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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	Michele Jolin to Janet L. Yellen at 17:54:53.00. Subject: Re: Adele's departure from CEA. (1 page)	06/15/1998	b(6)
002. email attachment	Suzanne Dale to [list] at 18:39:33.00. Subject: IGA Weekly Report. Memorandum for the President From Mickey Ibarra. Subject: Office of Intergovernmental Affairs Weekly Report -- June 8 - 12, 1998 (partial) (1 page)	06/06/1998	b(6)

COLLECTION:

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FOLDER TITLE:

[06/09/1998 - 06/19/1998]

2013-0223-F
ab1280

RESTRICTION CODES

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

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

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

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

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

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-JUN-1998 12:43:02.00

SUBJECT:

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

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

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

TEXT:
Janet:

Here's the latest draft (12:40 pm) of the testimony. I also have a copy of the draft Treasury testimony; I didn't detect any inconsistencies, except possibly on the size of the trade effects of the East Asian crisis (I'm going to consult with Mark H. on why, and perhaps we should remove our specific numbers), and there was considerable overlap in themes and substance.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D79]MAIL43678206Y.126 to ASCII,
The following is a HEX DUMP:

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 balance is an important aspect of the American economy, but is subject to a great deal of confusion. I will do what I can to try to shed a little light on the subject. [I would like to begin by commending Chairman Roth for this effort to bring some focus and clarity to this issue, which is often misunderstood.]

I. The Theory of Trade

Economists since Adam Smith have believed that international trade increases the real incomes of both trading parters. 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 to 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 has long 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 low tariffs -- remember that a 'tariff' is just another word for a tax on consumers -- we would benefit even more if other countries would lower their trade barriers. Since US trade barriers are already so low, most of the reductions in trade barriers that happen in international negotiations [such as NAFTA, the Uruguay Round, the proposed Free Trade Area of the Americas, and recent multilateral negotiations on information technology, telecommunications and financial services] end up cutting foreign countries' barriers on against goods much more than we cut our own -- already low -- barriers against foreign goods. The result is generally that foreign demand for our goods goes up by more than our deman for foreign goods goes up, bringing extra bonus to our real income.

Time after time we have seen that when foreign trade barriers are reduced, US exporting industries directly benefit via increased employment and profitability in the short term. As of January 1993, for example, the economy still had a lot of unemployment and excess capacity. One could say that the large increase in US exports between 1993 and 1997 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 economy tends to revert to full employment, and in a full-employment economy increases in exports must pull workers away from other activities. Trade still raises real income, but this takes less the form of more jobs quantitatively, and more the form of *better* jobs qualitatively. Studies show that export jobs pay 13-16 percent more than other jobs. [This may overstate the effect some. Just becuase a computer programmer in a software-exporting firm earns more than an unskilled worker does not mean you can raise the income of the latter by somehow putting him in front of a computer. Nevertheless even after adjusting for skills and firm-specific and industry specific-components to wages, export jobs seem to pay more than other jobs.] Thus, the long term effect of trade is not to produce more jobs, but to produce better-paying jobs throughout the economy.

II. The Trade Deficit and Macroeconomics

Perhaps the greatest source of confusion about trade is the interpretation and causes of trade deficits and surpluses. {In an immediate sense, there are three [inter-related] reasons for the increase in the US trade deficit in recent years: the appreciation of the dollar, the strong growth in US income, and (very recently) the effects of the East Asian crisis. But in a deeper or more fundamental sense, the trade deficit is the outcome of decisions regarding saving and investment -- the exchange rate and other macroeconomic variables are the channels of transmission.}

Deficits occur, by definition, when total domestic spending is greater than total domestic production. If we spend more than we produce, the difference is made up by imports. But when we run a trade deficit, what motivates foreigners to give us more goods than we give them in exchange? When we are running a trade deficit, for every dollar we pay to foreigners, they buy less than a dollar's worth of US goods. But what do the foreigners do with the dollars that they don't use to buy US goods? They could simply hold on to them, but that would be foolish because cash does not earn interest. In practice, what they do with their extra dollars is that they invest most of them in US assets.

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

CREATION DATE/TIME: 9-JUN-1998 09:44:09.00

SUBJECT: Re: [Fwd: Lerman's letter]

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

TEXT:
I think it would be appropriate to respond if the letter is sufficiently critical, although I haven't seen the Lerman letter--just the Loury response. Perhaps Sandy would be willing to take a crack at a response.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:10-JUN-1998 11:51:00.00

SUBJECT: Re: Gingrich Attacks CBO

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

TEXT:
I talked to Jon Orszag. He suggests that if you are asked this question you should say some of the following:
-- During the 1980s, forcasts that were too rosy got us in trouble. It contributed to spirling deficits.
-- As a result, the Administration was committed to basing its budget projections on credible assumptions.
-- Our assumptions have been conservative and credible.
-- And the record shows that this was the right way to go -- today we are projecting surpluses.
-- But, in either case, forcasting should not be politicized. It is important for forecasts to be based on the best economic evidence about the long range performance of the economy. Not on politicals or the policy wishes at that time.

---------------------- Forwarded by Michele Jolin/CEA/EOP on 06/10/98 11:44 AM ---------------------------

Jake Siewert
06/10/98 11:17:57 AM
Record Type: Record

To: Michele Jolin/CEA/EOP
cc: See the distribution list at the bottom of this message
Subject: Re: Gingrich Attacks CBO

Good. It would be good to hit a couple of points:

-- We've have certainly had differences with CBO, but this is a blatant effort to compromise what is supposed to be a non-partisan and independent organization.

-- Threatening to cut CBO's budget unless they return to the rosy scenarios of the 80's that produced a decade of deficits is worse than irresponsible -- it's blackmail.

-- We have fought hard to restore integrity to budgeting over the last 6 years, and we don't want to squander that renewed credibility by abandoning fiscal conservatism in forecasting.

In short, we should defend CBO withoput saying something too positive that they could throw back at us when we next disagree. The focus should be on Gingrich's threat and why it's wrong.
Message Copied
To:

Barry J. Toiv/WHO/EOP
Charles R. Marr/OPD/EOP
Jonathan Orszag/OPD/EOP
Melissa G. Green/OPD/EOP
Linda Ricci/OMB/EOP
Kara Gerhardt/WHO/EOP

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:10-JUN-1998 18:17:36.00

SUBJECT:

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]MAIL41356416F.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 central point I would like to make today is that the benefits of increased international trade are reflected in higher real income, not in a smaller trade deficit. 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, because the US is viewed by foreigners as a good place to invest.

I. The Benefits of Trade

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.

These benefits from trade are not merely theoretical. A large 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 has added around $1500 to per-capita income over the last 40 years.

It is often suggested that the major benefit of trade liberalization is job creation. In the long-term, however, the workings of the market, complemented by sound macroeconomic policies, will create jobs for those who want to work. Thus, increases in exports ultimately pull workers away from other activities. Trade still raises real income, but the boost comes from better jobs and lower prices. (Studies show that export jobs pay 13-18 percent more than other jobs).

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 spending exceeds its production. When this occurs, the shortfall is made up by importing more than is 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 do foreigners do with the dollars that they *don't* use to buy U.S. goods? In practice, the excess dollars get invested in 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 country's assets.

This relationship between spending, production, and the trade deficit can be expressed another way: A country's current account balance (a comprehensive measure which comprises not only the balance of trade balance in goods and services but also net investment income and transfers) is equal to the difference between national saving and national investment. The attached chart illustrates this relationship. When the demand for investment in the United States exceeds the pool of national saving, the difference is made up by borrowing from foreigners. 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 trade 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 national saving has not kept pace, despite the improvement due to federal deficit reduction.

When a trade deficit is used to finance productive investment, as in the US recently, it can be viewed as largely benign, because the extra investment raises productivity, resulting in a future national income that is more than enough higher to enable us to pay off the foreign borrowing. We would be *worse off* as a nation 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.

Let me return now to the more immediate causes of our rising trade deficit. Increasing trade deficits often accompany strong economic growth of the kind we have seen in the last few years, both because expanding domestic demand pulls in more imports, and because growth tends to cause the currency to appreciate. More recently, the East Asian crisis has boosted the deficit as the affected countries have cut back sharply on imports of goods from the U.S.

Fortunately, the slowdown in exports to East Asia comes at a time when domestic demand growth is extremely robust and labor markets have become 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, and permitting continued job growth with a more moderate path for interest rates and stronger investment spending than we would otherwise enjoy.

III. Are There Reasons for Concern?

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, particular sectors have been adversely affected. Before 1997, many U.S. producers enjoyed rapid growth in their exports to East Asia. Now, exports are down sharply to Asia in general, and to Korea, Southeast Asia, and Japan, in particular. 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 second reason for concern about our growing trade deficit follows in part from the first. Our rising trade deficit could undermine support for internationalist principles and for market-opening policies like those outlined by Secretary Rubin in his testimony. 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: Mark R. Hopkins (CN=Mark R. Hopkins/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-JUN-1998 16:00:44.00

SUBJECT: trade deficit & Asia crisis numbers

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

TEXT:
Janet,

Just to make sure you are clear on the following:

1) I left a revised version of the "cheat-sheat" on your desk. Please replace the version I gave you last night with the revised version.

2) In your testimony, regarding predicted Asian crisis effects, we are now giving a range of estimates on the impact of exports onlyto the various crisis countries. The bottom end of each range reflects Treasury's estimate, and the top end (always) reflects our estimate.

let me know if you have any questions.

Mark

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:10-JUN-1998 12:04:37.00

SUBJECT: Prognosis on Daschle Bill (Q&A)

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

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

TEXT:
Q: What are the prospects for the Daschle-DeLauro Bill Passing?

A: The bill has strong Democratic support. The President strongly supports strengthening the Equal Pay Act's ability to combat the negative forces of discrimination.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:10-JUN-1998 18:43:40.00

SUBJECT:

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

TEXT:
This version added back the sentence about the boost in saving due to deficit reduction and the sentence about holding inflation down. It is 1143 words (excluding the header).

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D98]MAIL42239416R.126 to ASCII,
The following is a HEX DUMP:

ORAL STATEMENT 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 central point I would like to make today is that the benefits of increased international trade are reflected in higher real income, not in a smaller trade deficit. 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, because the US is viewed by foreigners as a good place to invest. These capital flows have financed increases in plant and equipment investment that have exceeded even the growth in national saving due to deficit reduction since the beginning of the Clinton Administration.

I. The Benefits of Trade

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.

These benefits from trade are not merely theoretical. A large 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 has added around $1500 to per-capita income over the last 40 years.

It is often suggested that the major benefit of trade liberalization is job creation. In the long-term, however, the workings of the market, complemented by sound macroeconomic policies, will create jobs for those who want to work. Thus, increases in exports ultimately pull workers away from other activities. Trade still raises real income, but the boost comes from better jobs and lower prices. (Studies show that export jobs pay 13-18 percent more than other jobs).

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 spending exceeds its production. When this occurs, the shortfall is made up by importing more than is 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 do foreigners do with the dollars that they *don't* use to buy U.S. goods? In practice, the excess dollars get invested in 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 country's assets.

This relationship between spending, production, and the trade deficit can be expressed another way: A country's current account balance (a comprehensive measure which comprises not only the balance of trade balance in goods and services but also net investment income and transfers) is equal to the difference between national saving and national investment. The attached chart illustrates this relationship. When the demand for investment in the United States exceeds the pool of national saving, the difference is made up by borrowing from foreigners. 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 trade 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 national saving has not kept pace, despite the improvement due to federal deficit reduction.

When a trade deficit is used to finance productive investment, as in the US recently, it can be viewed as largely benign, because the extra investment raises productivity, resulting in a future national income that is more than enough higher to enable us to pay off the foreign borrowing. We would be *worse off* as a nation 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.

Let me return now to the more immediate causes of our rising trade deficit. Increasing trade deficits often accompany strong economic growth of the kind we have seen in the last few years, both because expanding domestic demand pulls in more imports, and because growth tends to cause the currency to appreciate. More recently, the East Asian crisis has boosted the deficit as the affected countries have cut back sharply on imports of goods from the U.S.

Fortunately, the slowdown in exports to East Asia comes at a time when domestic demand growth is extremely robust and labor markets have become 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, 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 some imports will provide a dampening influence on inflation.

III. Are There Reasons for Concern?

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, particular sectors have been adversely affected. Before 1997, many U.S. producers enjoyed rapid growth in their exports to East Asia. Now, exports are down sharply to Asia in general, and to Korea, Southeast Asia, and Japan, in particular. 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 second reason for concern about our growing trade deficit follows in part from the first. Our rising trade deficit could undermine support for internationalist principles and for market-opening policies like those outlined by Secretary Rubin in his testimony. 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: Mark R. Hopkins (CN=Mark R. Hopkins/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-JUN-1998 10:15:15.00

SUBJECT: net exports drag

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

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

TEXT:
According to the 5/28 release, in first quarter 1998,

GDP grew 4.8 percent
gross domestic purchases increased 7.3 percent
the contribution to change in GDP of net exports was -2.6 percentage points (annual rate)
    of which falling exports caused a .4 percentage point drag
    and rising imports caused a 2.2 percentage point drag

For comparison:
This was the first quarter (in the last 16) that exports were a drag on GDP growth
In 1Q 1997 rising imports were a 2.1 p.point drag, in 2Q97 they were a 2.5 p.point drag (in the last two quarters of 1997 the contributions were 1.7 and .7 -- both of these negative).

Let me know if that doesn't answer your question of last night.

