

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:21-JAN-1998 15:16:26.00

SUBJECT: possible handout for WEB on J banks

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

READ:UNKNOWN

TEXT:

Janet

As I said, I can't think of a table or chart on the subject to hand out in POTUS brief. But do you think it would be useful to hand out the accompanying page of bullet points?

(They are not the heart of my planned presentation; but rather the definition of the Japanese system -- the jumping off point for my discussion as to how well it works.)

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

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D83]MAIL40247502V.026 to ASCII,
The following is a HEX DUMP:

Attributes of the Japanese system In the post-war period, the financial system in Japan, as compared to the one characterizing the United States and the United Kingdom, has featured:

- high debt/equity ratios on the part of corporations
- greater reliance on bank loans than on securities markets
- close relationships between banks and the companies that borrow from them,
- extensive corporate cross-shareholding,
- barriers to hostile takeovers as a mechanism of corporate control
- emphasis on sales and market share as objectives of firm managers, as opposed to profits and stock price
- guidance from the government in banks' credit allocation decisions,
- repression of the rest of the financial system, e.g., taxes on securities transactions (in combination with the imposition of compulsory financing on banks: requirements to buy government bonds)

In the Japanese system, large corporations tend to have a “**main bank**,” which:

- maintains a long-term relationship with its client, typically including direct share-holding, and common membership in a *keiretsu*
- helps the firm access capital markets, sometimes by providing financial guarantees and underwriting the firm's securities
- monitors the firm's management, and
- -- when the corporation gets into difficulty -- sends some of its own executives to serve as directors on the firm's board, and continues to lend through the period of distress.

In the US, by contrast, a corporation suffers immediate penalties at the hands of impatient shareholders.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:21-JAN-1998 20:07:53.00

SUBJECT: report on Eizenstat mtg. re GCC

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

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

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

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

TEXT:

The 5:00 mtg. at State turned out to be chaired by Eizenstat, with a big agenda (which I will circulate). One interesting item was the question whether the President should sign the treaty now; the general consensus seemed to be to withhold signing (in addition to submission for ratification) until after Buenos Aires.

The most important item on the agenda from our viewpoint was the economic analysis. The view was that there had to be one, and that this meant eventually a report that would be released. He asked whether we could have the basic economic analysis (not the full report) ready in time for his testimony. The Senate Foreign Relations Committee has asked him for Feb. 5, but they thought they might possibly be able to postpone it another week. Jon and I told him that another week would help a lot -- that currently we are missing an authoritative interpretation of what to assume on sinks, as well as results from other models (in the latter case, to be honest, another week won't get us much more). He told his State people to try to get us some answers to our questions on sinks (Rafe...).

Stu was definite that someone from the economic team would have to testify. Half the time, the presumption among those present was that it would be Larry. But half the time other formulations were used (e.g., "someone from the economic team," "Larry or Janet," etc.).

Joe, et al: Regarding our work program, we'll know more after tomorrow's meeting. But after we fill in the holes in the basic analysis that we have done (e.g., other models), we also have to start thinking about "visuals," about quantifying (if not monetizing) climate effects, about things we can say about the impact on the energy bill of a typical family, and about other pieces of the argument, such as answering claims that there will be large numbers of unemployed. We will need to divide up these tasks among us, and with Treasury.

JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:21-JAN-1998 10:14:49.00

SUBJECT: FYI -- Child care white paper

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

READ:UNKNOWN

TEXT:

----- Forwarded by Michele Jolin/CEA/EOP on 01/21/98
10:14 AM -----

Sanders D. Korenman
01/21/98 10:13:51 AM
Record Type: Record

To: Amy N. Finkelstein/CEA/EOP
cc: Maria J. Hanratty/CEA/EOP, Rebecca M. Blank/CEA/EOP, Michele Jolin/CEA/EOP
Subject: Child care white paper

Amy,
I just spoke with Robert Pear of the NY Times regarding welfare reform, and gave him Phil Levine's number. But I wanted to let you all know that he made a point of heaping great praise on the Child Care White Paper, and asked who the author was (as in "Author, Author!").

He said he found it tremendously useful in a field full of questionable research and data, and predicted it will prove invaluable in the political debate ahead.
Congratulations.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Mary Fibich (CN=Mary Fibich/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:21-JAN-1998 16:01:27.00

SUBJECT: Economic Report Covers

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:

I'm very sorry about the length of time it has taken to get the Economic Report covers--or more accurately, not to get them.

After the initial delays which Alice related to you last week, GPO provided a product on Thursday, January 22, that was unusable -- output from a color laser printer that bore no resemblance to the product ordered. The colors were so different from the color chart samples and the actual proofs we requested that we could not have known what the actual colors would be.

Steve Jewell, OA Publishing Branch Chief, spoke to GPO last Thursday as soon as I notified him of the problem, and sent the request back with another request for the sample covers. This second request was hand delivered to GPO on Friday, January 23.

The inks were ordered on a Priority 1 basis so they'd get them immediately. This requires approval of the Public Printer. In his absence, the paperwork sat on his desk, and the ink was not ordered. The inks have now been ordered, but will not arrive until tomorrow.

I just got off the phone with the Production Manager, whom I'm told is the #2 person at GPO. He recognizes the importance of these covers and is taking steps to speed the process along. He has the plates on the press, ready to run the job as soon as the ink is delivered. They hope to deliver the covers to us tomorrow.

GPO will call me as soon as the covers are printed, and I'll meet the driver in the lobby of our building rather than let it go through the interoffice mail system.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:22-JAN-1998 09:35:57.00

SUBJECT: Ch. 7 and the Environment

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

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

CC: Mark R. Hopkins (CN=Mark R. Hopkins/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:

Bob Kyle suggested that I contact Jennifer Haverkamp over at USTR about language for trade and the environment.

Accordingly, Jennifer and I just had a lengthy conversation about how to introduce the subject. What we discussed was adding it into the trade negotiating authority section, perhaps drawing similarities between the problems with trade negotiating authority as it existed before fast track, namely its failure to cover non-tariff barriers, and the focus on labor standards and the environment today.

The primary similarity is that they are both elements of international negotiations that have impeded progress.

Unless any of you have concerns or alternative views, she is going to try and draft some language by early next week.

Jon

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: James M. Treadway (CN=James M. Treadway/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:25-JAN-1998 16:59:09.00

SUBJECT: Re: E-mail copies of Chs. 1 and 2

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

READ:UNKNOWN

TEXT:

Here they are. (Yes, I'm here--I came in to finish Chapter 4 and make sure Sandy gets it first thing tomorrow.)

Mike===== ATTACHMENT 1 =====

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

TEXT:

WPC

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1 a.m.

E

CHAPTER 1

pPromoting Prosperity in a HighEmployment Economy

*

The past year saw the Nation's economy turn in its best performance in a genera

tion. Over the course of 1997, output

growth and job creation remained vigorous

while inflation

declined. Real (inflationadjusted) gross domestic product (G

DP)

grew 3.x percent, and employment rose by 3.2 million, for an average rate of 267,000 jobs per month. The unemployment rate dropped below 5 percent for the first time in 24 years, yet core inflation (as measured by the consumer price index, excluding its volatile food and energy components) averaged only 2.2 percent, its lowest rate in over 30 years. This exceptional economic performance occurred during a period of historic deficit reduction: the Federal budget deficit, which reached \$290 billion in the 1992 fiscal year, declined to only \$23 billion in fiscal 1997. And the Administration has submitted a budget for fiscal

1999 that projects a balanced budget for the first time since 1969.

As 1998 begins, 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 such as an increase in inflation, an

accumulation of inventories, or financial imbalance. Higher inflation could

result from overheating or from 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. Economic turmoil in East Asia could affect

the global economy, but if international efforts to restore stability in East

Asia succeed, the main effect on the U.S. economy could simply be to allow continued growth and job

creation with a more moderate outlook for interest rates. Another

sign that an expansion is nearing its end would be a sudden accumulation

of inventories, as businesses find their sales falling short of production

. Yet sales were strong in 1997, and inventory sales ratios are near historical lows. Financial

imbalances can also threaten to disrupt an expansion. But today

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 one-day plunge in October" although its continuing high valuation relative to earnings is a source of concern to some. Although the business cycle may not have been vanquished, the economy is in fundamentally sound shape and well-equipped to handle unexpected bouts of rougher weather. A principal force behind the current expansion has been business investment. None of the growth in GDP over this expansion has come from increased government purchases, whereas more than two-fifths has come from greater gross private domestic product and investment (Chart 11). Because of the Administration's deficit reduction efforts, the contribution of government spending to overall growth has been much lower than in most previous postwar expansions (and Federal Government spending has actually declined), while that of private investment has been higher. Over the past 3 years this burst of investment has yielded the fastest growth in industrial capacity since 1969. Policies such as deficit reduction have contributed to 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 goes to American workers and firms, who have risen to the challenges of a competitive global economy and rapidly changing technology. The role of government in such an economy is not to prop up economic growth with government spending but, more subtly, to provide individuals and businesses with the tools they need to flourish through their own efforts. The range of appropriate government policies in such an economy includes promoting private investment through sound macroeconomic policies, encouraging the formation of skills through training and education, securing opportunity for the marginalized members of our society, and "where necessary" providing assistance to the

most vulnerable. Using government to complement, not replace, the market and the private sector has been a fundamental, guiding principle of this Administrations economic strategy from the very beginning. And it is this strategy that has borne fruit over the last 5 years.

Despite the economy's recent exemplary performance, a number of challenges remain.

The first is to preserve and nurture the successes achieved so far. And although progress has been made in addressing the longer term problems like slow growth in wages and incomes and widening income inequality that have affected the economy since the productivity slowdown of the early 1970s, more needs to be done.

This chapter describes the principles and policies of this Administration 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 ADMINISTRATIONS ECONOMIC STRATEGY

The Employment Act of 1946 which created the Council of Economic Advisers together with its later amendments gave the Federal Government responsibility for stabilizing short-run economic fluctuations, promoting balanced and noninflationary economic growth, and fostering low unemployment. This Administrations strategy

in pursuing this mandate has focused on getting the fundamentals right: reducing the budget deficit, investing in technology 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 of sluggish productivity growth and widening income inequality that began to afflict the economy in the early 1970s.

But there is more to the Administrations policy agenda than can be measured by aggregate economic statistics alone. Getting

the fundamentals right means removing the barriers that block people 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 fostering a personal commitment by all Americans to help others, a sense of shared responsibility for our Nations children, and a sense of community in an increasingly multiethnic society.

:B A CREDIBLE PLAN FOR DEFICIT REDUCTION

The policy course set in 1993 has contributed to the Nation's recent economic health and strength. In 1993 the economy was still recovering from the 1990-91 recession, and it labored under the burden of a Federal budget deficit that had ballooned to \$290 billion, an alltime record. The linchpin of the Administration's recovery strategy was a credible budget plan that could achieve substantial deficit reduction over the longer term, yet be balanced and gradual enough to allow the economy to gather strength and move toward full employment in the short term. The success of this program rested on achieving an interest rate environment conducive to investment, which would allow the economy to grow in the face of a contractionary fiscal policy. This in turn required that financial markets correctly anticipate an appropriately accommodative monetary policy. In large measure, that is exactly what happened. Longterm interest rates fell to 25-year lows in 1993, spurring a pickup in economic growth. A key feature of the Administration's deficit reduction plan was its credibility. A credible and realistic program for deficit reductionone that observers and financial markets judged likely to be fully implementedwas a precondition for the reduction in interest rates that spurred investment-led growth. Fundamental to the plan's credibility was the adoption of a set of economic projections that

represented conservative, mainstream forecasts of future growth and inflation. These projections eschewed the rosy scenarios of previous budgets, which 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 performance has been stronger than the Administration projected. In the 1980s expansive fiscal policy required relatively tight monetary policy in the form of high interest rates to prevent the economy from overheating. This policy mix is particularly unfavorable from the standpoint of fostering longer term growth: high interest rates impede capital formation, while mounting government deficits depress national saving and contribute to more borrowing from abroad. The net result of deficit reduction in the 1990s has been to promote a more balanced mix of fiscal and monetary policy. 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.

:B INVESTING IN PEOPLE AND TECHNOLOGY

The primary purpose of deficit reduction, however, is to encourage investment. Hence, this Administration recognized from the outset that a plan that balanced the budget at the expense of the government's own productive investments would ultimately be self-defeating. Far from curtailing public investment, the Administration has given investment in people and technology a major place in its economic agenda. 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 is especially vital in today's high-technology economy, where a skilled work force is an essential

al condition for future growth. Education is critical if Americans are to capitalize on the opportunities created by new technologies and more open global markets. And education and training programs are of particular importance in the present economic environment as a means of preventing poverty and ensuring opportunity for all. The return to education has risen dramatically since the late 1970s; today, highly skilled workers command a high premium in the labor market over their less skilled counterparts. This rising skill premium is an important reason why earnings inequality is greater today than it was in the late 1970s. Governments have an important role to play in ensuring that all Americans have the opportunity to accumulate the skills 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 more accessible. It also requires recognizing that learning must be a lifelong activity in an economy where technological change is ongoing. Investing in basic research and the development of new technologies is another important function of government. The private sector spends billions of dollars every year on research and development. But economists have long recognized that private sector spending alone in these areas will be less than the optimum. Since the fruits of a new scientific discovery, for example, are enjoyed not merely by the discoverer but by society as a whole, the private incentive for pursuing scientific research falls short of the total social benefit. 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. This analysis implies that the return to government investment in basic research and technology is likely to be especially high.

:B OPENING MARKETS AT HOME AND ABROAD

A third major component of the Administrations economic agenda is the promotion of freer and more competitive markets at home and abroad. Domestically, this has involved the pursuit of initiatives directed at enhancing competition particularly in such industries as telecommunications, electric power, financial services, and health care and a vigorous approach to antitrust enforcement. It has also meant addressing market failures in such areas as health care and environmental protection. In some cases the effect of these initiatives is a one-time boost to the level of output, through greater efficiency and lower costs. But these

policies can also sometimes lead to a faster rate of economic growth. For example, past experience provides evidence that sensible deregulation can not only help raise efficiency, but also spur continued innovation through greater competition. Moreover, some benefits of these policies are not captured in the GDP statistics at all, but rather take the form of improvements in our quality of life.

The Administration is also committed to reducing the burden of government regulation and ensuring that the benefits of new regulations justify their costs. Many government regulations apply to industries in which technological change is rapidly altering the nature of market competition. A key precept of this

Administrations approach to regulation, therefore, is that the regulatory process must be a dynamic one, in which regulatory policies are constantly reviewed so as to minimize their burden on consumers and businesses. Another important precept is to refrain from policies that regulate through government fiat in favor of policies that use market-based incentives to attain the desired outcome. Experience with such policies as permit trading for sulfur dioxide emissions suggests that this approach can help

ensure that compliance with socially beneficial goals is achieved efficiently and cost-effectively. This Administration has also worked hard to open markets abroad by encouraging fairer and freer international trade. From his earliest days in office, the President has advocated an outward-looking, internationalist trade policy. During the Administration's first 4 years the United States concluded over 200 trade agreements

with other countries. Some of these agreements, such as the North American Free Trade Agreement (NAFTA) and the Uruguay Round agreement of the General Agreement on Tariffs and Trade, were comprehensive in scope, whereas others had more limited aims but all are vital to our Nation's competitive future. 0*H&H&Economists generally recognize that an open economy offers both static and dynamic advantages. First, trade benefits 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 everything 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 argues that increased trade actually raises an economy's rate of growth, because increased competition and larger markets spur the acquisition of new skills and the development of new technologies. If so, the case for trade liberalization becomes 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-time increase in the level of output.

:A A RECORD OF ACCOMPLISHMENT

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

:B BENEFITS OF A HIGHEMPLOYMENT ECONOMY

Driven largely by strong growth in business fixed investment, growth in real GDP and employment picked up in the second half of 1993 and persisted in 1994. This robust growth led to a series of monetary policy tightenings over the course of 1994, which resulted in more moderate growth in 1995. In retrospect, 1995 may have been the pause that refreshes. Economic growth exceeded expectations in 1996, and strong growth continued through 1997. The result has been a highemployment economy with the potential to overcome some of the longer term problems of growth and income distribution that built up in the 1970s and 1980s.

A highemployment economy brings enormous economic and social benefits. Essential to personal economic security is the knowledge that work is available to those who seek it, at wages sufficient to keep them and their families out of poverty. A tight labor market increases the confidence of job losers that they will be able to return to work, lures discouraged workers back into the labor force, enhances the prospects of those already at work to get ahead, enables those who want or need to switch jobs to do so without a long period 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 2 percent; in 1997, 2 percent of GDP was \$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-employment economy in which jobs are plentiful and labor markets tight yields other benefits as well. Short-term economic conditions can affect long-term structural unemployment. 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 skilled or younger and more inexperienced workers into the labor force. These new labor market entrants gain much-needed job experience, building the skills they will need to hold down a job in the future. The importance of this can be seen from the experience of some European countries: prolonged stagnation or recession may have led to a permanent increase in unemployment there, as the unemployed and the never-employed see their skills become obsolete. Running a high-employment economy, then, may be one of the surest ways to ensure that an unacceptably large fraction of our citizens are not consigned to long-term joblessness and economic marginalization.

