

Withdrawal/Redaction Sheet

Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email attachment	Current Account Balance Forecast Summary (partial) [50 U.S.C. § 403g Central Intelligence Agency Act of 1949] (1 page)	10/29/1998	P3/b(3)

COLLECTION:

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

FOLDER TITLE:

[10/28/1998 - 11/24/1998]

2013-0723-F
ab1299

RESTRICTION CODES

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

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

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

C. Closed in accordance with restrictions contained in donor's deed
of gift.

PRM. Personal record misfile defined in accordance with 44 U.S.C.
2201(3).

RR. Document will be reviewed upon request.

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

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:28-OCT-1998 16:58:24.00

SUBJECT: Elise's chapter

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

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

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

TEXT:

Do we want to caucus sometime on Friday and decide what we think about this chapter and what to tell Elise? (I'm out of town tomorrow, and I think we ought to get back to her this week, if possible.)

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:28-OCT-1998 12:04:45.00

SUBJECT: bank chart & data

TO: Raymond P. Guiteras (CN=Raymond P. Guiteras/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.D50]MAIL446833103.326 to ASCII,
The following is a HEX DUMP:

Clinton Presidential Records Automated Records Management System [EMAIL]

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

Hex Dump file is not in a recognizable format, has been incorrectly decoded or is damaged.

File Name: p_20133862_cea_html_1.xls

Attachment Number: [ATTACH.D50]MAIL446833103.326

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:29-OCT-1998 13:48:28.00

SUBJECT: latest script

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

READ:UNKNOWN

TEXT:

Hi Janet,

Here's the latest version of the script I've been working on.

The batch of papers I left on your chair earlier includes the scenesetter from John.

Best,

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D77]MAIL430184200.326 to ASCII,
The following is a HEX DUMP:

First day, morning session

I. Adoption of the agenda and Chair's introductory remarks

10am

May I begin by saying that I am honored to continue serving as Chair of the Economic Policy Committee. I look forward to a stimulating and fruitful set of discussions by the Committee over the next two days on the state of the world economy and the ongoing work of the EPC.

Much of our work at this meeting will center around the economic outlook and the policy requirements facing decisionmakers in the major regions of the OECD. An important part of the outlook concerns recent developments in domestic credit conditions and international capital markets. While tumultuous events in Asia have at least not accelerated, threats to developing markets elsewhere, such as Russia and Latin America, have intensified. Capital market instability seems to lie at the root of these problems, and in particular, emphasis is warranted on developments in the Japanese financial sector.

Simultaneously, domestic credit has been a key concern in the United States and Europe. The last two months have witnessed an easing in US monetary policy in order to head off a credit crunch, and the level of European interest rates has increasingly become a pivotal issue as euro countries move toward monetary union two months from now. We will seek to elaborate on these issues as well in the time ahead.

We will also consider issues of more general importance to all OECD countries: the goals and procedures of fiscal and investment policies, and addressing the dynamic considerations of poverty. Besides having a chance to comment on the substance of these topics, I hope that we will also have a chance to discuss the direction of future work for the EPC and its working parties -- and by extension, the Economics Department as a whole.

Before I turn to Mr. Visco for his report on the activities of Working Party Three, I would like to make two points regarding participation in this meeting.

- **First**, lead speakers in each session should limit themselves to 10 minutes, while delegates from G-3 countries who are speaking about their own countries should try to limit themselves to a total of 15 minutes. General interventions will be limited to five minutes and enforced by a system of traffic lights. I would, however, like to encourage as many two-handed interventions as possible: if you want to respond directly to what a delegate says or address a question to a delegate, please raise both your hands and the Chair will recognize you to speak for one minute. I believe that these interventions are a very useful way of promoting interaction and turning these meetings into more of a discussion and less of a set of speeches.
- **Second**, I would urge the delegates to avoid describing in too much details the circumstances in your own particular countries. Instead, the discussions are most useful to those involved if the participants try to generalize from their own experiences in order to come up with coherent analyses and recommendations that have broader application.

II. Report by the Secretariat on WP-3 Activities

10:05am

I would now like to turn to Mr. Visco for a report on the recent activities of Working Party Three.

III. Report of the Chairman of Working Party on Short-Term Economic Prospects

10:15am

I would now like to turn to Mr. Koromzay for a report on Short-Term Economic Prospects.

IV. First topic: Global implications of turbulence in international financial markets
10:25am

(Introduction of Governor Meyer to lead off)

V. Second topic: Policy requirements in Japan

11:45am

(Introduction of Mr. Hansson (Sweden) to lead off)

12:10pm General discussion on Japan

1pm Adjourn for lunch until 2:45pm

First day, afternoon session

VI. First topic: Policy requirements in the U.S. and Europe

2:45pm

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

Introduction of Mr. Henry (Australia) to lead off on Europe

3:25pm General discussion on the U.S. and Europe

VII. Second topic: Challenges facing the Euro area

4:45pm

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

6pm Adjourn until 9:30am Friday

Second day, morning session

VIII. Report on WP-1

9:30am

(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.

IX. First topic: Public financial management and fiscal goals

9:40am

(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?

X. Second topic: Policies to deal with poverty

11:20am

(Introduction of Mr. Bayer (Austria) 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. Bayer to lead off discussion on the topic of sharpening the focus of anti-poverty policies.

XI. Other business

12:50pm

(Following the discussion, the meeting is adjourned)

1pm

Official Lunch

(topics: EPC Work Program, ECSS Meeting Follow-up)

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:29-OCT-1998 19:45:17.00

SUBJECT: Trade Info

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

READ:UNKNOWN

TEXT:

Janet,

In case you would like to have the text in electronic form, please find it attached.

I also have all of the data in worksheet files, and can forward if you would like.

Thanks,

Matt

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D61]MAIL45518720Q.326 to ASCII,
The following is a HEX DUMP:

Enclosures:

1. Table summarizing recent current account balance forecasts
2. Updated talking points on sector-specific and bilateral trade statistics (year on year growth in exports/imports)
4. U.S. Exports to selected East Asian countries.

Withdrawal/Redaction Marker

Clinton Library

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001. email attachment	Current Account Balance Forecast Summary (partial) [50 U.S.C. § 403g Central Intelligence Agency Act of 1949] (1 page)	10/29/1998	P3/b(3)

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CEA ([Yellen])
OA/Box Number: 950000

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[10/28/1998 - 11/24/1998]

2013-0723-F
ab1299

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CURRENT ACCOUNT BALANCE FORECAST SUMMARY

		Current Account Balance: Level			CAB as Percentage of G		
Organization	Month	1997	1998	1999	1997	1998	1999
(b)(3)							
Consensus Economics	Oct.		-234	-270			
DRI	Oct.	-155	-224	-258	-1.9	-2.6	-2.9
Federal Reserve	Sep.		-234	-319		-2.8	-3.6
IMF	Sep.	-155	-236	-290	-1.9	-2.8	-3.3
OECD	Oct.	-155	-225	-274	-1.9	-2.7	-3.1
Treasury	Oct.	-155	-235	-311	-1.9	-2.7	-3.1
WEFA	Oct.	-155	-223	-265	-1.9	-2.6	-3.0

Organization	Month	Merchandise Trade Balance			Real Net Exports		
		1997	1998	1999	1997	1998	1999
Blue Chip	Oct.				-247	-302	
(b)(3)							
DRI	Oct.		-242	-293	-136	-248	-314
Federal Reserve	Sep.				-136	-251	-341
OECD	Oct.	-198	-252	-283	-136	-252	-331
WEFA	Oct.				-136	-245	-301

Recent U.S. Trade Developments

CEA 10/29/98

- The U.S. trade deficit has deteriorated significantly in the last 12 months. The August deficit on trade in goods and services was \$16.8 billion, the largest on record and significantly larger than expected.
- Compared to a similar point in 1997, year-to-date goods exports in 1998 are down 0.8 percent. Year-to-date goods imports are up a modest 5.5 percent in the first eight months of 1998 as compared to the same period in 1997. Relative to past trends, the decline in exports is the more striking of the two figures.
- Year-to-date import growth (relative to the same period last year) is 5.0% from the Pacific Rim, 0.5% from Japan, 15.7% from China, 3.5% from Other Asia (Pacific Rim excluding Australia, China and Japan), 3.1% from Canada, 11.0% from Mexico and 10.9% from Western Europe.
- In sectors believed to be sensitive to the Asian crisis--automobiles and parts, semiconductors, steel, textiles and apparel--year-to-date seasonally adjusted imports grew 5.3 percent relative to the same period in 1997. Surprisingly, this is slower than total imports.
- Specifically, imports of autos and parts were up only 2.9%; imports of semi-conductors down 5.6%; imports of steel up 17.4% and imports of textiles and apparel up 13.9 percent. So, only imports of steel and textile and apparel are up at a faster rate than overall imports (see attached table).
- Most of the deterioration in the dollar value of the U.S. trade balance is due to the fall of U.S. exports to Asia; the contribution of import growth to the worsening of the trade balance has been so far very modest.
- As an indication of the likely effect of the East Asia crisis, the decline in U.S. exports to seven East Asian countries in the first eight months of 1998 was \$25 billion to \$34 billion, at an annual rate, depending on the seasonal adjustment method used (see attached table). Korea accounted for almost half of the decline.
- The conditions of the steel industry are quite sound; there is no clear evidence of serious injury from increased imports. Relative to the same period in 1997, in the January to June 1998 period steel industry shipments are up 5%, capacity utilization is up from 88% to 92%, employment is stable and import penetration has increased only from 25% to 26%; there is a somewhat larger increase in import penetration in some specific steel products (from 24% to 27% in hot-rolled sheet) but the changes are overall modest. The stock price of steel companies has underperformed the S&P 500 in the last 12 months. However, such stocks have systematically underperformed the S&P for the last 5 years. For most steel firms, the stock price has fluctuated for the last five years without any

positive trend, while the S&P 500 has gone up by over 100% during the same period. See the attached 5-year charts for US Steel, a typical integrated steel maker and Nucor, a typical mini-mill for a comparison of their performance relative to the S&P500.

- In another sensitive sector, autos, things look even better. Relative to the same period in 1997, in January to June 1998 import penetration is down from 33% to 32%, employment is up while production is stable. The stock price of the Big 3 auto makers has outperformed the S&P 500 in the last year, with the partial exception of GM whose stock has underperformed the S&P since August 1998 by about 10%.
- The deterioration of the trade deficit is larger in *real* terms, considering that import prices are falling and real import volumes rising. As the Asian currencies depreciated, real quantities of imports have gone up and import prices have fallen; this has kept the increase in the nominal dollar value of imports contained.
- The fall in import prices from the 4 NICS (Korea, Hong Kong, Singapore and Taiwan) was 9.4% between August 1997 and August 1998; similar figures for import prices from Japan show a 5.5% drop. Separate import prices for the other Asian crisis countries are not available, but are likely to be higher as their currencies fell by more than those of the 4 NICS.
- Import prices have also fallen because of the sharp drop in the global price of primary commodities caused by the Asian crisis and the slowdown in world growth. Import prices for petroleum goods were down 31.8% in August relative to a year before; import prices for agricultural goods are down 7.7% relative to a year ago.
- The fall in import prices from Asia appears to be driven by the fall in their currencies since the onset of the crisis. However, U.S. import prices have fallen less the currency values, suggesting that the pass-through from exchange rates to import prices has been less than full. This also implies that there is little evidence that dumping might be occurring.
- The IMF's latest growth forecast for 1998, released in the *World Economic Outlook*, is 2.0%, down from the 4.1% growth in 1997. This represents a precipitous drop from the 4.3% growth for 1998 forecasted in October 1997. Ominously, forecasted world growth for 1998 is now comparable to levels not seen since the pronounced world slowdowns of 1974-75, 1980-83, and 1990-91. Downward revisions are being driven by Asia. Japan's economy is expected to decline by 2.3%. The newly industrialized Asian economies (Hong Kong, Taiwan, Singapore, and Korea) are predicted to contract by 2.4%. The economies of the ASEAN-4 nations (Indonesia, Malaysia, Phillippines, and Thailand) are now expected to shrink by a sharp 10.4%. Expected growth in the Western Hemisphere is now 2.8%, down from 5.1% in 1997.

- The increased current account deficit appears to be a mostly macroeconomic problem as the increase in the U.S. investment rate has outpaced the increase in the savings rate. The differential growth performance between the U.S. and the rest of the world underlies this deterioration. Japan and Europe have a huge current account surpluses (\$94 billion and \$123b in 1997 respectively) but have had high and rising unemployment rates, falling employment levels and mediocre growth performance. The U.S. has a large current account deficit (\$155 billion in 1997) with very low unemployment rates, a very large increase of new jobs since 1993 and an impressive output growth performance. Such evidence suggests that current account deficits are associated with high growth while surpluses are associated with mediocre economic performance, rather than the other way around.
- Given the very volatile international financial markets, changes in U.S. trade policy towards protectionism might have serious market consequences. Stock markets, exchange rates and other financial assets prices could react very negatively to the perception that the U.S. may become more protectionist, inward looking and ready to start controversial trade actions against trade partners. Given the serious worldwide macroeconomic conditions and the contagious worldwide spread of the financial crisis, it is worth noticing that the Great Depression of the 1930s was exasperated by the dramatic switch to protectionist policies in the United States and the industrial world. One should also note that the effects on the households financial wealth of further falls of the stock market and the effects on real incomes and employment levels of a severe slowdown in US growth would be orders of magnitude larger than any benefit received by specific sectors via increased trade protection. Given the increasing worldwide pressures to restrict trade, it is of the utmost importance to maintain an open trade regime in the US and around the world.
- Section 201. The last time Section 201 was changed was in 1974 when the criterion for relief was eased from imports being the “major cause” of serious injury (i.e. imports being greater cause than all other factors combined) to imports being a “substantial cause of serious injury, or the threat thereof”. Petitions for escape clause relief rose from 2 in 1973 and none in 1974 to 13 in 1975. Between 1975 and 1990, the ITC conducted 62 investigations, which resulted in 30 affirmative determinations.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:30-OCT-1998 14:53:44.00

SUBJECT: Global Implication of Turbulence. . . .

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

READ:UNKNOWN

TEXT:

Hi Janet,

Dick Freeman just called to make sure we were aware of Gov. Meyer's leading off on this (first) topic at the EPC. I'm not up on the rules of the game, but Dick seemed to think that since Gov. Meyer was leading off discussion, you should then have a more prominent role in the miscellaneous US statements on the topic.

(Last I heard, Joe Gagnon was planning on adding his two cents about Korea, Thailand, and some G-22 things vis-a-vis the instabilities and global responses.)

Dick also mentioned that we'd have an opportunity to compare statements on the flight over, to make sure our collective ideas aren't at odds.

Best,

-Ryan

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:30-OCT-1998 02:55:22.00

SUBJECT: Supplementary Information on Trade

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

READ:UNKNOWN

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

READ:UNKNOWN

TEXT:

Janet and Jeff,

Sorry for the fire drill. Thursdays are notorious for International Staff Economists, even when RoundUps seemed to have been "rounded up" beforehand.

I put together a few more things you might want to peruse and/or distribute. I made three copies of the entire packet of material and left them on my desk. (I would have dropped them off in your offices, but they were locked.) It contains everything you have already received (in some cases slightly modified), as well as some new material. The packet on my desk is in the following order:

New Material:

- Table of Exports (from US) of Sensitive Product sectors. I took the same sectors as included in the Import table and added civilian aircraft and agriculture.

- Table of seasonally adjusted exports, imports, and trade balances with Asian countries. The export data is presented in Effects of Asia Crisis table, but it seemed useful to have it along with import data in one place. The comparison is year-on-year, for SA data through August.

- Updated graph of US Steel and Nucor stock prices versus S&P 500. Note: both have risen in the last couple of weeks. And, if I weren't trained in finance, I would say they look like they could be on an upward trend...

Editorial Modifications to Material You Received:

- Table of Imports. Formatting cleaned up incase it is distributed.

- Forecast Summary: Same table with an indication of confidentiality added.

Unmodified Material You Received

- The "US Bilateral Exports to East Asia" table: included just for completeness in case the whole packet is distributed.

New Material For General Background/FYI

- Three printouts from Yahoo Finance: two articles painting a fairly upbeat picture for US Steel and Bethlehem Steel (two typical integrated mills) in

1999. Also a list of ratings changes for Nucor (the prototypical Minimill): It is particularly noteworthy that one advisory service just upgraded it to a "Strong Buy" today (Thursday).

I did not include the talking points in the packet of information since they did not change and I suspect you will not be distributing them. I hope that you find the information useful.

-Matt

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:30-OCT-1998 15:28:30.00

SUBJECT: Re: Japan EDRC

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

READ:UNKNOWN

TEXT:

Yes, I would like to see the cable. I'm probably going to Japan in two weeks so I'm especially interested in it.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:30-OCT-1998 15:21:31.00

SUBJECT: Japan EDRC

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

READ:UNKNOWN

TEXT:

Hi Janet,

Another brief note: we have a State Department cable on the OECD's Japan EDRC review that took place in Paris on September 30th. Please let me know if you'd like to see it.

Best,

-Ryan

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:31-OCT-1998 20:44:52.00

SUBJECT: Last EPC doc

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

READ:UNKNOWN

TEXT:

Hi Janet,

I retrieved the last EPC document that was still missing: the report by the chair of WP-1.

There's nothing earth-shattering in it; I read through it and thought it pretty much encapsulated exactly what Becky had told us about the meeting.

Best,

-Ryan

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-NOV-1998 17:12:13.00

SUBJECT: great work by Raymond and Summer

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

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

READ:UNKNOWN

TEXT:

I would like to let you know that Raymond and Summer did a lot of great work this week pulling together data and compiling charts on various developing countries we expect to have bi-lateral meetings with in Buenos Aires.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-NOV-1998 14:45:39.00

SUBJECT: Joe's comments

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

TEXT:
Hi Janet,

Well, we haven't received Joe's remarks yet, but we do have some comments that he left for me on voice-mail. He read your remarks that I faxed over, and he had three points to raise:

1. He thought a part could be added in the section on what types of financial controls to employ. His suggestion is that banks and corporation could be required to do more matching or hedging in terms of matching assets to liabilities when exchange rate risks are involved.
2. He thought it might be emphasized that if exchange controls were to be employed, they shouldn't be structured so as to create incentives for short-term capital to replace long-term capital.
3. On the Chilean system of capital controls being phased out, he offered the view that while controls have been lessened, it may be that they're merely temporarily being lifted rather than permanently. Perhaps the Chileans are used that policy tool to encourage capital inflows.

