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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	Janet L. Yellen to Sarah Johanna Reber at 11:48:43.00. Subject: Re: Hello. (1 page)	10/13/1998	b(6)

COLLECTION:

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[10/06/1998 - 10/15/1998]

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]
- 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: Matthew R. McBrady (CN=Matthew R. McBrady/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 6-OCT-1998 02:25:01.00

SUBJECT: Re: NABE Speech - final draft

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

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

TEXT:
Janet,

Here is a copy of the checked version of your speech. I took the liberty of making a few changes, ranging from substantial to trivial. I also noted some instances in which you might want to make some fairly precise changes. Here they are (respectively):

Changes I made:

1. The only material fact which I could not verify was 1997 Japanese real GDP growth. On page 5, about half way down, you had noted it at - 0.4%. According to various World Economic Outlooks, it was recorded as 0.8%. Calculating real growth (in 1990 dollars) from October's IFS, the value obtained is a bit higher (at 0.89%). Since the value is highly dependent upon the price index chosen, other values might exist. If you have the -0.4% in a credible primary source, please change it back. At this stage, however, I took the liberty of changing it in the text to 0.8%.

2. On page 4, you refer to the drop-off in exports to the Seven Asian economies. Actually, exports to China are up in 1998, both year-on-year and seasonally adjusted (the latter vis-a-vis 1997 Q2). As we have been citing in the table we produce with each month's trade stat release, then, it is only fair to cite falling exports to Six Asian economies.

3. Editorial and otherwise trivial changes: I spelled out NAB -- New Agreement to Borrow -- since it was never originally referenced in the text in long form. I replaced "illiquid" with "troubled" on page 7 three-forths the way down. I also changed the "Asia Development Bank" to the "Asian Development Bank" and added an "s" to "government official" on p. 10. I pretended to be an I/O economist and busted up a very long sentence that was monopolizing the bottom of the page 12 market. Finally, I added a couple of commas where my English-teaching mother verified they needed to go. (Though I suspect one does not generally take the term "primary source" quite so genetically or literally...)

Other suggestions (ie things that I did not change):

1. From a bigger picture point of view, I got a little disoriented on

around page 9 with regard to whether or not you were still refering to the G-22 report. Leading off the second full paragraph with "Most analyses" threw me off the trail at first. I thought the discussion of the report was done, and you had moved on to other analyses of the situation. Then, for the next three pages, you came back to the report. It is an important report, and merits that detailed a treatment in the speech. Leading off with "The report echoes most other analyses of the crisis, which point to..." on page 9 might eliminate the confusion. (As written, it also made much more sense when I stopped and re-read the section. So, my initial confusion might have been idiosyncratic as well.)

2. When I wrote the world growth slowdown International Round Up, my fact-checker would not let me get away with calling the economic episodes of 1974-75, 1980-83, and 1990-91 "recessions." I thought it a bit extreme, but it didn't pass our acid test (meaning I had no primary sources stating that official recessions began and ended during those time frames). Using the phrase "pronounced world slowdowns" somehow lacks the same panache, though. It might be useful to get someone skilled in accessing domestic macro data to verify that the recessions did actually begin and end in those years.

3. On p. 4, you state the [US] manufacturing sector is experiencing weakness related to the crisis' impact. All I could scare up was information suggesting that job creation is a bit lower (but still positive). Some might take issue with this being an experience of weakness. Unless you have seen better data, a better phrasing might be "manufacturing sector is weakening as a result of the crisis" -- this seems more a statement of first derivatives than levels.

4. On page 7, you refer to a World Bank study that cites 20-65 percent of firms in Korea, Indonesia, and Thailand have balance sheet losses greater than equity. The phrase "balance sheet losses" is a bit ambiguous -- is it large cumulative accounting losses (thus leading to negative retained earnings in excess of book valued equity)? More directly, I have not seen this study, so was unable to verify the numbers. They seem in the ball park of what Nouriel and I have been hearing, though.

5. Page 1, the length of the recovery. Depending on whether you choose to start the recovery inclusive of March 91 or not, it needs to last either through December or to December to take over second place.

6. Finally, I accessed no primary data on farmers, but have seen repeatedly that agricultural prices and exports are down, and farmers are getting pinched. From a fact-checking protocol point of view, though, this is insufficient. If you have not seen primary data yourself indicating these facts, it might be worthwhile to check with Elise to make sure they square up.

7. Ditto for the tightening of credit standards and loan terms. I have seen that at least anecdotally a number of times in recent weeks, but have not found it in a primary source. If you haven't seen it recently, checking with Doug might make sense.

With these minor qualifications, consider it checked. I can try to follow up on 2, 3, 6, and 7 tomorrow AM if you think it's necessary, or if you haven't seen the data yourself. Otherwise, good luck with the speech!

-Matt

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D42]MAIL42875597Z.226 to ASCII,
The following is a HEX DUMP:

Remarks of
Janet L. Yellen
Chair of the President's Council of Economic Advisers
at the National Association for Business Economics
October 6, 1998

Thank you. It is a pleasure to join you at the 40th Annual Meeting of the National Association for Business Economics. Last June I received a brochure from the organizers of this meeting asserting that "We live in a golden economic age--healthy economic growth, low inflation, low unemployment and rising stock markets." It goes on to ask "Will this scenario continue into the next millennium?" The Administration's overriding objective is to ensure an affirmative answer to this question. This afternoon, I would like to describe some of the policies we believe are required to maximize the odds that the economic prosperity we are enjoying will indeed continue into the next millennium.

Let me begin by agreeing with the brochure's main assertion. U.S. growth has indeed been strong and inflation and unemployment remain exceptionally low. Contrary to the brochure's statement, the stock market has not continued to rise, but even with the retreat from its July high, household net worth remains at extraordinary levels relative to disposable income. In all of these ways, U.S. economic performance has been excellent. With all the recent attention on baseball records, it is worth noting that our economy too is on track to set a record this year. With continued growth through December, this expansion will enter its 93rd month, replacing 1982-90 as the longest peacetime expansion on record. But we should be much more ambitious. If growth is sustained into the next millennium, until February 2000 to be exact, this expansion will become the longest on record, surpassing the expansion of 1961 to 1969, which lasted 106 months.

But what are the odds that we can achieve this record? Although continued solid growth into the next millennium remains a likely outcome, the risks to this forecast have risen substantially as a consequence of the growing turmoil in international financial markets and the marked slowing of growth we are now witnessing in the world economy. Therefore, policies to contain the current crisis, to promote growth in the world economy and--taking the longer view--to reduce the odds of future crises-- are top priority items on the Administration's growth oriented economic agenda. I would like to focus primarily on these international issues in my remarks today touching only briefly on other policies that are needed to promote prosperity into the next century.

More than a year has elapsed since the Asian crisis began. Unfortunately, what started as a regional economic and financial crisis in East Asia has now developed into a larger global crisis, spreading to financial markets around the world, impacting global commodity markets, impairing economic development and imposing extraordinary hardship in the crisis afflicted countries, and posing risks to growth in industrial countries including the United States. There are few countries around the globe that have been unaffected.

The economic slump in the original crisis countries (Korea, Indonesia, Thailand and Malaysia) remains severe. The spillovers to other countries in the region, such as Hong Kong and Singapore, have been substantial. Japan, already in a serious and deepening recession prior to the crisis, has seen a significant decline in its exports to its key Asian trading partners, and its banks have been hit with financial losses related to lending in the region. Currencies and stock markets in Latin America have come under pressure, especially following the crisis in Russia. Emerging market spreads over Treasuries, about 1500 basis points in September 1998, are now

close to their highs during the 1995 Mexican peso crisis. The appetite for risk of international investors has fallen and there is some retrenchment from emerging markets towards safe haven assets and from stocks towards liquidity.

Over the past year, commodity prices have also declined, impacting industrial countries like Canada, Australia and New Zealand. In Latin America, the fall in oil prices has hit Mexico and Venezuela; the fall in copper prices is hurting Chile and Peru; and the decline in agricultural prices is affecting Argentina. Globally, all commodity exporters are hurting.

The impact of the crisis on the prospects for worldwide growth is evident in the most recent IMF *World Economic Outlook*, released in October 1998. The IMF now forecasts 2.0% world real growth in 1998, a precipitous drop from the 4.3% growth expected in October 1997. Forecasted world growth for 1998 is now comparable to levels not seen since the pronounced world recessions of 1974-75, 1980-83, and 1990-91. Japan's economy is expected to decline by 2.5%. The newly industrialized Asian economies (Hong Kong, Taiwan, Singapore, and Korea) are predicted to contract by 2.9%. The economies of the ASEAN-4 nations (Indonesia, Malaysia, Philippines, and Thailand) are now expected to shrink by a staggering 10.4%. Moreover, expected growth in the developing countries in the Western Hemisphere is now 2.8%, down from 5.1% a year ago; and Russia is expected to contract by 6% this year.

From the U.S. standpoint, the main impact of the international financial crisis on our economy to date has been a deterioration of net exports and a widening of the trade deficit. 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 six Asian countries: 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. The manufacturing sector is experiencing weakness related to the crisis' impact. Financial institutions with emerging market exposure have also suffered losses and are exposed to further losses, particularly if the impact of the crisis spreads to important trading partners in our own hemisphere; and market volatility has clearly increased. We have recently seen rising spreads on corporate debt, dramatically so in the case of junk bonds, and there has been a noticeable recent tightening of credit standards and loan terms in commercial lending--evidence of a generalized flight to safety by participants in financial markets. These conditions imply an effective tightening of financial conditions. Further deterioration in the international economic situation remains the single largest risk to a forecast of continued solid growth into the next millennium.

Turning to the question of how to sustain America's growth, the first imperative is to work with the international community to promote growth in the world economy and to stabilize international financial conditions. Chairman Greenspan noted recently that no country, including the United States, is an island in the world economy. The growth prospects of all industrial nations will suffer unless we all do our part to help the world economy to grow. This need has been clearly recognized by the G-7 finance ministers and central bank governors who issued a joint statement several weeks ago 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. Strong growth in the industrialized countries is a prerequisite for recovery of crisis afflicted economies.

In serving as a major engine of global growth, the United States will inevitably see an increase in its trade deficit and some sectors, particularly those that are heavily exposed to trade, will experience disproportionate impacts. Even so, the United States must accept a rising trade deficit if the crisis countries are to recover. This means working to counter protectionist pressures at home just as we urge the crisis impacted countries to keep their own markets open. The Clinton Administration is committed to outward looking, internationalist policies.

As the world's second largest economy, Japan has a key role to play in maintaining world economic growth and its performance will determine the prospects for Asia's recovery. Japan has now entered a full fledged recession. Real growth over the four quarters of 1997 amounted to 0.8%. In the first half of 1998, Japanese real GDP was down 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. The United States continues to believe that Japan must take strong measures to stimulate domestic demand, to restore confidence, to deal with the problems of its banking system, to open its markets and to deregulate its economy.

Beyond working to insure growth in the industrial world, the United States has been focused since the outset of this crisis on the need to contain financial contagion and to restore the confidence of market participants--a prerequisite for capital flows to continue. 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. It is now widely agreed that structural weaknesses, particularly in the process of financial intermediation, were an element in initiating the crisis. 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 inefficient or insolvent banks.

In a speech last Thursday, Secretary Rubin emphasized that the contagious effects of the ongoing crisis now threaten countries that have made great progress in implementing sound macroeconomic and structural policies and worked to strengthen the fundamentals of their economies. To deal with such threats, the President proposed on Friday to create a precautionary financial facility based in the IMF whose goal would be to provide assured access to assistance in the event of need to countries with sound policies which have acted responsibly, thereby helping them fight off the contagious impact of the ongoing crisis. In its communique on Saturday, the G-7 ministers and governors indicated their willingness to explore this idea. However, for the IMF to play its critical role in countering contagion, its resources must be expanded and the key step is for the U.S. at long last to meet its 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 New Agreement to Borrow. 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 emergency 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 affected countries.

In his speech at the Council on Foreign Relations, 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. In Indonesia, Korea and Thailand, for example, the combination of sustained high interest rates and illiquidity has led to harsh economic contraction and a vast overhang of bad debt. Debt to equity ratios that were already very high before the crisis (about 300% in Korea for the top 30 chaebols) have become unsustainable now (over 500% in Korea, 400% in Thailand and even higher in Indonesia) due to the real devaluation of their currencies and the burden of high real interest rates. In Indonesia, Korea, and Thailand, the World Bank estimates that 20-65 percent of firms have balance sheet losses greater than equity. When insolvent, highly leveraged companies cannot service their debt, a self reenforcing spiral is created in which banks' cash flows are squeezed, forcing them to contract new lending not only to troubled corporations but even to those in better health. The object of comprehensive restructuring is to restore the flow of credit so that firms in these countries can get back to the business of producing output and creating jobs.

In an effort to insure access of crisis impacted countries to critical imports and to help American businesses continue selling abroad, the Export-Import Bank will establish new

short-term credit facilities for critical Latin American markets. We will coordinate these efforts with our counterparts in other leading industrial nations to ensure that trade credit continues to flow during this period of financial stress. Moreover, to keep private capital flowing to crisis impacted economies, the Overseas Private Investment Corporation (OPIC) has developed a new instrument to help emerging economies raise money from international capital markets.

The President also has asked the World Bank and Asian 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.

Even as we work to mitigate the impact and contain the spread of the current crisis, the Administration is collaborating with other countries to find ways to strengthen the architecture of the financial system so that it is less crisis prone going forward. 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. Yesterday, at a meeting attended by the President, ministers and central bank governors from a group of industrial and key emerging market countries presented reports containing a plethora of recommendations to strengthen the international financial system. The work of this committee represents a continuation of a process begun in Naples and Halifax. It focuses on measures to increase transparency and strengthen financial systems, and proposes strategies for orderly workouts in the event of a future crisis.

There is a broad consensus on the need for greater transparency and openness both on

the part of debtor countries and official institutions such as the IMF. The Working Group report on

transparency and accountability stresses the need to enhance the relevance and reliability of information disclosed by the private sector through compliance with high-quality accounting standards. It calls for braodening the public disclosure of data_on foreign exchange reserves, external debt and financial sector soundness. And it recommends greater disclosure of data on the international exposure of investment banks, hedge funds and other international investors. Finally, it urges the IMF itself to be more open and transparent.

Transparency is necessary to provide investors with the information necessary to evaluate risk in lending, but such measures are not likely to be sufficient on their own to prevent another major crisis from occurring. In the current crisis, for example, some information was unavailable, but available indicators, many signaling caution, were apparently ignored by investors.

Most analyses of the crisis point to financial sector weaknesses as a central cause. 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 undercapitalized financial systems, 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 dramatically increased access to funds from abroad. Accordingly, the report proposes a series of reforms to strengthen domestic financial institutions and to create stronger incentives for borrowers and lenders to weigh risk and act with appropriate discipline, thereby reducing the odds of a crisis.

The task of strengthening financial systems is long-term and daunting. A partial list of needed elements 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 officials and regulators; improved corporate governance in both the financial and non-financial sectors; and implementation of efficient insolvency and debtor-creditor regimes.

The experience of Asia suggests that an excessive accumulation of short-term foreign currency denominated and unhedged foreign liabilities by the financial system was an important

cause of the financial fragility that triggered and exacerbated the crisis. Mismatches between the maturity and currency composition of financial institutions' assets and liabilities and an incorrect assessment of liquidity and currency risks aggravated the problem. These structural weaknesses, together with the herdlike mentality of international investors, who withdrew funds and failed to rollover their loans to the debtor financial institutions, triggered the crisis. Clearly, cross-border short-term interbank flows are highly volatile and there is now broad agreement that, at the minimum, they should be addressed in a strengthened regime of prudential supervision of banks. In addition to proposing measures to strengthen financial systems and guard against the buildup of unsustainable risk positions, the G-22 report proposes measures to strengthen the incentives of debtors and creditors to behave prudently. In particular, the report emphasizes the need to limit the scope of government guarantees and implicit insurance schemes, to maintain appropriate exchange rate regimes, and to develop methods for greater risk sharing between debtors and creditors, including increased reliance on bond markets as an alternative to bank finance. In recent crisis episodes, governmental guarantees at many levels apparently reduced the perception of risk by lenders and borrowers. In many countries, there was an expectation that corporations and banks would be bailed out by governments in the event of trouble. In many instances, too, the incentive of private parties to hedge exchange risk was diminished by the prevalence of fixed or semi-fixed exchange regimes. Such implicit and explicit guarantees may have distorted incentives, encouraging both debtors and creditors to take on excessive risk, to fail to hedge that risk, and to ignore available information pointing to potential problems. The report concludes that limiting guarantees, making those which are offered as explicit as possible, and pricing them appropriately could also contribute to crisis prevention.

While strengthening domestic financial systems may prevent some crises and make those that do occur less virulent, it is still likely that crises will not be eliminated altogether. And while a well designed insolvency regime can facilitate orderly workouts of corporate debt, the G-22 report emphasizes that no comparable internationally agreed and binding bankruptcy regime is likely to emerge to handle sovereign debtors. The report emphasizes that **temporary suspensions of debt payments should occur only in extreme situations as a last resort after all other reasonable alternatives have been explored.** But in such instances, there is a need to develop mechanisms to facilitate the orderly workout of sovereign liquidity crises and it is essential for the private sector to share in the burden of crisis resolution.

