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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	Michele Jolin to Rebecca M. Blank and Janet L. Yellin at 11:02:07.00. Subject: Becky's nomination. (1 page)	03/20/1998	b(6)
002. email	Rebecca M. Blank to Jeffrey A. Frankel, Keith O. Fuglie, Janet L. Yellen, and Michele Jolin at 15:44:36.00. Subject: Ag position. (1 page)	04/16/1998	b(6)

COLLECTION:

Clinton Presidential Records
Automated Records Management System [Email]
CEA ([Yellen])
OA/Box Number: 950000

FOLDER TITLE:

[03/12/1998 - 04/16/1998]

2013-0723-F
ab1276

RESTRICTION CODES

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

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

C. Closed in accordance with restrictions contained in donor's deed of gift.
PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).
RR. Document will be reviewed upon request.

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

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

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Donald R. Arbuckle (CN=Donald R. Arbuckle/OU=OMB/O=EOP [OMB])

CREATION DATE/TIME:12-MAR-1998 19:48:21.00

SUBJECT: fyi

TO: Kathleen A. McGinty (CN=Kathleen A. McGinty/OU=CEQ/O=EOP@EOP [CEQ])
READ:UNKNOWN

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

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

TEXT:
Bob Sussman, who represents a coalition of energy/electric utility companies, may give you a call about an EPA proposal - - the OTAG SIP call for NOx reductions -- which is with us for review. I have agreed to an EO 12866 meeting with him -- when its scheduled, I'll let you know in the event that you would like to attend. If this is an I-wouldn't-miss-it-for-the-world event for you, let me know. Thx.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:13-MAR-1998 02:03:15.00

SUBJECT: developing country participation: everybody's a winner!

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

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

TEXT:
Janet,

I apologize for not faxing this to you last night, but I told you that you cursed me when you said the WEB was in great shape and we'd be done early (talk to Chad).

Randy and I would like to have about 15 minutes with you sometime on Friday to discuss this once you've had a chance to go over it. We know you have a pretty busy schedule, but we think this is important, and we are very flexible (I'll even give up watching some of the Kentucky basketball game). Thanks.

Joe

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D9]MAIL40048017S.026 to ASCII,
The following is a HEX DUMP:

Proposal for Developing Countries:
To Cap and Trade Carbon Emissions Permits

I. The best form of participation by developing countries in the Kyoto Protocol would be a) acceptance of binding caps and b) agreement to trade emission permits internationally. Therefore such participation should be our top priority in international negotiations.

A. The economic rationale for such participation includes

- **Greater cost savings to the U.S.:** Participation by developing countries in international permit markets would greatly lower the costs to the U.S. of meeting the Kyoto cap (as CEA testimony showed). In particular, costs would be lower than with trading among only Annex I countries, and even lower than with such trading and the intrinsically less efficient project-by-project approach of CDM.

- **Greater environmental benefits:** Caps slightly below business as usual would lower global emissions, and provide environmental benefits not achievable by pursuing CDM, which only redistributes emissions geographically.

- **Greater economic benefits to developing countries:** With targets slightly below BAU, developing countries would enjoy net gains of many billions of dollars through the international sale of emission reductions achieved at lower cost than the world price. Moreover, an emissions permit market would yield greater gains than are available through CDM.

B. Non economic rationales include the long-run benefits of including developing countries into global negotiations, and greater compliance with the Byrd-Hagel resolution.

II. Problem: To persuade a developing country *voluntarily* to adopt a cap and then to trade permits internationally, international agreements must be structured to reduce the risk of inadvertent stringency and in particular to reduce the possibility of a cap so stringent as to cause economic losses to the developing country.

Proposed Solution: Negotiations should focus on slight reductions from the business as usual emissions level, where this level is expressed in a way that depends on the *future* values of economic variables.

Rationale: Such caps would avoid the risk of inadvertent stringency associated with higher than projected economic growth between now and the beginning of the commitment period in 2008. Developing countries would face only the much smaller risk that emissions would be higher than expected *given* the economic conditions realized in 2007.

Basic principles for implementing such an approach are:

- **Reasonable Forecasts**: The relationship between the cap (ignoring any real reductions in emissions) and the values of economic variables, when applied to emissions and such variables during recent years, should predict emissions reasonably well (and be without demonstrable statistical bias). Stating reasonable predictions reduces the risk of both inadvertent stringency and paper tons.

- **Predetermined Caps:** The cap should not depend on contemporaneous values of economic variables, so as to avoid uncertainty during the commitment period about the country's cap. For example, the cap should not vary with 2008 or 2010 GDP levels, although it may vary with 2007 GDP. Establishing the cap prior to the commitment period avoids the uncertainty associated with defining the cap during the commitment period which could negatively affect trade activity.

- **No Perverse Incentives:** The cap should depend on values of economic variables only indirectly related to emissions, to avoid creating perverse incentives for developing countries to increase emissions so as to have higher caps in the commitment periods. For example, the cap should not depend on energy consumption in 2007.

Illustration: To illustrate one way of implementing the solution, consider the following. Of course other ways of implementing the solution may work as well or better.

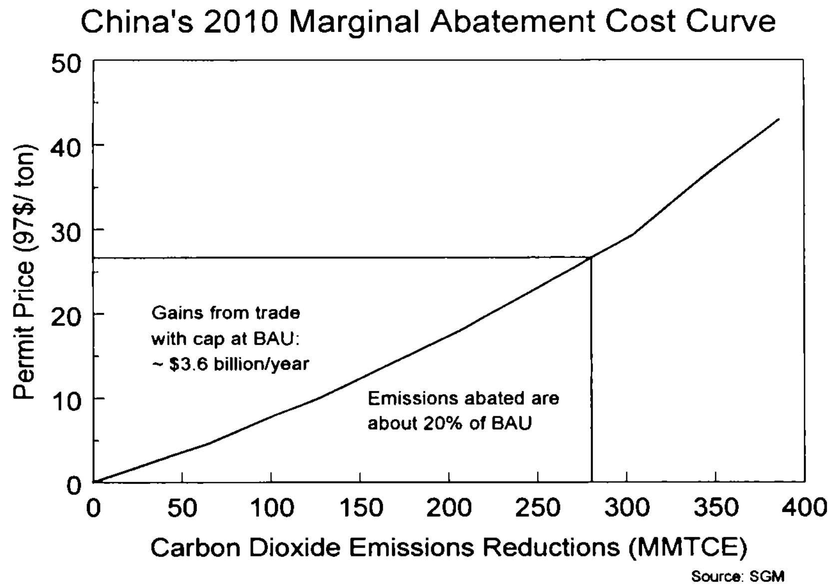
Assume that one key developing country accepts a target set at its business as usual level for the 2008 to 2012 commitment period. This country can then participate in international emissions trading, and it will accrue economic benefits for every ton of emissions it abates. The table below displays the significant gains from trade for large developing countries and the large cost-savings to the U.S. if just one developing country accepts an emissions cap at BAU and participates in emissions trading. The following charts also illustrate the gains from trade.

Trading Scenario	Country	Gains from Trade
Annex I + China	China	$3.6 billion/year
Annex I + China	United States	$11.6 billion/year[1]
Annex I + India	India	$1.6 billion/year
Annex I + Mexico	Mexico	$0.9 billion/year

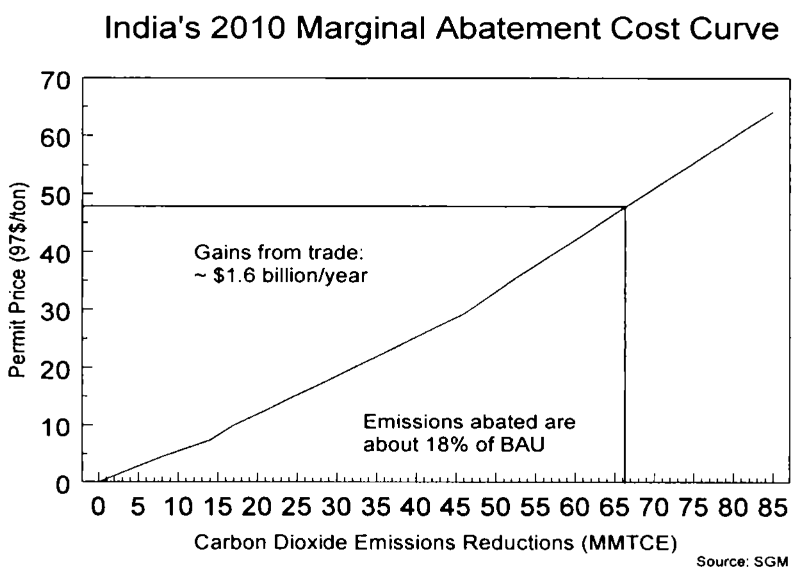
[1] Gains from trade for the U.S. are estimated based on the change in total cost of complying with its Kyoto target between Annex I only trading and Annex I plus China trading.

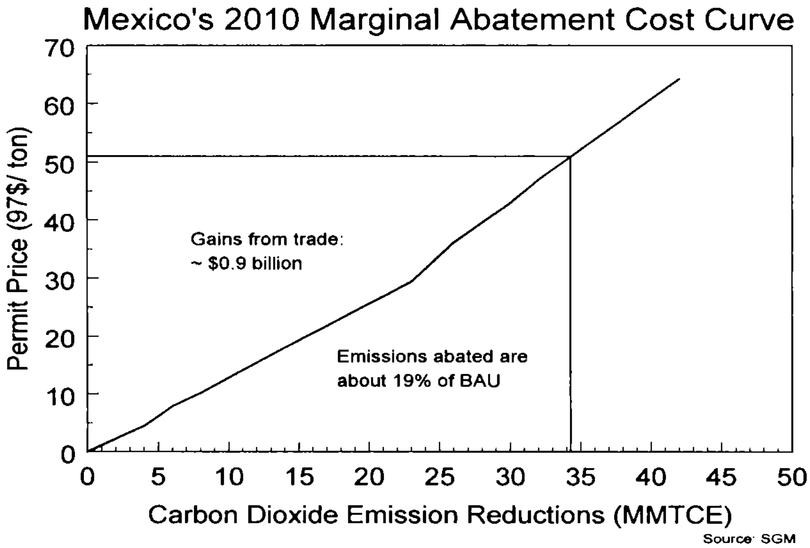
- Emissions caps for developing countries set below their business as usual level will result in lower gains from trade but some increase in environmental benefits. The higher costs of a cap set below BAU are borne by both the developing countries and the Annex I countries.

- Defining the business as usual level for a developing country as a function of its lagged GDP and lagged population and setting the emissions cap at that level yields a negligible risk of leaving the developing country worse off under cap and trade because of inadvertent stringency. A cap with significant emissions cuts below BAU can increase the risk of inadvertent stringency.



[Automated Records Management System Hex-Dump Conversion]


India's 2010 Marginal Abatement Cost Curve
Permit Price (97$/ton)
70
60
50
40
30
20
10
0
Gains from trade:
~ $1.6 billion/year
Emissions abated are
about 18% of BAU
0 5 10 15 20 25 30 35 40 45 50 55 60 65 70 75 80 85
Carbon Dioxide Emissions Reductions (MMTCE)
Source: SGM


Mexico's 2010 Marginal Abatement Cost Curve
70
60
50
40
30
20
10
0
Permit Price (97$/ ton)
Gains from trade:
~ $0.9 billion
Emissions abated are
about 19% of BAU
0
5
10
15
20
25
30
35
40
45
50
Carbon Dioxide Emission Reductions (MMTCE)
Source: SGM

Technical Appendix:

A. Data

We have compiled data on 3 variables: emissions of carbon dioxide, GDP, and population for 117 countries for the time period 1970-1992. The carbon dioxide emissions data, measured in millions of metric tons of carbon, are from the Carbon Dioxide Information Analysis Center (Oak Ridge National Laboratory, DOE). The GDP data, measured in 1987 U.S. dollars, are from the World Bank. The population data, measured in thousands of individuals, are from the United Nations Population Division.

B. Methods

We have estimated a fixed effects linear regression on the logs of these variables, for the countries in our data set, excluding those listed in Annex I. Our regression uses four non-overlapping 5 year intervals for each country. The residuals exhibit slight serial correlation (estimated first order serial correlation $\approx .15$). Our forecasts include the country specific constants.

C. Results

The fixed effects regression we estimated is

$$\text{Emissions} = a\ \text{GDP}_{t-1} + b\ \text{GDP}_{t-2} + c\ \text{Population}_{t-1} + \gamma\ \text{trend}$$

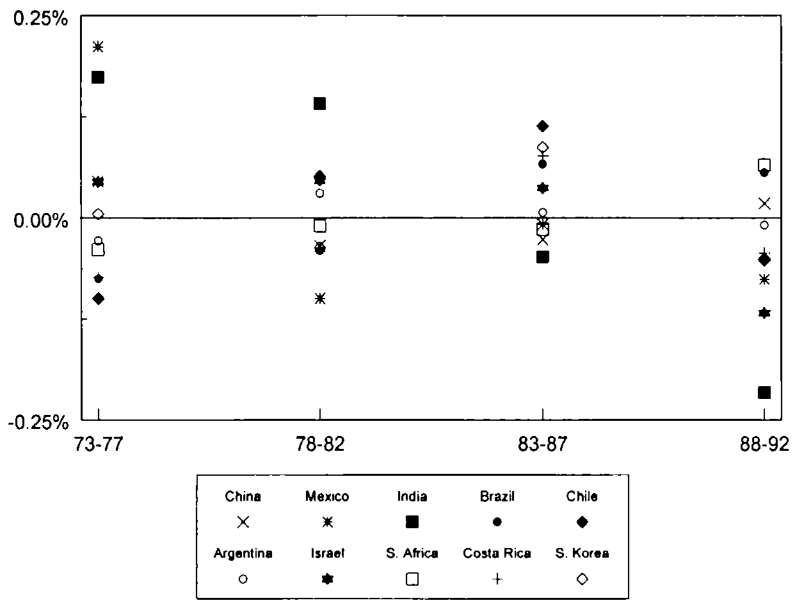
Emissions are the natural logarithm of the five year non-overlapping average of carbon emissions. All independent variables are lagged. GDP_{t-1} is the log of the gross domestic product in the year prior to the first year in the emissions variable, GDP_{t-2} is GDP in the year two years prior to the first year included in the emissions variable, and population_{t-1} is the country's population in the year prior to first year included in the emissions variable. Trend is one in the first 5 year period, and 2, 3 and 4 respectively in the subsequent 5 year periods. The useable data included 376 cross-section time series observations. The fixed effects regression used 98 degrees of freedom. The R squared was in excess of 0.99.

Model I Results

Variable Name	Coefficient Estimate	Standard Error
GDP_{t-1}	0.9501823	0.2443047
GDP_{t-2}	-0.411297	0.23894
$Population_{t-1}$	0.4836006	0.2055439
trend	0.0073712	0.0310638

As one illustration of the model's accuracy in predicting emissions, consider the chart below that maps actual and predicted emissions using within sample data for ten selected developing countries. The predicted value is never more than 1/4 of one percent away

Error in Model I Prediction as a Fraction of Actual Emissions



from the actual emissions average for any of the five year intervals.

To forecast emissions for the five year period beginning in 2008 using the results of this regression we input the World Bank forecasts of GDP for the years 2007 and 2006, and the United Nations forecasts of 2007 population. The forecasts of emissions for the budget period and the confidence intervals around these forecasts conditional on the assumed 2006 and 2007 values are described in the table below.

Country	2006 GDP (1987$, billions)	2007 GDP (1987$, billions)	2007 Population	Predicted Average Emissions, 2008-2012
China	1,385.8	1,493.5	1,357,627,000	2092 MMTC SE: 1.37 MMTC
India	752.1	799.7	1,140,563,000	345 MMTC SE: 1.34 MMTC
Mexico	268.2	282.7	113,385,000	157 MMTC SE: 1.33 MMTC

How Far Below BAU Should the Developing Countries' Caps Be Set?

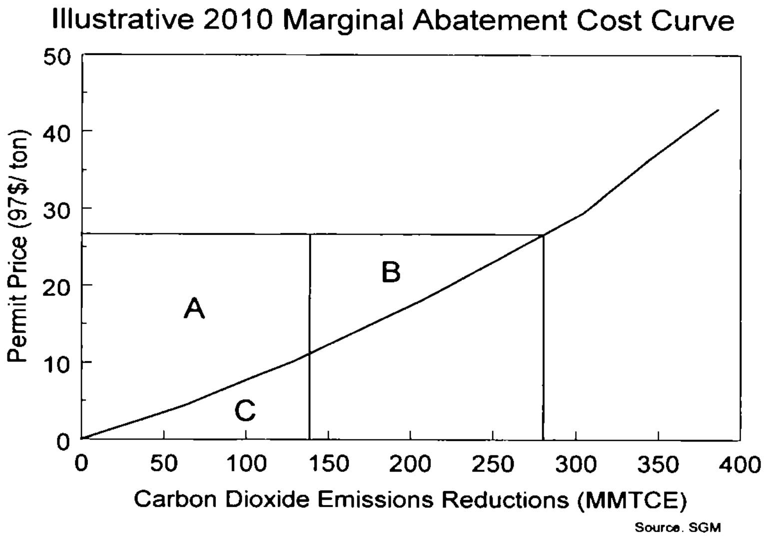
The answer to this question has many dimensions. Most commonly discussed is the issue of fairness: what commitments to reduce emissions should be made by countries whose economic resources differ substantially? Generally neglected but discussed below is the issue of efficiency. In particular, what are the implications for U.S. costs of increasingly more stringent caps on emissions from key developing countries?

More stringent developing country caps raise U.S. costs by restricting the supply of permits in world markets and so raising the price of permits. To assess the magnitude of this effect consider the cap which just leaves a country no better off than no cap at all. This "indifference" cap is where the costs of meeting the cap just equal the net gains from selling permits in world markets. In the figure on the next page, for a cap that is equivalent to a reduction from BAU of 138 MMTCE, net foreign exports are B, and the cost of meeting the cap is C. Since B=C in this example, the net gains from trade are nil. Imposing this "indifference" cap on China, leads to the following conclusions.

1) An indifference cap for China increases annual U.S. costs by $4.5 billion or 33% relative to a BAU cap for China.

2) The cost to the U.S. per ton of Chinese emissions reduced is $26 on average. (The marginal cost effectiveness is likely to be higher.) This is <u>not</u> the average cost of a ton of emissions purchased from China, but the average cost to the U.S. of China complying with a more stringent cap.

Thus developing country participation in the form of acceptance of caps significantly more stringent than business as usual will raise costs to the U.S.


Illustrative 2010 Marginal Abatement Cost Curve
Permit Price (97$/ ton)
0
10
20
30
40
50
A
B
C
0
50
100
150
200
250
300
350
400
Carbon Dioxide Emissions Reductions (MMTCE)
Source. SGM

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-MAR-1998 19:42:41.00

SUBJECT: developing countries paper submitted to Sandalow

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

TEXT:
Attached is the version we sent to David Sandalow. We asked that he
circulate it and place the paper on this week's agenda.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D92]MAIL49522747S.026 to ASCII,
The following is a HEX DUMP:

Proposal for Developing Countries:
To Cap and Trade Emissions Permits

I. From an economic perspective, the best form of participation by developing countries in the Kyoto Protocol would be a) acceptance of binding caps at or slightly below business as usual and b) agreement to trade emission permits internationally. Therefore such participation should be our top priority in international negotiations.

A. The economic rationale for such participation includes

- **Greater cost savings to the U.S.:** Participation by developing countries in international permit markets would greatly lower the costs to the U.S. of meeting its Kyoto cap (as CEA testimony showed). In particular, costs would be lower than with trading among only Annex I countries.

- **Greater environmental benefits:** Caps slightly below business as usual would lower global emissions relative to a world with only Annex I caps.

- **Greater economic benefits to developing countries:** With targets slightly below BAU, developing countries would enjoy net gains of many billions of dollars through the international sale of emission reductions achieved at lower cost than the world price.

- **Cap and trade yields greater benefits than CDM:** While the Clean Development Mechanism will likely result in cost savings to the U.S. relative to a world with only Annex I trading, a system including cap and trade of developing countries' emissions would yield greater cost savings to the U.S. and greater gains to developing countries than CDM. Further, cap and trade could achieve environmental benefits not achievable by pursuing CDM, which only redistributes emissions geographically.

B. A non economic rationale includes the long-run benefits of including developing countries into global negotiations, for example, as recognized by the Byrd-Hagel resolution.

II. Problem: To persuade a developing country *voluntarily* to adopt a cap and then to trade permits internationally, international agreements must be structured to reduce the risk of inadvertent stringency and in particular to reduce the possibility of a cap so stringent as to cause economic losses to the developing country.

Proposed Solution: Negotiations should focus on slight reductions from the estimated business as usual emissions level, where this level is expressed in a way that depends on the *future* values of economic variables, such as GDP.

Rationale: Such caps would avoid the risk of inadvertent stringency associated with higher than projected economic growth between now and the beginning of the commitment period in 2008. Developing countries would face only the much smaller risk that emissions would be higher than expected, *given* the economic conditions realized in 2007.

Basic principles for implementing such an approach are:

- **Reasonable Forecasts**: The relationship between the cap (ignoring any real reductions in emissions) and the values of economic variables, when applied to emissions and such variables during recent years, should predict emissions reasonably well (and be without demonstrable statistical bias). Relationships that give reasonably reliable predictions reduce the risk of both inadvertent stringency and paper tons which could increase global emissions.

- **Predetermined Caps:** The cap should not depend on literally contemporaneous values of economic variables, so as to avoid uncertainty during the commitment period about the country's cap. For example, the cap should not vary with 2008 or 2010 GDP levels, but rather with 2007 GDP.

- **No Perverse Incentives:** The cap should depend on values of economic variables only indirectly related to emissions, to avoid creating perverse incentives for developing countries to increase emissions so as to have higher caps in the commitment periods. For example, the cap should not depend on energy consumption in 2007.

III. Illustration: One sensible way of implementing the solution is described below. Other ways of implementing the solution may work as well or better. The conclusions are stated below and the details of our work follow.

- Defining the business as usual level for a developing country as a function of its GDP and population in earlier years and setting the emissions cap at that level yields a negligible risk of leaving the developing country worse off under cap and trade because of inadvertent stringency. A cap slightly below BAU would also yield negligible risk of leaving the developing country worse off.

- Emissions caps for developing countries set below their business as usual emission level will result in gains from trade lower than with a BAU cap, but provide environmental benefits. The higher costs of a cap set below BAU are borne by both the developing countries and the Annex I countries.

There are significant gains from trade for large developing countries and large cost-savings to the U.S. if just one developing country accepts an emissions cap at BAU and participates in emissions trading. Table 1 and Charts 1 through 3 illustrate these gains from trade from a baseline of full Annex I trading.

Table 1. Illustrative Gains from Trade for Developing Countries that Cap and Trade

Trading Scenario	Country	Gains from Trade	Permit Price[1] (1997$/ton)
Annex I only	United States	not applicable	$54
Annex I + China	China	$3.6 billion/year	$26
	United States	$11.6 billion/year[2]	
Annex I + India	India	$1.6 billion/year	$47
	United States	$2.5 billion/year[2]	
Annex I + Mexico	Mexico	$0.9 billion/year	$51
	United States	$1.2 billion/year[2]	

[1] These scenarios do not account for the cost savings available through the Clean Development mechanism and carbon sinks.
[2] Gains from trade for the U.S. are estimated as the change in the U.S. total cost of complying with the Kyoto Protocol relative to an Annex I only trading regime.

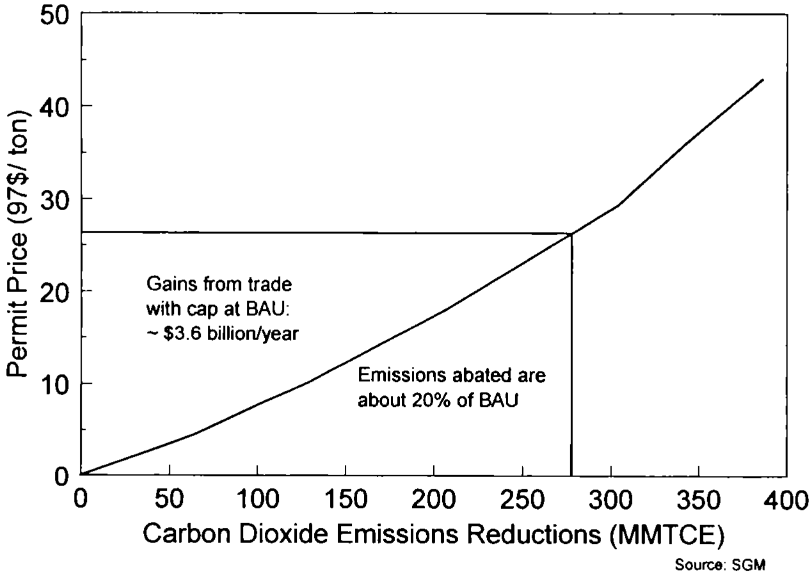


Chart 1. China's 2010 Marginal Abatement Cost Curve and Gains from Trade

Chart 2. India's 2010 Marginal Abatement Cost Curve and Gains from Trade

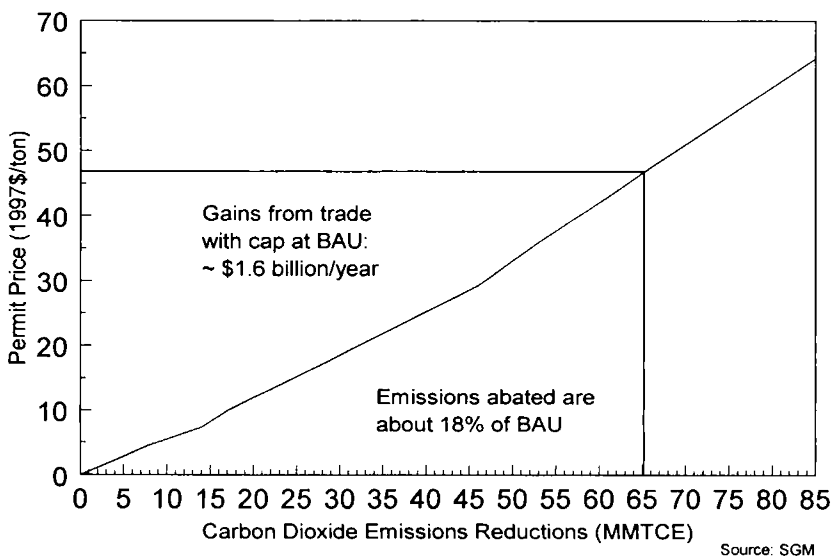
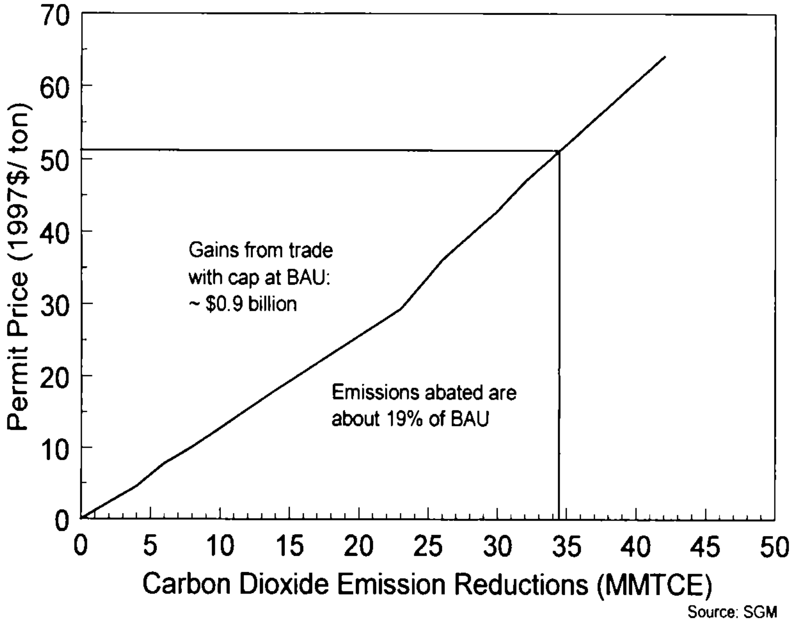
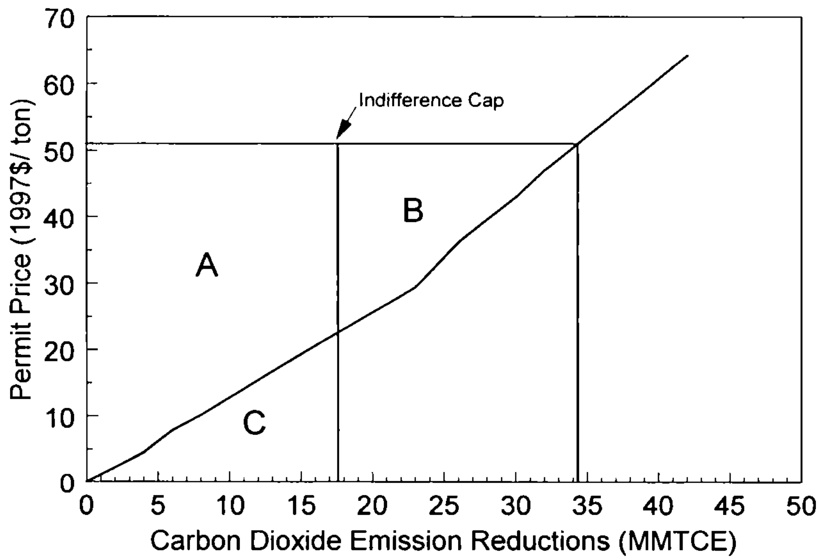


Chart 3. Mexico's 2010 Marginal Abatement Cost Curve and Gains from Trade



Permit Price (1997$/ton)
Carbon Dioxide Emission Reductions (MMTCE)
Gains from trade
with cap at BAU:
~ $0.9 billion
Emissions abated are
about 19% of BAU
Source: SGM



IV. How Far Below BAU Should the Developing Countries' Caps Be Set?

The answer to this question has many dimensions. Most commonly discussed is the issue of fairness: what commitments to reduce emissions should be made by countries whose economic resources differ substantially? Generally neglected but discussed below is the issue of efficiency. In particular, what are the implications for U.S. costs of increasingly more stringent caps on emissions from key developing countries?