Best,

-Ryan

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-NOV-1998 07:45:01.00

SUBJECT: Agenda for Principals Trade meeting

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

READ:UNKNOWN

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

READ:UNKNOWN

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

READ:UNKNOWN

TEXT:

----- Forwarded by Jeffrey A. Frankel/CEA/EOP on 11/02/98
08:43 AM -----

Malcolm R. Lee

11/02/98 12:03:19 AM

Record Type: Record

To: See the distribution list at the bottom of this message

cc: See the distribution list at the bottom of this message

Subject: Agenda for Principals - Please Send out

Sharon/Pete: Please send out first thing Monday to Principals. ML

Message Sent

To: _____
Sharon H. Yuan/OPD/EOP
Peter A. Weissman/OPD/EOP
Lael Brainard/OPD/EOP
Jonathan A. Kaplan/OPD/EOP
Melissa G. Green/OPD/EOP

Message Copied

To: _____
earp_gordana @ ustr.gov@INET@VAXGTWY @ VAXGTWY
Nouriel Roubini/CEA/EOP
Jeffrey A. Frankel/CEA/EOP
esserman_sue @ ustr.gov@INET@VAXGTWY @ VAXGTWY
Joshua Gotbaum/OMB/EOP

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D18]MAIL41042350Z.326 to ASCII,
The following is a HEX DUMP:

Sensitive but Unclassified

NEC Principals Meeting on Trade Agenda and Steel

Roosevelt Room

November 2, 1998

Agenda

1. Review of Overall Trade Agenda
2. Steel
 - Actions Taken
 - Actions Pending
 - Other Issues for Discussion
 - CVD regulations
 - import licensing
 - immediate increase in tariffs on Russian imports
 - self-initiation of 201
 - change in 201 injury standard

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-NOV-1998 13:55:13.00

SUBJECT:

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

READ:UNKNOWN

TEXT:

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

WPCE

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Meeting of the Economic Policy Committee November 56, 1998 First day, morning session

1. Adoption of the agenda and Chairs introductory remarks 10am P

May I begin by saying that I am honored to have the opportunity to continue serving as Chair of the Economic Policy Committee. I look forward to a stimulating and fruitful set of discussions by the Committee over the next two days on the state of the world economy and the ongoing work of the EPC. We meet at a time of enormous turmoil in the world economy with the threat to growth arguably exceeding anything we have faced in decades. Thus, much of our work at this meeting will center around the international financial crisis, the risk to the economic outlook and the policy requirements facing decision makers in the major regions of the OECD. More than a year has elapsed since the Asian crisis began. Unfortunately, what started as a regional economic and financial crisis in East Asia has now developed into a larger global crisis, spreading to financial markets around the world, impacting global commodity markets, impairing economic development and imposing extraordinary hardship in the crisis-afflicted countries, and posing risks to growth in the industrial world. There are few countries around the globe that have been unaffected.

XXXX#XXX

XY#The economic slump in the original crisis countries (Korea, Indonesia, Thailand and Malaysia) remains severe. The spill over to other countries in the region, such as Hong Kong

,

` and Singapore, have been substantial.

XXXX#XXX

X# Japan, already in a serious and deepening recession prior P to the crisis, has seen a significant decline in its export to its key Asian trading partners, and its banks have been hit with financial losses related to lending in the region. Since our last meeting, currencies and stock markets in Latin America have come under pressure, especially following the crisis in Russia. Emerging markets spread over Treasuries, about 1 500 basis points in September 1998, are now close to their highs during the 1995 Mexican peso crisis. The appetite for risk of international investor has fallen and there is some retrenchment from emerging markets towards safe haven assets and from stocks towards liquidity. Over the past year, commodity prices have also declined, impacting industrial countries like Canada, Australia and New Zealand. In Latin America, the fall in oil prices has hit Mexico and Venezuela; the fall in copper prices is hurting Chile and Peru; and the decline in agricultural prices is affecting Argentina. Globally, all commodity exporters are hurting. @)' The impact of the crisis on the prospects for worldwide growth is evident not only in marking down we see in the OECD's point forecasts for growth since last March, but also in the development of a pessimistic scenario which shows how the interacting risks in the current situation could interact to translate into markedly slower growth.

-@), Over the next two days we will assess the outlook in Asia, in other emerging markets, including Latin America, threatened by the contagious effects of the crisis, and discuss the repercussions of the crisis on the OECD countries, through both trade and financial linkages. We will consider what policies are needed in the OECD countries to stabilize financial conditions, to promote growth, and to avoid the eruption of similar crises in the future. We will also consider issues of general importance to OECD countries over the medium term: the goal and procedures of fiscal policies, and appropriate policies to address poverty. Besides having a chance to comment on the substance of these topics, I hope that we will also have a chance to discuss the direction of future work for the EPC and its working parties and by extension, the Economics Department as a whole. Before I turn to Mr. Visco for his report on the activities of Working Party Three, I would like to remind you of one important point concerning participation in this meeting. "We have agreed to cover over the next two days. It will be easy to fall behind and a brutal discipline on my part will be needed for us to remain on schedule. I therefore ask that lead speakers in each session limit themselves to 10 minutes. General interventions will be limited to five minutes and enforced by a system of traffic lights. I would, however, like to encourage as many two-handed interventions as possible: if you want to respond directly to what a delegate says or address a question to a delegate, please raise both your hands and the Chair will recognize you to speak for one minute. I believe that these interventions are a very useful way of promoting interaction and turning these meetings into more of a discussion and less of a set of speeches.

(# (# II. Report by the Secretariat on WP3 Activities p 10:0

5am I would now like to turn to Mr. Visco for a report on the recent activities of Working Party Three. III. Report of the Chairman of Working Party on Short Term Economic Prospects h\$ 10:15am I would now like to turn to Mr. Koromzay for a report on Short Term Economic Prospects.

IV. First topic: Global implications of turbulence in international financial markets *

\$' 10:25am Our first session today will focus on the global implications of international financial market developments. Some of the key questions relate to financial markets: In particular, is the worst over with respect to turbulence in financial markets? Or are we likely to see the crisis deepen or widen? Do delegates agree with the Secretariat's analysis showing that equity prices may still be overvalued in many countries? Have we seen a fundamental and lasting reassessment of risk premia? And, if so, what are the implications for capital flows to emerging markets? Could credit crunch conditions develop in industrial countries as well? With respect to policy, what should the crisis countries do to promote recovery in their own economies? Under what conditions, if any, should the crisis countries resort to capital controls to alleviate exchange market pressure? If the crisis deepens, how will this impact industrial economies? And what channels of influence will be most important? Trade channels? Financial

al channels? Or through global commodity markets? What can the OECD countries do to mitigate the crisis globally and in our own countries? Is there the need for and scope for policy coordination on the part of the OECD countries or can countries act alone? Is there the need for international action to promote greater stability in global financial markets? I would like to invite Governor Meyer to lead off our discussion of this topic with general discussion to follow.

V. Second topic: The current economic situation and policy requirements in the three major OECD regions.

We now turn to a general discussion of the economic prospects and requirements for policy in the three major OECD regions: Japan, Europe and the United States.

A. Japan

We begin with Japan. The Secretariat's assessment of the Japanese economy suggests that the current situation and the near-term outlook appear appreciably worse than a mere five months ago. After contracting at an estimated 2.5% rate in 1998, the Secretariat foresees modest expansion in 1999 and 2000. This assumes that the fiscal package that has been announced is implemented effectively and works to foster sustained economic recovery. In the Secretariat's view, the most pressing need at present is for Japan to deal with its banking crisis by using sufficient public funds aggressively and appropriately to strengthen weak but viable banks, accompanied by accelerated disposal of troubled assets, improved disclosure and stronger supervision? Do delegates agree with this assessment? Is fiscal policy adequate and on course to promote recovery in Japan given the severe deterioration in confidence which has occurred and the deep contractions in Asian trade partners? How is the implementation of the April fiscal package proceeding and what will be its effects on economic activity? With respect to financial sector reform, are there specific elements on which delegates would place particular priority? Do delegates think that it will be possible to address financial sector problems without exacerbating real sector problems? What risks to the international economy would be posed by protracted financial weakness and possible further contraction of the economy? Finally, delegates might comment on the implications of recent exchange rate developments for recovery in Japan and Asia. I would like to invite Mr. Hansson of Sweden to lead off our discussion. Afterwards, the floor will be open to the Japanese delegation for a response and a general discussion will follow. Following that discussion, we will adjourn for a two-hour lunch.

12:10pm` General discussion on Japan

1pm` Adjourn for lunch until 12:45pm

8 First day, afternoon session

B. Policy requirements in the U.S. and Europe

At 2:45pm we next turn to a discussion of policy requirements in the United States and Europe, two regions of the OECD where growth still remains healthy and is forecast to continue at a solid pace, assuming that policies remain supportive of growth. Since our last meeting, growth has continued at a surprisingly robust pace in the United States, 3.3% in 98Q3 according to last Friday's advance release. But the U.S. economy has been obviously impacted by world economic turmoil, with drag from deteriorating trade balance apparent and sharply increased financial turbulence translating in to greater market volatility, higher spreads, some difficulties for firms in financing investment through the issuance of high-risk bonds, and a clear downturn in non-residential investment. Assumptions about the required stance of monetary policy to sustain growth have accordingly shifted and the Federal Reserve has eased policy by 50 points since our last meeting to counter these intensified pressures. In Europe, the outlook remains positive. Growth has strengthened and the convergence of interest rates in the run-up to January is now occurring towards the lower levels prevailing in the region. Also aiding growth is the ability of Europe to enjoy at least a respite from further fiscal tightening measures, having achieved the Maastricht criteria goals last year. Nevertheless, the Secretariat argues that the imperative over the medium run, remains further fiscal improvement, both to deal with the demographic challenges ahead and to afford scope for automatic stabilizers to operate. Key questions which delegates are invited to address in considering the conjunctural situation in the United States and Europe concern the appropriate roles of monetary and fiscal policy in promoting continued growth. Is there a case for further monetary easing? And what role might there be for short-term fiscal policy in a worsening global scenario? Finally, we need to consider issues relating to trade tensions and protectionist pressures. Are such pressures apt to arise if trade imbalances widen, particularly with high unemployment in Europe and rising unemployment if growth begins to falter? I would like to first invite Mr. Grilli (Bank of Italy) and Mr. Henry of Australia.

straliato lead off our discussion. Mr. Grilli will focus on the United States and Mr. Henry will present his views on the European situation. Following these remarks, the delegates from the United States, Germany, France, Italy and the United Kingdom will be invited to respond to comments and to address issues raised in Main Issues. The floor will then be open for general discussion. 3:25pm` General discussion on the U.S. and Europe 8 VI. Second topic: Challenges facing the Euro area 4:45pm Our final topic for discussion this afternoon concerns the challenges facing the euro area as it prepares for a truly historic event: the introduction of the new euro in January with the European System of Central Banks assuming full responsibility for implementing a single monetary policy in the 11 state euro area. In this context, delegates are invited to comment on the issues facing both monetary and fiscal policy in the new environment. With respect to monetary policy, there are important institutional questions concerning its design and implementation. Will it be possible for the ECB to adopt a truly euro-wide perspective? What are the key challenges that must be faced in launching the euro? And with respect to fiscal policy, the major remaining independent national policy tool is there an adequate scope for the operation of automatic stabilizers, let alone for discretionary fiscal maneuver, given current fiscal positions and the Growth and Stability Pact's 3 percent deficit limit? I would like to invite Mr. Rennie of New Zealand to lead off our discussion after which the floor is open for general comments. 6pm` Adjourn until 9:30am Friday ,p&) -`* Second day , morning session h Good morning. In today's session, we will discuss issues relating to fiscal policy and h anti-poverty efforts, two topics recently covered by Working Party One last month. In just a second I will give the floor to Mr. Cotis so that they may report on the activities of WP1 including discussions relating to these topics. But first I would like to briefly report on my meetings last night with BIAC and TUAC. Report on BIAC and TUAC VII. Report on WP1 9:30am I would now like to invite Mr. Cotis to report on the activities of WP1. VIII. First topic: Public financial management and fiscal goals x 9:40am 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 the procedures governing policy have a pro-deficit bias. 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. Therefore, the first key question concerns the appropriate framework in which to establish fiscal goals and the desirability of greater reliance on rules in fiscal policymaking. Similar issues apply in the case of public investment strategies. Many countries report that public investment seems not to have been very effective in raising output or welfare. How then can public investment be made more effective, and how should policymakers determine when investment is effective and desirable? I would like to invite Vito Tanzi of the IMF to lead off our discussion. -`* IX. Second topic: Policies to deal with poverty h 11:20am Our last topic this morning concerns poverty and policies to alleviate it. The equity and efficiency trade-off 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 invite Mr. Bayer of Austria to lead off discussion on the topic of sharpening the focus of anti-poverty policies. X. Other business x# 12:50pm (Following the discussion, the meeting is adjourned) 1pm` Official Lunch )"%` (topics: EPC Work Program, ECSS Meeting Followup) *#& h Comment on: Global implications of turbulence in international financial markets. h Larry Meyer: Lead statements should cover the odds of further turbulence, channels through which advanced OECD economies may be affected and the need for policy coordination on the part of advanced OECD countries. JY: I would like to comment on two questions raised in the Main Issues document: The first concerns the need for international action to promote greater stability in global financial markets. These second relate to appropriate responses of emerging market economies to exchange market pressures particularly the use of capital controls. Is there a need for international action to promote greater stability in global financial markets? P

The answer to this question is yes, and the broad outlines of an appropriate program were contained in the G7 leaders' statement issued last Friday. Needed actions fall into four areas: steps to sustain and promote growth in industrial countries; lending to support countries faced with capital outflows; measures to restore growth and mitigate suffering in crisis-afflicted countries; and a host of steps to strengthen the architecture of the international financial system. "0 The first clear imperative is for industrial countries to take appropriate steps to promote (strong domestic demand and growth in their own economies the subject that will occupy us for the remainder of today's meeting. Strong growth in the industrialized countries who are the key customers of the crisis-afflicted countries is a prerequisite for those nations' recovery. For most industrial countries, trade and financial repercussions of the crisis have diminished the prospects for growth, so, at a minimum, policies are called for and in some countries already undertaken, to offset those impacts. Within inflation low in most of four countries and downward pressure on commodity and import prices working to further restrain inflation, there is ample scope to take appropriate macroeconomic measures.

(#(# "0 From the standpoint of recovery of the Asian crisis countries, Japan has a special and x# particularly critical role to play because its performance will determine the prospects for Asia's recovery. We will, of course, discuss later on this morning the policy requirements needed for Japan to succeed in this objective.

(#(# "0 I would add that, industrial countries will also have to work especially hard to counter (!\$ protectionist pressures in their own economies. The Secretariat's paper highlights the major shifts in current account balances that industrial countries, particularly the United States, are likely to see if they do serve as an engine of global growth. Sectors that are heavily exposed to trade will experience disproportionate impacts. Over the next year, calls for protection will be on the rise and we will need to work to counter them. We have urged the crisis-impacted countries to keep their own markets open and we must -`* remain committed to outward-looking, internationalist policies. The progress that we have made in building an increasingly open world trading system is at stake.

(#(# "0

Beyond working to promote growth in the industrial world, the United States has been 8 foc used since the outset of this crisis on the need to contain financial contagion and to restore the confidence of market participants a prerequisite for capital flows to continue. We continue to support the IMF in its goal of providing financial assistance to countries that are in crisis, contingent on their willingness to implement the reforms needed to restore economic confidence and strengthen the underpinnings of their economies while recognizing that in any given case, reasonable analysts may disagree about the precisely appropriate steps that should be part of a package, and there is no guarantee of success.

(#(# "0 Beyond traditional IMF

programs, the President has proposed and the G7 has agreed to establish an enhanced IMF facility to provide precautionary lines of credit that could be drawn on if needed by countries pursuing strong policies, accompanied, if needed and appropriate, with bilateral finance and appropriate private sector involvement. Such a facility could play a key role in fighting the contagion which is threatening countries that have made great progress in implementing sound macroeconomic policies and have worked to strengthen the fundamentals of their economies.

(# "0 We also recognize the need to do more to help crisis-stricken countries get back on their feet, restore growth, and mitigate the suffering which has been afflicted on so many citizens in the affected countries. We cannot tolerate a decade of lost growth. And serving as good customers for the products of crisis-stricken countries is not enough. We strongly support additional aid by the World Bank to strengthen social safety nets in crisis-affected countries.

(# "0 Finally, we see a need to work with individual countries and the international financial institutions to see if comprehensive restructuring plans might be devised to restore the flow of credit needed for firms in those countries to overcome the massive debt problems in which so many have become engulfed. For example, in Indonesia, Korea and Thailand, XXX the combination of sustained high interest rates and illiquidity has led to a harsh economic contraction and a vast overhang of bad debt. #XXXX #Debt to equity ratios that were already very X%! high before the crisis (about 300% in Korea for the top 30 chaebols) have become unsustainable now (over 500% in Korea, 400% in Thailand and even higher in Indonesia) due to the real devaluation of their currencies and the burden of high real interest rates. The World Bank estimates that 20-65 percent of firms in these three countries have balance sheet losses greater than equity. When insolvent, highly leveraged companies cannot service their debt, as a free-forcing spiral is created in which banks' cash flows are squeezed, forcing them to contract new lending not only to troubled corporations but even to those in better health.

