration and Congress. **How about starting with the larger challenge of preparing for the aging of our population, which**

includes not only Medicare and Social Security but also retirement security more generally. There are likely to be proposals in the SOTU concerning pension reform that could be included. First, the new balanced-budget act left two long-run issues largely unaddressed, namely, Social Security and Medicare reform. In the case of Medicare, some progress was made in addressing the program's immediate problems. But, necessity and time considerations dictated a delay of the comprehensive reforms that are required in order to ensure Medicare's long-term viability. Likewise, steps are needed to strengthen the finances of the Social Security system.

For almost 60 years. Socail Security has provided elderly Americans with retirement income security and protection against loss of family income due to disability or death. A large share of elderly Americans particularly those with low income, rely on Social Security as their primary source of pension income in retirement. The system has enjoyed dramatic success in reducing poverty rates among older Americans. However, many Americans now fear that Social Security will not be there for them when they are ready to retire. This concern reflects the widespread recognition that, under current "intermediate" projections of the Social Security Trustees, the Social Security system faces a long-term funding gap: beginning in 2012, the government will be unable to pay for current Social Security benefits out of currently collected payroll taxes and, by 2030, the existing Trust Fund balances would be exhausted. Absent policy changes in the meantime, the government would then faces several options, singly or in combination: It could reduce benefits until they are in line with current collections; it could raise payroll taxes in order to cover an unchanged level of benefits; and/or it could finance Social Security from other parts of the budget, by raising other taxes besides the payroll tax, cutting expenditures on other programs, or allowing the budget deficit to increase--*i.e.*, borrowing in order to make up for the shortfall. The Social Security "crisis" refers simply to the fact that one or more of these situations will occur absent any changes to the present system.

Although the seriousness of the financial imbalance facing the Social Security system should not be downplayed, its magnitude is not so large that the problem of restoring balance is insurmountable, particularly if early action is taken. For example, even if nothing is done, currently received payroll taxes will still be sufficient to permanently finance roughly 75 percent of benefits even after the Social Security Trust Fund is exhausted. Alternatively stated, if the gap over the next 75 years were financed entirely through higher payroll taxes starting now, a payroll tax increase of around 2 1/4%, approximately 1% of GDP, would be sufficient to restore balance, although a somewhat larger increase would be necessary to maintain balance in perpetuity. These facts suggest that the problem of placing Social Security on a sound financial footing will admit of eventual solution.

Medicare reform presents a somewhat thornier problem, both in terms of its complexity and its scale. Unlike Social Security, Medicare promises the delivery of a service--health insurance--as opposed to the provision of benefits in the form of a fixed payment of money. An additional complicating factor is that government has little influence in practice over the rate of increase of the cost of providing this service, which has largely been driven by technological advances in medical care. Higher costs for medical care are projected to account for the bulk of the increase in Medicare expenditures for the next 25 years or so, after which the aging of the baby-boom generation will act to raise expenditures through increases in program enrollment. Hence, any long-term reform will have to involve slowing the growth of health care prices as well as the volume and intensity of use of covered services, neither of which can be done easily.

The recently concluded budget legislation acted to address the pressing short-term problems facing Medicare. Prior to this legislation, the trust fund for the component of Medicare that covers hospital costs was projected to fall to zero in 2001. The current reforms will delay the trust fund's depletion until fiscal year 2007. The legislation also calls for the establishment of a bipartisan commission to assess and recommend the structural changes that will need to be implemented in order to ensure Medicare's continued viability.

A second major policy challenge involves continuing the drive for more open international markets. The pace with which preferential trade agreements are being negotiated between and among countries around the world is fast, and the United States could easily be left behind through inaction. Since 1992, other nations have negotiated 20 preferential trade agreements in Latin America and Asia that exclude the United States. The European Union has begun a process that will culminate in a free trade agreement with Brazil, Argentina, and other MERCOSUR nations; the President of one European nation has even gone so far as to declare that he economic interests of Latin America lie with Europe, and not the United States. Within South America itself, the four MERCOSUR nations are attempting to extend their preferential trade arrangements to encompass the entire continent. It is clear that now, more than ever, continued engagement will require an active effort on the part of the United States.

In 1997, the Senate voted in support of granting the President "fast track" authority to negotiate trade agreements. However, in the House of Representatives, the vote was postponed when it became clear that opposition was sufficient to derail the legislation. Public resistance to initiatives to open foreign markets may trace its roots to several factors, including the perception by some that free trade hurts American workers and also that it contributes to the U.S. trade deficit.

As we discuss in Chapter 7, market-opening initiatives do not cause net job losses to the U.S. economy as a whole but they do result in a reallocation of jobs into expanding, export-oriented industries. As we document, the jobs created by increased trade are good jobs, offering high pay. Nevertheless, some workers are hurt by more open markets, just as some workers are harmed by technological innovations, even when these initiatives unambiguously benefit the economy *taken as a whole.*

The Clinton Administration has realized from the beginning that it is the government's duty to minimize the impact of dislocations affecting workers who lose jobs by speeding up the adjustment process however it can. For example, one of the key provisions of NAFTA involved monitoring those industries that were in danger of being adversely affected by the free trade agreement, and the Administration committed itself early on to providing for dislocated workers through retraining programs. More generally, the Administration's commitment to investing in people through education and training serves as a strong complement to its policy of trade liberalization: since freer trade tends to benefit skilled workers most, the United States enjoys greater benefits from trade to the extent that more of its workers are highly skilled. **Discuss possible UI initiative and other plans to provide expanded TAA.**

A widespread misconception is that one of the benefits of increased trade comes in the form of an improved overall current account or trade balance. Economic policies do indeed affect the current account, but it is budget, saving, and investment policies, not trade liberalization policies, that do so. The current account is a macroeconomic phenomenon that reflects the gap between what we as a nation invest and what we save. The large budget deficits of the 1980s and early 1990s reduced the amount of saving that was available to cover the nation's investment in plant and equipment (investment was reduced as well, but not by as much), and this shortfall had to be filled by importing goods from abroad. In an important sense, the nation was overconsuming in the 1980s, financing its consumption binge by borrowing output from foreigners. The result was a large and persistent trade deficit.

Today, we still face a trade deficit, but for a very different reason. Reducing the government's budget deficit has left more room for investment in plant and equipment by the private sector. And invest it has: since 1993, real business fixed investment has grown nearly nine percent per year on average, a much faster rate than that of the preceding ten years. This rate of investment is above the rate at which Americans save--even with the federal government dissaving less by virtue of its smaller budget deficit. So, once again the shortfall is made up for by borrowing output from abroad, with the result being a current account deficit. But there is a big difference between borrowing in order to invest--as the economy is doing now--and borrowing in order to consume, as we did in the 1980s. In fact, running a trade deficit in order to expand the nation's productive capacity is not new to American history--in the 1800s, we did much the same thing in order to build up the nation's infrastructure, most notably during the railroad construction boom a century ago. Ironically, therefore, the trade deficit reflects the economy's current success in growing more rapidly than our trading partners and investing so much--and *not* our free trade policies.

We face more general challenges as well in shaping economic policies for the 21st century. First, we must act to help families address the problems that they face in today's economy. More families are faced with the need to juggle the demands of the workplace with the demands of home. We must act to ease this burden by ensuring that families have access to quality childcare and healthcare. **For this reason, the President's 1998 budget proposes a significant expansion in funding for childcare and improvements in its quality.** Policymakers must also ensure that policies are in place to support working families when they are forced to change jobs or occupations as a result of economic change. We must also continue to invest in our children. This, of course, means investing in education, but it also means investing in a broader sense. Today, far too many children--roughly one in five--are in families that are below the poverty line. The consequences of this for these children's future development--and, therefore, for the future of the Nation--are profound. Chapter # of this year's *Economic Report* considers these issues in greater detail. **[add more on families/children chapter?]**

Finally, this country's long-standing goal of achieving racial equality has not yet been reached. Trends in racial equality are influenced by long-term adverse economic trends, such as the increase in income inequality across workers with different skills. (Chapter # of this *Report* provides **[fill in short description of race chapter]**.) But it is still the case that, on average, a white worker will receive a wage that is 13 percent higher than an identically skilled nonwhite. This means that more is needed to promote racial equality; to that end, this Administration has pledged itself toward furthering a dialogue on race in America.

CONCLUSION

The United States economy currently enjoys the best of both worlds: high growth and low unemployment combined with low and stable inflation. And the success of Americans in adapting to the new economy in which they find themselves has been truly remarkable. But that success--and the economy's present strong condition--cannot be taken for granted. Recent developments do not herald the end of inflation, the conquest of the business cycle, or the complete reversal of such secular trends as weak productivity growth or rising income inequality that have been in place for over a generation. Rather, there will still be ups and downs and long-term changes that will demand action by individuals and governments alike. This Administration has put in place a set of policies that has allowed the economy to grow and flourish—in particular by putting the Nation's fiscal house in order. But we must continue to pursue sound policies aimed at opening markets at home and abroad, promoting private and public investment, and ensuring that all Americans, regardless of age or origin, have the skills they need to prosper in a world of change and opportunity.

Possible Boxes/Charts:

1. We could have a box showing the gains on a number of key indicators due to the stronger labor market during the recovery: This could include unemployment and/or Employment/Population ratios of some key demographic groups; permanent layoff/Employment; quit proxy (left job, 1-5 weeks)/Employment; labor force participation rate; duration of unemployment spells; fraction of long spell unemployment/employment; average hours; involuntary part time work; discouraged workers; Michigan measure of unemployment expectations etc.

