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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	Janet L. Yellen to Jeffrey A. Frankel at 16:58:40.00. Subject: FYI... (1 page)	06/02/1998	b(6)
002. email	Jeffrey A. Frankel to Hopkins_M, Aaron S. Edlin, jon D. Haveman, Janet L. Yellen, and Stone_CF at 15:19:01.00. Subject: mergers and international aspects. (partial) (1 page)	06/02/1998	b(6)

COLLECTION:

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

FOLDER TITLE:

[05/28/1998 - 06/09/1998]

2013-0723-F
ab1279

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

CREATION DATE/TIME:28-MAY-1998 18:19:21.00

SUBJECT: Mtg on Russia

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

TEXT:
I talked to Steinberg's assistant. She said that there was a tenative plan for a mtg on Russia for today, but then it was taken off the calendar and there was no plan to re-schedule. She said that she'd let me know if it does get re-scheduled. I also called Gene's office and they said that he has not held or been invited to a Russia meeting.
FYI, Below is what McCurry said at his press conference on the subject of Russia:

Now, President Yeltsin of the Russian Federation called President Clinton today to report on actions Russia is taking to reach agreement with the International Monetary Fund and to ensure that Russia stays on a sound economic track. President Yeltsin affirmed his support for his economic team, their commitment to implement a solid budget, their efforts to invigorate tax reform, and steps the Russian government is taking to create a climate to attract investment. President Clinton reiterated his firm support for Russia's reform efforts, its commitment to reach rapid agreement with the IMF, President Yeltsin's unequivocal commitment to back Prime Minister Kiriyenko's government and his reform.

As you heard me say yesterday, the President believes that Prime Minister Kiriyenko has a very sound and strong economic team in place that have a very good idea of the types of reforms that they want to pursue, and while the Russian Federation clearly faces some economic potholes in the road, they know how to pave them. I think there is a high degree of confidence in the work that President Yeltsin's team is doing.

Clearly, both Presidents also discussed the seriousness of the situation with respect to the nuclear tests by Pakistan and the situation on the Indian subcontinent. They agreed they need to stay in close touch and work together to defuse tensions in South Asia, and both Presidents noted the importance of the work that Foreign Minister Primakov and Secretary Albright did today at the North Atlantic Council ministers' meeting in Brussels. There is an historic first statement by the Partnership Joint Council, which is the entity NATO and Russia jointly formed to deal with matters with respect to Russia's partnership with a NATO that issued a very strong statement on the situation on the subcontinent today. And both Presidents welcome that development.

Separately, Prime Minister Kiriyenko had a conversation with Vice President Gore today in which the Prime Minister reaffirmed his strong commitment to economic reform. We can get more details -- the Vice President's office can get you more details from that call

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-JUN-1998 09:10:24.00

SUBJECT: OFHEO project

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

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

TEXT:
Janet and Jeff --

I just want to let you know the status of the OFHEO project that Steve referred to in his earlier memo. I had a meeting with Jeremy, Chris and Steve about 3 weeks ago (I think it was when you were in China), about the request for us to sending somebody to a working group over the summer that's putting together some important regulations. With Jeremy and Chris both leaving by the end of June, I asked Steve if he would at least attend the first meeting to see what this involved -- and we discussed the fact that we could decide exactly how involved we wanted to be once we knew more about the project. (Steve was somewhat reluctant to volunteer for this, although he admitted to actually knowing something about the topic, and he told me "I'll go if you tell me to," and I told him, "I want you to go to this first meeting."

Anyway, I had a long talk with Steve on Thursday night about this project. It's clearly not a "core" issue for us -- and Treasury and other groups should be doing all of the background work on it. I told Steve we obviously don't want him involved if it's going to take 3-4 weeks of his time, but I indicated that my expectation was that we'd be more "committee sitters" -- simply attending the working group meetings wtihout being involved in the inbetween work. If we couldn't do this comfortably, I suggested we should simply not get involved. Steve seems unsure about whether we can do this or not. He said he'd think about it.

My own sense -- if Steve doesn't feel he can be part of this working group without trying to do lots of background work, we should just drop it. The group is working from June-August 15, because the regulation they're working on has to be released by the end of August. Hence, it makes little sense to wait until one of our new staffers arrives -- either Steve does this or we don't participate. I don't feel really strongly about the issue -- I think it's not a core topic for us and we can easily not participate.

Anyway, that's the background, should the topic come up in your conversations wtih Steve or others.

Becky

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-JUN-1998 17:04:21.00

SUBJECT: Reporter's questions on CPI methodological changes and the SS deficit

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

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

TEXT:
I just had a 20 minute conversation with Aaron Bernstein (Business Week) who wanted to know how the CPI methodological changes would affect the long-term actuarial balance of the Social Security system. I explained to him how to think about the problem, and how to use the figures on page 80 of the ERP, how to use the multipliers published by the advisory council, but I gave him no figures that were not publicly available. I explained to him at great length that one also has to know precisely how much of these changes were anticipated by the SS trustees (which I did not).

I refused to answer several questions: on how much I thought the CPI methodological changes would affect the SS balance; what the CEA thought of the Boskin Commission recommendations; how much of the Boskin bias had been fixed by the BLS (although he says that BLS is saying that it is 0.23); what the CEA thought of the Moynihan proposal.

The phone conversation began with the usual (very explicit) caveats that everything was on background.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-JUN-1998 17:34:42.00

SUBJECT: Draft of Letter to Kucinich

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

TEXT:
Attached is a draft thank you letter to Congressman Kucinich. After you make any changes or corrections, you can e-mail it to Alice to format and send out.
Thanks

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D48]MAIL425507259.126 to ASCII,
The following is a HEX DUMP:

Dear Congressman Kucinich:

I want to thank you for your support during my hearing before the House Government Reform and Oversight Committee. You were truly an important ally. I appreciated knowing that there was a thoughtful and articulate supporter on my side.

As you know, the Administration is pursuing an international, market-based strategy to address the serious challenge of global climate change. Failing to address the threat posed by climate change could effect the lives and well-being of people around the world. I believe that Kyoto Protocol and an effective international emissions permit trading regime are important first steps toward addressing this challenge. Your efforts and support are appreciated.

Thank you again. I look forward to working with you on this issue in the future.

Please do not hesitate to contact me if you have any questions or concerns regarding this or any other economic issues.

Sincerely,

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-JUN-1998 15:00:28.00

SUBJECT: next mergers mtg.

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

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

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

CC: STONE_CF (STONE_CF @ A1 @ CD @ VAXGTWY [UNKNOWN]) (WHO)
READ:UNKNOWN

TEXT:
Janet,

Here is the draft that Dorothy sent Chad and me yesterday afternoon.

After having had lunch with her just now: She is wide open to suggestion, and was receptive to the possibility of including the question "Do trade remedies [in other countries as well as our own] sometimes act to reduce competition?" I hope to be able to give her more detailed suggestions by the end of the week.

She thought that another principals meeting, on these international aspects, was possible by late next week, though it might also slip to the week after. (It is possible that I will miss it: I will be away June 12-17.)

JF

---------------------- Forwarded by Jeffrey A. Frankel/CEA/EOP on 06/02/98 02:53 PM ---------------------------

Dorothy Robyn
06/01/98 01:08:21 PM
Record Type: Record

To: Jeffrey A. Frankel/CEA/EOP, Charles F. Stone/CEA/EOP
cc:
Subject: next mergers mtg.

Attached is a short background paper on international aspects of mergers and a draft agenda. I'd love you're feedback, particularly on the paper: Are these the right issues? Are there others that we should include?

Jeff: I'd especially appreciate your thoughts on the third issue in the paper -- trade policy and competition policy -- which I found the most conceptually difficult to sort out.

The agenda is very much a draft. Because the international issues seem to me to focus pretty heavily on the merger review process itself, we may want Klein and Pitofsky to play a much bigger role than the agenda implies. At the same time, Gene may want to get away from "presentations" altogether.

Thanks!

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D14]MAIL44966335G.126 to ASCII,
The following is a HEX DUMP:

International Aspects of Mergers, Concentration and Competition
Agenda for Principals Meeting
May 31, 1998

I. International Antitrust Enforcement

Markets for products and services are becoming increasingly global. At the same time, many countries are adopting competition regimes for the first time or increasing their enforcement of existing laws. As a result of these trends, competition authorities from one country are more frequently reviewing transactions/conduct that occurs in another country.

Countries have different standards governing when their courts have jurisdiction over conduct that occurs outside of their borders. Over the years, the U.S. has exercised its extraterritorial jurisdiction over antitrust activity with considerable enthusiasm, leading some countries to pass "blocking statutes" that permit their citizens to resist complying with our discovery requests. However, foreign competition authorities are gradually adopting the U.S. approach, and European law has been interpreted to reach much the same conduct covered by U.S. law. In response to the growing number of transactions involving foreign entities, competition authorities are intensifying their cooperation in two ways: first, through more sharing of evidentiary information and, second, by coordinating enforcement activities so as to allocate limited enforcement resources and avoid jurisdictional conflicts and.

Possible topics for discussion include:

1. ***Streamlining the merger review/antitrust enforcement process:*** U.S. firms are increasingly getting caught in a web of overlapping jurisdictions, and Bob Pitofsky's comment at the first meeting implied that other competition authorities are less efficient than ours. Moreover, U.S. firms can be subject to conditions imposed by more than one government. How can governments streamline the merger/alliance review process and better coordinate antitrust enforcement?

2. ***Avoiding the use of competition policy as industrial policy:*** Competition policy varies from country to country; in Europe, for example, competition authorities can legally consider the impact of a foreign merger (Boeing/McDonnell Douglas) on a domestic competitor (Airbus). That said, there is considerable suspicion that foreign governments, particularly the European Union, are using competition policy not just to ensure fair market practices but to protect domestic firms from more efficient competitors and other market forces. Is this suspicion justified? And, if so, what can we do about it?

3. ***Responding to proposals to harmonize competition policy internationally:*** Some legal scholars have called for moving to a single, international competition policy regime that would be administered by the WTO or OECD. U.S. competition authorities generally oppose this approach in favor of closer coordination of national enforcement regimes. What are the contours of this debate? What about other alternatives -- e.g., limited harmonization with, say, Canada? (My sense is that harmonization is being pushed in part by trade experts who want to use an international competition policy regime to solve persistent unfair trade practices. U.S. competition authorities seem particularly wary of harmonization proposals involving the WTO, for fear they would give trade specialists a bigger role in competition policy. This tension reflects philosophy not turf: Competition authorities view as anti-competitive many policies adopted in response to unfair trade -- e.g., antidumping duties.)

II. Implications of Global Competition for U.S. Antitrust Policy

The globalization of trade and competition means than U.S. firms face more foreign competitors in their home markets at the same time that they are under pressure to expand their operations abroad. As a result, they are putting greater emphasis on, among other things, operating efficiently and entering new markets -- both to attract new foreign customers and to remain competitive for their U.S. customers who now do business around the world. Mergers and other collaborative ventures are an important vehicle for achieving these goals.

In May 1996, the FTC issued a lengthy report on "Competition Policy in the New High-Tech, Global Marketplace," based on two months of public hearings on how the agency could keep pace with the changing economy. Most significant, the report recommended that the FTC and DOJ reexamine how they take into account whether a merger is likely to achieve economic efficiencies with competitive significance. (Longstanding Supreme Court case law expresses considerable skepticism about recognizing efficiencies in support of a proposed merger.) As a result of this recommendation and a subsequent FTC/DOJ task force, Section 4 ("Efficiencies") of the "1992 Horizontal Merger Guidelines" was revised in 1997 to incorporate the concept of "merger-specific efficiencies."

The FTC report also looked at the definition of geographic markets and concluded that the 1992 merger guidelines were flexible enough to incorporate foreign imports as appropriate. It reaffirmed the need to consider whether a merger would reduce competition in innovation (recall Pitofsky's comments on the merger of two Canadian vaccine developers). Finally, the report addressed the growing importance of joint ventures and other collaborative agreements as a way to expand into foreign markets, fund expensive R&D efforts and lower production and other costs. Despite legislation and other efforts to clarify what conduct is legitimate, fear of potential antitrust liability may continue to discourage some forms of pro-competitive collaborations among competitors, the report concluded. It recommended development of joint venture guidelines to provide further clarity. [Has this been done?]

Possible topics for discussion include:

1. ***The "rule of three" and other arguments that bigger is better in global competition:*** The much discussed "rule of three" holds that three giant firms will invariably end up with 60 percent of the market in mature industries, and many of the proposed mergers (e.g., SBC-Ameritech) are being justified on the grounds that companies must be big to compete globally. However, Pitofsky urged caution toward such justifications. How valid is the rule of three? When is bigger in fact better? In what other ways do mergers help companies compete globally?

2. ***Revisions to the "Efficiencies" section of the 1992 merger guidelines:*** What are these revisions and how are they being implemented? With what effect?

3. ***Does U.S. competition policy need to adapt in other ways?:*** Does fear of antitrust liability still have a chilling effect on pro-competitive collaboration among competitors? If so, how should we respond? Are there other ways in which U.S. competition policy needs to adapt to global competition?

III. The Nexus Between Trade Policy and Competition Policy

Competition policy and trade policy are linked in many ways, but two of them are particularly relevant to a review of "Mergers, Concentration and Competition." First, as noted above, mergers and other forms of collaboration are an important vehicle for getting into foreign markets -- particularly when trade barriers impede U.S. exports. Collaborative ventures can be a way not just to get around but also to pry open foreign markets (e.g., the U.S. has made "open skies" a quid pro quo for approval of certain international airline alliances). Second, like most countries, the U.S. has trade laws and policies that limit competition by foreign firms in U.S. markets. These include restrictions on foreign ownership of U.S. telecommunications firms, airlines and banks, among other entities; limits on operation of foreign airlines and other non-U.S. firms in the U.S.; and various Buy America and Fly America requirements. As a matter of practice, we have limited direct foreign ownership of U.S. defense contractors.

[There are other important links between trade/trade policy and competition policy, but I'm not sure they belong here. As I noted above, some people are keen to use competition policy to get at unfair trade practices. Similarly, U.S. competition authorities have signaled a willingness to use their extraterritorial jurisdiction to fight anticompetitive conduct by foreign firms. While important, these issues don't seem to me to be central to our review, except as they relate to merger review. Another link is the possible use by EU authorities of competition policy to limit U.S. firms' access to their markets. This ***is*** relevant to our review, but, conceptually, I have treated it as an "international antitrust enforcement" issue rather than a trade-related issue.]

Possible topics for discussion include:

1. ***Mergers as a vehicle for market access:*** To what degree are mergers/alliances between U.S. and foreign firms a vehicle for getting around various trade barriers and market access restrictions? Are there more direct ways to eliminate those barriers and restrictions?

2. ***Restrictions on foreign ownership of U.S. companies and participation in U.S. markets (and comparable foreign restrictions):*** Where do these restrictions still make sense and where do they not? How has U.S. policy toward foreign ownership and participation in telecommunications changed in light of the 1997 WTO agreement on telecom? What about comparable policy in foreign countries?

3. ***Foreign ownership of U.S. defense contractors:*** As DOJ sues to block the merger between Lockheed Martin and Northrup Grumman, European defense companies have expressed possible interest in buying Northrup. What is DoD's view of this?

DRAFT

Mergers, Concentration and Competition:
International Dimensions
June X, 1998
AGENDA

I. Introduction: Gene Sperling

II. International Antitrust Enforcement

A. Coordination between National Competition Authorities: Joel Klein

B. DG IV: Competition Policy or Industrial Policy?: Rodney Slater

III. Implications of Global Competition for U.S. Antitrust Policy

A. Industry Responses to Global Competition: Larry Summers

B. Changes in U.S. Antitrust Policy: Robert Pitofsky

IV. Trade Policy and Competition Policy

A. Mergers as a Vehicle for Market Access: Charlene Barshefsky

B. Foreign Ownership/Participation Restrictions: William Kennard
(William Cohen)

V. Discussion

VI. Next Steps: Gene Sperling

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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-JUN-1998 12:23:01.00

SUBJECT: Letter to Congressman Kucinich

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

TEXT:
Attached is a letter for Congressman Kucinich. Could you format it
properly and prepare it for my signature? (Could you also check the
spelling of his name?)=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D10]MAIL47095235Y.126 to ASCII,
The following is a HEX DUMP:

Dear Congressman Kucinich:

I want to thank you for your support during my hearing before the House Government Reform and Oversight Committee. You were truly an important ally. I appreciated knowing that there was a thoughtful and articulate supporter on my side.

As you know, the Administration is pursuing an international, market-based strategy to address the serious challenge of global climate change. A failure to address this threat could adversely affect the lives and well-being of people around the world for centuries to come. I believe that Kyoto Protocol and an effective international emissions permit trading regime are important first steps toward addressing this challenge. Your efforts and support are appreciated.

Thank you again. I look forward to working with you on this issue in the future.

Please do not hesitate to contact me if you have any questions or concerns regarding this or any other economic issues.

Sincerely,

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-JUN-1998 18:33:13.00

SUBJECT: microsoft

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

TEXT:
Mark Rainey and I have prepared 3 files on Microsoft. I have passed them to mark for one last edit and speakos removal. He should send them to you and Chad when he is finished.

I have left a memo to Howard on my desk and Vickie's.

take care.

Thanks again for having me here.--Aaron

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-JUN-1998 12:16:02.00

SUBJECT: Easter Island draft

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

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D40]MAIL41745235X.126 to ASCII,
The following is a HEX DUMP:

THE MALTHUSIAN ECONOMICS OF EASTER ISLAND

Thomas Malthus warned in 1798 that disease, famine and poverty were unavoidable consequences of the tendency for growth in population to outstrip growth in the means of subsistence. Several centuries of impressive gains in living standards, accompanied by rapid population growth and falling prices of resources and primary commodities (see Chart) have left most economists skeptical of the Malthusian logic. Recent evidence suggests, however, that the Malthusian pattern of economic growth, resource degradation and eventual economic decline may explain the mysterious rise and fall of Easter Island and, perhaps, other ancient civilizations.

