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001. email	Russ Winer to Janet L. Yellen at 11:16:00.00. Subject: We want you back. (1 page)	09/11/1998	Personal Misfile

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[09/09/1998 - 09/16/1998]

2013-0723-F
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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]**
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- **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]**

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- **b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]**
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- **b(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: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-SEP-1998 16:40:34.00

SUBJECT: talking points on EIA report

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: 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

TEXT:
Attached please find draft talking points on the EIA report. If you are comfortable with these, let me know, and I will send them on to Todd. If you have edits, let me know, and I will make them and then send them on.
Thanks,

Joe

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D0]MAIL43119225U.226 to ASCII,
The following is a HEX DUMP:

Differences Between EIA & Administration Analysis of Kyoto

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 well suited to making long-term forecasts.

EIA Analysis Does not Include Kyoto's Flexibility

- The EIA analysis does not attempt to model international trading. EIA used the NEMS model, which is a model of the U.S. energy sector, to assess the effects of the Kyoto Protocol. EIA did not conduct any analysis of cost-effective international trading opportunities. A traditional economic analysis of international trading should assess the demand and supply of emissions allowances and, by modeling a market where costs are minimized, identify a single international permit price. However, the EIA analysis assesses only the demand side of the issue for the United States, and then incorporates arbitrary assumptions about the international permit price and subsequent international transfers. In contrast, the Administration explicitly modeled international trading, as has every modeling team participating in the Energy Modeling Forum exercise assessing Kyoto. 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.

- The EIA analysis focuses solely on CO_2, ignoring other gases. The EIA study assumes that the United States achieves its target only by reducing carbon dioxide emissions, even though all six types of greenhouse gases are covered by the Protocol. Since the Kyoto agreement requires countries to reduce emissions to specific targets, on average across all types of greenhouse gases, the flexibility is available to reduce emissions of some gases more than others if it is cost-effective.

- The EIA analysis and the Administration's economic analysis are conservative on several issues. Both studies assume that the carbon sinks, such as forestry activities covered under the Kyoto Protocol, do not provide any net sequestration in the United States during the commitment period. Low-cost carbon sink options provide another opportunity to achieve emissions targets at lower cost. Further, these studies do not incorporate emissions reductions attributable to the Administration's electricity restructuring proposal, which could reduce carbon emissions by 25 to 40 MMTCE.

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 macro-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 the DRI macro model 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 flexibility of the U.S. economy.

Other Issues:

- EIA Assumes we do not anticipate climate change policies. In EIA's study, the U.S. does not implement Kyoto until 2005, and we therefore only have three to seven years to reduce emissions. The IAT analysis included model runs with the same model as used in this EIA study and evaluated the effects of lead time prior to the target year. The IAT report found that a 5-year "ramp-up" (starting in 2005) resulted in economic costs 65% greater than that associated with a 10-year "ramp-up" (starting in 2000). Thus, assuming a shorter transition period results in more pronounced economic costs.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-SEP-1998 13:30:27.00

SUBJECT: Stock Options and NW

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

TEXT:
---------------------- Forwarded by Howard A. Shelanski/CEA/EOP on 09/09/98 01:29 PM ---------------------------

Dorothy Robyn
09/09/98 11:01:28 AM
Record Type: Record

To: Howard A. Shelanski/CEA/EOP
cc:
Subject: Stock Options and NW

do you have time to pursue this; i have call into mark mcclellan on this but haven't reached him. i'm doing talking points for potus call to checchi.
---------------------- Forwarded by Dorothy Robyn/OPD/EOP on 09/09/98 11:01 AM ---------------------------

David W. Beier @ OVP
09/09/98 10:06:51 AM
Record Type: Record

To: Sally Katzen/OPD/EOP, Dorothy Robyn/OPD/EOP
cc:
Subject: Stock Options and NW

From our perspective we are not in favor of a PEB at this time. First, it would be inconsistent with the Administration's record of sharing the benefits of economic growth and our approach in 1993 in getting labor to make wage concessions to keep the airline alive. We should not be in a position of appointing a PEB at a time when management is reluctant to share in even future benefits in the form stock options. Second, there is little evidence that intervention will produce a positive or quick outcome. Finally, appointment of a PEB will do what we have all sougth to avoid; to wit, the use of PEB's in virtually all future airline labor disputes.

On the stock option question. It might be useful to have someoutreach to Treasury or the SEC --- informally --- to get some background on the accounting treatment the issuance of stock options would have on corporate earnings. My understanding is that this approach could actually have the net effect of increasing the share price of NW stock over time. This would appear to partially off set the potential dilution of the major shareholders. Clearly, Chechi et al. will have received robust legal and accounting advise. We should be in the position to at least know what they have likely been told.

Thanks

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:10-SEP-1998 09:20:44.00

SUBJECT: This morning's NW call

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

TEXT:
Negotiations are at a critical phase and could go either way right now. Yesterday the union made a substantial compromise offer. NW countered with very little, angering the union. Bruce Lindsey then got the company to make what he thinks is a very good "bottom line" offer to the union. The union negotiators took the offer to committee and treated it not as a take-it-or-leave-it proposition, but as another negotiating round. At that point Lindsey told the union he thought it was making a mistake and expressed displeasure that they refused to treat NW's offer as essentially final. He packed up and went to the airport, where he was when the call started. He told us he thought prospects for a change of heart by the union were slim. Then, during the call, Secy. Slater said he had just been called by Randy Babbit saying the union wanted Bruce to stay, indicating a potential breakthrough. Slater urged Bruce not to leave. At that point, the call ended. Karen is calling Babbit to drive home the point that Bruce will only stay if the union is serious about NW's offer. If that is the case, Bruce will go back to the negotiating site and we will get an update later. If not, then there is substantial momentum towards appointment of a PEB today, according to Bruce. At this point, the time of the next call has not been set.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:10-SEP-1998 17:23:01.00

SUBJECT: Asia speech

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

TEXT:
Attached is the Nouriel speech, with some adjusting by me and some notes
that I made.
It definately still needs work.... but I think the work needs to be done
by someone with more substantive understanding of the crisis. Jeff might
be willing to help out.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D91]MAIL43736335A.226 to ASCII,
The following is a HEX DUMP:

The Asian Crisis and
Reform of the International Financial Architecture

Janet L. Yellen
Chair, Council of Economic Advisers
National Association of Business Economists
October 6, 1998

Thank you. It is a pleasure to be here today.

Over the past year, the world's financial system has experienced an enormous amount of turmoil. From Asia to Russia to Latin America, investors and institutions and ordinary citizens are experiencing first-hand the effects of a global financial system in crisis. The impact on some nations' economies and their citizens has been devastating.

Clearly, steps need to be taken to reform and strengthen the international financial architecture. Preventing future currency and financial crises may not be possible but there is much that can be done to limit the frequency of their occurrence, the magnitude of their effects and their pernicious contagious spread.

Today, I'd like to talk to you about the steps that should be taken to reform the international financial system and to limit the frequency, magnitude and spread of international financial crises. But, before I talk about these reforms, let me first say a few words about the sources and causes of the recurring financial turmoil in the 1990s and then focus specifically on the causes of the recent turmoil in Asia.

FINANCIAL MARKET TURMOIL IN THE 1990s

Through the decade of the 1990s, world financial markets experienced several rocky periods. 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. In December 1994, the collapse of the Mexican peso 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.

While each of these crises has its own characteristics and specific causes, there are several common elements to the international financial turmoil. Let me discuss several of these elements:

First, 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.

Second, in all three episodes there was 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.

Third, while the process of global financial integration has been occurring for several decades now, it 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. Today, international capital flows are clearly hotter and more volatile than ever.

Fourth, in all three instances, financial turmoil was 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.

Finally, each of the currency crises was associated with financial sector and banking crises. This is most clearly evident in the Asian crisis and the Mexican peso crisis, where severe banking crises occurred. But it was also partly a feature of the ERM episode: in countries such a Sweden, Finland and Italy, banking crises emerged close to the currency turmoil episodes.

Examining and understanding these common elements are important in determining what steps need to be taken to reform the international financial architecture. The experiences through this decade can teach us important lessons about what needs to be done and how to do it.

THE ASIAN FINANCIAL CRISIS

It is also important to look carefully at the sources and causes of the recent financial turmoil in Asia. There has been a heated intellectual and academic debate about whether the Asian crisis was caused by poor economic fundamentals or irrational speculative panic. This debate has been particularly interesting since the Asian countries did not fit the traditional model -- that is, the macroeconomic fundamentals of the Asian economies appeared to be strong. The Asian economies had low budget deficits, low public debt, single digit inflation rates, high economic growth and high savings and investment rates.

For this reason, many observers initially concluded 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.

But, with the benefit of hindsight, it is clear that "irrational panic" is not the complete story. Below the surface of the apparently good macro fundamentals, the Asian economies suffered from serious weaknesses and distortions.

Let me now talk about some of these distortions that may have contributed to the Asian financial crisis.

[NOTE:The section below does not flow very well. The material is interesting but needs to be tied together better. I would have done it myself, but I think it may require decisions about the substance]

A combination of financial sector weaknesses and distortions -- such as, 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.

Domestic and international capital liberalization also aggravated the original distortions and flawed incentives faced by banks and firms, allowing them to borrow more and at cheaper rates in international capital markets.

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.

The fixed exchange rate regimes also exacerbated the problem in two ways: first, they led to real appreciation that worsened the current account problem; and 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.

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 short-term, foreign currency-denominated unhedged foreign debt that could not be easily repaid.

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.

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.

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.

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.

***[NOTE: The section below is from Nouriel's original version. It's too long w/ too much detail
but I left it in for you to look at and perhaps use some of the information. Otherwise, I assume that you would want to delete this.]***

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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.

REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

Given this analysis of the causes of the Asian crisis -- and the elements that were common to the other episodes of financial turmoil in this decade -- what sorts of measures should be taken to reform and strengthen the international financial system?

First, let me 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 in 1995 -- led to the Rey Report, which suggested 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. In fact, as a number of the recommendations of the Rey Report were never implemented. For instance, the report was clearly aware of domestic and international moral hazard issues and stressed the need for better market-based debt workout procedures.

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.

[NOTE: I think more needs to be said about Halifax II. What is it? Is it still going on? Has the Administration endorsed it? etc.]

There are three basic building blocs of the Halifax II international architecture reforms: 1) greater transparency; 2) strengthening financial systems; and 3) better crisis resolution and debt workout mechanisms.

Let me talk about each of these building blocs and why they are so important:

First, Greater transparency. There is a broad consensus on the need for greater transparency 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?

Second, Reforming and strengthening domestic financial institutions. Financial sector weaknesses were central causes of the Asia 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.

So, given this analysis and now evident and recurrent link between currency, debt and banking crises, a central element of the Halifax II reforms must be a radical reform and strengthening of domestic financial systems.

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. In the end, reform of domestic financial systems is an enormous task and, in the best scenario, it will take years to accomplish the long list of overdue reforms.

Third, better crisis resolution and debt workout mechanisms. While strengthening the international 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 does 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 ?

[NOTE: I'm not sure what Nouriel's intent is with the section below. It's a bunch of questions that aren't appropriate for a speech. Is there any way to make it more descriptive or factual?]

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, I 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.

CONCLUSION

To conclude, let me say that the worlds' economies and financial markets are increasingly interdependent. Turmoil in one region can spread and effect the economies and well-being of citizens in nations across the world.

Preventing future currency and financial crises may not be possible but there is much that can be done to limit the frequency of their occurrence, the magnitude of their effects and their rapid spread. The reforms of the international financial architecture I discussed above -- namely, greater transparency, reforming and strengthening domestic financial institutions, better crisis resolution and debt workout mechanisms -- would go a long way, if implemented, towards achieving such goals.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:11-SEP-1998 13:02:09.00

SUBJECT: speech attached

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.D47]MAIL44696145O.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 Mr. Littlefield, your parents who have volunteered to come along today, 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.

I. Introduction

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 another job in public policy. Most importantly, I would like to tell you about how critical it is that you go to college, and what can you do now to get to college. I chose to talk to you about this today for two reasons. The first is that as an economist, I know that education is very important to your future. 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 very, very 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 college.

II. The Importance of Education

A lot of economic research is about using data to see patterns. By data, I mean any information collected in a thorough way. 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 better 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 if you have a college degree -- but would be closed if you do 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.

III. Getting to College

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 in low income families, taking these classes *triples* the likelihood of going to college.

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.

IV. Conclusion

Because of what we know about how college helps people get jobs with better wages, 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 that next time we will visit you at your school. 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, but keep going. It is especially important for all of you to work *together* towards your goals. You can learn a lot from each other, and also encourage each other through rough spots. Don't be shy about asking friends and classmates for help, and be a good friend and classmate by offering to help others. The topics that come easily to you might be harder for your classmates, but then they can help you when you get stuck on something tough. You'll also find that you learn a lot yourself when you are helping someone else.

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 ...

Withdrawal/Redaction Marker
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	Russ Winer to Janet L. Yellen at 11:16:00.00. Subject: We want you back. (1 page)	09/11/1998	Personal Misfile

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

FOLDER TITLE:
[09/09/1998 - 09/16/1998]

2013-0723-F
ab1284

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

CREATION DATE/TIME:14-SEP-1998 17:53:16.00

SUBJECT: talking points on EIA analysis

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

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

TO: Julie M. Anderson (CN=Julie M. Anderson/OU=WHCCTF/O=EOP @ EOP [WHCCTF])
READ:UNKNOWN

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

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

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

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

TO: William J. Antholis (CN=William J. Antholis/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

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

TEXT:
Attached please find a draft of the talking points on the EIA analysis.
Please note that these are specific to a comparison of EIA with the
Administration Economic Analysis. I believe that both EPA and DOE staff
have also been working on talking points.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D29]MAIL449592750.226 to ASCII,
The following is a HEX DUMP:

Differences Between EIA & Administration Analysis of Kyoto

A preliminary evaluation suggests there are two broad explanations for the difference between the numbers reported in the various cases considered by the EIA and the numbers reported in the Administration analysis. 1) the EIA analysis uses models that do not take into account the international market dimension, which is central to the flexibility provisions in the Kyoto agreement; and 2) the EIA analysis assumes that most firms will not anticipate climate policy until 2005 or later.

EIA Analysis Does Not Include Kyoto's Flexibility

- The EIA analysis does not attempt to model international trading. EIA used the NEMS model, which is a model of the U.S. energy sector, to assess the effects of the Kyoto Protocol. EIA did not conduct any analysis of cost-effective international trading opportunities. A traditional economic analysis of international trading should assess the demand and supply of emissions allowances and, by modeling a market where costs are minimized, identify a single international permit price. However, the EIA analysis assesses only the demand side of the issue for the United States, and then incorporates arbitrary assumptions about the international permit price and subsequent international transfers. In contrast, the Administration explicitly modeled international trading, as has every modeling team participating in the exercise assessing Kyoto conducted under Stanford's Energy Modeling Forum. The least-cost scenario in the Administration's analysis makes more effective use of the potential for international trading than implied by EIA's most flexible scenarios.

- The EIA analysis focuses solely on CO_2, ignoring other gases. The EIA study assumes that the United States achieves its target only by reducing carbon dioxide emissions, even though all six types of greenhouse gases are covered by the Protocol. Since the Kyoto agreement requires countries to reduce emissions to specific targets, on average across all types of greenhouse gases, the flexibility is available to reduce emissions of some gases more than others if it is cost-effective.

- *Both* the EIA analysis and the Administration's economic analysis are conservative on several issues. Both studies do not take into account that carbon sinks, such as forestry activities covered under the Kyoto Protocol, could provide any net sequestration in the United States during the commitment period. Low-cost carbon sink options provide another opportunity to achieve emissions targets at lower cost. Further, these studies do not incorporate emissions reductions attributable to the Administration's electricity restructuring proposal, which could reduce carbon emissions by 25 to 40 MMTCE.

EIA Assumes Little Anticipation to Climate Change Policies

- EIA assumes most firms do not anticipate climate change policies. In EIA's study, the U.S. does not implement Kyoto until 2005, and we therefore only have a short time until the 2008-2012 budget window to reduce emissions. The IAT analysis included model runs with the same model as used in this EIA study and evaluated the effects of lead time prior to the target year. The IAT report found that a 5-year "ramp-up" (starting in 2005) resulted in economic costs 65% greater than that associated with a 10-year "ramp-up" (starting in 2000). Thus, assuming a shorter transition period results in more pronounced economic costs.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-SEP-1998 11:14:47.00

SUBJECT: Memo to President attached

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.D58]MAIL448765658.226 to ASCII,
The following is a HEX DUMP:

September 4, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: JANET L. YELLEN

SUBJECT: The Current Economic Situation and Prospects

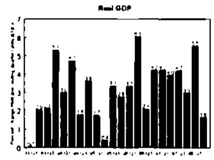
In light of recent volatility in world financial markets, you asked me to provide you with a brief update on the state of the U.S. economy. This memorandum assesses the current U.S. economic situation and prospects for future growth. It concludes that, consistent with consensus forecasts, the fundamentals are in place for continued solid economic growth, though developments in world markets continue to bear close monitoring.

The economy is healthy and remains largely free of the symptoms that often presage an economic downturn—such as an increase in inflation, an accumulation of inventories, or significant financial imbalances. The unemployment rate remains low, job growth remains robust, inflation remains tame, real wages and real personal income are rising, and consumer confidence is high. Even with the recent slide in the stock market, household net worth remains high relative to disposable income and businesses do not appear to be taking on excessive debt. The main impact of the Asian crisis on the U.S. economy has been a deterioration of net exports, including agricultural exports, and a widening of the trade deficit. Overall, economic growth appears to be moderating toward the solid pace anticipated in the Blue Chip consensus forecast as well as the Administration's *Midsession Review*.

I. Retrospective on the Second-Quarter

Growth in GDP moderated to a 1.6 percent annual rate in the second quarter (see chart on next page) after growing 4.2 percent over the previous 4 quarters. The moderation had been expected and was accounted for by three factors, the first two of which at least were temporary: the strike at General Motors, a sharp drop in non-auto inventory investment, and a deterioration of net exports. Final sales, which exclude inventory changes, grew at a robust 4.4 percent.

- With the strike at General Motors now settled, production schedules show that GM is recouping output lost during the strike. As a result, we expect motor vehicle production to be about flat in the third quarter and then to boost GDP growth in the fourth quarter.



- The drop in inventory investment toward more normal levels is a necessary step in the transition to an economy growing at the solid pace envisaged in the consensus forecast. The 2.6 percent annual growth rate of nonfarm inventories in the second quarter (partly reflecting the GM strike) is close to the rate of stockbuilding that is consistent with projections of solid growth over the next year.

- In contrast to these temporary factors, the widening trade deficit is likely to serve as a drag throughout the year, although the magnitude of that drag should diminish if economic conditions in crisis countries stabilize.

II. Analysis of the Current Situation

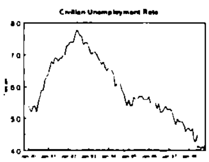
Labor markets

All available indicators show that the demand for labor remains strong.

- Job gains have averaged 237,000 per month so far this year, and nonfarm payroll employment grew 365,000 in August (about 150,000 of which was due to the rebound from the GM strike).

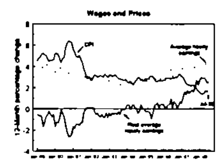
- The unemployment rate has been below 5 percent for over a year and stood at 4.5 percent in August (see upper chart on next page).

- Initial claims for unemployment insurance (available weekly through August 29) remained close to their lowest levels during this expansion.



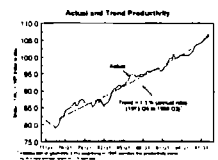
Real wages

Real wages have grown 2.5 percent over the past year (see lower chart). Growth in real wages recently has been the highest in over two decades. Thus far, these gains have been in line with productivity growth, which has grown 2 percent during the past year, somewhat faster than its historical trend (see upper chart on next page). Thus, wage growth has placed little upward pressure on prices.



Real incomes

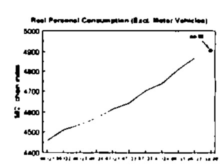
The combination of strong employment gains, together with large increases in real wages, has resulted in growth of real disposable personal income of 3.1 percent over the four quarters ending in 1998:Q2. Real disposable personal income grew a further 0.3 percent in July, and the



latest employment report points to further gains in August.

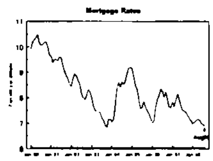
Consumption

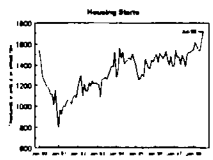
Real consumption grew at a rapid 5.8 percent annual rate in the second quarter, boosted by a jump in motor vehicle sales caused in part by generous incentive programs. Although motor vehicle purchases were weak in July and August following the termination of these incentive programs, very incomplete data from the third quarter show further gains for non-auto consumption (see lower chart) to a level that, at an annual rate, is 4.8 percent above the second-quarter average. .



Residential Investment

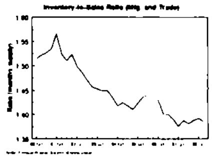
Strong real income growth, together with the drop in mortgage interest rates over the past year (see upper chart) is also buoying residential investment. The 1.6 million unit pace of housing starts so far this year is the highest in a decade (see lower chart). Because housing starts lead housing construction, the recent surge in starts points to strong construction for the next several months.





Inventories

The piling up of unsold goods can be an indicator that a recession is coming. As noted earlier, however, stockbuilding slowed along with the economy in the second quarter. As a result, inventories remain lean with respect to sales (see chart).



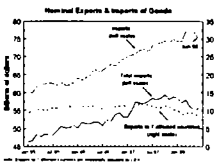
Business Investment

Equipment investment grew at an extraordinary 26 percent annual rate in the first half of 1998, following 5 years of double-digit growth. Business purchases of computers, where the rapid pace of innovation is driving new investment and prices have been falling sharply, accounted for much of this growth. In addition, low long-term interest rates have reduced the cost of capital, and further interest rate declines in recent weeks are a positive factor in the investment outlook. As long as the relative price of equipment is falling, it is likely that business investment will continue to grow faster than the economy as a whole. Such strong growth in investment bodes well for future growth in productivity.

International Factors

Real U.S. exports of goods and services fell in the first half of the year and net exports subtracted 2 percentage points from GDP growth. Country-by-country deflators are not available, but the evidence based on nominal exports suggests that all of the past year's weakness in exports is accounted for by the drop in our exports to seven Asian countries: China, Indonesia, Japan, Korea, Malaysia, the Philippines, and Thailand (see chart). Our imports from these countries have also risen—although these imports have been on an uptrend for several years. The Asian crisis has also affected U.S. farmers, who are experiencing low prices and shrinking exports, on top of bad weather in some regions.

Although the Asian economic crisis has clearly cut into American exports, several repercussions of the crisis have been favorable for the U.S. outlook. Thus far in 1998, U.S. refiners have been able to purchase imported crude for 5 to 6 dollars less per barrel than in 1997, which translates into lower gasoline prices for consumers. Non-oil import prices have fallen 3.9 percent over the past year—benefitting American consumers and helping to restrain inflation. Finally, the international economic situation has been one factor, along with the fiscal surplus, in keeping interest rates low.

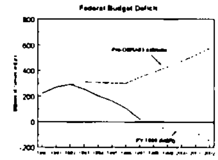


Inflation

Inflation remains under control. The consumer price index has increased only 1.7 percent over the past year—down from 2.2 percent during the same period a year ago. The more-comprehensive price index for GDP increased only 1.0 percent in the past year—down from 2.0 percent a year earlier. The effect of tight labor markets has been offset by ample industrial capacity, as well as falling import prices. These restraining influences are likely to remain in play in the medium term. The capacity utilization rate is expected to come back to its historical average level following the GM strike as high levels of investment continue to boost industrial capacity at least as fast as production. Import prices are likely to continue falling—reflecting the competitive international situation and the lagged effects of the dollar's appreciation over the past 3 years.

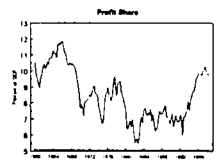
Deficit Reduction

For the first time since 1969, the Federal budget is in surplus, and the surplus is projected to increase in coming years (see upper chart). With the Federal budget no longer a drain on national saving, interest rates are lower—providing an incentive for greater private sector investment. Maintenance of this fiscal discipline is important to support economic growth going forward.



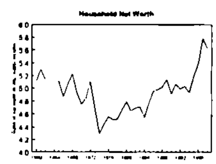
Profits

Although profits have edged lower as a share of GDP over the past 3 quarters, the profit share remains higher than at any other time since 1969 (see lower chart).



Financial Condition of Households and Businesses

Household debt has risen over this expansion, but the aggregate value of household assets has risen even more and the ratio of household net worth to disposable income has increased sharply (see chart). The debt burden of households (required interest and principal payments) appears to have stabilized as a share of disposable income. Delinquency rates on consumer loans generally, and on credit card loans in particular, appear to have stabilized. Similarly, personal bankruptcies, which had been rising, may be leveling off.



The debt burden of businesses has been declining, and indicators of problem loans have fallen to very low levels.

The relatively small number of large banks that have substantial foreign exposure have already felt some effects from the Asian crisis. These banks are obviously vulnerable to a further deterioration in world financial conditions. But at least so far, the effects of the Asian crisis seem to have been manageable.

III. Looking Ahead

Looking past the third quarter, it appears likely that economic growth and job creation will continue at a pace closer to the solid rates anticipated in the consensus forecast and the Administration's *Mid-Session Review*. Two factors working toward such moderation relate to consumption and net exports.

- Until now, consumption has been boosted primarily by large increases in real income, but also by substantial gains in stock-market wealth. Unless the stock market continues to surge, consumption is likely to grow at a more moderate pace. Continued real income growth—even taking account of the recent stock-market correction—is likely to motivate further, but smaller, consumption gains.

- Net exports, as noted above, are also likely to serve as a drag on growth. As the crisis-impacted economies stabilize, this drag could diminish.

The international financial picture has deteriorated in recent weeks. But based on the effects so far and the overall health and soundness of the U.S. economy, the likelihood that this expansion will become the longest during peacetime in postwar U.S. history remains very high. Clearly, however, a further deterioration in the international economic situation remains the single largest risk to a forecast of continued solid growth.

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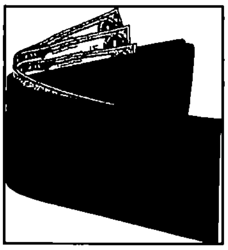
Equity Research—Americas

Industry: Economic Comment
August 3, 1998
EP2739

Rosanne M. Cahn 212/325-4729
rosanne.cahn@csfb.com

United States—Consumers of Last Resort



Domestic Spending

eCAHNomics

The economy took a breather in the second quarter, according to the "advance" GDP report of the Commerce Department's Bureau of Economic Analysis (BEA), showing 1.4% growth in real terms. That fans the flames of the consensus forecast that, for two years, has been expecting the economy to slow sharply.

Further favoring the consensus, important data are missing when BEA makes its advance estimate. BEA does not originate data; the statisticians use appropriate data from other government and private organizations (such as footage of oil wells drilled, from the American Petroleum Institute), adding it all up into GDP. Missing when the advance GDP is released are foreign trade, inventory, and construction data for the final month of the quarter. It looks like BEA was optimistic about June inventories but made reasonable assumptions about the rest.