Mark

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:10-JUN-1998 10:05:37.00

SUBJECT: Draft testimony on the trade balance for circulation

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

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

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

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

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

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D2]MAIL46270706K.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, 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 a country's current account balance (a comprehensive measure which comprises not only the balance of trade balance in goods and services but also net investment income and transfers) is equal to the difference between national saving and investment and national investment. The attached chart illustrates this relationship. 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 like those outlined by Secretary Rubin in his testimony. 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:10-JUN-1998 17:35:38.00

SUBJECT: Final Testimony

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

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

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

TO: Jon D. Haveman (CN=Jon D. Haveman/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: 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.D82]MAIL497434161.126 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

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 many 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 since the beginning of the Clinton Administration.

I. The Benefits of Trade

Going 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 goods, they can achieve a higher standard of living than if they try to produce everything themselves. More recently, economists have argued that trade can also enhance productivity through the effects of greater market size, enhanced competition, and importation of new ideas and technologies.

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 about $1500 to per-capita income.

Because policymakers in this country have long believed in the benefits of trade for all parties, the United States has long 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, international trade agreements typically produce much larger reductions in the trade barriers facing American goods in foreign markets than on foreign goods in the United States.

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 16 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 more jobs. Studies show that export jobs pay 13-18 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

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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 a country's current account balance (a comprehensive measure which comprises not only the balance of trade balance in goods and services but also net investment income and transfers) is equal to the difference between national saving and national investment. The attached chart illustrates this relationship. 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.

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 some of 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 and high capital mobility, 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 many 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. Sharp drops such as those seen in the value of the East Asian currencies lead 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.

Our sales to these countries have fallen sharply. Data for the first three months of this year show that our exports to the five most-affected countries are down between $17 billion and $21 billion (annualized) since the crisis began, depending on how one does the seasonal adjustment. Roughly two-thirds of the lost sales were to Korea. Exports to Japan are down another $6 to $8 billion over this period. Thus the total adverse movement across all six countries has been $23 to $29 billion. We expect the loss in sales to worsen during the remainder of the year, especially if Asian economies continue to contract. Furthermore, we have not yet seen the large increase in imports from the Asian countries that their devaluations are likely to produce.

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 affecting the U.S. 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, many U.S. producers enjoyed rapid growth in their exports to East Asia. That has now disappeared. As I have already noted, 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 like those outlined by Secretary Rubin in his testimony. 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: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-JUN-1998 11:28:37.00

SUBJECT: NEC suggests this response to Gingrich

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

TEXT:
---------------------- Forwarded by Michele Jolin/CEA/EOP on 06/10/98
11:27 AM ---------------------------

Jake Siewert
06/10/98 11:17:57 AM
Record Type: Record

To: Michele Jolin/CEA/EOP
cc: See the distribution list at the bottom of this message
Subject: Re: Gingrich Attacks CBO

Good. It would be good to hit a couple of points:

-- We've have certainly had differences with CBO, but this is a blatant effort to compromise what is supposed to be a non-partisan and independent organization.

-- Threatening to cut CBO's budget unless they return to the rosy scenarios of the 80's that produced a decade of deficits is worse than irresponsible -- it's blackmail.

-- We have fought hard to restore integrity to budgeting over the last 6 years, and we don't want to squander that renewed credibility by abandoning fiscal conservatism in forecasting.

In short, we should defend CBO withoput saying something too positive that they could throw back at us when we next disagree. The focus should be on Gingrich's threat and why it's wrong.
Message Copied
To:____

Barry J. Toiv/WHO/EOP
Charles R. Marr/OPD/EOP
Jonathan Orszag/OPD/EOP
Melissa G. Green/OPD/EOP
Linda Ricci/OMB/EOP
Kara Gerhardt/WHO/EOP

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:10-JUN-1998 16:49:59.00

SUBJECT: Oops. Forgot to attach.

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

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

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 many 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 since the beginning of the Clinton Administration.

I. The Benefits of Trade

Going 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 goods, they can achieve a higher standard of living than if they try to produce everything themselves. More recently, economists have argued that trade can also enhance productivity through the effects of greater market size, enhanced competition, and importation of new ideas and technologies.

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 about $1500 to per-capita income.

Because policymakers in this country have long believed in the benefits of trade for all parties, the United States has long 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, international trade agreements typically produce much larger reductions in the trade barriers facing American goods in foreign markets than on foreign goods in the United States.

It is often suggested that the major benefit of trade liberalization is job creation. [I think everything in italics should be removed, because it invites the question 'if exports created 38% of the jobs, how many jobs did imports destroy?' 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 16 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 13-18 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 a country's current account balance (a comprehensive measure which comprises not only the balance of trade balance in goods and services but also net investment income and transfers) is equal to the difference between national saving and national investment. The attached chart illustrates this relationship. 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.

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 some of 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 and high capital mobility, 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 many 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. Sharp drops such as those seen in the value of the East Asian currencies lead 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.

Our sales to these countries have fallen sharply. Data for the first three months of this year show that our exports to the five most-affected countries are down between $17 billion and $21 billion (annualized) since the crisis began, depending on how one does the seasonal adjustment. Roughly two-thirds of the lost sales were to Korea. Exports to Japan are down another $6 to $8 billion over this period. [Thus the total adverse movement across all six countries has been $23 to $29 billion.] We expect the loss in sales to worsen during the remainder of the year, especially if Asians' incomes continue to contract. Furthermore, we have not yet seen the large increase in imports from the Asian countries that their devaluations are likely to produce.

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 affecting 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, many U.S. producers enjoyed rapid growth in their exports to East Asia. That has now disappeared. As I have already noted, 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 like those outlined by Secretary Rubin in his testimony. 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.

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CHAIR, COUNCIL OF ECONOMIC ADVISERS
BEFORE THE
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COMMITTEE ON FINANCE

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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 central point I would like to make today is that the benefits of increased international trade are reflected in higher real income, not in a smaller trade deficit. 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, because the US is viewed by foreigners as a good place to invest.

I. The Benefits of Trade

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.

These benefits from trade are not merely theoretical. A large 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 has added around $1500 to per-capita income over the last 40 years.

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It is often suggested that the major benefit of trade liberalization is job creation. In the long-term, however, the workings of the market, complemented by sound macroeconomic policies, will create jobs for those who want to work. Thus, increases in exports ultimately pull workers away from other activities. Trade still raises real income, but the boost comes from better jobs and lower prices. (Studies show that export jobs pay 13-18 percent more than other jobs).

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 spending exceeds its production. When this occurs, the shortfall is made up by importing more than is 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 do foreigners do with the dollars that they *don't* use to buy U.S. goods? In practice, the excess dollars get invested 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 country's assets.

This relationship between spending, production, and the trade deficit can be expressed another way: A country's current account balance (a comprehensive measure which comprises not only the balance of trade balance in goods and services but also net investment income and transfers) is equal to the difference between national saving and national investment. The attached chart illustrates this relationship. When the demand for investment in the United States exceeds the pool of national saving, the difference is made up by borrowing from foreigners. 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 trade 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 national saving has not kept pace, despite the improvement due to federal deficit reduction.

When a trade deficit is used to finance productive investment, it can be viewed as largely benign, because the extra investment raises productivity, resulting in a future national income that is more than enough higher to enable us to pay off the foreign borrowing. We would be *worse off* as a nation 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.

Let me return now to the more immediate causes of our rising trade deficit. A key factor has been the strong growth in the United States while some of our major trading partners, including Japan and much of Europe, have been growing more slowly. Our faster growth has resulted in a larger increase in American demand for foreign goods than in foreign demand for our goods and services. The second key factor is the dollar's substantial appreciation over the last three years. Such appreciations often accompany strong economic expansions like the one the U.S. has experienced over this period.

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.

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 comes at a time when domestic demand growth is extremely robust and labor markets have become 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 some imports 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, particular sectors have been adversely affected. Before 1997, many U.S. producers enjoyed rapid growth in their exports to East Asia. Now, exports are down sharply to Asia in general, and to Korea, Southeast Asia, and Japan, in particular. 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 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 like those outlined by Secretary Rubin in his testimony. 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.

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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.

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

CREATION DATE/TIME:10-JUN-1998 11:09:02.00

SUBJECT: Yellen testimony on trade deficit -Reply

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

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

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

TEXT:
---------------------- Forwarded by Alice H. Williams/CEA/EOP on 06/10/98
11:08 AM ---------------------------

"SETSERB%DOM13.DOPO8" <BRAD.SETSER @ treas.sprint.com>
06/10/98 10:28:39 AM
Record Type: Record

To: Alice H. Williams/CEA/EOP, Christopher D. Carroll/CEA/EOP, Jeffrey A. Frankel/CEA/EOP, Lisa D. Branch/CEA/EOP
cc:
Subject: Yellen testimony on trade deficit -Reply

Date: 06/10/1998 10:15 am (Wednesday)
From: Brad Setser
To: EX.MAIL("Jeffrey_A._Frankel@cea.eop.gov",
"Alice_H._Williams@cea.eop.gov",
"Christopher_D._Carroll@cea.eop.gov",
"Lisa_D._Branch@cea.eop.gov")
Subject: Yellen testimony on trade deficit -Reply

Joe Gagnon has asked me to do some work to see if we can generate consensus estimates of the fall in exports using your seasonally adjusted data. Would you mind emailing the appropriate spreadsheet with the seasonally adjsuted Asian data?

Thanks.

Brad Setser

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Maria J. Hanratty (CN=Maria J. Hanratty/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-JUN-1998 15:54:18.00

SUBJECT:

TO: Zachary M. Candelario (CN=Zachary M. Candelario/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

TO: Susan P. Clements (CN=Susan P. Clements/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

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

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

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

TO: Rosalind V. Rasin (CN=Rosalind V. Rasin/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

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

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

TO: Rachel E. Rubinfeld (CN=Rachel E. Rubinfeld/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

TO: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP [CEA])
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TO: Michael A. Egner (CN=Michael A. Egner/OU=CEA/O=EOP [CEA])
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TO: Matthew C. Weinzierl (CN=Matthew C. Weinzierl/OU=CEA/O=EOP [CEA])
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TO: Mary Fibich (CN=Mary Fibich/OU=CEA/O=EOP [CEA])
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TO: Mark C. Rainey (CN=Mark C. Rainey/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

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

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

TO: Linda A. Reilly (CN=Linda A. Reilly/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

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

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

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

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

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

TO: Jasmin K. Sethi (CN=Jasmin K. Sethi/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

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

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

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

TO: Daniel K. Chang (CN=Daniel K. Chang/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

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

TO: Christel M. Sice (CN=Christel M. Sice/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

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

TO: Carol L. Capece (CN=Carol L. Capece/OU=CEA/O=EOP [CEA])
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TO: Brian A. Amorosi (CN=Brian A. Amorosi/OU=CEA/O=EOP [CEA])
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TO: Annette M. Richter (CN=Annette M. Richter/OU=CEA/O=EOP [CEA])
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TO: Amy N. Finkelstein (CN=Amy N. Finkelstein/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

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

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

TEXT:
I just received a question from Julie Fernandez, regarding a speech they would like to fact check for
this saturday. They would like to verify two statements:

1. Immigrants pay $1800 more in taxes than they receive in benefits.
2. Immigrants are paying into social security at record rates.

does anyone have any information to back this up?
mjh

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:10-JUN-1998 17:01:20.00

SUBJECT: Final version.

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

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D90]MAIL45460416Y.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 many 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 since the beginning of the Clinton Administration.

I. The Benefits of Trade

Going 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 goods, they can achieve a higher standard of living than if they try to produce everything themselves. More recently, economists have argued that trade can also enhance productivity through the effects of greater market size, enhanced competition, and importation of new ideas and technologies.

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 about $1500 to per-capita income.

Because policymakers in this country have long believed in the benefits of trade for all parties, the United States has long 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, international trade agreements typically produce much larger reductions in the trade barriers facing American goods in foreign markets than on foreign goods in the United States.

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 16 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 more jobs. Studies show that export jobs pay 13-18 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 a country's current account balance (a comprehensive measure which comprises not only the balance of trade balance in goods and services but also net investment income and transfers) is equal to the difference between national saving and national investment. The attached chart illustrates this relationship. 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.

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 some of 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 and high capital mobility, 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 many 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. Sharp drops such as those seen in the value of the East Asian currencies lead 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.

Our sales to these countries have fallen sharply. Data for the first three months of this year show that our exports to the five most-affected countries are down between $17 billion and $21 billion (annualized) since the crisis began, depending on how one does the seasonal adjustment. Roughly two-thirds of the lost sales were to Korea. Exports to Japan are down another $6 to $8 billion over this period. Thus the total adverse movement across all six countries has been $23 to $29 billion. We expect the loss in sales to worsen during the remainder of the year, especially if Asian economies continue to contract. Furthermore, we have not yet seen the large increase in imports from the Asian countries that their devaluations are likely to produce.

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 affecting 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, many U.S. producers enjoyed rapid growth in their exports to East Asia. That has now disappeared. As I have already noted, 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 like those outlined by Secretary Rubin in his testimony. 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: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-JUN-1998 09:58:43.00

SUBJECT: Other witnesses at the Finance Comm hearing

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:
The following are the witnesses for tomorrow:
Panel 1 -- Byron Dorgan
Panel 2 -- Rubin
Yellen
Panel 3 -- Dan Griswold
Robert Lawerence
Robert Scott (EPI)
Murray Weidenbaum

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:10-JUN-1998 18:32:39.00

SUBJECT: Final, final version

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

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

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

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
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TEXT:
=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D68]MAIL47028416Y.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

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

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Because policymakers in this country have long believed in the benefits of trade for all parties, the United States has long 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, international trade agreements typically produce much larger reductions in the trade barriers facing American goods in foreign markets than on foreign goods in the United States.