More stringent developing country caps raise U.S. costs by restricting the supply of permits in world markets and so raising the price of permits. To assess the magnitude of this effect consider the cap which just leaves a country no better off than no cap at all. This "indifference" cap is where the costs of meeting the cap just equal the net gains from selling permits in world markets. Chart 4 illustrates gains from trade for a small country. For a cap that is equivalent to a reduction from BAU of 17 MMTC, net gains from foreign exports are B, and the cost of meeting the cap is C. Since B = C in this example, the net gains from trade are nil.

Chart 4. Illustrative 2010 Marginal Abatement Cost Curve and Indifference Cap

Note: This indifference cap is illustrated for a country whose participation in world permit markets does not affect world permit prices.

Table 2 provides an illustration of the effects of emissions caps more stringent than BAU on China with Annex I plus China trading. Note that a small reduction below BAU has no real effect on the Annex I trading price, and thus no economic effects on the U.S. However, as the cap becomes more stringent, the Annex I trading price increases, resulting in higher total costs of compliance for the U.S. If China accepts a cap below BAU, the cost of this additional stringency to the U.S. -- essentially, the cost of supplying the environmental benefits associated with these emissions reductions -- can become significant. Thus developing country participation in the form of acceptance of caps more stringent than business as usual will raise costs to the U.S.

Table 2. Effects of Various Chinese Emissions Caps with Annex I Trading

Emissions Cap[1]	Permit Price (1997$/ ton)	Chinese Emissions Reductions (MMTC)	Chinese Emissions Sales (MMTC)[2]	Total Cost to U.S. of Complying with Kyoto	Cost to U.S. of Additional Stringency
BAU	$26	276	276	$13.4 b	not applicable
BAU - 1%	$26	276	262	$13.4 b	~$0
BAU - 5%	$29	304	235	$14.9 b	$22/ton
Indifference	$36	343	172	$17.9 b	$26/ton

[1] We employ the SGM BAU for China for the purposes of these calculations.
[2] Reductions in Chinese emissions less Chinese emissions sales yields net global reductions.

Imposing this "indifference" cap on China, given that its participation lowers world permit prices, leads to the following conclusions.

- An indifference cap for China increases annual U.S. costs by $4.5 billion or 33% relative to a BAU cap for China.

- If China accepts an emissions cap requiring reductions of approximately 170 MMTC below BAU, the average cost to the U.S. would be $26/ton. This is not the average cost of a ton of emissions purchased from China, but the average cost to the U.S. of the environmental benefits associated with China complying with a more stringent cap.

Summary of Analysis

A. Data

We have compiled data on 3 variables: emissions of carbon dioxide, GDP, and population for 117 countries for the time period 1970-1992. The carbon dioxide emissions data, measured in millions of metric tons of carbon, are from the Carbon Dioxide Information Analysis Center (Oak Ridge National Laboratory, DOE). The GDP data, measured in 1987 U.S. dollars, are from the World Bank. The population data, measured in thousands of individuals, are from the United Nations Population Division.

B. Methods

We have estimated a fixed effects linear regression on the logs of these variables, for the countries in our data set, excluding those listed in Annex I. Our regression uses four non-overlapping 5 year intervals for each country. Our forecasts include the country specific constants.

C. Results

The fixed effects regression we estimated is

$$\text{Emissions} = a\,\text{GDP}_{t-1} + b\,\text{GDP}_{t-2} + c\,\text{Population}_{t-1} + \gamma\,\text{trend}$$

Emissions are the natural logarithm of the five year non-overlapping average of carbon emissions. All independent variables are lagged. GDP_{t-1} is the log of the gross domestic product in the year prior to the first year in the emissions variable, GDP_{t-2} is GDP in the year two years prior to the first year included in the emissions variable, and population_{t-1} is the country's population in the year prior to first year included in the emissions variable. Trend is one in the first 5 year period, and 2, 3, and 4 respectively in the subsequent 5 year periods. The useable data included 376 cross-section time series observations. The fixed effects regression used 98 degrees of freedom. The R squared was in excess of 0.99.

Table 3. Model I Results

Variable Name	Coefficient Estimate	Standard Error
GDP_{t-1}	0.9501823	0.2443047
GDP_{t-2}	-0.411297	0.23894
$Population_{t-1}$	0.4836006	0.2055439
trend	0.0073712	0.0310638

As one illustration of the model's accuracy in predicting emissions, consider the chart below that maps actual and predicted emissions using within sample data for ten selected developing countries. The predicted value is never more than 1/4 of one percent away from the actual emissions average for any of the five year intervals.

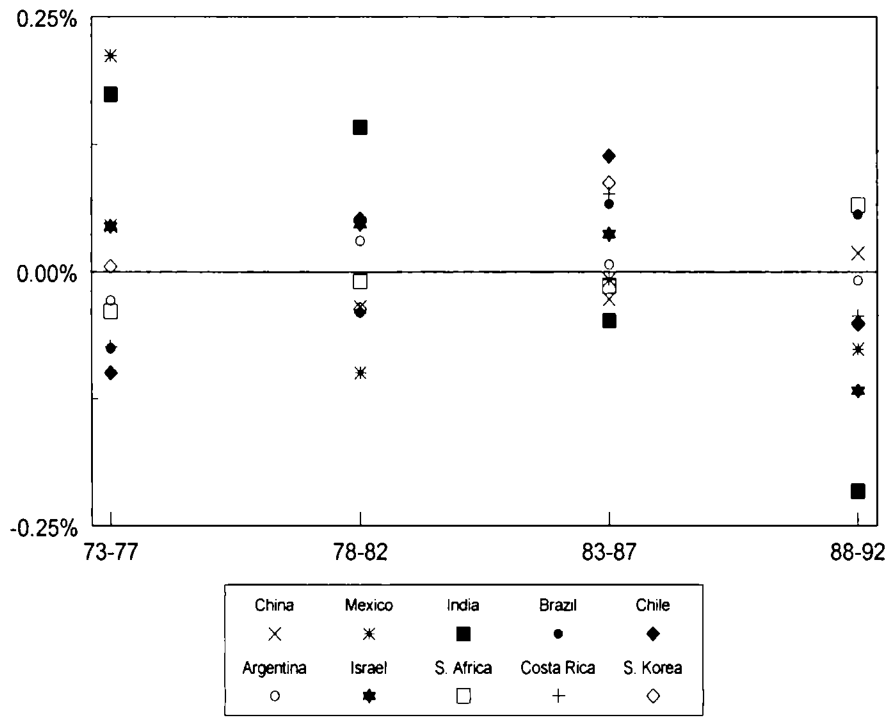


Chart 5. Error in Model I Prediction as a Fraction of Actual Emissions

To forecast emissions for the five year period beginning in 2008 using the results of this regression we input the World Bank forecasts of GDP for the years 2007 and 2006, and the United Nations forecasts of 2007 population. The forecasts of emissions for the budget period and the confidence intervals around these forecasts conditional on the assumed 2006 and 2007 values are described in the table below.

Table 4. Predicted Average Emissions, 2008-2012

Country	2006 GDP (1987$, billions)	2007 GDP (1987$, billions)	2007 Population	Predicted Average Emissions, 2008-2012
China	1,385.8	1,493.5	1,357,627,000	2092 MMTC SE: 1.37 MMTC
India	752.1	799.7	1,140,563,000	345 MMTC SE: 1.34 MMTC
Mexico	268.2	282.7	113,385,000	157 MMTC SE: 1.33 MMTC

The 95 percent confidence interval around the predicted emissions is approximately ± two standard errors. As shown in figure 1, these developing countries would incur net costs of a cap and trade only if the cap were about half the reduction needed to raise the marginal cost of abatement to the world price. Given figures 2-4, these levels are about 9 to 10 percent below BAU. Since such reductions from BAU are more than 10 times greater than the standard error, the risk of net costs is negligible, given the model.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:19-MAR-1998 20:34:53.00

SUBJECT: Energy Information Agency

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

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

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

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

TEXT:
I took a call from Jay Hakes a few days ago regarding his agency's work on the costs of the Kyoto Protocol in response to the request of the House Science Committee. He indicated, as we thought, that they can't model international trading. He is planning instead to furnish a schedule indicating what the price effects would be of various possible domestic emission reductions. He was looking for guidance from me on what was the largest possible share of the target that could be achieved through trading, and therefore what was the smallest possible share of reductions that could be done domestically. I advised him that I didn't have an obvious cut-off, and that he might as well do the entire curve from 0% to 100%. He seemed to indicate that this is what they would do.

I think he said they were aiming to do this by Labor Day.

I think he also said the International Energy Outlook was due in 3 weeks, and he would give us an embargoed advance copy.

He also said that their AEEI of .9 "has a lot of optimism in it."

JF

Withdrawal/Redaction Marker
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	Michele Jolin to Rebecca M. Blank and Janet L. Yellin at 11:02:07.00. Subject: Becky's nomination. (1 page)	03/20/1998	b(6)

COLLECTION:

Clinton Presidential Records
Automated Records Management System [Email]
CEA ([Yellen])
OA/Box Number: 950000

FOLDER TITLE:

[03/12/1998 - 04/16/1998]

2013-0723-F
ab1276

RESTRICTION CODES

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

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

C. Closed in accordance with restrictions contained in donor's deed of gift.
PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).
RR. Document will be reviewed upon request.

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

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

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:22-MAR-1998 15:43:58.00

SUBJECT: Script for EPC meeting

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

TEXT:
Script for EPC meeting. You will probably want to alter the pagination and font.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D15]MAIL427575081.026 to ASCII,
The following is a HEX DUMP:

First day, morning session

I. Adoption of the agenda and election of officers

(Because your term as EPC chair has formally expired, you will not have to preside over this portion of the meeting; instead, the Secretary-General will handle it. According to John Weeks, you will be reëlected as Chair, and Mr. Okita (Japan) and Mr. Cotis (France) will be reëlected as vice-chair and chair of EPC and WP-1, respectively. In addition, Mr. Bogaert (Belgium) will be elected as second vice-chair of EPC, Mr. Glass (UK) will be elected as vice-chair of WP-1, and Deputy Secretary Summers will be reëlected as chair of WP-3.)

II. Chair's introductory remarks

May I begin by saying that I am honored to be reëlected Chair of the Economic Policy Committee for the upcoming year. I look forward to a stimulating and fruitful set of discussions by the Committee over the next two days on the state of the world economy and the ongoing work of the EPC.

Much of our work at this meeting will center around the economic outlook and the policy requirements facing decisionmakers in the major regions of the OECD. An important part of the outlook concerns the implications of recent events in Asia; since our last meeting, turmoil in Asian emerging market economies has spilled over to the region's OECD economies as well. Although the situation in Asia appears to have stabilized for now, much work lies ahead in terms of implementing structural reforms in affected economies.

Outside Asia, the Secretariat projects stronger growth in Europe and a moderation in growth in the United States. Somewhat soberingly, however, the outlook calls for no improvement in unemployment in the OECD area as a whole, and unemployment will remain a problem even in those regions where some improvement is expected. It is appropriate, then, that this meeting will also provide an opportunity to discuss issues related to the implementation of the OECD *Jobs Study*, including reports on such topics as policies to foster entrepreneurship and human capital development.

We will also consider an issue of overwhelming importance for all OECD countries, namely, those policies that will be required in order to secure prosperity in our countries as our populations age. Besides having a chance to comment on the substance of these reports, I hope that we will also have a chance to discuss the direction of future work for the EPC and its working parties--and by extension, the Economics Department as a whole.

Before turning to Mr. Potter for his report on the recent activities of the Working Party on Short-Term Economic Prospects, I would like to make two points regarding participation in this meeting.

- **First,** lead speakers in each session should limit themselves to 10 minutes, while delegates from G-3 countries who are speaking about their own countries should try to limit themselves to a total of 15 minutes. General interventions will be limited to five minutes and enforced by a system of traffic lights. I would, however, like to encourage as many two-handed interventions as possible: If you want to respond directly to what a delegate says or address a question to a delegate, please raise both your hands and the Chair will recognize you to speak for one minute. I believe that these interventions are a very useful way of promoting interaction and turning these meetings into more of a discussion and less of a set of speeches.

- **Second**, I would urge the delegates to avoid describing in too much detail the circumstances in your own particular countries. Instead, the discussions are most useful to the participants if the participants try to generalize from their own experiences in order to come up with coherent analyses and recommendations that have broader application.

III. Report of the Chairman of Working Party on Short-Term Economic Prospects (Mr. Potter)

I would like to welcome Mr. Potter to give us the report of the Working Party on Short-Term Economic Prospects.

IV. Report by the Secretariat on WP-3 activities (Mr. Visco)

I would now like to turn to Mr. Visco for a report on the recent activities of Working Party Three.

<u>First topic</u>: **Implications of events in emerging market economies in Asia**

Our first session today will consider the ramifications of events in Asia, both for those economies directly affected as well as those affected through trade or financial ties. Key questions include the following:

- First, do delegates feel that we have seen the worst of the crisis? Are affected countries successfully started along the road to eventual recovery? Or is there still a danger that the crisis will spread to other economies in the region--as well as to other emerging-market economies?

- Second, to the extent that many of the problems in affected economies reflect deeper underlying weaknesses, are current and anticipated structural reforms sufficiently broad? Is the pace of reform sufficiently rapid? Do delegates feel that confidence in these economies' prospects has been partly--or even largely--restored, or are investors, firms, and individuals "on hold" until a commitment to reform on the part of policymakers has been firmly demonstrated?

- Third, what impact will recent events in Asia have on the financial systems of countries outside the region? How broadly are financial institutions and investors affected by their lending and investment in Asian countries?

- Finally, many countries that are not directly affected by the crisis will probably see a deterioration in their bilateral trade balances *vis-à-vis* affected countries. Although this will be a temporary situation, it may well lead to trade tensions, and could even spark a protectionist backlash. How concerned are Delegates about this scenario's occurring in their own countries?

I would like to invite Mr. Suárez Davila to lead off discussion on this topic. Following his introduction, I would ask the Delegates from Korea to discuss the situation in their country. (We will discuss the situation in a second OECD country in the region, Japan, in a separate session.) After the Korean delegation's presentation, the floor will be open for a general discussion.

<u>Second topic</u>: **The current economic situation and policy requirements in the three major OECD regions**

We now turn to a general discussion of the economic prospects and requirements for policy in the three major OECD regions--Japan, the United States, and Europe.

1. Japan

We begin with Japan. The Secretariat's assessment of the Japanese economy suggests that its recovery has been hampered--if not derailed--by a combination of policy and external shocks. Policymakers in Japan appear to face two major challenges: first, to conduct a macroeconomic policy that fosters a sustained economic recovery; and second, to implement broad structural reforms, especially those aimed at improving the long-term health of the financial sector through improved regulation and oversight.

- One question that arises is whether delegates agree that the proper policy course for the Japanese economy involves an approach that addresses financial sector weakness, stimulates the economy through fiscal and monetary measures, and reforms product markets and existing regulatory structures. Are there specific elements on which delegates would place particular priority?

- On a related point, one possible criticism of previous attempts to stimulate the economy through fiscal policy is that they have largely involved temporary measures. Delegates might therefore wish to discuss whether such policies as a permanent reduction in taxes might better promote recovery, and to consider how the government's medium- to long-term goal of fiscal consolidation might be accommodated within the context of such policies.

- In addition, the Japanese government has recently announced plans to address problems related to continued financial-sector weakness. I would encourage delegates to discuss whether they feel that these proposed policy actions will be sufficient to resolve outstanding balance-sheet issues and restore confidence in the financial sector. In order to make the discussion concrete, delegates might wish to refer to the experience of other countries that have pursued policies to restructure and recapitalize their banking sectors.

I would like to invite Mr. Cotis to lead the discussion. Afterwards, the floor will be open to the Japanese delegation for a response and further discussion. A general discussion will follow, and then we will adjourn for two hours for lunch.

First day, afternoon session

In this session, we will continue our discussion of the economic prospects and requirements for policy in the remaining two major OECD regions: the United States and Europe. We begin with the United States.

2. United States

Over 1997, real GDP in the United States grew by nearly four percent--far in excess of conventional measures of potential output. Despite extremely tight labor markets--unemployment averaged only 4.9 percent in 1997--inflation has remained in check, although some signs indicate that wage pressures may be building. The U.S. economy has benefitted in recent years from reductions in import prices, which have helped to keep inflation low; recent problems in Asia might allow import price inflation to remain low in the near future (although this certainly will not continue forever). Events in Asia have also had the effect of clouding the outlook somewhat: while a slowdown in Asia could help to moderate growth to a more sustainable rate by depressing the external sector, the timing and eventual magnitude of these effects is uncertain.

- Against this background, delegates might wish to consider the proper stance for policy, particularly monetary policy. Is there justification for a preëmptive tightening?

- In their discussion of policy requirements for the U.S., delegates might also wish to turn their attention to a longer-term policy concern, namely, whether the private component of U.S. national saving is adequate. An important contributor to the U.S. economy's recent performance has been continued progress in fiscal consolidation; nevertheless, the current account deficit has increased. Should policymakers address this issue? If so, how?

It is my pleasure to invite Mr. Schatz to introduce the discussion on this topic. Afterwards, I and other members of the U.S. delegation will respond to questions, with Governor Meyer addressing those issues related to monetary policy and the inflation outlook. The floor will then be open for a general discussion.

3. Europe

Events in Europe have been quite remarkable, with a large number of prospective EMU countries fulfilling virtually all of the criteria for eligibility. The Secretariat's outlook for Europe is also positive. In countries with mature expansions, growth is projected to moderate to a more sustainable rate, while the expansion in other parts of Europe appears to have moved onto a broader base that includes more components of aggregate demand. Nevertheless, a number of important hurdles confront European policymakers, particularly in the context of EMU.

- First, although many countries have met the convergence criteria for inflation, interest rates, and budget deficits, they have done so by pursuing mixes of fiscal and monetary policies that differ significantly across countries. In addition, the cyclical positions of the various prospective EMU countries also vary significantly. Delegates might therefore wish to consider how it will be possible to accommodate the differing policy stances and policy requirements of prospective euro countries under EMU.

- Second, unemployment remains high in prospective EMU countries, and is projected to remain so even as the recovery in these countries progresses; the implication is that it is largely structural in nature. Do delegates believe that policymakers in prospective EMU countries are doing enough to address the existence of structural unemployment? Are there specific actions that governments are undertaking or plan to undertake in the near future?

- Finally, and relatedly, will necessary structural reforms in such areas as regulation, competition, public pensions, and the banking sector be promoted by EMU? How important are such reforms in ensuring that EMU operates smoothly?

I would like to invite Governor Meyer to begin our discussion on these topics. I would then ask the delegates from the larger European countries to respond to Governor Meyer's remarks and provide their own views on these issues; afterward, the floor will be open for a general discussion.

V. Report by the Secretariat on WP-1 activities (Mr. Feiner)

I would now like to turn to Mr. Feiner for a report on the recent activities of Working Party One.

Third topic: **Forces shaping tax policy** *(N.B.: might be postponed to Fall EPC meeting if discussion on Europe runs late...)*

Our last topic for today concerns tax reform. An important practical goal of fiscal policy is to ensure that the collection of revenues imposes as few distortions and costs on the private economy as possible. Over the past 15 years or so, OECD governments have moved toward this goal by implementing a number of reforms to their tax structures.

However, the future poses a number of challenges to tax policy. As our populations age, a greater share of spending will go to social programs such as old-age pensions and medical insurance for the elderly; absent budget cuts in other areas, this will require additional revenue. In addition, further progress toward tax reform is needed in order to further reduce existing distortions. Finally, erosion of the tax base--which in the past occurred when high rates encouraged avoidance and evasion--could be exacerbated in the future as capital and labor find it easier to migrate to low-tax jurisdictions.

I would like to invite Mr. Okita to lead off our discussion of this topic, and then to open the floor to a general discussion. Some of the specific areas on which delegates might wish to comment include the following:

- First, what are the prospects for future reform? In particular, how might policymakers make tax systems less distortionary? What specific measures should be introduced, and are any currently under active consideration? And what are the potential adverse distributional effects of these measures?

- Second, is there a general feeling among delegates that tax-base erosion through geographic mobility is a real problem? Is it likely to become worse in the future? And do any suitable policy responses exist?

I now give the floor to Mr. Okita.

(Following this discussion, the meeting is adjourned until 9.30 a.m.)

Second day, morning session

Fourth topic: **Maintaining prosperity in an aging society**

In this morning session, we will discuss two sets of papers that are scheduled to be presented at the OECD Ministerial meeting at the end of this month. The first deals with the policy challenges posed by the aging of our populations, which is a phenomenon that will affect all OECD countries to a lesser or greater degree in the years ahead.

In general, I would encourage delegates to discuss the substance of these papers as well as specific areas in which delegates see a need for future work. For the aging paper specifically, I would ask delegates to pay especial attention to the seven "principles for reform" that are outlined, as well as to the paper's general assessment of policy requirements and recommended policy directions.

I would like to invite Mr. Hansson to lead the discussion on this topic; afterwards, the floor will be open for a general discussion.

Fifth topic: Implementing the Jobs Strategy

We next turn our attention to a second set of papers that are scheduled to be presented at the OECD Ministerial meeting at the end of this month. The first paper is an interim report that summarizes progress made by member countries toward implementing the specific recommendations of the Jobs Strategy, the second discusses policies designed to encourage entrepreneurial activity, and the third concerns investment in human capital.

Once again, I would like to encourage delegates to discuss the substance of these papers as well as specific areas in which delegates see a need for future work. I would also ask delegates to give their views as to what the focus should be of the full report on implementing the Jobs Strategy that is scheduled to be presented at the 1999 OECD Ministerial.

It is my pleasure to recognize Mr. Bogaert to lead off the discussion; afterwards, the floor will be open for a general discussion of these papers.

VI. Other business

(None that I know of, except the dates of the next meeting: 5th-6th November 1998. Note that Russian observership should be discussed at the SYG's lunch, not here.)

[Adjourn]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:22-MAR-1998 17:39:01.00

SUBJECT: European central bank participation in EPC after EMU

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

TEXT:
By way of a reminder: There is an item on page six of John Weeks's "scene-setter" regarding participation by European central banks after EMU (should they all get seats, &c.). Weeks suggests that you discuss this with Larry Summers, because Summers is formulating a policy on this for WP-3, and anything that is done for EPC should probably be consistent with WP-3.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:24-MAR-1998 06:14:54.00

SUBJECT: EPC statement on trade tensions

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

TEXT:
Statement on trade tensions; hard copy is on your chair. I can put
through any changes you wish this morning.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D22]MAIL44752228W.026 to ASCII,
The following is a HEX DUMP:

Statement on trade tensions

The Secretariat's forecast for the United States indicates that events in Asia will contribute to a sharp increase in the current account deficit, to about three percent of GDP in 1999. Although the U.S. economy is strong enough to absorb such a shock, previous experience does suggest that an important consequence of such a large deterioration in the current account may well be an increase in protectionist pressures and trade tensions.

Protectionist pressures are likely to rise in the United States if exporters suffer sharp losses in market share. They are likely to be exacerbated by large increases in bilateral deficits with lower-wage countries, as such deficits may well lead to renewed charges of "unfair competition." It is also sobering to note that several recent attempts to pursue trade liberalization policies in the U.S. have not been successful; in the eyes of many citizens and policymakers, the presence of a large current account deficit will further weaken the case for free trade.

Economists and policymakers who argue in favor of free trade tend to dismiss cries for protectionism as misguided, a throwback to mercantilist doctrines and the result of a lack of understanding of the nature and sources of the gains from trade. Similarly, focusing on a set of bilateral deficits is generally seen to stem from ignorance about how international trade works. However, it is important to note that the current situation provides cause for real concern. Even advocates of free trade admit that opening an economy to international competition leads to adjustments in production and corresponding dislocations in employment and investment across industries. In this ideal case, the benefit of such adjustments is that they involve reallocations of labor and capital to relatively more productive uses (the doctrine of comparative advantage at work) and often tend to be gradual. But it is very hard to argue that the sort of sharp and rapid adjustments in trade flows that will result from the problems in Asia will serve any useful purpose (save that of helping to increase economic activity in exporting countries). They will, however, induce structural changes that carry with them real costs, such as increased displacement of workers employed in sectors that are unduly affected by rising imports. [increased earnings inequality and higher long-term unemployment...] A backlash against trade liberalization is therefore quite within the realm of possibility.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Randall W. Lutter (CN=Randall W. Lutter/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:24-MAR-1998 10:10:48.00

SUBJECT: OIRA docketing procedures.