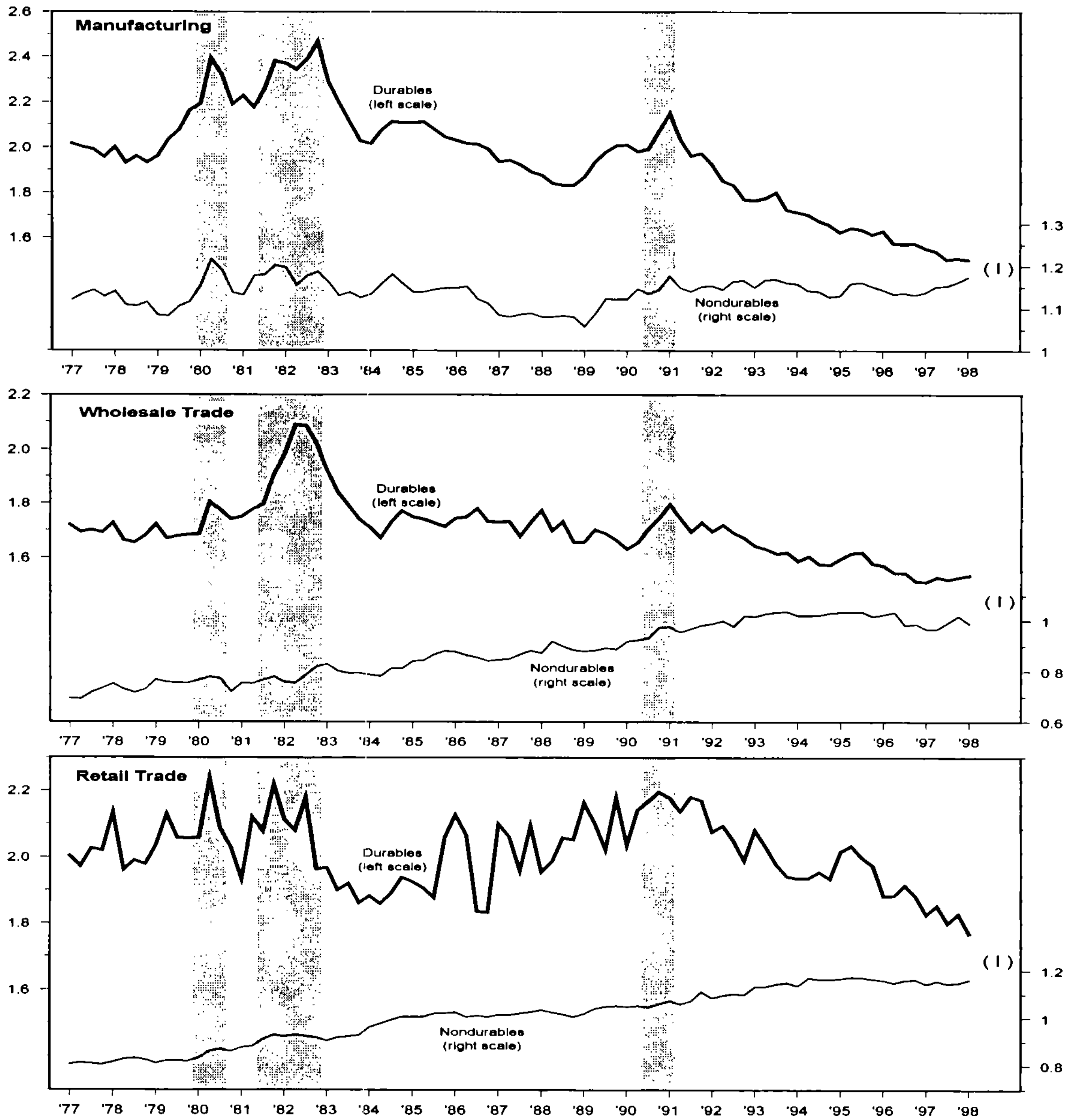
Inventory Subtraction from Growth Will Not Last

The General Motors strike was responsible for some of the production weakness in the quarter. June sales were not influenced. In fact, stemming partly from generous incentives and partly from robust economic conditions, sales reached their highest rate in the 1990s, 16.5 million seasonally adjusted annual rate, up from a solid 16.2 million in May. Production of course was impacted, meaning that inventories were drawn down sharply. *BEA estimated that auto inventory drawdown stemming from the strike subtracted 0.7 percentage points from growth.*

Inventories were also weak excluding autos, unrelated to the GM strike. The inventory-to-sales (I/S) ratios on Chart 1 show the situation at the end of the first quarter (second quarter data will not be available for another month). As we detailed then, I/S ratios were not high, even after the record rate of accumulation.[1] Nor did surveys suggest that companies were worried much about excess inventories. For example, in our analysts' survey, fully 76% reported that inventories were OK, 17% that they were too high, and 8% that they were too low.[1] In the June National Association of Purchasing Managers report, 73% thought inventories were OK, only 8% too high, and 19% too low.

[1] R. Cahn, *eCAHNomics*, "Top Down, Bottom Up," July 24, 1998.

Chart 1
Inventory-to-Sales Ratios for Manufacturing, Wholesale Trade, and Retail Trade
quarters



Source: Bureau of Economic Analysis.

[Automated Records Management System Hex-Dump Conversion]

The drop in inventory accumulation in the first quarter suggests a large decrease in I/S ratios. Inventories are unlikely to continue to accumulate at such low rates, since it would imply sustained steep declines that are unprecedented. A recovery in inventory accumulation above and beyond that of the poststrike rebound should boost second half growth.

Asian Drag on Foreign Trade Is Diminishing

The trade situation seems less penetrable. It seems hard to predict how far down Asian economies will be pushed by their financial and structural difficulties. But it is easy to know what has already happened. U.S. exports to eight Asian countries (China including Hong Kong, Japan, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand), accounting for 26.5% of total exports in 1997, fell at a seasonally adjusted 45% annual rate in the first quarter, when the economy grew 5.5%, and at an estimated 12% annualized decline in the second quarter. These exports have dropped nearly 25% from their peak in the first quarter of 1996. U.S. exports to Korea have been nearly halved.

The negative influence on the U.S. economy is the rate of decline times its weight in the economy. The drag in the future is unlikely to be as great as it has already been, i.e., any one quarter's decline should not be as large as the 45% plunge in the first quarter. Furthermore, these exports are rapidly becoming a smaller percentage of the economy, diminishing their negative influence.

Nonetheless, foreign trade subtracted 2.9 percentage points in the second quarter, even more than the 2.7 percentage points in the first. This amount was substantially greater than we anticipated and seems to contradict the analysis above. Some of the difference is explained by inappropriate seasonal adjustment of the trade data, a chronic problem.[2] The government trade deficit is bloated in the first and second quarters and too small in the third and fourth. *We estimate this bias subtracted about 0.6 percentage points from real GDP growth last quarter.* Reversing the seasonal adjustment bias should boost published growth figures in the second half, especially the fourth quarter.

Excluding Strike and Bias, First Half Growth Was 4%

Adding back the strike and seasonal adjustment special factors yields a 2.7% growth rate; averaged with the 5.5% first quarter, the first half increased at a 4.1% annual rate, hardly weak.

Final Sales Jumped Over 6%

Behind the published figure, and unaffected by special factors, was a tremendously strong increase in final sales to domestic purchasers of 6.3%, almost as strong as the first quarter's 6.6%. The important ingredients were consumer spending, up 5.5%, and capital goods, up 17.8%. Together, these two sectors account for 76.7% of GDP.

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[2] R Cahn, *eCAHNomics*, "Foreign Trade—A Small Problem," September 19, 1997.

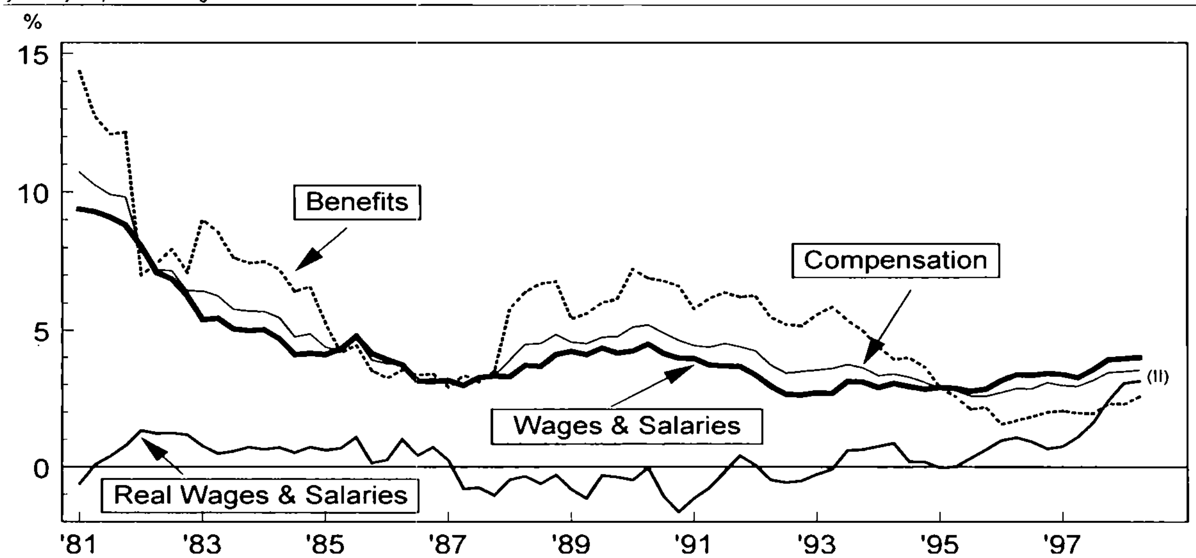
Rapid Income Growth and Optimism Support Consumer Spending

Consumers are bulletproof. As shown in Chart 2, real wages, which used to be the lowest line on the chart, have risen 3.1% in the past year, and are accelerating. Add to that the 2.4% increase in employment, for a rise of $5\frac{1}{2}$% in real wage and salary income, about three-fifths of total income. The rest of income (benefits, interest, dividends, proprietors' income, rental income, transfer payments) is rising about $1\frac{3}{4}$% in real terms, for a weighted average of 4% for real income. Considering sky-high optimism about the economy and ballooning mortgage refinancing opportunities, spending should continue to increase more rapidly than income.

Slower Income Growth Will Become Important Next Year

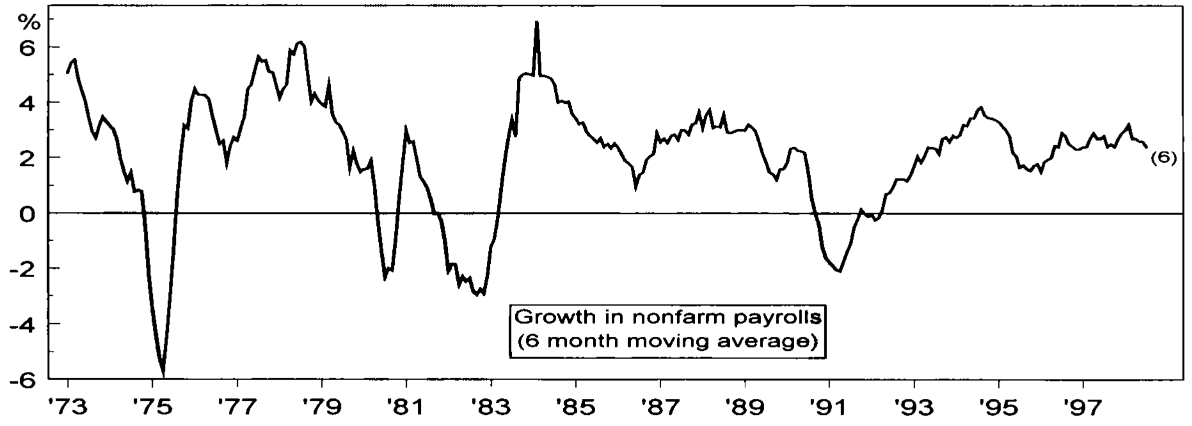
Employment growth is slowing and should trail off further. As shown in Chart 3, it has already receded from 3.2% in February to 2.4% in the past six months (annualized) and should drop further to 1-$1\frac{1}{2}$% by year-end. Companies must redouble efforts to increase labor productivity to counteract the profit squeeze created by rising wages and stagnant prices. Some, but not all, of the employment slowdown will be offset by further acceleration in real wages. However, the influence of slower income growth on spending is an ingredient in our expectation of a slowdown in 1999 and is not important for the second half of 1998.

Chart 2
Labor Compensation
year-to-year percent change



Source: Bureau of Labor Statistics, Bureau of Economic Analysis.

Chart 3
Employment Growth



Source: Bureau of Labor Statistics.

Don't Panic about a Zero Savings Rate

Households are not saving. As shown in the top line in Chart 4, the personal savings rate has been falling sharply, with the revisions augmenting the downtrend. In fact, the household savings rate can be negative, since it represents the *net* of new purchases of financial assets *minus* new increases in debt. The fact that the revised personal saving rate is so close to zero will panic some forecasters into thinking that consumers must stop spending and start writing bigger checks to mutual funds.

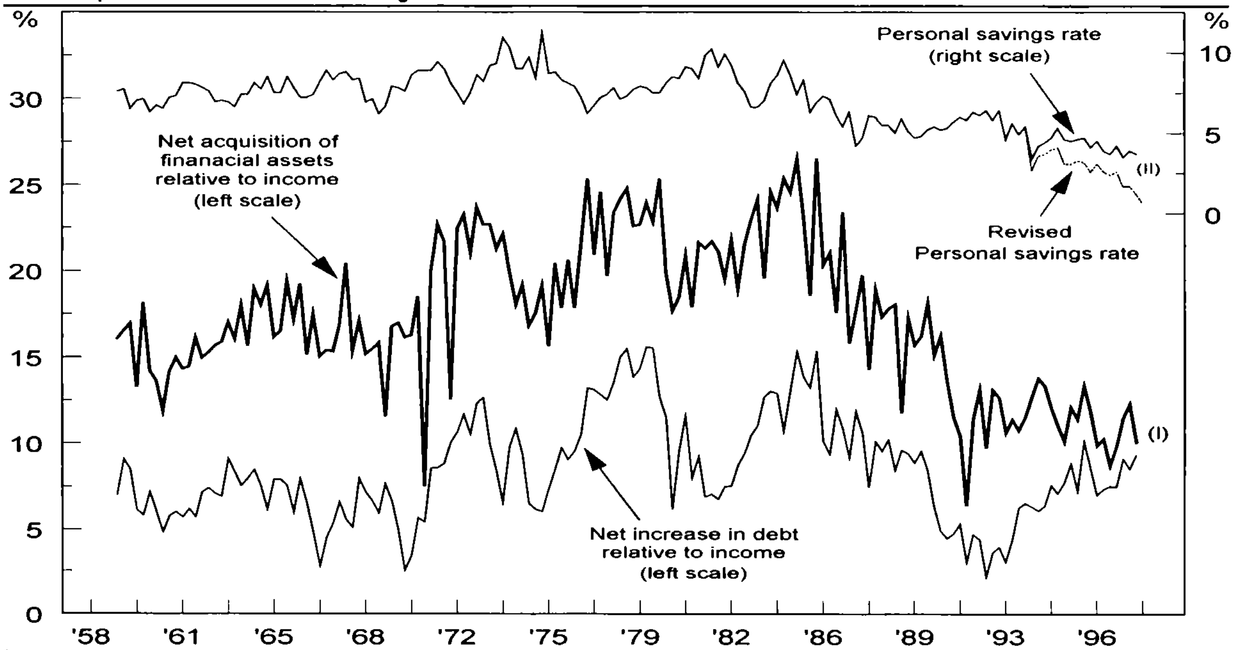
As Long as the Stock Market Is Fine

The prime reason for a low saving rate is shown by the middle line on the chart—a low rate of acquisition of financial assets relative to income. However, why should households save when savings objectives are being satisfied by high returns on existing assets? As shown by the top line in Chart 5, the ratio of the market value of financial assets relative to income is soaring, thanks to the U.S. stock market. Relying on a robust stock market would be unwise only if equities prices dropped sharply and did not recover. Under those circumstances, we would change our forecast. Rolling minor corrections have not damped consumer spending or raised saving.

U.S. Consumers of Last Resort in a World of Excess Saving

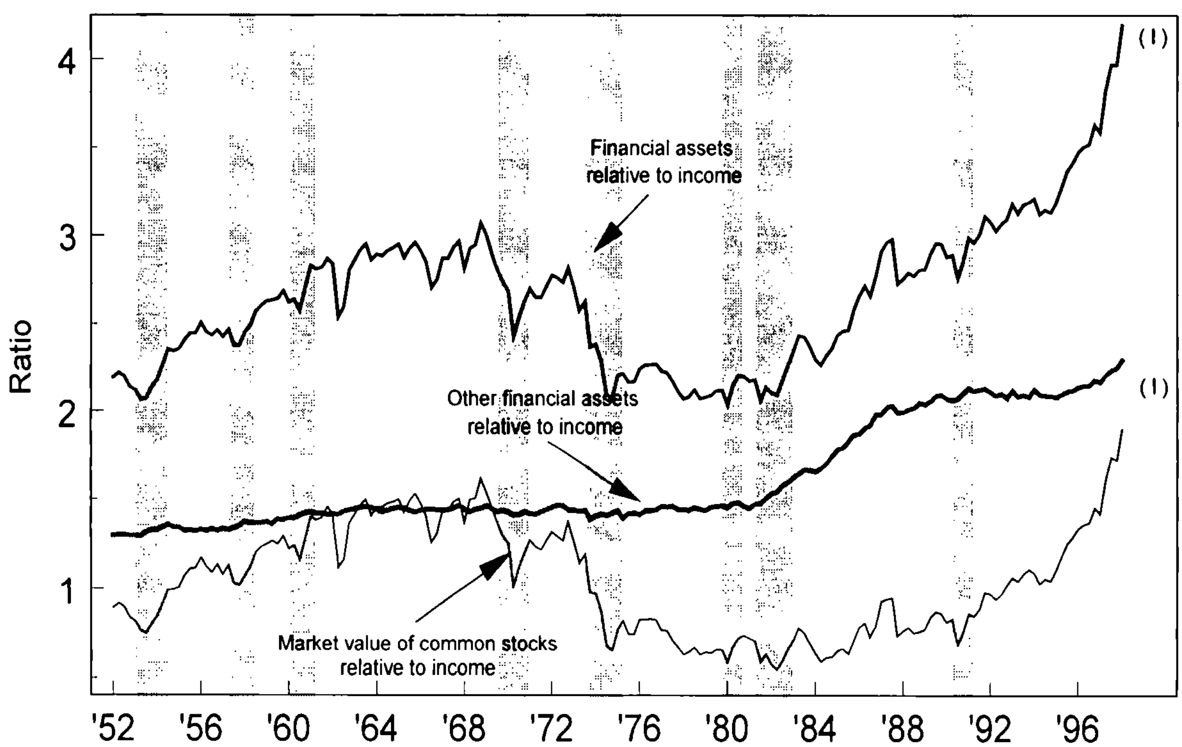
More generally, savings and investment rates are too high in the rest of the world, and probably in the United States too. Firms cannot make a decent rate of return (or provide jobs for workers) unless they sell their output to customers. We have argued that the ratios of investment to GDP, as shown in Chart 6, especially for developing countries, have proven to be too high in an era when markets are increasingly determining prices and quantities and governments' and cartels' influences are diminishing. Excess investment has been a prime cause of the difficulties of the Asian and former Communist economies. In this light, it is lucky, if not essential, that U.S. consumers continue their buying spree.

Chart 4
The Composition of the Personal Saving Rate



Source: Bureau of Economic Analysis, Federal Reserve Board.

Chart 5
Personal Financial Assets Relative to Income



Source: Bureau of Economic Analysis, Federal Reserve Board.

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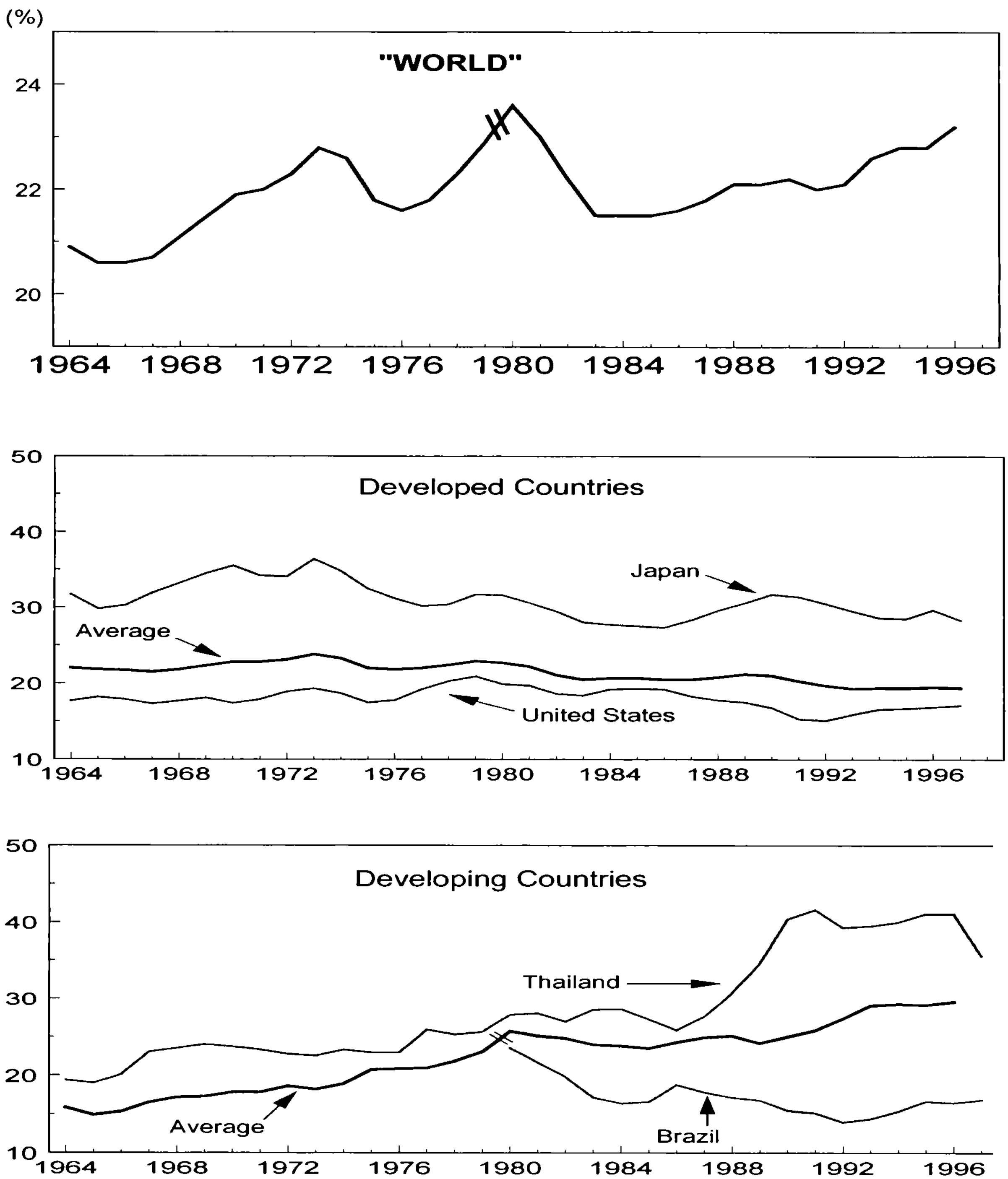
Chart 6
Gross Fixed Capital Formation as a Percent of GDP



"World" includes United States, Canada, Mexico, Germany, France, Italy, United Kingdom, Spain, India, Indonesia, Korea, Thailand, Malaysia, Philippines, Singapore, and Australia before 1980; thereafter, China, Brazil and Argentina are included. This accounts for about 70% of world GDP before 1980 and 85% after.

Gross fixed capital formation includes government investment, residential investment and business investment.

Source: International Monetary Fund.

[Automated Records Management System Hex-Dump Conversion]

Capital Goods Demand Continues to Blow Away Forecasts

More controversial than a strong consumer has been our forecast that domestic demand for capital goods would continue to jump at double-digit growth rates.[3] Yet another quarter of evidence is now available. We wonder what the naysayers will come up with this time.

The data in Table 1 present the situation before and after second quarter data and historical revisions were published. Over the 6 1/4 years of the boom, as shown in the column second from the right, real GDP (bottom line) rose at an average annual rate of 3.1%. The growth in total real capital goods was revised from 11.8% to 12.4%, as shown in line 7. The past year's gain was 17.7%, about the same as the annualized increase between the first and second quarters of 1998. There is no sign of a slowdown in domestic demand for capital goods.

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[3]R. Cahn, *eCAHNomics*, "Capital Goods Boom Going on Seven," May 21, 1998.

Productivity Needs Demand That Capital Spending Boom Will Last

Companies have no other choice but to continue the rapid increase in purchases of capital goods. Assuming demand continues to increase, there are three possible paths for business. (1) They could refuse to satisfy the rise in demand because it is not profitable. It is rare for companies to turn business away, so this path will probably not be selected. (2) They could add a lot of labor and a little capital. (3) They could add a lot of capital and a little labor, to meet the rise in demand. Since capital is cheap and labor is expensive, the choice is clear.

Table 1
Real Capital Goods Demand in This Recovery

Rank	Type of Equipment	Weight In 1997	Year-to-Year Percent Change (1997:I–1998:I)	Revised Year-to-Year Percent Change (1997:II–1998:II)	Revised Annual Growth Rate (1992:I–1998:II)	Compound Annual Growth Rate (1992:I–1998:I)
1.	Office and computing machines	34.1%	48.6%	56.7%	36.1%	35.9%
	(above in current dollars)	15.5	17.2	18.1	13.9	13.9)
2.	Mining and oilfield machinery	0.3	-0.9	28.4	20.0	17.9
3.	Trucks, buses and trailers	10.2	12.6	20.3	17.9	16.2
4.	Construction machinery	2.2	14.3	14.8	17.0	15.4
5.	Railroad equipment	0.7	33.4	21.8	16.9	13.9
6.	Aircraft	2.5	162.0	49.9	14.3	11.2
7.	TOTAL capital goods	100.0	18.0	17.7	12.4	11.8
8.	Communication equipment	11.7	15.4	19.0	11.0	10.8
9.	General industrial machinery	4.2	14.2	9.3	9.7	10.0
10.	Metalworking machinery	4.4	2.1	0.9	8.6	8.5
11.	TOTAL excluding computers	74.6	12.6	12.1	8.8	8.2
12.	Special industry machinery	4.7	19.9	2.0	5.6	7.1
13.	Tractors	1.7	15.7	15.8	7.2	6.9
14.	Agricultural machinery	1.6	16.9	13.0	8.2	6.7
15.	Furniture and fixtures	4.7	5.7	10.6	6.9	6.4
16.	Other equipment	2.9	14.4	7.3	6.9	6.4
17.	Electrical trans. & dist. equip.	3.2	9.2	4.7	6.6	5.2
18.	Service industry machinery	2.1	1.0	6.8	4.7	5.1
19.	Autos	7.1	-4.5	2.1	4.2	4.8
20.	Ships and boats	0.2	64.4	-22.5	3.8	4.5
21.	Fabricated metal products	1.7	3.7	2.7	5.0	3.9
22.	Photocopy and related equip.	2.7	2.3	3.1	3.6	3.2
23.	Scientific and engineering inst.	3.5	8.7	6.0	3.7	3.0
24.	Electrical equipment n.e.c.	1.8	16.1	15.5	6.0	2.9
25.	Engines and turbines	0.4	10.6	32.2	-0.3	-5.4
Memo:	Real GDP		3.9	3.5	3.1	3.0

Source: Bureau of Economic Analysis.

[Automated Records Management System Hex-Dump Conversion]

It Adds Up to a Pretty Picture

Together, consumer spending and capital goods account for over three-quarters of the economy. With the prospects for both so propitious, and current data so supportive, our thesis that domestic demand will offset weakness in exports seems intact. Add to the mix the certain poststrike rebound, the likely rebound in nonauto inventory accumulation, and a smaller foreign trade drag in the second half of 1998. It all adds up to another six months in which the economy will outpace consensus expectations. Looking back, the second quarter will appear to have been a head fake.

And all this without a pickup in inflation!

N.B.: Text written July 31, 1998.

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Equity Research—Americas

Industry: Economic Comment
February 13, 1998
EP0580

Rosanne M. Cahn 212/325-4729
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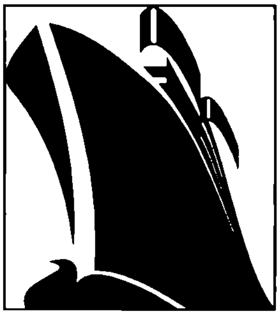
The Asian Crisis From the U.S. Point of View



Foreign Trade

eCAHNomics

Last September, before the extent of the Asian problems became known, we opined that the implications for U.S. growth stemming from the difficulties of the involved countries would be manageable.[1] The financial aspects of the crisis exploded in the interim, with a Korean bailout that had to be redone several times before the financial markets were convinced that it would be sufficient. Labor unrest is beginning there. Great uncertainty still surrounds settling Indonesia's difficulties.

Despite the drama of the crisis, we have changed our opinion surprisingly little. To make that conclusion more intuitive, note that the world economies are large enough to absorb the contractionary influences of the Asian countries' asset deflation and debt restructuring. In fact, the United States' economy alone is large enough to do the job without large implications for job losses or profit margin deterioration.

While monetary policy makers have not eased, bond markets have. In the United States, bond yields were 6.6% last August. They are now 5.8%. (German bond yields have dropped from $5\frac{3}{4}$% to 5% and Japanese from $2\frac{1}{2}$% to 2%.) U.S. stock prices have recovered. When they fell, they did not dampen consumers' confidence or have untoward influences on mutual funds investors.[2] Lower interest rates will underpin consumer spending, as will lower prices for Asian imports. U.S. consumer spending of \$$5\frac{1}{2}$ trillion is $2\frac{1}{4}$ times the size of the economies of Korea, Indonesia, Malaysia, and Thailand.

The implications of the Asian crisis for U.S. foreign trade are detailed in Tables 1 and 2. Their recessions will reduce demand for U.S. exports. As shown in the right-hand column of Table 1, slowing export growth to 4% this year from 10% in 1997 allows for large declines in exports to those countries and for deceleration to most other trading partners.