From the 1970s until the early 1990s, the economy's ability to reduce poverty through growth alone was hampered by a strong headwind: the sustained declines in wages at the low end of the earnings distribution over the past two decades 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

n actually declined, while those at the 90th percentile rose by almost 80 percent. Holding a job no longer ensured that a less skilled worker will be able to lift his or her family out of poverty. This adverse secular trend raises even

further the stakes of maintaining a high employment economy. Keeping the unemployment rate low and job growth high is also necessary if we are to move current welfare recipients into the work force. Early, indirect evidence here is encouraging: employment and labor force participation rates among single women who maintain families about 61 percent of whom have children under 18 have increased in the past few years. This is probably in part the result of recent welfare reform: the greatest acceleration in employment rates has occurred among those single women most likely to be affected by welfare reform, namely, those with young children. Nevertheless, it is obvious that fostering 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 the current expansion is yielding gains in living standards for all Americans, especially those at the bottom of the income distribution. The poverty rate fell to 13.7 percent in 1996, from 15.1 percent in 1993; the poverty rate for black Americans is at a historical low, and in 1997 unemployment among blacks fell to its lowest rate in 24 years. Since 1993, household income has grown in each quintile of the income distribution, with the largest percentage increase going to the poorest members of our society (Chart 12). Maintaining a full employment economy is essential if this progress is to continue.

:B DEFICIT REDUCTION: COMPLETING THE TASK

The most significant economic policy event of 1997 was the passage of a deficit reduction package that will finish the task of balancing the Federal budget by

1999. This will be the first balanced budget since 1969, and only the ninth since World War II (Chart 13). Some have claimed that the expanding economy, not government policy, deserves all the credit for vanquishing the deficit. It is certainly true that ups and downs in the business cycle have an important effect on both revenues and outlays, leading to fluctuations in the deficit. But even when cyclical factors are thus accounted for, it is evident that policy has played a major role in bringing the deficit under control. It is also worth noting that in January 1993, before the 1993 deficit reduction package was adopted, the Federal deficit was projected to remain in excess of \$350 billion in fiscal 1998 and to rise to \$650 billion in fiscal 2003, even when the economy was projected to be at full employment. Finally, it is difficult to imagine that the economy's performance would have been anywhere near as strong as it actually was without a credible and successful attempt to put the government's fiscal house in order. Improvements in economic conditions have definitely played a part in reducing the deficit, but a balanced budget would not now be in sight had the Nation remained on the fiscal course in place in 1992. Although a balanced budget is often taken as the goal of fiscal policy, from an economic standpoint the goal of deficit reduction is to raise investment. When the government's budget is in surplus, in the sense that its spending on goods, services, and transfers is less than its income (that is, its revenues), the government makes a positive contribution to national saving. As discussed in Chapter 2, a case for higher national saving can be based on the high return on saving in the United States and the fact that private saving remains low, particularly by international standards. A higher rate of national saving now would lead to a larger economy when the babyboom generation retires, thus making

g it easier to provide for their retirement without imposing undue burdens on younger generations. Second, although a balanced budget does not add to the governments marketable debt, which past deficits have ballooned, it does not subtract from it either. Paying that debt down rather than leaving a large government debt in place implies that a sizable portion of existing government resources will continue to be absorbed by interest payments, leaving less for all others pending. Indeed, one legacy of the runup in the national debt that accompanied the deficits of the 1980s and early 1990s has been a sharp increase in the share of total outlays that must be used to make interest payments on the debt (Chart 14).

:B POLICIES TO RAISE GROWTH, REDUCE INEQUALITY, AND INCREASE OPPORTUNITY

A significant part of the Administrations economic agenda also involves investment in people: in a broad sense, that encompasses education and training, measures to promote health, and policies that extend opportunity to all Americans. A number of policies have been put in place to ensure that these investments are made.

:C Education

The 1997 balanced budget agreement called for the largest Federal investment in education in 30 years, in the form of initiatives to improve the quality and accessibility of primary, secondary, and higher education. Higher education is a particular priority. The earnings of college graduates have risen sharply relative to those of workers with only a high school education; in todays economy, a college degree has become as vital for success as a high school diploma was a generation ago. Even posthigh school education that does not lead to a bachelors degree (such as an associate degree program or vocational or technical training) boosts earnings

substantially over just completing high school (Chart 15). Moreover, learning must be a lifelong process. A fundamental characteristic of our economy is constant technological change. Such progress holds the promise of higher living standards for all, but it also requires workers to adapt to employers demands for a welltrained, highly skilled work force. It is therefore critical to provide all individualsincluding those not traditionally thought of as a school agewith access to additional education or training. The Presidents higher education initiatives reflect these principles. Specific measures include:

XThe largest Pell grant increase in 20 years. The balanced budget agreement raises the maximum Pell grant by over10 percent, to \$3,000. Approximately 3.7 million students receive Pell grants, and close to a quarter of a million families will become eligible for the grant for the first time.(#

XHOPE scholarships for posthigh school education. In his 1997 State of the Union address, the President called for making the 13th and 14th years of education as universal as a high school education is today. The HOPE scholarship program accomplishes this by providing a tax credit for higher education expenses of as much as \$1,500, enough to cover tuition at a typical community college.(#

XA tuition tax credit for all Americans. A 20percent tax credit for posthigh school tuition expenses will be available for the first \$5,000 (and after 2002, \$10,000) of qualified education expenses. This tax credit is offered not just to college Americans but to those already working as well, to permit workers to upgrade their skills at any time during their life.(#

XTax exemptions for employerprovided education benefits. The budget agreement extends Section 127 of the tax code for 3 years, allowing workers to exclude up to \$5,250 of employerprovided education benefits from their taxable income.(#

XA tax deduction for interest on student loans. Up to \$2,500 of interest payments on loans for higher education expenses will be taxdeductible in any given tax year. (#%0*H&H&Because public education in the United States is largely administered by local authorities, the Federal Governments 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 to improve our public schools, and has worked to enact programs that will ensure that our children have access to the best possible primary and secondary education. These initiatives include:

XEstablishing national standards. Research shows that students in countries that have standardized, mandatory examination programs do better than students in countries that do not. The Administrations voluntary national testing program has as received full funding; this will allow for the development and pilot testing of national fourthgrade reading and eighthgrade mathematics examinations. (#XExpanding Head Start. The balanced budget agreement raised funding for Head Start by \$374 million, to \$4.4 billion, to reach the Administrations goal of having 1 million children in the Head Start program by 2002. Since 1993, funding for this program, which has shown great success in preparing lowincome preschoolers to enter school, has increased by 57 percent. The program will serve over 800,000 children and their families in 1998. (#XEstablishing a comprehensive literacy strategy. Every child%0*H&H&should be able to read by the third grade. To meet this basic goal, the Presidents comprehensive literacy strategy will receive nearly \$300 million in new funding. State teacher training and family literacy efforts will receive an additional \$41 million, and \$210 million will be earmarked in legislation to implement the Presidents America Reads initiative. (#

XIncreasing funding for charter schools. The President set a goal of having 3,000 locally designed public charter schools in operation by early in the next century. Funding for charter schools is increased by over 50 percent in the balanced budget agreement, to allow the Department of Education to support nearly 1,000 charter schools by the end of 1998. (#

:C Health

This Administration has made promoting health, increasing access to health insurance, and improving the functioning of health insurance markets a major priority. The Balanced Budget Act of 1997 allocates \$24 billion over 5 years to assist States in providing health insurance for up to 5 million children through Medicaid or other programs. This represents the single largest investment in children's health since Medicaid was begun in 1965. The Administration's 1999 budget proposes to expand health access to health insurance further by allowing uninsured 62 to 64-year-olds, as well as 55 to 64-year-olds who have been laid off or displaced from their jobs or have unexpectedly lost retiree health coverage, to buy into the Medicare program. These measures are fully financed so as not to increase the cost of Medicare to the government. The Balanced Budget Act also takes the first steps toward ensuring that Medicare itself remains viable. Structural reforms such as extended choice among health care plans, changes to annual Medicare enrollment, and the restructuring of payment systems will help save \$115 billion over 5 years. Recently passed legislation also provides additional funding for preventive care, such as mammograms, which can help keep health care 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 to examine longterm solutions to the problem of Medicare's viability.

The Administration has also promoted policies to improve the functioning of health

insurance markets, increase consumer protection, and improve access to new pharmaceuticals. The Health

Insurance Portability and Accountability Act of 1996 helps

workers who change jobs by making it easier to carry their health insurance with them to the new job. The President's Commission on

Consumer Protection

and Quality in the Health Care Industry, established to advise the President on changes in the health care

system, submitted a report, including a Consumer Bill of Rights

and Responsibilities, in 1997. [Need to coordinate with SOTU]

The Food and Drug Administration Modernization Act of 1997, which codifies

a number of initiatives taken by this Administration as part of the reinventing

government initiative, will help ensure the timely availability of safe

and effective new drugs. These

policies and others are considered in greater detail in Chapter 5

of this Report.

Finally, teenage tobacco use is one of the most important public health concern

s that the Nation faces, and it has been

rising in recent years. The increase

in the tobacco tax passed

last year will not only help fund the expansions in children's

health insurance coverage described above, but is also likely to reduce

teen smoking. The rise in the tax complements recent Food and Drug Administration

rules to limit advertising targeted at

youth. Finally, following a review

of a proposed agreement among

several State attorneys general and large tobacco companies, the

Administration announced its support of comprehensive legislation

designed to achieve large reductions in teen smoking, with strict financial

penalties on the tobacco industry if specific targets

in this effort are not met.

et.

:C Welfare Reform and Poverty Alleviation

%0*H&H&Welfare reform presents an ongoing challenge: to ensure that our needies

t citizens can maintain a decent standard of living without creating incentives that encourage a life of dependency.

This Administration has committed itself to a policy that

combines work incentives and community efforts to move people off

of welfare and into employment. This has contributed to the largest reducti

on in welfare rolls in history.

The same longterm changes in the wage structure that give greater rewards to ed

ucation and skill also imply that some workers will find it difficult to rais

e themselves and their

families out of poverty, even with a fulltime job. To make work

pay, all those who work must be guaranteed a minimum level of earning

s. The Administration has made an expansion of the earned income tax credit (EI

TC), which raises the takehome pay of lowincome workers who have children, a co

nerstone of its antipoverty strategy (Box11). This expansion has occurred alon

gside two increases in the minimum wage (the second of which, in September 1997

, raised the minimum wage from \$4.75 to \$5.15 an hour).

Although these policies have helped shrink the welfare rolls significantly sinc

e 1993, much remains to be done. The President has called for further reducing

the number of people on welfare

by 2 million over the next 2 years. To that end

, two additional

initiatives have been put in place to advance this Administrat

ions strategy for moving welfare recipients into%0*H&H&employment. The first is a tax credit for employers who hire

longterm welfare recipients; the credit re

bates to employers up

to \$3,500 in wages paid in the first year and up to \$5,000 in the

second. The second initiative is the Welfare to Work Job Challenge Fun

d, which will assist States and communities in moving longterm welfare recipien

ts into lasting, unsubsidized

employment. A hallmark of this fund, for which \$3 billion has

been earmarked, is that it is targeted to those areas of the country most in need of poverty alleviation.

Box 11. Poverty Alleviation, the Earned Income Tax Credit, and the Minimum Wage

A typical cash assistance program guarantees its maximum benefit to those who receive no income, then phases out this benefit as the recipient's income from other sources (usually labor) rises. The disincentive to work that such programs create has been a major concern perhaps the major concern of policymakers with regard to welfare policy. These disincentives will persist so long as we confine ourselves to considering policies with this structure. One way to avoid these work disincentive effects is to design programs that subsidize work by adding to the wages of low-income workers. One such program, the earned income tax credit, was expanded substantially in 1993 as part of the Federal Government's welfare reform initiative. Under the EITC, low-wage workers with children receive a credit against their earned income tax liability (income and payroll taxes); this credit is rebated in cash if the worker's income tax liability is zero. The EITC differs from the typical cash assistance program in that no benefits are paid to those who do not work, and benefits rise as earnings increase (up to some threshold earnings level). It therefore largely eliminates the typical program's work disincentive effects. The minimum wage complements and enhances the EITC. When used by itself to guarantee a subsistence level of income, the minimum wage must be set very high. But an excessively high minimum wage (that is, substantially above the current one) could discourage hiring. On the other hand, using the EITC alone to guarantee an income floor would require payment of a large subsidy, which must then be phased out slowly to minimize the

disincentive to earn additional income. This makes the program much more costly. Hence, the minimum wage and the EITC are best employed jointly in designing an optimal assistance package.

C The Child Tax Credit
The Administration proposed a tax cut to help working families with the expense of raising their children. The Taxpayer Relief Act of 1997 will reduce taxes for 27 million families by providing a tax credit of \$500 per child. This credit will benefit 45 million children under age 17, including 13 million children from working families with incomes below \$30,000. Because the credit is partially refundable, large families who have paid significant out-of-pocket payroll taxes can benefit even if they have little or no income tax liability.

B STRENGTHENING CITIES AND COMMUNITIES

This Administration has worked to make Federal resources available for investment in our Nation's cities and communities. The Administration has sought to expand the number of Empowerment Zones and Enterprise Communities. Designated zones and communities receive tax benefits and flexible grants and are entitled to apply for waivers of certain Federal regulations. Communities wishing to compete for these designations must submit a strategic plan for revitalization; this requirement mobilizes local communities and encourages them to harness their talents and resources in framing a plan for local economic development. The underlying principle is that communities know best how to solve their own problems but may lack the necessary resources. The initial round of competition, in 1994, led to the establishment of 95 Enterprise Communities and 9 Empowerment Zones; both urban and rural areas were represented. The Balanced Budget Act will establish 22 additional Empowerment Zones.

The Administration has also worked to promote fair access to loans and investment capital for residents of low and moderate income areas. Strengthening the Community Reinvestment Act has led to a rise in lending to minority and low income borrowers; since 1993, conventional home mortgage lending to black Americans has increased by 67 percent, lending to Hispanic borrowers is up nearly 50 percent, and lending activity in low and moderate income communities has risen by 38 percent. The Administration also obtained \$80 million in additional funding for Community Development Financial Institutions, which make investment capital and other financial products available to low and moderate income communities. The President's 1999 budget requests an additional \$45 million for this program. In addition, the President signed into law the brownfields program, which will provide tax incentives for the restoration of urban land contaminated by pollution. These incentives will leverage more than \$6 billion for nationwide private sector cleanups and the redevelopment of 14,000 contaminated and abandoned sites in economically distressed urban areas. Several basic principles inform these policies. First, they seek to equip communities with the tools they need in order to flourish; they are helping hands, not handouts. Second, they place the principal responsibility for community development with the communities themselves, because they are closest to their problems. Third, they emphasize private sector engagement rather than government mandates. And finally, they stress results over process: the Enterprise Communities/Empowerment Zones program, for example, gives communities broad scope to determine for themselves the best path for development; similarly, the reformed Community Reinvestment Act uses criteria based on actual outcomes to judge compliance with its provisions.

:B STRENGTHENING THE PERFORMANCE OF DOMESTIC MARKETS

As part of this Administration's commitment to free and open markets, the Antitrust Division of the Department of Justice has

worked together with the Federal Trade Commission to vigorously enforce the Nation's antitrust laws. Recent cases and investigations reveal that the Department of Justice and the Federal Trade Commission have both pursued an aggressive but balanced approach in enforcing antitrust law; in particular, both agencies have sought to ensure the continued growth and competitiveness of high technology industries. Chapter 6 of this Report describes how the antitrust agencies have worked to attain these goals in several recent cases.

OPENING FOREIGN MARKETS Progress was also made in 1997 toward opening foreign markets to U.S. goods, as a number of important international trade initiatives were finalized. Trade agreements affecting three important sectors were reached, concluding some unfinished business from the Uruguay Round of multilateral negotiations. The first of these agreements, the Information Technology Agreement (ITA), will eliminate tariffs on a large array of information technology products in which U.S. firms tend to be highly competitive. Whereas U.S. tariffs on these products are already low or nonexistent, Asian tariffs average around 30 percent. This means that the ITA will significantly advance American firms' competitiveness in Asian markets. Also successfully concluded were an agreement covering financial services, which will foster broad liberalization of banking, securities, and insurance markets, and a key agreement to liberalize basic telecommunications services (including telephone services). Chapter 7 of this Report considers the Administration's trade policies in more detail. These negotiations illustrate an important point about trade liberalization. Even though all three cases involved sectors in which the United States is generally thought to have a competitive advantage, other countries were willing never

theless
to agree to their liberalization. They did so because they
recognized t
hat the entry of efficient foreign firms in these
sectors would improve the com
petitiveness of their own economies: %0*H&H&securing goods of the highest qualit
y at the lowest possible
price is good for any economy.