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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 a country's current account balance (a comprehensive measure which comprises not only the balance of trade balance in goods and services but also net investment income and transfers) is equal to the difference between national saving and national investment. The attached chart illustrates this relationship. 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.

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 some of 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 and high capital mobility, 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 many 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. Sharp drops such as those seen in the value of the East Asian currencies lead 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.

Our sales to these countries have fallen sharply. Data for the first three months of this year show that our exports to the five most-affected countries are down between $17 billion and

$21 billion (annualized) since the crisis began, depending on how one does the seasonal adjustment. Roughly two-thirds of the lost sales were to Korea. Exports to Japan are down another $6 to $8 billion over this period. Thus the total adverse movement across all six countries has been $23 to $29 billion. We expect the loss in sales to worsen during the remainder of the year, especially if Asian economies continue to contract. Furthermore, we have not yet seen the large increase in imports from the Asian countries that their devaluations are likely to produce.

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. Fortunately, however, the slowdown in exports to East Asia is affecting the U.S. 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, many U.S. producers enjoyed rapid growth in their exports to East Asia. That has now disappeared. As I have already noted, 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 like those outlined by Secretary Rubin in his testimony. 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: Randall W. Lutter (CN=Randall W. Lutter/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:11-JUN-1998 10:42:09.00

SUBJECT: draft of McIntosh answers to part B

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

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

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

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

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

TEXT:
This draft has comments from Todd via Bob Tucillo, from Rob Weiner via Michelle, and is probably good to go. The only non-editorial change is the deletion of information about staff assignments that is not already in the ERP. Instead we reference the ERP information.

Can we send it?
Or should we give people a final chance to comment at the oversight meeting this p.m.? =================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D65]MAIL44349616V.126 to ASCII,
The following is a HEX DUMP:

Draft Answers to March 13 Questions To CEA from Representative McIntosh Chair of the House Subcommittee on National Economic Growth, Natural Resources, and Regulatory Affairs

B. Economic, Policy and Legal Analyses

8. Since January 1993, has your agency participated in any interagency effort(s) relating to climate change in any of the following areas: (a) review of current legislation and/or the need for any new legislation; (b) review of current rules, and needed revisions to current rules, and/or any needed new rules; (c) production or review of any environmental data and/or analyses; (d) production or review of any cost-benefit data or analyses; and/or (e) production or review of any economic data and/or economic analysis? If so, please identify the interagency effort, its member agencies, its membership not only from your agency but also from other Federal agencies and/or any non-Federal parties, all drafts and analyses from the efforts(s) and any comments from your agency on any drafts.

Response. The CEA has participated in numerous interagency processes related to climate change policy since January 1993. Most of these processes have been informal and have involved representatives of a variety of interested Federal agencies, including the Office of Science and Technology Policy (OSTP), the Council on Environmental Quality (CEQ), the National Economic Council (NEC), the Department of Treasury, the Environmental Protection Agency (EPA), the Department of Energy (DOE), the Department of State, the Department of Commerce (DOC), the U.S. Agency for International Development (USAID), the Department of Agriculture (USDA), and in some cases the Department of Transportation (DOT) and the Department of Defense (DOD).

Almost all CEA economists are employed in temporary positions usually lasting one year. None of the CEA economists now working on climate change was employed by CEA before 1996. For this reason, we do not know exactly which interagency efforts were conducted and joined by CEA staff prior to 1996.

The CEA Chair Dr. Janet Yellen and Member Dr. Jeffrey Frankel have contributed to interagency work on climate change. The names and assignments of staff are listed each year in the annual *Economic Report of the President*, the most recent of which was submitted to Congress in February 1998. (See page 270 of the 1998 *Economic Report of the President* for information about staff.) Former Chairman Dr. Joseph Stiglitz and former Member Dr. Alicia Munnell also worked on climate change.

One notable, slightly more formalized, interagency effort to analyze climate change policy was the Interagency Analytical Team (IAT). The IAT attempted to evaluate alternative climate policies through a variety of modeling and other analytical exercises. CEA staff participated in the IAT effort.

Another process to which CEA contributed was the 1994 policy dialogue to recommend options for reducing greenhouse gas emissions from personal motor vehicles, an initiative known as "Car Talk." CEA provided analytical support to members of the Policy Dialogue Advisory Committee. The CEA has also been active on economic issues involving the Intergovernmental Panel on Climate Change (IPCC) and the National Science and Technology Council (NSTC). While no current CEA staff serves as an author for IPCC publications, we understand that past staff have done so. Current CEA staff have also been involved in developing the Administration's electricity restructuring proposal. One component of the inter-agency discussions on electricity restructuring is the extent to which different policy options would reduce emissions of air pollutants, including greenhouse gas emissions.

Documents, responsive to this request, reflect internal deliberations of the Executive Office of the President with regard to ongoing policies of the Administration. Please contact the Office of Counsel to the President concerning these materials.

9. Has your agency either prepared or reviewed any environmental, cost-benefit, and/or economic data and analyses relating to the White House Initiative on Global Climate Change? If so, please provide a copy of all data, analysis, and any comments by your agency.

Response: The CEA has analyzed the economic effects of the Kyoto Protocol and presented our results in Dr. Janet Yellen's March 5, 1998, testimony before the House Commerce Committee. With respect to the Climate Change Technology Initiative (CCTI) proposed by the President in for the FY 99 Budget, the CEA has relied on information from DOE, EPA, and others for assessments of those initiatives.

Documents, responsive to this request, reflect internal deliberations of the Executive Office of the President with regard to ongoing policies of the Administration. Please contact the Office of Counsel to the President concerning these materials.

10. Did your agency comment on any of the draft testimony on climate change by Administration witnesses since the President's 1998 State-of-the-Union address? If so, please provide a copy of the draft testimony and any comments by your agency.

Response: CEA has reviewed and commented both formally and informally on numerous public statements by various officials regarding climate change policy.

Documents, responsive to this request, reflect internal deliberations of the Executive Office of the President with regard to ongoing policies of the Administration. Please contact the Office of Counsel to the President concerning these materials.

11. Has your agency suggested any alternative policy options for climate change? If so, please

provide a copy of all drafts and supporting analyses and any comments from other Federal agencies on your alternatives.

Response: The CEA has analyzed numerous alternative policy options for climate change and explored the advantages and disadvantages of various approaches. The CEA has made suggestions as to which policy options would lower the cost of emissions reductions, and many of our suggestions were included in the Kyoto Protocol. The Administration is also pursuing some policies, such as electricity restructuring and basic energy research, that we have advocated on economic grounds even independent of climate concerns.

12. Does your agency plan to revise any existing legislation or propose any new legislation relating to climate change (including legislation that will have the effect of reducing greenhouse gas emissions whether or not that is the intended purpose of regulatory action)? If so, please identify and describe all such initiatives, including a timetable for their development and submission to Congress. Also, provide any and all legal analyses regarding the applicability and availability of existing legislation to implement the Kyoto Protocol and any comments from other Federal agencies on the analyses.

Response: The CEA is not planning to revise or propose any new legislative initiatives. We have not prepared or commented on any legal analyses of the applicability and availability of existing legislation to implement the Kyoto Protocol.

13. Does your agency plan to revise any existing rules or propose any new rules relating to climate change (including regulatory actions that will have the effect of reducing greenhouse gas emissions whether or not that is the intended purpose of regulatory action)? If so, please identify and describe all such initiatives, including any cost-benefit analyses, and a timetable for their development and promulgation. Also, provide any and all analyses (prepared or considered) of the cumulative effect on the U.S. economy and/or energy system of all or any combination of regulations that were issued since 1992, that were proposed, and that are being developed that have or will have such effects.

Response: The CEA is not planning to revise or propose any new regulations relating to climate change. We considered during its preparation and interagency review, the analysis of all Federal regulations prepared by the Office of Management and Budget last year in response to the Stevens Amendment, [Section 645 of the Treasury, Postal Services and General Government Appropriations Act 1997 (P.L. 104-208)]. This analysis, dated September 30, 1997, is entitled "Report to Congress on the Costs and Benefits of Federal Regulations", and was forwarded to Congress last fall.

14. Has your agency participated in discussions or reviewed any documents relating to international emissions trading, joint implementation, and/or the Clean Development Mechanism? If so, please provide a copy of all drafts and any comments provided by your agency.

Response: The CEA has participated in discussions of the flexibility mechanisms in the Kyoto Protocol, and has reviewed and commented on numerous drafts related to international emissions trading, joint implementation and the clean development mechanism. We believe these sources of flexibility will reduce the cost to the United States of meeting the Kyoto targets.

Documents, responsive to this request, reflect internal deliberations of the Executive Office of the President with regard to ongoing policies of the Administration. Please contact the Office of Counsel to the President concerning these materials.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-JUN-1998 11:53:17.00

SUBJECT: Draft Merger Testimony

TO: Daniel.Rubinfeld (Daniel.Rubinfeld @ usdoj.gov @ inet [UNKNOWN])
READ:UNKNOWN

TEXT:
Any comments would be much appreciated.==================== ATTACHMENT 1
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ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D91]MAIL426515567.126 to ASCII,
The following is a HEX DUMP:

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 multibillion dollar bank in New York City, leading to a situation in which the merger of two small banks could pose 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 suggest 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 the reduced potential for technological spillovers to rivals. Mergers can also work to decrease the potential 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 as 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, such as 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. We cannot automatically conclude that markets with 2 or 3 competitors, such as the manufacture of commercial aircraft, 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: Mark R. Hopkins (CN=Mark R. Hopkins/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:12-JUN-1998 11:38:09.00

SUBJECT: Japan GDP down 1.3% qoq in 1st quarter

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

TEXT:

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Daniel.Rubinfeld@usdoj.gov@INET@LNGTWY (Daniel.Rubinfeld@usdoj.gov@INET@LNGTWY [UNKNOWN])

CREATION DATE/TIME:12-JUN-1998 15:47:39.00

SUBJECT: Merger Testimony

TO: Janet L. Yellen@eop (Janet L. Yellen@eop [CEA])
READ:UNKNOWN

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Janet: The attached is a prelminary draft, and should not be quoted, etc.
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The following is a HEX DUMP:

DEPARTMENT OF JUSTICE

STATEMENT

of

JOEL I. KLEIN

Assistant Attorney General
Antitrust Division
U.S. Department of Justice

Before the

Committee on the Judiciary
United States Senate

Concerning

Mergers and Corporate Consolidation

Washington, D.C.
June 16, 1998

Mr. Chairman, and members of the Committee, it is a pleasure for me to appear before you today on behalf of the Antitrust Division of the Department of Justice. Today's hearing, on merger and consolidations, is certainly a timely one. We are currently in the midst of an unprecedented and unparalleled merger wave that is sweeping the U.S. economy. It has reached the point that it is virtually a tidal wave.

To try to grasp the enormous level of on-going merger activity, I have looked at some historical and projected data that I would like to share with you. For every $1 of U.S. merger activity that occurred in 1992 (only six years ago), today there is $10 dollars occurring (a 1000% increase). Another amazing comparison is the following: if you combined the value of all U.S. merger activity that took place in 1990, 1991, 1992, 1993, 1994, 1995, and first six months of 1996, it would approximately equal the value of merger activity that can expected in 1998 alone. We will likely see close to $2 trillion worth of U.S. merger activity in 1998, approximately equal to one-fourth the value of our entire gross national product.

This merger wave is not slowing down, in fact it appears to be increasing. In the last year alone, the value of U.S. merger activity doubled, a bigger one-year percentage increase than any other year in the 1990s. The dollar value of the *increase* in merger activity from 1997 to 1998 alone is likely to surpass the value of *all* merger activity in the years 1990, 1991, 1992, and 1993 *combined* by a healthy margin.

Looking at the number of mergers, instead of the dollar value of mergers, confirms the existence of a merger wave. In the last four years, the number of Hart-Scott-Rodino premerger notification filings has doubled. Since 1992, the number of merger filings has tripled. There can be no doubt that there is substantially more merger activity now than at any other time in this country's history.

Many explanations have been given for the increase in merger activity that we have seen, among them the following: a robust economy and stock market; increased globalization; rapid technological change; deregulation; and general industry upheaval in particular industries. At this point let me just say that whatever the reason or reasons for the increase in mergers, a crucial, absolutely essential requirement that needs to accompany any merger wave of this size and scope is rigorous and vigorous antitrust enforcement.

Importance of Antitrust Enforcement with Respect to Mergers

Section 7 of the Clayton Act is an incipiency statute. That is, it is designed to prevent the potential for anticompetitive activity before it occurs. In pertinent part, Section 7 reads as follows: No person shall acquire stock or assets where "the effect of such acquisition may be substantially to lessen competition, or tend to create a monopoly." To the extent that a propsed merger may substantially lessen competition by facilitating collusion between remaining competitors or by creating or enhancing market power, the merger would violate Section 7.

The fact that Section 7 is an incipency statute evidences a recognition by Congress that it is crucial to make predictive judgments about the potential for competitive harm resulting from a merger rather than letting the merger go through and awaiting the anticompetitive results prior to challenging the merger. Section 7, in conjunction with the premerger notification provisions of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, allows us to prevent anticompetitive mergers before they can harm consumers.

Our focus as antitrust enforcers in reviewing mergers is always on whether a particular merger will hurt consumers by raising prices, reducing quality or limiting innovation. While most mergers are competitively neutral and some are even beneficial for competition and consumers, there can be no doubt that to preserve choice, innovation and lower prices, anticompetitive mergers must be prevented.