A worst-case scenario for imports, shown in line 2 of Table 2, is the same 10% dollar increase in 1998 as in 1997. The declining price of imports stemming from currency strength should not instantly elicit a comparable increase in the quantity purchased (the so-called J-curve effect).

[1] R. Cahn, "Foreign Trade—A Small Problem," *eCAHNomics*, September 22, 1997.
[2] R. Cahn, "Asked and Answered," *eCAHNomics*, December 15, 1997.

Table 1
Country Source of Growth in Exports of Goods

	Weight in 1996	1990	1991	1992	1993	1994	1995	1996	1997*	1998E*
Area	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(9)
Total	100%	8.2%	7.1%	6.2%	3.8%	10.2%	14.1%	6.9%	10.3%	4%
Canada	21.4	6.2	1.8	6.4	10.9	13.9	11.2	5.5	12.4	5
4 Latin American Countries	12.5	12.2	19.7	20.0	3.9	22.5	-1.0	19.3	24.6	8
Mexico	9.1	13.2	17.7	22.0	2.4	22.3	-8.9	22.7	25.7	10
Brazil	2.0	5.1	21.8	-6.5	5.3	33.7	41.2	11.2	24.6	0
Argentina	0.7	13.4	73.5	57.6	17.2	18.2	-6.1	7.8	26.8	10
Chile	0.7	17.7	10.5	34.1	5.4	6.8	30.3	14.5	6.5	5
Europe excluding Germany	18.9	13.2	3.3	-1.6	-1.2	4.4	13.7	5.0	10.3	8
Germany	3.8	11.3	13.6	-0.3	-10.9	1.6	16.5	4.9	4.6	5
Japan	10.8	9.2	-0.9	-0.7	0.2	11.7	20.3	5.1	-2.9	0
6 Asian Countries	13.4	8.4	10.7	6.8	10.6	14.1	26.5	3.6	7.3	-6
Republic of Korea	4.3	7.0	7.6	-5.6	1.0	21.9	40.8	4.9	-3.1	-15
Taiwan	2.9	1.4	14.7	15.7	6.0	5.8	12.8	-4.3	9.1	5
Singapore	2.7	9.2	9.7	9.3	21.3	11.5	17.8	9.0	5.9	5
Malaysia	1.4	19.3	13.9	11.9	39.0	14.9	26.5	-3.1	27.7	-15
Thailand	1.2	30.9	25.3	6.3	-5.6	29.2	37.0	8.0	7.8	-15
Philippines	1.0	12.2	-8.3	21.8	27.9	10.1	36.2	16.0	21.8	0
Hong Kong and China	4.2	-3.5	24.0	14.4	13.0	11.2	25.4	-0.1	8.3	10
OPEC	3.6	3.8	39.1	-3.7	6.2	-8.4	9.3	14.0	9.7	0
Other	11.6	1.9	3.6	20.5	-0.4	5.3	14.9	7.8	9.2	10

*1997 numbers reflect January through November data.
E = Estimates.
Source: Commerce Department, CSFBC estimates.

Table 2
The Outlook for the U.S. Current Account

$ in billions

	1991	1992	1993	1994	1995	1996	1997E	1998E
1. Exports of goods	$416.9	440.4	456.8	502.4	575.9	612.1	673	700
% change	7.1%	5.6	3.7	10.0	14.6	6.3	10	4
2. Imports of goods	$491.0	536.5	589.4	668.6	749.4	803.2	883	971
% change	-1.5%	9.3	9.9	13.4	12.1	7.2	10	10
3. Balance on goods (1–2)	$-74.1	-96.1	-132.6	-166.2	-173.6	-191.2	-210	-271
4. Exports of services	$164.2	177.2	186.7	197.2	218.7	236.8	256	269
% change	11.1%	7.9	5.4	5.6	10.9	8.2	8	5
5. Imports of services	$121.2	120.3	126.4	135.5	147.0	156.6	169	183
% change	1.0%	-0.8	5.1	7.2	8.5	6.5	8	8
6. Balance on services (4–5)	$43.0	56.9	60.3	61.8	71.7	80.1	87	86
7. Income on U.S. assets abroad	$141.4	125.9	129.8	154.5	196.9	206.4	237	256
% change	-13.4%	-11.0	3.2	19.0	27.4	4.8	15	8
8. Income on foreign assets in U.S.	$121.2	107.8	110.2	144.8	190.1	203.6	248	273
% change	-13.1	-11.0	2.2	31.4	31.3	7.1	22	10
9. Balance on income (7–8)	$20.2	18.0	19.7	9.7	6.8	2.8	-11	-17
10. Unilateral transfers	$5.1*	-35.5	-38.1	-38.8	-34.0	-40.0	-37	-40
11. Balance on current account (3+6+9+10)	$-5.7*	-56.4	-90.8	-133.5	-129.1	-148.2	-171	-242

*Includes $43 billion of payments by other countries to the United States for conducting the Gulf War.

Source: Bureau of Economic Analysis, CSFBC estimates.

U.S. Trade Deficit Deteriorates $70 Billion and Economy Still Grows 3%

Adding up the pieces, and projecting the balance on services, line 6, and income (cross-border interest and profits), line 9, leads to a projected $242 billion current account deficit projection, a deterioration of $71 billion from 1997. This result is incorporated in our forecast of real GDP growth of 3% during 1998.

That's Enough to Absorb All of the Asian Adjustment

Taking the estimates of Credit Suisse First Boston's economists who follow the Southeast Asian economies, the current account deficits of Korea, Thailand, Indonesia, Malaysia, and Philippines are expected to improve by $39 billion in 1998.[3] Experience with past crises suggests that initial estimates may prove conservative
—those economies may sink more, reducing imports, and allowing for greater trade improvements. However, even at double the size, the United States alone can still absorb most of their adjustment and still grow 3%. Surely demand from some other countries around the globe will contribute. Japanese stimulus would go a long way in helping both its own citizens as well as its neighbors.

Ballooning U.S. Trade Deficit Could Weaken Dollar in 1999

The $242 billion current account deficit amounts to 2.8% of GDP. That is not a record. The current account deficit exceeded that percentage in 1985 (3.0%), 1986 (3.5%), and 1987 (3.6%, $168 billion). However, it is sizable enough for the currency markets to begin to take notice. Chances are the dollar's strength, which could last through 1998, will start to wane in 1999 as currency markets focus on the ballooning trade deficit.

The Dollar Has Only Recently Surpassed Its 1990s Highs

The dollar is not as strong as it seems. To be sure, on a trade-weighted basis, it has jumped 24% from its low in mid-1995, as shown by the thick line in the middle of Chart 1. (The index includes 44 currencies, so all of the troubled Asian countries are included; it is measured in real terms to exclude distortions from inflation differentials among countries.) However, it is only 11% above its late-1993 high and has only been meaningfully above that level for a few months. There are long lags between when currency values change and when they influence trade flows. International business relationships are not rearranged quickly. Purchasers do not
immediately shift suppliers on the basis of an 11% price change. They must be convinced that it will persist in order to justify the cost and time it takes to switch. Therefore, just as the weakness in the dollar two years ago did not have a noticeable influence in increasing the global market share of U.S. goods because it did not persist, the dollar's current strength will have less immediate influence than many now fear. If the dollar turns down in 1999, the dollar's ongoing influence on U.S. competitiveness will also be less severe.

The dollar's round trip between the end of 1993 and the fall of 1997 is shown clearly on Chart 2, which portrays a long history of the trade-weighted index. In the 1990s, the dollar has routinely bounced off of the high that it has only recently surpassed.

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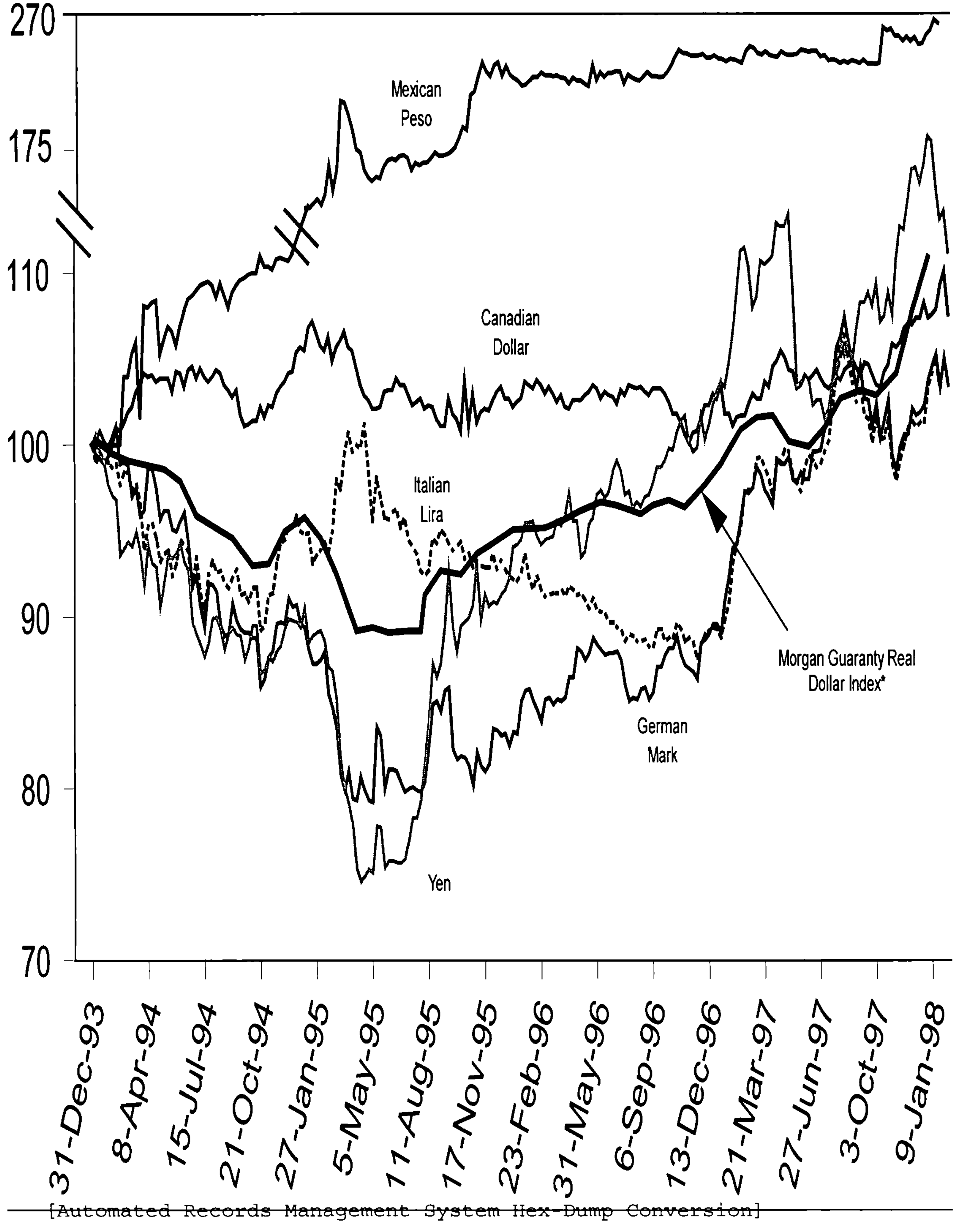
[3] C.K. Peng, M.S. Kumar, H. Miao, G. Saxton, "Asia," *Prospects 1998:Q1*, 10 January 1998.

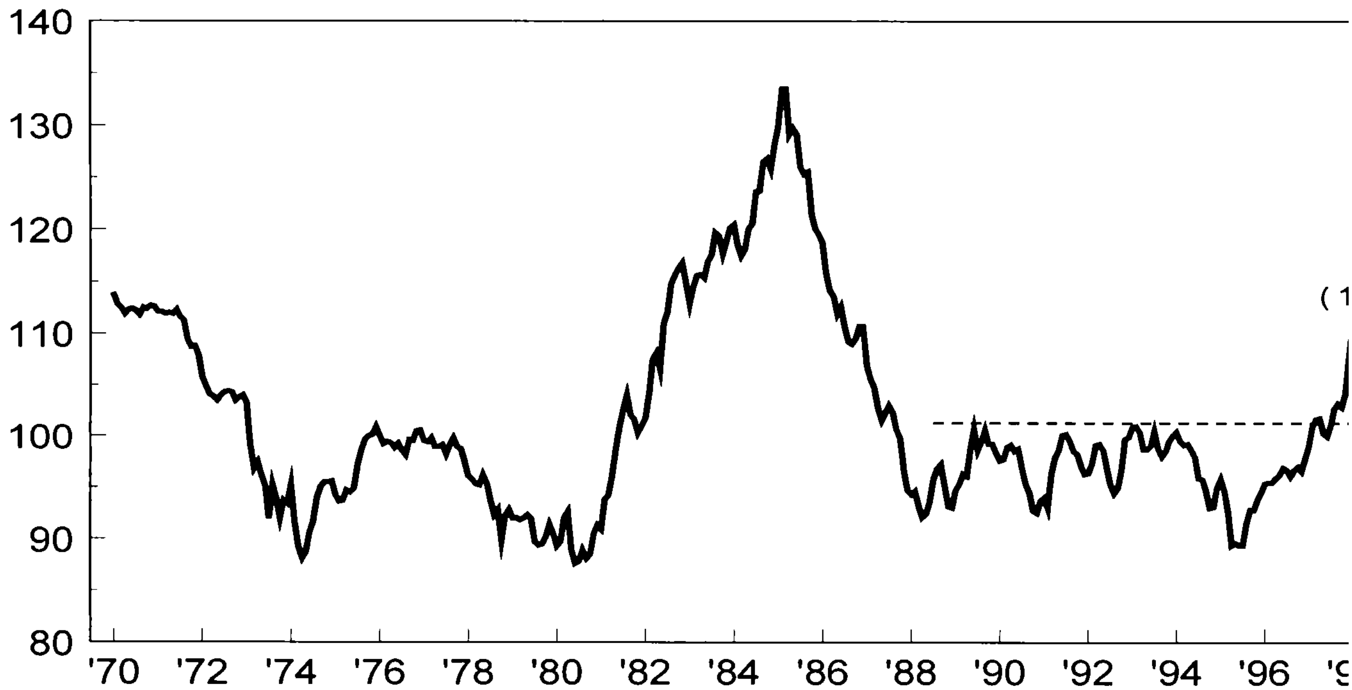
Chart 1
Is the Dollar Weak or Strong?

[Automated Records Management System Hex-Dump Conversion]


270
175
110
100
90
80
70
Mexican Peso
Canadian Dollar
Italian Lira
Morgan Guaranty Real Dollar Index*
German Mark
Yen
31-Dec-93
8-Apr-94
15-Jul-94
21-Oct-94
27-Jan-95
5-May-95
11-Aug-95
17-Nov-95
23-Feb-96
31-May-96
6-Sep-96
13-Dec-96
21-Mar-97
27-Jun-97
3-Oct-97
9-Jan-98

*44 Countries. Last data for February 6, 1998.
Source: Bank of America, Morgan Guaranty Trust.

Chart 2
Trade-Weighted Dollar[1]



[1] 44 Countries.
Source: Morgan Guaranty Trust.

[Automated Records Management System Hex-Dump Conversion]

A potential dollar reversal is more likely against the currencies of developed economies than against the currencies of the developing countries in Southeast Asia. Thus, the competitiveness of the United States vis-à-vis those countries might seem likely to suffer for an extended period. Imports from the troubled countries will become cheaper as a result of their currencies' devaluations. That risks their outcompeting U.S. producers or forcing them to lower their prices. In either case, U.S. workers and profitability of U.S. companies would be hit. However, the United States does not compete much with those countries.

The United States Does Not Compete Much With Southeast Asia

A detailed look at what the United States imports from the four countries is shown in Tables 3-6. Imports are concentrated in a handful of industries—semiconductors & electrical parts, telecommunications & electronic equipment, consumer audio & video, and miscellaneous consumer goods (chiefly textiles, floor coverings, cutlery, and dishes). The United States does not even have an industry in some of these cases, such as consumer electronics, having long ago turned to low-cost imports to supply domestic demand. In those cases, price declines will stimulate the demand for imports, helping the Asian countries, as devaluations are meant to do. But they will also boost overall U.S. consumer demand, since the lower prices for the goods in question will leave more room in budgets for other purchases. This should increase both jobs and profits. The profits of retailers, in particular, will be lifted through purchase of lower-cost products.

Concentration of Asian Production in Electronics Is a Micro, Not Macro, Problem

Capacity in the four Asian countries has been concentrated in the electronics industries. This is a consequence of their central-planning approach to economic management.[4] They fostered industries deemed winners. Not surprisingly, they all picked the same ones. This has resulted in significant excess capacity in those industries, with obvious consequences for price weakness and a profit squeeze for all producers. But since there are a small number of industries, this should not cause dire macroeconomic consequences.

Silver Linings for the Future

There are several silver linings. The Asian economies will become more market-oriented, thus more diversified and healthier in the future. Competition should be more rational from the point of view of others in the industry. In the present, customer of these industries benefit from lower costs.

The impact of import penetration on U.S. producers is summarized for the affected industries on the left side of Table 11. In the electronics/telecommunications equipment/computer categories, imports for the four Asian countries were a significant percentage of domestic shipments in 1995 (latest data that could be matched because of industry code differences), ranging from 6.5% for computers to 11.9% for semiconductors and electrical parts. Insofar as Asia supplies domestic industries rather than being a competitor, these percentages may exaggerate the impact. It may also be overstated by the fact that the types of equipment within these broad categories may not compete with U.S. producers. The United States tends to produce higher value-added products. The important point is that so few industries show up in the table.

[4] R. Cahn, "Another Farewell to Central Planning," *eCAHNomics*, January 16, 1998.

Table 3
U.S. Imports from Korea, by Commodity
$ in billions

Rank	Commodity	1996 % of Total	1996	1990-1996 Growth, Annual Rate
	Total	100.0%	$23.1	3.0%
1.	Semiconductors & electrical parts	28.7	6.6	21.6
2.	Consumer goods	17.6	4.1	-12.4
3.	Telecommunications & electronic equipment	11.2	2.6	21.0
4.	Computers & components	8.5	2.0	10.6
5.	Automobiles	8.3	1.9	8.4
6.	Rubber & leather materials, textile yarn & fabric	4.0	0.9	4.4
7.	Iron & steel	2.8	0.6	0.0
8.	Consumer audio & video	2.5	0.6	-10.8
9.	Light industrial machinery & equipment	2.1	0.5	9.1
10.	Household appliances	2.0	0.5	4.0
11.	Nonmetallic mineral & metal manufacturers	1.6	0.4	-0.6
12.	Power generation equipment	1.5	0.4	14.1
13.	Plastics, chemicals products & explosives	1.4	0.3	12.9
14.	Heavy transportation & construction equipment	1.3	0.3	0.7
15.	Heavy industrial machinery & equipment	1.2	0.3	22.2
16.	Other	5.3	1.1	4.1

Source: U.S. Commerce Department

Table 4
U.S. Imports from Malaysia, by Commodity
$ in billions

Rank	Commodity	1996 % of Total	1996	1990-1996 Growth, Annual Rate
	Total	100.0%	$18.3	22.2%
1.	Semiconductors & electrical parts	29.5	5.4	21.3
2.	Consumer audio & video	15.9	2.9	23.2
3.	Computers & components	15.3	2.8	73.4
4.	Consumer goods	14.8	2.7	17.4
5.	Telecommunications & electronic equipment	11.7	2.1	27.5
6.	Electrical power machinery & equipment	1.7	0.3	20.2
7.	Other	11.1	2.1	8.4

Source: U.S. Commerce Department

Table 5
U.S. Imports from Thailand, by Commodity
$ in billions

Rank	Commodity	1996 % of Total	1996	1990-1996 Growth, Annual Rate
	Total	100.0%	$11.7	13.1%
1.	Consumer goods	30.6	3.6	10.6
2.	Computers & components	15.2	1.8	26.0
3.	Meat, fish & dairy products	9.8	1.1	10.8
4.	Semiconductors & electrical parts	9.5	1.1	18.3
5.	Telecommunications & electronic equipment	4.9	0.6	16.8
6.	Consumer audio & video	4.0	0.5	6.0
7.	Electric power machinery & equipment	3.9	0.5	22.9
8.	Rubber	2.6	0.3	21.9
9.	Other	19.5	2.2	8.7

Source: U.S. Commerce Department.

Table 6
U.S. Imports from Indonesia, by Commodity
$ in billions

Rank	Commodity	1996 % of Total	1996	1990-1996 Growth, Annual Rate
	Total	100.0%	$8.8	15.6%
1.	Consumer goods	41.5	3.7	21.6
2.	Rubber	11.0	1.0	12.5
3.	Consumer audio & video	7.4	0.7	119.7
4.	Lumber, plywood & processed wood	6.0	0.5	2.6
5.	Flour, other food preparations, beverages & tobacco	5.5	0.5	15.8
6.	Crude petroleum	4.4	0.4	-7.3
7.	Telecommunications & electronic equipment	3.3	0.3	0.3
8.	Petroleum products	2.9	0.3	-6.6
9.	Other	18.0	1.4	25.1

Source: U.S. Commerce Department.

Hit to U.S. Exports Stems from Asian Income Constraints, Not Currency Per Se

U.S. exports to these countries will be hurt immediately by a drop in demand related to the economic adjustment required to correct their balance of payments problems, formalized in International Monetary Fund programs. This factor will influence these countries' imports from every country in the world. The loss of price competitiveness of U.S. exports to these countries is measured by the strength of the U.S. dollar relative to currencies of other countries, far smaller than the dollar's appreciation against these countries' own currencies.

Big Two-Way Trade in Electronics Is Not Necessarily All Negative for the U.S.

A detailed look at U.S. exports to the four countries is shown in Tables 7-10. As is the case for imports, there is a heavy concentration of export trade in a few industries. There is a big two-way trade in semiconductors & electrical parts, and to some extent computers & components. This probably reflects the shipments of parts made in Southeast Asia for further fabrication in the United States, or vice versa, in turn reexported from those countries. The latter activity is likely to be enhanced by their currency devaluations, further helping U.S. companies' profits. There may be some loss of jobs associated with a more rapid shift of production to Southeast Asia, but this accelerates a process that would have occurred anyway and comes opportunistically when the United States is short of labor.

Impact on Machinery Industries Vastly Exaggerated by Stock Market

Other industries that are heavily represented in U.S. exports to Southeast Asia are machinery & equipment. The categories of heavy industrial machinery & equipment and light industrial machinery & equipment are sizable U.S. exports to all of these countries. Two other categories, aircraft & ships and heavy transportation & construction equipment, also show up in the tables. However, for these industries, the troubled Asian economies are not big customers. As shown on the right side of Table 11, at most they totaled 3.3% of domestic shipments (heavy industrial machinery & equipment) in 1995, an amount not large enough to have important negative consequences for the U.S. industries. (Worst case, these exports drop to zero!) Therefore, even the impact on the industries that are most influenced will be manageable, while the macroeconomic influences should be easily absorbed by a healthy U.S. economy. Stocks of companies in these industries deserve another look in light of this specific analysis, which indicates that the Asian crisis may have been overly discounted in the stock prices.

Table 7
U.S. Exports to Korea, by Commodity
$ in billions

Rank	Commodity	1996 % of Total	1996	1990-1996 Growth, Annual Rate
	Total	100.0%	$24.8	9.9%
1.	Heavy industrial machinery & equipment	10.2	2.5	25.1
2.	Semiconductors & electrical parts	9.5	2.4	14.2
3.	Consumer goods	9.0	2.2	17.3
4.	Aircraft, ships	8.5	2.1	14.1
5.	Light industrial machinery & equipment	6.8	1.7	11.5
6.	Grain & animal feedstuffs	6.7	1.7	12.0
7.	Telecommunications & electronic equipment	6.2	1.5	18.0
8.	Chemicals other than liquid bulk chemicals	4.0	1.0	5.3
9.	Animal skins, textile fibers & waste	3.8	1.0	-5.2
10.	Plastics, chemical products, explosives	3.7	0.9	9.6
11.	Computers & components	3.2	0.8	14.2
12.	Meat, fish & dairy products	2.0	0.5	12.6
13.	Ores & scrap other than ferrous & aluminum	1.9	0.5	-2.8
14.	Oilseeds	1.8	0.4	14.6
15.	Motorcycles, automotive parts	1.7	0.4	20.2
16.	Pulp & waste paper	1.7	0.4	0.3
17.	Petroleum products	1.5	0.4	-5.7
18.	Flour, other food preparations, beverage & tobacco	1.5	0.4	13.1
19.	Nonmetallic mineral & metal manufacturers	1.3	0.3	10.9
20.	Electrical power machinery & equipment	1.3	0.3	15.5
21.	Pharmaceuticals, toiletries	1.2	0.3	19.4
22.	Lumber, plywood & processed wood	1.1	0.3	-4.1
23.	Heavy transportation & construction equipment	1.1	0.3	-1.9
24.	Nonferrous metals	1.1	0.3	7.7
25.	Paper & paper manufacturers	1.0	0.3	11.3
26.	Liquid bulk chemicals	1.0	0.3	0.8
27.	Rubber & leather materials, textile yarn & fabric	1.0	0.3	0.6
28.	Other	6.2	1.3	4.3

Source: U.S. Commerce Department.

Table 8
U.S. Exports to Malaysia, by Commodity
$ in billions

Rank	Commodity	1996 % of Total	1996	1990-1996 Growth, Annual Rate
	Total	100.0%	$7.9	16.4%
1.	Semiconductors & electrical parts	40.9	3.2	13.4
2.	Consumer goods	8.3	0.8	28.0
3.	Telecommunications & electronic equipment	6.8	0.5	35.6
4.	Heavy industrial machinery & equipment	5.6	0.4	22.9
5.	Light industrial machinery & equipment	4.0	0.3	21.2
6.	Aircraft, ships	3.7	0.3	-6.1
7.	Other	30.7	2.4	21.3

Source: U.S. Commerce Department.

Table 9
U.S. Exports to Thailand, by Commodity
$ in billions

Rank	Commodity	1996 % of Total	1996	1990-1996 Growth, Annual Rate
	Total	100.0%	$6.8	15.7%
1.	Aircraft, ships	14.7	1.0	13.2
2.	Semiconductors & electrical parts	13.4	0.9	9.6
3.	Consumer goods	10.9	0.7	26.7
4.	Telecommunications & electronic equipment	7.3	0.5	21.9
5.	Light industrial machinery & equipment	6.4	0.4	16.6
6.	Heavy industrial machinery & equipment	5.4	0.4	15.0
7.	Plastics, chemical products, explosives	4.0	0.3	14.1
8.	Other	37.9	2.6	16.2

Source: U.S. Commerce Department.

Table 10
U.S. Exports to Indonesia, by Commodity
$ in billions

Rank	Commodity	1996 % of Total	1996	1990-1996 Growth, Annual Rate
	Total	100.0%	$3.8	12.6%
1.	Heavy transportation & construction equipment	9.1	0.4	17.6
2.	Heavy industrial machinery & equipment	8.8	0.3	18.0
3.	Animal skins, textile fibers & waste	8.7	0.3	6.3
4.	Light industrial machinery	7.4	0.3	18.6
5.	Aircraft, ships	6.8	0.3	-5.9
6.	Other	59.2	2.2	16.3

Source: U.S. Commerce Department.

Table 11
U.S. Imports from and Exports to Four Troubled Asian Economies as a Percent of U.S. Shipments, Selected Commodities, 1995

Imports		Exports	
Semiconductors & electrical parts	11.9%	Semiconductors & electrical parts	5.9%
Telecommunications & electronic equipment	9.6	Heavy industrial machinery & equipment	3.3
Computers & components	6.5	Aircraft & ships	2.9
Automobiles	1.0	Telecommunications & electronic equipment	2.7
		Light industrial machinery & equipment	2.4
		Heavy transportation & construction equip.	0.4

Source: U.S. Commerce Department.

Other Countries in Asia Must Pull Their Weight, Especially Japan

The distribution of trade by country of the troubled economies is shown in Tables 12-15. The United States is the largest single buyer of exports from Korea and Thailand, and second largest buyer from Malaysia and Indonesia. The continued robust U.S. economy should moderate the difficulty of their adjustments. In general, however, much of their trade is within their region. Therefore, it is critical that the other Asian countries remain in a growth mode. At the present, this is expected. It would be extremely helpful if Japan were to instate a serious stimulus package, as has been suggested and is being pressed by U.S. officials. Japan is Indonesia's largest customer, the second largest for Korea and Thailand, and the third for Malaysia. However, Japan's record on savvy economic management in the 1990s is not good.

Other Asian Countries Should Offset The Drag from Reduced Exports

The need for other economies in the region to remain healthy is further emphasized by the fact that the four countries import heavily from the region. Over half of imports come from Asia for all countries except Korea, where it is a still-high 42%. Japan's prominence also shows up on the import side of the ledger. Other Asian countries will experience a drag from reduced exports. Offsetting domestic stimulus would foster a smoother adjustment for all countries.

