RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-OCT-1998 09:16:47.00

SUBJECT:

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

TEXT:
The charts are in the wrong order and need to be referenced. Chad will
fix that. ==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D92]MAIL424045981.226 to ASCII,
The following is a HEX DUMP:

The Economic Outlook
October 16, 1998

I. Overview

The economy has been growing faster than its long-run sustainable pace over the past 2-3 years, and most forecasts, including those of the Administration, have anticipated a slowdown in growth and a gradual rise in the unemployment rate to 5-5.5 percent by 2000.

- Prior to the onset of the Asian crisis, it had been widely assumed that the forecast slowdown would be achieved through a combination of a natural waning of the robustness of domestic demand (especially for consumption and investment goods) combined with a likely tightening by the Federal Reserve. Market interest rates reflected this assumption.

- With the onset of the Asian crisis, the channel through which the slowdown might occur changed. The likely decline in net exports due to the Asian crisis was seen as a likely alternative to Fed tightening. Net exports did in fact decline in the first half of 1998. But interest rates also fell as the world financial crisis intensified, global growth prospects diminished, and expectations about Fed actions were revised. Domestic demand continued to grow at a very robust pace in the first half of 1998.

In the past month or so, what was formerly seen as a relatively smooth path leading to slower growth has now begun to appear much bumpier. Although the consensus forecast continues to be for growth of about 2 percent in 1999, the Fed's decision yesterday to cut interest rates symbolizes the heightened degree of concern about downside risks.

- Attention is focused on a slowdown in the first half of 1999 (output in the fourth quarter of 1998 is likely to be boosted by a rebound in motor vehicle production).

- Almost all the components of demand could slow, and a smooth transition to 2 percent growth could be difficult to achieve.

II. Recent Trends and Future Prospects

A. Consumer Behavior

Until recently, consumer spending had been buoyed by a rising stock market and very strong consumer sentiment. Consumers have been spending a very high proportion of their income.

- 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.
- Consumption reached more than 99 percent of disposable income in the second quarter as stock market gains drove the ratio of household wealth to disposable income to very high levels (see chart).
- Consumer sentiment has fallen in the past few months, but its level in September was still in the 90th percentile of its historical distribution (see chart on next page).
- **Recent rates of consumption growth are unlikely to be sustainable without the impetus from a rising stock market and falling saving rate.**

B. Housing

The <u>level</u> of new home construction (at about a 1.6 million unit annual pace) is very high compared with its long-term demographic fundamentals (see lower chart). It has moved up to this level in response to falling mortgage rates and rising real incomes. But the pace may already be so high that there is little room for further expansion.

C. Business Investment

Growth in business investment, especially equipment, has been very high over the past several years, but the pace of expansion may be slowing.

- 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 (see chart) after substantial growth earlier in the expansion. Contracts for new construction, a leading indicator of construction activity have turned down sharply.

- The rapid pace of investment growth may have created an oversupply.

  - Industrial capacity has increased by 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.

  - If 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 two-thirds as much gross investment (including replacement) would be needed in an economy growing at 2 percent per year compared with one growing at 4 percent per year.

- The profit share has begun falling, and further declines may diminish corporate cash flow available to fund investment.

- One bright note is that some support for business investment is likely to continue to come from the falling relative price of investment goods (especially computers).

- **Thus, a number of factors point to a slowing in business investment. If credit crunch conditions develop as well (a topic that will be discussed later), even those who want to invest may have trouble getting the necessary funding.**

D. International Trade

Net exports made a negative contribution to growth in the first half and are likely to continue to deteriorate.

- 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.

- The IMF has recently revised downward its forecast for global growth to 2 percent.

- Slower growth is projected for many of our major trading partners, such as Canada, Mexico, and Latin America, even if a Latin American financial crisis is avoided.

E. Financial Market Risks

Financial market risks may be the wild card in the forecast. Some signs of an incipient credit crunch are emerging, which could seriously dampen spending.

- Stock prices have declined substantially since their peaks in July. For example, the S&P 500 is down 16 percent from its peak. Investors may be downgrading their expectations for future earnings or increasing the premium they require for taking on risk.

- The term premium (the difference between longer-term and shorter-term yields), which is a leading indicator of recessions has shrunk dramatically in the past 2 months.

- The quality spread between yields on riskier bonds and those on less risky bonds has increased dramatically recently, though it has been higher in the past. (Even so, most borrowing rates have declined, not increased, in recent weeks.)

- The Federal Reserve's latest survey of Senior Loan Officers shows a significant tightening of credit standards for large- and medium-sized firms.

- The degree of liquidity in financial markets, as measured, for example, by the premium of "on-the run" vs. "off- the- run" Treasury securities has widened noticeably.

F. Conclusion

With the unemployment rate below 5 percent and inflation continuing to be tame, the economy is in a good position to absorb shocks. But the shocks may be severe and the risk of recession has risen.

- Inflation continues to be very low, but it has probably stopped falling. The core CPI rose 2.5 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.

- Growth of production-worker hours has slowed to about a 1 percent annual rate of growth in both the second and third quarter--a figure that is consistent with a GDP growth rate of about 2 percent. However, initial claims for unemployment insurance remain very low, only 297,000 for the 4-week period ending on October 10th. 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.

- 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%.

Key Downside Risks include:

- The Stock Market could fall more, depressing consumption. For example, a 10% additional decline in the stock market might reduce 1999 growth by about 0.25% and about chop 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.

- Further deterioration in the international environment could depress net exports more than current forecasts assume. In addition, such deterioration could impact the financial environment, including the stock market, the level of risk premia and the health of the banking system.

- A larger than expected decline in investment spending could touch off a period of significant economic weakness, with "multiplier-accelerator" repercussions on consumption exacerbating a downturn.

- Although bank capital remains strong and most borrowing rates have declined or remained stable in spite of rising spreads, financial turmoil could intensify with widespread impacts on capital markets, bank capital, and bank lending.

III. Possible Policy Responses

A. The Role of Monetary Policy in Sustaining the Expansion

In principle, monetary policy, operating alone, can 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 signaled its intention to act. The U.S. situation, for example, contrasts sharply with that in Japan, where short-term rates stand at 0.25%. However, further Fed easing is unlikely to show through fully to market interest rates, because current rates are now premised on an assumption of additional easing over the next year.
    - Market participants currently anticipate significant Fed easing over the next six months. Macroadvisers' Consensus Open Market Committee expects the federal funds rate to be cut to about 4.4% over the next 12 months. The level of Fed funds futures suggests that market participants anticipate a funds rate of about 4.8% by year end.
- A quick reaction of monetary policy to changing economic conditions can potentially boost confidence.
- Monetary policy is arguably 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 raise bank profits, thereby helping banks to rebuild capital and boost lending.
    - The effectiveness of monetary policy under "credit crunch" conditions is, however, debatable. Some would argue that monetary policy proved ineffective in promoting recovery in 1990-92, during the credit crunch, when bank lending was constrained by low capital. However, others believe that the Fed simply underestimated the strength of the "headwinds" holding back lending and policy could have been eased more.

However, the size of the task facing the Fed has been rising over time.

- Recall that as the international outlook has deteriorated, the expected degree of Fed easing has increased substantially. At this point, not just a substantial Fed policy shift but also a substantial response to that shift are likely needed to attain growth in the projected 1.5-2% range for 1999.

Because the impact of monetary policy on the economy is uncertain, a task for monetary policy translates into greater risk concerning for the economy in 1999-2000. This risk is exacerbated by the historically atypical environment facing monetary policy at the present time.

- Monetary policy is most often eased to stimulate the economy following a recession, itself typically induced by a previous tightening of monetary policy to counter rising inflation. In response to lower interest rates, buyers of homes, cars, and other consumer durables, who had deferred purchases because of high interest rates, are often ready to respond. For example, the early stages of the current expansion were characterized by "pent up demand" for consumer durables. In the current situation, in contrast, interest rates have been declining since early in 1997. As a consequence, purchases of consumer durables and homebuilding have been growing robustly and stand at high levels. Certainly, interest sensitive spending may respond even more to further rate cuts. However, the response might be lower than in a typical easing episode.

If new downside pressures materialize, it is questionable whether monetary policy can offset them in a timely fashion.

- Monetary policy works with long and variable lags. A (currently) unanticipated easing of monetary policy in response to new economic shocks could take 6-12 months or more to produce a full economic response.

Beyond the "normal" channels of economic impact, the Fed and other bank regulators can affect lending conditions through their regulatory stance.

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

B. The Potential Role of Fiscal Policy

Fiscal policy will play a useful role in mitigating negative shocks via the automatic stabilizers if those stabilizers are allowed to work.

- In the event of a downturn, tax collections will automatically fall and outlays will rise, providing stimulus which mitigates the magnitude of any downturn. For 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 extended unemployment insurance 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 new spending initiatives--could play a positive role in sustaining the expansion.

- A decision to use fiscal policy actively to sustain the expansion would likely diminish, at least partially, the degree of Fed easing. Even so, the use of a package of tools--monetary <u>and</u> fiscal policy, rather than either alone--to sustain the expansion is arguably a less risky approach than sole reliance on monetary policy.
- In the current environment, the inflationary risk resulting from discretionary fiscal stimulus is likely to be low.

- 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. If conditions deteriorate more than now anticipated, a properly designed fiscal boost could impact spending rapidly.

Although discretionary fiscal policy could, in principle, play a positive role, there is a real danger that it would be mistimed. The fiscal policy record contains numerous episodes in which fiscal initiatives were mistimed and inappropriate.

- Most forecasters are currently concerned about excessive weakness in the first half of 1999. Given current information, fiscal stimulus designed to abate downside risk would be implemented at that time.

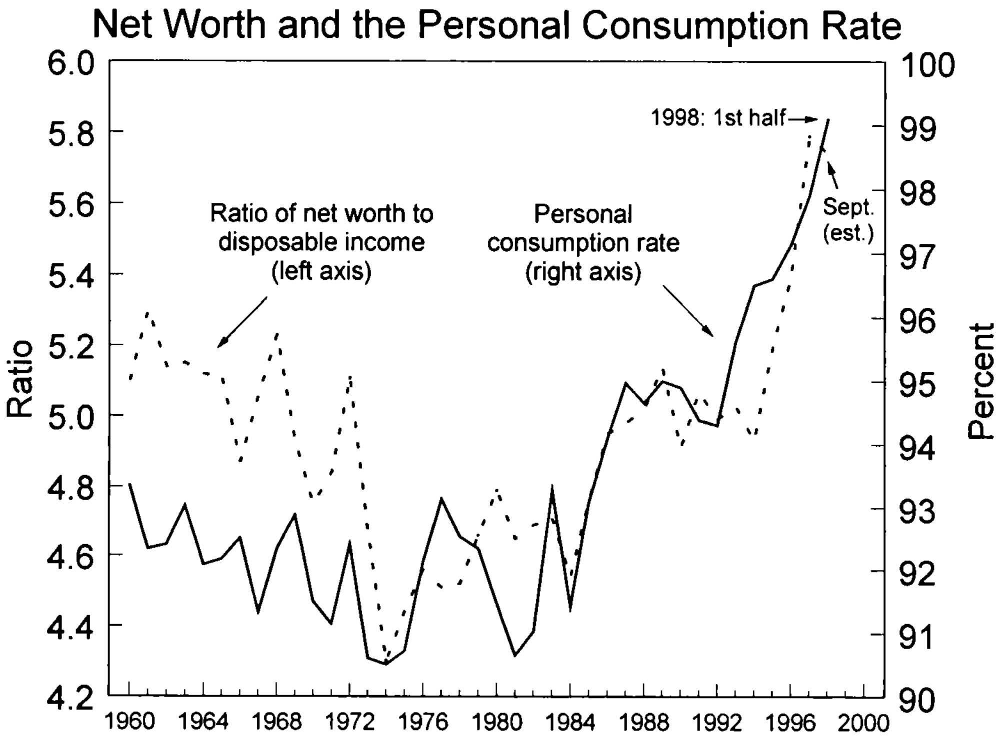
- Given the enormous uncertainty in the outlook, incoming information in the months ahead will be relevant in assessing the desirability of action. This suggests that there any plans should remain flexible as long as possible.

Fiscal actions taken to stimulate the economy could be quite costly.

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

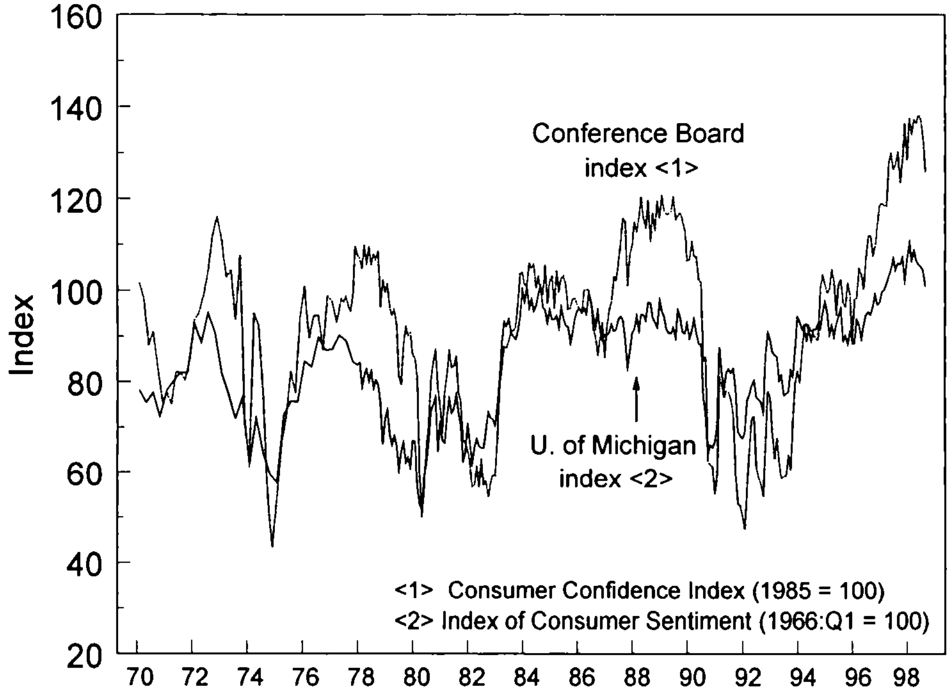
Permanent rather than temporary tax cuts typically have larger impacts on spending.

- Both economic theory and empirical evidence suggests that one- shot tax cuts (such as a one-time tax rebate) stimulate much less spending than permanent tax cuts. However, temporary tax cuts which affect the timing of durable goods purchases--such as a temporary investment tax credit or a temporary tax credit for consumer durables purchases--could have a larger spending impact.

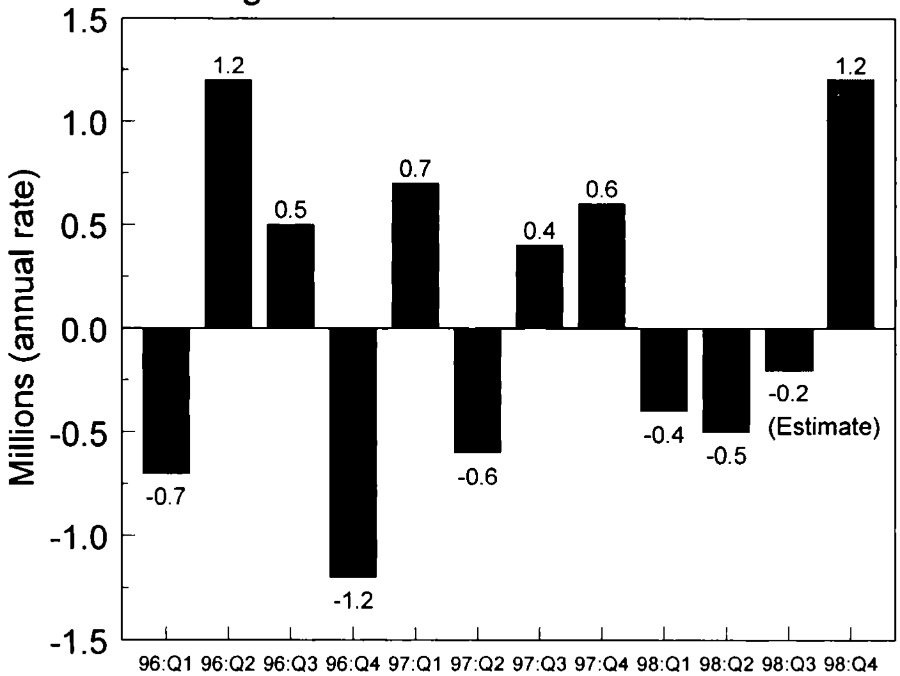


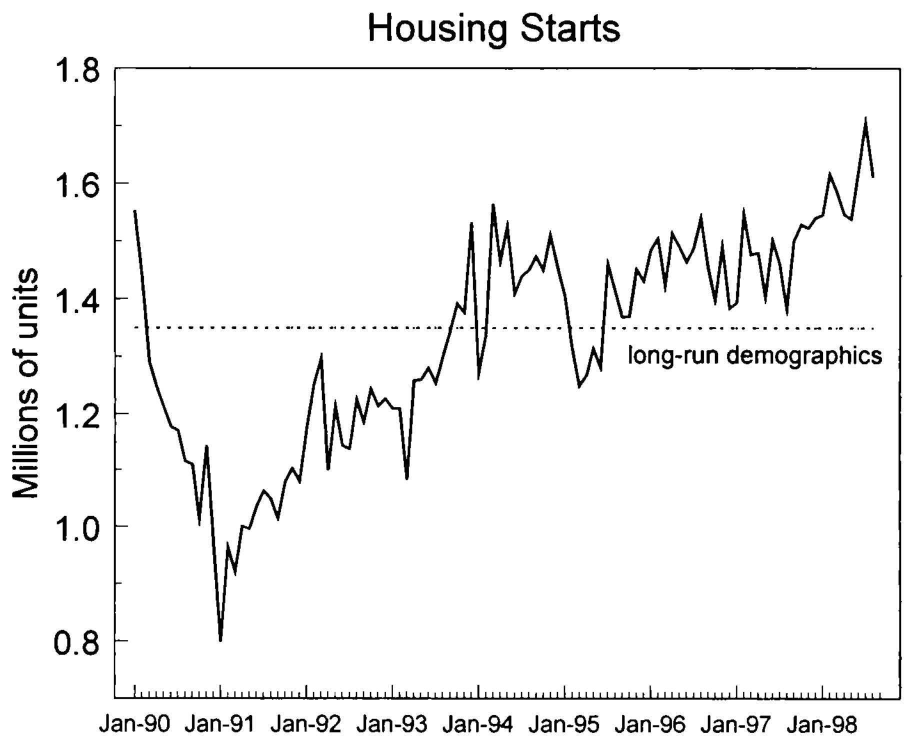
[Automated Records Management System Hex-Dump Conversion]

Consumer Attitudes



Change in Production of Motor Vehicles





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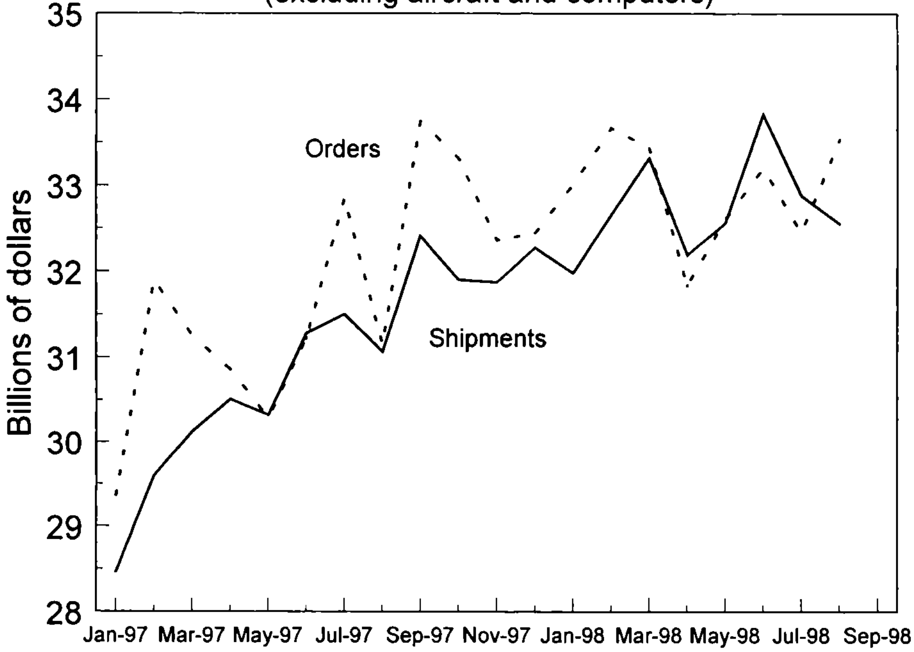
Nondefense Capital Goods
(excluding aircraft and computers)

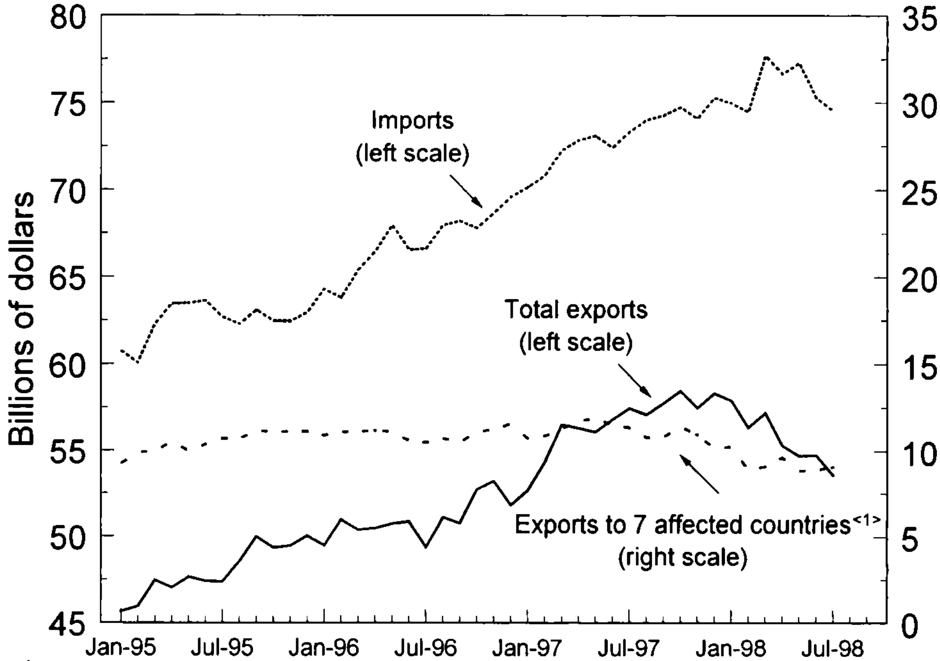


[Automated Records Management System Hex-Dump Conversion]