The Rise and Fall of Easter Island

At the time of its discovery by Europeans in 1722, Easter Island was a poor Polynesian island with a "late stone age" culture. Enormous carved stone statues, resting on large platforms around the island, bore witness though, to a past in which the island was both richer and more populous. The statues had been moved substantial distances from the island's lone quarry to their destinations; but observers estimated the population of the island at 3,000 in 1722--far too small to have transported the larger statues without appropriate tools. Moreover, the island had no trees suitable for making such statue-transport equipment. Local residents believed that the statues had walked to the platforms under the influence of a spiritual power.

What Happened?

A variety of theories have been advanced to explain the Easter Island mystery, but recent archaeological evidence suggests that Malthusian interactions were at work. The island was apparently settled around 400 A.D., at a time when great palm forests flourished. These forests were a nesting place for birds, a source of food. The palms also likely provided the wood needed for tools and for canoes used to fish. With abundant food, the population had ample time for artisan activities including carving and moving statues. As Malthus would predict, population grew rapidly. Radiocarbon dating shows that the statues were carved between 1100 and 1500 AD. By 900 AD, the pollen record points to noticeable forest reduction, although the pace of forest loss was likely gradual enough to have been imperceptible to the typical Easter Island resident over his 30 year lifespan. By 1400 the palm forest was gone. Loss of forests led to a reduction in fishing and to soil erosion, lowering agricultural yields. With falling food consumption, carving activity declined and ultimately ceased and violent internecine conflict began, with islanders developing dagger-like weapons and inhabiting caves and fortified dwellings. By 1774, statues that were still standing in 1722 had been knocked over, statue worship had disappeared, and the population had further declined in size.

Researchers believe that after perhaps a thousand years of peace and propsperity, Easter island suffered a Malthusian fate: Its population rose above a sustainable level, the environment was degraded to the point it could no longer support its population, the social order disintegrated, and the civilization crashed.

Why Easter Island?

If the Malthusian theory applies to Easter Island, how did other Polynesian islands, with similar demographics, culture and technologies, escape the same fate? A likely explanation relates to the particular species of palm tree (Chilean Palm) indigenous to Easter Island but found nowhere else in Polynesia. The Easter Island palms are particularly slow-growing, requiring 40 to 60 years to bear fruit. In contrast, the palms found elsewhere in Polynesia reach fruit-growing age in 7 to 10 years. More rapid forest growth implies a greater ability to regenerate a shrinking resource base once depletion is apparent, likely enabling other islands to avoid the dramatic collapse suffered on Easter Island. On Easter Island depletion, once it occurred, could not quickly be reversed. Moreover, the investments needed to rebuild Easter Island's resource base would have produced payoffs for the island's descendants but not for the inhabitants themselves.

Other Malthusian Episodes?

Recent archaeological evidence from core samples suggests that the Easter Island experience was likely not unique. Environmental decline may have precipitated the collapse of the Mayan, Mesopotamian and Anasazi (southwestern United States) cultures. In each case, decline of the resource base, particularly soil degradation, precipitated a population crash and the decline of a complex civilization. More recently, the violent Rwandan conflict between Hutus and Tutsis could also have been related to resource competition. Between 1950 and 1994, advances in health care and agricultural practice raised real incomes but also increased fertility, resulting in a quadrupling of the population. By the 1980's conflicts over land had increased in severity, and may have precipitated civil war.

Implications

In modern times, technological progress, reduced fertility in the face of rising income, and the evolution of more effective resource management institutions--including well defined property rights and international agreements to prevent "overgrazing of the commons"-- have normally short-circuited the Malthusian dynamic. However, adaptive responses become more difficult, when environmental degradation occurs gradually, when the payoff from environmental protection is long-deferred, and when cooperation on a large scale is needed--conditions which are all present, for example, in the case of global warming. The demise of Easter Island illustrates the operation of the Malthusian logic absent an effective environmental response.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-JUN-1998 15:19:01.00

SUBJECT: mergers and international aspects

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

TO: Aaron S. Edlin (CN=Aaron S. Edlin/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

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

TEXT:
I asked Tim Brennan for his views, and here is his reply. (Mark: He refers to what an FTC study that must be the same I asked you to try to get. We could get it from Dorothy Robyn if not elsewhere.)

So far, I am not picking up clear views/policy proposals in the people I am talking to.
Bob Litan supports Klein's approach: enhanced cooperation among countries' competition authorities. On Anti-dumping, he wondered if one could make a deal with countries that have anti-trust policy (e.g., the EU), that we would apply differenet AD rules against their products than the silly ones we apply against most countries -- more sensible rules where it would be harder for firms to get protection, and likewise for their AD rules against our firms.
Larry White had little to say on the international dimension, but on mergers more generally echoed something that I have heard amazingly often now: that managerial ego is the driving force (he says that the mergers are occurring in fields of rapid technological change -- or regulatory change -- because that is where managers can most plausibly use arguments about synergies as a cover for empire building).
JF

---------------------- Forwarded by Jeffrey A. Frankel/CEA/EOP on 06/02/98 03:07 PM ---------------------------

"Tim Brennan, Policy Sciences" <BRENNAN @ UMBC2.UMBC.EDU>
06/02/98 03:48:48 PM
Record Type: Record

Withdrawal/Redaction Marker
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
002. email	Jeffrey A. Frankel to Hopkins_M, Aaron S. Edlin, jon D. Haveman, Janet L. Yellen, and Stone_CF at 15:19:01.00. Subject: mergers and international aspects. (partial) (1 page)	06/02/1998	b(6)

COLLECTION:

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

FOLDER TITLE:

[05/28/1998 - 06/09/1998]

2013-0723-F
ab1279

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]

To: Jeffrey A. Frankel/CEA/EOP
cc:
Subject: mergers and international

Jeff,

[redacted] (b)(6)

[002]

On international dimension of merger policy, you posed three questions:

1. International Enforcement: My sense is that the Division or FTC can generally reach mergers of international firms, I think because they usually have US operations or divisions. One of the Division's biggest merger cases in the Clinton Administration came early, involving heavy-duty automatic truck transmissions. At least one of the parties was German, although GM may have been the attempting acquirer. But on this general area, I don't know much. I do have a sense that the Division and FTC generally work well with the EU on these matters, and have been improving relations with Japan, but I'm sure you know more about that stuff than I do. A conflict such as that arising in the Boeing/McDonnel Douglas case a year ago is the exception to the rule.

2. Global Competition and Merger Policy: I don't hear it said as much as I used to that US merger policy is too aggressive because we don't recognize threats from foreign competition. If we don't hear that complaint so frequently, it's a good thing. For it's simply not true. The Merger Guidelines' procedures for defining relevant "markets" (i.e., who competes with whom) include international firms where appropriate. I think it can be easy for some to exaggerate the scope of international competition in a lot of markets. Transportation costs do matter, as do other transaction costs that may arise in doing dealings across borders and languages. But if foreign firms can compete, DOJ and FTC will include them in assessing the competitive effects of a particular merger.

3. Trade Policy and Merger Policy: However, if trade policy stands in the way of foreign competition, DOJ has in the past excluded foreign firms from the market. The main example of this in my mind involved the steel mergers in the early '80s. Some, including our predictably industry-friendly folks in the Commerce Department, were aghast that the Division would

challenge those mergers, when Japanese, Brazilian, and German firms were selling steel in the U.S. However, not only were steel imports restricted during that time, but they were restricted to be some fraction of U.S. sales. Thus, if US steel producers were to collude to raise price and reduce output, our trade rules would reduce imports by a similar percentage. Thus, trade policy in effect made the foreign firms involuntary members of any U.S. steel cartel. In that case, DOJ properly regarded the relevant market as domestic rather than international. I assume DOJ and the FTC would act similarly today in contexts were similar trade barriers remain in place.

Hope these are helpful. I think the FTC issued a couple of years ago a report on Antitrust in the 21st Century or something like that, and international stuff may have been included. Also, I'm sure Chuck Stark at DOJ or others in the International Section could give you the thorough and accurate story.

Thanks for asking. If I can be of more help, particularly this summer, let me know. I've got to write three papers, and I'm still doing a bit of stuff for DOJ, but I'd be glad to help.

Best to Janet and everyone,

Tim

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Mark C. Rainey (CN=Mark C. Rainey/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 2-JUN-1998 19:36:49.00

SUBJECT: microsoft memos

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

TEXT:
Attached are three memos Aaron and I have prepared on Microsoft.
The suggested order of reading is:
1) mcrsft62.wpd -- summary of the case
2) proposal.wpd -- Aaron's proposal for better computer law
3) notes.wpd -- notes from a meeting about the case

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D61]MAIL41342535Y.126 to ASCII,
The following is a HEX DUMP:

2 June 1998

THE FEDERAL ANTITRUST SUIT AGAINST MICROSOFT

The Justice Department case.

Microsoft has a monopoly in the PC operating system market protected by high barriers to entry. Over 90% of new Intel-based PCs are shipped with a version of Windows pre-installed. One barrier to entry is the cost of designing a comparable operating system and the prospect that Microsoft could lower prices to marginal cost (zero) if a serious entrant appeared. The other barrier is that an operating system would have to be built along with a huge body of application programs to be truly comparable. Building an operating system that is fully compatible that would run existing programs is extremely difficult.

Because Netscape's Internet browser is distributed with code that runs Java programs, Netscape's Internet browser is an alternative platform to which Java software programs can be written. Since Java programs can be run on other operating systems as well, the distribution of Netscape together with Java may pose a threat to Microsoft's operating system monopoly. In order to protect its operating system monopoly, Microsoft has bundled its own browser with its operating system in Windows 98 and entered into agreements with PC manufacturers, Internet Access Providers (IAPs; such as America Online), and Internet Content Providers (ICPs; companies that have popular web sites, such as Disney) that promote the distribution of Microsoft's browser and limit the distribution of Netscape's browser. The Justice Department's suit seeks to force Microsoft to choose between unbundling its browser from its operating system or including Netscape Navigator. The Justice Department also seeks to enjoin the other agreements that promote Microsoft's browser and limit the distribution of Netscape.

Microsoft's Agreements with OEMs, IAPs, and ICPs.

Agreements with Original Equipment Manufacturers (PC manufacturers such as Compaq)

When installing Windows on their systems, OEMs:

- May not modify Windows software, nor delete or remove any features or functionality
- Shall not alter the content or sequence of the Windows "start up" screens
- Must not install any program to execute automatically upon initial boot
- Folders or icons added to the desktop must be the same size and shape as those delivered by Microsoft

Agreements with Internet Access Providers (such as America Online)

In return for being listed in the Online Services Folder or the Internet Connection Wizard (both of which are on the Windows desktop), Internet Access Providers:

- Must distribute Microsoft's Internet Explorer (IE) with their software and promotional materials unless the customer specifically requests another browser
- Must not ship more than 15-25% non-Microsoft browsers, even if requested by customers

- Must place download links to the IE download site on its website; limited from placing links to non-Microsoft browsers.

Agreements with Internet Content Providers (such as Disney)

In return for inclusion on the Windows desktop, Internet Content Providers:

- Must distribute and promote IE exclusively
- Must design website using IE-specific programming extensions so that site looks better when viewed with IE than with other browsers.

The Justice Department's Interpretation of the Agreements

According to the Justice Department, Microsoft is attempting to gain a monopoly in the browser market in order to protect its monopoly in PC operating systems. The Justice Department interprets Microsoft's agreements with OEMs, IAPs, and ICPs as illegal attempts to restrict the distribution of Netscape's browser.

- By shipping IE with Windows and not allowing OEMs to remove features, Microsoft ties IE to Windows. Although OEMs are allowed to install other browsers, the Justice Department alleges that OEMs do not like to do so because it increases consumer confusion, technical support costs, and product testing costs.

- Microsoft's agreements with Internet Access and Content Providers limit the distribution and promotion of competing browsers.

Microsoft's Interpretation of the Agreements

Microsoft argues that there are legitimate business justifications for its agreements.

- IE is tied to Windows because it is efficient to do so. For example, integrating HTML display capabilities into Windows eliminates the need for software developers to write such functionality into each different application they write.

- The restrictions on modifications to the bootup sequence and desktop are necessary to maintain the quality of Windows. Consumers may blame Microsoft for problems caused by OEM modifications.

The Justice Department's Proposed Remedies

The Justice Department seeks an injunction that would impose the following conditions:

- If Microsoft insists on including its own browser (IE) with Windows, it must also include Netscape's browser. OEMs must be given the option of deleting either or both browsers.
- Microsoft must give OEMs the right to modify the bootup sequence and desktop as long as the modifications do not impair the performance of Windows.
- Microsoft cannot enforce agreements with Internet Access and Content Providers that limit the distribution and promotion of competing browsers.

Microsoft will probably unbundle if forced to rather than include Netscape's browser. Probably PC makers will typically install Microsoft's browser, anyway. Although the Justice Department insist that they'd be compensated by Microsoft for the cost of removing the Microsoft browser, PC makers probably don't care very much which browser they install and will be very worried about Microsoft retaliating. (One example of retaliation would be giving worse service on technical support calls -- more ingenious devices are probably possible as well).

Microsoft and a proposal for better computer law

Introduction

The economics of computer software may mean that competition will always be an endangered species. Software exhibits dramatic economies of scale on both the demand and supply sides. Programs are expensive to create, but once one is written, it can cheaply be used by everyone. On the demand side, network externalities create an economy of scale: the value of a software program increases substantially as more people use it so a user can exchange data with more users and can get help using the program from more users. These factors suggests that competition may not be stable, or even efficient in this industry. However, the worry is that as competition withers so will innovation.

My guess is that the Justice Department remedy will be ineffective. It is probably a precedent well worth setting, however, because if the Justice Department had been able to intervene two years ago, the computer world might be a different and better place today.

Even if the Justice Department wins its case, Microsoft will probably choose to unbundle its browser from its operating system. I doubt that many PC makers will abandon Microsoft's browser. I suspect and the PC makers will suspect that Microsoft has all kinds of subtle and unverifiable ways of punishing them if they begin installing Netscape Navigator. Microsoft might simply be un-helpful at answering calls for technical support from PC makers that use Netscape. Since PC makers are probably fairly indifferent between whether they install Netscape or Microsoft's browser at this point, I doubt they will risk incurring the wrath of Microsoft. The battle is therefore probably over, except for precedent.

Proposal

If we actually want to do something about Microsoft, or the problem of monopoly in computer programs more generally, we should consider changing copyright law. Copyright for software should be very short, perhaps two or three years, since the useful life of a program is typically short as well. Also, like patents, software makers should be required to publish their "inventions" in order to get intellectual property protection. In the case of software, this would mean making source code public -- including detailed and helpful flow-charts and documentation that makes the source code genuinely usable. If the source good is not well-documented and usable, copyright protection should not be granted at all.

This proposal would give plenty of incentives for innovation. It would also facilitate innovation by competitors. A competitor might try to improve Microsoft's operating system and issue the next version itself.

Notes on Microsoft briefing 5/19/98 (Combined with information from talking to a programmer at Java Soft, a subsidiary of Sun corporation that makes Java.)

Suit was filed yesterday with 20 states Attorney General's

Windows is on over 90 percent of personal computers.

The Netscape/Java threat. Could Netscape supplant Windows as the operating system of choice? Netscape posed a threat to the Windows operating system because it implemented Java programs. Programs written in Java could be gotten from a distant machine and either run on the distant machine or imported to a PC and run there. The same program, written in Java, could be run equally well on a PC that runs Windows or on a Sun that runs Unix or a wide variety of other machines. This portability -- the slogan is "write once, run anywhere" -- is the "promise" of Java. Mostly, it works this way now. (Technical note: what Sun is doing is writing a "virtual machine" that is the same regardless of what platform is running the virtual machine. Obviously, Sun must do a great deal of work since their programs that create the virtual machine must be platform-specific. It seems highly efficient, however, that Sun do this work rather than have each programmer do it.)

There are many applications written in Java, though hardly the critical mass that Windows has at the moment. If there were a large mass of programs written in Java, there would be no particular reason to buy a Windows operating system. Any other system for which Sun has created a virtual machine would do equally well. (I don't know what a virtual machine program is actually called, but am confident this gives you the correct idea).

Microsoft recognized the threat. Microsoft recognized the threat and in 1995 Microsoft proposed to Netscape that they split the market by the type of operating system. Netscape would stay away from Windows 95 and Microsoft wouldn't build for other operating systems. This proposed market division was certainly a violation of the antitrust laws. (A per se violation). Netscape refused.

Browsers are generally gotten from either the OEM, like Gateway or Dell, or from an ISP service like America Online.

Microsoft made exclusive deals (the nature of exclusivity seems to vary) with ISPs in exchange for the ISP provider getting a good spot on the Windows desktop. Microsoft also agreed to not push its own ISP in exchange for America Online pushing Internet Explorer exclusively.

Deal with OEMs:
Microsoft required the OEM to display the same screens.
OEM had to install Internet Explorer. Question: could they install Netscape as well? Yes.

Microsoft agreed to allow OEMs to remove browser in January stipulated order.

The consequences. Although Netscape was dominant in 1995 and 1996, now Microsoft's Internet Explorer has 50 percent of the market. This should expand dramatically soon, as Internet Explorer gets 80 percent of new browsers. (To me, if Internet Explorer loses 20 percent, this suggests that many people prefer using Netscape).

The big barrier to entry in operating systems are the programs written for Windows. (My analysis: since Windows source code is complex, unavailable and not well-documented, no one can write a substitute that would run all these programs written for Windows. The programs would crash badly. Even Microsoft has trouble writing an operating system that runs all these programs!)

The new problem. Microsoft has now bundled Internet Explorer into the Windows operating system in Windows 98.

Proposed remedy. The Justice Department seeks a preliminary injunction forcing Microsoft to unbundle Windows and Internet Explorer in Windows 98. Their alternative proposal is to force Microsoft to also bundle Netscape and allow each consumer to choose.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 3-JUN-1998 14:56:42.00

SUBJECT: Interagency group on LDCs, models and targets

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

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

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

TEXT:
David Sandalow has asked me to co-chair with him a group on LDCs, models, and targets. I responded with enthusiasm. Maybe early next week.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 3-JUN-1998 15:03:21.00

SUBJECT: My non-attendance at WP3

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

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

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

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

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

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

TEXT:

WP3 meets early next week (June 9). I was going to do this one entirely on my frequent flyer miles. Despite Lisa's strenuous efforts over the last month or two, it now appears near-certain that the airline won't give me a seat . (Apparently paying passengers crowd out frequent-flyers in the summer travel season). So I'm not going.