Table 12
Korea's Merchandise Trade by Country, Year Ending June 1997
$ in billions

	Merchandise Exports		Merchandise Imports		
	Level	Percent of	Level	Percent of	Balance
Total	$130.6	100.0%	$152.0	100.0%	$-21.4
United States	20.5	15.7	32.8	21.6	-12.3
Japan	15.3	11.7	30.6	20.1	-15.3
China	12.8	9.8	9.3	6.1	3.5
Hong Kong	11.2	8.6	1.1	0.7	10.1
Singapore	6.1	4.7	2.6	1.7	3.6
Malaysia	4.7	3.6	3.3	2.2	1.4
Germany	4.3	3.3	6.8	4.5	-2.5
Indonesia	3.6	2.7	4.1	2.7	-0.5
United Kingdom	3.5	2.7	3.2	2.1	0.3
Thailand	2.5	1.9	1.3	0.8	1.3
Philippines	2.1	1.6	0.6	0.4	1.5
Australia	2.0	1.5	6.4	4.2	-4.4
Vietnam	1.7	1.3	0.0	0.0	1.7
Russia	1.6	1.2	1.6	1.0	0.0
Netherlands	1.5	1.1	1.1	0.7	0.3
Switzerland	1.4	1.1	2.3	1.5	-0.9
Canada	1.3	1.0	2.7	1.8	-1.3
France	1.3	1.0	2.1	1.4	0.7
Rest of World & Unallocated	33.4	25.6	40.3	26.6	-6.9
Memo:					
Asia	$68.4	52.4%	$63.8	42.0%	$4.6
Western Hemisphere	28.8	22.1	38.8	25.5	-10.0
Europe	19.6	15.0	25.1	16.5	-5.4
Middle East	4.1	3.2	16.7	11.0	-12.6
Africa	1.7	1.3	2.1	1.4	-0.5
Unallocated	8.0	6.1	5.5	3.6	2.5

Source: International Monetary Fund.

Table 13
Malaysia's Merchandise Trade by Country, Year Ending June 1997
$ in billions

	Merchandise Exports		Merchandise Imports		
	Level	Percent of	Level	Percent of	Balance
Total	$79.3	100.0%	$80.4	100.0%	$-1.0
Singapore	16.4	20.6	11.0	13.6	5.4
United States	13.7	17.3	12.3	15.3	1.4
Japan	10.6	13.4	18.6	23.1	-8.0
Hong Kong	4.7	5.9	1.9	2.4	2.8
Thailand	3.2	4.0	2.9	3.7	0.2
Netherlands	2.9	3.6	0.8	0.9	2.1
United Kingdom	2.6	3.3	2.1	2.6	0.5
Korea	2.5	3.2	4.4	5.4	-1.8
Germany	2.4	3.0	3.4	4.2	-1.0
China	1.9	2.4	2.2	2.7	-0.3
Australia	1.3	1.6	2.2	2.7	-0.9
Indonesia	1.2	1.6	1.5	1.9	-0.3
India	1.2	1.5	0.8	1.0	0.4
Philippines	0.9	1.2	0.9	1.1	0.0
Belgium-Luxembourg	0.8	1.0	0.5	0.6	0.4
Rest of World & Unallocated	13.1	16.5	15.2	19.0	-2.1
Memo:					
Asia	$49.7	62.7%	$50.5	62.8%	$-0.8
Western Hemisphere	15.5	19.5	13.7	17.0	1.8
Europe	11.7	14.8	13.4	16.7	-1.7
Middle East	1.7	2.2	0.6	0.7	1.2
Africa	0.6	0.7	0.6	0.7	0.0
Unallocated	0.1	0.1	1.6	2.0	-1.5

Source: International Monetary Fund.

Table 14
Thailand's Merchandise Trade by Country, Year Ending June 1997
$ in billions

	Merchandise Exports		Merchandise Imports		
	Level	Percent of	Level	Percent of	Balance
Total	$57.0	100.0%	$69.9	100.0%	$-12.9
United States	10.6	18.5	9.3	13.3	1.2
Japan	9.1	16.0	19.0	27.2	-9.9
Singapore	6.5	11.5	3.4	4.8	3.2
Hong Kong	3.1	5.5	0.9	1.3	2.2
Malaysia	2.5	4.3	3.6	5.1	-1.1
China	1.9	3.3	2.2	3.1	-0.3
United Kingdom	1.7	3.0	1.6	2.3	0.1
Germany	1.7	3.0	3.4	4.9	-1.8
Netherlands	1.6	2.9	0.6	0.9	1.0
Korea	1.1	1.9	2.5	3.6	-1.4
France	1.1	1.9	1.0	1.4	0.1
Indonesia	1.0	1.8	1.0	1.4	0.0
Australia	0.9	1.6	1.4	2.0	-0.5
Belgium-Luxembourg	0.8	1.5	0.7	1.0	0.2
Italy	0.7	1.2	1.1	1.6	-0.4
Canada	0.7	1.2	0.5	0.7	0.2
Philippines	0.6	1.1	0.6	0.8	0.0
Rest of World & Unallocated	11.3	19.8	17.2	24.6	-5.9
Memo:					
Asia	$31.3	54.9%	$39.5	56.5%	$-8.2
Western Hemisphere	11.8	20.7	11.0	15.8	0.8
Europe	10.1	17.8	12.6	18.1	-2.5
Middle East	2.2	3.9	4.6	6.6	-2.4
Africa	0.7	1.2	0.7	1.0	0.0
Unallocated	0.9	1.6	1.5	2.2	-0.6

Source: International Monetary Fund.

Table 15
Indonesia's Merchandise Trade by Country, Year Ending June 1997
$ in billions

	Merchandise Exports		Merchandise Imports		
	Level	Percent of	Level	Percent of	Balance
Total	$51.6	100.0%	$46.4	100.0%	$5.2
Japan	13.6	26.3	9.9	21.2	3.7
United States	7.7	15.0	5.0	10.8	2.7
Singapore	4.6	9.0	2.9	6.2	1.7
Korea	3.7	7.1	3.3	7.2	0.3
China	2.3	4.5	1.8	3.9	0.5
Netherlands	1.8	3.4	0.5	1.1	1.2
Germany	1.7	3.4	3.0	6.5	-1.3
Hong Kong	1.6	3.0	0.6	1.4	0.9
Australia	1.4	2.7	2.8	6.0	-1.4
Malaysia	1.2	2.4	1.1	2.4	0.1
United Kingdom	1.2	2.4	1.0	2.1	0.3
Thailand	0.9	1.7	1.3	2.8	-0.5
Italy	0.8	1.5	1.2	2.5	-.04
Spain	0.8	1.5	0.4	0.8	0.4
France	0.7	1.4	1.6	3.4	-0.9
Philippines	0.7	1.4	0.1	0.2	0.6
Belgium-Luxembourg	0.7	1.4	0.3	0.7	0.4
India	0.6	1.1	1.0	2.1	-0.4
Rest of World & Unallocated	5.5	10.7	9.5	18.5	-4.0
Memo:					
Asia	$31.2	60.5%	$26.0	56.0%	$5.2
Western Hemisphere	9.0	17.4	7.1	15.3	1.9
Europe	9.1	17.6	10.8	23.3	-1.7
Middle East	1.8	3.5	1.7	3.7	0.1
Africa	0.5	1.0	0.8	1.7	-0.3
Unallocated	0.0	0.0	0.0	0.0	0.0

Source: International Monetary Fund.

The Workout Should Proceed Apace with the United States Behind It

It may seem like the resolution of the Asian crisis hangs on a thin thread of doubtful Japanese stimulus and continued expansion of European economies that have self-absorbed restrictive economic policy in the runup to monetary union. However, the U.S. economy is steaming, its policy makers boldly leading the workout. There are no structural or cyclical impediments (i.e., inflation is not an issue) to easing U.S. monetary policy if necessary. The United States alone is large enough to save the day, as was specifically illustrated by the ability of the U.S. current account deficit to absorb fully the contraction of the deficits in the troubled
countries.

Political problems within the four countries are a wild card but if the economic changes are able to be effected, productive political change will accompany them.

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Beijing	86 10 6410 6611	Singapore	65 226 5088
Hong Kong	852 2847 0388	Sydney	61 2 9394 4400
Melbourne	61 3 9 280 1666	Wellington	64 4 474 4400
Osaka	81 6 243 0789		

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: rosanne.cahn@csfb.com@INET@LNGTWY (rosanne.cahn@csfb.com@INET@LNGTWY [UNKNOWN])

CREATION DATE/TIME:15-SEP-1998 11:31:04.00

SUBJECT: "full employment" report attached

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

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

TEXT:
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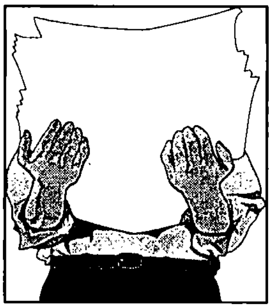
The following is a HEX DUMP:

Industry: Economic Comment
December 22, 1997
EP3476

Rosanne M. Cahn 212/325-4729
rosanne.cahn@csfb.com

What Is Full Employment?



Help Wanted

eCAHNomics

As soon as concerns about the Asian crisis abate, attention will shift back to the inflationary dangers of low unemployment in the United States.

Almost no respectable academic nor policy economist will admit to thinking that full employment, NAIRU (*n*on-*a*ccelerating *i*nflation *r*ate of *u*nemployment) is less than 5½%. However, actual unemployment has been around or below that rate for almost three years, yet acceleration in wage gains has been much lower than expected.

No one can figure out what the critical unemployment rate was because, starting in the 1960s, everything was inflationary—fiscal policy, monetary policy, price controls (the most inflationary policy because they precluded a supply response), two OPEC oil crises. Econometrics cannot precisely disentangle the influences. The initial phase of disinflation in the 1980s was dominated by inflation's hangover.

More technically, my learned colleagues have claimed to uncover the value of NAIRU by regressing inflation, the dependent variable, against the unemployment rate, other important variables such as some fiscal or monetary policy measure, and always lagged inflation. That methodology is fatally flawed. Neither econometrics nor the data are sufficiently robust to assign causality so precisely. The inclusion of lagged inflation, a clever ploy to raise the R^2 (the percent of the variation in the dependent variable explained by the independent variables), weakly defended as measuring inflation expectations, makes it impossible to figure out what NAIRU is.[1] Except *in extremis*, the concept is conceptually and empirically bankrupt at best, or worse, misleading.

[1] The Winter 1997 volume of *The Journal of Economic Perspectives* treats NAIRU issues in gory detail. The best article, "Time to Ditch the NAIRU," by James K. Galbraith sums up the problems:

> When these studies have specified that the natural rate [NAIRU] be fixed, the estimates have had rather large statistical error terms. When the studies have allowed the natural rate to move, it has shifted considerably. For example, according to characteristic estimates by Adams and Coe [*IMF Staff Papers*, June 1990, 37:2, 232-93]:
>
>> The natural rate of unemployment is estimated to have increased steadily from 3.5 percent in the mid-1960s to a peak of 7.25 percent in 1980, and then to have fallen back to about 5.75 percent in 1988 . . . .
>
> Yet . . . we still have no theory, and no external evidence, governing the fall of the estimated NAIRU . . . . [T]o hold to a concept in the face of 20 years of unexplained variation and failure of the profession to coalesce on procedural issues is quite another matter. This record has become an embarrassment to the reputation of the profession. (pp. 100-101)

Full Employment Was 4% in the 1960s

Evidence from the 1960s is least ambiguous. The expansion was record setting. It lasted 106 months, more than double the previous 45-month record (October 1949 through July 1953). The duration has still not been exceeded (the subsequent 1980s' expansion of 92 months takes second place). Real GDP increased 50%. The unemployment rate was below $5^1/2$% for all but the first year.

CPI inflation accelerated sharply after the unemployment rate fell below 4% in early 1966, as shown in Chart 1 after the leftmost line. Manufacturing capacity utilization, now 82.3%, was an extremely high 90.5%, further spurring inflation. However, inflation did *not* pick up before 1966 despite resources so tight that they would be considered highly inflationary today.

No Inflation, High Wage Gains, Booming Profits—Sound Familiar?

Labor compensation per worker, shown by the thick line in Chart 2, rose a strong 4.0% per year from the first quarters of 1961-1966, reflecting the tight labor markets. Real compensation hummed along at a 2.6% rate. Those five years represented the golden age of the U.S. economy. In addition to rapid rises in real wages and employment, profits increased an average 14% per year. And all that without noticeable inflation—the CPI rose 1.2% per year and producer prices a lower 0.9%! So much for capital versus labor—both benefited in the 1960s. So much for the notion that profit margins will be squeezed if labor costs go up and prices do not.

Uh Oh

But then there was too much of a good thing. Resource utilization got tighter. The unemployment rate stayed below 4% for the next four years, bottoming at 3.4% for 10 months from September 1968 through May 1969. The utilization rate rose to 91.6% by March 1966, though it did slip thereafter, since $7^1/2$% capacity growth exceeded the still rapid growth of output. Both wage and price inflation soared.

This explanation is in defense of picking 4% as full employment in the mid-1960s. It is a justifiable, not outlandish, choice, though reasonable people could disagree. For example, one could argue that unemployment might have fallen further without igniting inflation if capacity utilization were lower, as is the case now. Or one could argue that inflation would have picked up at higher unemployment, but long lags clouded the picture. The retrospective on NAIRU in the 1960s in the Adams and Coe work previously cited was an even lower 3.5%.

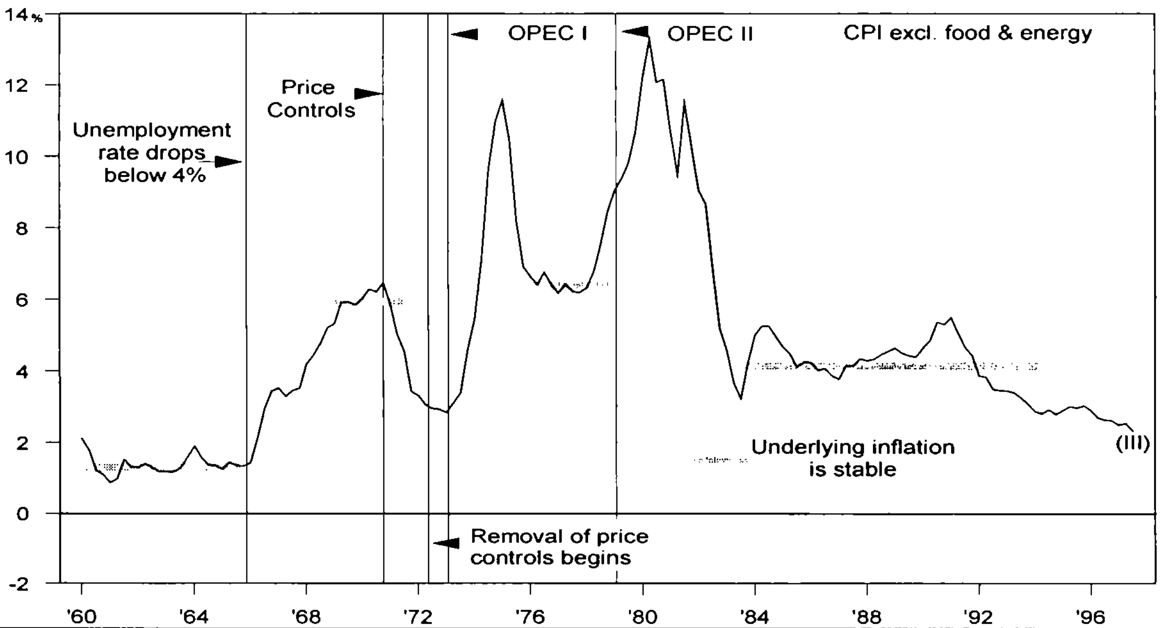
Why must labor markets become so tight before wage inflation becomes problematic? Prices are supposed to be determined by the intersection of supply and demand. The unemployment rate measures supply (the labor force) versus demand (employed) in labor markets. As the unemployment rate declines, it should push wage gains higher.

Labor Lacks Leverage Necessary to Extract Higher Wages

Our answer has been that labor is poorly organized to take advantage of its scarcity. Imagine, for example, that on January 9, 1998, December's unemployment rate, for whatever reason, is reported at 4.0%. Empowered with the knowledge of our great scarcity, and therefore value, we troop into our bosses' offices and demand big raises. The example is silly on purpose—to make clear that the market does not work that way. The only way that employees can get higher wages is if employers grant them or if workers get other job offers. In aggregate, wage gains can accelerate dramatically only if workers are so scarce that many employers are forced to bid personnel away from each other at higher wages.

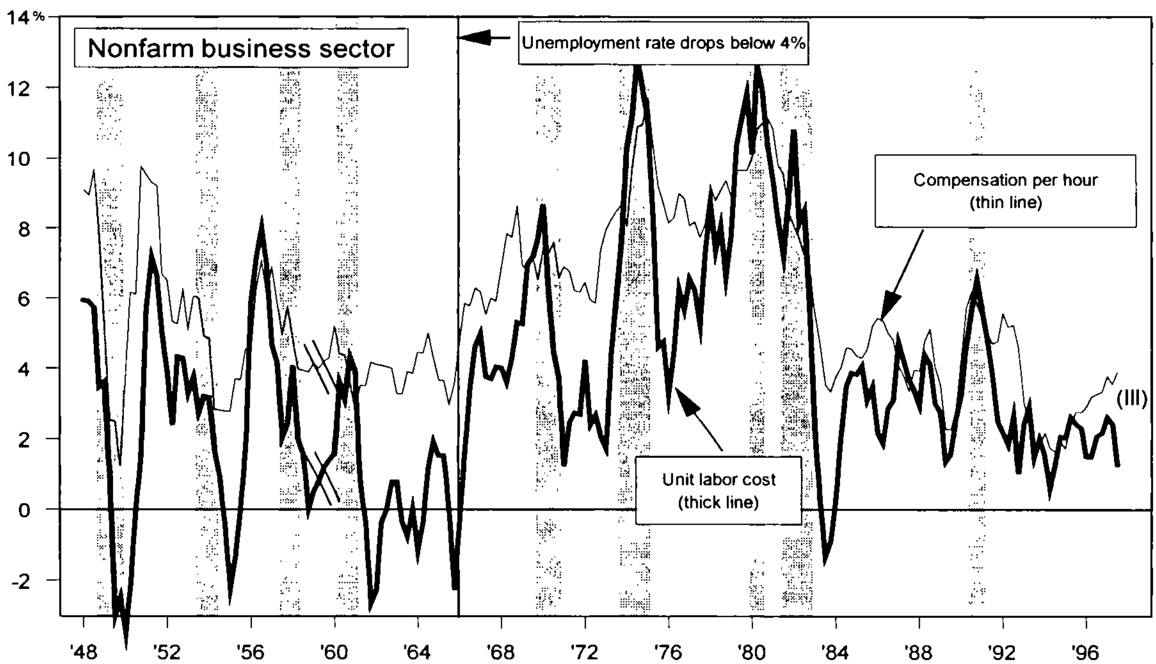
That such behavior is occurring in only one major occupation at the moment, evidences that it is still a microeconomic problem, not a macroeconomic one.

Chart 1
Core Consumer Price Inflation
year-to-year percent change



Source: Bureau of Labor Statistics.

Chart 2
Labor Cost Inflation
year-to-year percent change



Source: Bureau of Labor Statistics.

Employers Qua Monopsonists

There are two elegant ways to describe the structure of the labor market that bring a theoretical framework to bear. First, consider employers as monopsonists, or monopoly buyers. Though this is not literally true (they do not collude), the balance of power between employers and employees is extremely lopsided. Monopolists' prices are well above the price that would prevail if supply-demand conditions matched textbook ideals. Analogously, monopsonists pay much less than would be the case if perfect market conditions prevailed.

Another insightful approach comes from experimental economics. This relatively new microeconomics field studies how different market structures come into equilibrium. What has been learned is that auction markets are efficient—they reach the supply-demand equilibrium quickly.

Market Structure Adverse to Wage Gains

Posted-price, or take-it-or-leave-it markets are not efficient. Individuals get the short end of the stick, wearing both their shoppers' hats as well as their workers' hats—they pay higher prices and earn lower wages than would prevail at equilibrium. The market structure leaves shoppers and job seekers with little immediate ability to influence the price or the wage.

We plan further research, using experimental economics tools, to try to learn how the macroeconomic labor market behaves and to glean further insight into how much strain is required before there is significant upward pressure on wages.

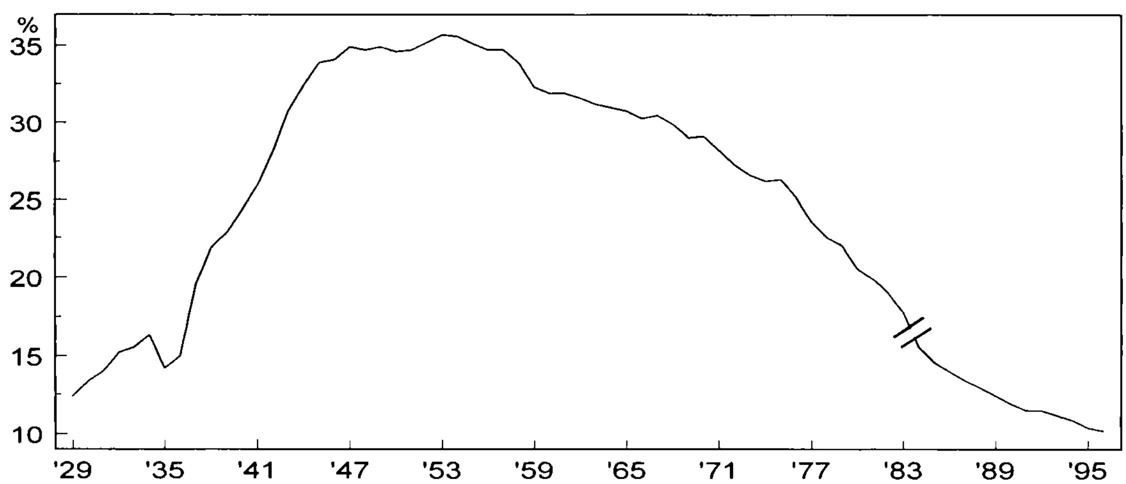
Assuming 4% was accurate for the mid-1960s, what are the objective differences between the 1960s and the 1990s?

Union Power Is Way Down

Unions are much less powerful. As shown in Chart 3, unionization has declined to 10% of the private labor force from 30% 30 years ago. Today, unions are concentrated in industries that are suffering from increased competition, either from abroad, in the case of manufacturing, or from deregulation, in the case of domestic industries.[2] It is not an accident that regulated industries are unionized.

[2] R. Cahn, "Don't Worry About Union Power," *eCAHNomics*, August 22, 1997.

Chart 3
Private Sector Union Members as a Percent of Workers



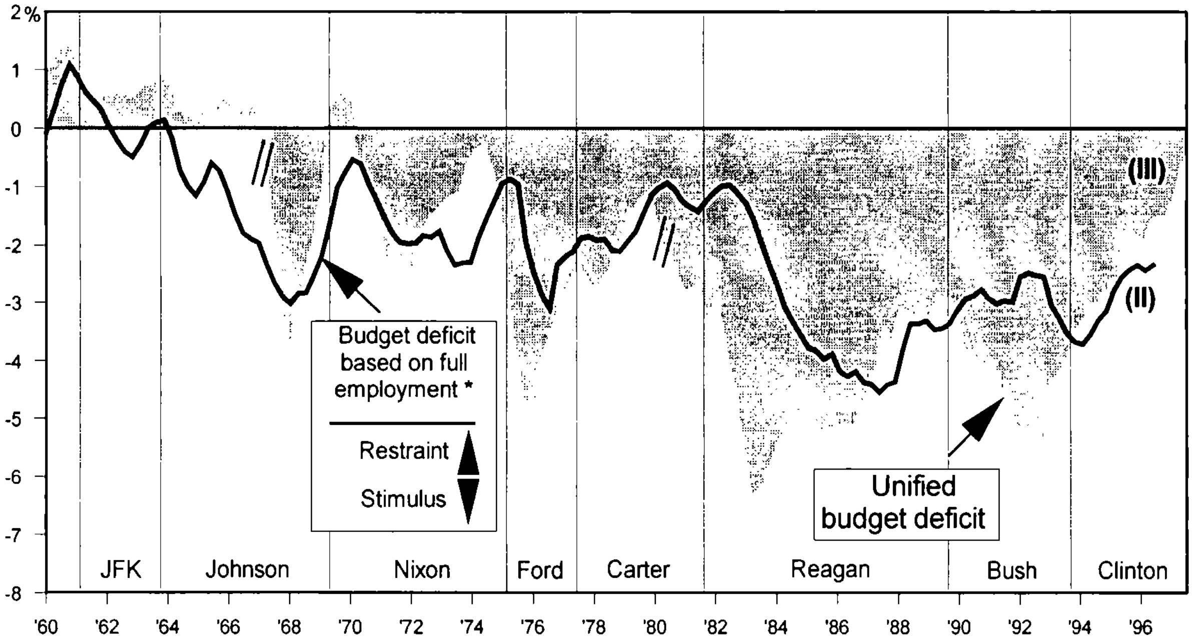
Source: The U.S. Union Source Book, Union Membership and Earnings Data Book, Bureau of Labor Statistics.

[Automated Records Management System Hex-Dump Conversion]

Fiscal Policy Is Antiinflationary

Fiscal policy is antiinflationary now, whereas it was inflationary in the 1960s. As shown by the solid line on Chart 4, the budget deficit, excluding the influence of the economy on the budget, was moving fairly steadily toward stimulus during the 1960s, whereas in the 1990s, the actual budget (shaded area) has shrunk steadily since 1992 and will be balanced soon. Part of that stems from policy—two deficit-reduction packages during the Clinton administration—and part from the revenue-generating effects of the strong economy and stock market.

Chart 4
Federal Deficit as a Percent of GDP
four-quarter moving average



Source: U.S. Treasury, Bureau of Economic Analysis, CSFBC. *Excluding payments to foreigners.

Monetary Policy Is Antiinflationary

Monetary policy is antiinflationary now whereas it was inflationary during much of the 1960s and 1970s.

Market-Opening Trade Policy

Foreign trade policy was modestly protectionist in the 1960s through 1980s, whereas it has become modestly market opening since the 1980s.

Companies Won't Abandon Long-Standing Cost-Cutting

Companies have spent the past decade or longer, depending on the industry, cutting labor costs. Transportation deregulation under President Carter in 1978 spurred efficiency measures in airlines, truckers, and railroads. Gradual financial market deregulation started cost-cutting in the early 1980s, telephone deregulation in the mid-1980s. Manufacturing firms' efficiency efforts date to the extreme strength
of the dollar in the mid-1980s. It seems unlikely that, having spent so many years painfully paring labor costs, companies would be eager to pay up for workers under any but the most pressing circumstances.

In other words, external circumstances are inhospitable to wage gains.

Labor Market Conditions Are Important Too

Conditions within the labor market itself will also influence wage gains. The types of jobs available in the 1990s' economy bear little resemblance to those in the 1960s. A much higher level of skill and training is required, and pay is commensurately higher. The demographics and experience of the labor force is also radically different from the 1960s. Whether these structural changes will promote or retard wage inflation is an open question, beyond the scope of this report.

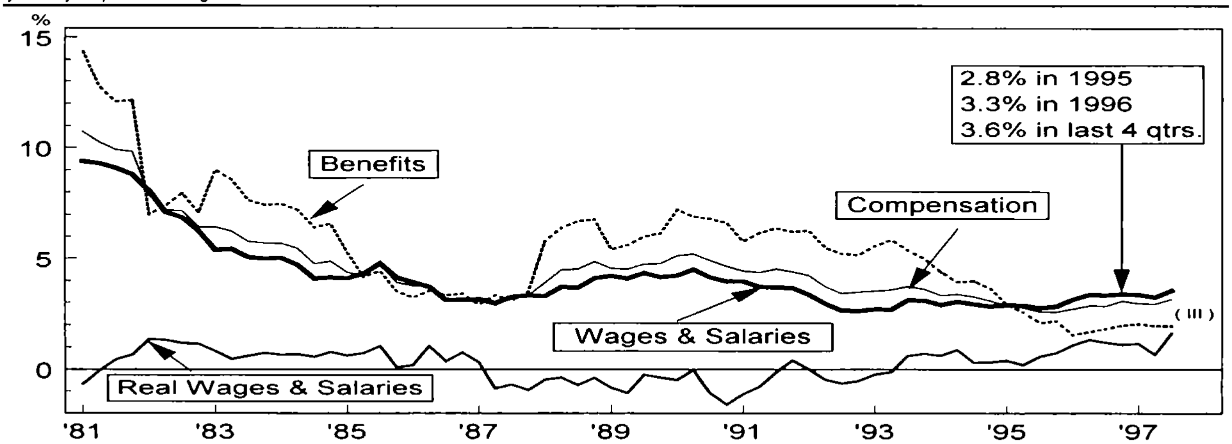
Full Employment Is 4% or Lower!