Alternatively, we could have a box on the quit rate proxy commenting on the significance of quits and their procyclicality.

2. Behavior of investment/government spending in the expansion

3. The structural and cyclical budget deficits. Debt/GDP and Interest/Outlays charts could also be useful

4. Possible international comparisons of budget deficits.

5. Sources of U.S. economic growth: education, TFP, capital accumulation

6. Chart on income distribution showing that all quintiles have experienced gains since 1993.

7. Chart showing that the return to education (the gap between the wages of college and high school educated men and women have increased.)

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 5-JAN-1998 18:01:57.00

SUBJECT: Rodrik Book

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

TEXT:
Do you by any chance have my copy of the Dani Rodrik book on Globalism? I was searching for it and thought you might have have used it in connection with the WEB article on the President's comments on job loss due to trade.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 5-JAN-1998 11:26:51.00

SUBJECT: Re: support for the statistical agencies

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

CC: stone_cf (stone_cf @ a1 @ cd @ lngtwy [UNKNOWN]) (WHO)
READ:UNKNOWN

CC: Michele Jolin (CN=Michele Jolin/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: Steven N. Braun (CN=Steven N. Braun/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 also agree with your suggestions. If there is a consensus, perhaps I
can talk with Frank Raines or Jack Lew about our willingness to be helpful
in lobbying for additional spending for statistics initiatives as well as
the usefulness of a CEA document prioritizing such initiatives. Janet

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 6-JAN-1998 11:04:44.00

SUBJECT: topics we could discuss at 3:00 re East Asia

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.D74]MAIL48054450S.026 to ASCII,
The following is a HEX DUMP:

ISSUES REGARDING MANAGEMENT

Country policies

Degree of austerity
- -- interest rates
- -- fiscal
- -- *the Sachsist critique*

Exchange rate policy
- -- extent of flexibility
- -- degree of devaluation
- -- dollar vs. yen

Banking system: longer-term structural reform vs. Shorter-term credit crunch

To what extent does debtor government stand by its debt obligations?
- -- guarantee all obligations, public and private?
- -- guarantee obligations of government plus banking system?
- -- extensions of maturities / restructuring of debt?
- -- negotiated moratorium
- -- unilateral moratorium

International financing

- -- amount ("Colin Powell" massive response?)
- -- how much from private sector
  - -- voluntary vs. "concerted"?
  - -- banks, vs. bonds, vs. other
- -- how much from public sector
  - -- IMF
  - -- MDBs
  - -- G7
    - -- U.S.: the ESF and the Congress
    - -- Other G7
  - -- Asia
    - -- non-Japan sources
    - -- "Asian Monetary Fund"
- -- *the [standard] moral hazard critique*

"Fallacy of composition" issues

Competitive devaluation
Global glut/deflation?

Systemic reform proposals

Halifax
-- information/transparency/data dissemination
-- banking supervision
-- facilitate creditor groups (no full "debt workout facilities" yet)

Comprehensive bailout proposals
-- 1980s precedents
-- global facilities (Kenen...)
-- coordinated write-down or reduction of debt overhang (Brady Plan...)
-- *First of the new crop: Soros*

Capital controls
-- on inflows
-- on outflows

Philosophy and Rhetoric

Liquidity vs. Solvency
Baker Plan vs. Brady Plan
Financial markets always right? Vs. Periodic excessive swings of investor confidence.
Country attitudes: mea culpa vs. Sound fundamentals
American system better than Asian system?
National security objectives

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 6-JAN-1998 11:07:46.00

SUBJECT: draft/outline of costs&benefits of Kyoto policy

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.D40]MAIL45074450S.026 to ASCII,
The following is a HEX DUMP:

Costs and benefits of US participation in the Kyoto Agreement

Costs (JA)

Reduction (in permit price and summed marginal cost/GDP) from Annex I trading

From umbrella that excludes EU (with and without Eastern Europe)

With higher AEEI's: 1.25 or 1.71 (5 labs)

JI (yielding 20% of gains from worldwide trading, beyond Annex I trading)

Participation of "key" LDCs in targets and trading

Full worldwide participation in targets and trading

Combinations of the above

Benefits (RL)

Reducing local air pollution (NAAQS...) ...

Auto congestion, accidents, and wear-and-tear on roads ...

Benefits from a federal electricity restructuring bill ...

[to go at the end:]

Two very large categories of potential benefits have been left out of the foregoing list of costs and benefits: revenue recycling and climate change mitigation.

Revenue recycling If the emission permits to be issued in the budget period, 2008-2012, were to be auctioned off, rather than allocated for free, the resulting revenue for the government could provide major benefits. If the revenue were used to reduce taxes that fall on capital (i.e., to reduce the capital gains tax or corporate income tax, or to add an investment tax credit), then the result would be an increase in investment, and therefore an increase in growth. According to the Repetto-Austin meta-analysis of 16 leading models, the assumption of such revenue recycling together with several other assumptions (non-carbon backstop fuel, CGE model, increased energy and product substitution, and an idealized form of JI equivalent to global trading) is enough to turn what would otherwise be a negative effect of GDP into a positive one

[2020]. Similarly, the IAT report estimated that under a policy of recycling revenues to business, the GDP effect would turn from negative to positive around 2010.[1] Using the revenue for deficit reduction is almost as good, because it lowers interest rates and again stimulates investment. Jorgenson, Shackleton, and other economists have similar findings.

However, returning the revenue to the general public through reductions in income taxes or payroll taxes, or through lump-sum redistribution, does not produce positive effects on GDP in these models. We suppose that cutting corporate taxes would be undesirable on political and income-distribution grounds, and that the government may want to use the revenue to ease the burden on those (e.g., displaced coal miners) who might be disadvantaged. For this reason, we have not as yet pursued the revenue recycling idea (also known as the double-dividend) any further.

Climate Change mitigation The goal of the entire exercise, of course, is to begin to move to an emissions path that implies lower levels of atmospheric concentrations of GHGs in future centuries, and thereby mitigate the likely extent of global climate change. Estimates of the economic damages from climate change (e.g., in the Integrated Assessment models of Nordhaus, Cline, and other economists) fall into the following areas: agriculture, sea-level rise, air conditioning and heating, water supply, human life and health, air pollution, and other costs (hurricanes, migration costs, human amenity, construction, leisure activities, urban infrastructure, and ecological damages such as forest loss and species loss). One must sympathize with those who critique the economists on the grounds that these costs are extremely difficult to quantify, particularly when it comes to possible catastrophe scenarios to which the scientists cannot assign a reliable probability.

It turns out that the subject of perhaps the greatest uncertainty and sensitivity is the discount rate that is applied to the benefits of averting future climate change. Such a discount rate is needed, because the economic costs of the policies under discussion occur over the next few decades, whereas the prime benefits of averting climate change occur in coming centuries. Yet there is little agreement, even among economists, on the appropriate discount rate. Cline, for example, explicitly considers a low discount rate (and a high aversion to possible catastrophe) in getting his conclusion that the benefits of early and strong action outweigh the costs.

We take it as self-evident that the benefits of averting climate change are potentially enormous. But we have, so far, chosen not to try to quantify them, in light of the quantitative uncertainties and in light of their timing (far outside the 2008-2012 window). We are inclined to favor an attempt to add up the various possible costs and benefits of emissions policy excluding climate change. Thus a conclusion might be phrased along lines such as "the net benefits of our policies to reduce emissions [under the following conditions...] are likely to be positive, even before taking into account the benefits of averting climate change itself."

[1] (Figure 13 in IAT); this analysis assumes stabilization at 1990 levels by 2010, with 10-year phase-in; assuming a 1.25 % annual decrease in EEI.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 6-JAN-1998 08:52:39.00

SUBJECT: Halifax

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

TEXT:
Since Dan is keen on Halifax, and Larry has scheduled-and-postponed a meeting on "Halifax 2" , I will try to look into it a bit.
In the meantime, I have looked up some comments I gave (in two speeches) in 1995, just before the Halifax summit, on the subject of systemic reforms that were being discussed at that time. I attach two relevant excerpts from my speaking notes on those occasions.==================== ATTACHMENT 1
===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D39]MAIL44372350S.026 to ASCII,
The following is a HEX DUMP:

J. Frankel, Woodrow Wilson Center, Smithsonian, June 14, 1995

Are international financial markets broken?
Should they be fixed [e.g., at Halifax?]

...**EXCERPT...**

[Last year at Naples Summit, the G7 agreed to review at Halifax the IFIs. In the interim we've had the Mexico crisis (and what some call a $ crisis). Might therefore expect to get some serious initiatives.]

Proposals on international debt

Big bailout fund to regularize future Mexicos. Leaked draft Halifax communique urges IMF to establish new "Emergency Financing Mechanisms." Objections:
(1) Moral hazard. Have to ensure conditionality. Two faces of moral hazard concerns: (i) countries will pursue worse policies, knowing will be bailed out (but they are still badly hurt by these crises, even when "bailed out"), and (ii) investors will be less careful (more serious problem).
(2) politically unacceptable (e.g., U.S. Congress).

Will get a doubling of **G.A.B.**, in part through expansion to other countries. Interesting economic issues, as to whether pre-authorized, and what that does to moral hazard. Interesting issues, more political in nature, of who gets to decide individual use:

...

MD Camdessus would like more. New IMF quota increase and SDR allocation, which the communique mentions, without pushing in a very serious way.[1] His speech one year ago suggested he would also like to use new fund for ForEx intervention; but I don't see same degree of systemic justification.