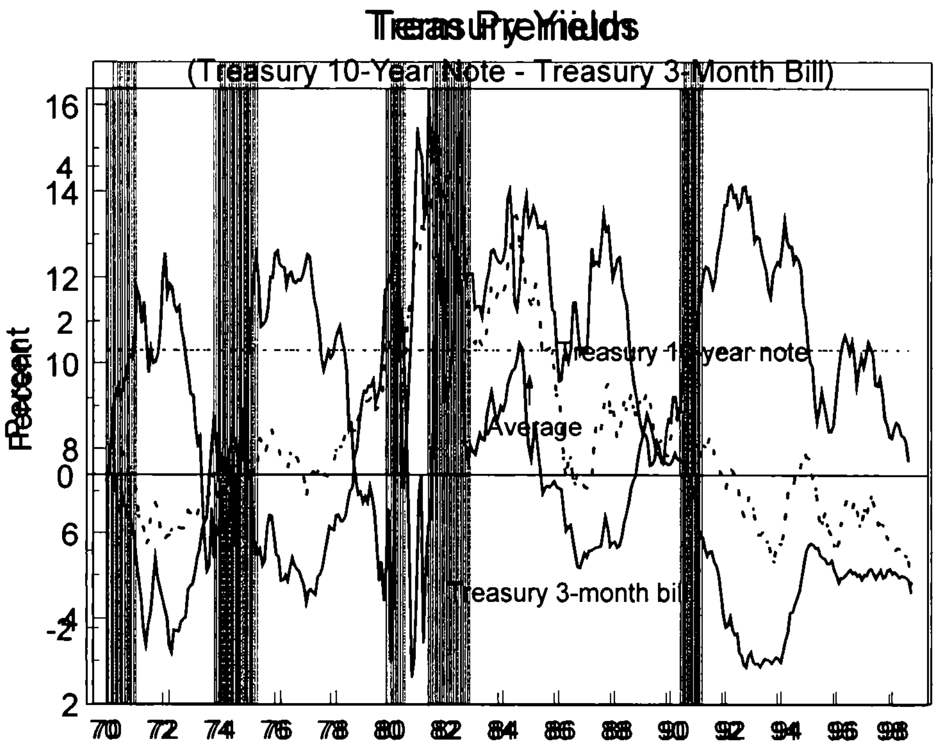
Profit Share

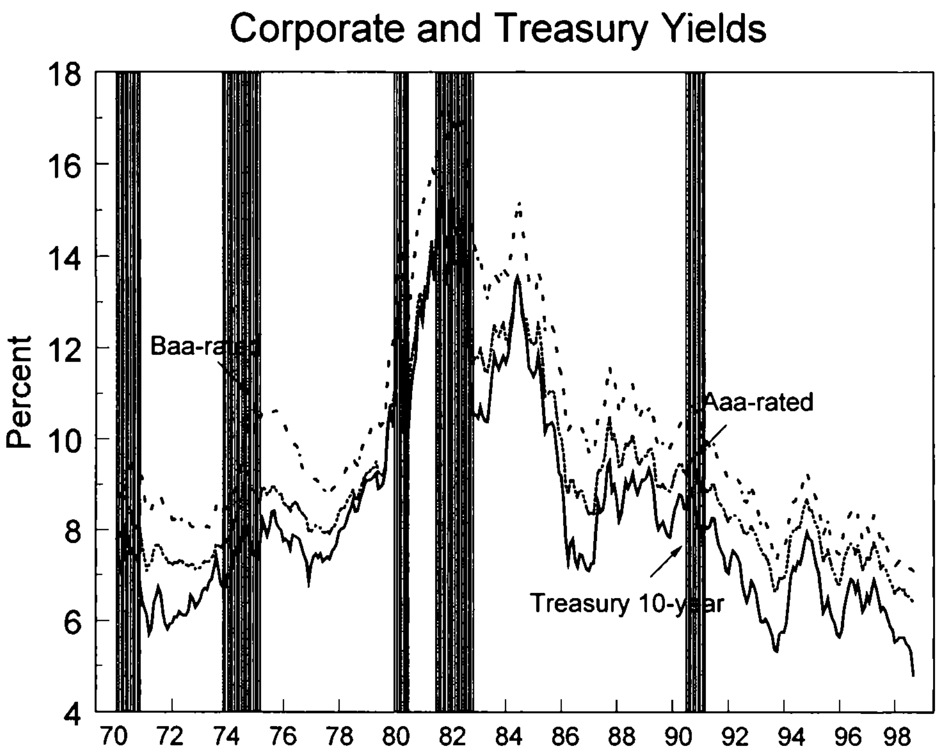
[Automated Records Management System Hex-Dump Conversion]

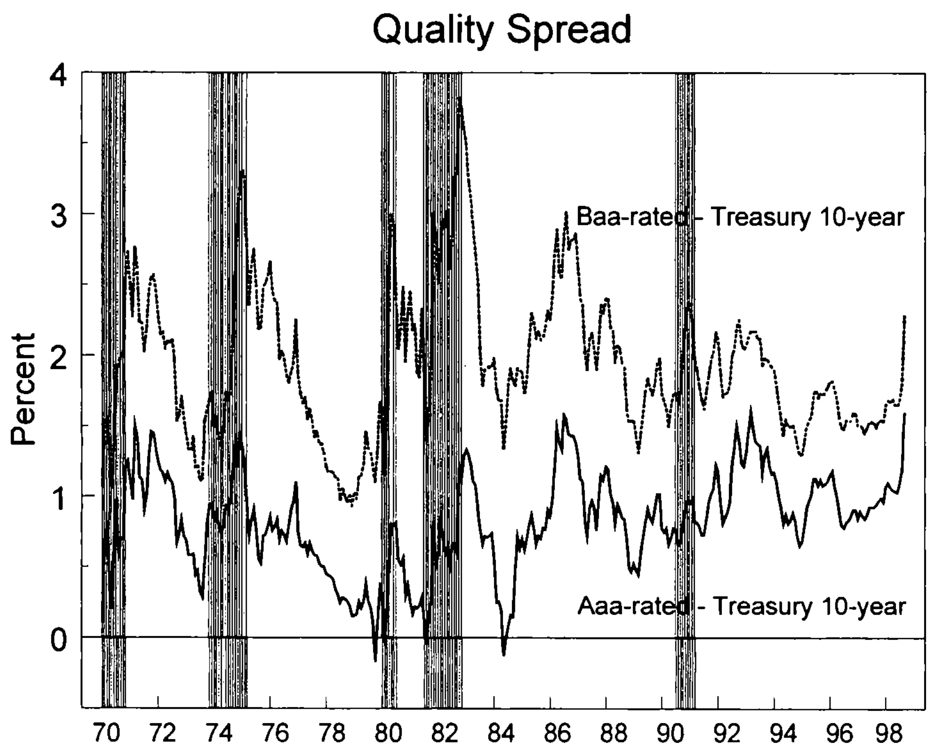
Exports & Imports of Goods



<1>China, Indonesia, Japan, Korea, Malaysia, Philippines, and Thailand


(Treasury 10-Year Note - Treasury 3-Month Bill)
Percent
Average
Treasury 3-month bill

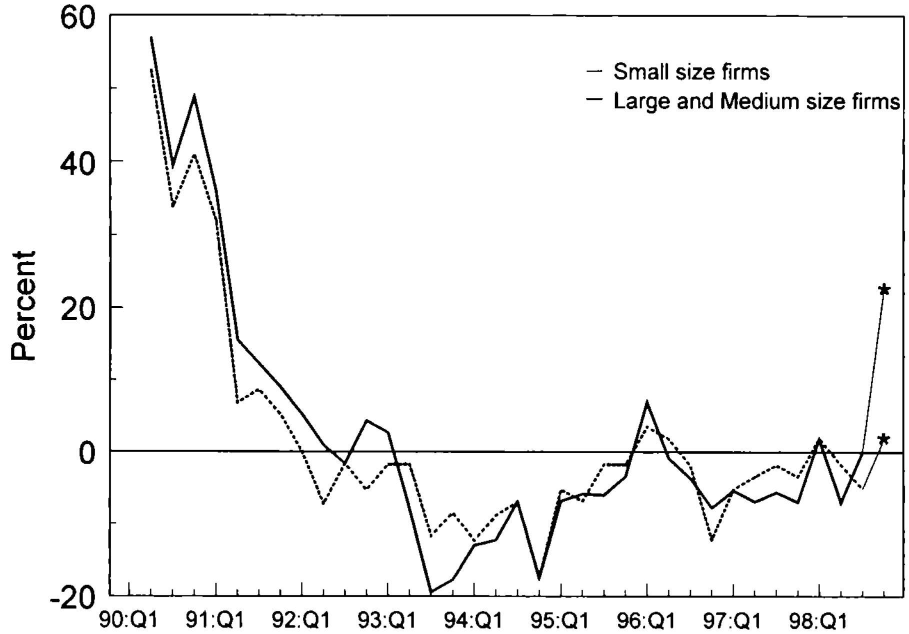




[Automated Records Management System Hex-Dump Conversion]

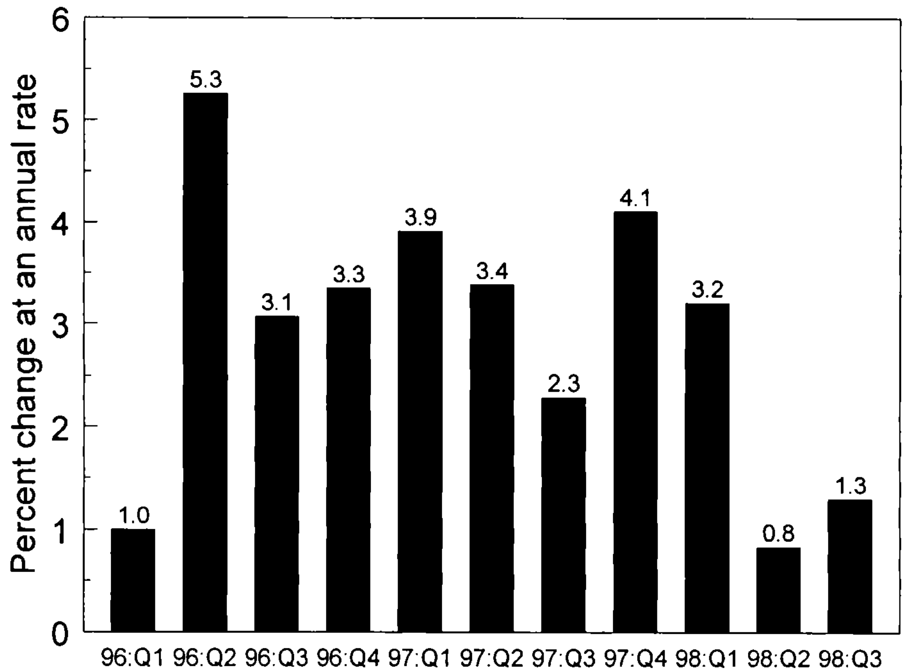
Measures of Supply and Demand for C & I Loans

Net Percentage of Domestic Respondents Tightening Standards for C & I Loans



* Indicates data from the special September survey

Production-Worker Hours



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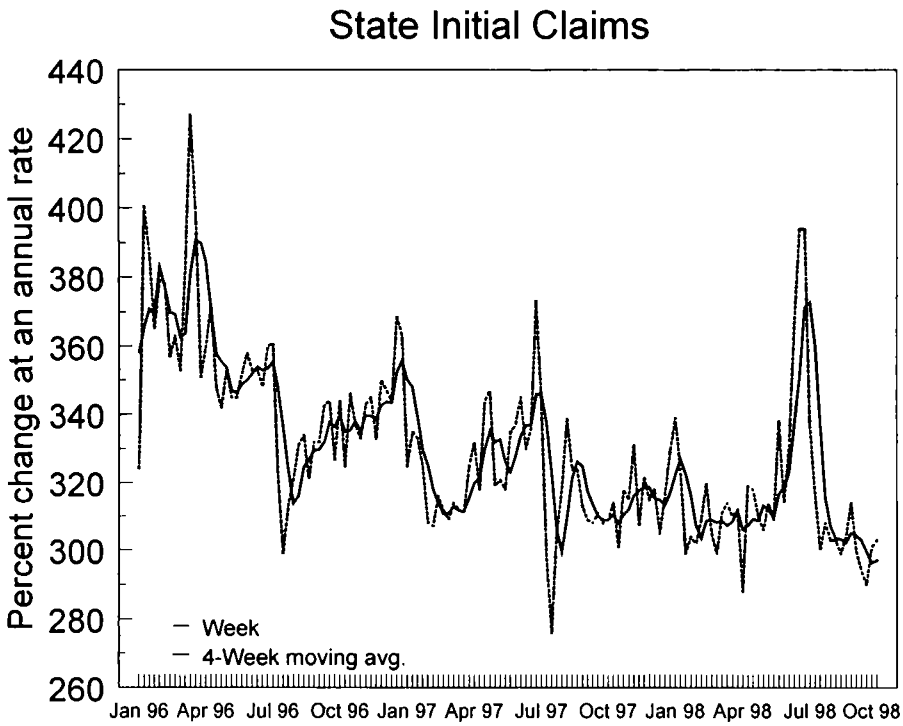
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Percent change at an annual rate
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420
400
380
360
340
320
300
280
260
Week
4-Week moving avg.
Jan 96
Apr 96
Jul 96
Oct 96
Jan 97
Apr 97
Jul 97
Oct 97
Jan 98
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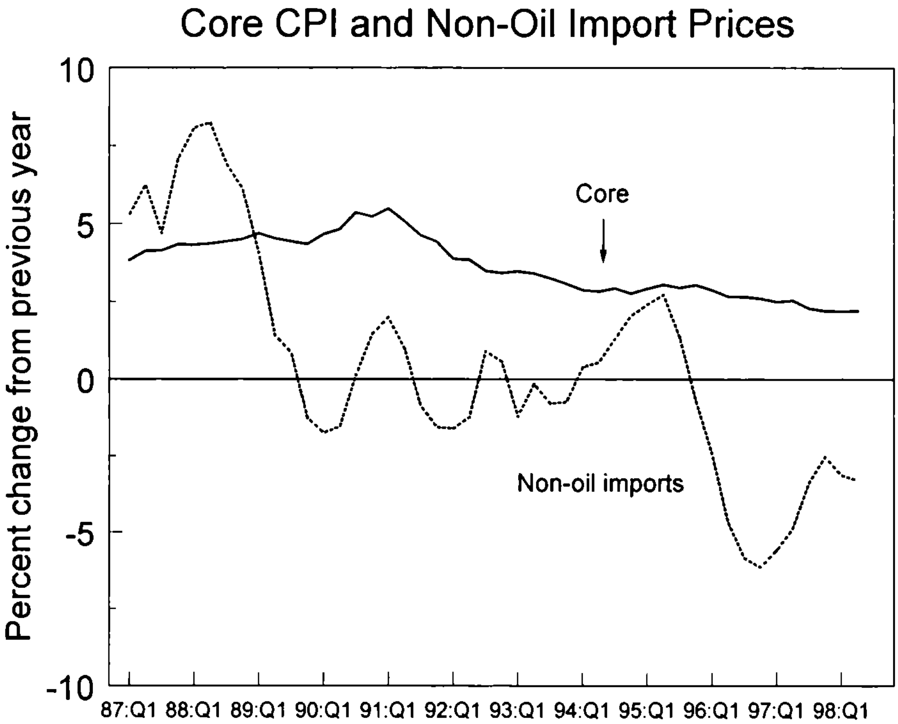
Oct 98


Core CPI and Non-Oil Import Prices
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-5
-10
Percent change from previous year
Core
Non-oil imports
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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-OCT-1998 16:14:06.00

SUBJECT: Clinton meeting with Obuchi

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

TEXT:
Janet, I met today for lunch Mr. Nishikawa from Japan Embassy. He briefed me on recent Japan macro conditions and policy issues. He appreciated your balanced views on Japan and trade in your NABE speech and was interested to know whether you will go to Tokyo when Clinton does to meet Obuchi. In that case, he would be happy to brief you on Japan and also to arrange a meeting with the new head of EPA. I told him I don't know about your travel plans, will check with you and get back to him. Please, let me know.
Nouriel

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-OCT-1998 09:07:43.00

SUBJECT: Sorry--I sent the wrong draft.

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

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:
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- The Stock Market could fall more, depressing consumption. For example, a 10% additional decline in the stock market might reduce 1999 growth by about 0.25% and about chop 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.

- Further deterioration in the international environment could depress net exports more than current forecasts assume. In addition, such deterioration could impact the financial environment, including the stock market, the level of risk premia and the health of the banking system.

- A larger than expected decline in investment spending could touch off a period of significant economic weakness, with "multiplier-accelerator" repercussions on consumption exacerbating a downturn.

- Although bank capital remains strong and most borrowing rates have declined or remained stable in spite of rising spreads, financial turmoil could intensify with widespread impacts on capital markets, bank capital, and bank lending.

III. Possible Policy Responses

A. The Role of Monetary Policy in Sustaining the Expansion

In principle, monetary policy, operating alone, can 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 signaled its intention to act. The U.S. situation, for example, contrasts sharply with that in Japan, where short-term rates stand at 0.25%. However, further Fed easing is unlikely to show through fully to market interest rates, because current rates are now premised on an assumption of additional easing over the next year.
    - Market participants currently anticipate significant Fed easing over the next six months. Macroadvisers' Consensus Open Market Committee expects the federal funds rate to be cut to about 4.4% over the next 12 months. The level of Fed funds futures suggests that market participants anticipate a funds rate of about 4.8% by year end.
- A quick reaction of monetary policy to changing economic conditions can potentially boost confidence.
- Monetary policy is arguably 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 raise bank profits, thereby helping banks to rebuild capital and boost lending.
    - The effectiveness of monetary policy under "credit crunch" conditions is, however, debatable. Some would argue that monetary policy proved ineffective in promoting recovery in 1990-92, during the credit crunch, when bank lending was constrained by low capital. However, others believe that the Fed simply underestimated the strength of the "headwinds" holding back lending and policy could have been eased more.

However, the size of the task facing the Fed has been rising over time.

- Recall that as the international outlook has deteriorated, the expected degree of Fed easing has increased substantially. At this point, not just a substantial Fed policy shift but also a substantial response to that shift are likely needed to attain growth in the projected 1.5-2% range for 1999.

Because the impact of monetary policy on the economy is uncertain, a task for monetary policy translates into greater risk concerning for the economy in 1999-2000. This risk is exacerbated by the historically atypical environment facing monetary policy at the present time.

- Monetary policy is most often eased to stimulate the economy following a recession, itself typically induced by a previous tightening of monetary policy to counter rising inflation. In response to lower interest rates, buyers of homes, cars, and other consumer durables, who had deferred purchases because of high interest rates, are often ready to respond. For example, the early stages of the current expansion were characterized by "pent up demand" for consumer durables. In the current situation, in contrast, interest rates have been declining since early in 1997. As a consequence, purchases of consumer durables and homebuilding have been growing robustly and stand at high levels. Certainly, interest sensitive spending may respond even more to further rate cuts. However, the response might be lower than in a typical easing episode.

If new downside pressures materialize, it is questionable whether monetary policy can offset them in a timely fashion.

- Monetary policy works with long and variable lags. A (currently) unanticipated easing of monetary policy in response to new economic shocks could take 6-12 months or more to produce a full economic response.

Beyond the "normal" channels of economic impact, the Fed and other bank regulators can affect lending conditions through their regulatory stance.

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

B. The Potential Role of Fiscal Policy

Fiscal policy will play a useful role in mitigating negative shocks via the automatic stabilizers if those stabilizers are allowed to work.

- In the event of a downturn, tax collections will automatically fall and outlays will rise, providing stimulus which mitigates the magnitude of any downturn. For 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 extended unemployment insurance 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 new spending initiatives--could play a positive role in sustaining the expansion.

- A decision to use fiscal policy actively to sustain the expansion would likely diminish, at least partially, the degree of Fed easing. Even so, the use of a package of tools--monetary <u>and</u> fiscal policy, rather than either alone--to sustain the expansion is arguably a less risky approach than sole reliance on monetary policy.
- In the current environment, the inflationary risk resulting from discretionary fiscal stimulus is likely to be low.

- 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. If conditions deteriorate more than now anticipated, a properly designed fiscal boost could impact spending rapidly.

Although discretionary fiscal policy could, in principle, play a positive role, there is a real danger that it would be mistimed. The fiscal policy record contains numerous episodes in which fiscal initiatives were mistimed and inappropriate.

- Most forecasters are currently concerned about excessive weakness in the first half of 1999. Given current information, fiscal stimulus designed to abate downside risk would be implemented at that time.

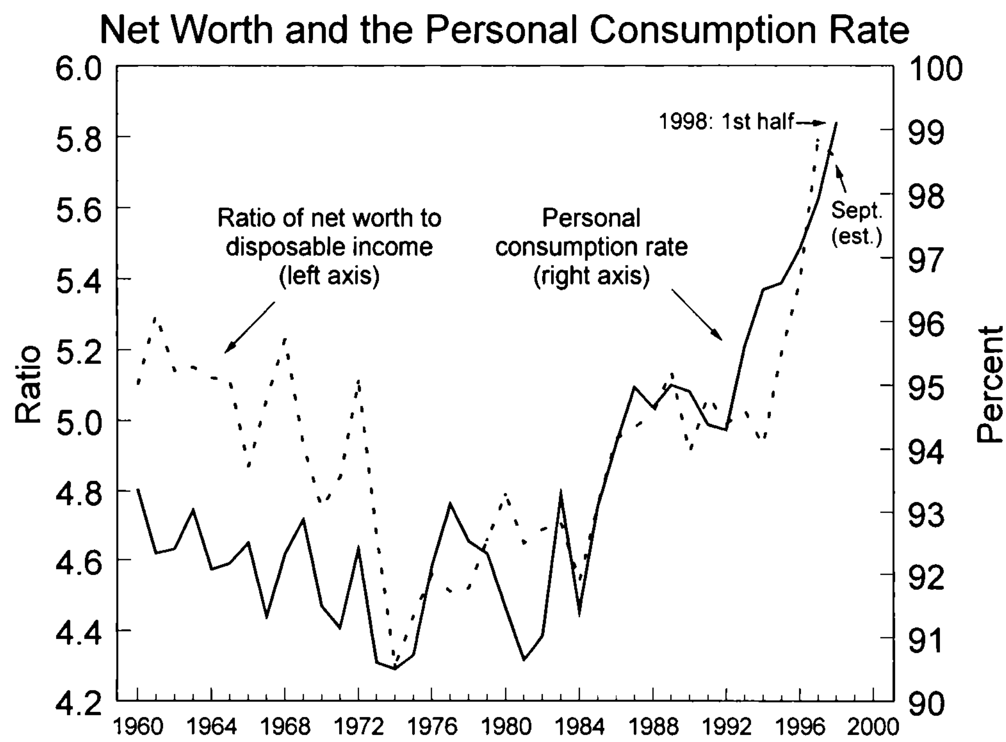
- Given the enormous uncertainty in the outlook, incoming information in the months ahead will be relevant in assessing the desirability of action. This suggests that there any plans should remain flexible as long as possible.