The wage acceleration to date, shown in the thick line on Chart 5, has been moderate. Companies have been able to accommodate that and the growth in employment by increasing labor productivity. There is no evidence to suggest that companies are running out of potential efficiencies, which are undertaken only under pressure. Given the rationale detailed in this report, the wage behavior to date, and the anecdotal evidence, we conclude that full employment will probably prove to be below 4%. That does not seem to be in the cards for 1998, even in our stronger-than-
consensus forecast—we project a decline to $4^1/4$%—and probably not in 1999 either.

The Fed's anxiety about potential inflationary influences of low unemployment may prompt a small tightening move in 1998, but there should be little provocation from the wage data.

N.B.: Text written December 19, 1997.

Chart 5
Labor Compensation
year-to-year percent change



Source: Bureau of Labor Statistics, Bureau of Economic Analysis.

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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:15-SEP-1998 18:26:27.00

SUBJECT: Tomorrow's John Berry Story

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

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

TEXT:

Ed Montgomery called to tell us that there would be a John Berry story in tomorrow's Washington Post about the difference between the household and payroll measures of employment. (The household measure has been growing significantly slower than the payroll measure; no one knows why.)

I have been aware of this issue for about 6 months. I regard it as a statistical puzzle with only minor macroeconomic implications.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: rosanne.cahn@csfb.com@INET@LNGTWY (rosanne.cahn@csfb.com@INET@LNGTWY [UNKNOWN])

CREATION DATE/TIME:15-SEP-1998 11:31:05.00

SUBJECT: report introducing concept of excess saving & investment

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

TEXT:
The chart in this report turned out to have an error in US data--chart
in the havout I gave you had the error corrected.

R==================== ATTACHMENT 1 ====================
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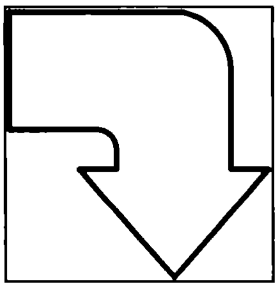
The following is a HEX DUMP:

Industry: Economic Comment
January 16, 1998
EP0156

Rosanne M. Cahn 212/325-4729
rosanne.cahn@csfb.com

Another Farewell to Central Planning



Southeast Asia

eCAHNomics

Q: What's worse than a market economic system?

A: Any other kind of economic system.

In a market economic system, prices are determined by supply and demand conditions. In turn, those prices allocate resources efficiently. A prime objective of an economic system is to produce as much as possible with limited resources—the market system does the best job.

No Nirvana Yet
Such a system does not produce economic nirvana, as some aver. The income distribution is often offensively skewed; the distribution of wealth more so (explaining Wall Street's love affair with it). Inequalities have undesirable social consequences that may be destabilizing.

Traditional Market Imperfections
Serious market imperfections stress the system and make it work less efficiently. For example, monopolies, oligopolies and cartels charge too high prices, have too high costs, too high profits and too little innovation. Under such structures, the superremunerations accrue to a handful of members of society and are not even available for government to spread (waste?) more widely.

Attempts to deal with such problems via regulation have limped along, only a bit less bad than the problem they were meant to cure, as the success of deregulation shows. Antitrust efforts have seemed more promising, though difficult to judge.

Newer Types of Market Imperfections
Negative or positive externalities are thorny. These are outputs produced by economic agents who do not experience their full benefit or cost. For example, open space benefits those who do not own the land, which is why most is owned by the government. Pollution is a negative externality. Polluters do not suffer the full negative consequences—others breathe the dirty air or are proscribed from full use of waterways.

Economists do not ignore these problems; they have been studied seriously and in-depth, with recommendations for handling them with minimum loss of efficiency.

Despite Faults, Market Systems Work Best

No matter how many faults can be laid at the doorstep of the market system, no other has proven superior; that is, all the others that have been tried have caused worse economic outcomes.

In fact, the other economic systems have performed so poorly that they are collapsing. The end of the 1980s witnessed the demise of communism, and the end of the 1990s is beholding the end of Japan, Inc. and its imitators.

Central Planning Is Inefficient, Has Perverse Incentives

That central planning is inefficient hardly needs explication. There are no market prices to serve as critical signals that reveal how to allocate resources. Its inefficiencies vitiate its alleged benefits, which, in any event, were never delivered.

Worse still, the incentives under central planning are perverse. They discourage individuals from working or saving and companies from innovating.

Human nature runs the gamut from altruism to extreme self-interest arrayed along the usual bell-shaped curve. Self-interest is heavily represented. Any economic system that neither acknowledges it nor incorporates it is likely to fail. The market system enables self-interest to turn into economic gain for the worker and consumption items for the shopper—Adam Smith's invisible hand.[1]

Human nature also runs a broad spectrum from workaholics to lazybones, honesty to corruption. Any economic system that does not penalize bad behavior will not function well.

Communism's fall at the end of the 1980s was swift and spectacular. The mystery was why it took so long to collapse. The transition to a market system for some countries, such as Russia, is extremely painful, a testimony to the benefits expected for future generations to make the interim suffering worthwhile.

Central Planning in Asia

The transformation of Southeast Asian economies from miracles to basket cases has been breathtaking. There are similarities and differences. The Japan, Inc. model followed by many of those countries contained a large element of central planning. Governments picked winners without being cognizant of the costs of being in the businesses. The heavily regulated financial system funneled money disproportionately toward the winners. Companies maximized market share rather than profits.

A Classic Paradox of Thrift

In the rush to increase production, consumption was shortchanged. Japan, the country with the largest amount of excess saving, now finds itself in a classic paradox of thrift. Too much saving in Japan has been chasing too few assets. That was primarily responsible for the 1980s' asset price bubble. Worldwide investment opportunities seem insufficient to absorb Japan's excess saving and provide reasonable returns. The best Japanese savers can hope for, in aggregate, is the domestic risk-free return, essentially zero. Most attempts to surpass that unattractive

[1] "As every individual, therefore, endeavors as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; *and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.* Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good."

Adam Smith, *Wealth of Nations*, Book IV, Chapter 2, italics added.

possibility have destroyed saving—buying Japanese stocks or real estate in the late 1980s (when the bubble burst), buying real estate or any other asset outside Japan in the early 1990s (when the yen strengthened in 1995), investing in near-

by
Southeast Asian countries in recent years, now destroyed by the crises there.

Consuming More Would Increase Saving

The harder that the Japanese try to save, the less saving that actually results. If they would spend more, providing end markets for the products that their companies make, rates of return would rise, rewarding savers and generating the outcome that they so desire.

The way to generate saving is to increase aggregate income. That requires a healthy market for the goods and services produced by business. Another way of stating the paradox of thrift is that it is not possible to save unless there is enough spending.

Hooray for the U.S. Buyer of Last Resort

The United States is doing more than its share of consuming on a global basis for which it used to be castigated. Now policymakers may be silently relieved that there is a buyer of last resort.

Watch Out for Too Much Investment Also

Another aspect of too much saving is too much investment. An efficient, market-oriented economic system would generate the optimal amount of investment—not the maximum amount. Tax policy would aim to be neutral, taxing investors and savers at the same rate as workers and consumers are taxed. Southeast Asia bears testimony to the notion that there is such a thing as too much investment.

The ratio of investment to GDP for the "world," shown in the top panel of Chart 1, has usually varied somewhat above 20% of GDP in the postwar period. This includes all types of investment—residential, business investment in equipment, plant, offices, stores, and government investment in infrastructure.

Most Developed Countries Invest Less than Developing Countries

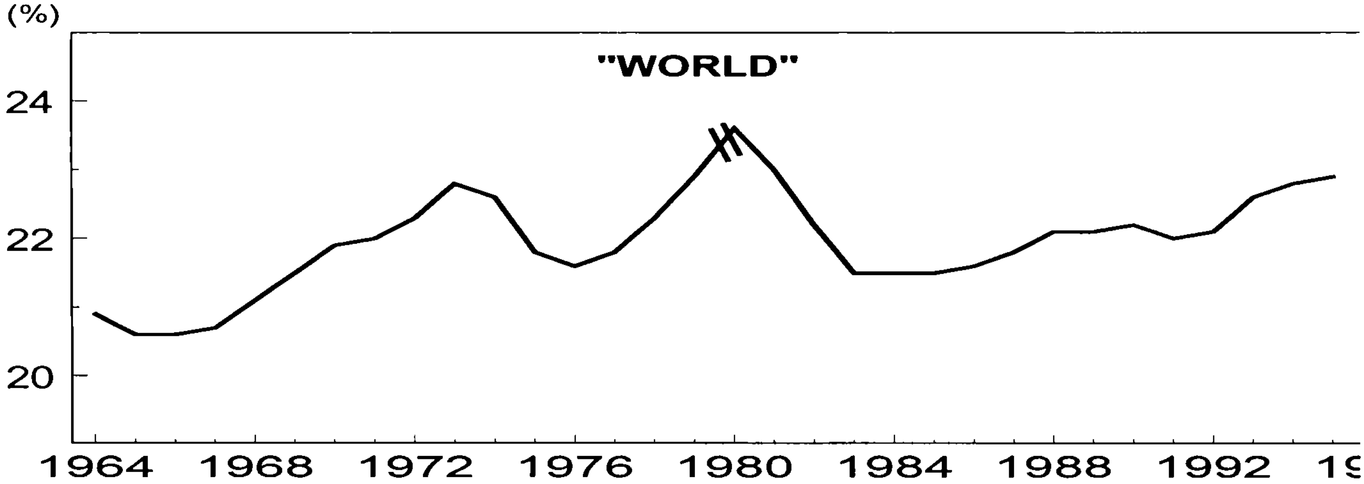
Most *developed countries'* ratios are below the world average. Their average investment ratio, shown as the black line on the middle panel, has been around 19% in the past few years versus 23% for the "world." The U.S. ratio is among the lowest for major countries (the U.K. ratio is lower), as shown by the lowest line on the middle panel. It has worked its way back over 17% in the 1990s' capital spending boom from 15% at its 1992 trough. Farther away from the mean at the other extreme is Japan. Its 30% ratio slightly exceeds the average for developing countries, a suspiciously high proportion.

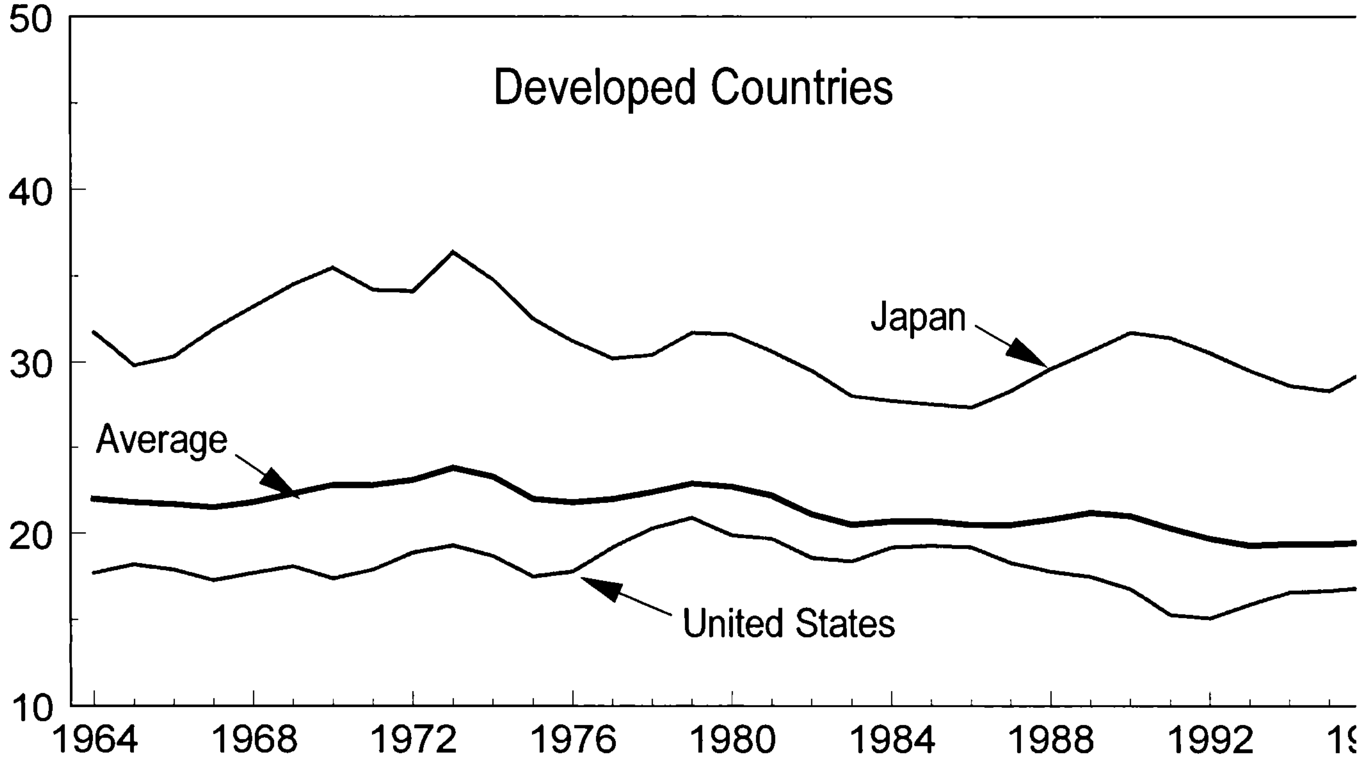
The average ratio for *developing countries*, shown by the black line on the lowest panel of the chart, is nearly 10 percentage points higher than that for developed countries. Somewhat higher relative investment may be warranted. One way for a developing country to increase its standard of living rapidly is by adding existing technology and capital to lower labor costs, enabling it to outcompete existing producers and increase market share.

The key is to have an economically appropriate amount of investment. Southeast Asian countries, from a mid-crisis retrospective, seem to have relied on this technique beyond the point at which it proved remunerative.

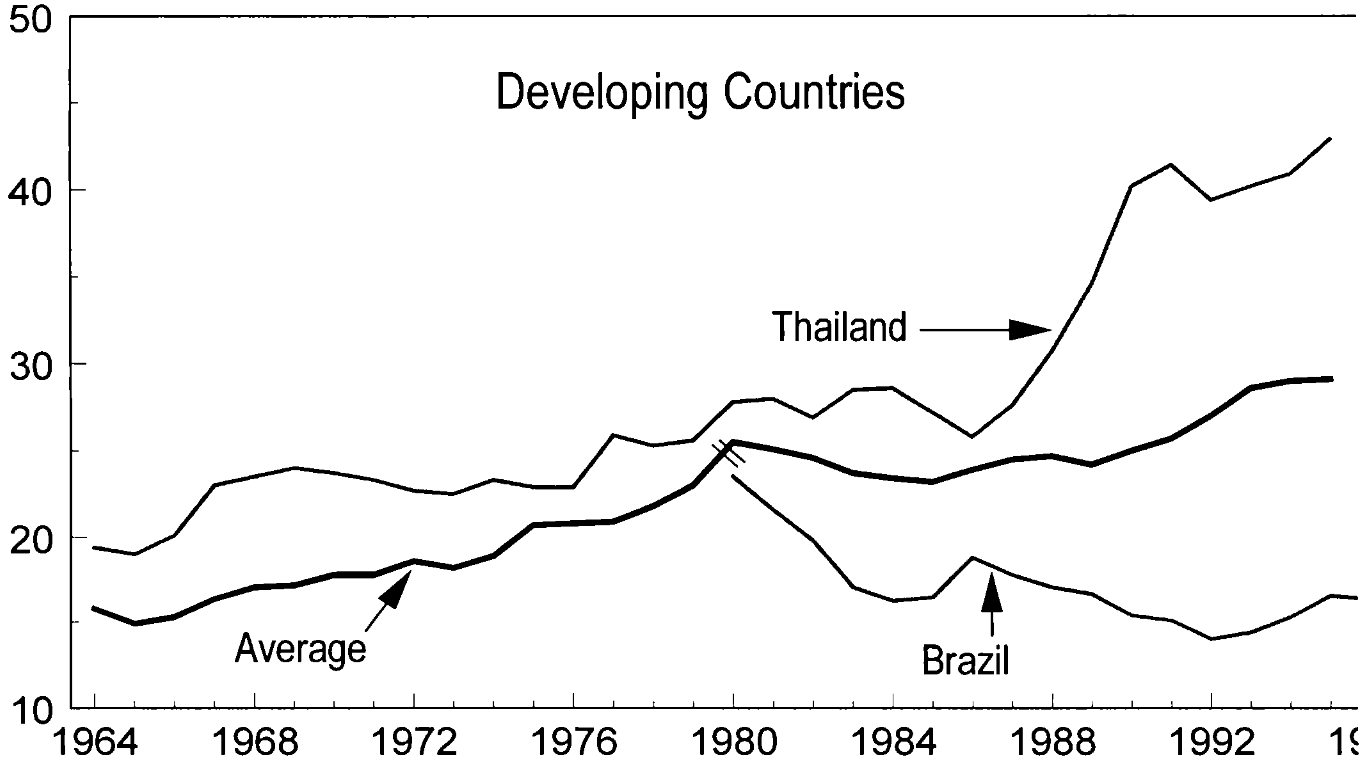
It is outside the scope of this report to prescribe what investment ratios would be optimal. Brazil is at the low end of the range, below the ratios for most developed countries. At the high end, Thailand in recent years has devoted an extraordinary 43% of GDP to investment. The all-time record among these countries was Singapore; nearly half of its GDP in 1982-84 was consumed by investment.

Chart 1
Gross Fixed Capital Formation as a Percent of GDP





[Automated Records Management System Hex-Dump Conversion]



"World" includes United States, Canada, Mexico, Germany, France, Italy, United Kingdom, Spain, India, Indonesia, Korea, Thailand, Malaysia, Philippines, Singapore, and Australia before 1980; thereafter, China, Brazil and Argentina are included. This accounts for about 70% of world GDP before 1980 and 85% after.
Gross fixed capital formation includes government investment, residential investment and business investment.
Source: International Monetary Fund.

How Investment Is Financed Is Important

It is now clear that there has been too much investment in many countries. Domestic saving rates are high in some of them, so the investment was financed internally. A country's current account balance, which includes net exports of goods and services as well as cross-border investment income (interest and dividends) flows, measures whether it is a net supplier of saving to the world—a current
account surplus—or a net borrower from the rest of the world—a current account deficit.[2]

Some Countries Have More than Enough Saving to Finance Internally

Japan, China and Singapore have current account surpluses, as shown in the middle column of Table 1. They can not only finance their own high investment internally, they have plenty left over to invest elsewhere. Japan's dilemma was detailed earlier—there are not enough opportunities in the globe to provide a decent rate
of return for the Japanese hoards. Singapore's and China's surpluses are much smaller and have not had negative consequences. Both countries have been large buyers of U.S. treasury securities.

While Others Had to Borrow Abroad

Other high investment countries had to obtain financing from outside to maintain strong capital spending. As shown in the lower part of the table, Thailand and Korea have run especially large deficits. It is no surprise, then, that these were two economies that got into the most trouble. Brazil also sticks out on the list, and the deficits of Indonesia and Malaysia are not insignificant, with the latter over 8% of GDP.

Other Critical Factors

Centrally directed excess saving and investment in Asia were important, but not the only factors that led to the collapse of the currencies and stock markets. Other critical contributors were the term structure and currency denomination of the debt, the types of projects for which the financing was used, and the leverage of the corporate sector. The global disinflationary environment as a backdrop eroded pricing power even without investment excesses and was certainly instrumental in precipitating the problem. New competition from countries with economic potential unleashed by the fall of communism, especially China, has eaten away at the market share of the former market share eaters.

Negative human behavior traits such as corruption, which have more opportunity for excess under central planning, acerbated the problems. Wresting the spoils away from the erstwhile controllers of the system complicates the solution.

Financial Markets Force the Change . . .

But now financial markets are disciplining economic policy. These countries have no choice but to open up their economies to competition and make lending an arm's length transaction if they would access international financial markets.

. . . to Greater Prosperity, Eventually

As with communism, the transitions to market economies will be extremely painful. After they are completed, these countries will be on a much more solid footing to pursue further development. Competition for developed countries will still be fierce but it will be more rational.

[2] Cross-border flows are not measured very accurately, especially financial ones. The most accurate data are for imports, subject to duties. Other flows tend to be undercounted. Therefore, there is a tendency for surpluses to be understated and deficits to be exaggerated. For 1995, for example, the total of the countries in the table, accounting for 85% of world GDP, reported an implausibly large combined deficit of $79 billion.

N.B. Text written January 16, 1998. Corrected for error in U.S. data April 27, 1998.

Table 1

Investment Ratios and Current Account Deficits, Selected Countries

1996 except where indicated, billions of U.S. dollars

Country	Gross Fixed Capital Formation as a % of GDP	Current Account Balance (U.S. Dollars)	Current Account Balance as a % of GDP
Developed Countries			
Australia	20.2%	$-15.9	-4.0%
Canada	17.5	2.8	0.5
France	17.5	20.5	1.3
Germany	20.9	-13.1	-0.6
Italy	17.0	41.0	3.4
Japan	29.6	65.9	1.4
Spain	19.9	1.8	0.3
United Kingdom	15.4	-0.4	0.0
United States	16.9	-148.7	-1.9
Developing Countries			
China	*34.3%*	$7.2	0.9%
India	*24.6*	*-5.6*	*-1.6*
Indonesia	*31.9*	*-7.0*	*-3.5*
Korea	36.8	-23.1	-4.8
Malaysia	*43.0*	*-7.4*	*-8.4*
Philippines	*22.2*	*-2.0*	*-2.7*
Singapore	*33.3*	14.3	15.2
Thailand	*42.0*	-14.7	-8.0
Argentina	21.5	-4.1	-1.3
Brazil	16.4	-24.3	-3.1
Mexico	17.2	-1.9	-0.4

Source; International Monetary Fund; figures in italics are for 1995.

CREDIT SUISSE | FIRST BOSTON

Americas

Eleven Madison Avenue
New York, NY 10010, U.S.A.
1 212 325 2000

Atlanta	1 404 656 9500	Mexico City	1 525 202 6000
Boston	1 617 556 5500	Philadelphia	1 215 851 1000
Buenos Aires	1 541 394 3100	Portland, ME	1 207 780 6210
Chicago	1 312 750 3000	San Francisco	1 415 765 7000
Houston	1 713 220 6700	São Paulo	55 11 3048 2900
Los Angeles	1 213 253 2000	Toronto	1 416 351 1600

Europe

One Cabot Square
London E14 4QJ, England
44 171 888 8888

Amsterdam	31 20 575 4444	Paris	33 1 40 76 8888
Budapest	36 1 202 2188	Prague	420 2 248 10937
Frankfurt	49 69 75380	Vienna	43 1 512 3023
Geneva	41 22 394 7000	Warsaw	48 22 695 0050
Madrid	34 1 532 0303	Zug	41 41 726 1020
Milan	39 2 7702 1	Zurich	41 1 333 5555
Moscow	7 501 967 8200		

Pacific

Shiroyama Hills
4-3-1 Toranomon
Minato-ku, Tokyo 105, Japan
81 3 5404 9000

Auckland	64 9 302 5500	Seoul	82 2 399 7355
Beijing	86 10 6410 6611	Singapore	65 226 5088
Hong Kong	852 2847 0388	Sydney	61 2 9394 4400
Melbourne	61 3 9 280 1666	Wellington	64 4 474 4400
Osaka	81 6 243 0789		

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Paul Davidson <pdavidson@utk.edu> (Paul Davidson <pdavidson@utk.edu> [UNKNOWN])

CREATION DATE/TIME:15-SEP-1998 14:19:37.00

SUBJECT: Irma Adelman suggested I contact you

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

TEXT:
Dear Janet Yellen:

Irma Adelman suggested I send the following to you:

Enclosed please find a copy of a newspaper article that I wrote that appeared in THE GUARDIAN yesterday, September 14, 1998 -- the same day President Clinton called for a conference on the global financial system.

Here is the GUARDIAN article (notice my solution will never require a lender-of-last-resort bail-out financed by taxpayers):

FROM THE GUARDIAN NEWSPAPER (U.K.)

Monday September 14, 1998

QUACK'S CURE FOR DEPRESSION WON'T QUIET OUR FEARS

By Paul Davidson

As Asian tigers collapse and Russian bears menace our entrepreneurial economy we are being haunted by the question, "Can it happen again?" Can we have another Depression at the end of the 20th century?

Writing in 1936, Keynes noted: "It is enterprise which builds and improves the world's possessions... Speculators may do no harm as bubbles on the steady stream of enterprise. But the position is serious when enterprise becomes the bubbles on a whirlpool of speculation."

Comparing the pre-1973 economic record with the period after 1973 indicates that, since 1973, enterprise has slowly become enmeshed in a whirlpool of speculation.

The post-war period to 1973 was a golden age of economic development. The real GDP per-capita growth rate for western nations between 1950 and 1973 was almost double the peak annual growth-rate of the industrialising nations during the Industrial Revolution, while labour productivity's annual growth trebled.

The 1973 oil-price shock was the event that ended the golden age. Policy makers threw away Keynes's prescriptions to constrain "hot money" International capital flows and fix exchange rates.

Instead, the laissez-faire philosophy was adopted, which made the exchange rate itself an object of speculation. With the removal of all restrictions on International capital flows in a world of flexible exchange rates, International financial transactions have grown 30 times as fast as the growth in trade.

When the world changed from a fixed to a flexible exchange-rate system, the annual growth rate in investment in plant and equipment in the West fell from 6 per cent, 1973's level, to less than 3 per cent. Lower investment growth means a slower growth rate in western nations - from 5.9 per cent to 2.8 per cent - while labour productivity growth declined even more dramatically, from 4.6 per cent to 1.6 per cent.

Since 1974, Nobel Prize-winner James Tobin has been almost alone in warning that free financial markets with flexible exchange-rates can have a "devastating impact on specific industries and whole economies".

Tobin advocates that governments limit market volatility by increasing the transaction costs on all International payments via a small "Tobin tax".

Unfortunately, the empirical evidence is that any increase in such costs significantly increases market volatility. The Tobin tax is the wrong tool for the speculative financial market problem, with all its implications for depression.

Are there alternatives that can restore the golden age? Since the Mexican peso crisis of 1994, pragmatists have advocated a lender of last resort to stop the loss of financial market liquidity and bail out International investors. In 1994, the US agreed to be lender of last resort. With liquidity facilities exhausted when the Asian crisis of 1997 and the Russian bear emerged in 1998, the International Monetary Fund stepped into the lender role.

When the IMF recently reached the end of its liquidity, director Stanley Fisher suggested the Group of Seven nations take over. This call for the G7 to be the lender is the equivalent of recruiting a volunteer firefighters to douse the flames in a burning, crowded theatre. Even if the fire is put out, there will be many innocent casualties.

Finally, "the man who broke the Bank of England", speculator George Soros, has suggested the establishment of a Russian currency board, fixing the exchange rate so domestic money does not exceed foreign reserves. When investors rush for the exit, the board maintains the exchange rate by selling foreign reserves and reducing domestic money supply.

Blood-letting can, as 17th-century quacks observed, reduce a fever - but often at a terrible cost to the patient. Similarly, such a Russian currency board might douse the flames of a currency crisis but the result will certainly be a moribund economy.

But an alternative is available, based on Keynes's post-war International monetary proposal for a co-operative International payments system with the safe-haven nation bearing a major degree of responsibility for solving the International liquidity crisis.

This allows us to design a system which will avoid currency fires while promoting global prosperity.

Keynes recommended the simultaneous institution of three conditions: a fixed but adjustable exchange-rate system; a built-in apparatus that prevents rapid International movements of liquid portfolio funds - that is, International capital movement regulations; and a mechanism that requires any nation with persistent current-account surpluses to accept the major burden of refluxing the resulting excessive foreign reserve credits back to other nations.

These simple Keynesian requirements can be embedded in an International payments system which includes some mutually agreed rules to create and reflux International liquidity as trade expands - while simultaneously maintaining the International purchasing power of the resulting International currency.

My proposal would be to create an International clearing union incorporating Keynes's three conditions. This proposal is explicitly designed to: (1) prevent a lack of global effective demand - due to any nation holding excessive foreign reserves or draining reserves from the system; (2) provide an automatic mechanism for placing the substantive load of payments adjustments on those nations who persistently amass excessive foreign reserves; (3) provide each nation with the ability to monitor and, when necessary, to control the movements of flight capital which can destabilise financial markets; (4) permit each nation to pursue full employment unhampered by International payments imbalances problems.

This solution will never require a lender-of-last-resort bail-out financed by taxpayers.