Sometimes I have heard people complain about a merger solely based on its size. However, antitrust analysis focuses on the specific competitive harms that may be associated with a particular merger, not on its size in the abstract. Thus, for example, a big merger may not be challenged because the merging parties are not competitors or potential competitors of one another and the merger does not raise any vertical antitrust issues. At the same time, we may challenge a smaller merger that involves the only two firms that make a particular product. The key for our review is whether the merger will harm consumers, not the sheer size of the corporate entities involved.

In contrast to the 1980s, when many mergers were primarily motivated by financial considerations, many of today's mergers are primarily motivated by business strategy. This means that more than ever before, mergers likely will raise competitive questions that need to be reviewed carefully to ensure that the mergers will not harm competition and consumers.

Precisely because many of these mergers are motivated by business strategy, it is crucial that we have the resources and ability to conduct a comprehensive review of proposed mergers prior to their consummation. The mergers occurring today can be expected to have long-term effects on markets. From a public policy standpoint, an ounce of cure today may prevent a pound of competitive harm later.

I frankly am concerned that the resources of the Antitrust Division are not keeping pace with this merger wave and that it could have deleterious ramifications. As I noted at the beginning of my testimony, the meger wave is expanding enormously and gives no evidence of cresting. In contrast, the Antitrust Division's funding has essentailly remained constant in the last four years. That needs to change.

Antitrust Division Merger Enforcement

The merger wave of the 1990s has left us with a full plate of mergers to review. Fortunately, with a talented, hard-working professional staff and useful investigatory tools such as HSR premerger notification, we bring sharp knives to our full plate. In FY 1997, the Division brought 31 merger challenges, a record number of merger challenges. So far this fiscal year, we have brought 27 more, well on our way to another record level of merger enforcement.

The challenges we have brought do not necessarily share any particular theme, other than the fact that the merger as proposed would substantially lessen competition. We have had concerns and sought competitive remedies in such diverse industries as banking, defense, radio, aluminum, electricity, cable, waste removal, telecommunications, and health care, among others. We have challenged horizontal mergers, vertical mergers, mergers between actual competitors and mergers between potential competitors.

But, at the same time, our enforcement record shows that we carefully review each merger so as not to hinder procompetitive, efficiency-enhancing transactions from going forward. Even during a record breaking merger wave, I think it is useful to remember that the majority of mergers do not threaten to harm competition and consumers; in fact, many mergers may increase efficiency, improve research and development, and lower prices to consumers. Because of these benefits, even when we do have reason to believe a merger as proposed may be anticompetitive, we examine whether there are effective ways to prevent the anticompetitive aspects of that merger from going forward, while not prohibiting parts of the deal that do not raise anticompetitive concerns.

Rationales for Mergers

Earlier in my testimony, I noted that there are a variety of different reasons proffered for many of the mergers currently being proposed. I mentioned technological change, increased globalization, deregulation, industry upheaval, and the robust economy and stock market. Of, course this list is not meant to be all-encompassing, but it illustrates some of the rationales that have been proffered for many mergers.

Some mergers are proposed as a response to technological changes in an industry. While many mergers of this type may raise no antitrust concern, we have to be cautious to ensure that a current dominant firm in the market is not merging to prevent an upstart from challenging its domination in an industry.

An example of an anticompetitive merger of this type is the Primestar merger that we sued to prevent last month. We filed suit to block Primestar's acquisition of direct broadcast satellite (DBS) assets of News Corp. and MCI. We concluded that the proposed acquisition would allow five of the largest cable companies in the U.S., which control Primestar, to protect their cable monopolies and keep out new competitors. Under the proposed acquisition, News Corp./MCI would transfer to Primestar authorization to operate 28 transponders at the 110 west longitude orbital slot and two high-power DBS satellites currently under construction. The 110 slot is one of only three orbital slots that can be used to provide high-power DBS service to the entire continental U.S. and is the last position available for independent DBS firms to use or expand into.

As we have alleged in our complaint, high-power DBS is the most serious competitive threat the cable industry has ever faced, and, in many areas, is the only significant competitor to cable. Primestar would have no incentive to use the valuable 110 capacity to compete aggressively against cable companies, because doing so would "cannibalize" its owners' existing cable subscribers. Rather, acquisition of these assets by Primestar's cable owners would prevent an independent firm from using the assets to compete directly and vigorously with their cable systems. In the end, the transaction would deny millions of American consumers the benefits of competition, including lower prices, higher quality, greater choice, and increased innovation. Some mergers are proposed to allow firms to sell their products or services internationally -- they argue that they want to compete globally. The increasing globalization of markets presents many challenges for an antitrust enforcer.

In merger analysis, it is especially important to determine the market in which competition is occurring. A merger or other activity that may appear to violate the antitrust laws if the market is presumed to be national in scope may be permissible if the market is actually international (or even global) in scope. This is because the broader geographic scope of the market is likely to result in additional competitors being included within the market, which is one of the main indicators for whether a merger can go forward without harming competition and consumers. At the same time, however, we have heard the mantra of increased globalization as the reason for mergers where the particular markets affected were likely to remain local, not global, for many years to come. Thus, the mere invocation of increased globalization as a purported rationale for a merger does not result in a free pass for competitive review. Instead, the particular facts and circumstances surrounding the markets involved need to be examined closely in order to ensure that consumers will not be harmed.

An example of a proposed merger where we concluded that purported global rationalizations did not suffice to prevent anticompetitive harm was our review of the proposed merger between Inco and Hanyes, two aluminum manufacturers. After examining the facts and circumstances of that matter, we concluded that the parties' claims of a global market did not withstand scrutiny and that the merger of these two aluminum producers would substantially lessen competition in the United States. Faced with an antitrust challenge, the parties abandoned the proposed merger.

Deregulation of an industry may provide heretofore unavailable merger options for companies. It is natural that we would expect to see an increase in mergers after deregulation, in part that may be the result of natural market forces that have been constrained due to the artificial market restrictions of the regulation. Such mergers, as viewed as a whole, are unlikely to raise serious competitive concern.

One example of an industry where there has been significant consolidation following deregulation is in radio markets. There have been hundreds of mergers in radio markets since Congress lifted the cap on the number of radio stations that could be owned in one market in the Telecommunications Act of 1996. Many of these mergers did not raise significant antitrust concern. At the same time, a few did. In the last two years, we concluded that a total of 14 radio mergers would likely be anticompetitive. As to the many other radio mergers, we concluded that they did not raise serious anticompetitive concerns and appropriately allowed the market to adjust to the lifting of the artificial market restrictions.

A similar story could be told with respect to banking mergers. As laws were changed to permit interstate banking, the industry adjusted, in part, through mergers. Many of these mergers did not raise antitrust concern and were a natural market response to the lifting of the artificial restrictions on the market. At the same time, certain individual proposed banking mergers did cause us concern. In the last two years, we have sought competitive remedies in a total of [20] banking mergers, including First Union/Corestates, Nationsbank/Barnett and Banc One/First Commerce.

While the merger wave of the 1990s has come ashore across our entire economy, for certain key sectors of our economy, including defense, it has included the vast majority of the major firms in the industry. There has been essentially a declining market resulting in substantial overcapacity. While a number of mergers were allowed to proceed unchallenged in the last 5 years, which allowed that overcapacity to be rationalized to a large extent, if that rationalization goes too far it can harm competition. Thus, in two cases in 1997 and one in 1998, we challenged major mergers in the defense industry due to competitive concerns. In 1997, we reached consent decrees with companies proposing mergers in the defense industry -- they involved two acquisitions last year by Raytheon, one of the defense electronics division of Texas Instruments, and one of General Motors' Hughes Aircraft subsidiary, and in 1998, we sued to challenge the proposed merger between Lockheed and Northrup Grumman.

In the Raytheon/Texas Instruments matter, we reached a settlement that allowed the acquisition to go forward, but required Raytheon to sell the Texas Instruments business that produces a key component for radar systems. I believe that the merger as originally proposed would have resulted in significantly higher prices paid by the Department of Defense -- and ultimately by taxpayers -- for advanced military radars used in major weapons systems.

We also concluded that the other Raytheon acquisition, of Hughes Aircraft, would harm competition if it went forward as proposed. We insisted on a broad range of remedies, including divestiture of two defense electronics businesses, to preserve competition in sophisticated technology for U.S. weapons systems. For another weapons system that both Hughes and Raytheon were competing for development and production of at the time of the merger, a new anti-tank missile for the Army, we required Raytheon to establish procedures to prevent the two competing teams of employees from sharing information with each other, thereby preserving the independence of these teams in the competition. And as an additional remedy, Raytheon agreed to set firm prices with the Air Force on certain air-to-air missiles for which Raytheon and Hughes had given competing bids before the merger.

In March of this year, we filed suit to block the acquisition of Northrup Grumman by Lockheed Martin. Working closely with the Department of Defense, we concluded that if the proposed merger were allowed to proceed, the U.S. military would suffer a substantial loss of competition and innovation for a number of critical systems and components, including radar for use in military aircraft, sonar systems used on submarines and surface ships, and electronic warfare systems designed to protect pilots from missile attack. The proposed $11.6 billion acquisition is the single largest ever challenged by federal antitrust authorities. Trial is scheduled to begin September 8.

The increase in the stock market value of a company's stock may enable it to effectuate a merger using its stock more easily. Thus, the robust stock market could result in more mergers. Most of these mergers are likely to be competitively neutral or even beneficial, however, some may be attempts to preserve or enhance market power. Expanding economy or not, we are tasked to and will review all mergers to ensure that they do not substantially lessen competition.

Challenges Ahead for Antitrust Enforcement Regarding Mergers

Antitrust enforcement in the merger area has never been as time-consuming, complex, or as central to the functioning of our economy as it is today. I would like to briefly touch on just two the major challenges I see ahead for the Antitrust Division's merger enforcement efforts.

- **Global Antitrust Enforcement**

Because we are increasingly seeing mergers that may affect competition and consumers in more than one country or continent and because of the increasing importance of antitrust in many countries around the world, it is not surprising that we increasingly are reviewing transactions that are also being considered by foreign competition authorities.

In mentioning this, of course, I am immediately reminded of the concerns that arose last summer when the Federal Trade Commission and the DG IV of the European Union reached different conclusions with respect to the Boeing/McDonnell-Douglas merger. While that kind of divergence is unique in our experience, we still must explore ways to avoid any recurrence and, to that end, we and the FTC have been working closely with DG IV. Given the understandable concerns about national sovereignty, navigating these waters -- along with other issues raised by multi-jurisdictional merger review -- will not be easy.

On this point let me emphasize that notwithstanding the great strides we have made in cooperative merger enforcement with the EC, the Department of Justice makes its own decisions, based on U.S. antitrust law, in all of its matters, independent of the enforcement decisions or interests of the EC. While cooperation is beneficial in cases where two different antitrust authorities are reviewing the same matter, we will not permit such cooperation to affect the independence of federal antitrust enforcement in the United States.

- **Efficient Merger Review**

Another significant challenge to antitrust enforcers involves how to keep up with the influx of premerger filings, how to effectively review them in a timely fashion without imposing substantial unnecessary cost on businesses or sacrificing consumer interests, and how to resolve cases when antitrust concerns exist after the investigation. I believe we have taken a number of important steps in these regards -- such as speeding review of matters that do not raise serious antitrust concerns, focusing our investigation at its earliest stages, and working closely with parties regarding our concerns, so that they can take steps to alleviate them. We are ever watchful, of course, that we are doing the best we can with the resources we have.

One area where we are attaining new efficiencies in merger review is through improved cooperation between the Division and the state attorneys general. Where appropriate, we try to work with state investigators, interviewing and even deposing witnesses together, and sharing documents where the parties consent or where the law permits. In several instances in the past few years, this close cooperation has led to the Division and states filing joint complaints. In March of this year, the Department, the Federal Trade Commission and the National Association of Attorneys General released a protocol under which federal and state antitrust enforcers will cooperate on merger investigations. The protocol reduces to writing the procedures that the Department and the FTC staff and states have been following in recent years. Working together with state AG's has helped both in achieving consistent antitrust enforcement and in extending our resources.

Finally, I will come back to the need for additional resources. In the past year alone, HSR filings have increased 30%. Five of the six largest mergers in this country's history are currently pending before the Antitrust Division. These mergers take significant time and resources to properly evaluate. Not ensuring that the antitrust agencies have the resources to keep up with the merger wave would, in my view, be a terrible mistake. The mergers are there; the resources need to be there as well.

Conclusion

I would like to conclude my remarks by reiterating that our focus in reviewing each merger is on whether the merger will hurt consumers by raising prices, reducing quality or limiting innovation. While we will not stand in the way of mergers that are competitively neutral or even beneficial for competition and consumers, we will continue to take whatever action is necessary -- and insist on whatever remedy is necessary -- to prevent anticompetitive mergers.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:15-JUN-1998 19:22:54.00

SUBJECT:

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
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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. I understand that my written testimony will be entered into the record, so I will be relatively brief in my remarks.

I. Mergers: a Historical Perspective

Given the attention merger activity is receiving, one is naturally inclined to ask whether we are in the midst of an unprecedented merger boom. My written testimony shows that the United States has, in fact, gone through four previous merger waves in the past hundred years. By almost any quantitative measure, the current merger wave is substantial. (Exhibit 1 provides a sample of recent mergers.) 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 turn of the last century.

But one reason current merger activity is so large relative to the size of the economy is the run up in stock prices in the past few years. When merger activity is expressed relative to the market value of U.S. companies, its level remains lower than it was in the 1980s (Exhibit 2, lower panel). However, based on the volume of merger activity so far this year, 1998 is likely to show a substantial rise over 1997 in this measure of merger activity as well.

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 believe 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.

Recognizing this, it might not be surprising that we found no comprehensive recent research on trends in aggregate concentration. As shown in exhibit 4, however, the share of the total assets of non-financial corporations held by large firms fell over the course of the 1980s, and aggregate concentration in manufacturing fell slightly in the early 1990s.