:B PROMOTING AN ECONOMICALLY SOUND ENVIRONMENTAL AGENDA

The Administration took several important steps in 1997 to
protect the environm
ent. These included efforts to address global
climate change and to improve air
quality. In December
representatives of the United States and some 160 other
c
ountries, meeting in Kyoto, Japan, agreed to establish binding
limits on indust
rial countries greenhouse gas emissions. These
limits are intended to stem the
disruptive effects of climate
change by stabilizing atmospheric concentrations
of greenhouse
gases. The Administration has proposed several marketbased
approa
ches to meeting the Kyoto limits. Domestically, tax
incentives for energyeffici
ent technologies and research and
development will spur early efforts to reduce
emissions. A
national system of tradable permits for greenhouse gas emission
s,
patterned after the successful permit trading program for sulfur
dioxide emi
ssions, will be implemented later. In addition, the
Kyoto agreement allows for
trading in greenhouse gas emissions
permits on an international scale, as well
as for opportunities
for firms in the industrial countries to receive emissions

credits for investing in climatefriendly technologies in
developing countries.

All of these efforts will help the United %0*H&H&States attain its greenhouse g
as emissions target in a costeffective way.

In July 1997 the Environmental Protection Agency (EPA)
issued a significantly m
ore stringent standard for groundlevel
ozone and a new standard for fine partic
ulate matter in the
atmosphere. Although the Clean Air Act does not allow for t
he

consideration of costs in setting these standards, under the Presidents policy the EPA must implement these healthbased standards in a costeffective manner . The Administrations plan for achieving the new air quality standards departs from traditional commandandcontrol approaches by designing regional strategies that will complement local efforts, and encouraging the development of trading programs for emissions of nitrous oxide, an ozone precursor. The nitrogen oxide trading program, like the acid rain program and the trading program envisioned for greenhouse gas emissions, enlists market incentives in controlling pollution and should reduce pollution more cheaply than do traditional regulatory approaches. Chapter 5 provides a detailed assessment of the Administration's environmental policies.

:A FACING THE CHALLENGES AHEAD

In many ways the U.S. economy today is very different from that in which our parents and grandparents lived and worked. Today, 24 percent of families are headed by a single parent, compared with 14 percent 25 years ago. And a percent of married women work, including percent of those with young children. This makes affordable, quality child care a pressing concern for most families. Meanwhile the nature of the labor market has changed significantly: few American workers 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 automobile industry did in the 1950s and 1960s. And the U.S. population is aging, implying that in the next century there will

be fewer workers for every retiree. This Administrations economic agenda is designed to deal with these changes and

the challenges they pose. If the American economy is to maintain its preeminence as the strongest and most dynamic in the world, both policymakers and citizens will have to meet and overcome a number of challenges in the 21st century. Several such challenges already loom large for this Administration and Congress. Perhaps the most important is preparing for the aging of the population, which requires reforming Medicare and Social Security and promoting retirement security more generally. The Balanced Budget Act left the longrun problems facing Social Security and Medicare reform largely unaddressed. As reported above, some progress was made in addressing Medicare's immediate problems, but the comprehensive reforms needed to ensure the program's longterm viability were delayed. Likewise, steps will have to be taken to strengthen the finances of the Social Security system. [Will need to coordinate with SOTU]

For almost 60 years Social Security has provided Americans with income security in retirement 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 system faces a longterm funding gap: beginning in 2012, unless the system is reformed, the government will be unable to pay current Social Security benefits in full out of current payroll taxes; it will then have to draw down the system's trust fund, and by 2030 those funds will be exhausted. The government would then face several options, which it could adopt singly or in combination: it could reduce benefits

until they are in line with collections, raise payroll taxes to cover an unchanged level of benefits, or finance the shortfall from other parts of the budget, by raising other taxes, cutting health expenditures on other programs, or borrowing and allowing the budget deficit to increase. One or more of these measures will have to be taken so long as no changes are made to the present system.

Although the seriousness of the financial imbalance facing Social Security should not be downplayed, its magnitude is not so large as to be insurmountable, particularly if early action is taken. For example, even if nothing is done and the trust fund is exhausted, payroll taxes will still be sufficient to finance permanently roughly 75 percent of benefits. Put another way, if the shortfall over the next 75 years were financed entirely through higher payroll taxes starting now, a payroll tax increase of around 2 percentage points, or approximately 1 percent of GDP, would suffice to restore balance. (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 can admit of eventual solution, and the President has proposed a process to devise an appropriate solution over the next 2 years. Pending such a solution, the President has proposed that any budget surpluses be placed in a reserve fund that can be used for Social Security reform.

Medicare reform presents a somewhat thornier problem, in terms of both its complexity and its scale. Unlike Social Security, Medicare promises not just the payment of a sum of money but the delivery of a service: health insurance. The government has little influence over the rate of increase in the cost of providing this service, which has been rising faster than general inflation for decades, largely 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 babyboom generation will act to raise expenditures still further through increases in program enrollment. Hence, any longterm reform will have to involve slowing both the rise in health care prices and the growth in volume and intensity of use of covered services. Neither will be accomplished easily. Before last year's budget legislation was enacted, the trust fund for the component of Medicare that covers hospital costs was projected to fall to zero in 2001. The 1997 reforms will delay the trust funds depletion until fiscal 2010. The legislation also calls for the establishment of a bipartisan commission to assess and recommend the structural changes that will be needed to ensure Medicare's longterm viability.

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

In 1997 the Senate voted to renew the President's so-called fasttrack negotiating authority. This authority allows the

President to negotiate trade agreements and submit them to the Congress for a yes or no vote, without amendments. However, in the House of Representatives the vote to renew fast-track was postponed when it became clear that opposition was sufficient to derail the legislation. Public resistance to this and other initiatives to open foreign markets may trace its roots to several factors, including the perception by some that free trade hurts American workers and contributes to the U.S. trade deficit. As discussed in Chapter 7, market-opening initiatives do not cause net job losses to the U.S. economy as a whole, although they do result in a reallocation of jobs into expanding, export-oriented industries. As the chapter documents, the jobs created by increased trade are good jobs, offering high pay. But some workers are indeed hurt by more open markets, just as some workers are harmed by technological innovation, even though market-opening initiatives unambiguously benefit the economy as a whole.

This Administration has realized from the beginning that it is the government's duty to minimize the impact of dislocations affecting workers who lose their jobs, by speeding 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 agreement, and the Administration committed itself early on to providing for dislocated workers through retraining programs. The President's 1999 budget includes proposals to expand the scope of trade adjustment assistance and to increase funding for these 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 our skilled workers most, the United States enjoys greater benefits from trade to the extent that more of its workers are

highly skilled.

A widespread misconception is that one of the benefits of increased trade comes

in the form of an improved balance of trade. Economic policies do indeed affect the current account

(the broad measure of U.S. international transactions that

includes investment income and transfers as well as trade in goods and services), but it is budget, saving, and investment policies, not trade libera-

lization policies, that do so. The

current account is a macroeconomic phenomenon that mirrors the

gap between what we as a Nation invest and what we save. The

large budget deficits of the 1980s and early 1990s were a form of negative sav-

ing, or dissaving, which reduced the total amount of national saving available

to cover the Nation's investment in plant and equipment. This shortfall had to be filled by importing

goods and services from abroad. In an important sense, the Nation

was overconsuming in the 1980s, financing its consumption binge by bor-

rowing from foreigners. The result was a large and persistent trade deficit.

We still have a trade deficit today, but for a very different reason. The near

elimination of the budget deficit has

left more saving available for investment

in plant and equipment

by the private sector. This investment still exceeds the Nation's

total saving, however, even though the Federal Government is dissav-

ing far less than it was, because investment is higher than in the 1980s, and

private saving lower. (Chapter 2 considers the

United States low saving rate in

some detail.) Once again, this

shortfall is made up for by borrowing output from abroad, and the

result is a current account deficit. But there is a big difference

between borrowing to invest as the Nation is doing

now and borrowing to consume,

as it did in the 1980s. In fact,

running a trade deficit in order to expand

and the Nation's productive capacity is not new to American history; we did much

the same thing in the last century, to build up the Nation's

infrastructure, most notably during the railroad construction boom. Ironically, therefore, today's 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.

It is always difficult to explain this macroeconomic perspective on the trade deficit to those who are primarily concerned with the microeconomics of their daily lives. But making the case in favor of trade is particularly important now,

because there is a real danger that countries will turn their backs on a liberal and integrated world economic order. Besides postponing the renewal of the President's traditional trade negotiating authority, the Congress chose not to support the sort of financial participation in international institutions that is normal for any major country, let alone a superpower. Meanwhile financial crises in East Asia have made U.S. international engagement more important, rather than less. Other emerging market countries are themselves in danger of reacting to the East

Asian crises by turning inward. It is important for their economic well-being, as well as our own, that they continue along the path toward an outward-oriented market system, on which they had until recently been making such astonishing progress. This will require difficult macroeconomic and structural adjustments on their part, including reducing their dependence on foreign borrowing.

This in turn means that these countries will have to reduce their trade deficits, and in some cases even turn them into trade surpluses. It is inevitable that this will lead to an increase in U.S. bilateral trade deficits with some East Asian countries. Again, however, such deficits are not the proper gauge of the success or failure of U.S. trade policy.

The Nation faces other, broader challenges 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 American workers today are faced with the need to juggle the demands of the workplace with the demands of family and home. Government must act to ease this burden by ensuring that families have access to quality child care and health care. For this reason the President's 1999 budget includes a \$20 billion increase in funding for child care, to make it accessible to more families and raise its quality. An important part of this proposal is increased tax credits for 3 million working families to help them pay for child care, as well as an increase in block grants to States that will directly subsidize child care for low-income families. In addition, the proposal calls for a new Early Learning Fund, along with support for the enforcement of State child care health and safety standards, scholarships for up to 50,000 child care providers per year, and funding for research and consumer education. We must also continue to invest in our Nation's children. Chapter 3 of this Report shows that the last 3 years have witnessed notable improvements in children's well-being along several fronts, including decreases in child poverty, increases in consumption of basic health care services, and improvements in health status and in some measures of educational achievement. However, many children remain economically vulnerable. One in five children in the United States lives in a family whose income is below the poverty line, one in seven does not have access to health insurance, and a large proportion of children fail to achieve basic levels of proficiency in science, mathematics, and reading. Chapter 3 considers ongoing and proposed Administration initiatives that address these problems. Finally, this country's longstanding goal of achieving racial equality has not yet been attained. Chapter 4 of this Report reviews trends in racial and ethnic economic inequality. Although there has been progress in narrowing these gaps in the

postwar period, it has been very uneven, with rapid progress in the 1960s and early 1970s followed by 20 years of stagnation from the early to mid 1970s to the early 1990s. For example, since the mid 1970s the wages of young black college graduates have fallen relative to those of their white counterparts. Although the current expansion has brought renewed progress, substantial racial and ethnic disparities in economic status persist. For example, the median wealth of white families is by some estimates 10 times that of black and Hispanic families. Many of the Administration's current and proposed policies, such as those that encourage community empowerment and education, help address these disparities. But more clearly needs to be done to promote racial equality and equality of opportunity. To this end, this Administration has pledged itself to furthering a dialogue on race in America.

:A CONCLUSION

The United States today enjoys some of the most favorable economic conditions in a generation: 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 strength cannot be taken for granted. Recent developments do not herald the end of inflation, the conquest of the business cycle, or the permanent reversal of such secular trends as weak productivity growth and rising income inequality. Rather, there are still long-term changes at work that demand action by individuals, businesses, and governments alike. This Administration has put in place a set of policies that has allowed the economy to grow and to 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.===== END ATTACHMENT 1 =====

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

TEXT:
===== END ATTACHMENT 2 =====

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:25-JAN-1998 18:32:11.00

SUBJECT: Re: E-mail copies of Chs. 1 and 2

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

READ:UNKNOWN

TEXT:

Many thanks. If I could get a redlined copy of Chapter 4 when you are finished revising it tomorrow, I would also appreciate having a chance to review that. I have reviewed all of the chapters that you have edited and they all look excellent. I have a few minor changes to discuss with various authors, but nothing major.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:25-JAN-1998 16:55:19.00

SUBJECT: E-mail copies of Chs. 1 and 2

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

TEXT:

Could you email me the current drafts of chapters 1 and 2? I need to prepare a speech on the economic outlook for Wednesday (and will also need one for the ERP release) and it would be useful to be able to "cut and paste" some of the material in those chapters. Thanks

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:25-JAN-1998 10:13:22.00

SUBJECT:: Re: GCC: offer of a meeting with McKibben and Wilcoxon on G-Cubed

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

READ:UNKNOWN

TEXT:

I think it would be very useful to meet with them but I don't know if I will be able to do so given the crush of various other events. Would it be worthwhile for you, Randy, Jeff, Adele and maybe Ray Squitieri to meet with them without me? I would try to come, but the odds are less than one.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:26-JAN-1998 12:53:40.00

SUBJECT: Ch. 2: current version of TB section

TO: STONE_CF (STONE_CF @ A1 @ CD @ LNGTWY [UNKNOWN]) (WHO)
READ:UNKNOWN

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

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

TEXT:

This is my re-revision of Mike's entering of the changes I wrote out yesterday. (Thus it supersedes all earlier versions.) I think it is ready for Janet to look at.

(If anyone wants to see the hand-marked changes that were entered here, let me know.)

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

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D4]MAIL44928452S.026 to ASCII,
The following is a HEX DUMP:

:C Net Exports and the Current Account

U.S. exporters had a good year in 1997, as real exports rose 12.3 percent. However, robust growth in domestic demand pushed imports up even more--by 14.4 percent--leading to a deficit in net exports equal to 2.1 percent of GDP.

One useful perspective on the performance of real net exports is the pattern of growth in the global economy. Four major locomotives matter for global economic growth: North America, Europe, Japan, and—in the past decade—the East Asian industrializing economies. Expectations at the end of 1996 were that growth would slow in the United States and that the other three regions would easily outpace it. Instead, the United States (and Canada) saw higher growth rates in 1997 (about 3.7 percent each), while growth among our trading partners in the other regions slowed. In Japan the recovery from the recession of the early 1990s came to a standstill. In Europe growth was lukewarm, except in a northern tier composed of the British Isles and the Nordic countries. In the developing countries of East Asia, slowing growth turned to financial crisis in the second half of the year (Box 2-2).

Box 2-2.--Turmoil in Asian Economies

The outbreak of financial crisis in Asia was one of the most notable--and troubling--developments in the global economy during 1997. The situation began in midyear as a currency crisis and intensified over the rest of the year, spilling over to the real sectors of the affected economies as well as to the rest of the world. The conditions that contributed to the crisis had been building for several years: the policymakers of several of these economies, particularly Thailand, had received repeated warnings from the international financial institutions and from their trading partners that their macroeconomic policies might not be sustainable and that financial sector stresses were mounting.

By May 1997 Thailand was in the throes of the fourth speculative attack on its currency, the baht, since August 1996. By then the buildup of financial difficulties and balance of payments pressures had reached such a point that efforts to defend the baht could not be sustained. Pressures soon spilled over to other emerging Asian economies (especially Indonesia, Malaysia, and South Korea), most of which also had some balance of payments weaknesses, as well as to Eastern Europe (most notably the Czech Republic). These countries' difficulties shook financial market confidence elsewhere in Asia and in emerging markets around the world, even those with sounder policies and economic fundamentals, in a contagion effect.

Since June, four of the countries in the region (Indonesia, the Philippines, South Korea, and Thailand) have requested and received assistance from the International Monetary Fund (IMF). In each instance the adjustment programs developed by the domestic authorities and the IMF have included a heavy emphasis on financial and structural adjustment measures (for example, to reform bank lending practices and further liberalize the economy), as well as the more traditional macroeconomic adjustments necessary to restore financial market stability. For each of the affected economies, the question of when their financial and balance of payments situations will stabilize depends, first and foremost, on whether and how aggressively they

implement their policy commitments, and second, on the easing of the contagion effect from those economies that continue to experience difficulties. In the medium term the return of these economies' strong growth performance will depend significantly upon the degree to which structural and financial sector reforms are implemented.

{end box}

Growth rates in the United States and its trading partners, along with exchange rates, are major determinants of short-run fluctuations in the trade balance. The fact that income increased more rapidly here in 1997 than it did in the advanced economies overall worked to increase U.S. imports from those economies more rapidly than their imports from the United States. The negative effects of the East Asian crunch on US net exports to developing countries had barely begun to show up at the end of the year.

The current economic expansion in the United States has been led by investment. Indeed, in a fundamental sense, trends in the trade balance -- or, more precisely, the current account balance reflect movements in saving and investment. (The current account is more comprehensive than the trade balance in goods and services, in that it includes investment income and transfers.) If firms wish to invest amounts greater than those that can be financed by the pool of domestic saving, they must tap foreign sources to provide the capital. In the 1980s net private investment fell as a share of GDP, and net national saving fell even faster, producing large current account deficits. The good news in the 1990s is that investment has been booming. But national saving has apparently not kept pace. (The interpretation is complicated by a swing in the statistical discrepancy required to reconcile the accounts.) Thus, the trend in the current account deficit has been upward.

The increases in the deficits in 1997 in nominal (dollar) terms turned out to have been quite small. The balance on all goods and services is estimated to have been in deficit by about \$112 billion, compared with \$111 billion the preceding year. The current account balance is estimated to have reached a deficit of about \$164 billion in 1997, up from \$148 billion in 1996. The small size of the increase in the trade deficit last year is probably related to changes in the exchange rate of the dollar.