(# -
''* What is the appropriate response of an emerging market economy to exchange market pressures and should capital controls be employed to contain these pressures? (

XXXX The Secretariat's paper asks whether capital controls can play a role in containing exchange market pressures in emerging market economies. This is a question that we are certain to be debating for many years to come. Certainly, the recent Asian experience and earlier episodes of financial turmoil show that excessive accumulation by a country's financial system of short-term, foreign currency-denominated, and unhedged foreign liabilities can be an important source of the financial fragility that can trigger and exacerbate a crisis. The risk and associated economic vulnerability stemming from these exposures was enormous. #XXX Xud#XXXX I think most @ of us would agree that the avoidance of such exposures is critical to the prevention of future crises. The recent G22 report contains a large number of reforms intended to avoid the development of such fragility in the future and work plans to strengthen the financial architecture must accelerate. With respect to capital flows, agreement has at last emerged that short-term interbank flows must be regulated as part of a strengthened regime of prudential supervision of banks. #XXXX Vg#XXXX A higher reserve requirement ratio on cross-border interbank loans and deposits in (emerging economies would be a simple way of addressing this issue. In the context of ongoing review of the Basle Capital Standards it may also be worth considering whether the low risk weight imposed on short-term bank lending to emerging markets is appropriate. A case can also be made that broader controls on capital inflows are needed. In Asia, for example, large-scale, risky, cross-border borrowing was undertaken directly by firms, and not just by banks. In the case of Indonesia, such corporate borrowing was massive, over \$70 billion, and well in excess of foreign borrowing by Indonesian banks. If corporate firms, like banks, are subject to distorted incentives resulting in excessive borrowing, controls on their foreign borrowing, especially short-term borrowings subject to sudden reversals, is arguably warranted to prevent disruptive exchange rate movements. #XXXX i#XXX

The experiences of Chile, Colombia and Slovenia with capital controls on short term inflows deserve to be studied. XXXXm#XXXX#XXXXn#XXXX h\$ #XXXXn#Statistica evidences suggest that the composition of capital inflows are as significant H&" leading indicator of the probability of currency crashes occurring. The higher the reliance on foreign direct investment, the lower the probability of crisis. The higher the reliance on foreign currency borrowing that is short term or intermediated through banks, the higher the probability of crisis. XXXX The available empirical evidence from Chile and the other countries that have imposed *& such controls on a broad range of short term capital inflows is mixed, however. Such controls do appear to affect the composition of inflows (away from short term and toward the longer term flows and FDI) without diminishing the overall volume of capital inflows. However, over time, they are subject to evasion and leakages (especially via trade credits) and tend to become less -''* effective. Arguably, the success of Chile in avoiding a major currency crisis is due more to its very effective prudential regulation and supervision of the financial system than the existence of controls on short term inflows. The Chilean controls have reportedly favored large corporations at the expense of small and medium ones. And, it is worth noting that during the recent financial turmoil such controls have been phased out in Chile, Colombia and Brazil in order to stimulate now much needed capital inflows and reduce pressures against the currency. #XXXXp#XXXX#XXXXVu#XXXX The arguments for controls on capital outflows, especially in the aftermath of a currency crisis, are extremely weak. Paul Kr

ugman recently articulated the main argument in favor of such controls. He contends that the economic recovery in Asia has been hampered by high interest rates. With capital mobility, a reduction in interest rates leads to exchange rate devaluations which are recessionary in Asia because of the high burden of foreign currency debt. So, to break the links between interest rates and exchange rates, and allow necessary lower interest rates without the cost of a currency devaluation, controls on capital outflows are hypothetically warranted. #XXXXu# x In spite of this theoretical rationale for controls on outflow, the counterarguments are, in my view, decisive. Such controls are difficult to make workable in practice and they can become a serious source of corruption. Eventually the accumulating distortions can become intolerable. Moreover, the willingness or even rumored willingness to resort to such controls is likely to inhibit long term investment and to accelerate capital flight. And the imposition of such controls in crisis situations can exacerbate contagion.

XXXX #XXX

Xz#XXXX While the arguments against imposing capital controls on outflows, especially during a crisis, are persuasive, countries with capital controls do need to be careful to liberalize restrictions on the capital account in a gradual and orderly way. As long as financial systems are weak and poorly regulated a hasty rush to capital account liberalization may encourage the accumulation of debt, excessive borrowing and lending, mismatch of maturities and currency denomination of assets and liabilities of financial institutions and firms that has proven to be so destabilizing in many recent and not recent episodes of financial and currency crises. #XXXX0{# x# Comments on the outlook in the United States X Larry Meyer: Given the downward risks in the present situation, is there a case for further preemptive monetary easing in the US and for lowering of interest rates in the euro area beyond what is embodied in the convergence process? Joe Gagnon: What is the possibility that trade tensions could emerge in the United States and European as external imbalances widen, growth falters and unemployment starts to rise? "0 If the financial crisis in the emerging markets escalates, we must wonder about the degree`

towhich the advanced economies, particularly the US will be able to offset continued trade adjustments in the emerging markets through higher domestic demand particularly since the burden of adjustment has not fallen and is not projected by the Secretariat to fall evenly on the industrialized countries. The Secretariat's projections make it evident that the bulk of the adjustment is expected to fall on the U.S. Virtually none of it will fall on Europe (Table 2) and Japan will make a negative contribution.

(#(# "0 The high U.S. current account deficit reflects

strong investment led growth and weak H saving. Although solid investment prospects can once in a while allow the US to finance such adjustments, we must remember that ultimately there must be a reversal and any reversal could be disruptive and accompanied by exchange rate realignments.

(# "0 We expect to see significant sectoral dislocations. Export industries such as aircraft, high tech sectors and agriculture and industries that compete with imports, particularly steel, autos, apparel and textiles, are likely to suffer.

(# JY: What potential role is there for short term fiscal policy if the global economic situation @ worsens?

!0 The international crisis has forced countries around the globe to confront the necessity of implementing the sound domestic policies which are ultimately fundamental to promote long term economic growth and inspire investor confidence. The United States is no exception and fiscal discipline is one of those fundamentals. This year our Federal budget is the \$70 billion in the black for the first time since 1969 and, under current policies, we are forecasting cumulative surpluses of over \$1.5 trillion in the next decade. In economic terms, the main purpose of deficit reduction was to boost national saving in order to lower interest rates, raise investment, and increase future consumption opportunities. Between the mid 1980s and the early 1990s, when it appeared that large deficits would persist as far as the eye could see, net national saving and net national investment declined as a share of national income. Since 1993, by contrast, we have seen double digit rates of -''* increase in business equipment investment, and net national investment as a share of national income has been on the rise. Still, the national savings rate in the United States remains low, private saving is currently nonexistent and the United States faces demographic and fiscal challenges ahead. The OECD has urged countries to pursue prudent fiscal policies to prepare for aging populations and the United States is committed to following that advice. We recognize that the only way to ease the burden on young people while guaranteeing a secure retirement for baby boomers is to augment national saving to expand the size of the pie available to support both workers and retirees. In order to protect the gains that have been achieved thus far and to use the opportunity we now have to address the demographic challenges facing the United States the President has insisted that we preserve every penny of the budget surplus until we have taken care of the social security system and he has thus far resisted tax cuts and spending increases financed out of project surpluses. It is our hope that we will be able to achieve bipartisan agreement on a reform for Social Security rapidly after a new Congress convenes. Social security is a soluble problem. Likely, such an agreement would use part of the surplus to address retirement needs. This means that, in the event of a downturn, the major stabilization burden will rest with monetary policy and the operation of four automatic stabilizers. The automatic stabilizers built H into fiscal policy will provide significant support for the economy if growth slows, assuming that the spending and tax decisions are not altered to counter the contraction in the surplus. Clearly, we should not allow that to occur. For example, a one percent drop in GDP would decrease the budget surplus by about \$253 billion. What about discretionary fiscal policy either tax cuts or spending initiatives? Such policy responses should never be entirely ruled out, because circumstances could arise in which monetary policy is unable to provide the needed stimulus to growth in a timely fashion. The situation in Japan illustrates a circumstance where, in our view, the need for an active fiscal policy response to address short term weakness outweighs the important longer term fiscal goal of coping with imminent demographic challenges. But the situation in the United States is very different from that in Japan and there is now ample latitude for monetary policy to act. Studies of the effectiveness of active fiscal policy in the United States reveal that actions intended to stabilize the economy often occur at the wrong time or in the wrong amount. And we know that taxes, once cut, are difficult to increase. Thus, consideration of active fiscal policy measures should be a last resort, not a first resort. 8' # C

ommentson: Public Financial Management and Fiscal Goals h A fundamental issue for every society to answer is how to trade off equity against efficiency. During times of strong growth and budget surpluses, countries may have the flexibility to reevaluate their fiscal policies with an eye toward moving toward a more ideal mix. The Secretariat's paper focuses primarily on

efficiency concerns surrounding public debt, particularly its distortionary cost in terms of crowding out of private sector capital. However, equity concerns are at least as important. The power of fiscal policy to reallocate resources both within and among generations is considerable. Debt primarily 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. The maintenance of a tighter fiscal stance in the years to come, when budget surpluses are now projected, would entail some shifting of lifetime tax burdens 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 face large costs of supporting more retirees per worker. I agree with the Secretariat's argument that it is important for countries to build more robust budget institutions to minimize deficit bias and allow credible commitment to fiscal discipline. Experience in the United States suggests that procedural rules work better to achieve this end than fixed targets. In the United States, legislators simply failed to meet established targets. But a series of budget acts placing caps on discretionary spending at predetermined levels and imposing pay-go requirements that any new spending initiative or tax cut be paid for without setting spending cuts or tax revenues have helped to achieve deficit reduction and are even now succeeding in preserving our emerging budget surplus. At the same time, these rules permit the automatic stabilizers to operate. We opposed a balanced budget amendment to our constitution, however, partly on the grounds that such a rigid rule could interfere with the operation of the automatic stabilizers. Accounting procedures clearly matter for transparency and informed debate concerning trade-offs. So-called Golden Rules, 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 pensions systems. Accounting conventions at the state level are transparent but also flexible. Experience suggests 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 has helped to keep all the operations of the federal system more overt. However, in contrast to private sector practice, the measurement of future commitments is generally omitted from federal deficit estimates. Given the high degree of uncertainty involved in estimates of future commitments, perhaps the best approach to the problem of unfunded liabilities involves their refinement and more widespread use of long-term forecasting techniques.

Turning to the subject of government investment strategies, it is clear that the effectiveness of public investment hinges on appropriate targeting. The US experience demonstrates that more appropriate targeting can result from decentralized decision making. While there has been scope for nationwide investment programs, such as the federal interstate highway program, the Internet, and basic scientific research, many of the most important public investments, are financed and operated at the state and local level. Investments in human capital, usually particularly 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 although there is also federal level involvement and policy direction. Retaining primary responsibility for such investments at a level of government closest to the people, whenever possible, helps moderate costs and maximize benefits. In deciding on public investment projects, governments should of course attempt to estimate both the costs and benefits that derive from the investment in question. That said, the relevant costs and benefits are not always readily quantifiable, particularly for projects affecting the quality of life and environment. And even when the structure of benefits and costs is less opaque, there is considerable room for divergent estimates of the costs and the benefits. The United States is moving in the direction of more private provision of public services, such as prison management and social assistance programs. Although the private sector does have the incentive to operate such services efficiently, it may, in the pursuit of maximum profits, offer high prices, low quantities or low quality services.

Care must be taken, and supervision must be provided, to insure that the end result is not the worst of both worlds. Finding the optimal degree of supervision in these areas is an ongoing challenge.

Comment on: Policies to Alleviate Longer Term Poverty

h The Secretariat's Q recent Q study of SR by the OECD Economics Department on the dynamic characteristics of flows into and out of poverty TV represents V U low income individuals represents Use various progress toward answering the fundamental questions W needed to design effective WX facing X anti-poverty Y policies: Y Z regime today: Z who are the poor, and how can we keep them from being poor? The effect of time as an economic variable are frequently ignored, in many cases merely because rich longitudinal data are not 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 is not a long-term solution to the poverty problem. Governments 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 that 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 in to 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 strain 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 durations 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. These 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 is not 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

ncentives 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 return to revamping systems of unemployment insurance in order to coordinate the aggregate 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 embedding disincentives is a much more daunting task. Given the characteristics of the long-term poor, as uncovered in literatures 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.===== END ATTACHMENT 1 =====

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: kelliott@iie.com@INET@LNGTWY (kelliott@iie.com@INET@LNGTWY [UNKNOWN])

CREATION DATE/TIME: 3-NOV-1998 16:53:20.00

SUBJECT: COP model

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

READ:UNKNOWN

TEXT:

- * This message contains the file 'quotaup.wk1', which has been
- * uuencoded. If you are using Pegasus Mail, then you can use
- * the browser's eXtract function to lift the original contents
- * out to a file, otherwise you will have to extract the message
- * and uudecode it manually.

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D85]MAIL462493707.326 to ASCII,
The following is a HEX DUMP:

Clinton Presidential Records Automated Records Management System [EMAIL]

This is not a presidential record. This is used as an administrative marker by the William J. Clinton Presidential Library Staff.

Hex Dump file is not in a recognizable format, has been incorrectly decoded or is damaged.

File Name: p_60739423_cea_html_1.xls

Attachment Number: [ATTACH.D85]MAIL462493707.326

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 3-NOV-1998 16:53:25.00

SUBJECT: Re: Capital ratios (fwd)

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

READ:UNKNOWN

TEXT:

Janet-

This is the share of bank assets at banks that are well capitalized. I could not find the series for adequately and under capitalized, but we could produce them tomorrow if you would like.

-- Bill English (m1bbe00) x5645

----- Forwarded Message

Date: Tue, 27 Oct 1998 17:20:20 -0500

From: "Adrian R. Sosa" <m1ars00@maue2>

To: Bill B English <m1bbe00@bkamp1>

Subject: Re: Capital ratios

WELLCAP

91:1	31.80
91:2	34.63
91:3	36.75
91:4	34.79
92:1	40.28
92:2	53.08
92:3	56.87
92:4	68.42
93:1	75.85
93:2	78.66
93:3	79.49
93:4	82.37
94:1	85.44
94:2	87.16
94:3	87.82
94:4	90.15
95:1	95.30
95:2	95.57
95:3	96.87
95:4	96.01
96:1	97.18
96:2	98.74
96:3	98.69

96:4 98.59
97:1 98.40
97:2 98.63
97:3 98.54
97:4 97.67
98:1 97.07
98:2 98.54

-Adrian

----- End of Forwarded Message

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

TEXT:

RFC-822-headers:

Received: from conversion.pmdf.eop.gov by PMDF.EOP.GOV (PMDF V5.1-9 #29131)
id <01J3H272T7W0005WZD@PMDF.EOP.GOV> for yellen_j@a1.eop.gov; Tue,
27 Oct 1998 17:36:31 EST

Received: from Storm.EOP.GOV by PMDF.EOP.GOV (PMDF V5.1-9 #29131)
with ESMTP id <01J3H26W5YU0002CAF@PMDF.EOP.GOV> for yellen_j@a1.eop.gov; Tue,

27 Oct 1998 17:36:27 -0500 (EST)

Received: from newfed.frb.gov ([132.200.32.65])
by STORM.EOP.GOV (PMDF V5.1-12 #29131)
with ESMTP id <01J3H26T5EV4004061@STORM.EOP.GOV> for yellen_j@a1.eop.gov; Tue,

27 Oct 1998 17:36:19 -0500 (EST)

Received: (from umailfwd@localhost) by newfed.frb.gov (8.8.8/8.8.8)
with UUCP id RAA00286 for yellen_j@a1.eop.gov; Tue,
27 Oct 1998 17:32:49 -0500 (EST envelope-from mlbbe00@Frb.GOV)

Received: from primary.frb.gov (primary.frb.gov [198.35.131.208])
by new-frbgate.frb.gov (8.8.8/8.8.8) with ESMTP id RAA21680 for
<yellen_j@a1.eop.gov>; Tue, 27 Oct 1998 17:30:48 -0500 (EST)

Received: from bkamp1.FRB.GOV (root@bkamp1.frb.gov [198.35.221.178])
by primary.frb.gov (8.8.6/8.8.6) with SMTP id RAA07338 for
<yellen_j@a1.eop.gov>; Tue,

27 Oct 1998 17:30:48 -0500 (EST envelope-from mlbbe00@bkamp1.frb.gov)

Received: from bkamp1 by bkamp1.FRB.GOV (SMI-8.6/SMI-SVR4) id RAA02396; Tue,
27 Oct 1998 17:30:46 -0500

Organization: Federal Reserve B.O.G.

X-Mailer: exmh version 2.0delta 6/3/97

===== END ATTACHMENT 1 =====

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: "Laurence J. Kotlikoff" <kotlikof@bu.edu> ("Laurence J. Kotlikoff" <kotlikof@bu.edu> [UNKNOWN])

CREATION DATE/TIME: 3-NOV-1998 16:53:31.00

SUBJECT: Re: Social Security reform

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

TEXT:
Hi Janet,

thanks for the quick reply.

I just want to point out that, apart from cutting government purchases, the only way to fix social security in a way that raises national saving over the next couple of decades is to shift the fiscal burden onto the current elderly relative to a) the intergenerational distribution of the fiscal burden that would arise under current policy and b) the distribution that would arise under a reform that places the transition costs on current and future workers. This is the clear-cut message of the life-cycle model and the life-cycle simulation studies I sent you that compare wage-tax, income-tax, and consumption-tax finance of the transition. So doing something that's "politically feasible" and doing something that will raise national saving are mutually incompatible.

I hope that you're also spreading the message among the "players" that the long-term crisis as measured by the Trustees is twice as large as the Trustees Report is stating. According to Steve Goss, SSA's Deputy Chief Actuary, the system (under intermediate assumptions) needs an immediate and permanent 4.7 percent point OASDI tax rate increase to equate the present value of projected taxes plus the current trust fund to the present value of projected benefit payments. This calculation doesn't truncated the projection at 75 years. If you do that, the requisite tax hike is 2.2 percentage points -- the value reported in the Trustees Report. The 4.7 requisite tax hike is probably a substantial understatement because the intermediate assumptions seem highly optimistic on longevity and real wage growth. Taking 5 cents more out of each dollar the typical worker earns is no minor matter, even if that nickle is taken in small pieces through the kinds of policies that Bob Ball and his gang recommend.

The long-term Social Security fiscal crisis is, in my view, so dangerous (accompanying, as it does, the government's health-care financing crisis) that concern with what's politically feasible is no longer a luxury we can afford.

Having said this, I know you are the last person playing the role of the politician in the policy discussions. Indeed, you are the only high-level economist in this administration that I trust to think beyond the next

election and vigorously advocate what's right. At some point, if you can't make headway against the political economists, you might consider going public with what you think should be done and with how bad you think the situation is. I know this is a perscription for getting fired, but that may be the best thing to do in this environment. I think Marty's public controversy with the Reagan Administration was his finest hour.

My very best, Larry

PS, one variant of my proposal that you might consider (which Peter Diamond would advocate) is having a single government provident fund manage the individual accounts and invest them in the global index fund. Wall Street won't like this, but it will reduce transactions costs. It will also make democrates more comfortable.

At 01:23 PM 10/28/98 -0500, you wrote:

>Message Creation Date was at 28-OCT-1998 13:23:00

>

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

CREATION DATE/TIME: 3-NOV-1998 11:22:33.00

SUBJECT:

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

READ:UNKNOWN

TEXT:

just in case===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D50]MAIL42309660O.326 to ASCII,
The following is a HEX DUMP:

Modernizing Bank Capital Standards

In 1989 Federal regulators adopted minimum risk-based capital (RBC) requirements for banks. RBC ratios have since come to play an important role in bank regulation and supervision. But these requirements may not be a reliable guide to the capital adequacy of large, global banks. Insuring that “regulation remains as modern as the markets” may require some updating.