Some think that my specific clearing union plan is Utopian. But if we start with the defeatist attitude that it is too difficult to change the awkward system in which we are trapped, then no progress will be made. "It" - depression - does not have to happen again if our Policy makers have sufficient vision to try this post-Keynesian, innovative approach. The health of the world's economic system will simply not permit us to muddle through.
--end of article

Since the President is calling for a long-range plan to map out global financial reform, I would hope that my clearing union proposal would be at least be considered by our government.

My clearing union proposal was spelled out in a number of books and professional articles. The most recent is my article in the May 1997 issue of THE ECONOMIC JOURNAL entitled: "Are Grains of Sand in the Wheels of International Finance Sufficient To Do The Job When Boulders Are Often

Required?". I am attaching a copy of this article to this email for your information.

Paul
- Bulls.fnlPaul Davidson
Holly Chair of Excellence in Political Economy
Editor, JOURNAL OF POST KEYNESIAN ECONOMICS [JPKE]
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================== ATTACHMENT 1 ==================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

FORTHCOMING IN THE ECONOMIC JOURNAL, MAY 1997 ISSUE.

ARE GRAINS OF SAND IN THE WHEELS OF INTERNATIONAL FINANCE SUFFICIENT TO DO THE JOB WHEN BOULDERS ARE OFTEN REQUIRED?*

Paul Davidson

University of Tennessee

*The author is grateful to John Hey and several referees for many helpful suggestions on an earlier draft of this paper.

Abstract: This paper criticizes the effectiveness of a Tobin Tax in acting as a deterrent to short-run round trip speculation on exchange rate movements. It is demonstrated that given the usual magnitude of a proposed Tobin tax, the deterrent to short-term speculation will be negligible and in all likelihood smaller than the deterrent to real trade flows and arbitrage activities. Finally an alternative proposal for preventing currency speculations while creating incentives for global full employment, based on Keynes's 1940s writings, is proposed.

In this journal's "Policy Forum", Eichengreen, Tobin, and Wyplosz (1995, p. 164) (hereafter ETW) argue that volatility in foreign exchange markets due to speculation can have "real economic consequences devastating for particular sectors and whole economies". To constrain "speculative behaviour... they [ETW] propose a global transaction tax...to discourage short-term round tripping"(Greenway ,1995, p. 160). At the same time this ETW proposal appeared in print, the winter 1994-5 Mexican peso crisis spilled over into the dollar problem. In international financial markets where image is often more important than reality, the dollar was dragged down by the peso while the German mark and Japanese yen appeared to be the only safe harbors for portfolio fund managers.

In February 1995, Federal Reserve Chairman Alan Greenspan testified before Congress that "Mexico became the first casualty...of the new international financial system" where electronic global communication permits hot portfolio money to slosh around the world "much more quickly". As the proportion of foreign assets, especially from "emerging markets", continue to bulk larger in portfolios, Keynes's (1936, p. 156) "beauty contest" analogy is an appropriate description of international fund managers' behaviour with respect to the foreign exchange market. To be profitable, fund managers must , in an instant, conjecture how other market players will interpret a news event occurring anywhere in the world. Even in the absence of reliable information, rapid evaluations of the potential effects of any event on exchange rates and hence on portfolio value are essential as rival market participants can move funds from one country to another in nanoseconds with a few clicks on the computer keyboard or a quick telephone call to some international market at any time of day or night.

In today's global economy any news event that fund managers even suspect that others will interpret as a whiff of currency weakness can quickly become a conflagration spread along the information highway. This results in lemming-like behaviour that can be self-reinforcing and self-justifying. If the major Central Banks immediately do not dispatch sufficient resources to intervene effectively to extinguish speculative currency fires, then the resultant publicity is equivalent to hollering "fire" in a theater. The consequent panic worsens the situation and central banks whose currencies are seen as safe havens may lose any interest in a coordinated response to the increasing inferno.[i]

Essentially pragmatists such as ETW are arguing that hot-money flows produce obvious disruptive real effects and therefore the social costs of an unfettered exchange rate system far exceeds any social benefits. In contrast, traditional theory presumes that government intervention in the form of taxes or regulations impose significant social costs while there are only social benefits produced by laissez-faire foreign exchange markets that permit individual free choice. (Some orthodox theorists will consider "ad hoc" central bank intervention in exchange markets an acceptable short-run palliative if disruptive "shocks" create disorderly market conditions. Purists will deny the need for any intervention.[ii])

If the pragmatists are correct that the social costs of free exchange markets exceed benefits, then what is required is not a system of "ad hoc" central bank interventions while what Greenspan calls the "new international financial system" burns the real economy. What is necessary is to build permanent fireproofing rules and structures that prevent "beauty contest" induced currency fires. Crisis prevention rather than crisis rescues must be the primary long-term objective. If the developed nations do not hang together on a currency-fire prevention system, then they will all hang separately in a replay of the international financial market crisis of The Great Depression.

I. IS SOCIAL CONTROL OF EXCHANGE MARKETS BAD?

Reasonable people do not think it is a violation of civil liberties to prohibit people from boarding an airplane with a gun. Moreover, no one would think we are impinging on individual rights, if the society prohibits anyone from entering a theater with a Molotov cocktail in one hand and a book of matches in the other -- even if the person indicates no desire to burn down the theater.

Yet, in the name of free markets, we permit the "Soros effect"[iii] where one or more fund managers anticipate the possibility of an exploding Molotov cocktail and therefore yell "fire" in the crowded international financial markets any time the "image" of a possible profitable fire moves them

Fifty years ago, Keynes (1980, p. 25) recognized that "there is not a country which can...safely allow the flight of funds [hot money]....Equally there is no country that can safely receive...[these portfolio] funds which cannot safely be used for fixed investment". ETW (1995, p. 164) have taken up this Keynesian theme and argued for fire prevention in the form of a permanent ad valorem tax on exchange transactions to put "sand in the wheels of super-efficient [international] financial markets". (This is equivalent to taxing, rather than banning the Molotov cocktail member of the theater audience.) ETW have also explored the possibility of imposing compulsory interest-free deposits or other capital requirements (therefore creating an "opportunity cost" tax) to "discourage short-term round tripping, but not long term investment" (Greenway, 1995, p. 160).

The 1995 policy form discussion in this journal of the "Tobin tax" between ETW (1995) and Garber and Taylor (1995) did not focus on the theoretical rational for such taxes. Rather the emphasis was on the institutional feasibility. Kenen's contribution (1995) concentrated specifically on capital controls and why he perceives the impossibility of such controls at this time. Little discussion of the theoretical rational for imposing any controls or costs on foreign exchange transactions is provided.

Keynes on the other hand, provided a rationale for such controls when he recognized that the existence of organized spot markets plus the social convention that assumes the existing state of affairs will continue until there is some reason to expect change. As long as the social convention is maintained, portfolio managers "need not lose sleep"[iv] for they know that only an unforseen "change in the news over the near future" can affect the value of their portfolio in the near future (Keynes, 1936, p. 153).[v] Each fund manager believes her portfolio is liquidity safe for any short period, while the underlying real investments and trade flows are fixed and illiquid for the community. In The General Theory, Keynes explained how this distinction could impose severe real costs on a closed economy especially when savers feared that the an existing state of normal affairs might not be maintained. In the 1940s, Keynes reanalyzed this problem in the open economy context and concluded, as the citation above suggests, that a system of outright prohibition of international hot money (liquidity-seeking) flows would be required. With the help of the formulas developed below, it is easy to see why Keynes believed that government controls of international hot money flows was desirable.

II. CAPITAL UNCERTAINTY AND SPECULATIVE FLOWS

Since the spot market price of any liquid asset in a well-organized, orderly free market can change over time, savers who are storing claims on resources must contemplate the possibility of an appreciation or depreciation in the asset's market price at any future date affecting the market value of their portfolio. This potential capital gain or loss is obtained by subtracting today's spot price

(p_s^{t0}) from the expected spot price at a future date (p_s^{t1}). When ($p_s^{t1} - p_s^{t0}$) > 0, a capital gain is expected from holding the asset till t1; if ($p_s^{t1} - p_s^{t0}$) < 0, a capital loss will be expected.

Let q be the future expected income to be received from holding a financial security and c be its carrying costs where both q and c are denominated in terms of a specific currency.

Offsetting the possible capital loss on choosing any liquid asset is the value of earnings (q-c) over the time interval the asset is held. There are also transactions costs (T_s) incurred in both buying and reselling any liquid asset. Measured in absolute monetary values q and c tend to increase with the length of the time interval the asset is held. On the other hand, T_s is independent of the time interval and normally increases at a decreasing rate as the transaction value of the asset increases. Consequently, as Hicks (1935, p.67) argued, since transactions costs "are independent of time...it will not pay to invest money for less than a certain period". In other words, if there are no expected capital gains (or losses) then for any given expected flow of q-c, T_s sets a minimum time interval that the asset must be held to prefer it to cash.

Orthodox literature tends to adopt the convention that q and c are evaluated as annual rates of return rather than as the absolute sums suggested supra. This annual rate of return evaluation approach often encourages the analyst to treat T_s as negligible. But as Kahn (1954, p. 91) has noted, if transactions were costless, maximizing the value of one's portfolio would be determined entirely by what is expected to happen between the initial instant and the immediate next instant "and expectations about later dates do not become directly relevant until tomorrow, when behavior is decided afresh". In other words, if T_s is negligible while the spot price is expected to change from moment to moment, then no rational fund manager should worry about the long-run earnings (q-c) of any portfolio investment. Every expected small change in the next moment's spot market price will provide sufficient capital gains or losses to induce significant changes in one's portfolio holdings. It therefore follows that given an unchanging expectation of the future earnings stream and potential capital gains or losses, when the magnitude of transactions costs (in absolute value terms) increase , then, the minimum time interval until one can expect a positive return from holding an asset increases. There is, however, always some possible larger absolute value of a capital gain that permits the holder to sell the asset earlier than this minimum period and still obtain a positive return.

ETW give the impression that because their proposed small grains of sand (i.e. a very low tax rate) converts to larger negative rates the shorter the time interval of a speculative round trip, therefore, the greater the disincentive the shorter the interval. For example, ETW (1995, p. 164) note that a 0.5% "tax translates into an annual rate of 4% on a three months' round trip...more for shorter trips". (Of course a 0.5% Tobin tax also translates into a 12% annual rate on a one month trip or a 365% tax on a one day round trip.) By evoking such high annual rates of return, the impression is conveyed that a "grains of sand" small Tobin tax will be an overwhelmingly large deterrent for daily or even monthly speculative flows, while the "grains of sand" tax is "a negligible deterrent consideration in a long term portfolio" (ETW, 1995, p. 165).

In truth, however, the Tobin tax, like all transactions costs, is independent of the round trip time interval, and therefore its deterrent capability is not a function of the time period. Comparing annualized rates for different time intervals obscures rather than clarifies the question of how big a deterrent is any given magnitude of a Tobin tax on a speculative round trip. This issue can be clarified by measuring capital gains or losses, q, c, and T_s as absolute values in the formulas developed <u>infra</u>. Then our analysis can demonstrate that an expected increase in the spot exchange rate of anything in excess of 1.1% is sufficient to more than offset the deterrent effect of a negative 365% annual rate on a daily round-trip, or a 12% return on a monthly trip, etc. imposed by a 0.5% Tobin tax. Accordingly, for our purposes, using absolute magnitudes provides a clearer guide to policy than annualized rates.

If, for a specific liquid asset the portfolio manager (without any risk aversion[vi]) expects

$$(q - c) + (p_s^{t1} - p_s^{t0}) - T_s > 0, \qquad (1)$$

then the manager is a "bull". If it is expected that

$$(q - c) + (p_s^{t1} - p_s^{t0}) - T_s < 0, \qquad (2)$$

then the fund manager is a "bear". A portfolio manager will choose, ceteris paribus. to move her money into those assets that are expected to yield the highest positive values[vii] and sell those assets that have negative perspective yields.

In the simplest case, if (q-c) minus T_s equals zero, then if

$$[p_s^{t1}/p_s^{t0}] > 1 \qquad (3)$$

then the person is a bull,

while if

$$[p_s^{t1}/p_s^{t0}] < 1 \qquad (4)$$

the person is a bear. In a closed economy, if one holds money as a liquid store of value, then there is no future net income[viii] $[(q - c) = 0]$, no capital gain or loss $[(p_s^{t1} - p_s^{t0}) = 0]$, and no transactions costs $[T_s = 0]$.

In an open-economy, flexible exchange rate system, fund managers will not only have to anticipate the expected future income (net of carrying costs), transactions costs of buying and reselling, and capital gain or loss on all tradeable domestic and foreign liquid securities that can be held in one's portfolio. For international liquid assets they must also factor in possible changes in exchange rates to the decision as to what, if any, international liquid assets to buy, hold or sell at any moment of time.

Whenever some event, whether ephemeral or not, induces one or more managers of large portfolios to suddenly change their expectations regarding future spot exchange rates, then there can be a significant movement of funds from one country to another. Even the mere suspicion that an event will encourage others to undertake a significant international flow can encourage lemming -like behaviour in fund managers to change their expectations of $(p_s^{t1} - p_s^{t0})$ and act promptly to try to beat the crowd.

In today's floating exchange rate system, nations must hold significant foreign reserves as a buffer stock to encourage and support orderly, organized exchange markets. Orderliness can be maintained in the face of lemming-like speculative portfolio flows until either:

(1) the foreign reserves of the nation suffering the outflow of hot money are nearly exhausted. Then the nation cannot maintain an orderly exchange rate market and fund managers who are late-comers can not readily convert their holdings into foreign assets if at all[ix], or

(2) the country being drained of reserves increases its interest rate (i.e., the q-c term) sufficiently to offset the expected potential capital loss from holding liquid assets denominated in its currency, or

(3) central banks (singularly or cooperatively) actively intervene in the exchange market in an attempt to change private sector expectations regarding $(p_s^{t1} - p_s^{t0})$, or

(4) some form of taxation is added to increase the value of the T_s term to offset the expected capital gain from an exchange rate change, or

(5) some form of outright prohibition of hot money portfolio-flows are successfully introduced.

The Tobin tax falls under item (4) where governments use taxation in an attempt to stop speculative flows of hot money[x]. By modifying inequalities (1) to (4) to account for a Tobin tax, we can estimate the magnitude of the effects of the tax on portfolio decisions. We want to focus attention on a comparison of the <u>ceteris paribus</u> effect of an expected change in the exchange rate on the fund manager's behaviour with and without a Tobin tax. To do so, let us include the fund manager's expected capital gains (or losses) for each security (<u>in terms of the currency the security is denominated in</u>) in the magnitude of (q - c). This will permit us to reserve the term $(p_s^{t1} - p_s^{t0})$for analyzing the <u>ceteris paribus</u> effect of a manager altering his view as to the value of the spot exchange rate <u>in the near future</u>. Thus the relationship for determining one's bullishness (or bearishness) requires evaluating the following terms:

$(q - c) + (p_s^{t1} - p_s^{t0}) - (x)(p_s^{t1} + p_s^{t0}) - T_s$

where (x) equals the magnitude of the Tobin tax rate. If

$$(q - c) + (p_s^{t1} - p_s^{t0}) - (x)(p_s^{t1} + p_s^{t0}) - T_s > 0 \qquad (5)$$

the person is a bull, while if

$$(q - c) + (p_s^{t1} - p_s^{t0}) - (x)(p_s^{t1} + p_s^{t0}) - T_s < 0 \qquad (6)$$

the portfolio manager is bearish.[xi] By comparing inequalities (5) and (6) with inequalities (1) and (2) it is obvious that given the values of (q-c) and T_s, a small Tobin tax increases slightly the differential between changes in expected future spot price and current spot price (for any given time interval) before speculative bull or bear responses are induced vis-a-vis the no Tobin tax situation. Consequently a small "grains of sand"Tobin tax, like any other small transaction cost, can stop speculation on <u>small</u> movements in the exchange rate. As the following inequalities demonstrate, any significant change in the exchange rate in the short-run will quickly swamp any "grains of sand" Tobin tax disincentive. Moreover, as we will also suggest, the Tobin tax can have a significantly larger impact on stemming international trade and arbitrage activities than its impact on a simple speculative round-trip.

For comparison with the no tax situation where we assumed $(q\text{-}c) - T_s = 0$, when there is a Tobin tax, if

$$[p_s^{t1}/p_s^{t0}] > [1 + x/ 1\text{-}x] \qquad (8)$$

then the person is a bull. Moreover, there will still be bearish sentiment, even if the current spot price is expected to rise as long as

$$[p_s^{t1}/p_s^{t0}] < [1 + x/1\text{-}x] \qquad (9)$$

Comparing inequalities (8) and (9) with inequalities(3) and (4) provides us with a measure of the the magnitude of the minimum expected changes in the exchange rate that must occur to induce bullishness or bearishness in the presence of a Tobin tax compared to the no tax case. For example, if the magnitude of the Tobin tax is 0.5%, then, ceteris paribus, the expected future spot price must increase only by more than 1.1 percent more than it would have had to increase in the absence of the tax to induce a bullish sentiment. In other words, even though the negative annual rate of return on a one-day round trip is 365% when there is a 0.5% Tobin tax,, any increase in the spot price of more than an additional 1.1% compared to the no tax situation can still spawn significant speculative flows. Consequently, the imposition of a Tobin Tax per se will not significantly stifle even very short run speculation if there is any whiff of a weak currency in the market. In fact, any Tobin tax significantly less than 100% of the expected capital gain (on a round trip) is unlikely to stop the sloshing around of hot money.

In other words, all that is required to set off speculative flows is an expected change in the exchange rate that is [1+x/1-x] greater than what would set off speculation regarding the exchange rate in the absence of the Tobin tax. Obviously, then, if an institution can be developed that assures portfolio managers that exchange rates will be stable over time, this will do more to inhibit speculative short-term round tripping than any small Tobin tax.

Almost by definition during a speculative run on a currency, one expects significantly large changes in the exchange rate over a very short period of time. For example, the Mexican peso fell by approximately 60% in the Winter of 1994-5. A Tobin tax of over 23% would have been required to stop the speculative surge of the peso crisis. At best then a "grains of sand" small Tobin tax might slow down the speculative fever when "grains of sand" small exchange rate changes are expected. When dealing with small differentials in exchange rates, however, one is likely to be discussing the question of arbitrage rather than speculation. Accordingly, the Tobin tax is more likely to be a constraint on arbitrage flows rather than on speculative flows. The former usually involves small differences in spot prices, while the latter term should be reserved for larger differences in prices.

The grains of sand Tobin tax might be the straw that breaks the speculative back of very small portfolio managers, since normal transactions costs (T_s) of foreign transactions are essentially regressive (Cf. Hicks, 1967, p. 67). An additional proportional (Tobin) tax on top of a large regressive transactions cost can keep small speculators out of the market. For movements of larger sums, however, the normal transactions costs quickly shrink to a negligible proportion of the total transaction. Since in today's free-wheeling financial markets, individuals with even small portfolio sums can join mutual funds that can speculate on foreign currencies, however, a Tobin tax is unlikely to constrain even small investors -- who can always join a large mutual fund to reduce the impact of total transactions costs sufficiently to reduce the remaining Tobin tax to relative insignificance whenever speculative fever runs high.

Finally, there is a rule of thumb that suggests that under the current flexible exchange rate system, there may be four or more normal hedging financial transactions involved in any single arms-length international trade transaction. This exceeds the two financial transactions implicit in a ETW proverbial short-term speculative (non-hedged) round-trip.[xii] If this two-to-one ratio is anywhere near correct, a 0.5% Tobin tax could be equivalent to instituting an additional 2% universal tariff on all goods and services traded in the global economy. It would appear then that a Tobin transaction tax might throw larger grains of sand into the wheels of international real commerce than it does into speculative hot money flows.

Whether this 2 to 1 ratio is accurate or not, the important principle involved here is that as long as some hedging transactions are required on arms-length real trade flows, the impact of the Tobin tax is likely to be at least as large and probably larger on international trade than on international portfolio flows.[xiii] Independent of questions of the political and economic feasibility of instituting a ubiquitous Tobin tax, therefore, proposals to increase marginally transactions costs for foreign exchange by either a Tobin tax or a small feasible opportunity cost tax on capital is unlikely to prevent speculative feeding frenzies that lead to attacks on major currencies while it may inflict greater damage on international trading in goods and services and arbitrage activities.

It is such considerations that led Keynes to suggest an outright prohibition of all significant international portfolio flows through the creation of a Supranational central bank and his "bancor" plan. At this stage of economic development and global economic integration, however, a supranational central bank is not politically feasible. Accordingly what should be aimed for is a more modest goal of obtaining an international agreement among the major trading nations. [xiv] To be economically effective and politically feasible, this agreement, while incorporating the economic principles that Keynes laid down in his bancor plan, should not require any nation to surrender control of local banking systems and fiscal policies.

Keynes introduced an ingenious method of direct prohibition of hot money flows by a "bancor" system with fixed (but adjustable) exchange rates and a trigger mechanism to put more of the onus of resolving current account deficits on surplus nations. It is possible to updated Keynes's prohibition proposal to meet 21st century circumstances. In the next section, such a system will be proposed. Moreover, this system will be in the best interests of all nations for it will make it easier to achieve global full employment without the danger of importing inflationary pressures from one's trading partners.

There is not enough space in this paper to debate all possible alternative proposals for fire prevention of currency speculation. It is, however, the proper public forum for raising the public's consciousness for a need for a permanent currency fire prevention institution rather than merely relying on either fire fighting intervention such as the suggested as an Emergency Fund financed by contributions of the G7 nations and managed by the IMF, or a laissez-faire policy on international capital markets that can produce currency fires to burn the free world's real economies. We must recognize the very real possibility that there can be no safe harbor when a major currency is attacked.

III. REFORMING THE WORLD'S MONEY

Fifty years ago, Keynes (1980, p. 168) provided a clear outline of what is needed when he wrote:

"We need an instrument of international currency having general acceptability between nations .... We need an orderly and agreed upon method of determining the relative exchange values of national currency units.... We need a quantum of international currency...[which] is governed by the actual current [liquidity] requirements of world commerce, and is capable of deliberate expansion.... We need a method by which the surplus credit balances arising from international trade, which the recipient does not wish to employ can be set to work...without detriment to the liquidity of these balances".

What is required is a closed, double-entry bookkeeping clearing institution to keep the payments `score' among the various trading regions plus some mutually agreed upon rules to create and reflux liquidity while maintaining the international purchasing power of the international currency. The eight provisions of the clearing system suggested in this section meet the criteria laid down by Keynes. The rules of this Post Keynesian proposed system are designed [1] to prevent a lack of global effective demand[xv] due to any nation(s) either holding excessive idle reserves or draining reserves from the system, [2] to provide an automatic mechanism for placing a major burden of payments adjustments on the surplus nations, [3] to provide each nation with the ability to monitor and, if necessary, to put boulders into the movement of international portfolio funds in order to control movements of flight capital[xvi], and finally [4] to expand the quantity of the liquid asset of ultimate international redemption as global capacity warrants.

Some elements of such a clearing system would include:

1. The unit of account and ultimate reserve asset for international liquidity is the

International Money Clearing Unit (IMCU). All IMCU's are held only by central banks, not by the public.

2. Each nation's central bank is committed to guarantee one way convertibility from IMCU deposits at the clearing union to its domestic money. Each central bank will set its own rules regarding making available foreign monies (through IMCU clearing transactions) to its own bankers and private sector residents[xvii].

Since Central Banks agree to sell their own liabilities (one-way convertibility) against the IMCU only to other Central Bankers and the International Clearing Agency while they simultaneously hold only IMCUs as liquid reserve assets for international financial transactions, there can be no draining of reserves from the system. Ultimately, all major private international transactions clear between central banks' accounts in the books of the international clearing institution.

3. The exchange rate between the domestic currency and the IMCU is set initially by each nation -- just as it would be if one instituted an international gold standard. Since enterprises that are already engaged in trade have international contractual commitments that would span the change-over interval, then, as a practical matter, one would expect that the existing exchange rate structure (with perhaps minor modifications) would provide the basis for initial rate setting.

Provisions #7 and #8 infra indicate when and how this nominal exchange rate between the national currency and the IMCU would be changed in the future.

4. Contracts between private individuals will continue to be denominated into what ever domestic currency permitted by local laws and agreed upon by the contracting parties. Contracts to be settled in terms of a foreign currency will therefore require some announced commitment

from the central bank (through private sector bankers) of the availability of foreign funds to meet such private contractual obligations.

5. An overdraft system to make available short-term unused creditor balances at the Clearing House to finance the productive international transactions of others who need short-term credit. The terms will be determined by the pro buono clearing managers.

6. A trigger mechanism to encourage a creditor nation to spend what is deemed (in advance) by agreement of the international community to be "excessive" credit balances accumulated by running current account surpluses. These excessive credits can be spent in three ways: (1) on the products of any other member of the clearing union, (2) on new direct foreign investment projects, and/or (3) to provide unilateral transfers (foreign aid) to deficit members. Spending on imports forces the surplus nation to make the adjustment directly through the balance on goods and services. Spending by way of unilateral transfers permits adjustment directly by the current account balance; while direct foreign investment provides adjustment by the capital accounts (without setting up a contractual debt that will require reverse current account flows in the future).

Proviso #6 provides the surplus country with considerable discretion in deciding how to accept the "onus" of adjustment in the way it believes is in its residents' best interests. It does not permit the surplus nation to shift the burden to the deficit nation(s) through contractual requirements for debt service charges independent of what the deficit nation can afford.[xviii] The important thing is to make sure that continual oversaving[xix] by surplus nations can not unleash depressionary forces and/or a building up of international debts so encumbering as to impoverish the global economy of the 21 century.

In the unlikely event that the surplus nation does not spend or give away these credits within a specified time, then the clearing agency would confiscate (and redistribute to debtor members) the portion of credits deemed excessive.[xx] This last resort confiscatory action by the managers of the clearing agency would make a payments adjustment through unilateral transfer payments in the current accounts.

Under either a fixed or a flexible rate system, nations may experience persistent trade deficits merely because trading partners are not living up to their means -- that is because other nations are continually hoarding a portion of their foreign export earnings (plus net unilateral transfers). By so doing, these oversavers are contributing to a lack of global effective demand. Under provision #6, deficit countries would no longer have to deflate their real economy merely to adjust payment imbalances because others are oversaving. Instead, the system would seek to remedy the payment deficit by increasing opportunities for deficit nations to sell abroad and thereby earn their way out of the deficit.

7. A system to stabilize the long-term purchasing power of the IMCU (in terms of each member nation's domestically produced market basket of goods) can be developed. This requires a system of fixed exchange rates between the local currency and the IMCU that changes only to reflect permanent increases in efficiency wages.[xxi] This assures each central bank that its holdings of IMCUs as the nation's foreign reserves will never lose purchasing power in terms of foreign produced goods, even if a foreign government permits wage-price inflation to occur within its borders. The rate between the local currency and the IMCU would change with inflation in the local money price of the domestic commodity basket.

If increases in productivity lead to declining nominal production costs, then the nation with this decline in efficiency wages [say of 5 per cent] would have the option of choosing either [a] to permit the IMCU to buy [up to 5 per cent] less units of domestic currency, thereby capturing all (or most of) the gains from productivity for its residents while maintaining the purchasing power of the IMCU, or [b] to keep the nominal exchange rate constant. In the latter case, the gain in productivity is shared with all trading partners. In exchange, the export industries in this productive nation will receive an increased relative share of the world market.

By altering the exchange rate between local monies and the IMCU to offset the rate of domestic inflation, the IMCU's purchasing power is stabilized. By restricting use of IMCUs to Central Banks, private speculation regarding IMCUs as a hedge against inflation is avoided. Each nation's rate of inflation of the goods and services it produces is determined solely by (a) the local government's policy towards the level of domestic money wages and profit margins vis-a-vis productivity gains, i.e., the nation's efficiency wage. Each nation is therefore free to experiment with policies for stabilizing its efficiency wage to prevent inflation. Whether the nation is successful or not, the IMCU will never lose its international purchasing power. Moreover, the IMCU has the promise of gaining in purchasing power over time, if productivity grows more rapidly than money wages and each nation is willing to share any reduction in real production costs with its trading partners.

Provision #7 produces a system designed to maintain the relative efficiency wage parities amongst nations. In such a system, the adjustability of nominal exchange rates will be primarily (but not always, see Provision #8) to offset changes in efficiency wages among trading partners. A beneficial effect that follows from this proviso is that it eliminates the possibility of a specific industry in any nation put at a competitive disadvantage (or secure a competitive advantage) against foreign producers solely because the nominal exchange rate was changed independently of changes in efficiency wages and the real costs of production in each nation.

Nominal exchange rate variability will no longer create the problem of a loss of competitiveness due solely to the overvaluing of a currency as, for example, experienced by the industries in the American "rust belt" during the period 1982-85. ETW (1995, p. 164) has noted that the appreciation of the dollar against the yen in the early 1980s “nearly destroyed the American automotive industry”. Even if temporary, currency appreciation can have significant permanent real costs, e.g., industries may abandon markets and the resulting idle existing plant and equipment may be cast aside as too costly to maintain.