[1] And cooperation among financial supervision agencies. And continuation of ESAF.

Sovereign bankruptcy (or "debt workout," LS prefers**) proceedings, at IMF** I see as an approach that is more attractive than alternatives. Jeff Sachs. If the absence of international bankruptcy proceedings is the source of the problem, then address it directly.

A future Mexico would, like Orange Country (or, better, like Macy's...) come to IMF and say "we can't pay. But we want to cooperate, are willing to agree to reforms, if you supervise..." Procedures to force creditiors to accept a widely agreed restructuring and to encourage new finance; incl. subordinating old debt to new. Moral hazard probably a less serious problem (if administered right) than the problem of legality. Serious legal difficulties with making it formally binding. Would all countires have to sign on, giving up sovereignty? Many like the U.S. would surely refuse. Perhaps confine it to a club of countries who can sign up when their external debt exceeds some threshold. (Signing up would not necessarily send a bad signal; taking out insurance. Maybe even send a good signal if the scheme were combined with enhanced reporting and monitoring requirements.) If legal difficulties are prohibitive, then at least make it informal. Can do better than wait for a default to happen, with no procedure in place to prevent chaos.

• If a country stops **reporting** information, that is information. (Reportedly Mexican CB stopped publicly reporting Reserves and DC after August, and at one point Mexican government insisted that Reserves figure be stricken from an IMF Board document).

IMF moving toward publishing the outcome of Article 4 consultations (now REDs, but not staff evaluation of policies). Apparently at Halifax they might agree to encourage countries voluntarily to publish the IMF reports. A small step in the right direction.

IMF could publish a monthly bulletin of statistics, including reserves and short-term debt, perhaps covering only major borrowers. (Being listed as a major borrower would not itself be a bad signal. If done in boom time, could actually raise attractiveness to investors, by assuring higher accountability in future.) Seal of approval if timely release of information. If a country stops reporting reserves, would get an asterisk.

Not equivalent to flashing a "sell signal;" it is politically naive to think the IMF Board would agree to such a thing, thereby likely precipitating a crisis, nor would it usually be desirable from an economic viewpoint. But such an asterisk would make the Wall Street analysts sit up and take a closer look at the situation in the country in question. [The right level would be, for example, to be reported in the inside of the *Financial Times*, but not on the front page of the *New York Times*.]

Apr. 28, 1995++ Jeffrey Frankel, Professor of Economics, Univ. of Calif., Berkeley
Senior Fellow, Institute for International Economics, Washington, DC

LESSONS FROM THE MEXICAN CRISIS

Presented at Council on Foreign Relations, New York, April 10, and Federal Reserve System Meeting, Washington, D.C., April 28, 1995. This is a revised version of presentations at the World Bank, Jan. 31, 1995, and the Federal Reserve Bank of Atlanta's Financial Markets conference, Coral Gables, Fla., March 2-4, 1995.

...

Lessons for Public Policy

...EXCERPT...

- **The global system has an interest in preventing international debt crashes**
  - Financial contagion. French mistake in not helping in Credit Anstalt crisis.
  - International macro transmission ("American jobs")
  - Want to reward, not punish, countries that have spent a decade liberalizing

- **The Mexican crisis has strengthened the argument for a debt work-out office at the IMF**
  - Bailout probably could not have been put together if it had not been the United States' neighbor. New Emergent-Country financing facility?
  - If the market failure is the absence of international bankruptcy proceedings, then perhaps, better than a lending facility, there should be such arrangements at the IMF (a la Sachs).
  - As everyone notes, need to guard against moral hazard.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 7-JAN-1998 19:42:48.00

SUBJECT: Kyoto ec. analysis

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

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

TEXT:
Joe, Randy and Ray (Squitieri) have made a tremendous amount of progress on the costs and benefits. But when we met with Gruber today, he thought that Larry would want to wait until the thing was somewhat more finished before having it presented to him. Thus we are again postponing the meeting with Larry that we had planned on Friday. But I thought that you might not want to wait another week for a progress report. So the plan is for Jon to come over on Friday, and we will give you an advanced look.
JF
JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 7-JAN-1998 10:43:55.00

SUBJECT: Mtg. with Japan's EPA tomorrow: briefing material

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

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

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

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

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

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

TEXT:
Janet,

I am passing along some material from Treasury (which supersedes what I gave you yesterday), and some additional material from the Fed.

The party line is as discussed: that we are to recommend that the Japanese undertake a fiscal expansion of 5 trillion yen = 1% GDP (most likely to be enacted in a spring supplemental, after the Diet passes the FY 1998 budget). The goal is roughly to provide enough stimulus in calendar year 1998 to reverse the fiscal contraction now planned for 1998 (which the recent supplemental was not sufficient to do), and also to offset roughly half of the fiscal contraction already carried out in 1997.

We expect a multiplier effect of 1 to 2. I plan to quiz EPA on whether and why they expect something smaller.

There is also interesting material on the Japanese banking question.

JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 8-JAN-1998 16:24:39.00

SUBJECT: Re: Russian Observer status in the OECD

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

TEXT:
Dr. Yellen:

The process is grinding on; I recently spoke with State about its progress. I can update you whenever you have a spare moment.

- Jeremy

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 8-JAN-1998 16:22:52.00

SUBJECT: Russian Observer status in the OECD

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

TEXT:
I received your note about OECD trips. We will have to talk with Jeff and Becky about our priorities. On another OECD matter, did you ever get back to OECD about putting together some guidelines on Observer status? Have you also conferred with State or Treasury, whichever is appropriate?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-JAN-1998 17:11:24.00

SUBJECT: insert to Ch.1, p.19 (revised)

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

TEXT:
This came to me after we talked this afternoon. I will look at it this weekend, but thought you might want it as well. (The version you currently have uses the version of Dr. Frankel's "insert to Ch.1, p.19" that he gave me earlier to-day.)

- Jeremy

---------------------- Forwarded by Jeremy B. Rudd/CEA/EOP on 01/09/98 05:09 PM ---------------------------

Jeffrey A. Frankel
01/09/98 04:59:56 PM
Record Type: Record

To: Jeremy B. Rudd/CEA/EOP
cc: Jon D. Haveman/CEA/EOP, STONE_CF @ A1 @ CD @ LNGTWY
Subject: insert to Ch.1, p.19 (revised)

Jeremy, I have revised and extended my insert.

Suggestions on these two paragraphs are welcome from any of you.

JF

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D3]MAIL49573680X.026 to ASCII,
The following is a HEX DUMP:

INSERT TO p.19

It is always a challenge to explain this macroeconomic perspective on the trade deficit to those who are primarily concerned with the microeconomics of their daily lives. That the White House make the case in favor of trade, however, is particularly important at the current juncture. There exists a danger of countries turning inward, away from a liberal and integrated world economic order. This danger exists in the United States, as well as elsewhere. In late 1997, the U.S. Congress refrained from supporting renewal of the President's traditional trade negotiating authority ("fast-track") and from supporting the sort of financial participation in the International Monetary Fund and other international institutions that is appropriate for a major country (let alone one considered a super-power).

Meanwhile, financial crises in East Asia have now made American international engagement more important, rather than less. Emerging-market countries are themselves in danger of reacting to the East Asian crises by turning inward. It is important to their economic well-being, as well as our own, that they continue along the outward-oriented market-system path on which they had until recently been making such astonishing progress. This will now require difficult macroeconomic and structural adjustments on their part, with the aim in part of reducing dependence on foreign borrowing. Reducing dependence on foreign borrowing means reducing their trade deficits, and in some cases turning them into trade surpluses. It is inevitable that this will lead to an increase in U.S. bilateral trade deficits with the East Asians. In 1998, the President will again seek Congressional support for his efforts to continue America's traditional role of global leadership -- particularly in the areas of international trade, which requires authority for market-opening negotiations, and international finance, which requires working in the international financial institutions. Obtaining such support will require explaining to the American people why, in the context of a strongly-growing high-employment economy, they need not fear bilateral deficits with East Asian countries.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-JAN-1998 12:40:43.00

SUBJECT: Asia Guidance -- to supplement Treasury material

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

TEXT:
Are you ok with this?
---------------------- Forwarded by Michele Jolin/CEA/EOP on 01/12/98
12:38 PM ---------------------------

Jake Siewert
01/12/98 12:37:00 PM
Record Type: Record

To: See the distribution list at the bottom of this message
cc:
Subject: Asia Guidance -- to supplement Treasury material

Message Sent
To:____
Antony J. Blinken/NSC/EOP
LUZZATTO_A @ A1 @ CD @ LNGTWY
Wendy E. Gray/NSC/EOP
David C. Leavy/NSC/EOP
Michele Jolin/CEA/EOP

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D98]MAIL42118411E.026 to ASCII,
The following is a HEX DUMP:

ASIA FINANCE

December 12, 1998

Economic Impact

Q: What's your assessment of the impact of the Asian economic crisis on America's economy?

A: The fundamentals of the American economy are exceptionally good. Growth is strong, wages are rising, private investment is booming, inflation is low, the federal budget is on track to be eliminated, and unemployment last year hit its lowest level (4.9 percent) in 24 years.

And there is every indication that U.S. economic prospects remain strong. Just last week, we learned that the economy added another 370,000 new jobs, bringing the total number of jobs created since I took office to 14.3 million.

At the same time, the world economy is increasingly interconnected and the turmoil in Asian economies will have an impact here at home. Restoring confidence and stability in Asia is very much in our long-term economic and national security interests. That's why the United States has been at the center of the international effort to reestablish stability and confidence in the region as soon as possible.