Private sector burden sharing is critical, not only because official money is unlikely to be sufficient in all circumstances, but also because it is absolutely essential in inducing market discipline and reducing potential moral hazard problems deriving from official assistance. In spite of its importance, private sector burden sharing is more difficult to achieve now than in the days when banks accounted for the bulk of international capital flows. Today, the proliferation of creditor institutions and instruments and the growth of international bond markets makes the problem of coordinating the actions of creditors during a crisis extremely difficult. **Thus, a key recommendation of the G-22** is to include **"collective action clauses" in bond contracts to provide for: collective representation of creditors; majority action to alter the** payment terms of a contract; and sharing of payments among creditors. All of these provisions work to facilitate speedy and orderly workouts.

One question on which researchers and policymakers remain sharply divided concerns the desirability of implementing controls on flows of capital, in advance of a crisis, to prevent the potential disruptions associated with volatile international capital flows. Debate on this topic is certain to continue. However, there is some agreement on the need for appropriate sequencing of capital account liberalization. The G-7 Finance Ministers statement at the Birmingham summit noted that, while progressive liberalization of a country's capital account may be warranted over time, countries should be careful to proceed in an orderly way. With strong financial systems, the arguments in favor of unfettered capital flows are strong. But during such a transition, the liberalization of the capital account should be gradual and carefully managed. Excessive accumulation of short-term debt, excessive borrowing and lending, mismatches of maturities and currency denomination of assets and liabilities of financial institutions and corporate firms--all factors that have proven so destabilizing in many recent and not so recent episodes of financial and currency crises--must be avoided.

The international crisis has forced countries around to globe to confront the necessity of implementing the sound domestic policies which are ultimately fundamental to promote long-term economic growth and inspire investor confidence. The United States is no exception. From the outset, the Clinton Administration has focused on getting the policy fundamentals right to help the United States grow and to inspire investor confidence. 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 into the next millennium.

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 played an important role 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 although, like domestic competition, it brings challenges when it disrupts established patterns of economic activity.

Conclusion

Let me conclude by pointing out what is at stake in meeting the challenge of sustaining America's growth into the next millenium. 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: Jsalop@worldbank.org (Jsalop@worldbank.org [UNKNOWN])

CREATION DATE/TIME: 6-OCT-1998 16:03:35.00

SUBJECT: high-level women

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

TEXT:
Janet,

Thank you again for participating on Friday -- you really helped the discussion. Plus it was very nice to see you.

I was also hoping to involve you in another event -- possibly a seminar or lecture at the Bank. I believe it is important to show women like you off -- both to Bank Senior Management (mostly men) and to young women coming up.

If you're game, we could think about a specific event. We're open as to timing and topic -- but it would be great to hear about the US economy in time of global financial turmoil. I'd prefer to do it sooner rather than later -- maybe November?

Please let me know.

Joanne

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 6-OCT-1998 00:31:04.00

SUBJECT: Nouriel

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

TEXT:
Janet, today Tuesday I need to be at the IMF/WB meeting for the US delegation at 8.00am. So I will not show up in the office in the morning. However, I got the pager and batteries and will call in to make sure that the speech is ok and that the connection with the pager is ok too if need comes for me to give the speech. Will try to call you around 8.00am.
Nouriel

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 7-OCT-1998 14:47:29.00

SUBJECT: NCEE speech

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

TEXT:
Attached is a draft of your National Coucil on Economic Education speech. In the invitation they ask you to speak for 5-7 minutes. And they ask that you "remark on the importance of economic literacy in informing policy debate, and comment on some of the similarities between the CEA and NCEE and its network in their activities of educating American people about economics and economic issues." This draft may be too long. And substantial portions are taken from your other speeches. But, it's a draft. Let me know if you'd like me to do more work on it.
Thanks.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D2]MAIL441834181.226 to ASCII,
The following is a HEX DUMP:

NATIONAL COUNCIL OF ECONOMIC EDUCATION

Remarks by CEA Chair Janet Yellen

October 15, 1998

Thank you for inviting me to be here tonight. I want to congratulate the National Council on Economic Education for it's work in advancing the understanding of economics, developing creative resources for economics teachers and promoting informed decisionmaking about economic choices. I also want to congratulate the "outstanding teachers" who will receive awards tonight. Your efforts to develop innovative educational programs and motivate students to learn economic concepts is a gift to society. And, you deserve our thanks.

I am a true believer in economic education. I believe that having a basic literacy in economic reasoning is as essential as the traditional 3 R's to informed decision making by individuals, households and firms. Before coming to Washington 4 years ago, I spent 23 years teaching microeconomics, macroeconomics and international finance to undergraduates, PhD students, MBAs and business executives. It has truly been a pleasure for me to see my students put economic insights to work in their daily lives, in running their businesses and in serving as policy makers in government. And, let me say: the core insights of economics clearly have direct relevance to the design and implementation of public policy.

ROLE OF ECONOMICS IN POLICY MAKING

Over the past 4 years, I have had the chance to put my economic training to work in the public interest -- first, in our nation's Central Bank and now, at the Council of Economic Advisers.

Serving as a Governor of the Federal Reserve was a dream that I had harbored ever since

I took my first course in macroeconomics as an undergraduate at Brown in 1965. When the phone rang, in April of 1994, and I was asked whether I would be interested in being considered for the position of Governor of the Federal Reserve System-- it therefore took me all of 2 seconds to say yes.

Monetary policy -- if, properly conducted -- has the potential to mitigate economic fluctuations and to create the backdrop of price stability which is a necessary prerequisite for sustainable growth at a maximum pace. Even more fundamental, the Federal Reserve's task is to insure the safe and sound operation of our national and global financial system. Having a seat at the coveted FOMC table provided an extraordinary opportunity for public service.

It was fascinating to have the chance to debate, to research and to weigh alternative explanations of what is responsible for America's good fortune and to tackle challenging strategic questions relating to the conduct of monetary policy--what its long run goals should be, whether and how to enunciate them, and what tactics to follow in attaining those goals.

Although I had been extremely surprised to receive a call inquiring about my interest in a Governorship at Federal Reserve, I confess that I was literally stunned when, two years later, I received a call from White House Chief of Staff Erskine Bowles asking if I would consider serving as Chair of the Council of Economic Advisers.

The CEA is one of the great creations of the American government--an economic consulting group within the White House. It is one of the smallest agencies in Washington. While others have budgets of billions, the CEA subsists, with its 3 members 10 senior economists, mainly one year rotators from academia, and support staff on a budget that is considerably smaller than that of a medium-sized department of economics, about one thousandth of the budget of the still fairly small Federal Reserve. Nevertheless, the CEA is the mouse that roars.

Beyond keeping the President informed about the key economic developments in the American and global economies, the CEA's duty is to assess the economic impacts on national welfare of the various policy options under consideration by the President relating to any Administration decision with a significant economic component, which is almost everything these days. To make such assessments, the CEA relies on the full body of available economic theory and data, including the most timely and relevant economic analyses available on whatever topic is under consideration. We reach out to the economics profession broadly to assimilate, and incorporate where possible, the best thinking on the topics under consideration.

Indeed, at any time, a dozen or more different issues may be under active consideration and debate: To provide a few examples, over the last year I have been involved in policy processes in the areas of: global warming, affirmative action, entitlements, tax reform, the budget, the tobacco agreement, financial sector modernization, implementation of new programs on children's health and fast track. In spite of this extraordinary range, I am discovering what other CEA chairs before me have observed--that the theoretical principles which most often require emphasis are not those at the frontiers of current research but rather the tried and true principles of supply and demand, opportunity costs, incidence, and comparative advantage that are the bread and butter of mainstream economics--all of the principles familiar to students of Economics One.

By applying core economic principles and focusing on the national interest, broadly defined, rather than any special interest, the CEA has always--in Democratic and Republican Administrations alike--served as a voice for sound and efficient policies. It has stood against the controlled economy in all of its forms. But it has also opposed completely unrestrained laissez faire. It has espoused the importance of capitalism and the market, but recognized that the government has a complementary role to play to make markets work and to address market failures. The CEA has always supported free, and also free-er, trade. We have usually been in favor of deregulation, and where regulation is necessary and desirable, as in the pursuit of environmental objectives, we have favored the use of prices and markets as the preferred means of achieving the object of regulation. And the CEA's job has always been to stop bad ideas from becoming policy and to focus on factors influencing the long run performance of the economy-- particularly its potential to grow.

One of the CEA's most useful roles is examining incentives and looking for loopholes. Faced with a constant stream of well-intentioned proposals, we typically ask: Will the policy actually work as planned? For example, will money given to the states for education or for welfare really be used for these purposes, or will it just add to the general state coffers with the money redistributed as the Governors and the state legislatures wish? Will seemingly small changes in financial regulations dismantle important safety provisions because opening the window a crack is the precursor to unforeseen inventions which will open the window wide? As economists we scrutinize carefully each and every proposal with the question: will the private market undo what the government seeks by legislation or by regulation?

People often make fun of economists. They joke, for example, that economists are always two handed: They typically say:, "On the one hand this, and on the other hand that" or "It all depends." But the body politic errs when it insists that the right answer can fit on a T-shirt. Economists are good at insisting on asking hard questions and demanding solid evidence. For this reason, economists and an understanding of economic concepts and principles is so important to the policymaking process.

IMPORTANCE OF ECONOMIC EDUCATION

My years as a Fed Governor and as Chair of the CEA have given me a chance to put textbook principles of macroeconomics into practice in the policymaking sphere. But, it has also given me a chance to see just how important economic education is in promoting critical thinking, well-reasoned decision making, effective problem-solving and in helping create more educated consumers and citizens. Fundamentally, understanding the choices or tradeoffs that arise from allocating scarce resources is critical to making decisions as individuals, as workers and as citizens. Among other things, economics offers methodologies for framing problems; it teaches logical, step-by-step reasoning; it imposes the discipline for identifying feasible options and relevant constraints; it teaches an appreciation of efficiency and the value of comparing costs and benefits; and it offers guidance in making decisions in the face of uncertainty.

Like the National Council of Economic Education, the CEA plays an important role in promoting understanding of economics and economic policies. Each year, the CEA produces the *Economic Report of the President*, which is a more than 200 page book that describes the state of the economy and the Administration's views on the economy's performance and it lays out the President's economic agenda and the economic rationale for particular policies. The annual *Economic Report* also provides an extraordinarily useful compendium of statistics that is widely used by students, academics, researchers and the business community.

The CEA also produces "whitepapers" on a range of issues, including the quality of jobs being created in the United States, the importance of education and the impact of welfare reform. In most cases, these whitepapers describe the substantive underpinnings and economic rationale for various Administration polices.

The CEA also works on a daily basis with business professionals, the general public and the press to help promote an understanding of current economic and financial conditions and of the rationale for particular domestic or international policies. A public that is informed and understands economics is more likely to understand what policymakers can -- and can not -- do to promote and sustain America's long-term economic health.

CONCLUSION

Let me conclude by saying that understanding economics and economic concepts is important for policymakers and for an informed and effective policymaking process. But it is also important for individuals, for households and for businesses to understand economics in order to make better choices. I applaud the efforts of the National Council of Economic Education to expand and enhance economic literacy. And, I want to again salute tonight's award winners. You deserve thanks for your efforts to kindle the enthusiasm of students for the study of economics and for helping students understand that economic concepts are immediately relevant to their lives and futures. You are laying the foundation of critical thinking skills that will help our nation's young people make better personal decisions, better decisions on the job, and better decisions as American citizens.

Thank you very much.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 7-OCT-1998 17:06:26.00

SUBJECT: Larry Meyer's speech

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

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

TEXT:
Did you have a chance to read his speech to the NABE? Among his interesting comments, he notes that the first phase of the international crisis had bad direct effects on the U.S. economy through net exports but good indirect effects through lower interest rates and probably stronger equity prices. In the current, second phase, the indirect effects through financial markets "will likely reinforce rather than offset" the restraint of net exports. I thought that was a useful to encapsulate the recent shift in outlook.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 7-OCT-1998 18:30:07.00

SUBJECT: Buenos Aires

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

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

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

TEXT:
State Dept has arranged to pick up my tab for the trip to Buenos Aires next week. The plan is to leave Monday night (arrive Tuesday morning), hold meetings Tuesday and Wednesday, and then depart Wednesday night (arrive in DC Thursday morning). Dan Reifsnyder will lead the delegation. Other members will include from State, Victoria Greenfield, from DOE, Phil Tseng and perhaps Rick Bradley, and from EPA, Clare Breidenich and one of the following: Bob Shackleton, Mike Shelby, or Peter Nagelhout.

There is a meeting Friday afternoon chaired by Melinda Kimble and David Gardner with this delegation. I will update you once I learn more.

Joe

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 7-OCT-1998 16:48:20.00

SUBJECT:

TO: arose (arose @ haas.berkeley.edu @ INET @ LNGTWY [UNKNOWN])
READ:UNKNOWN

TEXT:
Attached is a speech I gave yesterday on the financial crisis to the
NABE. ==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D64]MAIL423485186.226 to ASCII,
The following is a HEX DUMP:

Remarks of
Janet L. Yellen
Chair of the President's Council of Economic Advisers
at the National Association for Business Economics
October 6, 1998

Thank you. It is a pleasure to join you at the 40th Annual Meeting of the National Association for Business Economics. Last June I received a brochure from the organizers of this meeting asserting that "We live in a golden economic age--healthy economic growth, low inflation, low unemployment and rising stock markets." It goes on to ask "Will this scenario continue into the next millennium?" The Administration's overriding objective is to ensure an affirmative answer to this question. This afternoon, I would like to describe some of the policies we believe are required to maximize the odds that the economic prosperity we are enjoying will indeed continue into the next millennium.

Let me begin by agreeing with the brochure's main assertion. U.S. growth has indeed been strong and inflation and unemployment remain exceptionally low. Contrary to the brochure's statement, the stock market has <u>not</u> continued to rise, but even with the retreat from its July high, household net worth remains at extraordinary levels relative to disposable income. In all of these ways, U.S. economic performance has been excellent. With all the recent attention on baseball records, it is worth noting that our economy too is on track to set a record this year. With continued growth through December, this expansion will enter its 93rd month, replacing 1982-90 as the longest peacetime expansion on record. But we should be much more ambitious. If growth is sustained into the next millennium, until February 2000 to be exact, this expansion will become the longest on record, surpassing the expansion of 1961 to 1969, which lasted 106 months.

But what are the odds that we can achieve this record? Although continued solid growth into the next millennium remains a likely outcome, the risks to this forecast have risen substantially as a consequence of the growing turmoil in international financial markets and the marked slowing of growth we are now witnessing in the world economy. Therefore, policies to contain the current crisis, to promote growth in the world economy and--taking the longer view--to reduce the odds of future crises-- are top priority items on the Administration's growth oriented economic agenda. I would like to focus primarily on these international issues in my remarks today touching only briefly on other policies that are needed to promote prosperity into the next century.

More than a year has elapsed since the Asian crisis began. Unfortunately, what started as a regional economic and financial crisis in East Asia has now developed into a larger global crisis, spreading to financial markets around the world, impacting global commodity markets, impairing economic development and imposing extraordinary hardship in the crisis afflicted countries, and posing risks to growth in industrial countries including the United States. There are few countries around the globe that have been unaffected.

The economic slump in the original crisis countries (Korea, Indonesia, Thailand and Malaysia) remains severe. The spillovers to other countries in the region, such as Hong Kong, and Singapore, have been substantial. Japan, already in a serious and deepening recession prior to the crisis, has seen a significant decline in its exports to its key Asian trading partners, and its banks have been hit with financial losses related to lending in the region. Currencies and stock markets in Latin America have come under pressure, especially following the crisis in Russia. Emerging market spreads over Treasuries, about 1500 basis points in September 1998, are now

close to their highs during the 1995 Mexican peso crisis. The appetite for risk of international investors has fallen and there is some retrenchment from emerging markets towards safe haven assets and from stocks towards liquidity.

Over the past year, commodity prices have also declined, impacting industrial countries like Canada, Australia and New Zealand. In Latin America, the fall in oil prices has hit Mexico and Venezuela; the fall in copper prices is hurting Chile and Peru; and the decline in agricultural prices is affecting Argentina. Globally, all commodity exporters are hurting.

The impact of the crisis on the prospects for worldwide growth is evident in the most recent IMF *World Economic Outlook*, released in October 1998. The IMF now forecasts 2.0% world real growth in 1998, a precipitous drop from the 4.3% growth expected in October 1997. Forecasted world growth for 1998 is now comparable to levels not seen since the pronounced world recessions of 1974-75, 1980-83, and 1990-91. Japan's economy is expected to decline by 2.5%. The newly industrialized Asian economies (Hong Kong, Taiwan, Singapore, and Korea) are predicted to contract by 2.9%. The economies of the ASEAN-4 nations (Indonesia, Malaysia, Philippines, and Thailand) are now expected to shrink by a staggering 10.4%. Moreover, expected growth in the developing countries in the Western Hemisphere is now 2.8%, down from 5.1% a year ago; and Russia is expected to contract by 6% this year.