Fiscal actions taken to stimulate the economy could be quite costly.

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

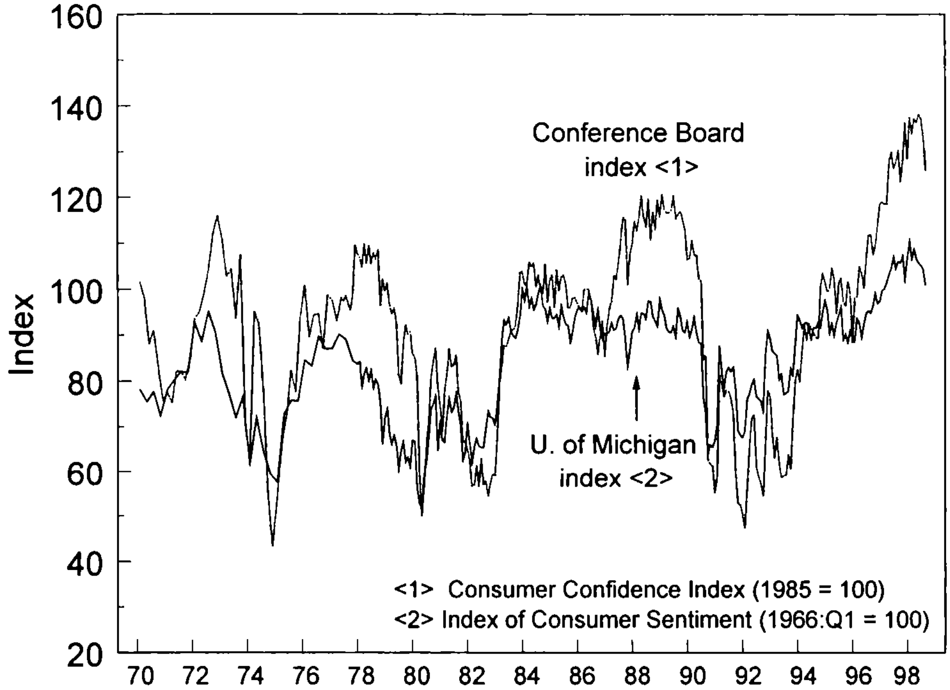
Permanent rather than temporary tax cuts typically have larger impacts on spending.

- Both economic theory and empirical evidence suggests that one- shot tax cuts (such as a one-time tax rebate) stimulate much less spending than permanent tax cuts. However, temporary tax cuts which affect the timing of durable goods purchases--such as a temporary investment tax credit or a temporary tax credit for consumer durables purchases--could have a larger spending impact.

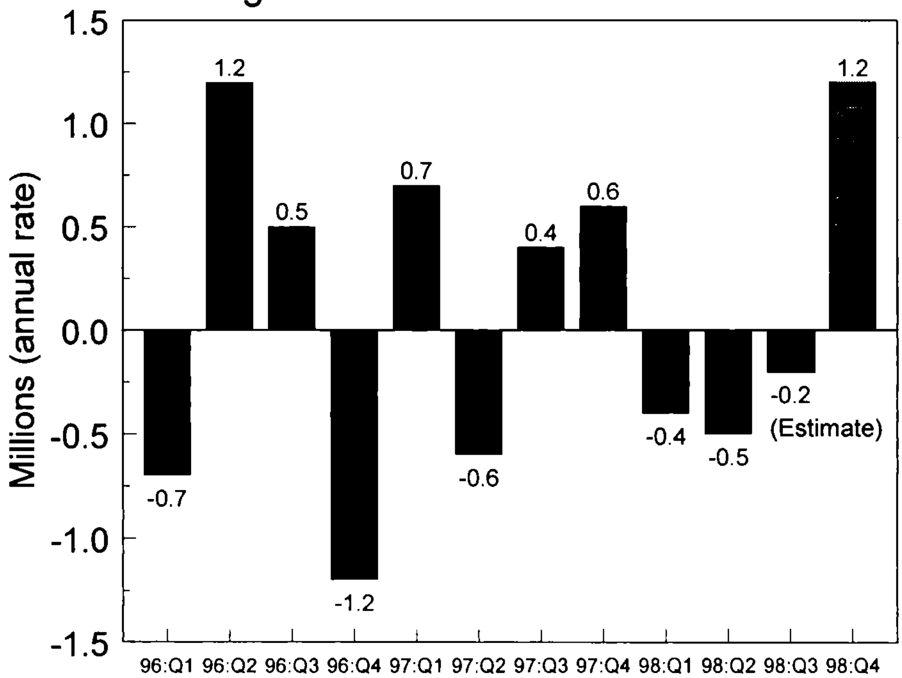


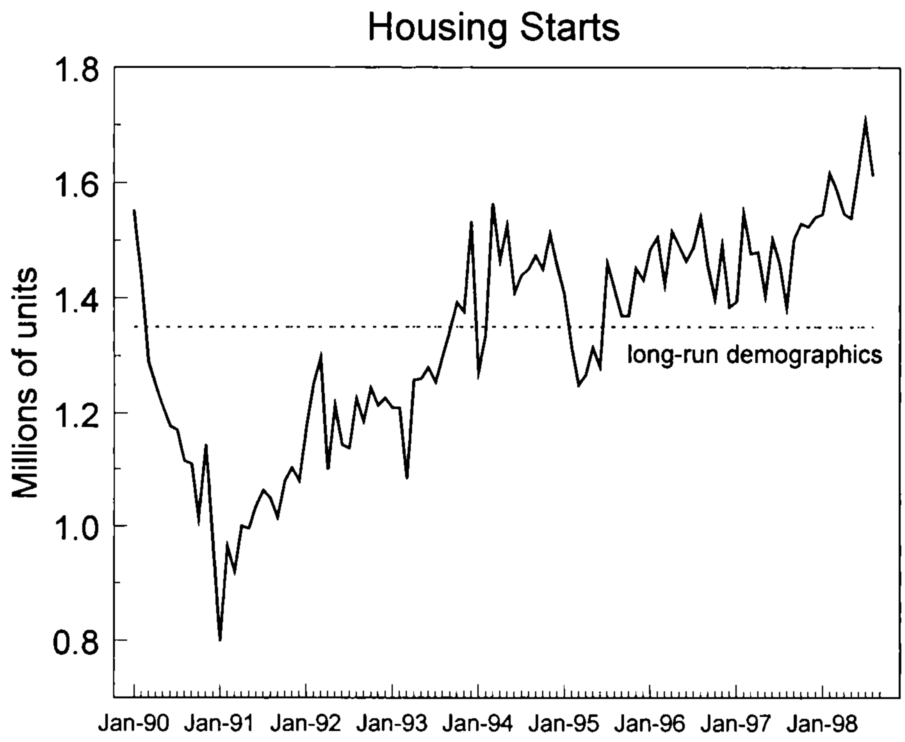
[Automated Records Management System Hex-Dump Conversion]

Consumer Attitudes

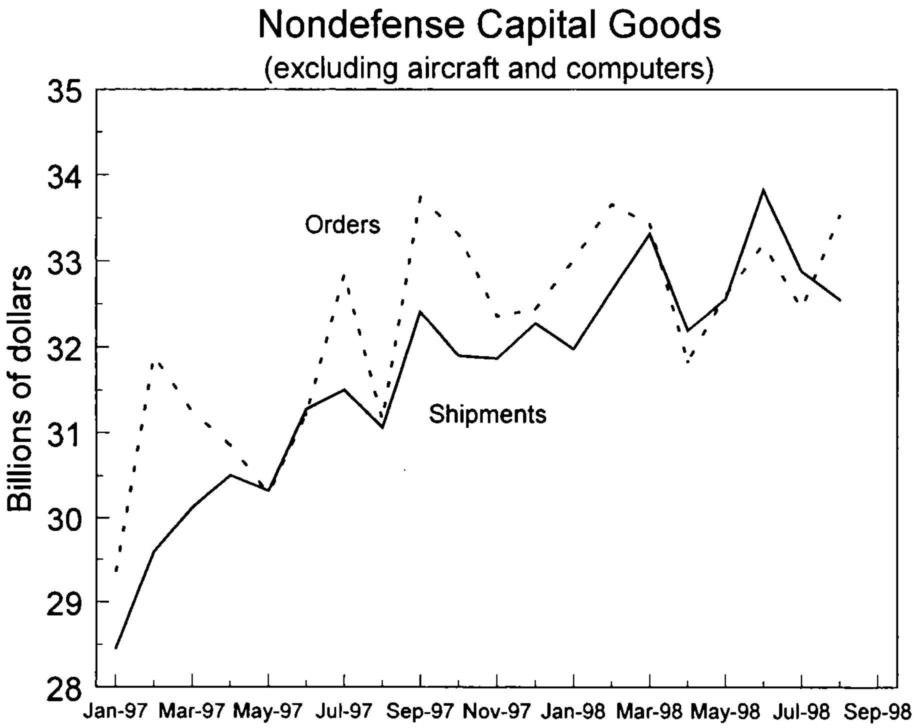


Change in Production of Motor Vehicles

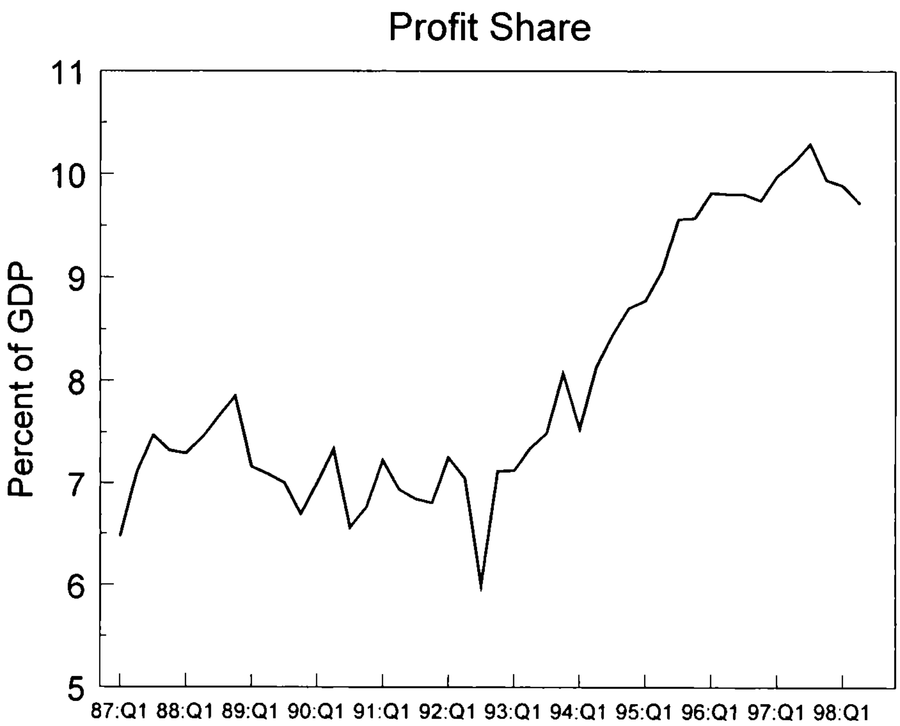




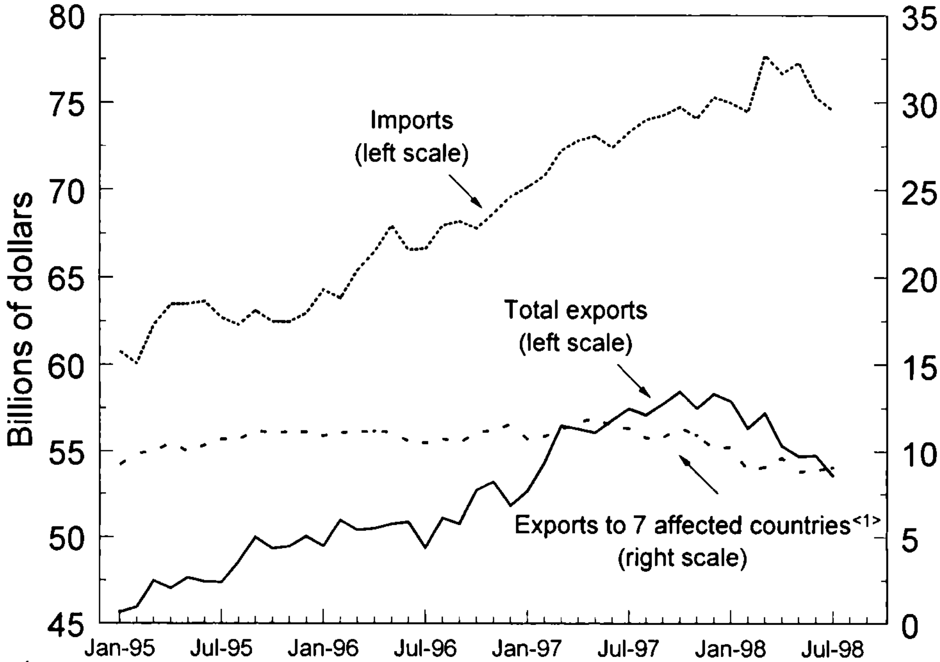
[Automated Records Management System Hex-Dump Conversion]



[Automated Records Management System Hex-Dump Conversion]


Profit Share
Percent of GDP
11
10
9
8
7
6
5
87:Q1 88:Q1 89:Q1 90:Q1 91:Q1 92:Q1 93:Q1 94:Q1 95:Q1 96:Q1 97:Q1 98:Q1

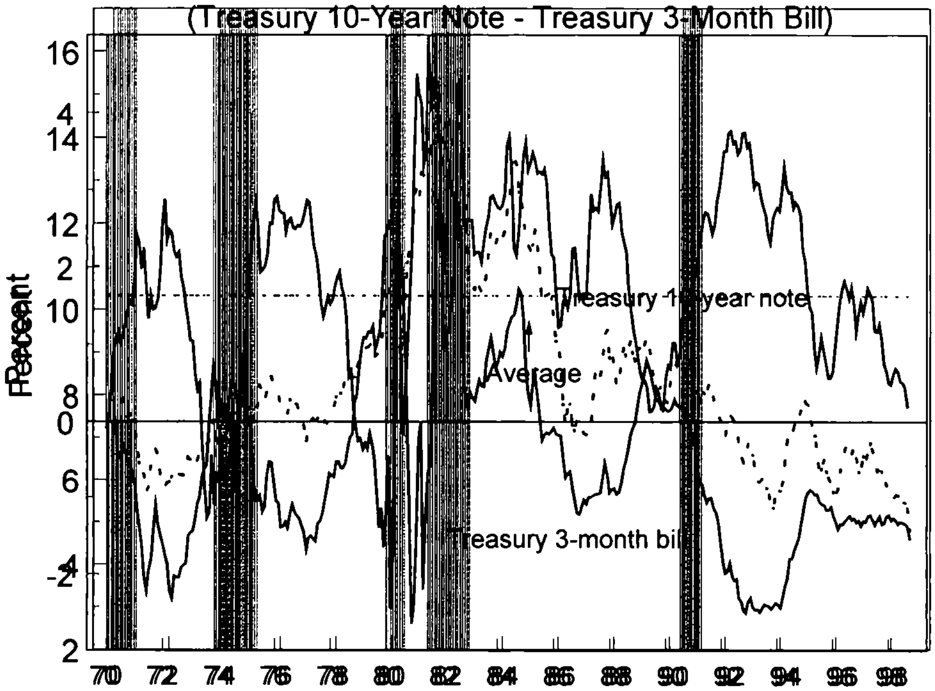
Exports & Imports of Goods



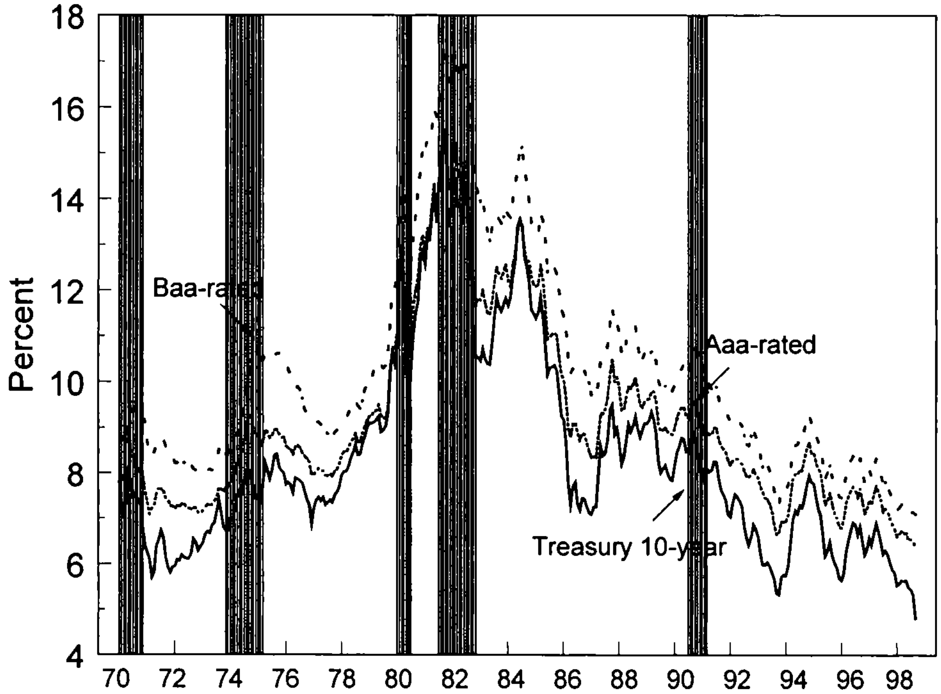
<1>China, Indonesia, Japan, Korea, Malaysia, Philippines, and Thailand

Treasury Yields

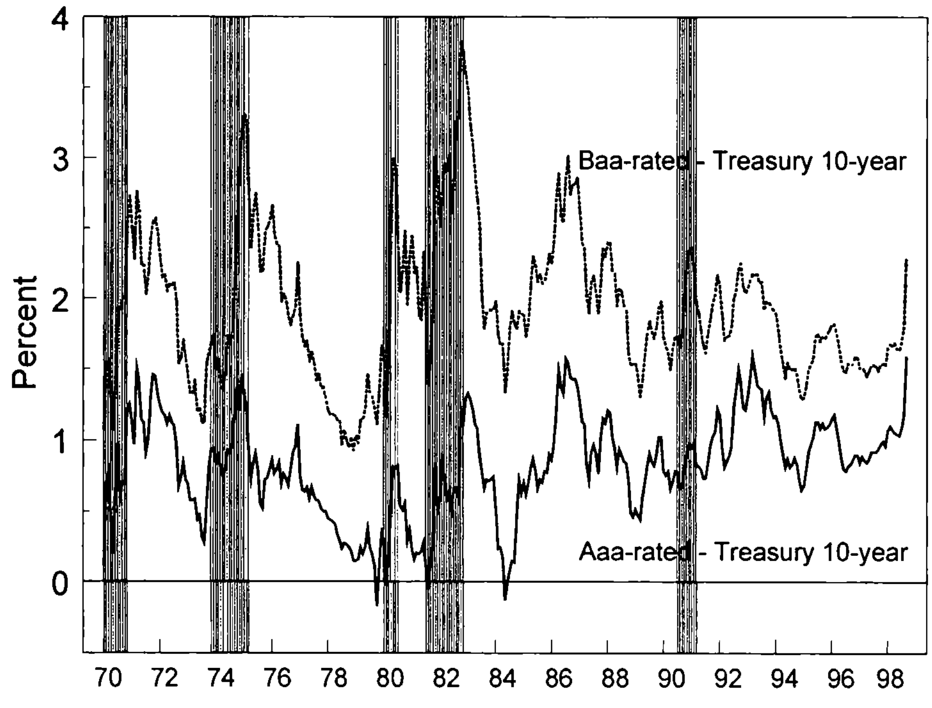
Term Premia



Corporate and Treasury Yields



Quality Spread



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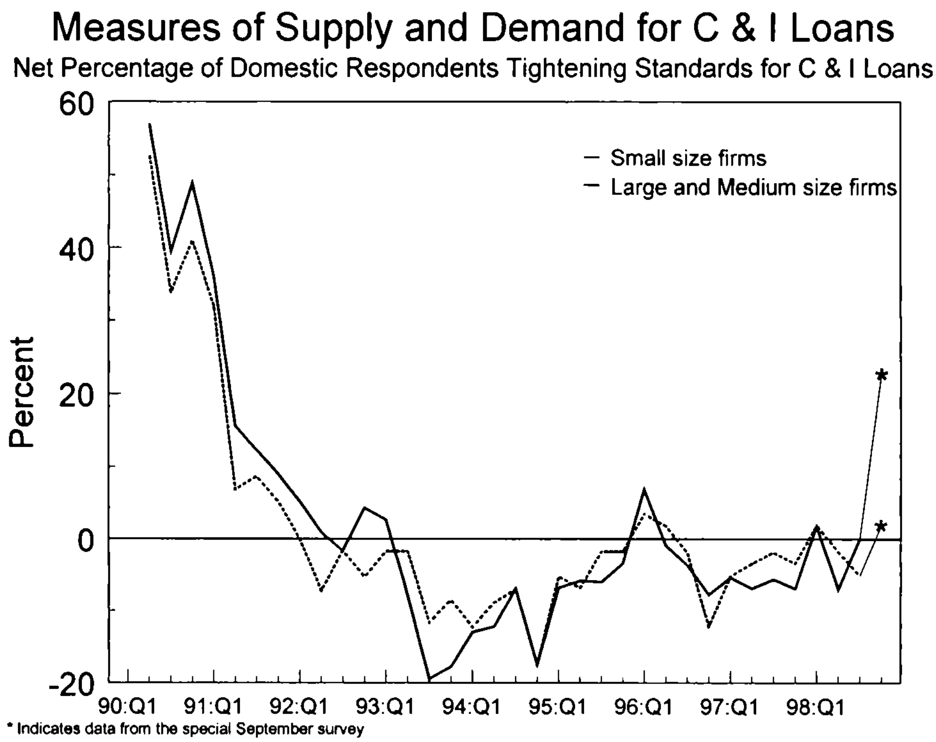
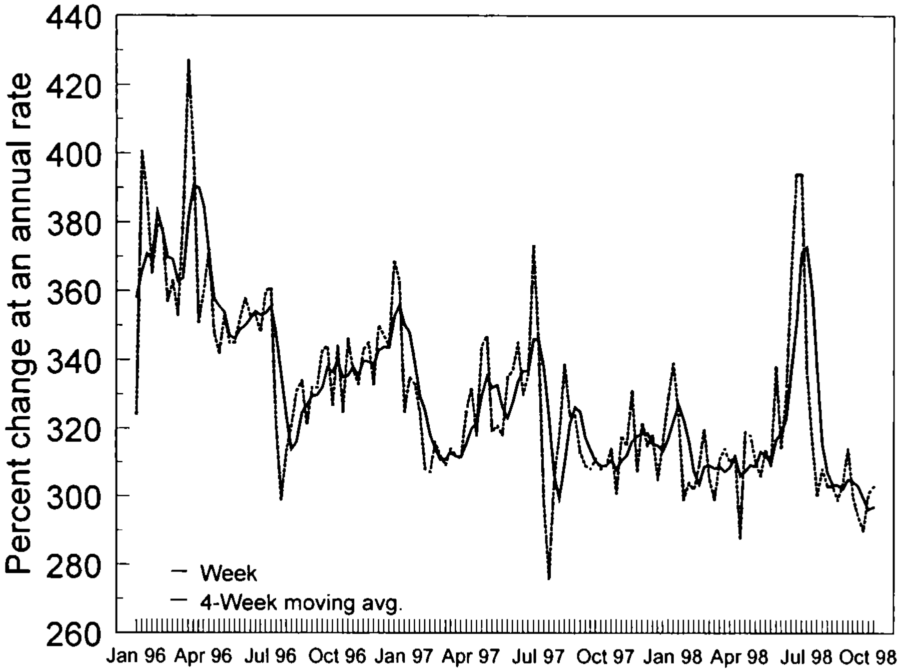