[If pressed]

Q: But exactly how much lower will growth be because of the Asian crisis?

A: Clearly, a prolonged period of slower growth in Southeast Asia and continued instability would not be good for U.S. economic and national security interests. That's why we are working to restore confidence and stability in the region.

Indonesia

Economic Prescription

Q: Is Indonesia on the brink of economic collapse? What message will Deputy Secretary Summers be delivering to the Indonesian government?

A: Indonesia is experiencing financial difficulties that the IMF program is designed to address. As part of that program, the Indonesian government has agreed to implement a series of measures to reform and clean up its financial system, to adjust monetary policy, to control public infrastructure spending, and to stem corruption.

We believe that vigorous and sustained implementation of the reforms agreed by Indonesia in conjunction with an IMF program offers the best prospects for restoring confidence in the Indonesia economy. Deputy Secretary Summers is in Indonesia today and will be affirming that message.

Implementation of Reform Commitments

Q: How do you judge whether Indonesia is carrying through on its policy commitments?

A: The IMF has the first line of responsibility for evaluating compliance with IMF-sponsored programs. The IMF team is in constant contact with the Indonesian authorities to suggest ways that policies can be implemented.

Stanley Fischer from the IMF met with President Soeharto today, and Managing Director Camdessus will be in Jakarta Thursday.

In addition, we are in regular contact both with the IMF team and the Indonesian authorities. Deputy Secretary Summers is in Indonesia today to emphasize the importance of implementing the economic reform measures adopted by Indonesia. He will meet with President Soeharto tonight (9:00 p.m. Eastern Standard Time or 9:00 a.m. local time.)

Stability of Soeharto Government

Q: Is the U.S. concerned about the stability of the Soeharto government? Do you believe Soeharto should step down?

A: Indonesia is experiencing financial difficulties that the IMF program is designed to address. Vigorous and sustained implementation of the reforms agreed by Indonesia in conjunction with their IMF program offers the best prospects for restoring confidence.

There have been several unfounded rumors in the past few days. President Soeharto remains in control of the Indonesian government, which has a strong economic team.

There has been no coup, and no widespread violence or demonstrations.
A presidential election is scheduled for March. The question of whether or not President Soeharto should seek re-election is a matter for him to decide, and the choice of Indonesia's leadership is a matter for the Indonesian people.

Regional Collapse

Q: What is your assessment of the financial situation in Asia? Are you concerned it might spiral out of control?

A: Several economies in the region are experiencing serious financial and economic difficulties. The Asia-Pacific region is important to us; we have substantial economic and security interests in seeing a return of confidence and stability as soon as possible. That is why we support international efforts to help these economies adjust.

These centerpiece of these efforts is implementation of reform commitments adopted by the affected governments. Vigorous implementation of these commitments offer the best prospects for restoring investor confidence.

For those countries who have demonstrated resolve in implementing a reform program, the IMF stands ready to extend financial support to provide a breathing space while the reforms take effect.

In some cases, where appropriate, several countries including the United States have also indicated they would provide back up financing if necessary as a second line of defense.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Sanders D. Korenman (CN=Sanders D. Korenman/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:12-JAN-1998 19:03:19.00

SUBJECT: Web file for Tuesday

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.D53]MAIL471496114.026 to ASCII,
The following is a HEX DUMP:

DRAFT

Mr. President,

Tomorrow I will address the advisory board to the President's Initiative on Race on the topic of racial and ethnic economic inequality in the labor market. My remarks will preview some of the material in the chapter on racial economic inequality we are planning (?) for the *1998 Economic Report of the President.*

You have seen some of this material in WEB pieces from time to time as well as in the materials we prepared for your town meeting on race in Akron. But there is a new interesting study that reinforces some of the earlier conclusions.

What do we think we know?
The key questions in this area are:
First: How much progress has there been in narrowing race differences in wages?

And, Second: To the extent that there has been progress in narrowing race differences in pay, why has that occurred? And in particular, what can we say about the role of the Federal government?

Although there is some disagreement, the following seems to be true:

1. In the 1940s both blacks and whites benefitted from the war-time economy. Blacks men advanced in pay relative to whites, mostly by moving to Northern manufacturing jobs.

2. In the 1950s, blacks and whites continued to advance, but there was little if any improvement in relative pay of blacks.

3. The 1960s and early 1970s saw substantial improvement in the pay of blacks both in absolute terms and relative to whites. Education played a role, but the most important factors appeared to be increased demand for black labor due to a combination of the strong economy of that time and Title VII Civil Rights Act of 1964. Since so much was happening at once, and since the Civil Rights Act was implemented nationwide, it is difficult to determine how much was due to what factors. But the improvement in relative pay was much greater in the South than in the North. Since the South was where Federal anti-discrimination efforts were focussed, most economists agree that the Federal role was substantial.

4. Black women made faster progress relative to white women than black men made relative to white men. Some time in the early to mid 1970s, wage of black women with similar education levels and similar ages caught or even surpassed those of white women. For example, among young college graduates, black women earned 5 to 10% more than white women in the early 1970s.

But after the early to mid-1970s, pay of blacks began to fall relative to whites. This is true whether or not one controls for education and age. One important unanswered questions is whether the erosion of relative pay of blacks has begun to reverse. All measures available show it falling from the mid 1970s to the mid-1980s. Some indicators show a reversal in the mid 1980s while others show continued deterioration. The 1990s are therefore something of a mystery.

Where do blacks stand today relative to whites?
1. Unadjusted differences
It depends a bit what data series one considers.
Median earnings of full-time workers on their usual job: black to white male weekly earning ratio is a bit over 0.71; for women it is about .83. By the way, the Hispanic white ratio is about 10 points lower.

2. Within education groups.
If you look at college graduates, the black to white ratio for men is about .79 and for women it is 0.90. For Hispanics it is 0.79 and 0.96.

If you look at HS graduates, the ratios are larger.

3. Full-blown regression adjustments of hourly wages.
Young Men: for HS grads and college grads, it is about 15%
Young Women: for HS grads and college grads, about 10%

Note that for both men and women, young college grads have seen tremendous decline in relative pay...from 10 percent premiums for blacks in the mid 1970s to 10 to 15% deficit in early 1990s

(We have data for women to 1991, to men for 1996).

Q: Why did progress stop or reverse?
Generally economists have there hypotheses

1. Increasing demand for skill. But for this to work to explain declining relative pay.
- unmeasured skills would need to be lower for blacks
- and unmeasured skill gaps would have to be converging more slowly than demand for skills is rising.

2. Discrimination
Problem:
- It would have to be increasing
- It would have to start increasing in the mid-1970s. This is possible, but usually "backlash" is thought to have begun with Reagan Administration. In fact, EEOC got enforcement teeth in 1972.

3. Other labor market changes:

- Decline in manufacturing, especially in Northern cities where blacks were disproportionately concentrated.
- Decline in unions and real value of minimum wage.

Q:What about Thernstroms' claim that progress has been steady since 1940?
A: It is true that blacks have made progress, but many indicators of progress stopped improving in the early to mid 1970s. A fairer characterization is: 10 to 15 years of rapid progress followed by 20 years of stagnation. The 1990s is too messy to give clear indications one way or another.

There is a new study, that we wrote about in last week's WEB, that confirms many of these lessons, but draws an interesting new one.

What does the new study show?
The new study examines the effects of the Equal Employment Opportunity Act of 1972, and discuss how it fits in with existing knowledge.

As you may know, the EEOA of 1972 extended coverage of Title VII of the Civil Rights Act of 1964 to small employers who previously not been covered--those with 15 to 24 employees.

In the North, prior to 1972 most small employers were covered under state Fair Employment Practices laws, while in the South they were not.

So a natural "test" of the effects of the 1972 law is to compare changes in employment, earnings and occupations of black men in these small firms in the South to those in the North. These firms are mostly in the construction and services industries.

A new study finds that the new law did in fact increase the employment and pay for black men in the South relative to the trend. It appeared to do so by pulling less-educated men into these jobs.

This process took place at a much faster rate in the South than in the North...the difference between the change in the South and North provides an estimate of the effects of the law.

Who gained?
This is where the study adds to knowledge. The earlier analyses suggested that better educated blacks were the primary beneficiaries of 1964 legislation. In fact, the "returns" to education for blacks before 1964 was much lower than for whites. After 1964 there was a rapid increase in the "returns" to black education. While you might think (and some argue) that this is due to improved quality of schooling, in fact the value of higher education increased even for older cohorts of blacks who had completed their education before 1964. Moreover, schools really did not integrate much in the South before the late 1960s, and that is where the big improvements came.

Wage gains were largest after 1964 among young people, especially those with college educations. Books were written about the "black elite" and so on.

But the new study showed that the 1972 law actually appeared to help men with relatively low education levels in the South, by pulling them from marginal positions in the labor market into smaller firms.

