Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	Pollakk to Janet L. Yellen at 06:15:58.00. Subject: Fwd: Council on Foreign Relations & The Federal Reserve. (partial) (1 page)	08/31/1998	b(6)
002. email	Steven N. Braun to Jeffrey A. Frankel and Janet L. Yellen at 12:16:15.00. Subject: Chart 2-2 (p58) in the 98 ERP. (1 page)	08/31/1998	b(6)

COLLECTION:

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

FOLDER TITLE:

[08/21/1998 - 09/04/1998]

2013-0723-F
ab1283

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: Douglas_W._Elmendorf@oa.eop.gov (Douglas_W._Elmendorf@oa.eop.gov [UNKNOWN])

CREATION DATE/TIME:21-AUG-1998 18:58:08.00

SUBJECT: update on Social Security

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

CC: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

TEXT:
(See attached file: annuit1.wpd)

(See attached file: savecal3.wpd)

Janet:

Since I'll be away next week (reachable at 252-261-4669 if you need me), I want to update you on the Social Security reform process. As you know, the Technical Working Group has spawned a large number of sub-groups, and Jeff Liebman and David Wilcox are pulling together a binder of materials that summarize what these groups have accomplished in the past two weeks. (The binder is intended for Gene and Larry, and it's not clear that it will be distributed to the whole working group, but I've asked Jeff to give you a copy.)

Here are the main topics:

1. Women. Becky and Jeff are in touch on this. The President will have an "event" on women and SS in September.

2. Integration of Individual Accounts with Traditional Benefits. This is about clawback rates, minimum guarantees, tax rates, etc. I've been working with Jeff, David, and others on this, and Steve Goss is running the numbers for various types of plans.

3. Effect on Saving. I've written (with significant input from Jeff and David) a description of how to calculate these effects under various assumptions. (This is attached.) Steve Goss is implementing this. The next step in this area is to finish the memo for the President about how to think about this topic, and I'll try to make that a priority when I get back.

4. Retirement/Health. Corky and Bob are working on this, and I've been kibitzing in meetings with Mark McClellan (David's deputy who is coordinating this group and generating a bunch of the health information from the Treasury staff).

5. Annuities. I wrote (with Gillian Hunter from OTA at Treasury) a

description of the current annuities market. (This is attached.) David is integrating this memo with other information and numbers produced by OMB.

6. Non-IA options, or what is the best Ball/Aaron/Reischauer plan we can devise? This topic is stalled until Jeff and I have time to talk about it, and we'd like your input. I've been able to learn a lot about the Swedish system, which may be helpful in this process.

7. The Return on Equities. David's staff has produced a memo arguing that the return to equities over the next 75 years will be well below what we've been assuming. I've had several conversations with Jeff (and one with David) about whether this is right. A bit on this topic is included in the attachment on saving.

I'd love to tell you more about all of these topics when you have a chance. I may also need some guidance on how to set priorities between this work and other things. For example, I'm also preparing several things for a group on consumer financial behavior and education, and Chad wants me to write a WEB piece when I get back.

Doug

- annuit1.wpd - savecal3.wpd================== ATTACHMENT 1 ==================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D95]MAIL40285533Y.226 to ASCII,
The following is a HEX DUMP:

The Current Annuity Market
Doug Elmendorf and Gillian Hunter
8/18/98

1. Almost all of the "annuity market" involves tax-sheltered investing rather than insurance about length of life.

   a) With *immediate* annuities, payments begin immediately. With *deferred* annuities, payments are deferred. In fact, almost everybody who owns a deferred annuity "cashes out" before receiving any annuity payments--they use deferred annuities for tax-sheltered saving (the tax treatment is parallel to after-tax IRAs).

   b) Total premium payments for individual annuities in 1995 were $99 billion, of which payments for immediate annuities represented only $6 billion. (Other ways of comparing these markets suggest that immediate annuities are even less important.)

2. Few people choose "pure" annuity payouts.

   a) *Single life* annuities make payments for the length of one person's life. *Two life* or *joint and survivor* annuities make payments to a surviving spouse. *Period certain* or *term certain* annuities make payments for at least n years (with *installment refund* annuities as a variant).

   b) In a 1993 survey, 93% of annuitants chose single life. Only 8% chose no refund or guarantee option. In 1994 in TIAA-CREF, roughly half of annuitants chose single life. Among them, 1/3 took no guarantee, with the rest split fairly evenly among 10-, 15-, and 20-year guarantee periods.

   c) Pure annuities seem less popular today than several years ago. This may be related to the stock-market boom.

3. Variable annuities are mostly a new phenomenon in the immediate annuity market.

   a) *Fixed nonparticipating* annuities pay a predetermined amount each year. *Fixed participating* annuities guarantee a minimum amount but pay more if the insurance company does well. *Variable* annuities are complicated (see (b)).

b) Variable annuities work in the following way: Assume an "investment rate" (say 5%). Given that investment rate, your life expectancy, and your lump sum of money (say $100,000), calculate the fixed annuity payment you would receive (say $9000). Choose investments for the lump sum. Then:

payment in 1st year = $9000
payment in 2nd year = $9000*(1+actual return)/(1+assumed investment rate)
payment in 3rd year = payment in 2nd year*(1+actual return)/(1+assumed investment rate)

Some implications are:

i) If your lump sum grows at exactly the assumed investment rate each year, your annuity is a fixed amount.
ii) If your lump sum grows faster than the investment rate each year, your annuity grows each year.
iii) If your lump sum falls in half in one year, your annuity falls roughly in half as well.
iv) Changes in portfolio value are essentially smoothed over your remaining life.

4. Adverse selection is a serious problem.

a) Warshawsky (1988) estimated the quantitative importance of this phenomenon by comparing mortality probabilities of the general population to those of annuity purchasers. He found the average cost over 1941-84 to be 13 percent of the amount invested. Mitchell, Poterba, Warshawsky, and Brown (1998) updated the calculation with some improvements through 1995; they found that for the 1970s, early 1980s, and 1995, the cost of adverse selection was about 9 percent. The explanation for the decline in unclear.

b) A question for Social Security reform: Would reducing current annuitized benefits reduce the adverse selection problem? Walliser says "only slightly."

5. Transactions costs are high.

a) Warshawsky (1988) estimated that over 1941-84, transactions costs on fixed annuities averaged 9 percent of the amount invested. These costs include marketing, corporate overhead, income taxes, and profits. Costs varied significantly over time, with higher costs when interest rates were high or rising. MPWB estimated that transactions costs fell to 4 percent by 1995, which Warshawsky (1997) attributes largely to the interest-rate cycle.

b) Variable annuities have an extra level of administrative costs, because they have asset management fees (e.g., mutual fund fees) in addition to insurance fees.

c) Some of this load is explicit. The rest arises implicitly from choosing mortality tables that are too conservative.

d) Costs vary across companies. Warshawsky (1998) presents the payouts on a $100,000 purchase of a fixed annuity for men age 65 in 1996:

	monthly	annual
first quartile payout:	$730	$8760
average payout:	760	9120
third quartile payout:	790	9480

e) A question for Social Security reform: Are these transactions costs socially wasteful? Not entirely. Explanation of annuities is probably valuable. Provision for investment risk and return to capital are unavoidable. Taxes go to the government.

f) A question for Social Security reform: Would these transactions costs decline over time? Maybe, as people become more familiar with annuities. Mutual fund fees have fallen. (What is different about this market and the markets for mutual funds and financial services and products more generally?)

g) A question for Social Security reform: Can these costs be effectively regulated? New York State limits marketing costs to 7% of premiums. Maybe the federal government could limit costs and force insurers to use a standard life table of its choosing (to avoid the implicit load). But how would this affect current state regulation and insurance of insurers?

Issues to Keep in Mind:

1. Should annuity purchase be mandated?

a) adverse selection
b) moral hazard of running down one's assets and then needing public assistance
c) if mandated, it's easier to require unisex pricing or ban risk underwriting if we want to (but it's not completely easy if people can choose among insurers)
d) do people understand why annuities don't seem to pay much?
e) what about the age 64-1/2 vs. Age 65-1/2 problem?

2. Should annuity purchase be handled privately or by the government?

a) are marketing costs and commissions socially wasteful?
b) what about insuring insurance companies?

c) will the government innovate?

d) avoiding adverse selection across insurers

3. Different reform proposals handle annuitization differently.

   a) Advisory Council's IA proposal required annuitization with a one-year guarantee to survivors regardless of when annuitant died.

   b) Advisory Council's PSA proposal did not require annuitization.

4. Insuring the Insurers

   a) State guarantee funds currently provide some backup in case insurance companies go bankrupt. But they might be unable or unwilling to back huge amounts of new funds.

References:

Brown and Poterba (1998), "Joint Life Annuities and Annuity Demand by Married Couples"

CBO (1998), "Social Security Privatization and the Annuities Market"

Friedman and Warshawsky (1988), "Annuity Prices and Saving Behavior in the United States"

Friedman and Warshawsky (1990), "The Cost of Annuities: Implications for Saving Behavior and Bequests"

Mitchell, Poterba, Warshawsky and Brown (1998), formerly MPW (1997), "New Evidence on the Money's Worth of Individual Annuities"

Poterba (1997), "The History of Annuities in the United States"

Walliser (1997), "Understanding Adverse Selection in the Annuities Market and the Impact of Privatizing Social Security"

Warshawsky (1988), "Private Annuity Markets in the United States, 1919-1984"

Warshawsky (1997), "The Market for Individual Annuities and the Reform of Social Security"

The Effect on National Saving of Potential Social Security Reforms
8/21/98

The first part of this memo describes the proposed formulas for Steve Goss to use to calculate the effect on national saving of alternative Social Security reform proposals. The second part of the memo explains the methodology and assumptions underlying those formulas.

1. Formulas

Let: DNW_t = deviation of national wealth in year t from its value in the absence of reform
DNS_t = deviation of national saving in year t from its value in the absence of reform
(Both are calculated in nominal terms and should be shown as shares of GDP.)

Then: $DNW_1 = S_1$
$DNW_t = S_t + DNW_{t-1}*(1+m)$ for $t>1$
where S_t is defined below, and m is the marginal product of capital (.07 plus inflation).

And: $DNS_t = DNW_t - DNW_{t-1}$

We define S_t in two different ways that correspond to alternative views of the political economy of the federal budget:

Political economy rule #1: On-budget spending and taxes are unaffected by reform.

S_t = $DSSTaxes_t$ - $DSSBenefits_t$ - (Consumption from IAs)$_t$

DSSTaxes = deviation of traditional Social Security taxes (i.e., excluding any clawbacks) from value in the absence of reform
DSSBenefits = deviation of traditional SS benefits from value in the absence of reform
Consumption from IAs = withdrawals from IAs - clawed-back amount
= (1-clawback rate)*(withdrawals from IAs)

Political economy rule #2: On-budget spending and taxes adjust to maintain the baseline unified surplus/deficit. (Also, equity purchases and transfers of the unified budget surplus to the trust fund both reduce the unified surplus, although if you use the surplus to buy equities, you can't count it twice.)

S_t = Maximum of (Trust fund net purchases of equities, Transfers of UB surplus to trust fund)$_t$
+ (Contributions to IAs-Withdrawals from IAs)$_t$

2. Methodology and Assumptions

The first part of this section describes our simplifying assumptions. Many of these assumptions could be relaxed, but at the price of additional complexity and reduced clarity. The second part of the section gives an intuitive description of the formulas on the previous page, and the third part reviews our choice of the marginal product of capital. The last part of the section provides further background on the formulas.

Worrisome Shortcuts

We assume that private saving is unaffected by Social Security reform. For example, we assume that all withdrawals from individual accounts are spent, and we assume that any tax cuts are spent. We could add more sophisticated behavioral responses later if people are interested. (We are ignoring any voluntary contributions to IAs, because including these contributions and later withdrawals without allowing for changes in other private saving seems silly.)

We assume that the political economy rules are symmetric. One could imagine a situation where surpluses are entirely spent away but deficits do not generate sufficient spending cuts to restore budget balance.

We ignore taxes on capital by assuming that the pre-tax marginal product accrues entirely to the sector that owns the capital. One implication is that we ignore fiscal effects on state and local governments. Once again, we could add the effects of taxes if people want, and we describe some of the appropriate modifications to our formulas on the next page.

Description of Formulas

The formulas we propose involve two basic steps:
1) for each year, calculate the increment to the capital stock out of non-capital income (S), and
2) cumulate those increments over time assuming that the incremental capital generates a marginal product (m).

We generated these formulas in two ways that provided a useful check on each other. One approach was simply to think through the logical structure of the problem and the way that different sectors would interact. The other approach was to build a spreadsheet that explicitly calculates income flows and net worth for each of these sectors and then develop shortcuts to determine effects on national wealth.

Now consider the intuition behind the formulas. Begin with the effects of changing social security taxes or benefits. Under political economy rule #1, these changes have one-for-one effects on national saving because both private saving and other government saving are unchanged. Under rule #2, these changes have no effect on national saving because on-budget taxes or spending are changed by an exactly offsetting amount.

Consider the effects of creating individual accounts. Think about the effect of IAs on two sectors: the government and the IAs themselves. (Because other private saving is fixed, we can ignore it.) The effect on government saving is: -contributions + (clawback rate*withdrawals). The effect on saving in IAs is: contributions - withdrawals. Under rule #1, on-budget taxes and spending are unaffected, so we can ignore them. Then, summing across the government and IA sector, contributions cancel out, leaving [(clawback rate-1)*withdrawals] as the net saving effect. Under rule #2, on-budget taxes and spending adjust to keep government saving unchanged. That leaves just the IA saving, which equals [contributions-withdrawals].

Consider the effects of swapping bonds for equities in the trust fund. Under rule #1, the reduction in the unified surplus has no effect on taxes or government spending. This is purely an asset swap, which has no effect on national saving. Under rule #2, the reduction in the unified surplus reduces spending or raises taxes by an exactly offsetting amount, which creates additional saving in that amount.[1]

(As an aside, separating out the federal corporate tax piece of the marginal product of capital would be straightforward. Suppose that political economy rule #1 were interpreted to mean that on-budget spending and taxes *excluding capital taxes* are unaffected by the unified surplus. Then, any extra corporate tax revenue from additional capital is saved by the government, and national wealth compounds at the pre-tax rate as we have assumed; our formulas require no modification. In contrast, under political economy rule #2, the additional corporate tax revenue is consumed. Our formulas would need to be modified to subtract this amount from S for each year.)

(Adding personal capital taxes would be more complicated for two reasons. First, private saving might respond to changes in capital taxes paid. Second, the amount of capital taxes paid would depend on the portfolio allocation of IAs as well as of the trust fund.)

The Marginal Product of Capital

We use .07 as our estimate of the real marginal product of capital. Elmendorf and

[1] It might seem that one could measure the effect of reform on national wealth by calculating its effect on debt held by the public and on equity holdings of the trust fund. But that captures only the government's wealth, and ignores private wealth. If people hold less equities and more debt, their wealth grows more slowly, and that effect must be included.

Mankiw (1998) used BEA data on national income and the capital stock to calculate that the MP_k has averaged about .06 over the past 35 years. But they admitted that their calculation excludes the return to capital that accrues to state and local governments through property taxes; according to Feldstein, Poterba and Dicks-Mireaux (1983) and Poterba (1997), allowing for such taxes boosts the return by roughly .01. Note that our chosen value of .07 is less than the marginal product of *nonfinancial corporate* capital, which is often cited as the return to additional national saving. Because corporate capital is more heavily taxed than other capital (such as housing), it earns a higher pre-tax return, estimated by Poterba (1997) to be .085. Yet, we find no reason to assume that any addition to the capital stock would flow disproportionately to corporations.

There are two reasons to expect the return to capital to decline over time, although we have not attempted to quantify these effects to use in the simulations.[2] One reason is the aging of the population, which will depress the MP_k by reducing the number of workers. However, the amount of capital will change as well, as saving responds to aging directly and to changes in the return to capital, so calibrating the overall effect of aging on the MP_k is quite difficult. Another reason that the MP_k might fall is that the nation regularly adds to the capital stock every year through national saving, and would add even more under some Social Security reform proposals; a larger capital stock means a lower return to a marginal unit of capital.

As an aside, our assumed rate of return on equities should be consistent with our view of the marginal product of corporate capital. Suppose that the present value of $1 of expected future corporate earnings is unchanged on average over long periods.[3] Then, the return to holding equities will equal the return to the underlying corporate capital after paying corporate taxes (where the effective tax rate is about 27 percent, according to Auerbach, 1996). If we expect the marginal product of that capital to average 7.5 percent in the future (1 percentage point below the past average), then the real return to equities will be 5.5 percent. Combined with Steve Goss's assumption of 3.5 percent inflation, the nominal return to equities will be 9 percent.

More About the Formulas

We assume a closed economy with four domestic sectors and four assets/liabilities:

- sectors: the Social Security trust fund, the rest of the federal government, individual accounts, the rest of the private sector

[2] Elmendorf and Mankiw also noted that their measure of the capital stock excludes inventories and land; including these elements would depress the estimated return on capital even in the historical period.

[3] In other words, assume that Tobin's q must average 1 in the long run, even if it can deviate substantially in the short run.

- financial instruments: special government bonds issued only to the trust fund, other federal bonds, corporate bonds (these are included in the spreadsheet but we have not yet considered any reforms that involve them), equities

This mechanical approach provides a useful check on rules of thumb that occur to us, and will be especially useful if we add capital taxes or behavioral offsets or other complicating factors.

The income on special govt bonds is based on our chosen interest rate; the income on equities depends on our chosen equity return.

We calculate private and public wealth separately, but not private and public saving. Doing so would be more complicated than it first appears, because some of the return to equities takes the form of revaluations that do not appear in the NIPA. Suppose that a private firm retains earnings that raise the price of equities owned by the government; the gain in wealth is the government's, but the NIPA will label the saving "private saving." On the other hand, if a private firm pays those earnings to the government as dividends that are then used to purchase new shares, the gain in wealth will still be the government's, but the NIPA will label the saving "public saving."

The trust fund's balance sheet is:

Assets	Liabilities
special govt bonds	
equities	

The trust fund balance in period t equals: [the balance in period (t-1)] + [income from the (t-1) balance] + [Social Security taxes] + [clawbacks] - [Social Security benefits].

The rest of the government's balance sheet is:

Assets	Liabilities
	special govt bonds
	other federal bonds

The ROG balance in period t equals: [the balance in period (t-1)] + [income from the (t-1) balance] + [corporate taxes] + [personal capital taxes] - [IA contributions] + [other taxes less spending].

Other federal bonds equals debt held by the public (DHBP). Capital income equals the negative of interest payments. Corporate taxes equal τ_c / $(1-\tau_c)$ * e * K , where τ_c is the corporate tax rate, e is the after-corporate tax return to equity (the rate at which equity holdings grow from year-to-year), and K is the incremental capital stock. Personal capital taxes are partly [τ_e * e * K_{ps}], where τ_e is the effective personal tax rate on equity and K_{ps} is the capital stock owned by the other private sector (which is taxable). Personal capital taxes also include taxes on bond income, but the net effect is small (private bond interest payments are deductible; interest receipts on private holdings of private and government bonds are taxed).

The individual accounts balance sheet is:

Assets	Liabilities
other federal bonds	
corp bonds	
equities	

The IA balance in period t equals: [the balance in period (t-1)] + [income from the (t-1) balance] + [contributions] - [withdrawals].

The balance sheet of the rest of the private sector is:

Assets	Liabilities
other federal bonds	
equities	
corp bonds (whatever's not held by IAs)	corp bonds

The other private sector's balance in period t equals: [the balance in period (t-1)] + [income from the (t-1) balance] + [income] - [consumption].

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:21-AUG-1998 18:07:29.00

SUBJECT: speech

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

CC: Douglas_W._Elmendorf@oa.eop.gov (Douglas_W._Elmendorf@oa.eop.gov [UNKNOWN])
READ:UNKNOWN

TEXT:
Here's a draft of the first few paragraphs of your upcoming speech--a brief review of current economic conditions and an introduction to the longer-term issues you're going to focus on. I'll leave a hard copy in your office.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D77]MAIL44689433Q.226 to ASCII,
The following is a HEX DUMP:

Economic Challenges for the 21st Century

A man walks into a bar with a duck on his shoulder. The bartender asks "What are you doing with that pig?" The man responds, "Are you stupid? That's not a pig, that's a duck." And the bartender says, "I was talking to the duck."

It is a pleasure for me to have the opportunity to talk to you today. The American economy is now enjoying its best performance in decades. Unemployment and inflation are at their lowest levels in a generation, and the elimination of the federal budget deficit has caused the net national saving rate to double since 1992. At the same time, the near-term outlook includes some clear risks, and I will touch on these in a moment. But I would like to focus my comments on three economic challenges for the 21st century--Social Security, climate change, and the design of international financial institutions.

Beginning with current conditions, the U.S. economy appears to have considerable forward momentum. As you know, growth of real GDP slowed sharply in the second quarter from its extraordinary first-quarter pace. Inventory accumulation shifted down, and net exports plummeted, with exports dropping 8 percent at an annual rate. Yet, domestic final demand remained quite strong: Consumer spending advanced sharply again, and investment in both business equipment and housing continued to move up at a double-digit rate.

One result of robust economic growth over the past several years has been a marked tightening of labor markets. The striking decline in the unemployment rate has boosted real wage gains and created new opportunities for many Americans. But it has also increased the risk that wage gains will outstrip productivity advances and lead to a pickup in inflation. A different, and perhaps more worrisome risk, is presented by economic developments overseas.

Serious economic problems in Japan and many East Asian countries have not been resolved as quickly as many observers had hoped, and the recent financial turmoil in Russia has increased the dangers for emerging market economies around the world. Portfolio shifts toward the safety and liquidity of U.S. assets have helped to reduce our interest rates and thereby to boost household and business spending. But the sharp decline in net exports in the first half of the year emphasizes that slumping foreign economies can hinder U.S. economic growth.

Instead of dwelling on these immediate concerns, however, I want to use most of my time to discuss longer-term challenges. Let me begin with Social Security reform. ...

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:21-AUG-1998 17:31:45.00

SUBJECT: Workability & (In)efficiency of Trading Limits

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

TO: david.wilcox (david.wilcox @ treas.sprint.com @ inet [UNKNOWN])
READ:UNKNOWN

TO: robert.cumby (robert.cumby @ treas.sprint.com @ inet [UNKNOWN])
READ:UNKNOWN

TO: David B Sandalow (CN=David B Sandalow/OU=CEQ/O=EOP @ EOP [CEQ])
READ:UNKNOWN

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

CC: Alan S. Polasky (CN=Alan S. Polasky/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 is a draft of the requested (3-part) memo on the (in)feasibility of
limits on trading. I propose to send it to Todd Monday morning.
JF=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D68]MAIL47496433E.226 to ASCII,
The following is a HEX DUMP:

DRAFT

To: Todd Stern

From: Jeff Frankel

Re: (Un)workability and (In)efficiency of Limits on Trading

The Administration has been united and consistent in emphasizing the critical importance of international trading to bring down the costs of meeting the Kyoto targets. We have argued strongly against European proposals to put a limit on trading -- pointing out the loss in efficiency that would result -- and we must continue to do so. But one should not get carried away. Limits on trading are not literally unworkable.

Two memos are attached. The first explains how limits on trading could be implemented if necessary, albeit with an extra layer of complexity -- just so that we understand the issue in our own minds. The second memo explains, in terms suitable for use with other countries, why limits on trading would be highly distortionary (even if we no longer feel able to assert that they would be literally unworkable).

1. Limits to Trade Can be Workable, Even Though Undesirable

Some proposals on international trading would limit the use of flexible mechanisms (international trading of Annex B 'assigned amount units,' Joint Implementation, and the Clean Development Mechanism) in meeting obligations under the convention. Such restrictions would add an additional layer of complexity, but are not necessarily fatal to the market.

Regardless of limits to trade, an institutional framework is required for trading.

We have consistently emphasized the central role of the private sector in doing the work of Kyoto. Nevertheless, to ensure the proper functioning of the permit market and that we meet our emissions commitments, we recognize the need for monitoring, recordkeeping, and enforcement by governments, at least at the domestic level.

At the international level, it is not realistic to have the private market undertake trades freely across national boarders without government oversight. Nations will need to demonstrate their compliance at the end of the budget period and will be concerned about counterfeiting, balance of payment statistics, and so on. Therefore, at a minimum, there will need to be a national registry of all international permit trades.

The added burden of implementing limits to trade would not be insurmountable.

Essentially, domestic permits would need to be traded for foreign permits at an "exchange rate" which reflected the added constraint of only being able to import or export a set quantity of permits. There are a number of ways to implement a limit, but the simplest might be for the government to issue "right-to-import" or "right-to-export" certificates up to the limit. If, for example, international purchases were recorded at the national trading registry, then the buyer would have to present one right-to-import certificate along with a foreign permit for it to be officially accepted. (They would be "*net* import" certificates: An American who sold a permit net-import certificate, which he would be free either to use or sell.) Similarly, anyone wanting to sell a permit internationally would have to acquire one right-to-export certificate and combine it with one domestic permit in order to export. Arbitrage would equate the price of domestic permits to the international price of permits plus the certificate price. The price of the certificates would fluctuate on the market, depending on how binding the limit is. Their price would be zero -- i.e., the domestic price and foreign price would be the same -- if the constraint were not binding. Similar mechanisms are currently used to implement import and export quotas throughout the world.

2. Limits to Trade are Highly Distortionary

Restrictions on the use of flexible instruments would be highly distortionary, raising the global costs of addressing climate change while not providing any additional environmental protection.

Difficulty in determining a baseline

Certain proposals would limit the reductions achieved abroad to a given percentage of total reductions, which requires defining total reductions from some business-as-usual (BAU) baseline. However, there is no internationally agreed methodology for forecasting emissions, and therefore international negotiations to determine such baselines are likely to be quite complicated. Of course, trading restrictions based on tons, instead of a percentage of BAU, would avoid this problem. In this case, the tonnage restriction for each country would have to be set, creating its own challenge for international negotiations.

Interference with the Clean Development Mechanism

According to the Kyoto Protocol, credits from CDM projects undertaken between 2000 and 2008 can be applied during the commitment period -- providing strong incentive for such investment. Restrictions on the share of reductions from flexible mechanisms could easily interfere with this incentive. Without knowing how reductions in 2008-2012 will be achieved, firms receiving credits now will not know whether those credits will ultimately be applicable to Annex I commitments or not. In other words, they will not know the potential value of their credits, increasing the uncertainty of their investments.

Increased administrative complexity

Restrictions will lead to requirements that both sellers and buyers have to report transactions, and to the development of mechanisms to ensure that parties stay within their limits. This will add an additional layer of transaction costs and administrative burden on the system. This creates an artificial market barrier that the new market will have to overcome, decreasing its efficiency.

Increased costs of meeting commitments.

Limits are distortionary. They would create differences in permit prices across countries (a foreign permit would trade at a premium to domestic permits), leading to a situation where countries pay a needlessly high price to achieve the same level of global emissions. Modelers have estimated the efficiency cost of placing limits on global trading:

Permit Prices for a Competitive Market of Annex I and Key Developing Countries

Country/Region	Domestic Permit Price, No Trading Constraint	Domestic Permit Price, 50% of Reductions Must Occur at Home
United States	$23/ton	$59/ton[1]
European Union	$23/ton	$79/ton
Australia	$23/ton	$44/ton
Japan	$23/ton	$158/ton
Canada	$23/ton	$132/ton

Source: SGM

[1] We suppose that this price is higher than the domestic political process is likely to accept.