[Automated Records Management System Hex-Dump Conversion]

State Initial Claims



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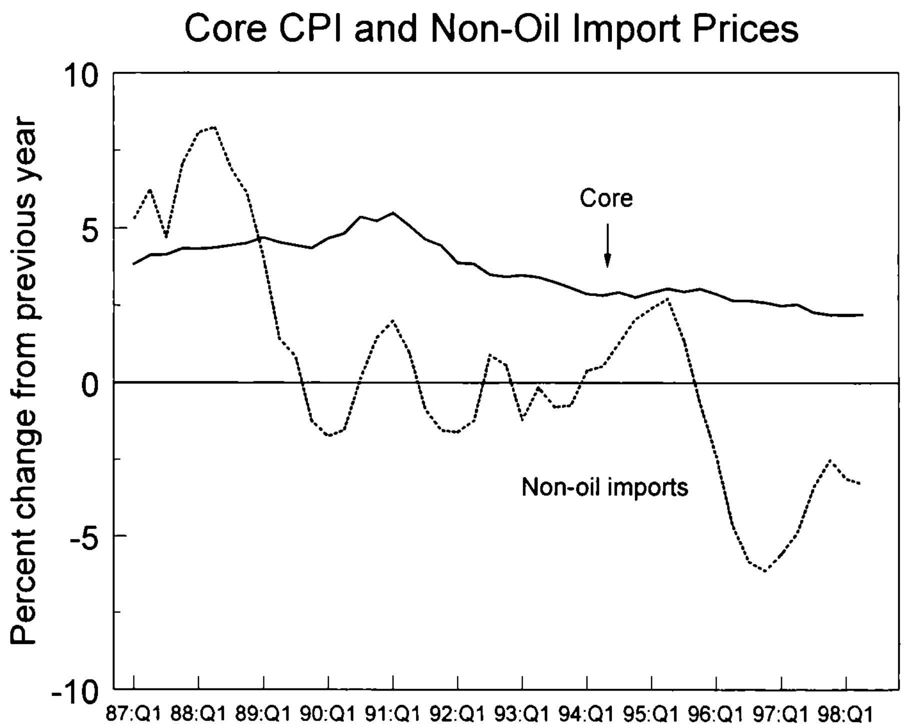

Core CPI and Non-Oil Import Prices
Percent change from previous year
10
5
0
-5
-10
Core
Non-oil imports
87:Q1
88:Q1
89:Q1
90:Q1
91:Q1
92:Q1
93:Q1
94:Q1
95:Q1
96:Q1
97:Q1
98:Q1

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-OCT-1998 09:03:53.00

SUBJECT: Re: Draft of presentation on the outlook--comments welcome

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

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

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

TEXT:
I don't think this is the right draft

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-OCT-1998 16:52:07.00

SUBJECT: Clinton meeting with Obuchi

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

TEXT:
What do you think?
---------------------- Forwarded by Janet L. Yellen/CEA/EOP on 10/16/98
04:51 PM ---------------------------

Nouriel Roubini
10/16/98 04:12:37 PM
Record Type: Record

To: Janet L. Yellen/CEA/EOP
cc:
Subject: Clinton meeting with Obuchi

Janet, I met today for lunch Mr. Nishikawa from Japan Embassy. He briefed me on recent Japan macro conditions and policy issues. He appreciated your balanced views on Japan and trade in your NABE speech and was interested to know whether you will go to Tokyo when Clinton does to meet Obuchi. In that case, he would be happy to brief you on Japan and also to arrange a meeting with the new head of EPA. I told him I don't know about your travel plans, will check with you and get back to him. Please, let me know.
Nouriel

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-OCT-1998 08:53:09.00

SUBJECT: Draft of presentation on the outlook--comments welcome

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

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.D87]MAIL45302598W.226 to ASCII,
The following is a HEX DUMP:

The Economic Outlook
October 16, 1998

I. Overview

The economy has been growing faster than its long-run sustainable pace over the past 2-3 years, and most forecasts, including those of the Administration, have anticipated a slowdown in growth and a gradual rise in the unemployment rate to 5 percent or slightly higher by 2000.

- Prior to the onset of the Asian crisis, it had been widely assumed that the forecast slowdown would be achieved through a combination of a natural waning of the robustness of domestic demand (especially for consumption and investment goods) combined with a likely tightening by the Federal Reserve. Market interest rates reflected this assumption.

- With the onset of the Asian crisis, the channel through which the slowdown might occur changed. The likely decline in net exports due to the Asian crisis was seen as a likely alternative to Fed tightening. Net exports did in fact decline in the first half of 1998. But interest rates also fell as the world financial crisis intensified, global growth prospects diminished, and expectations about Fed actions were revised. Domestic demand continued to grow at a very robust pace in the first half of 1998.

In the past month or so, what was formerly seen as a relatively smooth path leading to slower growth has now begun to appear much bumpier. Although the consensus forecast continues to be for growth of about 2 percent in 1999, the Fed's decision yesterday to cut interest rates symbolizes the heightened degree of concern about downside risks.

- Attention is focused on a slowdown in the first half of 1999 (output in the fourth quarter of 1998 is likely to be boosted by a rebound in motor vehicle production).

- Almost all the components of demand could slow, and a smooth transition to 2 percent growth could be difficult to achieve.

II. Recent Trends and Future Prospects

A. Consumer Behavior

Until recently, consumer spending had been buoyed by a rising stock market and very strong consumer sentiment. Consumers have been spending a very high proportion of their income.

- 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.

- Consumption reached more than 99 percent of disposable income in the second quarter as stock market gains drove the ratio of household wealth to disposable income to very high levels (see chart).

- Consumer sentiment has fallen in the past few months, but its level in September was still in the 90th percentile of its historical distribution (see chart on next page).

- **Recent rates of consumption growth are unlikely to be sustainable without the impetus from a rising stock market and falling saving rate.**

B. Housing

The <u>level</u> of new home construction (at about a 1.6 million unit annual pace) is very high compared with its long-term demographic fundamentals (see lower chart). It has moved up to this level in response to falling mortgage rates and rising real incomes. But the pace may already be so high that there is little room for further expansion.

C. Business Investment

Growth in business investment, especially equipment, has been very high over the past several years, but the pace of expansion may be slowing.

- 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 (see chart) after substantial growth earlier in the expansion. Contracts for new construction, a leading indicator of contruction activity have turned down sharply.

- The rapid pace of investment growth may have created an oversupply.
  - Industrial capacity has increased by 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.
  - If 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 two-thirds as much gross investment (including replacement) would be needed in an economy growing at 2 percent per year compared with one growing at 4 percent per year.
- The profit share has begun falling, and further declines may diminish investment funding.
- One bright note is that some support for business investment is likely to continue to come from the falling relative price of investment goods (especially computers).
- **Thus, a number of factors point to a slowing in business investment. If credit crunch conditons develop as well (a topic that will be discussed later), even those who want to invest may have trouble getting the necessary funding.**

D. International Trade

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

- 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.
- The IMF has recently revised downward its forecast for global growth to 2 percent.
- Slower growth is projected for many of our major trading partners, such as Canada, Mexico, and Latin America, even if a Latin American financial crisis is avoided.

E. Financial Market Risks

Financial market risks may be the wild card in the forecast. Some signs of an incipient credit crunch are emerging, which could seriously dampen spending.

- Stock prices have declined substantially since their peaks in July. For example, the S&P 500 is down 16 percent from its peak. Investors may be downgrading their expectations for future earnings or increasing the premium they require for taking on risk.

- The term premium (the difference between longer-term and shorter-term yields), which is a leading indicator of recessions has shrunk damatically in the past 2 months.

- The quality spread between yields on riskier bonds and those on less risky bonds has increased dramatically recently, though it has been higher in the past.

- The Federal Reserve's latest survey of Senior Loan Officers shows a significant tightening of credit standards for large- and medium-sized firms.

F. Conclusion

With the unemployment rate below 5 percent and inflation continuing to be tame, the economy is in a good position to absorb shocks. But the shocks may be severe.

- 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.

- Growth of production-worker hours has slowed to about a 1 percent annual rate of growth in both the second and third quarter--a figure that is consistent with a GDP growth rate of about 2 percent. However, initial claims for unemployment insurance remain very low, only 297,000 for the 4-week period ending on October 10th. 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.

- 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.

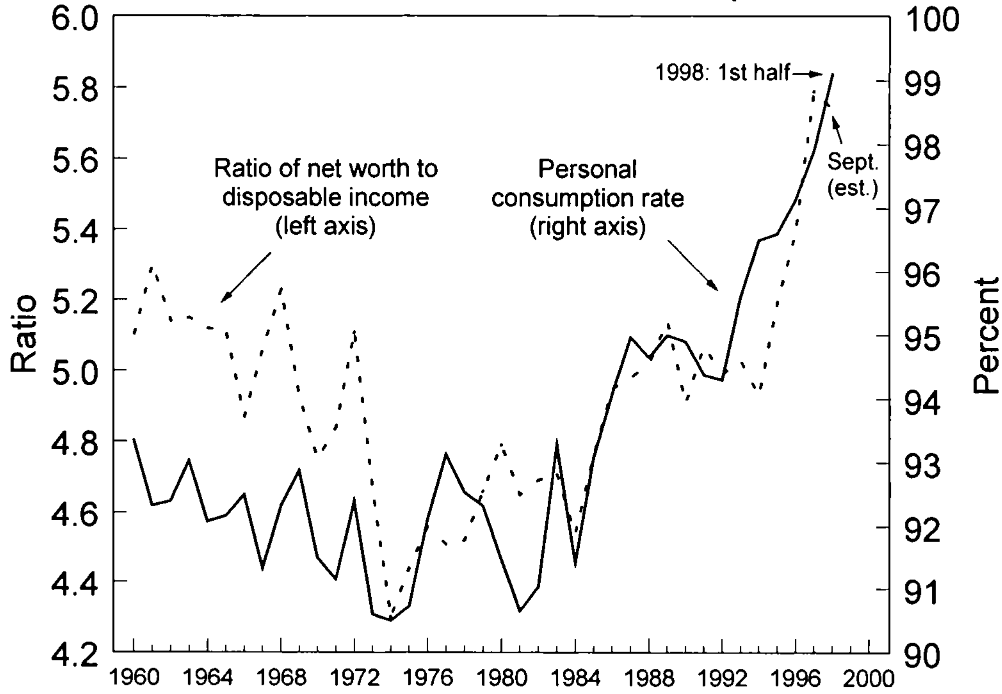
- Profit Outlook/Investment spending could fall

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

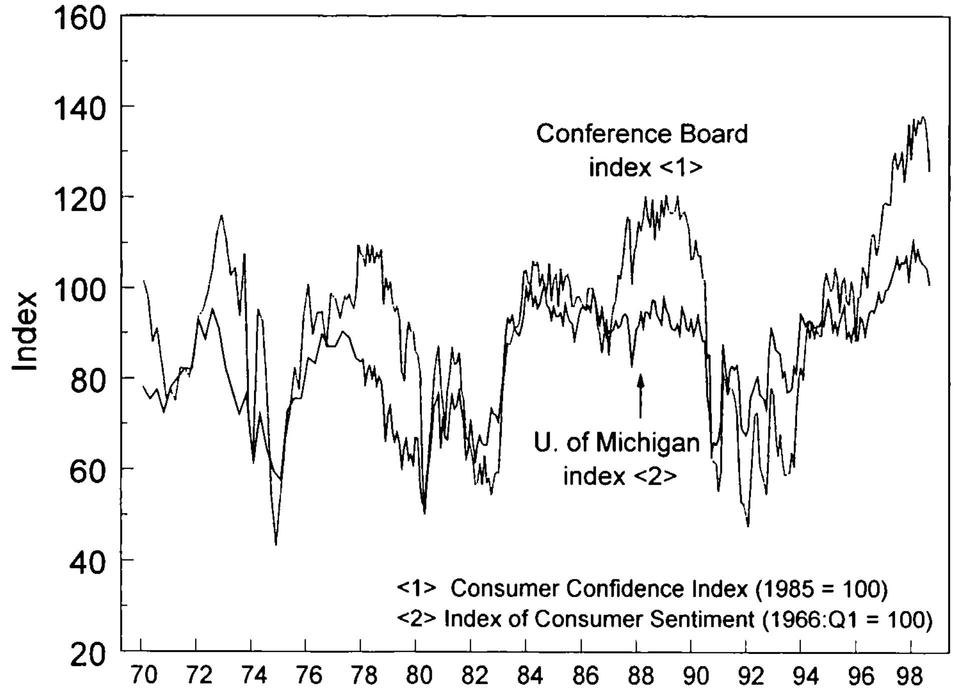
III. Possible Policy Responses

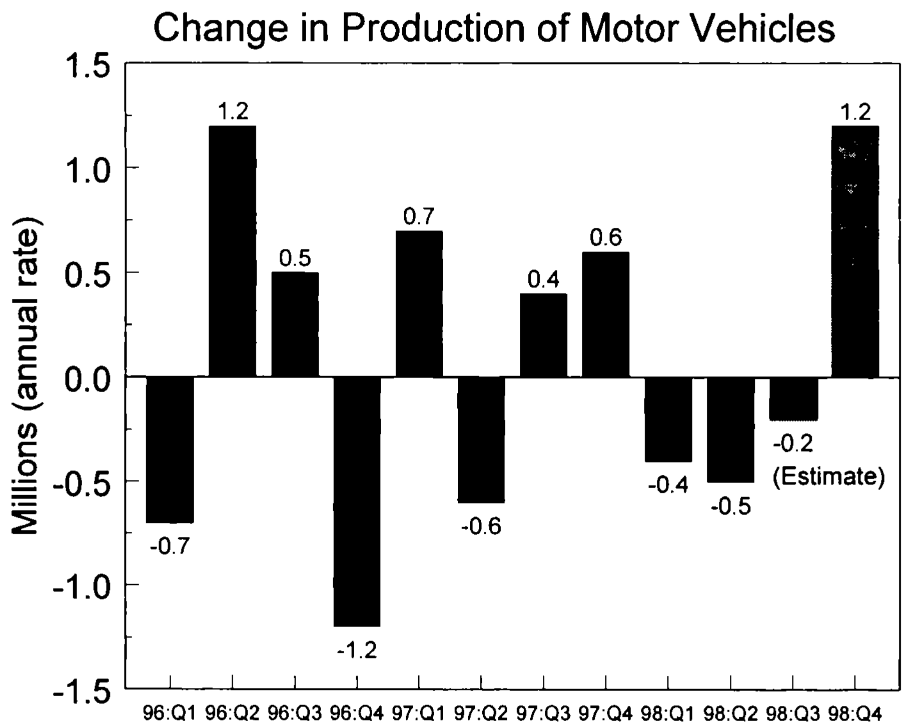
[Janet's material starts here]

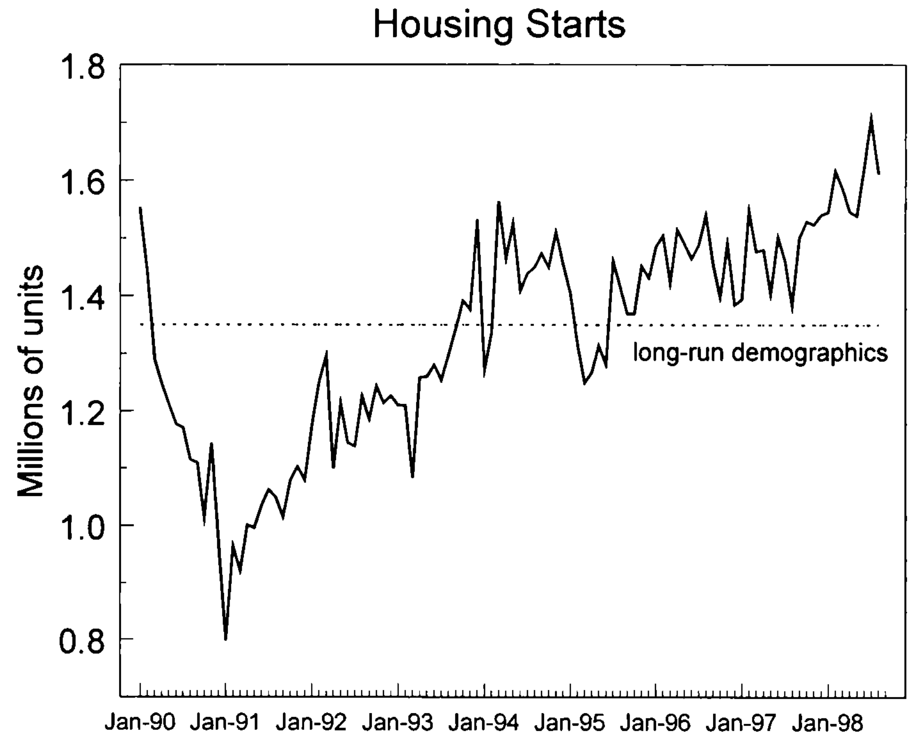
Net Worth and the Personal Consumption Rate

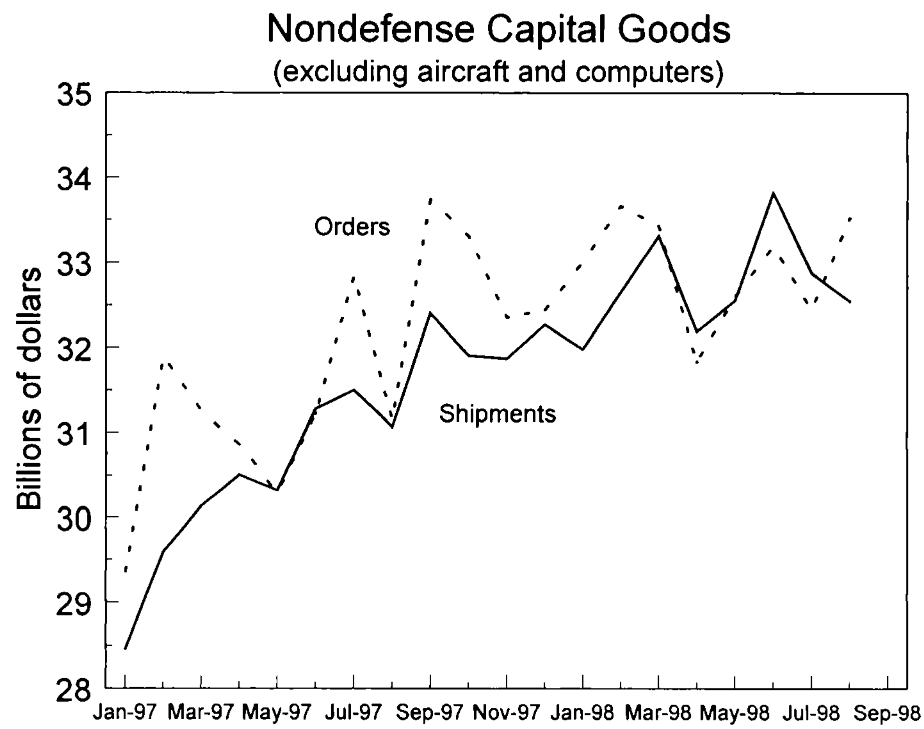


Consumer Attitudes




Change in Production of Motor Vehicles
Millions (annual rate)
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-0.7
1.2
0.5
-1.2
0.7
-0.6
0.4
0.6
-0.4
-0.5
-0.2
(Estimate)
1.2
96:Q1 96:Q2 96:Q3 96:Q4 97:Q1 97:Q2 97:Q3 97:Q4 98:Q1 98:Q2 98:Q3 98:Q4