The effect of exchange rates on the nominal trade balance last year is complicated. The trade-weighted exchange rate of the dollar rose (that is, the dollar strengthened) about 5 percent during the first quarter of the year. In the long run the effect of a stronger dollar should be to slow exports and encourage imports, and thus to depress the trade balance. But in the short run the effects on the nominal trade balance tend to go the other way. This is because importers do not have to pay out as many dollars to obtain the foreign currency they need to pay for previous quantities of imports (in what is called a valuation effect), and because it takes time for the quantity demanded to adjust. There can be a lag of 2 years or more before price changes have their full effect on trade volumes, dominating the valuation effect. (This pattern of response is often called the J-curve, because the dollar value of imports at first declines with a stronger dollar but later rises.) The difficulty in interpreting what happened in 1997 is due to the fact that, before the most recent appreciation, the dollar *also* increased in value between 1995 and 1996. Thus the upswing of the J-curve from that earlier appreciation may have partly canceled out the

downswing of the curve from the 1997 appreciation. The delayed effects of the dollar's appreciation, together with the other effects of the East Asian financial crisis, are likely to show up in a more marked increase in the trade deficit, by all measures, in 1998.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:26-JAN-1998 14:29:17.00

SUBJECT: Re: SOTU Rollout

TO: Ann F. Walker (CN=Ann F. Walker/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TEXT:

I will be happy to participate in the briefing tomorrow at 1:30 and also at 4:30 but I haven't seen a copy of the SOTU and am uncertain what you mean by the "general economic policy issues" in the SOTU. Are you referring to deficit reduction? Policy initiatives? It would be helpful if you could just indicate the areas you'd like me to cover in a bit more detail and send a few talking points.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:26-JAN-1998 20:46:02.00

SUBJECT: GCC chart we went over with Peter, Todd, and Bill Antholis

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

READ:UNKNOWN

TEXT:

Janet,

Per our conversation tonight.

Joe

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

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D66]MAIL42025752F.026 to ASCII,
The following is a HEX DUMP:

Table 1. Summary of Trading Scenarios with Permit Prices around \$15/ton

Trading Scenario	Tech	Sinks	Permit Price	Resource Cost	Value of Transfers	% Reductions in U.S.	Change in Gas Price	Change in Electricity Price
Annex I	1.0	100% reported	\$11/ton	\$5 billion	\$4 billion	19%	+\$0.03/gal	+\$0.002/kWh
Umbrella - EU, EE + 100% JI	1.0	no sinks	\$14/ton	\$8 billion	\$7 billion	19%	+\$0.03/gal	+\$0.002/kWh
Umbrella - EU, EE + key LDCs	1.0	no sinks	\$16/ton	\$9 billion	\$7 billion	22%	+\$0.04/gal	+\$0.002/kWh
Umbrella - EU, EE + Key LDC + 20% JI	1.0	no sinks	\$15/ton	\$8 billion	\$7 billion	20%	+\$0.04/gal	+\$0.002/kWh
Annex I + 20% JI	1.25	50% reported	\$14/ton	\$7 billion	\$5 billion	31%	+\$0.03/gal	+\$0.002/kWh

Table 2. Summary of Trading Scenarios with Permit Prices around \$30/ton

Trading Scenario	Tech	Sinks	Permit Price	Resource Cost	Value of Transfers	% Reductions in U.S.	Change in Gas Price	Change in Electricity Price
Annex I	1.0	50% reported	\$26/ton	\$12 billion	\$9 billion	34%	+\$0.06/gal	+\$0.004/kWh
Umbrella - EU	1.0	no sinks	\$26/ton	\$13 billion	\$11 billion	31%	+\$0.06/gal	+\$0.004/kWh
Annex I + 20% JI	1.0	no sinks	\$36/ton	\$17 billion	\$13 billion	38%	+\$0.09/gal	+\$0.005/kWh
Umbrella - EU, EE + 20% JI	1.0	no sinks	\$30/ton	\$15 billion	\$12 billion	34%	+\$0.07/gal	+\$0.004/kWh
Umbrella - EU, EE	1.25	no sinks	\$31/ton	\$15 billion	\$10 billion	45%	+\$0.07/gal	+\$0.005/kWh

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:26-JAN-1998 18:42:55.00

SUBJECT: GCC questions from Murkowski

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: Randall W. Lutter (CN=Randall W. Lutter/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:

At the end of last week, I had a voice mail from Lisa McNeilly of the Climate Change Task Force regarding our answers to the Murkowski questions. Apparently, the Administration never submitted the answers. Some agencies have asked to rewrite their answers (in light of Kyoto) before we submit them. She asked if we would like to change ours (although, she felt that given the nature of our questions, we would probably be content sending in what we had already drafted). Most of these questions focused on the IAT. Let me know if you have any changes to our answers -- I don't think we need to make any changes, unless you want to discuss ongoing analyses in the answer to q. 2. I apologize for forgetting to bring this up at the staff meeting this morning.

Responses to Murkowski Questions

2. When will the Administration release to the public the economic analysis that it used in reaching these targets and timetables?

The Administration relied on an array of economic tools and analyses during the process of selecting its target and timetable. Administration staff drew from the substantial economic literature on climate change, energy, and the environment in assessing options for our negotiating position. For example, the Administration considered analyses conducted by the Intergovernmental Panel on Climate Change, the previously released Interagency Analytical Team draft report, and the Department of Energy's Scenarios of U.S. Carbon Reductions. However, there is not a distinct economic analysis document.

3. Will the economic analysis used to arrive at these targets and

timetables be peer reviewed?

- a. If not, why not?
- b. If so, will the peer reviewers comments be made public?

There is not a distinct &economic analysis8 document that could be peer reviewed.

9. The economic modeling effort that was abandoned by the Administration earlier this year assumed that the mere announcement of an agreement to reduce carbon dioxide would immediately result in a 25% increase in the rate of improvement in energy efficiency.

- a. Was this a valid and realistic assumption?
- b. Did the peer reviewers feel it was a realistic assumption?

Several of the peer reviewers noted that the rate of energy efficiency improvement (the autonomous energy efficiency improvement, or AEEI) may be on the upper range of estimates of this variable. The Interagency Analytical Team employed this higher rate to represent the increase in technology research and development and diffusion that would occur as the economy operates under expectations of higher energy prices in the future. By the nature of several of the models used in the IAT process, the modelers had to incorporate these price expectations into the AEEI parameter. There is disagreement among informed modelers about how realistic is the AEEI used in the IAT.

10. The Administration economic modeling effort also assumed a decrease in long term interest rates to almost 2%.

- a. Was this a valid and realistic assumption?
- b. Don,t new taxes and higher costs tend to increase inflation and interest rates?

The IAT report indicates that in the modeling exercises, the revenues from carbon permit auctions are used to reduce the deficit. As we heard many times over the past several years during the balanced budget debate, cutting the Federal deficit will lower interest rates. In the IAT,s sensitivity analyses, the IAT found that recycling revenues by cutting corporate and payroll taxes would also lower interest rates. To the extent that revenue from carbon permits significantly reduce the deficit, this assumption is appropriate. All of these forms of revenue recycling stimulate saving and investment, and help raise the growth rate of the economy.

11. The Administration modeling effort did not consider the costs associated with the development, implementation, and monitoring of a trading program.

a. Was this a valid and realistic omission?

The purpose of the IAT was not to assess any specific policy position. Since the Administration had not yet developed a policy position internally, the IAT did not have a specific implementation policy to model. It would not be valid for the IAT to devise a specific, hypothetical trading program and model the costs of implementing it.

12. Did the Administration modeling effort take into account the adverse effects on U.S. competitiveness and the potential shifting of producers in the United States?

As several of the reviewers noted, the models used in the IAT do not handle international trade well and the IAT did not specifically account for effects on U.S. competitiveness. However, the Administration did rely on several analyses of competitiveness in coming to its decision on a negotiating position.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:26-JAN-1998 17:57:42.00

SUBJECT: Re: SOTU Rollout

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

READ:UNKNOWN

TEXT:

The attached document shows who else will be briefing the organization
leaders group.

----- Forwarded by Michele Jolin/CEA/EOP on 01/26/98
05:56 PM -----

ANN F.
WALKER
01/26/98 05:54:52 PM

Record Type: Record

To: Michele Jolin/CEA/EOP

cc:

Subject: Re: SOTU Rollout

She will be the economic person in the briefings she is scheduled for --
Frank and Gene will be the economic perspective in the briefings they are
doing. Attached is the draft schedule so you can see who is doing what.

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D2]MAIL46055652N.026 to ASCII,
The following is a HEX DUMP:

MONDAY

10:00am House Policy Staff
Briefers: Kagan, Lew, Murguia

11:00am Cabinet Communications Amplification Call
Briefers: Lewis, Spector

11:30am Senate Policy Staff
Briefers: Kagan, Lew, Murguia

1:00pm Congressional Hispanic Caucus Call
Briefers: Murguia, Sperling, Raines, Ibarra, Echaveste

1:30pm New Democrats Coalition
Briefers: VPOTUS, Murguia

TBD CBC Call
Briefers: Raines, Sperling, Kagan, Moore, Murguia

TBD Cong. Gary Condit - Blue Dog Coalition Chair Call
Briefers: Reed or Monica Dixon

TBD Cong. Patsy Mink
Briefers: Murguia

TBD Cong. Bernie Sanders
Briefers:

TUESDAY

8:30am Cabinet Staff Conference Call
Briefers: TBD - Beaubaire is getting the briefer

10:45am CBC Conference Call
Briefers: Sperling, Kagan, Moore, Raines, Murguia, Johnson, Marshall

1:00pm Governors Conference Call
Briefers: Erskine Bowles, Sosnik, Lewis, Reed, Raines

1:30 Mayors Conference Call
Briefers: Podesta, Lewis, Raines

1:30 OPL - Organization Leaders
Briefers: Mathews???, Reed, Yellen

2:00pm House and Senate Democratic Leadership, Capitol SC-5
Briefers: Bowles, Raines, Sperling, Hilley, Stein, Reed

3:30 OPL Organization Leaders
Briefers: Podesta, Lewis, McGinty
4:00pm **(NOTE TIME CHANGE)** House and Senate Democratic Press Secretaries
U.S. Capitol, SC-5
Briefers: Lewis, McCurry, Murguia

4:30pm(TBD)Cabinet Conference Call

4:30pm OPL Top Tier Talkers Call
Briefers: Podesta, Reed, Yellen, McGinty

- I. POST SOTU CALL Lewis
- II. POST SOTU CALL (TO BEGIN 10 MINUTES FOLLOWING POTUS SOTU CLOSE)
Briefer: **TBD**

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:26-JAN-1998 20:27:18.00

SUBJECT: Re: GCC questions from Murkowski

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

READ:UNKNOWN

TEXT:

I've indicated two small suggestions.

----- Forwarded by Jeffrey A. Frankel/CEA/EOP on 01/26/98

08:26 PM -----

Jeffrey A. Frankel

01/26/98 08:18:32 PM

Record Type: Record

To: Joseph E. Aldy/CEA/EOP

cc:

bcc: Records Management

Subject: Re: GCC questions from Murkowski

DO YOU THINK THE ANSWER TO NO.2 SHOULD SAY THAT THERE IS NOT CURRENTLY
SUCH A DOCUMENT?

ON NO. 12, WE SHOULD PROBABLY MAKE CLEAR THAT WE ARE TALKING ABOUT
INTERNATIONAL TRADE IN GOODS AND SERVICES. WE DON'T WANT ANYONE TO GET
CONFUSED AND THINK WE ARE SAYING THAT SGM DOESN'T HANDLE TRADE IN PERMITS
WELL.

OTHERWISE, ANSWERS LOOK GOOD.

JF

Joseph E. Aldy

01/26/98 06:42:58 PM

Record Type: Record

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

cc:

Subject: GCC questions from Murkowski

At the end of last week, I had a voice mail from Lisa McNeilly of the Climate Change Task Force regarding our answers to the Murkowski questions. Apparently, the Administration never submitted the answers. Some agencies have asked to rewrite their answers (in light of Kyoto) before we submit them. She asked if we would like to change ours (although, she felt that given the nature of our questions, we would probably be content sending in what we had already drafted). Most of these questions focused on the IAT. Let me know if you have any changes to our answers -- I don't think we need to make any changes, unless you want to discuss ongoing analyses in the answer to q. 2. I apologize for forgetting to bring this up at the staff meeting this morning.

Responses to Murkowski Questions

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Message Sent

To:

Janet L. Yellen/CEA/EOP

Jeffrey A. Frankel/CEA/EOP
Michele Jolin/CEA/EOP
Adele C. Morris/CEA/EOP
Randall W. Lutter/CEA/EOP

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:28-JAN-1998 13:58:48.00

SUBJECT: Draft Q&A on SS attached

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

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

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

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

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

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

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

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

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

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

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

TO: William H. White Jr. (CN=William H. White Jr./OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

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

TEXT:

Please feed me comments and edits (65358). Thanks.===== ATTACHMENT 1
=====

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D23]MAIL43794572A.026 to ASCII,
The following is a HEX DUMP:

Q&A on Social Security
January 28, 1998

Policy on the surpluses

Q: What is your policy with respect to the budget surpluses?

A: Our policy is that the surpluses projected in this budget should be reserved until we have addressed Social Security reform. In other words, our policy is Save Social Security first.

This policy reflects the fiscal responsibility that has been the hallmark of this Administration -- beginning in 1993 with enactment of the President's economic plan and continuing with passage of bipartisan budget legislation last year. We have achieved a balanced budget and are projecting budget surpluses for many years into the future.

But the retirement of the baby boom generation will put enormous pressure on the budget in the not-too-distant future. The Social Security Trust Fund is expected to be exhausted in 2029. The President believes that we must address the long-run challenge of Social Security reform before we spend the surplus on anything else.

FOLLOW: So are you guaranteeing that some of the surpluses will be used to bolster Social Security?

A: Again, the President's policy is that 100 percent of the surpluses should be reserved until we have addressed Social Security reform. We would expect that the surpluses would play some role in that reform.

But we will be engaging in a national dialogue on reform over the coming year over questions precisely like this one, and it would be premature at this point to talk definitively about specific solutions. We look forward to an active debate about using the surplus, as well as a variety of other steps, to strengthen Social Security for the 21st century.

Q: Would actually using the surplus for Social Security reform require legislation?

A: Yes, if the surpluses are transferred to the Trust Fund. Under current law, the Trust Fund can only accrue assets as it earns income (from tax revenue or from the income on assets already held by the Trust Fund). To transfer the unified surpluses to the Trust Fund, new legislation would be required to allow the Secretary of the Treasury to transfer additional assets to the Trust Fund.

The legislation to transfer the surpluses could be defined specifically in terms of the currently projected surpluses (which is the way that the estimates below are undertaken), or the surpluses that actually accrue.

Legislation would also be required to allow the Trust Fund to hold equities.

Q: How much could the surpluses benefit the Social Security system?

A: That depends on a variety of factors -- including how much of the surpluses are devoted to Social Security.

A very rough rule of thumb is that every \$100 billion transferred to Social Security in the form of Treasury bonds would extend the life of the Trust Fund by 1 year.

[Background: Under the intermediate projections of the OASDI Trustees, the Trust Fund is currently expected to be exhausted in 2029 and the 75-year actuarial imbalance in the system amounts to 2.23 percent of payroll.]

Q: What does “reserved” mean? What if you don’t accomplish reform before the surpluses begin accruing?

A: “Reserved” means that the surpluses should not be used for anything else until Social Security reform is accomplished. The President has made it clear that we want to accomplish reform during the next two years.

If surpluses accrue before Social Security reform is accomplished, the surpluses would by default be used to buy back publicly held debt from the public. But note that the vast majority of the surpluses are expected to accrue starting after 2000 -- after the President intends to have Social Security reform addressed.

Thus the issue of what would happen to surpluses in the meanwhile involves relatively small surpluses, if any. And we would not rule out legislation creating an explicit Reserve Fund or escrow account if that is necessary.

Q: Why don’t you use some of the surplus for Medicare, since its Trust Fund is expected to be exhausted in 2010 -- and Social Security doesn’t become a problem until 2029?

A: The Balanced Budget Act of 1997, in addition to producing more than \$500 billion in Medicare savings over 10 years, established a Medicare Commission. Senator Breaux was recently named to chair the commission, which will report back by March 1999. While the commission is studying the difficult issues involved in long-run Medicare

reform, the President believes that we should make progress on addressing Social Security reform.

It is also worth noting that once we have addressed Social Security reform, there is nothing to prevent us from using some of the surpluses for Medicare.

Q: Why don't you just buy down the debt?

A: First, let me note again that we are reserving the surpluses pending Social Security reform -- not requiring that all the surpluses must ultimately be used for Social Security.

Second, using some or all of the surplus for Social Security has two attractions: it ensures that the projected surpluses contribute to national saving, and it helps to address the current imbalance in the Social Security program. Buying down the debt has the first benefit, but does nothing directly on the second.

[Background: Buying down the debt, to the extent that it raises national saving relative to spending the surplus, does help to raise productivity and thus -- to a small degree -- benefits the Social Security system indirectly. But the effects are minor.]

FOLLOW: Would you consider using the surplus for anything other than Social Security?

A: The President's policy is that none of the surpluses should be used for anything else until we address Social Security. That neither rules in nor rules out using the surplus for other purposes once we have addressed Social Security. The key point is that we have to address Social Security first.