From the U.S. standpoint, the main impact of the international financial crisis on our economy to date has been a deterioration of net exports and a widening of the trade deficit. 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 six Asian countries: 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. The manufacturing sector is experiencing weakness related to the crisis' impact. Financial institutions with emerging market exposure have also suffered losses and are exposed to further losses, particularly if the impact of the crisis spreads to important trading partners in our own hemisphere; and market volatility has clearly increased. We have recently seen rising spreads on corporate debt, dramatically so in the case of junk bonds, and there has been a noticeable recent tightening of credit standards and loan terms in commercial lending--evidence of a generalized flight to safety by participants in financial markets. These conditions imply an effective tightening of financial conditions. Further deterioration in the international economic situation remains the single largest risk to a forecast of continued solid growth into the next millennium.

Turning to the question of how to sustain America's growth, the first imperative is to work with the international community to promote growth in the world economy and to stabilize international financial conditions. Chairman Greenspan noted recently that no country, including the United States, is an island in the world economy. The growth prospects of all industrial nations will suffer unless we all do our part to help the world economy to grow. This need has been clearly recognized by the G-7 finance ministers and central bank governors who issued a joint statement several weeks ago 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. Strong growth in the industrialized countries is a prerequisite for recovery of crisis afflicted economies.

In serving as a major engine of global growth, the United States will inevitably see an increase in its trade deficit and some sectors, particularly those that are heavily exposed to trade, will experience disproportionate impacts. Even so, the United States must accept a rising trade deficit if the crisis countries are to recover. This means working to counter protectionist pressures at home just as we urge the crisis impacted countries to keep their own markets open. The Clinton Administration is committed to outward looking, internationalist policies.

As the world's second largest economy, Japan has a key role to play in maintaining world economic growth and its performance will determine the prospects for Asia's recovery. Japan has now entered a full fledged recession. Real growth over the four quarters of 1997 amounted to -0.4%. In the first half of 1998, Japanese real GDP was down 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. The United States continues to believe that Japan must take strong measures to stimulate domestic demand, to restore confidence, to deal with the problems of its banking system, to open its markets and to deregulate its economy.

Beyond working to insure growth in the industrial world, the United States has been focused since the outset of this crisis on the need to contain financial contagion and to restore the confidence of market participants--a prerequisite for capital flows to continue. 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. It is now widely agreed that structural weaknesses, particularly in the process of financial intermediation, were an element in initiating the crisis. 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 inefficient or insolvent banks.

In a speech last Thursday, Secretary Rubin emphasized that the contagious effects of the ongoing crisis now threaten countries that have made great progress in implementing sound macroeconomic and structural policies and worked to strengthen the fundamentals of their economies. To deal with such threats, the President proposed on Friday to create a precautionary financial facility based in the IMF whose goal would be to provide assured access to assistance in the event of need to countries with sound policies which have acted responsibly, thereby helping them fight off the contagious impact of the ongoing crisis. In its communique on Saturday, the G-7 ministers and governors indicated their willingness to explore this idea. However, for the IMF to play its critical role in countering contagion, its resources must be expanded and the key step is for the U.S. at long last to meet its 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 New Agreement to Borrow. 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 emergency 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 affected countries.

In his speech at the Council on Foreign Relations, 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. In Indonesia, Korea and Thailand, for example, the combination of sustained high interest rates and illiquidity has led to harsh economic contraction and a vast overhang of bad debt. Debt to equity ratios that were already very high before the crisis (about 300% in Korea for the top 30 chaebols) have become unsustainable now (over 500% in Korea, 400% in Thailand and even higher in Indonesia) due to the real devaluation of their currencies and the burden of high real interest rates. In Indonesia, Korea, and Thailand, the World Bank estimates that 20-65 percent of firms have balance sheet losses greater than equity. When insolvent, highly leveraged companies cannot service their debt, a self reenforcing spiral is created in which banks' cash flows are squeezed, forcing them to contract new lending not only to troubled corporations but even to those in better health. The object of comprehensive restructuring is to restore the flow of credit so that firms in these countries can get back to the business of producing output and creating jobs.

In an effort to insure access of crisis impacted countries to critical imports and to help American businesses continue selling abroad, the Export-Import Bank will establish new

short-term credit facilities for critical Latin American markets. We will coordinate these efforts with our counterparts in other leading industrial nations to ensure that trade credit continues to flow during this period of financial stress. Moreover, to keep private capital flowing to crisis impacted economies, the Overseas Private Investment Corporation (OPIC) has developed a new instrument to help emerging economies raise money from international capital markets.

The President also has asked the World Bank and Asian 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.

Even as we work to mitigate the impact and contain the spread of the current crisis, the Administration is collaborating with other countries to find ways to strengthen the architecture of the financial system so that it is less crisis prone going forward. 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. Yesterday, at a meeting attended by the President, ministers and central bank governors from a group of industrial and key emerging market countries presented reports containing a plethora of recommendations to strengthen the international financial system. The work of this committee represents a continuation of a process begun in Naples and Halifax. It focuses on measures to increase transparency and strengthen financial systems, and proposes strategies for orderly workouts in the event of a future crisis.

There is a broad consensus on the need for greater transparency and openness both on

the part of debtor countries and official institutions such as the IMF. The Working Group report on

transparency and accountability stresses the need to enhance the relevance and reliability of information disclosed by the private sector through compliance with high-quality accounting standards. It calls for braodening the public disclosure of data_on foreign exchange reserves, external debt and financial sector soundness. And it recommends greater disclosure of data on the international exposure of investment banks, hedge funds and other international investors. Finally, it urges the IMF itself to be more open and transparent.

Transparency is necessary to provide investors with the information necessary to evaluate risk in lending, but such measures are not likely to be sufficient on their own to prevent another major crisis from occurring. In the current crisis, for example, some information was unavailable, but available indicators, many signaling caution, were apparently ignored by investors.

Most analyses of the crisis point to financial sector weaknesses as a central cause. 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 undercapitalized financial systems, 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 dramatically increased access to funds from abroad. Accordingly, the report proposes a series of reforms to strengthen domestic financial institutions and to create stronger incentives for borrowers and lenders to weigh risk and act with appropriate discipline, thereby reducing the odds of a crisis.

The task of strengthening financial systems is long-term and daunting. A partial list of needed elements 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 officials and regulators; improved corporate governance in both the financial and non-financial sectors; and implementation of efficient insolvency and debtor-creditor regimes.

The experience of Asia suggests that an excessive accumulation of short-term foreign currency denominated and unhedged foreign liabilities by the financial system was an important

cause of the financial fragility that triggered and exacerbated the crisis. Mismatches between the maturity and currency composition of financial institutions' assets and liabilities and an incorrect assessment of liquidity and currency risks aggravated the problem. These structural weaknesses, together with the herdlike mentality of international investors, who withdrew funds and failed to rollover their loans to the debtor financial institutions, triggered the crisis. Clearly, cross-border short-term interbank flows are highly volatile and there is now broad agreement that, at the minimum, they should be addressed in a strengthened regime of prudential supervision of banks. In addition to proposing measures to strengthen financial systems and guard against the buildup of unsustainable risk positions, the Working Group report proposes measures to strengthen the incentives of debtors and creditors to behave prudently. In particular, the report emphasizes the need to limit the scope of government guarantees and implicit insurance schemes, to maintain appropriate exchange rate regimes, and to develop methods for greater risk sharing between debtors and creditors, including increased reliance on bond markets as an alternative to bank finance. In recent crisis episodes, governmental guarantees at many levels apparently reduced the perception of risk by lenders and borrowers. In many countries, there was an expectation that corporations and banks would be bailed out by governments in the event of trouble. In many instances~~,~~ too, the incentive of private parties to hedge exchange risk was diminished by the prevalence of fixed or semi-fixed exchange regimes. Such implicit and explicit guarantees may have distorted incentives, encouraging both debtors and creditors to take on excessive risk, to fail to hedge that risk, and to ignore available information pointing to potential problems. The report concludes that limiting guarantees, making those which are offered as explicit as possible~~,~~ and pricing them appropriately could also contribute to crisis prevention.

While strengthening domestic financial systems may prevent some crises and make those that do occur less virulent, it is still likely that crises will not be eliminated altogether. And while a well designed insolvency regime can facilitate orderly workouts of corporate debt, the Working Group report emphasizes that no comparable internationally agreed and binding bankruptcy regime is likely to emerge to handle sovereign debtors. The report emphasizes that **temporary suspensions of debt payments should occur only in extreme situations as a last resort after all other reasonable alternatives have been explored.** But in such instances, there is a need to develop mechanisms to facilitate the orderly workout of sovereign liquidity crises and it is essential for the private sector to share in the burden of crisis resolution.

Private sector burden sharing is critical, not only because official money is unlikely to be sufficient in all circumstances, but also because it is absolutely essential in inducing market discipline and reducing potential moral hazard problems deriving from official assistance. In spite of its importance, private sector burden sharing is more difficult to achieve now than in the days when banks accounted for the bulk of international capital flows. Today, the proliferation of creditor institutions and instruments and the growth of international bond markets makes the problem of coordinating the actions of creditors during a crisis extremely difficult. Thus, a key recommendation of the Working Group is to include "collective action clauses" in bond contracts to provide for: collective representation of creditors; majority action to alter the payment terms of a contract; and sharing of payments among creditors. All of these provisions work to facilitate speedy and orderly workouts.

One question on which researchers and policymakers remain sharply divided concerns the desirability of implementing controls on flows of capital, in advance of a crisis, to prevent the potential disruptions associated with volatile international capital flows. Debate on this topic is certain to continue. However, there is some agreement on the need for appropriate sequencing of capital account liberalization. The G-7 Finance Ministers statement at the Birmingham summit noted that, while progressive liberalization of a country's capital account may be warranted over time, countries should be careful to proceed in an orderly way. With strong financial systems, the arguments in favor of unfettered capital flows are strong. But during such a transition, the liberalization of the capital account should be gradual and carefully managed. Excessive accumulation of short-term debt, excessive borrowing and lending, mismatches of maturities and currency denomination of assets and liabilities of financial institutions and corporate firms--all factors that have proven so destabilizing in many recent and not so recent episodes of financial and currency crises--must be avoided.

The international crisis has forced countries around to globe to confront the necessity of implementing the sound domestic policies which are ultimately fundamental to promote long-term economic growth and inspire investor confidence. The United States is no exception. From the outset, the Clinton Administration has focused on getting the policy fundamentals right to help the United States grow and to inspire investor confidence. 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 into the next millennium.

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 played an important role 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 although, like domestic competition, it brings challenges when it disrupts established patterns of economic activity.

Conclusion

Let me conclude by pointing out what is at stake in meeting the challenge of sustaining America's growth into the next millenium. 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: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 7-OCT-1998 17:06:09.00

SUBJECT: Larry Meyer's speech

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

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

TEXT:
Did you have a chance to read his speech to the NABE? Among his interesting comments, he notes that the first phase of the international crisis had bad direct effects on the U.S. economy through net exports but good indirect effects through lower interest rates and probably stronger equity prices. In the current, second phase, the indirect effects through financial markets "will likely reinforce rather than offset" the restraint of net exports. I thought that was a useful to encapsulate the recent shift in outlook.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 8-OCT-1998 14:25:16.00

SUBJECT: Draft memo

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.D0]MAIL488735282.226 to ASCII,
The following is a HEX DUMP:

October 8, 1998

To: Janet Yellen

From: Steven Braun (CEA)
Douglas Norwood (OMB)

Subject: What economic assumptions would make the budget surplus disappear?

You asked how much worse would the economy have to perform to eliminate the projected FY 1999 surplus (which now appears to be about $58 billion). The projected surplus would disappear if real GDP were to fall 1.9 percent over the 4 quarters of 1999 (or 0.5 percent on a year-over-year basis).

Revised baseline

In the Mid-Session Review (which was based on economic data available through mid-April), we projected the FY 1999 surplus at $54 billion. Adhering to the same general economic assumptions, but updating for more recent information (such as lower interest rates), real GDP is projected to grow 2.0 percent over the 4 quarters of 1999 (or 2.1 percent on a year-over-year basis) resulting in the upward revised budget surplus of $58 billion.

Rules of Thumb

As a rule of thumb, each percentage point of real GDP lost in 1999 reduces the expected surplus by roughly $28 billion: Nominal GDP in 1999 is likely to be about $8.8 trillion so that if real GDP were to fall 1 percentage point short of projections, total income would be about $88 billion lower . With the overall marginal tax rate at about 23 percent, the drop in revenues amounts to about $20 billion. Higher outlays (such as for unemployment compensation) would subtract about another $4 billion from the projected surplus. In addition, technical changes tend to exaggerate these purely economic effects, likely subtracting another $4 billion.

The table belows shows some alternative economic scenarios and projected budget outcomes.

Alternative Real GDP Scenarios and the Projected Surplus

	Real GDP Growth		Unemployment	FY 1999
	Q4/Q4	Yr/Yr	rate	Surplus <1>
Revised baseline	2.0%	2.1%	4.8%	$58 b.
Budget balance	-1.9	-0.5	6.0	0
Other alternatives				
Flat GDP	0.0	0.7	5.5	30
Recession	-2.6	-1.0	6.2	-11

<1> Does not reflect likely technical reestimates.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 8-OCT-1998 15:26:04.00

SUBJECT: Re: Draft memo

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

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

TEXT:
Sorry for the delay. You should read this over. I hope I haven't
murdered the memo.=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D37]MAIL45170628S.226 to ASCII,
The following is a HEX DUMP:

October 8, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: JANET L. YELLEN

SUBJECT: The budget surplus and the economy

This memo responds to your question concerning the likely relationship between the fiscal year 1999 surplus and economic conditions in 1999. The FY 1999 surplus now appears likely to be about $58 billion.[1] This projected surplus would disappear if real GDP were to decline 1.9 percent over the 4 quarters of 1999 (or 0.5 percent on a year-over-year basis).

The table belows shows some alternative economic scenarios and projected budget outcomes.

Alternative Real GDP Scenarios and the Projected Surplus

	Real GDP Growth Q4/Q4	Yr/Yr	Unemployment rate	FY 1999 Surplus
Revised baseline	2.0%	2.1%	4.8%	$58 b.
Budget balance	-1.9	-0.5	6.0	0
Other alternatives				
Flat GDP	0.0	0.7	5.5	30
Recession	-2.6	-1.0	6.2	-11

Revised baseline

In the Mid-Session Review (which was based on economic data available through mid-April), we projected the FY 1999 surplus at $54 billion. Updating this estimate to incorporate more recent information (such as lower interest rates), results in an upward revised FY 1999 budget surplus of $58 billion. This projection assumes that real GDP will grow 2.0 percent over the 4 quarters of 1999 (or 2.1 percent on a year-over-year basis).[2]

[1] This estimate is consistent with the Mid-Session Review's estimate of a $39 billion surplus for 1998; the higher surplus (ca. $70 billion) now expected for 1998 may raise the 1999 projection so that an even steeper economic downturn than estimated here would be required to eliminate the 1999 surplus.

Rules of Thumb

As a rule of thumb, each percentage point of real GDP lost in 1999 reduces the expected surplus by roughly $24 billion: Nominal GDP in 1999 is likely to be about $8.8 trillion. If real GDP were to fall 1 percentage point short of projections, total income would be about $88 billion lower. With an overall marginal tax rate of about 23 percent, the drop in revenues would amount to about $20 billion. Higher outlays (such as for unemployment compensation) would subtract about another $4 billion from the projected surplus.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 8-OCT-1998 15:55:05.00

SUBJECT: BWN speech

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

TEXT:
Attached is a draft of the speech. You are supposed to speak for just 10 minutes so it may be too long. But I thought you could take a look at it and suggest ways for me to cut it down.
Thanks.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D80]MAIL46243628N.226 to ASCII,
The following is a HEX DUMP:

Address by Janet Yellen to Business Women's Network's Annual Salute to Women, "Leadership Into the Next Millennium."
October 14, 1998, 12:20 p.m.

Thank you. It is a pleasure and an honor to be here with so many impressive women business leaders. And, I want to congratulate the Business Women's Network for organizing this interesting and important symposium on "Leadership into the Next Millennium." Women are indeed poised to lead the nation's industries and new ventures into the 21st Century. Recognizing today's women leaders and supporting and encouraging tomorrow's will help pave the way for greater participation by women in the business and financial worlds.

As you know well, women entrepreneurs and innovators and executives are making valuable and lasting contributions to America's economy. Women own nearly 40 percent of all firms in the United States, contributing $2.3 trillion to the economy. Nearly one in every five U.S. workers is employed by a woman-owned firm. And, women are starting businesses at twice the rate of all businesses.

To sustain and expand the growth and success of women-owned businesses, it is critical that our nation's economy remain healthy and strong. And that's what I'm hear to talk to you about today. In my brief remarks, I am going to discuss the current state of the American economy, especially in light of the turmoil in world financial markets and the international economy. I will then focus on the outlook going forward and the policies that are necessary to sustain growth in the United States and the world economy.