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

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

TEXT:
OIRA would not docket any memo it received from another agency about an ongoing rule-making. However it would keep such documents in a separate file in the event that Congress laters asks for them. The OMB director may have different procedures, but any memo copy of a memo that he forwarded to OIRA would be treated in this way.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:24-MAR-1998 06:13:18.00

SUBJECT: EPC statements

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

TEXT:
CLICHTP1.DOC: Comments on sustainable development paper

JAPANTP.DOC: Statement on Japanese fiscal policy, &c.

PRISAVTP.DOC: Statement on U.S. private saving, revised to reflect your comments

One more document to follow; hard copies of the above are on your chair. I will write up some remaining odds and ends this morning. You might want to have a look at the Japan talking points to make sure they do not have too strident a tone. At my reading speed, they are three minutes long, which leaves Governor Meyer with two minutes to talk about the Japanese financial sector.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D15]MAIL41742228O.026 to ASCII,
The following is a HEX DUMP:

Comments on sustainable development paper (from Joe Aldy)

[Note: Many of these topics are covered in a sketchy manner in Annex II of the paper; Moe might therefore feel that the paper covers these topics sufficiently and no further emphasis is needed. It might be good, however, to reiterate that these areas are of especial interest to us.]

1 Given that CEA's main interest in the climate change portion of the work program involves consideration of plans for emissions-permit trading, it would be good if the proposed work plan placed greater emphasis on the institutions that will be necessary in order to make international trading work. Questions that such work should address include:

- Nature of the permits: Would they be like financial instruments or goods?

- Institutional structure: Who would run and monitor the system? What mechanisms would be put in place for ensuring compliance, and who would administer them? How would the international system interact with domestic emissions reduction programs (*e.g.*, cap and trade, a carbon tax, or command and control).

[Another example of a relevant question: The structure of these markets will depend critically on whether buyers or sellers are held liable for ensuring that sale of a permit actually reflects an eventual reduction of pollution (on the part of the seller). This is a controversial point that would need to be addressed in any consideration of mechanism design.]

2 It would also be useful to give greater attention to the prospective rôle of developing countries; although this is mentioned in the paper, it is not emphasized in the work program. Our analysis indicates that LDC participation would make emission reduction much cheaper; hence, attention should be given to incentive structures that would encourage LDCs to take on emission reduction targets and join whatever international trading scheme exists.

3 The Kyoto Protocol only establishes emissions targets through 2012. Additional analyses could be conducted on possible emissions limits for the second and subsequent commitment periods. These analyses could serve two ends: first, they could provide an understanding of the economic costs of emissions cuts deeper than those specified in Kyoto, and second, they could illustrate the potential magnitude of emissions banking across commitment periods. Moreover, since most modelling exercises are sensitive to assumptions that are made after 2012, the effects of post-2012 emissions reductions will be incorporated in planned modelling work anyway. This last point should be considered if modelling exercises are to comprise a part of ECO's work (but see point 1, below), and each item will need to be dealt with for the portion of the work program that covers "moving beyond Kyoto."

<u>Other comments</u>

1 Currently, the proposed work plan for ECO appears to include additional work on modelling. Earlier, ECO complained that additional modelling work would require too many additional resources and indicated that extant work should be sufficient. You might request clarification of this point in your discussions with Messrs. Moe and Visco.

2 Development of sustainable development indicators is only useful if such indicators can be used to assess tradeoffs between various policies. Using them to assess "progress" toward sustainable development is probably not an operative goal, particularly since extrapolating trends in social or environmental indicators is likely to be difficult and controversial. (It is not entirely clear why the social dimension is included at all in discussions of sustainable development.)

3 John Weeks has noted that Ambassador Bondurant's view is to go forward on the sustainable development project. However, she has really only had input from agencies that are more interested in the environmental side of things (*e.g.*, EPA), and has not really heard the

economic perspective on these issues. You might therefore want to discuss the economic side of the sustainable development question with her.

Talking points on Japanese macroeconomic policy

If the Secretariat's forecast for 1998 proves correct, then this year Japan's economy will have grown at an average rate of about one percent per year over the past seven years. This would be a worrisome situation at any time, especially for a country that enjoyed real growth of roughly four percent per year over the preceding decade. What adds particular urgency to the situation in this case is Japan's position as the largest economy in Asia; simply put, economic recovery in Japan is a precondition for recovery in the region as a whole.

What to do is clear: Japan must undertake an aggressive, activist macroeconomic policy in order to expand its economy. The cornerstone of such a policy must be large-scale fiscal stimulus. We have abundant evidence that fiscal policy can have a pronounced effect on economic activity in Japan; over the past seven years, quarters in which fiscal policy was stimulative saw faster growth, and contractionary fiscal policy has assuredly acted to slow the economy. The situation in Japan provides a textbook case for expansionary fiscal policy: Japan faces a large (and growing) output gap, and monetary policy is extremely loose.

A fiscal stimulus package will most likely have to be large--perhaps as large as two percent of GDP. This reflects the depth of the slump the economy is presently in, the need to counteract what fiscal contraction is already planned for the near term, and the need to convince observers that the government is committed to sustained growth led by domestic demand. Moreover, a significant, *permanent* tax cut may have to be a part of such a stimulus package. Temporary tax cuts will have only transitory effects.

Finally, monetary policy should be kept as stimulative as possible. Obviously, with nominal interest rates as low as they are now, monetary policy will be unable to bear the full burden of promoting an expansion. But there is still some room to cut interest rates further, and no reason not to do so given that inflation is hardly a danger at present.

We frequently hear it asserted that Japan cannot afford to engage in expansionary fiscal policy because of a need to prepare for the demands of an aging population. I would like to challenge this assertion, however. It hardly seems plausible that maintaining anemic growth will better help the government prepare for future drains on the public pension system. And Japan has plenty of room to maneuver inasmuch as net government debt is less than 20 percent of GDP.

Expansionary fiscal policy is one of three critical steps that the Japanese government must take immediately in order to promote a recovery. In addition, longer-term emphasis must be placed on structural reforms in the areas of regulation and competition policy. The Japanese government's stated commitment to reform in these areas is very welcome, and implementation of such reforms will certainly raise Japan's output in the long run. But it is important to keep in mind that these types of policies will serve as complements--not substitutes--for substantial fiscal stimulus.

Finally, it is crucial for Japan to resolve outstanding problems in its financial sector. I would like to defer the remainder of my time to my colleague, Governor Meyer, who will discuss this point in detail.

Statement on private savings

The Secretariat's *Main Issues for Discussion* paper correctly points out that the United States' current account deficit has widened recently despite continued progress toward fiscal consolidation. The question that arises, therefore, is whether raising national saving through deficit reduction is sufficient, given levels of private saving that are in some sense "too low."

This is a complicated question that involves a number of issues. First, I would address the point made regarding recent changes in the current account deficit. It is quite true that the U.S. current account has recently widened in absolute terms. However, as a share of GDP the current account is less than two-thirds as large as its 1987 peak. This is not meant to dismiss the importance of recent changes in the current account deficit, but rather to point out first, that fiscal consolidation has been an important influence in raising the national saving rate (which has in turn reduced the relative size of the current account deficit), and second, that a longer-term perspective may be more useful in assessing changes in national saving.

From 1979 to the present, U.S. national saving as a share of GDP has dropped by about four percentage points. Of this decline, roughly eight-tenths of a percentage point has been the result of a lower public saving rate: although Federal government saving as a share of GDP has returned to its 1979 level, the saving rate of state and local governments has fallen. The remainder of the decline in the overall saving rate, therefore, has been the result of declines in the private saving rate, virtually all of which are in turn due to lower rates of personal saving.

Should we be concerned about this situation? We can approach this question in two ways. First, macroeconomic theory provides a useful analytical tool for determining whether a country's rate of saving is optimal--the so-called "golden rule." In essence, the golden rule implies that a country should save more if the net rate of return that individuals can receive on their additional saving is high enough to compensate them for deferring their consumption. Based on what we know--or think we know--about the rate of return on capital and other characteristics of the U.S. economy, it would appear that the rate of saving in the U.S. is well below the golden-rule level--that is, national saving is too low given existing investment opportunities in the U.S. economy.

If attractive investment opportunities are available at home but domestic saving is insufficient to pursue them, foreign investors can step in, and the resulting excess of investment over national saving is manifested in a current account deficit. In recent years, this has benefitted the U.S. inasmuch as it has allowed high rates of investment in capital equipment despite a low national saving rate. However, maintaining national investment over national saving comes at a price: growing indebtedness to foreign investors. In the long run, increased foreign indebtedness means that a larger fraction of future output will have to be transferred abroad in order to compensate foreign investors. Given the demands that will be placed on the U.S. economy over the next 30 or 40 years by the aging of its population, and given that many of the countries lending to the U.S. will face similar challenges in the future, a strong argument can be made that it would be better to finance more of our investment through higher national saving and less through borrowing abroad.

Second, from a microeconomic perspective the low personal saving rate is a problem if it indicates that individuals are not saving enough for their retirement. Available evidence suggests that a substantial fraction of the "baby boom" cohort is *not* adequately preparing for retirement, in the sense that they will not be able to maintain their pre-retirement standard of living after they retire. Once again, this indicates that the personal saving rate is "too low."

What are reasonable policy responses to this situation? On the macroeconomic side, further improvement in the government's budget position can help by directly raising national saving. Additional government saving will help to close the current account deficit; moreover, by encouraging capital formation this will also ease the burden on younger workers--who will be taxed to provide old-age pensions to retirees--by making them more productive.

While the current administration is receptive to implementing policies that encourage individuals to save, experience indicates that such policies are not easily found. In particular, it is unlikely that any single policy would be able to reverse the long-run downward trend in the personal saving rate. Obviously, this is an area in which knowledge of cross-country experiences would be extremely valuable.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:24-MAR-1998 13:56:51.00

SUBJECT: oil prices

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

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

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

CC: BLANK_R (BLANK_R @ A1 @ CD @ VAXGTWY [UNKNOWN]) (CEA)
READ:UNKNOWN

TEXT:
Janet,

Just to let you know, we've been working on oil and gasoline prices. Not only for a WEB article, but also due to WH concerns. Rahm Emanuel at the morning Senior mtg. asked whether the WH should put out a statement against "price gouging." Some of us were unenthusiastic about this idea.

We just now had a big conference call, led by Peter Orszag. The key outcome of that call, regarding statements to the public, is that we are all supposed to say little about the recent oil price increase, beyond "we're monitoring the situation..."
JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:30-MAR-1998 15:30:29.00

SUBJECT: developing countries paper

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

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

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

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

TEXT:
Attached is the latest version of the developing countries paper that we are circulating to interested parties. Also attached is the cover memo that includes the list of people who will receive the paper today.

Joe

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D43]MAIL42548588F.026 to ASCII,
The following is a HEX DUMP:

A Proposal for Developing Countries:
Participation in a "Target and Trade" System

I. This analysis demonstrates that the gains will be substantial if developing countries (a) accept binding targets at or slightly below their business as usual (BAU) emissions levels, and (b) trade from their respective targets. We believe that participation in a "target and trade" system should be the cornerstone of our international negotiations.

The economic and environmental rationale for such participation includes

- **Greater economic benefits to developing countries:** With targets at or only slightly below BAU, developing countries would enjoy net gains of many billions of dollars through the international sale of emission reductions achieved at lower cost than the world price.

- **Greater cost savings to the U.S.:** Participation by developing countries in international permit markets would greatly lower the costs to the U.S. of meeting its Kyoto target (as CEA testimony showed). In particular, costs would be lower than with trading among only Annex I countries.

- **Greater environmental benefits:** Targets slightly below business as usual would lower global emissions relative to a world with only Annex I targets. Further, reducing carbon dioxide emissions generates ancillary air quality benefits through lower particulate matter, sulfur dioxide, and nitrogen oxides emissions.

- **Target and trade yields greater benefits than CDM:** While the Clean Development Mechanism will likely result in cost savings to the U.S. relative to a world with only Annex I trading, a system including effective target and trade of developing countries' emissions would yield much greater cost savings to the U.S. and greater gains to developing countries than CDM. Further, target and trade could achieve environmental benefits not achievable by pursuing CDM, which only redistributes emissions geographically.

- **The principle of full participation:** Other rationale include the long-run benefits of including developing countries into global negotiations, for example, as recognized by the Byrd-Hagel resolution. By establishing participation now, further commitments might be feasible in future periods.

II. Problem: To persuade a developing country *voluntarily* to adopt a target and then to trade permits internationally, international agreements must be structured to reduce the risk of inadvertent stringency and in particular to reduce the possibility of a target so stringent as to cause large economic losses to the developing country.

Proposed Solution: Negotiations should focus on the estimated business as usual emissions level, where this level is expressed in a way that depends on the *future* values of economic variables, such as GDP.

Rationale: Such targets would avoid the risk of inadvertent stringency associated with higher than projected economic growth between now and the beginning of the commitment period in 2008. Developing countries would face only the much smaller risk that emissions would be higher than expected, *given* the economic conditions realized in 2007.

Basic principles for implementing such an approach are:

- **Reasonable Forecasts**: The relationship between the target (putting aside any real reductions in emissions) and the values of economic variables, when applied to emissions and such variables during recent years, should predict emissions reasonably well and be without demonstrable statistical bias. Relationships that give reasonably reliable predictions reduce the risk of either inadvertent stringency or paper tons which could increase global emissions.

- **No Perverse Incentives:** The target should depend on values of economic variables only indirectly related to emissions, to avoid creating perverse incentives for developing countries to increase emissions so as to have higher targets in the commitment periods. For example, the target should not depend on energy consumption in 2007, but could reflect pre-Kyoto emissions levels.

- **Predetermined Targets:** To avoid uncertainty during the commitment period about the country's target the target should not depend on contemporaneous values of economic variables. For example, the target generally should not vary with 2008 or 2010 GDP levels, but rather with 2007 GDP.

III. Illustration: One way of implementing the solution is described below. Other ways of implementing the solution may work as well or better. The conclusions are stated below; the details of our work follow in appendix 3.

- Defining the business as usual level for a developing country as a function of its GDP and population in earlier years and setting the emissions target at that level yields a negligible risk of leaving the developing country worse off under target and trade because of inadvertent stringency. Even a target slightly below BAU would also yield negligible risk of leaving the developing country worse off.

- Emissions targets for developing countries set below their business as usual emission level would of course result in gains from trade smaller than with a BAU target, while providing environmental benefits. The higher costs of a target set below BAU are borne by both the developing countries and the Annex I countries.

There are significant gains from trade for developing countries and large cost-savings to the U.S. if even one large developing country accepts an emissions target at BAU and participates in emissions trading. Table 1 and Charts 1 through 3 illustrate these gains from trade from a baseline of full Annex I trading.

Table 1. Illustrative Gains from Trade with Developing Countries that Target and Trade

Trading Scenario	Permit Price[1] (1997$/ton)	Country Gaining	Gains from Trade with Developing Countries
Annex I only	$54	United States	not applicable
Annex I + China	$26	China	$3.6 billion/year
		United States	$11.6 billion/year[2]
Annex I + India	$47	India	$1.6 billion/year
		United States	$2.5 billion/year[2]
Annex I + Mexico	$51	Mexico	$0.9 billion/year
		United States	$1.2 billion/year[2]

[1] These scenarios do not account for the cost savings available through the Clean Development Mechanism and carbon sinks.
[2] Gains from trade for the U.S. are estimated as the change in the U.S. total cost of complying with the Kyoto Protocol relative to an Annex I only trading regime.

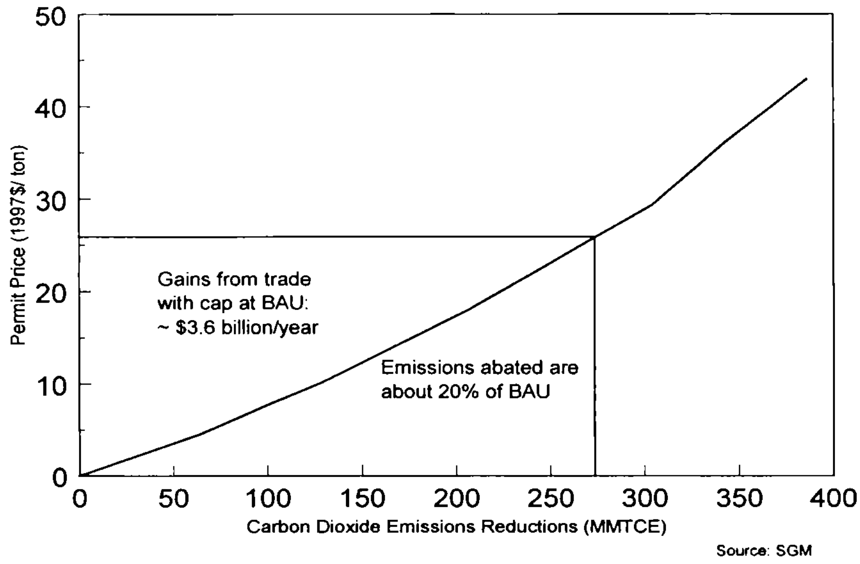


Chart 1. China's 2010 Marginal Abatement Cost Curve and Gains from Trade

Chart 2. India's 2010 Marginal Abatement Cost Curve and Gains from Trade

[Automated Records Management System Hex-Dump Conversion]

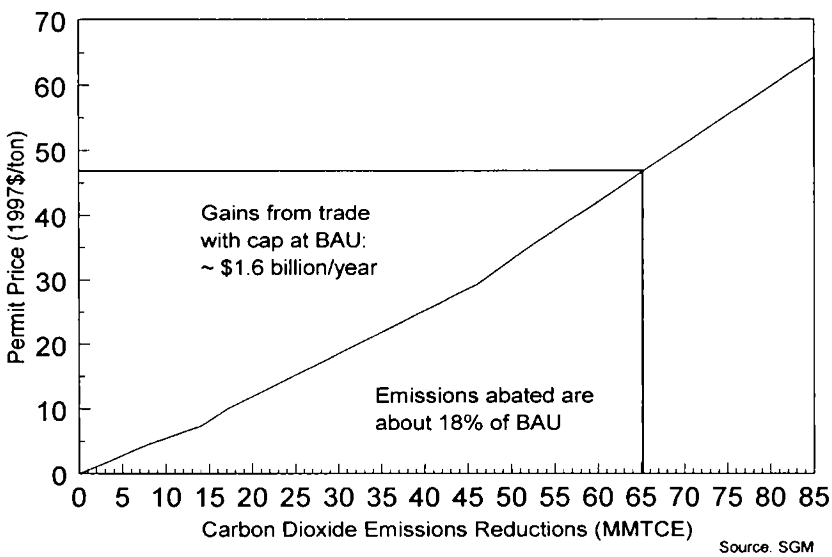
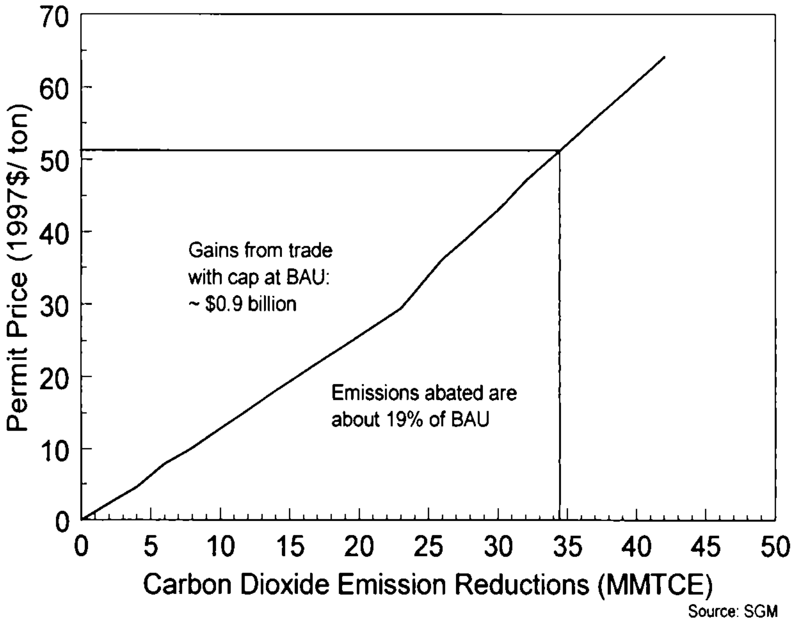


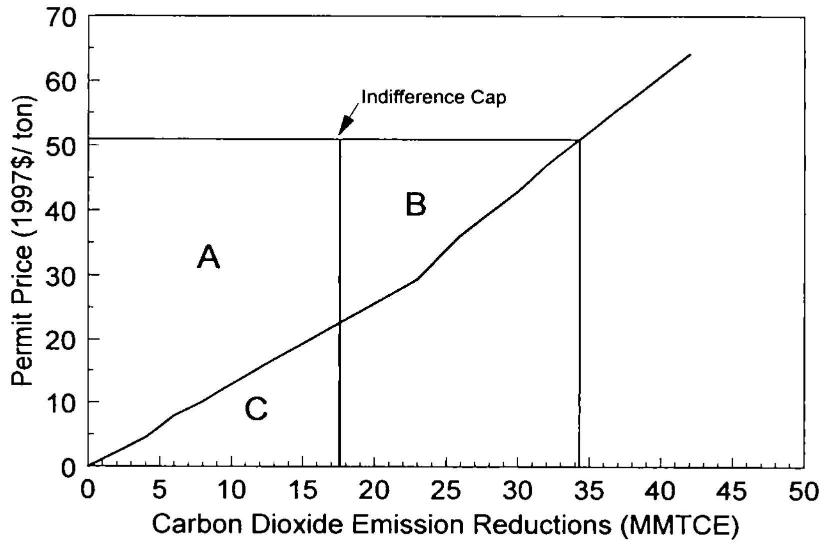
Chart 3. Mexico's 2010 Marginal Abatement Cost Curve and Gains from Trade



[Automated Records Management System Hex-Dump Conversion]

Appendix 1. Costs to the U.S. of Developing Countries Adopting Targets Below BAU

Regarding developing countries, most commonly discussed is the issue of fairness: what



commitments to reduce emissions should be made by countries whose economic resources differ substantially? Generally neglected, but discussed below, is the issue of efficiency. In particular, what are the implications for U.S. costs of increasingly more stringent targets on emissions from key developing countries?

The environmental gains from emissions reductions below BAU come at the price not only of economic costs incurred by a developing country that adopts the below-BAU target, but also economic costs by Annex I. More stringent developing country targets raise U.S. costs by restricting the supply of permits in world markets and so raising the price of permits.

To assess the magnitude of this effect consider the target which just leaves a country no better off than no target at all. This "indifference" target is where the costs of meeting the target just equal the net gains from selling permits in world markets. Chart 4 illustrates gains from trade for a small country. For a target that is equivalent to a reduction from BAU of 17 MMTC, net gains from foreign exports are B, and the cost of meeting the target is C. Since B = C in this example, the net gains from trade are nil.

Chart 4. Illustrative 2010 Marginal Abatement Cost Curve and Indifference Target

[Automated Records Management System Hex-Dump Conversion]

Note: For simplicity, this indifference target is illustrated for a country whose participation in world permit markets does not affect world permit prices.

Table 2 provides an illustration of the effects of emissions targets more stringent than BAU on China with Annex I plus China trading. Note that a small reduction below BAU has no real effect on the Annex I trading price, and thus no economic effects on the U.S. However, as the target becomes more stringent, the Annex I trading price increases, resulting in higher total costs of compliance for the U.S. If China accepts a target below BAU, the cost of this additional stringency to the U.S. -- essentially, the cost of supplying the environmental benefits associated with these emissions reductions -- can become significant. Thus developing country participation in the form of acceptance of targets more stringent than business as usual will raise costs to the U.S.

Table 2. Effects of Various Chinese Emissions Targets with Annex I Trading

Emissions Target[1]	Permit Price (1997$/ ton)	Chinese Emissions Reductions (MMTC)	Chinese Emissions Sales (MMTC)[2]	Total Cost to U.S. of Complying with Kyoto	Cost to U.S. of Additional Stringency
BAU	$26	276	276	$13.4 b	not applicable
BAU - 1%	$26	276	262	$13.4 b	~$0
BAU - 5%	$29	304	235	$14.9 b	$22/ton
Indifference	$36	343	172	$17.9 b	$26/ton

[1] We employ the SGM BAU for China for the purposes of these calculations.
[2] Reductions in Chinese emissions less Chinese emissions sales yields net global reductions.

Imposing this "indifference" target on China, given that its participation lowers world permit prices, leads to the following conclusions.

- An indifference target for China increases annual U.S. costs by $4.5 billion or 33% relative to a BAU target for China.

- If China accepts an emissions target requiring reductions of approximately 170 MMTC below BAU, the average cost to the U.S. would be $26/ton. This is not the average cost of a ton of emissions purchased from China, but the average cost to the U.S. of the environmental benefits associated with China complying with a more stringent target.

Appendix 2. Ancillary Environmental Benefits of Target and Trade in Developing Countries

The voluntary reduction of greenhouse gas emissions by developing countries under a target and trade system will simultaneously reduce emissions of several pollutants, producing ancillary environmental and human health benefits in those countries. The environmental and health benefits that accrue to those developing countries are unlikely to be offset by decreases in environmental quality in the United States because of our stringent health-based air quality standards.

A recent study in *Lancet* examines the emissions of one pollutant that are reduced along with carbon emissions: airborne particulate matter (PM). The study projects that by 2020, a climate change policy scenario in which developing countries reduce emissions to 10% below their BAU could produce an annual reduction of 563,000 statistical deaths.

The analysis below adapts the predictions in the *Lancet* study to estimate the mortality risk reduced from participation by three developing countries (China, India, and Mexico) in a target and trade system. These illustrative calculations take as given the emissions reductions from BAU resulting from permit sales that are predicted by SGM. It suggests that significant public health gains could result from developing country participation in international carbon permit markets.

Table 3. The Effects of International Carbon Permit Trading on Mortality Risk Associated with Particulate Matter Emissions

Country	Predicted carbon emissions reduction from international permit sales	Share of non-Annex I population in 2010	Annual PM statistical deaths avoided in 2010 by international carbon permit trading
China	20%	23.7%	136,700
India	18%	20.3%	105,300
Mexico	19%	2.0%	19,700

For developing countries that are too "small" to affect the world permit price, adopting a carbon target more stringent than BAU and participating in international trade does not yield additional ancillary benefits relative to a BAU target. Large countries, by adopting targets below BAU, would raise the world price relative to a BAU target, and thereby achieve greater carbon emissions reductions and ancillary benefits.

Caveats

Major assumptions beyond those in the *Lancet* article include:

- Deaths avoided in each non-Annex I country are proportional to the country's share of non-Annex I population.

- Deaths avoided are proportional to carbon emissions reductions.

- Each key developing country is the sole non-Annex I country to adopt a target and participate in international trading.

Appendix 3. Summary of Analysis

A. Data

We have compiled data on 3 variables: emissions of carbon dioxide, GDP, and population for 117 countries for the time period 1970-1992. The carbon dioxide emissions data, measured in millions of metric tons of carbon, are from the Carbon Dioxide Information Analysis Center (Oak Ridge National Laboratory, DOE). The GDP data, measured in 1987 U.S. dollars, are from the World Bank. The population data, measured in thousands of individuals, are from the United Nations Population Division.

B. Methods

We have estimated a fixed effects linear regression on the logs of these variables, for the countries in our data set, excluding those listed in Annex I. Our regression uses four non-overlapping 5 year intervals for each country. Our forecasts include the country specific constants.