Impaired compliance

In a world without effective international trading, a country that is substantially over its target in 2007 might figure that compliance is hopeless, because it is physically impossible to reduce emissions in so short a span of time. But in a world with effective international trading, a country has no defense against the charge that it can always buy its way out of a shortfall. Because compliance is physically possible in such a world, countries will take the agreement more seriously, and will take correspondingly serious actions.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas_W._Elmendorf@oa.eop.gov (Douglas_W._Elmendorf@oa.eop.gov [UNKNOWN])

CREATION DATE/TIME:21-AUG-1998 18:08:17.00

SUBJECT: speech

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

CC: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

TEXT:
(See attached file: intro1.wpd)

Here's a draft of the first few paragraphs of your upcoming speech--a brief review of current economic conditions and an introduction to the longer-term issues you're going to focus on. I'll leave a hard copy in your office.

Doug
- intro1.wpd=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D87]MAIL43099433E.226 to ASCII,
The following is a HEX DUMP:

Economic Challenges for the 21st Century

A man walks into a bar with a duck on his shoulder. The bartender asks "What are you doing with that pig?" The man responds, "Are you stupid? That's not a pig, that's a duck." And the bartender says, "I was talking to the duck."

It is a pleasure for me to have the opportunity to talk to you today. The American economy is now enjoying its best performance in decades. Unemployment and inflation are at their lowest levels in a generation, and the elimination of the federal budget deficit has caused the net national saving rate to double since 1992. At the same time, the near-term outlook includes some clear risks, and I will touch on these in a moment. But I would like to focus my comments on three economic challenges for the 21st century--Social Security, climate change, and the design of international financial institutions.

Beginning with current conditions, the U.S. economy appears to have considerable forward momentum. As you know, growth of real GDP slowed sharply in the second quarter from its extraordinary first-quarter pace. Inventory accumulation shifted down, and net exports plummeted, with exports dropping 8 percent at an annual rate. Yet, domestic final demand remained quite strong: Consumer spending advanced sharply again, and investment in both business equipment and housing continued to move up at a double-digit rate.

One result of robust economic growth over the past several years has been a marked tightening of labor markets. The striking decline in the unemployment rate has boosted real wage gains and created new opportunities for many Americans. But it has also increased the risk that wage gains will outstrip productivity advances and lead to a pickup in inflation. A different, and perhaps more worrisome risk, is presented by economic developments overseas.

Serious economic problems in Japan and many East Asian countries have not been resolved as quickly as many observers had hoped, and the recent financial turmoil in Russia has increased the dangers for emerging market economies around the world. Portfolio shifts toward the safety and liquidity of U.S. assets have helped to reduce our interest rates and thereby to boost household and business spending. But the sharp decline in net exports in the first half of the year emphasizes that slumping foreign economies can hinder U.S. economic growth.

Instead of dwelling on these immediate concerns, however, I want to use most of my time to discuss longer-term challenges. Let me begin with Social Security reform. ...

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:24-AUG-1998 10:24:07.00

SUBJECT: update on Social Security

TO: rjakerlof (rjakerlof @ aol.com [UNKNOWN])
READ:UNKNOWN

TEXT:
---------------------- Forwarded by Janet L. Yellen/CEA/EOP on 08/24/98
10:23 AM ---------------------------

Douglas W. Elmendorf
08/21/98 06:56:48 PM
Record Type: Record

To: Janet L. Yellen/CEA/EOP
cc: Douglas_W._Elmendorf @ oa.eop.gov
Subject: update on Social Security

Janet:

Since I'll be away next week (reachable at 252-261-4669 if you need me), I want to update you on the Social Security reform process. As you know, the Technical Working Group has spawned a large number of sub-groups, and Jeff Liebman and David Wilcox are pulling together a binder of materials that summarize what these groups have accomplished in the past two weeks. (The binder is intended for Gene and Larry, and it's not clear that it will be distributed to the whole working group, but I've asked Jeff to g
ive you a copy.)

Here are the main topics:

1. Women. Becky and Jeff are in touch on this. The President will have an "event" on women and SS in September.

2. Integration of Individual Accounts with Traditional Benefits. This is about clawback rates, minimum guarantees, tax rates, etc. I've been working with Jeff, David, and others on this, and Steve Goss is running the numbers for various types of plans.

3. Effect on Saving. I've written (with significant input from Jeff and David) a description of how to calculate these effects under various

assumptions. (This is attached.) Steve Goss is implementing this. The next step in this area is to finish the memo for the President about how to think about this topic, and I'll try to make that a priority when I get back.

4. Retirement/Health. Corky and Bob are working on this, and I've been kibitzing in meetings with Mark McClellan (David's deputy who is coordinating this group and generating a bunch of the health information from the Treasury staff).

5. Annuities. I wrote (with Gillian Hunter from OTA at Treasury) a description of the current annuities market. (This is attached.) David is integrating this memo with other information and numbers produced by OMB.

6. Non-IA options, or what is the best Ball/Aaron/Reischauer plan we can devise? This topic is stalled until Jeff and I have time to talk about it, and we'd like your input. I've been able to learn a lot about the Swedish system, which may be helpful in this process.

7. The Return on Equities. David's staff has produced a memo arguing that the return to equities over the next 75 years will be well below what we've been assuming. I've had several conversations with Jeff (and one with David) about whether this is right. A bit on this topic is included in the attachment on saving.

I'd love to tell you more about all of these topics when you have a chance. I may also need some guidance on how to set priorities between this work and other things. For example, I'm also preparing several things for a group on consumer financial behavior and education, and Chad wants me to write a WEB piece when I get back.

Doug

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D16]MAIL455464530.226 to ASCII,
The following is a HEX DUMP:

The Current Annuity Market
Doug Elmendorf and Gillian Hunter
8/18/98

1. Almost all of the "annuity market" involves tax-sheltered investing rather than insurance about length of life.

a) With *immediate* annuities, payments begin immediately. With *deferred* annuities, payments are deferred. In fact, almost everybody who owns a deferred annuity "cashes out" before receiving any annuity payments--they use deferred annuities for tax-sheltered saving (the tax treatment is parallel to after-tax IRAs).

b) Total premium payments for individual annuities in 1995 were $99 billion, of which payments for immediate annuities represented only $6 billion. (Other ways of comparing these markets suggest that immediate annuities are even less important.)

2. Few people choose "pure" annuity payouts.

a) *Single life* annuities make payments for the length of one person's life. *Two life* or *joint and survivor* annuities make payments to a surviving spouse. *Period certain* or *term certain* annuities make payments for at least n years (with *installment refund* annuities as a variant).

b) In a 1993 survey, 93% of annuitants chose single life. Only 8% chose no refund or guarantee option. In 1994 in TIAA-CREF, roughly half of annuitants chose single life. Among them, 1/3 took no guarantee, with the rest split fairly evenly among 10-, 15-, and 20-year guarantee periods.

c) Pure annuities seem less popular today than several years ago. This may be related to the stock-market boom.

3. Variable annuities are mostly a new phenomenon in the immediate annuity market.

a) *Fixed nonparticipating* annuities pay a predetermined amount each year. *Fixed participating* annuities guarantee a minimum amount but pay more if the insurance company does well. *Variable* annuities are complicated (see (b)).

b) Variable annuities work in the following way: Assume an "investment rate" (say 5%). Given that investment rate, your life expectancy, and your lump sum of money (say $100,000), calculate the fixed annuity payment you would receive (say $9000). Choose investments for the lump sum. Then:

payment in 1st year = $9000

payment in 2nd year = $9000*(1+actual return)/(1+assumed investment rate)

payment in 3rd year = payment in 2nd year*(1+actual return)/(1+assumed investment rate)

Some implications are:

i) If your lump sum grows at exactly the assumed investment rate each year, your annuity is a fixed amount.

ii) If your lump sum grows faster than the investment rate each year, your annuity grows each year.

iii) If your lump sum falls in half in one year, your annuity falls roughly in half as well.

iv) Changes in portfolio value are essentially smoothed over your remaining life.

4. Adverse selection is a serious problem.

a) Warshawsky (1988) estimated the quantitative importance of this phenomenon by comparing mortality probabilities of the general population to those of annuity purchasers. He found the average cost over 1941-84 to be 13 percent of the amount invested. Mitchell, Poterba, Warshawsky, and Brown (1998) updated the calculation with some improvements through 1995; they found that for the 1970s, early 1980s, and 1995, the cost of adverse selection was about 9 percent. The explanation for the decline in unclear.

b) A question for Social Security reform: Would reducing current annuitized benefits reduce the adverse selection problem? Walliser says "only slightly."

5. Transactions costs are high.

a) Warshawsky (1988) estimated that over 1941-84, transactions costs on fixed annuities averaged 9 percent of the amount invested. These costs include marketing, corporate overhead, income taxes, and profits. Costs varied significantly over time, with higher costs when interest rates were high or rising. MPWB estimated that transactions costs fell to 4 percent by 1995, which Warshawsky (1997) attributes largely to the interest-rate cycle.

b) Variable annuities have an extra level of administrative costs, because they have asset management fees (e.g., mutual fund fees) in addition to insurance fees.

c) Some of this load is explicit. The rest arises implicitly from choosing mortality tables that are too conservative.

d) Costs vary across companies. Warshawsky (1998) presents the payouts on a $100,000 purchase of a fixed annuity for men age 65 in 1996:

	monthly	annual
first quartile payout:	$730	$8760
average payout:	760	9120
third quartile payout:	790	9480

e) A question for Social Security reform: Are these transactions costs socially wasteful? Not entirely. Explanation of annuities is probably valuable. Provision for investment risk and return to capital are unavoidable. Taxes go to the government.

f) A question for Social Security reform: Would these transactions costs decline over time? Maybe, as people become more familiar with annuities. Mutual fund fees have fallen. (What is different about this market and the markets for mutual funds and financial services and products more generally?)

g) A question for Social Security reform: Can these costs be effectively regulated? New York State limits marketing costs to 7% of premiums. Maybe the federal government could limit costs and force insurers to use a standard life table of its choosing (to avoid the implicit load). But how would this affect current state regulation and insurance of insurers?

Issues to Keep in Mind:

1. Should annuity purchase be mandated?

   a) adverse selection
   b) moral hazard of running down one's assets and then needing public assistance
   c) if mandated, it's easier to require unisex pricing or ban risk underwriting if we want to (but it's not completely easy if people can choose among insurers)
   d) do people understand why annuities don't seem to pay much?
   e) what about the age 64-1/2 vs. Age 65-1/2 problem?

2. Should annuity purchase be handled privately or by the government?

   a) are marketing costs and commissions socially wasteful?
   b) what about insuring insurance companies?

c) will the government innovate?
d) avoiding adverse selection across insurers

3. Different reform proposals handle annuitization differently.

   a) Advisory Council's IA proposal required annuitization with a one-year guarantee to survivors regardless of when annuitant died.
   b) Advisory Council's PSA proposal did not require annuitization.

4. Insuring the Insurers

   a) State guarantee funds currently provide some backup in case insurance companies go bankrupt. But they might be unable or unwilling to back huge amounts of new funds.

References:

Brown and Poterba (1998), "Joint Life Annuities and Annuity Demand by Married Couples"
CBO (1998), "Social Security Privatization and the Annuities Market"
Friedman and Warshawsky (1988), "Annuity Prices and Saving Behavior in the United States"
Friedman and Warshawsky (1990), "The Cost of Annuities: Implications for Saving Behavior and Bequests"
Mitchell, Poterba, Warshawsky and Brown (1998), formerly MPW (1997), "New Evidence on the Money's Worth of Individual Annuities"
Poterba (1997), "The History of Annuities in the United States"
Walliser (1997), "Understanding Adverse Selection in the Annuities Market and the Impact of Privatizing Social Security"
Warshawsky (1988), "Private Annuity Markets in the United States, 1919-1984"
Warshawsky (1997), "The Market for Individual Annuities and the Reform of Social Security"

The Effect on National Saving of Potential Social Security Reforms
8/21/98

The first part of this memo describes the proposed formulas for Steve Goss to use to calculate the effect on national saving of alternative Social Security reform proposals. The second part of the memo explains the methodology and assumptions underlying those formulas.

1. Formulas

Let: DNW_t = deviation of national wealth in year t from its value in the absence of reform
DNS_t = deviation of national saving in year t from its value in the absence of reform
(Both are calculated in nominal terms and should be shown as shares of GDP.)

Then: $DNW_1 = S_1$
$DNW_t = S_t + DNW_{t-1}*(1+m)$ for t>1
where S_t is defined below, and m is the marginal product of capital (.07 plus inflation).

And: $DNS_t = DNW_t - DNW_{t-1}$

We define S_t in two different ways that correspond to alternative views of the political economy of the federal budget:

Political economy rule #1: On-budget spending and taxes are unaffected by reform.

S_t = $DSSTaxes_t$ - $DSSBenefits_t$ - $(\text{Consumption from IAs})_t$

DSSTaxes = deviation of traditional Social Security taxes (i.e., excluding any clawbacks) from value in the absence of reform
DSSBenefits = deviation of traditional SS benefits from value in the absence of reform
Consumption from IAs = withdrawals from IAs - clawed-back amount
= (1-clawback rate)*(withdrawals from IAs)

Political economy rule #2: On-budget spending and taxes adjust to maintain the baseline unified surplus/deficit. (Also, equity purchases and transfers of the unified budget surplus to the trust fund both reduce the unified surplus, although if you use the surplus to buy equities, you can't count it twice.)

S_t = Maximum of $(\text{Trust fund net purchases of equities, Transfers of UB surplus to trust fund})_t$ + $(\text{Contributions to IAs-Withdrawals from IAs})_t$

2. Methodology and Assumptions

The first part of this section describes our simplifying assumptions. Many of these assumptions could be relaxed, but at the price of additional complexity and reduced clarity. The second part of the section gives an intuitive description of the formulas on the previous page, and the third part reviews our choice of the marginal product of capital. The last part of the section provides further background on the formulas.

Worrisome Shortcuts

We assume that private saving is unaffected by Social Security reform. For example, we assume that all withdrawals from individual accounts are spent, and we assume that any tax cuts are spent. We could add more sophisticated behavioral responses later if people are interested. (We are ignoring any voluntary contributions to IAs, because including these contributions and later withdrawals without allowing for changes in other private saving seems silly.)

We assume that the political economy rules are symmetric. One could imagine a situation where surpluses are entirely spent away but deficits do not generate sufficient spending cuts to restore budget balance.

We ignore taxes on capital by assuming that the pre-tax marginal product accrues entirely to the sector that owns the capital. One implication is that we ignore fiscal effects on state and local governments. Once again, we could add the effects of taxes if people want, and we describe some of the appropriate modifications to our formulas on the next page.

Description of Formulas

The formulas we propose involve two basic steps:
1) for each year, calculate the increment to the capital stock out of non-capital income (S), and
2) cumulate those increments over time assuming that the incremental capital generates a marginal product (m).

We generated these formulas in two ways that provided a useful check on each other. One approach was simply to think through the logical structure of the problem and the way that different sectors would interact. The other approach was to build a spreadsheet that explicitly calculates income flows and net worth for each of these sectors and then develop shortcuts to determine effects on national wealth.

Now consider the intuition behind the formulas. Begin with the effects of changing social security taxes or benefits. Under political economy rule #1, these changes have one-for-one effects on national saving because both private saving and other government saving are unchanged. Under rule #2, these changes have no effect on national saving because on-budget taxes or spending are changed by an exactly offsetting amount.

Consider the effects of creating individual accounts. Think about the effect of IAs on two sectors: the government and the IAs themselves. (Because other private saving is fixed, we can ignore it.) The effect on government saving is: -contributions + (clawback rate*withdrawals). The effect on saving in IAs is: contributions - withdrawals. Under rule #1, on-budget taxes and spending are unaffected, so we can ignore them. Then, summing across the government and IA sector, contributions cancel out, leaving [(clawback rate-1)*withdrawals] as the net saving effect. Under rule #2, on-budget taxes and spending adjust to keep government saving unchanged. That leaves just the IA saving, which equals [contributions-withdrawals].

Consider the effects of swapping bonds for equities in the trust fund. Under rule #1, the reduction in the unified surplus has no effect on taxes or government spending. This is purely an asset swap, which has no effect on national saving. Under rule #2, the reduction in the unified surplus reduces spending or raises taxes by an exactly offsetting amount, which creates additional saving in that amount.[1]

(As an aside, separating out the federal corporate tax piece of the marginal product of capital would be straightforward. Suppose that political economy rule #1 were interpreted to mean that on-budget spending and taxes *excluding capital taxes* are unaffected by the unified surplus. Then, any extra corporate tax revenue from additional capital is saved by the government, and national wealth compounds at the pre-tax rate as we have assumed; our formulas require no modification. In contrast, under political economy rule #2, the additional corporate tax revenue is consumed. Our formulas would need to be modified to subtract this amount from S for each year.)

(Adding personal capital taxes would be more complicated for two reasons. First, private saving might respond to changes in capital taxes paid. Second, the amount of capital taxes paid would depend on the portfolio allocation of IAs as well as of the trust fund.)

The Marginal Product of Capital

We use .07 as our estimate of the real marginal product of capital. Elmendorf and

[1] It might seem that one could measure the effect of reform on national wealth by calculating its effect on debt held by the public and on equity holdings of the trust fund. But that captures only the government's wealth, and ignores private wealth. If people hold less equities and more debt, their wealth grows more slowly, and that effect must be included.

Mankiw (1998) used BEA data on national income and the capital stock to calculate that the MP_k has averaged about .06 over the past 35 years. But they admitted that their calculation excludes the return to capital that accrues to state and local governments through property taxes; according to Feldstein, Poterba and Dicks-Mireaux (1983) and Poterba (1997), allowing for such taxes boosts the return by roughly .01. Note that our chosen value of .07 is less than the marginal product of *nonfinancial corporate* capital, which is often cited as the return to additional national saving. Because corporate capital is more heavily taxed than other capital (such as housing), it earns a higher pre-tax return, estimated by Poterba (1997) to be .085. Yet, we find no reason to assume that any addition to the capital stock would flow disproportionately to corporations.

There are two reasons to expect the return to capital to decline over time, although we have not attempted to quantify these effects to use in the simulations.[2] One reason is the aging of the population, which will depress the MP_k by reducing the number of workers. However, the amount of capital will change as well, as saving responds to aging directly and to changes in the return to capital, so calibrating the overall effect of aging on the MP_k is quite difficult. Another reason that the MP_k might fall is that the nation regularly adds to the capital stock every year through national saving, and would add even more under some Social Security reform proposals; a larger capital stock means a lower return to a marginal unit of capital.

As an aside, our assumed rate of return on equities should be consistent with our view of the marginal product of corporate capital. Suppose that the present value of $1 of expected future corporate earnings is unchanged on average over long periods.[3] Then, the return to holding equities will equal the return to the underlying corporate capital after paying corporate taxes (where the effective tax rate is about 27 percent, according to Auerbach, 1996). If we expect the marginal product of that capital to average 7.5 percent in the future (1 percentage point below the past average), then the real return to equities will be 5.5 percent. Combined with Steve Goss's assumption of 3.5 percent inflation, the nominal return to equities will be 9 percent.

More About the Formulas

We assume a closed economy with four domestic sectors and four assets/liabilities:

- sectors: the Social Security trust fund, the rest of the federal government, individual accounts, the rest of the private sector

[2] Elmendorf and Mankiw also noted that their measure of the capital stock excludes inventories and land; including these elements would depress the estimated return on capital even in the historical period.

[3] In other words, assume that Tobin's q must average 1 in the long run, even if it can deviate substantially in the short run.

- financial instruments: special government bonds issued only to the trust fund, other federal bonds, corporate bonds (these are included in the spreadsheet but we have not yet considered any reforms that involve them), equities

This mechanical approach provides a useful check on rules of thumb that occur to us, and will be especially useful if we add capital taxes or behavioral offsets or other complicating factors.

The income on special govt bonds is based on our chosen interest rate; the income on equities depends on our chosen equity return.

We calculate private and public wealth separately, but not private and public saving. Doing so would be more complicated than it first appears, because some of the return to equities takes the form of revaluations that do not appear in the NIPA. Suppose that a private firm retains earnings that raise the price of equities owned by the government; the gain in wealth is the government's, but the NIPA will label the saving "private saving." On the other hand, if a private firm pays those earnings to the government as dividends that are then used to purchase new shares, the gain in wealth will still be the government's, but the NIPA will label the saving "public saving."

The trust fund's balance sheet is:

Assets	Liabilities
special govt bonds	
equities	

The trust fund balance in period t equals: [the balance in period (t-1)] + [income from the (t-1) balance] + [Social Security taxes] + [clawbacks] - [Social Security benefits].

The rest of the government's balance sheet is:

Assets	Liabilities
	special govt bonds
	other federal bonds

The ROG balance in period t equals: [the balance in period (t-1)] + [income from the (t-1) balance] + [corporate taxes] + [personal capital taxes] - [IA contributions] + [other taxes less spending].

Other federal bonds equals debt held by the public (DHBP). Capital income equals the negative of interest payments. Corporate taxes equal τ_c / (1-τ_c) * e * K , where τ_c is the corporate tax rate, e is the after-corporate tax return to equity (the rate at which equity holdings grow from year-to-year), and K is the incremental capital stock. Personal capital taxes are partly [τ_e * e * K_{ps}], where τ_e is the effective personal tax rate on equity and K_{ps} is the capital stock owned by the other private sector (which is taxable). Personal capital taxes also include taxes on bond income, but the net effect is small (private bond interest payments are deductible; interest receipts on private holdings of private and government bonds are taxed).

The individual accounts balance sheet is:

Assets	Liabilities
other federal bonds	
corp bonds	
equities	

The IA balance in period t equals: [the balance in period (t-1)] + [income from the (t-1) balance] + [contributions] - [withdrawals].

The balance sheet of the rest of the private sector is:

Assets	Liabilities
other federal bonds	
equities	
corp bonds (whatever's not held by IAs)	corp bonds

The other private sector's balance in period t equals: [the balance in period (t-1)] + [income from the (t-1) balance] + [income] - [consumption].

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:24-AUG-1998 10:25:20.00

SUBJECT: Workability & (In)efficiency of Trading Limits

TO: rjakerlof (rjakerlof @ aol.com [UNKNOWN])
READ:UNKNOWN

TEXT:
---------------------- Forwarded by Janet L. Yellen/CEA/EOP on 08/24/98
10:24 AM ---------------------------

Jeffrey A. Frankel
08/21/98 05:32:27 PM
Record Type: Record

To: David B Sandalow/CEQ/EOP, david.wilcox @ treas.sprint.com @ inet,
robert.cumby @ treas.sprint.com @ inet, Janet L. Yellen/CEA/EOP
cc: Joseph E. Aldy/CEA/EOP, Quindi C. Franco/CEA/EOP, Alan S.
Polasky/CEA/EOP
Subject: Workability & (In)efficiency of Trading Limits

This is a draft of the requested (3-part) memo on the (in)feasibility of
limits on trading. I propose to send it to Todd Monday morning.
JF

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D46]MAIL474564530.226 to ASCII,
The following is a HEX DUMP:

DRAFT

To: Todd Stern

From: Jeff Frankel

Re: (Un)workability and (In)efficiency of Limits on Trading

The Administration has been united and consistent in emphasizing the critical importance of international trading to bring down the costs of meeting the Kyoto targets. We have argued strongly against European proposals to put a limit on trading -- pointing out the loss in efficiency that would result -- and we must continue to do so. But one should not get carried away. Limits on trading are not literally unworkable.

Two memos are attached. The first explains how limits on trading could be implemented if necessary, albeit with an extra layer of complexity -- just so that we understand the issue in our own minds. The second memo explains, in terms suitable for use with other countries, why limits on trading would be highly distortionary (even if we no longer feel able to assert that they would be literally unworkable).

1. Limits to Trade Can be Workable, Even Though Undesirable

Some proposals on international trading would limit the use of flexible mechanisms (international trading of Annex B 'assigned amount units,' Joint Implementation, and the Clean Development Mechanism) in meeting obligations under the convention. Such restrictions would add an additional layer of complexity, but are not necessarily fatal to the market.

Regardless of limits to trade, an institutional framework is required for trading.

We have consistently emphasized the central role of the private sector in doing the work of Kyoto. Nevertheless, to ensure the proper functioning of the permit market and that we meet our emissions commitments, we recognize the need for monitoring, recordkeeping, and enforcement by governments, at least at the domestic level.

At the international level, it is not realistic to have the private market undertake trades freely across national boarders without government oversight. Nations will need to demonstrate their compliance at the end of the budget period and will be concerned about counterfeiting, balance of payment statistics, and so on. Therefore, at a minimum, there will need to be a national registry of all international permit trades.

The added burden of implementing limits to trade would not be insurmountable.

Essentially, domestic permits would need to be traded for foreign permits at an "exchange rate" which reflected the added constraint of only being able to import or export a set quantity of permits. There are a number of ways to implement a limit, but the simplest might be for the government to issue "right-to-import" or "right-to-export" certificates up to the limit. If, for example, international purchases were recorded at the national trading registry, then the buyer would have to present one right-to-import certificate along with a foreign permit for it to be officially accepted. (They would be "*net* import" certificates: An American who sold a permit net-import certificate, which he would be free either to use or sell.) Similarly, anyone wanting to sell a permit internationally would have to acquire one right-to-export certificate and combine it with one domestic permit in order to export. Arbitrage would equate the price of domestic permits to the international price of permits plus the certificate price. The price of the certificates would fluctuate on the market, depending on how binding the limit is. Their price would be zero -- i.e., the domestic price and foreign price would be the same -- if the constraint were not binding. Similar mechanisms are currently used to implement import and export quotas throughout the world.

2. Limits to Trade are Highly Distortionary

Restrictions on the use of flexible instruments would be highly distortionary, raising the global costs of addressing climate change while not providing any additional environmental protection.

Difficulty in determining a baseline

Certain proposals would limit the reductions achieved abroad to a given percentage of total reductions, which requires defining total reductions from some business-as-usual (BAU) baseline. However, there is no internationally agreed methodology for forecasting emissions, and therefore international negotiations to determine such baselines are likely to be quite complicated. Of course, trading restrictions based on tons, instead of a percentage of BAU, would avoid this problem. In this case, the tonnage restriction for each country would have to be set, creating its own challenge for international negotiations.

Interference with the Clean Development Mechanism

According to the Kyoto Protocol, credits from CDM projects undertaken between 2000 and 2008 can be applied during the commitment period -- providing strong incentive for such investment. Restrictions on the share of reductions from flexible mechanisms could easily interfere with this incentive. Without knowing how reductions in 2008-2012 will be achieved, firms receiving credits now will not know whether those credits will ultimately be applicable to Annex I commitments or not. In other words, they will not know the potential value of their credits, increasing the uncertainty of their investments.

Increased administrative complexity

Restrictions will lead to requirements that both sellers and buyers have to report transactions, and to the development of mechanisms to ensure that parties stay within their limits. This will add an additional layer of transaction costs and administrative burden on the system. This creates an artificial market barrier that the new market will have to overcome, decreasing its efficiency.

Increased costs of meeting commitments.

Limits are distortionary. They would create differences in permit prices across countries (a foreign permit would trade at a premium to domestic permits), leading to a situation where countries pay a needlessly high price to achieve the same level of global emissions. Modelers have estimated the efficiency cost of placing limits on global trading:

Permit Prices for a Competitive Market of Annex I and Key Developing Countries

Country/Region	Domestic Permit Price, No Trading Constraint	Domestic Permit Price, 50% of Reductions Must Occur at Home
United States	$23/ton	$59/ton[1]
European Union	$23/ton	$79/ton
Australia	$23/ton	$44/ton
Japan	$23/ton	$158/ton
Canada	$23/ton	$132/ton

Source: SGM

[1] We suppose that this price is higher than the domestic political process is likely to accept.

Impaired compliance

In a world without effective international trading, a country that is substantially over its target in 2007 might figure that compliance is hopeless, because it is physically impossible to reduce emissions in so short a span of time. But in a world with effective international trading, a country has no defense against the charge that it can always buy its way out of a shortfall. Because compliance is physically possible in such a world, countries will take the agreement more seriously, and will take correspondingly serious actions.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Nouriel Roubini (CN=Nouriel Roubini/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:24-AUG-1998 09:21:19.00

SUBJECT: Some news Monday morning

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

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

TEXT:
Top Russian shares managed slight gains on Monday, climbing back from
lower levels, as the country's battered stock market shrugged off news of
the
recall of Prime Minister Viktor Chernomyrdin as prime minister. The
battered Russian rouble, effectively allowed to devalue last week, slid
further against the dollar.