The Current State of the Economy

Let me turn to the current state of the economy. In short: the fundamentals are in place for continued solid growth, though developments in world markets continue to bear close monitoring and pose real risks to our economy.

At this time, the U.S. 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 has been below 5% for more than a year; job growth remains robust; inflation remains tame; real wages and real personal income are rising; and, consumer confidence is high. For the first time since 1969, the Federal budget is in surplus, and the surplus is projected to increase in coming years. And, 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*.

Outlook for U.S. Economy

It is reassuring that our nation's 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.

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 our economy will continue to see solid growth and job creation. 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 and enhance 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 briefly review our agenda for addressing the global financial troubles:

- 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. In serving as a major engine of global growth, the United States will inevitably see an increase in its trade deficit and some sectors, particularly those that are heavily exposed to trade, will experience disproportionate impacts. Even so, the United States must accept a rising trade deficit if the crisis countries are to recover. This means working to counter protectionist pressures at home just as we urge the crisis impacted countries to keep their own markets open. The Clinton Administration is committed to outward looking, internationalist policies.

- Other nations must also do their part to help the world economy to grow. 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. 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 inefficient or insolvent banks.

- The President has also emphasized 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 emergency 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 affected countries. President Clinton 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 credit 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. 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.

Stabilizing the global financial turmoil and promoting world economic growth is a critical element to sustaining our nation's current economic health and strength.

In my remarks, I've focused on the Administration's strategy for addressing the world's financial crisis because addressing this challenge is so key our nation's economic performance. But, beyond that, I would like to say just a few words 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.

<u>Conclusion</u>

Now, let me conclude by pointing out what is at stake in meeting the challenge of sustaining America's growth. 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. And, a strong economy will help women create and expand businesses. Promoting women's business enterprises helps to create jobs and strengthen our economy and expand economic opportunity to more Americans.

NOTE: Below are paragraphs that Nora drafted on what the Administration is doing to promote women's businesses. You may want to include them. But, I think that it may not be necessary. There are others in the Administration who will probably address these issues in more detail.

[While the U.S. economy overall is doing well given current global developments, women are doing particularly well. Women's earnings have increased dramatically over the last several decades, both in absolute terms and relative to men's earnings. As we see so clearly here today, a large and growing number of women own their own businesses or hold high executive and professional positions. Yet women have not achieved all this through passive participation--it has required energetic and ongoing efforts from women in the labor market, and from both the public and private sectors.

This means that while women are starting businesses at twice the rate of all businesses, and while women own nearly 40 percent of all firms in the U.S., thus employing one in every five U.S. workers and contributing $2.3 trillion to the economy, government recognizes the importance of this contribution and the need for continued assistance to women in business.

Government assistance to women in business has taken several different forms recently. The U.S. Small Business Administration, headed by Aida Alvarez, has taken the lead on many issues related to women business owners. Between 1993 and 1997 the Small Business Administration approved nearly 50,000 loans to women entrepreneurs. And the number of loans has been growing: in 1997 alone, the Small Business Administration granted more than 10,000 loans, worth $1.67 billion, to women small business owners -- *triple* the number of loans granted in 1992. The Small Business Administration also works to increase contracting opportunities for women business owners, and runs conferences designed to help women entrepreneurs develop winning small business strategies. And the Small Business Administration's Online Women's Business Center offers valuable information and advice about running your business, as well as facilitating information exchange, providing a comprehensive resource database for women business owners, and giving links to other related Internet sites.

The Federal government also works for women in business through the Women's Bureau of the Department of Labor, which focuses on more general issues facing women employees, not just women business owners. The Women's Bureau is particularly active in encouraging family-friendly workplace policies and in assessing and improving the child care options for American workers.

The Clinton Administration recognizes that helping women in business is not a one-shot deal, and that a continued outreach effort is necessary. Linking government agencies, like the Small Business Administration and the Women's Bureau, with the private sector is key for any successful strategy. I therefore commend the Business Women's Network and all of its members not only for their role in facilitating communication within the private sector, but for encouraging an active conversation between women in business and the government agencies which are here to help them.]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-OCT-1998 04:18:24.00

SUBJECT: non-paper on a growth target for Argentina

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

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

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

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

TEXT:
Attached is the 2nd draft of a non-paper the USG would consider giving to the Argentines for a discussion on a growth target. The 1st draft was done by EPA; this draft, while generally in the same direction as the EPA draft, is significantly rewritten. We apparently have the task of trying to highlight the key issues for them to consider in designing a target. There are 2 options presented to reduce risk of inadvertent stringency/inadvertent laxness -- our developing country proposal, and a safety valve (hybrid quantity/price system).

Should we be more specific? Should we focus/encourage a specific course of action? Also, what should I push for, if not in the paper, in discussions (both with other USG people and the Argentines)?

I have a strategy session at 3:15 Friday at State to discuss the trip. If you have comments on the paper or to these questions, I would appreciate it if you could get those to me by early afternoon. Thanks,

Joe

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D31]MAIL428031382.226 to ASCII,
The following is a HEX DUMP:

A Growth Target for Argentina: Technical Considerations

Introduction

Now that developed countries have agreed to targets in the Kyoto Protocol, some non-Annex I countries have begun consideration of their own binding targets. The approach used in setting targets for Annex I countries -- a fixed proportion of a historic year's emissions -- would be very restrictive on developing countries expecting high rates of economic growth. Realistic targets for developing countries should reflect their projected development and accommodate some emissions growth. However, the targets should also reflect real reductions in emissions below the projected business as usual level.

Recognizing that developing countries' emissions should be permitted to grow, some analysts have proposed "growth targets" for developing countries. A growth target is a target set higher than the current emission level, but lower than the business as usual (BAU) projection. Growth targets provide for continued economic development but with a lower emission growth rate. In addition, adoption of a growth target would allow developing countries to participate in international trading of greenhouse gas allowances. This paper outlines some of the issues involved in designing a growth target for Argentina, and suggests some related areas of potential collaboration between the United States and Argentina.

Target Formulation

While setting an emissions target is, in the end, a political decision, it is important to inform this decision with relevant analysis. To facilitate the decision-making, analysis should be conducted on several issues, including the projected business as usual emissions, the costs of abating greenhouse gas emissions, and the benefits of emissions abatement.

Business As Usual

Projections of greenhouse gas emissions, like any long-term projection, is an inherently difficult task, since these projections are premised on several uncertain variables, such as economic growth. For example, consider these three illustrative cases based on 1995 carbon emissions from fossil fuel combustion of 35.3 MMTCE.

Growth Rate, 1995-2010	Source of Growth Rate	Projected 2010 Emissions
2.7%	Assumes 1990-95 carbon growth rate applies through 2010	52.7 MMTCE
4.2%	Assumes the EIA carbon growth rate for Other Central/South America region for 1995-2020 applies through 2010	65.5 MMTCE
5.0%	Assumes GDP grows 5% through 2010 and carbon grows at the same rate	72.8 MMTCE

The highest projection is nearly 40% greater than the lowest projection in this illustration. Of course, the lower bound reflects an emissions growth rate that occurred while the Argentine economy grew at 5.7%, so if the rate of economic growth were lower than this between 1995 and 2010, the lower bound even could be too high.

Given this uncertainty, a fixed target for Argentina established in the near future would present some risks. The target could be inadvertently stringent if Argentina experienced faster economic growth than was expected, resulting in higher costs than what might have been projected. Conversely, the target could be inadvertently lax, even non-binding on an economy, if the economy grows slower than was expected, resulting in fewer actual emissions reductions (or paper tons) than what might have been projected.

Projections of future emissions can be further complicated based on several other issues. First, the relationship between carbon emissions and economic growth has varied significantly over the past twenty years in Argentina. During the 1980s, carbon emissions grew while the economy contracted. However, during the first half of the 1990s, carbon emissions grew at less than half the rate of economic growth. Second, the Kyoto Protocol sets targets for a comprehensive "basket" of greenhouse gases (CO_2, CH_4, N_2O, HFCs, PFCs, SF_6), and includes carbon sinks. Data availability on the emissions and their sources may be limited in some cases.

To address the risks associated with establishing a target, consider a couple of options. First, Argentina could agree to a binding target that would be indexed to a set of economic and demographic variables that explain greenhouse gas emissions well. While the concept of a target would be agreed to in the near term under this approach, the target level would not actually be set until these economic and demographic variables were known for 2007. This approach, by eliminating the uncertainty associated with projecting economic performance between now and 2007, would address much of the risk of an inadvertently stringent target and the risk of an inadvertently lax target. Of course these risks could still be realized if economic performance varies significantly between the commitment period and the year(s) prior to the period. It should also be noted that some greenhouse gases may not track the same economic variables as does carbon dioxide, so multiple methodologies may be necessary to capture the entire basket of gases.

Alternatively, Argentina could agree to a binding target coupled with a "safety valve". In a sense, the combination of the target and safety valve would reflect a hybrid quantity/price approach to reducing emissions. For example, if the cost of reducing emissions reached or exceeded a pre-specified level, then Argentina would be granted additional allowances. This would provide a ceiling on the cost of compliance. Further, since this ceiling cost would be set at some positive level, Argentina would have to undertake some emissions reduction before triggering the safety valve, thereby eliminating the risk that a target could create hot air. Of course, identifying this ceiling would be difficult, and would depend on the cost of abatement as well as the policies implemented to reduce emissions.

Cost of Abatement

To evaluate the effects of a percentage reduction below business as usual, it is important to understand the costs of the opportunities to abate emissions. This task involves identifying the technologies, processes, and fuel-switching options that can reduce emissions, the costs of switching to these climate-friendly options, and the policies necessary to stimulate their adoption. The first of these is related to "bottom-up" studies that evaluate the technological potential for products and processes that can result in substituting climate-friendly capital for the existing capital stock. To gain a sense of the larger macroeconomic effects of reducing emissions, "top-down" models, such as macroeconomic and computable general equilibrium models, can assess the impact of reductions on GDP, energy prices, energy consumption, and, in the case of the macro models, employment. These models can be used to effectively develop a marginal abatement cost curve for specific energy sub-sectors or for the country as a whole. Finally, the policies under consideration to reduce emissions can also affect the evaluation of costs. Most top-down models assume that emissions are reduced cost-effectively (e.g., through a tradable permit system or a carbon tax). However, if other approaches to reduce emissions are pursued because of other policy criteria, it is important to understand how the costs of these policies may vary from what the models may estimate.

According to information provided in Argentina's National Communication, the Argentine economy is relatively carbon efficient compared to many other developing, and some developed, countries. Indeed, the carbon-to-GDP ratio for Argentina in 1990 is lower than the ratio for the United States. This low carbon-to-GDP ratio reflects Argentina's high reliance on carbon-lean and non-carbon sources of energy, such as hydropower and natural gas.[1] For this reason,

[1] The OECD's International Energy Agency reports the following breakdown by fuel for Argentina's 1995 carbon emissions: coal 2%; petroleum 53%; and natural gas 44%. The Energy Information Administration also reports that hydropower and nuclear power generate "over half"

Argentina may not have as many opportunities to reduce emissions as countries that are more coal-intensive.

Benefits of Abatement

In addition to the costs of abatement, it is important to evaluate the benefits of abatement when considering an emissions target. First, by reducing emissions of greenhouse gases, the climate benefits from lower global emissions. However, it is quite difficult to assess the long-term climate benefits associated with emissions reductions undertaken by one country. Complementing the climate benefits, reducing greenhouse gas emissions can generate ancillary benefits, such as improved air quality. Since emissions of several local air pollutants, including particulate matter, sulfur dioxide, NO_x, and volatile organic compounds, are associated with the combustion of fossil fuels, any policies that reduce emissions of combustion-related carbon dioxide would also reduce emissions of these pollutants. Depending on the extent of existing pollution, and the magnitude of the emissions reduction, the public health benefits could be significant. Further, policies to stimulate sink activity could result in multiple ancillary benefits, such as watershed protection and wildlife habitat.

Next Steps

Data Development

To improve an understanding of the potential range of BAU over a 10 to 20 year horizon, it is important to develop and refine projections of economic output and of energy consumption.

Argentina may have, or may have the capacity to have, significant carbon dioxide sequestration activity. Resolving the uncertainties regarding data on carbon sinks is extremely important to better understand the costs of complying with a specified target.

The Argentine National Communication provides estimates of emissions of some, but not all, greenhouse gases. It is important to complete an inventory of all greenhouse gases, and to refine estimates of emissions from sources where there may be significant uncertainties, such as from agriculture.

Abatement Studies

To develop reliable estimates of the economic cost of carbon mitigation, a computable general equilibrium model, incorporating detailed treatment of the energy sector, or a macroeconomic

of Argentina's electricity.

model of the Argentine economy would be needed. The former is more appropriate for longer time horizons while the latter can assess short-term transition effects. Coupled with the cost of abating carbon emissions, the analytic capacity to evaluate the reduction in emissions of local air pollutants and the resulting change in public health should also be developed. The U.S. Government could work with Argentine researchers to develop this capacity.

Identification of Policy Mechanisms

The Kyoto Protocol stipulates that all Annex B countries have the discretion to implement their own policies and measures to comply with their targets. It is important for the Argentine Government to assess which policies and measures may be most appropriate for Argentina's circumstances. Possible policies include a domestic cap and trade program, a carbon tax on energy, efficiency standards, tax incentives, removal of subsidies, investment in R&D, etc. We could share the U.S. experiences with these various policies with the Argentine Government.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:11-OCT-1998 20:33:32.00

SUBJECT: Argentina paper

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

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

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

TEXT:
This is the most recent draft of the non-paper we will give to the
Argentina government. Unfortunately, the safety valve proposal was axed
by State (and others shared their concerns). Melinda has given her ok,
but I have not yet heard from Todd or Sandalow.

Joe

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D31]MAIL49348648X.226 to ASCII,
The following is a HEX DUMP:

A Growth Target for Argentina: Technical Considerations

Introduction

Now that developed countries have agreed to greenhouse gas (GHG) targets in the Kyoto Protocol, some non-Annex I countries have begun to consider adoption of their own binding targets. For developing countries, adoption of such a target could yield significant ancillary economic and environmental benefits through increased energy efficiency, improvements in air quality and conservation of resources. In addition, adoption of a growth target would allow developing countries to participate in international trading of greenhouse gas allowances.

The approach used in setting targets for Annex I countries -- a fixed proportion of a historic year's emissions -- would be very restrictive on developing countries expecting high rates of economic growth. Realistic targets for developing countries must accommodate their sustainable development and accommodate some emissions growth. However, the targets should also result in real reductions in emissions below the projected business as usual (BAU) level. In response, some analysts have proposed an emission growth targets for developing countries. A growth target is a target set higher than the current emission levels, but lower than the business as usual (BAU) projection. Emission growth targets would provide for continued economic development but with a lower emission growth rate.

Determination of the appropriate level of a target is a difficult task for any country, and requires assessment of key factors such as economic output, the size and structure of the energy sector, and the cost and benefits of emission abatement. It was clear in the negotiations of the Kyoto Protocol, that Annex I countries vary greatly in their national circumstances, and that these differences influenced the cost and availability of emission abatement opportunities. Ultimately, the differentiated targets in the Kyoto Protocol, and for some countries the EU burden-sharing agreement, reflect variations in countries national circumstances. Table I illustrates these differences and countries adopted targets.

These same factors will be critical for a developing country's consideration of a GHG growth target. This task may be further complicated by the particular challenges facing developing countries. These challenges may include volatile economic growth rates, evolving energy structures, availability of long-term data resources, and
limited resources. While these factors create additional difficulty in assessing an appropriate target, they may also present significant opportunities for developing countries to cost-effectively reduce emissions. This paper outlines some of the issues involved in designing a growth target for Argentina, and suggests some related areas of potential collaboration between the United States and Argentina.

Target Formulation

Setting an emissions target is, in the end, a decision based on political, economic, and environmental factors. It is important to inform this decision with relevant analysis, including the projected business as usual emissions, the costs of abating greenhouse gas emissions, and the benefits of emissions abatement.

Business As Usual

Projections of greenhouse gas emissions, like any long-term projection, is an inherently difficult task, since these projections are premised on several uncertain variables, such as economic growth. For example, if Argentina's emissions grew at a rate comparable to what it experienced during the 1980s, its emissions would be much lower than if emissions grew at a rate comparable to what it has experienced during the 1990s.

Given this uncertainty, a fixed target for Argentina established in the near future would present some risks. The target could be inadvertently stringent if Argentina experienced faster economic growth than was expected, resulting in higher costs than what might have been projected. Conversely, the target could be inadvertently lax, if the economy grows slower than was expected, resulting in fewer, or even no actual emissions reductions than what might have been projected.

Projections of future emissions can be further complicated based on several other issues. First, the relationship between carbon emissions and economic growth has varied significantly over the past twenty years in Argentina. During the 1980s, carbon emissions grew while the economy contracted. However, during the first half of the 1990s, carbon emissions grew at less than half the rate of economic growth. Second, the Kyoto Protocol sets targets for a comprehensive "basket" of greenhouse gases (CO_2, CH_4, N_2O, HFCs, PFCs, SF_6), and includes carbon sinks. Data availability on the emissions and their sources may be limited in some cases.