The role of capital requirements. A bank’s capital acts as a cushion to absorb unanticipated losses and declines in asset values that could otherwise cause it to fail. Capital requirements are important because deposit insurance and other aspects of the Federal safety net (such as “too big to fail” intervention) provide incentives for risk-taking that need to be counterbalanced by exposing bank shareholders to a larger percentage of potential losses. 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 its 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 four risk buckets. Cash, at one extreme, receives a risk weight of zero. Most non-mortgage loans receive a risk weight of 100 percent.

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

Are capital adequacy standards adequate? Critics question whether the Basle capital requirements provide an adequate measure of banks’ risk positions.

- One big bucket. 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 percent risk weight and 8 percent capital requirement to cover credit risk.
- Little diversification. 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. Through securitization and other financial innovations, a sophisticated bank can increase the riskiness of its portfolio to a preferred level while meeting or exceeding the regulatory capital requirements. One technique is cherry-picking, which involves shifting low-risk assets with unduly high regulatory capital requirements off the regulated banking book while retaining higher risk assets. This regulatory arbitrage might explain why, with capital ratios as high as they are, 70 percent 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.

Alternatives to RBC requirements. 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." A recent amendment to the Basle Accord permits banks to use their own Value-at risk (VaR) models for calculating RBC requirements against specific risks within their trading portfolios (bonds, swaps, derivatives). U.S. regulators are studying the feasibility of extending this approach and using banks' internal models to estimate the economic capital required to support credit activities on the banking book. However, the failure of Long-Term Capital Management—a firm that relied heavily on such a model-based approach—serves as a cautionary tale. An even more radical alternative than internal models is to base a bank's capital requirement on its own pre-commitment to a maximum loss exposure over a designated horizon, with appropriate penalties for non-compliance..

Conclusion. 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. The challenge is to protect the public interest in a safe and sound banking system while allowing banks adequate scope to pursue sophisticated profit-maximizing strategies.

The pre-commitment approach. A methodology for determining 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: 3-NOV-1998 15:05:27.00

SUBJECT: Meeting of Academics with the Vice President

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

READ:UNKNOWN

TEXT:

Attached is a note concerning the proposed meeting of academics with the
Vice President. My apologies for the delay.===== ATTACHMENT 1

=====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D66]MAIL44550270Z.326 to ASCII,
The following is a HEX DUMP:

To: David Beier
From: Janet Yellen
Subject: meeting of academics with the Vice President

I apologize for the long delay in responding to your request for comments concerning the meeting of academics with the Vice President. The list that you circulated comprises a group of first rate, largely academic economists, drawn from an enormous array of different fields. As you and I discussed, it might be useful to focus a bit more narrowly in the meeting. One possibility is to confine the discussion to developments in the global economy, including trade and financial policy issues. Attached is a list of individuals, all very good taken from your list with some additions, that would be appropriate for such a gathering. An alternative is to invite a much more varied array of people covering many different fields. In the second alternative, the focus would presumably be on what the group sees as the key policy challenges and what new policy initiatives they would recommend to address them. In that case, your original list would probably be more appropriate.

Economists Specializing in International Economics

From your original list:

Fred Bergsten, Institute for International Economics
Susan Collins, Georgetown
Richard Cooper, Harvard
Paul Romer, Stanford
Ken Rogoff, Princeton
Robert Solow, MIT (not in international but a very wise and broadly knowledgeable Nobel laureate)
Laura Tyson, Berkeley
Rudiger Dornbusch, MIT
Bob Litan, Brookings Institution

Recommended additions:

Barry Eichengreen, Berkeley
Dani Rodrik, Kennedy School-Harvard
Morris Goldstein, Institute for International Economics
Maurice Obstfeld, Berkeley

You could also consider adding Jeffrey Sachs (Harvard) and Paul Krugman (MIT) to the list. Sachs, Krugman and Dornbusch are probably the three most outspoken individuals in the field; all are colorful and extremely talkative; most have been, at least on occasion, critical of the Administration, at least to some extent, concerning its handling of the Asian crisis.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 3-NOV-1998 16:53:26.00

SUBJECT: Capital ratios (fwd)

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

READ:UNKNOWN

TEXT:

Janet-

Here is the capital ratio data. We also have data on the share of industry assets at banks in the various regulatory capital categories (well capitalized, adequately capitalized, under capitalized), if that would be useful.

-- Bill English (m1bbe00) x5645

----- Forwarded Message

Date: Tue, 27 Oct 1998 15:40:15 -0500
From: "Adrian R. Sosa" <m1ars00@maue2>
To: m1bbe00@maue2
Subject: Capital ratios

I also put the text file caprates.txt in your spool.

-Adrian

These Series are Not Seasonally Adjusted

All Banks

TOT TIER1 LEVERAGE

90:1	9.52	7.68	6.26
90:2	9.60	7.77	6.29
90:3	9.59	7.75	6.28
90:4	9.80	7.77	6.21
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91:2	10.45	8.35	6.50
91:3	10.63	8.52	6.60
91:4	10.72	8.60	6.52
92:1	11.15	9.02	6.72
92:2	11.60	9.37	6.98
92:3	11.92	9.61	7.18
92:4	12.35	9.89	7.24

93:1	12.74	10.26	7.51
93:2	12.94	10.40	7.60
93:3	13.09	10.55	7.67
93:4	13.21	10.68	7.75
94:1	13.23	10.71	7.62
94:2	13.20	10.70	7.71
94:3	13.19	10.69	7.74
94:4	13.05	10.52	7.65
95:1	12.95	10.46	7.68
95:2	12.81	10.33	7.61
95:3	12.87	10.37	7.74
95:4	12.68	10.20	7.62
96:1	12.86	10.34	7.71
96:2	12.74	10.21	7.75
96:3	12.68	10.13	7.80
96:4	12.56	9.97	7.66
97:1	12.64	10.06	7.80
97:2	12.47	9.91	7.77
97:3	12.41	9.88	7.77
97:4	12.24	9.60	7.55
98:1	12.31	9.52	7.54
98:2	12.30	9.48	7.61

Top 10

TOT1 TIER11 LEVERAGE1

90:1	7.24	4.57	4.54
90:2	7.22	4.61	4.54
90:3	7.18	4.55	4.44
90:4	7.96	4.73	4.58
91:1	8.13	4.83	4.78
91:2	8.46	5.10	4.92
91:3	8.46	5.08	4.88
91:4	8.38	5.02	4.63
92:1	8.76	5.37	4.90
92:2	9.22	5.67	5.23
92:3	9.57	5.90	5.44
92:4	10.60	6.62	5.84
93:1	10.92	6.97	6.20
93:2	11.32	7.30	6.29
93:3	11.55	7.60	6.47
93:4	12.05	8.06	6.72
94:1	11.88	7.99	6.20
94:2	11.84	8.02	6.27
94:3	12.11	8.17	6.31
94:4	12.32	8.34	6.32

95:1	11.70	7.98	6.11
95:2	11.64	7.93	5.91
95:3	11.62	8.01	6.21
95:4	11.64	8.11	6.16
96:1	11.57	8.01	6.16
96:2	11.42	7.92	6.23
96:3	11.46	7.99	6.43
96:4	11.41	7.97	6.24
97:1	11.48	8.03	6.38
97:2	11.26	7.92	6.27
97:3	11.23	7.91	6.35
97:4	11.16	7.74	6.14
98:1	11.05	7.64	6.07
98:2	11.08	7.57	6.23

Next 90

TOT2 TIER12 LEVERAGE2

90:1	8.38	6.50	5.46
90:2	8.47	6.57	5.46
90:3	8.53	6.61	5.51
90:4	8.60	6.63	5.43
91:1	8.87	6.90	5.66
91:2	9.11	7.11	5.78
91:3	9.39	7.37	5.99
91:4	9.72	7.65	6.04
92:1	10.17	8.11	6.29
92:2	10.92	8.80	6.73
92:3	11.27	9.00	6.98
92:4	11.47	9.02	6.93
93:1	11.80	9.27	7.10
93:2	11.89	9.27	7.15
93:3	12.05	9.39	7.17
93:4	12.10	9.48	7.28
94:1	12.16	9.50	7.28
94:2	12.12	9.50	7.31
94:3	11.87	9.30	7.24
94:4	11.64	8.98	7.12
95:1	11.74	9.07	7.24
95:2	11.58	8.92	7.18
95:3	11.73	9.00	7.29
95:4	11.47	8.73	7.19
96:1	11.80	8.99	7.31
96:2	11.72	8.90	7.37
96:3	11.57	8.74	7.35
96:4	11.51	8.58	7.30

97:1	11.72	8.87	7.61
97:2	11.63	8.83	7.73
97:3	11.49	8.79	7.63
97:4	11.30	8.43	7.38
98:1	11.61	8.49	7.50
98:2	11.61	8.53	7.53

Next 900

TOT3 TIER13 LEVERAGE3

90:1	10.38	8.99	6.79
90:2	10.59	9.17	6.88
90:3	10.48	9.06	6.80
90:4	10.46	8.98	6.65
91:1	10.87	9.36	6.79
91:2	11.06	9.54	6.90
91:3	11.34	9.84	7.03
91:4	11.36	9.86	7.01
92:1	11.85	10.33	7.13
92:2	12.16	10.58	7.29
92:3	12.55	10.98	7.47
92:4	12.72	11.13	7.50
93:1	13.30	11.68	7.81
93:2	13.47	11.83	7.97
93:3	13.63	11.96	8.03
93:4	13.50	11.83	8.02
94:1	13.73	12.05	8.09
94:2	13.71	12.01	8.24
94:3	13.72	12.07	8.35
94:4	13.39	11.74	8.18
95:1	13.59	11.93	8.30
95:2	13.41	11.74	8.34
95:3	13.48	11.79	8.40
95:4	13.15	11.46	8.20
96:1	13.40	11.70	8.33
96:2	13.54	11.88	8.49
96:3	13.58	11.92	8.54
96:4	13.38	11.69	8.38
97:1	13.37	11.64	8.40
97:2	13.59	11.99	8.56
97:3	13.73	12.16	8.69
97:4	13.57	11.98	8.55
98:1	13.73	12.00	8.57
98:2	13.77	12.03	8.66

Remainder

TOT4 TIER14 LEVERAGE4

90:1	13.88	12.77	8.57
90:2	13.93	12.83	8.63
90:3	13.97	12.87	8.68
90:4	13.82	12.70	8.52
91:1	15.13	13.96	8.54
91:2	15.22	14.05	8.60
91:3	15.33	14.15	8.64
91:4	15.38	14.20	8.57
92:1	15.74	14.55	8.71
92:2	16.02	14.82	8.88
92:3	16.30	15.10	9.04
92:4	16.41	15.21	8.95
93:1	16.87	15.66	9.21
93:2	17.02	15.81	9.35
93:3	17.05	15.84	9.44
93:4	17.04	15.84	9.43
94:1	17.16	15.96	9.46
94:2	17.17	15.97	9.57
94:3	17.21	16.01	9.74
94:4	17.09	15.91	9.73
95:1	17.19	16.01	9.93
95:2	17.09	15.92	9.98
95:3	17.01	15.82	9.96
95:4	17.05	15.89	9.89
96:1	17.25	16.08	10.01
96:2	17.17	16.02	10.09
96:3	17.10	15.95	10.17
96:4	16.89	15.75	10.07
97:1	17.09	15.95	10.13
97:2	16.84	15.69	10.16
97:3	16.90	15.78	10.21
97:4	16.77	15.65	10.14
98:1	16.77	15.58	10.12
98:2	16.70	15.51	10.16

--Adrian R. Sosa
Federal Reserve Board
Monetary Affairs
(202) 736-5646

----- End of Forwarded Message

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

TEXT:

RFC-822-headers:

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id <01J3GZ9AIVY8006A5V@PMDF.EOP.GOV> for yellen_j@al.eop.gov; Tue,
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by primary.frb.gov (8.8.6/8.8.6) with SMTP id PAA03501 for
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Received: from bkamp1 by bkamp1.FRB.GOV (SMI-8.6/SMI-SVR4) id PAA27566; Tue,
27 Oct 1998 15:52:03 -0500

Organization: Federal Reserve B.O.G.

X-Mailer: exmh version 2.0delta 6/3/97

===== END ATTACHMENT 1 =====

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 5-NOV-1998 16:52:42.00

SUBJECT: President's Trip to Japan

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

TEXT:

Maria -- I understand that you are likely to be in charge of the President's trip to Asia. I have requested authorization to participate in one day of meetings on the Japan portion of the trip -- specifically, the President's November 19 meetings with PM Obuchi and in the Roundtable with Japanese Business Executives. I will support the President by helping to brief him on the state of Japan's economy, the credibility of Japan's economic reforms, and the impact of Japan's economic troubles on the US economy.

I intend to fly commercial to and from Tokyo. On November 18 and on November 20, I will meet with the heads of Japan's economic agencies, various Japanese industry and banking executives, and academic economists. I believe that to provide the President with sound projections about the future performance of the American economy I need to better understand the credibility of Japan's efforts to strengthen its economy and reform the banking sector, and identify other possible barriers to Japan's economic recovery. Please let me know if you have any questions or need more information. -- Janet

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-NOV-1998 11:33:05.00

SUBJECT:

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

READ:UNKNOWN

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

READ:UNKNOWN

CC: Lael Brainard (CN=Lael Brainard/OU=OPD/O=EOP @ EOP [OPD])

READ:UNKNOWN

TEXT:

Janet, Jeff,

Caroline Atkinson asked me last week to write a note for Larry Summers discussing how the Asian crisis and its global contagion could have been prevented and/or its real and financial effects contained. I wrote this paper over the weekend and sent it to Treasury. They tell me that they will now widely circulate it at Treasury. I attach a copy for you (it is in Wordperfect format).

Nouriel

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D49]MAIL47158521D.326 to ASCII,
The following is a HEX DUMP:

The Asian crisis and its global contagion: what could have been done to prevent it and/or dampen its effects?

Nouriel Roubini, CEA 11/7/98

Introduction: A “consensus” view of the causes of the crisis.

The goal of this paper is to consider the Asian crisis and its global contagion from a new angle. Instead of presenting only an analysis of the causes of the crisis, I will start from a brief explanation of the crisis to develop an analysis of what could have been done differently to prevent the crisis or minimize its effects. In particular, I will consider whether the many policy recommendations in the G-22 reports on international architecture reform, different IMF policies, different policies by the crisis countries could have prevented the crisis or dampened its severe real effects. In discussing what could have been different, I consider the following factors: financial sector and corporate governance weaknesses; capital account liberalization; the role of capital adequacy standards; an international lender of last resort role for the IMF; moral hazard from IMF rescue packages; the role of transparency; contagion effects and how to prevent them; the choice of the exchange rate regime; lessons for Brazil; involving the private sector in burden sharing; the role of foreign banks; the role of IMF policies in the crisis.

Before we start discussing what could have been different, we need to spend a little time analyzing whether the crisis was due to fundamentals or “panic”. The latter view has identified phenomena such as irrational panic, fickle investors, volatile hot money, self-fulfilling multiple equilibria, non-fundamental speculative capital flight and irrational bank runs as being the main causes of the crisis. An analysis of the causes of the crisis is important because, depending on one’s view of what were the causes, one will reach different conclusions about what could have been done differently.

Note that the two views of the crisis are not completely inconsistent with each other as multiple equilibria require economic fundamentals to be in a vulnerable region to occur and fundamental explanations are consistent with their view that, even if fundamental weaknesses triggered the crisis, the subsequent movement of asset prices (exchange rates and stock stock markets) and capital flow reversals may have been excessive and not warranted by the initial fundamentals. However, the fundamentals views puts a strong emphasis on the role of the weaknesses and bad policies.

The “panic” view of the crisis has been supported by the fact that the Asian crisis did not feature the traditional fundamental factors evident in previous classic currency crisis episodes. Traditional currency and debt crises – such as the ones observed in Latin America in the 1980s – tended to share the following stylized characteristics: crisis countries had large budget deficits and high public debt; they suffered high inflation as a result of deficit monetization; and they experienced low economic growth and had low savings and investment rates. In Asia, however, the opposite conditions prevailed in most countries just prior to the crisis: low budget deficits, low public debt, single digit inflation rates, high economic growth and high savings and investment rates. This apparent contradiction supported the formulation of self-fulfilling crisis models, which challenged the more conventional

interpretations based on economic fundamentals.

According to the “fundamentals” view of the Asian crisis, beneath apparently strong economic fundamentals lay serious institutional weaknesses, macroeconomic policy mistakes, and severe structural distortions. These weaknesses eventually triggered the crisis in the summer of 1997. I present below a “consensus” explanation of the crisis that, while being fundamentals-based, considers the role of non fundamental factors.

First, note that East Asia had both structural strengths and structural weaknesses. East Asian countries grew very rapidly rate for over two decades, a phenomenon widely-hailed as the “Asian Miracle.” This success has been attributed to a number of structural factors: high savings rates, education, particularly high rates of basic education and literacy compared to other poor developing countries, and a pronounced work ethic. Effective macroeconomic management contributed low budget deficits and low inflation rates. These economies, however, also concealed structural weaknesses which have now been credited with contributing to triggering the financial crisis. Many can be categorized as the excessive utilization of centralized coordination rather than decentralized market incentives. Particular examples include widespread government favoritism in promoting selected industries and exports, and anti-competitive protection of domestic industries. Examples also abound in the private sector: relationship-driven banking hindered capital market discipline and flexibility and reliance on debt rather than equity, incorporating informal rather than formal enforcement mechanisms.

Second, the financial sectors were prone to weaknesses and distortions such as moral hazard deriving from implicit or explicit government bailout guarantees of the financial institutions, relationship banking, corrupt credit practices, directed credit to favorite firms and sectors and political distortions in the allocation of credit, poor regulation and supervision of the banking system.

Third, such financial sector weaknesses led to a lending boom and overinvestment in projects and sectors that were risky and of low profitability, such as real estate and other non-traded sectors and excessive capacity accumulation in some traded goods sectors. Also speculative purchase of assets in fixed supply fed an asset price bubble, with stock markets and real estate prices rising beyond what fundamentals warranted. Poor corporate governance and crony capitalism exacerbated the distortions in this system and fueled the excessive investment boom. Also, the absence of developed securities (bond and equity) markets implied that most capital inflows were intermediated by the domestic banking system (with the exception of Indonesia where large international bank loans went directly to the corporate sector).

Fourth, domestic and international capital liberalization may have aggravated the original distortions and wrong incentives faced by banks and firms as it allowed them to borrow more and at cheaper rates in international capital markets. Moreover, the huge increase in net capital flows to East Asia in the early 1990s was also driven by developments in the OECD area. Low interest rates in the G-7 area led to major flow of capital to emerging markets. Economic and financial weakness in Japan led Japanese institutions to lend to East Asian countries without a careful monitoring of credit risk. Excessive optimism about Asia and

emerging markets led to a “herd-like” rush to lend to these economies. The major reduction in the price of risk in the early 1990s as measured by sovereign spreads suggests that lenders were excessively optimistic and imprudent about their assessment of risk in emerging markets. International banks lenders may have also suffered of a moral hazard problem as they perceived their loans to Asian banks as being effectively guaranteed by governments (as it happened ex-post).