The rouble, which the government devalued last week, fell to 7.1400 from
7.0050 against the dollar at the Moscow Interbank Currency Exchange and
analysts said it was likely to remain
weak amid the current political uncertainty and worries about an end to t
he country's financial crisis would come.

Nervousness in Latin America that this week may be worse than last week.

Markets and currencies down in Asia overnite.

Jeff Frankel cited in the WSJ today as:

"Even defenders of free markets are dismayed by the
power of currency
markets to punish nations beyond the extent of their
transgressions.
Theorists claim "that speculators only punish countries
that follow bad
policies, and that they punish them to a degree
proportional to the
policies," says White House economic adviser Jeffrey
Frankel. But
Mexico's experience calls that thinking into question:
"Every time we have
one of these [currency crises], it gets harder to argue
that markets work
perfectly," says Mr. Frankel."

Stan Fischer criticizes Germany and US:
IMF's Fischer Blames Kohl For Lack Of G-7 Russia Rescue -FAZ

Dow Jones Newswires

BONN -- Stanley Fischer, deputy director of the International Monetary Fund, blamed Russia's deepening financial crisis on the failure of German Chancellor Helmut Kohl to spur the Group of Seven lead ing industrial nations to give direct financial assistance, in an interview in a German newspaper Monday.

"It was clear that the situation (in Russia) had become untenable after the G-7 failed to rush to Russia's aid," Fischer said in Germany's Frankfurter Allgemeine Zeitung. "Without the Germans, of course no other European country was prepared to support Russia financially," he added.

"I'm not sure whether Chancellor Helmut Kohl wouldn't have acted differently if elections were two years away and not six weeks," he said.

The German chancellor's failure to take the helm was exacerbated by the fact that U.S. President Bill Clinton is "in difficulties" and thus unable to "lead from a position of strength," Fischer said. "Without Germany, no other European country was prepared to help Russia.

Expected Russian Conversion plan (not announced yet):

Russia's domestic government debt will be converted into new paper under equal conditions for foreign and local investors, the ITAR-Tass news agency quoted the outgoing Prime Minister, Sergei Kiriyenko as saying Monday.

The debt swap was scheduled to be announced last Wednesday, but foreign investors said it was delayed after they cried foul over the terms for foreign investors in the original plan.

It isn't clear whether the government will be offering investors face value or market value for their treasuries. However, investors are expecting the government to offer them three swap plans.

Investors are expecting one plan to offer five-year, dollar denominated paper offering a coupon of 6%, while another plan would offer three-year, ruble-denominated paper with a much higher coupon in excess of 50%. A last option would allow investors to keep their existing treasuries, and, after two years, cash them in for paper exchangeable into dollars.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:24-AUG-1998 10:26:44.00

SUBJECT: paper on emissions trading rules

TO: rjakerlof (rjakerlof @ aol.com [UNKNOWN])
READ:UNKNOWN

TEXT:
---------------------- Forwarded by Janet L. Yellen/CEA/EOP on 08/24/98
10:26 AM ---------------------------

Jeffrey A. Frankel
08/21/98 09:07:18 AM
Record Type: Record

To: Alan S. Polasky/CEA/EOP, Joseph E. Aldy/CEA/EOP, Quindi C. Franco/CEA/EOP
cc: Janet L. Yellen/CEA/EOP
Subject: paper on emissions trading rules

We're meeting at 10:30 on this in the WCCCenter. (Who wants to come? Shouldn't be all 4 of us.) Several of us should read this paper by then.
JF
---------------------- Forwarded by Jeffrey A. Frankel/CEA/EOP on 08/21/98
09:04 AM ---------------------------

Ray.R.S.Squitieri @ MS01.DO.treas.sprint.com
08/20/98 06:37:00 PM
Record Type: Record

To: Dirk Forrister, Jeffrey A. Frankel, T J. Glauthier, James W. Rubin
cc:
Subject: paper on emissions trading rules

Date: 08/20/1998 06:34 pm (Thursday)
From: Ray Squitieri
To: kimble-sandalow
Subject: paper on emissions trading rules

This paper will be the basis for discussion in Friday's meeting. The attachment contains the same paper in Word Perfect format.

Addressing the risk of overselling in international emissions trading

Issue for Decision: How to address the risk that a party may oversell emissions permits, and fail to retain enough to cover its emissions?

I. Background

In proposing trading rules, the US has attempted to strike a balance between economic efficiency and incentives for compliance. An efficient market in emissions permits will help keep costs down. Incentives for compliance are needed to achieve our environmental objectives. The agencies have come to agreement on most aspects of trading rules, but have not yet agreed on the proper allocation of the risk of overselling.

The US has several objectives in crafting rules for emission trading. Trading rules should create an economically efficient market. In addition, they should help achieve the Kyoto targets, should create an incentive for compliance, and should encourage participation by the FSU and prospective new entrants from the developing world.

The EU and environmental groups are concerned about overselling, especially by Russia and Ukraine. They fear that these countries will oversell their allotments early in the 5-year compliance period (2008-2012), and cite weak compliance and regulatory regimes in these countries. They believe that trading rules should contain additional incentives for compliance.

Others, including potential market participants, are concerned that some compliance incentives could hobble the nascent market in tradable permits. They believe that trading rules should focus, above all else, on facilitating development of the new market.

Recognizing that there are limited levers in traditional international law to
compel Party compliance, the US has supported including positive incentives for compliance within the trading rules, where that can be done without significantly burdening efficient market function. Specifically, before Kyoto the US proposed including two compliance provisions in trading rules:

* A Party not complying with its measurement and reporting obligations would lose its eligibility to engage in further emissions trading.

* A Party that has run out of assigned amount during the 5-year commitment period would lose its eligibility to make further sales (although it would still be able to buy), so long as it remains in deficit.

II. Options

1) Seller bears the risk. If the selling party does not possess enough assigned amount to cover its emissions at the end of the period, the excess, with a penalty, would be deducted from its assigned amount for the next budget period. The party might also be subject to restrictions of sales in the second period. Buyers are responsible for ensuring that they

obtain clear title to any units purchased, but are not subject to the risk that permits will be recalled or devalued. Tradeable units already sold remain the property of the buyer.

Benefits: Simplest and most efficient, because transaction costs are lowest. Buyers would be certain of the face value of any tonnes bought, and tonnes would be interchangeable. Buyers need not assess the risk of the selling Party*s ultimate compliance. Loss of trading eligibility
and repayment requirements provide incentive for compliance.

Downsides: Significant risk of overselling and unremedied excess emissions. Compliance incentives depend on Parties* commitment to participate in the global climate change treaty over the long haul. Loss
of trading eligibility and repayment requirements alone may not be sufficient to prevent overselling by a government that seeks a short-term financial bonus.

2) Buyer bears the risk. If the selling Party does not possess enough assigned amount to cover its emissions at the end of the period, emissions permits that it had previously sold would be taken back from buyers and applied to cover the shortfall. The last permits sold would be the first ones returned (LIFO); alternatively, all permits sold could be devalued by the same proportion. Buyers, who would be on notice of these rules from the start, would have to assess the risks of a Party*s non-compliance. They might manage risks in several ways: by discounting prices paid, creating a portfolio of permits from different Parties and of different vintages; by making contracts contingent on compliance of the selling Party; or by buying options or taking other offsetting positions.

Benefits: Creates strongest protection against overselling. Uses market mechanisms to promote environmental objectives. A Party at risk of having excess emissions will receive lower prices for its permits; this creates a financial incentive to comply. Excess emissions are automatically covered, up to the extent of prior sales.

Downsides: Likely to increase costs. Likely to impede development of trading, as allowances would differ in risk (and price) according to the original seller. Would require private sector buyers to assess and manage the likelihood of selling Parties* eventual non-compliance. Market tools for doing so efficiently could develop over time, but are not likely to exist at first; this could impose a significant burden on the nascent emissions trading market.

Some have raised the possibility of a *domino effect,* in which noncompliance of a seller leads to noncompliance not only of the first buyer but of all subsequent buyers as well, implying de facto joint-and-several liability. A cumbersome iterative international process would be necessary if one party*s compliance were linked to another*s. Others have argued that this domino problem could be limited either by a LIFO rule, or by a rule limiting liability to the first buyer only.

Options (3), (4), and (4a) are intended to offer more protection against overselling than *seller bears the risk,* and less burden on the trading market than *buyer bears the risk.*

(3) Seller bears the risk, percentage cap on sales. In the first year, if a country had net sales greater than, for example, one-fifth of its 5-year allocation, then it could not sell any more, until emissions data came in showing that the country had repaid its deficit through some combination of emission reductions and permit purchases. In the second year, if the country had cumulative net sales greater than two-fifths of its 5-year allocation, the same conditions would apply; and so on for later years. Naturally, shares other than one-fifth, two-fifths, etc. could be used. The first-year share should be well below 100 percent of the five-year allocation, and yet well above any reasonable level of sustainable legitimate emissions sales, including *hot air.*

Benefits: Trading takes place with low transaction costs because buyers do not bear the risks of sellers* non-compliance. Cap limits potential overselling, compared to option 1).

Downsides: Although caps limit overselling, they do not prevent it. Unclear how these options would work where parties to the Convention devolve emissions permits to firms, as an individual firm*s right to sell would depend on whether prior sales by other firms had reached the cap. This option requires detailed data on both spot and forward trades, as well as emissions, data that the central government may not have. Sellers may find ways to game the system.

(4) Seller bears the risk, with reserve account. Sellers would be required to set aside a specified percentage (perhaps 10 percent or 20 percent) of the total sold. These permits could be sold at or near the end of the five-year period, if they were not needed to cover the selling Party*s emissions. Until then, they would serve as a compliance reserve against possible excess emissions.

Benefits: Low transaction costs, as in option (3). Compliance reserve grows with volume of permit sales. Reserve margin offers more protection against overselling than option (1). Whether protection against overselling is more or less than provided by option (3) is difficult to analyze, depending in part on the percentages chosen.

Downsides: Protection against overselling is still incomplete for any percentage set aside less than 50%. Interim permit prices (prices during the five-year period) may rise because fewer permits would be available for sale, until they are released at the end. The higher the percentage set aside, the greater this effect.

(4a) Seller bears the risk, buyer liability applies to reserve account. Variations on options (3) and (4) could allow sale of permits above the cap or sale of permits in the compliance reserve, under the condition of buyer liability. In other words, most permits would trade without any contingencies, but sales of the permits above the cap or in the compliance reserve would be subject to the risk of being recalled and returned to the seller Party to cover a shortfall at the end of the period.

Benefits: Provides more protection against overselling than options (3) and (4), because sales above the cap are subject to recall against seller*s excess emissions. All permits are allowed to go to market; most trade on basis of seller liability without contingencies, while
buyer liability is focused where most pertinent to compliance risk. May provide selling parties with more incentives for compliance, since a price signal reflecting the party*s compliance risk will be created for the permits in the compliance reserve.

Downsides: Same as option 2); potential burdens on the market are limited to only those permits trading under buyer liability.

III. Positions of US interest groups and other parties

The following picture emerges from a series of stakeholder meetings coordinated by the White House Climate Change Task Force:

* Most private sector potential buyers and brokers expressed a strong preference for avoiding buyer liability, although they recognized that seller liability alone does not address the risk of overselling.

* A minority of potential buyers and brokers said buyer liability would be workable.

* Environmental organizations prefer buyer liability.

Among the Parties:

* Other buyer members of the Umbrella Group generally favor *seller bears the risk.*

* Russia and the Ukraine have endorsed Umbrella Group proposals to date. They are eager to get trading underway in order to begin realizing revenue. They have acknowledged the need to build up their monitoring and regulatory capacity and are looking to trading revenue as a source of funds for such efforts. They have not yet been engaged in detailed consideration on liability or the risk of overselling.

* The EU currently favors buyer liability but has recognized problems such as the potential domino effect on compliance. The EU also supports the additional compliance features listed above under *seller bears the risk.* Option 4a) may also appeal to the EU as a means for both sides to get some of what they want.

IV. Strategy and timing

(a) Strategy and timing considerations. The overselling issue will be on the agenda of back-to-back meetings of the Umbrella Group and the Annex I Experts Group beginning on Labor Day. This argues for coming

to agreement on a US position by September 4.
In G-8 workgroup discussions in July, the Umbrella and EU sides agreed that even though they have deep differences on the highly-charged political issues of (supplementarity, *hot air*), both sides have a stake in
showing some progress on trading and the other flexibility mechanisms at Buenos Aires. The G-8 workgroup agreed that a realistic goal for COP-4 at Buenos Aires is to reach Annex I-wide agreement on a number of mostly technical trading issues (e.g., emissions monitoring and reporting methods, systems for tracking transfers, procedures for participation by legal entities) and to obtain a COP decision on a work plan and schedule for resolving the remaining issues by COP-5.

In this context, it is worth trying to resolve the overselling issue this fall.
While the issue is not simply technical (involving potential trade-offs between compliance and efficiency objectives), it is not as highly charged as supplementarity or *hot air.* If held over after Buenos Aires, it is likely to become more politicized and harder to solve. Addressing it
now could also facilitate a solution to broader compliance concerns the EU has raised (concerning Article 18), which will also tend to become more politicized and harder to resolve if not addressed by Buenos Aires. The EU has argued for adopting binding compliance consequences under Article 18 before trading may commence under Article 17. Since Article 18 requires an amendment of the Protocol, this approach would introduce a major delay. The US and its Umbrella partners have sought instead to include important compliance provisions in the Article 17 trading rules themselves. Some progress in moving the EU towards our view was made at the G-8 discussion group in July. Since the EU is especially fearful of over-selling by Russia and the Ukraine, an effective response to that risk now could help get the EU off the Article 18 soap box. Of course, if an acceptable solution to the overselling issue is not reached by then, we always have the option of keeping it open for COP-5.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D80]MAIL475664531.226 to ASCII,
The following is a HEX DUMP:

Addressing the risk of overselling in international emissions trading

Issue for Decision: How to address the risk that a party may oversell emissions permits, and fail to retain enough to cover its emissions?

I. Background

In proposing trading rules, the US has attempted to strike a balance between economic efficiency and incentives for compliance. An efficient market in emissions permits will help keep costs down. Incentives for compliance are needed to achieve our environmental objectives. The agencies have come to agreement on most aspects of trading rules, but have not yet agreed on the proper allocation of the risk of overselling.

The US has several objectives in crafting rules for emission trading. Trading rules should create an economically efficient market. In addition, they should help achieve the Kyoto targets, should create an incentive for compliance, and should encourage participation by the FSU and prospective new entrants from the developing world.

The EU and environmental groups are concerned about overselling, especially by Russia and Ukraine. They fear that these countries will oversell their allotments early in the 5-year compliance period (2008-2012), and cite weak compliance and regulatory regimes in these countries. They believe that trading rules should contain additional incentives for compliance.

Others, including potential market participants, are concerned that some compliance incentives could hobble the nascent market in tradable permits. They believe that trading rules should focus, above all else, on facilitating development of the new market.

Recognizing that there are limited levers in traditional international law to compel Party compliance, the US has supported including positive incentives for compliance within the trading rules, where that can be done without significantly burdening efficient market function. Specifically, before Kyoto the US proposed including two compliance provisions in trading rules:

- A Party not complying with its measurement and reporting obligations would lose its eligibility to engage in further emissions trading.

- A Party that has run out of assigned amount during the 5-year commitment period would lose its eligibility to make further sales (although it would still be able to buy), so long as it remains in deficit.

II. Options

1) Seller bears the risk. If the selling party does not possess enough assigned amount to cover its emissions at the end of the period, the excess, with a penalty, would be deducted from its assigned amount for the next budget period. The party might also be subject to restrictions of sales in the second period. Buyers are responsible for ensuring that they obtain clear title to any units purchased, but are not subject to the risk that permits will be recalled or devalued. Tradeable units already sold remain the property of the buyer.

Benefits: Simplest and most efficient, because transaction costs are lowest. Buyers would be certain of the face value of any tonnes bought, and tonnes would be interchangeable. Buyers need not assess the risk of the selling Party's ultimate compliance. Loss of trading eligibility and repayment requirements provide incentive for compliance.

Downsides: Significant risk of overselling and unremedied excess emissions. Compliance incentives depend on Parties' commitment to participate in the global climate change treaty over the long haul. Loss of trading eligibility and repayment requirements alone may not be sufficient to prevent overselling by a government that seeks a short-term financial bonus.

2) Buyer bears the risk. If the selling Party does not possess enough assigned amount to cover its emissions at the end of the period, emissions permits that it had previously sold would be taken back from buyers and applied to cover the shortfall. The last permits sold would be the first ones returned (LIFO); alternatively, all permits sold could be devalued by the same proportion. Buyers, who would be on notice of these rules from the start, would have to assess the risks of a Party's non-compliance. They might manage risks in several ways: by discounting prices paid, creating a portfolio of permits from different Parties and of different vintages; by making contracts contingent on compliance of the selling Party; or by buying options or taking other offsetting positions.

Benefits: Creates strongest protection against overselling. Uses market mechanisms to promote environmental objectives. A Party at risk of having excess emissions will receive lower prices for its permits; this creates a financial incentive to comply. Excess emissions are automatically covered, up to the extent of prior sales.

Downsides: Likely to increase costs. Likely to impede development of trading, as allowances would differ in risk (and price) according to the original seller. Would require private sector buyers to assess and manage the likelihood of selling Parties' eventual non-compliance. Market tools for doing so efficiently could develop over time, but are not likely to exist at first; this could impose a significant burden on the nascent emissions trading market.

Some have raised the possibility of a "domino effect," in which noncompliance of a seller leads to noncompliance not only of the first buyer but of all subsequent buyers as well, implying de facto joint-and-several liability. A cumbersome iterative international process would be necessary if one party's compliance were linked to another's. Others have argued that this domino problem could be limited either by a LIFO rule, or by a rule limiting liability to the first buyer only.

Options (3), (4), and (4a) are intended to offer more protection against overselling than "seller bears the risk," and less burden on the trading market than "buyer bears the risk."

(3) Seller bears the risk, percentage cap on sales. In the first year, if a country had net sales greater than, for example, one-fifth of its 5-year allocation, then it could not sell any more, until emissions data came in showing that the country had repaid its deficit through some combination of emission reductions and permit purchases. In the second year, if the country had cumulative net sales greater than two-fifths of its 5-year allocation, the same conditions would apply; and so on for later years. Naturally, shares other than one-fifth, two-fifths, etc. could be used. The first-year share should be well below 100 percent of the five-year allocation, and yet well above any reasonable level of sustainable legitimate emissions sales, including "hot air."

> ***Benefits:*** Trading takes place with low transaction costs because buyers do not bear the risks of sellers' non-compliance. Cap limits potential overselling, compared to option 1).
>
> ***Downsides:*** Although caps limit overselling, they do not prevent it. Unclear how these options would work where parties to the Convention devolve emissions permits to firms, as an individual firm's right to sell would depend on whether prior sales by other firms had reached the cap. This option requires detailed data on both spot and forward trades, as well as emissions, data that the central government may not have. Sellers may find ways to game the system.

(4) Seller bears the risk, with reserve account. Sellers would be required to set aside a specified percentage (perhaps 10 percent or 20 percent) of the total sold. These permits could be sold at or near the end of the five-year period, if they were not needed to cover the selling Party's emissions. Until then, they would serve as a compliance reserve against possible excess emissions.

> **Benefits:** Low transaction costs, as in option (3). Compliance reserve grows with volume of permit sales. Reserve margin offers more protection against overselling than option (1). Whether protection against overselling is more or less than provided by option (3) is difficult to analyze, depending in part on the percentages chosen.
>
> **Downsides:** Protection against overselling is still incomplete for any percentage set aside less than 50%. Interim permit prices (prices during the five-year period) may rise because fewer permits would be available for sale, until they are released at the end. The higher the percentage set aside, the greater this effect.

(4a) Seller bears the risk, buyer liability applies to reserve account. Variations on options (3) and (4) could allow sale of permits above the cap or sale of permits in the compliance reserve, under the condition of buyer liability. In other words, most permits would trade without any contingencies, but sales of the permits above the cap or in the compliance reserve would be subject to the risk of being recalled and returned to the seller Party to cover a shortfall at the end of the period.

Benefits: Provides more protection against overselling than options (3) and (4), because sales above the cap are subject to recall against seller's excess emissions. All permits are allowed to go to market; most trade on basis of seller liability without contingencies, while buyer liability is focused where most pertinent to compliance risk. May provide selling parties with more incentives for compliance, since a price signal reflecting the party's compliance risk will be created for the permits in the compliance reserve.

Downsides: Same as option 2); potential burdens on the market are limited to only those permits trading under buyer liability.

III. Positions of US interest groups and other parties

The following picture emerges from a series of stakeholder meetings coordinated by the White House Climate Change Task Force:

- Most private sector potential buyers and brokers expressed a strong preference for avoiding buyer liability, although they recognized that seller liability alone does not address the risk of overselling.
- A minority of potential buyers and brokers said buyer liability would be workable.
- Environmental organizations prefer buyer liability.

Among the Parties:

- Other buyer members of the Umbrella Group generally favor "seller bears the risk."
- Russia and the Ukraine have endorsed Umbrella Group proposals to date. They are eager to get trading underway in order to begin realizing revenue. They have acknowledged the need to build up their monitoring and regulatory capacity and are looking to trading revenue as a source of funds for such efforts. They have not yet been engaged in detailed consideration on liability or the risk of overselling.
- The EU currently favors buyer liability but has recognized problems such as the potential domino effect on compliance. The EU also supports the additional compliance features listed above under "seller bears the risk." Option 4a) may also appeal to the EU as a means for both sides to get some of what they want.

IV. Strategy and timing

(a) Strategy and timing considerations. The overselling issue will be on the agenda of back-to-back meetings of the Umbrella Group and the Annex I Experts Group beginning on Labor Day. This argues for coming to agreement on a US position by September 4.

In G-8 workgroup discussions in July, the Umbrella and EU sides agreed that even though they have deep differences on the highly-charged political issues of (supplementarity, "hot air"), both sides have a stake in showing some progress on trading and the other flexibility mechanisms at Buenos Aires. The G-8 workgroup agreed that a realistic goal for COP-4 at Buenos Aires is to reach Annex I-wide agreement on a number of mostly technical trading issues (e.g., emissions monitoring and reporting methods, systems for tracking transfers, procedures for participation by legal entities) and to obtain a COP decision on a work plan and schedule for resolving the remaining issues by COP-5.

In this context, it is worth trying to resolve the overselling issue this fall. While the issue is not simply technical (involving potential trade-offs between compliance and efficiency objectives), it is not as highly charged as supplementarity or "hot air." If held over after Buenos Aires, it is likely to become more politicized and harder to solve. Addressing it now could also facilitate a solution to broader compliance concerns the EU has raised (concerning Article 18), which will also tend to become more politicized and harder to resolve if not addressed by Buenos Aires.[1] Of course, if an acceptable solution to the overselling issue is not reached by then, we always have the option of keeping it open for COP-5.

[1] The EU has argued for adopting binding compliance consequences under Article 18 before trading may commence under Article 17. Since Article 18 requires an amendment of the Protocol, this approach would introduce a major delay. The US and its Umbrella partners have sought instead to include important compliance provisions in the Article 17 trading rules themselves. Some progress in moving the EU towards our view was made at the G-8 discussion group in July. Since the EU is especially fearful of over-selling by Russia and the Ukraine, an effective response to that risk now could help get the EU off the Article 18 soap box.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:25-AUG-1998 16:54:48.00

SUBJECT: Bridge News Service vs. Bloomberg

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:
Our current Bridge MoneyCenter News Service Terminal in Room 314 seems not to offer our staff as much useful information or real time data from the various stock exchanges as they could get from Bloomberg.

Also, this system is not Y2K compliant, so Bridge will not be offering this product at some point in the future, but instead is currently offering an upgraded product as a replacement. Their new system is Bridge Stations Plus. Both the old and new Bridge products offer a lower base price than Bloomberg. But since their pricing is not all inclusive as Bloomberg is, it is cost prohibitive to get the real time data for the various domestic and international stock exchanges from Bridge. Bridge passes on a per-exchange monthly fee for each stock exchange their client needs in real time, and that is why CEA subscribes only to their more basic service.

Bridge provides the DOW and bond yields in real time. But the S&P, Nasdaq and G-7 exchanges are provided with a delay, and the other international markets are available as of the previous day's close. Bloomberg, on the other hand, provides all of the following in real time for their one all-inclusive price: bond prices and all stock indices including the Dow, S&P, NASDAQ, G-7, and other international equity markets.

Bloomberg prices their product such that the first subscription pays a premium. But for two or more subscriptions, the price drops $420 per month. OMB subscribed to Bloomberg when Frank Raines was Director. They are awaiting word from their new Director re: whether he wishes to keep it. If they should keep their subscription, CEA's charge would be $5,040 per year less than if we were the only subscriber in the complex.

Also, OA's Information Science & Technology Division is looking into Y2K replacement products for the Information Management products that they provide to the desktop. Other EOP agencies and the White House may need only high-end general news service products, and it looks as if their decision will not be made before the beginning of the new fiscal year, but I will keep in touch with them to learn if we can avail ourselves of any cost savings if the product they choose would work for CEA.

Here are the costs of the various options.

Annual Subscription Installation

Current Bridge Money Center News
$11,004 n/a
(not Y2K compliant)

Bride Station Plus via phone
connection $13,212
$1,500***
(Y2K compliant)

Bloomberg via Internet
connection $14,640* $19,680** 50
Bloomberg via phone
connection $18,840* $23,880**
350

*Second EOP subscriber
**Only EOP subscriber
***The Bridge system would require the purchase of a new $2,500 PC. The Bloomberg product can run on one of our older PCs that we were planning to take out of service anyway.

I'm trying to arrange for demonstrations of both companies' products for the first two weeks in September and will pick times that you would be available in case you would like to see them.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:25-AUG-1998 11:09:43.00

SUBJECT: Re: charter school talk

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

TEXT:
I would very much appreciate it if you can put together a complete talk. I have a several major speeches I am working on myself, and am a luncheon speaker the previous day (September 10) so I do not have time to work on this. Perhaps you could begin by preparing an outline and we can discuss it before you go beyond that. However I will be out of town beginning Thursday morning through Sunday, so it is probably best if you could get me something rough today of we could talk on the phone tomorrow. Thanks for your help on this.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Nora E. Gordon (CN=Nora E. Gordon/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:25-AUG-1998 11:11:59.00

SUBJECT: Re: charter school talk

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

TEXT:
Actually, I think I can put an outline together relatively quickly. Would you like to discuss it after your photo shoot? If you prefer to do it by phone, I understand. This isn't much of a vacation.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:25-AUG-1998 11:22:13.00

SUBJECT: Asia crisis speech attached

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

TEXT:
---------------------- Forwarded by Janet L. Yellen/CEA/EOP on 08/25/98
11:21 AM ---------------------------

Nouriel Roubini
08/12/98 07:42:00 PM
Record Type: Record

To: Janet L. Yellen/CEA/EOP
cc:
Subject: Asia crisis speech attached

Janet,, I attach the speech on Asia.
I will prepare on Russia tonite to discuss it with you in the morning.
Nouriel

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D39]MAIL46835563X.226 to ASCII,
The following is a HEX DUMP:

The Asian Crisis and International Financial Architecture Reform

A. Currency and financial turmoil in the 1990s

The currency and financial crisis in Asia has brought to the fore the issue of whether we need to reform the international monetary system – or international financial architecture. In order to discuss whether and how such architecture might need reform, it is useful first to understand the sources and causes of such a widespread and recurrent financial turmoil.