Cost of Abatement

To evaluate the effects of a percentage reduction below business as usual, it is important to understand the costs of the opportunities to abate emissions. This task involves identifying the technologies, processes, and fuel-switching options that can reduce emissions, the costs of switching to these climate-friendly options, and the policies necessary to stimulate their adoption. The first of these is related to "bottom-up" studies that evaluate the technological potential for products and processes that can result in substituting climate-friendly capital for the existing capital stock. To gain a sense of the larger macroeconomic effects of reducing emissions, "top-down" models, such as macroeconomic and computable general equilibrium models, can assess the impact of reductions on GDP, energy prices, energy consumption, and, in the case of the macro models, employment. These models can be used to effectively develop a marginal abatement cost curve for specific energy sub-sectors or for the country as a whole. Finally, the policies under consideration to reduce emissions can also affect the evaluation of costs. Most top-down models assume that emissions are reduced cost-effectively (e.g., through a tradable permit system or a carbon tax). However, if other approaches to reduce emissions are pursued because of other policy criteria, it is important to understand how the costs of these policies may vary from what the models may estimate.

According to information provided in Argentina's National Communication, the Argentine economy is relatively carbon efficient compared to many other developing, and some developed, countries. Indeed, the carbon-to-GDP ratio for Argentina in 1990 is lower than the ratio for the United States. This low carbon-to-GDP ratio reflects Argentina's high reliance on carbon-lean and non-carbon sources of energy, such as hydropower, nuclear, and natural gas.[1] For this

[1] The OECD's International Energy Agency reports the following breakdown by fuel for

reason, Argentina may not have as many low-cost opportunities to reduce emissions as countries that are more carbon-intensive.

Benefits of Abatement

In addition to the costs of abatement, it is important to evaluate the benefits of abatement when considering an emissions target. First, by reducing emissions of greenhouse gases, the climate benefits from lower global emissions. However, it is quite difficult to assess the long-term climate benefits associated with emissions reductions undertaken by one country. In addition to the climate benefits, reducing greenhouse gas emissions can generate ancillary benefits, such as improved air quality. Since emissions of several local air pollutants, including particulate matter, sulfur dioxide, NO_x, and volatile organic compounds are associated with the combustion of fossil fuels, any policies that reduce emissions of combustion-related carbon dioxide would also reduce emissions of these pollutants. Depending on the extent of existing pollution, and the magnitude of the emissions reduction, the public health benefits could be significant. Further, policies to stimulate sink activity could result in multiple ancillary benefits, such as watershed protection and wildlife habitat.

Opportunities through International Trading

By taking on an emissions target, Argentina could participate in international trading of emissions allowances. This participation would provide two benefits. First, it mitigates the risk that a target could impose significant economic costs, because there would be the option to purchase emissions allowances at a lower cost from other countries were Argentina's reductions costly. Second, if Argentina found that reducing its emissions cost less than the international trading price for emissions allowances, it could undertake reductions beyond those specified in its target, sell these excess allowances to other countries, and earn economic gains from these trades.

Possible Options for a Target

To address the risks associated with establishing a target, consider two possible options. These are meant to be simple illustrations of possible approaches for reducing the risks associated with establishing a target. Other approaches may work as well as these.

Since much of the risk in establishing a target derives from the difficulty in making long-term economic forecasts, the risk could be reduced by essentially shortening the time frame covered

Argentina's 1995 carbon emissions: coal 2%; petroleum 53%; and natural gas 44%. The Energy Information Administration also reports that hydropower and nuclear power generate "over half" of Argentina's electricity.

by the forecast. At least two options exist. First, would be to establish a target, of the form of X% below business as usual, where business as usual would be indexed to a set of economic and demographic variables that explain greenhouse gas emissions well. While the concept of a target and the reduction from business as usual would be agreed to in the near term under this approach, the business as usual (and the emissions level of the target) would not actually be set until these economic and demographic variables were known for, say, 2006 or 2007. The relationship between the business as usual and these variables (e.g., GDP, carbon intensity, etc.) would be made explicit now, so there would be more certainty at the time the target is announced. For instance, it could be agreed that if GDP grew at a 5.7% annual rate between now and 2007, then the target would be X. Moreover, given existing projections for these economic and demographic variables, an estimate of the business as usual, and the target, could be made now.

This approach, by eliminating the uncertainty associated with projecting economic performance between now and 2007, would address much of the risk of an inadvertently stringent target and the risk of an inadvertently lax target. Of course these risks could still be realized if economic performance varies significantly between the commitment period and the year(s) prior to the period. It should also be noted that some greenhouse gases may not track the same economic variables as does carbon dioxide, so multiple methodologies may be necessary to capture the entire basket of gases.

Second, would be to establish a target now and revisit it later based on specified economic conditions. This could also be of the form of X% below business as usual, but a projection of business as usual would be used to set the emissions level of the target. At the time of setting the target, one or a small set of parameters would be established for evaluating the target just before the commitment period. For example, if the economy performed beyond a pre-specified level between now and the beginning of the commitment period, then the target could be readjusted to reflect this additional growth. Conversely, if the economy performed at less than what was expected, the target could be readjusted downward.

Next Steps

Data Development

To improve an understanding of the potential range of BAU over a 10 to 20 year horizon, it is important to develop and refine projections of economic output and of energy consumption.

Argentina may have, or may have the capacity to have, significant carbon dioxide sequestration activity. Resolving the uncertainties regarding data on carbon sinks is extremely important to better understand the costs of complying with a specified target.

The Argentine National Communication provides estimates of emissions of some, but not all, greenhouse gases. It is important to complete an inventory of all greenhouse gases, and to refine estimates of emissions from sources where there may be significant uncertainties, such as from agriculture.

Abatement Studies

To develop reliable estimates of the economic cost of carbon mitigation, a computable general equilibrium model, incorporating detailed treatment of the energy sector, or a macroeconomic model of the Argentine economy would be needed. The former is more appropriate for longer time horizons while the latter can assess short-term transition effects. Coupled with the cost of abating carbon emissions, the analytic capacity to evaluate the reduction in emissions of local air pollutants and the resulting change in public health should also be developed. The U.S. Government could work with Argentine researchers to develop this capacity.

Identification of Policy Mechanisms

The Kyoto Protocol stipulates that all Annex B countries have the discretion to implement their own policies and measures to comply with their targets. It is important for the Argentine Government to assess which policies and measures may be most appropriate for Argentina's circumstances. Possible policies include a domestic cap and trade program, a carbon tax on energy, efficiency standards, tax incentives, removal of subsidies, investment in R&D, etc. The United States could share its experiences with these various policies with the Argentine Government.

Table I: Comparison of Annex I Country Indicators and Emission Targets

Country	1990 Carbon Intensity [1]	1990 GDP per capita[2]	Kyoto Protocol Target	Internal EU Target
Australia	2.95	14.44	+ 8%	NA
Japan	1.63	14.33	-6%	NA
Hungary	3.16	5.35	-6%	NA
Iceland	1.62	13.36	+10%	NA
Poland	6.54	3.82	-6%	NA
United States	2.93	18.05	-7%	NA
France	1.22	13.90	-8%*	0%
Germany	2.03	14.34	-8%*	-21%
Ireland	2.50	9.27	-8%*	+13%
Portugal	1.55	7.48	-8%*	+27%
United Kingdom	2.05	13.22	-8%*	-12.5%

[1] Ton of Carbon Equivalent per $100 Gross Domestic Product (1995 International Dollars)
[2] $1,000 per person (1995 International Dollars)
* Common European Union Target

Sources: Carbon Dioxide Information Analysis Center, Oak Ridge National Laboratory;
Penn World Data Tables;
United Nations Population Division

Growth Rate, 1995-2010	Source of Growth Rate	Projected 2010 Emissions	Percent Above 1990 Emissions
1.25%	Assumes 1980-95 carbon growth rate applies through 2010	42.5 MMTCE	42%
2.7%	Assumes 1990-95 carbon growth rate applies through 2010	52.7 MMTCE	76%
4.2%	Assumes the EIA carbon growth rate for Other Central/South America region for 1995-2020 applies through 2010	65.5 MMTCE	119%
5.0%	Assumes GDP grows 5% through 2010 and carbon grows at the same rate	72.8 MMTCE	143%

This table is based on 1995 emissions of 35.3 MMTCE (Carbon Dioxide Information Analysis Center, Oak Ridge National Laboratory). Argentina's 1995 combustion-related carbon emissions were about 18% higher than its 1990 level of 30.0 MMTCE.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-OCT-1998 15:14:15.00

SUBJECT: the latest version of the Argentina paper

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

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

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

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

TEXT:
FYI -- it has changed again, based on a meeting with Todd, Sandalow, and Bill. They don't want us to offer any options now, so that section was pulled.

Joe

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

TEXT:
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The following is a HEX DUMP:

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Determination of the appropriate level of a target is a challenging task for any country, and requires assessment of key factors such as economic output, the size and structure of the energy sector, and the cost and benefits of emission abatement. It was clear in the negotiations of the Kyoto Protocol, that Annex I countries vary greatly in their national circumstances, and that these differences influenced the cost and availability of emission abatement opportunities. Ultimately, the differentiated targets in the Kyoto Protocol, and for some countries the EU burden-sharing agreement, reflect variations in countries national circumstances. Table I illustrates these differences and countries adopted targets.

These same factors will be important for a developing country's consideration of a GHG growth target. This task may be complicated by the particular challenges facing a specific developing country. These challenges may include volatile economic growth rates, evolving energy structures, availability of long-term data resources, and limited resources. While these factors create additional difficulty in assessing an appropriate target, they may also present significant opportunities for developing countries to cost-effectively reduce emissions. This paper outlines some of the issues involved in designing a growth target for Argentina, and suggests some related areas of potential collaboration between the United States and Argentina.

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Cost of Abatement

To evaluate the effects of a percentage reduction below business as usual, it is important to understand the costs of the opportunities to abate emissions. This task involves identifying the technologies, processes, and fuel-switching options that can reduce emissions, the costs of switching to these climate-friendly options, and the policies necessary to stimulate their adoption. The first of these is related to "bottom-up" studies that evaluate the technological potential for products and processes that can result in substituting climate-friendly capital for the existing capital stock. To gain a sense of the larger macroeconomic effects of reducing emissions, "top-down" models, such as macroeconomic and computable general equilibrium models, can assess the impact of reductions on GDP, energy prices, energy consumption, and, in the case of the macro models, employment. These models can be used to effectively develop a marginal abatement cost curve for specific energy sub-sectors or for the country as a whole. Finally, the policies under consideration to reduce emissions can also affect the evaluation of costs. Most top-down models assume that emissions are reduced cost-effectively (e.g., through a tradable permit system or a carbon tax). However, if other approaches to reduce emissions are pursued because of other policy criteria, it is important to understand how the costs of these policies may vary from what the models may estimate.

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[1] Ton of Carbon Equivalent per $100 Gross Domestic Product (1985 International Dollars)

[2] 1985 International Dollars

* Common European Union Target

Sources: Carbon Dioxide Information Analysis Center, Oak Ridge National Laboratory;
Penn World Data Tables;
United Nations Population Division.

Illustrative Business As Usual Projections for Argentina

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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:13-OCT-1998 14:02:24.00

SUBJECT: possible policies

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

TEXT:
Here are the two documents.=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
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The following is a HEX DUMP:

Summary of Current Financial Conditions
October 9, 1998
Doug Elmendorf

1. *Domestic financial conditions are not spiraling down.*

* equity markets are volatile but prices have hardly collapsed
    * since year-end: Dow, SP500, NYSE, Nasdaq, Wilshire down 1-4%
    * since record high: indices down 15-25%
    * since Sept 1: Dow and SP500 down 1%, Nasdaq down 4%

* capital markets are shaken but not stirred
    * risk spreads have widened, but most corporate borrowers face lower rates than 2 months ago
    * issuance of corporate-grade debt has dropped owing to both demand and supply hesitation
        * supply is weak because some issuers are expecting spreads to narrow
        * demand is weak because underwriters don't want the risk or because investors are waiting for Q3 earnings reports or because ?
    * junk issuance has re-emerged a bit (July: 2.3b, Aug: .6 b, Sept: 1.4 b; Q2: 1.5 b, Q3: 1.4 b)
    * junk yield spread has leveled off

* bank lending is tightening but not disappearing
    * Senior Loan Officer Survey shows sharp swing toward tightening of terms and standards in September -- but this is only for big firms, and even there, less than 1/4 of banks on net report these steps
    * why are big firms facing changes but small firms are not?
        * maybe the big firms that turn to banks are actually riskier than the small firms that turn to banks
        * maybe banks change behavior toward small firms more slowly (if you don't change quickly for big firms, a surge in their demand could overwhelm you, while small firms do less substituting and may value predictability as part of an implicit contract)
        * maybe big banks lend to big firms, and the big banks are worried about their capital bases
    * C&I loans grew 17% (a.r.) in September -- some of this is clearly substitution out of capital markets, but it does contradict Newman's statement
        * this could be inventory accumulation

2. *The cost of capital has risen.*

* for all firms, cash flow growth is way down
    * but level of profits remains high

* for big, safe firms
    * equity capital: availability irrelevant
    * market borrowing: availability down, cost down
    * bank borrowing: not very relevant

* for big, risky firms
    * equity capital: availability irrelevant
    * market borrowing: availability down, cost up
    * bank borrowing: availability down, cost up

* for small firms
    * equity capital: availability down, cost up
    * market borrowing: availability irrelevant
    * bank borrowing: availability unchanged for now; cost unchanged for now

* for consumers
    * consumer credit: availability unchanged, cost unchanged
    * mortgage borrowing: availability unchanged, cost down (not as much as Treas)

3. *We are probably not entering a credit crunch.*

* what does this term mean?
    * maybe, quantity constraints in addition to price constraints

* there is a flight to both safety and liquidity
    * all risk spreads have widened
    * the spread between on-the-run and off-the-run securities has widened

* financial institutions are basically very healthy in the U.S.
    * bank profits have been very high
    * chargeoffs have been very low
    * bank capital ratios have been very high
    * brokerage capital ratios have been high too, I think
    * this is a contrast with the situation in 1990

* underlying economic conditions in the U.S. are extremely strong
    * very low unemployment and inflation
    * no imbalances
    * high consumer confidence

* some re-evaluation of risk is healthy
    * spreads had fallen very low over the past few years
    * the Fed and OCC had warned about this

* what are the biggest risks?
    * the underestimation of risk was not as bad as in some past expansions (e.g., chargeoffs still low), but the shock may be larger this time
    * an overreaction to past exceeses?
    * a cascade of international defaults or market turmoil that depletes bank capital -- watch out for Latin America or hedge fund collapses

* markets have been growing in importance relative to financial institutions — how does this matter?

3. *Wealth effects*

* if stock prices are little changed going forward, consumption growth could be about 1 percentage point slower in 1999 than in 1998 (essentially, a return to a neutral wealth effect rather than the boosts of the past several years)

4. *Confidence effects*

* hard to predict but potentially important for both households and businesses
* household debt is quite high and saving is quite low
* in 1987, confidence and consumption dropped quite sharply in October but reversed by year-end
* sudden household unease about debt levels may have brought on the 1990 recession

Thoughts on Countercyclical Policy
October 12, 1998

1. *Automatic stabilizers would provide significant stimulus.*

   A. A one percent drop in GDP would increase the budget deficit by $x billion. This fiscal stimulus might boost GDP again by as much as y percent.
   - * The 1994 welfare reform reduced the size of the stabilizers by changing entitlements--where spending increased automatically as welfare rolls increased--into block grants.

   B. Automatic stabilizers could be strengthened.
   - * Unemployment insurance could be changed to ...

2. *Monetary policy could probably provide sufficient stimulus.*

   A. The Federal Reserve could cut the overnight interest rate by as much as 5 percentage points.
   - * This contrast with Japan, where short-term rates have been quite close to zero since 19xx.
   - * A given absolute drop in rates may have a larger effect when rates are lower. In other words, it's the proportional change in rates that matters for some purposes: equity valuation, investment(??).
   - * But medium-term and long-term interest rates already incorporate substantial further cuts in short-term rates, so the true amount of remaining stimulus is smaller than the level of the funds rate suggests.
   - * Also, increasing financial problems might lead to even lower inflation expectations, which would push up real interest rates.

   B. Monetary policymakers can respond to changing economic conditions quickly.
   - * This quick reaction could boost confidence, which would be important if falling confidence were a cause of the economic problem.

   C. Monetary policy might be well focused (naturally targeted) on the problem.
   - * If an economic slowdown were rooted in financial factors, then expansionary monetary policy--which affects the economy through financial markets--might address those problems effectively.
   - * Because banks and investors think in terms of spreads, wider risk spreads can be counteracted by reducing safe rates.
   - * Cutting interest rates tends to raise bank profits and thereby help banks to rebuild capital.