In Thailand, the finance companies were largely unregulated as they were non-banking institutions and they borrowed excessively to finance the boom in the real estate sector. Liberalization of capital account regulations, such as the Bangkok Offshore Facility, led Thai financial and corporate firms to borrow excessively and at very short-term maturities. 56 of these finance companies were severely distressed even before the Thai baht crisis and were eventually closed down once the currency crisis emerged.

In Korea, the excessive investment was concentrated among the chaebols, the large conglomerates dominating the economy. The chaebols’ control of financial institutions, together with government policies of directed lending to favorite sectors and misguided industrial policies led to excessive investment in traded sectors such as autos, steel, shipbuilding and semiconductors. The excessive capacity thus created was associate with very low profitability of such investment. By early 1997, well before the onset of the won crisis, Korea was in sharp economic difficulties and seven out of the main thirty chaebols were effectively bankrupt.

In Indonesia, corrupt business practices were rampant and over 80 percent of all bank credit consisted of directed credit, channeled to politically favored firms and sectors. Indonesia had already suffered from a banking crisis in the early 1990 but did not reform its banking system away from relationship finance and crony allocation of credit. Empirical studies confirm that the return to capital sharply fell in the region as the result of excessive investment. Studies show a rapid build-up of fixed assets throughout Asia from 1992 to 1996 with particularly rapid growth in Indonesia and Thailand. With most of the growth finance with debt (especially in Thailand and Korea), high levels of corporate leverage were already prevalent in 1996, well before the currency crisis increased the burden of foreign debt. At the same time, moderate to low profitability severely impaired the ability of many Asian firms to meet their interest rate obligations. In Korea, the average debt to equity ratio of the top 30 chaebols was over 300% by the end of 1996; and by 1997 the return on invested capital was below the cost of capital for two third of the these top chaebols.

Fifth, the excessive investment boom in the East Asian region led to large and growing current account deficits that were financed mostly via the banking system and the accumulation of short-term, foreign currency-denominated and unhedged liabilities. Regimes of exchange rates that were semi-fixed to the dollar exacerbated the problem in two ways. a) they led to real appreciation (as a result largely of the 1995–98 appreciation of the dollar) that worsened the current account problem; b) they were a manifestation of the broader moral hazard problem, as fixed rates helped give banks and firm a lower cost of foreign capital.

While budget deficits were apparently low, the implicit and explicit government guarantees of a bailout of the financial system in a crisis implied a large and growing unfunded public liabilities that emerged once the currency crisis triggered a wider banking crisis.

Sixth, exogenous disturbances made the East Asian countries vulnerable to a crisis: the slowdown of export growth among many Asian countries in 1996 and the worsening of the terms of trade, partly associated with a slump in the world price of semiconductors; the persistent stagnation of the Japanese economy in the 1990s; the weakness of the yen that caused a real appreciation of Asian currencies that were effectively pegged to the U.S. dollar; and the emergence of China as a major regional competitor.

In 1997, the asset bubble started to burst. The stock markets dropped and the emergence of wide losses and/or outright defaults in the corporate sectors revealed the low profitability of past investment projects; non-performing loans were already high and increasing before the currency crisis hit the East Asian economies. Then, the firms, banks and investors that had heavily relied on external borrowing were left with a large stock of short-term, foreign currency-denominated and unhedged foreign debt that could not be easily repaid. The exchange rate crisis that ensued exacerbated the problem, as the currency depreciation dramatically increased the real burden of the debt that was denominated in foreign currencies and led to further financial crisis for banks and firms. The free fall of currencies was intensified by the sudden rush of firm, banks and investors to cover their previously unhedged liabilities in foreign currency; in turn, this accelerated depreciation aggravated the original foreign currency debt problem creating a vicious circle.

Seventh, the initial behavior governments that were weak, not very credible, and uncommitted to structural reforms worsened the policy uncertainty, led to widespread capital outflows and worsened the currency depreciation. In some countries such as Russia and Indonesia, the inability of government to perform with integrity basic functions such as tax collection and bank regulation exacerbated the crisis.

Eighth, while the crisis was triggered by fundamentals, it is highly likely that currency and stock markets overreacted, falling more than merited by economic fundamentals. Panic, herd behavior and a generalized increase in risk aversion by investors led to capital flight and a sudden reversal of capital flows that exacerbated the crisis. Just as the dramatic capital inflow from 1990 to 1997 was probably excessive, the sudden reversal of capital in 1997 was extremely rapid, was not fully justified by fundamentals and certainly contributed to exacerbate the crisis. Thus, the two explanations of the crisis -- driven by fundamentals or based on self-fulfilling expectations -- are not necessarily mutually exclusive.

The instability and sharp reversal of capital flows to the East Asian region as the investors' panic emerged in the second half of 1997 is clearly evident in the data. Net private flows to the five Asian crisis countries (Thailand, Korea, Indonesia, Malaysia and the Philippines) equaled \$ 84 billion in 1995 and \$ 94 billion in 1996. In 1997, the reversal was dramatic as the capital flows show a net outflow of \$ 6 billion. This represents a reversal of \$ 100 billion between 1996 and 1997, representing more than 10 percent of the GDP of these

five countries. Notice also that most of the reversal occurred in the second half of 1997 as foreign investors fled and international banks sharply withdrew their short term loans to these five countries. Commercial banks accounted for three quarters of this reversal as they went from lending \$ 58 billion in 1996 to withdrawing a massive \$ 29 billion in 1997. While equity investments also fell in 1997, the decision by international commercial banks not to roll over their loans to Korea, Thailand and Indonesia severely exacerbated the financial crisis and the currency collapse. In 1998, it is estimated that net private outflows were even larger than in 1997, about \$ 25 billion, with banks withdrawing another \$ 31 billion from the region. The result of this drastic reversal of capital flows has been a severe adjustment of the current account of the affected countries and a sharp contraction in economic activity. The current account deficit for the five crisis countries went from a deficit of \$ 55 billion in 1996 to one of \$ 26 billion in 1997 (with most of the adjustment in the second half of the year) and a estimated surplus of \$ 59 billion in 1998. As private capital has sharply fallen, the financing gap has been transferred to the official sector (IMF, multilateral and bilateral official creditors) and foreign reserves: while in 1996 the Asian five made net transfers to official creditors of \$ 3 billion, in 1997 they received net official flows of \$ 31 billion and are estimated to have received net official flows equal to \$ 28 billion in 1998. Moreover, while in 1995 and 1995, net private inflows in excess of current account imbalances led to sharp increases in foreign exchange reserves , to the tune of \$ 14 and \$ 19 billion in 1995 and 1996 respectively, the turnaround of capital flows in 1997 led to a massive loss of foreign exchange reserves equaling \$ 31 billion.

While the reversal of capital flows in 1997 was partly explained by the weak fundamentals and poor policies followed by the crisis countries, its size and concentration in the second half of 1997 confirms that investors, especially commercial banks, panicked and contributed to the severity of the crisis.

Given this analysis of the crisis, we will discuss next what could have been done differently to prevent the crisis and/or minimize its costs. We will consider in order the factors that contributed to the crisis and the policies or actions that could have led to different outcomes.

Financial sector and corporate governance weaknesses

It is now widely agreed (even by proponents of the “panic” view) that financial sector weaknesses were an important element of vulnerability that contributed to the crisis. This is also bolstered by broader evidence on over 70 cases of cases of banking crises in the last 20 years and many episodes of “twin crises”, banking and currency crises. Very weak corporate governance systems may have also contributed to vulnerabilities that eventually triggered the crisis.

The answer to the question of what could have been different is both very simple and easy and complex at the same time. In fact, one could argue that if the crisis countries had only had strong financial systems with well supervised and regulated banks and financial institutions, incentive compatible deposit insurance, credible and enforced capital adequacy standards and arms-length banking, the lending distortions created by the financial system would have been avoided and the excessive borrowing and lending would have not occurred. Similarly, a

different corporate governance system along the Anglo-Saxon lines would have avoided the severe investment mistakes made by the corporate sector.

Obviously, the above answer is too simple as the reality was more complex. First, the East Asian economic model was based on relationship banking and a heavy government interference in the corporate sector; for example, the chaebols system was at the root of the Korean economic system. Second, it is too easy to say that banks should have been well regulated and supervised. The fact that they were not well supervised was partly a policy choice to maintain a system of implicit and explicit government guarantees and use the financial system to pursue a certain model of economic growth. Third, even in the best circumstance, it would take at least a decade to design a strong system of financial regulation and supervision. The recommendations of the second G-22 group are very good but it would have taken years to implement them before the crisis. Fourth, the IMF and the World Bank had a severe deficiency of skills and human capital in surveillance of the financial system. The typical IMF country report had a page on the financial sector and entire chapters on tax and spending policy. Only a very large investment of human and financial resources by IMF/WB before the crisis would have given them the ability to monitor and supervise the financial sector. Given the pervasiveness and increasing frequency of banking and financial crises around the world in the last 20 years, the IMF/WB should probably make such an investment in its surveillance capacity. Future crises are likely to be more and more of the Asian type rather than just due to the traditional macroeconomic imbalances. Finally, it would be healthy to have a different system of corporate governance in Asia but such reforms will take years to occur, if ever. For example, it is not clear whether the chaebols system with its incestuous relations between firms, financial institutions controlled by chaebols and government will change in the future. Certainly, no one considered changing it before the crisis.

The conclusion is that, while domestic capital market liberalization is good and inevitable, when it occurs in an environment characterized by severe distortions and political biases, it may eventually lead to a financial crisis. Case in point is the US S&L crisis where domestic liberalization of S&L without prudential regulation and supervision and adequate capital standards led to a classic banking crisis.

Capital account liberalization

There is now a broad consensus, certainly broader than a year ago, that capital account liberalization should be orderly and cautious, especially when a financial system is weak. The benefits of free capital flows are numerous and, as financial systems become stronger, the arguments for progressively liberalizing the capital account and eventually reaching free capital mobility are compelling. But, as long as financial systems are weak, poorly regulated and subject to political distortions, a hasty rush to capital account liberalization may be unwise and destabilizing. During the transition, the liberalization of the capital account will have to be cautious and gradual. It has to be carefully managed to prevent the accumulation of debt, excessive borrowing and lending, mismatch of maturities and currency denomination of assets and liabilities of financial institutions and corporate firms that has proven to be so destabilizing in East Asia and many other episodes of financial and currency crises.

Of course, the first best solution is to go for where the true distortion is. If financial systems are weak, then you want to do good regulation and supervision, incentive compatible deposit insurance and enforce capital adequacy standards. For example, in the US after the S&L

we did not impose inter-regional capital controls to the ability of New York residents to make deposits in S&Ls in Texas and California; we decided instead to regulate and supervise better the S&Ls. Similarly, good supervision and regulation would have been first best in East Asia compared to a second best policy of capital controls.

However, the reality in East Asia and most emerging markets is that such good financial regime did not exist before the crisis (and would have taken years to develop); therefore, capital account liberalization contributed to the crisis by allowing weak financial institutions that were previously controlled to indulge in reckless international borrowing. So what, could have been done differently? Certainly, fixing the financial system was the first best alternative policy. However, if one takes for granted that political and institutional distortions prevented the development of a strong financial system, the liberalization of the capital account should have been less rapid. In all these countries, such liberalization occurred too fast compared to the weak state of their financial systems. For example, while in Thailand commercial banks were regulated and no new banks licences were issued for decades, the largely unregulated finance companies emerged as a consequence of the regulation of the banks. Also the Bangkok Offshore Facility was a policy mistake as it allowed corporations and financial institution to borrow excessively short-term foreign currency funds.

As excessive short-term capital inflows that were rapidly reversed in 1997-98 were an important factor in the crisis, capital controls on inflows or, to use a more politically-correct term, prudential regulation of interbank cross-border capital flows, would have help to reduce the inflow of short-term currency denominated and unhedged capital. Controls on both lender banks and borrowing banks could have been considered. Controls on lender banks, in the form of higher risk weights in capital standards for short-term cross-border interbank loans were justified by two arguments. First, you cannot always rely on emerging markets regulators to do the right thing; so lender countries regulators should have controlled their banks' behavior. Second, as part of the inflow stage was caused by supply factors in lender countries and excessive optimism of lenders, a regulation on the lender side would have been warranted. Whether the correct way to regulate the risks taken by lender banks would have been a change in risk weights for lending to emerging market banks or rather an alternative approach (such as value at risk models or use of subordinated debt) is an issue we will discuss below.

On the borrower side, controls could have taken three forms. One, higher reserve requirements for short-term foreign currency cross-border interbank loans. Two, limits on net open foreign currency positions of the banks, preferably symmetric and including both spot and forward positions. Three, higher risk weights in the capital standards for foreign currency loans to domestic corporations.

One crucial issue in the regulation of short-term capital inflows is whether the controls should have been imposed only on banks or on non-banks financial institutions and non-financial corporate firms as well. The argument for imposing them only on banks is that, if one is concerned about systemic risk, one should only isolate the banking system from the effects of volatile short-term inflows. However, the arguments for across-the-board controls on all short-term inflows are several. First, as the Chilean experience shows, controlling inflows to banks shifted the inflows to other firms, such as corporations, that were not regulated with the consequence that controls were step-by-step extended to all agents. Second, as the experience of Indonesia shows, a large fraction of the international bank lending can go directly to

corporations rather than being intermediated by the banking system. If there are distortions on the lender and/or corporate side (such as implicit guarantees) that lead to excessive lending, one would want to control the behaviour of corporations as well. Third, excessive lending to corporations can be a source of systemic risk, as Indonesia proves again. If corporations systematically go in financial distress because of excessive foreign borrowing, they will also cause the near bankruptcy of the domestic banks whose non-performing loans would surge as a consequence of the poor decisions of corporates to borrow excessively from abroad in foreign currency. Fourth, derivatives can be easily used by non-banks and corporations to evade controls imposed on banks only. So, controls on short-term inflows should be extended to all agents in the economy. This also implies that the controls should not distinguish between FDI and other types of investment; all short-term investments should be covered. An example in point; after Chile introduced its restrictions on short-term inflows, there was a surge of FDI to create companies whose only business was to buy domestic short-term bonds. So, this loophole via FDI has to be closed as well.

Finally, controls on outflows before the crisis: a) would have been mistaken for all the reasons why controls on outflows are bad; b) they were ineffective to prevent the crisis when Thailand introduced them in the spring of 1997; and c) the threat of their use by more countries could have accelerated the crisis even in those countries not introducing them through a contagion effect (such as the one experienced in emerging market after their imposition in Russia and Malaysia).

However, it is also clear that if one believes that liberalization of the capital account should be orderly and gradual, there is an open issue of how to partly reverse a liberalization that has been excessive given the underlying weaknesses of the financial sector. Usually, the order of liberalization starts with financial institutions, then non-financial corporations and only at the end individual residents. However, if the main weaknesses are in the financial sectors, a modest temporary reversal of liberalization should probably start with the financial sector. While such reversal be controversial and undermine confidence after a crisis has occurred, it should be considered as a strengthening in prudential regulations before a crisis occurs.

However, note that if such changes are implemented too late when the country is already under attack and losing reserves, they may accelerate rather than delay a currency crisis. In fact - when policy changes are made too late - asking the banks to have higher reserves against short-term foreign currency liabilities, higher capital standard for foreign currency loans, and balanced net foreign currency positions may just lead to a scramble to hedge open positions and force loan recalls that may actually accelerate the reserve loss and increase the probability of a collapse. So prudential regulation of Asian banks foreign currency positions should have started well before crisis in order to prevent it rather than increasing its chance of occurring.

The role of capital adequacy standards.

One could ask whether the well known shortcomings of the 1988 Basle capital accord were a contributing factor in the crisis and whether tighter standards would have limited excessive lending to the Asian countries. The answer is complex. On one side, it is true that the standards contributed to the problem. For example, current standards have given distorted incentives to banks in developed countries to make short-term rather than longer-term loans to banks in emerging markets as risk weights on

former loans are lower than those on the latter. The Asian experience, however, suggests that short-term cross-border interbank flows are more highly volatile and unstable than longer term bank loans. Moreover, under current standards, loans made by lender banks to highly graded non-financial corporations in their own country have higher risk weights than cross-border short term loans to banks in emerging markets. On top of this, the Basle standards have a number of other serious shortcomings that are well known.

The arduous tasks of reforming the Basle Capital Accord has just started and will take years to accomplish; therefore, not much could have been done before the Asian crisis to change such standards and prevent them from contributing to the crisis. There is now a broad debate on how such standards should be reformed. One view is to have enhanced capital adequacy ratios that address the new and different risks faced by banks in the globalized economy. An alternative, more radical, approach is to move to a system emphasizing less externally imposed standards and rely more on internal banks models and assessment of risks. Value-at-risk models may be a useful approach and many are recommending them as a better alternative to strengthened standards that may easily become obsolete. A third approach would be to rely more on market discipline for bank regulation; for example, it has been suggested (by Calomiris and others) that some subordinated debt may be issued by banks and purchased by other banks at capped interest rates as a way to ensure that financial institutions monitor each other risk activities.

There is a broad debate on which one of these alternative approaches provides the most effective form of supervision and regulation of banks in the globalized environment in which they operate. However, one should suggest some caution in the belief that better “state-of-the-art” risk management techniques by banks, such as value-at-risk (VAR) models will do the job. In fact, the recent experience with Russia and its contagion to Latin America suggests that such risk models paradoxically did not help to prevent a crisis; they instead contributed to transmit contagion rather than prevent it.

The reasons are as follows. First, VAR models break down when the distribution of returns is not normal. If there are fat tails or jump processes associated with extreme realizations (such as big devaluations, defaults and other extreme market events associated with crises), VARs do not provide a good assessment of risk. Second, VARs tend to capture only market risk and are unable to consider well credit risk and transfer risk deriving from the possibility of default and capital controls (for example on forward hedges) such as those imposed by Russia and Malaysia. When such risk factors are included in VARs they lead to bang-bang solutions rather than smooth portfolios shares readjustment: i.e. you go to corners such as dropping out of a large number of emerging markets rather than smoothly adjusting your portfolio. Third, when default or transfer risk occurs, rational contagion may occur. For example, as Russia and Brazil returns are correlated, if you are long on Russia you will short Brazil to diversify risk. So, a collapse of Russia will rationally lead you to dump Brazil. Fourth, if you hedged the exchange rate risk element of a long GKO position with forward dollar positions, sudden capital controls on such forward hedges will lead to losses; state-of-the-art VAR models of risk will then trigger margin calls that will force the leveraged investors to rapidly dump all their portfolio of emerging market investments. More in general, state-of-the-art mark-to-market regulations lead to margin calls whenever there is a sharp drop in asset prices in one emerging market, forcing

leveraged investors to adjust drastically their positions in a wide range of markets, transmitting thus contagion. In this sense, paradoxically traditional bank lending risk assessment where marking to market was not immediately required may have been stabilizing as it allowed banks to postpone margin calls and not force their borrowers to adjust too fast their portfolios.