On the question of whether individual U.S. markets are, on average, becoming more competitive or more concentrated, we also found no reliable comprehensive study. This is mainly because of the care and effort needed to define the relevant market in every particular case. Because appropriately defined markets may not be national in scope and may not correspond to standard industry definitions, readily available data may not be terribly relevant for public policy purposes and should be interpreted with considerable caution.

Mr. Chairman, 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 peformance should therefore focus on the impact of mergers on 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 resulting 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 (some see the merger of the Union Pacific and Southern Pacific railroads in 1995 as a notable example of such an outcome.)

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 system that emerged following the deregulation of the airline industry is one example, though it is one that raises questions of increased concentration as well) 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 suggest 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 and divorces are not uncommon (such as the unraveling of AT&T's 1991 acquisition of NCR). Studies of bank mergers suggest that, in spite of the potential for improved efficiency, in general, they have not improved the efficiency or profitability of banks.

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 the increased ability to appropriate the benefits of R&D. Mergers can also work to decrease the potential 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 as prices and profits. 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.

Thus far, I have been discussing motives for mergers generally. 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.

- (2) Technological change. Innovation can change the size and type of firm that is seen as most profitable. For example, large scale may be needed to exploit some advances in information technology and telecommunications, such as 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. Such high stock market values may make it seem attractive to fund an acquisition with stock (this is the dominant funding source in the current merger wave). But an overvalued stock market should 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. We cannot automatically conclude that markets with 2 or 3 competitors will be less competitive than those with 20 or 30.

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 (companies in the same industry that serve different and currently non-competing markets) or mergers seeking "synergy" among companies in different industries. Analysis of the economic impacts requires careful analysis of particular markets and defies easy generalizations.

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P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
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b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
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b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

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TO: Judith A. Winston (CN=Judith A. Winston/OU=PIR/O=EOP @ EOP [PIR])
READ:UNKNOWN

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

TO: Stephanie S. Streett (CN=Stephanie S. Streett/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: Stacie Spector (CN=Stacie Spector/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

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

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

TO: Bruce N. Reed (CN=Bruce N. Reed/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

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

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

CC: Maria E. Soto (CN=Maria E. Soto/OU=PIR/O=EOP @ EOP [PIR])
READ:UNKNOWN

CC: Jaime E. Uzeta (CN=Jaime E. Uzeta/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TEXT:
Attached you will find the IGA Weekly Report for the week of June 8-12.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D74]MAIL43277766L.126 to ASCII,
The following is a HEX DUMP:

June 6, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: Mickey Ibarra

SUBJECT: Office of Intergovernmental Affairs Weekly Report -- June 8 - 12, 1998

Tobacco

- Support for the tobacco bill is deteriorating among Governors. In the face of several Senate amendments this week that would reduce the states share of money from a potential settlement ($196.5 billion over 25 years), we organized a number of conference calls this week with Bruce Reed to prevent the Governors' from dropping their support for the tobacco bill. At the request of the National Governors Association (NGA), we are working with DPC to draft a letter to the Governors stating the Administration's opposition to new amendments that would further reduce the states share of money and limit their spending options.

- Governor Chiles (D-FL) called Senator Graham (D-FL) on Thursday night to urge him to vote against the tobacco bill. Governor Chiles is also preparing a letter urging the Florida congressional delegation to oppose legislation that would provide less funding than agreed upon in Florida's state settlement.

Transportation

- Thirty-seven state and local elected officials attended the TEA-21 Bill Signing on Tuesday. Prior to the ceremony, we briefed the elected officials on the legislation and other key priorities. I provided an overview of IGA's mission and objectives, Karen Tramontano talked about the Census, Josh Gotbaum discussed the negative impact the Kasich budget resolution would have on states, and Secretary Rodney Slater highlighted the benefits of the transportation legislation. Working with White House Press, we also arranged radio, print, and television interviews for each official before the ceremony.

Springfield, Oregon

- We held a conference call with Mayor Morrisette (D-Springfield, OR), Commissioner Bobby Green, (D-Lane County, OR) and other key officials to discuss ideas for avoiding tragedies like those experienced at Thurston High School. Earlier in the week, the Mayor participated in a meeting of elected, school and other officials whose cities had undergone the same trauma. The City and County have begun a process to look for solutions. They asked the White House to consider convening a meeting with the affected communities, and to include the Departments of Justice, Education, FEMA, as well as congressional participants.

US Conference of Mayors

- Lynn Cutler and Mona Mohib will attend the 66th Annual U.S. Conference of Mayors in Reno, NV, June 19-23, 1998. You are addressing the mayors via satellite on Friday, June 19th, from the White House. Secretaries Cuomo, Herman and Slater and Attorney General Reno are all speaking. We are opening a Federal Resource Center (One Stop Shop) for the meeting. Twenty Federal agencies will have displays and personnel to answer questions from mayors and their staff for four days. Since you suggested this idea last year, we have organized these centers at many of the meetings of state and local officials. It has been well received.

Oceans Conference

- Lieutenant Governor Madeleine Bordallo (D-Guam), Mayor Beverly O'Neil (D- Long Beach, CA), Mayor Dan Albert (D- Monterey, CA), King County Executive Ron Sims (D- King County, WA), and a host of state legislators were extremely pleased with the National Oceans Conference. The consensus is that the conference was a huge success.

Governors

- Governor Lawton Chiles (D-FL) lauded your announcement on Friday that you will extend the current moratorium against oil and gas drilling in the outer continental shelf, and to protect not only the West coast of Florida from drilling, but also the East Coast.

- Governor Chiles has requested that you declare an emergency for the State of Florida as a result of the extreme fire hazards in eight North Florida counties.

- As you know, Governor George Voinovich's (R-OH) mother passed away on Wednesday, June 10. He was, very appreciative of your remarks concerning his mother at the transportation bill signing ceremony on June 9.

Withdrawal/Redaction Marker
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
002. email attachment	Suzanne Dale to [list] at 18:39:33.00. Subject: IGA Weekly Report. Memorandum for the President From Mickey Ibarra. Subject: Office of Intergovernmental Affairs Weekly Report -- June 8 - 12, 1998 (partial) (1 page)	06/06/1998	b(6)

COLLECTION:

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

FOLDER TITLE:

[06/09/1998 - 06/19/1998]

2013-0223-F
ab1280

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]

Mayors

- Mayor Dennis Archer (D-Detroit, MI) called about the EPA proposed regulations under Title VI on the environmental impact on minority communities. He was very upset about the regulations. After we communicated with EPA and CEQ, Carole Browner committed to call the Mayor and ask him, along with five other mayors, to join the advisory panel examining these regulations. The Mayor is very pleased and indicated his interest in trying to negotiate a position that will be positive for the environment, the communities, and business interests.

- Mayor Lee Clancey (D-Cedar Rapids, IA), one of the most outstanding women mayors, switched parties and registered as a Democrat last Friday. The Mayor is not ready yet to make a public statement. [redacted] (b)(6) (b)(6) [002]

- Secretary Slater was very helpful in resolving the issues that Mayor Mike White (D-Cleveland, OH) had with the rail merger of CSX and Norfolk Southern. This week, the merger was approved by the Surface Transportation Board.

Indian Country

- We met with fifteen tribal leaders to discuss Indian Country issues on June 11. Issues ranging from tribal sovereignty to unmet health care needs were addressed. We were able to tell them about the Economic Development in Indian Country conference scheduled for August, as well as progress we are making with other issues.

- We also met with six Tribal leaders from the White Mountain Apache Tribe of Arizona in regards to the restoration project at the historic Fort Apache site. The Fort Apache site is on the World Monuments list of 100 most endangered sites and the tribe is seeking funds from the Bureau of Indian Affairs to assist in the restoration project.

Insular Affairs

- Senate Energy and Natural Resources Committee Chairman Frank Murkowski (R-AK) announced two more hearings on Puerto Rico's status -- one on independence issues and the other on a substitute for the House-passed status choice bill. His staffer is discussing a possible substitute with us and says the Committee may vote on it next month. Meanwhile, Senator Connie Mack (R-FL) called for action on the bill

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:15-JUN-1998 17:35:44.00

SUBJECT: Tomorrow's testimony

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

TEXT:
Attached is a double-spaced version of your testimony for tomorrow.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:15-JUN-1998 17:39:27.00

SUBJECT: One more time...

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.D97]MAIL48592766Q.126 to ASCII,
The following is a HEX DUMP:

Testimony of Dr. Janet L. 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.

- <u>The Great Merger Wave of the 1890s</u>. 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. The sharp decline in merger activity during 1903 and 1904 was probably related to the onset of a severe recession and the legal precedent for prohibiting market-dominating mergers under the antitrust laws that was established by the Northern Securities Case.

- <u>The Roaring Twenties</u>. 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). Efforts to dismantle conglomerate firms put together in the previous wave and redeploy their assets more efficiently may have been an important driving force. 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 many mergers are neither purely horizontal (in general large horizontal mergers would raise antitrust issues) nor purely conglomerate. Rather they represent market extension mergers (companies in the same industry that serve different and currently non-competing markets) or mergers seeking "synergy," in which companies in related markets expect to take advantage of "economies of scope."

By almost any quantitative measure, the current merger boom 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-Nationsbank 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 turn of the last century.

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

One reason current merger activity is so large relative to the size of the economy is the run up in stock prices in the past few years. When merger activity is expressed relative to the market value of U.S. companies, its level remains lower than it was in the 1980s (Exhibit 2, lower panel). However, based on the volume of merger activity so far this year, 1998 is likely to show a substantial rise over 1997 in this measure of merger activity as well.

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 Service 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 alone compiled by the FTC from Quarterly Financial Reports 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 economic activity being concentrated in large firms. 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 individual 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 multibillion dollar bank in New York City, leading to a situation in which the merger of two small banks could pose 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 in the market for "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 U.S. markets 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 resulting 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 (some see the merger of the Union Pacific and Southern Pacific railroads in 1995 as a notable example of such an outcome.)

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 system that emerged following the deregulation of the airline industry is one example, though it is one that raises questions of increased concentration as well) 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 suggest 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 and divorces are not uncommon (such as the unraveling of AT&T's 1991 acquisition of NCR). Studies of bank mergers suggest that, in spite of the potential for improved efficiency, in general, they have not improved the efficiency or profitability of banks.

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 the increased ability to appropriate the benefits of R&D. Mergers can also work to decrease the potential 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 as prices and profits. 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.

Thus far, I have been discussing motives for mergers generally. 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. Innovation can change the size and type of firm that is seen as most profitable. Some mergers today 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, such as 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. Such high stock market values may make it seem attractive to fund an acquisition with stock (this is the dominant funding source in the current merger wave). But an overvalued stock market should 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. We cannot automatically conclude that markets with 2 or 3 competitors will be less competitive than those with 20 or 30.

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 (companies in the same industry that serve different and currently non-competing markets) or mergers seeking "synergy" among companies in different industries. Analysis of the economic impacts requires careful analysis of particular markets and defies easy generalizations.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-JUN-1998 11:27:03.00

SUBJECT: briefings for trip

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:
Should we arrange for some briefings this week and next on both China and Korea? I would expect that these would be by experts in the energy sector, the environment, the climate change negotiations, as well as their economies. We may not necessarily need briefings on their economies, since I presume Janet received briefings before the last trip, but given the present state of the Korean economy, it might be useful to get a sense of how its recovery is going.

Joe

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-JUN-1998 09:00:03.00

SUBJECT:

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

TEXT:
Janet:

Mike Prell has asked that any reporting I do of the stock market consultants' meeting not have any names associated with views, because he promised participants that 1) there would only be Federal Reserve people there and 2) what they said would not go out of the Board room. So please do not repeat anything I told you about the meeting, especially with names attached to views.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:17-JUN-1998 15:52:04.00

SUBJECT:

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

TO: Sarah J. Reber (CN=Sarah J. Reber/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:
=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D45]MAIL461174862.126 to ASCII,
The following is a HEX DUMP:

ARTICLE

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 some past societies. One of the most interesting cases is that of Easter Island.

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.

SPECIAL ANALYSIS

Putting a Value on Improvements in Health

To judge whether or not the the substantial increases in health care expenditures over the past three decades have been excessive from an economic standpoint, they should be compared with the value of resulting improvements in health. A recent study that develops estimates of the value of total improvements in health between 1970 and 1990 sheds new light on this question.

Health improvements. From 1970 to 1990, the health of the population improved markedly. Life expectancy at birth rose from x to x years, and life expectancy at age 65 rose from x to x (see bottom chart). The quality of life also improved. Although the prevalence of chronic conditions has increased because people are living longer, improved medical technology allows individuals with a given condition to enjoy a better quality of life. Accounting for these changes, the authors estimate that the value of "quality-adjusted" life expectancy for people born in 1990 was about $95,000 greater than for people born in 1970. In addition, for people aged 65 in 1990, the value of remaining life expectancy was about $170,000 greater than for people aged 65 in 1970.

These estimates, which are designed to reflect people's willingness to pay for longer and better life, are large by many measures. For example, ...

Medical spending. Per-capita spending on medical care rose from $x to $x over this period (see chart). The study estimates that the present value of expected lifetime medical spending at birth increased by about $25,000 between 1970 and 1990, while the present value of remaining lifetime health spending at age 65 increased by about $45,000.