Proviso #7 also prevents any nation from engaging in a beggar-thy-neighbor, export-thy-unemployment policy by pursuing a real exchange rate devaluation that does not reflect changes in efficiency wages. Once the initial exchange rates are chosen and relative efficiency wages are locked in, reductions in real production costs that are associated with a relative decline in efficiency wages is the main factor (with the exception of provision #8) justifying an adjustment in the real exchange rate.

Although provision #6 prevents any country from piling up persistent excessive surpluses this does not mean that it is impossible for one or more nations to run persistent deficits. Proposal #8 infra provides a program for addressing the problem of persistent export-import deficits in any one nation.

8. If a country is at full employment and still has a tendency towards persistent international deficits on its current account, then this is prima facie evidence that it does not possess the productive capacity to maintain its current standard of living. If the deficit nation is a

poor one, then surely there is a case for the richer nations who are in surplus to transfer some of their excess credit balances to support the poor nation.[xxii] If it is a relatively rich country, then the deficit nation must alter its standard of living by reducing the relative terms of trade with major trading partners. Rules, agreed upon in advance, would require the trade deficit rich nation to devalue its exchange rate by stipulated increments per period until evidence becomes available to indicate that the export-import imbalance is eliminated without unleashing significant recessionary forces[xxiii].

If, on the other hand, the payment deficit persists despite a continuous positive balance of trade in goods and services, then there is evidence that the deficit nation might be carrying too heavy an international debt service obligation. The pro buono officials of the clearing union should bring the debtor and creditors into negotiations to reduce annual debt service payments by [1] lengthening the payments period, [2] reducing the interest charges, and/or [3] debt forgiveness.[xxiv]

If any government objects to the idea that the IMCU provisions provide governments with the ability to limit the free movement of "capital" funds, then this nation is free to join other nations of similar attitude in forming a regional currency union and thereby assuring a free flow of funds among the residents of the currency union.

CONCLUSION

In normal times with free capital markets. "speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubbles on a whirlpool of speculation" (Keynes, 1936, p. 159). The grains of sand of a Tobin tax may prick the small bubbles of speculation, but the sand is more likely to significant restrict the flow of real trade and international arbitrage activities. On the other hand, the sands of the Tobin tax will be merely swept away in whirlpools of speculation. Boulders are needed to stop the destructive currency speculation from destroying global enterprise patterns, for "it is enterprise which builds and improves the world's possessions" (Keynes, 1930, p. 148).

ETW should be praised for forcing economists to focus their attention on the problem of excessive speculative volatility in the exchange rate markets. This problem is not easily resolved. If we start with the defeatist attitude that it is too difficult to change the awkward system in which we are enmeshed, then no progress will be made (Cf. Garber and Taylor, 1995, Kenen, 1995). We must reject such defeatism at this exploratory stage and merely inquire whether particular proposals for improving the operations of the international payments system to promote global growth will be effective without creating more difficulties than those inherent in the current system. The health of the world economic system will not permit us to muddle through.

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NOTES

i . The more uncertain (i.e., not statistically reliably predictable {see Davidson, 1991}) the future appears, the more fund managers may admit they can not anticipate what will happen in the near future . Consequently the greater the impending speculative storm, the more desirable it will be to storing saving in a "safe harbor".This possession of safe liquid assets soothes our fears of becoming illiquid if anything unpredictable occurs during the stormy period.

ii. Orthodox theorists reach this conclusion by conflating the concept of speculation with that of arbitrage. Since the latter is always a stabilizing force, orthodoxy insists that the former is also always stabilizing.

iii. In a single day in September 1992, fund manager George Soros not only made millions by speculating against the English pound but he also forced the Bank of England to abandon any attempt to maintain an orderly exchange market while staying within the EMS.

iv. In Keynes's day major international financial markets did not operate around the global and hence permit trading 24 hours a day. In today's global financial system, sleep is more of a luxury for international portfolio managers.

v. Each manager believes herself equally capable as her rivals to interpret quickly the effects of any changes as they occur.

vi. Mainstream theorists often assume that the fund manager requires a risk premium evaluated in terms of a probability. Thus if we were to analyze the problem in terms of probablistic risk equation (1) would be rewritten as:

$$(q - c) + P[(p_s^{t1} - p_s^{t0})] - T_s > 0, \qquad (1a)$$

where P (<1)is the probability risk or decision weight. On the other hand, Keynes (1936, p.. 148) and others (e.g., Davidson, 1991) have argued that uncertainty is different from probabilitic risk. In a world of uncertainty no reliable probability ratio can be assigned. Consequently, in what follows, the equations in the text will not be weighted by any probability ratio. This implies that fund managers must rely upon their "animal spirits" in deciding whether to act on their conjectures about the future.

vii. If we permit unlimited borrowing to finance asset holdings, then since the cost of borrowing is included in computing c, the portfolio manager will buy all available assets as long as they meet inequality (1). If fund managers are limited in their ability to borrow, then they will choose those assets with the highest values for inequality (1).

viii. If bank demand deposit money provides some positive interest income each day that it is held, then the q in our equations would have to be redefined as daily income in excess of what could be earned by holding demand deposit (Cf. Keynes, 1936, p. 167n). In principle nothing is lost by ignoring this complication.

ix. The fear of this occurrence can, in itself, induce a panic among fund managers similar to what occurs when someone yells fire in a theater.

x. In his Treatise on Money, Keynes (1930, pp. 313-4) proposed "punitive taxation" on the floating of foreign issues in the domestic securities market and an additional 10 per cent income tax on income earned by domestic residents on foreign loans in order to constrain foreign domestic portfolio investment primarily for income earning purposes. In this Treatise proposal, Keynes did was not dealing with speculative activities.

xi. If one prefers to introduce risk aversion via a probabilistic risk factor P, where P <1, then the relevant inequalities are:

$$\text{if } (q - c) + P[(p_s^{t1} - p_s^{t0}) - (x)(p_s^{t1} + p_s^{t0})] - T_s > 0 \tag{5a}$$

the person is a bull, while if

$$(q - c) + P[(p_s^{t1} - p_s^{t0}) - (x)(p_s^{t1} + p_s^{t0})] - T_s < 0 \tag{6a}$$

the portfolio manager is bearish.

xii. Although there is very little direct evidence of this multiple for arms-length real international trade flow, there are logical reasons why a multiple should exist. First any bank that provides a forward transaction to a customer without having a client who needs an identical opposite trade will hedge the risk via engaging in spot and swap transactions. Such bank behavior implies a multiple of the original customer transaction. Secondly, the growth of swap and forward transactions via-a-vis spot transactions is consistent with the view that more hedging per trade transactions are occurring compared to the past. (I am indebted to Jan Kregel for this suggestion.)

xiii. Many politicians favor a Tobin tax as a "cash cow" rather than for its alleged affect on slowing international speculation. A Tobin tax is seen as a rich source of tax revenue. Kelly (1994) has estimated that a 0.5 per cent Tobin tax would yield one billion pounds sterling per day for the English government.

xiv. To encourage global cooperation within this agreement, the major trading partners should insist that other nations that want to trade with them and receive most favored nation treatment must join the agreement.

xv. Williamson (1987, p. 200) recognizes that when balance of payments "disequilibrium is due purely to excess or deficient demand", flexible exchange rates per se can not facilitate international payments adjustments.

xvi. This provides as an added bonus by making tax-avoidance and profits from illegal trade more difficult to conceal.

xvii. Correspondent banking will have to operate through the International Clearing Agency, with each central bank regulating the international relations and operations of its domestic banking firms. Small scale smuggling of currency across borders, etc., can never be completely eliminated. But such movement's are merely a flea on a dog's back -- a minor, but not debilitating, irritation. If, however, most of the residents of a nation hold and use (in violation of legal tender laws) a foreign currency for domestic transactions and as a store of value (e.g., it is estimated that Argentineans hold more than $5 billion U.S. dollars), this is evidence of a lack of confidence in the government and its monetary authority. Unless confidence is restored, all attempts to restore economic prosperity will fail.

xviii.Some may fear that if a surplus nation is close to the trigger point it could short circuit the system by making loans to reduce its credit balance prior to setting off the trigger. Since preventing unreasonable debt service obligations is an important objective of this proposal, a mechanism which monitors and can restrict such pre-trigger lending activities may be required.

One possible way of eliminating this trigger avoidance lending loophole is as follows: An initial agreement as to what constitutes sensible and flexible criteria for judging when debt servicing burdens become unreasonable is established. Given these criteria, the clearing union managers would have the responsibility for preventing additional loans which push debt burdens beyond reasonable servicing levels. In other words, loans that push debt burdens too far, could not be cleared though the clearing union, i.e., the managers would refuse to release the IMCU's for loan purposes from the surplus country's account. (I am indebted to Robert Blecker for suggesting this point.)

The managers would also be required to make periodic public reports on the level of credits being accumulated by surplus nations and to indicate how close these surpluses are to the trigger point. Such reports would provide an informational edge for debtor nations permitting them to bargain more successively regarding the terms of refinancing existing loans and/or new loans. All loans would still have to meet the clearing union's guidelines for reasonableness.

I do not discount the difficulties involved in setting up and getting agreement on criteria for establishing unreasonable debt service burdens. (For some suggestions, however, see the second paragraph of provision #8.) In the absence of cooperation and a spirit of goodwill that is necessary for the clearing union to provide a mechanism assuring the economic prosperity of all members, however, no progress can ever be made.

Moreover, as the current international debt problem of African and Latin American nations clearly demonstrates, creditors ultimately have to forgive some debt when they previously encourage excessive debt burdens. Under the current system, however, debt forgiveness is a last resort solution acceptable only after both debtor and creditor nations suffer from faltering economic growth. Surely a more intelligent option is to develop an institutional arrangement which prevents excessive debt servicing burdens from ever occurring.

xix. Oversaving is defined as a nation persistently spending less on imports plus direct equity foreign investment than the nation's export earnings plus net unilateral transfers.

xx. Whatever "excessive" credit balances that are redistributed shall be apportioned among the debtor nations (perhaps based on a formula which is inversely related to each debtor's per capita income and directly related to the size of its international debt) to be used to reduce debit balances at the clearing union.

xxi. The efficiency wage is related to the money wage divided by the average product of labor, it is the unit labor cost modified by the profit mark-up in domestic money terms of domestically produced GNP. At this preliminary stage of this proposal, it would serve no useful purpose to decide whether the domestic market basket should include both tradeable and non-tradeable goods and services. (With the growth of tourism more and more nontradeable goods become potentially tradeable.) I personally prefer the wider concept of the domestic market basket, but it is not obvious that any essential principle is lost if a tradeable only concept is used, or if some nations use the wider concept while others the narrower one.

xxii. This is equivalent to a negative income tax for poor fully employed families within a nation.

xxiii. Although relative prices of imports and exports would be altered by the change in the terms of trade, the adjustment is due to the resulting income effect, not a substitution effect. The deficit nation's real income will fall until its import surplus disappears.

xxiv. The actual program adopted for debt service reduction will depend on many parameters including: the relative income and wealth of the debtor vis-a-vis the creditor, the ability of the debtor to increase its per capita real income, etc.

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Remarks of Janet L. Yellen

Chair, Council of Economic Advisers

to Macroeconomic Advisers' Washington Policy Symposium

September 10, 1998

It's a pleasure to join you today. A predecessor of mine on the Council of Economic Advisers warned me that on many days CEA members feel like those little steel balls in pinball machines--bouncing back and forth from one short deadline project to the next, forced to switch directions rapidly and with little warning. I understand what he meant. Crises requiring immediate attention are rarely in short supply.

Even so, a substantial portion of the Administration's economic agenda relates to longer term issues that will be critical to the performance of the U.S. and world economies not next week or next year but instead decades or even further in the future. We have had the luxury of elevating the priority of these longer term issues because the fundamentals of the U.S. economy are extremely sound. This assessment, offered repeatedly by the President and other Administration officials, remains accurate, in my view, in spite of our increasing vulnerability to repercussions from the current international financial crisis. Obviously, we have not escaped the effects of the Asian crisis. It has taken a toll on U.S. exports, which, according to our estimates, are down about $30 billion at an annual rate, as a direct result. It is causing losses at major financial institutions with emerging market exposure. And it is clearly contributing to volatility in our own financial markets. A widening or deepening of the crisis remains the single greatest threat to the continued expansion of the U.S. economy. The Administration is intensely focused on the need to restore growth to the world economy and stability to the world's financial system.

That said, the American economy has been and still is enjoying its best performance in decades, with unemployment and inflation at the lowest levels in a generation, a rate of national saving which is double what it was six years ago, real wage growth which has recently been the highest in two decades, and, importantly, a federal budget which is in surplus this year after three decades of deficits. As my colleague Joe Minarik undoubtedly emphasized this morning, if we maintain the fiscal discipline now in place, budget surpluses over the next decade are projected to exceed $1.5 trillion under both CBO and OMB (MSR) assumptions. It is in good economic times like these, that we have the luxury and the resources to anticipate problems ahead and prepare for them. Moreover, the cost of addressing longer term problems is usually lower when one has the foresight and discipline to act early than if one procrastinates.

Three of the central issues on our longer term economic agenda are the development of policies to reduce the risk of future crises in the international financial system, namely the design of a new financial architecture; measures to address the consequences of global climate change; and Social Security reform. Seeing that your agenda for this conference includes discussion of the first two of these topics, I thought I might most usefully focus on the third--Social Security reform--in my remarks today. My objective is to describe the problem we face, the President's principles for evaluating reform options, and some of the difficult tradeoffs that must be faced in devising a reform.

In his State of the Union address, the President proposed to "Save Social Security First" by reserving every penny of the surplus until we have agreed on a plan to secure the financial viability of Social Security. To accomplish this task, the President proposed a process of public education and debate followed by the forging of a bipartisan agreement. He and the

Vice-President have participated over the last five months in a number Social Security fora, whose purpose has been to afford Americans the opportunity to better understand the problems facing the Social Security system and to explore alternative solutions to these problems. This process of public discussion will culminate with a White House conference in December. The plan is to then begin bipartisan negotiations with Congressional leaders in January 1999 to devise a comprehensive plan to strengthen Social Security.

I think it is fair to say that the President's proposal to Save Social Security First has been enormously popular--so much so that there exists strong bipartisan support for tackling reform. Certainly, the Administration remains committed to its pledge to leave every penny of the surplus intact until reforms are enacted. The President's budget proposed new initiatives in a number of key areas, including child care, education, the environment and health care, but all of the proposed initiatives were paid for so that they would not deplete projected surpluses.

It should come as no surprise that Americans are eager to fix Social Security, because it is an extremely successful 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 retirement benefits are indexed for inflation and provide a lifetime annuity--a package which is difficult if not impossible to obtain in private markets. In fact, less than half of all individuals aged 65 and older received any private pension benefits in 1994. As a result, Social Security benefits are the largest source of income for 2/3 of those in this age group and the only source of income for 18 percent of them. The system has enjoyed dramatic success in reducing the poverty rate among retirees, helping to lower the elderly poverty rate from 35 percent in 1959 to 11 percent in 1996. Social Security is also more than just a pension plan: It is a family protection plan, and nearly 1 in 3 beneficiaries are not retirees. For the average wage earner who dies and leaves a spouse and two children, Social Security provides survivors benefits equivalent to a $300,000 life insurance policy; one in six 20 year olds will die before retirement age. Social Security also provides disability protection, and 3 in 10 20 year olds will become disabled for some period before retirement.

The most commonly used yardstick to measure the financial soundness of the Social Security system is the 75-year actuarial balance. The Social Security actuaries now project 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. By 2013, payroll contributions are expected to fall short of benefits; by 2021 the shortfall is expected to exceed Trust Fund interest earnings, so the Trust Fund will begin to decline; and by 2032, the Trust Fund is expected to be depleted, after which time contributions would still be sufficient to pay about 75 percent of current law benefits. 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. That is the most common way to scale the current problem. As the CEA noted, however, in its 1997 Economic Report, the 75-year actuarial balance actually understates the financial imbalance over the very long term because the actuaries' projections show surpluses in the early years of the 75 year horizon and growing deficits later on when demographic forces have their full effect.

Although Social Security faces a financial imbalance, poll results suggest that the magnitude of the problem has been exaggerated in the minds of many who report that they doubt that Social Security will be there for them at all. In fact, although the seriousness of the financial imbalance facing Social Security should not be downplayed, its magnitude is not so large as to be insurmountable, particularly if early action is taken. This is a solvable problem, and many ideas have been and will be put on the table to address it.

The President has emphasized that at this stage in the national debate he remains open-minded and committed to giving every option a fair hearing. It is far too early to prejudge the outcome of the debate. However, the President has set forth five principles to guide the reform process, reflecting his judgement about the appropriate goals for reform. His first principle is to strengthen and protect Social Security for the 21st century. This is an overriding goal, and it warns against proposals that fail to provide a comprehensive solution to the solvency problem. For example, a proposal that simply diverts existing payroll taxes into a new system of individual accounts would not qualify as a comprehensive solution because it reduces Social Security's revenues and makes the existing imbalance even larger. However, several comprehensive proposals have been advanced that include such individual account carve-outs.

A second principle for Social Security reform is to maintain fiscal discipline--to insure that surpluses are not drained before addressing Social Security reform, and that fiscal policy plays a helpful role in preparing for the retirement of the baby boomers. The key factors contributing to the projected Social Security 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. When the Social Security Act was passed in

1935, the life expectancy of a 65 year old American was about 13 years. Today, life expectancy for a 65 year old is 18 years and rising. At the same time, people are retiring earlier. In 1950, the average age for first receiving Social Security retirement benefits was 68; today it's 63. As a consequence of these changes, the ratio of employed workers to retirees has fallen from about 5 to 1 in 1960 to 3-1/2 to 1 today. In only 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. A natural 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 this is to increase national saving, a goal to which continued fiscal discipline would contribute.

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; moreover, $130 billion of surplus placed in the Trust Fund and invested in government bonds would extend the expiration date of the Trust Fund by roughly a year or reduce the taxable payroll gap by about 0.1. National saving could also increase if the surpluses are used to fund individual accounts and such accounts add to private saving. But if the surpluses 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--a secure base for retirement planning. 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, which highlights his commitment to preserving the disability and survivors' insurance aspects of the OASDI program.

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 discuss 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 pure defined-benefit structure of Social Security or to move at least partly 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. This is often referred to as the "transition problem." Surpluses in the unified budget--used either to augment the Trust Fund or to fund individual accounts--could at least partially mitigate the transition problem, by bringing additional funds into the Social Security system.

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 than government bonds over nearly all long periods of time in the United States during the past century. Between, for example, 1959 and 1996, the S&P 500 returned an average 3.84 percent more per year than bonds in the Trust Fund. There is no guarantee, however, that the equity premium in the future will match its historical average. And equity investments involve substantial risk over shorter time periods. For example, on three occasions during the past 70 years, the S&P 500 index has declined more than 35 percent over two years, while Japan's Nikkei index has fallen over 60 percent since 1989. 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. If such investments merely represented a swap of bonds for equities, there would be a corresponding swap of equities for bonds in private portfolios. If the total supplies of equities and bonds were unchanged, this exchange 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. They doubt that the government has the will to renounce the use of growing annual surpluses in the Social Security system. Some also argue that for many Americans without private retirement accounts, individual accounts established by the government could, through a demonstration effect, stimulate additional private saving. However, under current budget projections, individual accounts could not be funded out of the surplus forever, so a permanent commitment to their funding could set the stage for future fiscal deficits.

Many supporters of individual 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 while allowing scope for equity investments. 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. Supporters of an "equities in the Trust Fund" approach argue that it can achieve the same objective as individual accounts with lower administrative cost and greater sharing of the risks of market fluctuations both within and across generations. I think it is an open question, though, whether institutions could be designed that would allow the Trust Fund to purchase equities but still ensure that the government did not gain too much influence over the economy. Depending on the share of the Trust Fund invested in equities, the Social Security system could end up holding a substantial fraction of the stock market. Could the government avoid the pressure to make investment decisions for purposes other than maximizing the rate of return while minimizing risk? How would stock proxies be voted?

In the Federal Thrift Savings Plan, governance issues have been handled successfully by insulating investment managers from political calculations, narrowly defining their goals, and permitting investment only in index funds. However, the Thrift Savings Plan involves far less money than Social Security does, and it is essentially a collection of individual accounts managed by the government rather than a government-owned Trust Fund. In considering these governance issues, we may benefit from studying the experience of other countries engaged in similar reform efforts. For example, the Canadian Pension Plan will begin investing in private securities in early 1999. Equity purchases will be restricted to indexes, the fund will not be allowed to hold more than 30 percent of the voting shares of any firm, and investment decisions will be made by a board charged with a fiduciary responsibility to manage the fund in the best interests of the contributors and beneficiaries.

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. For example, proposals to contribute a flat percentage of the payroll tax to individual accounts benefit high income workers the most. In contrast, proposals to use budget surpluses to make equal dollar contributions to individual accounts could be highly progressive.

Some opponents of individual accounts believe that the administrative costs of these accounts would be excessively high. The administrative cost of the current Social Security system is extremely low, representing less than one cent of every dollar of contributions. Investing part of the Trust Fund in equities would raise that cost only slightly, with the additional expenses probably amounting to less than a few basis points of each dollar invested. But the cost of directing the appropriate contributions to millions of individual accounts and managing the assets in those accounts could be much higher. In Chile and the UK, for example, the administrative costs of individual accounts may reduce retirement income by 20 percent or more. And in the United States, even passively managed index funds incur expenses that average around 60 basis points per year, according to a recent Department of Labor study. Moreover, analysts note that many proposals for individual accounts involve accounts that would be quite small, especially when they were first created, so that any fixed cost per account could absorb a significant share of the annual investment return for many people. The Federal Thrift Savings Plan incurs costs of about 10 basis points per year, but it allows for only a small range of investment choices, and all of its participants work for the same employer. Restricting investment options or services in individual accounts would reduce costs, but might disappoint people accustomed to better service for their private portfolios.

[Automated Records Management System Hex-Dump Conversion]

If individual accounts are introduced as part of the solution to Social Security's actuarial imbalance, the question will arise whether to require people to convert their account balances to annuities when they retire. One advantage of requiring annuitization is ensuring that individuals do not outlive their assets. Such a step may be especially important if withdrawals from individual accounts substitute for some part of traditional Social Security benefits, which automatically take the form of annuities. Requiring annuitization also minimizes the problem of adverse selection, which raises the price of private annuities today and reduces their use. But people may want to bequeathe some of their accumulated wealth, and requiring annuitization would restrict their ability to do so. Balancing these various objectives is another difficult problem.

In addition to proposals concerning individual accounts, uses of the budget surplus, and the investment policies of the Trust Fund, negotiations on Social Security reform may entail consideration of options regarding changes in the retirement age. As I mentioned earlier, and as you know, at the same time that people are living longer, they are retiring earlier. The increasing share of life spent in retirement--which is evident in other industrialized countries as well--is in part a natural reaction to higher income. But it may also be partly a reaction to public policies that unduly encourage retirement at specific ages. Social Security reform plans have been proposed that would phase in more rapidly the currently scheduled increase in the normal retirement age to 67, raise the retirement age beyond 67, or index the retirement age to life expectancy. Examining these proposals should be part of the public debate. But in the interest of fairness, we must look closely at the likely impact of any reform in this area on those Americans in physically demanding jobs or with disabilities.

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.

Remarks of
Janet L. Yellen
Chair of the President's Council of Economic Advisers
at Institutional Investors Conference
September 15, 1998

Thank you. It is a pleasure to be here. In my remarks today I would like to discuss the current state of the American economy, especially in light of the turmoil in world financial markets and the international economy. I would then like to focus on the outlook going forward, particularly the risks to the outlook, as well as the policies that are necessary to sustain growth in the United States and the world economy.

With all the recent attention on baseball records, I would like to remind you that the U.S. economy too is on track to set a record this year. With continued growth, this expansion will enter its 93rd month in December, replacing 1982-90 as the longest peacetime expansion on record. As I will discuss further in a minute, the economic fundamentals remain sufficiently strong that I am not overly worried that mentioning this possibility will jinx the expansion. Moreover, if we are successful in sustaining America's growth, this expansion will hit its 107 month in February 2000, making it the longest expansion on record. (The expansion of 1961 to 1969, lasted 106 months.)

The Current State of the Economy

Let me turn to a discussion of the current state of the economy, in order to lay the groundwork for a discussion of where we go from here. Last week, in light of the turmoil in world financial markets, the President asked me for an update on the state of the U.S. economy. I was able to report to him that, consistent with consensus forecasts, the fundamentals are in place for continued solid economic growth, though developments in world markets continue to bear close monitoring and pose decided risks to our economy.

The economy is healthy and remains largely free of the symptoms that often presage an economic downturn—such as an increase in inflation, an accumulation of inventories, or significant financial imbalances. The unemployment rate remains low, job growth remains robust, inflation remains tame, real wages and real personal income are rising, and consumer confidence is high. Even with the recent retreat in the stock market from its July high, household net worth remains high relative to disposable income and businesses do not appear to be taking on excessive debt. To date, the main impact of the Asian crisis on the U.S. economy has been a deterioration of net exports and a widening of the trade deficit. Some financial institutions with emerging market exposure have also suffered losses; and market volatility has clearly increased. However, overall, economic growth appears to be moderating toward the solid pace anticipated in the Blue Chip consensus forecast as well as the Administration's *Midsession Review*.

Let me tick off a few particulars.

- GDP growth. Growth in GDP moderated to a 1.6 percent annual rate in the second quarter after growing 4.2 percent over the previous 4 quarters. The moderation had been expected and was accounted for by three factors: the strike at General Motors, a

sharp drop in non-auto inventory investment, and a deterioration of net exports. Final sales, which exclude inventory changes, grew at a robust 4.4 percent.
With the strike settled, GM will be out to recoup output lost during the strike, which should actually boost GDP in the fourth quarter.

The drop in inventory investment was a necessary part of the transition to more moderate and sustainable growth. The 2.6 percent annual growth rate of nonfarm inventories in the second quarter (which partly reflected the GM strike) is close to the pace consistent with such growth. And inventories remain relatively lean compared with sales.

In contrast to these temporary factors, the widening trade deficit is likely to serve as a drag on growth throughout the year, though the magnitude of that drag should diminish if economic conditions in crisis countries stabilize.

- Labor markets. All available indicators show that the demand for labor remains strong. The unemployment rate has been below 5 percent for more than a year; job gains have averaged 237,000 per month so far this year, and initial claims for unemployment remain close to their lowest levels during this expansion.

- Inflation. Inflation remains under control. The consumer price index has increased only 1.7 percent over the past year—down from 2.2 percent during the same period a year ago. The effect of tight labor markets has been offset by ample industrial capacity, one of the favorable consequences of the rapid pace of investment in plant and equipment since 1993, as well as falling import prices. These restraining influences are likely to remain in play in the medium term.

- Real wages. Real wages have grown 2.5 percent over the past year. Growth in real wages recently has been the highest in over two decades. Thus far, these gains have been in line with productivity growth, which has grown 2 percent during the past year, somewhat faster than its historical trend. Thus, wage growth has placed little upward pressure on prices.

- Housing. Strong real income growth, together with the drop in mortgage interest rates over the past year is also buoying residential investment. The 1.6 million unit pace of housing starts so far this year is the highest in a decade. Because housing starts lead housing construction, the recent surge in starts points to strong construction for the next several months.

- Business Investment. Equipment investment grew at an extraordinary 26 percent annual rate in the first half of 1998. Business purchases of computers, where the rapid pace of innovation is driving new investment and prices have been falling sharply, accounted for much of this growth. In addition, low long-term interest rates, partly the consequence of the Asian crisis, have reduced the cost of capital, and further interest rate declines in recent weeks are a positive factor in the investment outlook. As long as the relative price of equipment is falling, it is likely that business investment will continue to grow faster than the economy as a whole. Such strong growth in investment bodes well for future growth in productivity.

- Deficit reduction. For the first time since 1969, the Federal budget is in surplus, and the surplus is projected to increase in coming years. With the Federal budget no longer a drain on national saving, interest rates are lower—providing an incentive for greater private sector investment.

Short-term Risks and Outlook

It is reassuring that so many economic fundamentals are in such good shape so far into this expansion. But it is also fortunate, because the U.S. economy needs to be in fundamentally sound shape to weather the storms that have hit the world economy over the past year.

Real U.S. exports of goods and services fell in the first half of the year and net exports subtracted 2 percentage points from GDP growth. According to our estimates, the Asian crisis has reduced exports thus far by about $30 billion at an annual rate. It appears that all of the past year's weakness in exports is accounted for by the drop in our exports to seven Asian countries: China, Indonesia, Japan, Korea, Malaysia, the Philippines, and Thailand. Our imports from these countries have also risen—although these imports have been on an uptrend for several years. The Asian crisis has also affected U.S. farmers, who are experiencing low prices and shrinking exports, on top of bad weather in some regions.