The lesson is that VARs models may be useful but they should be augmented for “stress testing” to consider the risks faced by banks when extreme market conditions and financial crises create additional risks that traditional models based on a normal distribution of risks cannot assess.

Finally, regulation of market access and standards that restrict international lending activities to large institutions that satisfy restrictive standards may have also helped to limit the risks deriving from the activities of banks in East Asia and emerging markets. They are, however, controversial as emerging economies may perceive them as limiting competition and their ability to develop international financial institutions. It is also not clear how they could have been realistically used to prevent ex-ante the Asian crisis: i.e. could we have realistically prevented Korean banks from operating in the United States once Korea became a member of the OECD club? But such restrictions could certainly be a useful tool to reduce the probability of future crises.

International lender of last resort

Some have argued that, if at the onset of the crisis, we had lent a large amount of money (say \$200 billion) to the crisis countries without conditions, we could have prevented the crisis and/or minimized its severe real consequences. This question is linked to the broader issue of whether we need an international lender of last resort (ILLR) and what should be the characteristics of such a ILLR. The answer to the questions of whether the Asian crisis could have been avoided with a large and powerful ILLR depends a lot on your interpretation of the crisis. If the crisis was due to sheer panic with no role for fundamentals, then a full ILLR would have been the right answer. If, as I believe, fundamentals weaknesses were central factors in the crisis, throwing good money after bad money would have worsened the problem rather than solve it. If some “irrational” factors were an element in the crisis, on top of serious fundamentals, then the right answer is probably the traditional one: large IMF support was warranted but only conditional on the implementation of serious structural and stabilization reforms.

Why do we need a lender of last resort, domestic or international? It is an institution necessary for a successful fractional reserve banking system. A fundamental problem arises when banks maintain only a small percentage of deposits on reserve and utilize the rest to make loans. If many depositors attempt to withdraw their funds at the same time, the bank will quickly run out of cash. This “liquidity problem” has little impact upon healthy banks that can quickly call in their loans at full value. If early liquidation reduces their value, however, bank runs can cause even healthy banks to fail.

In such instances a “lender of last resort” can make emergency loans to the bank, so that it need not liquidate loans to repay depositors. Instead, it can call in its loans gradually (absorbing smaller losses), or attract again depositors in order to pay back the lender of last resort. Deposit insurance also acts to prevent bank runs, albeit through a simpler mechanism. It seeks to prevent runs by reducing the fear of losing deposits in the event of a bank failure.

Both strategies, however, tend to amplify inherent conflicts of interest. Since banks fund

their investments predominantly with depositors' money, they have an incentive to "gamble" with the purchase of excessively risky assets. This "moral hazard" is checked, at least in part, both by the possibility of bankruptcy if investments fail and by the requirement that the bank fund at least a portion of its investments with its own equity capital. Hence requirements, both domestically and internationally, that banks hold at least a certain ratio of capital to loans and a certain ratio of reserves to deposits and other liabilities.

Deposit insurance and lenders of last resort amplify this moral hazard. When depositors are insured, they have no incentive to monitor banks to ensure that they do not make excessively risky loans. If banks have access to a lender of last resort, they can borrow funds in the event that they are caught short of cash. They are thus less likely to go bankrupt as a result of failed investments. Either policy, then, necessitates strong regulation and supervision of banks and strict capital adequacy ratios. Otherwise, incentives for excessively risky lending will be heightened and either the deposit insurer or the lender of last resort will ultimately be stuck with the losses.

Moreover, the desirability of these policies hinges upon the prevalence of bank runs induced by sheer panic rather than unsound banking practices. If the banks have made excessively risky loans that may jeopardize their solvency, support from a lender of last resort or deposit insurance is harmful: it worsens the incentives to take excessive risks. It can also lead to a situation in which excessive risks are taken specifically because a bailout is expected.

Commercial banks operating in an international context present a formally analogous problem. With unrestricted capital markets, they are free to accept deposits from both domestic and foreign residents, in both domestic and foreign currency. Bank runs are arguably even more likely, however, particularly since some of the "deposits" are likely to be highly volatile, short-term, interbank loans from foreign banks. If such loans are suddenly withdrawn, as in the case of Korea in late 1997, the central bank may not have enough foreign exchange reserves to satisfy the demand for foreign currency. Then, the exchange rate may deteriorate, fall, foreign reserves may be rapidly exhausted, or both.

All short-term domestic currency assets of the country can also be potentially converted into foreign currency during an attack, further straining foreign reserves and the exchange rate. In a closed economy, the central bank can respond to a run on the domestic banks by issuing (in principle) an unlimited supply of domestic currency liquidity. In an open economy, on the other hand, the central bank is limited in its ability to respond to a run on the domestic currency by its stock of foreign reserves. If the run on the domestic currency is due to a pure speculative attack and not related to fundamental weaknesses of the country, then an international lender of last resort role for the IMF or some other international provider of liquidity is justified. Otherwise, as in the domestic analogy, healthy banks -- or in the international context, healthy countries -- can fail.

Reality, however, may be more complex. The run on a currency may be due to a serious deterioration of macroeconomic fundamentals (such as large fiscal deficits, a large external imbalance and a real appreciation of the currency). In this case providing international liquidity through a lender of last resort facility may imply throwing good money after bad money. Unconditional provision of international liquidity may also lead - as in a closed economy - to moral hazard; a country with weak fundamentals may be led to continue pursuing improper economic policies, or a country with solid fundamentals might abandon them in the expectation

of a bailout. Finally, investors themselves might exhibit moral hazard, if the expectation of an international bailout led them to invest in a weak country disregarding its inherent risks. In such a case, they could use the international liquidity to take the money and run, i.e. as in a closed economy lender of last resort support may not prevent a bank run if the bank is fundamentally unsound.

The above discussion suggests that there is a delicate tradeoff between the benefits of having an international lender of last resort who can prevent pure speculative runs on a currency and the moral hazard distortions created by such an institution.

Now, let us consider whether a variant of a full fledged ILLR, i.e. the IMF contingent facility recently suggested by the U.S. and approved by the G-7 countries, could have stemmed the Asian crisis. There are two ways in which such facility is in principle different from standard IMF facilities. First, countries would pre-qualify; second, the funds would not be delivered in tranches but in potentially “unlimited quantities” at the discretion of the qualified country subject to unjustified attack. The two questions are then: would Thailand, Korea, Indonesia and Malaysia have qualified for such a facility in 1997? Did they deserve to pre-qualify? The answer to the first question depends on the criteria used to decide who pre-qualifies: if we take the traditional usual suspects (inflation, budget deficits, growth, savings and investment rates) we could have argued that all Asian crisis countries would have qualified. If we consider more structural factors, such as the severe weakness of the financial system, the implicit public liability deriving from the future bailout of the financial system, short-term debt, current account deficits and real appreciation, the answer would have been no. The answer to the second answer is that, if we agree with the above analysis of the fundamental causes of the Asian crisis, it would have been a big mistake to waste a large sum of public money to try to unconditionally rescue these countries: the result would have only been an even bigger bailout of all investors that were trying to get out of these economies. Capital flight would have not been prevented, the official lending would have been lost via a loss of foreign reserves that would have bailed out domestic and foreign investors, the eventual collapse would have not been prevented and the costs of it would have been even larger. Given what we learned in the last year about the structural weaknesses of East Asia, it is very implausible to claim that a big ILLR would have prevented the crisis or would have been a wise tool to use if such facility had existed.

The above analysis has also implications for the scope of the IMF contingency facility that has been recently approved by the G-7. The first question is: how many countries would pre-qualify for such a facility? The likely answer is very few, at most Argentina, Chile, Hungary and Poland under current conditions. Should Brazil pre-qualify for this facility rather than for a traditional IMF package with lots of conditionality? Given the overall macro conditions of Brazil, it would very hard to argue that Brazil should pre-qualify. Brazil is characterized by a large budget deficit, a large current account deficit, a significant real appreciation, a huge amount of short-term public debt, an exchange rate policy that is likely to be unsustainable, a severe loss of foreign reserve with domestic and foreign investors trying another moral hazard play, very high domestic interest rates and sovereign spreads that might undermine any primary fiscal adjustment unless rates fall sharply following a stabilization package. Under such conditions, it is very hard to argue that Brazil should pre-qualify and should have unlimited access to a ILLR fund. A more traditional conditionality package (with fiscal contraction augmented with semi-coercive bailing in of banks and domestic investors and an increase in the rate of currency

crawl) appears more warranted with the only new twist being an early and more rapid disbursement of the funds in the package.

The analysis above therefore implies that such a contingent facilities would have not prevented the Asian crisis, that it should have not been used to try to do that and that it will have a relatively limited role in preventing future crises.

Moral hazard from IMF rescue packages

One dimension of the moral hazard problem is the role played by the IMF rescue packages in East Asia and Russia in 1997-98, in Mexico in 1995 and in Brazil soon. Concern has been expressed about the possibility that IMF-led rescue packages in Asia and Russia may have created a moral hazard. This is because expectations of a bail-out can lead investors and creditors to refrain from effectively monitoring their investment and lending strategies. Also, officials in debtor countries may pursue excessively risky courses of action, leaving a country more vulnerable to sudden shocks to fundamentals and shifts in market sentiment. While the residents of the country hit by a crisis suffer because of the crisis-induced recession, the creditors do not bear a fair share of the burden of the crisis to the extent that they are bailed out.

Unquestionably, the risks of creating moral hazard will be thoroughly assessed during the coming debate on international policy design and crisis prevention in emerging markets. However, several objections should be raised against a simplistic reading of the problem. First, there is no direct evidence that the surge in capital flows to Asia after 1995 was related to expectations of international bailouts in the aftermath of the Mexican rescue package. The second objection regards the issue of who bears the costs of the crisis: a majority of private creditors, especially bond-holders and equity investors, took a huge hit. By the end of 1997, foreign equity investors had nearly lost three quarters of their equity holdings in some Asian markets. It is however true that commercial banks were partially spared: for example, foreign banks operating in Korea demanded public guarantees on bank loans as a precondition for rolling over the existing loans. However, the conditions for these rollovers represented some distribution of the burden between debtors and creditors as short-term loans were converted into medium-term bonds (at interest rates a few hundred basis points above Treasury rates). The third objection argues that the availability of international support in the event of a crisis will not in fact lead countries to adopt unsound policies. In general, countries try to avoid going to the IMF, since such support comes with quite strict conditions and is politically expensive. In this regard, attaching conditions to assistance gives policymakers incentives to do the right thing. Furthermore, casualties of financial crises typically suffer recessions even with IMF programs.

A fourth, and more substantial point, is that moral hazard may be the lesser evil: the alternative response to a crisis -- to leave countries and creditors to sort out their debts on their own -- may have more dramatic and distortionary consequences. The lessons from the interwar period and the 1980s point out that such a strategy requires complex negotiations over a long period of time, during which access to international markets is curtailed and long-term growth drastically reduced. Also, the experience of the 1990s suggests that highly interdependent economies can be subject to the rapid transmission and the 'contagious' spread of speculative waves and financial panic across regions. In this scenario, a delay in taming a local crisis with the appropriate program of international assistance - and the failure to restore market confidence

promptly -- would greatly increase the chances of a systemic chain reaction across countries.

In this regard, the fact that IMF rescue packages are subject to strong conditionality makes such a support very different from a pure unconditional international lender of last resort facility. The issue of moral hazard becomes more delicate when one considers the possibility of setting up an international contingent facility that would provide loans to well-behaved countries that are subject to speculative pressures. As discussed above, in this case it is fundamental to have ex-ante conditionality in the sense of deciding in advance which countries deserve such unconditional lending, so as to avoid the moral hazard deriving from the improper use of funds by countries that have weak economic fundamentals. Designing a facility that provides such lender of last resort liquidity and avoids moral hazard distortions implies a careful assessment of the criteria for this ex-ante conditionality. Conversely, countries that are under pressure because of fundamental weaknesses in their economies should have access to international financial support under traditional conditionality, i.e., the pursuit of macroeconomic adjustment and structural reform.

The role of transparency

There is a broad consensus that lack of transparency played a role in the crisis. There is also agreement on the need for greater transparency and openness both on the part of debtor countries and on the part of official institutions such as the IMF. The report of the G-22 working group on transparency and accountability makes several recommendations. First, the IMF should examine and broadly publicize countries' adherence to international standards of transparency -- of data as well, more broadly, of fiscal and monetary policy. Second, we need international agreements on better accounting and disclosure standards for private financial institutions -- including sound practices for loan evaluation, loan-loss provisioning and credit risk disclosure. Third, the private financial sector must consider appropriate measures for disclosure of international exposures of all types of financial institutions, including hedge funds. Finally, the IMF and other international financial institutions (IFIs) also needs to be more open and transparent. The report recommends several ways to make IFIs more transparent. For example, it recommends that IFIs adopt a presumption in favor of the release of information, except where release might compromise confidentiality. It also called for national authorities supporting the publication by the IMF of Letters of Intent, background papers to Article IV reports (reports following the regular yearly visit by the IMF to a member state), and Public Information Notices following the IMF Executive Board discussion of Article IV reports.

While transparency is important and was certainly lacking before the crisis, alone it will not be enough to prevent another major crisis from occurring. Information in Asia on specific statistics such as the countries' net foreign reserves (including central banks' forward transactions) and the offshore liabilities of the financial and corporate system would have been useful, and its unavailability may have exacerbated the investors' uncertainty. But it is hard to argue that the most important information was hidden. For example, the size of the current account imbalances and the level of short-term foreign currency denominated

liabilities, as well as myriad of other data, were well known and regularly published. For some reason, probably excessive optimism and blindness deriving by the long history of high growth in Asia, until the onset of the crisis investors completely ignored the warning signals coming from a very large number of indicators.

We should not also overestimate how much more information on macro data would have prevented the Asian crisis. Take the case of Thailand. A lot has been made of the fact that investors did not know the extent to which Thailand had mortgaged its foreign reserves through forward sales of its reserves. Suppose, investors would have had this information sooner; then, most likely, the attack on the baht would have occurred even earlier than July. One could counter-argue that such public information would have forced the Thai authorities to drastically tighten interest rates early on to prevent the collapse. But, since they knew the magnitude of their reserves and, in spite of that, they did not sufficiently increase rates to stem the collapse, it is hard to argue that they would have behaved otherwise if such information had been publicly available. A recent example is South Africa where the net foreign reserves of the central bank (including forward contracts) are known and published, a country that still suffered severe speculative attacks against its currency and sharp depreciation in 1998.

Of course, more transparency will help: the design and implementation of disclosure rules, bankruptcy and foreclosure laws, international accounting standards will be very useful but benefits may show up only in the long-run.

Contagion effects and how to prevent them

The spread of market dislocations from one country to the next (within East Asia and from Asia to Russia and from Russia to Latin America and US capital markets) -- the so-called contagion -- has been observed in 1997-98 in the behavior of exchange rates, stock markets, and emerging market sovereign spreads. As with explanations for the crisis itself, some observers interpret this contagion as proof that markets are irrational and prone to unjustified panic. To consider two recent examples, the contagion from Russia to Brazil, Latin America and G-7 countries capital markets has been presented as an example of irrational markets, multiple equilibria and herd behavior. Similarly, the remarkable recovery of world confidence in the last few weeks following a minor 50 basis points easing by the Fed has also been argued to be a proof of multiple equilibria.

What could have been done in 1997 and 1998 to prevent contagion within Asia and from Asia to other regions? The answer depends again on our model of contagion.

In spite of popular explanations of "irrational" transmission of contagion, there are various explanations of contagion based on economic fundamentals. Here are some of the main ones:

Trade Linkages: When a country devalues its currency, the competitive position of its major trading partners worsens hurting their current account.

Competitive Devaluations: Contagion may also spread as a result of competitive devaluations among countries that are competitors in third-country markets. If one country devalues, a

competitor may be tempted to devalue as well to restore its competitiveness.

Other Real and Financial Linkages: Contagion may also depend on other real and financial links. If a country invests in and lends heavily to another, negative economic news in the latter will negatively affect markets in the former.

Common Shocks: Contagion may be due to common shocks or policies. For example, the weakening of the yen has negatively affected some Asian currencies. In addition, falling commodity prices hurt commodity exporter countries. Thus the same economic shock can affect countries as distant as Russia, Mexico, Canada, Australia, New Zealand, Chile, Peru and Argentina.

Imperfect Information and Investor Expectations: Poor economic policies and negative shocks in one country may lead investors to expect that similar policies and shocks will affect other countries. One country's devaluation may signal to investors that other similar countries in the same region have similar problems (such as large budget deficits, large external imbalances, weak foreign reserves and high short-term foreign debt) or that they are not willing to defend their currency aggressively. In such cases, contagion results from a negative revision of expectations derived from the original crisis country leading to attacks on such currencies. The unwillingness of country after country in Asia to defend more aggressively its exchange rate parity with high interest rates in 1997 revealed to investors the policy preference of many East Asian countries.

Against these fundamentals-based explanations stands alternatives based on 'irrational' investors' behavior and sentiment. As volatility increased in financial markets, investors withdrew from many emerging economies without careful distinctions about which had strong fundamentals and which were structurally weak. Phenomena such as financial panic, herd behavior, loss of confidence and a generalized increase in risk aversion may have played some role in the spread of the crisis in 1997-98 within Asia, from Asia to Russia, from Russia to Latin America and other emerging markets and eventually to G-7 capital markets.