Q: Does your policy on surpluses mean that no new tax cuts or spending initiatives of any kind can be enacted in 1998?

A: No, as long as the tax cuts are paid for dollar for dollar. Our policy means that until we have addressed Social Security reform, any new tax cuts or spending initiatives can be enacted only if they are fully paid for. Tax cuts should not use up the surpluses when those surpluses could be needed for Social Security.

We are open to tax cuts that meet our principles of fairness, simplicity, economic growth, and not raising the deficit. Indeed, our budget includes many new tax cuts and spending initiatives. But these are fully paid for. They do not add one dime to the deficit or reduce surpluses by one dime.

Q: Shouldn't you balance the non-Social Security budget?

A: The unified budget is the traditional measure used to analyze the budget. It determines the net change in publicly held debt.

The most important objective for us is to continue raising our national saving rate -- up from 3.1 percent of GDP in 1992 to 6.4 percent now, largely because we have cut the Federal deficit by over 90 percent. Higher saving will help us to raise investment and productivity, which will help to prepare for the future -- including the retirement of the baby boomers. And the unified budget reflects the Federal government's contribution to national saving.

Social Security process

Q: What process is the President proposing for getting Social Security reform accomplished?

A: The President announced in his State of the Union message a three-stage process for making the determination of how we will adequately address retirement needs:

1. Regional conferences in 1998. The President believes that we must use 1998 to raise the visibility of Social Security reform. He challenges every American to attend a conference or forum on the issue -- or to organize and host one if there aren't any planned in a given area.

The President and the Vice President will be attending several bipartisan conferences organized jointly by the Concord Coalition and the AARP on Social Security reform, and will also be hosting a conference on private retirement savings in July. The national dialogue should allow all Americans to express their views, and hear the views of others.

2. White House conference. In December 1998, the President will host a bipartisan White House Conference on Social Security as a culmination of the various conferences, forums, and discussions held throughout the year. The purpose of the White House conference is to bring together the lessons learned from the national dialogue.

3. Bipartisan negotiations in January 1999. Following the White House conference in December, the President and his team will begin negotiations in January 1999 over Social Security reform. The President is firmly committed to strengthening the Social Security system.

Q: Speaker Gingrich has called for a commission to make recommendations to resolve Social Security's financial problems. Does the Administration support establishing such a commission?

A:

- What is critically important is that the American people become educated and engaged in the issue of Social Security reform. The President has challenged the American people to attend one of the many conferences that will be held over the coming year on this crucial topic. He and the Vice President will be attending several bipartisan conferences.
- At the end of the year, the President will host a White House conference on Social Security which he hopes will begin the process for establishing a bipartisan framework to bring forward meaningful reform that all parties can support.
- So we welcome any steps that the Speaker or others feel are desirable to advance the cause. All we ask is that they finish their work before the White House conference in December.

Social Security reform

Q: Does the Administration support investing part of the Trust Fund in equities?

A: The Administration believes that this option should be carefully considered as part of any bipartisan process on Social Security reform.

Stock market investment could yield higher rates of return, but would also entail higher risk. There are also significant issues of corporate governance and, more generally, the issue of the government's role in the stock market.

All of these issues need to be carefully examined before making any conclusions can be drawn about whether Social Security should invest in the stock market.

We look forward to an active national debate during 1998 over the best way to move forward, before hosting the White House conference in December and beginning bipartisan negotiations in January 1999.

Q: Does the Administration support individual accounts as part of any solution to the Social Security problem?

A: The Administration looks forward to a healthy national debate during 1998 over the benefits and costs of individual accounts. Right now, we would not necessarily want to rule out moderate individual accounts -- but only if they were part of an overall package that strengthened the existing system and preserved fairness and progressivity. So it

doesn't seem productive to speak hypothetically about individual accounts -- my views about them depend on the overall package within which they would be put.

Some have pointed to the benefits of individual accounts, while others have emphasized concerns about their potential transaction costs, shifting of investment risk to individual workers, and lack of progressivity.

We look forward to an active national debate during 1998 over the best way to move forward, before hosting the White House conference in December and beginning bipartisan negotiations in January 1999.

Q: Generic question about "real reforms" (e.g., retirement age, state and local workers, etc.)

A: The Administration looks forward to an extensive exchange of views over the coming year regarding the best ways to strengthen and reform the Social Security system. [Pending approval by POTUS: We believe that the right way to move forward is to ensure that any reforms:

- Strengthen and protect Social Security for the 21st century;
- Maintain universality and fairness;
- Provide a benefit people can count on;
- Help give the low income disabled, retired, and survivors financial security;
- Preserve fiscal discipline.]

Trust Fund

Q: How large is the Trust Fund currently?

A: The Old-Age, Survivors, and Disability Insurance (OASDI) Trust Fund currently amounts to approximately \$650 billion.

Q: How quickly is the Trust Fund growing?

A: In 1997, Social Security income exceeded expenses by approximately \$80 billion (roughly \$40 billion in interest income, and \$40 billion in non-interest income minus expenses). So the Social Security Trust Fund increased by about \$80 billion in 1997.

The Trust Fund is expected to increase by about \$100 billion in 1998.

Q: When is the Trust Fund currently expected to be exhausted?

A: Under the intermediate projections of the Social Security Trustees, the (combined OASI and DI) Trust Fund is expected to be exhausted in 2029. Non-interest income will begin to fall below expenses in 2012, and total income (including interest on the bonds held by the Trust Fund) will fall below expenses by 2019. The Trust Fund will thus start declining in 2019, and be exhausted by 2029 if no reforms are enacted.

[Even after the Trust Fund is exhausted in 2029, however, the system will continue to receive enough to pay about three-quarters of current law benefits.]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:29-JAN-1998 20:41:18.00

SUBJECT: Re: Addition to introduction to chapter 5

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

TEXT:

I think your proposed change is fine. If Mike Treadway thinks it is too jargony he may suggest an edit. Thanks for taking care of this.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:29-JAN-1998 16:12:56.00

SUBJECT: CPI memo

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

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

READ:UNKNOWN

TEXT:

As requested by Janet, please find attached a draft memo from her to the POTUS on the CPI. I hope the draft is helpful.

Please make sure that Steve Braun reads the memo, to ensure that I have not made any mistakes. Thanks.===== ATTACHMENT 1 =====

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D17]MAIL445866820.026 to ASCII,
The following is a HEX DUMP:

January 29, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: JANET YELLEN

SUBJECT: Consumer Price Index (CPI)

This memorandum responds to the questions you asked about my January 20 memorandum on the CPI (attached). It also responds to a letter that Erskine had forwarded to me from Senator Moynihan, in which the Senator noted that you had agreed that we needed to get a proper cost-of-living measure and that ongoing improvements in the CPI may make it easier to switch to the type of measure supported by Senator Moynihan.

As mentioned in my previous memo, the BLS will be implementing a variety of improvements in the CPI throughout 1998 and 1999. For example, starting with the CPI that will be released on February 24, the index will incorporate a new market basket (based on purchases between 1993 and 1995, rather than between 1982 and 1984), and a new system for measuring computer prices.

With respect to the two questions you had about my earlier memo:

- We expect the planned improvements in the CPI will reduce its annual rate of increase by 0.41 percentage point per year. But that additional 0.41 percentage point reduction in the CPI is already incorporated into our economic assumptions -- and thus does not affect our budget projections.
- The Social Security Trustees' assumptions have incorporated some, but not all, of the improvements in the CPI. In particular, their COLA projections do not yet reflect about 0.33 percentage point per year of the reductions that have occurred or are planned. A 0.33 percentage point reduction would reduce the 75-year actuarial imbalance in the Social Security system by approximately 0.5 percent of payroll (out of a current gap of 2.23 percent), and extend the life of the Trust Fund by about 5 years (from 2029 to perhaps 2033 or 2034).

With respect to Senator Moynihan's note:

- The Boskin Commission's central estimate for the overall bias in the CPI was 1.1 percentage point per year. We estimate that the changes implemented since 1995, as well as those planned for 1998 and 1999, would reduce the Boskin estimate by about 0.33 percentage point per year -- reducing his estimate of the bias to about 0.8 percentage point per year. The BLS has indicated some willingness to publish a new index that would correct for upper-level substitution. Using such a new index for cost-of-living adjustments, which would require legislation, would further narrow the gap between the official cost-of-living adjustment and Professor Boskin's desired index, to approximately

0.65 percentage point per year.

- That remaining gap -- of 0.65 percentage points per year -- largely reflects the difficulty of accurately measuring quality improvements, and is unlikely to be bridged in a manner that is supported by the BLS. It is the component of the Boskin report that attracted the most criticism within the broader economics community, because its size and perhaps even existence is extremely hard to quantify.

Thus, my conclusion is that while the improvements in the CPI and the possible new index are narrowing the gap between the BLS and Professor Boskin, such improvements do not necessarily make it any easier to go all the way to what Professor Boskin and Senator Moynihan advocate. In particular, the new index being considered by the BLS does not make it any easier to reach consensus on the most controversial aspect of the Boskin report: the so-called quality bias. Given this situation, Professor Boskin and Senator Moynihan will likely still argue that a significant upward bias exists in the CPI or any putative new BLS index, and the BLS will continue to object strongly to that conclusion. The larger economics community continues to debate the issue, and has not reached any definitive conclusions.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:29-JAN-1998 16:28:20.00

SUBJECT: Sign-off for ERP Charts

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

TEXT:

On Tuesday, you were given a packet of ERP charts to review. Cathy needs to give them to the printer tomorrow AM. If you have any changes, please let me know by end of the day.

Otherwise, they will go as presented.

THanks.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:29-JAN-1998 22:15:29.00

SUBJECT: Pam Burdman letters

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

READ:UNKNOWN

TEXT:

Alice: I attach drafts of 3 letters for Pam Burdman as per her instructions and packet. Could you put these out and fix them up.

Multiple copies of some are needed. The originals are attached. ===== ATTACHMENT 1

=====

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D72]MAIL48390882U.026 to ASCII,

The following is a HEX DUMP:

January 29, 1997

Residential Fellowship Program
Media Studies Center
580 Madison Ave. 42nd floor
New York, N.Y. 10022

Dear Sir:

I write in strong support of Pamela Burdman's application for a fellowship at the Freedom Forum's Media Studies Center to study issues relating to the impact of technological change on traditional universities. As Pamela's thesis advisor and teacher in several courses at the University of California at Berkeley I came to know her well. I can attest to her outstanding analytic and research skills as well as her keen and insightful intellect. Pam has identified a fascinating set of emerging issues relating to the impact of technology on teaching and learning. Technological change is certain to shape the organization of learning and the economics of higher education in the United States and the world in coming decades. The fellowship would afford Pamela an excellent opportunity to deepen her understanding of these topics, thereby enriching her journalistic coverage of these issues. This is an area where Pam would likely have the potential to shape an important future debate.

I have known Pam since 1990, as a student in the joint MBA and Asian Studies Masters program at the University of California at Berkeley. Pam came to the program with an extremely strong record at Princeton and a remarkable set of skills--in Chinese studies, philosophy and journalism. Eager to learn economics and core business topics, Pam excelled in all of her course work earning top grades in the MBA program while expanding her knowledge of Chinese language, literature and culture in the Berkeley's top ranked Asian studies program. She combined her mastery of economics, business, and Asian culture in her thesis, which I was fortunate to have the chance to supervise. Pam's thesis drew on her understanding of Chinese culture and history to explore the reasons for and possible solutions to ongoing trade policy disputes between the United States and China over intellectual property rights. Her thesis was a tour de force earning stellar reviews in both departments. This research demonstrated both Pam's creative intellect and her disciplined approach to scholarly endeavor.

Since her graduation, I have followed Pam's career primarily as an admiring reader of her contributions to the San Francisco Chronicle. I believe that Pam's strong investigative skills are clearly in evidence in her impressive series of articles on human-smuggling from China, and in her contributions on immigration and affirmative action. These are, to my mind, outstanding journalistic achievements. The fellowship to pursue study at the Media Studies Center would nurture further contributions and I strongly recommend her for this distinguished award.

Sincerely,

January 17, 1998

Nieman Selection Committee
One Francis Avenue
Cambridge, MA. 02138

Dear Sir:

I write in strong support of Pamela Burdman's application for a Nieman Fellowship to study issues relating to the impact of technological change on traditional universities. As Pamela's thesis advisor and teacher in several courses at the University of California at Berkeley I came to know her well. I can attest to her outstanding analytic and research skills as well as her keen and insightful intellect. Pam has identified a fascinating set of emerging issues relating to the impact of technology on teaching and learning. Technological change is certain to shape the organization of learning and the economics of higher education in the United States and the world in coming decades. The Nieman Fellowship would afford Pamela an excellent opportunity to deepen her understanding of these topics, thereby enriching her journalistic coverage of these issues. This is an area where Pam would likely have the potential to shape an important future debate.

I have known Pam since 1990, as a student in the joint MBA and Asian Studies Masters program at the University of California at Berkeley. Pam came to the program with an extremely strong record at Princeton and a remarkable set of skills--in Chinese studies, philosophy and journalism. Eager to learn economics and core business topics, Pam excelled in all of her course work earning top grades in the MBA program while expanding her knowledge of Chinese language, literature and culture in the Berkeley's top ranked Asian studies program. She combined her mastery of economics, business, and Asian culture in her thesis, which I was fortunate to have the chance to supervise. Pam's thesis drew on her understanding of Chinese culture and history to explore the reasons for and possible solutions to ongoing trade policy disputes between the United States and China over intellectual property rights. Her thesis was a tour de force earning stellar reviews in both departments. This research demonstrated both Pam's creative intellect and her disciplined approach to scholarly endeavor.

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Sincerely,

January 29, 1998

Knight Fellowships
Building 120, Room 424
Stanford University
Stanford, CA 94305-2050

Dear Sir:

I write in strong support of Pamela Burdman's application for a Knight Fellowship to study issues relating to the impact of technological change on traditional universities. As Pamela's thesis advisor and teacher in several courses at the University of California at Berkeley I came to know her well. I can attest to her outstanding analytic and research skills as well as her keen and insightful intellect. Pam has identified a fascinating set of emerging issues relating to the impact of technology on teaching and learning. Technological change is certain to shape the organization of learning and the economics of higher education in the United States and the world in coming decades. The Knight Fellowship would afford Pamela an excellent opportunity to deepen her understanding of these topics, thereby enriching her journalistic coverage of these issues. This is an area where Pam would likely have the potential to shape an important future debate.

I have known Pam since 1990, as a student in the joint MBA and Asian Studies Masters program at the University of California at Berkeley. Pam came to the program with an extremely strong record at Princeton and a remarkable set of skills--in Chinese studies, philosophy and journalism. Eager to learn economics and core business topics, Pam excelled in all of her course work earning top grades in the MBA program while expanding her knowledge of Chinese language, literature and culture in the Berkeley's top ranked Asian studies program. She combined her mastery of economics, business, and Asian culture in her thesis, which I was fortunate to have the chance to supervise. Pam's thesis drew on her understanding of Chinese culture and history to explore the reasons for and possible solutions to ongoing trade policy disputes between the United States and China over intellectual property rights. Her thesis was a tour de force earning stellar reviews in both departments. This research demonstrated both Pam's creative intellect and her disciplined approach to scholarly endeavor.

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Sincerely,

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Mark R. Hopkins (CN=Mark R. Hopkins/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:29-JAN-1998 20:26:12.00

SUBJECT: trade balance

TO: Charles F. Stone (CN=Charles F. Stone/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 looked over the rewrites, and all the suggestions seem like good ones.
I don't have control of the document to make the changes, but I will pass
along those pertaining to Chapter 7 to Mike Treadway and ask him to make
them.

Your handling of how to spin the statistical discrepancy is far superior
to the alternative I was considering--namely, that since the entire growth
of the current account deficit can be attributed to the growing
statistical discrepancy, then the trade deficit should not be related to
market opening because clearly it is due solely to the increasing
sloppiness of government statisticians

:-) Mark

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: James M. Treadway (CN=James M. Treadway/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:29-JAN-1998 11:42:10.00

SUBJECT: Redline comparisons of ERP chapters

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:

I think what I have done is, as they say around here, responsive to your request. I'm providing Alice with the following files to be printed out:

intc7cln compares the current (seventh) version of Chapter 1 (introd.cl7, dated 1/28) against the first edited version (introd.cln dated 1/12)

I have not entered any changes in Chapter 2 since macro.cln dated 1/22; Chad expects to give me a round of changes this evening. I'll provide a redline comparison of those changes with the next clean version.

Maria just gave me her first round of changes to Chapter 3. I'll proceed as with Chapter 2.

racc3cln compares the current Chapter 4 (race.cl3, dated 1/28) against the first edited version (race.cln, dated 1/26)

regc2cln compares the current Chapter 5 (regulat.cl2, dated 1/26) against the first edited version (regulat.cln, dated 1/18)

antc4cln compares the current Chapter 6 (antitrust.cl4, dated 1/28) against the first edited version (antitrust.cln, 12/23/97)

internat.rv3 is an already existing record of differences between internat.cl7 (1/20) and internat.cl8 (the current version, dated 1/28); Jon had requested that I provide redline versions of each new round of changes for his chapter.