I assume that it would be inconvenient to send someone (Jeremy or Jon or Chris) on a full-fare coach ticket on such short notice, and that we will just not be represented at this meeting? Any views?

JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 3-JUN-1998 15:20:29.00

SUBJECT: Re: My non-attendance at WP3

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

TEXT:
How much would it cost for you to go at CEA expense? Would you have to go 1st class? We can look at the travel budget to see how much we have left, given that at the end of fiscal year we renew our pot.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 4-JUN-1998 17:18:12.00

SUBJECT: Article about Larry Summers

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

TEXT:
John Cassidy of the New Yorker is writing a peice about Larry Summers. He is going to be in DC on MOnday aft and would like to interview you. Would you be willing to sit down w/ him for half an hour?
Thanks.
Michele

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 7-JUN-1998 20:12:46.00

SUBJECT: WEFA Press Conf on Tues

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: Joseph E. Aldy (CN=Joseph E. Aldy/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:
WEFA is holding a press conf on Tuesday where they are supposedly releasing a state-by-state analysis of the impact of climate change polcicies (I assume the Kyoto Protocol). Todd's office would like CEA to do talking points that can be used to respond.
Given that we won't have the WEFA analysis in advance, I assume that the talking points should be general. Todd's office is hoping we can focus on the costs of not acting.
Attached is a rough draft of talking points I pulled together from a summary of Janet's testimony.
Joe or Randy, could you edit and/or add to this based on what you think WEFA might present?? Can you add more about the costs of not acting??
Thanks.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D6]MAIL45092775V.126 to ASCII,
The following is a HEX DUMP:

TALKING POINTS
ECONOMIC IMPACT OF KYOTO PROTOCOL
June 8, 1998

* ***President Clinton is committed to addressing the problem of global climate change while maintaining a strong economy.***

* ***The Kyoto Protocol is a form of insurance against the threat of global climate change.*** It is difficult to put a price tag on the cost of doing nothing to address the problem of climate change. But researchers have nonetheless developed troubling cost estimates of not acting -- ranging in the tens of billions of dollars per year for the United States. And, these estimates do not even fully reflect the value of the insurance against the unknown risk of large-scale and potentially irreversible catastrophic events, such as a weakening of the Gulf Stream.

* ***Doing it smart: The Kyoto Protocol includes measures that reduce the costs of reducing greenhouse gas emissions.*** Effective international emissions permit trading, joint implementation by Annex I countries, the Clean Development Mechanism, and other aspects of the Kyoto Protocol will reduce the costs of emissions reductions. The Administration also supports federal electricity restructuring legislation that could achieve modest emissions reductions and will provide consumers with substantial savings on their energy bills.

> The Kyoto Protocol includes many cost-saving provisions -- and economic analyses that ignore these provisions do not accurately reflect the economic impact of the Kyoto Protocol.

* ***The Administration believes that the costs of the Kyoto Protocol will be modest.*** With effective mechanisms for international emissions permit trading, joint implementation, and the Clean Development Mechanism, as well as meaningful developing country participation and flexible timetables, the Administration's overall assessment is that the economic cost to the United States will be modest.

> ***Administration assessment is consistent with formal model results.*** Despite the limitations of any single model in assessing the economic impact of the Kyoto Protocol, economic model results are fully consistent with this conclusion. For example, estimates derived using the Second Generation Model (SGM) suggest that the resource costs of attaining the Kyoto targets for emission reductions might amount to just $7 to $12 billion per year in 2008 to 2012 -- or just 0.1 percent of projected GDP.

> ***Administration assessment does not include climate and non-climate benefits, savings from electricity restructuring and several cost-mitigating factors.*** The Administration estimate of the economic impact excludes a range of climate and non-climate benefits, the likely savings from electricity restructuring and several cost-mitigating factors, such as carbon sinks and increases in energy efficiency from the President's $6.3 billion climate change initiative.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 7-JUN-1998 22:07:03.00

SUBJECT: Itinerary for China trip

TO: Joseph E. Aldy (CN=Joseph E. Aldy/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 a proposed itinerary for the trip to China. Please give me
your comments or suggestions. I need to submit it sometime this afternoon.
Thanks.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D99]MAIL48510875E.126 to ASCII,
The following is a HEX DUMP:

REQUEST TO PARTICIPATE IN THE PRESIDENT'S TRIP TO CHINA: CEA CHAIR JANET YELLN

Particpants:

CEA Chair Janet Yellen
CEA Senior Adviser Joseph Aldy

Proposed Itinerary:

** *Note: Todd Stern and David Sandalow are enthusiastic about CEA Chair Janet Yellen's meeting with officials from China and Korea to discuss global climate change and the benefits of participaing in the international trading regime proposed in the Kyoto Protocol.* ***

Friday, June 26, 1998

Yellen arrives in Beijing w/ US delegation

Saturday, June 27, 1998

Morning — Brief the President for Meeting with Premier Zhu.
Yellen will assist in briefing the President on China's economic reforms, and if appropriate, China's participation in the Kyoto Protocol. Yellen met with Premier Zhu in early May to discuss China's economy and economic reforms. During this meeting, she also had a brief discussion with Zhu on the issue of global climate change.

Afternoon — Attend President's Meeting with Premier Zhu

Afternoon — Visit US Company (e.g. Babcock&Wilcox)
Yellen will visit one of the US companies that requested a Presidental visit. Yellen could visit Babcock&Wilcox, Intel, Hewlett-Packard, IBM, Motorola or Praxair.

Evening — Attend State Banquet

Sunday, June 28, 1998

Afternoon — Tour of the Great Wall w/ the President's delegation

Evening — Dinner with group of Chinese academics from Peking University

Monday, June 29, 1998

Morning Attend President's visit to Peking University

During Yellen's visit to China in early May, she met with the same group of Peking University economists with whom the President will be meeting.

Afternoon Yellen Meetings on Global Climate Change and the Kyoto Protocol

Yellen will hold follow-up discussions on the issue of global climate change and the benefit to China of participating in the international trading regime proposed in the Kyoto Protocol.

Tuesday, June 30, 1998

Morning Yellen departs for Seoul, Korea

Afternoon Yellen meets with Korean Government officials to discuss Climate Change

NSC and the WH Climate Task Force would like Yellen to meet with Korean officials to discuss climate change and the benefits to Korea of participating in the international trading regime proposed in the Kyoto Protocol

Wednesday, June 31, 1998

Morning Yellen continues meetings with Korean Government officials regarding Climate Change

Afternoon Yellen departs for Washington, DC

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Shannon Mason (CN=Shannon Mason/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME: 8-JUN-1998 17:25:39.00

SUBJECT: NEC Deputies meeting Wednesday June 10th

TO: Roger S. Ballentine (CN=Roger S. Ballentine/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

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

TO: Paul J. Weinstein Jr. (CN=Paul J. Weinstein Jr./OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

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

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

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

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

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

TO: Audrey T. Haynes (CN=Audrey T. Haynes/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: Bruce R. Lindsey (CN=Bruce R. Lindsey/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

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

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

TO: Jack Lew (Jack Lew @ 395-1005 @ fax [UNKNOWN])
READ:UNKNOWN

CC: June G. Turner (CN=June G. Turner/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

CC: Patricia E. Romani (CN=Patricia E. Romani/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

CC: Melissa M. Murray (CN=Melissa M. Murray/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

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

CC: Sandra L. Via (CN=Sandra L. Via/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D18]MAIL45148395H.126 to ASCII,
The following is a HEX DUMP:

June 8, 1998

MEMORANDUM FOR NEC DEPUTIES

FROM: SALLY KATZEN

SUBJECT: WEDNESDAY DEPUTIES MEETING

There will be an NEC Deputies meeting Wednesday June 10th at 10:00, room to be determined. We will continue the discussion from the bankruptcy meeting last Friday. Specifically, we will focus on the non-dischargability and child support issues, as well as a report of the working group's effort to craft a specific proposal on needs-based bankruptcy consistent with our discussion at the last meeting. A detailed agenda will be distributed late tomorrow afternoon. You may wish to review the portions of last weeks' memorandum and the DoJ attachment on nondischargeability and child support.

If you have any questions, need additional copies of last week's memorandum, or need to confirm attendance or give clearance information, please call Shannon at 456-2800. See you there.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 8-JUN-1998 20:08:53.00

SUBJECT: developing country participation

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 a 2-pager we put together that Treasury will hand over to reps of the Mexican finance ministry at a meeting later this week as a part of the Bi-National Commission annual get-together. They will discuss climate change as well as other fun issues (e.g., money laundering). This provides a sense of what kind of information on developing country targets other agencies (in this case, State and the Climate Change Task Force) are comfortable with providing to the outside world.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D48]MAIL446764958.126 to ASCII,
The following is a HEX DUMP:

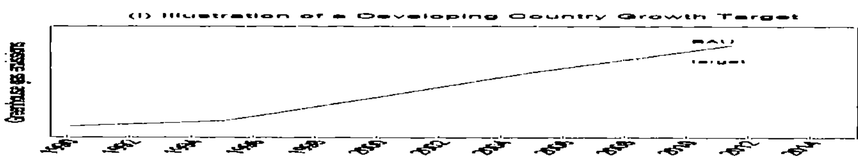
Developing Country Participation in International Emissions Trading

If a developing country (a) chooses to adopt a growth target slightly below its business as usual (BAU) emissions, and (b) trades its emissions allowances internationally, it could enjoy substantial economic and environmental gains.

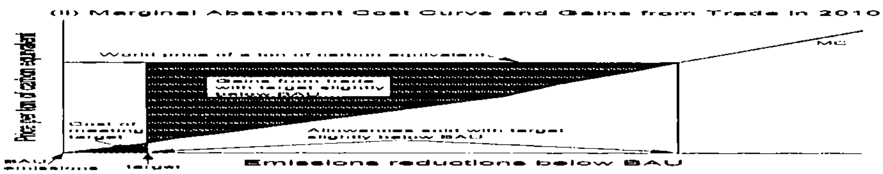
- **Economic Benefits.** As potential sellers, developing countries with targets slightly below BAU projections could enjoy net gains from participation in international emissions trading, because they can achieve emissions reductions relatively "cost-effectively" (i.e., at a cost per metric ton of carbon equivalent that is less than the world trading price). Even with this participation, a country's emissions could continue to grow above current levels (see figures below).

- **Environmental Benefits.** A world with broad-based participation in international emissions trading, including participation by countries with growth targets slightly below their BAU projections, could result in lower global greenhouse gas emissions relative to a world with narrow participation. Moreover, reductions in greenhouse gas emissions would generate ancillary air quality benefits through reductions in sulfur dioxide, nitrogen oxides, and particulate matter emissions.

Benefits of Trade: The following example illustrates (i) a potential growth target, set slightly below a developing country's BAU projection, and (ii) the economic benefits



available to this developing country through international emissions trading.



These gains from trade represent revenue from sales of emissions allowances less the cost to the developing country of reducing emissions.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 8-JUN-1998 14:58:20.00

SUBJECT: South Asia mtg w/ the POTUS

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

TEXT:
I found out that the mtg with the President on South Asia is about India and Pakistan -- no economic components.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 8-JUN-1998 11:01:45.00

SUBJECT: Revised merger talking points

TO: Charles F. Stone (CN=Charles F. Stone/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.D43]MAIL41267785Y.126 to ASCII,
The following is a HEX DUMP:

Mergers Discussion 5-27-98

The CEA has distributed three memos to serve as a basis for our discussion of merger trends. I will just take a few minutes to highlight the key points.

1. The first is a one-pager that discusses how antitrust policy has evolved since 1950. The bottom line is that today's antitrust authorities take a harder look at mergers than was the case during the 1980s, when almost all mergers went unchallenged. However, we are far from the "big is bad" policy of the 1950s-1970s, when almost all mergers were opposed. Today, mergers are opposed when analysis suggests that they will hurt competition, but the government frequently loses in court under prevailing judicial interpretations of the antitrust laws.

2. The second memo (actually, the third in your packet) provides some **facts** on merger trends and economic concentration.

    - The first question this memo addresses is: **Are we in the midst of an unprecedented merger boom?** The answer (see Exhibit 2) is that merger activity has certainly increased, but it is not clear that the level of merger activity is "unprecedented." Certainly, the number of mergers and the dollar value of announced deals is very high. Almost $1 trillion worth of deals were announced in 1997 and the final tally for 1998 could be even higher. Expressed relative to the size of the economy, we would have to go back to the great merger wave at the turn of the last century to find a comparable level of merger activity. However, when the level of activity is expressed relative to the market value of U.S. companies, the level of merger activity was higher in the 1980s. **Thus, the run up in stock prices in the past few years is one reason why current merger activity is so large relative to the size of the economy.**

    - A second question that naturally arises is: **What does this merger activity mean for the economy?** Here the memo provides some facts about the importance of large firms in the economy and in particular industries; and some sketchy information about trends in concentration in the aggregate. I think it is fair to say that economists have found little reason to think that broad economic indicators like the rate of economic growth, inflation, or unemployment are much affected by changes in merger activity or the share of aggregate economic activity accounted for by the largest 100 or 200 firms (so-called aggregate concentration)—at least on the order of those that have typically been observed in the U.S. Economic analysis suggests that the main route by which mergers affect economic performance is through their impact on competitive conditions in **specific** markets. **Because appropriately defined markets may not be national in scope and may not correspond to standard industry definitions, such data may not be terribly relevant for public policy purposes and should**

be interpreted with considerable caution.

- That said, let me briefly mention some findings in the "facts" memo:

  - On aggregate concentration, we were able to get data from the FTC on the share of assets held by the top 50, 100, 150, and 200 non-financial corporations between 1958 and 1988 (Exhibit 4). These show a decline in aggregate concentration between the mid-1970s and the mid-1980s. A somewhat longer series on aggregate concentration in manufacturing shows modestly increasing concentration between the mid-1970s and the mid-1980s and a modest decline by 1993.

  - On the question of whether U.S. markets are, on average, becoming more competitive or more concentrated, we found no reliable comprehensive study. **This is mainly because of the care and effort needed to define the relevant market in every particular case.** *The Commerce Department provides valuable information every 5 years in its economic censuses, but its industry concentration ratios for the US as a whole need to be interpreted cautiously.*

    - For example, industries are classified by similarity of production process; hence glass containers and plastic containers are treated as separate industries even though they may be close substitutes in many uses (a monopoly in glass containers would be of little value if users could turn to plastic when the price went up).

    - Also, concentration ratios are reported for the U.S. **national** market. They understate the amount of competition in industries where imports are important (like automobiles) and they overstate it when markets are local or regional (like cement, newspapers, or the banking services used by typical households and small businesses). This is one reason why large size is not the same as monopoly power: A $50 million bank in rural Georgia could have more market power than a multibillion dollar bank in New York City leading to a situation in which the merger of 2 small banks poses greater concern from an antitrust perspective than of two huge banks like Chase and Chemical.

3. So with this evidence in mind, let me turn to the memo on the causes and consequences of mergers.

- **Let's begin with motives.** The main reason managers give for undertaking mergers is to increase efficiency. And studies show that, on average, the combined equity value of the acquired company and the purchasing company rises as a result of the merger. However, an increase in shareholder value can arise for reasons other than greater efficiency—such as increased market power and the ability to increase profits by raising prices. And the separation of ownership from control in the modern corporation means that mergers may serve the interests of managers more than shareholders (e.g., empire building, increased salary associated with running a larger firm). Finally, even if mergers are designed to enhance efficiency, they often don't work and can instead create inefficiencies (the merger of the Union Pacific and Southern Pacific railroads in 1995 is widely seen as a disaster).

- **There are numerous ways that mergers can contribute to economic efficiency**. One is by reducing **excess capacity** (this justification has been invoked in hospital, defense, and banking mergers). Another is by achieving **economies of scale** or network externalities (the hub and spoke network of airlines is one example) or **economies of scope** ("synergy") as in the case of investment/commercial banking, where similar risk management techniques and credit evaluation skills are utilized in a wide variety of financial services. Mergers may also **improve management** (studies sugggest large differences in efficiency among seemingly similar firms like banks.) Most mergers probably are undertaken with the expectation of achieving efficiencies, though the outcomes may sometimes be disappointing. For example, studies of bank mergers showed that, in spite of the potential for improved efficiency, in general, mergers have not improved the efficiency or profitability of banks. Divorces are not uncommon (AT&T's 1991 acquisition of NCR unravelled.)

- **In principle, mergers can also be undertaken to increase market power and reduce competition**. In this event consumers could be harmed through higher prices, lower service, reduced variety and, in the view of some, a reduced pace of innovation, although some argue that increased market power should raise innovation due to fewer spillovers. Mergers can also work to decrease the potenetial for future competition. There is abundant evidence that, when one compares markets of a given type, such as local banking markets, the degree of concentration in a market is correlated with such measures of economic performance like price-cost margins. And there is some evidence that mergers have raised prices, as in the case of the mid 1980s airline mergers. Other things equal, higher concentration leads to worsened performance, which is why the Merger Guidelines, after assessing what the appropriate definition of the market is from a product and geographical perspective, looks at the impact of a merger on the level of concentration. However, statistical evidence suggests this is not the main motive for most mergers, perhaps reflecting the presence of antitrust monitoring and enforcement.

- A natural question is why so many firms are merging now. There is no single reason. The following are some of the prevailing explanations:

  - <u>(1) Adjusting to falling regulatory barriers</u>. Mergers have followed the removal of branching restrictions in banking and ownership restrictions in radio. Banks are probably achieving efficient scale by merging. Absent our history of regulation, the U.S. banking industry would probably have far fewer small banks and look more like the banking system in most other countries.

Mergers in the telecommunications industry are also tied to the breakup of AT&T and to the deregulation and market-opening steps that followed the Telecommunications Act of 1996.