Consider now the contagion from Russia to Latin America and US capital markets and its reversal in the last few weeks? Are these two episodes evidence of irrational contagion and herd behavior? The answer is probably not. Consider first why the Russian crisis was transmitted in less than a week to Brazil, Latin America, the rest of emerging markets (with sovereign spreads increasing from 900 basis points to over 1500 basis points) and US capital markets. There were a number of "news" or changes in fundamentals that emerged after the August 17 Russian policy decisions. First, investors realized that there was little money left in the IMF and a greater reluctance to use it. Second, the country that was considered to be the best example of "nuclear" too-big-to-fail was allowed to fail surprising all investors. Third, this country implemented an unexpected and large devaluation and an effective unilateral default on its domestic debt. Fourth, Russia imposed severe capital controls that led to huge extra losses for investors that had used forward contracts to hedge their GKO positions; at the same time Malaysia introduced drastic capital controls. These two capital control episodes led to a concern that many more emerging markets would impose such controls as well. Fifth,

investors realized that in terms of macro conditions (budget deficit, current account deficit, real appreciation, large short-term domestic currency debt, falling reserves, political and policy uncertainty) Brazil looked very similar to Russia. Sixth, as discussed above modern state-of-the-art VAR risk management models forced margin calls and bang-bang corner decisions for holders of emerging market portfolios. Seventh, the Russian default caused large losses for a large number of financial institutions and high leveraged hedge funds while risk management models and the ensuing margin calls exacerbated the rush to dump emerging markets assets. Finally, contagion may also result from the unwinding of moral hazard plays by international investors. The news that Russia – the example of a country deemed too-big-to-fail – would not receive further official assistance given its policy weaknesses and its decision to devalue, default on its debt, and impose exchange controls, shook international investors' confidence and increased their concern that other emerging markets might follow similar policies and/or may not be bailed out. Spreads on emerging market sovereign instruments had not previously priced this possibility and thus the spread of contagion to Brazil and Latin America sovereign spreads was rapid and sharp. Was the increase in spreads excessive given the changed fundamentals? First, note that it reflected more the large increase in investors' risk aversion rather than irrational increase in the subjective probability of default. In fact, such spreads would imply probability one of default on all emerging market instruments only if the investors were risk neutral. As such spreads rose sharply even for countries such as Argentina and Chile where it was unlikely that probability of default were that high, the alternative explanation is that the surge reflected a sharp increase in the aversion towards risk by investors. Whether such risk aversion partly irrational is an issue that is very hard to assess.

If one considers all the above factors, it is hard to argue that sheer panic was behind this episode of contagion. What about the recovery of confidence and fall in spreads since the second half of October? Is this another example of multiple equilibria and herd behavior triggered by a minor change in Fed policy? Again, many fundamentals factors were at work. First, the Fed eased twice, once unexpectedly signaling a strong commitment to prevent a global and US crisis and minimize the risks of a liquidity crisis in the US. Second, Congress eventually passed the \$18 billion IMF refunding legislation opening the way for \$90 billion of new money to the IMF. Third, the commitment to draw a line in the sand on Brazil and design a large rescue package helped to prevent a severe implosion in Latin America. Fourth, the passage of bank reform legislation in Japan and the expectation of a supplementary fiscal package helped the asset markets recovery in Asia. Fifth, the sharp increase in the value of the yen reduced the risks of a China devaluation that would have led to another round of competitive devaluations in Asia; it will also help exports to Japan of other East Asian countries. Sixth, a series of uncoordinated interest rate reductions in US, Japan, Europe and Canada helped to restore liquidity and confidence. Finally, the rescue of LTCM prevented systemic effects that could have resulted from its collapse.

The above analysis suggest that it is unlikely that sheer panic and herd behavior can

explain the episodes of contagion observed in 1997 and 1998. These episode also suggests that, given the increasing integration of international financial markets, there are not easy ways to prevent the type of financial contagion observed in the fall of 1998.

The choice of the exchange rate regime

What role did the exchange rate regime play in the onset of the Asian crisis? And would a different exchange rate regime made a difference? These are difficult questions with no easy answers. There is a long-standing question about what exchange rate regime can minimize financial turmoil in a world of volatile capital flows. First, note that countries with relatively different regimes (Korea, Thailand, Malaysia and Indonesia) were all subject to a currency crisis while countries that came relatively unscathed out of the crisis (Hong Kong, Singapore, Taiwan, China, Philippines) has also a wide variety of exchange rate systems.

All the four crisis countries had systems of semi-fixed or managed exchange rates but there were some differences. Thailand and Malaysia had a system closer to a stronger peg while Korea and Indonesia had a system closer to a managed crawling peg. As a result, before the crisis significant real appreciation occurred in Thailand and Malaysia but much less so in Korea and Indonesia. Similarly countries that survived had very different regimes: a currency board in Hong Kong, fixed rates in China, a managed float in the Philippines and a switch from a managed regimes to a stronger float after the speculative attack in Taiwan and Singapore.

Some have argued that the Asian countries made a mistake in pegging their currencies to a basket where the US dollar weight was too large (effectively about 80-90%). One reply is that each country was giving only a small formal weight to the U.S. dollar in their basket (about 30%) but since all their regional trading partners were also tracking partially the U.S. dollar, the effective weight of the dollar became much larger than its formal one in the basket. However, such bias could have been fixed by giving a higher explicit weight to the yen or to the European currencies. A different explanation of the dollar tracking policy is that, when the dollar started to appreciate against the yen in mid-1995, being tied to the dollar implied very cheap yen borrowing costs for East Asian borrowing countries. With Euro-yen rates being nominally very low, and their currencies being tied to the US dollar and appreciating relative to the yen, the 'carry-trade' was extremely profitable and implied very large negative yen borrowing rates for East Asian banks and corporations. Indeed, the amount of borrowing from Japanese financial institutions was massive. However, this appreciation against the yen, together with the terms of trade shock that buffeted East Asia in 1996 ended up undermining the competitiveness of these countries and resulted in growing current account imbalances. Some have also questioned whether the U.S. policy of a strong dollar might have had the unintended side consequence of partially undermining the competitiveness of the East Asian currencies relative to Japan.

The above preliminary look at the data suggests that, in general, it is hard to argue that a particular exchange rate regime is a panacea, or even that is preferable to others for all countries at all times. Poor economic policies and structural problems will eventually lead to a

fall in the value of a currency regardless of whether the exchange rate regime adopted by a country is fixed, flexible or an hybrid. Furthermore, the choice of regime should depend on the attributes of the country in question and the circumstances it faces at a particular stage in its history.

However, the choice of exchange rate regime may indirectly affect the likelihood of a currency and financial crisis. First, note that all three episodes of currency crisis in the 1990s (ERM in 1992–93, Mexico in 1994–95 and Asia in 1997–98) occurred under a regime of semi-fixed exchange rates. Also, evidence from a broad sample of episodes of large real appreciations suggests that almost always such real appreciation is undone through a large sharp nominal depreciation.

Second, note that semi-fixed exchange rate regimes can be associated with real currency appreciation that may worsen a current account problem. While, as the experiences of Argentina, Brazil, Mexico and Israel suggest, a fixed rate may have a useful nominal anchor function, protracted fixed rates in the aftermath of an exchange rate-based stabilization may lead to real appreciation, worsening of the trade balance and eventually undermine the fixed rate parity. Exchange rate-based stabilizations may be more successful if the initial fixed rate anchor regime is followed by a crawling peg regime where the exchange rate is allowed to depreciate on the basis of the inflation differential between the domestic economy and the world. Such a policy may help prevent real appreciation and external imbalances that eventually undermine rigid fixed rate regimes. Some of the East Asian episodes are consistent with the view that fixed exchange rate exacerbated the tendency to real appreciation and increased the current account imbalance.

Third, in Asia fixed exchange rates may have reflected a symptom of a broader moral hazard problem as fixed rates may have lead banks and firms to have a lower cost of foreign capital than would have been optimal and led them to believe that they faced only a one-sided exchange rate risk. In this regard, more flexible exchange rates before the crisis would have explicitly introduced two-way risk and may have prevented the accumulation of unhedged foreign currency liabilities. Such regimes also allow for more macroeconomic policy flexibility than do more rigid exchange rate regimes, and thus can facilitate a country's adjustment to external shocks, such as the swings in capital flows and terms of trade shocks that have been factors in the Asian crisis.

Fourth, strong fixed exchange rate regimes can be credible and stable if they are backed by consistent macroeconomic policies such as fiscal and monetary restraint and strong and well-supervised financial systems. However, all too often systems of fixed exchange rates are not credible in that the underlying macroeconomic conditions, macro policies and financial sector weaknesses are not consistent with the maintenance of a pegged currency.

Fifth, many but not all episodes of banking crises are associated with currency crises, the "twin crises" phenomenon. This can be partly interpreted as regimes of fixed exchange rates contributing to the vulnerabilities of the financial system that eventually cause both a banking and currency crisis.

The above arguments and experience suggests that, unless a country can credibly commit to irrevocably fixed exchange rates, regimes with a greater degree of nominal and real exchange rate flexibility may be less prone to currency crises, massive capital outflows, and financial crashes than regimes where exchange rate are fixed but the underlying economic fundamentals do not render such a peg fully credible and sustainable.

One should also observe that, in East Asia, the regimes of fixed or highly managed exchange rate, forced the monetary authorities to follow policies of sterilized intervention in the face of the surge of capital inflows. Such a policy, however, implied high interest rates that further exacerbated the inflow. It is usually argued that the alternative policies of letting the nominal exchange rate appreciate or have non-sterilized intervention with fixed rates would have caused a real appreciation (and a consequent worsening of the current account) via either a nominal appreciation in the former case or an overheating-driven higher inflation in the later regime. While that may be correct, the correct response to such a surge in inflows may have been to stem it via Chilean style of controls on inflows that would have affected the composition, if not the absolute amount, of such inflows.

More importantly for Asia and future financial crises, different exchange rate regimes are capable to different degrees of addressing problems of financial sector instability and rapid reversals of capital flows. For example, credible currency boards may be able to prevent a currency crisis but they do not generally allow the monetary authority to perform its function of lender of last resort in the presence of a bank run. This means that a strong financial system with well supervised banks is a necessary condition for a credible currency board. The lack of a lender of last resort function in a currency board is exacerbated when a fraction of the liabilities of the banking system is in foreign currency. Flexibility in the form of escape clauses that allow some lender of last resort role even in a currency board – such as the easing of reserve requirement during episodes of severe capital flight – may prevent severe credit crunch if a speculative attack occurs but at the cost of the credibility of such a system. The use of contingent credit facilities that allow the central bank to borrow reserves during period of speculative pressure may also help.

Conversely, systems of pegged but adjustable exchange rate may allow more room for a lender of last resort role for the government but at the cost of undermining the commitment to a fixed exchange rate. Also, the presence of a large stock of short-term foreign currency-denominated liabilities in the banking system is very problematic for all regimes of exchange rate fixity. As the Asian crises suggests, in a fixed exchange rate regime, domestic financial obligations are potential claims on a country's hard currency reserves; lack of credibility can rapidly lead to capital flight, the depletion of such reserves and the eventual collapse of a peg. The possibility of bad multiple equilibria with attacks on a currency not based on fundamentals is the largest in all regimes of fixed exchange rates, including currency boards. If suddenly foreign banks decide not to roll over their loans, foreign investors try to liquidate domestic assets and domestic investors liquidate liquid assets to acquire foreign ones, even very large stocks of foreign reserves of a central bank can be depleted and a

currency collapse occur. This is the biggest Achilles heel of all fixed rate regimes.

Regimes of more exchange rate flexibility instead allow a stronger lender of last resort function for the monetary authorities at the cost of potentially greater exchange rate movements. However, even totally flexible exchange rate regime may not be able to prevent a serious financial crisis associated with a rapid reversal of capital flows. For example, the sudden flight of domestic and foreign residents from domestic assets leads to a sharp depreciation and sharp asset prices fall that may contribute to a financial crisis. Also, if there is a large stock of unhedged foreign currency deposits in the banking system, sudden capital flow reversals in the form of no rollover of short term loans can lead to a financial crisis even in a flexible exchange regime. The no rollover may force banks to liquidate loans and assets and cause financial distress.

Moreover, in the above episodes of capital flight with flexible rates, while foreign reserve are not lost, the depreciation of the currency can be very rapid and lead to financial distress if there is a large stock of foreign currency denominated debt. Also, without a nominal anchor the degree of depreciation may get out of hand and not be determined by fundamentals. Moreover, unlike the U.S., no emerging market has a pure float where there is no feedback from exchange rates to the setting of monetary policy via short term interest rates. This means that the attempt to slow the rate of currency fall in a dirty float may still lead to very high nominal and real interest rates (see Mexico in the summer/fall of 1998) leading to severe financial distress for banks, firms and the economy. The above observation, as well as the experience of Korea and other Asian countries, suggest that financial crises caused by sudden reversals of capital flows and no rollover of interbank loans, can cause a financial crisis even when exchange rates are allowed to float.

In this sense, all exchange rate regimes, floating, managed floating, fixed and currency board are vulnerable to a financial and banking crisis if the financial system is weak in the first place and if sudden reversals of capital flows occur.

The recent Mexican experience is a case in point. On one side, one can argue that the fact that Mexico in 1998 was on a float prevented a major crisis unlike 1994. In fact, the peso has fallen in recent months by over 20% without causing the panic and crisis that one observed when the collapse of the peso peg occurred in 1994. This would prove that, unlike conventional wisdom to the contrary, even small open economies can afford to have a regime of flexible exchange rate. On the other side, even with a float Mexico has not been sheltered from the crisis. First, nominal interest rates are very high leading to an economic slowdown. Second, the banking system is again in very fragile conditions, three years after a major and very costly bailout in 1994-95.

Lessons for Brazil

While the above analysis suggests that, all in all, a more flexible exchange rate regime may help to reduce the vulnerability of fixed and semi-fixed regimes, there is a serious problem of the exit strategy for countries that have been for too long on the wrong peg parity.

Mexico in 1994, Italy and UK in 1992, Thailand in 1997 and Russia in 1998 could have prevented a currency crisis if they had gone off the peg way before the crisis, say one or two years earlier. However, once a pegged currency comes under pressure, the probability that the country may decide to go off the peg will certainly increase the chances that a collapse would occur. This is, for example, the bind in which Brazil is right now. Brazil should have probably decided to have a faster peg a while ago to prevent the current built-up real appreciation; but a step devaluation now or a sharp increase in the rate of crawl may lead to a collapse of the currency as confidence may be shattered. So, the lessons from ERM, Mexico, East Asia, Russia and Brazil now is to avoid early on a peg or crawl that is not consistent and credible. Better to be on a more flexible float early on, or to move to a credible currency board with dollarization at the other extreme.

So, is there no exit strategy? This is not necessarily the case. In the case of Brazil, one could argue that markets have already priced in some devaluation and even some restructuring (with haircut) of the domestic debt as long as such restructuring is not predatory (i.e. not Russia again). In that case, a one-step modest devaluation and/or an increase in the rate of crawl may give more credibility to an IMF package centered around a fiscal contraction. In fact, if devaluation expectations remain after the IMF package, domestic interest rates may not fall and high real interest rates would undermine any primary adjustment that Brazil may implement. Even if domestic rates fall from the current highs (50%) closer to 20-25%, the fiscal arithmetic of the interest on the public debt will undermine the credibility of the Brazilian package in the same way in which high interest rates contributed to undermine the credibility of the Russian package. Also, if domestic and foreign investors are not bailed in, we could have Russia all over again. In fact, domestic and foreign investors will take the chance provided by the \$40b package to take the money and run. After all, given all the risks and uncertainties in Brazil, a rational investor will decide that it is better to cash in the 50% returns of the last few months, get out of reals and into dollars and see what happens in the next few months. Also, evidence suggests that US banks not only are not been bailed in but they are actively reducing their positions in Brazil. The biggest United States banks in Brazil have sharply reduced their exposure to Brazil between June and the end of September Chase has \$3.8 billion in exposure to Brazil, down from \$4.3 billion at the end of June; J. P. Morgan has \$2.2 billion, down from \$4 billion; BankAmerica has \$3.3 billion, down from \$3.9 billion, and BankBoston has less than \$1 billion, down from \$1.7 billion. Citigroup has \$4.4 billion in Brazilian exposure in June but does not have more current figures. US banks are clearly bailing themselves out at the expense of Brazil reserves and soon IMF ones.

The above analysis suggests that a large IMF package for Brazil with only the promise of a major fiscal adjustment may fail. The other element of the package will need to be: some increase in the rate of crawl; a bail-in of the US and European banks with a commitment to roll over loans and maintain the same exposure they had in 1997; a bail-in of domestic holders of public bonds. As a large fraction of such bonds are held by the Brazilian banks, moral suasion

and/or more coercive tools to ensure roll-over of such positions will have to be implemented. Moreover, current yield on public bonds already include a large expectation and premium for restructuring and default. A consolidation of the debt that would imply a haircut reducing the return to such investments to a real interest rate that is fair and reasonable (say 10%) would only be fair. No economy and no fiscal system can survive with a short-term public debt of \$200 billion at real interest rates of 50%. Finally, a faster rate of crawl cum or without a small one-step devaluation may also help to restore the external balance and give credibility to the package. The above strategy is not without risks but a IMF package based only on the fiscal adjustment may not very credible either and may not prevent a dramatic collapse.

Involving the private sector in burden sharing

The above discussion about Brazil has already suggested the importance and problems involved in bailing in investors and ensuring that the private sector is involved in sharing the burden of the adjustment. This issue is very complex and has many aspects that are relevant for what happened in East Asia and for the future.

A first consideration is that one of the known weaknesses of Asia - the absence of well developed bonds markets - and the reliance on banking intermediation was a mixed blessing. In fact, on one side one would certainly want to develop strong and liquid securities markets in Asia where government and corporations can issue bonds and equity rather than rely only on shorter term and volatile bank loans. On the other side, given that the crisis did occur, the prevalence of banking intermediation rather than bonds made the involvement of the international investors in the burden sharing more easy. In Korea, the fact that a limited number of domestic and international banks were involved made the rollover of these loans (or better their restructuring into medium term bonds) much more easy. Historically, in the 1970s and 1980s, bank loans accounted for about two thirds of net capital flows to developing economies. In the 1990s, instead, bonds, and portfolio equity and foreign direct investment became much more prominent than bank lending. This massive switch from bank lending to securitized flows has brought new challenges to the management of financial crises. When banks accounted for the majority of international capital flows, it was easier to coordinate the actions of a smaller number of financial institutions in order to restructure and/or reduce debt burdens. With the proliferation of creditor institutions and instruments and the growth of international bond markets in the 1990s, the problem of coordinating the actions of creditors during a crisis has become more difficult.

One of the recommendations of the G-22 reports - already present in the Rey Report - was to introduce collective action clauses in bond contracts. These clauses should provide for: (i) collective representation of creditors; (ii) majority action to alter the payment terms of the contract; and (iii) sharing of payments among creditors. While these clauses would have not prevented the Asian debt crisis, they could have helped its management. If a large fraction of lending to Asia had been in the form of bonds rather than bank loans and if such collective action clauses had been introduced, the crisis deriving from the sudden reversal of flows following the no-rollover of banks loans would have been prevented and a more orderly workout of debts could have been feasible. One could suggest that such collective action clauses should be first introduced in the AGRF (Asian Growth and Recovery Fund) bonds to be issued to finance the

interest cost of bank recapitalization in Asia. Also, given the growing importance of bonds relative to bank loans in lending to emerging markets, the introduction of such clauses in future bonds contracts should be highly recommended.