At the outset, note that the Asian crisis of 1997-98 is already the third episode of major currency and financial turmoil in the 1990s. First, in 1992-93 the currencies of the European Monetary System experienced severe speculative attacks that led to the devaluation of the Italian lira and British pound in the fall of 1992; these were followed by the sequential devaluation of several other ERM members and the eventual loosening of the ERM exchange rate bands in the summer of 1993. Next, the collapse of the Mexican peso in December 1994 led to a severe "Tequila effect" with several Latin American currencies under attack. Finally, the devaluation of the Thai baht in July 1997 triggered the Asian currency and financial crisis that rapidly spread like a domino to other regional currencies; directly and indirectly, the Asia flu has had contagious effects as far as Russia, South Africa and Latin America.

1. Common elements of the 1990s crises

While each of these crises has its own characteristics and specific causes, we can see several common elements; identifying these is important to understand the issues we face when trying to reform the international architecture. In summary, such common elements are as follows:

1. All three crisis episodes occurred under a regime of semi-fixed exchange rates. While ERM currencies and the Mexican peso were clearly on a peg, the same was true – with some degree of variety – for most Asian currencies. This leaves open the question of which exchange rate regime can minimize financial turmoil in a world of volatile capital flows.

2. In all three episodes there has been significant contagion with domino-like devaluations spreading from one country to the other. Therefore, traditional views of currency crises as single country events have to be significantly modified.

3. While the process of global financial integration has been occurring for several decades now, it has picked up speed in the 1990s as the size and speed of international capital flows has dramatically increased and the range of assets traded internationally (including exotic derivative instruments) has mushroomed. Nowadays, international capital flows are clearly

hotter than ever and as volatile as ever.

4. Such financial turmoil has been preceded by a significant liberalization of the capital account and progressive elimination of capital controls. Italy and France had fully liberalized their capital account right before the onset of the 1992 ERM crisis. Mexico had progressively liberalized its domestic and international financial regime in the early 1990s. And East Asian countries had gone through a process of significant financial liberalization - both domestic and international - throughout the 1990s.

5. Currencies crises have been associates with financial sector and banking crises. This is most clearly evident in the Asian crisis episode and the Mexican peso crisis when severe banking crises occurred. But it has also been partly a feature of the ERM episode: in countries such a Sweden, Finland and Italy, banking crises emerged close to the currency turmoil episodes.

Indeed, the Asian crisis shows that there may be a serious link between currency and banking crises. In this regard, Diaz-Alejandro had already pointed out 20 years ago - in his seminal "GoodBye Financial Repression, Hello Financial Crash" - the possible link between financial liberalization in an environment of financial market distortions and the emergence of currency and financial crisis. Indeed, one of the lessons of the Asian crisis is that weaknesses and fragility in the financial and banking sector make a country very vulnerable to severe currency and financial turmoil.

6. In each of these episodes there has been a heated intellectual and academic debate in whether the crisis was caused by poor economic fundamentals or irrational speculative panic. In the case of the Asian crisis, this debate has been particularly interesting as the Asian countries did not fit the traditional model of what causes a currency and debt crisis, i.e. the "usual suspects" do not show up. Your garden variety currency/debt crisis has the following suspects: you got a country with a large budget deficit and high public debt; inflation is high as these deficits are monetized; economic growth is low, savings and investment rates are low. In Asia you got the reverse before the crisis: low budget deficit, low public debt, single digit inflation rates, high economic growth and high savings and investment rates.

Since the usual suspects did not show up, many authors were led to believe that the crisis was due to irrational panic, fickle investors, volatile hot money, self-fulfilling bad equilibria, non-fundamental speculative capital flight and irrational bank runs.

2. Fundamental causes of the Asian crisis

In spite of these "irrational panic" explanations of the Asian crisis, we have realized by now that, below the surface of apparently good macro fundamentals, serious weaknesses and fragility, macroeconomic policy mistakes and severe distortions were lurking; such crack eventually undermined the so called Asian economic model.

The ingredients of this new fundamentalist interpretation of the crisis are by now reasonably clear but it is worth summarizing them in some detail:

1. A combination of financial sectors weaknesses and distortions (moral hazard, relationship banking, corrupt credit practices, directed credit and political distortions in the allocation of credit) led to a lending boom and overintestment in investment projects and sectors that were very risky and of low profitability (real estate, non-traded sectors, speculative purchase of assets in fixed supply). Poor corporate governance and crony capitalism exacerbated the distortions in this system and fueled the excessive investment boom.

2. Domestic and international capital liberalization also aggravated the original distortions and wrong incentives faced by banks and firms as it allowed them to borrow more and at cheaper rates in international capital markets.

3. In turn, the excessive investment boom led to large and growing current account deficits that were financed mostly via the banking system and the accumulation of short-term, foreign currency-denominated and unhedged liabilities.

4. The fixed exchange rate regimes exacerbated the problem in two ways: first, they led to real appreciation that worsened the current account problem; second, they were a symptom of a the broader moral hazard problem as fixed rates led banks and firm to have a lower cost of foreign capital. While budget deficits were apparently low, the implicit and explicit government guarantees of a bailout of the financial system in a crisis implied a large and growing unfunded public liabilities that emerged once the currency crisis triggered a wider banking crisis.

5. In 1997, the asset bubble started to burst, the stock markets started to drop and the emergence of wide losses and/or outright defaults in the corporate sectors signaled the low profitability of past investment projects. Then, the firms, banks and investors that had heavily relied on external borrowing were left with a large stock of a) short-term b) foreign currency-denominated c) unhedged foreign debt that could not be easily repaid.

6. The exchange rate crisis that ensued exacerbated the problem as the currency depreciation dramatically increased the real burden of the debt that was denominated in foreign currencies and led to further financial crisis for banks and firms. The free fall of currencies was intensified by the sudden rush of firm, banks and investors to cover their previously unhedged liabilities in foreign currency; in turn, this accelerated depreciation aggravated the original foreign currency debt problem creating a vicious circle.

7. Contagion was itself more the result of fundamentals than irrational panic. Specifically, a vicious circle of "competitive devaluations" explains part of the contagion. The first wave of depreciations in the summer of 1997 modified the `effective' real exchange rate and worsened cost-competitiveness in all the countries in the region that had initially maintained their nominal exchange rate fixed. As one after the other, the currencies of countries that were competing in the same world markets came under attack and depreciated sharply, the equilibrium fundamental

value of the other currencies that had not depreciated yet started to deteriorate. Therefore, contagion may not be the result of irrational panic but the result of: a) trade spillovers and competitive devaluations; b) common domestic and external shock hitting many economies at the same time; c) financial, investment and real links that transmit the real shocks of one country to the asset values (stocks, exchange rate) of other countries.

8. The behavior of weak and not very credible governments that were not committed to structural reforms worsened the policy uncertainty, led to widespread capital outflows and worsened the currency depreciation.

9. Rapid reversals of the capital inflows occurred as domestic and international investors sometimes panicked and dumped currencies, stocks and other regional assets and international banks rapidly withdrew their short-term loans to Asian financial institutions. While the crisis was triggered by fundamentals, at some point currencies and stock market overreacted and fell more than granted by the initially weak fundamentals and misalignments.

3. A more detailed analysis of the causes of the crisis [section to be used in a longer speech]

In Asia, the large current account deficits were driven by high rates of investment rather than low and falling public and private savings. While common wisdom holds that borrowing from abroad to finance the accumulation of domestic capital should not raise concerns about external solvency, the evidence for the Asian countries in the mid-1990s highlights that the profitability of new investment projects was low. For instance, in Thailand, Indonesia, Korea and Malaysia the share of non-performing loans before the crisis was large. In Korea, 20 of the largest 30 conglomerates displayed in 1996 a rate of return on invested capital below the cost of capital. By mid-1997, 8 of the 30 largest conglomerates were effectively bankrupt. At the macroeconomic level, evidence that investment efficiency was already falling before the crisis is provided by the dynamics of the incremental capital output ratio, defined as the ratio between the rate of investment (as percentage of GDP) and the rate of growth of the economy. In all countries but Indonesia and the Philippines, this indicator increased sharply between the two sub-periods 1987-1992 and 1993-1996.

Why did investment rates and capital inflows in Asia remain high even after the negative signals sent by the indicators of profitability? In part, the fall of interest rates in industrial countries (especially in Japan) lowered the cost of capital for firms and motivated large financial flows into the Asian countries. But at the very root of the sustained capital accumulation was the structure of incentives under which the corporate and financial sectors operated in the region. The so-called `moral hazard' problem in Asia exhibited three different, yet strictly interrelated dimensions at the corporate, financial, and international level. Political pressures to maintain high rates of economic growth had led to a long tradition of public guarantees to private projects, some of which were effectively undertaken under government direction, directly subsidized, or supported by policies of directed credit to favored firms and/or industries. Even in the absence of explicit promises of `bail-out', the production plans and strategies of the corporate sector largely overlooked costs and riskiness of the underlying investment projects. With financial and industrial policy enmeshed within a widespread business sector network of personal and political favoritism, and with governments that appeared willing to intervene in favor of troubled firms, markets operated under the impression that the return on investment was `insured' against adverse shocks.

The financial counterpart of the `moral hazard' problem in investment was the strong tendency for national banks to borrow excessively from abroad and lend excessively at home, thus playing a key role in channeling funds toward projects that were marginal if not outright unprofitable from a social point of view. Lax supervision and weak regulation of the financial system, low capital adequacy ratios, lack of incentive-compatible deposit insurance schemes, insufficient expertise in the regulatory institutions, distorted incentives for project selection and monitoring, and outright corrupt lending practices, all contributed to the build-up of severe structural weaknesses in the undercapitalized financial system, whose most visible manifestation was a growing share of non-performing loans. The distortions generated by such behavior were enhanced by the rapid process of capital account liberalization and financial market deregulation in the region during the 1990s, that had increased the supply-elasticity of funds from abroad. The extensive liberalization of capital markets was consistent with the policy goal of providing a large supply of low-cost funds to national financial institutions and the domestic corporate sector.

The same goal motivated exchange rate policies aimed at reducing the volatility of the domestic currency in terms of the US dollar, that translated into low risk premiums on dollar denominated debt. The international dimension of the moral hazard problem hinged upon the behavior of international banks, that over the period leading to the crisis had lent large amount of funds to the region's domestic intermediaries, with apparent neglect of the standards for sound risk assessment. Underlying such overlending syndrome may have been the presumption that short-term interbank cross-border liabilities would be effectively guaranteed by either a direct government intervention in favor of the financial debtors, or by an indirect bail-out through IMF support programs in the event of a crisis. A very large fraction of foreign debt accumulation was in the form of short-term, unhedged, foreign-currency denominated liabilities: by the end of 1996, a share of short-term liabilities in total liabilities above 50% was the norm in the region. Moreover, the ratio of short-term external liabilities to foreign reserves - a widely used indicator of financial fragility - was above 100% in Korea, Indonesia and Thailand. As a result of the cumulative effects of the fundamental financial and real imbalances considered above, by 1997 the Asian countries appeared quite vulnerable to financial crises, either related to sudden switches in market confidence and sentiments, or driven by deteriorating expectations about the poor state of fundamentals.

The external balance counterpart of the excessive investment boom were large and growing current account deficits. At the end of 1996 Thailand, the Philippines, Malaysia and Korea ran current account deficits of the order of 5% of GDP or higher, while the Indonesian deficit was slightly less sizable. There were a number of country-specific and global factors underlying these large external imbalances:

1. Several adverse shocks had caused a significant export slowdown from the region. The long period of stagnation of the Japanese economy in the 1990s had contributed to the deterioration of the trade balances; in the months preceding the eruption of the crisis, the hopes for a Japanese recovery were shattered by a sudden decline in economic activity in this country. Sector-specific shocks such as the fall in the demand for semi-conductors in 1996, and adverse terms of trade fluctuations, had also contributed to decelerate export growth in several Asian countries between 1996 and 1997.

2. The sharp appreciation of the US dollar relative to the Japanese yen and the European currencies since the second half of 1995 had led to deteriorating cost-competitiveness in most Asian countries whose currencies were effectively pegged to the dollar. Competitive pressures were enhanced by the increasing weight of China in total export from the region.
Also, expectations of a monetary contraction in the US in the summer of 1997 may have played a role in precipitating the crisis.

3. To some extent, the external deficits reflected currency misalignment. Based on standard real exchange rate measures, many Asian currencies had appreciated in the 1990s, although the degree of real appreciation had not been as large as in previous episodes of currency collapses (such as Mexico in 1994). The dynamics of the real exchange rate had been asymmetric across countries: by 1997 the extent of real appreciation was evident in Malaysia and the Philippines, while in South Korea, Thailand and Indonesia, real exchange rate indicators had not moved significantly relatively to 1990.

B. International financial architecture reform

Given this analysis of the causes of the crisis, how should we reform the international financial system?

First, note that after the Mexican peso crisis there was a broad debate on reforming the international financial system to prevent Mexican-type of crises from occurring again or being so virulent. The official process, named Halifax I after the G-5 summit meeting there in 1995, led to the Rey Report suggesting a number of reforms of the system.

The fact that another major crisis erupted in Asia just two years later does not imply that the proposed reforms were misguided. Quite to the contrary, as a number of the recommendation of the Rey Report were never implemented. The report was clearly aware of domestic and international moral hazard issues and stressed the need for better market-based debt workout procedures. For example, reforms of bond contracts (such as sharing clauses, majority voting and creditors committees) were suggested as well as changes in IMF rules such as a policy of "lending into arrears".

The eruption of the crisis in Asia renewed the need to revisit the unfinished business of Halifax I and has led to Halifax II, an official process the involves the G-22 group of advanced and emerging economies.

There are three basic building blocs of the Halifax II international architecture reforms:

1. Greater transparency.

2. Strengthening financial systems.

3. Better crisis resolution and debt workout mechanisms.

1. Greater transparency.

There is a broad consensus on the need for greater transparence both on the part of debtor countries and official institutions such as the IMF. However, it is not obvious that transparency alone will be enough to prevent another major crisis from occurring. While the lack of information in Asia on issues such as the countries' net foreign reserves and the offshore liabilities of the financial and corporate system may have exacerbated the investors' uncertainty and concerns, it is hard to argue that information was lacking. For example, the size of the current account imbalances, the level of short-term foreign currency denominated liabilities as well as myriad of other data were well known and regularly published. Still, until the onset of the crisis, investors appeared to ignore the warning signals coming from a number of indicators.

Moreover, while everyone is in principle in favor of greater transparency, there is still a wide divergence of opinion on how much information should be released. For example, would a more systematic public release by the IMF of country documents lead debtor countries to be less frank and open in their dealings with the Fund?

2. Reforming and strengthening domestic financial institutions.

Our discussion above suggests that financial sector weaknesses were central causes of the crisis. National banks and other financial institutions borrowed excessively from abroad and lent excessively at home, thus playing a key role in channeling funds toward projects that were marginal if not outright unprofitable. Lax supervision and weak regulation of the financial system, low capital adequacy ratios, lack of well designed deposit insurance schemes, insufficient expertise in the regulatory institutions, distorted incentives for project selection and monitoring, and outright corrupt lending practices, all contributed to the build-up of severe structural weaknesses in the undercapitalized financial system, whose most visible manifestation was a growing share of non-performing loans. The distortions generated by such behavior were enhanced by the rapid process of capital account liberalization and financial market deregulation in the region during the 1990s, that had increased the supply-elasticity of funds from abroad.

2.1 How to strengthen financial systems

Given this analysis and now evident and recurrent link between currency, debt and banking crises, a central element of the Halifax II reforms will have to be a radical reform and strengthening of domestic financial systems. The task is haunting and, in the best scenario, it will take years to accomplish the long list of overdue reforms. A partial list of such reforms includes: strong prudential regulation and supervision of bank and non-bank financial institutions; application of Basle (or Basle-enhanced) capital adequacy ratios; design of incentive-compatible deposit insurance schemes; design and implementation of disclosure rules, bankruptcy and foreclosure laws; development of liquid and deep financial markets, especially securities (bond and equity) markets; national implementation of the Basle core principle of banking supervision; coordination and cooperation among international organizations and international supervisory entities in strengthening financial systems; technical assistance and training to government official and regulators; improving corporate governance both in the financial and non-financial sector; implementing efficient insolvency and debtor-creditor regimes; structuring an orderly capital account liberalization, and in particular prudential controls in light of the current size and speed of capital flows.

2.2. The debate on capital controls.

Each of the above complex issues would require a detailed discussion but one of them - capital controls - will have to be addressed very soon. In general, there is an agreement that, once strong financial systems are in place, there are no strong arguments in favor of capital controls as the benefits of international capital mobility are quite compelling. The issue, however, is whether some capital controls may be useful in the transition to such strengthened financial system, i.e. what is the optimal speed of capital account liberalization when financial systems are still weak and in the process of being reformed.

The arguments in favor of some capital controls, especially on 'hot money' short-term capital inflows, are several. First, large inflows of short-term capital or "hot money" can be destabilizing: if 'fickle' investors become suddenly pessimistic about the economic prospects of a country, the large inflows of yesterday suddenly become the massive capital outflows of today that may lead to the collapse of a currency. This is especially true in countries with weak economic fundamentals and fragile financial systems. Second, large capital inflows may also lead to a perverse cycle: under flexible exchange rates they initially cause a currency appreciation as a investors buy the country's financial assets; under fixed exchange rates, they cause an increase in foreign reserves, rapid monetary growth and inflationary pressures that lead to a real appreciation. In both regimes, over time this appreciation leads to a loss of competitiveness that in turn causes a widening current account deficit. As this external imbalance grows, the country is forced to rely even more on capital inflows to finance the deficit. Eventually, the accumulation of this foreign debt may become unsustainable, especially if these liabilities are short-term, foreign-currency denominated and unhedged. In fact, as international investors become nervous about the country's ability and willingness to service such a large foreign debt, sudden capital outflows may ensue leading to a currency collapse.

There are, of course, strong arguments against these controls. First, free capital mobility leads to a market allocation of savings to the best investment opportunities. Such free mobility should not be restricted unless there is a very strong distortion in the market allocation of capital. Second, the reason why Chile and Colombia - countries that have introduced controls on short-term capital inflows - have been sheltered until recently from speculative attacks may not be the controls, but rather the existence of a strong financial system with solid prudential regulation and supervision. A country with strong banks, does not need capital controls. Third, advanced market economies with solid policies, good fundamentals and sound financial systems do not have capital controls and are not subject to devastating financial crises. Fourth, over time, investors find ways to avoid them, that is they tend to become ineffective. Fifth, controls increase borrowing costs and may reduce firms' investment. Finally, approval of targeted controls might lead countries to use capital controls indiscriminately, thus insulating unsound policies from the discipline of the marketplace. These arguments suggest a presumption in favor a principle of free capital mobility.

Is there evidence that short-term debt makes a country more vulnerable to a crisis? Yes, but with an important caveat. A number of recent studies suggest that a large amount of short-term liabilities (relative to the size of the foreign reserves) increases the probability of a crisis or leads to a more severe crisis if one occurs but only if the country has weak economic fundamentals. Such weaknesses include large current account deficits and real appreciation, an excessive bank lending boom, weak financial systems and a large amount of non-performing loans. So, short-term debt is particularly dangerous only in an otherwise fragile country with unsound economic policies.

While short-term portfolio flows can be dangerous as they can be suddenly withdrawn and cause a crisis, foreign direct investment, long-term bonds and equities are argued to be stabilizing as they represent longer term capital inflows. So, if you do have an external imbalance, you may be less vulnerable if you finance it with long-term capital. Chile and

Colombia introduced their controls exactly to avoid these boom and bust cycles of capital flows. A number of recent studies suggest that such controls are only partially effective. They do not seem to affect the overall level of capital inflows and current account imbalances but they do affect the composition of such inflows: short-term borrowing is discouraged while there is greater reliance on long-term borrowing.

One possible idea is to place the penalty only on *banks*' short-term borrowing from abroad, in the form of higher reserve requirements on their foreign-currency borrowing than on domestic borrowing. This would fall well within the kind of enhanced prudential banking regulation that the United States and the IMF have for some time urged on developing countries. Wider capital controls policies – covering most short-term inflows, not just banks ones – such as those implemented by Colombia and Chile will have to be studied in more detail to assess their effectiveness.

3. Better crisis resolution and debt workout mechanisms.

While strengthening financial system may prevent some crises or make them less virulent if they do occur, we cannot expect that such crises will be eliminated altogether. Therefore, if a crisis occur, the issue becomes: how to make sure that the crisis resolution is achieved with a minimum amount of cost in terms of economic growth and overall economic performance ? This very broad question represents the third pillar of a new architecture. Indeed, the questions here are more than one.

A first set of questions deals with policies to prevent crisis and to limit their scope and issues of creditor coordination:

1. How can we limit the domestic and international moral hazard issues? I.e. how can we limit the markets' expectations that, if a crisis occurs, debtor countries governments and/or international financial institutions will bail out the financial institutions and/or the corporate sector?

2. How can we credibly limit government guarantees to private sector - both financial and corporate sectors - prior to and during crises?

3. Is there an important role for private insurance, either in the form of contingent credit lines (such as those arranged by Mexico and Argentina) or other forms of true insurance where countries structure their external assets and liabilities with a greater degree of explicit risk sharing than has been the case in the past ? Also, if the private sector does not provide these credit and insurance facilities, is there are role for international financial institutions to do so?

4. Which institutional arrangements can we design to promote creditor coordination during a crisis? Should we change debt contract to introduce sharing rules, default clauses,

majority voting and creditor steering committees? Is there a role for coordination before and during a crisis between creditors, debtors and broader international community?

A second set of questions deals with how to improve the crisis management:

1. What is the role of government of country at risk of a balance of payments crisis?

2. What should be the role of international official community during a crisis, both in terms of the scale of international assistance and the amount of policy adjustment (conditionality) requested from the debtor?

3. What should the private sector financial contribution be as the design of a Fund program may show the need for a financial contribution from private creditors, which could take the form of the provision of new credits, a debt rollover or a debt rescheduling?

A third and quite delicate set of questions regards the issue of a suspensions of payments (or debt standstills).

1. Should only cooperative solutions be pursued where debtors and creditors agree on a temporary debt payments suspension? Or, as purely voluntary solutions may not always be feasible, is there a role for unilateral mandatory debt suspensions? In certain circumstances, mandatory suspensions may be unavoidable.

2. What should be the scope of any payments suspension? You need to select which type of obligations to suspend, whether to use or not capital controls in a partial suspension and whether to employ comprehensive exchange controls in some cases.

3. What are the features of an effective payments suspension as several countries have suspended payments on all or a portion of their external debt in the past?

4. Should there be an informal or formal official sanction for a standstill? Should this sanction take the form of IMF 'lending into arrears' or something stronger such as a formal IMF approval of such standstill? What are the legal implications of such a sanction?

5. How to make sure that the impact of a standstill is limited, i.e. it does not severely limit for a long time access to international capital markets and it does not lead to contagion to other countries?

6. Which mechanisms could protect debtors from legal action if payments are suspended? Could the IMF Article VIII.2.b be interpreted to achieve these objectives? If not, should the international community consider amending Article VIII.2.b to help achieve these objectives?

A final set of questions concerns the design of orderly workout negotiations that lead to debt restructuring:

1. Could the mechanisms already existing for restructuring inter-governmental debts and syndicated bank loans owed by governments in the context of IMF programs (Paris and London Clubs) be a model for broader private debt restructuring?

2. Which ex-ante measures will encourage the provision of new credit after the imposition of a de facto standstill?

3. Which mechanisms will encourage the prompt extension of private debt maturities and/ or provision of new credit?

4. How to design schemes that encourage private debt restructuring if and when appropriate?

The above questions are very complex and a rich set of answers can be given on each of them. Arguments pro and con each proposal can me made but there are usually no easy answers to these very difficult questions.

Here, we will make a few general observations on some of these points.

First, international bailout-related moral hazard might not have been the reason why international banks lent to Asia but, right now, after 5 major bailouts (Mexico, Thailand, Indonesia, Korea and Russia), it is certainly a bigger issue than before. So, being clear about the fact (and conditions under which) official financing is truly exceptional seems necessary to prevent a belief in the markets that everyone will be bailed out. Of course, letting one or more countries go under (sooner rather than later) would be the best credible signal we could send to the markets that bailouts are not going to become the norm. The international community needs to regain its credibility on this important question.

Second, in the case of a debt standstill, it is clear that a voluntary debt suspension should be preferred to a mandatory one. However, there is always a serious risk of a destructive "race for the door" before the negotiations for a voluntary agreement are even started, let alone before an agreement is even reached (see what happened in Mexico, Thailand, Korea, Indonesia). These examples suggest that, by the time you even start to negotiate a voluntary agreement you have usually already lost most of your reserves and suffered a severe currency collapse that turns a liquidity problem into a solvency one. Do we believe that any future crisis will be orderly worked out (i.e. not lead to a severe financial crisis) via voluntary agreements? Experience suggests that they usually arrive too late after the mayhem has already occurred.

Third, there is a clear tradeoff between costs (moral hazard, domestic bailouts and unlimited use of international resources) and benefits (they may help crisis resolution) of government guarantees. Then, the question is how do you decide what is the sensible middle ground? One influential view is that the (domestic) moral hazard deriving from such implicit and explicit government guarantees (especially before the onset of a crisis) were a crucial cause of the crisis. To simplify the argument: a corporate/financial system with implicit/explicit deposit insurance, little risk capital, little prudential supervision and regulation - and excessive domestic and external liberalization went on a excessive lending boom to risky projects knowing it will be bailed out in the case of a crisis.

Then, if one believes in this analysis of the crisis, one should be biased in favor of limiting as much as possible the scope of government guarantees, before the crisis, during the crisis and during the workout process. Banks may be special and in need of support to avoid a major economic collapse but we should deal with that distortion/externality at the prevention stage (strong banking system with strong prudential regulation and supervision and serious capital adequacy ratios), not through ex-post guarantees that validate the moral hazard incentives of banks and firms.

4. Conclusion

In conclusion, preventing altogether future currency and financial crises may not be possible but there is a lot that we can do to limit the frequency of their occurrence, the magnitude of their effects and their pernicious contagious spread once they do occur. The reforms of the international financial architecture being discussed in the Halifax II process would go a long way, if implemented, towards achieving such goals.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:25-AUG-1998 14:14:10.00

SUBJECT: Cluster meetings

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:
Attached is a proposed list for the particpants and times for the cluster meetings.
Before scheduling these, however, I have a couple of questions:
1. Do you want to have cluster mtgs? are they useful? Should we begin them the week after Labor Day? Are these the right groupings of staff?
2. If we schedule them, can we try to keep them on the schedule? I know things come up and there will always be conflicts. But, last year, they were canceled so frequently that scheduling them became kind of a joke. So, if we could ask the secretaries to make an effort to keep them on the schedule, we might have better luck.
Please let me know what you think.
Thanks.
=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D29]MAIL480201736.226 to ASCII,
The following is a HEX DUMP:

<u>Cluster Groups</u>

<u>Macro / Financial Institutions</u> **(1st and 3rd Monday, 3:00pm)**
JLY, JAF, MJ
Steve Braun
Doug Elmendorf
Chad Stone
Summer Scott***

<u>Industrial Organization (IO)</u> **(1st and 3rd Tuesday, 10:00am)**
JLY, JAF, MJ
Howard Shelanski
Steve Polasky
Quindi Franco
Bert Huang***

<u>International</u> **(2nd and 4th Tuesday, 10:00am)**
JLY, JAF, MJ
Nouriel Roubini
Howard Shelanski
Matt McBrady***
Ray Guiteras

<u>Environmental/Agriculture</u> **(1st and 3rd Wed., 10:00am)**
JLY, JAF, MJ
Steve Polasky
Joe Aldy
Elise Golan
Quindi Franco***
Ray Guiteras

<u>Labor</u> **(2nd and 4th Friday, 10:00am)**
JLY, JAF, MJ
Robert Schoeni
Cordelia Reimers
Bert Huang
Nora Gordon***
Andy Feldman

*** **Responsible for preparing the cluster mtg agenda**

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Nouriel Roubini (CN=Nouriel Roubini/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:25-AUG-1998 08:37:37.00

SUBJECT: Re: news

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

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

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

TEXT:
Russia:
Russia's rouble suffered its worst fall in nearly four years on Tuesday as
acting Prime Minister Viktor Chernomyrdin
scrambled to put together a government.President Boris Yeltsin, who sacked
the entire government on Sunday for failing to end Russia's deep financial
crisis, issued an order to the departing government to continue working
until
the new team was formed.But the rouble fell after Russia's top debt
negotiator, Anatoly Chubais, who is influential in the West, said any
government indecision now could cause serious new economic damage.
The rouble, allowed to devalue last week, fell 10 percent to 7.88 from
7.14 to the dollar on Tuesday after trading was twice suspended -- the
worst fall in a single day since plunging on
what became known as Black Tuesday in October 1994. Ten days ago it was at
about 6.2 to the dollar. ``People don't want roubles, it's just that
simple," said Dirk Damrau, head of research at MFK Renaissance finance
house. ``Once this starts, it will continue."