Q:But aren't small firms crummy employers?
A: Compared to large firms, on average, yes. But don't forget that these men went to this sector voluntarily. Also, the evidence suggests that they were less-educated men. The mean education level fell in that sector in the South. Some were not employed or were employed in inferior jobs in Agriculture or informal jobs. For instance, self employment rates fell in the South (and income of self-employed men was very low). It is also unlikely that people would leave a higher-paying job in a larger firm for one of these jobs, although there is no longitudinal evidence on this point.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-JAN-1998 13:19:22.00

SUBJECT: CLINTON CONSIDERING PROPOSAL TO RAISE THE MINIMUM WAGE

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

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

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

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

TEXT:
---------------------- Forwarded by Janet L. Yellen/CEA/EOP on 01/12/98
01:18 PM ---------------------------

ORSZAG_J @ A1
01/12/98 11:12:00 AM
Record Type: Record

To: See the distribution list at the bottom of this message
cc:
Subject: CLINTON CONSIDERING PROPOSAL TO RAISE THE MINIMUM WAGE

Date: 01/12/98 Time: 10:17
CClinton considering proposal to raise the minimum wage

WASHINGTON (AP) At the urging of allies in Congress, President Clinton is considering seeking an increase in the minimum wage, a spokesman said today.

``It's being looked at," press secretary Mike McCurry said. ``I don't think there's been any decision at all one way or the other."

In 1996, Congress raised the minimum wage by 90 cents an hour in two steps: from $4.25 to $4.75 an hour Oct. 1, 1996, and to $5.15 an hour on Sept. 1, 1997.

Republicans in Congress likely would fight any increase. They opposed the last increase arguing that it would cost jobs but retreated under political pressure.

Sen. Edward Kennedy, D-Mass., has proposed increasing the minimum wage by $2.10 an hour to $7.25 over the next five years.

``An increase in the minimum wage has been suggested by many of our friends and supporters in Congress," McCurry said. He said

Clinton was exploring a number of ideas about how to restore the economic power of the minimum wage relative to what it has been in the past.

McCurry said the 1996 increase ``did not bring it up to the full value it had'' in years past.

``At this point, it's still something I'd put in the category of being looked at,'' McCurry said.

APNP-01-12-98 1025EST

Message Sent
To:____
Anne H. Lewis
Jake Siewert
Gene B. Sperling
Russell W. Horwitz
Janet L. Yellen
Michele M. Jolin

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:13-JAN-1998 14:53:07.00

SUBJECT: Eisenstat

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

TO: Randall W. Lutter (CN=Randall W. Lutter/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Jonathan.gruber (Jonathan.gruber @ treas.sprint.com @ inet [UNKNOWN])
READ:UNKNOWN

TO: Adele C. Morris (CN=Adele C. Morris/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

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

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

TEXT:
Stu told me has been asked if he can testify on Kyoto Feb. 5 or 10 (maybe it was Senate Foreign Relations Committee; he said they hadn't asked for a member of the economics team yet), and he asked if we would have an economic analysis ready by then. I said I thought so.

I asked if he thought we had to have a study in the form of a document, along the lines of IAT (beyond testimony). He said he thought "no", not by Feb. or March. But probably eventually.

JF
JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:13-JAN-1998 14:56:10.00

SUBJECT: Tarullo mtg. on E.Asia crisis: report

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

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

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

TEXT:
The subject of today's EA mtg. turned out not to be EA per se, but rather
on potential vulnerabilities elsewhere.
Plus some tid-bits on Summers mission to Indonesia and Thailand.
Let me know if you want more.
JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-JAN-1998 16:41:34.00

SUBJECT: Tarullo E.Asia crisis mtgs.

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

TEXT:
Janet,

At each of the two Asia meetings I have attended (Tues. and Wed.) attendance has been entirely at the Deputy level (or lower), with the exception of Tarullo himself. I would like to ask that you please consider the possibility of sending me on a routine basis. Let's discuss it, at least?

JF

P.S. I plan to be out of the office on Friday (NYC).

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-JAN-1998 16:33:51.00

SUBJECT: report on Wed. Tarullo mtg. on EAsia crisis

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

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

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

TEXT:
Janet
There was some quick talk about developments regarding Japan, Thailand, Korea and Indonesia. But, as yesterday, most of the time was spend reviewing possible vulnerabilities in other parts of the world, in this case Brazil and Ukraine. It sounds like perhaps they intend to do Turkey and Pakistan in the next meeting. Let me know if you want more info.

Some discussion of "communications/outreach." They have my list of outside people, and apparently want me to continue talking to them, without any attempt at micro-coordination. But Tarullo, based on this own phone calls, is pessimistic.
JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:15-JAN-1998 19:21:43.00

SUBJECT: comments on GCC section in ERP from Todd Stern et al.

TO: Randall W. Lutter (CN=Randall W. Lutter/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: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Keith O. Fuglie (CN=Keith O. Fuglie/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Michele Jolin (CN=Michele Jolin/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 got a call from Peter Orszag this morning -- he asked me to join him, Todd Stern, David Sandalow, and Bill Antholis to discuss the climate change section. In general, I think they really like what we have done. Here are their comments:

1. p. 1, para. 2: Add a reference to severe weather in our list of potential impacts.

2. p. 1, para. 3: Explain why no single country has the incentive to reduce emissions sufficiently (add a sentence on free rider effect).

3. p. 2, para. 1: Move the sentence that summarizes the all Annex I target (1990 -5%) to the end of that paragraph.

4. p.3, para. 2: First sentence is awkward, and we should add "the" before point.

5. p. 3, para. 2: We have been pretty fair between upstream and downstream, but this paragraph may appear to give more weight to upstream because it discusses it more. They suggest deleting the sentence that begins "Commercial distribution of fossil fuel would require...." They did like our addition of a reference to the possibility of a hybrid.

6. p. 3, para. 5: They did not like the "should" in the beginning of our third point. I suggested that we rewrite the first sentence as "Third, a permit system that would allow trades across all sectors would minimize

total cost." They said they could live with that change.

7. p. 4, para. 1: They did not like our fourth point on upstream/downstream (reduce uncertainty in economic costs and environmental protection), and wanted it deleted. I don't think any of us would lose any sleep if it were taken out, so I agreed to delete it.

8. p. 5, para. 1: They want us to be more explicit that Kyoto gave us the right to trade emissions, so we worked on a change to the second sentence and a third sentence that states that this right would serve as the foundation for a trading regime.

9. p. 5, para. 2: In the second sentence, they suggested that we rewrite it as: "For countries that have no domestic tradeable permit systems because they opt for a commmand-and-control or tax approach to controlling emissions, it may still be possible instead to arrange exchanges of permits on a government-to-government basis." (We originally had firms in place of countries, which does not make much sense.)

10. p. 5, para. 3: They did not like the end of this paragraph because it may draw the ire of the greens by saying that we will buy all of Russia's paper tons (even though that's what we're going to do), and because we say the U.S. will be buyer, which may be inferred to mean the government. They suggested that we drop the last four sentences, and add "An international market would allow firms to trade permits with each other." I suggest we keep the last sentence "The gains from international trade in permits would be particularly large if developing countries were to participate."

11. p. 6, para. 1: They want us to check with Rosina about the estimate of when developing country emissions pass developed country emissions. Further, Sandalow suggested that we add a chart about the stock of greenhouse gas emissions and the responsibility apportioned to developing and developed countries. I will contact Rosina or her staff.

12. p. 6, para. 2: They would like us to insert "Some may be concerned that" before the sentence "Energy-intensive industries could choose to relocate...." and modify the end of the sentence to read "although there is little evidence to suggest that this would pose a significant problem in most industries." (It used to end "significant problem for the U.S. balance of trade.")

13. p. 6, para. 2: In the next sentence, they would like the end of that sentence to read "to seek meaningful participation by key developing countries to reduce greenhouse gas emissions as a condition for taking on binding emissions reductions."

14. p. 6-7: The last sentence of the developing countries section they would like to read: "The President has indicated he will not submit the Kyoto agreement for Senate ratification until there is meaningful participation by key developing countries."

15. p. 7: The JI section should have the header "Joint Implementation/Clean Development Mechanism" since the Protocol also

allows JI in Annex I countries, and this is distinct from CDM.

16. p. 7, para. 2: The discussion on JI should make it clear that it is a win-win: developing countries get technology while we get lower cost abatement.

17. Federal procurement: Todd asked if we could insert a sentence about the policy to stimulate markets for energy efficient technologies through federal procurement. I told him we could probably work something like that in the energy diffusion section.

18. Energy chart: Peter felt that Gene would not like the energy chart because it might be inferred that the government has slacked in its funding of energy R&D. Keith told me he would modify the chart (either break out public and private, or do private only).

19. Permit price chart: They think we should pull it out. They are happy with us saying that trading and JI could cut costs by a factor of 6, but they are concerned that people will ask what the price is for domestic only abatement if we include the chart. There was a feeling that this was out in front of the economic analysis the Administration is doing. (However, they did think it was a clever way to get around the price issue.)

20. Greenhouse gas emissions chart: They want us to delete the dotted line that goes all the way across the chart and just insert a line during the 5 year commitment period.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:15-JAN-1998 20:19:10.00

SUBJECT: report on today's Tarullo EA crisis mtg.

TO: Janet L. Yellen (CN=Janet L. Yellen/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:
Treasury was not ready to present on Turkey and Pakistan, so that will probably come next time. (I now have State's document running-down emerging Market Vulnerabilities, if you want it. We need to discuss China's State Planning Council at some point; no hurry.)

So most of the time was spent discussing Thailand instead. The key point is that we need to show the Thais that we really care about them, notwithstanding the fact that we didn't put any money into the rescue package last August. Wolf from State went through a list of possbilbities (ExIm type things) that amounted to little. The main conclusion is that when the finance minister comes next week, POTUS might drop by his meeting with Berger, and invite the Thai PM to come to the WH eventually (this info not to be spread at this point, I would think).