D. The United States is unlikely to experience a true credit crunch.

- * Risk spreads had narrowed considerably during this expansion, so even the substantial widening of the past year has not made them especially wide by historical standards.
- * Financial institutions have been very healthy, with high profits, low chargeoffs, and high capital ratios. This makes banks less likely to curtail lending very substantially for a long time.
- * Both of these factors contrast sharply with the situation in 1990. The second factor contrasts sharply with the situation in Japan this decade.

E. Even if a credit crunch occurred, monetary policy would probably still be an effective tool.

- * The slow recovery in 1990-92 may have occurred not because monetary policy was pushing on a string, but because monetary policymakers underestimated the strength of the headwinds. After all, the funds rate was still well above zero.

3. Discretionary countercyclical fiscal policy would be important under some circumstances.

A. Monetary policy usually works with substantial lags.

- * A financial crisis might cause quantity rationing, while monetary policy works through price changes. Are the lags from quantity rationing shorter? How is that consistent with the view that monetary policy--which used to work more through quantitity rationing (disintermediation, e.g.)--always had long lags?
- * If financial markets anticipate policy more today, has that shortened the lags?

B. If the financial system grinds to a halt, then expansionary fiscal policy would be needed.

- * Even if lower rates help stricken banks to rebuild capital, that process can take years.
- * This is the situation in Japan today.

C. The Administration might want faster economic growth in the short run than the Federal Reserve.

- * Faster growth in the United States would/would not [let's try to find out] have a noticeable effect on economic conditions overseas.
- * Faster growth in the United States is probably not sustainable for very long.
- * If the Fed thinks that fiscal policy is providing sufficient economic stimulus, monetary policy would probably not be eased as much as otherwise.

4. What sort of discretionary countercyclical fiscal policy would make sense?

A. The policy would probably have to involve significant dollars to have much effect.

* One percent of GDP is $80 billion.

B. We would like policies that do not contradict the Administration's consistent emphasis on investing in the future.
   * The rationale for balancing the budget--and for avoiding tax cuts this past year--is to save for future needs.
   * We don't want to adversely affect the long-term budget outlook. This argues for temporary changes.
   * But the whole point is to find policies that boost demand, so this is a little tricky.

C. Temporary investment incentives are appealing.
   * This clearly involves investing in the future.
   * Temporary cuts work better than permanent cuts in this area.
   * This may be better focused than a consumption cut, if investment drops sharply owing to a restriction of credit. We would not want to boost consumption spending if unemployment and unused capacity were in the capital-goods sector.
   * But the direct benefit goes to companies to rich and people.

D. Consumption incentives are tricky.
   * Short-term cuts may be less effective, but long-term cuts ruin the long-term budget picture.
   * Increased saving incentives may boost both private saving and consumption.

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	Janet L. Yellen to Sarah Johanna Reber at 11:48:43.00. Subject: Re: Hello. (1 page)	10/13/1998	b(6)

COLLECTION:

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

FOLDER TITLE:

[10/06/1998 - 10/15/1998]

2013-0723-F
ab1287

RESTRICTION CODES

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

- P1 National Security Classified Information [(a)(1) of the PRA]
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- P3 Release would violate a Federal statute [(a)(3) of the PRA]
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- P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

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- b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
- b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
- b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
- b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
- b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-OCT-1998 09:34:11.00

SUBJECT: Nabe speech

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

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D58]MAIL443436686.226 to ASCII,
The following is a HEX DUMP:

Remarks of
Janet L. Yellen
Chair of the President's Council of Economic Advisers
at the National Association for Business Economics
October 6, 1998

Thank you. It is a pleasure to join you at the 40th Annual Meeting of the National Association for Business Economics. Last June I received a brochure from the organizers of this meeting asserting that "We live in a golden economic age--healthy economic growth, low inflation, low unemployment and rising stock markets." It goes on to ask "Will this scenario continue into the next millennium?" The Administration's overriding objective is to ensure an affirmative answer to this question. This afternoon, I would like to describe some of the policies we believe are required to maximize the odds that the economic prosperity we are enjoying will indeed continue into the next millennium.

Let me begin by agreeing with the brochure's main assertion. U.S. growth has indeed been strong and inflation and unemployment remain exceptionally low. Contrary to the brochure's statement, the stock market has not continued to rise, but even with the retreat from its July high, household net worth remains at extraordinary levels relative to disposable income. In all of these ways, U.S. economic performance has been excellent. With all the recent attention on baseball records, it is worth noting that our economy too is on track to set a record this year. With continued growth through December, this expansion will enter its 93rd month, replacing 1982-90 as the longest peacetime expansion on record. But we should be much more ambitious. If growth is sustained into the next millennium, until February 2000 to be exact, this expansion will become the longest on record, surpassing the expansion of 1961 to 1969, which lasted 106 months.

But what are the odds that we can achieve this record? Although continued solid growth into the next millennium remains a likely outcome, the risks to this forecast have risen substantially as a consequence of the growing turmoil in international financial markets and the marked slowing of growth we are now witnessing in the world economy. Therefore, policies to contain the current crisis, to promote growth in the world economy and--taking the longer view--to reduce the odds of future crises-- are top priority items on the Administration's growth oriented economic agenda. I would like to focus primarily on these international issues in my remarks today touching only briefly on other policies that are needed to promote prosperity into the next century.

More than a year has elapsed since the Asian crisis began. Unfortunately, what started as a regional economic and financial crisis in East Asia has now developed into a larger global crisis, spreading to financial markets around the world, impacting global commodity markets, impairing economic development and imposing extraordinary hardship in the crisis afflicted countries, and posing risks to growth in industrial countries including the United States. There are few countries around the globe that have been unaffected.

The economic slump in the original crisis countries (Korea, Indonesia, Thailand and Malaysia) remains severe. The spillovers to other countries in the region, such as Hong Kong, and Singapore, have been substantial. Japan, already in a serious and deepening recession prior to the crisis, has seen a significant decline in its exports to its key Asian trading partners, and its banks have been hit with financial losses related to lending in the region. Currencies and stock markets in Latin America have come under pressure, especially following the crisis in Russia. Emerging market spreads over Treasuries, about 1500 basis points in September 1998, are now

close to their highs during the 1995 Mexican peso crisis. The appetite for risk of international investors has fallen and there is some retrenchment from emerging markets towards safe haven assets and from stocks towards liquidity.

Over the past year, commodity prices have also declined, impacting industrial countries like Canada, Australia and New Zealand. In Latin America, the fall in oil prices has hit Mexico and Venezuela; the fall in copper prices is hurting Chile and Peru; and the decline in agricultural prices is affecting Argentina. Globally, all commodity exporters are hurting.

The impact of the crisis on the prospects for worldwide growth is evident in the most recent IMF *World Economic Outlook*, released in October 1998. The IMF now forecasts 2.0% world real growth in 1998, a precipitous drop from the 4.3% growth expected in October 1997. Forecasted world growth for 1998 is now comparable to levels not seen since the pronounced world recessions of 1974-75, 1980-83, and 1990-91. Japan's economy is expected to decline by 2.5%. The newly industrialized Asian economies (Hong Kong, Taiwan, Singapore, and Korea) are predicted to contract by 2.9%. The economies of the ASEAN-4 nations (Indonesia, Malaysia, Philippines, and Thailand) are now expected to shrink by a staggering 10.4%. Moreover, expected growth in the developing countries in the Western Hemisphere is now 2.8%, down from 5.1% a year ago; and Russia is expected to contract by 6% this year.

From the U.S. standpoint, the main impact of the international financial crisis on our economy to date has been a deterioration of net exports and a widening of the trade deficit. 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 six Asian countries: 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. The manufacturing sector is experiencing weakness related to the crisis' impact. Financial institutions with emerging market exposure have also suffered losses and are exposed to further losses, particularly if the impact of the crisis spreads to important trading partners in our own hemisphere; and market volatility has clearly increased. We have recently seen rising spreads on corporate debt, dramatically so in the case of junk bonds, and there has been a noticeable recent tightening of credit standards and loan terms in commercial lending--evidence of a generalized flight to safety by participants in financial markets. These conditions imply an effective tightening of financial conditions. Further deterioration in the international economic situation remains the single largest risk to a forecast of continued solid growth into the next millennium.

Turning to the question of how to sustain America's growth, the first imperative is to work with the international community to promote growth in the world economy and to stabilize international financial conditions. Chairman Greenspan noted recently that no country, including the United States, is an island in the world economy. The growth prospects of all industrial nations will suffer unless we all do our part to help the world economy to grow. This need has been clearly recognized by the G-7 finance ministers and central bank governors who issued a joint statement several weeks ago 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. Strong growth in the industrialized countries is a prerequisite for recovery of crisis afflicted economies.

In serving as a major engine of global growth, the United States will inevitably see an increase in its trade deficit and some sectors, particularly those that are heavily exposed to trade, will experience disproportionate impacts. Even so, the United States must accept a rising trade deficit if the crisis countries are to recover. This means working to counter protectionist pressures at home just as we urge the crisis impacted countries to keep their own markets open. The Clinton Administration is committed to outward looking, internationalist policies.

As the world's second largest economy, Japan has a key role to play in maintaining world economic growth and its performance will determine the prospects for Asia's recovery. Japan has now entered a full fledged recession. Real growth over the four quarters of 1997 amounted to -0.4%. In the first half of 1998, Japanese real GDP was down 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. The United States continues to believe that Japan must take strong measures to stimulate domestic demand, to restore confidence, to deal with the problems of its banking system, to open its markets and to deregulate its economy.

Beyond working to insure growth in the industrial world, the United States has been focused since the outset of this crisis on the need to contain financial contagion and to restore the confidence of market participants--a prerequisite for capital flows to continue. 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. It is now widely agreed that structural weaknesses, particularly in the process of financial intermediation, were an element in initiating the crisis. 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 inefficient or insolvent banks.

In a speech last Thursday, Secretary Rubin emphasized that the contagious effects of the ongoing crisis now threaten countries that have made great progress in implementing sound macroeconomic and structural policies and worked to strengthen the fundamentals of their economies. To deal with such threats, the President proposed on Friday to create a precautionary financial facility based in the IMF whose goal would be to provide assured access to assistance in the event of need to countries with sound policies which have acted responsibly, thereby helping them fight off the contagious impact of the ongoing crisis. In its communique on Saturday, the G-7 ministers and governors indicated their willingness to explore this idea. However, for the IMF to play its critical role in countering contagion, its resources must be expanded and the key step is for the U.S. at long last to meet its 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 New Agreement to Borrow. 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 emergency 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 affected countries.

In his speech at the Council on Foreign Relations, 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. In Indonesia, Korea and Thailand, for example, the combination of sustained high interest rates and illiquidity has led to harsh economic contraction and a vast overhang of bad debt. Debt to equity ratios that were already very high before the crisis (about 300% in Korea for the top 30 chaebols) have become unsustainable now (over 500% in Korea, 400% in Thailand and even higher in Indonesia) due to the real devaluation of their currencies and the burden of high real interest rates. In Indonesia, Korea, and Thailand, the World Bank estimates that 20-65 percent of firms have balance sheet losses greater than equity. When insolvent, highly leveraged companies cannot service their debt, a self reenforcing spiral is created in which banks' cash flows are squeezed, forcing them to contract new lending not only to troubled corporations but even to those in better health. The object of comprehensive restructuring is to restore the flow of credit so that firms in these countries can get back to the business of producing output and creating jobs.

In an effort to insure access of crisis impacted countries to critical imports and to help American businesses continue selling abroad, the Export-Import Bank will establish new

short-term credit facilities for critical Latin American markets. We will coordinate these efforts with our counterparts in other leading industrial nations to ensure that trade credit continues to flow during this period of financial stress. Moreover, to keep private capital flowing to crisis impacted economies, the Overseas Private Investment Corporation (OPIC) has developed a new instrument to help emerging economies raise money from international capital markets.

The President also has asked the World Bank and Asian 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.

Even as we work to mitigate the impact and contain the spread of the current crisis, the Administration is collaborating with other countries to find ways to strengthen the architecture of the financial system so that it is less crisis prone going forward. 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. Yesterday, at a meeting attended by the President, ministers and central bank governors from a group of industrial and key emerging market countries presented reports containing a plethora of recommendations to strengthen the international financial system. The work of this committee represents a continuation of a process begun in Naples and Halifax. It focuses on measures to increase transparency and strengthen financial systems, and proposes strategies for orderly workouts in the event of a future crisis.

There is a broad consensus on the need for greater transparency and openness both on

the part of debtor countries and official institutions such as the IMF. The Working Group report on

transparency and accountability stresses the need to enhance the relevance and reliability of information disclosed by the private sector through compliance with high-quality accounting standards. It calls for braodening the public disclosure of data_on foreign exchange reserves, external debt and financial sector soundness. And it recommends greater disclosure of data on the international exposure of investment banks, hedge funds and other international investors. Finally, it urges the IMF itself to be more open and transparent.

Transparency is necessary to provide investors with the information necessary to evaluate risk in lending, but such measures are not likely to be sufficient on their own to prevent another major crisis from occurring. In the current crisis, for example, some information was unavailable, but available indicators, many signaling caution, were apparently ignored by investors.

Most analyses of the crisis point to financial sector weaknesses as a central cause. 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 undercapitalized financial systems, 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 dramatically increased access to funds from abroad. Accordingly, the report proposes a series of reforms to strengthen domestic financial institutions and to create stronger incentives for borrowers and lenders to weigh risk and act with appropriate discipline, thereby reducing the odds of a crisis.

The task of strengthening financial systems is long-term and daunting. A partial list of needed elements 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 officials and regulators; improved corporate governance in both the financial and non-financial sectors; and implementation of efficient insolvency and debtor-creditor regimes.

The experience of Asia suggests that an excessive accumulation of short-term foreign currency denominated and unhedged foreign liabilities by the financial system was an important

cause of the financial fragility that triggered and exacerbated the crisis. Mismatches between the maturity and currency composition of financial institutions' assets and liabilities and an incorrect assessment of liquidity and currency risks aggravated the problem. These structural weaknesses, together with the herdlike mentality of international investors, who withdrew funds and failed to rollover their loans to the debtor financial institutions, triggered the crisis. Clearly, cross-border short-term interbank flows are highly volatile and there is now broad agreement that, at the minimum, they should be addressed in a strengthened regime of prudential supervision of banks. In addition to proposing measures to strengthen financial systems and guard against the buildup of unsustainable risk positions, the Working Group report proposes measures to strengthen the incentives of debtors and creditors to behave prudently. In particular, the report emphasizes the need to limit the scope of government guarantees and implicit insurance schemes, to maintain appropriate exchange rate regimes, and to develop methods for greater risk sharing between debtors and creditors, including increased reliance on bond markets as an alternative to bank finance. In recent crisis episodes, governmental guarantees at many levels apparently reduced the perception of risk by lenders and borrowers. In many countries, there was an expectation that corporations and banks would be bailed out by governments in the event of trouble. In many instances, too, the incentive of private parties to hedge exchange risk was diminished by the prevalence of fixed or semi-fixed exchange regimes. Such implicit and explicit guarantees may have distorted incentives, encouraging both debtors and creditors to take on excessive risk, to fail to hedge that risk, and to ignore available information pointing to potential problems. The report concludes that limiting guarantees, making those which are offered as explicit as possible~~,~~ and pricing them appropriately could also contribute to crisis prevention.

While strengthening domestic financial systems may prevent some crises and make those that do occur less virulent, it is still likely that crises will not be eliminated altogether. And while a well designed insolvency regime can facilitate orderly workouts of corporate debt, the Working Group report emphasizes that no comparable internationally agreed and binding bankruptcy regime is likely to emerge to handle sovereign debtors. The report emphasizes that **temporary suspensions of debt payments should occur only in extreme situations as a last resort after all other reasonable alternatives have been explored.** But in such instances, there is a need to develop mechanisms to facilitate the orderly workout of sovereign liquidity crises and it is essential for the private sector to share in the burden of crisis resolution.

Private sector burden sharing is critical, not only because official money is unlikely to be sufficient in all circumstances, but also because it is absolutely essential in inducing market discipline and reducing potential moral hazard problems deriving from official assistance. In spite of its importance, private sector burden sharing is more difficult to achieve now than in the days when banks accounted for the bulk of international capital flows. Today, the proliferation of creditor institutions and instruments and the growth of international bond markets makes the problem of coordinating the actions of creditors during a crisis extremely difficult. **Thus, a key recommendation of the Working Group** is to include **"collective action** clauses" in bond contracts to provide for: collective representation of creditors; majority action to alter the payment terms of a contract; and sharing of payments among creditors. All of these provisions work to facilitate speedy and orderly workouts.

One question on which researchers and policymakers remain sharply divided concerns the desirability of implementing controls on flows of capital, in advance of a crisis, to prevent the potential disruptions associated with volatile international capital flows. Debate on this topic is certain to continue. However, there is some agreement on the need for appropriate sequencing of capital account liberalization. The G-7 Finance Ministers statement at the Birmingham summit noted that, while progressive liberalization of a country's capital account may be warranted over time, countries should be careful to proceed in an orderly way. With strong financial systems, the arguments in favor of unfettered capital flows are strong. But during such a transition, the liberalization of the capital account should be gradual and carefully managed. Excessive accumulation of short-term debt, excessive borrowing and lending, mismatches of maturities and currency denomination of assets and liabilities of financial institutions and corporate firms--all factors that have proven so destabilizing in many recent and not so recent episodes of financial and currency crises--must be avoided.