C. Results

The fixed effects regression we estimated is

$$\text{Emissions} = a\ GDP_{t-1} + b\ GDP_{t-2} + c\ \text{Population}_{t-1} + \gamma\ \text{trend}$$

Emissions are the natural logarithm of the five year non-overlapping average of carbon emissions. All independent variables are lagged. GDP_{t-1} is the log of the gross domestic product in the year prior to the first year in the emissions variable, GDP_{t-2} is GDP in the year two years prior to the first year included in the emissions variable, and population_{t-1} is the country's population in the year prior to first year included in the emissions variable. Trend is one in the first 5 year period, and 2, 3, and 4 respectively in the subsequent 5 year periods. The useable data included 376 cross-section time series observations. The fixed effects regression used 98 degrees of freedom. The R squared was in excess of 0.99.

Table 4. Model I Results

Variable Name	Coefficient Estimate	Standard Error
GDP_{t-1}	0.9501823	0.2443047
GDP_{t-2}	-0.411297	0.23894
$Population_{t-1}$	0.4836006	0.2055439
trend	0.0073712	0.0310638

As one illustration of the model's accuracy in predicting emissions, consider the chart below that maps actual and predicted emissions using within sample data for ten selected developing countries. The predicted value is never more than 1/4 of one percent away from the actual emissions average for any of the five year intervals.

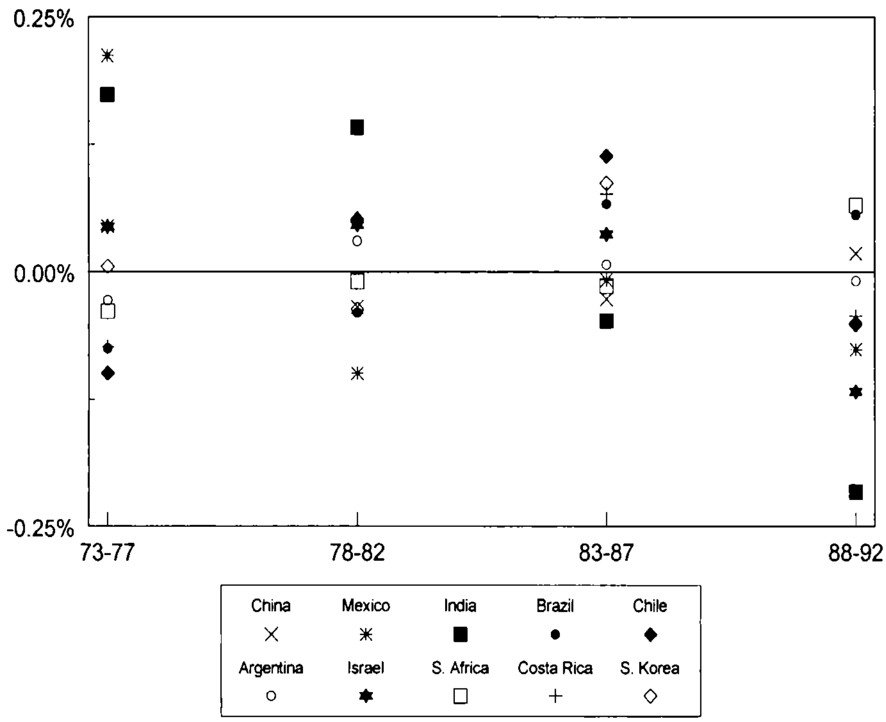


Chart 5. Error in Model I Prediction as a Fraction of Actual Emissions

MEMORANDUM

TO:	Art Fraas	395-7285
	David Gardiner	260-0275
	Joe Glauber	690-4915
	Victoria Greenfield	647-5713
	Jonathan Gruber	622-2633
	Howard Gruenspecht	586-5391
	David Hales	216-3174
	Abe Haspel	586-3047
	Jeff Hunker	482-4636
	Mark Mazur	586-9626
	Peter Orszag	456-2223
	Dan Reifsnyder	736-7336
	David Sandalow	456-2710
	Jeff Seabright	216-3230
	Ray Squitieri	622-1294
	Bob Tuccillo	395-5836

FROM: Joe Aldy

DATE:March 30, 1998

RE: Background paper on participation by developing countries

Attached you will find the latest version of our background paper on a target and trade proposal for developing countries. This is an update of the CEA paper listed under developing country commitments in the handout on post-Kyoto diplomatic policy papers distributed at last Wednesday afternoon's meeting at State Department. Given the interest expressed at that meeting and in subsequent conversations, we circulate this paper to provide you with more details underlying the developing country target and trade proposal. We consider this paper to be a document supplementing the target and trade proposal in the State Department developing countries paper distributed at last week's meeting.

We welcome all comments and suggestions you may have.

Pages to follow: 10

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:30-MAR-1998 13:49:25.00

SUBJECT: Meeting with Katherine Abraham

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

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

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

TEXT:
Jeff and Janet --

Katherine Abraham wants to brief us on their latest round of CPI adjustments (Particularly their use of geometric means.) They're planning on announcing this publicly in about 2-3 weeks, and she suggested it might be useful to us to get the briefing on this before it's publicly announced. I assume you're both more than willing to hold such a meeting.

Francine -- can you check our three schedules, find some available times (maybe toward the end of this week or early next week) and check with Katherine's secretary to see when she can come by? Thanks.

Becky

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:30-MAR-1998 16:28:12.00

SUBJECT: Re: Meeting with Katherine Abraham

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

TEXT:
I would be happy to have the chance to meet with Katherine on this.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:31-MAR-1998 14:35:55.00

SUBJECT: Timing of China Trip

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

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

TEXT:
Janet -
One reason you may want to come back from Paris before going to China is that the first quarter GDP (adv) will be released on Thursday, April 30.
As you know, that is always a big day for press and other briefings.
Michele

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Christopher D. Carroll (CN=Christopher D. Carroll/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 6-APR-1998 09:40:01.00

SUBJECT: Draft of CFR speech.

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:
Janet:
Here's my first stab at the speech for the Council on Foreign Relations. I'll get you a print copy as well. The last paragraph on Japan may need to be toned down a bit.
=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

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lyheedthemessagethatinternationalcapitalmarketshavebeensendingthemforalongtimen ow;indeed,wecanhopethattheEastAsiancrisiscouldprovetheclarioncallthatJapanhasne ededformanyyears.RRTTRR================= END ATTACHMENT 1 =================

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 6-APR-1998 14:37:00.00

SUBJECT: Comments on FOMC minutes from 2/3&4/98

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

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

TO: 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

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

TEXT:

While reading the just-released minutes from the February 3&4 FOMC meeting, the following phrases caught my eye--not because these phrases show a break from policy--but because they say directly (or at least as directly as the FOMC ever says) that the FOMC has backed away from the the notion of a preemtive strike against inflation (or against anything else). The Committee thinks that appropriate action can be delayed until the need becomes clear. Accordingly, the FOMC is not going to shoot at an overheated economy until they see the "whites of the eyes of increasing inflation," nor are they going to react to the Asian crisis until they see the real effects.

... the [FOMC] members....agreed that, under foreseeable circumstances, needed adjustments to policy probably could be made on a timely basis once the balance of underlying forces became more evident. Accordingly, a steady policy would not incur an unacceptable risk of a seriously deteriorating economic performance. In the interim, the greater risk would be to make a preemptive policy move on the basis of inadequate evidence regarding underlying economic trends.

...all members agreed that prevailing uncertainties indicated the desirability of retaining a symmetric instruction in the directive.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 7-APR-1998 18:41:01.00

SUBJECT: Adm vs. CBO

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

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

TEXT:
I just read the chapter on "Comparison of Economic Forecasts" in the CBO's An Analysis of the President's Budgetary Proposals for Fiscal Year 1999 --which arrived in the mail today.

The conclusion of this section is,

"The Administration's economic assumptions for the next six years differ little from those of the Congressional Budget Office, although the differences have noticeable effects on estimated surpluses in the later years of the projections."

The discussion dwells on two differences:
the CBO's higher inflation forecast (a consequence of their choice of a 5.8 NIIRU vs. our 5.4 NIIRU), and
Our richer income shares (we have a higher percentage of GDP in wages & salaries and profits). CBO notes that they have income growing slower than GDP as they forecast a shrinking statistical discrepancy. (Our statistical discrepancy is a constant share of GDP.)

Overall, I do not foresee any problems arising because of our small differences with CBO.

P.S. CBO projects an $8 billion surplus for this fiscal year.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 8-APR-1998 12:13:01.00

SUBJECT:

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

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

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

TEXT:
At yesterday's welfare implementation working group meeting, a staffer from DOL reported that three states have indicated no intention to apply for federal Welfare to Work funds: Idaho, Utah, and Mississippi. Idaho and Utah are awash in funds due to a large caseload decline. Mississippi should be a greater concern, and DOL intends to speak further with them. Mississippi presents a troubling case of substantial "need" (it is, after all, the state with the second-highest poverty rate in the nation after N ew Mexico, with 1995-1996 poverty rate of 22.1). But there is an apparent lack of political will there to provide additional services to move the welfare poor to work.

Again, DOL is investigating further.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 8-APR-1998 16:01:35.00

SUBJECT: Estimates of FY 98 surplus

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

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

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

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

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

TEXT:
1) CBO

CBO's monthly budget review (dated Monday) hints that the FY 98 surplus
will be $18 billion.

The complete quote is:

"The cumulative deficit through March is estimated to be about $40
billion below the
comparable level recorded a year ago. If the cumulative surplus for
April through September
matches last year's performance, the fiscal year will end with an $18
billion surplus

Off the record, my source at CBO said that he thought the surplus would be
about $20-25 billion

2) Goldman Sachs

$40 billion

3) ISI Group $60 billion

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-APR-1998 12:49:57.00

SUBJECT: Title for CFR speech

TO: Christopher D. Carroll (CN=Christopher D. Carroll/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:
CFR needs a title for Janet's speech. Any suggestions?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-APR-1998 10:57:49.00

SUBJECT: implementation of LDC targets

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

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

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

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

TEXT:

We should be gratified that the CEA proposal (to ask LDCs to agree to targets at or near BAU) has recently had an influence on US policy. But it is important that we (CEA) stay a step ahead of everyone else with regard to how carefully we have thought through the specific questions that need to be decided, and our preferred answers to those questions. In writing last week's WEB article, I think we came to realize that we need to think and talk more about some specifics among ourselves (in particular, the pros and cons of pre-Kyoto BAU vs. post-Kyoto BAU). The attached one-pager is meant to facilitate such a discussion, at least among ourselves (and possibly more widely thereafter).

Let's all try to talk about this very soon.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D78]MAIL41573489P.026 to ASCII,
The following is a HEX DUMP:

Preliminary, close hold

JF, 4/9/98

TARGETS FOR DEVELOPING COUNTRIES

This note lists five questions that must be answered in considering alternative possible specific versions of the CEA proposal that LDCs be asked to accept emissions targets "at or near" their forecasted BAU paths.

To begin, it goes without saying that :

- there is always a tradeoff between the environmental benefits of bigger cuts vs. the economic costs. More specifically,
- aggressive cuts relative to the expected pre-Kyoto BAU path will be even more firmly opposed by the LDCs than the BAU path itself; while
- increases relative to the pre-Kyoto BAU path (e.g., ratifying forecasted leakage from the Kyoto agreement) will be firmly opposed by environmentalists.

(1) Should the explicit goal (in the first commitment period) be:

- post-Kyoto BAU (including estimate of leakage)
- pre-Kyoto BAU, or
- pre-Kyoto BAU minus some percentage?

(2) Should the goal be implemented in the form of:

- numbers negotiated internationally by diplomats over the next few years
- numbers produced by a body of "objective experts" over the next few years
- a formula to be agreed now, with specific numbers determined in 2007
- a formula to be agreed now, with numbers determined contemporaneously in 2008-2012 ?

(3) If it is to be a formula, which of the following variables should be included?

- GDP
- population
- pre-Kyoto emission levels
- time trend
- other

(4) If it is to be a formula, how should the weights on the variables be determined?

- pure cross-section statistical estimates using past data
- time-series or panel-data statistical estimates using past data
- negotiated common formula
- negotiation of different formulas for different countries

(5) Should there be any general presumption that the approach (e.g., the choice of variables to enter the formula) might be applied not only to LDCs in 2007-2012, but also to

- LDCs in subsequent commitment periods (presumably with further cuts)?
- Annex I countries in the future as well, with a goal in the (very) long run of a common

formula to apply to all countries?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-APR-1998 10:27:27.00

SUBJECT: Information from DPC on status of proposals to restore Food Stamp eligibility for immigrants

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

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

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

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

TEXT:
---------------------- Forwarded by Sanders D. Korenman/CEA/EOP on
04/09/98 10:23 AM ---------------------------

Diana Fortuna
04/09/98 10:10:04 AM
Record Type: Record

To: Sanders D. Korenman/CEA/EOP
cc:
bcc:
Subject: Re:

Here is a blurb I wrote on this last week for our weekly report that explains where we are. The outlook for this passing right away continues to be very clouded -- Sen. Gramm is arguing against it, Lott is holding it, so this may go nowhere. The Administration was very involved in negotiating this package. They only had about $800m to spend for this, so we tried to get the best $800m we could. If we get this we will continue to argue to get the balance of our $2.5 billion request, but getting that will be even harder than getting this.

Agreement Reached to Restore Food Stamps to Legal Immigrants -- A conference committee reached agreement last week on a plan to restore $818 million over five years in food stamps to legal immigrants. The President,s budget proposed to restore $2.5 billion for this purpose. However, the bill,s prospects for passage on the Senate floor are somewhat clouded. Sen. Lott has now put a hold on the bill because he wishes to use the bill,s funding sources for transportation purposes.

The conference agreement reflects the Administration,s request for refugees and asylees, the Hmong, and the disabled. For refugees and asylees, it would lengthen from 5 to 7 years the period of time that they are eligible for food stamps after they arrive in the U.S., giving them more time to naturalize. Hmong immigrants from Laos who assisted the U.S. in Vietnam and then came to the U.S. War would remain eligible for food stamps. Disabled legal immigrants who entered the country before welfare reform was passed and who became disabled after they entered the country would also retain food stamps.

The agreement differs from the Administration,s proposal in two respects. First, it will provide food stamps for children who were here when the law was signed, but not their parents. The President's budget would cover both children and their parents, and both those here when the law was signed and those who arrived after. Second, the agreement will retain eligibility for the elderly who were 65 or older and in the U.S. when the welfare law was signed. Our budget proposal would have gone further, also providing benefits to those who were in the country when the law was signed and who subsequently turn 65.

A major source of funding for these restorations is a cutback in funding for food stamps administrative costs, based on the rationale that states are able to claim these costs twice, under both food stamp and the TANF block grant. States dispute this rationale.

Sanders D. Korenman
04/08/98 06:27:13 PM
Record Type: Record

To: Diana Fortuna/OPD/EOP
cc:
Subject:

Do you have anything on Administration's vs. congressional proposals for restoration of immigrant eligibility for Food Stamps. I am looking for a simple description of how they differ.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:10-APR-1998 17:02:14.00

SUBJECT: Re: web briefing

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

TEXT:
We are not scheduled to see the President next week--he is off to Chile on Thursday--but we are expecting to see him the following week. I don't know at this point what I will want to talk about two weeks from now, assuming that the WEB actually happens, but I will keep in mind your interest in having this topic discussed as well as your interest in coming as it gets nearer. Thanks for writing such a good article.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:10-APR-1998 12:12:20.00

SUBJECT: Jon Orszag complaint

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

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

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

TEXT:
FYI -- Jon called to complain that he thought the Car Insurance Premiums WEB piece came too close to making policy conclusions. He said that the piece was ok up to the conclusion section.
I told him that I'd pass on his concerns. (and for what it's worth, he sounded slightly irritated, but it don't sound like it was too serious of a thing)

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:10-APR-1998 17:14:32.00

SUBJECT: LDC targets: revised version

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

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

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

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

TEXT:
The revisions are my attempt to reflect what we thought in our meeting
today.=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D46]MAIL45872699Y.026 to ASCII,
The following is a HEX DUMP:

Preliminary, close hold

JF, 4/9/98

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- pre-Kyoto BAU, or
- pre-Kyoto BAU minus some percentage?

(2) Should the goal be implemented in the form of:

- numbers negotiated internationally by diplomats over the next few years
- numbers produced by a body of "objective experts" over the next few years
- a formula to be agreed now, with specific numbers determined in 2007
- a formula to be agreed now, with numbers determined contemporaneously in 2008-2012 ?

(3) If it is to be a formula, which of the following variables should be included?

- GDP
- population
- pre-Kyoto emission levels
- time trend
- other

(4) If it is to be a formula, how should the weights on the variables be determined?

- pure cross-section statistical estimates using past data
- time-series or panel-data statistical estimates using past data
- negotiated common formula
- negotiation of different formulas for different countries

(5) Should there be any general presumption that the approach (e.g., the choice of variables to enter the formula) might be applied not only to LDCs in 2007-2012, but also to

- LDCs in subsequent commitment periods (presumably with further cuts)?
- Annex I countries in the future as well, with a goal in the (very) long run of a common

formula to apply to all countries?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Christopher D. Carroll (CN=Christopher D. Carroll/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:13-APR-1998 11:06:57.00

SUBJECT: Speech.

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

TEXT:
Janet:
Here's the CFR speech.

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

TEXT:
WPC
R#GWrmY#ziFClnE`KaP]Ytq9=5r4
F wp4_Ic|WFLe=dmfc)~]f51@elQj> V&6]HZ^<J}b_Fb Y?AE}^g|0-.t3SaGT]2Bk8yS*"W>#*w
x /d[!WF
|~ dc7q<&Lt:lDXt7EZ^L/7^N$DPc.Y;GRAX^m s4_6!FrD_pMO^Sd,u!>/X1%#?oy;*
#UN %0(2w@E4Local PrinterWINSPOOL0(9 Z6Times New Roman RegularX($C:\PROGS\WP\ST
ANDARD.WPT
aEbcdeEfghiEjE$3|xj
!Thankyou.Iamdelightedtohavethisopportunitytodiscussrecenteventsin Asiawithsucha broadanddistinguishedarrayofthinkersoninternationaleconomicissues.Iwouldliketos pendmytimetodayonthreetopics:WhatwerethefundamentalcausesoftheEastAsiancrisis;h owappropriatehastheresponseoftheIMFandtheinternationalcommunitybeen;andwhatcons equencesmightthecrisishaveforcountriesbothwithinandoutsideofEastAsia.Expostat temptstoidentifythefundamentalcausesofafinancialcrisisalwayssufferfrom p thepro blemofdistinguishinginsightfromhindsight.Anyfinancialjournalisttodaycantellyout hatthecrisiswastheinevitableconsequenceofovervaluedexchangerates,largecurrentac countdeficits,shorttermcapitalinflows,opaquefinancialsystems, cronycapitalism,m oregenerallytheproblemsofthe Japanesemodelofcapitalmarkets,oroneofseveralothers upposedlyfatalflawsinEastAsiancapitalism.Butitseemsfairtosaythatayearagonobodys uspectedthatsuchacalamitywasremotelypossible,althoughallofwhatarenowdescribedas thefatalflawsoftheEastAsianeconomieswerereasonablywidelyunderstoodeventhen,atle astbyexperts.Indeed,asrecentlyastheearly1990seconomistsweredebatingvigorouslywh ethertheJapanesemodelofcapitalmarketswassuperiortothe AngloSaxonmodel.Thereas onfortherecentwidespreadadmirationofbothfinancialandnonfinancialaspectsofEastAs ianeconomiesisobvious:thesecountriesmusthavebeendoingsomethingveryright,)$(be causeoverthecourseofthelastthirtyyearsorsotheyachievedthesinglegreatestspurtofe conomicgrowthinthehistoryofmankind.Thereislittledisputeabouttheimportanceofsome @-(, ofthethingsthesecountriesgotright:highsavingrates,rapidlyincreasinglevels ofeducation,andhardwork.Theroleofthesecountries'financialsystemsinfosteringgrow thmaybemoremurky,butitisatleastclearthattheflawsofthosefinancialsystemswerenots ufficienttopreventsomeremarkableaccomplishments.Akeyelementinanysuccessfulexpla nationoftheEastAsiancrisismustthereforebeananswertothequestionofhowasystemthatw

orkedsowellforsolongcouldsuddenlyfail.Oneproblemincomingupwithanoverarchingex
planationoftheEastAsiancrisisisthattheafflictedcountriesdifferfromeachotherinma
nyimportantrespects.Still,attheriskofovergeneralizing,Ithinkthesecountriesdosha
resomeimportantsimilaritiesthatarelikelyattheheartoftheproblemstheyhaveallsuffe
red.Inparticular,thecrisiscountriesfavoredcentralizedandbehindthescenesmechanis
msfortheallocationofcapital.Theparticularinstitutionsvariedfromthecaptivebankso
ftheKoreanchaebolstothefinancecompaniesofThailandto governmentlinkedbanksinIn
donesia,butingeneralalargepartofcapitalallocationswerenotmadebyadecentralizedop
encapitalmarketviaarmslengthtransactions;instead,decisionsweremadeoutofthepubli
ceyeandoftenwerebasedonpersonalandbusinessrelationshipsorgovernmentalinfluencem
orethanonreliableaccountingorotherinformationabouttheborrowersortheirinvestment
projects.Itisusefultorecallagainthatthissystemworkedremarkablywellforalongtim
e.Relianceonpersonal,business,orgovernmentaltiesintheallocationofcapitalapparen
tlycanworksolongastheultimateinvestmentdecisionsaregenerallysoundandsaversretai
ntheir h+&* confidenceinthatsoundness. @-(, OnethingwemayhavelearnedfromtheEa
stAsianexperienceisthatinthelongrun,relianceonsuchbehindthescenesrelationshipsf
orcapitalallocationmayleadtoincreasinglypoorinvestmentdecisions.Oneplausibleexp
lanationmightcomefromsupposingthatatearlystagesofdevelopment,therearemanyobviou
shighreturninvestmentstomake,butatlaterstages,afterthelowhangingfruithasbeenplu
cked,expectedreturnsfrominvestmentprojectsarebothlowerandhardertoperceive. Rela
tionshiplendingwouldworkatearlystagesofdevelopmentbecausetheborrowerstandstorea
plargeeconomicrewardsfrompursuingthehighreturnprojects,butmightbreakdownatlater
stagesbecausewhenoveralleconomicreturnsarelowertheborrowermaybetemptedtoindulge
inprojectswithnoneconomicsidebenefitssuchasempirebuildingorinternationalprestig
eorevendirectmonetarycompensationstotheborrowerlike commissions.Still,itisimpor
tanttoemphasizethatthesecommentsaresomewhatspeculative;whileanecdotesaboundabou
tpoorinvestmentdecisionsinEastAsiainthelastfewyears,theevidenceforalargeandgene
raldeteriorationinexanteinvestmentquality isbynomeansoverwhelmingatthispoint,
althoughthereiscertainlysomeevidencethatexpost returnsinthelastfewyearspriorto
thecrisiswerelowerthanpreviousreturnshadbeen.Of course,analternativeexplanatio
nfortheimmediateprecrisisdeclineinreturnsisthatitreflectstheslowdowningrowththa
tmostEastAsiancountriesexperiencedatthetime.Note,however,that,totheextentthatth
eprecrisisgrowthslowdownwasinterpretedasevidenceofapermanentdownshiftingofthese
countriesgrowthengines,itcouldhavehadanegativeeffectonexpectedfuturereturnsjust
asrealasanyeffectassociatedwithincreasinglypoorinvestmentchoices.Regardlessof
whetherornottherewasarealdeteriorationininvestmentqualitybefore @-(, thecrisis,
whatdoesseemclearfromtheEastAsiancrisisisthata relationshipsmodelofcapitalalloc
ationisextraordinarilysusceptibletoadeteriorationinperceptionsaboutthequalityof
investmentdecisions.Ifdepositorswhohadpreviouslybeenwillingtorelyonpastperfor
manceasaguaranteeoffuturesuccesssuddenlybecomeconcernedthatcapitalallocationdec
isionsmay 8
havegoneawry,thelackoftransparentanddirectinformationonthequalityofinvestmentd
ecisionscanbeafatalblowtomarketconfidenceinthequalityofthosedecisions.Evenifman
yormostofthecapitalallocationdecisionshavebeensound,thelackofinformationmeansth
atsaverscannotproperlyevaluatewhichbanksorchaebolsorotherinstitutionshavemadego
od decisionsandwhichhavemadebadones,andthiscanleadthemtodecidetowithdrawtheir
capitalfromallinstitutionsindiscriminately.Becausethelongterminvestmentsthathav
ebeenundertakenonthebasisofthoseshorttermdepositscannotbeliquidatedexceptatenor
mouslosses,suchadeteriorationinconfidencecanbringtheentirefinancialsystemtotheb
rinkofcollapse.Thisinterpretationhelpsresolvetheproblemthatitisdifficulttoide
ntifyaconsistentmacroeconomicexplanationofthecrisisthatworkswellinallaffectedco
untries.Overvaluedexchangerateswereperhapsaprobleminsomecountriesbutnotall;thec
urrentaccountdeficitwaslargeinThailandbutsmallinKorea;theslumpinthesemiconducto
rindustryposedlargeproblemsinKoreabutfewinIndonesiaorThailand;andsoon.If,howeve

r,thefundamentaltriggerofcrisisineachcasewasadeclineininvestors'confidenceinthe soundnessofthelongterminvestmentsbackinguptheirshorttermdeposits,thentherewould benonecessaryreasontoexpectthesamemacroeconomicprecursorsineachcase.Instead,ina financialsystemorganizedaroundrelationshipsratherthaninformation,theconfidenceo finvestorsinthe @-(, soundnessofrelationshiplendingitselfisanabsolutefundamenta l.Andthepotentialforcontagionfromonecountrytoanothermaydependmoreontheextenttow hichinvestorsperceivesimilaritiesbetweenthetwocountries'financialsystemsthanont heextentofactual ` similarity.Oneironyofthisinterpretationisthattheextensivep resscoverageofthecrisis,andtheviewcommonlyexpressedinthepressthatthecrisisrevea ledthefailureofanEastAsianorJapanesemodelofcapitalism,mayactuallyhavesubstantia llyacceleratedandexacerbatedtheffailureofthatmodelffproblemsf.gAgain,thepointis ggButagainthepointshouldbemadegthatatransparentfinancialsysteminwhichinvestorsc anjudgethesoundnessofbanksandcorporationsonthebasisofobjectiveandreliabledatawo uldhavebeenmuchlessvulnerabletosuchcontagion.Anotherimplicationofthisinterpre tationofthecrisisisthatthosewhodecrythebuildupofshorttermforeigndebtintheprecri sisperiodhmayhhaveapoint.EnormousamountsforeignbankloansfloodedintotheEastAsian countriesoverthepastfewyears,oftenatinterestratesthatreflectedonlyaverymodestri skpremiumrelativetosafeinvestmentsathome.Thelowriskpremiamanyhavereflectedabeli efthat,eveninthosecountrieswithoutexplicitdepositors'insurance,governmentscould neverallowwholesalebankfailuresandthereforeinvestors'moneyeffectivelyhadagovern mentguarantee.Itispreciselythesesortsoflenderswhoaremostlikelyandmostabletoacti nwaysthatendangerthestabilityofthefinancialsystem.Becausetheyareearningonlymode striskpremia,ittakesonlyamodestincreaseintheperceptionofrisktoconvincethemtowit hdrawtheircapitalwhentheirloansexpire.Sinceshorttermloansbydefinitionexpirerela tivelyquickly,massiveshorttermlendingatlowriskpremiaispreciselythe @-(, combina tionoffactorsmostlikelytoleadtosuddenandmassivecapitalflight.Thispointleadsme tomyfirstremarksontheresponseoftheIMFtothecrisis.Somecommentatorshavearguedthat thelongtermhealthoftheinternationalfinancialsystemhasbeenjeopardizedbythewillin gnessoftheIMFtocometotherescueofthesecountries.Accordingtothisview,theforeignle ndersneedtolosesomemoney,preferablyalotofmoney,inordertodiscouragethemfromengag inginsimilarbehavior,andcausingsimilarcrises,inthefuture.WhileIheartilyagreet hatirresponsiblelendersshouldnotbebailedout,itturnsouttobeextraordinarilydiffic ulttopunishsuchlenderswithoutcausingcatastrophicconsequencesintheaffectedcountr iesandperhapselsewhere.Onceagainthelackoftransparencyinthefinancialsystemisacri ticalproblem,becausepotentialsuppliersofnewcapitalstillcannotdistinguishthegood borrowersfromthebad.Ifexistingdebtisdefaultedon,thelikelyeffectwouldbetocauseac ompletewithdrawalofcapitalfromtheaffectedcountrypotentiallyleadingtoacompletefi nancialmeltdown.ItissimplynotacceptabletosaythatThailandshouldbedestroyedinorde rtopunishJ.P.Morgan.Thetrickistofindmethodsbywhichlenderscanbeforcedtotakeafi nancialhitwithoutjeopardizingthestabilityofthefinancialsystem.Perhapsthemoststr aightforwardsolutionwouldbetoencouragecapitalflowstotaketheformofequityandbondi nvestmentsratherthanbanklendinginaforeigncurrency.Pricesinstockandbondmarketsad justtochangesinperceivedriskautomaticallyandinwaysthatcanposesubstantiallylesss ystemicriskthanforeigncurrencydenominatedshorttermloans.Theproblemwiththissolut ionisthatinordertofunctionwell, @-(, stockandbondmarketsrequiretimely,honest,an dcrediblereportingoffirms'financialcircumstancesinotherwords,atransparent,wellr egulated,andwellfunctioningsetofpubliccapitalmarkets.Buildingsuchmarketsisalong termchallenge,notashorttermfix.Onthewhole,theIMFseemstohaverecognizedtheuniqu echaracteroftheEastAsiancrisisandtohavereactedappropriatelyhh:a``aThedimensiona longwhichtheEastAsianprogramsdiffermostmarkedlyfromanypreviousIMFprogramisinthe iremphasisontheimportanceoftransparency,openness,andaccountabilityincapitalmark ets.DeputyTreasurySecretarySummersrecentlyremarkedthatoneofthemosthopefulsignsh ehasseenthattheIMFprogramsarehavingtherighteffectcamefromaconversationwithateac herofnightschoolcoursesinaccounting,whosaidthatinpreviousyearshehadnormallyhad2