Austrialia, NZ and Canada
The Australian dollar limped to new 12-year lows on Tuesday, battered by
a world-wide flight to quality in financial
markets.The round-robin of emerging market crises have prompted fresh
fears of sagging prices for basic materials, further undermining support
for the
commodity-producing dollar bloc countries, analysts said.The New Zealand
dollar also weakened while the Canadian dollar hovered near record lows
set overnight.

Asia
Asian stocks and Pacific Rim
currencies found their support Tuesday in the
improved performances of major share markets
overseas.
Gains in Wall Street overnight and a slightly firmer
yen were all positive factors for regional markets.

But traders say they are still anxious about volatility on other emerging markets and the situation in Russia and Latin America are still being closely watched.

With the exception of Singapore, where shares fell 0.65 percent, the major Pacific Rim markets rose Tuesday, with Tokyo stocks edging up 0.56 percent, Hong Kong issues gaining 0.57 percent and Australian shares a full 1 percent.

Elsewhere in the region, Indonesia's exchange shed 0.92 percent. Malaysian stocks powered ahead 2.20 percent, supported in part by a stronger ringgit, while South Korean stocks rose 1.66 percent on futures-related purchases in prime blue chips and on returning confidence as the yen and overseas markets showed signs of stabilizing.

Tokyo's Nikkei average posted a modest rise on Tuesday after an overnight gain in the yen and strength in New York stocks, traders said.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:27-AUG-1998 14:37:35.00

SUBJECT: Back to School event and Women's speech

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

TEXT:
I talked to Nora about both the Back to School Event and your October 14 speech to the Women's Business Network. She is going to e-mail you (tomorrow before she goes away) a statement for the Back to School Event. And she is going to draft a statement on the economy and the importance of women-owned businesses. I asked her to e-mail in to me by mid-Sept. I will make sure it is on track and then be sure that you have a final version by the first week in October.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Nouriel Roubini (CN=Nouriel Roubini/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:27-AUG-1998 10:02:40.00

SUBJECT: Russia news

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

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

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

TEXT:
Russian economy on the edge

Ruble, stock market dive; Kremlin denies rumors Yeltsin has stepped down

August 27, 1998: 9:47 a.m. ET

As Russia's crippled currency market ground to a halt again Thursday and stocks there started another steep slide, Moscow leaders said they are considering extreme measures to stop the ruble's slide and get the rocky financial situation back on solid ground

Russia's acting Prime Minister Viktor Chernomyrdin and parliament are mulling ideas including price controls and a halt to ruble convertibility, a key Chernomyrdin ally said.

Alexander Shokhin, head of Chernomyrdin's parliamentary party, said a document already is being drafted by the acting government and parliament's lower house, the Duma, that will contain ideas that once might have seemed "exotic" but now seem necessary.

Various media reports indicate the options might including privatizing some industries and giving President Boris Yeltsin an easy out -- a contract to leave office while retaining certain privileges.

The Kremlin Thursday dismissed rumors in world financial markets that Yeltsin already had resigned.

"It's just impossible that such a thing could have happened without us telling you," an official in the Kremlin press office said.

Russia's central bank suspended all overseas trade of the ruble on the main currency exchange for the second time in as many days Thursday, as Russians continued their flight to safety in the U.S. dollar.

The ruble fell 40 percent against the German mark in European trading Wednesday, and Russia's besieged central bank said it no longer could afford to intervene to support it.

Thursday trade at the Interbank Currency Exchange opened at 8.2 rubles per dollar against the offered rate of 9.5. The central bank had set an artificial rate of 7.86 Wednesday, and trade was suspended within minutes Thursday. On the street, black market traders were getting as much as 12 rubles to the dollar.

A central bank order said the MICEX session was suspended indefinitely until further notice.

It also said reserves had dropped to $13.4 billion on Aug. 21 from $15.1 billion a week earlier.

Russia's main shares index, the RTS1-Interfax, fell 13 percent against the previous close at 1200 GMT on Thursday to its lowest recorded level, 66.46 points.

The market briefly suspended trade, as the fall, almost nine percent against its opening level, also triggered a circuit breaker.

The ruble has been sliding since President Boris Yeltsin sacked his previous prime minister Sergei Kiriyenko Sunday and reinstated Chernomyrdin -- widely seen as his eventual successor -- only five months after removing him from office.

Yeltsin also announced a short-term debt repayment plan that leaves overseas investors out in the cold.

Holders of Russian bonds are facing losses that could top $33 billion, according to conservative estimates quoted by Britain's Financial Times Thursday.

Funds run by investment guru George Soros, who earlier this month sent the ruble tumbling after suggesting a devaluation of the currency, is reported to have lost some $2 billion alone.

Rumors are circulating in Russia that Chirnomyrdin, as presumed successor to Yeltsin, already is staging a coup to win over control of the economy from Yeltsin.

"There has been mention that this creeping coup has already taken place," said Stephen Green, a principal with Renaissance Capital. "It's clear that Chirnomyrdin is already in control at this point. Yeltsin probably won't have much to do with the economy and political situation going forward."

That doesn't bode well for investors. Chirnomyrdin historically has had little interest in reform and reportedly has proposed the establishment of a new government that would look more like the former Soviet regime.

From Washington to Paris, world leaders urged

Russia to take stern steps to correct its financial upheaval.

A spokesman for Chernomyrdin said the prime minister is closely following the activity of the markets and is prepared to take action if necessary.

"It's very difficult to say because right now, as it stands for now, you play it step by step, because the situation is so difficult, because you have to watch the markets, you have to watch the ruble," spokesman Konstantin Voitsekhovich said.

Withdrawal/Redaction Marker
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	Pollakk to Janet L. Yellen at 06:15:58.00. Subject: Fwd: Council on Foreign Relations & The Federal Reserve. (partial) (1 page)	08/31/1998	b(6)

COLLECTION:

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

FOLDER TITLE:

[08/21/1998 - 09/04/1998]

2013-0723-F
ab1283

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: POLLACKK@NDU.EDU@INET@LNGTWY (POLLACKK@NDU.EDU@INET@LNGTWY [UNKNOWN])

CREATION DATE/TIME:31-AUG-1998 06:15:58.00

SUBJECT: Fwd: Council on Foreign Relations & The Federal Reserve

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

TEXT:
Janet:

Just thought you'd get a kick out of this. [redacted] (b)(6) [001]
[redacted] (b)(6)

I hope all is well.

Fondly,

- Ken

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

TEXT:
From: yaphej@NDU.EDU@INET@EOPMRX@LNGTWY
*To: POLLACKK@NDU.EDU@INET@EOPMRX@LNGTWY
Date: 8/25/98 3:43pm
Subject: Fwd: Council on Foreign Relations & The Federal Reserve
================== END ATTACHMENT 1 ==================

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

TEXT:

From: roundtable@mail.geocities.com@INET@EOPMRX@LNGTWY
*To: President@whitehouse.gov@INET@EOPMRX@LNGTWY
Date: 8/8/98 8:46am
Subject: Council on Foreign Relations & The Federal Reserve
The Joint Chiefs of Staff DoD Publication 1 (1987) Glossary
of Department
of Defense Military Associated Terms defines:

"COVERT OPERATIONS: (DoD, Interpol, Inter-American Defense
Board)
Operations which are so planned and executed as to conceal
the identity of
or permit plausible denial by the sponsor. They differ from
clandestine
operations in that emphasis is placed on concealment of
identity of sponsor
rather than on concealment of the operation."

The Council on Foreign Relations has used covert operations
to conceal
their identity while methodically taking control of the
Department of
State, Central Intelligence Agency, and the Executive,
Legislative, and
Judicial branches of the Government. The Council on Foreign
Relations
established and controls the Federal Reserve System.

The Federal Reserve System has a profound effect on the
United States and
World economies. Why haven't any Nobel prize winning
Economists noticed the
warping of Federal Reserve Systems history; and
concealment of the
Council on Foreign Relations sponsorship and control? Why
haven't any Nobel
prize winning economists explained to the American public
what effect one
small groups control of the Federal Reserve System can have?
How does
control of the Fed by one small group change many Nobel
prize winning
economic theories? Does controlling the Federal Reserve
System help to
explain why Council on Foreign Relations members have
amassed 75% of the
nations industrial and financial assets?

Does the Council on Foreign Relations practice a type of
insidious
McCarthyism where individuals do not get the chance to have
their side of
the story heard or face their accuser? Does the Council on
Foreign

Relations secretly blacklist scholars, and members of the media who connect their sponsorship to historical events? Does the Council on Foreign Relations discredit and destroy the careers of such people? Does the Council on Foreign Relations see to it that such people cannot get their material published or distributed?

The way the CFR works is clearly explained by the famous journalist Walter Lippmann. Lippmann was a member of the mysterious Round Table Group; editor of the publication THE NEW REPUBLIC; member of America's first intelligence organization the INQUIRY; the official interpreter of the meaning of Woodrow Wilson's Fourteen Points to the British Government; attended the Paris Peace Conference after World War I; and a Council on Foreign Relations founding father.1

Chapter I, of Lippmann's book, PUBLIC OPINION is titled "The World Outside and the Pictures in Our Heads." Lippmann, writes,

"This then, will be the clue to our inquiry. We shall assume that what each man does is based not on direct and certain knowledge, but on pictures made by himself or given to him. If his atlas tells him that the world is flat he will not sail near what he believes to be the edge of our planet for fear of falling off. If his maps include a fountain of eternal youth, a Ponce de Leon will go in quest of it. If someone digs up yellow dirt that looks like gold, he will for a time act exactly as if he had found gold.
The way in which the world is imagined determines at any particular moment what men will do. It does not determine what they will achieve. It determines their effort, their feelings, their hopes, not their accomplishments and results. The very men who most loudly proclaim their "materialism" and their contempt for "ideologues," the Marxian communists, place their entire hope on what? On the formulation by propaganda of a

class-conscious group. But what is propaganda, if not the effort to alter the picture to which men respond, to substitute one social pattern for another? What is class consciousness but a way of realizing the world? National consciousness but another way? And Professor Giddings' consciousness of kind [i.e. stereotypes], but a process of believing that we recognize among the multitude certain ones marked as our kind?"2

Lippmann's conclusion is,

"I argue that representative government, either in what is ordinarily called politics, or in industry, cannot be worked successfully, no matter what the basis of election, unless there is an independent, expert organization for making the unseen facts intelligible to those who have to make the decisions...My conclusion is that public opinions must be organized for the press if they are to be sound, not by the press as is the case today. This organization I conceive to be in the first instance the task of a political science that has won its proper place as formulator, in advance of real decision, instead of apologist, critic, or reporter after the decision has been made..."3

The Council on Foreign Relations is the "independent, expert organization" Lippmann is suggesting. Lippmann is advocating the creation of a totalitarian state. If one small group is permitted to control public opinion, that small group can use their power to benefit the aims of the group rather than the public at large. People's actions are strongly influenced by their knowledge base. People act on their beliefs. By corrupting a persons knowledge base you can manipulate their actions.

Around 1935 men such as George Gallup, Elmo Roper and Archibald Crossley, were studying opinion polling as a tool to help social scientists and

psychologists study genuine problems, to learn how people looked at things,
and to better understand why people of various backgrounds, interests,
loyalties, and information levels held certain opinions. The Council on
Foreign Relations funded early work on polling. The Council would use
knowledge gained from polls to help script and determine the effectiveness
of psycho-political operations. Gallup's and Roper's surveys appeared in
Fortune magazine. After the war Truman would choose the Director of Fortune
magazine to become head of Economic Security Policy for Europe. The
Director was a Council on Foreign Relations member named John Kenneth
Gailbraith. Elmo Roper would become deputy Director for the Office of
Strategic Services in World War II. The Office of Strategic Services would
become the Central Intelligence Agency.4

"In UNWRITTEN TREATY [Warburg, James P., Harcourt, Brace and Co., NY
1946 pg 15-16], Council on Foreign Relations member James P. Warburg
writes,

" It cannot be stated with sufficient emphasis that information is
one thing - propaganda quite another.
The purpose of spreading information is to promote the functioning
of man's reason.
The purpose of propaganda is to mobilize certain of man's emotions
in such a way that they will dominate his reason...
The function of an information agency is to disseminate truth - to
a make available fact and opinion, each carefully labeled and separated
from the other. The aim of an information agency is to enable as many
people as possible to form their own individual judgments on the basis of
relevant fact and authoritative opinion.
The function of a propaganda agency is almost the exact opposite:
it is not to inform, but to persuade. In order to persuade it must
disseminate only such fact, such opinion, and such fiction masquerading as

fact as will serve to make people act, or fail to act in the desired way."

James Paul Warburg was a financier, author, and government official. In
1939 Warburg was strongly opposed to American isolationism and neutrality.
He became a leading spokesman for the Committee to Defend America by Aiding
the Allies. He helped found the Fight for Freedom Committee, which called
for American entry into World War II. In 1941, in Madison Square Garden he
debated Charles Lindbergh of America First, an isolationist organization.
Warburg was appointed special assistant in the Office of Coordinator of
information. In 1942 he was appointed deputy director of the overseas
branch of the Office of War Information in London with responsibility for
propaganda aimed at the Axis powers and occupied European Nations. The name
of Warburg's agency is meant to confuse and mislead. According to Warburg's
distinction between information and propaganda, The Office of War
Information should have been named the Office of War Propaganda.5

The Office of Coordinator of Information was created in 1941. One purpose
of the agency was to pool information gathered by all of the Intelligence
Services. The second purpose of the agency was psychological warfare. The
Office of Coordinator of Information mobilized the talents of
psychoanalysts across the country to study domestic morale, and the effects
of psychological warfare techniques on morale. At the same time it also
studied Hitler and his influence on the German people. Sometime in 1942 the
agency was reorganized into two independent agencies -- the Office of
Strategic Services and the Office of War Information. The psychological
warfare study was in the domain of the Office of War Information.6

James P.'s father, Paul M. Warburg was a founding father of the Council on
Foreign Relations and the Federal Reserve system. To this

day the Federal
Reserve system is staffed and run by Council on Foreign
Relations members.
Conspicuously absent from history books, and economic
courses are any
mention of the role of the Council on Foreign Relations in
establishing
and running the Federal Reserve System.

In "The Anglo American Establishment," Carroll Quigley
writes, "The Rhodes
Scholarships, established by the terms of Cecil Rhodes
seventh will, are
known to everyone. What is not so widely known is that
Rhodes in five
previous wills left his fortune to form a secret society,
which was to
devote itself to the preservation and expansion of the
British Empire. And
what does not seem to be known to anyone is that this secret
society was
created by Rhodes and his principal trustee, Lord Milner and
continues to
this day [1949]...This society has been known at various
times as Milner's
Kindergarten, as the Round Table Group, as the Rhodes crowd,
as The Times
crowd, as the All Souls group, and as the Cliveden set." 7

The Council on Foreign Relations was formally established in
Paris in 1919
along with its British Counterpart the Royal Institute of
International
Affairs. The Council on Foreign Relations and Royal
Institute of
International Affairs can trace their roots back to Rhodes
secret society.
Rhodes became fabulously wealthy by exploiting the people of
South Africa.
Rhodes is the father of Apartheid.

Many American members were American intelligence officers
that belonged to
the first American Intelligence Agency -- THE INQUIRY. Many
British
members were British Intelligence Agents. THE INQUIRY and
its members, who
included such notable Americans as Col. Edward Mandel House,
Walter
Lippmann, Isaiah Bowman, and James Shotwell, wrote most of
Woodrow Wilson's
14 points. The INQUIRY members attended the Paris Peace
conference and
traded off most of the Fourteen Points to establish the

League of Nations.
Wilson was so disturbed by the INQUIRY's betrayal he suffered a stroke and physical collapse and refused to speak to his influential advisor INQUIRY member Edward House ever again. The American people refused to join the League of Nations, because they did not want to belong to an organization that could force America to go to war and whose intent was to be an international police force.

Col. House was an active member of the American Round Table Branch before becoming a Council on Foreign Relations founding father. House would play a key role in establishing a Graduated Income tax and the Federal Reserve System.

In 1886 a group of East Coast Millionaires including William Rockefeller, Joseph Pulitzer, J.P. Morgan, Henry Goodyear, and Edwin and George Gould bought Jekyll Island,Georgia, for $125,000. They named themselves the Jekyll Island club. The activities of some of the members changed world events. By the early 20th century Jekyll Island Club members represented 1/6th of the world's wealth. 8

On March 13, 1907 a financial panic was triggered by rumors that the Knickerbocker Bank, and The Trust Company of America were about to become insolvent. The rumors were started by the House of Morgan. There was a run on the banks. Morgan helped to avert the panic he helped to create. Morgan imported $100 million worth of gold from Europe to stop the run on the banks. This exercise was a Round Table psycho-political operation. It provided America with the perception and rationalization that what the United States needed was a central banking system.9

The Senate created the National Monetary Commission to study the problem. Senator Nelson Aldrich (John D. Rockefeller's father-in-law) headed the commission. To investigate the matter the Commission toured

the continent
of Europe to study the European central banking system.
Aldrich didn't have
any banking experience. It took nearly two years and
$300,000 of tax-payer
money to wine and dine the men of the European central
banking system
before the committee was able to complete their study.
Towards the end of
1910, a group of men held a secretive meeting on Jekyll
Island, Georgia. 10

The purpose of the 1910 Jekyll Island meeting was to
write the final
recommendations for the National Monetary Commission report.
Senator
Aldrich arranged the meeting. The men who attended included:
Henry P.
Davison (House of Morgan - J.P. Morgan and Co.); Benjamin
Strong (House of
Morgan - Bankers Trust Co.); Frank A. Vanderlip (House of
Rockefeller -
National City Bank); A. Piatt Andres (Assistant Secretary
of the
Treasury); and Paul Warburg (House of Warburg and House of
Khun-Lobe &
Co.). According to the memoirs of Frank Vanderlip, "Despite
my views about
the value to society of greater publicity for the affairs of
corporations,
there was an occasion, near the close of 1910, when I was as
secretive -
indeed as furtive - as any conspirator...I do not feel it is
any
exaggeration to speak of our secret expedition to Jekyll
Island as the
occasion of the actual conception of what eventually became
the Federal
Reserve System." Congress acted on the report and created
the Federal
Reserve act which President Woodrow Wilson signed on 23
December 1913. 11

In December of 1963, on the fiftieth anniversary of the
Federal Reserve,
the fifth edition of a book titled, "THE FEDERAL RESERVE
SYSTEM: PURPOSES
AND FUNCTIONS," was printed. As with earlier editions, the
stated purpose
of the book was "to better public understanding of the
System's trusteeship
for the nations credit." The real purpose of the book was
not to inform but
to persuade Americans to accept the massive control the

Federal Reserve had
upon the American Economy. A small group of Americans, the Council on
Foreign Relations, was using psychological warfare techniques not only as a
means of systematic nationalistic aggression, but as a means of deceiving
their own countrymen. 12

The 50th anniversary edition, and the former editions, were collaborative
products of the Federal Reserve Board of Governors staff. The book tells us
that the Federal Reserve's, "original purposes, as expressed by its
founders, were to give the country an elastic currency, to provide
facilities for discounting commercial paper, and to improve the supervision
of banking." It then explains, "From the outset, there was recognition that
these original purposes were in fact parts of broader objectives, namely,
to help counteract inflationary and deflationary movements, and to share in
creating conditions favorable to a sustained, high level of employment, a
stable dollar, growth of the country, and a rising level of consumption.
"13

That the broader objectives were recognized from the outset are anything
but clear. The first edition of "THE FEDERAL RESERVE SYSTEM: PURPOSES AND
FUNCTIONS " wasn't printed until a quarter of a century after the founding
of the Fed. The first edition was printed in May of 1939 just as the World
was about to go to war. The stress of war made it easier to persuade people
to accept the broader objectives of the Federal Reserve system. The threat
of world war made the threat of a Central Bank inconsequential. The first
edition of the book was part of a ongoing massive propaganda campaign
financed with tax-payer money and focused at the average American citizen.
These campaigns are nothing more then psychological warfare operations
written about by James Paul Warburg.

In "THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS," we

learn, the
Federal Reserve is a corporation, accountable to the United States
government, but owned by banks which have purchased shares of stock. The
Federal Reserve Bank is the bankers banker. If a commercial or savings bank
wants to lend more money to customers, it borrows money from its bank - the
Federal Reserve. The Federal Reserve is a watchdog that audits every banks
records to make sure loan decisions are based on sound judgments and that
regulations are being followed. The Federal Reserve is the controller of
the currency, the US Governments bank where the Treasury has its bank
account. The Federal Reserve is the nation's check-clearing system -
processing over 15 billion checks a year. The Federal Reserve is the keeper
of the worlds gold. The gold is kept in a vault at the New York Federal
Reserve bank. Most of the gold stored in the Fed belongs to other nations
and represents about one-third of the official gold reserves of the the
world's non-communist countries.14

In "THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS," we learn, the
Federal Reserve is run by a seven-member board of Governors appointed by
the President and confirmed by the Senate. Terms of office last 14 years to
insulate governors from political pressures. Terms are staggered, with one
expiring every two years. There's one chairman and one vice-chairman, both
of whom hold terms of four years. The seven members of the board of
Governors, the President of the Federal Reserve bank of New York, and four
other Federal Reserve Bank Presidents are members of a group called the
Federal Open Market Committee. This Committee is responsible for the
purchase and sale of government securities. That means they are responsible
for influencing the cost and availability of money and credit.15

Conspicuously absent from "THE FEDERAL RESERVE SYSTEM: PURPOSES AND

FUNCTIONS ," is any mention of the role of the Council on Foreign Relations
in establishing and running the Federal Reserve System; and the power the
Council on Foreign Relations (or any small group) would realize by
controlling the FED. While long terms on the board of governors were
established to to insulate governors from political pressures no safeguards
were established to insulate governors from pressures from a private group
such as the Council on Foreign Relations.

The Federal Reserve, through its influence on credit and money, affects
indirectly every phase of American enterprise and commerce and every person
in the United States. In 1924 Reginald McKenna chairman of the Board of
Midland Bank, and former British Chancellor of the Exchequer (i.e. head of
the Central Bank of England 1915-16), told Midland Bank stockholders in
England, "They who control the credit of a nation direct the policy of
governments and hold in their hands the destiny of the people." Midland
Bank was established by the head of the Round Table, Lord Alfred Milner.
Mckenna's insight into power of "they who control the credit of a nation"
is not mentioned in "THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS ."16

In 1913, CFR founding father Colonel House helped pick the charter members
of the original Federal Reserve Board. Among those chosen were Paul Warburg
[House Warburg and House of Khun-Lobe & Co.] and Benjamin Strong [House
of Morgan and House of Khun-Lobe & Co.]. House, Warburg, and Strong were
American Round Table group members. According to Round Table Group
historian, Carroll Quigley, the aim of the dynastic banking houses was,
"...nothing less than to create a world system of financial control in
private hands able to dominate the political system of each country and the
economy of the world as a whole. This system was to be controlled in a
feudalist fashion by the central banks of the world acting

in concert, by
secret agreements arrived at in frequent private meetings
and conferences.
The apex of the system was to be the Bank for International
Settlements in
Basle, Switzerland, a private bank owned and controlled by
the world's
central banks which were themselves private corporations.
Each central bank
, in the hands of men like Montague Norman of the Bank of
England, Benjamin
Strong of the New York Federal Reserve Bank, Charles Rist of
the Bank of
France, and Hjalmer Schact of the Reichs bank, sought to
dominate its
government by its ability to control Treasury loans, to
manipulate foreign
exchanges, to influence the level of economic activity in
the country, and
to influence cooperative politicians by subsequent economic
rewards in the
business world."17

Montague Norman was a member of the British Round Table
Group, Benjamin
Strong was a member of the American Round Table Group.
According to
Quigley, "Strong owed his career to the favor of the Morgan
Bank,
especially of Henry P. Davison, who made him secretary of
Bankers Trust
Company of New York (in succession to Thomas W. Lamont) in
1904, used him
as Morgan's agent in the banking rearrangements following
the crash of
1907, and made him vice-president of the Bankers Trust
(still in succession
to Lamont) in 1909. He became governor of the Federal
Reserve Bank of New
York as the joint nominee of Morgan, Kuhn, Loeb and Co. in
1914. Two years
later, Strong met Norman for the first time, and they at
once made an
agreement to work in cooperation for the financial practices
they both
revered."18

Alan Greenspan, Paul Volcker, G. William Miller, and William
McChesney
Martin have all chaired the Federal Reserve board. All are
members of the
Council on Foreign Relations. As of September 1993, the
Congressional
Budget Office estimated that handling losses in failed

savings and loan institutions would cost $120 billion from 1990 through 1998 (this figure does not include $60 billion spent before 1989). The loss figure has recently been reported to be over $250 billion, double the original estimate. Among those found guilty of bank fraud were Neil Bush and Lance Benson. Neil is the son of CFR member George Bush, Lance is the son of CFR member Bill Clinton's Secretary of the Treasury Lloyd Benson. Despite being found guilty of fraud Neil Bush and Lloyd Benson escaped punishment and didn't pay back any money. So much for taking responsibility for ones actions! Wasn't one of the jobs of the Federal Reserve to be watchdog?

In 1987 leaders of America's major banks went to Tokyo. They met with our finance minister and governor of the central bank. They urged more positive cooperation by Japanese banks. The big American banks were caught in the dilemma of their Latin American Debt. On the one hand, they had to suffer the losses caused in part by their own over-lending, which meant they could not continue being exposed to new loans to Latin America. On the other hand, they were unable to jettison Latin America, which for them was an important market. The leaders of the banks attending the meeting were John Reed of Citibank, Willard Butcher of Chase, Lewis Preston of Morgan, and Tom Clausen of the Bank of America. Reed, Butcher and Preston are all members of the Council on Foreign Relations.

The United States Code contains the general and permanent laws of the United States. The United States Code is prepared and published by the Office of the Law Revision Counsel of the House of Representatives. The laws have been classified into fifty categories. A category is called a Title. For example, laws pertaining to the President are found in Title 3 The President. Title 12 is called Banks and Banking. A reading of laws

contained in Title 12 back up the statement that Congress has not given
authority for determining money policy to the Federal Reserve System.

Title 50 War and National Defense clearly spells out such a role for the
Federal Reserve. Title 50 Section 101 is the National Security Emergency
Preparedness Policy. In this policy in Part 15 - Department of the Treasury
in Section 1501 Lead Responsibilities we find that "the Secretary of the
Treasury shall: (1) Develop plans to maintain stable economic conditions
and a market economy during national security emergencies; emphasize
measures to minimize inflation and disruptions; and minimize reliance on
direct controls of the monetary, credit, and financial systems. These plans
will include provisions for: (a) Increasing capabilities to minimize
economic dislocations by carrying out appropriate fiscal, monetary, and
regulatory polices and reducing susceptibility to manipulated economic
pressures; (b) Providing the Federal Government with efficient and
equitable financing sources and payment mechanisms."