I will give you some documents. As you will see, Lael has now created a master list of validators into which my "call list" is integrated, and they seemed appreciative at the meeting.
JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Amy N. Finkelstein (CN=Amy N. Finkelstein/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:16-JAN-1998 16:50:11.00

SUBJECT: Minimum wage update

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

TEXT:
Janet --

Just to clarify, here is the current plan:

We will examine all the demographic characteristics that we decided in our meeting yesterday (with Treasury, Labor, and NEC).

For all estimates we will present:
1. the number of people affected (e.g. how many blacks affected)
2. the category as a percentage of the wage group (e.g. what percent of the affected people are black)
3. the percentage of the category affected (e.g. the percentage of blacks affected).

We will estimate the total number of people affected with and without disemployment effects (Jon Gruber will be supplying an estimated elasticity to calculate disemployment effects). We will not adjust the numbers affected in different demographic subgroups for disemployment effects.

We will do three wage cuts for all of this:
5.15-5.40 (assumes constant real wage distribution)
5.40-6.00 (assumes constant nominal wage distribution)
5.40-Jeremy's estimate. (assumes nominal wage growth at the bottom of the distribution does not keep up with inflation.)

We will also present the above analysis for Kennedy's proposal. For this we will do two wage cuts:
less than or equal to $7.25 (this assumes no change in nominal wage distribution)
less than or equal to some number less than $7.25 based on Jeremy's estimate.

We are meeting with Peter Orszag Monday afternoon to show him what we have done and discuss what information should be presented (and how!).

We are not doing poverty simulations at this point (i.e. predicted change in poverty rates for a given minimum wage increase) because this would be relatively complex and require more data manipulation than seems feasible this weekend.

Let me know if there's anything you think is missing.

--Amy

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-JAN-1998 12:43:13.00

SUBJECT: Re: BLS changes

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

TEXT:
I have mentioned orally on a few occasions that BLS is making changes but
will write a note explaining the changes over the weekend.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-JAN-1998 12:44:32.00

SUBJECT: BLS changes

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

TEXT:
Can you help me draft a note to POTUS explaining past and expected future BLS methodological changes and their impact on the CPI? We need to get this out ASAP.
---------------------- Forwarded by Janet L. Yellen/CEA/EOP on 01/16/98 12:43 PM ---------------------------

Sylvia M. Mathews
01/16/98 12:17:11 PM
Record Type: Record

To: Michele Jolin/CEA/EOP, Janet L. Yellen/CEA/EOP
cc: Jonathan A. Kaplan/OPD/EOP
Subject: BLS changes

Would you please draft a note to the President re: how BLS changes have been incorporated into our inflation statistics. POTUS asked the question this week and we said that you (Janet) would get back tohim. If he asked you this orally and you explained already, please let me know and ignore this note. TY

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-JAN-1998 17:10:40.00

SUBJECT: ERP President's statement

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

TEXT:
Attached. ==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D24]MAIL49896651 4.026 to ASCII,
The following is a HEX DUMP:

To the Congress of the United States:

For the last five years, this Administration's economic agenda has been guided by a simple but profound vision: to ensure that the American Dream is alive for everybody who is responsible enough to work for it, and to find a way to bring our people together into one America. The Administration's philosophy of opportunity, responsibility and community is now America's guidepost to the 21st century.

When this Administration took office in 1993, deficits were growing, unemployment was high, and wages were stagnant. To reverse this course, we took a new and different approach, putting in place a bold strategy to shrink the deficit and balance the budget, invest in our people and open markets to American goods and services. The goal was to remove the impediments that had constrained the American economy and give our workers the tools and training to help them thrive in our changing economy

The strategy has succeeded: 14 million new jobs have been created; unemployment was below 5 percent for 9 months in 1997 while inflation remained low; growth was solid; and the benefits of that growth are being shared by all Americans, as poverty dropped and wages began to increase. We also saw the biggest drop in welfare rolls in history, with our pro-family welfare reform efforts that focus on work. There are challenges that remain, but this is a proud record of accomplishment for the American people.

The Clinton Administration's Economic Strategy

From the beginning, this Administration's economic strategy has had three crucial elements -- reducing the deficit, investing in our people, opening markets abroad and expanding U.S. exports.

Deficit reduction. The Administration's 1993 deficit reduction plan set our nation on a course of fiscal responsibility, while making critical investments in the skills and well-being of our people. In January, 1993, the deficit was $290 billion. Today, the budget deficit is less than $23 billion. That is a reduction of $267 billion -- more than 90 percent. Our deficit today is the smallest share of our economy since 1970. And, for the first time in 50 years the deficit has gone down five years in a row. The 1997 balanced budget law will help complete the process, giving us the first balanced budget in a generation by FY1999.

Investing in our People. In the new economy, the most precious resources America has are the skills and ideas of working Americans. Investing in the education and health of our people will help all Americans reap the rewards of the our growing, changing economy. Those who are better educated, who are flexible, who have the skills to move from one job to another and seize new opportunities, will be rewarded.

The 1997 balanced budget agreement includes the largest increase in aid to education since 1965, and the biggest increase to help people go to college since the G.I. Bill was passed 50 years ago. The budget has $1 billion more for Head Start, it establishes the America Reads program to mobilize a million volunteers to promote literacy, and contains money to help connect every classroom and library in this country to the Internet by the year 2000.

It also contains a new HOPE Scholarship to guarantee all Americans access to at least two years of college; other tuition tax credits for all college and skills training; an IRA that allows tax-free withdrawals to pay for education; the biggest increase in Pell Grants in two decades; a million, total, work-study slots; and doubling of aid for dislocated workers.

There is still more that needs to be done to address the challenges of educating our people. We need to increase the quality of education in our public schools. We need to provide more options to parents in public school through public school choice and allowing teachers to organize new charter schools within public school districts. We need national standards and voluntary national exams to begin with 4th grade reading and 8th grade math.

We have also taken measures to enhance worker security and improve the well-being of working families. The Family and Medical Leave law signed into law in 1993 ensures that millions of people do not have to choose between being good parents and good workers. The Kennedy-Kassebaum law helps millions to keep their health care if they take a new job or if someone in their _family gets sick. The minimum wage was increased, the earned income tax credit (EITC) was expanded, and a $500-per-child tax credit was provided. The new balanced budget also spends $24 billion to expand health care to 5 million of the most vulnerable Americans -- 5 million children, almost all in working families, without health insurance. That is the largest investment in health care since the creation of Medicaid in 1965.

Opening Markets and Expanding Exports. To create good jobs and increase wages, we must open markets abroad and expand U.S. exports. Indeed, about a third of the economic growth that has produced 13 million new jobs over the past five years has come from selling more American products overseas.

There were over 220 trade agreements signed in the first four years of this administration. In the areas covered by the over 20 agreements signed with Japan, our exports went up by over 80 percent. And the recently signed information technology agreement, covering 90 percent of information technology services in the world, amounts to a $5-billion tax or tariff cut on high-value added American products.

Because of the importance of trade to our economy and our workers, it is critically important that fast track negotiating authority be renewed. In general, U.S. markets have been more open to the world for decades. Our goal is to open more foreign markets to U.S. exports.

Fast track authority is a tool that has been given to Presidents of both parties for more than 20 years. It allows the President to negotiate a trade agreement, and then requires that Congress take an up or down vote on the agreement as a whole. This authority gives the President the ability to create open and fair trade for business and working people, and to advance our nation's prosperity.

Seizing the benefits of our growing, changing economy

Going forward, the central challenge for our nation's economy is ensuring that American workers are equipped to seize the benefits of our new and changing economy. Information and technology and global commerce are leading the transformation of the global economy. The new strength of a nation will be found in the skills, knowledge, and imagination of its people.

This Administration's strategy -- balancing the budget, investing in our people, opening markets abroad -- will support and enhance America's strength in this new economic era. It is a strategy for an economy of the 21st century, removing barriers to our economy's potential and providing our people with the strength, the skills, the security, and the flexibility needed to reap the rewards of our growing, changing economy.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Sylvia M. Mathews (CN=Sylvia M. Mathews/OU=WHO/O=EOP [WHO])

CREATION DATE/TIME:16-JAN-1998 12:17:18.00

SUBJECT: BLS changes

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

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

CC: Jonathan A. Kaplan (CN=Jonathan A. Kaplan/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TEXT:
Would you please draft a note to the President re: how BLS changes have been incorporated into our inflation statistics. POTUS asked the question this week and we said that you (Janet) would get back tohim. If he asked you this orally and you explained already, please let me know and ignore this note. TY

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Amy N. Finkelstein (CN=Amy N. Finkelstein/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:18-JAN-1998 20:40:05.00

SUBJECT: draft of new minimum wage memo

TO: Rebecca M. Blank (CN=Rebecca M. Blank/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:
Attached are the new numbers I have tabulated, as well as a brief explanation. Based on our conversation with Peter tomorrow afternoon, I can make graphs of the tabulations he thinks most interesting, and summarize them in the text.

Please let me know if there's anything additional you'd like to see before we meet with him.

Also, the current draft says nothing about potential disemployment effects. I was not sure if this was something we wanted to go into. Jon Gruber reported back that the literature on disemployment effects from past small increases estimates an effect that ranges from no adverse employment effects to a 3 percent decrease in teen employment for every 10 percent increase in the minimum wage.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D49]MAIL40288081Q.026 to ASCII,
The following is a HEX DUMP:

Who Is Affected By Increases in the Minimum Wage?