- (2) Technological change. Some mergers may be motivated by the widely touted, but still nascent, phenomenon of "convergence" in the information technology industry. For instance, as textbook publishers begin to supplement their materials with multimedia software, they may acquire small software companies. To the extent that rapid technological change means that it is unclear what technologies will be used in the near future, firms may hedge their bets: this may explain why a local telecommunications company might merge with a cable television provider. In addition, large scale may be needed to exploit some advances in information technology and telecommunications (securitization, credit scoring).

- (3) Globalization. The emergent global economy may demand large scale to participate. A European and American firm may combine to take advantage of the distribution networks that each has on its own continent. *Also, to the extent that European or Asian firms are more integrated in certain sectors such as the financial sector, U.S. firms may find it necessary to integrate more to provide one-stop shopping for foreign customers who demand that.*

- (4) High stock market. Price-earnings ratios have increased to near-record levels during the current merger wave, and some analysts feel that the market may be overvalued. This may make it attractive to fund an acquisition with stock (the dominant funding source in the current merger wave) But an overvalued stock market does not necessarily lead to more mergers, because if other firms are also overvalued then there are fewer attractive targets to acquire.

• As I mentioned earlier, in evaluating the consequences of mergers we should focus on **particular** well-defined markets. **In this regard, it is important to recognize that mergers do not necessarily increase concentration in any well-defined market. Merging firms may be in different businesses, non-competing regions, or in supplier-buyer relationships**. (In banking, for example, national concentration has increased dramatically due to mergers, but concentration measures for local banking deposits have been extremely stable because most mergers have been between banks serving different regions.) Even when the merger is among competitors, increasing global competition or domestic entry could be simultaneously reducing concentration. In addition, the entry of new firms or the threat of entry can offset the potentially anticompetitive impact of a merger. And finally, the structural characteristics of markets, and not just the number of firms, influence the nature of competition in a given market (Boeing/Airbus; Pepsi/Coke.) We cannot automatically conclude that markets with 2 or 3 competitors will be less competitive than those with 20 or 30. Currently the antitrust authorities seem willing to challenge mergers with obvious anticompetitive effects.

4. To wrap up, the United States is currently in the midst of its fifth major merger wave in the past hundred years. Industries that are particularly prone to mergers include telecommunications, banking, and financial services. These are sectors in which the regulatory environment has been changing rapidly, opening up new opportunities and challenges. This merger wave is taking place in a strong stock market, and stock rather than cash is the preferred medium for making acquisitions. Many of the prominent mergers are neither purely horizontal (in general large horizontal mergers would raise antitrust issues) nor purely conglomerate. Rather, they represent market extension mergers like SBC-Ameritech (companies in the same industry that serve different and currently non-competing markets) or mergers seeking "synergy," like Travelers-CitiCorp, which presumably expects to achieve "economies of scope" in offering a full line of financial services. Analysis of the economic impacts requires careful analysis of particular markets and defies easy generalizations.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-JUN-1998 21:17:55.00

SUBJECT: with minor revisions

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

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D72]MAIL47920606H.126 to ASCII,
The following is a HEX DUMP:

TESTIMONY OF DR. JANET YELLEN
CHAIR, COUNCIL OF ECONOMIC ADVISERS
BEFORE THE
U.S. SENATE
COMMITTEE ON FINANCE

June 11, 1998

US Trade Policy and the Trade Deficit: Causes and Consequences

Mr. Chairman and members of the Committee. Thank you for the opportunity to discuss the trade deficit with you today.

The trade deficit is an important economic statistic, but its interpretation is subject to substantial confusion. A country's trade balance is often--wrongly--used as a measure of the success of its market-opening policies or the benefits of its engagement in international trade. The most important idea I would like to express to you today is that the benefits of increased international trade are reflected in higher real income, not in a smaller trade deficit. Indeed, the rising U.S. trade deficit in recent years mainly reflects the strength of the American economy, which has grown rapidly in comparison with the economies of our trade partners. In part, the trade deficit reflects the fact that our fast-growing economy is pulling in a lot of imports. But at the same time it also reflects the fact that the U.S. is attracting substantial international capital flows. These have financed increases in plant and equipment investment that have exceeded even the growth in national saving due to deficit reduction.

I. The Benefits of Trade

Going all the way back to Adam Smith, one of the most important insights of economics is that international trade increases the real incomes of all countries that engage in it. Trade is not a zero-sum game in which the gains of some countries come only at the expense of other countries. To the contrary, trade is a positive-sum game in which both sides gain.

For a long time, arguments for trade were based on the principle of *comparative advantage*. When countries specialize in the economic activities for which they are particularly well-suited and rely on trade to acquire other things, they can achieve a higher standard of living than if they try to produce everything themselves. More recently, economists have argued that there are benefits to trade that go beyond those arising from comparative advantage. Trade can enhance productivity through the effects of greater market size, enhanced competition, and improvements that come from contact with foreigners and their alternative production styles, including both new technology and new ideas about the efficient organization of firms.

These benefits from trade are not merely theoretical. A large and growing economics literature has found that those countries that are open to trade tend to grow faster and have higher levels of per-capita income than countries that close themselves off from international competition and trade. One estimate is that the globalization of the U.S. economy over the last 40 years has added between $1,500 and $2,000 to current median family income.

Because policy makers in this country have long believed in the benefits of trade for all parties, the United States, in the postwar period, has been the world's leading advocate for trade liberalization. U.S. tariffs are among the lowest in the world. While we benefit directly from our own low tariffs--through lower prices to consumers-- we would benefit even more if other countries were to lower their tariffs and other trade barriers. Since U.S. trade barriers are already so low, the international trade negotiations that have been concluded in recent years have typically produced much larger reductions in the trade barriers facing American goods in foreign markets than on foreign goods in the United States. The result has therefore generally been that foreign demand for our goods has risen by more than our demand for foreign goods, producing an extra boost to our real income.

It is often suggested that the major benefit of trade liberalization is job creation. When our economy is operating below its potential, with slack in the job market, export growth can produce job gains, helping the economy move toward full employment. As of January 1993, for example, the economy had substantial unemployment and excess capacity. One could say that the large increase in U.S. exports between 1993 and 1997--roughly 10% per year at an annual rate-- accounted for 38 percent of the increase in output over that period, and a proportionate share of the almost 15 million jobs that were created over that period. In the long-term, however, the workings of the market, complemented by sound macroeconomic policies, are sufficient to create jobs for those who want to work. Thus, increases in exports must ultimately pull workers away from other activities. Trade still raises real income, but the boost comes from better jobs and not just more jobs. Studies show that export jobs pay 13-16 percent more than other jobs. Indeed, export jobs are better even after adjusting for worker skills and firm-specific and industry specific-components to wages.

II. Macroeconomics and the Trade Deficit

Perhaps the greatest source of confusion about trade relates to the interpretation and causes of trade or current account deficits and surpluses.

A trade deficit occurs, by definition, when a country's total domestic spending exceeds its total domestic production. When this occurs, the shortfall is made up by importing more goods than are exported. When the U.S. runs a trade deficit, foreigners buy less than a dollar's worth of U.S. goods for every dollar they earn from their export sales to us. The natural question is, what motivates foreigners to supply us with more goods than we supply to them in exchange? And what do foreigners do with the dollars that they don't use to buy U.S. goods? In practice, foreigners typically use the excess dollars to invest in interest-bearing U.S. assets. Indeed, it is the desire of foreigners to purchase attractive U.S. assets--to lend us the money needed to finance a trade deficit--that makes it possible to run such a deficit. Countries can run deficits only if foreigners want to add to their holdings of the deficit country's assets. In fact, one can as readily argue that the desire of foreigners to acquire attractive U.S. assets is responsible for the U.S. trade deficit as the reverse.

This relationship between spending, production, and the trade deficit can be expressed another way. I will not bore you with the details but it turns out that in an accounting sense the trade deficit is equal to the difference between national saving and national investment. When the demand for investment in the United States exceeds the pool of national saving, the difference is made up by borrowing from foreigners. Conversely, when saving exceeds investment, the surplus is invested abroad. The United States first experienced large current account deficits during the mid-1980s, when net investment fell as a share of national income and net national saving fell even faster. The deficit shrank briefly as investment collapsed in the 1990-91 recession, but it has reemerged in the current expansion. The good news in this expansion is that investment has been booming. But saving does not appear to have kept pace, despite the improvement due to federal deficit reduction. (The interpretation of current trends in saving, investment, and the current account is complicated by the statistical discrepancy between GDP measured as the sum of all spending on output and as the sum of all income generated in producing that output.)

When a trade deficit is used to finance productive investment, as it is now, it can be viewed as largely benign, because the extra investment raises the productivity of our workforce, resulting in higher future national income. It is that return that should enable us to pay off the foreign borrowing we have undertaken to help finance our investments. We would be *worse off* as a nation, and our interest rates would have been higher, if, over the last few years, we had been forced to curtail our investment. Our ability to attract funds from abroad is a vote of confidence in the ability of our high-performing economy to put these funds to good use. However, maintaining national investment above national saving does entail the price that what we borrow, we will eventually need to repay.

Let me return now to the more immediate causes of our rising trade deficit. A key factor responsible for this trend is strong growth in the United States relative to our major trading partners. Our strong growth has resulted in a larger income-induced increase in American demand for foreign goods than in foreign demand for our goods and services. The second key factor is the dollar's appreciation, which has been substantial over the last three years. In a system of flexible exchange rates, an appreciation in a currency reflects a desire by foreigners to hold that currency. Appreciations very often accompany strong economic expansions like the one the U.S. has experienced over this period, and in that sense the appreciation of the dollar is unsurprising given that the U.S. economy has grown much more rapidly than those of our trading partners over the past few years.

More recently we have seen a surge in the trade deficit that reflects the effects of the East Asian crisis. The sharp drop in the value of the East Asian currencies has led to an increase in U.S. demand for the goods produced by these countries (which are now much cheaper to us than before). At the same time, the East Asian countries have cut back sharply on imports of goods from the U.S. both because our goods are effectively much more expensive for them, and also because their incomes have fallen substantially.

The most recent data, for the first three months of this year, already point to a significant impact of the crisis on our trade balance. To estimate the magnitude of the impact, it is natural to compare our trade with the affected countries over the last three months with the magnitude of trade flows in the second quarter of 1997, immediately before the Thai baht began to float and the crisis began. (This comparison relies on seasonal adjustments of bilateral trade data computed by the Council of Economic Advisers since such adjustments are not computed by Commerce Department itself.) According to our estimates, the U.S. bilateral balance has deteriorated by $14 billion with respect to Korea, and $10 billion with respect to Malaysia, Indonesia, Thailand, and the Philippines, and $10 billion with respect to Japan. [chk] We expect further deterioration in the remainder of the year.

It is often argued that the Asian crisis, by decreasing U.S. net exports, will diminish U.S. growth over the next year or longer. There is no denying that net exports are exerting, and will continue to exert, a drag on U.S. economic growth. According to some estimates, the East Asian crisis, taking account of its impact on Japan, could subtract as much as 1 percentage point from GDP growth over the next year [*check*]. Fortunately, however, the slowdown in exports to East Asia is impacting the US economy at a time when domestic demand growth is extremely robust and labor markets have becoming increasingly tight. The consensus among forecasters is that the East Asian crisis could serve as the brake that subdues growth toward a more sustainable pace, preventing overheating, and permitting continued job growth with a more moderate path for interest rates and stronger investment spending than we would otherwise enjoy. 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 dampening influence on inflation.

III. Are There Reasons for Concern?

My testimony so far has been that the trade deficit largely reflects the strength of the American economy. But I do not want to leave you with the impression that there are no reasons to be concerned about a large trade deficit.

First, even in the absence of any negative aggregate impact on output and employment due to a growing trade deficit, particular sectors have been adversely affected. Before 1997, U.S. producers in such sectors as aircraft and agriculture enjoyed rapid growth in their exports to East Asia. That has now disappeared. Exports are down sharply to Asia in general, and to Korea, Southeast Asia, and Japan, in particular. They can be expected to continue to fall in the remainder of this year. In addition, we will probably see increased imports from these countries, especially in such sectors as autos, steel, textiles and apparel, and semiconductors and other electronics. The crisis countries have no choice but to shift their trade balances into surplus, since they are no longer able to borrow from abroad to finance the trade deficits that most of them ran before the crisis. It is their inability to borrow in world capital markets that is responsible for the currency depreciations and income reductions that are in turn causing them to buy less from us and to sell more to us.

The second reason for concern about our growing trade deficit follows in part from the first. Our rising trade deficit, particularly in such key areas of the economy as manufacturing and agriculture, could undermine support for internationalist principles and for market-opening policies. If the widening U.S. trade deficit were to create the false impression that the U.S. stands to lose rather than to gain from continued engagement in international markets, then it would be a costly development indeed.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-JUN-1998 09:08:48.00

SUBJECT: [Fwd: Lerman's letter]

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

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

TEXT:
Attached is a note from Glen Loury about a letter to The New Republic by Bob Lerman about the ERP chapter on race. (Loury wrote his earlier review of this chapter for TNR and this is a response to his review.) Do we want to respond to this?

Becky

---------------------- Forwarded by Rebecca M. Blank/CEA/EOP on 06/09/98 09:07 AM ---------------------------

SARAH J. REBER
06/09/98 09:06:26 AM
Record Type: Record

To: Rebecca M. Blank/CEA/EOP, Melissa A. Clark/CEA/EOP, Zachary M. Candelario/CEA/EOP, Michele Jolin/CEA/EOP
cc:
Subject: [Fwd: Lerman's letter]

---------------------- Forwarded by Sarah J. Reber/CEA/EOP on 06/09/98 09:05 AM ---------------------------

Sanders Korenman <korenman @ earthlink.net>
06/09/98 08:59:11 AM
Please respond to korenman@earthlink.net
Record Type: Record

To: Sarah J. Reber/CEA/EOP
cc:
Subject: [Fwd: Lerman's letter]

Received: from acs6.bu.edu (root@ACS6.BU.EDU [128.197.152.60]) by
holland.it.earthlink.net (8.8.7/8.8.5) with ESMTP id CAA18900 for
<korenman@earthlink.net>; Sun, 7 Jun 1998 02:03:40 -0700 (PDT)
Received: from ECON-PC152.bu.edu (PPP-82-14.BU.EDU [128.197.8.66]) by
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Date: Sun, 07 Jun 1998 05:05:21 -0400
From: Glenn Loury <gloury@bu.edu>
Subject: Lerman's letter
X-Sender: gloury@acs-mail.bu.edu
To: korenman@newton.baruch.cuny.edu
Cc: korenman@earthlink.net
Message-id: <3.0.3.32.19980607050521.007134dc@acs-mail.bu.edu>
MIME-version: 1.0
X-Mailer: QUALCOMM Windows Eudora Pro Version 3.0.3 (32)
Content-type: text/plain; charset=us-ascii
Content-transfer-encoding: 7BIT

Sandy: I assume you saw Bob Lerman's long letter in The New Republic, commenting on the CEA report's treatment of role of family structure in accounting for black/white differences in family incomes. He questions why CEA chose to approach this question from point of view of how much did **change** in relative prevalence of single parent families affect black/white family income gap. He suggests that your calculation is irrelevant.

It seems clear to me that the answer to Lerman goes something like this: In the context of a discussion of how much progress we have made over time toward racial equality, when an indicator (relative family income) shows little progressive movement, it is appropriate to ask whether this is due to an offsetting degradation in some other variable (relative family composition). The CEA calculation was intended to show that, with regard to racial differences in the resources available to families, the lack of progress is not mainly due to a worsening of the family structure gap between blacks and whites.

The Thernstroms's use of Lerman's estimate amounts to saying this: During a period (1960-1990) when the proportion of white children living with a single parent quadrupled, if this proportion among blacks had somehow managed to remain unchanged, then the rate of poverty among black children would be "only" 30%, rather than in excess of 40%.

I think a short letter from you to the New Republic clarifying this point would be helpful. GL

cc: Chuck Lane, editor, tnr

Glenn C. Loury

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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-JUN-1998 17:51:10.00

SUBJECT: Oral testimony

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

TEXT:
I enclose two versions of the oral testimony. One was the House International Relations Committee version (#6) which is longer and the second, the most recent version, which is somewhat reorganized and also shorter (#12). =================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

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ORAL TESTIMONY OF DR. JANET YELLEN
CHAIR, COUNCIL OF ECONOMIC ADVISERS
BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS
ON THE ECONOMICS OF THE KYOTO PROTOCOL
JUNE 4, 1998

Thank you, Mr. Chairman and members of the Committee. The President has said that we can work to avert the grave dangers of climate change, while at the same time maintaining the strength of our economy. I am pleased to have this opportunity to appear before the Committee to elaborate on the Administration's views on these issues.

Effects of Climate Change

Before discussing the likely cost of U.S. efforts to avert climate change, it is important to recognize the costs and risks facing our nation should we fail to act. Current concentrations of greenhouse gases have reached levels well above those of preindustrial times. As a consequence, the Intergovernmental Panel on Climate Change estimates that global temperatures will increase by between 2 to 6 degrees Fahrenheit in the next 100 years, with a best guess of about 3.5 degrees Fahrenheit. Despite the difficulties of deriving quantitative assessments of the damages from climate change, researchers have nonetheless developed monetary estimates of damages that prompt substantial concern, and range in the tens of billions of dollars per year for temperature changes projected to occur in the next century. If left uncontrolled, disruption of the Earth's climate may thus pose substantial costs in terms of harm to commerce and the environment alike. These costs--and they are significant--provide the primary motivation for actions to reduce greenhouse gas emissions. Moreover, these estimates do not, and cannot, accurately reflect the value of reducing the unknown risk of large-scale and potentially irreversible events with potentially catastrophic consequences. There is a strong argument for the Kyoto Protocol as a form of insurance against a serious environmental threat.

The Economic Costs

In taking action to reduce emissions, economic analysis suggests that two elements are absolutely essential: the effort must be flexible and market-based, to ensure that we reduce emissions in the most efficient way; and the effort must be global, for without global emissions reductions the effort would be ineffective. The nature of the climate change problem--that greenhouse gas emissions have the same effect on the climate regardless of how, where, and, within limits, when they occur--suggests three basic approaches to lower the cost of achieving given levels of environmental protection. We term these "when", "what", and "where" flexibility.