I haven't looked closely at the outputs of the comparison routine except that of Chapter 5 so don't know how useful they will be. But it seemed to work OK for Chapter 5. I'll try again if any didn't work. This was easier even than I thought.

Mike

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Keith O. Fuglie (CN=Keith O. Fuglie/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:29-JAN-1998 17:47:06.00

SUBJECT: Addition to introduction to chapter 5

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

TEXT:

I propose to add the following to the middle of the first paragraph (new stuff in bold):

..."In a well-functioning market the price of a good or service reflects both its marginal value to the consumer and its marginal cost to the producer. So long as there is no divergence between the private and social values and costs of these goods and services, the market system is likely to bring about the most efficient allocation of economic resources. However, economists also recognize that sometimes prices might be distorted and a market economy may fail to allocate resource efficiently ."

Do you think this may be too heavy with economic jargon?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: James M. Treadway (CN=James M. Treadway/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:30-JAN-1998 11:31:53.00

SUBJECT: Chapter 6 passes the post

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

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

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

CC: Mark C. Rainey (CN=Mark C. Rainey/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:

Mark has given me the fact-check corrections on the antitrust chapter, and I've entered them into the document. Aaron had previously signed off. It awaits only the Chair's blessing, plus I plan to read it one more time before sending to the desktoppers.

Meanwhile I'll distribute the current clean (antitrust.cl5) version and a version showing the fact-check changes (antitrust.rv2).

Mike

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:30-JAN-1998 13:05:44.00

SUBJECT: CEA Report chapter one

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

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

TEXT:

----- Forwarded by Janet L. Yellen/CEA/EOP on 01/30/98
01:04 PM -----

Joseph J. Minarik

01/30/98 12:24:52 PM
Record Type: Record

To: Janet L. Yellen/CEA/EOP
cc: Michele Jolin/CEA/EOP
Subject: CEA Report chapter one

A couple of days ago, you suggested that it wouldn't be the worst thing in the world if I gave chapter 1 one more read. I'm sorry that I have taken this long.

Almost everything I did is of the nature of editorial twiddles. I did have one thought on tobacco, and one on social security. On tobacco, it struck me as possibly misleading to say that we approve of the settlement; I suggested changing that to "the principles of" the settlement. The categorical statement could raise the question of why we did not simply write legislation to implement the settlement. The answer is that we want a payment, we want marketing restrictions, we want a youth target, etc., but we believe that the liability, antitrust, and dollar provisions were off somewhat.

On social security, the enumeration of specific spending cut and payroll tax options, while hypothetical and mathematically unimpeachable, struck me as risky -- and in one sense unnecessarily so. If I were Speaker Gingrich, on record as saying that we can fix the system without pain, I would cite that menu as the Administration's prescription for pain. If instead you merely state that policy steps would be necessary, without the specifics, you convey virtually all of the information to the intelligent reader without the message risk.

I also had a couple of factual questions about the quantitative status of

the program in the early part of the next century. I believe I am right on those, but I don't have chapter and verse at hand, so someone might want to double-check them.

The only remaining systematic point is my never-ending campaign, at the behest of my college freshman English teacher (who died at the end of the year from an unpredictable reaction between a prescription drug and a non-prescription pain reliever), to use "since" only in reference to relative time, and "because" for causation.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:30-JAN-1998 12:24:55.00

SUBJECT: CEA Report chapter one

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

READ:UNKNOWN

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

READ:UNKNOWN

TEXT:

A couple of days ago, you suggested that it wouldn't be the worst thing in the world if I gave chapter 1 one more read. I'm sorry that I have taken this long.

Almost everything I did is of the nature of editorial twiddles. I did have one thought on tobacco, and one on social security. On tobacco, it struck me as possibly misleading to say that we approve of the settlement; I suggested changing that to "the principles of" the settlement. The categorical statement could raise the question of why we did not simply write legislation to implement the settlement. The answer is that we want a payment, we want marketing restrictions, we want a youth target, etc., but we believe that the liability, antitrust, and dollar provisions were off somewhat.

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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Mark R. Hopkins (CN=Mark R. Hopkins/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:31-JAN-1998 20:30:02.00

SUBJECT: FDI and technology

TO: Lael Brainard (CN=Lael Brainard/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: 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:

The following is a rewrite of several rewrites of the FDI section on benefits to host countries. I believe it addresses and balances each of the concerns that were raised by Lael, Janet, and Jon. I hope you agree. If you have any further comments, please let me know before Sunday night, so I can have Mike make the changes that will go to the printer on Monday.

Thanks. -Mark

Lastly, through the direct control of their affiliates, multinationals provide crucial links in the international dissemination of technology and best practices. This promotes more efficient production and resource use in host countries and rising incomes throughout the world. The recent literature on economic growth emphasizes the importance of a growing common pool of ideas in increasing growth rates among all countries. As new trade and investment agreements are negotiated to strengthen global intellectual property rights, these transfers can occur while maintaining the profitability of innovating firms and incentives to innovate. FDI is frequently identified as an important vehicle for increasing productivity in host countries, in some cases contributing relatively more to growth than does domestic investment. Although developing countries that employ outdated technologies may have the most to gain from the new ideas brought by foreign multinationals, they are not the only countries that gain. The resurgent competitiveness of the U.S. automobile industry in the 1990s is often attributed to the adoption of the just-in-time⁸ inventory practices used successfully by Japanese production facilities located in the United States.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-FEB-1998 18:51:56.00

SUBJECT: Jeff's Testimony on GCC and Budget Rollout

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

READ:UNKNOWN

TEXT:

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

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**DRAFT TESTIMONY:
ECONOMIC ANALYSIS OF KYOTO AGREEMENT**

[Expressions in square brackets need to be discussed, and in some cases deleted. Additional technical passages may also need to be simplified or cut, even for purposes of written testimony, let alone oral. Numbers will need to be rounded off, to avoid a false sense of precision. But I would suggest holding such suggestions at the first round of vetting, or entering them into a parallel document, and concentrating for the moment on making this document an accurate Economic Analysis and well-crafted statement of our position.]

The President has said that we can work to avert the dangers of climate change, while at the same time maintaining the strength in our economy. I am pleased to have this opportunity to elaborate.

Basic Economic Rationale of the Kyoto Treaty

What is the basic rationale, from an economist's perspective, for the Kyoto Agreement?

The earth's surface is warming from the accumulation of greenhouse gases from myriad sources worldwide, none of which presently pay the cost to others of warming's ill effects. As a result of these distorted incentives, disruption of the Earth's climate is likely to proceed at an excessive pace and if left uncontrolled may pose substantial costs in terms of disruption to commerce and the environment alike.

Costs of Climate Change

The Intergovernmental Panel on Climate Change (IPCC) jointly established by the World Meteorological Organization and the United Nations Environment Programme, concluded in 1995 that "the balance of evidence suggests that there is a discernible human influence on global climate." Current concentrations of carbon dioxide, methane, nitrous oxide, and the other so-called greenhouse gases have reached levels well above those of preindustrial times. Of these, carbon dioxide (CO₂) is the most important: net cumulative CO₂ emissions resulting from the burning of fossil fuels and deforestation account for about two-thirds of potential warming from changes in greenhouse gas concentrations related to human activity. If growth in global emissions continues unabated, the atmospheric concentration of CO₂ will likely double, relative to its preindustrial level, midway through the next century. The IPCC estimates that global temperatures will increase by between 2.5 to 6 degrees Fahrenheit in the next 100 years, with a best guess of about 3.5 degrees F [ADD C TOO?].

The accumulation of greenhouse gases poses significant risks to the world's climate and

to human well-being. Potential consequences include a rise in sea levels, greater frequency of severe weather events, shifts in agricultural growing conditions from changing weather patterns, threats to human health from increased range and incidence of diseases, changes in availability of freshwater supplies, and damage to ecosystems and biodiversity.

While scientists believe that human activities are leading to a gradual warming of the average temperature of the earth, the change in temperature in a given region at a given time may differ substantially from this average. Indeed, models predict warming will be greater in high latitudes than in the tropics, and greater over land than ocean. Many models predict larger increases in evaporation than in precipitation over midlatitude land areas, which would result in drier conditions in those regions, especially during summer in North America and Europe.

The derivation of quantitative or monetary estimates of the damages from such climate changes taxes today's forecasting models. Nonetheless, respected researchers have developed estimates of the monetary damages expected were there to be an average worldwide temperature increase of approximately 2.5 degrees Centigrade, or approximately 4.5 degrees Fahrenheit. For example, William Cline, while at the Institute for International Economics, estimated that such a temperature change for the U.S. economy today, would impose annual damages of more than \$60 billion per year. Of these the biggest categories of monetary damages would be \$18 billion in lost agricultural production, \$11 billion in additional electricity costs, and \$7 billion in new costs to maintain the existing supply of fresh water. [All these are 1990 \$: convert to 1997 \$] Other researchers have developed similar estimates. For example, William Nordhaus of Yale University [originator of the Integrated Assessment models that do seek to monetize the effects of global warming], has developed comparisons of estimates of the dollar income loss attributable to doubling of carbon dioxide concentrations. He finds that the Cline estimate is in the center of three estimates for the U.S. and that the high estimate is only 1.3 times greater than the low estimate. It must be noted however that this similarity of estimates masks the true uncertainty associated with forecasts of the damages from given increases in global warming.

Although categories of damages like disease incidence and sea level increase are uncertain they are in principle subject to quantification and valuation using standard methods.

Far more difficult to include in an analysis of the benefits of climate change protection is the small and unknown possibility of large-scale and potentially irreversible discrete events with potentially catastrophic consequences. Two such possibilities serve as illustrations. [check these "facts"] Warming of Northern tundra may release very large amounts of methane currently frozen into the subarctic permafrost, thereby leading to potentially devastating acceleration of an otherwise controllable global warming process. Second, evidence from climate models suggests that some types of climate change may lead to displacement of the Gulf Stream that warms Western Europe. Evidence from ocean core samples suggests that such reversals of ocean currents have occurred in previous ice ages. Reductions in the risk of such catastrophic outcomes must be considered in addition to the costs and benefits that can be reasonably quantifiable. Indeed since American families are averse to risk, such

possibilities are especially important in evaluating whether the benefits of a particular climate control policy justify the costs.

Need for Global Action

Climate change is a complex, long-term problem requiring global cooperation and a long-term solution. It is a unique economic problem in that emissions of different gases anywhere in the world will have very similar effects on global climate at a given date in the future. No single country has an incentive to reduce emissions sufficiently to protect the global environment against climate change. Each has an economic incentive to “free ride” on the efforts of others. Even if the United States sharply reduced its emissions unilaterally, greenhouse gas emissions from all other countries would continue to grow, and the risks posed by climate change would not be significantly abated.

The threat of disruptive climate change has led to coordinated international efforts to reduce the risks of global warming by reducing emissions of greenhouse gases. The first international agreement to address global warming was the Framework Convention on Climate Change signed during the Earth Summit in Rio de Janeiro in 1992. This convention established a long-term objective of limiting greenhouse gas concentrations and encouraged the established industrial countries to return their emissions to 1990 levels by 2000. Since then it has become clear that the United States and many other participating countries will not meet this goal.

To address the lack of progress among many industrialized countries toward meeting this first target, the United States and approximately 160 other nations, in negotiations held in Kyoto, Japan, last December, agreed to take substantial steps to stabilize atmospheric concentrations of greenhouse gases. The Kyoto agreement, which requires the advice and consent of the Senate, would place binding limits on industrial countries’ emissions of the six principal categories of greenhouse gases: CO₂, N₂O, methane, sulfur hexafluoride, perfluorocarbons, and hydrofluorocarbons. Each industrial country’s “1990 baseline” is actually based on its 1990 emissions of CO₂, methane, and N₂O and its choice of 1990 or 1995 levels of the other three categories of gases. The United States agreed to a target of 7 percent below 1990 levels over 2008–12. To meet that target, net U.S. emissions of greenhouse gases—all emissions minus removals of CO₂ by certain forestry-related activities—must average no more than 1,484 million metric tons of carbon equivalent per year during that period. The targets for the European Union and Japan are 8 percent and 6 percent below 1990 levels, respectively. Australia, New Zealand, Norway, and the countries of the former Soviet Union all have less stringent limits. In sum, over the period from 2008 to 2012, the industrial countries are expected to reduce their average emissions of greenhouse

gases to about 5 percent below their 1990 levels. [PERHAPS BELONGS ONLY IN EIZENSTAT TESTIMONY?]

Flexibility and Market Mechanisms

The nature of the climate change problem suggests some methods to lower costs of achieving given levels of environmental protection. Such methods have long been championed by economists interested in increasing the efficiency of protection. They were the sort of thing that 2600 economists had in mind last year when they signed a letter, urging action on climate change:

“Economic studies have found that there are many potential policies to reduce greenhouse gas emissions for which the total benefits outweigh the total costs...The most efficient approach to slowing climate change is through market-based policies.” What are these methods and policies? They can be characterized in three categories of flexibility: “when flexibility,” “what flexibility,” and -- perhaps most important of all -- “where flexibility.”

First is “when flexibility” (timing). Since climate change is a long-term problem, the exact timing of emissions reductions is in some sense not important. Thus the freedom to delay or accelerate reductions within an agreed upon time frame that ensures credibility of emissions reductions also lowers costs. The Kyoto Protocol incorporates this principle in three ways. First, the cuts to be made in the first period are less severe than those that had been proposed by many other countries, most notably the Europeans. By imposing relatively milder cuts [relative to the business-as-usual path] in the early years, we can greatly reduce costs such as those from prematurely scrapping coal-fired electricity plants still in the prime of their operating lives, while attaining the same environmental goals in terms of ultimate atmospheric concentrations of carbon in the year 2100. [IS THAT SENTENCE OK?] Second, the [medium-term] emissions target is not specified in terms of a specific year, but rather in terms of an average over a five-year period (2008-2012). Averaging over five years, instead of requiring countries to meet a specific target each year, can lower costs, especially given an uncertain future. The averaging can smooth out the effects of short-term events such as fluctuations in the business cycle and energy demand, or hard winters and hot summers that would increase energy use and emissions. Further, if firms perceive that a new technology will soon be usable that will reduce the costs of reducing emissions, they can emit more greenhouse gases in the beginning of the period and less at the end. And third there is allowance for “banking” emission reductions within the 2008-2012 commitment period, for use in a subsequent commitment period [although the emission targets of the next period have not yet been specified].

Second is “what flexibility” (six gases). Emissions of different kinds of gases, not just carbon dioxide, contribute to the greenhouse effect. Since the IPCC has developed conversion factors for all greenhouse gases by estimating their global warming potentials, reductions in emissions of one pollutant can be used to substitute for increases in emissions of another by an amount that causes equivalent environmental effects. The Kyoto Protocol stipulates that

countries with binding targets are expected to reduce their total greenhouse gas emissions by certain percentages, but does not require specific reductions for specific gases. Since a molecule of sulfur hexafluoride is 23,900 times more potent over 100 years than a molecule of CO₂, it may be cheaper to achieve the same environmental benefit by eliminating one [molecular] unit of SF₆ than nearly 24,000 units of CO₂. Our initial rough analysis indicates that a strategy of reducing non-CO₂ greenhouse gases by *more* than 7% below their 1990/1995 baseline levels while reducing CO₂ by *less* than 7% below its 1990 level could reduce all emission permit prices by more than 10%. [This analysis is based on the integrated SGM/non-CO₂ cost curve.] Thus allowing countries flexibility in what gases they reduce -- essentially trading emissions reductions across gases -- can help lower significantly the costs of meeting their targets. Another source of "what flexibility" is the treatment of sinks, i.e., land use activities that promote the removal of carbon from the atmosphere through the growth of plants. Promoting such sinks may reduce atmospheric concentrations of CO₂ at much lower costs than reducing emissions.

Third [and most importantly] is "where flexibility" (international). Emissions have the same environmental consequences regardless of where in the world they occur. Therefore the least-cost approach to controlling climate change is to reduce emissions wherever such reductions are cheapest. The Kyoto agreement includes two important cost-saving provisions of this nature. First, it provides for industrial countries to trade rights to emit greenhouse gases with each other. This market in emissions permits will ensure that emission reductions occur where they are least expensive within the industrial countries. In particular, U.S. companies could purchase emissions reductions in other participating countries when doing so would lower their costs. This arrangement will lower costs without affecting the level of environmental protection. Second, the agreement allows industrial countries to invest in "clean development" projects in the developing world and use these projects' certified emissions reductions toward meeting their targets. Many such clean-development projects may be quite cheap in terms of the cost per ton of emissions avoided. Details of these provisions will be worked out in negotiations in Buenos Aires later this year.

Developing Country participation

The President has made clear that his support of the agreement is dependent on meaningful participation of key developing countries, i.e., countries outside the 38 industrialized Annex I countries that agreed to binding emissions reductions. He will not submit the Treaty to the Senate without such participation.