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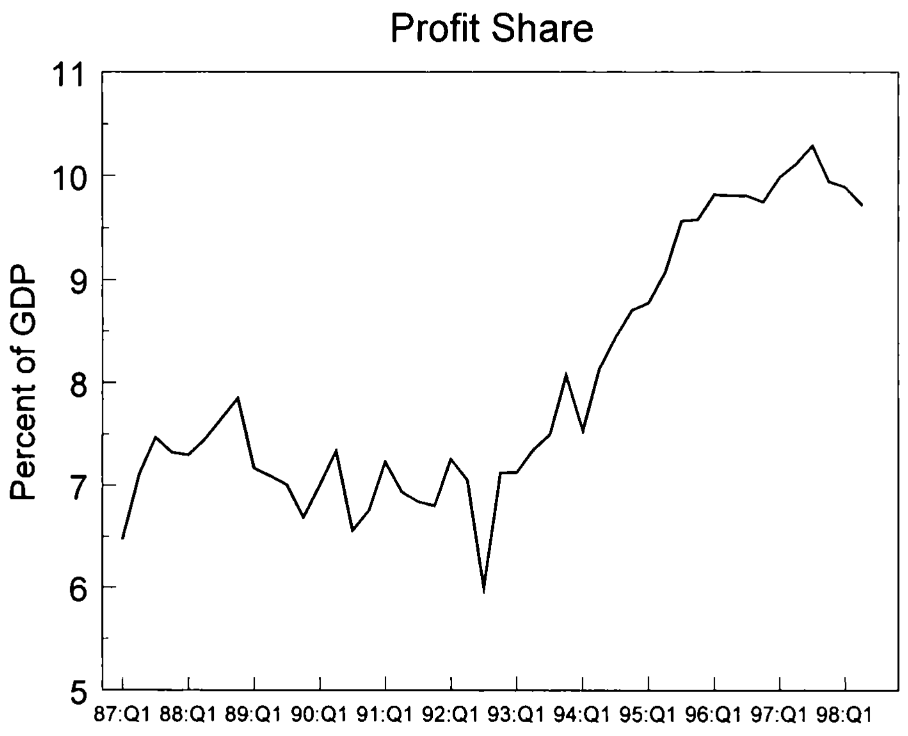
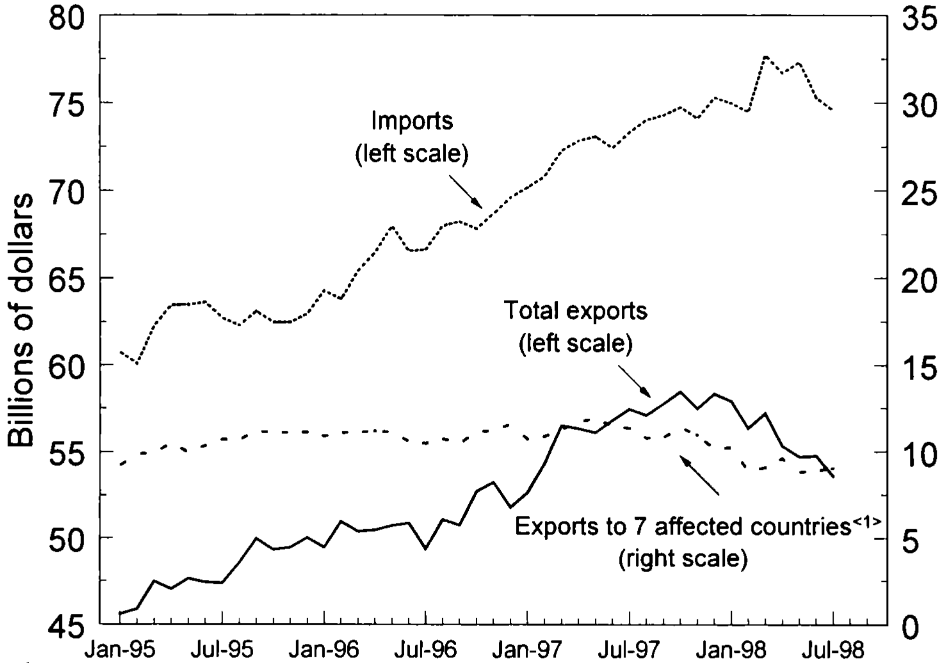
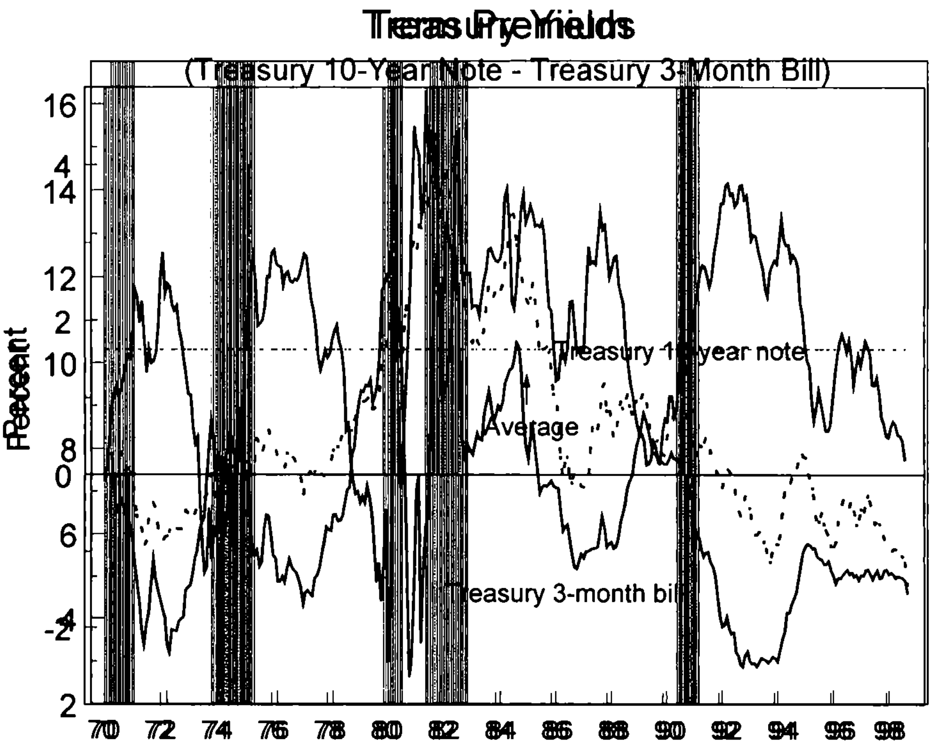


Profit Share
Percent of GDP
11
10
9
8
7
6
5
87:Q1 88:Q1 89:Q1 90:Q1 91:Q1 92:Q1 93:Q1 94:Q1 95:Q1 96:Q1 97:Q1 98:Q1

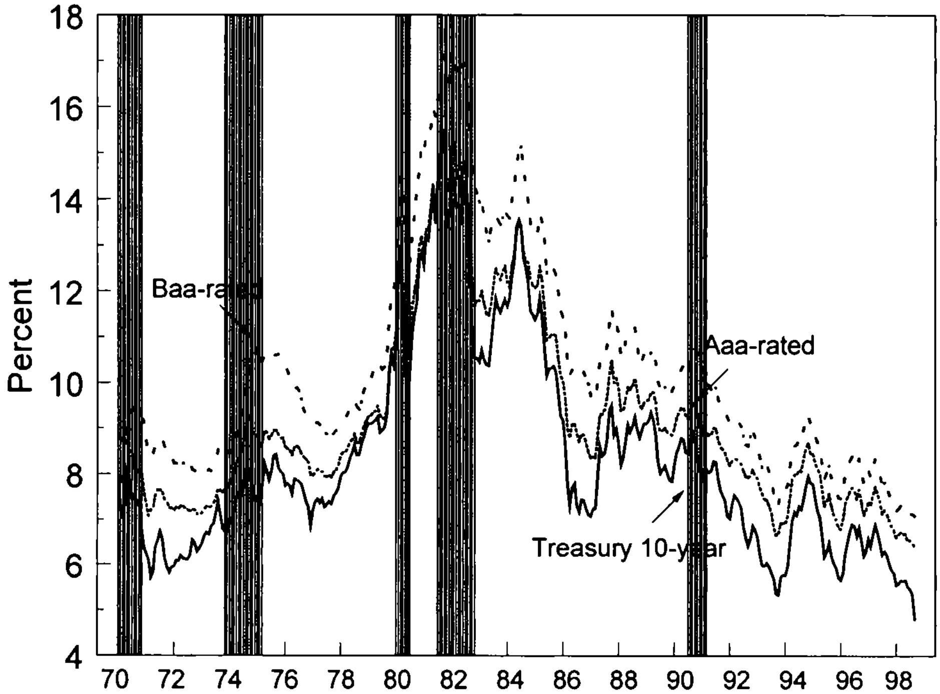
Exports & Imports of Goods



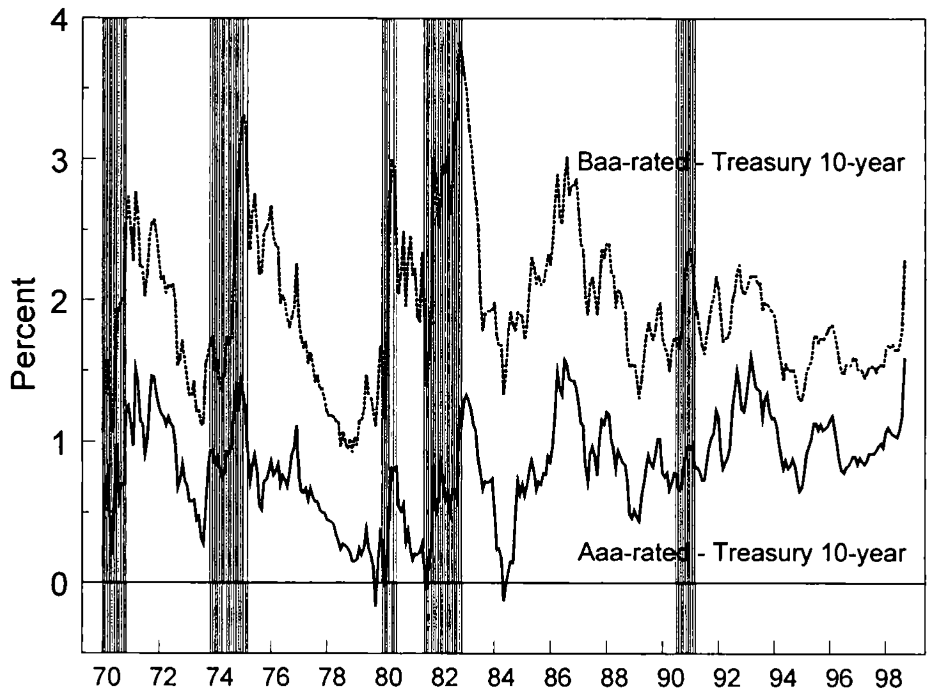
<1>China, Indonesia, Japan, Korea, Malaysia, Philippines, and Thailand


(Treasury 10-Year Note - Treasury 3-Month Bill)
Treasury 10-year note
Average
Treasury 3-month bill
Percent
70 72 74 76 78 80 82 84 86 88 90 92 94 96 98

Corporate and Treasury Yields



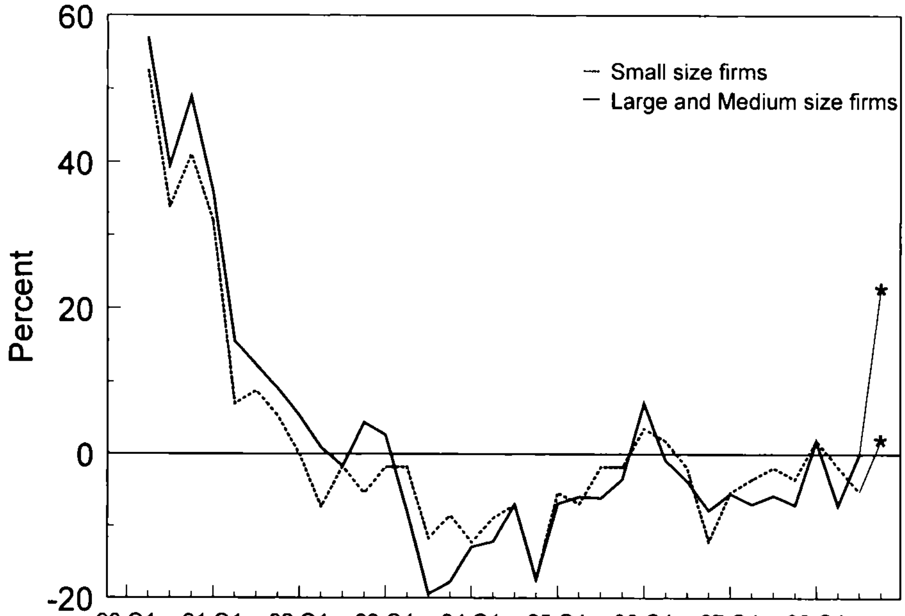
Quality Spread



[Automated Records Management System Hex-Dump Conversion]

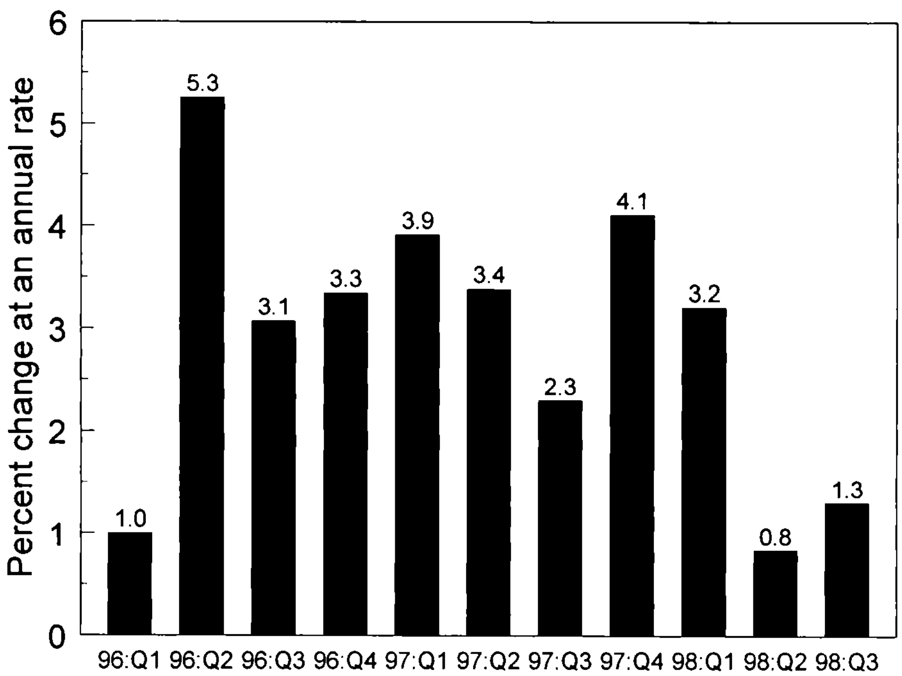
Measures of Supply and Demand for C & I Loans

Net Percentage of Domestic Respondents Tightening Standards for C & I Loans



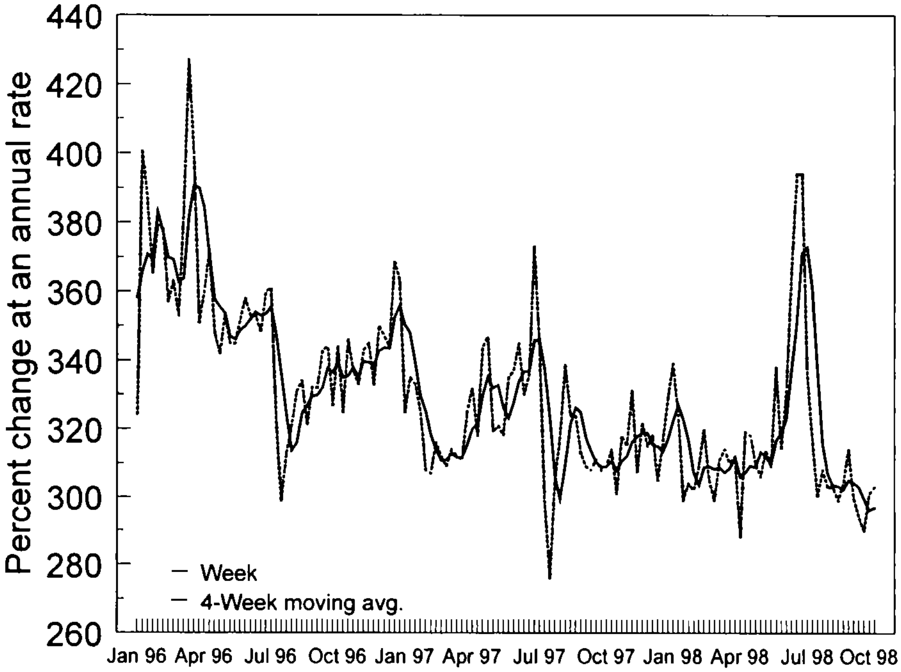
* Indicates data from the special September survey

Production-Worker Hours

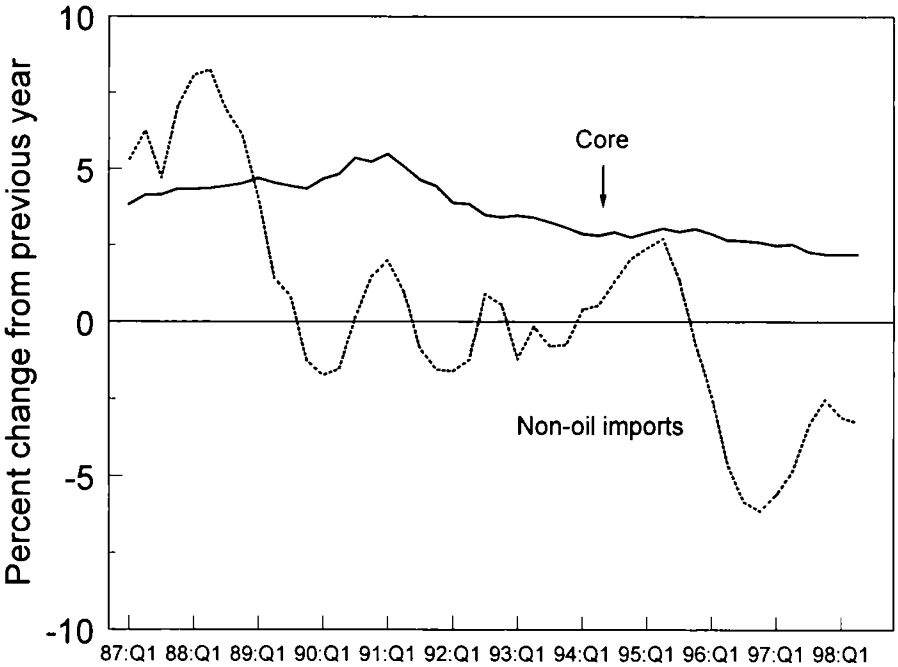


[Automated Records Management System Hex-Dump Conversion]

State Initial Claims



Core CPI and Non-Oil Import Prices



[Automated Records Management System Hex-Dump Conversion]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-OCT-1998 01:12:18.00

SUBJECT:

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

TEXT:
Ignore the funny icon. This should detach OK and be read as a normal WP document. I included the charts at the back, but they could be cut and pasted into a separate document. See you later this a.m.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D13]MAIL49912498F.226 to ASCII,
The following is a HEX DUMP:

The Economic Outlook
October 16, 1998

I. Overview

The economy has been growing faster than its long-run sustainable pace over the past 2-3 years, and most forecasts, including those of the Administration, have anticipated a slowdown in growth and a gradual rise in the unemployment rate to 5 percent or slightly higher by 2000.

- Prior to the onset of the Asian crisis, it had been widely assumed that the forecast slowdown would be achieved through a combination of a natural waning of the robustness of domestic demand (especially for consumption and investment goods) combined with a likely tightening by the Federal Reserve. Market interest rates reflected this assumption.

- With the onset of the Asian crisis, the channel through which the slowdown might occur changed. The likely decline in net exports due to the Asian crisis was seen as a likely alternative to Fed tightening. Net exports did in fact decline in the first half of 1998. But interest rates also fell as the world financial crisis intensified, global growth prospects diminished, and expectations about Fed actions were revised. Domestic demand continued to grow at a very robust pace in the first half of 1998.

In the past month or so, what was formerly seen as a relatively smooth path leading to slower growth has now begun to appear much bumpier. Although the consensus forecast continues to be for growth of about 2 percent in 1999, the Fed's decision yesterday to cut interest rates symbolizes the heightened degree of concern about downside risks.

- Attention is focused on a slowdown in the first half of 1999 (output in the fourth quarter of 1998 is likely to be boosted by a rebound in motor vehicle production).

- Almost all the components of demand could slow, and a smooth transition to 2 percent growth could be difficult to achieve.

II. Recent Trends and Future Prospects

A. Consumer Behavior

Until recently, consumer spending had been buoyed by a rising stock market and very strong consumer sentiment. Consumers have been spending a very high proportion of their income.

- 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.
- Consumption reached more than 99 percent of disposable income in the second quarter as stock market gains drove the ratio of household wealth to disposable income to very high levels (see chart).
- Consumer sentiment has fallen in the past few months, but its level in September was still in the 90th percentile of its historical distribution (see chart on next page).
- **Recent rates of consumption growth are unlikely to be sustainable without the impetus from a rising stock market and falling saving rate.**

B. Housing

The <u>level</u> of new home construction (at about a 1.6 million unit annual pace) is very high compared with its long-term demographic fundamentals (see lower chart). It has moved up to this level in response to falling mortgage rates and rising real incomes. But the pace may already be so high that there is little room for further expansion.

C. Business Investment

Growth in business investment, especially equipment, has been very high over the past several years, but the pace of expansion may be slowing.

- 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 (see chart) after substantial

growth earlier in the expansion. Contracts for new construction, a leading indicator of contruction activity have turned down sharply.

- The rapid pace of investment growth may have created an oversupply.

  - Industrial capacity has increased by 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.

  - If 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 two-thirds as much gross investment (including replacement) would be needed in an economy growing at 2 percent per year compared with one growing at 4 percent per year.

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

- One bright note is that some support for business investment is likely to continue to come from the falling relative price of investment goods (especially computers).

- **Thus, a number of factors point to a slowing in business investment. If credit crunch conditons develop as well (a topic that will be discussed later), even those who want to invest may have trouble getting the necessary funding.**

D. International Trade

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

- 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.

- The IMF has recently revised downward its forecast for global growth to 2 percent.

- Slower growth is projected for many of our major trading partners, such as Canada, Mexico, and Latin America, even if a Latin American financial crisis is avoided.

E. Financial Market Risks

Financial market risks may be the wild card in the forecast. Some signs of an incipient credit crunch are emerging, which could seriously dampen spending.

- Stock prices have declined substantially since their peaks in July. For example, the S&P 500 is down 16 percent from its peak. Investors may be downgrading their expectations for future earnings or increasing the premium they require for taking on risk.

- The term premium (the difference between longer-term and shorter-term yields), which is a leading indicator of recessions has shrunk damatically in the past 2 months.

- The quality spread between yields on riskier bonds and those on less risky bonds has increased dramatically recently, though it has been higher in the past.

- The Federal Reserve's latest survey of Senior Loan Officers shows a significant tightening of credit standards for large- and medium-sized firms.

F. Conclusion

With the unemployment rate below 5 percent and inflation continuing to be tame, the economy is in a good position to absorb shocks. But the shocks may be severe.

- 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.

- Growth of production-worker hours has slowed to about a 1 percent annual rate of growth in both the second and third quarter--a figure that is consistent with a GDP growth rate of about 2 percent. However, initial claims for unemployment insurance remain very low, only 297,000 for the 4-week period ending on October 10th. 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.

- 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.