Although the Asian economic crisis has clearly cut into American exports, several repercussions of the crisis have been favorable for the U.S. outlook. Thus far in 1998, U.S. refiners have been able to purchase imported crude for 5 to 6 dollars less per barrel than in 1997, which translates into lower gasoline prices for consumers. Non-oil import prices have fallen 3.9 percent over the past year—benefitting American consumers and helping to restrain inflation. Finally, the international economic situation has been one factor, along with the fiscal surplus, in keeping interest rates low.

Looking ahead over the next few quarters, net exports are likely to continue to be a drag on growth, though this drag would diminish with the stabilization of crisis-impacted economies. Growth in consumer spending may also moderate. Until now, consumption has been boosted primarily by large increases in real income, but also by substantial gains in stock market wealth. The big boost from a surging stock market may now be behind us. However, continued real income growth should motivate further, but smaller consumption gains.

To sum up, the international financial picture has deteriorated in recent weeks. But based on the effects so far and the overall health and soundness of the U.S. economy, it remains likely that we are in what will turn out to be the longest peacetime expansion on record. Clearly, however, a further deterioration in the international economic situation, including the possibility that the crisis could engulf Latin America, remains the single largest risk to a forecast of continued solid growth.

Sustaining America's Growth

Turning to the question of how to sustain America's growth, a first imperative is that we work with the international community not only to stabilize conditions but also to promote growth in the world economy. As Chairman Greenspan noted recently, no country, including the United States is an island in the world economy and our growth prospects will suffer if we do not work to promote and restore growth in the world economy.

Let me review our agenda in this area before turning to other elements of our pro-growth agenda.

- First and foremost, the United States has been and must remain a major engine of global growth so that we play a positive role in helping crisis countries recover. Strong growth in the United States and the strong dollar, combined with weak growth in so many of our trading partners makes it inevitable that our trade deficit will swell, negatively impacting some sectors that are heavily exposed to trade. Even so, we must remain prepared to accept a rising trade deficit to help the crisis countries recover. This means guarding against protectionist pressures at home and maintaining a strong labor market conditions so that workers who might be displaced as a result of the crisis can obtain other jobs. The Clinton Administration is committed to outward looking, internationalist policies.
- Other nations must also do their part to help the world economy to grow. Yesterday, the G-7 Finance ministers and central bank governors issued a joint statement indicating that, in their view, the balance of risks in the world economy has shifted so that countries should commit to preserving or creating conditions for sustainable domestic growth.

Analogous to Chairman Greenspan's recent statement they recognized that in many parts of the world inflation is low or falling.

- Japan has a critical role to play as the world's second largest economy and a key determinant of the prospects for Asia's recovery. Japan has now entered a full fledged recession/deflation. Japan's real growth in FY 1997 ended up at -0.7%. In the first half of 1998, real GDP was down at 4.3% at an annual rate--far worse than expected. Japan risks descent into a deflationary spiral in which falling prices raise real interest rates, further discouraging spending. We continue to believe that Japan must take strong measures to stimulate domestic demand led economic growth, to restore confidence, to deal with the problems of its banking system to open its markets and to deregulate its economy.
- Since the outset of this crisis, we have supported the IMF in its goal of providing financial assistance to countries in crisis that are willing to implement the often tough reforms needed to restore economic confidence and strengthen the underpinnings of their economies. We continue to believe that countries must eschew inflationary finance, end cronyism in lending, act to discourage corruption and take steps to strengthen their banking systems by closing or recapitalizing inefficent or insolvent banks.
- The President emphasized yesterday that the world must stand ready to offer assistance to countries with sound policies who have acted responsibly to help them fight off the contagious impact of the ongoing crisis. Even now, the currency crisis is threatening to engulf the economies of Latin America. One key step is to meet our obligation to the International Monetary Fund. The IMF's resources are now badly strained and Congress

simply must act now to enable the United States to meet its own IMF obligations by paying our dues and providing our contribution to the NAB. Market participants need to know that the IMF has the ability to act and failure by the Congress to pay our dues threatens this confidence, placing our own economy at substantial risk. The President also urged the major economies to stand ready to activate the $15 billion now in the emergewncy fund of the IMF--the General Agreement to Borrow--to ensure that the IMF continues to support reform and fight contagion.

- At the same time that we support the basic IMF approach which entails asking countries to take responsibility for improving economic fundamentals, we need to do more to help countries get back on their feet, to restore growth and to mitigate the suffering which has been afflicted on so many citizens in the the affected countries. Yesterday, President Clinton announced that he has asked Secretary Rubin to work with other financial authorities and international economic institutions to explore comprehensive plans to help Asian corporations emerge from massive debt, where individual firms have been swept under by systemic national economic problems. The object is to restore the flow of credt so that businesses in these countries can get back to work making products and creating jobs.

- The President also has asked the World Bank and Asia Development Bank to double their aid through an expanded Social Compact initiative with a focus on strengthening the social safety net in crisis affected countries. The focus would be on job assistance, basic needs, children, the elderly and groups in the affected countries who are most vulnerable to economic change.

- Finally, a necessary part of addressing the world financial crisis is to devise ways to reduce the vulnerability of the international system to similar crises in the future. Work has been ongoing, in a variety of international fora, to work toward this end. Most recently, for the first time, a group of industrial and key emerging market countries dubbed the Group of 22 met to work toward the strengthening of the system. Yesterday, the President called on Secretary Rubin and Chairman Greenspan to chair a major meeting of the G-7 and key emerging market finance ministers and central bankers here in Washington to present a report to the heads of state by the beginning of next year. The purpose is to devise ways to strengthen the international financial architecture going forward to reduce the likelihood of future crises or lessen their severity if they occur. We need to improve the rules of the road so that the countries can enjoy the benefits of capital flows while reducing the risks and impacts of economic crises of confidence. These measures include increasing transparency, strengthening financial systems, and devising strategies for orderly workouts in the event of a future crisis.

Finally, I would like to say just a bit about the other components of the Administration's overall economic strategy. From the outset, this Administration has focused on getting the policy fundamentals right and that approach must continue. Three key policy fundamentals have been fiscal discipline, investing in the skills of the American people, and promoting policies to enhance competition at home and engagement in the global economy. These were the right policies early on for encouraging the job creation needed to move the economy to full employment and they are the right policies now for nurturing and sustaining the expansion.

As I mentioned earlier, the Federal budget is in the black for the first time since 1969. This is a remarkable accomplishment and reflects a virtuous cycle of sound policies and favorable economic performance. Successful deficit reduction has an important role to play in restoring Americans' confidence in the ability of their government to manage its affairs. But in economic terms, the main purpose of deficit reduction is to boost national saving in order to lower interest rates, boost investment, and increase future consumption opportunities. Between the mid-1980s and the early 1990s, when it appeared that large deficits would persist as far as the eye could see, net national saving and net national investment declined as a share of national income. Since 1993, by contrast, we have seen double-digit rates of increase in business equipment investment, and net national investment as a share of national income has been on the rise.

The key challenge going forward is to protect the gains that have been achieved thus far. In particular, the President is committed to building a secure retirement for the baby boomers and a secure future for our children. That is why he has insisted that we preserve every penny of the budget surplus until we have taken care of the social security system and why he will resist reckless tax or spending schemes that would squander the surplus.

The second key element of the President's policy that will sustain America's growth is investment in the skills of the American people. In today's increasingly technologically complex world, it is important that American workers have the skills necessary to adapt and compete. A solid education from the early years on is critical to achieving that objective. The President is committed to making American education the best in the world, to having more teachers and smaller classes in the early grades, to extra help with early reading, to modernizing our schools, and to connecting all of our classrooms and libraries to the Internet by the year 2000.

Finally, sustaining America's growth means working to increase competition in our own markets, and to remain engaged in the world economy. The case for open and competitive commerce is that it forces us to innovate and to compete, ultimately speeding the productivity gains that are the source of improved living standards. That is why the President has introduced legislation, for example, to restructure the U.S. electricity sector--to enhance competition. The economic case for opening markets to international trade is equally strong. Trade offers American producers broader markets and it offers American consumers lower prices and a wider choice of goods. But trade, like domestic competition, also brings challenges when it disrupts established patterns of economic activity. The impact of recent developments in the world economy may also obscure the benefits of expanding international trade if the widening trade deficit is mistakenly interpreted as a gauge of the success or failure of our trade policy.

Conclusion

Let me conclude by pointing out what is at stake in meeting the challenge of sustaining America's growth. Since the productivity slowdown of the early 1970s and until recently, real wages and standards of living have stagnated, especially for those at the bottom of the economic ladder. Gains achieved during expansions were given back in recessions. Now that we have achieved a high-employment economy grounded in sound policies, we have the potential to overcome some of the longer run problems that have plagued the economy for a long time. Continued strong investment should encourage growth in productivity and real wages. Strong labor markets should provide opportunities for workers who might otherwise have been discouraged to acquire job skills and experience that will create a stronger labor force attachment. Certainly, this Administration is committed to pursuing the policies most likely to achieve these gains.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: rosanne.cahn@csfb.com@INET@LNGTWY (rosanne.cahn@csfb.com@INET@LNGTWY [UNKNOWN])

CREATION DATE/TIME:15-SEP-1998 11:11:33.00

SUBJECT: message + attached report

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

TEXT:
Dear Janet:

I found our luncheon discussion quite interesting. It challenged me to think of the implications of my hypothesis about too much saving from your point of view--policy. Normally, I think about it from the financial market point of view, with the simplified implication being that asset prices will continually be run up, inevitably to be followed by some form of "crash," until global excess saving is diminished by more sensible policies specific to that issue, which I do not expect to occur anytime soon.

Weaving together four threads--Kindleberger's book (you might consider rereading it), what Mimi Sasaki-Smith has been telling me about the consequences an excessively easy monetary policy in Japan (leveraged investors borrow there for nothing and balloon asset values everywhere else with the proceeds), some of the work our strategist, Chris Callies has done (the consequences of margin calls on said hedge funds when the markets finally cracked) and my work on excess global savings--I conclude that an even bigger global bubble in asset values will occur in the next few years, followed by an even bigger crash. Easy monetary policy looks like it's going to spread to most countries. The combination of easy monetary policy with a structure generating too much saving (and no sign of structural reform in the countries that are the biggest sinners) suggests that more of the monetary ease will go into increasing asset values than increasing demand. Uh oh--not exactly what we need.

And then all the erstwhile capitalists, like George Soros, go crying on the op-ed pages with self-serving pleas for salvation for countries, like Russia, that no one should have invested in in the first place.

I've attached my most recent report about "Fair-Weather Capitalists" and will e-mail you about 4 others, one per e-mail, that cover the topics that we discussed at lunch. I'll also add you to my list for future reports.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D72]MAIL47971575R.226 to ASCII,
The following is a HEX DUMP:

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Equity Research—Americas

Industry: Economic Comment
September 11, 1998
EP3217

Rosanne M. Cahn 212/325-4729 *rosanne.cahn@csfb.com*

Fair-Weather Capitalists

AHNomics

Financial market participants express a deeply held belief in "market" economic systems. Yet when asset prices decline there is a quick cry, like that of a toddler, for a powerful figure to make it better. As in that analogy, short-term comfort may be forthcoming, but it is of limited use if long-term solutions do not follow.

Market systems, unlike those that are administered by humans, are neutral with respect to who gets rewarded and who gets hurt, embodying no concept of "fair." Markets are relentless in optimizing allocation of resources, punishing economic agents that get in the way, but handsomely paying those who get it right.

Real markets, even financial ones, are not like the atomistic academic ideal. Unavoidable market imperfections, such as monopolies, cartels, externalities (such as pollution), cause the system to function suboptimally. Financial markets get overwhelmed by emotional waves at tops and bottoms, rendering other analysis, even when accurate, irrelevant.

Even so, this process lacks an arbitrary nature. Financial markets evince a firm faith in Fed Chairman Greenspan's ability to get it right. That confidence seems solidly based on his record during the prosperous 1990s. Yet this is the same Alan Greenspan who declared on December 5, 1996, some 1200 Dow-Jones points ago (and a bigger 31% on the S&P 500), that the U.S. stock market was deluding itself with irrational exuberance. Smart as he is, he was wrong about that one. No single human being, nor group, can know as much as is embodied in the combined actions of all economic agents.

Carrots and sticks are essential elements of making sure that economic agents do the "right thing." That is, of course, not a moral statement, but instead refers to firms maximizing profits and individuals maximizing utility. It refers to government policy being stable, and neutral with respect to market forces, e.g., not playing favorites with tax policy. It means that governments should enforce the order of law with respect to property rights, contracts, etc., so that commerce can be conducted without interference from unlawfulness and chaos.

U.S. Deregulation and Market-Opening Efforts

In the past two decades the United States has followed an erratic path away from government control toward market determination. For example, deregulation of transportation industries took place 20 years ago under President Carter, and presidents since then have advanced deregulation. This has had a profound influence in reducing U.S. service-sector costs. Administrations also worked slowly but steadily toward tearing down international trade barriers.

Demise of Communism

Overseas the moves away from command-and-control systems toward ones that were more market-oriented have been younger in vintage but at times produced spectacular results, notably the demise of Communism.

Financial Markets Force Change. . .

Financial markets have occasionally forced change that policymakers resisted, such as the breakup of the ERM in 1992.[1] Currency markets compelled Japan to face up to its inconsistent policy of trying to prevent the yen from weakening and keep stock and bond prices stable in the wake of the burst bubble in 1990[2] and to import more in 1994.[3]

. . . Or Discipline, Eventually

Developing countries that borrow abroad would seem to have an external discipline through the lender. However, that has proved to be weak. Only when borrowing reached extremes did currency markets step in to insist that denial give way to recognition of economic reality. The Latin American crises of 1974 and 1982 were finally precipitated by the currency markets, but long after lending became ludicrously high.

The Beginning of the End of Excess Saving and Investment

More recently, currency markets and then stock markets have insisted that the overexpansion in Asian countries' production come to a halt.[3] Created by policies that were quasi-centrally planned, in such forms as government-business partnerships or governments that picked winning industries to foster, excess saving within the countries (as well as the overflow from Japan) built up capacity to provide more goods than world markets could absorb at reasonable prices, even before Asian demand itself fell away.

The problem with all the solutions that have been tried, including the International Monetary Fund bailout (with conditions attached), is that the appeal to old authoritarian responses will quickly become irrelevant if the underlying problems are not identified and changed.

This raises the question of what the fundamental economic imbalance is.

We have argued that the globe is floating in a sea of excess saving and investment. This conclusion flies in the face of received wisdom, with most analysts whining about too little. The drive of responsible people to provide for the future is how we got into this fix in the first place. The hard-headed, unopinionated, market system is in the process of driving the transition to a better balance between consumption and investment.

Consumer and Producer Both Important

A company cannot earn a reasonable rate of return nor employ workers unless it sells its products or services. If all countries were to pursue export policies similar to some Asian countries, such as Japan, who would buy the output? In classic economics, neither the customer nor the producer merits special treatment.

[1] R. Cahn, "The Voter Creates Economic Policy—The Financial Markets Are Their Tools," *Weekly Insights*, September 17, 1992, "The Financial Markets Force Policy—Phase II," *Weekly Insights*, November 25, 1992.

[2] R. Cahn, "The Perils of Planning," *Weekly Insights*, March 2, 1990, "The Yen Crisis," *Weekly Insights*, August 8, 1994

[3] R. Cahn, "Another Farewell to Central Planing," *eCAHNomics*, January 16, 1998.

A market economic system does not produce the maximum amount of anything—saving, investment, market share, productivity, jobs, consumption, wages, steel, toilet paper—but rather the efficient amount. It does so by transmitting price and rate of return signals that tell economic agents how best to orient their efforts to earn the highest labor or investment income.

Data Show that Investment Is Too High. . .

The data suggest there is too much saving and investment worldwide. (Savings equals investment, so anything that is true of one is also true of the other.) As shown in Chart 1, the ratio of investment to GDP is about 23% for the world—19% for developed economies and 29% for developing ones. They should have higher investment. Their need for infrastructure and housing is great. Their companies add state-of-the-art capital to lower labor costs, taking market share from higher-labor-cost countries, freeing up expensive labor to produce higher-value-added output. However, intuitively, a 10-percentage-point gap seems too large.

. . . Especially in Asia. . .

Several Asian tigers have even higher ratios—42% in Malaysia, 36% in Thailand (down from a peak 41%), 35% in Korea, for example. Notice that these are troubled economies. Singapore's ratio was 48% from 1982-84, meaning that nearly half of its annual output was investment, now down to 35%.

. . . Which Is the Core of Japan's Problems

In Japan, investment accounts for 28% of GDP (see chart), nearly as high as the average for developing countries. Its saving is even greater, another 3% of GDP. Japan's too much saving chasing too few productive investments caused its asset price bubble in the 1980s. When the bubble burst, it destroyed the excess saving. More recently, Japan plowed its saving into nearby Asian countries, exacerbating their excess investment situation. Poof. Now that's gone too.

By contrast, the United States, France, United Kingdom, and Italy all have ratios of 18% or less. There is no macroeconomic evidence of too little savings or investment in these countries, despite anecdotal dissatisfaction (too few high-price hotel rooms in New York City, poor roads in the United Kingdom, for example).

Even U.S. Saving and Investment Might Be Too High

First principles suggest that the United States may have too much saving and investment. Both are tax-advantaged (tax-free retirement contributions, deductibility of accelerated depreciation). Generally, anything that benefits from favorable tax treatment is overrepresented in the economy versus what would occur if everything were taxed equally, leaving markets to determine efficient allocations.

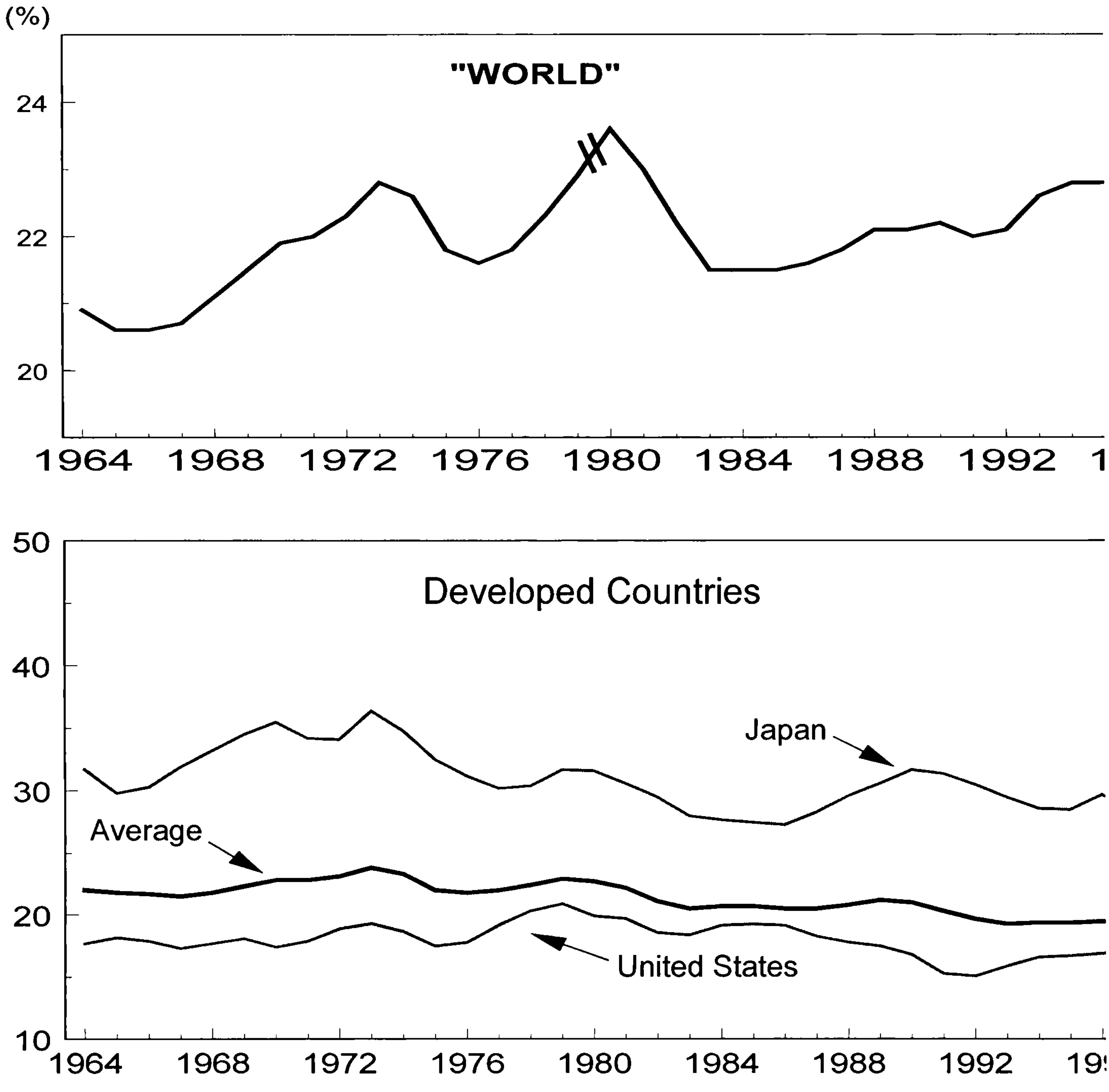
But Is Low Enough to Help Out

The U.S. savings rate is lower than its investment rate. Now apparent, that was not caused by the government deficit. The United States has been essential both by sopping up other countries' excess savings and also by being their consumer of last resort. Without U.S. borrowers, rates of return earned by savers abroad would have been even lower. Without U.S. customers, there would have been fewer jobs in Japan and other Asian countries. The United States has not suffered either.

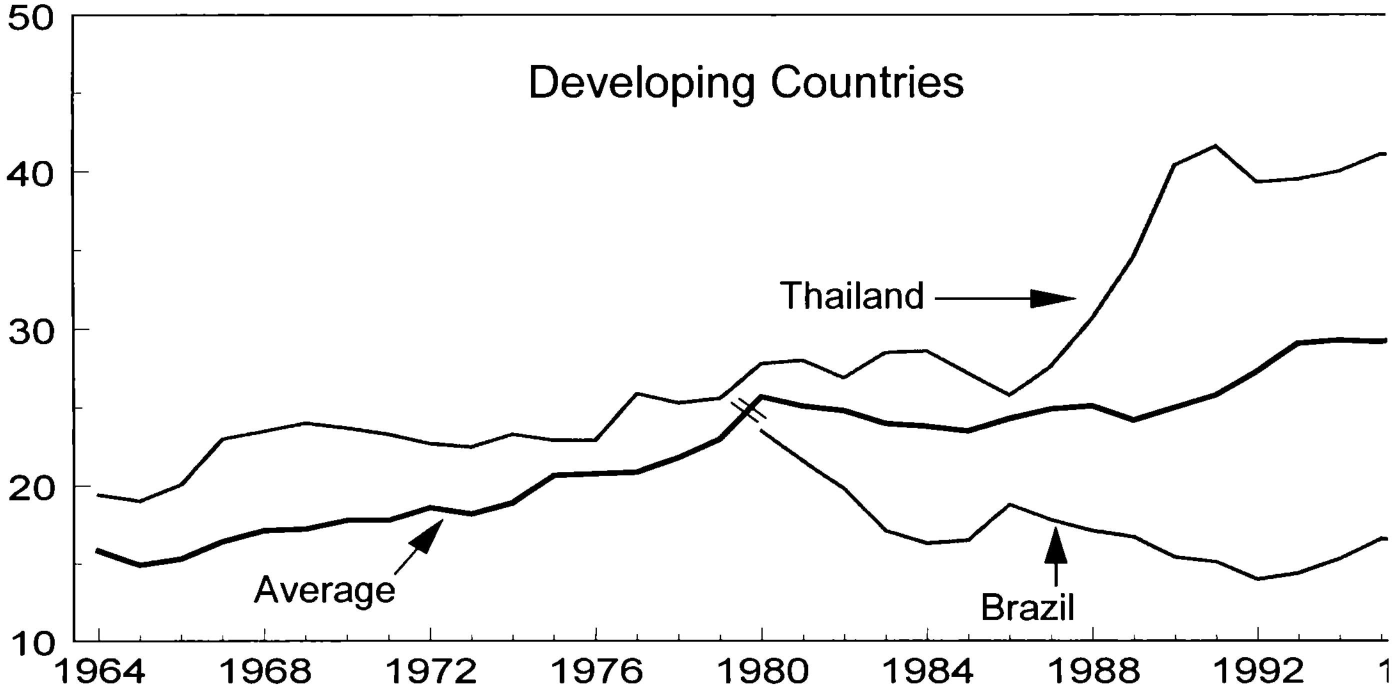
Destruction of Excess Saving Is Market's Way of Teaching Policymakers

Market economic systems, when working properly, tend to be self-correcting, usually by causing pain, essential in the learning process. One way to view the Asian crisis is that financial markets are telling those economies that they have too much saving and investment. In the case of the smaller, developing economies, the financial markets are forcing them to adjust quickly to more sensible policies that will benefit their own consumers, workers, and investors sooner. Japan has enough internal resources to resist, not in the interest of its economy, but perhaps favoring certain powerful parties.

Chart 1
Gross Fixed Capital Formation as a Percent of GDP



[Automated Records Management System Hex-Dump Conversion]



"World" Includes United States, Canada, Mexico, Germany, France, Italy, United Kingdom, Spain, India, Indonesia, Korea, Thailand, Malaysia, Philippines, Singapore, and Australia before 1980; thereafter, China, Brazil, and Argentina are included. This accounts for about 70% of world GDP before 1980 and 85% thereafter.

Gross fixed capital formation includes government investment, residential investment, and business investment.

Source: International Monetary Fund.

[Automated Records Management System Hex-Dump Conversion]

The consequences of too much global savings and investment are improvident lending (no matter what strictures are imposed by authorities) and successive runups in asset prices, followed by crashes, the purpose of which is to destroy the excess saving. Downward pressure on prices of goods produced by too much investment will hold the world in disinflation.

Powers-that-Be Resist Change

Policymakers chafe under the yoke of market systems. They are reluctant to yield power. They wish to replace complex systems with simple solutions. Thus some of the more authoritarian regimes, such as Malaysia and Hong Kong, impose capital controls or try to manipulate markets. Long-standing control advocates, such as Jack Kemp, revive in popularity. Erstwhile free-market defenders such as Rudiger Dornbusch and Paul Krugman of M.I.T. cave in to the uncertainty of the moment.

Less Control, Not More, Is Solution

Exchange-rate and other capital controls do not solve fundamental structural problems, only mask them for a period. Unless economies are to return to tighter and tighter controls, these old methods will soon enough be defeated by markets. Rates of return on financial and real assets will continue to be unrewarding (and often negative) for those who insist upon overemphasizing saving and investment and underemphasizing consumption. That's the bad news.

Interest Rate Cuts Do Not Address the Problem

Interest rate cuts, by the Fed in isolation or coordinated among major economies, could provide only temporary relief. They would not be responsive to the core of the problem. They would also establish a terrible moral hazard (reward for bad behavior) that countries need not mend their counterproductive policy ways because central banks are on the ready to bail them out (without extracting the meager concessions wrought by the I.M.F.).

Look Forward to Market Forces Winning

The good news is that if our analysis were accurate, it would present a wonderful future for standards of living around the globe. It would mean that everyone could consume more now and still have plenty left over to provide for the future. Economic leaders should cede influence so we can get to the better outcome sooner.

N.B.: Text written September 11, 1998.

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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Elise H. Golan (CN=Elise H. Golan/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:16-SEP-1998 07:23:24.00

SUBJECT: Export Enhancement Program for Flour

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

TEXT:
Janet,
I made a few phone calls. Hard to say whether EEP will wither and die or whether a new round of meetings will be convened. Dan Heath at OMB doesn't think that the issue will go directly to the top of anyone's agenda. He was pleased that State is no longer pro-EEP. The pro-EEP voices are now restricted to USDA and Commerce, with OMB, Treasury and CEA against. USTR seems to be sitting on the fence.

I have the suspicion that Ag will get anything it wants for the next few months.

Elise

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Bert I. Huang (CN=Bert I. Huang/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:16-SEP-1998 21:11:40.00

SUBJECT: Charles Schultze, Herb Stein, and You

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

TEXT:
Dear Janet,

What would you think of a Brown Bag lunch -- featuring Charles Schultze, Herb Stein, and you -- talking about the role of CEA over the years?

I think it will be meaningful to see our own work so displayed in the gallery of history. Perhaps we could schedule it to be a motivating break during the long, dark ERP winter.

Becky suggested Schultze and Stein since they are often in town at Brookings and AEI. Of course, both have written and spoken widely about the business of advising presidents.

If you are interested, please let me know what days and weeks are generally best for you, and I'll invite them and coordinate schedules.

Thanks! Bert 5-5618