Is medical care worth the cost? In addition to advancements in medical technology, many factors including smoking, diet, exercise, and environmental quality influence the health of the population. The authors compare changes in expected lifetime medical spending to changes in the value of quality-adjusted life expectancy to estimate an "effectiveness ratio" for medical care. They conclude that if advancements in medical care were responsible for at least 30 percent of the observed improvements in health, the additional medical spending was, on average, worth it. Of course, these calculations are ambitious and require making assumptions about things that are inherently difficult to measure and subject to a wide range of estimates. Also, these are estimates of the cost-effectiveness of medical care, on average; they do not imply that every treatment or procedure has been cost-effective.

Conclusion. Health expenditures have recently begun rising more quickly, after several years of slow growth (although still not approaching the double-digit growth rates of the 1980s). But it is important to bear in mind the health improvements that additional spending may provide, even if estimating the value of those health benefits is difficult.

SPECIAL ANALYSIS

Life Insurance: Profiles in Coverage

A recent New York Times article suggested that people are forgoing life insurance in exchange for self insurance through investment in the stock market. While a decrease in life insurance coverage might be cause for concern, a more careful look at the evidence suggests that there has been only a modest decline in life insurance coverage: 78 percent of households owned life insurance in 1992, compared with 83 percent in 1960. What *has* declined are the types of life insurance that can also serve as tax-deferred savings shelters or tax-exempt bequests.

Types of life insurance. Term life insurance provides life insurance for a specified period of time, with annual premiums increasing with the age of the policyholder. Whole life insurance policies, in contrast, charge a constant annual premium throughout the life of the policy. The premium charged in the early years is higher than the actual cost of the insurance coverage; the excess amount of the premium is held in reserve as the policy's cash value, and this cash value grows over time from investment earnings. A policyholder who surrenders a whole life policy receives the cash value contained in the policy at the time of surrender. There has been a strong trend away from whole life policies toward term policies over the last 15 years.

Why buy life insurance? Both term and whole life insurance provide insurance for dependents of the policyholder against financial hardship in the event of the policyholder's death. But whole life insurance also serves as a savings vehicle. Because it builds up a cash value, a whole life policy can serve as a tax-deferred way of saving. While there is no direct evidence on the percentage of policies that are held until death, over 80 percent of payments to life insurance policyholders in 1996 were for cash surrender values paid on policies terminated voluntarily. In addition, money received under a life insurance contract paid by reason of the death of the insured—including the investment income earned on the accumulated cash value—is not taxed. For high wealth families, therefore, whole life insurance can be used to reduce Federal estate taxes. Indeed, among those whose policies are paid out due to death, over two-thirds of the insured are over 65 when they die and almost one quarter are over 80.

Explaining changing patterns of life insurance. The modest decline in life insurance coverage may be consistent with the changing demographics of the population: young families with children are prime buyers and as a proportion of the population, they have been declining over xx years. There is no direct evidence on why the demand for the savings features of whole life may have decreased. One reason could be that other savings vehicles have become more popular; prior to 1981, there were no other tax-deferred savings vehicles. In addition, the high returns in the stock market may make life insurance a less attractive savings vehicle, and finally, lower income tax rates reduce the benefit from tax deferred savings. Another possibility is that the motivation for a tax-exempt way of making bequests has decreased as the exemption threshold on estates has increased.

Conclusion. Life insurance has traditionally served multiple functions, offering not only insurance in the event of death but also a tax-deferred savings vehicle and a tax-exempt bequest vehicle. Americans are covered by insurance against death in roughly similar proportions as always, but there is evidence that the other features of life insurance are less in demand than they used to be.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:17-JUN-1998 14:13:32.00

SUBJECT: March 30 target and trade paper

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:

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

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

The economic and environmental rationale for such participation includes

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

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

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

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

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

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

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

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

Basic principles for implementing such an approach are:

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

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

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

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

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

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

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

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

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

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

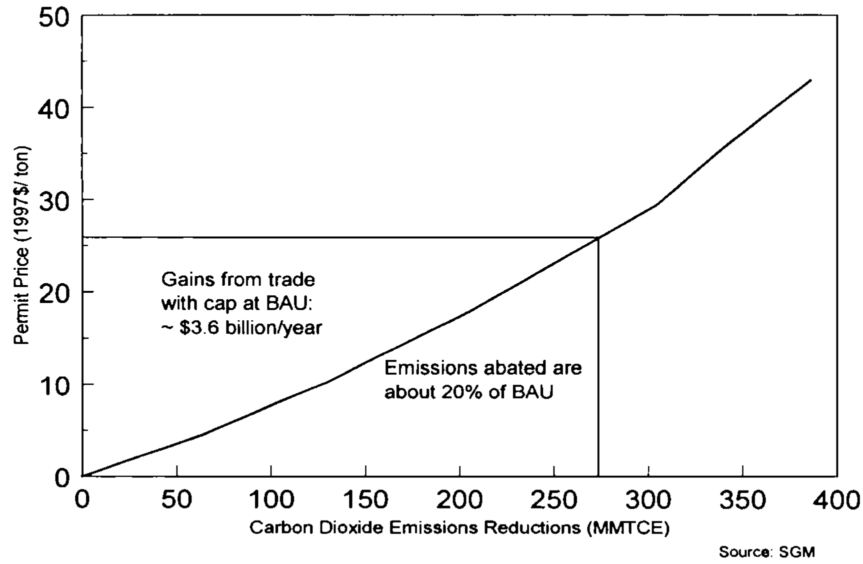


Chart 1. China's 2010 Marginal Abatement Cost Curve and Gains from Trade

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

[A[Automated Records Management System Hex-Dump Conversion]utomated Records Management System Hex-Dump Conversion]

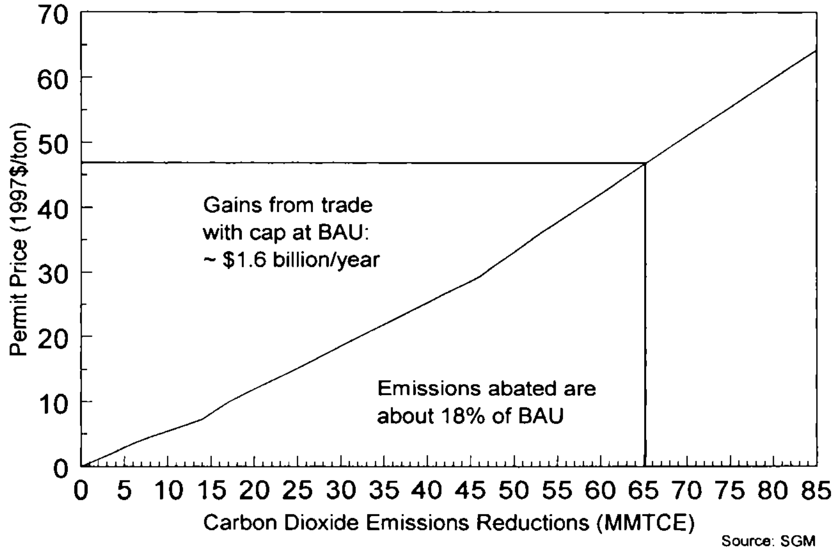
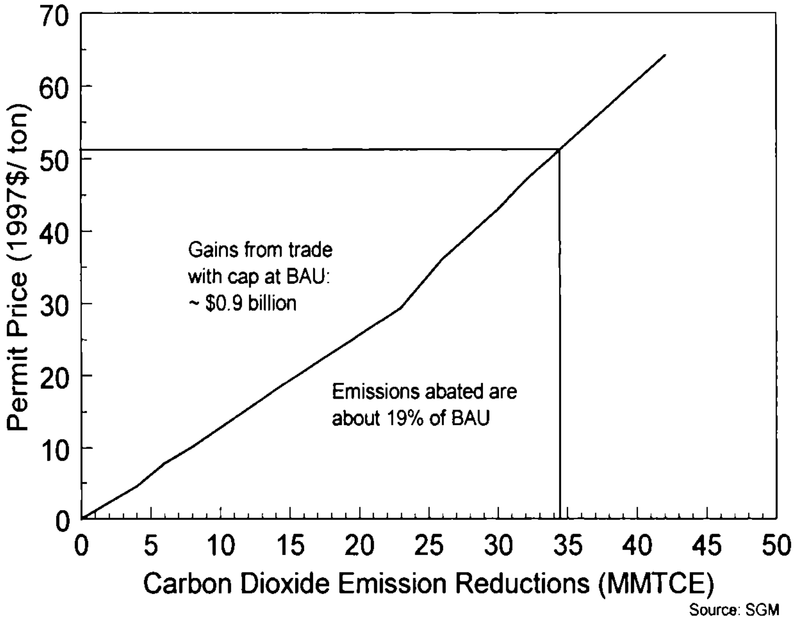


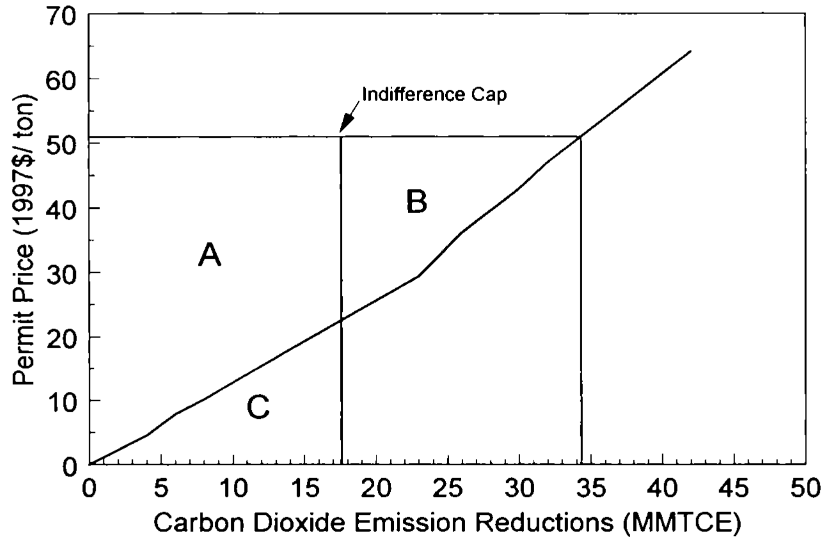
Chart 3. Mexico's 2010 Marginal Abatement Cost Curve and Gains from Trade



[Automated Records Management System Hex-Dump Conversion]

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

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



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Caveats

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

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

- Deaths avoided are proportional to carbon emissions reductions.
- Each key developing country is the sole non-Annex I country to adopt a target and participate in international trading.

Appendix 3. Summary of Analysis

A. Data

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

B. Methods

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

C. Results

The fixed effects regression we estimated is

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

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

Table 4. Model I Results

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

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

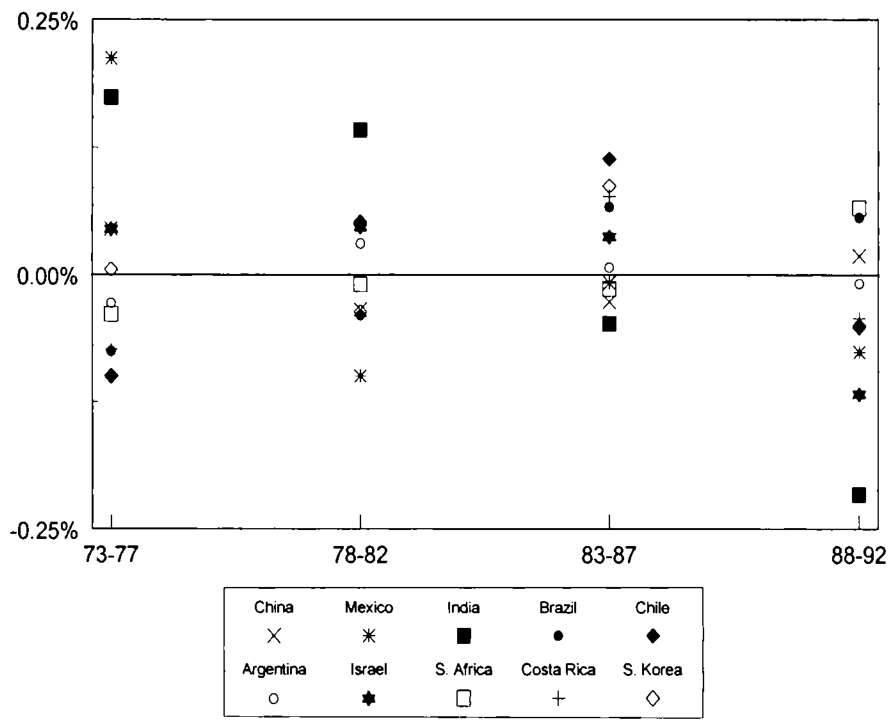


Chart 5. Error in Model I Prediction as a Fraction of Actual Emissions

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:18-JUN-1998 17:53:48.00

SUBJECT: GCC-China one-pager, revised

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

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CLIMATE CHANGE, "MEANINGFUL LDC PARTICIPATION", TARGETS, AND CHINA

One area where China should more fully participate alongside other leading countries is the global environment. The Kyoto Protocol negotiated in December calls for specific reductions in emissions among industrialized countries of the greenhouse gases that lead to global warming . So far, China and other developing countries have not adopted commitments to emission targets.

We cannot solve the climate change problem without participation by developing countries. The Senate voted 95-0 for the Byrd-Hagel resolution, making LDC commitment to emission targets a pre-requisite for ratifying the Kyoto treaty. There was a logic to this resolution. The whole effort to address climate change will not succeed without the developing countries, as they are the fastest-growing source of emissions, and will surpass the industrialized countries early in the century (probably by 2020, according to the International Energy Outlook 1998 released recently by the EIA). China alone is expected to surpass the United States as the largest emitter by around 2015.