2studentsinhiswintertermclasses,butthisyearhehad385.Asforthelongertermagendaf
orthereformofinternationalfinancialinstitutions,theclearestimperativeistodevelo
pmoretimely,comprehensive,andreliablefinancialinformationforIMFmembercountries.
ThisprocessisalreadyunderwayundertheauspicesoftheIMF'sSpecialDataDisseminationS
tandard,butthescope,accuracy,andtimelinessofthedataprovidedneedtobeimproved.Afu
rtherimperativeistofostertheadoptionofstrongbankandfinancialregulatoryinstituti
onsinallIMFmembercountries.Onelessonthatemergesfromboth——theEastAsiancrisisandman
ypreviouscrisesisthattheinteractionbetweenhighlyliquidglobalcapitalmarketsandpo
orlyregulated,poorlysupervisedlocalfinancialsystemsbcanbbtendstobleadtodisaster
.[Metaphorofsuperhighwaysandofframps,orjetairlinersanddirtrunways]. @-(, This
leadsmeatlasttoconsiderationoftheconsequencesoftheEastAsiancrisisforforeignrela
tions.Hereonecouldadopteitheranoptimisticorapessimisticview.Pessimismmightargue
thatthecrisisislikelytoleadtoturninginward:increasingtradefrictions,increasingt
radebarriers,arisingsurgeofprotectionism,andinparticularaclosingofinternational
capitalmarketstoforeigninvestment.Theworstcasescenariosherecanbequiteawful,andI
havenoappetitetospinthemout.Fortunately,earlyindicationsareofamuchmorebenignout
come,atleastincountriesotherthanIndonesia.Thecrisiscountrieshaveexpressedremark
ablystrongcommitmenttomaintainingopentrade.AndtheelementsoftheIMFprogramsemphas
izingtransparencyandopennessofcapitalmarketsseemtobemakingconsiderableheadway,e
speciallyinKorea,whichisfortunatetohaveasitsnewPresidentamanwhohasapassionateco
mmitmenttoanopensocietyinwhichbehindthescenesdominationbygovernmentandchaebolsb
ecomesa p thingofthepast.Iamoptimistic,too,abouttheimpactintheUnitedStatesan
dEurope.WhilethecrisiswillalmostsurelyleadtoasubstantialincreaseintheUStradedef
icitwithEastAsia,andtoanassociatedslowdowningrowth,anegativeshocktoaggregatedem
andcouldhardlycomeatabettertime.Thefinancialmarkets'consensusisthattheEastAsian
crisishasheadedoffanincreaseininterestrates,andtheneteffectonGDPgrowthislikelyt
obemodest.ThereisthefurthersidebenefitthatthesharpdeclinesinAsiancurrenciesandt
heconsequentdeclineinthedollarpriceofimportsfromthatregionwillprovideatransitor
ydampeninginfluenceoninflation.Ofcourse,adeterioratingtradebalancecancauseapoli
ticalbacklashevenifaggregatemacroeconomiceffectsaremodestorpositive,andtheAdmin
istrationwillneedtobepreparedtofighthardtokeeptheUSfromturninginwardinresponset
othosepressures.Atthemomentthe @-(, toppriorityistosecureaproposedadditiontothe
IMFscapitalbase,andthistaskhassomeurgencybecauseitislikelytobehardertoachieveaf
terabigsurgeinthetradedeficit.Insum,theAdministrationremainsdeeplycommittedtoma
intainingandbuildingontheworldsincreasinglyopentradingsystemandtheinternational
institutionsthatpreservethatsystem;giventheoverallstrengthoftheUSeconomyitseems
likelythatanypoliticalconsequencesofarisingtradedeficitcwillccshouldcbemanageab
le.ConsequencesofthecrisisforWesternEuropewillbesomewhatdifferent;Europeanban
kshadmoreexposurethanAmericanbankstotheEastAsianeconomiesandwilllikelyhavetowri
teofflargerlosses.Ontheotherhand,EuropeantradewithEastAsiaissomewhatsmallerthan
thatoftheUnitedStates,sotheteeffectontradebalancesmaybesmaller.Onthewhole,thec
risisappearsnomorelikelytohavealargeeffectinEuropethanintheUnitedStates.Thegr
eatestcauseofconcernaboutinternationalrepercussionsofthecrisishastodowithJapan.
JapanesebankswereratherheavilyexposedtoEastAsia,and,unlikebanksintheUSorEuropet
heconditionoftheJapanesebankingsystemwasfragileevenbeforethecrisis.Still,thepro
blemsEastAsiaposesforJapanaresmallcomparedtothatcountryshomegrownproblems.While
EastAsiacouldinprinciplebethestrawtobreaktheJapanesecamel'sback,itisalsopossibl
ethattheapparentcollapseoftheJapanesemodelofcapitalmarketsabroadwillfinallypers
uadetheJapaneseauthoritiestotakedecisiveactiontoaddressthelongtermproblemsfacin
gthatcountry.Thegreatestdangertotheinternationalfinancialsystemremainsacollapse
inJapan,ratherthananyfurtherdeteriorationintherestofEastAsia.Hereagain,themantr
aoftransparency,openness,andsoundprudentialbankregulationneedstoberepeated.Ifth
e @-(, Japaneseauthoritieshadacteddecisivelytocleanuptheirbankingsystemintheear
ly1990s,andhadinstitutedthenthebankingreformsthatareevennowbeinghesitatedover,i

tseemslikelythatJapancouldhaveavoidedmuchofitseconomicstagnationofthepastseveny ears.LetushopethattheJapaneseauthoritieswillfinallyheedthemessagethatinternatio nalcapitalmarketshavebeensendingthemforalongtimenow;indeed,wecanevenhopethatthe EastAsiancrisiscouldprovetheclarioncallthatJapanhasneededformanyyears.iij je edNotealsothatanalternativeinterpretationoftheprecrisisdeteriorationininvestm entperformanceisthatitreflectstheeffectofanunanticipateddeclineinoverallgrowthr ates.Thisisapotentiallyimportantpoint,becausetotheextentthatIftherateofreturnon individualinvestmentprojectsdependspartlyontheoverallaggregategrowthrate,adecli neingrowthcanleadtoadeteriorationinreturns;futhermore,adeclineinanticipatedfutu regrowthratescanhaveadramaticeffectonassessmentsofdebtcarrying capacity,since borrowersinafastgrowingcountrymightbeexpectedtobeableto growintoevenlargefuture debtpaymentswhileborrowersinaslowergrowingcountrymightnot.Hence,analternativein terpretationIftherateofreturnonanyinvestmentprojectisinfluencedbytheoverallgrow thrateoftheeconomyasawholethenperhapsmostborrowerscanbeexpectedto growintotheir futuredebtpaymentburden,butdebttakenonunderanassumptionofhighgrowthcouldbedisas trousifgrowthslows.d================= END ATTACHMENT 1 =================

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:13-APR-1998 17:22:52.00

SUBJECT: current version of 1-p. LDC target questions

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

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

TEXT:
Just to be sure everybody has it. The revisions were minor.=================== ATTACHMENT 1
===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D46]MAIL42155820D.126 to ASCII,
The following is a HEX DUMP:

Preliminary, close hold

JF, 4/12/98

TARGETS FOR DEVELOPING COUNTRIES

This note lists six questions that must be answered in considering alternative possible specific versions of the CEA proposal that LDCs be asked to accept emissions targets "at or near" their forecasted BAU paths.

To begin, it goes without saying that :

- there is always a tradeoff between the environmental benefits of bigger cuts vs. the economic costs. More specifically,
- aggressive cuts relative to the expected pre-Kyoto BAU path will be even more firmly opposed by the LDCs than the BAU path itself; while
- increases relative to the pre-Kyoto BAU path (e.g., ratifying forecasted leakage from the Kyoto agreement) will be firmly opposed by environmentalists.

(1) Should the explicit goal (in the first commitment period) be:

- post-Kyoto BAU (including estimate of leakage)
- pre-Kyoto BAU, or
- pre-Kyoto BAU minus some percentage?

(2) Should the goal be implemented in the form of:

- numbers negotiated internationally by diplomats over the next few years
- numbers produced by a body of "objective experts" over the next few years
- a formula agreed now, contingent on future data
- submissions from countries as to how they propose to determine their own BAU (including the possibility of a formula), subject to a process of expert review / international approval

(3) If it is to be a formula, should it be:

- with specific numbers determined in 2007 contingent on data available then
- with numbers determined contemporaneously in 2008-2012 ?

(4) If it is to be a formula, which of the following variables should be included?

- GDP
- population
- pre-Kyoto emission levels
- time trend
- other

(5) If it is to be a formula, how should the weights on the variables be determined?

- chosen by international body of "objective experts"
- pure cross-section statistical estimates using past data
- time-series or panel-data statistical estimates using past data
- negotiated common formula
- negotiation of different formulas for different countries

(6) Should there be any general presumption that the approach (e.g., the choice of variables to enter the formula) might be applied not only to LDCs in 2007-2012, but also to

- LDCs in subsequent commitment periods (presumably with further cuts)?
- Annex I countries in the future as well, with a goal in the (very) long run of a common formula to

apply to all countries?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Sarah J. Reber (CN=Sarah J. Reber/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:14-APR-1998 10:02:58.00

SUBJECT: Lunch seminar with former CEA Chairs

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

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

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

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

TEXT:
Janet,

Becky suggested that I try to invite some of the former Chairs of CEA who are in the area (Herb Stein, Alan Greenspan, Charlie Schultze, and Joe Stiglitz) to a Friday lunch seminar to share their thoughts about CEA and how it has changed. I think that this is a great idea and everyone would really enjoy it.

If you agree, though, I think that it would be nicer (and more likely to elicit a positive response) if you invited them. I would also like to be sure choose a time when you, Becky, and Jeff are able to come. Let me know if you have any thoughts on the invite list, format, timing, etc. I can coordinate scheduling with Alice.

Thanks,
Sarah

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-APR-1998 18:45:34.00

SUBJECT: Asia Speech: Comments from Treasury & other relevant friends

TO: Michele Jolin (CN=Michele Jolin/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:
-- Page 7: second paragraph: Instead of "at least in countries other than Indonesia," accentuate the positive "particularly in Thailand and South Korea."

-- Page 8: first paragraph (continued from page 7): Take out sentence "At the moment, the top priority is ..." Instead, say that:

It is particularly important that Congress provide the International Monetary Fund with resources it needs to help stabilize Asian economies. The crisis in Asia poses a threat to American jobs and exports, and we already have seen evidence that weaknesses in economies there are having an impact here. To ensure that the American economy continues on the path of steady growth, Congress must make sure that the IMF is strong enough to respond to any broadening of the current crisis.

-

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-APR-1998 13:55:54.00

SUBJECT: Council on Foreign Relations Speech

TO: Michele Jolin (CN=Michele Jolin/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.D36]MAIL44273530D.126 to ASCII,
The following is a HEX DUMP:

Lessons from the Asian Crisis

Janet Yellen

Council on Foreign Relations, April 15, 1998

Thank you. I am delighted to have this opportunity to discuss recent events in Asia with such a broad and distinguished array of thinkers on international economic issues.

I would like to spend my time today on three topics: What were the fundamental causes of the East Asian crisis; how appropriate has the response of the IMF and the international community been; and what consequences might the crisis have for countries both within and outside of East Asia.

Ex post attempts to identify the fundamental causes of a financial crisis always suffer from the problem of distinguishing insight from hindsight. Any financial journalist today can tell you that the crisis was the inevitable consequence of overvalued exchange rates, large current account deficits, short-term capital inflows, opaque financial systems, "crony capitalism," more generally the problems of the "Japanese model" of capital markets, or one of several other supposedly fatal flaws in East Asian capitalism. But it seems fair to say that a year ago nobody suspected that such a calamity was remotely possible, although all of what are now described as the fatal flaws of the East Asian economies were reasonably widely understood even then, at least by experts. Indeed, as recently as the early 1990s economists were debating vigorously whether the Japanese model of capital markets was superior to the "Anglo-Saxon model."

The reason for the recent widespread admiration of both financial and nonfinancial aspects of East Asian economies is obvious: these countries must have been doing *something* very right, because over the course of the last thirty years or so they achieved the single greatest spurt of economic growth in the history of mankind. There is little dispute about the importance of some of the things these countries got right: high saving rates, rapidly increasing levels of education, and hard work. The role of these countries' financial systems in fostering growth may be more murky, but it is at least clear that the flaws of those financial systems were not sufficient to prevent some remarkable accomplishments. A key element in any successful explanation of the East Asian crisis must therefore be an answer to the question of how a system that worked so well for so long could suddenly fail.

One problem in coming up with an overarching explanation of the East Asian crisis is that the afflicted countries differ from each other in many important respects. Still, at the risk of overgeneralizing, I think these countries do share some important similarities that are likely at the heart of the problems they have all suffered. In particular, the crisis countries favored centralized and behind-the-scenes mechanisms for the allocation of capital. The particular institutions varied from the captive banks of the Korean *chaebols* to the finance companies of Thailand to government-linked banks in Indonesia, but in general a large part of capital allocations were not made by a decentralized open capital market via arms-length transactions; instead, decisions were made out of the public eye and often were based on personal and business relationships or governmental influence more than on reliable accounting or other information about the borrowers or their investment projects.

It is useful to recall again that this system worked remarkably well for a long time. Reliance on personal, business, or governmental ties in the allocation of capital apparently can work as long as the ultimate investment decisions are generally sound *and* savers retain their confidence in that soundness. _

One thing we may have learned from the East Asian experience is that in the long run, reliance on such behind-the-scenes relationships for capital allocation may lead to increasingly poor investment decisions. One plausible explanation might come from supposing that at early stages of development, there are many obvious high-return investments to make, but at later stages, after the low-hanging fruit has been plucked, expected returns from investment projects are both lower and harder to perceive. "Relationship lending" would work at early stages of development because the borrower stands to reap large economic rewards from pursuing the high-return projects, but might break down at later stages because when overall economic returns are lower the borrower may be tempted to indulge in projects with non-economic side benefits such as empire-building or international prestige or even direct monetary compensation to the borrower like "commissions." Still, it is important to emphasize that these comments are somewhat speculative; while anecdotes abound about poor investment decisions in East Asia in the last few years, the evidence for a large and general deterioration in *ex ante* investment quality is by no means overwhelming at this point, although there is certainly some evidence that *ex post* returns in the last few years prior to the crisis were lower than previous returns had been.—_Of course, an alternative explanation for the immediate pre-crisis decline in returns is that it reflects the slowdown in growth that most East Asian countries experienced at the time. Note, however, -that, to the extent that the pre-crisis growth slowdown was interpreted as evidence of a permanent downshifting of these countries' growth engines, it could have had a negative effect on expected future returns just as real as any effect associated with increasingly poor investment choices.

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Regardless of whether or not there was a real deterioration in investment quality before the crisis, what does seem clear from the East Asian crisis is that a "relationships" model of capital allocation is extraordinarily susceptible to a deterioration in *perceptions* about the quality of investment decisions. If depositors who had previously been willing to rely on past performance as a guarantee of future success suddenly become concerned that capital allocation decisions *may* have gone awry, the lack of transparent and direct information on the quality of investment decisions can be a fatal blow to market confidence in the quality of those decisions. Even if many or most of the capital allocation decisions have been sound, the lack of information means that savers cannot properly evaluate which banks or *chaebols* or other institutions have made good decisions and which have made bad ones, and this can lead them to decide to withdraw their capital from all institutions indiscriminately. Because the long-term investments that have been undertaken on the basis of those short-term deposits cannot be liquidated except at enormous losses, such as a deterioration in confidence can bring the entire financial system to the brink of collapse.

This interpretation helps resolve the problem that it is difficult to identify a consistent macroeconomic explanation of the crisis that works well in all affected countries. Overvalued exchange rates were perhaps a problem in some countries but not all; the current account deficit was large in Thailand but small in Korea; the slump in the semiconductor industry posed large problems in Korea but few in Indonesia or Thailand; and so on. If, however, the fundamental trigger of crisis in each case was a decline in investors' confidence in the soundness of the long-term investments backing up their short-term deposits, then there would be no necessary reason to expect the same macroeconomic precursors in each case. Instead, in a financial system organized around relationships rather than information, the confidence of investors in the soundness of relationship lending itself is an absolute fundamental. And the potential for contagion from one country to another may depend more on the extent to which investors *perceive* similarities between the two countries' financial systems than on the extent of actual similarity.

One irony of this interpretation is that the extensive press coverage of the crisis, and the view commonly expressed in the press that the crisis revealed the failure of an East Asian or Japanese model of capitalism, may actually have substantially accelerated and exacerbated the failure of that model. Again, the point is that a transparent financial system in which investors can judge the soundness of banks and corporations on the basis of objective and reliable data would have been much less vulnerable to such contagion.

Another implication of this interpretation of the crisis is that those who decry the buildup of short-term foreign debt in the pre-crisis period may have a point. Enormous amounts of foreign bank loans flooded into the East Asian countries over the past few years, often at interest rates that reflected only a very modest risk premium relative to safe investments at home. The low risk premia many have reflected a belief that, even in those countries without explicit depositors' insurance, governments could never allow wholesale bank failures and therefore investors' money effectively had a government guarantee. It is precisely these sorts of lenders who are most likely and most able to act in ways that endanger the stability of the financial system. Because they are earning only modest risk premia, it takes only a modest increase in the perception of risk to convince them to withdraw their capital when their loans expire. Since short-term loans by definition expire relatively quickly, massive short-term lending at low risk premia is precisely the combination of factors most likely to lead to sudden and massive capital flight.

This point leads me to my first remarks on the response of the IMF to the crisis. Some commentators have argued that the long-term health of the international financial system has been jeopardized by the willingness of the IMF to come to the rescue of these countries. According to this view, the foreign lenders need to lose some money, preferably a lot of money, in order to discourage them from engaging in similar behavior, and causing similar crises, in the future.

While I heartily agree that irresponsible lenders should not be bailed out, it turns out to be extraordinarily difficult to punish such lenders without causing catastrophic consequences in the affected countries and perhaps elsewhere. Once again the lack of transparency in the financial system is a critical problem, because potential suppliers of new capital still cannot distinguish the good borrowers from the bad. If existing debt is defaulted on, the likely effect would be to cause a complete withdrawal of capital from the affected country -- potentially leading to a complete financial meltdown. It is simply not acceptable to say that Thailand should be destroyed in order to punish J.P. Morgan.

The trick is to find methods by which lenders can be forced to _take a financial hit without jeopardizing the stability of the financial system. Perhaps the most straightforward solution would be to encourage capital flows to take ~~the~~ form of equity and bond investments rather than bank lending in a foreign currency. Prices in stock and bond markets adjust to changes in perceived risk automatically and in ways that can pose substantially less systemic risk than foreign-currency-denominated short-term loans. The problem with this solution is that in order to function well, stock and bond markets require timely, honest, and credible _reporting of firms' financial circumstances -- in other words, a transparent, well-regulated, and well-functioning set of public capital markets. Building such markets is a long-term challenge, not a short-term fix.

On the whole, the IMF seems to have recognized the unique character of the East Asian crisis and to have reacted appropriately: The dimension along which the East Asian programs differ most markedly from any previous IMF program is in their emphasis on the importance of transparency, openness, and accountability in capital markets. Deputy Treasury Secretary Summers recently remarked that one of the most hopeful signs he has seen that the IMF programs are having the right effect came from a conversation with a teacher of night school courses in accounting, who said that in previous years he had normally had 22 students in his winter term classes, but this year he had 385.

As for the longer-term agenda for the reform of international financial institutions, the clearest imperative is to develop more timely, comprehensive, and reliable financial information for IMF member countries. This process is already under way under the auspices of the IMF's Special Data Dissemination Standard, but the scope, accuracy, and timeliness of the data provided need to be improved. A further imperative is to foster the adoption of strong bank and financial regulatory institutions in all IMF member countries. One lesson that emerges from both the East Asian crisis and many previous crises is that the interaction between highly liquid global capital markets and poorly-regulated, poorly supervised local financial systems can lead to disaster. [Metaphor of superhighways and off-ramps, or jet airliners and dirt runways].

This leads me at last to consideration of the consequences of the East Asian crisis for foreign relations. Here one could adopt either an optimistic or a pessimistic view. Pessimism might argue that the crisis is likely to lead to turning inward: -increasing trade frictions, increasing trade barriers, a rising surge of protectionism, and in particular a closing of international capital markets to foreign investment. The worst-case scenarios here can be quite awful, and I have no appetite to spin them out. Fortunately, early indications are of a much more benign outcome, at least in countries other than Indonesia. The crisis countries have expressed remarkably strong commitment to maintaining open trade. And the elements of the IMF programs emphasizing transparency and openness of capital markets seem to be making considerable headway, especially in Korea, which is fortunate to have as its new President a man who has a passionate commitment to an open society in which behind-the-scenes domination by government and *chaebols* becomes a thing of the past.

I am optimistic, too, about the impact in the United States and Europe. While the crisis will almost surely lead to a substantial increase in the US trade deficit with East Asia, and to an associated slowdown in growth, a negative shock to aggregate demand could hardly come at a better time. For the past two years, the US economy has been growing at a pace in excess of its estimated long-term trend, with labor markets growing increasingly tight. The financial markets' consensus is that the East Asian crisis has headed off an interest rate hike by the Federal Reserve, and the net effect is that GDP growth is likely to grow at a rate nearer potential. There is the further side-benefit that the sharp declines in Asian currencies and the consequent decline in the dollar price of imports from that region will provide a transitory dampening influence on inflation. Of course, a deteriorating trade balance can cause a political backlash even if aggregate macroeconomic effects are modest or positive, and the Administration will need to be prepared to fight hard to keep the US from turning inward in response to those pressures. At the moment, the top priority is to secure a proposed addition to the IMF's capital base, and this task has some urgency because it is likely to be harder to achieve after a big surge in the trade deficit. In sum, the Administration remains deeply committed to maintaining and building on the world's increasingly open trading system and the international institutions that preserve that system; given the overall strength of the US economy it seems likely that any political consequences of a rising trade deficit will be manageable.

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Consequences of the crisis for Western Europe will be somewhat different; European banks had more exposure than American banks to the East Asian economies and will likely have to write off larger losses. On the other hand, European trade with East Asia is somewhat smaller than that of the United States, so the net effect on trade balances may be smaller. On the whole, the crisis appears no more likely to have a large effect in Europe than in the United States.

The greatest cause of concern about international repercussions of the crisis has to do with Japan. Japanese banks were rather heavily exposed to East Asia, and, unlike banks in the US or Europe the condition of the Japanese banking system was fragile even before the crisis. Still, the problems East Asia poses for Japan are small compared to that country's homegrown problems. While East Asia could in principle be the straw to break the Japanese camel's back, it is also possible that the apparent collapse of the Japanese model of capital markets abroad will finally persuade the Japanese authorities to take decisive action to address the long-term problems facing that country. The greatest danger to the international financial system remains a collapse in Japan, rather than any further deterioration in the rest of East Asia. Here again, the mantra of transparency, openness, and sound prudential bank regulation needs to be repeated. If the Japanese authorities had acted decisively to clean up their banking system in the early 1990s, and had instituted then the banking reforms that are even now being hesitated over, it seems likely that Japan could have avoided much of its economic stagnation of the past seven years. Let us hope that the Japanese authorities will finally heed the message that international capital markets have been sending them for a long time now; indeed, we can even hope that the East Asian crisis could prove the clarion call that Japan has needed for many years.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-APR-1998 14:06:00.00

SUBJECT: Re: WTO strategy: let's talk this p.m.

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

TEXT:
I share your inclination, although 1 is also a possibility.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-APR-1998 10:31:57.00

SUBJECT: Re: Lunch seminar with former CEA Chairs

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

TEXT:
I think this would be a very nice idea and I will be happy to invite the former chairs, although I am not certain if Greenspan will come. I would suggest doing this in late May, after we are back from China, or in June. Alice can check my schedule and see what's available.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Christopher D. Carroll (CN=Christopher D. Carroll/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:14-APR-1998 17:16:06.00

SUBJECT:

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

TEXT:
Janet:

In response to Jeff's email, would you like me to beef up the bit about IMF funding a bit more? If so, could you attach your latest version of the speech?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-APR-1998 17:16:04.00

SUBJECT: current version of my E.Asia speech

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

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

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

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

TEXT:
This version differs from earlier drafts principally in that the first half spells out what was previously only in outline form. (I am giving the talk at the Int.Trade Commission on Thursday.)