As a result of U.S. diplomatic efforts, all three forms of flexibility are broadly reflected in the Kyoto Protocol. The choice of a multi-year budget period, ending later than many countries proposed, with allowance for "banking" of emissions reductions, constitute key elements of "when flexibility." These provisions mitigate costs by permitting reductions at times when they are less rather than more costly. The inclusion of all six greenhouse gases and certain sink activities that promote removal of carbon from the atmosphere provide substantial "what flexibility". The U.S. succeeded in having the Kyoto Protocol stipulate that countries with binding targets are to reduce total greenhouse gas emissions by certain percentages, but the Protocol does not require specific reductions for specific gases. Moreover, sinks can be used to offset emissions targets. The inclusion of international emissions trading among countries that take on binding targets, coupled with an agreement allowing industrial countries to receive emissions reduction credit for certified investments in "clean development" projects in the developing world, are the critical forms of "where" flexibility incorporated in the Kyoto Protocol. Although details of these provisions need to be finalized in negotiations in Buenos Aires later this year, we believe that these mechanisms can produce substantial reductions in the costs of attaining our environmental objectives.

Economic analysis also points to the need for a global solution to a problem which is global. Around 2015, under a continuation of business as usual, a majority of world emissions are projected to come from developing countries. Without developing country participation we cannot achieve adequate climate protection. In addition, developing country participation would permit relatively low-cost emissions reductions to be internationally recognized as a substitute for more expensive reductions in many industrial countries. The President has made clear that he will not submit the Kyoto Protocol to the Senate without meaningful participation from key developing countries.

Economic Effects

An economic analysis of climate change faces three broad categories of difficulties. First are the uncertainties that still remain over the terms of the ultimate treaty. Second are the inherent limitations of available models to analyze even short-term costs and benefits. And finally is the impossibility of putting a single monetary figure on the long-term benefits of climate change mitigation.

Mindful of the limitations of any single model as a tool for evaluating the economic impact of the Kyoto Protocol, we have employed a broad array of techniques to assess the various possible costs and non-climate benefits of the Administration's emissions reduction policy. Ignoring the benefits of mitigating climate change itself, our conclusion is that the net costs of our policies to reduce emissions are likely to be small if those reductions are undertaken in an efficient manner and we are successful in securing meaningful developing country participation as well as effective international trading and clean-development mechanisms in future negotiations. As I explain in my written testimony, this conclusion is not entirely dependent on, but is fully consistent with, formal model results. For example, given the factors, such as trading, just delineated, but excluding the benefits of acting and the impact of electricity restructuring, estimates derived using Battelle's Second Generation Model suggest that the resource costs of attaining the Kyoto targets for emission reductions might amount to just $7 to $12 billion per year in 2008 to 2012 -- or just 0.1 percent of projected GDP. That small net premium, in effect, purchases a partial insurance policy against a serious environmental threat.

A comprehensive economic evaluation of the Administration's climate change policies must also take into account the potential payoffs from the full package of proposed Administration climate change initiatives. As you know, the President's FY 1999 budget includes a $6.3 billion package of tax cuts and R&D over the next 5 years; this package makes good sense in terms of energy policy even ignoring any payoff for climate change. A second responsible step entails industry-by-industry consultations to prepare emission reduction plans in key industrial sectors. A final component of the President's climate change policy is his support for electricity restructuring in a manner that will offer approximately $20 billion in cost savings to electricity consumers, while offering modest reductions in greenhouse gas emissions.

I look forward to continuing to work with members of this Committee, as well as other interested parties, in further analyzing the Kyoto Protocol and evaluating the effects of reducing greenhouse gas emissions.

I welcome your questions.

ORAL TESTIMONY OF DR. JANET YELLEN
CHAIR, COUNCIL OF ECONOMIC ADVISERS
BEFORE THE HOUSE COMMERCE COMMITTEE
ON THE ECONOMICS OF THE KYOTO PROTOCOL
MARCH 4, 1998

Thank you, Mr. Chairman. The President has said that we can work to avert the grave dangers of climate change, while at the same time maintaining the strength of our economy. I agree and am pleased to have this opportunity to appear before the Committee to elaborate on the Administration's views on these issues.

The international agreement that was reached in Kyoto this past December is a crucial step forward in addressing global climate change. But it is only one step in a long journey. Since the international effort to reduce greenhouse gas emissions is still in some respects a work-in-progress, it is not yet possible to provide a full authoritative analysis of it. In my testimony today, I will attempt to identify key elements of the agreement and the Administration's policy, such as international emissions permit trading, meaningful developing country participation, the inclusion of land-use activities that absorb carbon ("sinks") and six categories of gases, as well as domestic initiatives, that can ensure that reductions in global greenhouse gas emissions are consistent with continued strong economic growth.

Effects of Climate Change

The Intergovernmental Panel on Climate Change (IPCC) jointly established by the World Meteorological Organization and the United Nations Environment Programme, concluded in 1995 that "the balance of evidence suggests that there is a discernible human influence on global climate." Current concentrations of carbon dioxide, methane, nitrous oxide, and the other so-called greenhouse gases have reached levels well above those of preindustrial times. As a result of the increased concentration of greenhouse gases, the IPCC estimates that global temperatures will increase by between 2 to 6 degrees Fahrenheit in the next 100 years, with a best guess of about 3.5 degrees Fahrenheit. The IPCC reports that a doubling of carbon dioxide levels would lead to approximately 10,000 additional deaths per year for the current U.S. population from higher summer temperatures, even after netting out the effects of warmer winters and acclimatization. The IPCC also predicts sea level increases of about 20 inches by 2100, with greater increases in subsequent years. Despite the difficulties of deriving quantitative assessments of the damages from climate change, researchers have nonetheless developed monetary estimates of damages that prompt substantial concern, and range in tens of billions of dollars per year for temperature changes projected to occur in the next century. If left uncontrolled, disruption of the Earth's climate may thus pose substantial costs in terms of harm to commerce and the environment alike. These costs--and they are significant--provide the primary motivation for actions to reduce greenhouse gas emissions.

These estimates do not, and cannot, accurately reflect the value of reducing the unknown risk of large-scale and potentially irreversible events with potentially catastrophic consequences, such as warming of the Northern tundra sufficient to release very large amounts of methane from the permafrost and thereby leading to accelerated warming. There is thus a strong argument for the Kyoto Protocol as a form of insurance against a serious environmental threat.

Kyoto Protocol

To address climate change, the United States and approximately 160 other nations agreed in negotiations held in Kyoto, Japan, last December, to reduce emissions of greenhouse gases. The Kyoto Protocol, which requires the advice and consent of the Senate, would place binding limits on each industrial country's combined emissions of the six principal categories of greenhouse gases. These limits apply to the 38 so-called Annex I countries, which are the industrialized countries, defined to include Russia, Ukraine, and most Eastern European countries.

In taking action to reduce emissions, economic analysis suggests that two elements are absolutely essential: the effort must be flexible and market-based, to ensure that we reduce emissions in the most efficient way; and the effort must be global, for without global emissions reductions the effort would be ineffective. The nature of the climate change problem--that greenhouse gas emissions have the same effect on the climate regardless of how, where, and, within limits, when they occur--suggests three basic approaches to lower the cost of achieving given levels of environmental protection. We term these "when", "what", and "where" flexibility.

As a result of U.S. diplomatic efforts, all three forms of flexibility are broadly reflected in the Kyoto Protocol. The choice of a multi-year budget period, ending later than many countries proposed, with allowance for "banking" of emissions reductions, constitute key elements of "when flexibility." These provisions mitigate costs by permitting reductions at times when they are less rather than more costly. The inclusion of all six greenhouse gases and certain sink activities that promote removal of carbon from the atmosphere provide substantial "what flexibility". The U.S. succeeded in having the Kyoto Protocol stipulate that countries with binding targets are to reduce total greenhouse gas emissions by certain percentages, but does not require specific reductions for specific gases. Moreover, sinks can be used to offset emissions targets. The inclusion of international emissions trading among countries that take on binding targets, coupled with an agreement allowing industrial countries to receive emissions reduction credit for certified investments in "clean development" projects in the developing world, are the critical forms of "where" flexibility incorporated in the Kyoto Protocol. Although details of these provisions need to be finalized in negotiations in Buenos Aires later this year, we believe that these mechanisms can produce substantial reductions in the costs of attaining our environmental objectives.

The problem of climate change is global and so requires a global solution. Around 2030, under a continuation of business as usual, a majority of world emissions are projected to come from developing countries. Without developing country participation we cannot achieve adequate climate protection. In addition, developing country participation would permit relatively low-cost emissions reductions to be internationally recognized as a substitute for more expensive reductions in many industrial countries. The President has made clear that he will not submit the Kyoto Protocol to the Senate without meaningful participation from key developing countries (who are not included in Annex I).

Economic Effects

An economic analysis of climate change faces three broad categories of difficulties. First are the uncertainties that still remain over the terms of the ultimate treaty. Second are the inherent limitations of available models to analyze even short-term costs and benefits. And finally is the impossibility of putting a single monetary number on the long-term benefits of climate change mitigation.

Mindful of the limitations of any single model as a tool for evaluating the economic impact of the Kyoto Protocol, we have employed a broad array of techniques to assess the various possible costs and non-climate benefits of the Administration's emissions reduction policy. Ignoring the benefits of mitigating climate change itself, our conclusion is that the net costs of our policies to reduce emissions are likely to be small if those reductions are undertaken in an efficient manner and we are successful in securing meaningful developing country participation as well as effective international trading and clean-development mechanisms in future negotiations. As I explain in my written testimony, this conclusion is not entirely dependent on, but is fully consistent with, formal model results. For example, given the factors, such as trading, just delineated, but excluding the benefits of acting and the impact of electricity restructuring, estimates derived using Battelle's Second Generation Model suggest that the resource costs of attaining the Kyoto targets for emission reductions might amount to just $7 to $12 billion per year in 2008 to 2012 -- or just 0.1 percent of projected GDP. That small net premium, in effect, purchases a partial insurance policy against a serious environmental threat.

A comprehensive economic evaluation of the Administration's climate change policies must also take into account the potential payoffs from the full package of proposed Administration climate change initiatives. As you know, the President's FY 1999 budget includes a $6.3 billion package of tax cuts and R&D over the next 5 years; this package makes good sense in terms of energy policy and will jumpstart our efforts. A second responsible step entails industry-by-industry consultations to prepare emission reduction plans in key industrial sectors. A final component of the President's climate change policy is his support for electricity restructuring in a manner that will offer approximately $20 billion in cost savings to electricity consumers, while offering modest reductions in greenhouse gas emissions.

I look forward to continuing to work with members of this Committee, as well as other interested parties, in further analyzing the Kyoto Protocol and evaluating the effects of reducing greenhouse gas emissions.

I welcome your questions.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-JUN-1998 21:25:31.00

SUBJECT: Slightly revised version of testimony

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READ:UNKNOWN

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
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TESTIMONY OF DR. JANET YELLEN
CHAIR, COUNCIL OF ECONOMIC ADVISERS
BEFORE THE
U.S. SENATE
COMMITTEE ON FINANCE

June 11, 1998

US Trade Policy and the Trade Deficit: Causes and Consequences

Mr. Chairman and members of the Committee. Thank you for the opportunity to discuss the trade deficit with you today.

The trade deficit is an important economic statistic, but its interpretation is subject to substantial confusion. A country's trade balance is often--wrongly--used as a measure of the success of its market-opening policies or the benefits of its engagement in international trade. The most important idea I would like to express to you today is that the benefits of increased international trade are reflected in higher real income, not in a smaller trade deficit. Indeed, the rising U.S. trade deficit in recent years mainly reflects the strength of the American economy, which has grown rapidly in comparison with the economies of our trade partners. In part, the trade deficit reflects the fact that our fast-growing economy is pulling in a lot of imports. But at the same time it also reflects the fact that the U.S. is attracting substantial international capital flows. These have financed increases in plant and equipment investment that have exceeded even the growth in national saving due to deficit reduction.

I. The Benefits of Trade

Going all the way back to Adam Smith, one of the most important insights of economics is that international trade increases the real incomes of all countries that engage in it. Trade is not a zero-sum game in which the gains of some countries come only at the expense of other countries. To the contrary, trade is a positive-sum game in which both sides gain.

For a long time, arguments for trade were based on the principle of *comparative advantage*. When countries specialize in the economic activities for which they are particularly well-suited and rely on trade to acquire other things, they can achieve a higher standard of living than if they try to produce everything themselves. More recently, economists have argued that there are benefits to trade that go beyond those arising from comparative advantage. Trade can enhance productivity through the effects of greater market size, enhanced competition, and improvements that come from contact with foreigners and their alternative production styles, including both new technology and new ideas about the efficient organization of firms.

These benefits from trade are not merely theoretical. A large and growing economics literature has found that those countries that are open to trade tend to grow faster and have higher levels of per-capita income than countries that close themselves off from international competition and trade. One estimate is that the globalization of the U.S. economy over the last 40 years has added between $1,500 and $2,000 to current median family income.

Because policy makers in this country have long believed in the benefits of trade for all parties, the United States, in the postwar period, has been the world's leading advocate for trade liberalization. U.S. tariffs are among the lowest in the world. While we benefit directly from our own low tariffs--through lower prices to consumers-- we would benefit even more if other countries were to lower their tariffs and other trade barriers. Since U.S. trade barriers are already so low, the international trade negotiations that have been concluded in recent years have typically produced much larger reductions in the trade barriers facing American goods in foreign markets than on foreign goods in the United States. The result has therefore generally been that foreign demand for our goods has risen by more than our demand for foreign goods, producing an extra boost to our real income.

It is often suggested that the major benefit of trade liberalization is job creation. When our economy is operating below its potential, with slack in the job market, export growth can produce job gains, helping the economy move toward full employment. As of January 1993, for example, the economy had substantial unemployment and excess capacity. One could say that the large increase in U.S. exports between 1993 and 1997--roughly 10% per year at an annual rate-- accounted for 38 percent of the increase in output, and a proportionate share of the almost 15 million jobs that were created over that period. In the long-term, however, the workings of the market, complemented by sound macroeconomic policies, are sufficient to create jobs for those who want to work. Thus, increases in exports must ultimately pull workers away from other activities. Trade still raises real income, but the boost comes from better jobs and not just more jobs. Studies show that export jobs pay 13-16 percent more than other jobs. Indeed, export jobs are better even after adjusting for worker skills and firm-specific and industry specific-components to wages.

II. Macroeconomics and the Trade Deficit

Perhaps the greatest source of confusion about trade relates to the interpretation and causes of trade or current account deficits and surpluses.

A trade deficit occurs, by definition, when a country's total domestic spending exceeds its total domestic production. When this occurs, the shortfall is made up by importing more goods than are exported. When the U.S. runs a trade deficit, foreigners buy less than a dollar's worth of U.S. goods for every dollar they earn from their export sales to us. The natural question is, what motivates foreigners to supply us with more goods than we supply to them in exchange? And what do foreigners do with the dollars that they don't use to buy U.S. goods? In practice, foreigners typically use the excess dollars to invest in interest-bearing U.S. assets. Indeed, it is the desire of foreigners to purchase attractive U.S. assets--to lend us the money needed to finance a trade deficit--that makes it possible to run such a deficit. Countries can run deficits only if foreigners want to add to their holdings of the deficit country's assets. In fact, one can as readily argue that the desire of foreigners to acquire attractive U.S. assets is responsible for the U.S. trade deficit as the reverse.

This relationship between spending, production, and the trade deficit can be expressed another way. I will not bore you with the details but it turns out that in an accounting sense the trade deficit is equal to the difference between national saving and national investment. When the demand for investment in the United States exceeds the pool of national saving, the difference is made up by borrowing from foreigners. Conversely, when saving exceeds investment, the surplus is invested abroad. The United States first experienced large current account deficits during the mid-1980s, when net investment fell as a share of national income and net national saving fell even faster. The deficit shrank briefly as investment collapsed in the 1990-91 recession, but it has reemerged in the current expansion. The good news in this expansion is that investment has been booming. But saving does not appear to have kept pace, despite the improvement due to federal deficit reduction. (The interpretation of current trends in saving, investment, and the current account is complicated by the statistical discrepancy between GDP measured as the sum of all spending on output and as the sum of all income generated in producing that output.)

When a trade deficit is used to finance productive investment, as it is now, it can be viewed as largely benign, because the extra investment raises the productivity of our workforce, resulting in higher future national income. It is that return that should enable us to pay off the foreign borrowing we have undertaken to help finance our investments. We would be *worse off* as a nation, and our interest rates would have been higher, if, over the last few years, we had been forced to curtail our investment. Our ability to attract funds from abroad is a vote of confidence in the ability of our high-performing economy to put these funds to good use. However, maintaining national investment above national saving does entail the price that what we borrow, we will eventually need to repay.

Let me return now to the more immediate causes of our rising trade deficit. A key factor responsible for this trend is strong growth in the United States relative to our major trading partners. Our strong growth has resulted in a larger income-induced increase in American demand for foreign goods than in foreign demand for our goods and services. The second key factor is the dollar's appreciation, which has been substantial over the last three years. In a system of flexible exchange rates, an appreciation in a currency reflects a desire by foreigners to hold that currency. Appreciations very often accompany strong economic expansions like the one the U.S. has experienced over this period, and in that sense the appreciation of the dollar is unsurprising given that the U.S. economy has grown much more rapidly than those of our trading partners over the past few years.

More recently we have seen a surge in the trade deficit that reflects the effects of the East Asian crisis. The sharp drop in the value of the East Asian currencies has led to an increase in

U.S. demand for the goods produced by these countries (which are now much cheaper to us than before). At the same time, the East Asian countries have cut back sharply on imports of goods from the U.S. both because our goods are effectively much more expensive for them, and also because their incomes have fallen substantially.