Most of the manmade greenhouse gases that have already accumulated in the upper atmosphere were put there by the rich countries. *It is understandable that poorer countries feel that they should not have to sacrifice their economic well-being to deal with the problem. But we are not asking them to do so.* The Chinese need to be aware that their participation in the global system of targets and trading of emissions [as a desirable possible interpretation of "meaningful participation"] carries both environmental and economic benefits for them. The economic and environmental rationale for their participation includes

- **Economic benefits to China:** With targets at (or only slightly below) the estimated Business-as-Usual (BAU) path that they would have followed anyway, China and other developing countries would enjoy net gains of many billions of dollars through the international sale of emission reductions achieved at lower cost than the world price.

- **Environmental benefits for all:** Targets slightly below BAU would lower global emissions. (A ton of carbon has the same effect regardless where emitted.) Even targets *at* BAU would prevent emission cutbacks in the rich countries from "leaking" out to poor countries (via a reduction in world oil prices, or the relocation of carbon-intensive industries from participating to non-participating countries). Further, being paid to reduce carbon dioxide emissions generates ancillary air quality benefits for China, through lower particulate matter, sulfur dioxide, and nitrogen oxides emissions.

- **Cost savings to the U.S.:** Participation by developing countries in international permit markets would greatly lower the costs to the U.S. and other advanced countries of meeting their Kyoto targets. It is far cheaper for China to reduce emissions, e.g., by switching from dirty coal-fired power plants to cleaner forms of energy, than it is to do so in countries that have already industrialized. This is the basis of the estimated [cited in CEA economic analysis] that a target-and-trade system with LDC participation would reduce costs to the U.S. by 80-90 percent.

To persuade China and other developing countries *voluntarily* to adopt targets, international agreements can be structured to reduce the risk of inadvertent stringency (e.g., if the country's economic growth were to turn out to be unexpectedly rapid), and in particular to reduce the possibility of a target so stringent as to cause large economic losses to the developing country. Symmetrically, the agreements would be structured to make unlikely the creation of new "hot air" (e.g., if a country's economic growth were unexpectedly slow).

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:18-JUN-1998 14:49:37.00

SUBJECT: Final version of VP economic speech (slight update of previous press version)

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READ:UNKNOWN

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

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

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

TEXT:
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02:49 PM ---------------------------

Eli G. Attie @ OVP
06/18/98 02:44:48 PM
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Subject: Final version of VP economic speech (slight update of previous
press version)

---------------------- Forwarded by Eli G. Attie/OVP on 06/18/98 02:43 PM

Wendy C. New
06/18/98 02:27:31 PM
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To: See the distribution list at the bottom of this message
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Subject: Final version of VP economic speech (slight update of previous
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Paul J. Cusack/OVP

=================== ATTACHMENT 1 ===================
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REMARKS BY VICE PRESIDENT AL GORE
AS PREPARED FOR DELIVERY
CENTER FOR NATIONAL POLICY
Thursday, June 18, 1998

Thank you for having me here today, to talk about a subject that is vital to any policy debate: how we keep our economy growing, and create more jobs and opportunities for the American people.

Nearly one year ago, I came before the Center for National Policy to make a simple case: that the new economic strategy President Clinton and I have pursued since 1993 was not only working, but that it represented something new in economic policy, and something new in our history; that it was helping to create a new economy -- but that we faced stiff challenges to that strategy, on every major front.

Back then, we were still fighting to balance the federal budget. We were still fighting for the strategic investments in training, in education, in technology and the environment that are so critical to growth. We were still fighting for American leadership and engagement in the world.

But above all, we were fighting those in the other party who simply refused to abandon the out-of-date dogmas of the past -- those who believed that the politics of raw ideology should take precedence over the policies that actually build and sustain prosperity.

We won those fights. In 1993, without a single Republican vote we enacted the new economic plan that virtually eliminated the budget deficit, and produced what many are now calling the strongest economy in our history. That laid the groundwork for the bipartisan balanced budget that helped us finish the job, and helped to keep our economy growing.

If there were any doubts then about the wisdom of our economic course, there should be none today. In the past 5 ½ years, our economy has significantly raised standards of living and added more than 16 million new jobs. We have the fastest real wage growth in 25 years, the lowest unemployment in 28 years, the smallest national government in 35 years, the highest rate of small business formation in history, and the highest rate of private home ownership in history -- all with the lowest inflation in 32 years. No wonder the Chairman of the Federal Reserve called today's economic performance "as impressive as any I have witnessed in my near half-century of daily observation of the American economy...it is possible that we have, in a sense, moved 'beyond history.'"

Actually, you could call it the law of intended consequences. We worked hard for these results. Ours was a three-part strategy, merging elements that had never been combined before: strict fiscal discipline, strategic investments in the future, and international engagement. Of course, government didn't create all those new jobs and opportunities -- the American people did. But government helped lay the foundation. And at the heart of our efforts was a new way of thinking. From our first day in office, we said: let's abandon the failed orthodoxies of the past, and build our economic strength on what actually works.

Five and a half years ago, you couldn't have described that as a traditional Democratic strategy, and certainly not a Republican strategy. But it has been a winning strategy. It has not only changed the political debate, it has changed America for the better.

Today, once again, our progress is threatened. Despite all the evidence that our economic strategy is working, some in the Congressional majority are determined to work against it. They would unravel our fiscal discipline -- even at the risk of raising interest rates, shattering confidence in our economy, and squandering the resources we need to finally close the generational deficit. They would squeeze down on our strategic investments in job training and education, and research and development. They would widen the opportunity gap instead of closing it, denying us the highly-skilled workforce we need for the 21st Century. Some would even compromise our leadership in the world -- holding hostage our ability to stabilize the world economy, and defend our economic and security interests abroad.

Worst of all, I fear that some in the Congressional majority have become so blinded by politics that their primary goal is not economic progress, but partisan conflict.

So I come here today to issue a warning: if we allow risky, partisan schemes to disrupt American economic policy, we could jeopardize our economic recovery. We could lose our best chance to shape the 21st Century into the most prosperous and productive time the world has ever known.

First, let us remember how far we have already come. When President Clinton and I took office, America's economy was reeling from years of flabby budgets, phony numbers, and flimsy investments. From 1981 to 1987, when the other party held both the White House and the Senate, they put in place the most reckless economic plan our nation has ever seen: irresponsible tax schemes, made-up numbers, and massive deficits. I know it's hard to imagine it today, but they actually quadrupled America's national debt in less than 12 years -- an act of breathtaking contempt for future generations.

The result was a vicious cycle, with faltering growth leading to bigger deficits, and bigger deficits causing higher interest rates -- crowding out the private investment that is the real engine of growth and jobs. By the early 90's, we had deficits at record levels, $300 billion a year, stretching out as far as the eye could see. Every time businesses felt a little strength in the economy and borrowed money to invest and expand, the combination of their borrowing and the government's deficit financing would put pressure on interest rates and the recovery would stall.

For years, Americans heard there were only two choices: tax and spend, or cut and run. We knew there was a <u>third</u> way: invest and grow.

As I said last month in Detroit, we replaced the vicious cycle with a <u>virtuous</u> cycle -- lower interest rates, more investment, more jobs, more growth -- which then fueled even greater investment in our future. And this is about more than spreadsheets and statistics -- it's about providing the opportunity that has always been the heart of the American dream. It's about giving every child a chance at a better, brighter future.

That is why, at every step of the way, we tried to reach across party lines -- to build what should have been a new bipartisan consensus on economic policy. It didn't quite work out that way -- and not just in 1993. In 1995 and '96, the other party shut down the government rather than agree to the strategic investments we believed our economy needed.

But then, chastened by the outrage of the American people, the Republican leaders were forced to accept President Clinton's priorities. Still, in 1997, it took months of intense negotiations to produce a bipartisan balanced budget agreement based on those priorities. And it saddens me to say that now we are seeing that partisanship again, on three major fronts:

First, there are some in the Congress who would risk our economy by allowing the first balanced budget in a generation to become our last balanced budget.

By trying to use the budget surplus before it even rolls in -- and by recklessly voting to eliminate the entire tax code, with no way to replace it -- they would jeopardize everything we have fought for these past 5 ½ years: low interest rates, and a stable climate for investment. Our chance to tackle tough, long-term challenges like saving Social Security and Medicare. And the confidence of world financial markets, which could be damaged even before these risky plans pass through the Congress -- simply because of the prospect of new deficits.

Our economic power comes from a vote of confidence in America, a vote cast in markets around the world that evaluate every government's policies every day, through billions of transactions.

Today's economy operates on the information standard, not the gold standard. If investors think you're playing fiscal games, interest rates climb almost instantly.

That is why, barring an economic reversal, a national emergency, or a foreign crisis, I believe we should balance the budget this year, next year, and every year. Not through a Constitutional Amendment that would clog up the courts -- that was always just a cop-out for those who couldn't make the hard decisions to do it the right way -- but through the resolve of our national leaders.

Without that fiscal discipline, we will never cross the next great budgetary frontier -- saving Social Security for our children. So when President Clinton saw that we would have the first budget surplus in 30 years, he challenged leaders of both parties to reserve every penny of any surplus until we save Social Security first.

At first Congressional leaders embraced that pledge. And anyone who doubts the commitment of our own party to fiscal discipline and serious entitlement reform should note this fact: today, many of the most progressive Democrats have signed on to save Social Security first.

But in the Congressional majority, some have tried to back away -- proposing that the surplus be squandered on large, risky, and indiscriminate tax schemes, with no regard for our long-term fiscal future.

Last October, in testimony before the House Budget Committee, Speaker Gingrich was practically licking his chops over the first hint of a surplus -- proposing that it be used for everything from military projects to highways to reducing the debt, and a large tax cut to boot. Then, this April, before the House Ways and Means Committee, he announced that he'd seen the light, and said "I support the President's call to use every penny of the surplus to save Social Security."

The attacks came pretty quickly from within the GOP; one prominent Republican accused him of "hiding behind a 'wait-and-see' posture" rather than calling for more tax cuts. And just two days later, in early May, the Speaker couldn't take the pressure from his right-wing anymore, so he changed his mind and said he wanted to go back to using half the surplus for tax cuts. Barely two weeks after that, the Speaker supported the President's pledge again.

Ladies and gentlemen, we need an unbreakable commitment to save Social Security first -- not every other day, but every day.

Ways and Means Chairman Bill Archer's position has been more consistent. He has said all along that a large part of the surplus should be spent on tax cuts, because "the surplus is surging out of control." Think about that: a surplus that's "out of control." At least that's better than a Congressional majority that's out of control.

I recognize that it is easy -- sometimes irresistible -- to squander every penny the moment it becomes available. Some would say it's good politics. But it is dangerous fiscal policy. We've solved the budget deficit, but closing the generational deficit will take even greater fiscal resolve.

Yesterday, in one of the most irresponsible political schemes we have yet seen, the Republican House voted to abolish the tax deduction for college scholarships, voted to abolish the tax deduction for child care, and voted to abolish the tax deduction for health care for millions of families. It was a vote to raise the cost of home mortgages for struggling young families. It was a vote to make it impossible for any family or business to invest in the future with certainty or stability.

That may be why the non-partisan Tax Executive Institute said scrapping the code "illustrate[s] the folly of making tax policy by sound bite and should be rejected."

The Washington Post called it "a way to posture on the cheap in an election year...They've stopped producing bills in favor of producing bumper stickers."

The Chief Economist of the Chamber of Commerce calls the idea "more than a little dangerous." And now the National Association of Manufacturers is against it, too.

No wonder business thinks this idea is nutty -- because predictability and stability are essential for business planning. But then, stability is not a prized principle in today's Republican Party politics.

Let me be clear: we support tax reform -- which is why we have proposed the most sweeping set of IRS reforms and taxpayer rights since the tax code was first enacted. We support tax cuts -- tax cuts that are carefully targeted and fully paid for. Both of our major deficit reduction plans -- in 1993 and in 1997 -- contained targeted tax cuts. Today, taxes for middle-income families are the lowest they have been in two decades. But we do not support tax reform by wrecking ball. And we do not support using the budget surplus as a Congressional candy jar, which would only revive the runaway deficits of the past, and endanger the recovery we have worked so hard to sustain.

Let us keep the fiscal discipline our economy demands. Let us join together, across party lines, to save Social Security first -- and let's keep that commitment until the problem is solved.

Our economy faces a second threat. There are some in the Congress who would cut the strategic investments that give us faster growth and safeguard our prosperity for the 21st Century.

Through lean fiscal management -- and because of our efforts to reinvent government, eliminating more than 200 outdated programs, reducing the federal workforce by more than 330,000, and saving $137 billion -- President Clinton has proven that we can balance the budget and invest in the future at the same time. And I believe there are three kinds of priority investments for our future: investments in people; investments in places; and investments in productivity.

Especially in this New Economy and Information Age -- fueled by innovation, driven by new technology, shaped increasingly by minds and not just by matter -- we need an aggressive commitment to invest in our people. That starts with education and job training -- for the highly-skilled workforce that is already in short supply. According to one recent survey, over 60% of corporate leaders say that the number-one barrier to sustained economic growth is the lack of skilled workforce. We must invest more in a world-class education for every American -- from pre-school to college to job training and retraining. We need quality health care, and a Patients Bill of Rights -- because a healthy workforce is a productive workforce. We need measures to strengthen families, because that's where people find fulfillment and healing.

We must also invest in the places where families live -- our cities, towns, and communities -- to make them safe, clean, sustainable places for economic growth. That means aggressive action to clean up our environment and protect our precious open spaces. It means more police and safer streets. It means empowering communities, especially our poorest areas -- because we know they have the most untapped potential. It means metropolitan strategies for development -- encouraging regions to work together to create jobs, clean our environment, and prevent urban and suburban sprawl.