We examine the demographic characteristics of workers likely to be affected by two different increases in the minimum wage. Under one scenario, the minimum wage is increased roughly in line with expected inflation, reaching $6.00 per hour by 2003.. The other scenario examined is Senator Kennedy's proposal, which would increase the minimum wage in 50 cent increments, reaching $7.25 per hour by September 2002.

Real wages have been roughly constant at the bottom of the income distribution over the last 10 years. We therefore assume constant real wages at the bottom of the income distribution through 2003. Consequently, we assume that those affected by an increase in the minimum wage to $6.00 per hour by 2003 are those who are currently earning the $5.15 per hour minimum wage. Similarly, those affected by an increase in the minimum wage to $7.25 per hour in 2002 are those currently earning $6.40 per hour or less.

Table 1 presents the number of people likely to be affected by a minimum wage increase, assuming no disemployment effects.

Table 2 presents the characteristics of those affected by a minimum wage increase. For example, if the minimum wage is raised to $6.00 by 2003, about 39 percent of those affected by the increase would have less than a high school education. Table 2 reveals that, under either scenario, those affected are disproportionately low-skilled, black, female, teenagers, not the primary earner in the family, and poor. The proportion of the affected group that has a given set of characteristics is roughly similar under the two scenarios for a minimum wage increase examined. For example, 17 percent of those affected by an increase to $6.00 by 2003 are black, compared with 15 percent of those affected by an increase to $7.25 by 2002.

Table 3 indicates what proportion of various demographic groups would be affected by a minimum wage increase. For example, if the minimum wage is raised to $6.00 by 2003, 24 percent of those without a high school degree would be affected.

Table 1: Numbers of people affected.

	Increase to $6.00 by 2003	Increase to $7.25 by September 2002
Total	2,097,000	4,342,000
Education		
Less than High School	822,712	1,477,000
High School	649,494	1,469,000
More than High School, no BA	538,248	1,195,000
BA or more	87,018	200,616
Race/ethnicity		
black	358,327	66,234
white	1,644,000	3,485,000
asian	69,220	140,117
hispanic	176,666	423,191
Gender		
female	1,286,000	2,612,000
male	811,216	1,730,000
Family status		
Teen	746,441	1,285,000
Adults	1,351,000	3,057,000
Married adult female	411,901	966,349
Married adult male	167,672	421,919
Single adult, no children	516,540	1,140,000
Single adult with children	254,918	528,739
Primary earner in family	559,619	1,264,000
Gender/race		
White male	661,938	1,429,000
White female	981,873	2,056,000
Black female	243,407	437,588

Black male	114,921	228,646
Asian male	19,173	48,372
Asian female	50,047	91,744
Hispanic male	93,256	227,878
Hispanic female	83,410	195,313
Economic indicators		
Poor	394,288	683,011
Below 200 percent of poverty	899,553	1,762,000
Poor adults	294,707	519,794
Adults below 200 percent of poverty	652,843	1,340,000
Median family income	31,600	31,600

Table 2: Demographic Characteristics of those affected as a percent of wage category

	Increase to $6.00 by 2003	**Increase to $7.25 by September 2002**	**All wage and salary workers**
Education			
Less than High School	39	34	13
High School	31	34	32
More than High School, no BA	26	28	28
BA or more	4	5	26
Race/ethnicity			
black	17	15	11
white	78	80	85
asian	3	3	4
hispanic	8	10	10
Gender			
female	61	60	47
male	39	40	53
Family status			
Teen	36	30	7
Adults	64	70	93
Married adult female	20	22	25
Married adult male	8	10	32
Single adult, no children	25	26	27
Single adult with children	12	12	9
Primary earner in family	27	29	51
Gender/race			
White male	32	33	46
White female	47	48	39
Black female	12	10	6
Black male	6	5	5

Asian male	1	1	2
Asian female	2	2	2
Hispanic male	4	5	6
Hispanic female	4	5	4
Economic indicators			
Poor	19	16	6
Below 200 percent of poverty	43	40	21

Table 3: Percentage of Demographic Category Affected

	Increase to $6.00 by 2003	Increase to $7.25 by September 2002
Total	8	16
Education		
Less than High School	24	44
High School	7	17
More than High School, no BA	7	15
BA or more	1	3
Race/ethnicity		
black	12	22
white	7	15
asian	7	14
hispanic	11	26
Gender		
female	10	20
male	6	13
Family status		
Teen	38	65
Adults	5	12
Married adult female	6	14
Married adult male	2	5
Single adult, no children	7	15
Single adult with children	11	23
Primary earner in family	4	9
Gender/race		
White male	6	12
White female	9	19

Black female	14	25
Black male	9	18
Asian male	4	9
Asian female	10	18
Hispanic male	9	23
Hispanic female	13	30
Economic indicators		
Poor adults	24	42
Adults below 200 percent of poverty	14	28

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:19-JAN-1998 19:05:59.00

SUBJECT: draft letter to POTOS on the CPI (with Table)

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

CC: 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.D40]MAIL46549681K.026 to ASCII,
The following is a HEX DUMP:

DRAFT

January 21, 1998

To:
From: Janet L. Yellen
Subject: BLS Methodological Improvements

As shown in the attached table, the BLS has made methodological improvements that we estimate to have lowered the annual increase in the CPI by 0.28 percentage point since 1995. More improvements are in train through 1999, and we estimate these will lower the CPI by a further 0.31 percentage point. In sum, BLS actions since 1995 have or are expected to lower the increase in the CPI by 0.69 percentage point by 1999. Of this total, 0.36 percentage point had been anticipated by the Boskin Commission and by those responsible for the the long-run Social Security projection. The Boskin Commission would probably lower their estimate of the CPI bias by 0.33 percentage point. Similarly the Social Security projection of the CPI might also be lowered by this same 0.33 percentage point--give or take a bit reflecting disagreement on how to score these effects.

The BLS has requested further budget authority to fund programs that would increase the agency's ability to measure substitution and quality changes, as detailed on the last page of the table. The upper-level substitution effects would be incorporated in a separate annual index. (The BLS already has the capability of measuring substitution bias; these new programs would reduce the sampling error.) However, new legislation would be required for this index to be used in the Social Security indexation formula.

Table 1: Recent and Prospective Methodological Changes to the CPI

Change	Date	Effect on CPI	Reduces Boskin est.	Not yet in SS proj.	Description
Generic prescription drugs	1/95	-.01	yes	yes	Generic drugs had been considered different drugs than the proprietary brands that they replaced. With this change, generic drugs are now considered perfect substitutes.
Food-at-home seasoning	1/95	-.10	no	no	Fixed the so-called "formula bias" in the food category where it caused the most problems. Already accounted for in Boskin & SS estimates.
Owners' equivalent rent formula	1/95	-.10	no	no	The BLS follows the rent of renters who live in neighborhoods that are primarily occupied by homeowners. After it was discovered that the old formula for aggregating these rents was biased upwards, the aggregation formula was revised to eliminate this bias. Already accounted for in Boskin & SS estimates.
Rent composite estimator	1/95	+.03	no	no	Rents had been measured at both 1- and 6-month intervals, and both changes were used in estimating the CPI. But after it was discovered that the 1-month changes were biased towards showing no change, only the 6-month changes were used. Already accounted for in Boskin & SS estimates.
General Seasoning	6/96	-.10	no	no	Fixed the so-called "Formula bias" in the non-food categories. Estimated to have lowered the CPI by 0.1 percentage point. Already accounted for in Boskin & SS estimates.
Change	Date	Effect on CPI	Effect on Boskin est.	Not yet in SS proj.	Description
Hospital Services	1/97	-.06	yes	yes	In contrast to previous procedures which measured the list price of medical inputs (such as an hour of physician's time), the BLS changed

Index					to a system of measuring transaction prices on patients bills. Using evidence that transaction prices have not been increasing as fast as list prices, we estimate that the substitution of list for transaction prices will lower the increase of the CPI by 0.06 percentage point per year. However, even larger effects are possible if the items on billing records turn out to be outputs rather than inputs--thereby allowing productivity growth to reduce medical price inflation. In addition, the BLS has now grouped inpatient and outpatient surgery into the same category. At present, the agency is aggregating these with fixed weights, but if the agency ever decides that (much cheaper) outpatient surgery is a substitute for inpatient surgery, the effect on hospital inflation would be raised considerably.
Personal computer hedonics	1/98	-.06	yes	yes	The BLS will switch to measuring computer prices by the price of intrinsic characteristics (like speed and memory) rather than by following price declines among selected models.
Updated market basket	1/98	-.15	no	no	Update the market basket from 1982-84 to 1993-95. Already accounted for in Boskin & SS estimates.
Change	Date	Effect on CPI	Reduces Boskin est.	Not yet in SS proj.	Description
Geometric means	1/99	-.15	yes	yes	BLS will announce in February 1998 which of the 214 categories (such as apples, or "prescription drugs") will be aggregated using the current system of arithmetic weighting (which assumes the consumer always buys, say, 3 Delicious and 2 MacIntosh apples) or or geometric weighting (which assumes that the consumer buys more Delicious apples when they become cheaper). Geometric aggregation is clearly appropriate for apples, but probably not for prescription drugs. If geometric aggregation were to be used for every category, it would lower the CPI by 0.25 percentage point per year, but the BLS is likely

					to consider it appropriate for only about half the categories.
Rotation by item	1/99	-.05	yes	yes	The "Point-of-puchase survey" (POPS) selects which within-category items (such as which apple variety) consumers purchase and where they buy them. Currently, the (POPS) is done once every five years on a regional basis--so that one-fifth of the regions are updated every year. The BLS will switch to national updating by item--a change that will allow more frequent item selection in the categories with the most new-product introductions, such as consumer electronics.
Total of past & announced		-.69	-.33	-.33	
Change	Date	Effect on CPI	Reduces Boskin est.	Not yet in SS proj.	Description
Proposed:					
Data collection for hedonics	1/99	?	?	?	Would fund the collection of data to support hedonic quality adjustment.
Consumer expenditure survey expansion	1/00	?	?	?	Would increase the sample size for the Consumer Expenditure Survey, Although not strictly required, this would facilitate 1) a shorter lag for incorporating new market baskets, and 2) superlative indexes.
Accelerated update system	1/01	?	?	?	Would reduce the lag in incorporating new market baskets. (For example the 1993-95 basket is not being implemented until 1998. With a larger CE sample, only a 2-year CE sample would be required this shortening the lag required for a new market basket.
Superlative Indexes	1/02	.15	.15	.15	BLS would issue a second superlative index in October for the annual average of the previous year. Would not lower the published CPI, but,

					with new legislation, could be incorporated into government programs.