The most recent data, for the first three months of this year, already point to a significant impact of the crisis on our trade balance. To estimate the magnitude of the impact, it is natural to compare our trade with the affected countries over the last three months with the magnitude of trade flows in the second quarter of 1997, immediately before the Thai baht began to float and the crisis began. (This comparison relies on seasonal adjustments of bilateral trade data computed by the Council of Economic Advisers since such adjustments are not computed by Commerce Department itself.) According to our estimates, the U.S. bilateral balance has deteriorated by $14 billion with respect to Korea, by $10 billion with respect to Malaysia, Indonesia, Thailand, and the Philippines, and by $10 billion vis-a-vis Japan. [chk] We expect further deterioration in the remainder of the year.

It is often argued that the Asian crisis, by decreasing U.S. net exports, will diminish U.S. growth over the next year or longer. There is no denying that net exports are exerting, and will continue to exert, a drag on U.S. economic growth. According to some estimates, the East Asian crisis, taking account of its impact on Japan, could subtract as much as 1 percentage point from GDP growth over the next year [*check*]. Fortunately, however, the slowdown in exports to East Asia is impacting the US economy at a time when domestic demand growth is extremely robust and labor markets have becoming increasingly tight. The consensus among forecasters is that the East Asian crisis could serve as the brake that subdues growth toward a more sustainable pace, preventing overheating, and permitting continued job growth with a more moderate path for interest rates and stronger investment spending than we would otherwise enjoy. 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 dampening influence on inflation.

III. Are There Reasons for Concern?

My testimony so far has been that the trade deficit largely reflects the strength of the American economy. But I do not want to leave you with the impression that there are no reasons to be concerned about a large trade deficit.

First, even in the absence of any negative aggregate impact on output and employment due to a growing trade deficit, particular sectors have been adversely affected. Before 1997, U.S. producers in such sectors as aircraft and agriculture enjoyed rapid growth in their exports to East Asia. That has now disappeared. Exports are down sharply to Asia in general, and to Korea, Southeast Asia, and Japan, in particular. They can be expected to continue to fall in the remainder of this year. In addition, we will probably see increased imports from these countries, especially in such sectors as autos, steel, textiles and apparel, and semiconductors and other electronics. The crisis countries have no choice but to shift their trade balances into surplus, since they are no longer able to borrow from abroad to finance the trade deficits that most of them ran before the crisis. It is their inability to borrow in world capital markets that is responsible for the currency depreciations and income reductions that are in turn causing them to buy less from us and sell more to us.

The second reason for concern about our growing trade deficit follows in part from the first. Our rising trade deficit, particularly in such key areas of the economy as manufacturing and agriculture, could undermine support for internationalist principles and for market-opening policies. If the widening U.S. trade deficit were to create the false impression that the U.S. stands to lose rather than to gain from continued engagement in international markets, then it would be a costly development indeed.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-JUN-1998 14:48:19.00

SUBJECT:

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

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TEXT:
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TESTIMONY OF DR. JANET YELLEN
CHAIR< COUNCIL OF ECONOMIC ADVISERS
BEFORE THE
U.S. SENATE
COMMITTEE ON FINANCE

June 11, 1998

US Trade Policy and the Trade Deficit: Causes and Consequences

Thank you for inviting me to testify on the trade deficit. I am happy to have the chance to appear before you today. The trade deficit is an important statistic concerning the American economy, but one whose interpretation is subject to substantial confusion. A country's trade balance is often--wrongly--used as a measure of the success of its market-opening policies or the benefits of its engagement in international trade. I will argue that the benefits of increased international trade are reflected in higher real income, not as a smaller trade deficit. The rising U.S. trade deficit in recent years is actually a reflection of our strong American economy: our economy has grown rapidly in comparison with those of our trade partners and our deficit permits us to invest even more than we can finance from our now larger pool of national savings.

I. The Theory of Trade

Economists since Adam Smith have believed that international trade increases the real incomes of all trading partners. Rather than being a zero-sum game where one trading partner is a winner and the other is a loser, trade is a positive-sum game in which both sides gain.

The original arguments for trade were based on the theory of *comparative advantage*. In essence, these arguments demonstrated that if countries specialized in producing those things that they were best at making, and then traded with other countries, all countries could be better off than if each country tried to produce everything on its own. More recently, economists have argued that there are benefits to trade that go beyond those identified by the theory of comparative advantage. Trade can enhance productivity through the effects of greater market size, enhanced competition, and improvements that come from contact with foreigners and their alternative production styles, including both new technology and new ideas about the efficient organization of firms.

These benefits from trade are not merely theoretical. A large and growing body of economic literature has found that those countries that are open to trade tend to grow faster and have higher levels of per-capita income than countries that close themselves off from international competition and trade. One calculation based on an academic paper suggests that the globalization of the US economy over the last 40 years has added an estimated $1,730 to current median family income.

Because US policymakers have long believed that trade is a positive-sum game, the United States, in the postwar period, has been the world's greatest advocate for trade liberalization, with the result that US tariffs are among the lowest in the world. While we benefit directly from our own low tariffs -- remember that a 'tariff' is just another word for a tax on consumers -- we would benefit even more if other countries were to lower their trade barriers. Since U.S. trade barriers are already so low, the international trade negotiations that have been concluded in recent years, have typically produced much larger reductions in the trade barriers facing American goods in foreign markets than on foreign goods in the United States, where barriers are low now. The result has therefore generally been that foreign demand for our goods has risen by more than our demand for foreign goods, producing an extra bonus to our real income.

It is often argued that the majore benefit of trade liberalization is job creation. When our economy is operating below its potential, with slack in the job market, export growth can produce job gains, helping the economy move toward full employment. As of January 1993, for example, the economy had substantial unemployment and excess capacity. One could say that the large increase in US exports between 1993 and 1997--over xx% per year at an annual rate--accounted for 38 percent of the increase in output over that period [chk current figure], and a proportionate share of the 15 million jobs that were created over that period. In the long-term, however, the workings of the market, complemented by sound macroeconomic policies are sufficient to create jobs for those who want to work. Thus, increases in exports must ultimately pull workers away from other activities. Trade still raises real income, but the boost comes from better jobs and not just more jobs. Studies show that export jobs pay 13-16 percent more than other jobs. Indeed, export jobs are better even after adjusting for worker skills and firm-specific and industry specific-components to wages.

II. The Trade Deficit and Macroeconomics

Perhaps the greatest source of confusion about trade relates to the interpretation and causes of trade or current account deficits and surpluses.

A trade deficit occurs, by definition, when a country's total domestic spending exceeds its total domestic production. When spending exceeds production, the shortfall is made up by importing more goods than we export. When the U.S. runs a trade deficit, for every dollar we pay to foreigners for imports, they buy less than a dollar's worth of US goods. The natural question is What motivates foreigners to supply us more goods than we supply them in exchange? And what do foreigners do with the dollars that they don't use to buy US goods? In practice, foreigners typically use the excess dollars to invest in interest bearing U.S. assets. Indeed, it is the desire of foreigners to purchase attractive U.S. assets--to lend us the money needed to finance a trade deficit--that makes it possible to run such a deficit. Countries can run deficits only if foreigners want to add to their holdings of that country's assets. In fact, one can as readily argue that the desire of foreigners to acquire U.S. attractive U.S. assets is responsible for the U.S. trade deficit as the reverse.

Just as a country's trade deficit can be viewed as the gap between @@@@@

[Since trade deficits occur when national spending is greater than national income,] in order to understand the underlying causes of trade deficits, we need to look at trends in national saving and spending. The US national saving rate has increased sharply over the last 5 years as the once-enormous Federal budget deficit has been tamed. If other kinds of spending had remained the same, this increase in national saving would have led to a shrinking trade deficit. But everything else, of course, did not remain the same. In particular, the past six years have witnessed a historic boom in investment spending. Investment has risen even more than national saving, and the result has been an *increase* in the trade deficit even as national saving has risen.

Economists traditionally make the point that there are two kinds of trade deficits: those that finance consumption, and those that finance investment. When a trade deficit is used to finance investment, it can be viewed as largely benign, because the extra investment will result in higher future national income that will make it feasible to pay off the foreigners who made the investments. We would be *worse off* as a nation if over the last few years we had been unable to invest as much as we have invested.

Let me return now to the more immediate causes of the increase in the trade deficit. One factor is the substantial appreciation of the US dollar over the last three years. In a system of flexible exchange rates, an appreciation in a currency reflects a desire by foreigners to hold that currency. Appreciations very often accompany strong economic expansions like the one the US has experienced over this period, and in that sense the appreciation of the dollar is unsurprising given that the US economy has grown much more rapidly than those of our trading partners over the past few years.

Another important point is that the trade deficit reflects a sort of "safety valve" that is now helping to prevent overheating of the US economy. If we had to satisfy purely through domestic production all of the demand for consumption and investment spending that US consumers and businesses are currently generating, there would be serious upward pressures on prices that would almost surely have led to an acceleration of inflation by now [and in increase in interest rates]. Instead, the rising US dollar and the drop in the currencies of many of our trading partners (particularly the East Asian countries) have led to downward pressure on inflation even as we are experiencing the lowest unemployment rate in nearly 30 years.

This leads me to the point that much of the very recent surge in the trade deficit reflects the effects of the East Asian crisis. The sharp drop in the East Asian currencies has led to an increase in US demand for the goods produced by these countries (which are now much cheaper to us than before), while at the same time the East Asian countries have sharply cut back on imports of goods from the US because our goods are effectively much more expensive for them, and their incomes have fallen sharply. The resulting surge in the US trade deficit is undoubtedly exerting a moderating force on US economic growth, but it is hard to remember a time when the US economy was better positioned to be able to deal with such effects. The major effect of the Asian crisis on the US will be in the composition of demand and of output rather than the level. [Estimates may well be right that the East Asia crisis(including Japan) will reduce the US trade balance by as much as much as 1 percent of GDP this year. But if the alternative would not simply to add 1 percent to the stimulus to GDP offered by domestic demand. Such a rate of growth of total demand for US goods would outstrip the supply capacity of the economy {stats.}. Rather, other sectors, such as construction which has recently been booming, would get crowded out.]

III. This Does Not Mean That the US Trade Deficit is Not a Source of Any Concern

I would not want to give the impression from what I have said that the US trade deficit is an unalloyed joy. Far from it; there are a number of troublesome aspects to the deficit. [They fall into three categories: adverse effects on some individual sectors, effects on political support for international engagement, and long-run sustainability.]

1. Some US sectors are being adversely affected by East Asian crisis

[Even though we do not currently see negative effects on overall output and employment, relative to what they would otherwise be, nevertheless] there have been adverse effects on particular sectors. In the years preceding 1997, US producers in such sectors as aircraft and agriculture enjoyed rapid growth in their exports to East Asia. That has now disappeared. Exports are down sharply to Asia in general, and to Korea, Southeast Asia, and Japan, in particular. They can be expected to continue to fall in the remainder of this year. In addition, we will probably see increased imports from these countries, especially in such sectors as autos, steel, textiles and apparel, and semiconductors and other electronics. [The crisis countries have no choice but to start running trade surpluses, since they are no longer able to borrow from abroad to run the trade deficits that most of them ran before the crisis. Their reductions in expenditure and income and their devaluations are bringing about a decline in their purchases from us, and increases in their sales to us.]

The most recent data are for the first three months of this year. To estimate the effects of the crisis on the trade balance, the cleanest comparison would be with the three months preceding the floating of the Thai baht, i.e., the second quarter of 1997. [This comparison requires seasonal adjustment of the bilateral trade data which the Commerce Department does not do, but which the CEA has undertaken on its own]. Our bilateral balance has deteriorated by $14 billion with respect to Korea, and $10 billion with respect to Maylaysia, Indonesia, Thailand, and the Phillipines, and $10 billion with respect to Japan. We expect further deterioration in the remainder of the year.

Let me repeat that these statistics do not necessarily portend a significant loss in aggregate US output and employment relative to what it otherwise would be. Growth in other sectors has been very strong, and we believe this will continue to be true. Nevertheless, we recognize the losses inflicted on some sectors.

2. Politics: Risk of isolationist/protectionist backlash

The second possible negative aspect of the trade deficit follows in part from the first.

Our rising trade deficit, particularly in such key areas of the economy as manufacturing and agriculture, could have unfortunate political consequences: It could undermine support for internationalist principles and for market-opening policies, and it could generate support for isolationist philosophies or for protectionist policies.

The President has asked the Congress for authority to negotiate international market-opening agreeements on a fast-track basis. We failed the first time to persuade Congress of the need, but we plan to try again. But there is no question that gaining such approval is more difficult when opponents can point to a rising trade deficit as a political argument against trade liberalization.

Similarly, we have asked the Congress to approve $18 billion in additional funding for the International Monetary Fund, and have not yet obtained it. While the IMF funding would have been appropriate this year in any case, the East Asian financial crisis makes it especially important. As our colleagues in the Treasury say, failing to support the IMF this year would be like canceling your insurance policy after you have already gotten sick. Opponents of IMF aid may try to use the rising trade deficits with countries that have received IMF assistance as an argument against further IMF funding. We believe that this argument is fundamentally in error, since without the IMF financial packages, our trade balance with East Asia might have deteriorated even more than it has; financially devastated countries would be unable to afford even the reduced levels of our exports they are continuing to buy now.

If the widening US trade deficit were to create the false impression that the US loses from its international economic activities, that it is desirable (or even possible) for us to withdraw from engagement with the rest of the world then it would be a costly development indeed. Now, more than ever, is a time to look outward, not to turn inward.

3. Long-term issues of sustainability

I have already explained that there are other ways of viewing the deficit, besides as the difference between exports and imports -- that it is also the difference between saving and investment. Yet another way to view the deficit is the amount of borrowing from abroad, or (equivalently) residents of other countries' net investment in the United States. While our ability to attract funds from abroad is a vote of confidence in the health of the American economy, this capital inflow also has a negative side. What one borrows one of course has to pay back. [Were this not true, running deficits indefinitely would be a great way of living well without having to earn the money to pay for it all !]

Alternative 1: [If a country runs large current account deficits for a long period of time, it may eventually have trouble paying back the money it has borrowed. [Such trouble can take the form of a sharp real depreciation of the currency and a period of reduced real income and consumption.] This is particularly a danger if the macroeconomic fundamentals are poor, specifically if the deficits are associated with a high level of private consumption of government deficits. But this is not the case with the United States currently. As I have explained, we have rapid growth, led not by government deficits but by private demand, especially strong private investment. [Eventually there will be an adjustment and the deficit will come down.] That we are currently investing in plant and equipment, and in the education of our children, suggests that we are earning a higher return in terms of physical and human capital than the borrowing us is costing in interest payments to foreign investors.]

Alternative 2: The best long-term solution to the trade deficit would be for us to maintain the high rates of investment that the economy currently experiences, but to increase the national saving rate so that the investment is financed by domestic saving rather than foreign saving.

Eventually the trade deficit will have to come down. Anything we could do to raise national saving would be beneficial and would have this effect. But there is no reason why we cannot go on financing our deficit for sometime. So long as our fundamentals are strong, international investors are more than happy to put their money here. In the meantime, our high-performing economy is putting these funds to good use. That we are currently investing in plant and equipment, and in the education of our children, suggests that we are earning a higher return in terms of physical and human capital than the borrowing us is costing in interest payments to foreign investors...

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-JUN-1998 18:05:07.00

SUBJECT:

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

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

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The following is a HEX DUMP:

TESTIMONY OF DR. JANET YELLEN
CHAIR, COUNCIL OF ECONOMIC ADVISERS
BEFORE THE
U.S. SENATE
COMMITTEE ON FINANCE

June 11, 1998

US Trade Policy and the Trade Deficit: Causes and Consequences

Mr. Chairman and members of the Committee. Thank you for the opportunity to discuss the trade deficit with you today.

The trade deficit is an important economic statistic, but its interpretation is subject to substantial confusion. A country's trade balance is often--wrongly--used as a measure of the success of its market-opening policies or the benefits of its engagement in international trade. The most important idea I would like to express to you today is that the benefits of increased international trade are reflected in higher real income, not in a smaller trade deficit. Indeed, the rising U.S. trade deficit in recent years mainly reflects the strength of the American economy, which has grown rapidly in comparison with the economies of our trade partners. In part, the trade deficit reflects the fact that our fast-growing economy is pulling in a lot of imports. But at the same time it also reflects the fact that the U.S. is attracting substantial international capital flows. These have financed increases in plant and equipment investment that have exceeded even the growth in national saving due to deficit reduction.

I. The Benefits of Trade

Going all the way back to Adam Smith, one of the most important insights of economics is that international trade increases the real incomes of all countries that engage in it. Trade is not a zero-sum game in which the gains of some countries come only at the expense of other countries. To the contrary, trade is a positive-sum game in which both sides gain.

For a long time, arguments for trade were based on the principle of *comparative advantage*. When countries specialize in the economic activities for which they are particularly well-suited and rely on trade to acquire other things, they can achieve a higher standard of living than if they try to produce everything themselves. More recently, economists have argued that there are benefits to trade that go beyond those arising from comparative advantage. Trade can enhance productivity through the effects of greater market size, enhanced competition, and improvements that come from contact with foreigners and their alternative production styles, including both new technology and new ideas about the efficient organization of firms.

These benefits from trade are not merely theoretical. A large and growing economics literature has found that those countries that are open to trade tend to grow faster and have higher levels of per-capita income than countries that close themselves off from international competition and trade. One estimate is that the globalization of the U.S. economy over the last 40 years has added between $1,500 and $2,000 to current median family income.

Because policymakers in this country have long believed in the benefits of trade for all parties, the United States, in the postwar period, has been the world's leading advocate for trade liberalization. U.S. tariffs are among the lowest in the world. While we benefit directly from our own low tariffs--through lower prices to consumers-- we would benefit even more if other countries were to lower their trade barriers. Since U.S. trade barriers are already so low, the international trade negotiations that have been concluded in recent years have typically produced much larger reductions in the trade barriers facing American goods in foreign markets than on foreign goods in the United States. The result has therefore generally been that foreign demand for our goods has risen by more than our demand for foreign goods, producing an extra boost to our real income.