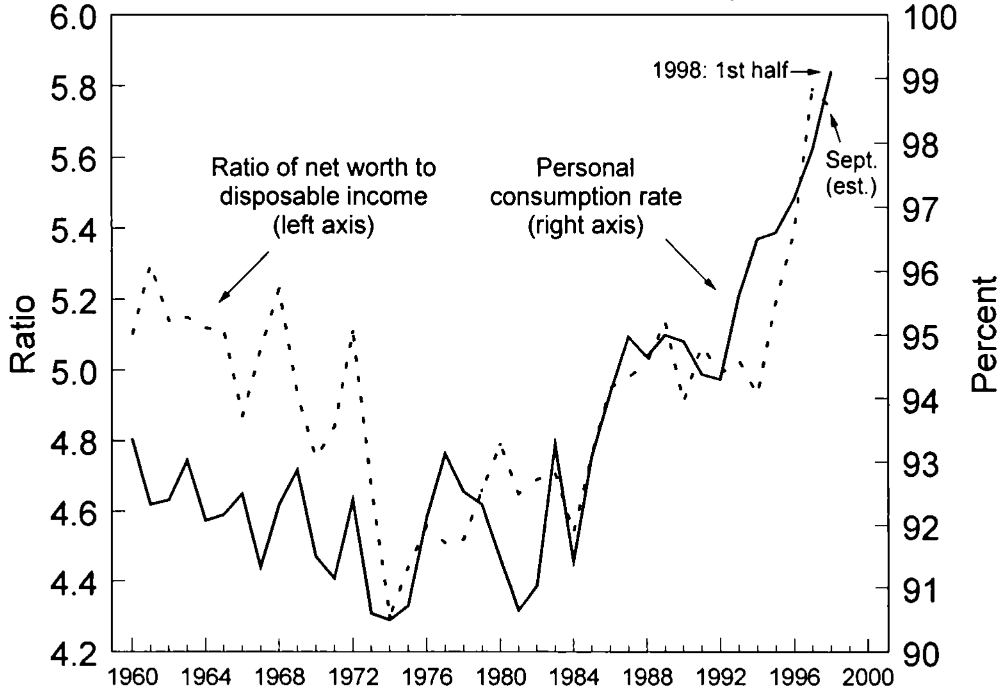
- Profit Outlook/Investment spending could fall

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

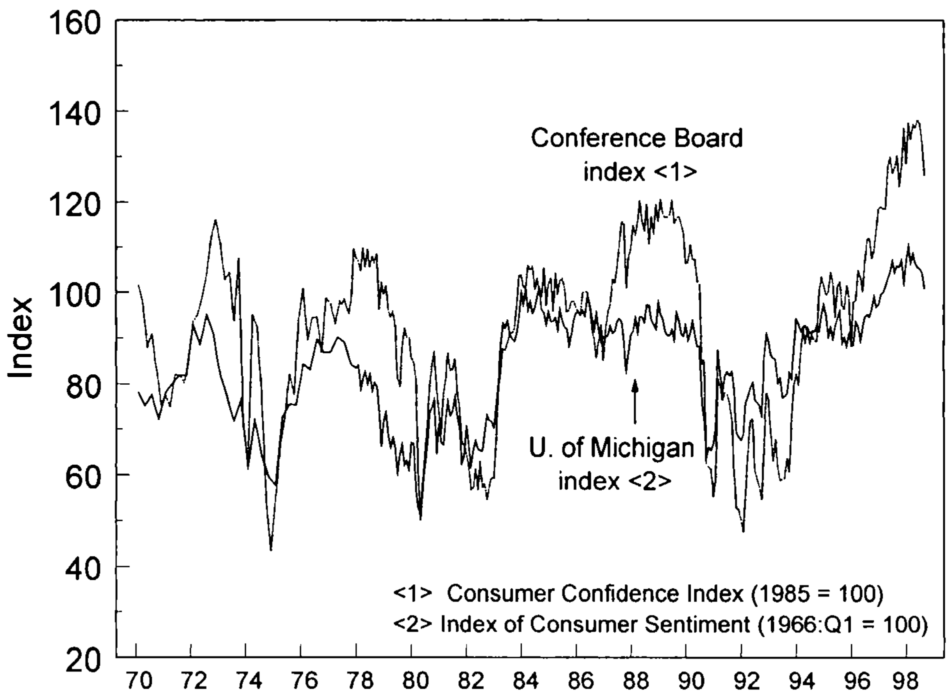
III. Possible Policy Responses

[Janet's material starts here]

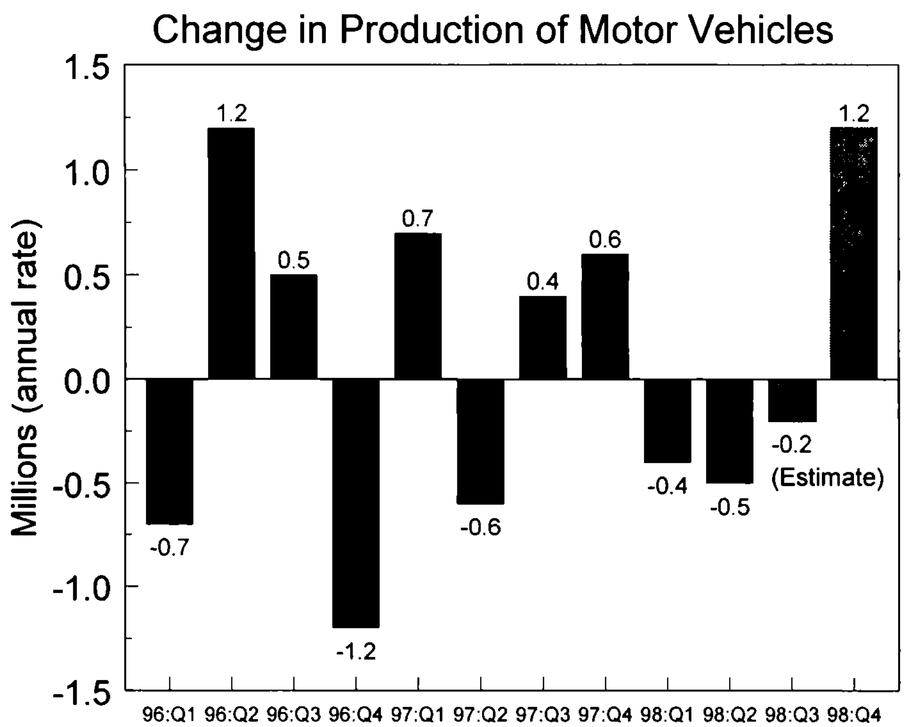
Net Worth and the Personal Consumption Rate



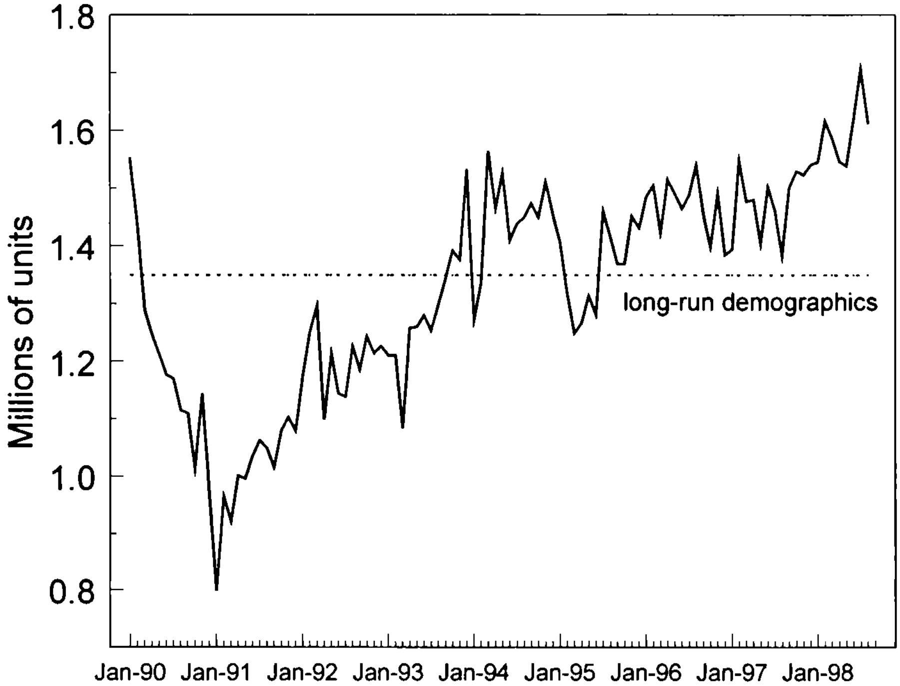
Consumer Attitudes



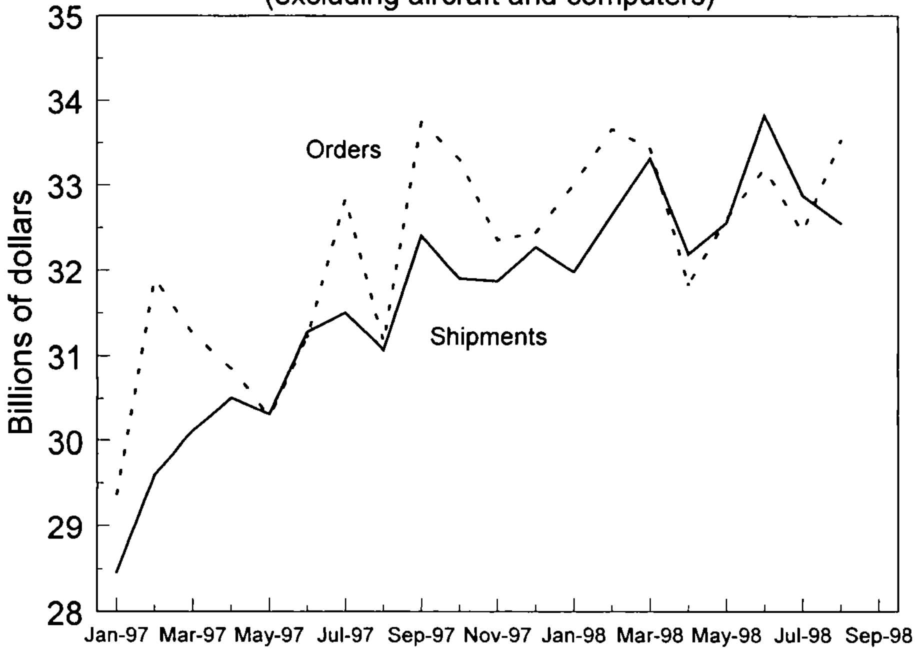
[Automated Records Management System Hex-Dump Conversion]

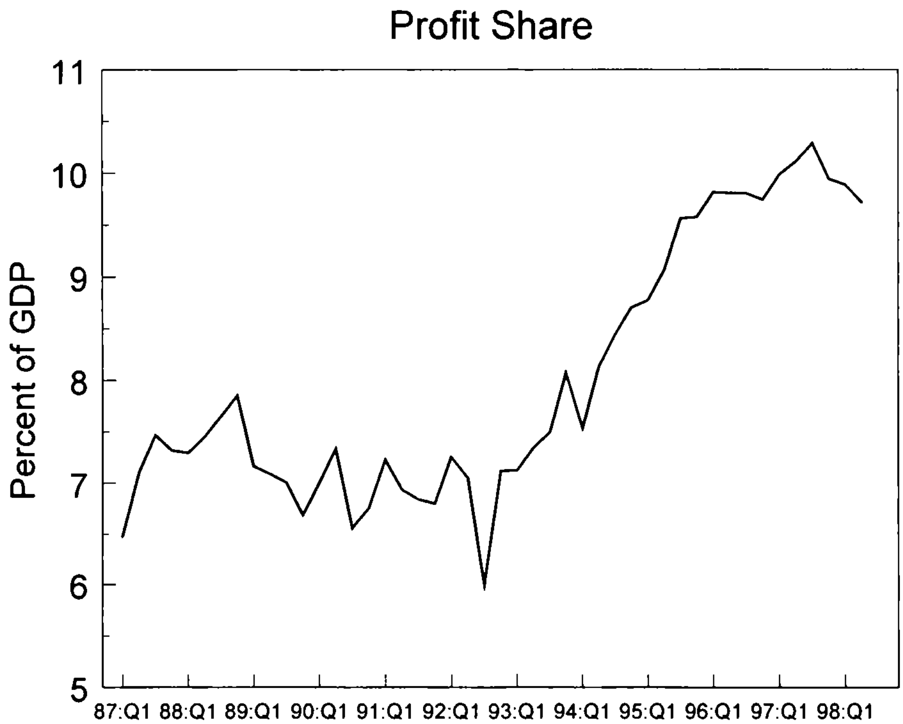

Change in Production of Motor Vehicles
Millions (annual rate)
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-0.7
1.2
0.5
-1.2
0.7
-0.6
0.4
0.6
-0.4
-0.5
-0.2
(Estimate)
1.2
96:Q1
96:Q2
96:Q3
96:Q4
97:Q1
97:Q2
97:Q3
97:Q4
98:Q1
98:Q2
98:Q3
98:Q4

Housing Starts



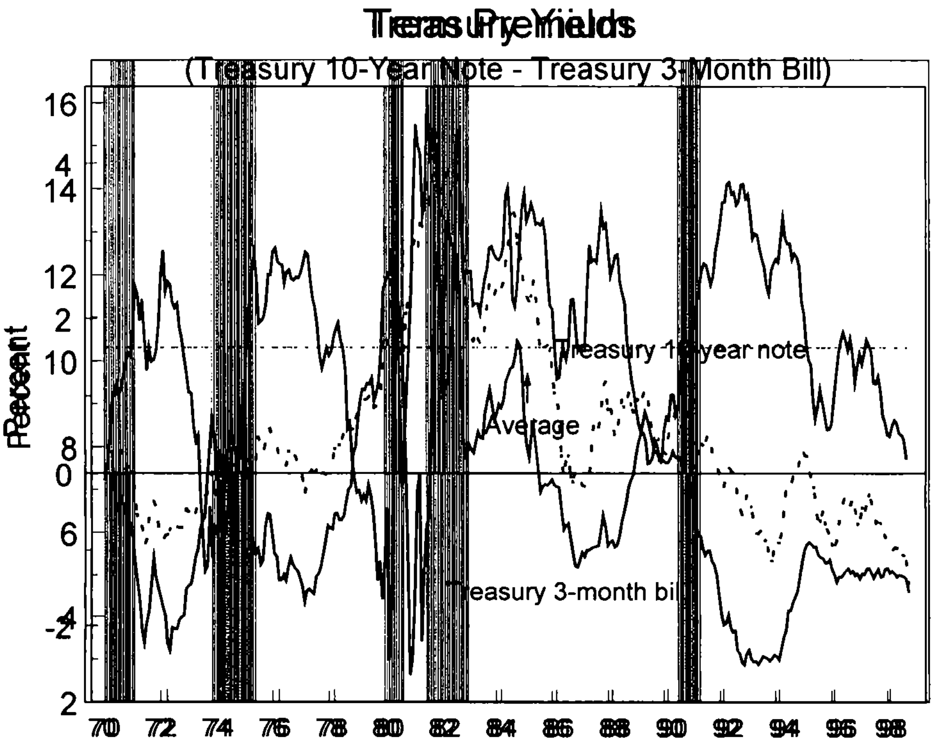
Nondefense Capital Goods
(excluding aircraft and computers)



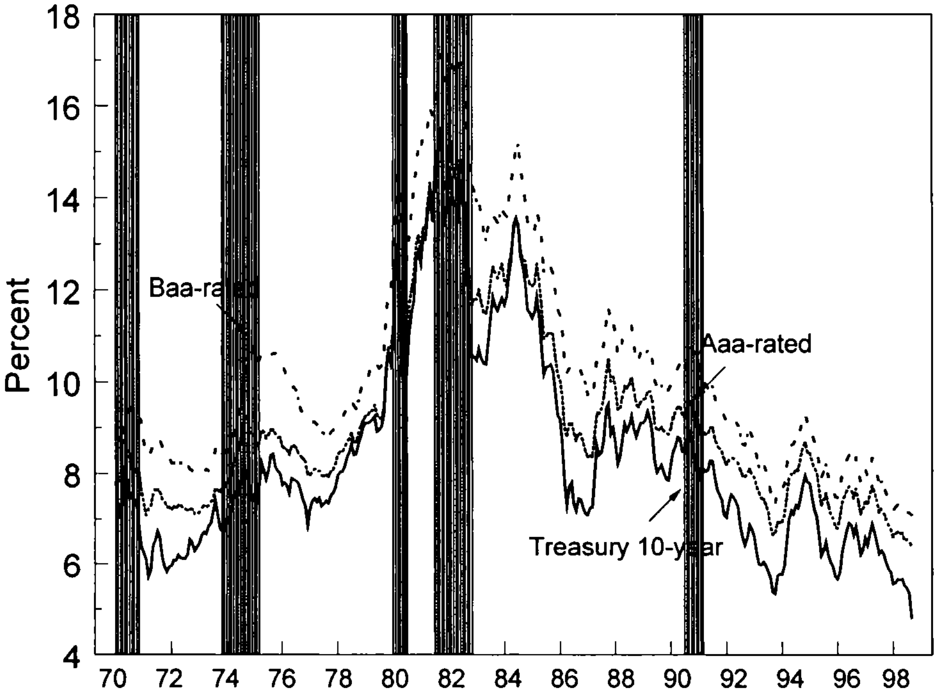

Profit Share
11
10
9
8
7
6
5
Percent of GDP
87:Q1 88:Q1 89:Q1 90:Q1 91:Q1 92:Q1 93:Q1 94:Q1 95:Q1 96:Q1 97:Q1 98:Q1

<1>China, Indonesia, Japan, Korea, Malaysia, Philippines, and Thailand

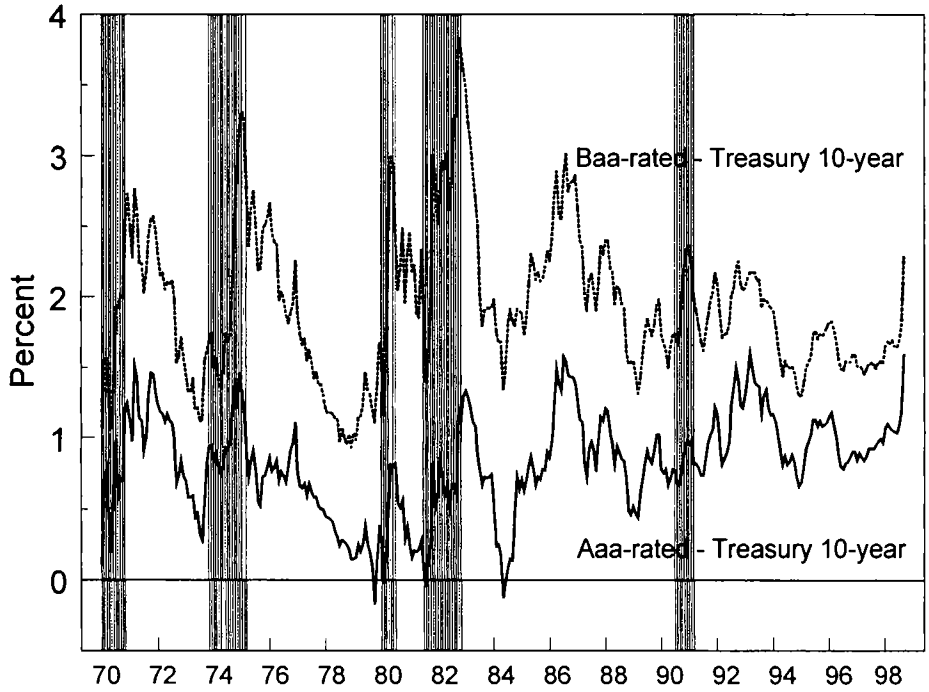
[Automated Records Management System Hex-Dump Conversion]


(Treasury 10-Year Note - Treasury 3-Month Bill)
Treasury 10-year note
Average
Treasury 3-month bill
Percent

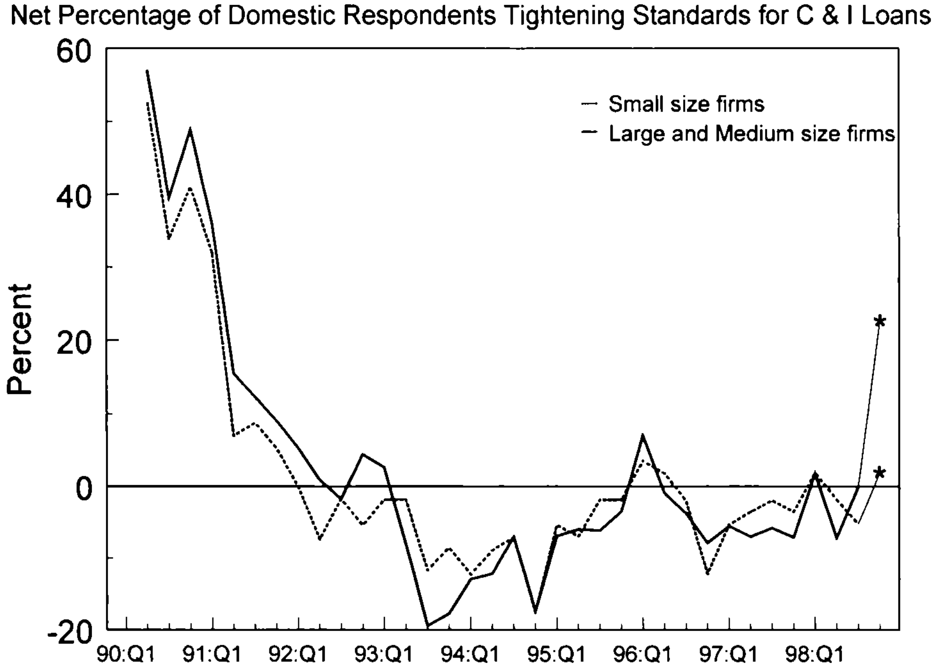
Corporate and Treasury Yields



Quality Spread

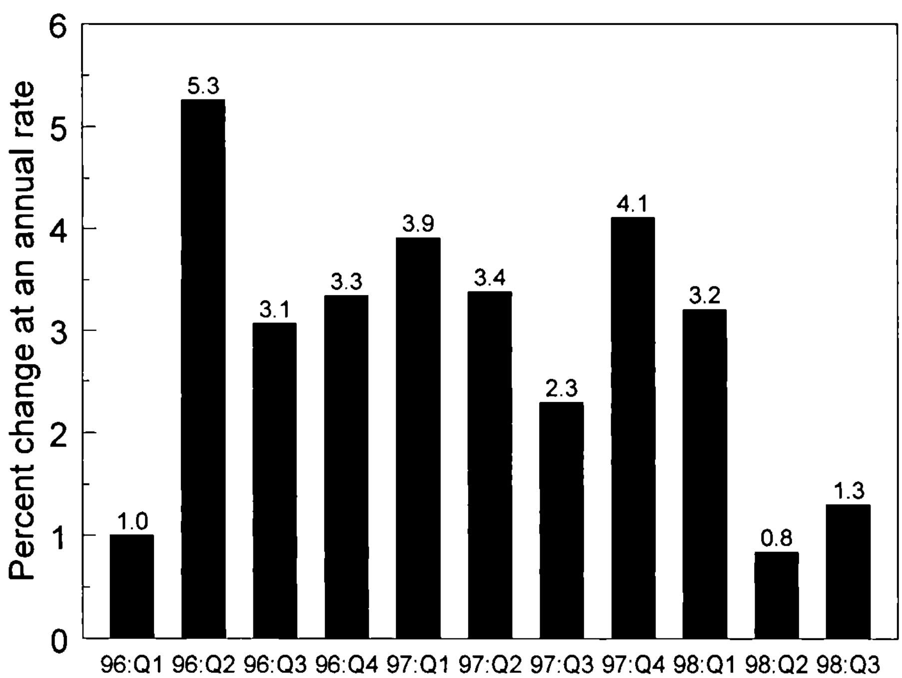


Measures of Supply and Demand for C & I Loans



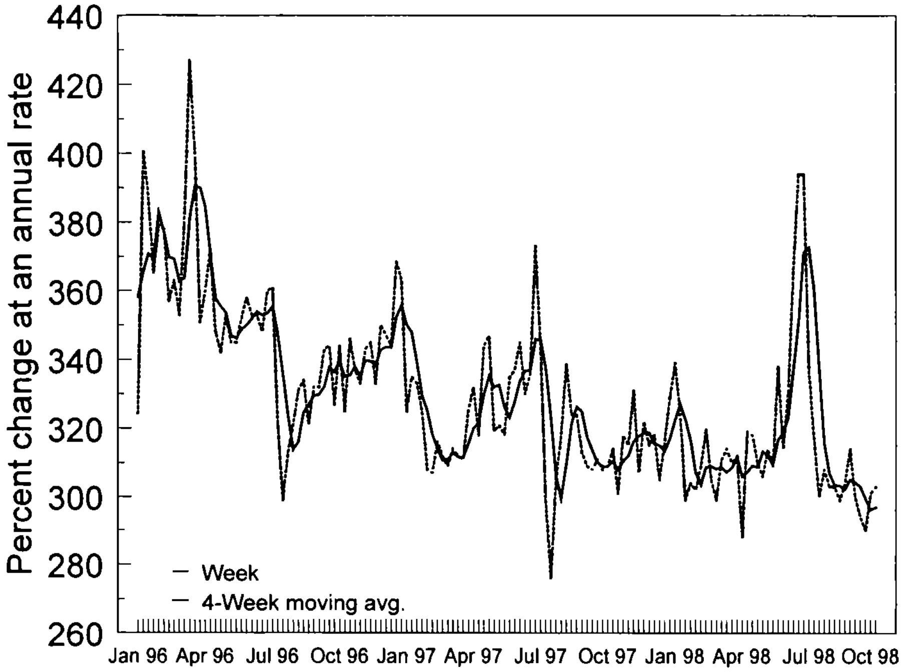
* Indicates data from the special September survey