There are several reasons why such meaningful participation is essential. First, developing countries are projected to contribute a majority of total emissions by 2030 under a continuation of business as usual. Thus without their participation emissions reductions by the industrialized countries will not achieve necessary protection from climate change. Second, principles of basic fairness suggest all countries should do their part, depending on their ability to

contribute to the solution. Thus even poor countries should contribute, although the existence of more pressing social needs in such countries will inevitably limit the magnitude of their contributions. Third, their participation may serve to limit emissions increases in such countries that might otherwise be an unintended consequence of the Kyoto agreement [so-called leakage]. For example, as Annex I countries comply with their targets, their demand for oil will fall, perhaps causing the price of oil to fall on world markets, and encouraging non-participating countries to use more oil and emit more carbon than they otherwise would have. Similarly, the most energy-intensive activities in US manufacturing might relocate to non-participating countries, again raising emissions there. Fourth, developing country participation would permit cheaper emissions reductions achieved in these countries to be internationally recognized as a substitute for more expensive emissions reductions that might otherwise be achieved by U.S. companies domestically.

So far I have not mentioned the word "competitiveness," the most commonly feared locus of adverse effects from going ahead without developing country participation. On the one hand, if "loss of competitiveness" refers to predictions of negative effects on the aggregate trade balance, as I have seen in one study, then I must say that I see no reason why this should happen. On the other hand, if it refers to adverse effects on some individual manufactured exporting industries -- those that are especially energy-intensive [such as aluminum...] -- I must confess that such effects are possible. It is difficult to undergo as thorough a structural change in the economy as required here without having the effect of expanding some sectors and contracting others. But energy constitutes only 2.2 percent of total costs to US industry. Two-thirds of all emissions are not in manufacturing at all, but in transportation and buildings. I believe it more accurate to say that we need developing country participation for the reasons I outlined above, than to say that we need it to avoid adverse effects on competitiveness.

Difficulties of economic analysis

Now that we have a protocol, even if it is not yet complete nor ready for the President's submission to the Senate, the time has come to explain to you in more detail our economic analysis. This includes rough estimates of the range of some of the possible costs and benefits of our climate change policy, under various possible assumptions. But before I mention a single number, I wish to emphasize some of the limitations to any such estimates [-- the ways in which they are necessarily uncertain and problematic]. The difficulties associated with economic analysis of this issue fall into three broad categories. They are: the impossibility of putting a single monetary number on the long-term benefits of climate change mitigation, uncertainties that still remain over the terms of the ultimate treaty, and inherent limitations of the models of even short-term costs and benefits.

Impossibility of reliably estimating the monetary benefits of climate change mitigation

The goal of the entire exercise, of course, is to begin to move to a path of emissions that implies lower levels of atmospheric concentrations of greenhouse gases future in centuries, and

thereby mitigates the likely extent of global climate change. Estimates of the economic damages from climate change [for example, 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 have at least some sympathy 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.

A subject of great uncertainty and sensitivity is the “discount rate” that is applied to the benefits of averting future climate change. Such a discount rate is needed if benefits are to be expressed in monetary terms, 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. How do we weigh short-term costs against long-term benefits? There is little agreement, even among economists, on the appropriate discount rate applicable to a question so great in import as the future climate of the planet. Cline, for example, explicitly adopts 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. [RANDY WARNS THAT THIS PARAGRAPH MIGHT BE USED TO UNDERMINE GOOD OMB PRACTICE IN OTHER AREAS OF REGULATION.]

A similar point concerns risk-aversion. To what extent are we willing to take chances with our planet? The point applies particularly to catastrophe scenarios. Scientists have thought of many possible scenarios, most of which they are fortunately not yet prepared to pronounce as high-probability based on current evidence, but which might be truly catastrophic for the Planet if they were to occur. There is a strong argument for the Kyoto agreement as Planet insurance. But what numerical weight should one assign to these risks? It is difficult for an economist, or anyone, to know.

Finally, and most importantly, even if we were confident of our ability to quantify the effects of emissions cuts on the environment, measured by CO₂ concentrations or average temperatures, we would then need to make arbitrary assumptions about future international agreements to limit emissions beyond the 2012 window. The reason is that the emission cuts agreed upon at Kyoto are only a first step on a long journey. International conferences have not begun to talk about specific emissions paths after 2012. Yet these are the paths on which atmospheric concentrations in the year 2100 and beyond -- and thereby the major climate effects entirely depend. The first step that we propose to take over the next 15 years is critical. But it is not critical because it will in itself go far to solving the climate change problem -- emissions during any given decade are small compared to the cumulative concentrations in the atmosphere. Rather it is critical because we can't take the second and third steps until we have taken the first. And we don't yet know how big will be those future steps to which the nations of the world agree.

It is evident that the benefits of averting climate change are potentially enormous. But

we have chosen not to try to quantify them in monetary terms, in light of the difficulties I have enumerated: the quantitative uncertainty of these benefits, their timing (in future centuries, far outside the 15-year horizon covered by the treaty), and the need to make arbitrary guesses regarding the post-2012 path of cuts in emissions of greenhouse gases cuts in order to produce large reductions in future concentrations in the atmosphere. We have opted for an attempt to add up the various possible costs and benefits of emissions policy *excluding* climate change. To give away the punch line, our conclusion is as follows: “the net costs of our policies to reduce emissions are likely to be small [under certain assumptions regarding, for example, domestic and international trading], even before taking into account the benefits of averting climate change itself.”

Terms of the treaty

Although we know a lot more than we did before Kyoto about the proposed terms of the international effort and what they would mean for the United States, there is still much that we don't know. First, as is often the case in a legal document of this length and complexity, there are some provisions of which the proper legal interpretation is not yet clear to simple economists such as ourselves. [Okay to say?] Of particular concern here is the treatment of so-called sinks. This refers to activities that affect the rate at which carbon is removed from the atmosphere and “sequestered,” specifically by the planting of trees. Second, a number of items, concerning international trading and developing countries, which had not been definitively settled by the end of the last all-night session of the Kyoto talks were explicitly assigned to future negotiations [in Buenos Aires next fall]. [?] The Kyoto Protocol provides opportunities for the industrial countries to trade rights to emit greenhouse gases with each other. Countries may also invest in “clean development” projects in the developing world and use these projects' certified emissions reductions toward meeting their targets. [This provision embraces the President's proposal known as “Joint Implementation” -- JI.] Both of these mechanisms allow for emissions reductions to occur where they are least expensive. But in both cases, the all-important details of the provisions remain to be worked out at Buenos Aires. This makes projections difficult.

The third and final category of parameters yet to be determined pertains to the actions of future administrations and Congresses. This includes, first, pre-2008 domestic policy measures, such as future R&D programs to extend the work that President Clinton has proposed in the current budget. It includes, second, important aspects of how the tradable emissions-permit plan is implemented in 2008-2012, such as where in the energy economy permit requirements are imposed, how permits are distributed, and -- if all or some are auctioned -- what is done with revenues. [And it includes, third, any agreements that might be entered into regarding further steps to address climate change post-2012, which might have effects on prices and technological change even pre-2012.]

Inherent limitations of models

Even within a given model, answers depend critically on the precise nature of the

question asked. For example, I will illustrate momentarily how the costs of emissions reductions depend critically on the extent of global participation and international trading that a treaty is assumed to feature. Even when all the features are specified, different models can give different answers -- a concrete illustration of the range of uncertainty to which we must assign the predictions of any one model. One area where the uncertainty is particularly great is the pace of technological progress, and the extent to which it will accelerate in response to government programs for R & D and dissemination. Economics does not offer a good understanding of how technological progress is determined, in part because it is the stuff of experimentation, brainstorming, genius, breakthroughs, perceptions and habits. Invention is largely determined by inspiration -- notwithstanding Edison, who assigned a 99% share to perspiration -- and inspiration is difficult to fit into a mathematical formula or economic model. Models and experts on climate change policy tend to have a wider range of disagreement on the speed with which technology can be changed than on any other single issue.

Furthermore, each model has strengths and weaknesses; each has questions to which it is better or worse suited to answer. Some, for example, model the energy sector in detail. Some allow for the fact that a coal-fired power plant cannot costlessly be converted to one that runs on natural gas. Some have enough tax policy detail to distinguish alternative ways of redistributing revenues that might be raised if emission permits were to be auctioned. Some are capable of showing short-term macroeconomic disequilibria. Some include a long-term "carbon cycle" model that can keep track of the accumulation of GHG concentrations in the atmosphere and their climatological effects. Some break down the rest of the world into regions and so can model international trade. No one model does everything. [JOE AND RANDY FEAR THIS SUB-SECTION MAY SOUND TOO APOLOGETIC REGARDING THE USEFULNESS OF MODELS.]

The basis of our analysis

The existence of modeling difficulties does not mean that we can abandon rigorous economic analysis. Rather, we have employed a broad set of economic tools to analyze the policy options. Such tools include models of the energy sector and economy over the next 25 years, including but not limited to the models that have been used in Energy Modeling Forum exercises, the IPCC's review of the economic and social dimensions of climate change, and in the Interagency Analytical Team (IAT) effort last year. [I have already referred to the Integrated Assessment class of models, those that are designed to operate on the longer time frame that is relevant for thinking about climatological effects.] Other tools include simple relevant statistics, "meta-analyses" of existing models, historical and sectoral examples, and basic economic reasoning. Drawing on this broad array of analytical tools allowed an intelligent evaluation of the policy alternatives.

To our knowledge, no model -- whether used inside the government or not -- was as of December set up precisely to analyze the parameters of the agreement that was reached in Kyoto. Even we in the Administration did not know exactly what we would get until the end of the negotiations [e.g., the 2008-2012 commitment window, a target 7 % below 1990 levels, six gases, etc.], while most of the model-builders outside the government tend to require a lag as

long as several years to incorporate the current policy parameters into their models. No model is currently designed to assess sinks, let alone all six gases.

Since Kyoto, the Council of Economic Advisers [in collaboration with the Treasury and other agencies] has sought to evaluate the implications of what was agreed to with a particular model, the Second Generation Model of Battelle Laboratories. [Of the models readily available to us on short notice,] the SGM was the one best positioned to analyze the role of international trade in emission permits, which we consider to be a critical element of the Kyoto Treaty. Thus the SGM is the basis of the estimates that I am about to give you. (We dealt with the problem of the six gases by integrating the SGM model results with cost analyses of the others by EPA.) But, mindful of the limitations that any one model has, we are eager to feed the Kyoto parameters into other models, to get a better feel for the range of possible effects. Much of this work will have to go on outside the government. For example, we have had discussions with the Energy Modeling Forum, based at Stanford University. The EMF is a long-running exercise in which many of the leading models participate [giving predictions as to the effects of a commonly specified set of policy parameters]. We have given them some advice on how features of the Kyoto legal language can be translated into terms recognizable to an economist. Unfortunately, the Energy Modeling Forum believes that its members will need until mid-year to produce reliable results [check].

How Trading Brings Down Costs

I said in Congressional testimony last July that we can do this smart or we can do this dumb. To elaborate, the costs of cutting emissions can be much reduced if flexible, market mechanisms are used. As regards domestic implementation, the President's program has two key aspects: a \$6.3 billion commitment over the next five years for research and development spending (\$2.7 billion) and tax incentives to mobilize cutting-edge technology (\$3.6 billion), and a plan to require tradable permits for greenhouse gas emissions during the period 2008-2012. It is critical that the permits are to be tradable. This will allow emissions automatically to be cut in the sectors and regions of the economy where it is cheapest to do so.

The same principle holds internationally. In some countries, where energy use is high and tilted toward carbon-producing sources, it should be relatively easy to enact large reductions.

In others, where energy use has already been reduced and made cleaner, it is expensive to enact further reductions in carbon emissions. If the latter kind of countries can achieve their targets by paying the former to reduce emissions in their place, the same aggregate reduction in emissions can be achieved at lower costs. This is the same as saying that the same climate benefits can be achieved at lower costs, since the global climate effect of a ton of carbon is the same regardless where it is emitted.

Estimated reduction in costs from Annex I trading

In the language of the treaty, "Annex I" is the set of countries that have agreed to take on binding limitations in emissions of greenhouse gases. They are basically the set of industrialized countries, defined to include Russia, Ukraine, and most other Eastern European countries. Even in the case where participation is limited to this set of countries, costs can be

reduced substantially by trading among the group. (To illustrate, Russia and the Ukraine consume six times as much energy per dollar of output as does the United States [where we in turn consume more than Europe or Japan].)

The estimate we derived from the SGM [integrated with the government cost analysis regarding the other five gases] was that, under certain base-case assumptions [AEEI=1% + no sinks], trading among Annex I countries reduces the cost to the United States of achieving its targets for 2008-2012 emissions by about [43%-55%], relative to a situation where we had to achieve all these reductions at home. This concept of costs is meant to capture aggregate resource costs to the US economy, including the cost to domestic firms of purchasing emission permits from Russia and other countries where emission reductions are cheaper than in the United States [or in other major industrialized countries].

A useful rough check on this estimate can be obtained from other model[s], notwithstanding that they are likely to be more distant approximations to the parameters of the Kyoto Treaty. The G-cubed model, for example, says that trading among Annex I countries reduces US permit prices by roughly 40 percent, and reduces overall costs by roughly 20 percent [CHECK]. [The G-cubed model is better designed than most to analyze trading of permits in a system where the usual international trade in goods and services is also important.]

Estimated reduction in costs from umbrella trading

One possibility that emerged in Kyoto, which none of us foresaw, was the idea that the United States might undertake trading with a subset of Annex I countries, dubbed the “umbrella,” that would exclude the European Union. [The initial list of proposed participants includes the United States, Australia, Canada, Japan, New Zealand and Russia, with strong indications of interest from some others.] The motivation for this idea was that the Europeans have been reluctant to agree to the sort of international trading that we want (preferring that they achieve their goals collectively in a group of their own, called the “EU bubble”). It is too early to say whether the umbrella concept will in fact be accepted by the parties. But it is an important concept to consider, for three reasons. First, it is conceivable that it will be formally agreed to in future negotiations. Second, even if the final treaty does not explicitly include the umbrella, but rather allows trading among all signatories (as the United States has proposed all along), it is conceivable that umbrella countries will agree, outside the treaty, to trade only among themselves. Third, the aversion toward international trading that the Europeans have expressed suggests that they might refrain from making the trades to which they would be entitled.

The significance of the umbrella idea in the present context is that it has the potential to further reduce costs to the United States. The reason is that if the Europeans are not bidding against us for the cheap emission rights that the Russians and other Eastern Europeans have to sell, then the price will be even lower. Our SGM results suggest that, relative to the situation in which we must make all our reductions at home, the umbrella arrangement would reduce costs by an estimated 61-75 per cent, depending on whether the former Warsaw Pact countries are classed with the EU, or are instead assumed to fall within the umbrella. The G-cubed model estimates that an umbrella that includes the Warsaw Pact countries would reduce permit prices by roughly 70 percent and reduce overall costs by roughly 50 percent. [CHECK]

Estimated reduction in costs from LDC participation

The next consideration is participation by developing countries. The President has said that he will not submit the treaty for ratification without such participation. It is by no means certain that we will be able to sign up all developing countries for full binding commitments inside the same commitment window as the rich countries. A moderate version of developing country participation is Joint Implementation. JI cannot realistically be expected to yield all the gains of full participation, but it might shave costs by roughly another 23 percent, on top of the reduction from trading among Annex I countries. Another possibility is that we persuade some of the key developing countries that are the largest emitters to commit to targets, and allow us to buy emission reductions from those paths. The model estimate is that this would cut 55 percent off costs, on top of Annex I trading. [The four countries included in this particular estimate are China, India, Brazil and Korea.] Once these savings have been attained, the estimated benefits of persuading the rest of the developing world to go along with full commitments are relatively small. [No difference, in the 1/23/98 table.] The combination that gives the best possible result for the United States would be an umbrella that excludes the EU, but that otherwise includes full worldwide participation and trading. The cumulative reduction in costs relative to obtaining all reductions domestically is an estimated 88 percent.

I offer these numbers because they show the potential effectiveness of trading at reducing costs dramatically. But it is important that I repeat three caveats: First, as always, there is a wide range of uncertainty around all these estimates. Second, they apply to an idealized version of trading, one that assumes no problems of enforcement or transactions costs. Third, it is unlikely that we will get all our partners to agree in Buenos Aires to the very most optimistic or ambitious case. But the numbers show major savings even without getting the most optimistic case. And if we don't get enough of what we want, we won't sign/submit the treaty.

Non-climate Benefits

As I have indicated, achieving emission-reductions efficiently means using market mechanisms, which means raising the prices of fossil fuels and other sources of greenhouse gases. We recognize that such price increases are not without pain. But there are some partially-offsetting benefits, in three areas: air pollution, traffic congestion, and highway accidents.

Reductions in carbon emissions also lead to reductions in emissions of pollutants that contribute to excess concentrations of fine particulate matter and low-level ozone.
[Quantification forthcoming]

[We have just learned of an EIA error that has the effect of rendering earlier estimates illegitimate. We hope to have something on Monday:

Jeff: The cost-savings from ancillary emissions reductions need more work. On Friday I learned from EIA that one of their columns was mislabeled, and the correct estimated Nox emissions reduction fell by half to 1.6 million tons. I also learned that their baseline excludes the EPA's November 1997 OTAG SIP call proposal, which would have reduced Nox emissions by 1.6 million tons. If we take as a baseline the OTAG SIP call proposal (some form of which is necessary to meet the final ozone and PM rules) then there are no net reductions that would result from \$20/ton or \$30/ton carbon prices. EPA has promised me new analyses of the same issue by Monday, and they may help us out. However it is not clear that they will be able to construct a baseline that provides estimates of ancillary benefits that avoid double counting with the NAAQS costs and benefits. RL]

Traffic congestion hurts motorists by causing delays and inconvenience. Higher fuel prices will lead to reductions in congestion as motorists choose other means of travel, share rides, or even forgo less important trips. We estimate that higher fuel prices resulting from carbon permit prices of \$20/ton will reduce travel delays associated with congestion, and that the value of such time savings to consumers would be about \$0.4 billion per year.