It is often suggested that the major benefit of trade liberalization is job creation. When our economy is operating below its potential, with slack in the job market, export growth can produce job gains, helping the economy move toward full employment. As of January 1993, for example, the economy had substantial unemployment and excess capacity. One could say that the large increase in U.S. exports between 1993 and 1997--over xx% per year at an annual rate--accounted for 38 percent of the increase in output over that period [chk current figure], and a proportionate share of the 15 million jobs that were created over that period. In the long-term, however, the workings of the market, complemented by sound macroeconomic policies are sufficient to create jobs for those who want to work. Thus, increases in exports must ultimately pull workers away from other activities. Trade still raises real income, but the boost comes from better jobs and not just more jobs. Studies show that export jobs pay 13-16 percent more than other jobs. Indeed, export jobs are better even after adjusting for worker skills and firm-specific and industry specific-components to wages.

II. Macroeconomics and the Trade Deficit

Perhaps the greatest source of confusion about trade relates to the interpretation and causes of trade or current account deficits and surpluses.

A trade deficit occurs, by definition, when a country's total domestic spending exceeds its total domestic production. When this occurs, the shortfall is made up by importing more goods than are exported. When the U.S. runs a trade deficit, for every dollar we pay to foreigners for imports, they buy less than a dollar's worth of U.S. goods. The natural question is, what motivates foreigners to supply us with more goods than we supply to them in exchange? And what do foreigners do with the dollars that they don't use to buy U.S. goods? In practice, foreigners typically use the excess dollars to invest in interest bearing U.S. assets. Indeed, it is the desire of foreigners to purchase attractive U.S. assets--to lend us the money needed to finance a trade deficit--that makes it possible to run such a deficit. Countries can run deficits only if foreigners want to add to their holdings of the deficit country's assets. In fact, one can as readily argue that the desire of foreigners to acquire attractive U.S. assets is responsible for the U.S.

trade deficit as the reverse.

This relationship between spending, production, and the trade deficit can be expressed another way. I will not bore you with the details but it turns out that in an accounting sense the trade deficit is equal to the difference between national saving and national investment. When the demand for investment in the United States exceeds the pool of national saving, the difference is made up by borrowing from foreigners. Conversely, when saving exceeds investment, the surplus is invested abroad. The United States first experienced large current account deficits during the mid-1980s, when net investment fell as a share of national income and net national saving fell even faster. The deficit shrank briefly as investment collapsed in the 1990-91 recession, but it has reemerged in the current expansion. The good news in this expansion is that investment has been booming. But saving does not appear to have kept pace, despite the improvement due to federal deficit reduction. (The interpretation of current trends in saving, investment, and the current account is complicated by the statistical discrepancy between GDP measured as the sum of all spending on output and as the sum of all income generated in producing that output.)

When a trade deficit is used to finance investment, as it is now, it can be viewed as largely benign, because the extra investment will result in higher future national income that will make it feasible to pay off the foreigners who made the investments. We would be *worse off* as a nation if over the last few years we had been forced to curtail our investment.

Let me return now to the more immediate causes of the increase in the trade deficit. One factor is the substantial appreciation of the US dollar over the last three years. In a system of flexible exchange rates, an appreciation in a currency reflects a desire by foreigners to hold that currency. Appreciations very often accompany strong economic expansions like the one the U.S. has experienced over this period, and in that sense the appreciation of the dollar is unsurprising given that the U.S. economy has grown much more rapidly than those of our trading partners over the past few years.

Another important point is that the trade deficit reflects a sort of "safety valve" that is now helping to prevent overheating of the U.S. economy. If we had to satisfy purely through domestic production all of the demand for consumption and investment spending that U.S. consumers and businesses are currently generating, there would be serious upward pressures on prices that would almost surely have led to an acceleration of inflation by now [and in increase in interest rates]. Instead, the rising US dollar and the drop in the currencies of many of our trading partners (particularly the East Asian countries) have led to downward pressure on inflation even as we are experiencing the lowest unemployment rate in nearly 30 years.

This leads me to the point that much of the very recent surge in the trade deficit reflects the effects of the East Asian crisis. The sharp drop in the East Asian currencies has led to an increase in U.S. demand for the goods produced by these countries (which are now much cheaper to us than before), while at the same time the East Asian countries have sharply cut back on imports of goods from the U.S. because our goods are effectively much more expensive for them, and their incomes have fallen sharply. The resulting rise in the U.S. trade deficit is undoubtedly exerting a moderating force on U.S. economic growth, but it is hard to remember a time when the U.S. economy was better positioned to be able to deal with such effects. The major effect of the Asian crisis on the U.S. will be in the composition of demand and of output rather than the level. Estimates may well be right that the East Asia crisis (including Japan) will reduce the U.S. trade balance by as much as much as 1 percent of GDP this year. But this does not mean that in the absence of these effects GDP growth would be that much higher. Such a rate of growth of total demand for U.S. goods would outstrip the supply capacity of the economy. Rather, other sectors, such as construction which has recently been booming, would get crowded out.

III. Are There Reasons for Concern?

My testimony so far has been that the trade deficit largely reflects the strength of the American economy. But I do not want to leave you with the impression that there are no reasons to be concerned about a large trade deficit.

1. Some U.S. sectors are being adversely affected by East Asian crisis

First, even though we do not currently see negative effects on overall output and employment, relative to what they would otherwise be, particular sectors have been affected. Before 1997, U.S. producers in such sectors as aircraft and agriculture enjoyed rapid growth in their exports to East Asia. That has now disappeared. Exports are down sharply to Asia in general, and to Korea, Southeast Asia, and Japan, in particular. They can be expected to continue to fall in the remainder of this year. In addition, we will probably see increased imports from these countries, especially in such sectors as autos, steel, textiles and apparel, and semiconductors and other electronics. The crisis countries have no choice but to start running trade surpluses, since they are no longer able to borrow from abroad to run the trade deficits that most of them ran before the crisis. Their reductions in expenditure and income and their devaluations are bringing about a decline in their purchases from us, and increases in their sales to us.

The most recent data are for the first three months of this year. To estimate the effects of the crisis on the trade balance, the cleanest comparison would be with the three months preceding the floating of the Thai baht, i.e., the second quarter of 1997. (This comparison requires seasonal adjustment of the bilateral trade data which the Commerce Department does not do, but which the CEA has undertaken on its own). Our bilateral balance has deteriorated by $14 billion with respect to Korea, and $10 billion with respect to Maylaysia, Indonesia, Thailand, and the Phillipines, and $10 billion with respect to Japan. We expect further deterioration in the remainder of the year.

Let me repeat that these statistics do not necessarily portend a significant loss in aggregate U.S. output and employment relative to what it otherwise would be. Growth in other sectors has been very strong, and we believe this will continue to be true. Nevertheless, we recognize the losses inflicted on some sectors.

2. The risk of isolationist or protectionist backlash

The second possible negative aspect of the trade deficit follows in part from the first. Our rising trade deficit, particularly in such key areas of the economy as manufacturing and agriculture, could undermine support for internationalist principles and for market-opening policies, and it could generate support for isolationist philosophies or for protectionist policies.

The President has asked the Congress for authority to negotiate international market-opening agreeements on a fast-track basis. We failed the first time to persuade Congress of the need, but we plan to try again. But there is no question that gaining such approval is more difficult when opponents can point to a rising trade deficit as a political argument against trade liberalization.

Similarly, we have asked the Congress to approve $18 billion in additional funding for the International Monetary Fund, and have not yet obtained it. While the IMF funding would have been appropriate this year in any case, the East Asian financial crisis makes it especially important. As our colleagues in the Treasury say, failing to support the IMF this year would be like canceling your insurance policy after you have already gotten sick. Opponents of IMF aid may try to use the rising trade deficits with countries that have received IMF assistance as an argument against further IMF funding. We believe that this argument is fundamentally in error, since without the IMF financial packages, our trade balance with East Asia might have deteriorated even more than it has; financially devastated countries would be unable to afford even the reduced levels of our exports they are continuing to buy now.

If the widening U.S. trade deficit were to create the false impression that the U.S. loses from its international economic activities, that it is desirable (or even possible) for us to withdraw from engagement with the rest of the world then it would be a costly development indeed. Now, more than ever, is a time to look outward, not to turn inward.

3. Long-term issues of sustainability

While our ability to attract funds from abroad is a vote of confidence in the health of the American economy, this capital inflow imposes interest and debt repayment obligations. If a country runs large current account deficits for a long time, it may eventually have trouble paying back the money it has borrowed. Such trouble can take the form of a sharp real depreciation of the currency and a period of reduced real income and consumption. This is particularly a danger if the macroeconomic fundamentals are poor, specifically if the deficits are associated with a high level of private consumption of government deficits. But this is not the case with the United States currently. That we are currently investing in plant and equipment, and in the education of our children, suggests that we are earning a higher return in terms of physical and human capital than the borrowing us is costing in interest payments to foreign investors.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-JUN-1998 12:45:52.00

SUBJECT: rough draft of merger written testimony

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READ:UNKNOWN

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Testimony of

Janet Yellen, Chair
Council of Economic Advisers

before the

Senate Judiciary Committee

June 16, 1998

Mr. Chairman and members of the Committee, it is a pleasure to be here this morning to talk about some of the economic issues raised by the current merger wave. My testimony contains four sections. The first puts the current merger wave into historical perspective. The main message from that section is that merger activity has certainly increased substantially in the past few years, but it is not clear that the level of merger activity is "unprecedented." The second section examines the question of what the current increase in merger activity means for the economy. Here the main message is that mergers affect economic performance primarily through their impact on competitive conditions in specific markets rather than on broader macroeconomic conditions. The third section looks at the causes and consequences of mergers. Here there is no simple conclusion. Many, if not most mergers are motivated by the desire to achieve greater operating efficiencies and lower costs. But it is impossible to rule out anticompetitive motives or simple managerial hubris as explanations for mergers. The final section provides a summary and tentative evaluation of the current merger wave.

I. Mergers: a Historical Perspective

The United States is in the midst of its fifth major merger wave in a hundred years. The previous four merger waves provide background and perspective for assessing today's merger activity.

- The Great Merger Wave of the 1890s. The first great merger wave at the turn of the last century was the culmination of the trust movement, when numerous small and mid-sized firms were consolidated into single dominant firms in a number of industries. Examples include Standard Oil and U.S. Steel. One estimate is that this merger wave encompassed at least 15 percent of all plants and employees in manufacturing at the turn of the century. An estimated 75 percent of merger-related firm disappearances occurred as a result of mergers involving at least five firms, and about a quarter involved 10 or more firms at a time. Merger activity declined sharply during 1903 and 1904 at the same time as a severe recession and the Northern Securities case, which established a legal precedent for prohibiting market-dominating mergers under the antitrust laws.

- The Roaring Twenties. The merger movement of the 1920s saw the consolidation of many electric and gas utilities as well as manufacturing and minerals mergers. Some of the most prominent manufacturing mergers (such as the one that produced Bethlehem Steel) created relatively large number-two firms in industries previously dominated by one giant.

- The "Go-Go" Sixties. The 1960s conglomerate wave represented a deflection of the "urge to merge" away from horizontal (same-industry) mergers, perhaps due to stronger antitrust enforcement. The constant-dollar value of mergers in manufacturing and minerals surpassed the prior peak attained in 1899 (though it remained much smaller as a share of the economy). The 1960s boom was also fueled by a strong stock market and financial innovation (such as convertible preferred stocks and debentures). This merger wave ended with a decline in stock prices that was especially severe for companies that had aggressively pursued conglomerate mergers.

- The Deal Decade of the 1980s. Unlike other merger booms, this one began in a depressed stock market. With stock prices low relative to the cost of building new capacity, it appeared cheaper to expand by takeover. The 1980s boom was marked by an explosion of hostile takeovers and financial innovation (such as junk bonds and leveraged buyouts). The 1980s wave was unique in the prevalence of cash purchases (as opposed to acquisition through stock). Finally, the antitrust environment was more permissive and companies were more willing to attempt horizontal mergers.

Qualitatively, the current merger wave appears to be a reversion to pre-1980s form in some ways: It is taking place in a strong stock market, and stock rather than cash is the preferred medium. But mergers are neither purely horizontal (in general large horizontal mergers would raise antitrust issues) nor purely conglomerate. Rather they represent market extension mergers like SBC-Ameritech (companies in the same industry that serve different and currently non-competing markets) or mergers seeking "synergy," like Travelers-Citicorp, which presumably expects to achieve "economies of scope" in offering a full line of financial services.

By almost any quantitative measure, the current merger boom of 1997-98 is substantial.

(Exhibit 1 provides a sample of recent mergers.) For example, the largest deal announced so far is the $70 billion Travelers Group-CitiCorp merger, but the $62 billion SBC-Ameritech and the $60 billion Bank America-Nation's Bank merger are also huge in dollar terms. (The total value of all deals announced in 1992—a year of especially low activity—was only $150 billion.) The value of all deals announced in 1997 ($957 billion) was equivalent to about 12 percent of GDP, and activity so far in 1998 suggests another record year by this measure (Exhibit 2, upper panel). The last time merger activity was this large a share of GDP was during the Great Merger Wave at the beginning of this century.

Comment [COMMENT1]: A1: New York Times May 17, 1998;

However, when the level of activity is expressed relative to the market value of U.S. companies, the level of merger activity remains lower than it was in the 1980s (Exhibit 2, lower panel). Thus, the run up in stock prices in the past few years is one reason why current merger activity is so large relative to the size of the economy.

II. Mergers, Concentration, and Aggregate Economic Performance

What does this merger activity mean for the economy? I think it is fair to say that economists have found little reason to think that broad economic indicators like the rate of economic growth, inflation, or unemployment are much affected by changes in merger activity or the share of aggregate economic activity accounted for by the largest 100 or 200 firms (so-called aggregate concentration)—at least on the order of those that have typically been observed in the United States. Economic analysis suggests that the main route by which mergers affect economic performance is through their impact on competitive conditions in specific markets.

Let me elaborate a little on these points. Heightened merger activity tends to call attention to the importance of large firms in the economy and raise popular concerns that economic power is becoming increasingly concentrated in a few mega-corporations. In 1976, for example, the business journalist Andrew Tobias wrote an article in *New York* magazine entitled, "March 3, 1998: The Day They Couldn't Fill the FORTUNE 500." Well, needless to say, Fortune magazine continues to publish its Fortune 500 with all the spots filled. Indeed, Statistics of Income data from the IRS show that in 1994, there were about 4.3 million incorporated business enterprises operating in the United States. Of course, most of these were relatively small (Exhibit 3.)

About 7,000 corporations (0.2 percent of the total number) had assets of $250 million or more. These large corporations held $19.5 trillion of the $23.4 trillion in assets in the corporate sector (83 percent) and their receipts of $7.2 trillion represented 54 percent of the $13.4 trillion aggregate corporate receipts. (Aggregate corporate receipts are larger than GDP because of double counting—steel sold to automobile producers shows up as sales by steel manufacturers, but it is also reflected in the price of automobiles.) And companies at the top of the Fortune 500 are extremely large.

- General Motors topped the 1998 list with revenues of $178 billion and assets of $229 billion (about 1.5 percent of total corporate revenues and about 1 percent of total corporate assets). Three other firms (Ford, Exxon, and Wal-Mart) had revenues in excess of $100 billion.

- Fannie Mae topped the list of Fortune 500 companies ranked by assets, with $392 billion of assets. Five other companies (Travelers Group, Chase Manhattan Corp., Citicorp, General Electric, and Morgan Stanley Dean Witter Discover) had assets in excess of $300 billion. (The merger of Travelers and Citicorp would move CitiGroup to the top by a wide margin).

- Wal-Mart Stores is by far the largest employer among the Fortune 500, with 825,000 employees. General Motors is second with 608,000 employees, and Ford and United Parcel each have employment in excess of 300,000.

We found no comprehensive recent research on trends in aggregate concentration (the share of total assets or some other measure of size accounted for by the largest 50, 100, 150, or 200 companies). No official, long, consistent data series are currently maintained. However, Federal Trade Commission estimates of the concentration of assets in the nonfinancial sector show relative stability from the late 1950s to the early 1970s and a modest decline from then until 1988, the last year for which calculations have been made (exhibit 4, upper panel). In 1988 about 19 percent of the assets of nonfinancial corporations were held by the top 50 firms; 32 percent were held by the top 200 firms. Data for manufacturing show a modest increase in the share of manufacturing assets accounted for by the top 100 and top 200 firms between the mid-1970s and the mid-1980s and a modest decline by 1993 (exhibit 4, lower panel). The top 100 manufacturers held 48 percent of manufacturing assets in 1993; the top 200 firms held 60 percent of the assets.

Thus, the evidence we have does not suggest any alarming trend toward increasing concentration. Moreover, large size is not the same as monopoly power. For example, an ice cream vendor at the beach on a hot day probably has more market power than many multi-billion dollar companies in competitive industries (such as Gateway with less than 5 percent of the PC market). Thus, questions about whether market concentration is a problem tend to focus on particular markets rather than on the economy as a whole. As with aggregate concentration, little research has been done recently on trends in the proportion of markets that are relatively concentrated or relatively unconcentrated.

The Bureau of the Census publishes information about concentration (the share of the market accounted for by the largest 4, 8 and 20 firms) for a large number of industries as part of its quinquennial economic censuses (the latest data available are for 1992). However, these industry concentration ratios need to be interpreted with considerable caution. Two major concerns are:

- Industries are classified by similarity of production process. Hence, glass containers and plastic containers are treated as separate industries even though they may be close substitutes in many uses (a monopoly in glass containers would be of little value if users could turn to plastic when the price went up.)

- Industry concentration ratios are reported for the U.S. national market. Such concentration ratios understate the degree of competition when imports are important (automobiles) and they overstate it when markets are local or regional (cement or newspapers). This is one reason why large size is not the same as monopoly power. A $50 million bank in rural Georgia could have more market power than a multimillion dollar bank in New York City, leading to a situation in which the merger of two small banks poses greater concern from an antitrust perspective than a merger of two huge banks like Chase and Chemical.

When the antitrust authorities look at a merger they put considerable effort into defining the appropriate market and its characteristics. For example, when the FTC successfully challenged the merger of Staples and Office Depot, they used statistical analysis to show that even though these firms controlled a very small share of the retail market for office products, they had substantial market power. The relevant market turned out to be "the sale of consumable office supplies through office superstores." Because such careful analysis is more likely to be done for particular industries (often as a result of an antitrust investigation), there is no reliable comprehensive study of whether markets in the U.S. are generally becoming more concentrated or more competitive. One analyst has suggested however, that dominant firms account for less than 3 percent of GDP.