Janet and Chris: I haven't seen the current version of Janet's CFR speech. I assume that since the draft I saw, you have added some about how we have to fund the IMF. But if it still needs more on that subject, you might want to look at page 5 of mine.=================== ATTACHMENT 1
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ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D75]MAIL47983630J.126 to ASCII,
The following is a HEX DUMP:

Jeffrey A. Frankel
Member, Council of Economic Advisers
April 14, 1998

THE ASIAN MODEL, THE MIRACLE, THE CRISIS AND THE FUND

Delivered at: Joint Economic Committee;
National Bureau of Economic Research, Cambridge MA;
Brookings Institution; Bretton Woods Commission; Lehman Brothers;
Milken Institute Global Conference, Los Angeles;
Congressional Research Service;
International Trade Commission

Until recently, there were essentially two schools of thought regarding East Asian economic success. Under to the first school, the Asian miracle illustrates the virtues of the capitalist system. According to the second school, East Asia is different from western capitalism, and its *differences* are the key to its success. Now, after a continent-full of crashes, we are led to a third hypothesis. The rules of economics apply to East Asia similarly to elsewhere after all, whether for better or worse.

I would like to address in my remarks the policy response to the East Asian crisis on the part of the International Monetary Fund and G-7 governments, including a number of criticisms of that response. But I will begin by reviewing the origins of the crisis.

Origins of the crisis

Macroeconomics played some role in the crisis, but not the lead role. Some mistakes of macro policy were made in 1997 in Thailand for example. Excessive current account deficits led to excessive indebtedness. When current account deficit turned to overall balance of payments deficit, the government was too slow to follow the IMF's advice of allowing the currency to depreciate, with the result that much of Thailand's reserves were lost and the crash was worse than it otherwise would have been, once it occurred. In this respect, the it resembled the Mexican peso crisis of 1994. It appears that current account deficits in excess of 4% of GDP are a sign of possible trouble ahead.

But large-scale borrowing by itself need not lead to a crisis. Statistical evidence suggests that a large current account deficit or high level of debt are not highly significant predictors of crises. More important than the magnitude of the current account deficit is *how it is financed*, and how the funds are *used.* The composition of the capital inflow matters. East Asian countries in 1997 relied too much on short-term foreign-currency-denominated debt (again as in Mexico in 1994). Although securities were supposed to have achieved a new importance in these countries in the 1990s -- indeed this was the origin of the phrase "emerging markets" -- the banking sector turned out to be central. There was a mis-match between the banks' liabilities and their assets, with much of the money going to speculative real estate deals.[1]

The main problem in East Asia was not macroeconomic, however, but structural. Deep flaws afflicted the financial system. They include excessive leverage, and a banking system based excessively on directed lending, connected lending and other collusive personal relationships. Ten years ago, we [finance experts] called it relationship banking, and thought it might help to minimize "problems of asymmetric information and incentive incompatibility;" today we call it "crony capitalism."

The U.S. model -- shared with the U.K. and so sometimes called the Anglo-American model -- emphasizes arms-length market relationships. For example, firms rely heavily on securities markets to finance investment. To be sure, banks play an important role. But even bank loans tend to be made on arms-length terms. Certainly the government has little to say about where bank credit is allocated. One lesson now widely drawn from the crisis -- and I believe correctly so -- is that the Anglo-American style financial structure apparently works better after all, as compared to the Japanese-Asian system.

The much-vaunted Japanese financial system is looking tarnished. Precisely the attribute of the system that previously appeared to be a virtue, the willingness of banks to go on lending to firms in distress (because the banks had "longer horizons" than impatient American investors), now turns out to have led to serious problems. Borrowers who should have been cut off were not, with the result that further billions were lost.

The Asian style of corporate governance tends in the direction of maximizing market share, rather than what neoclassical economic theory says should be maximized, namely profitability or the price of the company's stock. For awhile it looked like this was an arcane theoretical point, of interest to economists but not to real-world firms. How could there ever be too much investment or too much growth? Now we see that Asian firms made precisely this mistake. This is what I had in mind at the outset of my talk when I said that the rules of economics turn out to apply to East Asia similarly to elsewhere.

Dangers of "analysis by smugness"

[1] In Frankel and Rose (1996), high short-term bank debt is shown to be a statistically significant positive predictor of the probability of currency crash [, while high reserves and FDI have the opposite effect].

In pronouncing this verdict, one must acknowledge the dangers of analysis by hindsight, dangers of American triumphalism, and dangers of excessive swings of the pendulum known as "conventional wisdom". The dangers of 20-20 hindsight are clear. Until recently everyone thought that these countries had good fundamentals -- as indeed they did, relatively speaking. Many of us warned of the drawbacks of the financial system.[2] But few thought it would lead to a very sharp slowdown, and nobody thought the crisis would be this big.

Financial crises are inherently hard to predict, and one shouldn't enter into contortions to explain why this one should have been obvious ahead of time. Statistical results produce warning factors that are significant, but still do not tell us that the probability of a crisis is greater than 50 percent. [Indeed, if there existed techniques that could predict financial crises with high reliability, the market would quickly invalidate them: the clever people on Wall Street would adopt the techniques, would sell the assets of any country that was entering the danger zone, and would thereby prevent the crisis situation from developing in the first place. Obviously this mechanism does not always work.]

What are the dangers of excessive swings of pendulum and (now) of American triumphalism? Not everything about East Asian economies was wonderful before 1997, contrary to the drift of much that was said in the 1980s; and conversely not everything about them is bad now. I have already mentioned the structure of the financial system. One should include on the list of Asian economic flaws: corporate governance directed more toward empire-building than toward shareholder profitability or consumer welfare, patterns of corruption, and excessive government interference in the economy. I will even venture to cross over from economics to politics, at the risk of trespassing (whether on the sovereignty of the countries or the turf of political scientists -- I am not sure which is the greater danger). We were told in the past that Asian values did not place as high weight as did Westerners on democracy, free speech and other civil freedoms. I think many Asians may have concluded recently that -- even leaving aside the non-economic benefits of such rights -- there are financial advantages to the rule of law, transparency, clearly-established procedures for government succession, freedom of expression.

Just as not everything about East Asia was in fact admirable before 1997, so not everything about them is bad now. There was indeed an Asian economic miracle. Thirty years ago it seemed that industrialization was a privilege reserved de facto for only the European-settled regions of the world, with the sole exception of Japan. The East Asians disproved this in a few short decades. In the original Industrial Revolution, it took the United Kingdom 58 years to double its income (starting from 1780). It took the United States almost as long (47 years, starting from 1839; and Japan 35 years, from 1885). Korea accomplished the feat in 11 years, from 1966, and then China just 10 years (counting from 1977 or 1983). Among the reasons for the East Asian accomplishment were high saving rates, hard work, a strong emphasis on basic education and outward orientation (participation in international trade

[2] My own record can be checked: Frankel (1996, 1997). In my view, the only commentator who can be truly proud of what he wrote about Asia beforehand is Krugman (1994a, b).

and investment). These are all important determinants of growth, that work in other countries as well.

A full acknowledgement of the dangers of analysis by hindsight leaves one with a simple question: if the origins of the Asian crisis lie in the structural flaws in the Asian financial system, then why did it occur when it did? What in economic sturcture or fundamentals changed between the Miracle and the Crisis?

Perhaps there exist natural stages of development, and the Japan-Asian financial system was not poorly suited to countries at early stages of development. After all, when the alternative for a firm is financing all investments out of family savings or retained earnings from earlier investments, financial intermediation by banks is a tremendously important innovation. And as long as growth is rapid, high leverage (that is, a high ratio of debt to equity) is sustainable, maybe even desirable. But when growth slows down, the financial system needs to adapt. Firms need to reduce leverage.

Some slowdown in East Asian growth was inevitable after the breakneck pace of the preceding three decades. But the slowdown interacted badly with the highly-leveraged financial system. The result was the crisis.

Why do I say that a slowdown was inevitable? On the list of causes of rapid East Asian growth, in addition to such standard fundamentals as the accumulation of physical and human capital and the outward orientation of the economies, was a simple principle that economists call convergence. A country that starts out behind the leaders in per capita income, will tend to close part of the gap over time by growing more rapidly, conditional on those good fundamentals. The reasons are the high rate of return on capital, and the opportunity to emulate frontier technology and management practices of the leader countries. But to the extent that the gap has been closed after a few decades, this source of growth is no longer there. Countries run into diminishing return to capital and constraints on infrastructure (including roads, water and air). As they draw closer to the frontier, they have no more to learn from the those that have gone before than vice versa. Japan had achieved convergence by the 1980s, and Hong Kong and Singapore by the 1990s. Korea and the others still had a ways to -- a very long way in some cases. Nevertheless, the basic principle remains, that the smaller the remaining gap, the smaller is this particular source of growth.

There were other reasons as well for the initial slowdown in output growth in East Asia, besides the inevitable convergence. One was the bursting of Japan's pre-1990 asset-market bubble (exogenous from the viewpoint of the rest of East Asia, but perhaps in itself an example of the interaction which I am identifying.) Another was the 1996 slowdown in world electronics market, which sharply reduced the rate of growth of exports in these countries before any signs of financial crisis.

Our strategy for dealing with the crisis

I will now turn to the subject of the strategy that we have used to deal with the crisis. It has three parts:

- supporting reform programs in individual afflicted countries,
- providing temporary financing where needed, conditional on those reforms, and
- encouraging action by our major trading partners [especially Japan, but also Europe and China] to promote global growth and minimize contagion

The first two of these requires a bit of elaboration.

Reform programs in individual countries

In one sense, this is an historic opportunity to help bring about needed structural reforms. These include strengthening financial systems, especially in the area of banking regulation; improving transparency and supervision, e.g. in corporate accounting standards; reducing interrelationships between banks, governments and corporations, including directed lending and connected lending; improving corporate governance, adopting institutions for corporate control, establishing workable bankruptcy procedings and fighting corruption; continuing to liberalize trade and open capital markets, especially to foreign direct investment. All of this is in addition to maintaing sound macroeconomic policies: fiscal, monetary, and exchange rate.

Providing temporary financing

Public funds are not a substitute for private funds, but rather only a catalyst or complement to private funds. Another way of saying this is that we are "bailing investors in," not bailing them out. The aim is to restore investor confidence. This seems to be working: e.g., Korea has recently been very successful at securing longer-term private finance.

The central provider of public funds and monitor of conditionality is the International Monetary Fund (with secondary roles for the World Bank and Asian Development Bank). The International Financial Institutions allow us to internationalize the financial burden, which the United States and other major countries would otherwise have to bear individually. Conditionality is better adminstered multilaterally as well. [Conditionality is the part of the program that spells out and the enforces requirements regarding country policies on which the financing is conditional .] The IMF is the right institution for the job. It was originally established at US initiative, it has the requisite technical expertise, and it allows us to exercise our influence in a highly leveraged way. I believe it is critical that the Congress approve the Administration's requests for IMF funding, both the New Arrangements to Borrow ($3 ½ b) and the regular capital increase ($14 ½ b). These are not budget expenditures. They are more akin to investments, which will not -- and historically have not -- cost taxpayers one dime.

[In addition to funding through the International Financial Institutions, the United States has joined others to indicate willingness to provide supplementary funds, if necessary in some situations and if a country fully adheres to reform program. If and when we were to disburse such finds, they would be in the form of short term loans, with repayment guaranteed by borrowing government. The hope is that making more funds available reduces the chances that they will have to be used.]

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Critiques of the management of the crisis

I have heard a number of critiques of the strategy that we and the IMF are following. They fall into three areas: those concerning the efficiency of financial markets, those concerning the amount of financing, and those concerning policy conditionality. Many of the critiques contradict each other. One might almost say that for every critique, there is an equal an opposite critique coming from the other direction. [One cannot claim that they necessarily cancel each other out. But when a member of the public reads so many attacks on the Fund, he or she might be tempted to conclude that where there is smoke there's fire. Thus it is important to realize that the critiques come from different directions, and to consider carefully the specifics of each one.]

<u>Regarding efficiency of financial markets</u>

Critique 1: Financial markets work best with no government interference. There is no need for government action in this crisis.

This is the view of the "no bailout" crowd. But I disagree that governments and the IMF have no role to play in a crisis such as this.

There are three reasons why we need to be involved [and should not simply try to allow the market to solve the problem on its own].

- First, there is the risk of financial contagion. Much as the crisis spread from Thailand to other East Asian developing countries, it could spread further, and not always to countries that deserve it. The weak Japanese financial system is one possible channel of transmission.

- Second, there will be a large negative effect on our net exports to East Asia. This is not of great concern [to CEA] as regards impacts on aggregate US growth or employment -- our economy had so much momentum going into this crisis -- and still has -- that we can withstand the loss of net exports (without necessarily losing much output and employment relative to what otherwise would have happened). But there is a danger that the fall in the trade balance, particularly the bilateral balances vis-a-vis East Asia, will lead to an isolationist or protectionist political backlash within the United States, which would in itself be harmful.

- Third is the geopolitics. We have an interest in East Asian economic success, both as a source of stability and progress in the region itself (Korea and Thailand have been and are military allies, and Indonesia is a potential site of social instability) and as an example to other developing countries (as developing countries around the world have opted for capitalism over state planning, they have been inspired by the example of East Asian success).

So we can't walk away from East Asia.

Critique 2. This crisis shows that financial markets work badly; the countries shouldn't have opened up to international investors in the first place, and we shouldn't press them to continue to do so now.

This critique takes the diametrically opposed view of the efficiency of financial markets from Critique 1.

I would not claim that modern financial markets work perfectly. Even though some of the contagion in this case can be explained by competitive devaluation, it is true that it is hard to explain all the contagion in this way. Investors appear to have had excessive optimism up to last year, and to suffer from excessive pessimism now. But we are better off with modern financial markets than without them.

There is a useful analogy from Robert Merton [recent Nobel Prize winner], which I will embellish. Today's financial markets are like superhighways. They get you where you want to go fast. By this I mean that they are useful: they help countries finance investment and therefore growth, and they smooth and diversify away fluctuations. But accidents occur, and they tend to be big ones -- bigger than they used to be when people were not able to drive so fast. The lesson is not that superhighways are bad. But drivers need to drive carefully, society needs speed limits and cars need air bags. [And police cars with radar. Halifax II: regulators need to be as modern as the markets, in Rubin's words.]

Regarding financing

Critique 3: Too much public finance in response to the crisis (vs. Critique 4: Not enough)

There are two versions of the complaint that too much money is being channeled to the crisis countries. The first is the question "Why should we bail out countries that are such tough competitors for our own firms on world markets?" The second variety of the critique has to do with moral hazard. Both raise important questions. But both have answers.

In the years prior to 1996, US exports to East Asia grew very rapidly. We would like to return to that path. The crisis strategy ultimately helps our firms sell to East Asia in three ways: short-term, medium-term, and long-term.

- providing finance, so that the countries continue to buy our goods this year (even if at reduced levels).
- helping to restore growth, so that they can buy more next year, and
- pursuing fundamental market-opening, so that can buy more in the long term.

Everyone has now learned about moral hazard, the principle that bailing out investors and borrowers reduces their incentive to be more careful next time. The moral hazard point is a correct one, and it enters in to the East Asia developments in a number of ways. But there is a danger of exaggerating it. It is a standard principle of economics that actions in one area can generate partly offsetting reactions in another. That is not in itself a reason not to take action. In our highway example, there is research demonstrating that drivers react to seat belts and airbags by driving faster and less safely than they used to. But that is not a reason to dispense with air bags. If it were, that logic would say that to discourage dangerous driving, we should put a spike in the steering wheel (as Michael Mussa of the IMF says).

The crisis countries already pay large penalties under the current system. Standards of living were severely reduced in Latin America after the 1982 crisis and in Mexico after the 1994 crisis; and incomes will also be sharply depressed in East Asian countries as a consequence of the 1997 crisis. The countries would not willingly choose to repeat the experience. On the creditor side, the securities investors are suffering large losses as well (declines in prices of currencies, bonds, and stocks).

There has been a lot of concern that banks in creditor countries aren't taking enough of a hit.

- First, many banks *are* taking large hits. J.P. Morgan, Chase, and Citibank have reported adverse effects on profits.

- Second, it may not be altogether inappropriate that banks make out better than securities investors when times are bad -- this is compensation for the fact that they do not make out as well when times are good (spreads were quite low before the crisis []- perhaps in part because the East Asians were not as eager to borrow as they might have been, with the example of Mexico and other Latin American countries in the 1980s and 1995]]).

- This is not to deny that the effort to contain the crisis response may have an element of moral hazard vis-a-vis the banks. If anyone has suggestions how to make the banks (who are in a strong bargaining position, because they don't have as much to lose as in 1980s) take a larger loss, without unraveling the whole package that is holding the line against default, I think Secretary Rubin would like to hear them.

Beyond that, as we consider what if anything should be done to modify the international financial system so as to reduce the frequency and severity of accidents in the future perhaps we should consider that bank loans appear to be one of the more danger-prone modes of international capital flows. Foreign Direct Investment has the advantage of greater stability. Securities investment has the advantage that risk is efficiently shared: in the event of trouble, market prices automatically decline. [Perhaps securities investors are less prone to panic in an attack than are bankers. They have an illusion of control -- they can form a mental picture of themselves selling just before a crash -- much like people seem to be more afraid of plane crashes than car crashes, because as drivers they have the illusion of control.] Statistical tests showed that the percentage of capital inflows that are bank loans, especially short-term or floating rate loans denominated in foreign currency, has a statistically significant effect on the probability of a currency crisis, while FDI has a significant beneficial effect. (This is research I undertook before coming to the Council of Economic Advisers, with Andrew Rose of U.C.Berkeley.)

Regarding policy conditionality

Too much exchange rate flexibility, vs. Not enough.

The exchange rate policy debate in the current context has some of the flavor of the similar debate after the Mexican peso crisis of December 1994. Then you could read in any newspaper that a foolish mistake had been made regarding the currency; you had to read more carefully to figure out that half the commentators were saying that the mistake was not to have devalued the peso earlier and the other half that the mistake was to have devalued at all.

In the East Asian episode, there is justice in the statement that Thailand should have allowed its currency to depreciate earlier (as the IMF urged). But here as elsewhere, there is danger of exaggerating in hindsight how obvious this was. Most of the East Asians had long been described as successfully preventing their currencies from becoming overvalued in the way that Latin Americans have historically done. Many westerners in fact urged them to *appreciate* their currencies, in response to balance of payments surpluses and consistent with the Balassa-Samuelson argument that rapidly-growing countries should experience increases in the relative price of non-traded goods, and therefore real appreciation of their currencies. The main point I wish to make with regard to exchange rate policy is that neither currency boards on the one hand nor pure floating on the other is a panacea. Following good policies is a complicated matter, with lots of pieces to the puzzle; one cannot solve all problems with a single wave of the currency wand. And it is important to realize that a fervent belief in the virtue of free markets does not help settle the debate. Free-market monetarists are just as passionate in their belief that currencies should float, on the grounds that central banks have no business buying and selling foreign exchange, as are free-market supply-siders in their belief that exchange rates should be fixed, on the grounds that central banks have no business exercising independent monetary policy.

[The right answer, fix vs. float, depends on the circumstances of the country in question. To elaborate on the currency board: a number of countries have found it useful. Indonesia probably does not currently have all the attributes of a country that would make it best-suited to a currency board. It does have one -- desperate circumstances, which make it worthwhile to give up some policy independence for monetary stability. But it lacks others: a small highly open economy, a strong desire for economic integration with a major-currency country or set of countries, and enough reserves and/or a strong enough banking system to avoid converting what would otherwise be a currency crisis into a banking crisis. Perhaps the most important element in those countries where the currency board has worked is an explicit willingness to give up that policy independence, as well as to open the economy and to be ruled by the market.]

But it is true that the combination of an overvalued currency and a lot of debt denominated in foreign currency (particularly short-term debt) was a major contributing factor, perhaps the major precipating factor, to the crisis in Thailand, much as it was in Mexico 3 years earlier.

Too much macro austerity, vs. Not enough

Macroeconomic retrenchment is not the central aspect of the country programs. The austerity and hardship that the countries are undergoing in these programs is the consequence of the crisis and the loss of investor confidence, not of the IMF's response to the crisis. It is probably inevitable, in circumstances where the priority is to reverse capital flight and attract wary investors, that interest rates be raised at least somewhat. If the programs are successful, the interest rates can soon be brought back down before they do lasting damage to the real economy. As regards fiscal austerity, it is true that the initial agreements with the IMF were predicated on hopes regarding economic growth and corresponding budget surpluses that soon proved a bit overoptimistic; these targets have since been modified.

Too much required structural reform

The IMF is not simply applying the same cookie-cutter to East Asia that it applied in the past to Latin America or other problem debtors. The new country programs do emphasize structural reform more than macroeconomic austerity. This is entirely appropriate, in that these countries have historically followed good monetary and fiscal policies. [The Fund has evolved during its history -- shifting from the balance-of-payments problems of industrialized countries in the 1950s and 1960s, to the currency problems of developing countries post-1973 and their debt problems post-1982, and then adding the broader problems of the transition economies post-1989. Better that it continue to evolve post-1997, to address the financial and other structural problems in East Asia, than that (like some institutions) it fail to change with the times.]

The most important source of moral hazard is between the Asian governments and their financial institutions and large corporations. Thus we are doing the right thing in pushing them to increase transparency and supervision, improve governance, open their financial markets, and loosen banking relationships (directed lending and connected lending). It is a historic opportunity to get them to undertake important structural reforms they would not otherwise have done. [The same applies to opening up their economies to trade and finance.]

This is not to say that a country with a primitive domestic financial system should necessarily be opened up to the full force of international capital flows before the appropriate domestic market reforms and prudential financial regulations have been put into place. To conclude with a last application of the automobile analogy, if the planned route for a superhighway draws near to a primitive village, it is not a good idea to design an off-ramp that dumps high-speed traffic into the center of town before its streets are paved, intersections are regulated, and pedestrians learn the dangers of walking in the street. But neither is it practical or desirable to try to insulate the village from the modern world indefinitely. Emerging-market countries should proceed *both* with domestic reforms and opening to the outside world, in the proper balance and sequence.

Addendum 1

One little-noticed bit of hindsight regarding exchange rates is the claim that a major contributing factor to the crisis was the 1995-97 appreciation of the dollar against the yen and other currencies, with East Asian countries pegged to the dollar. It is true that the appreciation of the currency to which the East Asian currencies were most closely linked has cost them exports in Japan and other third markets. But there is another effect that goes the other way from the country distribution of East Asian exports: the currency-distribution of their denomination of debt. If it had been the yen that had appreciated instead of the dollar, we would now be hearing (correctly) that a major contributing cause of the crisis was that a large share of the debt is denominated in an appreciating currency. I say this because in the late 1980s, and up until the yen's peak in 1995, the most widely discussed problematic aspect of Southeasian debt was precisely this. (You may recall the stories about the "yen carry" trade: yen funds were borrowed at low interest rates in Japan and invested at higher interest rates in dollar-linked countries, a strategy that would come acropper if the yen appreciated against the dollar, much as the celebrated "convergence play" in Europe came acropper in the currency crises of 1992-93. Now this effect is conveniently forgotten, in an attempt to explain why the crisis was entirely to be expected during a period when the yen depreciated rather than appreciated.)

Addendum 2

Why are the crisis countries important to us? As the President said in the State of the Union,

Now, why should Americans be concerned about this?
First, these countries are our customers. If they sink into recession, they won't be able to buy the goods we'd like to sell them.
Second, they're also our competitors. So if their currencies lose their value and go down, then the price of their goods will drop, flooding our market and others with much cheaper goods, which makes it a lot tougher for our people to compete.
And, finally, they are our strategic partners. Their stability bolsters our security.]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-APR-1998 18:59:25.00

SUBJECT: Asia Speech: Comments from Treasury & other relevant friends

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

TEXT:
---------------------- Forwarded by Janet L. Yellen/CEA/EOP on 04/14/98
06:59 PM ---------------------------

Lael Brainard
04/14/98 06:45:41 PM
Record Type: Record

To: Janet L. Yellen/CEA/EOP, Michele Jolin/CEA/EOP, Jon D. Haveman/CEA/EOP
cc:
Subject: Asia Speech: Comments from Treasury & other relevant friends

-- Page 7: second paragraph: Instead of "at least in countries other than Indonesia," accentuate the positive "particularly in Thailand and South Korea."

-- Page 8: first paragraph (continued from page 7): Take out sentence "At the moment, the top priority is ..." Instead, say that:

It is particularly important that Congress provide the International Monetary Fund with resources it needs to help stabilize Asian economies. The crisis in Asia poses a threat to American jobs and exports, and we already have seen evidence that weaknesses in economies there are having an impact here. To ensure that the American economy continues on the path of steady growth, Congress must make sure that the IMF is strong enough to respond to any broadening of the current crisis.

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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-APR-1998 13:59:46.00

SUBJECT: WTO strategy: let's talk this p.m.

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

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

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

TEXT:
I would like by COB to try to communicate to Lael a likely CEA vote on
which of four options we are likely to favor. re long-term WTO strategy:
1 call for a new round now.
2 sector-by-sector negotiations
3 "a new type of round for hte 21st centruy, and offer to host 1999
ministerial"
4 offer to host 1999 ministerial, but remain silent on new negotiations.
(Her memo elaborates.)
I am (quite tentatively) inclined toward number 3.
Let's try to talk around 4:30.
JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-APR-1998 12:00:50.00

SUBJECT: early action credit

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

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

CC: 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

TEXT:
I attended a meeting on early action credit this morning. Below I present an overview of the issues discussed, and a proposal I raised that may address some of our concerns.

Overview

Several issues were discussed:

1) Could an early action credit (EAC) system be designed that would not prejudge the domestic trading system?

2) Would the EAC program be upstream or downstream?

3) Would credits be 1 for 1 with permits?

4) If done through legislation, would EAC go to the Hill with implementing legislation, or before?

5) Should we design EAC and domestic trading system now?

Jon and Peter are going to write up a summary of options that reflect how one could address many of these issues.

Apparently, industry folks are becoming more and more interested in this issue, and the WH is interested because industry-by-industry consultations will be starting up soon. Todd made it very clear -- EAC is going forward, now we must decide how to design it.

Using Article 6 for Early Action Credit

I threw out an idea that gathered some interest, but was discussed only briefly. Article 6 of the Protocol allows for JI projects within Annex I countries. In a conversation with Jonathan Pershing of the State Department, it appears possible that the parties to the Protocol could adopt a uniform set of rules for CDM and for JI. While the Protocol does not specifically allow banking of JI credits from 2000-2007 to the first commitment period (although it does specifically allow such banking of CDM credits), Jonathan Pershing indicated that the rules for JI could allow for such banking. If that were the case, a firm in an Annex I country could invest in a JI project within Annex I in the year 2000, and gain emissions credits to use/sell over 2008-2012. So, it is conceivable that a U.S. firm could invest in a JI project in the U.S. before 2008 and earn emissions credits to use/sell in the commitment period.

This has potential benefits relative to other discussions on early action:

1) It would not require legislation. Granted, the U.S. would still need to ratify, but it is possible, according to Jonathan Pershing, that projects could be undertaken by U.S. firms prior to U.S. ratification in either the CDM or the JI context and then gain credits after U.S. ratification -- this is an issue that would need to be resolved in subsequent negotiations over rules. Of course, the value of all EAC options depend on ratification.