Vehicle use leads to costly accidents and to highway injuries including fatalities. Higher fuel prices will reduce vehicle use. Assuming that accidents fall proportionately with vehicle use, the savings from reduced accidents and the value of reduced mortality risk is approximately \$0.3 to \$2.7 billion/ year [depending on whether lighter cars are less crashworthy] given a \$20/ton carbon price.

Finally, a variety of other benefits that are harder to quantify are likely to result from reductions in carbon emissions. With respect to transportation, reduced vehicle use will also reduce the cost of road repair and maintenance. Second, reduced coal use will reduce the cost of sulfur dioxide controls, as utilities switch to energy sources other than coal. Reduced coal use will also lower mercury emissions. Finally, reduced energy use will also increase U.S. energy independence. Our inability to estimate these effects quantitatively does not imply that they are necessarily small or unimportant.

One caveat: Since these benefits (especially those related to transportation) result from policies that have the effect of raising fuel prices, they are unlikely to apply to the extent that non-price mechanisms are used to achieve emissions cuts.

Summary: Range of estimated costs for a particular case

By way of summary, I will focus on a particular case: the case of trading under umbrella, together with full participation by key LDCs. [While this is a fairly ambitious/optimistic case, it is more attainable than is early worldwide participation.] Our estimate is that the net costs of attaining our Kyoto targets for emission reductions is \$5 to \$7 billion (depending on whether Eastern Europe is included in the umbrella and on which measure of benefits is used).

A more tangible measure of costs is estimated effects on energy prices. The SGM-based estimate [integrated with the non-Co2 analysis] is that the price of emissions would be in the range \$12 to \$16 per ton of carbon equivalent. We expect that energy prices at the household level would rise by about 3 percent under the Kyoto accords [CHECK. 4 % if the permit price is \$20. 5% if \$30.] . Fuel oil prices would rise by about 5 percent, natural gas prices by 4 percent, gasoline prices by 3 percent, and electricity prices by 2 percent.

Estimated effects on a family of four

The 3 percent increase in energy prices at the household level would raise the average family's energy bill by about \$75 [This assumes permit price of \$15. For other permit prices, just scale up or down linearly]. On the other hand, the expected 10 percent decline in electricity prices resulting from industry restructuring will reduce the average household's electricity bill by about \$80 offsetting most of the rise in the total energy bill.

[Would these price increases be regressive?] Some economic studies have shown that energy taxes --and, presumably, increases in energy prices --are regressive when measured against current income. This means that poorer people pay more as a percentage of their current income than richer people. But current income is not a very stable measure, and so may not give a true picture. For example, students or retirees usually have lower current income than those now in the labor force. This means that current household expenditure may be a better measure of well-being than current household income. To address this concern, some studies have measured energy expenditures against all current expenditures, and found that energy taxes, or equivalently, higher energy prices, would not be very regressive.]

Electricity restructuring

These estimates do not mean that households energy expenses will in fact be higher in 2010 than today. In the first place, energy prices fluctuate year-by-year for all sorts of reasons. They could go either up or down. But even if we leave out unpredictable fluctuations, a complete analysis of the Administration's energy policies would include the effects of the federal electricity restructuring bill that the President plans to propose. An electricity sector freed from government regulation would be a more efficient energy sector. Costs to consumers will fall. Effects on the environment are of several sorts, both positive or negative. A reasonable overall estimate of the effects of adding federal electricity restructuring to the rest of the President's program to address climate change is to achieve the same environmental goals at a cost saving of some \$16 billion [check the range]. This benefit is enough to offset the rest of the costs of climate change policy estimated above.

[Randy asks CAN WE ANNOUNCE DOLLAR ESTIMATES OF SAVINGS FROM A POLICY PROPOSAL WHERE WE HAVE NOT YET IDENTIFIED THE SPECIFIC? IN ADDITION, IF THE ELECTRICITY RESTRUCTURING INCLUDES A MORE STRINGENT RPS, OR CARBON CAP AND TRADE, THEN THE COST SAVINGS ESTIMATES WOULD BE INAPPLICABLE. CAN'T THE ELECTRICITY POLICY BE DECIDED IN TIME FOR TESTIMONY?]

Effects on employment and aggregate output

You may have noticed that I have said nothing about job losses resulting from climate change policy. There will be some losses of employment in some industries. [For example, it is inevitable, if we are to reduce carbon emissions, that there will be fewer people working in the coal industry 15 years from now than there would otherwise be.] But a large number of jobs will be created in other sectors [many of them high-tech jobs paying high wages]. By analogy, energy restructuring will eliminate jobs in some companies and create jobs in others.

We are not predicting any substantial negative effect on aggregate employment. The

overwhelming majority of models that address climate change do not predict aggregate job losses. Admittedly, these are models that incorporate full employment of the labor force by design. But this is probably the right sort of model to apply, in the case of a structural change that is to be determined and publicly known 15 years in advance. Workers will be able to plan ahead, and move into expanding fields rather than contracting ones. The same is true of capital and technology.

Given a 15-year lead time, monetary policy [by which I mean to include the actions of the Federal Reserve together with the price-setting behavior of the private economy] will be able to adjust to avoid any losses in aggregate demand [which might otherwise result from a contraction of the real money supply]. Thus there need be no negative effects on output and employment.

The situation might be different if a large energy shock were to hit the economy with no warning, as happened in the oil crisis of 1973-74, when the real money supply, output and employment all contracted sharply. The reassuring conclusion regarding aggregate output might also be different if the policy were to be implemented inefficiently (e.g., by command-and-control style regulations of the sort put in place in that oil crisis), rather than efficiently (i.e., by market mechanisms of the sort that the President has proposed to use).

I have seen one study that claims large losses in output and employment from climate change policy [EPI, 8/14/97]. But it did not in my view take into account the points I have made about the ability of the economy to adjust to structural change when there is 15-year warning. Furthermore, it did not take into account such cost-reducing elements of the agreement and of our proposed implementation as international and domestic trading. [Nor did it take into account provisions of the Kyoto agreement such as those pertaining to sinks and six gases.]

Estimates Are Conservative in Several Ways

These estimates are conservative in three very important ways [: sinks, technology, and climate change benefits]. The first point, sinks, concerns a provision of the Kyoto Protocol that has received less attention than it merits. It is only *net* emissions -- emissions to the atmosphere minus sequestration -- that are to be reduced 7 percent below 1990 levels, not gross emissions. The United States plants many trees every year, and would receive credit for this activity under the Protocol. Very preliminary estimates suggest that sinks can reduce the costs of meeting the Kyoto target by 45 to 77 percent [1/23/98]. (This is on top of the gains from trading among Annex I countries). But neither we nor other analysts are yet sure exactly how to interpret the legal language. Because the quantitative uncertainty is still large, we have not yet opted to include this effect into the net cost numbers that I cited earlier. But we know that the effect is likely to be favorable as well as large.

Our estimates are also conservative regarding the payoff to the President's Climate Change Technology Initiative. The logic is somewhat analogous to the rationale behind the macroeconomic assumptions that we feed into our budget forecasts: in the presence of uncertainty, we are conservative in our estimates of the speed with which the economy will grow, tax receipts will rise, and the budget will improve. That way, any revisions or surprises that

occur are likely to be in the pleasant direction.

The nature of our conservatism here is that we assume in our modeling that, because of lags, most of the payoff from new technology research and dissemination expenditures (as opposed to those in the past) comes after 2012. The parameter that figures most prominently [and controversially] in analysis of technological progress in the energy field is the rate of improvement in the so-called Autonomous Energy Efficiency Index (AEEI), that is the rate at which the total use of energy falls relative to GDP. In our base-case analysis, the basis of the numbers I have reported to you, we took an AEEI of 1.0 percent per year, just above the number in the Energy Information Administration's Annual Energy Outlook.

A little optimism regarding the effects on the discovery and adoption of new technologies would boost this number to 1.25 percent. This alternative optimistic view of technology reduces the estimated permit price in 2010 by 20 to 31 percent, and reduces the estimated total resource cost 23 to 33 percent (depending how wide a set of countries is assumed to participate in trading). Overall costs come out to only \$ 9 - \$14 billion in the cases of trading under the umbrella [depending whether Eastern Europe falls under the umbrella], or \$5 - \$6 billion with participating key LDCs. Net of non-climate benefits, the costs are \$ 4 to 11 billion. Measured in more familiar terms, the effects of the "technology optimism" case would to reduce the increase in gasoline prices to only 3 cents per gallon [check all these numbers!], in electricity prices to 0.2 cents per kWh, and in total energy bill for a typical family to \$50. (These estimates would be even lower, if we took into account either sinks or the benefits of electricity restructuring.)

This "technology optimism" case is far from the most optimistic outcome that might occur. Some estimates coming from engineering models predict even higher rates of AEEI improvement, and thus even lower costs.

The third, and most important, respect in which the estimates I have presented are conservative is that they leave out the benefits of mitigating Climate Change itself. A full cost-benefit analysis would include mitigation in the benefits column. [The only reason we have not done so, as I have explained, is the difficulty in coming up with a number to capture the monetary benefits.] But I trust that nobody will lose sight of our objective -- keeping our planet the hospitable home that we enjoy today.

STATEMENT OF CEA CHAIR JANET L. YELLEN ON THE ECONOMIC ASSUMPTIONS
OF THE FY 1999 BUDGET

My job this afternoon is to tell you about the budget's economic assumptions. For the past 5 years, this Administration has built a record of conservative and credible economic assumptions. Comparing our earlier projections with the economy's actual performance therefore shows that to the extent we have erred, we have done so on the side of underestimating real growth. The assumptions in this year's budget coincide closely with the views of a consensus of economic forecasters.

The news over the past two years has been very, very good. Real GDP grew 3.8 percent for 1997 as a whole--the highest growth rate in nine years, and measures of income have been growing even faster. The unemployment rate has fallen from 7½ percent in 1992 to 4.7 percent in the fourth quarter. Over 14 million jobs have been created during this Administration. And all this has been accomplished while inflation has declined to its lowest level since 1965.

Although growth has exceeded our expectations in recent years, we believe that for budgetary purposes we should not count on a continuation of growth at its recent extraordinary pace. We are projecting that real GDP will continue to grow--but at a slower 2 percent annual rate over the four quarters of 1998, and this 2 percent pace is projected to persist for a further 2 years. At the same time, the unemployment rate is assumed to edge up about two tenths of a percentage point per year. Inflation, as measured by the CPI, is assumed to edge up only

slightly over the next three years.

After 2000, real GDP growth is projected to resume its trend growth rate of 2.4 percent, and the unemployment rate stabilizes at 5.4 percent.

This shift to more moderate growth assumed in this budget recognizes that, by conservative, mainstream assumptions, growth has exceeded the pace that can be maintained on a sustained basis without an eventual tendency for upward inflationary pressure. Our assumed real growth rates are not the *best* that the Administration believes the economy can achieve--the outcome could be better.

Let me conclude by saying that the growth-oriented economic strategy adopted by this Administration has clearly paid off. The Administration's 1993 deficit reduction plan created the conditions necessary for the vibrant economic performance we are now enjoying; our economy is the strongest in a generation. We have in place a solid foundation for sustained economic growth and rising living standards for all Americans.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-FEB-1998 15:39:22.00

SUBJECT: Re: edited President's Message

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

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

TEXT:

I have reviewed your edit of the President's message and like all of the changes that you have made. I agree that they should be fact-checked.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-FEB-1998 15:41:42.00

SUBJECT: Revised rollout remarks

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

READ:UNKNOWN

TEXT:

----- Forwarded by Janet L. Yellen/CEA/EOP on 02/01/98

03:41 PM -----

Janet L. Yellen

02/01/98 03:35:10 PM

Record Type: Record

To: Steven N. Braun/CEA/EOP

cc:

Subject: Revised rollout remarks

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

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D51]MAIL41096513I.026 to ASCII,

The following is a HEX DUMP:

STATEMENT OF CEA CHAIR JANET L. YELLEN ON THE ECONOMIC ASUMPTIONS
OF THE FY 1999 BUDGET

My job this afternoon is to tell you about the budget's economic assumptions. For the past 5 years, this Administration has built a record of conservative and credible economic assumptions. Comparing our earlier projections with the economy's actual performance therefore shows that to the extent we have erred, we have done so on the side of underestimating real growth. The assumptions in this year's budget coincide closely with the views of a consensus of economic forecasters.

The news over the past two years has been very, very good. Real GDP grew 3.8 percent for 1997 as a whole--the highest growth rate in nine years, and measures of income have been growing even faster. The unemployment rate has fallen from 7½ percent in 1992 to 4.7 percent in the fourth quarter. Over 14 million jobs have been created during this Administration. And all this has been accomplished while inflation has declined to its lowest level since 1965.

Although growth has exceeded our expectations in recent years, we believe that for budgetary purposes we should not count on a continuation of growth at its recent extraordinary pace. We are projecting that real GDP will continue to grow--but at a slower 2 percent annual rate over the four quarters of 1998, and this 2 percent pace is projected to persist for a further 2 years. At the same time, the unemployment rate is assumed to edge up about about two tenths of a percentage point per year. Inflation, as measured by the CPI, is assumed to edge up only

slightly over the next three years.

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This shift to more moderate growth assumed in this budget recognizes that, by conservative, mainstream assumptions, growth has exceeded the pace that can be maintained on a sustained basis without an eventual tendency for upward inflationary pressure. Our assumed real growth rates are not the *best* that the Administration believes the economy can achieve--the outcome could be better.

Let me conclude by saying that the growth-oriented economic strategy adopted by this Administration has clearly paid off. The Administration's 1993 deficit reduction plan created the conditions necessary for the vibrant economic performance we are now enjoying; our economy is the strongest in a generation. We have in place a solid foundation for sustained economic growth and rising living standards for all Americans.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: James M. Treadway (CN=James M. Treadway/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 1-FEB-1998 16:52:47.00

SUBJECT: latest version of Chapter 7

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

TO: Mark R. Hopkins (CN=Mark R. Hopkins/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

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

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

TEXT:

I've finished the latest round of revisions to Chapter 7 and will print out and distribute same: internat.rv5 (redlined showing changes since last version) and internat.10c (clean). Few changes through most of the text, but a couple of paragraphs were rewritten (with a few edits of mine in situ), and the authors appear to be about finished with revisions, so it's worth Members' looking at.

Mike

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: James M. Treadway (CN=James M. Treadway/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 1-FEB-1998 14:56:27.00

SUBJECT: Latest Chapter 5 version

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

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

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

CC: Sarah J. Reber (CN=Sarah J. Reber/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

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

TEXT:

I've done the text corrections that Keith gave me on Friday. Because they are few and small, and because Joe has maybe a dozen fact-check changes to give me tomorrow morning (Monday), I plan to wait for those and then print out and distribute the chapter.

Mike

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-FEB-1998 14:46:13.00

SUBJECT: draft rollout remarks

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.D9]MAIL461935131.026 to ASCII,
The following is a HEX DUMP:

STATEMENT OF CEA CHAIR JANET L. YELLEN ON THE ECONOMIC ASSUMPTIONS
OF THE FY 1999 BUDGET

My job this afternoon is to tell you about the budget's economic assumptions. For the past 5 years, this Administration has built a record of conservative and credible economic assumptions. Comparing our earlier projections with the economy's actual performance shows that--while our assumptions have been remarkably accurate--we have erred on the side of being conservative. The assumptions in this year's budget are similarly conservative.

The news over the past two years has been very, very good. Real GDP grew 3.8 percent for 1997 as a whole--the highest growth rate in nine years, and measures of income have been growing even faster. The unemployment rate has fallen from 7½ percent in 1992 to 4.7 percent in the fourth quarter. Over 14 million jobs have been created during this Administration. And all this has been accomplished without any increase in inflation.

Although growth has exceeded our expectations in recent years, we believe that for budgetary purposes we should not plan on continuing to have this much good fortune. Looking ahead, our economic assumptions are designed to be conservative. We are projecting real GDP to continue its expansion--but at a slower 2 percent annual rate over the four quarters of 1998, and this 2 percent pace is projected to persist for a further 2 years. At the same time, the unemployment rate is assumed to edge up about two tenths of a percentage point per year. Inflation, as measured by the CPI, is assumed to edge up only slightly over the next three years.

After 2000, real GDP growth is projected to resume its trend growth rate of 2.4 percent, and the unemployment rate stabilizes at 5.4 percent.

Let me conclude by saying that the growth-oriented economic policies enacted by this Administration have clearly paid off. The Administration's 1993 deficit reduction plan helped create the climate for the current strong economic performance, and our economy is the strongest in a generation. We have provided a solid foundation for sustained economic growth and rising living standards for all Americans.