[Automated Records Management System Hex-Dump Conversion]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:19-JAN-1998 09:32:19.00

SUBJECT: Memorandum from Secretary Daley

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

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

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

TEXT:
---------------------- Forwarded by Janet L. Yellen/CEA/EOP on 01/19/98
09:31 AM ---------------------------

JDorskind @ doc.gov
01/16/98 06:58:00 PM
Record Type: Record

To: See the distribution list at the bottom of this message
cc:
Subject: Memorandum from Secretary Daley

Secretary Daley has directed that I deliver the following memorandum to you. I will provide the hard-copy original on Tuesday. Please feel free to contact me if you have any questions.

The text of the Secretary's memorandum follows:

January 16, 1998 (approved by Secretary Daley by phone in Prague)

MEMORANDUM FOR JANET YELLEN

FROM: WILLIAM M. DALEY

SUBJECT: The State of the Union Address and
Presidential Initiatives on
Economic Statistics

The President's FY 1999 budget includes support for two initiatives on economic statistics that I know interest you and, in my own view, could make compelling points for his State of the Union address.

Ours is a time of such rapid and fundamental economic and social change, and some of our most basic statistical measures have not keep pace with these changes. First and most important, we must be certain that our GDP statistics capture all the value of information age industries. As you have noted in your forthcoming Economic Report of the President, a significant and persistent discrepancy has emerged between the size of the economy as measured by the product accounts and the income accounts. As a result, we cannot say for certain just how fast the American economy has been growing, how much the real incomes of American families have risen, or
how much productivity is increasing. The only way to resolve these issues is to provide additional support for the Bureau of Economic Analysis and the Census Bureau to study the discrepancy and close it. The FY 1999 budget proposes to increase the BEA's appropriation from $42.7 million to $48.4 million and provide an additional $9.4 million for GDP-related analysis by the economic division of Census.

Second, it's time to modernize our poverty measures. As you know, we still
use an official measure developed in the 1960s, which excludes both the benefits of in-kind assistance and the effects of taxes and tax credits. As a result, the nation's official poverty measure is unaffected when we change the food stamps program, or housing assistance, or the Earned Income
Tax Credit. In 1995, a National Academy of Sciences panel recommended a number of changes to update the poverty measure, and the FY 1999 budget includes additional funds for the Census Bureau to use available data sources to produce an estimate more consistent with the Academy's approach.
The budget also includes support for the Census Bureau to expand the sample for the Survey on Income and Program Participation, which tracks in-kind benefits and taxes, to produce more accurate income and poverty estimates in the future.

We should do our best to ensure that the American people know about and appreciate these initiatives. I hope you will join me in urging the President to include them in both the State of the Union and the Administration's public budget presentations to the Hill.

cc: The Honorable Franklin Raines, Gene Sperling, John Hilley, and Michael Waldman

----

Jim Dorskind
Director, Executive Secretariat
Office of the Secretary, U.S. Department of Commerce
Ph: 202-482-3934 Fax: 202-482-4576 jdorskind@doc.gov

Message Sent
To:____

Katherine Hubbard
Franklin D. Raines
Gene B. Sperling
Michael Waldman
Janet L. Yellen

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

TEXT:
RFC-822-headers:
Received: from conversion.pmdf.eop.gov by PMDF.EOP.GOV (PMDF V5.0-4 #6879)
 id <01ISIOONFXXS0158O0@PMDF.EOP.GOV>; Sun, 18 Jan 1998 10:17:43 -0500 (EST)
Received: from storm.eop.gov (storm.eop.gov)
 by PMDF.EOP.GOV (PMDF V5.0-4 #6879) id <01ISIOOMF8KG004VVQ@PMDF.EOP.GOV>; Sun,

 18 Jan 1998 10:17:41 -0500 (EST)
Received: from SMTP.OSEC.DOC.GOV ([204.193.255.3])
 by STORM.EOP.GOV (PMDF V5.1-7 #6879)
 with SMTP id <01ISIONX1MAY001WW9@STORM.EOP.GOV>; Sun,
 18 Jan 1998 10:17:08 -0500 (EST)
Received: FROM COMMOSECMTA.SMTP.OSEC.DOC.GOV BY SMTP.OSEC.DOC.GOV ; Sun,
 18 Jan 1998 10:17:07 -0500 (EST)
================== END ATTACHMENT 1 ==================

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:20-JAN-1998 08:44:33.00

SUBJECT: Index the ERP?

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

TO: Rebecca M. Blank (CN=Rebecca M. Blank/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:
Mike Treadway has a proposal for creating an index for the ERP (below).
Do you think this would be useful? Worth the money? Would it be better
to try and do it next year?
Thanks.
Michele
---------------------- Forwarded by Michele Jolin/CEA/EOP on 01/20/98
08:42 AM ---------------------------

James M. Treadway
01/19/98 12:02:01 PM
Record Type: Record

To: Michele Jolin/CEA/EOP
cc:
Subject: Index the ERP?

Michele,

I've been thinking about the ERP's lack of an index. By far the majority of published books of 250+ pages have indexes at the back. An index is really considered essential in a book that size if the reader is to be able to find passages of interest. Given that the ERP serves multiple audiences with many diverse interests, anything we can do to direct them to what they're looking for would add value.

Of course, we've never done an index because there's never been time. It normally takes a couple of weeks at least to write an index,and you can't do it until the report is in final page format. The detailed table of contents is intended as a substitute, but it is a poor one.

Here's an idea: what if we did an index after the report is out and posted it on the CEA website? We could even insert a statement at the end of the table of contents directing readers to the URL. (Cathy Fibich points out that the ERP text on the Internet is searchable, but that too is a poor substitute for a real index.)

I've written indexes for a number of IIE and World Bank books and could easily do one for the ERP. Given that I'm already quite familiar with the content, I could do the index probably in a little over a week. I estimate that I would charge CEA somewhere between $1,500 and $2,000 to do it.

What do you think?

Mike

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:20-JAN-1998 14:11:59.00

SUBJECT: Re: BLS and minimum wage tabs

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

TEXT:
Many thanks.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:20-JAN-1998 17:45:59.00

SUBJECT: Sandalow Comments on Chapt 7

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/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

TEXT:
David Sandalow left a message saying that he is concerned that there is no mention of the environment or sustainable development in the International Chapter. He also said that the environment will be an issue in the fast track debate and that it should be discussed in that section. He thinks that no mention is a noticeable ommission. I e-mailed him back saying that we are in the final stages of production so it may be too late to make these kind of changes. I asked him to let me know if it would be a S ERIOUS problem if these changes are not made. I'll let you know what he says.
Michele

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:21-JAN-1998 10:47:28.00

SUBJECT: Trade Deficit Q & A

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

TEXT:
Are you ok with these Q&A?
Thanks
---------------------- Forwarded by Michele Jolin/CEA/EOP on 01/21/98
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Jake Siewert
01/21/98 10:41:45 AM
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To: Barry J. Toiv/WHO/EOP, Darby E. Stott/WHO/EOP
cc: Michele Jolin/CEA/EOP
Subject: Trade Deficit Q & A

=================== ATTACHMENT 1 ===================
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TEXT:
Unable to convert ARMS_EXT:[ATTACH.D21]MAIL44899302E.026 to ASCII,
The following is a HEX DUMP:

Trade Deficit
January 21, 1998

Q: Do the new trade numbers reflect any deterioration because of the Asia crisis?

A: Today's trade figures do not show clear signs of an expansion of the deficit because of the Asian financial crisis. In fact, the deficit narrowed somewhat to $8.0 billion in November -- down from $9.1 billion last month.

There was some good news in the report. Automotive exports were up, and the deficits with China and Japan were the lowest since last summer. And for Mexico, the November deficit is the lowest since the January 95 level and is down relative to the preceding year. For the Newly Industrialized Countries and other emerging markets in the Pacific Rim (other than China), the deficit for the year-to-date is down slightly relative to the same period last year.

The right measure of the success of our trade policy is the growth of U.S. exports, which has been phenomenal. Exports through November 1997 have grown 10 percent relative to the same period in 1996, and over 45 percent since the beginning of the Administration. In fact, export growth has fueled one-third of the current expansion.

Q: But don't you expect the Asian crisis to make the deficit worse over time as the Asian countries export their way out of this slump?

A: There is every indication that U.S. economic prospects remain strong. At the same time, the world economy is increasingly interconnected, and restoring confidence and stability in Asia is very much in our long-term economic and national security interests.