The international crisis has forced countries around to globe to confront the necessity of implementing the sound domestic policies which are ultimately fundamental to promote long-term economic growth and inspire investor confidence. The United States is no exception. From the outset, the Clinton Administration has focused on getting the policy fundamentals right to help the United States grow and to inspire investor confidence. 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 into the next millennium.

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 played an important role 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 although, like domestic competition, it brings challenges when it disrupts established patterns of economic activity.

Conclusion

Let me conclude by pointing out what is at stake in meeting the challenge of sustaining America's growth into the next millenium. 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: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:15-OCT-1998 15:09:23.00

SUBJECT:

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

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

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D7]MAIL46527688U.226 to ASCII,
The following is a HEX DUMP:

Draft. Close hold. JF. 10/14/98

Contingent fiscal stimulus

- The official Administration forecast has all along called for a slowdown from the unsustainably high growth rate of 4 % in 1996 and 1997 to 2 % in 1998 and 1999.

- Some amount of slowdown has been inevitable, given capacity constraints, especially in the labor force. The alternative to negative impacts on economic growth from the rising trade deficit (and from other components of demand) probably would have been negative impacts of higher interest rates.

- In the event, the slowdown came abruptly in the 2nd quarter of 1998:
  1998I 98 II 98 III* 98 IV*

- The CEA forecast for the most likely path of the economy in 1999 entails only a small further slowdown relative to our earlier forecast. Our best estimate is for __ % growth on a Q4/Q4 basis, or __ % on a year/year basis.
  1999 I* 99II* 99III* 99 IV*

  [* = CEA forecast]

- The downside risks to the forecast have increased. The probability of any random year containing at least one quarter of a recession is higher than one might think: about 30 per cent. One can make a more intelligent updated estimate based on recent information. Such indicators as the slope of the yield curve suggest that the probability of recession might now be greater than before. [As recent as mid-1997, an econometric forecasting model based on such variables said that the probability of a recession in the coming year was *less* than the unconditional 30 percent.]

- Although JP Morgan is apparently the only major forecaster expecting a US recession next year, some in the financial community are now emphasizing "alternative" or "worst-case" scenarios that assign a non-negligible probability to recession. Goldman Sachs, for example, recently reported that a model based on various securities market indicators is consistent with a 40% probability of recession in the next 12 months. [A WEFA Special Report for September states that the likelihood of a global meltdown is now "significant," and assesses its probability at 30%. Noting the recent occurrence of key elements of its worst-case scenario, Standard & Poor's DRI also increased its subjective probability of a world recession to 30-35%. {I haven't heard back from JIM

STOCK.}]

- In the event of an incipient recession, automatic stabilizers would provide significant stimulus.

- One possible sort of policy initiative would be to strengthen some automatic stabilizer now:
  - The welfare contingency fund. (Is it big enough?)
  - Trigger for UI extended benefits
  - Health insurance for the unemployed
  - Other aspects of protection for low-skilled workers.

- Monetary policy would likely provide stimulus, albeit with a substantial lag between policy change and effect on the economy.

- Discretionary fiscal policy could in theory provide additional stimulus. The lag between policy change and economic effect can be short, though the lag between economic data and the government's reaction regarding fiscal policy decisions is usually quite long.

- What kind of fiscal stimulus would make sense? ...

- If discussions of possible stimulus measures were to begin, it would be critical for as long a time as possible to keep them contingent on developments in the economy. The Administration could deliberate on the specifics of a possible tax cut or spending increase (perhaps even in public) while the exercise was still described as an insurance policy or fire extinguisher kept on the shelf for emergencies ("break glass in case of recession"). Reaction-time is important: Historically, timely fiscal interventions are less common than occasions where fiscal expansionary measures attained their peak effects on the economy at a time when they were no longer appropriate, or where the opposite sorts of errors were made.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:15-OCT-1998 15:46:22.00

SUBJECT: Re: probability of a banana

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

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

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

TEXT:

Stock's model (when the yield curve slope is included) has a 40-44 % probability of a banana in 1999. Vs. 30 % unconditional (i.e., in a typical year).

Janet, I suggest inserting this into the 6th bullet point of the talking points I sent you (in place of the WEFA and DRI estimates, which were about global banana).

I can certainly think of drawbacks of this estimate; but I think it is key to have some specific estimate, to help make concrete the point regarding a contingency that is an alternative to the best-guess forecast.

I will send around Stock's faxed table.

JF

---------------------- Forwarded by Jeffrey A. Frankel/CEA/EOP on 10/15/98 03:40 PM ---------------------------

james_stock @ Harvard.Edu
10/15/98 02:41:51 PM
Record Type: Record

To: Jeffrey A. Frankel/CEA/EOP
cc:
Subject: Re: probability of a banana

I had to go to a meeting but I now have had a chance to check the calculations more carefully. There was a data error in what I did before (I shouldn't have rushed.....). I'm now faxing you the updated numbers with some description. Your intuition about the effect of the yield curve was right, the models with this in them have a higher probability.

Let me know if this is clear or if you have questions. I'll only be around for 45 minutes more today (seminar) but will be in first thing tomorrow.

Jim

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:15-OCT-1998 18:18:12.00

SUBJECT: Current draft of talking points

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

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D81]MAIL42861298J.226 to ASCII,
The following is a HEX DUMP:

THE ECONOMIC OUTLOOK AND POLICY OPTIONS

The Economic Outlook

- **Growth over the last 2-3 years has been unsustainably high. Most forecasters, including the Administration's Mid-Sessiion Review, have anticipated a slowdown in growth and a gradual rise in the unemployment rate toward 5% or slightly over by 2000.**

  - Over the last ten quarters, real GDP growth has averaged about 3.8%--well in excessive of our estimated growth rate of potential output (2.5.) As a consequence, unemployment declined from 5.6% in 1996:Q1 to 4.4% in 1998:Q2, below our estimate of NAIRU. Given capacity constraints, particularly in the labor market, a slowdown has been viewed as inevitable.

  - The Administration's MidSession Review forecast 2% growth in 1999-2001 and a rise in the unemployment rate to x. The Blue Chip consensus forecast stands at 2.1% for 1999.

  - Prior to the intensification of the Asian crisis, it had been widely assumed that the forecast slowdown would be achieved through a combination of a natural waning in the robustness of domestic demand combined with a likely tightening of Fed policy. Market interest rates reflected this assumption.

- As the international financial crisis has intensified and world growth prospects have diminished, market interest rates have declined substantially. These declines reflect, in part, a reevaluation of the degree of monetary tightness necessary to attain a slowdown in the face of worsening trade performance. These interest rate declines have been working to stimulate interest sensitive spending, countering the direct negative impact of the crisis on net exports. Contrary to expectations, domestic demand has remained robust and real growth remained strong the first half of 1998.

Why is real growth expected to slow?

- There are good reasons to anticipate that virtually all spending components will grow less rapidly in 1999 than over the past two years.

- **Net Exports**. The outlook for world growth has deteriorated substantially and net exports will continue to hold down growth. Net exports subtracted 2% from real growth in the first half of 1998 and could subtract more (or less) going forward. Growth expectations have been written down in Canada, Mexico and other countries that have not succumbed to the crisis.
- **Consumption** growth has long outstripped income growth resulting in negative savings rate. Even a levelling off of the stock market would result in slower consumption growth. A decline would further lower growth.
- **Investment spending** has been growing at exceptional rates and capacity utilization is now low by historical standards. Slowing growth in final sales works to depress investment spending. In additon, corporate cash flow may diminish at a time when market conditions and the willingness of banks to lend is deteriorating.
- **Residential investment** spending has already been boosted by lower interest rates and housing starts are at high levels relative to underlying demographics.
- Under current fiscal assumptions, the Federal government's structural surplus will increase, constituting a small additional drag on spending.
- Some signs of an incipient credit crunch are emerging, implying an effective tightening in monetary conditions.

    - Risk spreads over Treasury debt have increased and terms and standards for loans show some signs of increasing. In part, a reassessment of risk is taking place, leading to greater caution in lending, to all risky borrowers including emerging market borrowers and those at home. Some banks have sustained losses which may impair their ability to lend. Liquidity in financial markets has declined noticeably.

    - The seriousness of these financial market changes should not be overblown. Borrowing rates for most borrowers have actually declined in recent weeks, even as spreads have increased. Higher risk borrowers have seen an increase in rates. Stricter lending terms are reported by under one quarter of banks and only for lending to large corporations. Financing remains readily available to households and for mortgages. Banks have been and remain extremely well capitalized.

- There is a danger that bank regulators will force tighter standards on banks inducing a credit crunch. Recall, however, that bank regulators have long urged greater caution in lending and risk assessments and cannot easily reverse course as banks appear to be marginally pulllling back from lending the regulators have long warned is risky. Greater caution in lending is, on balance, a healthy development.

- Volatility in financial markets has increased and liquidity has declined. Further losses may occur.

The forecast of slowing growth assumes a significant easing of monetary policy.

- The Macroadvisers consensus panel expects 100 bp decline in the Fed funds rate by spring.

The forecast contains considerable downside risk.

- Downside risks to the forecast have increased. The probability of any random year containing at least one quarter of a recession is higher than one might think: about 30 per cent. A well-known econometric model developed at the National Bureau of Economic Research now places the probability of a recession at 40-44%. As recently as mid-1997, this model placed the probability of a recession in the coming year *below* the unconditional 30 percent.]

- Although JP Morgan is apparently the only major forecaster expecting a US recession next year, some in the financial community are now emphasizing "alternative" or "worst-case" scenarios that assign a non-negligible probability to recession. Goldman Sachs, for example, recently reported that a model based on various securities market indicators is consistent with a 40% probability of recession in the next 12 months. [A WEFA Special Report for September states that the likelihood of a global meltdown is now "significant," and assesses its probability at 30%. Noting the recent occurrence of key elements of its worst-case scenario, Standard & Poor's DRI also increased its subjective probability of a world recession to 30-35%. {I haven't heard back from JIM STOCK.}]

- The Stock Market could fall more, depressing consumption. For example, a 10% additional decline in the stock market could chop a quarter point from 1999 grown and about ½ percentage point off growth in 2000. In spite of substantial (15-25%) drops from recent highs, stocks remain at high P/e ratios. Earnings could easily disappoint profit expectations built into these valuations.

- Possible further deterioration in the international environment. There would be repercussions for net exports, the stock market and risk premia.

- Profit Outlook/Investment spending could fall

- Increasing volatility/bank losses, increased risk resulting in a credit crunch

The Role of Monetary Policy in Sustaining the Expansion

- **In principle, monetary policy is the only tool needed to keep the expansion on track.**

    - **The Federal Reserve has ample room to cut its overnight interest rate,** which now stands at 5.00%, and has clearly signalled its intention to act. The U.S. situation, for example, stands in sharp contrast to that in Japan, where short-term rates are 0.25%. However, to the extent that current market interest rates are already premised on the assumption that the Fed will cut its overnight rate substantially over the next year, the scope for further easing is somewhat smaller than the level of the funds rate suggests.

        - Market participants currently anticipate about 100 bp of Fed easing over the next six months. Macroadvisers' Consensus Open Market Committee currently expect the federal funds rate to be cut to about 4.4% over the next 12 months. Fed funds futures anticipate a funds rate of 4.8% by year end.

    - A quick reaction of monetary policy to changing economic conditions can potentially boost confidence.

    - Monetary policy may be particularly well suited to dealing with a slowdown rooted in tightening financial conditions--due, for example, to wider risk spreads.

        - Wider risk spreads can be counteracted by reducing safe rates.

        - Lower short term rates tend to riase bank profits, thereby helping banks to rebuild capital and boost lending.

        - Monetary policy may be effective even if a credit crunch occurs. Although some suggested that monetary policy was ineffective in promoting recovery in 1990-92, during the credit crunch, policymakers may simply have underestimated the strength of the headwinds. Policy could have been eased more.

    - The magnitude of the job that has implicitly been assigned to monetary policy to maintian the expansion has been rising in the face of continued deterioration in the international outlook has deteriorated. Substantial Fed easing and a substantial response to that easing are likely needed simply to attain growth in the projected 1.5-2% range for 1999.

- **However, the effectiveness of monetary policy in impacting the economy is uncertain, translating into risk in the forecast for 1999-2000.** The risk is exacerbated by the fact that environment facing monetary policy is historically atypical.

    - Monetary policy is most often eased to stimulate the economy after a recession, itself induced by a tightening of monetary policy to counter rising inflation. When monetary policy is eased, buyers of homes and durables like cars who had deferred purchases because of high rates, typically respond. In contrast, interest rates have been declining over the past year and purchases of durables and homes are at high levels. Interest sensitive spending could respond to further cuts but the response might be lower than in a typical easing episode.

- **Monetary policy works with long and variable lags.** If downside risks materialize, resulting in a further deterioration in the outlook, it is questionable whether monetary policy prove capable of countering such shocks in a timely manner.

- We should be careful to avoid "procyclical bank regulation"--increasing pressure on banks to avoid risk as the economy is turning down. However, supervisors have been emphasizing the need for increased caution in lending for some time, and banks may finally be heeding that message.

The Potential Role of Fiscal Policy

- In the event of a downturn, the **automatic stabilizers** (reduced taxes and increased outlays automatically resulting from slower growth) built into fiscal policy will provide significant stimulus, mitigating the magnitude of a recession. This assumes that the spending and tax decisions are not altered to counter the contraction in the surplus. Fo example, a one percent drop in GDP would decrease the budget surplus by about $24 billion.

- The automatic stabilizers are arguably less effective now than formerly and could potentially be strengthened.

- The 1994 welfare reform reduced the size of the stabilizers by changing entitlements into block grants. There is a real question of whether the welfare contingency fund is large enough to weather a significant downturn.

- **The trigger for UI extended benefits is too high:** In most states, extended benefits are triggered when the state's insured unemployment rate is at least 6 percent. Once triggered, the program provides an additional 13 weeks of benefits on top of the basic 26 weeks. Since 1970, there has been a substantial drop in the ratio of insured unemployment to the total civilian unemployment rate. As a consequence, the total unemployment rate might have to climb as high as 15 percent to trigger extended benefits. Problems with automatic triggering of benefits became obvious in the last recession.

- Discretionary fiscal policy--either tax cuts or spending initiatives--could also play a role in maintaining the expansion.

  - A possible case against using fiscal policy to sustain the expansion is that it may simply be offset by a tighter monetary policy.

- In contrast to monetary policy, the lag between fiscal policy changes and economic effects can be short, though the lag between economic data and the government's reaction regarding fiscal policy decisions is usually quite long.

- Discretionary fiscal policy may be, and often is mistimed--occurring at the wrong time, or in the wrong amount. In considering possible fiscal stimulus, information obtained about the outlook over the next few months will be useful in assessing its desirability.

- An addtional argument in favor of active fiscal policy is that it is arguably less risky to rely on a package of tools--monetary <u>and</u> fiscal policy, rather than either alone--to keep the expansion going. This is particularly true in a situation where the role assigned to monetary policy has increased as the outlook has deteriorated, creating increased risk.

- What type of stimulus makes sense? Typically, permanent rather than temporary tax cuts produce a large spending impact. s on spending. Temporary tax cuts which could have potent spending impacts are those which affect the timing of durable goods purchases--such as a temporary investment tax credit or a temporary tax credit for consumer durables purchases.

- The bang per buck of tax cuts is not huge. For example, a permanent $30 billion tax cut would be likely to boost real GDP growth by about 0.5% in the year in which it occurs.

If discussions of possible stimulus measures were to begin, it would be critical for as long a time as possible to keep them contingent on developments in the economy. The Administration could deliberate on the specifics of a possible tax cut or spending increase (perhaps even in public) while the exercise was still described as an insurance policy or fire extinguisher kept on the shelf for emergencies ("break glass in case of recession"). Reaction-time is important: Historically, timely fiscal interventions are less common than occasions where fiscal expansionary measures attained their peak effects on the economy at a time when they were no longer appropriate, or where the opposite sorts of errors were made.