Thus, large firms, and the merger of large firms, are an important feature of the American economy. But they have been for over a century and there is little evidence of any alarming trend toward greater concentration of economic power in the aggregate. The analysis of how mergers affect economic performance should probably therefore focus on the impact of mergers in specific, well-defined markets.

III. Causes and Consequences of Mergers

Keeping that perspective in mind, let me now turn to the causes and consequences of mergers. The main reason managers give for undertaking mergers is to increase efficiency. And studies show that, on average, the combined equity value of the acquired company and the purchasing company rises as a result of the merger. However, an increase in shareholder value can arise for reasons other than greater efficiency—such as increased market power and the ability to increase profits by raising prices. And the separation of ownership from control in the modern corporation means that mergers may serve the interests of managers more than shareholders (e.g., empire building, increased salary associated with running a larger firm). Finally, even if mergers are designed to enhance efficiency, they often don't work and can instead create inefficiencies (the merger of the Union Pacific and Southern Pacific railroads in 1995 is widely seen as a disaster).

There are numerous ways that mergers can contribute to economic efficiency. One is by reducing excess capacity (this justification has been invoked in hospital, defense, and banking mergers). Another is by achieving economies of scale or network externalities (the hub and spoke network of airlines is one example) or economies of scope ("synergy") as in the case of investment/commercial banking, where similar risk management techniques and credit evaluation skills are utilized in a wide variety of financial services. Mergers may also improve management (studies sugggest large differences in efficiency among seemingly similar firms like banks.) Most mergers probably are undertaken with the expectation of achieving efficiencies, though the outcomes may sometimes be disappointing. For example, studies of bank mergers showed that, in spite of the potential for improved efficiency, in general, mergers have not improved the efficiency or profitability of banks. Divorces are not uncommon (AT&T's 1991 acquisition of NCR unravelled.)

In principle, mergers can also be undertaken to increase market power and reduce competition. In this event consumers could be harmed through higher prices, lower service, reduced variety and, in the view of some, a reduced pace of innovation, although some argue that increased market power should raise innovation due to fewer spillovers. Mergers can also work to decrease the potenetial for future competition. There is abundant evidence that, when one compares markets of a given type, such as local banking markets, the degree of concentration in a market is correlated with such measures of economic performance like price-cost margins. And there is some evidence that mergers have raised prices, as in the case of the mid 1980s airline mergers. Other things equal, higher concentration leads to worsened performance, which is why the Merger Guidelines, after assessing what the appropriate definition of the market is from a product and geographical perspective, looks at the impact of a merger on the level of concentration. However, statistical evidence suggests this is not the main motive for most mergers, perhaps reflecting the presence of antitrust monitoring and enforcement.

A natural question is why so many firms are merging now. There is no single reason. The following are some of the prevailing explanations:

- (1) Adjusting to falling regulatory barriers. Mergers have followed the removal of branching restrictions in banking and ownership restrictions in radio. Banks are probably achieving efficient scale by merging. Absent our history of regulation, the U.S. banking industry would probably have far fewer small banks and look more like the banking system in most other countries.

  Mergers in the telecommunications industry are also tied to the breakup of AT&T and to the deregulation and market-opening steps that followed the Telecommunications Act of

1996.

- (2) Technological change. Some mergers may be motivated by the widely touted, but still nascent, phenomenon of "convergence" in the information technology industry. For instance, as textbook publishers begin to supplement their materials with multimedia software, they may acquire small software companies. To the extent that rapid technological change means that it is unclear what technologies will be used in the near future, firms may hedge their bets: this may explain why a local telecommunications company might merge with a cable television provider. In addition, large scale may be needed to exploit some advances in information technology and telecommunications (securitization, credit scoring).

- (3) Globalization. The emergent global economy may demand large scale to participate. A European and American firm may combine to take advantage of the distribution networks that each has on its own continent. *Also, to the extent that European or Asian firms are more integrated in certain sectors such as the financial sector, U.S. firms may find it necessary to integrate more to provide one-stop shopping for foreign customers who demand that.*

- (4) High stock market. Price-earnings ratios have increased to near-record levels during the current merger wave, and some analysts feel that the market may be overvalued. This may make it attractive to fund an acquisition with stock (the dominant funding source in the current merger wave) But an overvalued stock market does not necessarily lead to more mergers, because if other firms are also overvalued then there are fewer attractive targets to acquire.

- As I mentioned earlier, in evaluating the consequences of mergers we should focus on particular well-defined markets. In this regard, it is important to recognize that mergers do not necessarily increase concentration in any well-defined market. Merging firms may be in different businesses, non-competing regions, or in supplier-buyer relationships. (In banking, for example, national concentration has increased dramatically due to mergers, but concentration measures for local banking deposits have been extremely stable because most mergers have been between banks serving different regions.) Even when the merger is among competitors, increasing global competition or domestic entry could be simultaneously reducing concentration. In addition, the entry of new firms or the threat of entry can offset the potentially anticompetitive impact of a merger. And finally, the structural characteristics of markets, and not just the number of firms, influence the nature of competition in a given market (Boeing/Airbus; Pepsi/Coke.) We cannot automatically conclude that markets with 2 or 3 competitors will be less competitive than those with 20 or 30. Currently the antitrust authorities seem willing to challenge mergers with obvious anticompetitive effects.

IV. Conclusion.

To wrap up, the United States is currently in the midst of its fifth major merger wave in the past hundred years. Industries that are particularly prone to mergers include telecommunications, banking, and financial services. These are sectors in which the regulatory environment has been changing rapidly, opening up new opportunities and challenges. This merger wave is taking place in a strong stock market, and stock rather than cash is the preferred medium for making acquisitions. Many of the prominent mergers are neither purely horizontal (in general large horizontal mergers would raise antitrust issues) nor purely conglomerate. Rather, they represent market extension mergers like SBC-Ameritech (companies in the same industry that serve different and currently non-competing markets) or mergers seeking "synergy," like Travelers-CitiCorp, which presumably expects to achieve "economies of scope" in offering a full line of financial services. Analysis of the economic impacts requires careful analysis of particular markets and defies easy generalizations.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-JUN-1998 09:04:04.00

SUBJECT: Re: testimomny and trade numbers

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

TEXT:
FYI
---------------------- Forwarded by Jeffrey A. Frankel/CEA/EOP on 06/09/98 09:02 AM ---------------------------

Jeffrey A. Frankel
06/09/98 09:02:24 AM
Record Type: Record

To: Mark R. Hopkins/CEA/EOP
cc: Christopher D. Carroll/CEA/EOP
bcc: Records Management
Subject: Re: Asia trade numbers

Mark, thanks for doing the numbers.

Chris, you should send me a copy of the current version.

Perhaps we should end the text of the testimony with:

Eventually the trade deficit will have to come down. Anything we could do to raise national saving would be beneficial and would have this effect. But there is no reason why we cannot go on financing our deficit for sometime. So long as our fundamentals are strong, international investors are more than happy to put their money here. In the meantime, our high-performing economy is putting these funds to good use. That we are currently investing in plant and equipment, and in the education of our children, suggests that we are earning a higher return in terms of physical and human capital than the borrowing us is costing in interest payments to foreign investors...

Mark R. Hopkins
06/08/98 08:46:22 PM

Record Type: Record

To: Jeffrey A. Frankel/CEA/EOP, Christopher D. Carroll/CEA/EOP
cc:
Subject: Asia trade numbers

For part III of the testimony, according to Steve's SA numbers, you can fill in the blanks with the following:

1) [Comparing 1Q98 with 2Q97, SA . . .]Our bilateral balance has deteriorated by $14 billion with respect to Korea, and $10 billion with respect to Southeast Asia* [and $10 billion with respect to Japan].

* I defined Southeast Asia as Malaysia+Indonesia+Thailand+Philippines only. It might be worth noting this.

2) For the part about certain sectors (autos, et. al.) it will take me a little while. We haven't done any of this analysis for 2nd quarter 1997 (only 1st quarter 1997).

3) For "the large increase in exports accounted for 38 percent of the increase in output over that period", the 38 percent is still correct (in real terms).

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-JUN-1998 20:31:11.00

SUBJECT: Revised testimony

TO: Charles F. Stone (CN=Charles F. Stone/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:
==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D24]MAIL463795067.126 to ASCII,
The following is a HEX DUMP:

TESTIMONY OF DR. JANET YELLEN
CHAIR, COUNCIL OF ECONOMIC ADVISERS
BEFORE THE
U.S. SENATE
COMMITTEE ON FINANCE

June 11, 1998

US Trade Policy and the Trade Deficit: Causes and Consequences

Mr. Chairman and members of the Committee. Thank you for the opportunity to discuss the trade deficit with you today.

The trade deficit is an important economic statistic, but its interpretation is subject to substantial confusion. A country's trade balance is often--wrongly--used as a measure of the success of its market-opening policies or the benefits of its engagement in international trade. The most important idea I would like to express to you today is that the benefits of increased international trade are reflected in higher real income, not in a smaller trade deficit. Indeed, the rising U.S. trade deficit in recent years mainly reflects the strength of the American economy, which has grown rapidly in comparison with the economies of our trade partners. In part, the trade deficit reflects the fact that our fast-growing economy is pulling in a lot of imports. But at the same time it also reflects the fact that the U.S. is attracting substantial international capital flows. These have financed increases in plant and equipment investment that have exceeded even the growth in national saving due to deficit reduction.

I. The Benefits of Trade

Going all the way back to Adam Smith, one of the most important insights of economics is that international trade increases the real incomes of all countries that engage in it. Trade is not a zero-sum game in which the gains of some countries come only at the expense of other countries. To the contrary, trade is a positive-sum game in which both sides gain.

For a long time, arguments for trade were based on the principle of *comparative advantage*. When countries specialize in the economic activities for which they are particularly well-suited and rely on trade to acquire other things, they can achieve a higher standard of living than if they try to produce everything themselves. More recently, economists have argued that there are benefits to trade that go beyond those arising from comparative advantage. Trade can enhance productivity through the effects of greater market size, enhanced competition, and improvements that come from contact with foreigners and their alternative production styles, including both new technology and new ideas about the efficient organization of firms.

These benefits from trade are not merely theoretical. A large and growing economics literature has found that those countries that are open to trade tend to grow faster and have higher levels of per-capita income than countries that close themselves off from international competition and trade. One estimate is that the globalization of the U.S. economy over the last 40 years has added between $1,500 and $2,000 to current median family income.

Because policy makers in this country have long believed in the benefits of trade for all parties, the United States, in the postwar period, has been the world's leading advocate for trade liberalization. U.S. tariffs are among the lowest in the world. While we benefit directly from our own low tariffs--through lower prices to consumers-- we would benefit even more if other countries were to lower their trade barriers. Since U.S. trade barriers are already so low, the international trade negotiations that have been concluded in recent years have typically produced much larger reductions in the trade barriers facing American goods in foreign markets than on foreign goods in the United States. The result has therefore generally been that foreign demand for our goods has risen by more than our demand for foreign goods, producing an extra boost to our real income.

It is often suggested that the major benefit of trade liberalization is job creation. When our economy is operating below its potential, with slack in the job market, export growth can produce job gains, helping the economy move toward full employment. As of January 1993, for example, the economy had substantial unemployment and excess capacity. One could say that the large increase in U.S. exports between 1993 and 1997--roughly 10% per year at an annual rate-- accounted for 38 percent of the increase in output over that period [chk current figure], and a proportionate share of the almost 15 million jobs that were created over that period. In the long-term, however, the workings of the market, complemented by sound macroeconomic policies are sufficient to create jobs for those who want to work. Thus, increases in exports must ultimately pull workers away from other activities. Trade still raises real income, but the boost comes from better jobs and not just more jobs. Studies show that export jobs pay 13-16 percent more than other jobs. Indeed, export jobs are better even after adjusting for worker skills and firm-specific and industry specific-components to wages.

II. Macroeconomics and the Trade Deficit

Perhaps the greatest source of confusion about trade relates to the interpretation and causes of trade or current account deficits and surpluses.

A trade deficit occurs, by definition, when a country's total domestic spending exceeds its total domestic production. When this occurs, the shortfall is made up by importing more goods than are exported. When the U.S. runs a trade deficit, foreigners buy less than a dollar's worth of U.S. goods for every dollar they earn from their export sales to us. The natural question is, what motivates foreigners to supply us with more goods than we supply to them in exchange? And what do foreigners do with the dollars that they don't use to buy U.S. goods? In practice, foreigners typically use the excess dollars to invest in interest bearing U.S. assets. Indeed, it is the desire of foreigners to purchase attractive U.S. assets--to lend us the money needed to finance a trade deficit--that makes it possible to run such a deficit. Countries can run deficits only if foreigners want to add to their holdings of the deficit country's assets. In fact, one can as readily argue that the desire of foreigners to acquire attractive U.S. assets is responsible for the U.S.

trade deficit as the reverse.

This relationship between spending, production, and the trade deficit can be expressed another way. I will not bore you with the details but it turns out that in an accounting sense the trade deficit is equal to the difference between national saving and national investment. When the demand for investment in the United States exceeds the pool of national saving, the difference is made up by borrowing from foreigners. Conversely, when saving exceeds investment, the surplus is invested abroad. The United States first experienced large current account deficits during the mid-1980s, when net investment fell as a share of national income and net national saving fell even faster. The deficit shrank briefly as investment collapsed in the 1990-91 recession, but it has reemerged in the current expansion. The good news in this expansion is that investment has been booming. But saving does not appear to have kept pace, despite the improvement due to federal deficit reduction. (The interpretation of current trends in saving, investment, and the current account is complicated by the statistical discrepancy between GDP measured as the sum of all spending on output and as the sum of all income generated in producing that output.)

When a trade deficit is used to finance productive investment, as it is now, it can be viewed as largely benign, because the extra investment raises the productivity of our workforce, resulting in higher future national income. It is that return that should enable us to pay off the foreign borrowing we have undertaken to help finance our investments. We would be *worse off* as a nation, and our interest rates would have been higher, if, over the last few years, we had been forced to curtail our investment. Our ability to attract funds from abroad is a vote of confidence in the ability of our high-performing economy to put these funds to good use. However, maintaining national investment above national saving does entail the price that what we borrow, we will eventually need to repay.

Let me return now to the more immediate causes of our rising trade deficit over the last four years. A key factor responsible for this trend is strong growth in the United States relative to our major trading partners. Our strong growth has resulted in a larger income-induced increase in American demand for foreign goods than in foreign demand for our goods and services. The second key factor is the dollar's appreciation, which has been substantial over the last three years. In a system of flexible exchange rates, an appreciation in a currency reflects a desire by foreigners to hold that currency. Appreciations very often accompany strong economic expansions like the one the U.S. has experienced over this period, and in that sense the appreciation of the dollar is unsurprising given that the U.S. economy has grown much more rapidly than those of our trading partners over the past few years.

More recently we have seen a surge in the trade deficit that reflects the effects of the East Asian crisis. The sharp drop in the value of the East Asian currencies has led to an increase in U.S. demand for the goods produced by these countries (which are now much cheaper to us than before). At the same time, the East Asian countries have cut back sharply on imports of goods from the U.S. both because our goods are effectively much more expensive for them, and also because their incomes have fallen substantially.

The most recent data, for the first three months of this year, already point to a significant impact of the crisis on our trade balance. To estimate the magnitude of the impact, it is natural to compare our trade with the affected countries over the last three months with the magnitude of trade flows in the three months prior to the crisis' inception--namely, the second quarter of 1997 when the Thai baht began to float. (This comparison relies on seasonal adjustments of bilateral trade data computed by the Council of Economic Advisers since such adjustments are not computed by Commerce Department itself.) According to our estimates, the U.S. bilateral balance has deteriorated by $14 billion with respect to Korea, and $10 billion with respect to Malaysia, Indonesia, Thailand, and the Phillippines, and $10 billion with respect to Japan. We expect further deterioration in the remainder of the year.

It is often argued that the Asian crisis, by decreasing U.S. net exports, will diminish U.S. growth over the next year or longer. There is no denying that net exports are exerting, and will continue to exert, a drag on U.S. economic growth. According to some estimates, the East Asian crisis, taking account of its impact on Japan, could subtract as much as 1 percentage point from GDP growth over the next year. Fortunately, however, the slowdown in exports to East Asia is impacting the US economy at a time when domestic demand growth is extremely robust and labor markets have becoming increasingly tight. The consensus among forecasters is that the East Asian crisis could serve as the brake that subdues growth toward a more sustainable pace, preventing overheating, and permitting continued job growth with a more moderate path for interest rates and stronger investment spending than we would otherwise enjoy. 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 dampening influence on inflation.

III. Are There Reasons for Concern?

My testimony so far has been that the trade deficit largely reflects the strength of the American economy. But I do not want to leave you with the impression that there are no reasons to be concerned about a large trade deficit.

First, even in the absence of any negative aggregate impact on output and employment due to a growing trade deficit, particular sectors have been adversely affected. Before 1997, U.S. producers in such sectors as aircraft and agriculture enjoyed rapid growth in their exports to East Asia. That has now disappeared. Exports are down sharply to Asia in general, and to Korea, Southeast Asia, and Japan, in particular. They can be expected to continue to fall in the remainder of this year. In addition, we will probably see increased imports from these countries, especially in such sectors as autos, steel, textiles and apparel, and semiconductors and other electronics. The crisis countries have no choice but to shift their trade balances into surplus, since they are no longer able to borrow from abroad to finance the trade deficits that most of them ran before the crisis. It is their inability to borrow in world capital markets that is responsible for the currency depreciations and income reductions that are causing them to buy less from us and to sell more to us.

The second reason for concern about our growing trade deficit follows in part from the first. Our rising trade deficit, particularly in such key areas of the economy as manufacturing and agriculture, could undermine support for internationalist principles and for market-opening policies. If the widening U.S. trade deficit were to create the false impression that the U.S. or our trade partners stand to lose rather than to gain from continued engagement in international markets, then it would be a costly development indeed.