2) Greater certainty about the value of the emissions credits. In JI, once a project is approved, a firm would know the number of emissions credits it will earn. However, in some forms of EAC, firms will earn credits that would be converted into emissions permits during the commitment period, but the conversion ratio would be dependent on the number of firms that earn credits (the more credits earned, the more credits necessary to earn one permit, if there is a cap on the number of emissions permits that will be allocated to early actors).

3) Does not prejudge the domestic trading system. Since JI projects can occur under Article 6 anyway, supporting Article 6 efforts does not tip our hand as to how we might design the domestic trading system.

4) This form of EAC could count towards our commitment. This may be the most important aspect of this approach. Other forms of EAC would simply reallocate rights to domestic emissions permits based on demonstrated early efforts, but would not address the magnitude of our commitment under the Protocol. However, JI emissions credits would, in effect, be like printing paper. Every certified emissions reduction under JI (or CDM) could be used to increase the U.S. target. For example, if through Article 6, U.S. firms undertake projects that reduce emissions by 100 MMTCE, our target would be 100 MMTCE less stringent (this assumes that these U.S. firms do not sell their JI generated emissions credits abroad).

The potential drawbacks:

1) Assessing reductions relative to a baseline. Both JI and CDM will encounter the difficulty of assessing emissions reductions relative to a project-specific baseline. However, most forms of EAC appear to suffer the same difficulty.

2) Uncertainty about JI banking. While Jonathan Pershing indicated that

he believes Annex I countries will be allowed to bank JI credits, and in fact, we are pushing that position so that existing JI projects pursuant to the Rio Treaty will generate credits starting in 2000, I could not find any reference to banking in Article 6. This may have to be resolved in discussions on rules at Buenos Aires and subsequent negotiations.

Let me know if you would like to discuss this issue further.

Joe

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-APR-1998 08:30:28.00

SUBJECT: Shanghai

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:
Janet,
I'm trying to pin down meetings in Shanghai. Would you please express a preference over the following:

Head of the stock exchange
Central bank governer
U.S. Banking Community
Mayor of Shanghai
Academics

You will have a lunch, afternoon and dinner available for meetings.

Thanks much - Jon

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-APR-1998 10:52:12.00

SUBJECT: Rubin's speech on new architecture

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

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

TEXT:
I have typed up what seem to me the key elements of a possible Halifax 2
from Rubin's speech. The language is virtually all Treasury's.
JF=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D47]MAIL445514500.126 to ASCII,
The following is a HEX DUMP:

JF 4/15/98

Key elements of possible "New Architecture" in Sec. Rubin's 4/14 speech

I. Better Information

1. Expansion of data availability, including a more complete picture of usable central bank reserves in IMF's Special Data Dissemination Standards
2. Qualitative information on risk, including on countries' banking supervision, bankruptcy procedures, judicial systems...
3. More transparency of the IMF
4. Incentives for countries to improve transparency

II. Stronger national financial systems

1. Global standards, including

   "core principles for effective banking supervision," IOSCO, bankruptcy regimes, accounting, overall corporate governance...
2. International surveillance of countries' financial regulatory systems
3. Authorities in major financial centers could consider conditioning access by banks on quality of home-country supervision regimes...

[4. Properly timed financial liberalization]

   * WTO financial services agreement
   * Chile-style capital controls must not erode discipline on macro policies.

But could explore narrower prudential limits on banks to prevent excessive buildup of short-term foreign liabilities

III. Mechanisms so that private sector more fully bears consequences of its investment decisions.

...

* Includes flexible forms of debt agreements
* The idea of a broader international bankruptcy regime has appeal; but with current knowledge, political obstacles may be insurmountable.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-APR-1998 15:28:48.00

SUBJECT: Council on Foreign Relations, revised speech

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

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

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!87MXXdXXd7 Er XXLessonsfromtheAsianCrisis JanetYellen,ChairCouncilofEconomicAdvisersApril15,1998CouncilonForeignRelations,NewYork,N.Y.Thankyou.Iamdelightedtohavethisopportunitytodiscussrecenteventsin Asiawithsuchabroadanddistinguishedarrayofthinkersoninternationaleconomicissues.Iwouldliketospendmytimetodayonthreetopics:WhatwerethefundamentalcausesoftheEastAsiancrisis?;hHowappropriatehastheresponseoftheIMFandtheinternationalcommunitybeen?;aAndwhatconsequencesmightthecrisishaveforcountriesbothwithinandoutsideofEastAsia?.Expostattemptstoidentifythefundamentalcausesofafinancialcrisisalwayssufferfrom @ theproblemofdistinguishinginsightfromhindsight.Anyfinancialjournalisttodaycantellyouthatthecrisiswastheinevitableconsequenceofovervaluedexchangerates,largecurrentaccountdeficits,shorttermcapitalinflows,opaquefinancialsystems, cronycapitalism,moregenerallytheproblemsofthe Japanesemodelofcapitalmarkets,oroneofseveralothersupposedlyfatalflawsinEastAsiancapitalism.Butitseemsfairtosaythatayearagonobodysuspectedthatsuchacalamitywasremotelypossible,althoughallofwhatarenowdescribedasthefatalflawsoftheEastAsianeconomieswerereasonablywidelyunderstoodeventhen,atleastbyexperts.Indeed, ,"* asrecentlyastheearly1990seconomistsweredebatingvigorouslywhethertheJapanesemodelofcapitalmarketswassuperiortothe AngloSaxonmodel.ThereasonfortherecentwidespreadadmirationofbothfinancialandnonfinancialaspectsofEastAsianeconomiesisobvious:thesecountriesmusthavebeendoingsomethingveryright, 0 becauseoverthecourseofthelastthirtyyearsorsotheyachievedthesinglegreatestspurtofeconomicgrowthinthehistoryofmankind.Thereislittledisputeabouttheimportanceofsomeofthethingsthesecountriesgotright:highsavingrates,rapidlyincreasinglevelsofeducation,andhardwork.Theroleofthesecountries'financialsystemsinfosteringgrowthmaybemoremurky,butitisatleastclearthattheflawsofthosefinancialsystemswerenotsufficienttopreventsomeremarkableaccomplishments.AkeyelementinanysuccessfulexplanationoftheEastAsiancrisismustthereforebeananswertothequestionofhowasystemthatworkedsowellforsolongcouldsuddenlyfail.Oneproblemincomingupwithanoverarchingexplanation

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eperhapsaprobleminsomecountriesbutnotall;thecurrentaccountdeficitwaslargeinThai
landbutsmallinKorea;theslumpinthesemiconductorindustryposedlargeproblemsinKorea

butfewinIndonesiaorThailand;andsoon.If,however,thefundamentaltriggerofcrisisineachcasewasadeclineininvestors'confidenceinthesoundnessofthelongterminvestmentsbackinguptheirshorttermdeposits,thentherewouldbenonecessaryreasontoexpectthesamemacroeconomicprecursorsineachcase.Instead,inafinancialsystemorganizedaroundrelationshipsratherthaninformation,theconfidenceofinvestorsinthesoundnessofrelationshiplendingitselfisanabsolutefundamental.Andthepotentialforcontagionfromonecountrytoanothermaydependmoreontheextenttowhichinvestorsperceivesimilaritiesbetweenthetwocountries'financialsystemsthanontheextentofactual ` similarity.Oneironyofthisinterpretationisthattheextensivepresscoverageofthecrisis,andtheviewcommonlyexpressedinthepressthatthecrisisrevealedthefailureofanEastAsianorJapanesemodelofcapitalism,mayactuallyhavesubstantiallyacceleratedandexacerbatedthefailureofthatmodel.Again,thepointisthatatransparentfinancialsysteminwhichinvestorscanjudgethesoundnessofbanksandcorporationsonthebasisofobjectiveandreliabledatawouldhavebeenmuchlessvulnerabletosuchcontagion. ,'"* 8Anotherimplicationofthisinterpretationofthecrisisisthatthosewhodecrythebuildupofshorttermforeigndebtintheprecrisisperiodmayhaveapoint.EnormousamountsofforeignbankloansfloodedintotheEastAsiancountriesoverthepastfewyears,oftenatinterestratesthatreflectedonlyaverymodestriskpremiumrelativetosafeinvestmentsathome.Thelowriskpremiamanyhavereflectedabeliefthat,eveninthosecountrieswithoutexplicitdepositors'insurance,governmentscouldneverallowwholesalebankfailuresandthereforeinvestors'moneyeffectivelyhadagovernmentguarantee.Itispreciselythesesortsoflenderswhoaremostlikelyandmostabletoactinwaysthatendangerthestabilityofthefinancialsystem.Becausetheyareearningonlymodestriskpremia,ittakesonlyamodestincreaseintheperceptionofrisktoconvincethemtowithdrawtheircapitalwhentheirloansexpire.Sinceshorttermloansbydefinitionexpirerelativelyquickly,massiveshorttermlendingatlowriskpremiaispreciselythecombinationoffactorsmostlikelytoleadtosuddenandmassivecapitalflight.ThispointleadsmetomyfirstremarksontheresponseoftheIMFtothecrisis.SomecommentatorshavearguedthatthelongtermhealthoftheinternationalfinancialsystemhasbeenjeopardizedbythewillingnessoftheIMFtocometotherescueofthesecountries.Accordingtothisview,theforeignlendersneedtolosesomemoney,preferablyalotofmoney,inordertodiscouragethemfromengaginginsimilarbehavior,andcausingsimilarcrises,inthefuture.WhileIheartilyagreethatirresponsiblelendersshouldnotbebailedout,itturnsouttobeextraordinarilydifficulttopunishsuchlenderswithoutcausingcatastrophicconsequencesintheaffectedcountriesandperhapselsewhere.Onceagainthelackoftransparencyinthefinancial ,'"* systemisacriticalproblem,becausepotentialsuppliersofnewcapitalstillcannotdistinguishthegoodborrowersfromthebad.Ifexistingdebtisdefaultedon,thelikelyeffectwouldbetocauseacompletewithdrawalofcapitalfromtheaffectedcountrypotentiallyleadingtoacompletefinancialmeltdown.ItissimplynotacceptabletosaythatThailandshouldbedestroyedinordertopunishJ.P.Morgan.Thetrickistofindmethodsbywhichlenderscanbeforcedtotakeafinancialhitwithoutjeopardizingthestabilityofthefinancialsystem.Perhapsthemoststraightforwardsolutionwouldbetoencouragecapitalflowstotaketheformofequityandbondinvestmentsratherthanbanklendinginaforeigncurrency.Pricesinstockandbondmarketsadjusttochangesinperceivedriskautomaticallyandinwaysthatcanposesubstantiallylesssystemicriskthanforeigncurrencydenominatedshorttermloans.Theproblemwiththissolutionisthatinordertofunctionwell,stockandbondmarketsrequiretimely,honest,andcrediblereportingoffirms'financialcircumstancesinotherwords,atransparent,wellregulated,andwellfunctioningsetofpubliccapitalmarkets.Buildingsuchmarketsisalongtermchallenge,notashorttermfix.Onthewhole,theIMFseemstohaverecognizedtheuniquecharacteroftheEastAsiancrisisandtohavereactedappropriately:ThedimensionalongwhichtheEastAsianprogramsdiffermostmarkedlyfromanypreviousIMFprogramisintheiremphasisontheimportanceoftransparency,openness,andaccountabilityincapitalmarkets.DeputyTreasurySecretarySummersrecentlyremarkedthatoneofthemosthopefulsignshehasseenthattheIMFprogramsarehavingtherighteffectcamefromaconversationwithateacherofnightschoolcoursesin ,'"* accounting,whosaidthatinpreviousyearshehadnormallyhad22stu

dentsinhiswintertermclasses,butthisyearhehad385.Asforthelongertermagendaforth
ereformofinternationalfinancialinstitutions,theclearestimperativeistodevelopmor
etimely,comprehensive,andreliablefinancialinformationforIMFmembercountries.This
processisalreadyunderwayundertheauspicesoftheIMF'sSpecialDataDisseminationStand
ard,butthescope,accuracy,andtimelinessofthedataprovidedneedtobeimproved.Afurthe
rimperativeistofostertheadoptionofstrongbankandfinancialregulatoryinstitutionsi
nallIMFmembercountries.Onelessonthatemergesfromboth";"theEastAsiancrisisandmanypre
viouscrisesisthattheinteractionbetweenhighlyliquidglobalcapitalmarketsandpoorly
regulated,poorlysupervisedlocalfinancialsystemscanleadtodisaster.Thisleadsmea
tlasttoconsiderationoftheconsequencesoftheEastAsiancrisisforforeignrelations.He
reonecouldadopteitheranoptimisticorapessimisticview.Pessimismmightarguethatthec
risisislikelytoleadtoturninginward:increasingtradefrictions,increasingtradebarr
iers,arisingsurgeofprotectionism,andinparticularaclosingofinternationalcapitalm
arketstoforeigninvestment.Theworstcasescenariosherecanbequiteawful,andIhavenoap
petitetospinthemout.Fortunately,earlyindicationsareofamuchmorebenignoutcome,par
ticularlyinThailandandSouthKorea.Thecrisiscountrieshaveexpressedremarkablystron
gcommitmenttomaintainingopentrade.AndtheelementsoftheIMFprogramsemphasizingtran
sparencyandopennessofcapitalmarketsseemtobemakingconsiderableheadway,especially
inKorea,whichisfortunatetohaveasitsnewPresidentamanwhohasapassionatecommitment
,`'* toanopensocietyinwhichbehindthescenesdominationbygovernmentandchaebolsbeco
mesa thingofthepast.Iamoptimistic,too,abouttheimpactintheUnitedStatesandEuro
pe.WhilethecrisiswillalmostsurelyleadtoasubstantialincreaseintheUStradedeficitw
ithEastAsia,andgrowthoverthenextyearisapttoproceedataslowerpacethanduringthepas
tyear,theUSeconomyiswellpositionedtoabsorbthenegativeshocktoaggregatedemandasso
ciatedwiththeAsiancrisis.Forthepasttwoyears,theUSeconomyhasbeengrowingatapacein
excessofitsestimatedlongtermtrend,withlabormarketsbecomingincreasinglytight.The
consensusamongforecastersisthattheEastAsiancrisiscouldserveasthebrakethatsubdue
sgrowthtowardamoresustainablepace,preventingoverheating,andpermittingcontinuedj
obgrowthwithamoremoderatepathforinterestrates.Thereisthefurthersidebenefitthatt
hesharpdeclinesinAsiancurrenciesandtheconsequentdeclineinthedollarpriceofimport
sfromthatregionwillprovideatransitorydampeninginfluenceoninflation.Ofcourse,the
rearerisksattachedtowiththisoptimisticassessment;andadeterioratingtradebalancec
ancauseapoliticalbacklashevenifaggregatemacroeconomiceffectsaremodestorpositive
.TheAdministrationwillneedtobepreparedtofighthardtokeeptheUSfromturninginward
inresponsetothosepressures.ItisparticularlyimportantthatCongressprovidetheInter
nationalMonetaryFundwiththeresourcesitneedstohelpstabilizetheAsianeconomies.The
crisisinAsiaposesathreattoAmericanjobsandexportsaswellastoworldeconomicgrowth.W
e,andwealreadyhaveseenevidencethatweaknessesineconomiesthereare havinganimpacthe
re.ToensurethattheAmericaneconomycontinuesonthepathofsteadygrowth,Congress ,`'*
mustmakesurethattheIMFisstrongenoughtorespondtoanybroadeningofthecurrentcrisis
.Insum,theAdministrationremainsdeeplycommittedtomaintainingandbuildingontheworl
dsincreasinglyopentradingsystemandtheinternationalinstitutionsthatpreservethats
ystem;giventheoverallstrengthoftheUSeconomyitseemslikelythatanypoliticalconsequ
encesofarisingtradedeficitwillbemanageable.ConsequencesofthecrisisforWesternE
uropewillbesomewhatdifferent;EuropeanbankshadmoreexposurethanAmericanbankstothe
EastAsianeconomiesandwilllikelyhavetowriteofflargerlosses.Ontheotherhand,Europe
antradewithEastAsiaissomewhatsmallerthanthatoftheUnitedStates,sotheneteffectont
radebalancesmaybesmaller.Onthewhole,thecrisisappearsnomorelikelytohavealargeeff
ectinEuropethanintheUnitedStates.Thegreatestcauseofconcernaboutinternationalr
epercussionsofthecrisishastodowithJapan.Japanesebankswereratherheavilyexposedto
EastAsia,and,unlikebanksintheUSorEurope,theconditionoftheJapanesebankingsystemw
asfragileevenbeforethecrisis.Still,theproblemsEastAsiaposesforJapanaresmallcomp
aredtothatcountryshomegrownproblems.Hopefully,theapparentcollapseoftheJapanesem
odelofcapitalmarketsabroadwillreinforceJapansresolvetocarryoutthestructuralrefo

rmsthatareneededtoaddressthelongtermproblemsfacingthatcountry.Hereagain,themant raoftransparency,openness,andsoundprudentialbanksupervisionandregulationneedsto berepeated.TheEastAsiancrisismightprovejusttheaclarioncallthatJapanhasneeded.fo rmanyyears.================= END ATTACHMENT 1 =================

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-APR-1998 12:35:36.00

SUBJECT: RE: What is the 2nd decimal place?

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

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

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

TEXT:
---------------------- Forwarded by Steven N. Braun/CEA/EOP on 04/16/98
12:34 PM ---------------------------

Jackman_P <Jackman_P @ BLS.GOV>
04/16/98 12:13:37 PM
Record Type: Record

To: Steven N. Braun/CEA/EOP
cc:
Subject: RE: What is the 2nd decimal place?

Our estimate to two decimal places is .20, although as noted, we do not believe that the precision extends to the nearest hundredth.

From: Steven_N._Braun@cea.eop.gov [SMTP:Steven_N._Braun@cea.eop.gov]
Sent: Thursday, April 16, 1998 11:49 AM
To: Jackman_P; greenless_j@bls.gov
Subject: What is the 2nd decimal place?

What is the 2nd decimal place of your .2 estimate of the effects of geos
on
the CPI. If you are not telling, why not? (As I have done all my
estimates of budget implications using .15, do I need to multiply them
by
4/3? or not?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-APR-1998 13:19:39.00

SUBJECT: Re: Shanghai

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

TEXT:
All of the possibilities sound interesting. We are probably likely to learn most from academics and U.S. banks, but Mayor, Stock Exchange and Central Bank Governor would also be interesting and might be obligatory given that we are on an official visit. Perhaps we could blend the official and unofficial--e;g;, CB Governor, Stock Exchange head and US banks. US banks may have some particularly interesting and relevant perspectives on developments there and it would be good to have at least a short visit with them.

Withdrawal/Redaction Marker
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
002. email	Rebecca M. Blank to Jeffrey A. Frankel, Keith O. Fuglie, Janet L. Yellen, and Michele Jolin at 15:44:36.00. Subject: Ag position. (1 page)	04/16/1998	b(6)

COLLECTION:

Clinton Presidential Records
Automated Records Management System [Email]
CEA ([Yellen])
OA/Box Number: 950000

FOLDER TITLE:

[03/12/1998 - 04/16/1998]

2013-0723-F
ab1276

RESTRICTION CODES

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

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

C. Closed in accordance with restrictions contained in donor's deed of gift.
PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).
RR. Document will be reviewed upon request.

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

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

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Christopher D. Carroll (CN=Christopher D. Carroll/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:16-APR-1998 15:23:11.00

SUBJECT: Here's the draft.

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:
WPC
.DyscG"O(X0z|z A~bi!f^m_@H|J
4c:vs(?3T._1r#S]r"]J&0k"yE_G9e^l=1hxh36`W.;r~x&eNPJf#0[k0)1K6GlL>*q7>QQM?(Mp5g
wb[.D%a
h8'1OB\a|aip@jv.n4\6qpl;%r:H]!21kgNmj";_4]y}T8zy7g<8O4g_zQ #~UN %0(2w@7
4wLocal PrinterWINSPOOL0(9 Z6Times New Roman RegularX($C:\PROGS\WP\STANDARD.WPT

<V=>E?@EABCDEE$3|xE
!CCIwouldliketospendmytimetodaysharingwithyoumythoughtsabouttherecenteconomiccr
isisinAsiaandwhatlessonsthatcrisismayhavefortheroleoftheUnitedStatesandinternat
ionalfinancialinstitutionsinfuturecrises.Letmestartwithalittlerecenthistory.T
hepasttenorfifteenyearshaveseenanunprecedentedexpansionintheextenttowhichthecou
ntriesoftheworldaretiedtogether,bothbyinstantcommunicationandbyinternationaltra
de,institutions,andmarkets,includingfinancialmarkets.Onthewhole,thisprocessofgl
obalizationhasbeenanenormouslypositivedevelopment.Ithasopenednewmarketsandprovi
dednewopportunitiesforworkers,farmers,andbusinessesaroundtheworld.Forexample,mo
rethan40percentofUSexportstodayareabsorbedbydevelopingcountries,anextraordinary
increaseoverpastexportpatterns,andthejobsassociatedwiththeseexportsarehighpayin
g,goodjobs.Theincreasingproductivityofourtradingpartnershashelpedkeepinflationd
ownandimprovestandardsoflivingintheUnitedStates.AndoutsidetheUS,literallyhundre
dsofmillionsofpeoplehavebeenliftedoutofpovertyaroundtheworldbytheeconomicgrowth
andtradeoverthepasttwentyorthirtyyears.Inthisnewglobaleconomy,countriesaremor
etightlylinkedthaneverbeforetoeachothersfates.Adecadeago,acollapseinthecurrency
ofasmall,distantcountryslikeThailandwouldhavebarelyhaveratedamentioninthetypica
lAmericannewspaper.Lastyear,however,thatcurrencycrashtriggeredacrisisinotherEas
tAsiancountriesthathasdominatednewscoverageinawaythatnootherforeignfinancialcri
sishaseverdonebeforeinthiscountry.Thereasonforthechangeisthatwenowhavemoreats
takethaneverbeforeinthe @-(, economicperformanceofthesecountries.Notonlyarethey
majorcustomersforourproducts,therichcountriesanddevelopingcountriesareincreasin
glylinkedbyfinancialties.In1996,thedevelopedcountriesincludingtheUSinvestedmore
than$250billioninemergingmarketscomparedtoroughly$20billiontenyearsearlier.Much
ofthismoneywasfrombanks(especiallyinJapanandEurope),althoughUSmutualfunds,pensi
onfunds,andindividualinvestorsalsoparticipated.Butwhateveritssource,theextentof
thisinvestmentmeansthateconomicturmoilinEastAsiahasadirectfinancialimpactonthed
evelopedworldscapitalmarkets,includingourown.Indeed,abriefplungeinUSstockslastO
ctoberwaswidelyattributedtoturmoilintheHongKongstockmarketthatwas,inturn,linked
tothecrisissetoffbyThailandscurrencycrash.IhopethatIhaveconvincedyouthatwecan

notaffordtobeindifferenttotheEastAsiancrisisbecauseindifferenceandinactionwould undermineourowninterests.Buttoidentifytheproperresponsetothecrisis,itisnecessar ytodetermineitscausewhichisnoeasytask.Attemptstoidentifythefundamentalcausesofa financialcrisisalwayssufferfromtheproblemofdistinguishinginsightfromhindsight.M anyafinancialjournalisttodaycantellyouthatthecrisiswastheinevitableconsequenceo fsomepieceofeconomicsjargon:overvaluedexchangerates,largecurrentaccountdeficits ,shorttermcapitalinflows,opaquefinancialsystems,oroneofseveralothersupposedlyfa talflawsinEastAsiancapitalism.Butitseemsfairtosaythatayearagonobodysuspectedtha tacalamitylikewhatwehaveseenwaspossible,althoughallofwhatarenowdescribedasthefa talflawsoftheEastAsianeconomieswerereasonablywidelyunderstoodeventhen,atleastby experts.Indeed,asrecentlyastheearly1990seconomistsweredebatingvigorouslywhether theJapanesemodelofcapitalmarketsthatwasadoptedinEastAsia @-(, wassuperiortotheA mericanmodel.ThereasonfortherecentwidespreadadmirationofEastAsianeconomiesiso bvious:thesecountriesmusthavebeendoingsomethingveryright,becauseoverthelastthir tyyearsor 8

sotheyachievedthesinglegreatestspurtofeconomicgrowthinthehistoryofmankind.Ther eislittledisputeabouttheimportanceofsomeofthethingsthesecountriesgotright:highs avingrates,rapidlyincreasinglevelsofeducation,andhardwork.Theroleofthesecountri es'financialsystemsinfosteringgrowthmaybemoremurky,butitisatleastclearthatthefl awsofthosefinancialsystemswerenotsufficienttopreventsomeremarkableaccomplishmen ts.AkeyelementinanysuccessfulexplanationoftheEastAsiancrisismustthereforebeanan swertothequestionofhowasystemthatworkedsowellforsolongcouldsuddenlyfail.Onepr oblemincomingupwithanoverarchingexplanationoftheEastAsiancrisisisthattheafflict edcountriesdifferfromeachotherinmanyimportantrespects.Insortingthroughthemanyan dconflictingstoriesaboutWhatWentWronginAsia,Ifindithelpfulasapreliminarytogobac ktothebasicquestionofwhatcapitalmarketsdo:theytransformfinancialsavingsintophys icalinvestments.Thistransformationisdifficultforthreereasons:first,thepeoplewit hsavingsgenerallywantconvenientandguaranteedshorttermaccesstothem(thatis,theywa ntliquidity);second,almostallinvestmentopportunitiesrequirealongtermcommitmentt oyieldagoodreturn,andcanbeliquidatedonlyataheavyloss;and,finally,thegathering,p rocessing,andcomprehensionofinformationaboutinvestmentprojectsarecostlyandtimec onsuming.Thetraditionalsolutiontothissetofproblems,isabank,whichacceptsthesho rtterm @-(, depositsofsavers,gathersandprocessesinformationaboutpotentialborrow ers,and(ifthebankisfunctioningproperly)offerslongtermloanstothoseborrowersjudge dtobesufficientlylikelytorepayatasufficientlyhighinterestrate.Thehattrickofprov idingsaverswithshorttermliquiditybackedupbyilliquidlongtermassetsisaccomplished byrelyingonanassumptionthatallthesaversarenotlikelytowanttowithdrawtheirdeposit satthesametime.Aslongasthisassumptionholdstrue,smallreservesofcashcanmeetthedem andsofwhateverdepositorshappentowanttowithdrawtheirsavingsonagivenday.However ,evenawellrunbankcanbedestroyedovernightiftoomanypeopledecidetowithdrawtheirsav ingsatthesametime.Oncethebank'scashreservesaregone,intheabsenceofsomeoutsidehel pitmusteithertelldepositorsthattheycannotwithdrawtheirsavings,oritmustselloffit silliquidassets,likelyatahugeloss,anddistributetheinadequateproceedstotheremain ingunsatisfieddepositors.Theremarkablepointinthisstoryisthatevenforawellrunba nktheoutcomeisaselffulfillingprophecy:Ifeverybodybelievesthebankissound,itsrese rveswillbesufficienttomeetliquiditydemands,andthebank,itsdepositors,anditsborro werswillallreaptheirjustrewards.Butifforsomereasondepositorsbegintosuspectthatt oomanyotherdepositorsmaytryto $X" withdrawtheirdeposits,theneachdepositorhasani ncentivetorushtothebankandtrytowithdrawtheirownsavingsfirstcausingabankrun.Ifev eryonedoesthis,thebankcollapses.Evenworse,ifthefailureofonebankmakesdepositorsi notherbanksthinkthattheirsavingsmaybeatrisktoo,thereisarealpossibilityofacontag ioninwhichonebankfailurepromptsmanymore. @-(, Abankrunwillnothappenifdeposito rsareabsolutelycertainthattheywillbeabletowithdrawtheirfundsupondemand,andsothe simplesolutiontotheproblemofbankrunsistocreatealenderoflastresortoradepositinsu