Production-Worker Hours

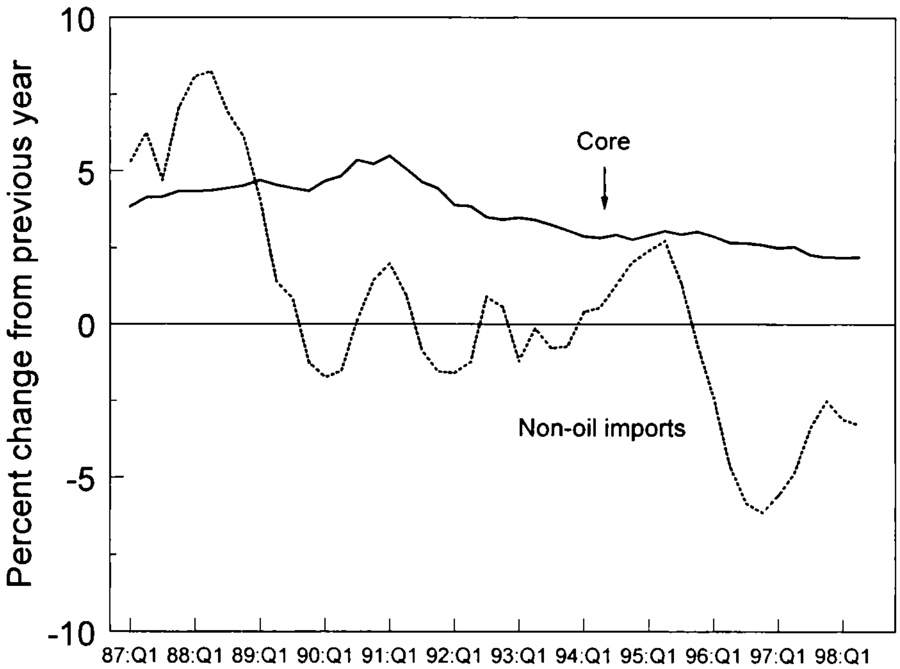


[Automated Records Management System Hex-Dump Conversion]

State Initial Claims



Core CPI and Non-Oil Import Prices



[Automated Records Management System Hex-Dump Conversion]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:19-OCT-1998 15:15:37.00

SUBJECT: Speech at the World Bank

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

TEXT:
Uri Dudush called. He wants to organize a "2-3 hour" meeting with you and the high-level economists at the World Bank. He wants you to talk about the state of the US and global economies and what needs to be done. He will then have the regional chief economists go around the table and give their views on the economies of the region. He said they can do it any day. Is this something you'd be willing to do? And do you want to do it for that long?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: David W. Beier (CN=David W. Beier/O=OVP [UNKNOWN])

CREATION DATE/TIME:21-OCT-1998 09:31:47.00

SUBJECT: Dec. Meeting with the VP

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

CC: Ansley Jones (CN=Ansley Jones/O=OVP @ OVP [UNKNOWN])
READ:UNKNOWN

TEXT:
Thanks again for looking at the list of potential economist experts for a Dec. 9th meeting with the VP. As we discussed the hope is to broaden the VP's range of contacts and input from leading economists. As you suggested we ought to narrow the field to a field of economics, and thus, international finance issues seems most appropriate.

Thanks for offering up more detailed suggestions.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:21-OCT-1998 23:46:35.00

SUBJECT: International Roundups

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

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

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

TEXT:
Sorry I couldn't give you all hard copies: your doors were (not surprisingly) locked. I am also emailing these to Chad, so if he forwards them to you please disregard this message.

Thanks,
Matt

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D59]MAIL447996491.226 to ASCII,
The following is a HEX DUMP:

INTERNATIONAL ROUNDUP

Coffee Contributes to Colombia's Highs and Lows. Like other developing countries, Colombia has been recently under pressure from international financial markets. Reserve losses in August led up to a surprise devaluation of the peso on September 2. This devaluation took little pressure off the currency, and had to be supplemented by successive increases in interest rates. President Pastrana has also recently submitted fiscal reform proposals to Congress, pledging to reduce the deficit to 2% of GDP by 1999. Nonetheless, the peso has continued to trade near the edge of its exchange band. While mistakes by policy-makers and swings by global investors have played dominant roles in the crises elsewhere, Colombia's difficulties have been compounded by changing global prices of primary commodities, particularly coffee. In 1997, coffee accounted for 20% of Colombian exports. In August, however, exports were already a third off their average third quarter 1997 pace, and coffee prices have continued to decline. Historically, a classic commodity price cycle has governed Colombia's real exchange rate (i.e., nominal exchange rate adjusted for price levels). (see chart of the week). During the phase of the cycle when world coffee prices are high, Colombia's increased export revenues have tended to feed into higher foreign exchange reserves, money supply, and, in turn, domestic prices (constituting a "real appreciation"). Rising wages and production costs are then felt by all Colombian exporters, and competitiveness in the non-commodity sector is impaired (an economic phenomenon known as "Dutch Disease"). With the current decrease in coffee prices and financial market turmoil, Colombia is squarely in the down-phase of the cycle: an outflow of reserves and a tightening of monetary conditions at home.

Hyundai Wins Bid for Kia, Faces Challenges of Corporate Restructuring. The fate of Kia, the car maker auctioned off for the third time this week, illustrates both the factors leading up to the current crisis and many daunting challenges which must be overcome in resolving it. Arguably, the magnitude of Kia's troubles resulted from an extreme case of "connected" lending: Kia's former Chief Executive was jailed earlier this week for embezzlement, and reports claim he used this money for bribes to obtain preferential bank loans and keep Kia afloat. Since it defaulted on debt estimated at over Won12 trillion, Kia has been put on the auction block three times. The most recent auction concluded Monday, with Hyundai Motors submitting the winning bid. The deal, however, awaits creditor approval -- and creditors have killed each of its predecessors by refusing to submit to the debt write-offs demanded. According to press reports, Hyundai is currently demanding a Won7.3 trillion write-off (roughly $5.5 billion), Won2.5 trillion of which will be swapped for equity. Allegedly, Kia's largest creditor, the Korea Develop Bank, favored Ford's bid. Even if its creditors approve, Hyundai will face an uphill battle to return Kia to viability. In addition to the write-off, analysts estimate that Kia's remaining debt will have to be restructured. According to most economists, however, redundant investments in saturated industries were key factors initiating the current crisis. As a result, both a company's financial structure and its productive assets must be restructured if it is to succeed. Though Kia's notoriously tough labor union is likely to resist any large-scale layoffs, many analysts remain optimistic. Some suggest Hyundai has the necessary clout to rationalize production, and that in the wake of its failed bid Samsung will cease automobile production. If so, some of the excess capacity that has plagued the Korean car industry may well be eliminated. [This is already too long, so I won't try to integrate yet another dimension. But, we could also use this as a vehicle to discuss the recent deal struck today to open Korean auto markets to US car makers. Arguably that reduces Ford's need to have won the Kia bid. As Nouriel is fond of pointing out, though, it's a shallow victory for American industry to have won the right to export to an industry running at 40-45% capacity.]

Banks Nervous about Future of Chinese ITICs. International investors have lent billions of dollars to China's International Trust and Investment Corporations, ITICs, apparently on the assumption that their obligations were backed by the state. Last week's closure of the Guangdong ITIC along with the failure of two more government-owned groups to make payments on their foreign debts has challenged this view. According to many, the Chinese Prime Minister ordered the recent closure of GITIC, over-riding local opposition, and signaling that such implicit guarantees have disappeared. Upon closing GITIC, the Chinese central bank pledged that obligations to international creditors would be made a priority as long as loans were accompanied by the appropriate official documentation. Many bankers have extended loans with very little documentation, however, and the status of unregistered short-term lending remains unclear.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Ryan D. Edwards (CN=Ryan D. Edwards/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:21-OCT-1998 15:04:37.00

SUBJECT: Re: Dave Wyss (DRI) tomorrow (Wed.) @ 4 pm in NEOB 9104

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

TEXT:
I'm not even sure what DRI is, and I'm not in the loop on forecasting, generally. :) Let's do the EPC thing. I've made copies of the Draft Main Issues in case participants need them, and I have some of the OECD documents (I checked at 1:30pm today). Let me know if you'd like me to prepare any of them; they're generally quite long!

-Ryan

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:21-OCT-1998 09:19:59.00

SUBJECT: CCTI

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:
I spoke with Bob Tuccillo yesterday afternoon, and he gave me a brief overview of how much of the Administration's CCTI request was included in the final budget deal. We had asked for about $1.3 billion, and received just over $1 billion. Almost all of this is for R&D. Bob thinks that the only tax credits/incentives in the budget were extensions of existing credits (e.g., the tax credit for wind and biomass energy). If you want details on specific programs within the CCTI, let me know, and I'll see if Bob can compile something for us.

Joe

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:21-OCT-1998 20:03:14.00

SUBJECT: Todd memo to POTUS cmts. due 9 a.m.

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

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

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

TEXT:

On page 4, under Caps on Emissions Trading, I propose that we propose to Todd adding a sentence to the second paragraph after the second sentence ("According to our analysis, caps on emissions trading would significantly increase inefficiencies...")

The sentence I want to add is something like: "Estimates from the model used in the Administration Economic Analysis are that trading caps of 50% could more than double the price per ton of carbon."

If I don't hear otherwise, I will feel free to convey this suggestion to Todd at 9 a.m.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:21-OCT-1998 17:42:34.00

SUBJECT: Japan trip

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

TEXT:
The President will be in Japan on November 18-20 and then will go to Korea. I talked to Laura Marcus about your participation. She is happy to help, if you decide you want to go. (And Lael's message is below) So, I think it is your decision as to whether you want to go to Japan in November or try to schedule it for February. Let me know what you want to do.
Thanks.
Michele
---------------------- Forwarded by Michele Jolin/CEA/EOP on 10/21/98 05:36 PM ---------------------------

Lael Brainard
10/20/98 12:23:07 PM
Record Type: Record

To: Michele Jolin/CEA/EOP
cc:
Subject: Re: Possible Yellen mtg w/ Japan's EPA head

MJ--
Could make sense. Probably depends somewhat although not completely on question of Rubin & Summers participation. Haven't heard yet from Mike, but I presume there will be some Treasury presence. Also have not heard yet from Daley & Barshefsky, but presume they will be participating.

Let me know how you think she is leaning.

LB

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:21-OCT-1998 13:52:50.00

SUBJECT: Re: Dave Wyss (DRI) tomorrow (Wed.) @ 4 pm in NEOB 9104

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

TEXT:
David Wyss is chief forecaster at DRI. It's no problem since I'm not
going to hear him---I'm going to meet with Meyer as scheduled. Did you
want to hear Wyss?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:22-OCT-1998 08:13:17.00

SUBJECT: Re: Press on Friday

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

TEXT:
Yes. I would be quite willing to do some press. Are there some talking points or guidelines on what particularly to cover?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:23-OCT-1998 18:21:59.00

SUBJECT: financial market update

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:
The financial-market event that was supposed to happen today and Monday will NOT happen, thanks to a clarification of the new Japanese regulation. I can fill you in on the details on Monday if you're interested.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:23-OCT-1998 18:23:18.00

SUBJECT: Colombian Finance Minister

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

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

TEXT:
Janet,

I am currently scheduled to meet here with the Colombian Finance Minister, 4 p.m. on Tuesday Oct. 26. Do you want to drop by? Or to have the meeting in your office?

Originally it was with Mauricio Cardenas (my former thesis advisee), who I believe is now Minister of Transportation there; then his office said he would bring the Finance Minster along.

JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:26-OCT-1998 12:21:17.00

SUBJECT: financial-market tidbits

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

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

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

TEXT:
A few minor points to complement the Fed summary:

1. We've noticed for several weeks that the widening gap between the on-the-run and off-the-run 30-year Treasury yields was not mirrored in the 10-year yields. I finally called a friend in NY, who in turn talked to some traders, and the principal explanation seems to be this: The quantity of 30-year securities issued most recently was much smaller than the quantity issued previously, which accentuates the inherent liquidity premium of the on-the-run issue. (This is why it's important for Treasury to maintain sizeable auction sizes, even if auctions occur less frequently as a result.) The reverse is true for the most recent 10-year issues, which offsets the normal liquidity premium.

2. September data from the Natl Federation of Independent Business suggested that small businesses continued to have ample access to credit.

3. Bank credit growth appears to have remained quite strong in October, with large gains in business, real estate and consumer lending.

Doug

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Ryan D. Edwards (CN=Ryan D. Edwards/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:27-OCT-1998 11:54:32.00

SUBJECT: Notes on Poverty, Nov 97 EPC

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

TEXT:
Hi Janet,

I found the electronic version of the notes on poverty from the November '97 EPC --- that's the document you thought you might not have and wanted a copy of. It was in Jeremy's directory on this computer. Please find it enclosed.

Best,

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D29]MAIL48803000Q.326 to ASCII,
The following is a HEX DUMP:

The Secretariat's paper raises a number of interesting and important questions; but it is, unfortunately, impossible to do full justice to them within the time allotted for a statement. I would therefore like to focus my remarks on several issues that have been foremost in U.S. policymakers' minds during their most recent attempt at welfare reform.

A typical cash assistance program guarantees a given amount of money to those who receive no income, and then phases out this benefit as income--that is, labor income--rises. Such a program discourages work, and these work disincentives have been a major concern--perhaps *the* major concern--of U.S. policymakers. Today, policymakers have concluded that there is really no way to correct these disincentives *so long as we confine ourselves to considering policies that are similar to the cash assistance program just outlined.* We therefore have to broaden the menu of policies that are up for consideration.

One way to avoid the work disincentive effects of the canonical cash assistance program involves closely tying benefits to a work requirement. In particular, one can either mandate a work requirement directly, or else structure programs so as to provide strong incentives for work. For example, a welfare program might directly require a potential recipient to work for a given number of hours per week, or it might make eligibility for certain benefits conditional on employment. Experimental versions of these programs are presently being pursued at the regional level in the United States.

This kind of policy has its own problems, however. In particular, it makes no real allowance for those who *cannot* work. In addition, if it is to be successful such a program requires a large administrative infrastructure in order to provide for extensive employment-support services and supervision of participants. While this raises program costs, it does permit the welfare authority to obtain a better idea as to whether a person cannot find a private-sector job, in which case other provisions can be made (such as public-sector employment or a disability pension).

A second way to mitigate the disincentive effects of a standard cash assistance program involves constructing a program that subsidizes the wages of low-income workers. This type of program has recently been expanded as part of the U.S. government's current welfare reform initiative, and is known as an "earned income tax credit," or EITC. Under the EITC, low-wage workers with children receive a credit against their earned-income tax liability; this credit is rebated in cash if the worker's tax liability is zero.

An EITC-style program is quite different from a typical cash assistance program in that benefits are zero under the EITC for those who do not work and rise as earnings increase (up to some threshold earnings level). The EITC therefore largely eliminates the disincentive effects that face low-wage workers in the standard cash assistance program.

This program represents a wage subsidy that is paid out to employees. In general, such a subsidy is probably superior to one that is paid to *employers* if income assistance is the subsidy's primary goal. First, it is easier to target *family* income with an employee-based subsidy, since an employer-based subsidy is received by *all* low-wage workers, including those (such as secondary earners or teenagers) who might not be members of a needy family. Second, a wage subsidy paid to employers is probably more likely to result in wage reduction, while a subsidy paid to employees is less likely to do so, as it is largely hidden from employers. (Such wage reduction makes an employer-based wage subsidy a less attractive policy from an income assistance standpoint.)

I would note that the minimum wage complements and interacts with an EITC-style program in an important way. Using the minimum wage by itself in order to guarantee a subsistence level of income is problematic in that it requires the minimum wage to be very high, which discourages employment. On the other hand, using the EITC alone in order to guarantee an income floor requires payment of a large subsidy that must then be phased out slowly in order to minimize disincentive effects. This makes the program much more costly. Hence, the minimum wage and the EITC must be employed jointly in designing an optimal assistance package.

The Secretariat's paper discusses a separate class of policies that involves transfers that are targetted according to nonincome criteria. I would conclude by adding to the comments made by the Secretariat's paper with a couple of comments of my own. First, a basic problem with this type of policy is that very few nonincome criteria can be targetted in a nonproblematic manner. Consider, for example, a policy that provides income support to single-parent families with children. In the United States, this sort of program would be (and has been) criticized on the grounds that it can adversely affect family formation by encouraging the creation of single-parent households. It can even be difficult in practice to target criteria that are in principle free of an incentive problem--witness the high rates of disability that are reported in countries with generous disability pensions. That said, the potential does exist in the U.S. for narrow targetting of transfers that could likely have a high impact with only limited cost. For example, targetting children who live in inner-city areas might represent a beneficial and relatively inexpensive antipoverty program. However, these sorts of policies do raise important equity issues; for example, why should a child in an inner city enjoy assistance as opposed to a child in a rural area if both are poor? It is also unclear whether a similar potential exists for narrowly targetted transfers in other OECD countries.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:27-OCT-1998 21:28:59.00

SUBJECT: WEB article

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

TEXT:
Attached is a very rough first draft of a potential WEB article on bank capital standards. It needs a lot of work and I would be quite happy to see it deferred until some later date, assuming you think this translates into a useable article at all. Nevertheless, here's what I have thus far in case you need something. I have time series data from Bill English on the capital ratios of U.S. banks by size class through the second quarter of 1998 for the "chart" mentioned.==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D12]MAIL46020700J.326 to ASCII,
The following is a HEX DUMP:

ARTICLE

Modernizing Bank Capital Standards

Bank capital serves as a financial cushion to protect depositors and the deposit insurance fund in the event of losses in a bank's asset portfolio. For this reason, a bank's capital ratio is considered a key gauge of its financial soundness. Recent global financial turmoil highlights, however, what bank supervisors have long known: for large, global banks such ratios are increasingly falling short of regulatory ideals as a measure of financial soundness. To insure that "regulation remains as modern as the markets," measures of capital adequacy could benefit from some updating.

What is the capital ratio? The most commonly used measure of bank capital adequacy is the total risk-based capital ratio, defined as the ratio of a bank's total capital to it's risk- weighted assets. The 1988 Basle Capital Accord, a G-10 agreement applying to internationally active banks, determined "risk-weights" by placing all assets in 4 risk buckets. Most non-mortgage loans receive a risk weight of 100%.

Our well-capitalized banks. Judged by their risk-based capital ratios, U.S. banks are in extraordinarily sound condition (see chart). Capital ratios of all banks have increased substantially since 1990, averaging 12.3% in the second quarter of 1998--well above the Basle minimum capital ratio of 8%. In fact, the share of bank assets at well-capitalized banks (those with capital ratios above 10%) stood at 98.5 percent in the second quarter of 1998, up from 30% in 1990.

Shortcomings of the "risk-based" capital rules. Critics of the Basle Accord's risk measurement scheme question the interpretation of such figures, arguing that the rules generating such capital ratios are arbitrary, inconsistent and ungrounded in any conceptually adequate or quantifiable measure of "risk.". For example:

- Most bank assets--ranging from a secured loan to a triple-A borrower to an unsecured loan with a junk bond rating--are assigned the identical 8% credit risk capital requirement. (Loans to OECD governments are considered riskless, incurring no capital charge whatever.)

- Diversification of a bank's assets receive no consideration in determining portfolio risk. Although theory and practice prove that it is highly risky to put all of one's eggs in a single basket, a portfolio consisting entirely of agricultural loans to California farmers is judged identical in its risk by the Basle rules as a diversified portfolio of loans across businesses and regions.

Regulatory arbitrage. The "one-size-fits-all" nature of capital regulations affords banks the chance to game the capital standards if they are deem "too high". Through regulatory capital arbitrage, a sophisticated bank can increase the riskiness of its portfolio to a level deemed economic while meeting or exceeding the regulatory capital requirements. In effect, cherry-picking permits a bank to remove low risk assets, with unduly high regulatory capital requirements, from its books while retaining higher risk assets. This might explain why, with, capital ratios at such high levels, 70 % of the top 50 U.S. banking companies nevertheless have their parent debt rated single A or lower and no major U.S. bank holding company's parent corporate debt is rated AAA.

Search for alternatives: model based approaches. One alternative to the Basle Accord's rule-based measures of risk entails increased reliance on the mathematical models now used by globally active banks to measure and manage risk as a matter of "best business practice." The Basle Supervisors agreed, in rules taking effect last January, to allow banks to rely on internal models to set capital charges against the risk of loss from price fluctuations affecting a bank's trading portfolio (bonds, swaps, derivatives). The agreement allows banks, with adequate internal models, to hold capital against market risk equal to three times the bank's own estimate of its value at risk (VaR)--defined as the loss it would incur with 1% or less probability on its portfolio over a two-week time horizon. Regulators in the United States are studying the feasibility of employing such a "model-based approach" in assessing capital charges against credit risk.