Has the Federal Reserve been acting as if we have been in a perpetual
National Security Emergency? Has the federal reserve been fine tuning the
economy of the United States and advertising that it had the legal powers
to do so when it really does not?Allen Greenspan, head of the Federal
Reserve, Clinton's Economic Advisor Laura Dandrea Tyson, Clinton's
International Security Advisor Lynn Etheridge Davis (who is also a Vice
President of Chase Bank) and President Bill Clinton are all Council on
Foreign Relations members.

Is the destiny of the American people being controlled by a group who have
and hold the power to direct the credit policy of our nation. A group that
has circumvented the check and balance safe-guards built into the system to
prevent any one group from having this kind of power over

the American citizen. A group whose self-proclaimed drive is for personal profit and who lack the honesty and integrity to make decisions based on public good.

Are Council on Foreign Relations members furthering a plan for a world order based on an economy of unrest? Are Council on Foreign Relations members subtle fascists intently interested in private ownership of property, under their control? Did the Council on Foreign Relations instigate and perpetuate the cold war? Did they do this to accumulate and protect Council holdings? Was this done by establishing and maintaining the most powerful U.S. military establishment in peacetime history?

Is the next stage in the plan to co-opt and divide eastern Europe and the rest of the world? Is the next stage in the plan for powerful World-Wide military establishment of "volunteer" military forces under UN command in the role of Peacekeepers? Was detonation of the first nuclear bomb, in Alamogordo New Mexico, on July 16, 1945, in a field test code-named Trinity, the Council's subtle way of sounding the deathbell for Jefferson's Trinity of inalienable rights of Life, Liberty and Pursuit of Happiness?

Was Nuclear Proliferation, and Mutually Assured Destruction (MAD) part of a Council on Foreign Relations psycho-political operation to keep the world in a state of controlled insanity? Is the current threat of Nuclear terrorism by some rogue nation part of a Council on Foreign Relations psycho-political operation to rationalize keeping the United States in a perpetual state of National Security so the Federal Reserve can "legally" control the economy? Are the Council on Foreign Relations controlled State Department, and CIA operatives working with the Britain's Royal Institute of International Affairs controlled State Department and British Secret

Service operatives to infiltrate, teach. and provide some small terrorist group with the necessary technology to make the threat of Nuclear terrorism a reality in some hapless city in the United States or other Western Nation?

The following book review, by Jane H. Ingraham, tells the story of the Founding of the Federal Reserve by the Round Table, and provides insight into how they really operate:
(http://www.execpc.com/~jfish/bkrvws/jekyll.txt)

Book Review: The Creature From Jekyll Island.

Killing the Banking Beast
Jane H. Ingraham
The New American
Vol 10, Number 18 September 5, 1994

The Creature From Jekyll Island, by G. Edward Griffin, Appleton, WI: American Opinion Publishing, Inc., 1994, 608 pages, paperback, $19.50. (For ordering information, see end of article.)

Has it ever occurred to you that the federal government has no need of taxes for revenue? Are you aware that banks prefer lending to governments because governments seldom repay loans? Do you realize that if all debts, both public and private, were paid, there would be no money at all in circulation?

These are only a few of the startling facts that fill the pages of this illuminating expose of the Insider scam called The Federal Reserve System (Fed). Although author G. Edward Griffin admits to having wondered if another book on the Federal Reserve is necessary (his six pages of bibliography suggest that the subject may have previously attracted attention), it is unlikely that any book has ranged across 2,000 years of money and banking from Diocletian to the Rothschilds to Alan Greenspan -- and tied it into the new world order -- as thoroughly as The Creature From

Jekyll Island.

Griffin cuts through the obscurities about the Fed that are intentionally meant to mystify and disarm its victims (all of us). Convinced that the subject of money and banking is too arcane and complicated to understand, we victims are trapped in a world view that utterly fails to jibe with reality. The money manipulators, says Griffin, are exploiting our ignorance for the advancement of their own appalling plans; the urgency of awakening us to our danger has driven Griffin to write this extraordinary book.

Although Griffin has never held an academic position, he is a top-notch teacher. Making this little-understood subject simple by splendid organization, his account is divided into six sections with varying numbers of chapters; each section and chapter is introduced by a concise paragraph while each chapter is also summarized. Thus the reader is kept in touch with where he has been and where he is going, an ingenious and helpful device considering the enormous scope of Griffin's narrative.

His explanations and definitions are meticulously worded; one can sense the care with which each word was chosen, leaving no room for confusion. Griffin continually draws documentation from primary sources, quoting letters, speeches, and published works that both enlighten and horrify. His own writing is difficult to quote; it is so trenchant that nearly every sentence entices. Yet at the same time Griffin has mastered the art of speaking personally to the reader, who never loses the feeling of being directly addressed. All this adds up to a superbly clear, engrossing book that, once started, is impossible to put down.

Setting the Stage

In order to help us fully understand our present predicament, Mr. Griffin ranges far afield in explaining the historical, economic, and political antecedents of today's money system. We are given a crash course on the nature of money; the origin of banks and the concept of fractional reserves; how this led to the seductive idea of using the same money over and over; how this inevitably led to economic disaster wherever and whenever tried. We are instructed about the Rothschild formula, which perfected the art of making enormous profits from loans to governments, especially for wars; how this led to preventing any one nation from becoming strong enough to establish peace (the famous balance of power); how those who could instigate wars or revolutions were financed (including the Bolsheviks in 1917); how we Americans were sucked into World War I in order to save J.P. Morgan's loans to England; how environmentalism is now the weapon of choice replacing war.

We are taken to the super-secret meeting of Insider financiers and Rothschild agent Paul Warburg on Jekyll Island in 1910 where the basic plan for what became the Federal Reserve Act was formulated; we learn that these plotters were already affiliated with the conspiratorial British one world Round Table group which preceded the Council on Foreign Relations (our secret government); we are astounded by the brazen deception of Congress that pushed through this unconstitutional act creating the Insiders' fundamental tool -- a central bank with the ability to inflate. We are told how this same tool has been expanded internationally through the International Monetary Fund (IMF) and World Bank in order to create worldwide inflation, pay enormous sums of perpetual interest on never paid-up loans to Insider banks, and socialize the Third World, all courtesy of us unsuspecting taxpayers. Lastly, Griffin foretells our dismaying fate if our course is not altered; then he lays out a step-by-step procedure of how to alter it, inviting us to join with him in doing so.

Griffin looks the Fed "creature" straight in the eye and tells us it is not federal, it has no reserves, and it is not a bank. It is, in fact, a pernicious cartel operating against the public interest. The widespread belief that the Federal Reserve exists to "stabilize the economy" is hogwash; the real reason for its existence is the making of money -- not out of "thin air" as is commonly supposed, but, more accurately, out of debt. Griffin explains that it is the act of borrowing by the federal government that causes money to spring into existence.

Griffin takes us through the Open Market steps by which Treasury IOUs (bonds) are converted by the Federal Reserve into money through the issuance of Federal Reserve checks with no money in existence to cover them; anyone else doing this would go to jail. Congress has made this legal for the Fed, however, because this hidden process allows our congressmen to enjoy unlimited revenue without having to visibly raise taxes. Without this service, says Griffin, the monetary/political partnership would dissolve, and Congress would abolish the Fed.

Money Multiplied

Griffin explains that these Federal Reserve checks are endorsed by the government, deposited in a Federal Reserve bank, and used to pay government expenses by checks which create the first wave of fiat (unbacked paper) money that floods into the economy. Recipients deposit these checks into commercial banks that are part of the Fed system. Here is where the real inflationary action is. (The Federal Reserve holds "only" seven percent of the national debt of almost $5 trillion. The 12 percent held by foreigners and the 56 percent held by Americans are not inflationary because the money used for purchase already existed.)

Commercial banks, like the Federal Reserve, also create money out of nothing -- and collect interest on it -- by multiplying every dollar deposited nine times. This amazing feat is accomplished through the device of fractional reserves, whereby the Fed allows 90 percent of deposits to be loaned out. As deposits become loans and loans become deposits, this process repeats with smaller numbers each time around. For instance, $1 million in government money (first wave) gives birth to $900,000 (second wave), which gives birth to $810,000 (third wave), etc., until the process plays itself out. Thus, the banking cartel creates an amount of money that is nine times the amount of the original government debt that made the process possible.

Griffin shows that when the original debt is added in, the Federal Reserve and the commercial banks together have created approximately ten times the amount of the underlying government debt. Since this newly created money causes the purchasing power of all money to decline, the resulting rise in prices is, in reality, a hidden tax. As Griffin puts it:

> Without realizing it, Americans have paid over the years, in addition to their federal income taxes and excise taxes, a completely hidden tax equal to approximately ten times the national debt!

Griffin is astonished at the public's indifference to this fleecing; he blames it on ignorance based on disinformation. Nothing could prove him more right than the current deception that inflation is higher prices caused by full employment and a strong economy; therefore, letting the "steam" out of the economy and slowing growth (and thereby employment) is "good." This talk is madness. Alan Greenspan. chairman of the Federal Reserve (who has the temerity to say he is "worried about inflation"), is repeating this claptrap as he pretends to control inflation

by increasing
interest rates that merely devastated the bond market,
clobbered the stock
market, and helped only the bankers. Thus the Insiders are
perfectly
protected and the scam rolls on.

There are many more threads to Griffin's discourse on the
operations of the
banking cartel that should not be missed, such as:

* How holders of Treasury bonds can be paid off only by the creation of an identical bond out of nothing.

* Why the U.S. has to be, must be, in debt.

* How the Discount Window (Fed loans to banks) creates more phony money.

* How the federal government could operate without levying any taxes whatsoever.

* How the Fed causes booms and busts.

* How, since 1913, our money has depreciated by over 1,000 percent.

* How a gold standard automatically stabilizes prices.

* How the Fed can now monetize the debts of foreign governments!

Without the extensive knowledge offered by Griffin, no
American can fully
understand the financial reality of our time.

Understanding the Game

Also critical to our reality check is an understanding of
how the Fed
protects and enriches the banking brotherhood in the
international arena.
The game our Insiders are playing makes the Rothschilds look
like novices.
Here it is in a nutshell: The game starts with a mammoth
loan (created out
of nothing through the magic of fractional reserves) from
one of our
megabanks (Citicorp, Chase Manhattan, Bank of America, etc.)
to a Third
World country with scant means of servicing the debt much

less ever repaying the principle. Are these top bankers stupid? Hardly; Griffin explains that this is the kind of loan these bankers love, since they make their money from interest on the loan, not on repayment of the loan. They prefer the loan never to be repaid. They know they can't lose because the Federal Reserve guarantees that massive loans that go into default will not be allowed to seriously affect the issuing bank (too big to fail) because this would "disrupt the entire economy."

So, says Griffin, "since the System makes it profitable for banks to make large, unsound loans, that is the kind of loans banks will make. Furthermore, it is predictable that most unsound loans will go into default." Sure enough; pretty soon default threatens. The bank creates additional money out of nothing and lends that so its interest stream continues on both the original loan plus the new loan (the "roll-over" play). At the next crisis, the bank creates still more money out of nothing to cover the interest on both loans plus an additional amount for the borrower to spend freely (the "up-the-ante" play). Finally the bank agrees to a lower interest rate and a longer period for repayment (the " rescheduling" play). Eventually it is time for the "Final Maneuver." Congress agrees to guarantee future payments and the whole mess is shifted to the backs of U.S. taxpayers while the borrower is trapped into an IMF "austerity" program that makes an "end run" around his sovereignty.

Now money moves through various foreign aid channels to the deadbeat borrower, who continues to pay perpetual interest to the bank. Almost all of this money is generated by the Federal Reserve; as it moves out into the economy it dilutes the value of the money already there. The American people, says Griffin, have no idea they are footing the bill to enrich the

Insider bankers.

Founder' Fears Realized

Readers may be surprised to learn that the Federal Reserve is the fourth central bank the United States has had, the previous three having crashed in inevitable raging inflation and widespread economic disaster. So clearly did our Founders understand and fear worthless paper money forced on the public by legal tender laws (precisely what we now have) that they filled the proceedings of the Constitutional Convention with statements of their horror of it. We Americans today, deprived of hearing such truth, need to listen to their words:

* George Mason of Virginia:

"I have a mortal hatred of paper money."

* John Langdon of New Hampshire:

"I would rather reject the whole [Constitution] than grant the new government the right to issue fiat money."

* George Reed of Delaware:

"The right to issue fiat money would be as alarming as the mark of the beast in Revelation."

* Thomas Paine:

"The punishment of a member of Congress who should move for such a law ought to be death."

Griffin does not stop with presenting the known picture, but projects today's reality into the future. His first projection is a doomsday scenario his second is a realistic plan for saving our country and ourselves. These chapters might, after all, be the most important ones in the book. Griffin sees doomsday as an engineered financial debacle the severity of which will cause panicked Americans to welcome a World Bank "rescue" with a world currency. The IMF/World Bank is already functioning - in conjunction with the Federal Reserve - as a world central bank. A world currency is already designed, awaiting a crisis to justify its introduction. From this point on, writes Griffin, there will be no escape from the new world order. At present the U.S. is being deliberately weakened by seemingly insane spending both at home and abroad: As just one more dismaying example, during President Clinton's recent trip to Europe he blithely promised more billions of dollars to Poland, Ukraine, and the Baltic countries. The name of the game is to spend - on anything, anywhere. The object is to bring down the system.

Life in the New World Order

What will life be like in the Insiders' new world order? Griffin spells it out from the words of the Insiders themselves. One source is the 1966 secret Hudson Institute study commissioned by Defense Secretary Robert McNamara, entitled Report From Iron Mountain. This study coldbloodedly discusses various means by which government might control the populace and perpetuate itself in power in the absence of war (UN peace).

Griffin's review (with extensive quotes) of this truly diabolical Insider study is masterful; he takes it apart and shows us its consummate evil. The study's premise is that historically the only means by which a government has ever been able to "secure the subordination of citizens to the state" is war. Only war has been able to provide the external threat without which no government can accumulate power. War is used to make the masses put up with all kinds of privation, taxation, and controls without complaint. No amount of sacrifice in the name of victory is rejected. Resistance is viewed as treason.

But, says Griffin, Report From Iron Mountain explains that the war system may have to be replaced because "it may now be possible to create a world government in which all nations will be disarmed and disciplined by a world army, a condition which we will call peace." In this case, what could be a substitute for war?

Here, explains Griffin, is the origin of the stratagem to promote ecological doom as the new enemy that threatens the entire world. The threat need not be real, provided the masses can be convinced it is real. Credibility is the key, not reality. Griffin writes that Report From Iron Mountain explains the avalanche of phony scientific claims that are uncritically publicized by the Insider-controlled media, as well as the funding of environmental "crazies" by corporations and businesses that would appear to have the most to lose. He sees the plan as being brilliantly successful.

The barrage of propaganda has had a phenomenal result. Politicians are now being elected on nothing but "concern for the environment and a promise to clamp down on nasty industries," with no one caring about the damage done to the economy or our freedoms. Just as no sacrifice is too great in time of war, what happens to the economy or our freedom is of no consequence "when the very planet on which we live is sick and dying."

Griffin introduces us to multi-millionaire Maurice Strong, the powerful UN environmental czar, who gives us the whole line: The U.S. is committing environmental aggression against the rest of the world. Current lifestyles of the affluent middle class -- high meat intake, frozen and convenience foods, electric household appliances, cars, air conditioning, suburban housing -- all this has to go. The world's ecosystems can be preserved only by lowering our standard of living by rationing, taxation, and political domination by world government.

Reading this section will forever change the way in which you view
government. Yet, says Griffin, this perverted, power-mad Insider fix need
not prevail. None of these dreadful things needs to happen. He outlines a
procedure by which the Federal Reserve can be abolished, the national debt
paid, and the country returned to a sound monetary system based on silver
and gold. All that is needed are the efforts of concerned and caring
Americans. Griffin invites us to join him in freeing ourselves from the
one-world conspirators. It can be done.

To order: "The Creature From Jekyll Island"

send $19.50 + $2.00 shipping to:

American Opinion Book Services
P.O. Box 8040
Appleton, WI 54913

or by credit card: 414-749-3783

roundtable

[1] Quigley, Carroll, Tragedy and Hope, Macmillan, New York 1966, p. 939;
The Anglo-American Establishment, Books In Focus, New York 1981 pg.
182-183, 232-233. "The Anglo-American Establishment" was written in 1949.
It contains one brief reference to a "group of experts, " the INQUIRY"",
present at the Paris Peace Conference on page 182. On page 233 Quigley
warps history by disassociating the secret society from the authorship of
Wilson's 14 points. Quigley never refers to the INQUIRY in writing again,
even in his later and more well known 1300 page tomb "Tragedy and Hope,"
published 1966.

[2] Lippmann, Walter PUBLIC OPINION, Harcourt, Brace and Co., NY, 1922 pgs
25-26

[3] Lippmann, Walter PUBLIC OPINION, Harcourt, Brace and Co., NY, 1922 pg 31-32

[4] Hadley Cantril, The Human Dimension: Experiences in Policy Research,
Rutgers The State University, 1967 pg 22-25

[5] Dictionary of American Biography Supplement Eight 1966-1970, Garraty,
John A., Carnes Mark C., Charles Scribner's Sons, NY, Collier Macmillan
Publishers London, 1936, pgs 679-680

[6] Langer, Walter C. The Mind of Adolf Hitler, The Secret Wartime Report,
Basic Books Inc., New York, London (1972) Foward (by William L. Langer)
v-vi, 3-8

[7] Quigley, Carroll, The Anglo-American Establishment, Books in Focus, PO
Box 3481, Grand Central Station, NY, NY 10163, 1981 pg ix [Quigley died in
1977.

[8] AAA Publishing, Georgia - North Carolina - South Carolina TourBook,
Heathrow, FL 32746-5063, pg 46

[9] Larry Abraham, Call it Conspiracy, Double A. Publications, Seattle
Washington, 1985, 52-53; Cleon Skousen, The Naked Capitalist - A Review
and Commentary on Dr. Carroll Quigley's Book 'Tragedy and Hope - A History
of the World In our Time', published as a private edition by W. Cleon
Skousen, 2197 Berkeley Street, Salt Lake City, Utah, 84109, 1971, 8th
Printing, pgs 16-18

[10] Larry Abraham, Call it Conspiracy, Double A. Publications, Seattle
Washington, 1985, 52-53; Cleon Skousen, The Naked Capitalist - A Review
and Commentary on Dr. Carroll Quigley's Book 'Tragedy and Hope - A History
of the World In our Time', published as a private edition by W. Cleon
Skousen, 2197 Berkeley Street, Salt Lake City, Utah, 84109, 1971, 8th
Printing, pgs 16-18

[11] Larry Abraham, Call it Conspiracy, Double A. Publications, Seattle
Washington, 1985, 52-53; Cleon Skousen, The Naked Capitalist - A Review

and Commentary on Dr. Carroll Quigley's Book 'Tragedy and Hope - A History
of the World In our Time', published as a private edition by W. Cleon
Skousen, 2197 Berkeley Street, Salt Lake City, Utah, 84109, 1971, 8th
Printing, pgs 16-18

[12] Board of Governors of the Federal Reserve System, The Federal Reserve
System - Purposes and Functions, 1913-1963, 50th Anniversary Edition,
Washington, DC, 1963 Library of Congress Catalog Card Number 39-26719 pg.
vii [First Edition 1939, Second Edition - 1947, Third Edition - 1954.
Fourth Edition - 1961]
.
[13] ibid pg 1-2

[14] Board of Governors of the Federal Reserve System, The Federal Reserve
System - Purposes and Functions, 1913-1963, 50th Anniversary Edition,
Washington, DC, 1963 Library of Congress Catalog Card Number 39-26719 pg.
166-169,270-273

[15]Board of Governors of the Federal Reserve System, The Federal Reserve
System - Purposes and Functions, 1913-1963, 50th Anniversary Edition,
Washington, DC, 1963 Library of Congress Catalog Card Number 39-26719 pg.
15-27, 215-266

[16] Quigley, Carroll, Tragedy and Hope, Macmillan, New York 1966, p. 325

[17] Quigley, Carroll, Tragedy and Hope, Macmillan, New York 1966, p. 324

[18] Quigley, Carroll, Tragedy and Hope, Macmillan, New York 1966, p. 326

Visit the Roundtable Web Page:
http://www.geocities.com/CapitolHill/2807
E-mail: roundtable@mail.geocities.com
read on-line: Psychological Operations In Guerrilla Warfare (The CIA's
Nicaragua Manual); The Secret Team by Fletcher Prouty; The NAFTA PSYOP;
Nitze's Not-Sees; & More

visit: U.S. Army War College - Meet Henry L. Stimson and
Elihu Root
Professors of Military Studies

================= END ATTACHMENT 2 =================

=================== ATTACHMENT 3 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
================= END ATTACHMENT 3 =================

=================== ATTACHMENT 4 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
RFC-822-headers:
Received: from conversion.pmdf.eop.gov by PMDF.EOP.GOV (PMDF V5.1-9 #29131)
id <01J11WYEANM8002NGX@PMDF.EOP.GOV> for yellen_j@a1.eop.gov; Wed,
26 Aug 1998 08:27:51 EDT
Received: from Storm.EOP.GOV by PMDF.EOP.GOV (PMDF V5.1-9 #29131)
with ESMTP id <01J11WYBTFTC002L48@PMDF.EOP.GOV> for yellen_j@a1.eop.gov; Wed,

26 Aug 1998 08:27:47 -0400 (EDT)
Received: from NDU.EDU ([198.76.85.6]) by STORM.EOP.GOV (PMDF V5.1-12 #29131)
with SMTP id <01J11WXMNAA80002IN@STORM.EOP.GOV> for yellen_j@a1.eop.gov; Wed,

26 Aug 1998 08:27:13 -0400 (EDT)
Received: from NDU-Message_Server by NDU.EDU with Novell_GroupWise; Wed,
26 Aug 1998 08:25:46 -0500
X-Mailer: Novell GroupWise 4.1
================= END ATTACHMENT 4 =================

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:31-AUG-1998 16:30:43.00

SUBJECT: copy of merger answers

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.D76]MAIL45690534P.226 to ASCII,
The following is a HEX DUMP:

Answers to questions submitted by Senator Chuck Grassley for the Judiciary Committee hearing on "Mergers and Corporate Consolidation in the New Economy," June 16, 1998

1) *Dr. Yellen, I believe that special attention needs to be paid to the potential anti-competitive and negative impact of mergers on consumers and businesses in rural and small communities. I think that Federal regulators should give these considerations substantial weight when they evaluate and make their final determinations in regard to these mergers.*

A) *What impact do mergers have on rural America? Are the consolidations in various industries something rural and small communities should fear?*

Answer: In general, mergers raise the same questions in regard to rural America as they do in regard to the rest of the country. On the positive side, mergers can encourage greater efficiency, by reducing excess capacity, taking advantage of economies of scale and scope, and encouraging technological progress. Over time, such efficiencies translate into lower prices and better products and services for consumers. On the negative side, mergers that increase market concentration can lead to higher prices and reduced consumer benefits. Mergers, like other forms of economic change, can also disrupt established patterns of economic and social activity.

When the antitrust agencies review mergers, they do so with an eye to protecting competition for the benefit of consumers; considerable attention is paid to market definition, so that the effects are evaluated in the proper context. Most mergers have been found to be procompetitive or competitively neutral. Those that would reduce competition and harm consumers are challenged. Antitrust enforcement does not, and probably should not, encompass the broader range of possible economic and social effects that may be associated with mergers. Other policies that are more appropriate for addressing those effects include promoting full employment and macroeconomic stability, developing a skilled and well-trained workforce, providing unemployment insurance and other safety net programs, and helping communities address the challenges of economic change.

Rural America, like the rest of the country, is protected against the harmful effects of mergers on competition, while being able to enjoy the efficiency-enhancing effects of most mergers, through effective enforcement of the antitrust laws. Broader economic and social changes, whether arising from mergers or other forces, such as deregulation technological change, or international competition, may pose challenges for rural and small communities. But they should not engender fear.

B) *Are these considerations on the Administration's radar screen.*

Answer: These concerns are very much on the Administration's radar screen. After a period in the 1980s when most mergers went unchallenged, the antitrust agencies have been aggressive in enforcing the nation's antitrust laws during this Administration. In addition, the Administration's overall economic strategy has been focused on promoting growth and embracing change while trying to insure that no groups or regions are left behind. The Administration is monitoring a wide range of economic developments, including the impact of mergers and other economic change, on both rural and small communities and the rest of the nation.

C) Are there any particular industries where mergers can have a disproportionately negative impact on small and rural communities? If there are, what can we do to address the issue?

Answer: Most mergers appear to be pro-competitive or competitively neutral. However, the industries in which mergers have been taking place, such as telecommunications, transportation, and banking are important to rural America. Issues such as loss of air service or loss of banking services are legitimate worries, but there is little evidence that mergers *per se* pose major problems in this regard. Maintaining the appropriate level of transportation services in rural America and keeping rural communities economically vital are legitimate public policy concerns, but the tools of antitrust enforcement are probably not the right policy instruments for this task.

2) I have been particularly concerned about mergers and alliances going on in the airline industry, and the possible negative impact they may have on rural states. Iowans have been experiencing inadequate air service and high airfares for some time now, and this has and will continue to adversely impact the economic development of many small and rural communities in my state. While other things are probably occurring in the airline industry, like predatory pricing, restrictive gate practices and hub dominance, I think that airline mergers and alliances also play a role in this problem.

A) Have you examined the airline industry and the problems facing many small and rural communities with respect to high airfares and poor air service? Do you have an opinion of what is happening in the industry, do you think that there is a problem and, if so, do you have any suggestions on how we can fix it?

Answer: Most evaluations of the overall impact of airline deregulation have concluded that consumers in general have more service options and pay lower fares as a result. Mergers, restructuring, and the development of the hub-and-spoke system have contributed to producing these gains. Many air travelers to and from small and rural communities have also benefited. But the picture is not perfect. While some communities have experienced service increases and reduced fares, others may have experienced service reductions and higher fares. This spring, as I am sure you know, a survey showed that fares were substantially higher on the Des Moines-Chicago and Minneapolis-St. Paul routes than they were on the Omaha-Chicago or Kansas City-Chicago routes. The key difference was the presence or absence of competition from a low-cost carrier.

Pursuing policies that encourage and protect competition are important for achieving the maximum economic benefits achievable in a deregulated airline industry. Studies suggest that some of the airline mergers in the 1980s reduced competition and led to higher fares in some affected markets. It should be pointed out, however, that these mergers took place in a more permissive antitrust enforcement environment than today's. Now, in addition to heightened scrutiny by the antitrust agencies, the Department of Transportation is proposing to investigate situations in which it appears that a major airline may have engaged in unfair competitive practices against a new entrant. Finally, the Essential Air Service program provides for federal subsidies, if necessary, to maintain basic service to communities on the certificated airline map in 1978.

3) *At the hearing, I asked Mr. Greenspan about consolidation in the banking industry, and the concerns of farmers and small businesses that they will have more dificulty in getting the credit they need to run their businesses. Specifically, farmers and small business owners I have talked to are concerned that the rapid consolidation in the banking industry will result in a lack of available credit in rural areas in my state of Iowa.*

A) *In your opinion, have the recent mergers in the banking industry resulted in, or will they result in, a reduction of available credit in particular industries or in rural areas of the country?*

Answer: Banking mergers illustrate one of the key points I made in my testimony about the importance of careful analysis of particular markets. Because the antitrust authorities and bank regulators have focused on protecting competitive conditions in well-defined markets, concentration in local markets has remained roughly constant through the merger waves of the 1980s and the 1990s, even as concentration at the national level has increased and the number of banking organizations nationwide has declined. At the same time, however, surveys indicate that many individual customers of local banks that have been taken over by larger institutions believe that they are losing the benefits of the personalized service that only local banks can provide. How important these benefits are and whether they have been offset by some advantages offered by large banks remains largely a matter of speculation.