ranceagencywhocanstepintoprovidethenecessarycashincaseofabankrun.Andhereiswhere
theproblemeconomistscall moralhazardrearsitsuglyhead.Ifdepositorswillbebailedou
tevenintheworstofcircumstances,thebankwillhaveanincentivetotakeexcessiveriskswi
ththedepositors'money,becausefromthebankspointofview,iftheriskpaysoff,thebankke
epstheprofits,butiftheriskyinvestmentsgobad,thegovernmentbailsoutdepositors.Its
headsIwin,tailsthegovernmentloses.Thus,itisessentialtotiedepositinsuranceprote
ctionto prudentialbankregulationandmonitoring,wheretheword prudentialconveystha
tthepurposeoftheregulationistopreventbanksfromtakingunduerisks.Thusfareveryth
ingIhavesaidisstraightfromMoneyandBanking101,andIapologizetoanyoneforwhomitmayb
ereview.Butsettingoutthestoryexplicitlyisusefulbecauseithighlightstwoessentialw
aysinwhichhumanjudgemententerstheproblem.Firstisthatacollapseinthebeliefsofdepo
sitorsthattheirmoneyissafecanleadtobankrunsandpossiblytosevereeconomicconsequen
cessuchasbankfailuresortheterminationoflongterminvestmentprojectsatheavylosses.
Thesecondchannelofjudgmentistheprocessbywhichbankmanagersdecidehowtodispensethe
irloanablefunds.Inmyview,mostoftheplausiblestoriesaboutwhathappenedinEastAsiaca
nbeinterpretedasstoriesaboutthesetwochannelsofjudgementandtheirinteractions.And
realizingthatrealeconomicoutcomesdependcriticallyonchangeablehumanjudgementshel
pstoanswerthequestionthatmanylaypeopleandjournalistshaveaskedaboutthiscrisis:wh
ydidnttheexpertsontheseeconomiesknowbeforehandthatsomethingwas @-(, wrong?Parto
ftheansweristhatthecrisisreflectsawholesale,andselffulfilling,changeofopinionam
onginvestorsaboutwhetherEastAsianinvestmentsaresound.Nobodypredictedthecrisispa
rtlybecauseitisverydifficulttoanticipatesuchaprofoundchangeinotherpeoplesjudgem
ents.Thisemphasisontheimportanceofjudgementleadsnaturallytothequestionofhowpe
oplemakejudgements.PatrickHenryoncesaid Iknownowayofjudgingthefuturebutbythepas
t.IfPatrickHenryhadbeenamoneymanagerintheearly1990shewouldprobablyhavebeenverye
nthusiasticaboutinvestmentinEastAsia.Andthereinmayliealargepartoftheproblem.Con
sidertwoalternativemethodsofmakinginvestmentdecisions.ThefirstistoadoptPatrickH
enry'smethodandinvestininvestments similartowhateverhasperformedwellinthepast,w
ithoutbotheringtoomuchaboutwhatlaybehindthisgoodperformance;becauseyoucanthinko
fthismethodasbasingfutureexpectationsonchartsofpastperformance,Iwillcallthisinv
estmentmethod chartism.Thesecondmethodofjudginginvestmentsistogatherlotsofrelev
antfinancialinformationaboutalternativeinvestments,considerthecircumstancesunde
rwhicheachislikelytoperformwellandhowlikelythosecircumstancesaretoprevail,andch
ooseaccordingly.Thisstrategy,whichIwillcall fundamentalismbecauseitreliesonanan
alysisofthefundamentalfinancialinformationthatdeterminesuccessorfailureoftheinv
estment,isdifficultandcanrequirelargeamountsofdataandexpertisetoimplementandisi
mpossibleifaccurateandcarefulfinancialinformationaboutalternativeprojectsissimp
lyunavailable.Withthesethoughtsinplace,letmestartwiththesimpleststoryaboutthe
natureoftheEastAsiacrisis:thatitwasconceptuallynomorethanseriesofgiantbankruns.
Tounderstand @-(, thisstoryitisnecessarytorealizethatforeignbankshadextendedeno
rmousamountsofshorttermloanstobanksandcompaniesintheEastAsiancountries,andthatt
heseshorttermloanswerethenusedtofinancelongterminvestments.Becausethelenderalwa
yshastheoptionnottorenewashorttermloan,suchloansposeexactlythesamekindsofproble
mthatbankdepositsdo:ifalllenderssuddenlydecidethattheirshorttermloansareriskier
thantheyhadthought,theywillnotbewillingtorenewthoseloanswhentheyexpire.Thesudde
nunwillingnesstorenewshorttermloansislikeasuddendecisionofalldepositorstowithdr
awtheirbankdeposits:itcanleadtoacollapseoftheborrowingbankorcorporation,whichha
slikelyusedtheproceedsoftheshorttermloantofinancelongterminvestmentsthatcannotb
eliquidatedexceptataveryheavycost.Thestory,roughlyspeaking,isthatthecollapseo
ftheThaibahtinJuly,andthesubsequentclosingofalargenumberofThaifinancialinstitut
ionswhichforeignlendersmightpreviouslyhavesupposedweresafeborrowers,spurredafea
rthatsimilarshorttermloanstootherEastAsianborrowerswerenotsosafeaslendershadsup
posed.Sincethoseloanshadbeenmadeatinterestratesbarelyaboveratesavailableintruly
safeinvestmentsathome,evenamodestincreaseindoubtwasenoughtoinducetheforeignlend

erstowanttobringtheirsavingshome.Butbecauseitwasimpossiblefortheborrowerstorepa yalloftheshorttermloanssimultaneously,acrisisensued.Theproponentsofthis bankrun viewofthecrisisdenyquiteexplicitlythatthelongterminvestmentsmadebyborrowerbanks andcorporationsweregenerallyunsound(ofcourse,theydonotdenythattherearesomespeci ficexamplesofbadlending,buttheydodenythattherewasamajordeteriorationinthequalit yoflongtermlendingdecisions).If h+&* thisstoryisright,thenthemainpolicyerrorint hecrisiswasafailureofgovernmentauthoritiesto @-(, promiseapromptandunconditiona lbailouttoallbankdepositors.Itseemsfairtosaythatthisisnotthemajorityviewofthe crisis.Certainlythejournalisticfocushasbeenonexamplesofpoorlongterminvestmentde cisions,fromtheIndonesiannationalcarprojecttowidespreadoverinvestmentinrealesta tetotheextraordinaryempirebuildingofsomeKoreanconglomerates.Alloftheseexampless tronglysuggestthattherewassomething
8
amissinthesecondstageofthefinancialprocess,wheredecisionsaremadeaboutwhichreal longterminvestmentsareworthfinancing.Thereareseveralkindsofstoriesaboutwhatwa samissthere.Letmestart,again,withthesimplest:astraightmoralhazardstory.Inthisvi ew,theessentialproblemwasinsufficient(ornonexistent) prudentialbanksupervision, givingthebankstheclassic headsIwin,tailsthegovernmentlosesincentivestooverinves tinhighrisk,highexpectedreturnventures.Themostconvincingapplicationofthismodeli stothelargevolumeofloanstorealestateprojects.Inhindsight,muchofthislendingseems obviouslyfoolish;whybuildhugeofficetowersincitiesthatalreadyhavesubstantialoffi cevacancyrates?Butpropertypriceshadbeenrisingquicklyforyears,andaslongastheycon tinuedtorise,suchloanscouldbeveryprofitable.Iflendersdidrecognizesomeprospectof apossiblecollapseintherealestatemarket,realestateloansareexactlythekindofhighri sk,highreturninvestmentsthatwouldbeexpectedfromabanksubjecttoamoralhazardproble m.Althoughthestandardmoralhazardstorymaybeapotentialexplanationfortheoverinve stmentinrealestate,itdoesnotcapturesomeoftheotherkindsofcapitalallocation @-(, problemsthatseemtohavebeencommonintheEastAsianeconomies.Onecategoryofsuchproble mshasbeendesignated cronycapitalism;inthisview,banksandotherfinancialintermedia riesallocatedcapitalonthebasisofpersonal,business,orgovernmentalconnectionsrath erthanonthebasisofanyinformationtheyhadaboutthefundamentaleconomicvalueofthespe cificinvestmentprojectstheywerefinancing.OnethingwemayhavelearnedfromtheEastA sianexperienceisthatinthelongrun,relianceonsuchbehindthescenesrelationshipsforc apitalallocationmayleadtoincreasinglypoorinvestmentdecisions.Oneplausibleexplan ationmightcomefromsupposingthatatearlystagesofdevelopment,therearemanyobvioushi ghreturninvestmentstomake,butatlaterstages,afterthelowhangingfruithasbeenplucke d,expectedreturnsfrominvestmentprojectsarebothlowerandhardertoperceive. Relatio nshiplendingwouldworkatearlystagesofdevelopmentbecausetheborrowerstandstoreapla rgeeconomicrewardsfrompursuingthehighreturnprojects,butsuchlendingpracticesmigh tbreakdownatlaterstageswhenoveralleconomicreturnsarelowerbecausetheborrowermayb etemptedtoindulgeinprojectswithnoneconomicsidebenefitssuchasempirebuildingorint ernationalprestige,orevendirectmonetarycompensationstotheborrowerlike commissio ns.Thisbringsmebacktothedistinctionbetweenthe chartistandthe fundamentalistme thodsofmakinginvestmentdecisions,becauselendingtopartieswhorepaidpastloanswitho utrequiringcarefulfinancialanalysisofthenewloanisaformofchartism.Similarly,fore ignlendersprovidingshorttermloanstoEastAsianbankswerealsoengaginginchartismifth eyassumedthattheirloansweresafesimplybecausesimilarshorttermloanshadbeenrepaidi nthepast. @-(, Indeed,giventhepoorfinancialdisclosurerulesandlaxregulationthatc haracterizedthebankingsectorsinsomeEastAsiancountries,itishardtobelievethatthem assiveshorttermloanstobanksinthesecountriescouldhavebeenbasedonanyinformationot herthanpastperformance. ` IthinkthatperhapstheclearestlessonoftheEastAsiancri sisisthatasystembasedonrelationshiplendingandpastperformance,ratherthanfundamen talinformation,isextraordinarilysusceptibletocollapseiftheprovidersofcapitalbeg intosuspectthatsomeborrowersorsomebanksmayhavemadebadinvestments.Iftheonlyinfor

mationalenderhasaboutaborroweristhatsimilarborrowershaverepaidinthepast,thenthe
newsthatsomesimilarborrowersaresuddenlynotrepayingcanhaveadevastatingeffectonco
nfidence,andthereforeonthefinancial H systemandtheeconomyasawhole.Ifforeignlend
ingtoEastAsianbankswasbasedonchartism,isnothardtoseehowthefailureofafewThaibank
sinthesummerof1997couldhavetriggeredawidespreadlossofconfidenceinEastAsianbanks
.Thisstory,orsomethinglikeit,seemstomethemostplausibleexplanationofthebroadch
aracteristicsoftheEastAsiancrisis.Anditisclearlydistinguishablefromthesimpleban
krunormoralhazardstoriesinitsdiagnosisthattheseverityofthecrisisisdueinlargepar
ttoatendencyintheseeconomiestoallocatecapitalnotonthebasisofsoundfinancialinfor
mationbutratheronthebasisofrelationshipsandpastexperience.Iturnnowtothequesti
onofwhathasbeenandshouldbedonetocontainthecrisisandtopreventsimilarfuturecrises
. @-(, NewspaperheadlinesabouttheInternationalMonetaryFund'seffortstoaddresst
heEastAsiancrisistendtofocusontheenormoussumsofmoneythatareinvolvedrangingupto a
staggering$57billionintheKoreanrescuepackage.Intruth,theamountsofmoneythathaveb
eendirectlyprovidedbytheIMFtotheafflictedcountriesaremuchmoremodesttheheadlinef
iguresincludeallpossiblefuturecommitmentsbyboththeIMFandothercountriesparticipa
tingintherescueplans.Indeed,despitetheheadlinefocusondollars,therealnewsaboutth
eIMF'sprogramsinEastAsiawasthattheseplansdifferedfromanypreviousIMFrescuepackag
einseveralcriticalrespectsmostnotablyintheirnovelemphasisonstructuralreformsint
hefinancialsectorsoftheaffectedcountries,reformsdesignedpreciselytoaddressthepr
oblemsofrelationshiplending,laxbanksupervision,andpooraccountingandtransparency
thatIhavejustarguedweretherealreasontheEastAsiancrisiswassoswiftandsosevere.O
neconsequenceofthehighvisibilityoftheIMFprogramsisthevisibilityofcriticismsofth
eIMF.Amemberofthepublicmightwellconcludethatsomethingmustbeseriouslywrongwithth
eIMFonthegroundsthat wheretheressmoke,theresfire.Whatisnotobviousexcepttoexpert
s,however,isthatmostofthecriticismsoftheIMFarematchedbyequalandoppositecriticis
mscomingfromtheotherdirection.Ofcourse,thefactthattheIMFisbeingattackedfromboth
sidesonmostissuesdoesnotnecessarilyprovethatitspoliciesrepresenttherightbalance
,andinhindsightitdoesappearthattheIMFmayhavemadesomemistakesinitsinitialreactio
nstothecrisis.Butwiththeaidofhindsightalmostanypolicydecisioncanbesecondguessed
.Badasthecrisishasbeen,IhavenodoubtthatitwouldhavebeenfarworseiftheIMFhadnotbee
ntheretoadministersomemuchneededgoodadviceandtohelprestoreatleastsomedegreeofin
vestorconfidenceintheaffectedcountries. @-(, Idisagree,particularly,withthose
criticswhosaythatboththeUSandtheworldwouldbebetteroffiftheIMFdidnotexist.Themai
nargumentthatthesecriticsmakeisthatthemereexistenceoftheIMFencouragesinternatio
nalinvestorstorecklesslylendmoneywithoutworryingaboutwhethertheborrowingcountry
orbankiscreditworthy,ontheassumptionthatanIMFpackagewillbailthemoutiftheinvestm
entprovestohavebeenbad.Thisisanotherexampleofthe moralhazardargumentmadeearlier
,butnowtheentityaccusedofprovidingabailoutisnotanationalgovernmentbuttheIMF.Whi
leIheartilyagreethatirresponsiblelendersshouldnotbebailedout,itturnsouttobeextr
aordinarilydifficulttopunishsuchlenderswithoutcausingcatastrophicconsequencesin
theaffectedcountriesandperhapselsewhere.Onceagainthelackoftransparencyinthefina
ncialsystemisacriticalproblem,becausepotentialsuppliersofnewcapitalstillcannotd
istinguishthegoodborrowersfromthebad.Ifexistingdebtisdefaultedon,thelikelyeffec
twouldbetocauseacompletewithdrawalofcapitalfromtheaffectedcountrypotentiallylea
dingtoacompletefinancialmeltdown.ItissimplynotacceptabletosaythatThailandshould
bedestroyedinordertopunishJ.P.Morgan.Itisevenmoreunacceptablegiventherealdanger
offinancialcontagionthatcouldspreadfromsuchacalamityeventotheUS.RecallthatinOct
oberasharpplungeintheUSstockmarketwasattributedtofinancialturmoilinHongKongthat
wasinturndirectlyrelatedtotherestoftheEastAsiancrisis.WhiletheUSstockmarketreco
vered,wehavenoguaranteethatthingsmightnothaveturnedoutmuchworseiftheIMFhadnotbe
enaroundtoprovidesomeassistancetoThailandandtheotherstrickenEastAsianeconomies.
Andevenasidefromthepossibilityoffinancialmarketcontagion,economiccollapseinEast
AsiawouldseverelydamageourtradewiththatregionhurtingUSexportersintheshortrunan

dtheUSstandardoflivinginthelongrun.Finally,therearepowerfulgeopolitcialreasonst hatweshouldcareabouteconomicstabilityinEastAsia.TheUSstillhas @-(, 37,000troops inKorea,andhasstrongmilitaryandpoliticaltieswithJapanandothercountriesintheregi on.Wethereforehaveseriousnationalsecurityreasonsinadditiontoeconomicreasonstoca reabouttherecoveryoftheEastAsianeconomies.TheEastAsiancrisishasstrainedtheIMF 'sfinancialresourcesnearlytotheirlimit.Thismeansthatifacrisisshoulderuptinanoth erbigcountry,oriftheEastAsiancrisisshouldtakeaturnfortheworse,theIMFmightnotbea bletoprovideacrediblerescuepackage.Theresultingfinancialcollapsecouldspread,jus tasThailand'scrisisspread,andthedamagetotheglobalfinancialsystemcouldbesevere.A saresultIbelieveitisciritcalthattheCongressquicklyapprovetheAdministration'sreq ueststoincreasetheIMF'sfinancialreserves.Thisshouldbeaneasydecision,becausethes earenotbudgetexpenditurestheyarejustlinesofcreditfortheIMF,andsoaremoreakintoin vestments.SuchIMFfundingincreaseshavenevercosttheUStaxpayeradime,andtheproposed increasesinIMFreserveswillalsocostnothing.Andtheyprovidearealmeasureofincreased securityfortheUSandtheworld'sfinancialsystem.FundingincreasesfortheIMF,howeve r,areonlythefirstandmostobviouspriorityinrespondingtothecrisis.Weneedtotakestep storeducethelikelihoodthatsimilarcriseswilleruptinthefuture,andtominimizethecon sequencesofsuchproblemsasdooccur.Itseemstomethattherearethreeelementsthatshou ldbepartofanyreformeffort.Thefirstistoimprovetheinformationavailable,sothatinve storscanmaketheirlendingdecisionsonthebasisofaninformedassessmentofthefundament als.Tobewellinformed,aninvestorneedstoknowagreatdealaboutboththespecificborrowe randabouttheeconomiccircumstancesof @-(, theborrowerscountry.Wethereforeneedtos tronglyencouragecountriestorequireimprovedaccountingandreportingfromtheirbusine sses,andwealsoneedtomakesurethatdataareavailableonthefinancialpositionofthecoun tryasawhole.Particularlyimportantinthisrespectaregooddataoncentralbankreservesa ndmoregenerallyontotalshorttermforeigndebt.Investorsalsoneedgoodqualitativeinfo rmationonrisk,includingassessmentsofthequalityofcountriesbankingsupervision,ban kruptcyprocedures,judicialsystems,andanyotherinstitutionalarrangementsthatcanha veanimportanteffectonrisk.Second,manycountriesneedtostrengthentheirnationalfi nancialsystems.Thereareseveralproposedinternationalstandardsforbankingsupervisi onandregulationthatcouldbeadopted;ataminimumthereshouldbesomeregularsystemofass essmentandsurveillenceofbanksandotherfinancialinstitutions.Thereisausefulanalog yfromRobertMerton,areceneconomicsNobelPrizewinner.Todaysglobalfinancialmarkets arelikesuperhighways:Theygetyouwhereyouwanttogofast.Bythis,Imeantheyareuseful:t heyhelpcountriesfinanceinvestmentandthereforegrowth,andtheyhelpbufferandsmootha wayeconomicfluctuations.Butwhenbuildinganexitrampfromasuperhighwaytoanewvillage ,itisessentialforthevillagetopavetheroads,installstreetlights,andmakesurethepped estriansunderstandthenewrulesofthegamebeforeopeninguptheexitramp.Anddriversshou ldexercisecautioninnavigatinginnewandunfamiliarterritory.Idonotknowhowthemoni toringandreportingonfinancialandbankingsystemsshouldbeimplemented,thoughtherear eseveralalternativeproposals.Onepossibilityisthatregulatorsincountrieswithstron gfinancialsystemscouldprohibitbanksfromcountrieswithinadequate @-(, regulatoryr egimesfromparticipating.Regulatorsmightalsorequiregreaterriskbasedcapitalreserv esforloansextendedtoborrowersincountrieswithpoorfinancialregulatorysystems.Fi nally,weneedtodevelopmechanismssothattheprivatesectorbearstheconsequencesofitso wninvestmentdecisionsmorefully.Perhapsthemoststraightforwardsolutionwouldbetoen couragecapitalflowstotaketheformofequityandbondinvestmentsratherthanbanklending inaforeigncurrency.Pricesinstockandbondmarketsadjusttochangesinperceivedriskaut omaticallyandinwaysthatcanposesubstantiallylesssystemicriskthanforeigncurrencyd enominatedshorttermloans.Thissolutionfitswellwiththeotherreformpieces,becausein ordertofunctionwell,stockandbondmarketsrequiretimely,honest,andcrediblereportin goffirms'financialcircumstancesinotherwords,atransparent,wellregulated,andwellf unctioningsetofpubliccapitalmarkets.Buildingsuchmarketsisalongtermchallenge,not ashorttermfix.Inconclusion,IwouldsaythatIamano:9p9:;ptimistaboutthe;=courseof futuredevelopments=>==>?.?B...BB?TheEastAsiacrisishas?B@?certainly?@BAdrivenhom etheimpABE< %0!$ <EDFinally, ` TheIMFseemstohaverecognizedtheuniquechar acteroftheEastAsiancrisisandtohavereactedappropriately:Thedimensionalongwhichth eEastAsianprogramsdiffermostmarkedlyfromanypreviousIMFprogramisintheiremphasiso ntheimportanceoftransparency,openness,andaccountabilityincapitalmarkets.Thesear epreciselytherightDeputyTreasurySecretarySummersrecentlyremarkedthatoneofthemos thopefulsignshehasseenthattheIMFprogramsarehavingtherighteffectcamefromaconvers ationwithateacherofnightschoolcoursesinaccounting,whosaidthatinpreviousyearsheh adnormallyhad22studentsinhiswintertermclasses,butthisyearhehad385.Theessentia lproblemwithafinancialsystembasedonrelationshiplendingandwithpoorbanksupervisio n,regulation,andreportingisthat fundamentalistinvestmentisimpossible,becauseitr equiresinformationthatissimplynotavailable.onlyiftheaccountingandotherfinancial informationnecessaryareavailable.Incontrast,abankingsysteminwhichlendingdecisio nsaremadeonthebasisofaccurateandcredibleaccountinginformation,bybanksthataresub jecttoastrongregulatoryregime,willbemuchlesssubjecttoatotalandcatastrophiclossi nconfidencebecausethebetterinformationwillmakeiteasierforthesoundbankstoconvinc edepositorsoftheirsoundness. @-(, isthat,asthemutualfundssay, Pastperformanceis notaguaranteeoffuturereturns.Solongasthecroniesallocateinvestmentfundstoproduct iveventures,cronycapitalismcanworkwellevenifthelenderhaslittleinformationaboutt hefundamentalvalueoftheprojects,andevenifdepositorshavelittleinformationonthele ndingpracticesofthebank.Acatastrophicproblemarises,however,ifsuspicionisaroused aboutwhethermoneyallocatedtocronieshasbeeninvestedefficiently,becauseAfterall,p astexperienceoflending cronycapitalismgov'tdirectedlootingTomanyinthisa udienceallofthiswillbereview.ButIfinditausefulreview,becausealloftherellyconvi ncingstoriesabouttheEastAsiancrisiscontainsomeelementofabankrun,andthelogicofba nkrunsprovidesusefulguidepostsforthinkingaboutcriticalelementsofthe @-(, crisis evenforthosewhobelievethatthecrisiswasconsiderablymorecomplexthanasimplebankrun .ThefactthattherewasnomajorchangeinthestructureofEastAsianfinancialmarketsleadi nguptothesummerof1997andcertainlynochangethatcausedwidespreadalarmcastsdoubtont hosebecameamatterofcommonnoticeanddiscussion,althoughintruththeunderlyingWest andtodayinthefullstreamofatideofchangesthatcollectivelyhavecometobetermedthe gl obalizationoftheUSandindeedtheworldeconomy.The globalizationoftheUSeconomyh asbecomeapopularcatchphraseinthe1990s,neatlycapturingtheReturningtomyearlierd ichotomyofinvestmentstrategies,inthisview,theforeignlenderswerechartists:becaus eshorttermloanstoEastAsianbanksandcompanieshadalmost @-(, alwaysbeenrepaidinthe past,theyassumedthatsuchloanswouldcontinuetoberepaidinthefuture.Inthisviewtheca useofthecrisiswassimplythechangeinopinionwroughtbythenewinformationthatinvestme nts similartothoseinThailandmightwerelesssafethanhadbeenthought.Intheend,both ofthesestoriesareaboutthedangersof chartisminmakinginvestmentdecisions;ifbothba nksandsavershadmadetheirdecisionsonthebasisofpubliclyavailable,transparentfinan cialinformationaboutthefundamenalsofthespecificinvestmentsbeingfinanced,therewo uldhavebeenmuchlessscopeforpanicbecauselenderswouldhavebeenbetterabletodistingu ishgoodinvestmentsfrombadonesandsaverswouldhavebeenmuchbetterabletodistinguishb ankswithmostlygoodloansfromthosewithmostlybadones.And,asIdiscussedearlier,acoll apseinconfidencecanleadtorealandcatastrophiceconomicconsequences.Whencreditisex tendedonthebasisthatpastloanshavepaidoff @-(, Theproblemisthatlenderswhoextende dcreditonthebasisofpersonalorbusinessrelationshipsmaylacksufficientinformationo nfundamentalstodistinguishwhichloansaregoodandwhicharebadoncesuspicionsarearous ed;similarly,ifsavers(orforeignlenders)hadassumed(intheabsenceofreliablefinanci alinformationorastrongregulatorysystem)thatEastAsianbankswereverysafebecausethe yhadnotdefaultedinthepast,thenitisnothardtoseehowthefailureofafewThaibanksinthe summerof1997couldhavetriggeredawidespreadlossofconfidenceinEastAsianbanks.Tothe extentthatthe croniesinquestioncontrolledbusinessesthathadastrongtrackrecordofp astsuccess,requiringandanalyzingdetailedinformationonboththeborrowerandthepropo

sedinvestmentprojectmightsimplyhaveseemedtothelenderawasteoftimeandeffort.Thisf ormofchartismmayworkfinesolongasmostborrowershaveaccesstohighreturnprojects,bec auseeachcronycapitalistneedstomaintainagoodreputationforrepaymentifhehopestohav eaccesstofutureloans.Overthepastdecadetheincreasing globalizationoftheUSandthew orldeconomieshasenteredforcefullyintotheAmericanpublicsconsciousness.Whilethede velopmentsthatarebroughttomindbythewordglobalizationincludemanytrendsthathavebe enunderwayfordecades,thepasttentofifteenyearshaveseenaremarkableexpansioninthee xtenttowhichthe @-(, countriesoftheworldaretiedtogether,bothbyinstantcommunicat ionandbyinternationalmarketsandinstitutions,includingfinancialmarkets.AsmyCEAco lleagueJeffFrankelsays,thepurposeofIMFfundsisnottobailinvestorsoutbuttobailthem backin.Thisstrategyseemstobeworking:Korea,forinstance,hasrecentlybeenabletoretu rntoprivatecapitalmarketstosecureitsfirstlongtermfinancingsincebeforethecrisise rupted.Andthefactthatthecrisishadapalpable,ifbrief,effectoneventheUSstockmark etinOctoberillustratesthatthedangeroffinancialcontagionfromcriseslikethisisreal evenforthedevelopedcountries.D================= END ATTACHMENT 1 =================