A cautionary note. The failure of Long-Term Capital Management--a firm that relied heavily on such a model based approach--serves as a reminder that models based on historical data and "normal probability distributions" have limitations: they may underestimate the size and frequency of extreme financial price movements. Moreover, they completely ignore the ability of active risk management to take measures to limit losses over periods as long as two weeks.

The pre-commitment approach. An alternative, and even more radical departure from the Basle approach to assessing capital charges, would require each bank to precommit to a maximum loss exposure over a designated horizon. This self-assessed loss commitment becomes the bank's market risk capital charge. Any bank that incurs cumulative trading losses in excess of its capital commitment would be subject to penalties, with the penalties providing the banks an incentive to align their capital precommitments with its internal evaluation of risk and its self-assessed risk management capacity. This approach is undergoing testing by the New York Clearing House.

Implications. As the activities undertaken by sophisticated banking organizations have become more complex, the difficulty for examiners in evaluating bank capital adequacy using traditional capital tools has increased. Hence, the search for improved measures of capital adequacy and approaches to the setting of capital standards. Of course, bank supervisors have long understood that the monitoring of capital ratios is only one part of a more comprehensive supervisory process including, in recent years, heavier emphasis on evaluating the quality of a bank's risk management and internal controls. Research shows that supervisory ratings, although subjective, are far better than risk-based capital ratios in predicting bank insolvency.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:27-OCT-1998 13:18:07.00

SUBJECT: Budget surplus announcement Wed

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

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

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

TEXT:
The MTS will be released tomorrow, Wednesday, most likely at 3 pm. The President will make the announcement about the surplus. The 3 PM time is not for public consumption. The public line is "sometime on Wednesday."

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:27-OCT-1998 09:28:27.00

SUBJECT: Japan trip

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

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

TEXT:
I spoke to Rob Shapiro about the Japan trip. His contact person is Vicki Sims, so Michele should stay in touch with her about arrangements. He has several meetings he would like to set up for us on Friday with academic and private economists. The purpose is to learn about what is going on from those who are knowledgeable and will speak something other than the government party line. We should try to make Friday a full day of meetings--with his groups, and with EPA, Bank of Japan and the Council of Economic Advisers. He hopes to participate in the President's schedule with Secretary Daley on Thursday, but is uncertain just how that will work out. We may also have time available on Thursday for meetings.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:27-OCT-1998 16:38:28.00

SUBJECT: Re: Capital ratios (fwd)

TO: m1bbe00 (m1bbe00 @ Frb.GOV @ INET @ LNGTWY [UNKNOWN])
READ:UNKNOWN

TEXT:
Many thanks for the data. It is exactly what I was looking for. It would also be useful to have data on the share of bank assets in different capital classes if that's not too difficult.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Ryan D. Edwards (CN=Ryan D. Edwards/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:27-OCT-1998 18:56:17.00

SUBJECT: OECD update

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

TEXT:
Hi Janet,

I've been in touch with Martine Durand and John Weeks about various things, and all seems to be proceeding smoothly, although there is some worry about the Vice-Chair situation, of course.

Joe Gagnon still seems to be coming; he suggested we may wish to exchange papers at some point in order to be certain we won't be contradicting each other during remarks.

An update on my progress: I've now completed ROUGH DRAFTS of one statement each on fiscal policy and poverty, and also of the two script passages on those issues. I intend to read through them and get them to you tomorrow morning. John Weeks has provided me with a tentative scenesetter that will get finalized later (he said by tomorrow, hopefully), and I've gone ahead and begun work on your script.

More as things develop,

-Ryan

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:28-OCT-1998 17:17:07.00

SUBJECT: Web on bank capital--slightly revised

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.D56]MAIL47398610J.326 to ASCII,
The following is a HEX DUMP:

ARTICLE

Modernizing Bank Capital Standards

A bank's capital ratio is considered a key gauge of its financial soundness because capital serves as a financial cushion to protect depositors and the deposit insurance fund in the event of losses in a bank's asset portfolio. In fact, under FDICIA's prompt corrective action system, a deteriorating measure of capital adequacy serves as the trigger for increasingly severe supervisory actions and penalties. Bank supervisors are aware, however, that for large, global banks such ratios are have become less informative than commonly believed. To insure that "regulation remains as modern as the markets," measures of capital adequacy could benefit from some updating.

What is the capital ratio? The most commonly used measure of bank capital adequacy is the total risk-based capital ratio, defined as the ratio of a bank's total capital to it's risk- weighted assets. The 1988 Basle Capital Accord, a G-10 agreement applying to internationally active banks, determined "risk-weights" by placing all assets in 4 risk buckets. Cash, at one extreme, receives a risk weight of zero. Most non-mortgage loans receive a risk weight of 100%.

Our well-capitalized banks. Judged by their risk-based capital ratios, U.S. banks are in extraordinarily sound condition (see chart). Capital ratios of all banks have increased substantially since 1990, averaging 12.3% in the second quarter of 1998--well above the Basle minimum capital ratio of 8%. In fact, the share of bank assets at well-capitalized banks (those with capital ratios above 10%) stood at 98.5 percent in the second quarter of 1998, up from 30% in 1990.

Shortcomings of the "risk-based" capital rules. Critics of the Basle Accord's risk measurement scheme question the interpretation of such figures, arguing that the rules generating such capital ratios are arbitrary, inconsistent and ungrounded in any conceptually adequate or quantifiable measure of "risk.". For example:

- Most bank assets--ranging from a secured loan to a triple-A borrower to an unsecured loan with a junk bond rating--are assigned the identical 100% risk weight and 8% capital requirement to cover credit risk. Loans to OECD governments are considered riskless, unless the government rescheduled its sovereign debt in the previous five years. And loans to other banks, whether domestic or foreign, receive a 20% weight.

- Diversification of a bank's assets receives no consideration in determining portfolio risk. Although theory and practice prove that it is highly risky to put all of one's eggs in a single basket, a portfolio consisting entirely of agricultural loans to California farmers is treated identically with respect to risk as a diversified portfolio of loans across businesses and regions.

Regulatory arbitrage. The "one-size-fits-all" nature of the Basle capital regulations affords banks the chance to game the system when the capital charges are deemed "too high". Through regulatory capital arbitrage, a sophisticated bank can increase the riskiness of its portfolio to a level considered economic while meeting or exceeding the regulatory capital requirements. Cherry-picking permits a bank to remove low risk assets, with unduly high regulatory capital requirements, from its books while retaining higher risk assets. This might explain why, with, capital ratios at such high levels, 70 % of the top 50 U.S. banking companies nevertheless have their parent debt rated single A or lower and no major U.S. bank holding company's parent corporate debt is rated AAA.

A search for alternatives: model based approaches. One alternative to the Basle Accord's rule-based measures of credit risk entails increased reliance on the mathematical models now used by globally active banks to measure and manage risk as a matter of "best business practice." In new rules taking effect last January, governing capital charges against the market risk of loss from price fluctuations affecting a bank's trading portfolio (bonds, swaps, derivatives), the Basle Supervisors have moved in this direction. The agreement allows banks, with adequate internal models, to hold capital against market risk equal to three times the bank's own estimate of its value at risk (VaR)--defined as the loss it would incur with 1% or less probability on its portfolio over a two-week time horizon. Regulators in the United States are studying the feasibility of employing such a "model-based approach" to assess capital charges against credit risk as an alternative or a supplement to the current 'risk-weighted asset' approach..

A cautionary note. The failure of Long-Term Capital Management--a firm that relied heavily on such a model based approach--serves as a reminder that models based on historical data and "normal probability distributions" have limitations: they may underestimate the frequency and potential losses due to extreme financial price movements. Moreover, they completely ignore the ability of management to take measures to limit losses over periods as long as two weeks.

The pre-commitment approach. A methodology for determing capital charges against market risk which is even more radical than the internal model approach would require banks to precommit to a maximum loss exposure over a designated horizon. This self-assessed loss commitment would become the bank's market risk capital charge. Any bank that incurs cumulative trading losses in excess of its capital commitment would be subject to penalties, with the penalties providing the bank an incentive to align its capital precommitment with its internal evaluation of risk and risk management capacity. This approach is undergoing testing by the New York Clearing House.

Implications. As the activities undertaken by sophisticated banking organizations have become more complex, the difficulty for examiners in evaluating bank capital adequacy using traditional capital tools has increased. This is motivating a search for improved measures of capital adequacy and new approaches to the setting of capital standards. Of course, bank supervisors have long understood that the monitoring of capital ratios is only one part of a comprehensive supervisory process including, in recent years, emphasis on evaluating the quality of a bank's risk management and internal controls. Research shows that supervisory ratings, although subjective, are far better than risk-based capital ratios in predicting bank insolvency.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:28-OCT-1998 13:25:28.00

SUBJECT: Re: Social Security reform

TO: kotlikof (kotlikof @ bu.edu @ INET @ LNGTWY [UNKNOWN])
READ:UNKNOWN

TEXT:
Thank you for sending me all of the work on social security reform. Your plan contains some extremely novel and interesting elements, and I have discussed some of them with others here who are working on Social Security reform. I agree that we will have to be ready to move in some new directions to achieve reform, and we are trying to think about novel ideas. I suspect, however, that your suggestions about how to handle the privatization transition issue--through lower expenditures, CPI fixes and a consumption tax--are likely to prove politically infeasible. We are certainly sensitive to the need to fix Social Security, however, in a way that raises national saving. Please let us see anything further that you write on this subject. I'll send the message to George. Hope he gets it--I don't.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Ryan D. Edwards (CN=Ryan D. Edwards/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:28-OCT-1998 11:19:59.00

SUBJECT: Drafts

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

TEXT:
Hi Janet,

I'm enclosing three documents: the public financial management comments, the poverty comments, and my current (rough, except for the sections on those two topics) script for you. I've had a chance to proof them, so they should at least be a good start from which to work. By all means change as much or as little as you want; I definitely felt like a bit of a rookie while I was drafting these. :)

Best,

-Ryan

PS Let me know if you'd like hardcopies too.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D56]MAIL45268210X.326 to ASCII,
The following is a HEX DUMP:

IV. Public Financial Management and Fiscal Goals

A fundamental question for every society to answer is how it trades off equity against efficiency. During times of strong growth and budget surpluses, countries have the flexibility to reevaluate their fiscal policies with a eye toward choosing the optimal mix while unfettered by short-term stabilization requirements.

While recent attention has been focused on efficiency concerns surrounding public debt, such as the relative size of the cost of public capital, the equity concerns are at least as important. The power of fiscal policy to reallocate resources both within and among generations is considerable. Debt represents primarily the latter. A cost-benefit framework for choosing the optimal path of debt is incomplete without reference to intergenerational redistribution.

In the United States, the President has committed to maintaining budget surpluses until the Social Security system is placed on solid footing for both the baby-boom and future generations. By resisting the urge to loosen fiscal policy even though the government is in the black, policymakers are shifting some of the lifetime tax burden away from future taxpayers and toward current taxpayers. This seems appropriate in light of the demographic transition our nation will be experiencing. Future generations, although they will be richer than current Americans, will already face large costs of supporting more retirees per worker.

Recent experience aside, it is important create appropriate incentive structures that help politicians to current policies according to their future implications as well as their present impacts. Procedural rules rather than fixed targets seem to be the better choice in this case. In the United States, experience with deficit targets has been less than entirely successful, as legislators have simply failed to meet them. A series of acts this decade may constitute a step in the right direction; various legislation has capped growth rates of expenditure programs at predetermined levels and limited increases by requiring offsetting cuts elsewhere. Such procedural rules may help by providing specific ways in which fiscal conservatism may be maintained, rather than merely setting up consequences for when it isn't.

Accounting procedures clearly matter for transparency. Without transparency, public debate on issues of fiscal policy lacks a full understanding of the true tradeoffs involved. So-called "Golden Rules" in other countries, prohibiting borrowing for purely current expenditures, capture essentially the same budgeting processes followed by the States in our federal system. Currently, their fiscal conditions are exemplary, even down to the funding of pension systems. Accounting conventions at the state level are transparent but also flexible. Experience would seem to suggest that when fiscal policy is made at a more local level, there is greater accountability, perhaps because localities have clear incentives to keep their tax bases from moving elsewhere within the union.

At the federal level, the Unified Budget principle helps keep all the operations of the federal system more overt. A chief issue here is the measuring of future commitments, an aspect of common accounting that is generally omitted from federal numbers. While there are many good reasons why an accounting of future obligations is highly pertinent, the high degree of uncertainty involved suggests that the best way to approach the problem of unfunded liabilities may be refinement and more widespread use of long-term forecasting techniques.

On the subject of government investment strategies, it is clear that the effectiveness of public investment hinges on appropriate targeting. As demonstrated by the US experience, more appropriate targeting can result from a decisionmaking process that is decentralized. While there has been scope for nationwide investment programs, such as the federal interstate highway program or the internet, many of the most important public investments are financed and operated at the state and local level. Investments in human capital are some of the most important and potentially rewarding investment activities. While partially directed from the federal level, these investments, usually in the form of education and job training, are chiefly administered at the local level through a system of local property taxes and local schools. Retaining primary responsibility for such investments at a level of government closest to the people, when possible, helps moderate costs and maximize benefits.

On that note, governments should of course consider the costs, including the distortion costs and the crowding-out implicit in public funds, in relation to the benefits that derive from the investment in question. That said, there is additional scope for public investment strategies in areas whose characteristic costs and benefits are not as readily quantifiable. In industrialized countries especially, "quality-of-life" and environmental benefits are likely to escape traditional measurement techniques. Even when the structure of benefits and costs is less opaque, there is considerable room for divergent interpretations in cost-benefits analysis, which inevitably raises the possibility of partisan manipulation. Costs and benefits should be a part of every policy debate, but assigning them a deciding role seems unwise in light of widespread abilities to "cook the books."

Concerning the issue of maximizing benefits over costs, the general presumption that the private sector by its very nature has more incentive than government to achieve optimality is largely well-founded. However, when it comes to redistributing current responsibilities for infrastructure development away from government and toward the private sector, care must be taken to insure that the end result isn't the worst of both worlds. While government incentives may be divergent from social preferences for a variety of reasons, there is no guarantee that any particular private venture is sufficiently attuned to them either. Government supervision is essential in many cases to alleviate the high-price, low-quantity or low-quality problems of natural monopolies.

The United States is moving in the direction of more private provision of public services, such as prison management and social assistance programs. Finding the optimal degree of supervision in these areas is an ongoing challenge.

V. Policies to Alleviate Longer-Term Poverty

The recent study by the OECD Economics Department on the dynamic characteristics of low-income individuals represents serious progress toward answering the fundamental questions facing anti-poverty regimes today: who are the poor, and how can we keep them from being poor? The effects of time as an economic variable are frequently ignored, in many cases merely because rich longitudinal data aren't readily available. Paying closer attention to the characteristics of poverty through time will greatly assist in devising effective policy to combat poverty permanently rather than temporarily.

That said, there is much work to be done on refining the tools governments can use to alleviate poverty. Much attention in the United States has been paid to the disincentive effects of traditional anti-poverty programs that merely transfer resources from rich to poor. A primary reason for that emphasis is the desire to move toward a more long-term solution; if people face incentives to change their behavior and remain impoverished because of the way the system is designed, then the program isn't a long-term solution to the poverty problem. Government should strive to improve aspects of citizens' lives without constructing incentives for them to move away from rewarding pursuits.

The Earned-Income Tax Credit in the United States, like employment subsidies used abroad, are steps in the right direction on this count. By conditioning a certain form of public assistance on work effort, the EITC encourages the working poor to maintain employment habits while providing a cushion against downturns. Programs that are designed around economic activity rather than those distinctly separate from such activity have the benefit of encouraging beneficial patterns while lending assistance to the needy, as measured by their incomes. One of the important findings of the Poverty Dynamics paper was the close association of transitions into and out of low-income with changes in employment. It stands to reason that structuring a program around working will tend to raise incomes by reducing the frequency of those transitional periods. It will certainly raise labor force participation, as suggested by recent US experience. Participation facilitates longer-term employability by revitalizing human capital.

Two critiques of EITC-type programs should give us some pause, however, about the broader applicability of these setups. The first is mechanical: by its very nature, the EITC and other work subsidies will tend to create fiscal strains through increasing expenditures. In the United States, the expansion of EITC outlays attests to this, although an insignificant share of the growth may be due to program-switching effects. Work subsidies are generally targeted solely on the basis of income, and as a result apply quite broadly to populations. In an era of tightening fiscal policy and restraint, the prospects of a blossoming spending program probably do not appeal to the majority of governments. Second and definitely more important is the fact that the preponderance of literature on poverty duration suggests the existence of two distinct groups characterized by their mobility into and out of poverty through time. One more temporary group, characterized by exit hazard rates that are U-shaped, may well be positively affected by a work subsidy that aims to complement their activities. The second group, commonly referred to as the long-term poor, will probably not be helped by programs that condition on working. Targeting is probably the single-most important tool for helping these people.

While the OECD report mentions that the key characteristics of long-term poor are often different across countries, there should be confidence that within each country, the specific qualities germane to poverty targeting can be determined. These characteristics at least appear to be similar, if they are in fact not precisely the same, across national boundaries. In the United States, it seems as though the original concept of public assistance, as "Aid to Families with Dependent Children," was on the right track. Single mothers, especially those who are less-skilled and in regions of high-unemployment, have tended to comprise the bulk of the long-term poor throughout history.

Even if the issue of targeting were easily resolved, however, it isn't entirely clear what should be done for the subset of the population that is chronically poor. Lump-sum transfers aimed at single mothers, taxed away as the amount of work increases and usually based on the number of dependent children in a household, have been criticized as creating incentives to remain single, poor, and pregnant, even though there is relatively little empirical evidence of substantial effects of welfare on family formation. It may be time to find alternative solutions.

Investing in the human capital of the working-age portion of the long-term poor is one alternative; encouraging participation in such a skills program would probably require the use of "carrot-and-stick" methods that provide an explicit system of rewards and consequences. The US experience suggests that it is precisely these combinations that have the most marked effects.

Another more drastic possibility is a general system of public works, in which the government directly employs the long-term poor and extends the on-the-job-training that private firms may be too risk-averse to provide. A program such as this may run contrary to the general climate of fiscal austerity in the same way that a broad-based work subsidy does. There may be returns to revamping systems of unemployment insurance in order to coordinate the aggregative impacts of income maintenance programs. As shown in many studies, job opportunities are at least as important as wages in alleviating long-term poverty. Child-care policies fit under this rubric as well; better coordinating the menagerie of public assistance programs can lead to better results. Finally, it may well be the case that more systemic circumstances are helping perpetuate poverty. If the effects of ghettos, crime, and discrimination are significant, those issues need to be addressed in order to make progress.

Identification for purposes of targeting is only the first step; extending effective assistance without imbedding disincentives is a much more daunting task. Given the characteristics of the long-term poor, as uncovered in literature such as the Poverty Dynamics report, the next step will be designing and testing policy tools aimed at those groups. It is likely that whatever the solution, the immediate costs of ameliorating the problems of long-term poverty will be substantial. As the literature has resoundingly shown, however, the problem is of a long-term nature. Even costly solutions are well worth the temporary sacrifice, if the ultimate benefit is the reduction in long-term poverty.

<u>First day, morning session</u>

I. Adoption of the agenda and election of officers

II. Chair's introductory remarks

<u>First topic</u>: Global implications of turbulence in international financial markets

Introduction of Governor Meyer to lead off.

<u>Second topic</u>: Policy requirements in Japan

Introduction of Mr. Schatz (Germany) to lead off

<u>First day, afternoon session</u>

<u>First topic</u>: Policy requirements in the U.S. and Europe

Introduction of Mr. Grilli (Bank of Italy) to lead off on the U.S.
back to back with
Introduction of xxx (Mexico) to lead off on Europe

<u>Second topic</u>: Challenges facing the Euro area

Introduction of Mr. Rennie (New Zealand) to lead off

<u>Second day, morning session</u>

I. Wrap-up of WP-1

(Introduction of Mr. Cotis (chair of WP-1) to wrap up)

Good morning. In today's session, we will discuss issues relating to fiscal policy and anti-poverty efforts, two topics recently covered by Working Party One last month. I would now like to give the floor to Mr. Cotis so that he may discuss the contributions of that group on these topics.

<u>First topic</u>: Public financial management and fiscal goals

(Introduction of Mr. Vito Tanzi (IMF) to lead off)

Our first topic today concerns the formulation of fiscal policy and public investment strategies. In an era when levels of debt in relation to GDP are generally falling and government budgets are enjoying surpluses, policymakers can afford to step back and take a less myopic approach to fiscal policy. Since government debt represents trading resources across time, a dynamic approach to the question of optimal borrowing and investment is appropriate.

Yet in many cases it has appeared that policymakers have a pro-deficit bias, more in their procedures than in their thinking as of recent times. The question that immediately arises is how we might reform policymaking structures to better include a long-term approach. This assumes of course that we know what a long-term approach actually implies; without that knowledge, judging the progress of reform would be difficult.

Similar thoughts apply in the case of public investment strategies. It has been reported that public investment seems not to have been very effective in raising output or welfare. The debate here will likely occur on two fronts: first, how public investment could be effective, and second, how policymakers might go about determining when investment is effective and desirable.

I now yield to Mr. Tanzi to open the discussion, highlighting as I do the key questions involved:

* What is the appropriate framework in which to establish fiscal goals?

* Should there be greater use of rules in fiscal policymaking?

* What measures should be taken to raise the effectiveness of public investment?

* How might cost-benefit analysis best be used in program selection?

<u>Second topic</u>: Policies to deal with poverty

(Introduction of Mr. Sluimers (Netherlands) to lead off)

Our last topic this session concerns poverty and policies that might alleviate it. The equity and efficiency tradeoff is perhaps best encapsulated by the efforts of societies to improve the lot of the least well-off with resources from the rest of the economy. It is worth noting that while our two topics this morning may seem to be at loggerheads, there is considerable common ground. Circumspect public financial management must weigh the good of the future against the present in deciding the optimal level of borrowing and investment, and an effective anti-poverty regime must take a dynamic approach, aiming to invest resources now in order to reduce a long-term problem. Here our focus is primarily on the recipients of anti-poverty transfers and subsidies and the prospects for their uplifting.

Much attention is often paid to the implicit moral hazard of such social safety nets as those we consider here. While important insofar as incentives can create a lasting problem over time, equally as weighty is a discussion of the interminably poor, whose prospects and outlook seem to respond relatively little to anything, often over the course of their entire lifetimes.

Recent work by the OECD Economics Division has continued the fruitful application of time-duration models to the issue of dynamic poverty. Within each of four industrial countries, this work has explicitly identified two groups, one whose conditions may in fact be responsive to the usual tools of public policy, and the other whose patterns seem locked in place. It is toward the betterment of these two groups, often referred to as the short-term and long-term poor, that policy must be adapted.

Let me now turn to Mr. Sluimers to lead off discussion on the topic of sharpening the focus of anti-poverty policies.