B) *Do you agree with Chairman Greenspan's comments at the hearing that he believes the dramatic increase in concentration in the banking industry will have no effect on agricultural credit, small business credit, or any other rural credits generally?*

In general, I agree with the thrust of Chairman Greenspan's comments. Bank consolidation mainly affects concentration at the national level and appears to have a much more limited impact on competition in local markets, which is what matters for the average small borrower. At this time, it does not appear that worthy borrowers, in rural areas or elsewhere, are in danger of being denied credit because of bank consolidation. In addition to the fact that concentration has not increased in local markets, community banks continue to thrive and new banks continue to be established every year.

4) *Dr. Yellen, I have heard concerns from Iowans about proposed mergers in the telecommunications industry. People think that the merged companies will cherry-pick customers from urban areas because they can make a lot more money from those markets. And they are worried that companies will bypass small and rural communities, leaving them with higher rates and reduced service.*

A) *Do you see this happening in the telecommunications industry? How can you address my constituents' concerns?*

Answer: The Telecommunications Act of 1996 was designed to increase competition and promote technological advances in the telecommunications industry. At the same time, a number of safeguards were incorporated into the act to prevent the kinds of substantial loss of service that seems to underlie your question. I expect that over the next decade your constituents are more likely to experience an improvement than a deterioration in their telecommunications services environment as a result of increased competition, new entry, and technological advance. But I am also confident that the antitrust authorities and the Federal Communications Commission will be vigilant in preventing any major service deterioration from mergers.

5) *Dr. Yellen, people are expressing concern about mergers of large American companies with large foreign companies. They are worried that a merged company with foreign headquarters, in trying to create efficiencies, will move jobs and factories from American communities to other countries. They are also concerned that if the economy goes sour and the merged company decides that there need to be layoffs and factory closings, the American jobs will be the first to go. Consequently, local communities will also lose out in the long term because job cuts and factory shut-downs will negatively impact the economy in that area.*

A) *Are these legitimate concerns? How do you respond to these constituents that are worried about their local economies?*

Answer: In a market-oriented economy, businesses have considerable latitude with regard to employment and location decisions. So, the scenarios laid out in your question are possible as a matter of logic. However, a skilled workforce and knowledge of specific markets are frequently key assets that a firm seeks to acquire when it merges with another firm. As a general proposition, the same kinds of considerations that affect domestic firms' decisions about plant closings, restructurings, or new plant opening also affect foreign-owned firms' decisions. Creating a fundamentally sound policy environment remains the best way to deal with potential economic and social disruptions from either foreign or domestic mergers. Appropriate policies include: promoting full employment and macroeconomic stability, developing a skilled and well-trained workforce, providing unemployment insurance and other safety net programs, and helping communities address the challenges of economic change.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:31-AUG-1998 17:19:46.00

SUBJECT: draft of speech attached

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

TEXT:
Nora's speech is below. I think it needs to be shortened. Let me know if you'd like me to do some work on it.
Thanks.

---------------------- Forwarded by Michele Jolin/CEA/EOP on 08/31/98 05:16 PM ---------------------------

Nora E. Gordon
08/28/98 04:45:16 PM
Record Type: Record

To: Michele Jolin/CEA/EOP
cc:
Subject: draft of speech attached

feel free to edit at will, or save comments for me to edit when i return. i'll be meeting with the principal late in the afternoon on sept. 8, my first day back, so i can run this by her too.
have a great weekend!
nora

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D3]MAIL47974534Q.226 to ASCII,
The following is a HEX DUMP:

ADDRESS TO CESAR CHAVEZ PUBLIC POLICY CHARTER HIGH SCHOOL
INDIAN TREATY ROOM, FRIDAY SEPT. 11, 2:00 P.M.

Note: there will be about 60 ninth graders, which is the entire school for the year. Also attending will be the principal, Mrs. Irasema Salcido, who is the person I have talked to, and the three teachers.

Thank you very much. Good afternoon. I'd like to welcome your principal, Mrs. Salcido, your teachers, Ms. Fighera, Ms. Russo-Downey, and **fill in new social studies name, check on any board members in attendance**, your parents who have volunteered to come along today **get names**, and all of you, the entering class of Cesar Chavez Public Policy Charter High School. I haven't met you all yet, but I know that all of you have been working very hard to start your school, and I admire your dedication.

It is especially fitting that you all should be here today, in the Old Executive Office Building, with the White House right out the window, for two main reasons. One is that the Clinton Administration is a big supporter of charter schools, and of students, parents, teachers, and administrators striving for the best schools they can have. Your school is a great example of this. Your goal of academic excellence for serving the public is commendable. The other reason you should be here today is to learn your way around, because I hope some of you will be returning here in the future for professional reasons. You are at the Cesar Chavez School to prepare for college and for careers in public policy. For many of you, I hope that will mean serving your country through government service, either in the federal government, like us at the Council of Economic Advisors and everyone at the White House and in the many federal agencies, or in DC government or other city or state governments, or on Capitol Hill in the legislative branch of government. It is crucial that hardworking, smart, motivated young people like yourselves keep our government going, and that you are involved in public policy as educated and politically active young people before you begin these professional careers.

What I would like to talk to you about today is how you can get here, or to whatever job in public policy to which you aspire. Most importantly, I would like to tell you about how critical it is that you go to college, and how to do this. I chose to talk to you about this today for two reasons. The first is that as an economist, I think it is very important. I also chose this topic after seeing some of your comments in your school newsletter, the Chavez Grapevine. Many of you wrote that you hope to make this city a better place through education. Lazema Brown wrote that she would like to "encourage young people to stay in school to get their education," Kristle Harrington wants to "fix DC schools," and Sandtruis Lucas wrote that children should not be on the street, but "should want to become someone important." I am thrilled that you are thinking about these issues already, and I think you already know my main message: that education is important. Now I would like to tell you exactly why it is so important, and how you can all achieve the high goals you have set for yourselves.

A lot of economic research is about using data to see patterns. By data, I mean any information collected systematically. One area in which economists have seen a very strong pattern is in the importance of college. A lot of the research about the importance of college uses data collected in the census, from the entire U.S. population every ten years. Census data shows us that now more than ever, people who have a college education have better jobs with higher earnings than people without a college education. And the earnings of those who have gone to college are growing faster than the earnings of those who have not.

This trend is true for the whole population, so good advice for *any* high school student who wants a stable income in the future is to study hard and graduate from college. This advice is *especially* important for all of you, as young people who care about DC and the United States and want to play a significant part in making your community a better place. For careers in public policy and public service, a college degree is very important. Many jobs will be open to you with this degree that otherwise would not.

Your school is set up to help you go to college. That already puts you ahead of the game. Take advantage of the resources at your school, the tutoring, mentoring, and SAT preparation. The path to college will not always be easy, but it is something that all of you should be able to do. With the right academic preparation, that your school is offering to you, and with information about how college can be possible for you financially, nothing can stand in your way.

So what can you do to make sure that college will happen for you? Well, serious academic preparation in high school is an important first step. Math classes are especially important.

Students who take rigorous mathematics and science courses are much more likely to go to college than those who do not. Taking classes like algebra, geometry, and chemistry increases the chances of attending college for everyone, and especially for financially disadvantaged students. For students with low income families, taking these classes *triples* the likelihood of going to college. And what matters with math is what classes you take, not where you take it. Students from public schools who had taken these rigorous math classes learned just as much math, as measured on a standardized test, as students who took those same classes at private schools.

Unfortunately, many students do not take these courses. They *are* challenging, but *you can rise to the challenge*. Don't be scared of math. With practice, math, just like everything else, gets easier. You are especially lucky to have lots of sources of extra help available to you at your school. Use them. Use them early, and use them often, because math classes build on each other. If you feel confused at the beginning, get help then. If you fall behind in math class at the beginning of high school, it is hard to advance to the kinds of classes that will help you for college. So make a commitment to math now. You won't be sorry.

Not only will math classes help you get into college and help you once you are in college, but having a good math background is also important for more and more jobs. Like college, math is important for everyone, but especially important for you. If you want to change public policy, you must understand statistics. Even if you do not end up using statistics in your own work, you want to be able to understand other people's statistics, so you know if you agree or disagree with their conclusions. Math will help you read the newspaper critically. You should decide for yourself what you think about different issues, rather than just adopting the view of the person writing a newspaper article or reporting a story on TV.

And if you want to be an economist, math is absolutely necessary. Economists use math when they are analyzing data, to discover trends like the importance of college, or what makes a country's economy grow, or what makes a company profitable. They also use math to make economic models -- basically, using math to express an idea in a simple and elegant form. Other public policy professionals need to understand math and economics also. Budget analysts at the Office of Management and Budget, one block up on 17th Street, use math all the time to figure out the budget for the whole federal government. People on Capitol Hill use math to identify and think about key political and economic problems. And public interest groups use statistics all the time to make their arguments more credible.

Once you have taken all the academic classes you need for college, your work is still not complete. As I'm sure you have heard, college is expensive. There is a wide range in how expensive it can be. State colleges cost less, and very elite colleges cost more. You should go to the college that is best for you. Colleges that cost more in total tuition also give more financial aid, so that you might end up paying the same amount at two schools with very different tuitions.

What is financial aid? Well, financial aid for college is usually composed of three elements: grants, which are money the college or government or some other organization gives you for college and you never have to pay back, loans, which are partially subsidized by the federal government, and work-study, which is when the college gives you a part-time job to help pay for tuition and other costs.

Because of what we know about how college helps people get jobs with good earnings, and jobs that help our country improve and our economy grow, President Clinton has worked very hard to make sure that when we start this new century, the first two years of college will be as universal as a high school education has been for the last fifty years. That's why we've provided a HOPE Scholarship, which is a $1500 tax credit to help pay the first two years of college tuition, and other tax credits for the junior and senior year of college. We have also simplified the student loan program and made interest tax deductible on student loans. There are also now more Pell Grants and more work-study jobs. AmeriCorps is a way to earn money for college by doing community service. These probably sound like a lot of details to you now, but all you need to remember is that there are many programs available to help you pay for college, and that your school will help you figure out these programs. The Department of Education also has lots of information on the Internet to help you see which resources are right for you.

Because all of us at the Council of Economic Advisers are so impressed with your school and the commitment all of you have made, we are pleased to be coming to visit you at your school next time. This school year, several of our economists will be coming to talk to you about different kinds of economic policies. You'll learn about environmental policy and global warming, about what's going on in international economies, like the Asian currency crises and current developments in the Russian economy, and about some topics in labor and social economics, like welfare reform. We are very excited to be a part of the first year of the Cesar Chavez Public Policy Charter High School.

So now you know some important things to do in the next four years to prepare for an exciting and satisfying career in public policy, or, if you change your mind, in many other fields as well. Take lots of challenging academic classes now. Take four years of math. Aim high for college, and look into lots of different resources for financial aid.

At times, these things will be difficult. You will be tired. Some of your friends won't be studying as hard as you are. Keep going. If you stick with it, you will really be proud of all you will learn. And all that you learn will not only help you for college, for jobs, and as an educated citizen, but it will enrich your life and make you better able to help others. All of the people you see in important positions in public policy and elsewhere have had times in school when something was hard and they didn't feel like doing it. What you need to do is think about how good you will feel once you have learned whatever that hard thing is. View learning as a challenge. Embrace the challenge. And always remember the motto of your school: si se puede *(phonetic:see say pway-day)*, it can be done.

Now I'd like to spend some time answering your questions. I hear that you've all prepared some questions already. I'd be happy to answer any questions you have about economics, what we do at the Council of Economic Advisers, the federal government, or the policy-making process. Please raise your hands, and when you ask your question stand up and tell me your name first.

20 minutes of Q and A.

Before you go, we have some gifts for you. We have ...

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:31-AUG-1998 21:25:48.00

SUBJECT: Mtg w/ McIntosh staff

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

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

TEXT:
Janet -- Just so you know, Rob Weiner and I are going to meet w/
McIntosh's staff on Wednesday AM to discuss documents and the subpoena.
I'll let you know the results of the meeting.
Thanks.
Michele

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Howard A. Shelanski (CN=Howard A. Shelanski/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 1-SEP-1998 11:34:35.00

SUBJECT:

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:
Attached is our preliminary outline for the ERP's micro chapter.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D73]MAIL459870442.226 to ASCII,
The following is a HEX DUMP:

Outline of Micro Chapter of ERP

Regulation and Innovation

I. Introduction

A. The Changing Face of Regulation

1. Increased health, safety and environmental regulations.

2. Deregulation of many industries (e.g. electricity, telecom) but continued regulatory concerns in other industries.

3. Continued vigilance in competition policy.

B. Innovation and the Economy

1. Definition of innovation and discussion of stages of innovation (invention, adoption, diffusion).

2. The importance of innovation to long-run growth and productivity in all sectors of the U.S. economy.

3. Measures of innovation and performance of high-tech industries.

4. International trade dimensions.

C. Links between Innovation and Regulation

1. The effect of regulation on innovation. Regulation can affect economic incentives to innovate by changing the risk/reward tradeoffs that firms face.

   a) Example: price caps versus rate of return regulation.

   b) Example: market based environmental regulation schemes versus command and control.

   c) Safe harbors from liability

2. The effect of innovation on regulation. Innovation can change the face of industries and force changes in regulation.

a) Example: convergence between telephone, cable, computer.

b) Example: new product or process may require new regulation.

c) [Box: electric power]

C. Current Importance of Relationship between Innovation and Regulation.

1. Competition Policy.

2. Environmental Regulation.

II. Competition Policy and Innovation

A.. Market Structure, Merger Policy, and Innovation

1. Current economic context: continuation of strong merger activity; increased importance of innovative activity; trade issues.

2. Dynamic vs. static analysis of market performance and economic welfare.

3. The challenge for competition policy: principles for maximizing static economic efficiency likely do not apply to maximizing innovation and dynamic efficiency.

a) Conventional competition policy holds that more competition is better.

b) The link between market concentration and innovation is much less clear; similarly complex is the link between firm size and innovation.

4. Changes in market concentration and firm size can affect innovation.

a) Linking market structure and innovation: theory and evidence.

(i) Compare to static analysis where pure competition is generally considered best.

b) Linking firm size and innovation: theory and evidence.

c) Possible dynamic implications of current structural changes in U.S. economy in light of evidence and theory discussed above.

6. How current antitrust policy on market structure fits with what we know about

relationship between structural conditions and innovation.

a) While innovation is not the traditional focus of competition policy, antitrust regulation has not been blind to dynamic effects on competition.

b) The competition-oriented focus of antitrust, while not theoretically optimal for maximizing innovation, may accommodate innovation concerns reasonably well because of the limited range of cases in which enforcement actually occurs.

c) Hard policy questions remain about the degree to which innovation effects should be considered, but by and large U.S. antitrust policy is doing a good job and is likely capable of handling future challenges within existing rules.

7. Intellectual property rights. [Box: pharmaceuticals and genetic prospecting.]

B. Network Competition and Innovation

1. Products that exhibit network effects and feedback effects; explanation of demand-side externalities.

2. "Tipping" equilibria, lock-in effects, and network market structure. [Possible box: credit card networks comapred to software.]

3. Static vs. dynamic analysis of consumer welfare in network markets.

4. The roles and possible effects of competition policy and intellectual property rules.

5. Application: the Internet and electronic commerce. [Box: privacy.]

III. Environmental Regulation and Innovation

A. Alternative forms of environmental regulation and innovation incentives

1. Different forms of environmental regulation (e.g., taxes, tradeable permits, best available control technology standards) yield different incentives to innovate to reduce abatement costs.

a) Static analysis with single firm. Comparison of private and social incentives to innovate to lower abatement costs.

b) Dynamic analysis and the ratchet effect. Incentives to innovate when regulation changes to reflect post-innovation conditions.

c) Joint research ventures and licensing agreements among firms.

2. Role for direct government R&D, or R&D incentives, to promote environmentally friendly technology.

B. Climate change and the rate of technological progress (AEEI)

C. Regulation and expected abatement costs

1. Evidence on *a priori* versus *ex-post* costs estimates of abatement costs.

a) SO_2 emissions trading program.

b) RECLAIM.

2. Explanation of the differences in estimated *a priori* versus *ex-post* cost estimates.

D. Diffusion and adoption of new technology

1. Diffusion of innovation among firms; empirical evidence.

2. Diffusion of innovation among consumers. [Box: consumer choice of appliances and the relative importance of energy efficiency versus other product characteristics.]

E. Multiple pollutants, innovation and industry regulation

1. Providing correct investment and innovation incentives with regulation of multiple pollutants. [Possible box: electric utilities, climate change and clean air regulations]

2. Innovation when standards/networks are important. Example: alternative fuel vehicle technology whose success depends on development of a fuel distribution network.

F. Effect of environmental regulation on competitiveness and growth

1. Porter hypothesis and rebuttals.

2. Evidence of the link between environmental regulation to growth.

3. The race to the bottom: is there evidence that firms locate where environmental standards are lax?

4. Evidence on a Kuznets curve for the environmental goods.

G. Environmental regulation and trade

1. Environmental regulations as a trade barrier. [Box: the tuna-dolphin case]

2. Effects of environmental regulation on pattern of production and trade flows.

3. National environmental regulation and international environmental problems.
The issue of unilateral policy and leakage.

IV. Conclusion

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-SEP-1998 19:43:29.00

SUBJECT: Re: speech

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

TEXT:
If this is really likely to be a problem, I would probably prefer to return to "Plan A"--namely to discuss three of the longer term issues the Administration is focused on--Social Security, Climate Change and reform of the international financial situation, instead of giving a speech just on Social Security. Larry Summers gave a speech in May to the Committee for Economic Development that I spotted on the Treasury WEBsite (see http://www.treas.gov/press/releases/pr2468.htm) that has a similar structure. I think we can cover most of the points that you made in your draft remarks without going beyond what Larry, Ken Apfel and others have already said publicly. Let's discuss this first thing in the morning.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 1-SEP-1998 17:29:35.00

SUBJECT: speech

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

CC: Douglas_W._Elmendorf@oa.eop.gov (Douglas_W._Elmendorf@oa.eop.gov [UNKNOWN])
READ:UNKNOWN

TEXT:
Jeff Liebman is concerned that your Social Security speech may raise Gene's hackles on two grounds. First, the Administration is trying not to say much on this topic. Second, when something is said, Gene may want to be the one who says it. (Also, Gene doesn't know yet that you plan to speak on this topic, so he may be surprised just about that.)

As a result, Jeff recommends that you send Gene a draft of the speech Thursday evening when Gene gets back to town (with a copy to Jeff). This will give us a chance to react to Gene's comments before the last minute.

Doug

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-SEP-1998 09:29:51.00

SUBJECT: Re: copy of merger answers

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

TEXT:
The responses to the merger questions look just great. Many thanks for taking on this difficult assignment. We should probably circulate them for approval prior to sending them on. Do you want to send a copy of the answers to Dorothy and Sally?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-SEP-1998 15:01:28.00

SUBJECT: Re: Head of International Energy Agency wants to meet with Janet

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

TEXT:
I am willing to meet with the head of the IEA--Could you ask Sandy to
schedule it?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-SEP-1998 18:20:50.00

SUBJECT: Question about Census briefing

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

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

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

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

TEXT:
I've received an inquiry from the DPC, asking if we're going to convene a briefing by Census on their forthcoming income and poverty numbers (due out on Sept 24.) Evidently we set something like this up last year. Have we indeed done this before? Should we do it again (seems like a good idea to me)? Who should set it up?

Let me know if you have any information on this one.

Becky

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Karen Tramontano (CN=Karen Tramontano/OU=WHO/O=EOP [WHO])

CREATION DATE/TIME: 2-SEP-1998 22:47:01.00

SUBJECT: Memo to POTUS

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

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

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

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

TEXT:
Erskine asked me to get a memo to the President this evening. It is
attached -- I hope I reflected everyone's opinion on this matter. Janet I
tried to reach you but was unable to -- but I believe I reflected your
views. Sally, I spoke directly w/ Dorothy who was comfortable w/ the memo.====================
ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D34]MAIL44635354Z.226 to ASCII,
The following is a HEX DUMP:

September 2, 1998

MEMORANDUM TO THE PRESIDENT

FROM KAREN A. TRAMONTANO

SUBJECT: Status Report: Strike at Northwest Airlines

Purpose

To provide you with an update regarding the strike at Northwest Airlines and to inform you of Congressional meetings and other action that has occurred in this matter.

Background

As you know, Secretary Slater met with Northwest Airlines and the Pilots' Association on Tuesday which has resulted in the parties agreeing to meet with the mediator on Saturday. That meeting will take place in Chicago and has been publicly described as "Exploratory" "in the hope of determining what the parameters of a settlement might be."

Northwest Airlines has begun to lay-off its employees. After laying-off approximately 170 employees yesterday 27,000 employees were laid-off today. The vast majority of these employees are mechanics and flight attendants. Northwest plans to maintain about 10,000 reservation clerks through the Labor Day weekend but if the strike is not resolved will lay them off next Tuesday.

This afternoon Senators Dorgan, Conrad, and Rep Pomeroy sent you a letter requesting that you appoint a Presidential Emergency Board (PEB) immediately. A copy of the letter is attached.

Secretary Slater, Larry Stein, Dorothy Robyn and I met with Senators Daschle, Dorgan, Conrad and Johnson this evening. The purpose of the meeting was to inform the Senators that Secretary Slater notified Mesaba Aviation, Inc. and Express Airlines that they cannot suspend air service without 90 days notice under the Essential Air Service program. Accordingly, Slater has asked the airlines by the close of business tomorrow to lay out plans to provide the statutory minimum service. Mesaba serves the Dakotas, Minnesota, Michigan, Wisconsin, Iowa and Illinois. Express serves Tennessee, Kentucky, Alabama and Mississippi. Northwest made the decision to stop these carriers from flying--the pilots for these carriers have a separate collective bargaining agreement and will fly if the Airlines are operational. A copy of Slater's letters are attached.

During the meeting, the Senators reiterated their strong desire that you act now to appoint a PEB. They also told Slater that they appreciated his effort regarding the regional carriers but these efforts would not substitute for a PEB. Senator Dorgan stated that he would try to reach you as early as tomorrow (Wednesday) to ask you to appoint a PEB. Although Senator Daschle did not say so in the meeting, we have every indication that he will give the parties a limited opportunity to work this out but does not want this strike to drag into next week.

Recommendation

At this time we recommend no change in the Administration's position for the following reasons:

1. The severe economic impact that we expected last week as a result of the strike did not materialize;

2. Although there are examples like the Dakotas where the economic impact is harsh, this is not sufficient to necessitate the appointment of a PEB;

3. Most passengers have either been accommodated on other carriers or did not book with Northwest as a result of their knowledge of a potential strike;

4. The appointment of a PEB will put the government in the middle of airline industry negotiations and will leave little incentive if any for the industry to bargain with its unions;

5. In the particular case of Northwest which has three other open union contracts, it will put the Administration in the middle of those negotiations as well as the pilots';

6. Unlike the America Airlines situation where the parties needed more time to negotiate and asked us for a PEB, labor is not seeking our intervention; and specifically asked us not to intervene. Northwest has been actively seeking a PEB to extract themselves from a very difficult management/labor situation;

7. The National Mediation Board has not recommended the appointment of a PEB; the Board did make that recommendation in the American Airlines;

8. Over 40 members of Congress have asked you not to intervene in the strike.

For these reasons, Secretary Slater, Bruce Lindsey, John Podesta, Janet Yellin and I recommend that the parties be given an opportunity to negotiate and resolve this dispute. NEC staff concur with this recommendation. I was unable to consult with Gene Sperling. Although Larry Stein agrees with the general recommendation, he would not want us to allow the parties to go beyond Monday without a resolution or a PEB.

If negotiations prove futile, Bruce, John and I recommend intervention but only if Senator Daschle ensures that legislation extending the "cooling off period" through next year can be enacted. Absent that action appointing a PEB that would end after Congress recesses would mean that a subsequent pilot strike would be this Administration's problem exclusively.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jude Wanniski <jwanniski@polyconomics.com> (Jude Wanniski <jwanniski@polyconomics.com> [UNKNOWN])

CREATION DATE/TIME: 3-SEP-1998 10:49:23.00

SUBJECT: northwest strike

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

TEXT:
Here's something for you to think about, Janet. Also, read the Novak column today in the WashPost... I've been advising Kemp on the monetary deflation, also on how to fix the ruble. If you have questions, I'd be happy to help. With the Prez having a tough time, the more problems he can solve, the more support he will have. Also, I hope you've seen Angell's switch. It took me 18 months to persuade him that the Fed had us in a true monetary deflation.

September 3, 1998

Open Letter to Northwest Airlines: Management and Labor

Under normal circumstances, the collective bargaining process would have been able to produce a contract prior to the deadline. What is not normal
is
that the national economy is being whipsawed by the worst monetary turbulence since the 1870s, although similar to the monetary deflation of 1981-82. The breakdown between Northwest management and the Northwest pilots
is due to the fact that both sides are unaware of the external financial forces over which they have no control. The turbulence has been caused by policy errors at the Federal Reserve, our central bank. Here is what I mean:

1. In a true monetary inflation, the entire general price level moves up to get back in line with a fall in the dollar's value relative to gold. Gold
is
the most monetary of all commodities, which is why it is always the first dollar price to rise when the Fed makes an inflationary error. When there
is
this kind of upward shift in the gold price because the error persists, other commodity prices will follow in train, and eventually prices of everything in the price universe will settle at the new higher plateau. Because oil also has more monetary properties than most other commodities
--
it won't spoil, for example -- it is among the first to follow a gold price rise. We observed this in 1971-73, when President Nixon took us off the gold
standard and the gold price quadrupled, to $140/oz. from $35/oz. Only then was it possible for the world price of oil to follow in tandem, quadrupling to $10/bbl. from $2.50/bbl.

2. When the central bank makes an error in the opposite direction, by not supplying the liquidity the market economy demands, the first price to fall also is gold. That is, when "dollars" become scarce relative to gold, the dollar price of gold falls. Other commodity prices are forced to follow in train, the order in the train depending on their monetary characteristics. Again, oil will be among the first to adjust to the new, lower general price
level demanded by the dollar/gold price change.

3. In understanding why your contract talks thus far have failed, note that in the last five years the dollar/gold price has followed an inflationary path from 1993 to late 1996, and from then has followed a deflationary path.
That is, a relatively steady gold price from 1985 to 1993 ended in late 1993
when the Fed supplied more liquidity than the market demanded. The gold price rose to a $385 plateau from the $350 plateau. Other prices began to rise in train, including the price of oil. In late 1996, the market began demanding more dollar liquidity, but the Fed refused to supply it. The price
of gold has been dropping ever since, fed by global demands for dollar liquidity associated with this scarcity. This is a true monetary deflation -- not simply a temporary fall in SOME prices associated with a recessionary
decline in the demand for goods.

4. In such a deflationary scenario, an airline is subject to the abnormal forces in an unusual way, because its cost of doing business is so heavily dependent upon the price of oil. In the first instance, an airline company will enjoy unusual profits, because the price of fuel declines sharply. An airline in the United States, which is not primarily a commodity economy, will benefit even more than an airline in a country that primarily serves commodity production. That is, traffic remains high while costs decline, thus producing extraordinary profits.

5. In the second instance, though, other prices caught in the deflation scenario change the profit picture for the airline. Its passenger traffic begins to decline, first because its own commodity producers -- U.S. farmers, miners, oil producers and the communities that serve them -- are forced to economize on air travel. As the deflation plays out, all other producers are forced to economize on their air travel as well, with the airline company forced to cut ticket prices to offset the decline in demand.

6. The stock market, as we know, anticipates the profit picture. As it sees the dollar/gold price at $280 instead of the $385 plateau, it knows the happy time for airline profits are behind it, with the crush of competition on the near horizon. This is why airline stocks rose last year and have fallen in recent months. Unless the Federal Reserve allows for sufficient liquidity to push the gold price up to at least $325, the economy will remain in this deflationary environment.