And we must make investments in productivity, by funding cutting-edge research and technology, to fuel innovation and expand electronic commerce. That is why we are investing in 21st Century scientific research, and in the Next Generation of the Internet, moving at speeds 1,000 times faster than today.

Last year, we struck a bipartisan agreement for strategic investments in America's future. But the budget resolution that has now passed the House breaks the spirit of that agreement. It would mean severe and unnecessary cuts in areas that are essential to our economic future.

It could force deep cuts in job training and college scholarships. It could threaten Medicare and Medicaid, and even food safety. It could cut child care, and critical efforts to move people from welfare to work. It would cut efforts to ensure clean water and delay the clean-up of dangerous toxic waste sites. It could completely eliminate our 21st Century Research Fund, to invest in path-breaking scientific inquiry and new technology. It could even cut our efforts to put more police on the streets, all across America.

We don't know the full details of this smoke-and-mirrors budget; its savings and cuts are so vague, the New York Times concluded that it "fails the basic integrity test." But here is what we know to be true: a budget scheme that cuts training and education means we will not have the skilled workforce we need for the 21st Century. A budget scheme that cuts police and the environment means we will not have safe, clean communities to attract new investment and jobs.

Don't take it from me. One respected budget expert went so far as to say that the House Republican budget is "just a mockery." That was Senator Pete Domenici, Chairman of the Senate Budget Committee. I would guess that quite a few Republicans share that view.

There is one more investment -- one that is especially important to me, and to our children's future -- that has now fallen victim to partisan politics. And that is the fight against youth smoking.

When the Senate Commerce Committee, the very committee on which I used to serve, considered this issue, an overwhelming bipartisan majority -- nineteen to one -- voted for a comprehensive bill to dramatically reduce youth smoking, save lives, and save our economy tens of billions of dollars. Then something happened: the mighty tobacco industry decided to kill it. That's when the partisan parlor games began.

The Republicans said they wanted a tax cut in the bill -- so a tax cut was included. They said the bill spent too much on social programs -- so the spending was cut. They said the lawyers' fees were too high -- so the fees were cut.

For too many Republicans, those complaints were nothing but a smokescreen. Even with all those changes, last night the Republican Senate tried to kill the tobacco bill. Of course, 14 courageous Republicans joined 43 of the 45 Senate Democrats in supporting the bill. But that was still three shy of the 60 we needed to move the bill along.

Let me be clear: every Senator who voted to kill the tobacco bill voted against a tax cut for middle income families; against new measures to crack down on drugs; against life-saving research into cancer and other diseases. Every Senator who voted to kill the tobacco bill voted <u>not</u> to save one million American lives.

I know it must have been a difficult decision by the Republican leadership to kill the tobacco bill, not only because most Americans believe that it was morally wrong to do so, but also because they must have known it would cause a huge change in the people's perception of the Republican Party, and they must have decided that it was worth it anyway. And I'm sure people will get used to the new image -- the same way people got used to the Sugar Bowl on New Year's Day becoming the Nokia Sugar Bowl, the Fiesta Bowl becoming the Tostitos Fiesta Bowl, and the Independence Bowl becoming the Poulon Weedeaters Independence Bowl. Now, we're all going to have to get used to the Republican Party becoming the RJ Reynolds Republican Party.

America needs a comprehensive, bipartisan bill to reduce youth smoking. It's time for the RJR Republican Party to stop playing politics with American lives. And we're going to keep pushing this fight again and again, until we win this victory for our children.

There is another reason why we must support all these strategic investments in our future. Only by making our economy work for everyone -- only by sharing and extending prosperity here at home -- can we build and sustain a consensus for open markets, for international engagement, and for aggressive leadership in the world.

<u>There are some in the Congressional majority who would risk our economy by shutting out the world, instead of leading and engaging it</u>.

Above all issues, American leadership used to be the greatest bipartisan preserve. Today, a dangerous and growing isolationism -- a willingness to play politics at home with our interests around the world -- could push our prosperity <u>over</u> the edge. It is an abandonment of a great and longstanding internationalist tradition in the other party. And it is one of the single greatest threats to our continued economic strength.

We have seen this Congress drag its feet on IMF funding, while the Asian financial crisis deepens, affecting not only the markets of Europe, but also our own.

We have seen this Congress withhold our dues to the United Nations in order to play politics with a woman's right to choose. In the process, they are jeopardizing our progress in reforming the U.N., and potentially costing us our vote in the U.N. General Assembly at the end of this year.

Is that any way to honor the legacy of internationalism left by President Eisenhower, President Nixon, and President Bush?

We have been working hard, within the Democratic Party, to try to fashion a third way on trade -- to aggressively open markets while advancing labor rights and environmental protections around the world. But most do agree that with one-third of our growth tied to exports in the past five years, we must move forward in opening markets.

In the past few months alone, we launched a new trade partnership with the European Union, and new trade talks with Latin America. A major agreement to keep global electronic commerce duty-free. A landmark international anti-corruption convention. And as you know, I believe we must do still more to open up markets.

I also believe, as the President told the World Trade Organization last month, that competition among nations must never become a race to the bottom -- in environmental protections, consumer protections, or labor standards. Our goal must be to help more people benefit from the enormous possibilities of the global economy.

But our entire party can agree on this: if we shut ourselves off from the world; if we give up our seat at the table of world affairs; if we walk away from the most urgent financial crises for the sake of politics, our own economy and our own workers will suffer. And we will lose the leverage to fight for <u>freedom</u> -- freely-elected governments, the free flow of ideas, the free movement of products and people -- which is the surest route to prosperity both at home and around the world.

Consider the IMF. One look at this morning's trade numbers shows why the Congressional majority is wrong to undermine it. When Asian economies are hurt -- when foreign customers can't buy our products -- when foreign currencies lose their value, and our competitors try to flood the marketplace with cheap, devalued goods -- we are the ones that are hurt. We need the IMF to work with countries that are at risk, before the risk spreads to us. The IMF needs reform of its own. But to cut off IMF support now is like shutting down the Fire Department when the house next door is on fire.

It is one of the great and tragic ironies of our history that we are sometimes prone to turn inward when our power is greatest, when our economy is strongest, when our interests are most secure. That is why it is so wrong for Republicans to retreat into isolationism at the very brink of a new American century -- and that is why we are grateful to those brave few in the other party who are fighting for the IMF, and for paying our dues to the U.N., and for engagement in the world. Today, our ability to lead and shape the world economy is at its peak. We waste that power at our own peril.

Taken together, the postures and positions taken by this Congressional majority are as astonishing as they are irresponsible: removing all predictability from the tax code and squandering the surplus. Squeezing down on the education and training our workers and businesses need. Blocking our efforts to stabilize the global financial markets that are essential to our economy.

Consider this: the Republican Party of 1998 has achieved the remarkable feat of being simultaneously anti-labor and anti-business.

You all know about the new hit movie, "The Truman Show." When it comes to this Congress, I think we could use more Truman, and less show.

For 5 ½ years, President Clinton and I have sought to build a new economic consensus in this country -- one that reaches beyond the false choices and rigid politics of the past. After so much success, why would we go back to failed old economic dogmas? Why would we unravel the strategy we worked so hard to build?

I am still hopeful that we can forge a bipartisan solution to our economic challenges, and put prosperity before partisanship, once and for all. I am still hopeful that we can appeal to the great, lost traditions of the other party -- of economic growth, of fiscal discipline, of international leadership. But with jobs and incomes at stake, hope is not enough. The American people must be on notice. It is, after all, their economy. After sixteen million new jobs, and year after year of unbroken economic growth, we owe it to them to keep it strong. Thank you.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:18-JUN-1998 11:01:55.00

SUBJECT: Re: Mtg w/POTUS on Friday

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

TEXT:
The note looks fine. You should go ahead and send it.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:18-JUN-1998 10:26:30.00

SUBJECT: Mtg w/POTUS on Friday

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:
Below is my proposal for an e-mail:

Jon -- Gene told Janet last night that there is a briefing scheduled w/ the President on Friday. He asked her advice on possible topics for the briefing. Janet has 2 suggestions and would be happy to help brief the President on these possible topics:
1) State of the US Macro Economy: Given the turmoil in Asia, it might be useful to give the President an update on the state of the US economy -- is inflation still contained (given the recent CPI #s)?; are our projections for growth and unemployment still on track?; possible impact of GM Strike etc.; OR
2) China's Possible Role in Climate Change efforts: Given the President's trip to China and the importance of China's participation in efforts to control greenhouse gas emmissions, it might be useful to brief the President on the work CEA has done which shows the economic benefits to China of participating in the international permits trading regime proposed in the Kyoto Protocol. And, given the importance of China's participation, it might be useful to brief the President on how LDC participation is critical to reducing the costs to the United States.
Let me know what you think. And, please let me know if you think that Gene would like Janet to help brief on these topics.
Thanks.
Michele
Michele

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:18-JUN-1998 18:20:19.00

SUBJECT: Tomorrow's mtg

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

TEXT:
I talked to Melissa in Gene's office. She said that Gene got my e-mail and that he is planning to sit down and plan tomorrow's POTUS mtg when he gets done w/ everything tonight. She said that he will call you. I also asked her to page me when she knows what the agenda is for tomorrow.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:18-JUN-1998 12:11:53.00

SUBJECT: comments on economic analysis

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

TEXT:
---------------------- Forwarded by Joseph E. Aldy/CEA/EOP on 06/18/98 12:11 PM ---------------------------

Joseph E. Aldy
06/17/98 07:27:52 PM
Record Type: Record

To: Todd Stern/WHO/EOP
cc: Jonathan H. Adashek/WHO/EOP
Subject: comments on economic analysis

Todd,

I have received comments from State Dept (3 sets of comments), EPA, OSTP, Sally, and you on the latest draft. I have incorporated most comments. I need to talk to you about a couple of your comments. Most important is your comment at the bottom of p. 31 -- it didn't come through in the photocopy, and I know it is important, so I want to make sure that I get it right.

Can we talk sometime Thursday morning? Janet has expressed to me that it is imperative that we get this report done before we leave for China, and I almost have the next (and last I hope) draft done. Thanks,

Joe

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:19-JUN-1998 09:28:21.00

SUBJECT:

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.D48]MAIL421046173.126 to ASCII,
The following is a HEX DUMP:

BRIEFING OF PRESIDENT

Impact of Asian situation on the U.S. economy

- We are clearly seeing an impact of the Asian crisis on our export performance. This was apparent in the trade data we received yesterday, it has been apparent for some months, and it will only get worse. Data for the first three months of this year show that our exports to the five most affected countries are down between $17 billion and $21 billion at an annualized rate since the crisis began. Roughly two thirds of the lost sales were to Korea. Exports to Japan are down another $6 to $8 billion over this period. Thus the total adverse movement across all six countries has been $23 to $29 billion. We expect the loss in sales to worsen during the remainder of the year, especially if the Asian economies continue to contract. Furthermore, we have not yet seen the large increase in imports from the Asian countries that their devaluations are likely to produce. The trade deficit was $114 billion in 1997; It is likely to rise to $160-170 in 1998 and about $200 in 1999 according to consensus forcasts. And the current account deficit, now at $166 billion (2.1% of GDP) is likely to reach 3% by 1999.

- Asia is not the only drag operating on the economy this quarter and in the second half of the year. Inventory investment is also likely to fall substantially; It hit a record of about $100 billion in the first quarter, which is an unsustainable pace. It will almost surely decline.

- Implications for growth: In spite of these two drags on the economy, a probable scenario is that we will nevertheless see solid growth this quarter--in the 2-3% range--with slightly lower growth--in the vicinity of 2% in the second half of the year. This is below the sizzling pace of growth over the past year, but still consistent with job growth of 100-150000 jobs per month and unemployment near its present level. Indeed, we are already seeing some signs of a moderation in growth (slower growth in production worker hours) The reason why the U.S. economy is likely to continue performing well is because consumption and investment spending remain extraordinarily robust. One of the factors thought to be fueling consumption spending is the stock market. In addition, the Asian crisis has probably led to lower intereset rates, which are supporting interest sensitive spending.

- The GM strike: If the GM strike continues through the end of June, we estimate that real growth in the second quarter would be about 0.6% point lower. Unless the strike is prolonged well beyond that, the output losses could be recouped later in the year so that the net effect would simply be to shift output from one quarter to another.

- Some risks on the downside: The Asian crisis is a clear downside risk, particularly if it widens or deepens. (Japan could descend into a deflationary spiral; China could devalue setting off competitive depreciations; more countries could become involved; their could be an intensification of the financial crisis affecting U.S. banks; the trade situation could be worse than anticipated)

- There is some evidence that a profit squeeze is developing in the United States. Labor costs have begun to tick upward and are growing faster than prices. Pretax corporate profits have declined for two consecutive quarters--the first time this has happened since the last recession. Economic measures of profits are growing more slowly; On the other hand, analysis continue to expect strong corporate profit growth. If profits are already under pressure with growth at 4.8%, the situation could intensify if growth slows below its current sizzling pace. This situation could lead to a change in sentiment triggering a stock market correction. As we have previously discussed, such a correction could easily affect consumption. However, growth on the order of 2% is still possible even in the face of a stock market correction.

- Having said that, I would also note that there are upside risks. Labor markets continue to be tight very tight; If growth does not moderate somewhat, labor markets would become yet tighter, posing inflationary risks. there is evidence that core inflation is no longer declining; and some of the beneficial factors that have been holding inflation down, including import price reductions, health insurance costs and declines in energy prices are likely to contribute less in the future than thus far. Inflation remains low and is still under control and real wages have been rising at a healthy clip (up 2.8% over the past 12 months) but there are risks.

- The current situation is an unusually risky one but the risks are not all on the downside.