- **Recent evidence suggests that the widely anticipated slowdown in growth is finally occurring although the current level of activity remains quite strong. Most observers expect a gradual rise in the unemployment rate toward 5% or slightly higher through 1999.**

- Many forecasts are currently undergoing downward revisions. Some especially knowledgeable observers are particularly pessimistic. Moreover, the degree of Fed easing upon which most forecasts are premised has risen substantially.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:15-OCT-1998 18:17:33.00

SUBJECT: possible policies

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

TEXT:
---------------------- Forwarded by Janet L. Yellen/CEA/EOP on 10/15/98
06:17 PM ---------------------------

Douglas W. Elmendorf
10/13/98 02:01:01 PM
Record Type: Record

To: Janet L. Yellen/CEA/EOP
cc:
Subject: possible policies

Here are the two documents.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D66]MAIL45251298L.226 to ASCII,
The following is a HEX DUMP:

Summary of Current Financial Conditions
October 9, 1998
Doug Elmendorf

1. *Domestic financial conditions are not spiraling down.*

* equity markets are volatile but prices have hardly collapsed
    * since year-end: Dow, SP500, NYSE, Nasdaq, Wilshire down 1-4%
    * since record high: indices down 15-25%
    * since Sept 1: Dow and SP500 down 1%, Nasdaq down 4%

* capital markets are shaken but not stirred
    * risk spreads have widened, but most corporate borrowers face lower rates than 2 months ago
    * issuance of corporate-grade debt has dropped owing to both demand and supply hesitation
        * supply is weak because some issuers are expecting spreads to narrow
        * demand is weak because underwriters don't want the risk or because investors are waiting for Q3 earnings reports or because ?
    * junk issuance has re-emerged a bit (July: 2.3b, Aug: .6 b, Sept: 1.4 b; Q2: 1.5 b, Q3: 1.4 b)
    * junk yield spread has leveled off

* bank lending is tightening but not disappearing
    * Senior Loan Officer Survey shows sharp swing toward tightening of terms and standards in September -- but this is only for big firms, and even there, less than 1/4 of banks on net report these steps
    * why are big firms facing changes but small firms are not?
        * maybe the big firms that turn to banks are actually riskier than the small firms that turn to banks
        * maybe banks change behavior toward small firms more slowly (if you don't change quickly for big firms, a surge in their demand could overwhelm you, while small firms do less substituting and may value predictability as part of an implicit contract)
        * maybe big banks lend to big firms, and the big banks are worried about their capital bases
    * C&I loans grew 17% (a.r.) in September -- some of this is clearly substitution out of capital markets, but it does contradict Newman's statement
        * this could be inventory accumulation

2. *The cost of capital has risen.*

* for all firms, cash flow growth is way down
    * but level of profits remains high

* for big, safe firms
    * equity capital: availability irrelevant
    * market borrowing: availability down, cost down
    * bank borrowing: not very relevant

* for big, risky firms
    * equity capital: availability irrelevant
    * market borrowing: availability down, cost up
    * bank borrowing: availability down, cost up

* for small firms
    * equity capital: availability down, cost up
    * market borrowing: availability irrelevant
    * bank borrowing: availability unchanged for now; cost unchanged for now

* for consumers
    * consumer credit: availability unchanged, cost unchanged
    * mortgage borrowing: availability unchanged, cost down (not as much as Treas)

3. *We are probably not entering a credit crunch.*

* what does this term mean?
    * maybe, quantity constraints in addition to price constraints

* there is a flight to both safety and liquidity
    * all risk spreads have widened
    * the spread between on-the-run and off-the-run securities has widened

* financial institutions are basically very healthy in the U.S.
    * bank profits have been very high
    * chargeoffs have been very low
    * bank capital ratios have been very high
    * brokerage capital ratios have been high too, I think
    * this is a contrast with the situation in 1990

* underlying economic conditions in the U.S. are extremely strong
    * very low unemployment and inflation
    * no imbalances
    * high consumer confidence

* some re-evaluation of risk is healthy
    * spreads had fallen very low over the past few years
    * the Fed and OCC had warned about this

* what are the biggest risks?
    * the underestimation of risk was not as bad as in some past expansions (e.g., chargeoffs still low), but the shock may be larger this time
    * an overreaction to past exceeses?
    * a cascade of international defaults or market turmoil that depletes bank capital -- watch out for Latin America or hedge fund collapses

* markets have been growing in importance relative to financial institutions — how does this matter?

3. *Wealth effects*

* if stock prices are little changed going forward, consumption growth could be about 1 percentage point slower in 1999 than in 1998 (essentially, a return to a neutral wealth effect rather than the boosts of the past several years)

4. *Confidence effects*

* hard to predict but potentially important for both households and businesses
* household debt is quite high and saving is quite low
* in 1987, confidence and consumption dropped quite sharply in October but reversed by year-end
* sudden household unease about debt levels may have brought on the 1990 recession

Thoughts on Countercyclical Policy
October 12, 1998

1. *Automatic stabilizers would provide significant stimulus.*

   A. A one percent drop in GDP would increase the budget deficit by $x billion. This fiscal stimulus might boost GDP again by as much as y percent.
      * The 1994 welfare reform reduced the size of the stabilizers by changing entitlements--where spending increased automatically as welfare rolls increased--into block grants.

   B. Automatic stabilizers could be strengthened.
      * Unemployment insurance could be changed to ...

2. *Monetary policy could probably provide sufficient stimulus.*

   A. The Federal Reserve could cut the overnight interest rate by as much as 5 percentage points.
      * This contrast with Japan, where short-term rates have been quite close to zero since 19xx.
      * A given absolute drop in rates may have a larger effect when rates are lower. In other words, it's the proportional change in rates that matters for some purposes: equity valuation, investment(??).
      * But medium-term and long-term interest rates already incorporate substantial further cuts in short-term rates, so the true amount of remaining stimulus is smaller than the level of the funds rate suggests.
      * Also, increasing financial problems might lead to even lower inflation expectations, which would push up real interest rates.

   B. Monetary policymakers can respond to changing economic conditions quickly.
      * This quick reaction could boost confidence, which would be important if falling confidence were a cause of the economic problem.

   C. Monetary policy might be well focused (naturally targeted) on the problem.
      * If an economic slowdown were rooted in financial factors, then expansionary monetary policy--which affects the economy through financial markets--might address those problems effectively.
      * Because banks and investors think in terms of spreads, wider risk spreads can be counteracted by reducing safe rates.
      * Cutting interest rates tends to raise bank profits and thereby help banks to rebuild capital.

D. The United States is unlikely to experience a true credit crunch.
  * Risk spreads had narrowed considerably during this expansion, so even the substantial widening of the past year has not made them especially wide by historical standards.
  * Financial institutions have been very healthy, with high profits, low chargeoffs, and high capital ratios. This makes banks less likely to curtail lending very substantially for a long time.
  * Both of these factors contrast sharply with the situation in 1990. The second factor contrasts sharply with the situation in Japan this decade.

E. Even if a credit crunch occurred, monetary policy would probably still be an effective tool.
  * The slow recovery in 1990-92 may have occurred not because monetary policy was pushing on a string, but because monetary policymakers underestimated the strength of the headwinds. After all, the funds rate was still well above zero.

3. Discretionary countercyclical fiscal policy would be important under some circumstances.

A. Monetary policy usually works with substantial lags.
  * A financial crisis might cause quantity rationing, while monetary policy works through price changes. Are the lags from quantity rationing shorter? How is that consistent with the view that monetary policy--which used to work more through quantitity rationing (disintermediation, e.g.)--always had long lags?
  * If financial markets anticipate policy more today, has that shortened the lags?

B. If the financial system grinds to a halt, then expansionary fiscal policy would be needed.
  * Even if lower rates help stricken banks to rebuild capital, that process can take years.
  * This is the situation in Japan today.

C. The Administration might want faster economic growth in the short run than the Federal Reserve.
  * Faster growth in the United States would/would not [let's try to find out] have a noticeable effect on economic conditions overseas.
  * Faster growth in the United States is probably not sustainable for very long.
  * If the Fed thinks that fiscal policy is providing sufficient economic stimulus, monetary policy would probably not be eased as much as otherwise.

4. What sort of discretionary countercyclical fiscal policy would make sense?

A. The policy would probably have to involve significant dollars to have much effect.

* One percent of GDP is $80 billion.

B. We would like policies that do not contradict the Administration's consistent emphasis on investing in the future.
    * The rationale for balancing the budget--and for avoiding tax cuts this past year--is to save for future needs.
    * We don't want to adversely affect the long-term budget outlook. This argues for temporary changes.
    * But the whole point is to find policies that boost demand, so this is a little tricky.

C. Temporary investment incentives are appealing.
    * This clearly involves investing in the future.
    * Temporary cuts work better than permanent cuts in this area.
    * This may be better focused than a consumption cut, if investment drops sharply owing to a restriction of credit. We would not want to boost consumption spending if unemployment and unused capacity were in the capital-goods sector.
    * But the direct benefit goes to companies to rich and people.

D. Consumption incentives are tricky.
    * Short-term cuts may be less effective, but long-term cuts ruin the long-term budget picture.
    * Increased saving incentives may boost both private saving and consumption.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:15-OCT-1998 16:27:54.00

SUBJECT:

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

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D49]MAIL480640987.226 to ASCII,
The following is a HEX DUMP:

Draft. Close hold.

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- In principle, monetary policy can be used to keep the economy on track. The Federal Reserve has ample room to cut its overnight interest rate, which now stands at 5.00%.

- A significant easing of monetary policy is likely to be necessary to attain growth in the 1.5-2% range in 1999. Indeed, as the international outlook has deteriorated, the

- A significant Market participants currently anticipate about 100 bp of Fed easing over the next six months. Macroadvisers' Consensus Open Market Committee currently expect the federal funds rate to be cut to about 4.4% over the next 12 months. Fed funds futures anticipate a funds rate of 4.8% by year end. Expectations of significant easing are already built into market rates.

- However, monetary policy lags are long and interest rates have already declined substantially, stimulating interest sensitive spending.

- If monetary policy is capable of keeping the economy on track, expansionary fiscal policy may simply be offset by a less expansionary monetary policy.

- In the present circumstances, monetary policy may be less effective than normally in stimulating the economy.

    - In contrast to the usual situation in which monetary policy is eased (after a period of high interest rates to contain inflation) interest rates have already been declining and interest sensitive spending is already at high levels.

    - Credit conditions may be tightening.
    - Further interest rate cuts could stimulate mortgage refinancings, although there is debate about the scope for this stimulus to work.

- It is arguably less risky to rely on a package of tools--monetary and fiscal policy--to keep the expansion going than on one alone.

- In the event of a downturn, the automatic stabilizers will provide significant stimulus, mitigating the magnitude of a recession. For example, a one percent drop in GDP would increase the budget deficit by about $24 billion. At a minimum, these stabilizers should be allowed to work and will serve to mitigate any downturn.

- One possible sort of policy initiative would be to strengthen some automatic stabilizer now:
  - The 1994 welfare reform reduced the size of the stabilizers by changing entitlements into block grants. There is a real question of whether the welfare contingency fund is large enough to weather a significant downturn.

  - Trigger for UI extended benefits: In most states, extended benefits are triggered when the state's insured unemployment rate is at least 6 percent. Once triggered, the program provides an additional 13 weeks of benefits on top of the basic 26 weeks. Since 1970, there has been a substantial drop in the ratio of insured unemployment to the total civilian unemployment rate. As a consequence, the total unemployment rate might have to climb as high as 15 percent to trigger extended benefits. Problems with automatic triggering of benefits became obvious in the last recession.

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- What type of stimulus makes sense? Typically, permanent rather than temporary tax cuts are needed to have a significant impact on consumption spending.

  - The bang per buck of tax cuts is not huge. For example, a permanent $30 billion tax cut needed cost

If discussions of possible stimulus measures were to begin, it would be critical for as long a time as possible to keep them contingent on developments in the economy. The Administration could deliberate on the specifics of a possible tax cut or spending increase (perhaps even in public) while the exercise was still described as an insurance policy or fire extinguisher kept on the shelf for emergencies ("break glass in case of recession"). Reaction-time is important: Historically, timely fiscal interventions are less common than occasions where fiscal expansionary measures attained their peak effects on the economy at a time when they were no longer appropriate, or where the opposite sorts of errors were made.

- **Recent evidence suggests that the widely anticipated slowdown in growth is finally occurring although the current level of activity remains quite strong. Most observers expect a gradual rise in the unemployment rate toward 5% or slightly higher through 1999.**

- Many forecasts are currently undergoing downward revisions. Some especially knowledgeable observers are particularly pessimistic. Moreover, the degree of Fed easing upon which most forecasts are premised has risen substantially.

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READ:UNKNOWN

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

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D98]MAIL46248098H.226 to ASCII,
The following is a HEX DUMP:

Exhibit 1: Evolution of Forecasts & Economic Outlook

- The consensus projections for the second half of 1998 and for the four quarters of 1999 have been marked down only slightly over the past 2 months. Despite the markdowns, these projections still show output slightly stronger than projected in the Mid-Session Review.

Evolution of Blue Chip Consensus
(Real GDP growth, annual rate)

Publication date	1998:H2	1999 (Q4/Q4)
10/10	2.2	2.1
9/10	2.3	2.3
8/10	2.3	2.4
7/10	2.3	2.4
6/10	2.2	2.4
5/10	2.3	2.4
4/10	2.2	2.4
MSR (5/26)	2.0	2.0

- There seems to be more talk about recessions recently. DRI (which projects 1¼ percent growth in the first half of 1998) says that the probability of a recession in the next two years is 50 percent). Two (usually) mainstream institutions (Morgan & Chase) are projecting zero or negative growth in the first half of 1999. The Federal staff is projecting...

- Because of the well-anticipated boost from fourth-quarter motor vehicle production (chart), concern about weak growth is focused on the first half of 1999.

- Consumption, housing, exports, and business investment are all expected to decelerate, contributing to the slowing of real GDP to 2 percent.

- The soft landing to 2 percent growth may be difficult to execute gracefully. Business investment, exports, and consumption may well slow too much.

Exhibit 2: Consumer behavior

- Consumer sentiment has fallen in the past few months. Even so, the September level of consumer confidence remains in the 90th percentile of its historical distribution (chart). The level of consumer confidence, rather than its change is the most relevant to the future growth of real consumtion.

- Excluding motor vehicles, consumption in the third quarter appears to have grown at about a 4½ percent annual pace.

- Motor vehicle consumption bounced back to a solid 15.5 million unit annual rate in September. But for the quarter as a whole motor vehicle sales were off sharply as major buyer-incentive plans advanced sales into May and June from July and August.

- Rapid growth of the consumption probably was caused by the large increases in the stock market, and the saving rate plunged to below 1 percent.

- Waning effects of stock-market rise--exacerbated by recent correction. Worry: the stock market may fall further, and if so, it may restrain consumption growth further.

Exhibit 3: Residential Investment

- The level of new home construction (at about a 1.6 million unit annual pace) is very high compared with its long-term demographic fundamentals (chart). It has moved up to this level in response to falling mortgage rates and rising real incomes. But it is already so high that it doesn't have to move up much more.

Exhibit 4: Business Investment

- Investment in business equipment appears to have slowed dramatically in the third quarter--after growing 18 percent during the previous four quarters. One indicator of equipment investment, shipments and orders of nondefense capital goods (excluding aircraft and computers), although highly volatile has been flat since the first quarter.

- Construction of business structures has flattened out this year (chart) after substantial growth earlier in the expansion. Contracts for new construction, a leading indicator of contruction activity have turned down sharply.

Is there a surplus of investment?

- Industrial capacity has increased about 4½ percent in each of the past several years.
- The capacity utilization rate is now BELOW its long term average--despite very tight labor markets.
- As GDP slows to 2 percent (from 4 percent for the 4 quarters ending in 1998:Q1), business investment may slow even more. Only about half as much capacity growth--and 2/3 as much gross investment (including replacement) will be needed in this 2 percent economy as in the 4 percent economy.

- The profit share has begun falling, and further declines may diminish investment funding.

- On the other hand, some support for business investment is likely to come from the falling relative price of investment goods (especially computers).

Exhibit 5: U.S. International Transactions

- All of the decline in U.S. exports of goods over the past year has been to the 7 countries affected by the Asian crisis.

Net exports made negative contribution in first half and are likey to continue to deteriorate.

- lagged effects of rise in the dollar over the past 3 years.
- Asian economic crisis is not over.

- On the bright side, net exports are not likely to decline as fast as in the first half. Therefore they are not likely to subtract as much from growth as they did.

Exhibit 6: Inflation

- Inflation continues to be very low, but it has probably stopped falling. The core CPI rose 2._ percent for the 12 months ending in September--up slightly from the 2.2 percent year-earlier increase.

- The pricing power of domestic producers has been restrained by the continuing decline in non-oil import prices. However, the recent decline in the dollar may limit further declines in the longer run.

Exhibit 7: Labor Market

- Athough clearly showing a decelleration of growth, the labor market as a whole remains fairly strong.

- Growth of production-worker hours has slowed to about a 1 percent annual rate of growth in both the second and third quarter (chart)--a figure that is consistent with a GDP growth rate of about 2 percent.

- Initial claims for unemployment insurance remain very low, only 297,000 for the 4-week period ending on October 10th (chart).

- Payroll employment grew only 69,000 in September (but this is not much weaker than the 115,000 per month pace that we would expect if the economy were growing at its 2.4 percent potential.)

- The major labor-market negative is the 150,000 decline in manufacturing jobs since March.

Exhibit __: Financial Markets

- In addition to the Asian Crisis (a problem of long standing), the recent increase in concern about macroeconomic prospects is connected to the behavior of financial markets.
- The S&P 500 is down 16% from its peak.
- The term premium (which is a leading indicator of recessions) has shrunk damatically in the past 2 months (chart).
- The quality spread has increased dramatically--but, even so, is not especially high (chart).
- The Federal Reserve's latest survey of Senior Loan Officers shows a significant tightening of credit standards for large- and medium-sized firms (chart).
- Have the indications of financial stress had any noticeable effect on real activity?