7. Unfortunately, Northwest pilots began their contract planning in last

year's happy time. They had taken pay cuts during the recession caused by the Bush tax increase of 1990 and hoped to return to at least that pay scale
in this contract period. This was an entirely reasonable goal, and one Northwest could have met if the Federal Reserve had stopped the dollar deflation a year ago at $325 gold. This would have meant slightly lower fuel
prices, but would not have wrecked other commodity producers who are part of
the passenger picture. At $280 gold, no airline could afford to pay its pilots at the scale now in effect throughout the system. If Northwest agreed
to the pilot demands, it would soon be bankrupt.

8. The only reasonable solution at Northwest would be a one-year extension of the current contract. This is because nobody in the world knows what the Federal Reserve will do about the deflation. On the record, its most recent pronouncement was that it is still more worried about inflation than deflation. A great policy debate is now unfolding, with Jack Kemp having the
political lead in arguing that the Fed should add liquidity until gold reaches $325. If the Fed tomorrow announced this as policy, the market would
immediately bid gold to $325, knowing the liquidity would follow.

9. At this level, the gap between management and labor at Northwest would vanish, for the most part, and a contract would soon be in hand. Because we are not likely to see the Fed follow Kemp's advice in the immediate future, the risks associated with these monetary uncertainties cannot be accepted by
Northwest management, nor should the unions insist they do so. A simple extension of the current contract, with a handshake understanding that it will be reopened when the smoke clears, is the most reasonable and logical course of action.

10. With so much acrimony in the air between management and labor, it would be wise for President Clinton to get Northwest back into the air with an executive order, and encourage discussion along the lines suggested here. Once both sides realize why the unusual deflationary episode is the root cause of their ability to come to terms, the air should clear and a constructive path of discussion opened.

* * * * *

This open letter is being faxed to Northwest Airlines, the union, and the AFL-CIO this afternoon. We will post it on our website at Friday noon, to run over the weekend for the benefit of Northwest employees, shareholders, vendors and customers. It is also being faxed to Chairman Janet Yellen of the President's Council of Economic Advisors and to Erskine Bowles, White House Chief of Staff. Please pass the letter on to anyone you might know at the company as I have no personal contacts there. The topic may arise on FoxNewsSunday with Tony Snow, as his guest Sunday at 9 a.m. EST will be Jack
Kemp, who will discuss several political and economic matters that are in

the news.   Jude Wanniski

Jude T. Wanniski
President - Polyconomics, Inc.
Tel. (973) 267-4640; Fax. (973) 539-4025
(http://www.polyconomics.com)

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 3-SEP-1998 19:06:06.00

SUBJECT: Memo to POTUS

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

TEXT:
---------------------- Forwarded by Janet L. Yellen/CEA/EOP on 09/03/98
07:05 PM ---------------------------

Karen Tramontano
09/02/98 10:46:46 PM
Record Type: Record

To: Lawrence J. Stein/WHO/EOP, Sally Katzen/OPD/EOP, Janet L.
Yellen/CEA/EOP, Dorothy Robyn/OPD/EOP
cc:
Subject: Memo to POTUS

Erskine asked me to get a memo to the President this evening. It is attached -- I hope I reflected everyone's opinion on this matter. Janet I tried to reach you but was unable to -- but I believe I reflected your views. Sally, I spoke directly w/ Dorothy who was comfortable w/ the memo.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D68]MAIL48103364G.226 to ASCII,
The following is a HEX DUMP:

September 2, 1998

MEMORANDUM TO THE PRESIDENT

FROM KAREN A. TRAMONTANO

SUBJECT: Status Report: Strike at Northwest Airlines

Purpose

To provide you with an update regarding the strike at Northwest Airlines and to inform you of Congressional meetings and other action that has occurred in this matter.

Background

As you know, Secretary Slater met with Northwest Airlines and the Pilots' Association on Tuesday which has resulted in the parties agreeing to meet with the mediator on Saturday. That meeting will take place in Chicago and has been publicly described as "Exploratory" "in the hope of determining what the parameters of a settlement might be."

Northwest Airlines has begun to lay-off its employees. After laying-off approximately 170 employees yesterday 27,000 employees were laid-off today. The vast majority of these employees are mechanics and flight attendants. Northwest plans to maintain about 10,000 reservation clerks through the Labor Day weekend but if the strike is not resolved will lay them off next Tuesday.

This afternoon Senators Dorgan, Conrad, and Rep Pomeroy sent you a letter requesting that you appoint a Presidential Emergency Board (PEB) immediately. A copy of the letter is attached.

Secretary Slater, Larry Stein, Dorothy Robyn and I met with Senators Daschle, Dorgan, Conrad and Johnson this evening. The purpose of the meeting was to inform the Senators that Secretary Slater notified Mesaba Aviation, Inc. and Express Airlines that they cannot suspend air service without 90 days notice under the Essential Air Service program. Accordingly, Slater has asked the airlines by the close of business tomorrow to lay out plans to provide the statutory minimum service. Mesaba serves the Dakotas, Minnesota, Michigan, Wisconsin, Iowa and Illinois. Express serves Tennessee, Kentucky, Alabama and Mississippi. Northwest made the decision to stop these carriers from flying--the pilots for these carriers have a separate collective bargaining agreement and will fly if the Airlines are operational. A copy of Slater's letters are attached.

During the meeting, the Senators reiterated their strong desire that you act now to appoint a PEB. They also told Slater that they appreciated his effort regarding the regional carriers but these efforts would not substitute for a PEB. Senator Dorgan stated that he would try to reach you as early as tomorrow (Wednesday) to ask you to appoint a PEB. Although Senator Daschle did not say so in the meeting, we have every indication that he will give the parties a limited opportunity to work this out but does not want this strike to drag into next week.

Recommendation

At this time we recommend no change in the Administration's position for the following reasons:

1. The severe economic impact that we expected last week as a result of the strike did not materialize;

2. Although there are examples like the Dakotas where the economic impact is harsh, this is not sufficient to necessitate the appointment of a PEB;

3. Most passengers have either been accommodated on other carriers or did not book with Northwest as a result of their knowledge of a potential strike;

4. The appointment of a PEB will put the government in the middle of airline industry negotiations and will leave little incentive if any for the industry to bargain with its unions;

5. In the particular case of Northwest which has three other open union contracts, it will put the Administration in the middle of those negotiations as well as the pilots';

6. Unlike the America Airlines situation where the parties needed more time to negotiate and asked us for a PEB, labor is not seeking our intervention; and specifically asked us not to intervene. Northwest has been actively seeking a PEB to extract themselves from a very difficult management/labor situation;

7. The National Mediation Board has not recommended the appointment of a PEB; the Board did make that recommendation in the American Airlines;

8. Over 40 members of Congress have asked you not to intervene in the strike.

For these reasons, Secretary Slater, Bruce Lindsey, John Podesta, Janet Yellin and I recommend that the parties be given an opportunity to negotiate and resolve this dispute. NEC staff concur with this recommendation. I was unable to consult with Gene Sperling. Although Larry Stein agrees with the general recommendation, he would not want us to allow the parties to go beyond Monday without a resolution or a PEB.

If negotiations prove futile, Bruce, John and I recommend intervention but only if Senator Daschle ensures that legislation extending the "cooling off period" through next year can be enacted. Absent that action appointing a PEB that would end after Congress recesses would mean that a subsequent pilot strike would be this Administration's problem exclusively.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Quindi C. Franco (CN=Quindi C. Franco/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 3-SEP-1998 15:40:56.00

SUBJECT: Differences - EIA & Admin Analysis

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

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

CC: William J. Antholis (CN=William J. Antholis/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

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

TEXT:
Prior to your 4:00 briefing of the EIA study, attached is a preliminary evaluation of the differences between the studies.

Quindi Franco
395-3142=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D4]MAIL47461264W.226 to ASCII,
The following is a HEX DUMP:

Differences Between EIA & Administration Analysis of Kyoto
-- DRAFT --

A preliminary evaluation suggests there are two broad explanations for the different conclusions reached in the EIA and Administration analysis of the Kyoto agreement: 1) the EIA analysis does not fully represent the flexibility of the Kyoto agreement; and 2) the EIA analysis uses models that are not suited to making long-term forecasts.

EIA Analysis Does not Include Kyoto's Flexibility

- The EIA analysis does not model international trading. EIA tries to assess Kyoto by calculating the cost of meeting various levels of domestic reductions that might be required under a trading regime. The Administration explicitly modeled international trading. The least-cost scenario in the Administration's analysis, (with permit prices of $14-23 per ton carbon equivalent in 2010), includes more extensive international trading than implied by EIA's most flexible scenarios. This flexibility can reduce costs by 23% (in EIA's least stringent scenario).

- The EIA analysis focuses solely on CO2, ignoring other gases & sinks. Reducing emissions of other gases and increasing sinks may be cheaper than controlling CO2. In fact, this flexibility can reduce costs by over 10%. By excluding these opportunities, EIA's analysis does not represent the Kyoto Protocol.

EIA Uses Models Inadequate for Making Long-term Projections

- EIA's energy model (NEMS) underestimates people's flexibility. The NEMS model assumes that, even over the long term, people have little ability to respond to price signals. While this may be accurate when looking at the short-term impacts of energy policies and for forecasting business-as-usual, it is inadequate for forecasting the effect of long term climate change policies. Likewise, on the supply side, NEMS believes the energy sector will be unable to provide industry with flexible options for switching fuels. Because it is not forward looking, NEMS does not see sufficient natural gas available without significant price increases. While there is no expert consensus on this point, many analysts and the natural gas industry believe NEMS is overly conservative in its estimates.

- EIA's economic model (DRI) is less suited for making long-term projections. One of the main goals of climate policy is to induce process adjustments to reduce greenhouse gas emissions. DRI, however, assumes that the way we produce goods today will remain the same into the future. While this may be accurate for making short-term macroeconomic forecasts (which is what DRI was designed for), it is a severe limitation for analyzing climate policies. The Administration used a general equilibrium-type model which more accurately incorporates the inherent flexibility of the U.S. economy

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Howard A. Shelanski (CN=Howard A. Shelanski/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 3-SEP-1998 18:05:05.00

SUBJECT: Northwest Airlines and bankruptcy

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

TEXT:
Janet:

Dorothy Robyn and I had an interesting phone conversation with a Wall Street airline industry analyst this evening. He said that in his opinion, no one would miss Northwest if it exited the market and that a well-capitalized entrepreneur like Southwest would quickly take over the Minneapolis hub and most current NWA routes. This backs up our view. He noted that NWA's pacific routes would most likely be purchased by American Airlines; he agreed that United would not be allowed to buy them for antitrust reasons. Delta is the second most likely purchaser. So even on those routes, no competitive harm to consumers is likely if NWA exits.

The analyst also said he thought bankruptcy to be a slim possibility right now given NWA's $ 3 billion cash reserves, but that a reorganization could occur if the strike lasted more than a month, although he thought such duration to be unlikely. He warned that bankruptcy has in the past conferred a competitive advantage on carriers by lowering their cost structure. Continental was the example he offered. He indicated that strategic use of bankruptcy protection is a potential problem, although probably within the current law. The harm here, if any, would seem to fall more on other carriers than on consumers, however.

I just thought I'd pass this on.

Howard.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 3-SEP-1998 10:52:41.00

SUBJECT: ERP Chapter on Aging

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

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

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

Sandra Daigle (Sandra Daigle [CEA])
READ:UNKNOWN

TEXT:
Janet -- I see we have a Labor/Public Finance cluster meeting scheduled for 10 a.m. tomorrow. Would this be a good time to discuss the draft outline of the ERP Chapter on Aging?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 3-SEP-1998 14:17:29.00

SUBJECT: Re: ERP Chapter on Aging

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

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

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

TEXT:
It would be fine to discuss the Aging outline at the meeting.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Julianne B. Corbett (CN=Julianne B. Corbett/OU=WHO/O=EOP [WHO])

CREATION DATE/TIME: 3-SEP-1998 13:46:47.00

SUBJECT: Radio Address for tomorrow

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

TEXT:
I wanted to get some information from you on the radio address for the briefing memo...could you send that to me?

Julianne
Dep. Dir. of Radio

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jonathan Orszag (CN=Jonathan Orszag/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME: 3-SEP-1998 15:43:58.00

SUBJECT: Draft language

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:
Tomorrow, the VP is giving a speech in the morning. He'll be doing a short paragraph about the jobs numbers. Here's some draft language from his speechwriter. Any comments? I will be sending this to Treasury also.
---------------------- Forwarded by Jonathan Orszag/OPD/EOP on 09/03/98 04:43 PM ---------------------------

Eli G. Attie @ OVP
09/03/98 03:21:48 PM
Record Type: Record

To: Jonathan Orszag/OPD/EOP
cc:
Subject: Draft language

DRAFT VP INSERT

Before I begin, I have some important news to share about the state of America,s economy. Today, we received new evidence that America,s economy is vibrant and strong. Last month, the economy created ___,000 new jobs, the unemployment rate remained as low as it has been in 28 years, and real wages continued to rise -- all with no signs of inflation on the horizon. For nearly a quarter century, our nation had not seen an unemployment rate dip below five percent; it has now stayed below five percent for 14 months in a row. Let there be no doubt: America,s job engine is roaring into the 21st Century.

I want to make one further point. The volatility we saw in our financial markets this week -- and the difficulties that are being faced in some foreign economies, due in part to their failure to take the tough, disciplined, pro-growth steps that we have taken -- have raised concerns about America,s continued growth. As today,s employment numbers show, the fundamentals of our economy are as solid as a rock. That, more than anything else, is what our economy needs to keep growing, steady and strong. And if we stick to the economic course President Clinton has charted for this nation -- balanced budgets, targeted investments, and pushing for economic reform and open markets around the world -- our economy will stay dynamic and strong.

Withdrawal/Redaction Marker
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
002. email	Steven N. Braun to Jeffrey A. Frankel and Janet L. Yellen at 12:16:15.00. Subject: Chart 2-2 (p58) in the 98 ERP. (1 page)	08/31/1998	b(6)

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

FOLDER TITLE:
[08/21/1998 - 09/04/1998]

2013-0723-F
ab1283

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

CREATION DATE/TIME: 4-SEP-1998 18:20:44.00

SUBJECT: Memo to Erskine Bowles

TO: Sandra F. Daigle (CN=Sandra F. Daigle/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.D23]MAIL42945374O.226 to ASCII,
The following is a HEX DUMP:

September 4, 1998

MEMORANDUM FOR ERSKINE BOWLES

FROM: JANET L. YELLEN

SUBJECT: Recommendation concerning a county trigger requirement for in the emergency agriculture assistance package.

In our meeting this morning, I argued that the emergency agriculture package should include a "county" and not an "individual" trigger for supplemental crop insurance. I believe there are strong policy reasons in favor of this approach.

- **Requiring a county trigger would reduce fraud and abuse in these supplemental payments**. The payments are intended to provide additional benefits to those farmers who have suffered losses from a succession of natural disasters. Yet, many farmers have had losses due to poor management decisions and the government should not be rewarding them with additional taxpayer funds. The county-loss trigger ensures that the losses were due to natural disasters, since a significant number of farmers in an area would have to have suffered losses for the payments to be triggered.

- **Handling inequities via appeal:** Payments to deserving farmers in counties that do not meet the county trigger could easily be accomplished, by having local USDA offices verify that a farmer's losses were due to natural disasters.

- **Providing additional payments without a county trigger hurts the credibility of the crop insurance program.** USDA tracks farmers who have had inordinate crop insurance indemnities under their "Non-standard classification system" in the crop insurance program. This tracking was a recent innovation in the program to help it move toward actuarial soundness, as required by law. Prior to the innovation, a small number of farmers were inordinately weighing down the viability of the program. Farmers under this classification system are generally charged higher insurance premiums, in much the same way as an individual's car insurance premiums are increased if they have repeated accidents. Providing additional payments to good and poor farm managers in the same proportions undermines the incentive to make farm management improvements.

- **Previous emergency assistance appropriations for farmers required a county-wide loss trigger.** (The last of these appropriations was in 1993, as the 1994 Crop Insurance Reform Act amended the Budget Enforcement Act to disallow such appropriations in the future.) Although Secretary Glickman argues that the current proposal would provide "supplemental crop insurance payments", the payments would clearly be identical to previous disaster payments to farmers.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 4-SEP-1998 09:51:10.00

SUBJECT: Climate Change requests

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

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

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

TEXT:
Rob Weiner is putting together BY COB TUESDAY SEPT 8 a summary of all the time and $ cost of the Congressional requests. Please e-mail me by NOON ON TUESDAY your estimates for:

1) # of hours spent searching your files for climate records and xeroxing them for my use (include your secretary's time);

2) # of hours spent answering the questions to the following:

A. McIntosh's March 13 letter (the 1st letter from McIntosh, w/ 34 detailed questions)
B. McIntosh's June 3 letter (the 2nd letter from McIntosh, which asked us to provide more detail to our answere to question 4 on historical budget authority)
C. Talent's June 30 letter (follow-up questions from Small Bussiness Committee hearing.

Joe, would you please provide ESTIMATES of the time that Randy and Adele spent on answering quesitons and collecting documents.

Thanks.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 4-SEP-1998 16:43:51.00

SUBJECT: Social Security speech

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

CC: Douglas_W._Elmendorf@oa.eop.gov (Douglas_W._Elmendorf@oa.eop.gov [UNKNOWN])
READ:UNKNOWN

TEXT:
Here's the revised draft. Feel free to call me at home (301-320-0375) if
you want to talk about it over the weekend.

Doug

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D44]MAIL42795274A.226 to ASCII,
The following is a HEX DUMP:

Draft Speech
REVISED 9/4/98
[Including both the introductory material and the Social Security material from previous drafts.]

Economic Challenges for the 21st Century

...

The American economy is now enjoying its best performance in decades. Unemployment and inflation are at their lowest levels in a generation, and the elimination of the federal budget deficit has caused the net national saving rate to double since 1992. At the same time, the near-term outlook includes some clear risks, and I will touch on these in a moment. But I would like to focus my comments on three economic challenges for the 21st century--Social Security, climate change, and the design of international financial institutions.

Beginning with current conditions, the U.S. economy appears to have considerable forward momentum. As you know, growth of real GDP slowed sharply in the second quarter from its extraordinary first-quarter pace. Inventory accumulation shifted down, and net exports plummeted, with exports dropping 8 percent at an annual rate. Yet, domestic final demand remained quite strong: Consumer spending advanced sharply again, and investment in both business equipment and housing continued to move up at a double-digit rate.

One result of robust economic growth over the past several years has been a marked tightening of labor markets. The striking decline in the unemployment rate has boosted real wage gains and created new opportunities for many Americans. But it has also increased the risk that wage gains will outstrip productivity advances and lead to a pickup in inflation. A different, and perhaps more worrisome risk, is presented by economic developments overseas.

Serious economic problems in Japan and many East Asian countries have not been resolved as quickly as many observers had hoped, and the recent financial turmoil in Russia has increased the dangers for emerging market economies around the world. Portfolio shifts toward the safety and liquidity of U.S. assets have helped to reduce our interest rates and thereby to boost household and business spending. But the sharp decline in net exports in the first half of the year emphasizes that slumping foreign economies can hinder U.S. economic growth.

Instead of dwelling on these immediate concerns, however, I want to use most of my time to discuss longer-term challenges. Let me begin with Social Security reform. The President and Vice-President have participated in several of a series of Social Security fora scheduled for this year, in which Americans have had--and will have--the opportunity to explore alternative solutions to the problems facing Social Security. The President proposes to begin bipartisan negotiations with Congressional leaders in January 1999 to devise a comprehensive plan to strengthen Social Security so that it can continue providing financial support to retirees, survivors, and the low income disabled for many generations to come.

Before talking about the problems facing Social Security, I want to emphasize how important Social Security is to the lives of Americans and how successful it has been as a social program. For almost 60 years, Social Security has provided Americans with income security in retirement and protection against loss of family income due to disability or death. Social Security benefits are the major source of income for 2/3 of those over age 65 and virtually the only source of income for 1/3 of the elderly. The system has enjoyed dramatic success in reducing poverty rates among older Americans. In addition, Social Security provides valuable survivors' and disability benefits to the 1 in 3 beneficiaries who are not retirees.

The central problem facing Social Security is the determination by the Social Security actuaries that the current balance in the trust fund together with projected revenues over the next 75 years will be insufficient to fund the benefits promised under current law. Of course, future taxes and benefits depend on a variety of economic and demographic factors that cannot be predicted perfectly, so the actual problem may be smaller or larger than we now believe. Nevertheless, the intermediate projections of the actuaries imply that the imbalance in the Old Age, Survivors' and Disability Insurance program over the next 75 years amounts to around 2-1/4 percent of taxable payroll, or about 1 percent of GDP.

The President has enumerated five principles for Social Security reform. His first principle is to strengthen and protect Social Security for the 21st century, which means that we should consider only comprehensive reforms that eliminate the actuarial imbalance. The key factors contributing to the projected imbalance are improvements in life expectancy and a reduction in birth rates, which have put us on a path of rapid declines in the number of employed workers for every retired American. In 1960, that ratio was 4.5 to 1; today it is 3.3 to 1, and in 30 years time, it will be just 2 to 1 and still falling.

In addition to the aforementioned effects on OASDI, this demographic transition will have important effects on the Medicare and Medicaid programs as well as on the economic environment outside the government. For the nation as a whole, the central problem is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. The solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing these steps is greater national saving.

Thus, another of the President's principles for Social Security reform is to maintain fiscal discipline. National saving increased from 3.4 percent of net national product in 1992 to 7.6 percent in the first half of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output. If the projected budget surpluses are saved, they will add to national saving; if they are dissipated, they will neither help to strengthen Social Security nor add to national saving.

The President listed three other principles to guide Social Security reform. One principle is to maintain universality and fairness. The current program provides benefits on a progressive basis, and ensuring progressivity is an important standard by which reform proposals should be judged. Another principle is to provide a benefit that people can count on. I will come back to this principle of retirement income security when I discuss some prominent reform proposals. Finally, the President has said that we must preserve financial security for low-income and disabled beneficiaries.

The President's principles will provide a framework for Social Security reform, but they do not precisely determine its outcome. Even within this framework, the President and the Congress will face some difficult choices in the coming months. I would like to highlight some of the issues and tradeoffs that will be important. Of course, I am not going to endorse specific reform ideas at this time, because the President has made it clear that he does not want to prejudge the public debate or hinder bipartisan consideration of alternative proposals.

One overriding question is whether to stick with the traditional defined-benefit structure of Social Security or move in the direction of a defined-contribution structure with individual accounts. Some people argue that individual accounts could earn a higher rate of return than the trust fund can, pointing to the difference between returns on average private portfolios and projected rates of return on Social Security. But this comparison is misleading in at least two crucial ways. First, most of today's payroll tax goes to current beneficiaries. If current workers put their payroll tax contributions into individual accounts for their own retirements, we would need to find some other way to pay current benefits. Put differently, the Social Security system paid benefits to some past generations of retirees that greatly exceeded their contributions. This policy created an implicit debt that must be paid somehow by current and future generations, and a Social Security system which does that will necessarily generate a lower return than a new system that does not have that accumulated burden.

The second way that comparing rates of return between average private portfolios and Social Security is misleading is that most private portfolios invest in riskier assets than does the Social Security trust fund. These riskier assets--equities in particular--have paid higher returns on average than government bonds, but they do involve risk. Moreover, some analysts have questioned whether investing Social Security funds in equities--through either the trust fund or individual accounts--would have positive effects on saving or rates of return for the nation as a whole. These analysts note that swapping bonds for equities in Social Security involves a corresponding swap of equities for bonds in private portfolios. If the total supplies of equities and bonds were unchanged, this swap would raise the return earned on Social Security contributions but reduce the return earned on people's other retirement savings.

Of course, knowledgeable proponents of individual accounts understand these points and favor establishing such accounts for other reasons. Some supporters of individual accounts believe that national saving can be increased more effectively by moving funds out of the government and into private hands. Some supporters of these accounts believe that it is important to allow individuals to choose the portfolio allocation of their Social Security contributions.

One justification that is offered for this view is that people should be able to decide for themselves how much risk they want to bear. However, at the same time, some supporters of individual accounts want the government to restrict people's investment options to reduce their risk, or they want the government to guarantee some minimum level of benefits. Balancing flexibility against protection is a difficult problem. Another justification that is given for allowing individuals to choose portfolio allocations is to minimize government involvement in financial markets. I think it is an open question whether institutions could be designed that would allow the trust fund to purchase equities while ensuring that the government did not gain too much influence over the economy.

Critics of individual accounts raise a number of concerns beyond the ones I have already mentioned. Some opponents of these accounts worry about how to maintain Social Security as a progressive program that is fair to all Americans. It seems that progressivity would require, at the least, that contributions to these accounts be a larger share of payroll for lower-income workers. Some opponents of individual accounts believe that the administrative costs of these accounts would be excessively high. These analysts note that many of these accounts would be quite small, especially when they were first established, and even a small cost per account could absorb a significant share of the annual investment return for many people. Restricting investment options or services would reduce costs, but might disappoint people accustomed to better service for their private portfolios.

I do not intend this discussion of difficult choices to imply that no solution can be found to the challenges posed by an aging society. Indeed, I am confident that a bipartisan effort to reform Social Security can succeed next year. But to achieve this goal, and to prepare the nation for the retirement of the baby boomers, we must continue to ask hard questions about alternative reform proposals. There is no magic bullet for Social Security reform, but careful analysis and thought can help guide us to the best decisions.

[What could be added? 1. Issues about raising the retirement age. 2. "The actuarial imbalance provides an impetus for rethinking the program in light of all the economic and social changes since the program was introduced." But then what do we say about this in detail? 3. More about the importance of maintaining "social insurance." 4. Annuitization of IAs.]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Mark A. Weatherly (CN=Mark A. Weatherly/OU=OMB/O=EOP [OMB])

CREATION DATE/TIME: 4-SEP-1998 17:52:52.00

SUBJECT: One pager on county office trigger

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

CC: Ronald M. Cogswell (CN=Ronald M. Cogswell/OU=OMB/O=EOP@EOP [OMB])
READ:UNKNOWN

CC: Daniel D. Heath (CN=Daniel D. Heath/OU=OMB/O=EOP@EOP [OMB])
READ:UNKNOWN

TEXT:
Sorry it's late; we got a little caught up in another issue. Call Daniel
or me if any questions.==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D17]MAIL49569274S.226 to ASCII,
The following is a HEX DUMP:

Why a County Trigger Should Be Required for Farmer Assistance

Requiring a county trigger would reduce fraud and abuse in these supplemental payments. The payments are intended to provide additional benefits to those farmers who have suffered losses from a succession of natural disasters. Yet, many farmers have had losses due to poor management decisions and the government should not be rewarding them with additional taxpayer funds. The county-loss trigger ensures that the losses were due to natural disasters, since a significant number of farmers in an area would have to have suffered losses for the payments to be triggered.

Providing additional payments without a county trigger hurts the credibility of the crop insurance program. USDA tracks farmers who have had inordinate crop insurance indemnities under their "Non-standard classification system" in the crop insurance program. This tracking was a recent innovation in the program to help it move toward actuarial soundness, as required by law; prior to the innovation a small number of farmers were inordinately weighing down the viability of the program. Farmers under this classification system are generally charged higher insurance premiums, in much the same way as an individual's car insurance premiums are increased if they have repeated accidents. Providing additional payments to poorer farm managers in the same proportion as good managers are paid undermines the incentive to make farm management improvements.

Although Sec. Glickman argues the current proposal would provide "supplemental crop insurance payments", the payments would clearly be identical to previous disaster payments to farmers. Previous emergency assistance appropriations for farmers required a county-wide loss trigger. (The last of these appropriations was in 1993, as the 1994 Crop Insurance Reform Act amended the Budget Enforcement Act to disallow such appropriations in the future.)

Payments to deserving farmers in counties that do not meet the county trigger could easily be accomplished, by having local USDA offices verify that a farmer's losses were due to natural disasters.