A second issue regards whether international investors were bailed in or bailed out in Asia and what role did moral hazard play in their investment decisions. While a majority of private creditors, especially bond-holders and equity investors, took a huge hit, commercial banks who lent to Asian banks were partially spared: for example, foreign banks demanded and received public guarantees on bank loans as a precondition for rolling over the existing loans or turning them into medium-term bonds. The case of interbank cross-border loans is the clearest case where moral hazard was at work and foreign investors were bailed out.

While the G-22 report may recommend that the safety net of public guarantees for the banking system and deposit insurance schemes should not cover the foreign cross-border liabilities of the banking system, there is a serious issue of whether such policy could be credibly implemented. In principle, the safety net of deposit insurance should cover only small domestic depositors, the only agents that have high costs in monitoring what the banks are doing. Large depositors and international banks that lend to emerging market banks should not be covered by such guarantees, either ex-ante or ex-post. However, over and over again, such guarantees have emerged, most often ex-post, leading to a situation where international cross-border bank lending decisions are not carefully assessed for the risks that they imply. Imposing a different regime may not be easy and credible. Note that Chile in 1982 made the argument that international loans to domestic banks were a private sector liability. The result was that international banks threatened the immediate cutoff of all trade loans forcing the government to back off and fully guarantee such foreign liabilities of the banks. This is a perverse regime where, over and over again, international banks make lending decisions to emerging market banks without due consideration to the risks involved and then they get bailed out ex-post. Recommendations for a different practice are not going to be enough in the next crisis, as in Asia all loans were guaranteed ex-post. One will need internationally agreed clauses and binding rules that enforce the principle that such liabilities should not be guaranteed, either ex-ante or ex-post. The treatment of international cross-border bank liabilities appears as the most serious and perverse source of international moral hazard (conversely, the implicit and explicit bailout guarantees of domestic banks by governments are the biggest domestic source of moral hazard). International banks lent to emerging market banks under the view that they would be either directly bailed by domestic banks or indirectly via the IMF rescue packages. The evidence presented above that the massive net banks outflows from East Asia (\$29 billion in 1997 and \$31 billion in 1998) were covered by the inflows of official support matches this banks' bailout view.

A third issue is that the East Asian experience in general suggests that orderly workouts, bailing in of investors, coordination of creditors, consultation between the official sector and creditors and other similar recommendation in the G-22 reports may all be necessary but should be implemented before the crisis occurs rather than after currencies have started to collapse, reserves have been lost and panic has been triggered. If the rollover of the Korean bank debt had occurred in November 1997 rather than in January 1998, the near default of Korea at the end of 1997, the currency collapse and the panic that emerged in December could have been controlled better. Some temporary debt payment suspensions and cooperative solutions to standstill conditions early on in the crisis may have been useful in the Asian episodes and prevented the

panic that was eventually experienced. Similarly, a more cooperative and less unilateral and confiscatory approach to the standstill in Russia as well as refrain from capital controls (that froze the commercial banks foreign contracts) would have been necessary right at the time of the first July package to prevent the rush to the door that occurred until August 17. Such early cooperative workout would have also led to a better outcome of the restructuring of the domestic debt that was effectively unavoidable already in July given the circumstances. In Russia, we did not see an orderly and cooperative bail-in of investors. Instead, first in July there was no attempt to design an explicit bail-in and whoever could get out, thus triggering an unsustainable reserve loss. Then, in August the restructuring was imposed unilaterally at punitive default rates leading to a collapse of the entire plan. One would hope that a more cooperative outcome will be designed in advance in the Brazilian case.

Finally, would private contingent credit facilities as those in Argentina have helped to prevent or moderate the Asian crisis? First, one could observe that many countries in Asia would not and should have not qualified for such credit lines if the lenders had carefully assessed the underlying financial weaknesses of these countries. Second, such credit lines may help at the margin but their size would have been and will be in the future relatively small relative to the short-term liabilities of the typical emerging market. In other terms, the few countries who deserve them and can get them (say Argentina) may need them the least while those who may need them the most (countries under attack because of weak fundamentals) may not be able to qualify for them at reasonable interest rates.

Role of foreign banks

One issue that has importance for the Asian crisis and future crises is whether a substantial ownership by foreign banks of the domestic financial system could have beneficial effects for a country and contribute to prevent currency and financial crises. In the case of East Asia, most of the international banking lending was made from BIS country banks to East Asian banks who in turn lend to domestic corporations. Even in the case of Indonesia, where there was a large amount of direct lending from international banks directly to corporations, such lending was mostly offshore; for the most part, foreign banks were not operating within Indonesia borrowing and lending onshore. Conversely, it has been argued that a strong direct ownership of a fraction of the domestic financial system by foreign banks in countries such as Argentina and, in a smaller measures, in other Latin American countries, may be a stabilizing factor.

Apart from bringing competition, efficiency, new managerial skills and banking know-how, international banks may provide other benefits in a period of crisis. First, if a foreign bank just lends to an emerging market bank, it does not have any stake in the loans that the domestic bank does in turn to domestic firms. If expectation of a crisis increase, it may be rational for a foreign bank not to roll over its loans to the domestic bank even if this decision may trigger a financial crisis by running down foreign reserves and/or forcing the local bank to call in loans and trigger financial distress for corporations. If, instead, a foreign bank would operate locally, it would have more at stake and be less likely to call in loans and repatriate home its liabilities; in fact, calling in loans would trigger a crisis harming the bank directly. Second, since one cannot always trust the emerging markets regulators ability to properly supervise and regulate their domestic banks, the presence of foreign banks could mitigate such a problem. Foreign banks may behave less on the basis of relationship banking and more arms-length; they

may be subject to less pressure to provide directed lending; and strong regulations by home country (say US) regulators of the activities of their home-based banks may indirectly provide regulation of the activities of their foreign-based branches. Third, a safety net in the form of lender of last resort role for an emerging market central bank may be less necessary if foreign owned banks can rely on home countries funds to cover sudden and rapid deposit withdrawals observed during episodes of bank panic. Given the above arguments, some have claimed that, at one extreme, a large fraction of emerging markets banking system should be controlled by foreign banks to ensure competition, efficiency and stability. The examples of Hong Kong and Singapore where a large fraction of the banking system is foreign owned may be cases in favor of such a view.

Are there any objections to such a view? One is, of course, a question of sovereignty. But why should countries care about who owns their banks more than they care about who owns their factories? The reason is that banks have been traditionally used for political purposes, directed lending, as sources of revenues via financial repression. This is why governments are wary of letting go of domestic banks. While these arguments explain positively why governments do not want a foreign ownership of domestic banks, they provide a stronger normative argument in favor of such foreign ownership. A second argument is that, it is not obvious that foreign banks would behave properly and avoid excessive gambles. A reference is the case of Chile in the early 1980s where the Chileans subsidiaries of foreign banks were also involved in very risky loans and excessive credit creation. A third argument is that, if the financial system is owned by a small number of foreign banks, it is not obvious that such banks would not request ex-post the lender of last resort support of the local central bank if economic shocks or poor lending decisions have led to bad loans and financial distress in the banking system. Such foreign banks may have the power to impose ex-post liquidity and other forms of support such as a government bail-out of their bad loans.

The above objections may not be very strong and the arguments in favor of foreign ownership of domestic banks in emerging market may have more validity. However, more thinking will have to be put on these questions. Do foreign owned banks in emerging markets need a domestic safety net (lender of last resort and deposit insurance)? Will they expect it, require it and get it ex-post if they experience financial distress? Should the home country rather than the host country regulator provide regulation and lender of last resort support? These are complex questions with no easy answers.

The role of IMF policies in the crisis

The severity of the economic crisis in East Asia has led some to challenge the IMF packages and question their wisdom from many different directions. Did the IMF make mistakes in Asia and did its role exacerbate the crisis?

First, we have already discussed above whether the IMF could and should have played a international lender of last resort role in Asia and provided massive and unconditional liquidity at the onset of the crisis. The answer we gave above was no as these countries suffered of structural problems and should not have pre-qualified for unconditional support.

Second, the breadth of the restructuring efforts required by the IMF raised a concern that the Fund has been playing an excessively intrusive role in domestic affairs. The argument has been made that, by including in the programs a number of structural elements, the IMF was

moving beyond its traditional macro-adjustment related areas of competence, historically confined to monetary and fiscal policy. However, given the extent to which the Asian meltdown was attributable to structural problems rather than the traditional macroeconomic imbalances, an effective rescue strategy had to address the issues at the very core of the crisis. IMF lending to the Asian region would have served no purpose if the weaknesses of the financial sector (ranging from poor bank supervision and regulation to murky relations among governments, banks and corporations) were not removed by appropriate structural reforms. Similarly, the insistence on good governance and the avoidance of 'crony capitalism' represented a precondition to avoid future crises, as halfhearted reform efforts would not help to re-establish market confidence. As careful analyses suggest that the origin of the Asian crisis was not due to irrational speculation and panic of investors, but rather to structural weaknesses in these economies that emerged in full force in 1997, it was essential to address such structural problems in order to solve the crisis.

Third, some have argued that the high interest rates prescribed by the IMF to limit currency depreciation had severe repercussions on real growth in economies of the Asian countries. The argument, however, has been challenged on a key point. Loose monetary policies in the early stages of a currency crisis exacerbate the extent of the depreciation, which in turn increases the burden of foreign currency-denominated liabilities issued by banks and firms. In the presence of large external net liabilities, loose monetary policies could actually produce financial distress and bankruptcies, setting in motion the same vicious circle described above. A loose monetary policy would of course also ignite inflationary expectations as the experience of Indonesia illustrates. One could argue that the severity of the Asian crisis was in part the result of the unwillingness of the governments to undertake the appropriate restrictive measures early on and at the right time. The low interest rate policies in Thailand and Malaysia after the runs on the Thai baht suggests why the crisis worsened over the fall of 1997. It has been argued that a policy of temporary monetary tightness and high interest rates could have either prevented the currency crisis or moderated the degree of currency devaluation. The fact that countries in the region waited for too long before increasing interest rates explains why the currencies went into a downward spin. On the other hand, it has been suggested that the reason why the policy makers were weary of increasing interest rates was that the severe structural weakness of the financial and corporate sector would have caused financial distress and a real economic contraction under a policy of high interest rates. In general, the current available evidence on whether temporarily high interest rates can prevent a currency crisis is mixed.

Fourth, some have argued that the fiscal policy requirements included in the IMF plans were unnecessarily strict. At the onset of the crisis, the Asian countries under attack were running low budget deficits or fiscal surpluses, and were characterized by relatively low ratios of public debt to GDP. However, loose fiscal policies at the onset of the crisis would have raised doubts about the policy-makers' commitment to reduce the outstanding current account imbalances, jeopardizing the credibility of their plans. Also, while fiscal deficits and debt were typically low before the crisis, in several Asian countries the projected fiscal costs of post-crisis financial bail-outs are estimated to be in the range of 20 to 40% of GDP. As these extra public liabilities translate into a permanent increase in the interest bill paid by Asian governments of 2-5% of GDP per year, there is an argument that fiscal balances must be appropriately adjusted. In this respect, the IMF fiscal plans, on a country-by-country basis, were targeted to raise the necessary revenues to meet these extra interest costs. When the recessions soon materialized in

the course of 1998, the IMF progressively loosened its fiscal conditions to allow for cyclically-adjusted fiscal deficits. It is fair to acknowledge that the year's revelations about the size and depth of the recessionary effects of the crisis surprised not only the Asian governments and the IMF board, but the vast majority of country analysts as well. Still, the IMF may have been a bit slow in realizing the possible effects of fiscal retrenchment and in easing its fiscal requirements.

Fifth, some authors have charged that IMF plans to close insolvent banks led to runs on financially healthy banks, especially in Indonesia. This argument is not entirely convincing. First, local authorities were at fault if measures to prevent bank runs -- such as "incentive-compatible" deposit insurance schemes -- were not in place in Indonesia. Moreover, when a run occurred, President Suharto's government bore responsibility for failing to enact promised reforms in exchange for the \$40 billion international rescue effort. In support of this view is the fact that the requirements imposed on Indonesia by the IMF, including the closing of insolvent banks, were similar to those demanded of Thailand and Korea; yet, neither country experienced bank runs of the same magnitude as those hitting Indonesia. Also, it can be argued that in the Indonesian case, more rather than less should have been done: as early as September 1997, widely circulated documents listed more than 16 Indonesian banks experiencing financial difficulties. Instead, the prompt reopening of a closed bank owned by one of President Suharto's sons diminished the public's confidence in the rescue plan as a whole. While the above arguments are correct, the IMF may have not fully realized the consequences of bank closing in a situation in which there were only implicit deposit guarantees and great uncertainty about which banks were sound and which were not.

Conclusion

The analysis in this paper suggests that, given the fundamental weaknesses of the East Asian economies, some economic crisis in the region was probably unavoidable by 1997. However, some of the policy reforms recommended in the G-22 reports on international financial architecture, different macroeconomic and financial policies before the crisis could have contributed to dampen the ensuing 'panic', moderate the severe real effects of the crisis and limit its contagious spread within the region and across the world.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-NOV-1998 10:28:53.00

SUBJECT: Re: travel budget

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

READ:UNKNOWN

TEXT:

That's good news. Does reprogramming require permission of the White House Administrative people or can we just do it without permission?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-NOV-1998 10:11:09.00

SUBJECT: travel budget

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

READ:UNKNOWN

TEXT:

As you know, in the past CEA and other EOP agencies were not allowed to move money from another part of their budget to their travel budget without requesting a formal re-programming from Congress. For FY 99, there was NO language that restricted the use of other funds on travel. For this reason, in FY99 CEA can, without a formal request to Congress, use up to \$50,000 from other parts of the budget to fund travel. Last year, after bonuses were given out, CEA had roughly \$40,000 left over. These funds mostly were used to buy equipment.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-NOV-1998 17:53:19.00

SUBJECT: Re: A small favor

TO: Raymond P. Guiteras (CN=Raymond P. Guiteras/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

I would be happy to sign some ERPs. Come by any time tomorrow.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-NOV-1998 10:45:21.00

SUBJECT: Re: travel budget

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

TEXT:

According to Cathy, we do not need to get the WH Office of
Administration's sign-off, as long as it is less than \$50,000.

Janet L. Yellen
11/09/98 10:26:43 AM
Record Type: Record

To: Michele Jolin/CEA/EOP
cc:
Subject: Re: travel budget

That's good news. Does reprogramming require permission of the White
House Administrative people or can we just do it without permission?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Robert_F._Schoeni@cea.eop.gov (Robert_F._Schoeni@cea.eop.gov [UNKNOWN])

CREATION DATE/TIME:12-NOV-1998 14:33:34.00

SUBJECT: Revised Labor Chapter

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

READ:UNKNOWN

CC: Cordelia W. Reimers (CN=Cordelia W. Reimers/OU=CEA/O=EOP [CEA])

READ:UNKNOWN

TEXT:

Janet, we have made a number of changes to the labor chapter since we gave it to you on Tuesday. If you are going to read the draft before you leave the office tomorrow, let us know and we will give you a copy of the latest version. Otherwise, we will continue to make additional changes up until COB tomorrow.

Thanks.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-NOV-1998 17:26:10.00

SUBJECT: Mtg w/ new CEQ Chair

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

READ:UNKNOWN

TEXT:

Do you have any interest in having lunch or meeting with the new head of the CEQ George Frampton? You may not be interested... but I thought since he's new you might want to chat with him -- maybe about climate change. I haven't raised this w/ CEQ... but if you are interested, I will ask Alice to call and set it up.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Robert F. Schoeni (CN=Robert F. Schoeni/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:12-NOV-1998 14:30:17.00

SUBJECT: Revised Labor Chapter

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

READ:UNKNOWN

CC: Cordelia_W._Reimers@cea.eop.gov (Cordelia_W._Reimers@cea.eop.gov [UNKNOWN])

READ:UNKNOWN

TEXT:

Janet, we have made a number of changes to the labor chapter since we gave it to you on Tuesday. If you are going to read the draft before you leave the office tomorrow, let us know and we will give you a copy of the latest version. Otherwise, we will continue to make additional changes up until COB tomorrow.

Thanks.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-NOV-1998 14:13:59.00

SUBJECT: Social Security 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:

Jeff and I had lunch today, and I thought I'd pass on his agenda for staff work over the next several weeks:

1. analysis of traditional reform options (substitutes or complements for the 3 common reforms we've been using)
2. analysis of sweeteners for Dems (widows' benefits, etc.; Corky is involved with this)
3. annuities (I'll give you our latest draft on this topic later today)
4. summary description of IA workability (based largely on work done by the group previously)
5. fiscal effects (continued attention by Jeff and me)
6. guarantees in IAs
7. mechanics of taking new funding off-budget (I suggested this item to him based on your concerns)

If you have specific thoughts on these issues, or would like others pursued, let me know. Thanks again for getting me into this morning's meeting!

Doug

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-NOV-1998 10:37:45.00

SUBJECT: OECD regulatory reform update

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

READ:UNKNOWN

TEXT:

Hi Janet,

Bob Winship sent a fax explaining how the Secretariat wants to push back to March the country reviews of regulatory reform for the US and Netherlands.

I called him, and he explained several things that were enlightening to me:

1. this is distinct from the EDRC
2. it originally was going to occur in December
3. mainly other divisions such as OMB, USTR, etc. rather than CEA would likely be involved
4. Bob thought the move was a good idea

(We also talked about CEA's plans for March, with Jeff attending WP-3, Steve and either Jeff or Becky maybe attending the EDRC review the next day, and then Becky attending the WP-1 the day after that.)

So I told Bob I'd mention this all to you, but I was pretty sure this was OK.

Best,

-Ryan

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:13-NOV-1998 18:06:56.00

SUBJECT: Negative Japanese Interest rates

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

READ:UNKNOWN

TEXT:

Janet et al.

Nouriel and I decided to look a little further into the negative interest rates issue. From what I have been able to dig up today, this is the current status of our understanding. Might be useful background for your trip.

This is also a work in progress. I am still thinking through the issue of constraints on the pricing of swaps -- many would have thought that an obvious constraint was that the basis could not exceed the f/x libor rate, but the markets have recently disproven that proposition in giving us negative yen rates for swaps. Note also, I think it is this rate that has gone negative. I can't imagine that pure yen deposits have also begun to fetch negative rates, since Japanese banks can always just leave them with the Central Bank. The difference between yen swaps and yen deposits is beyond the reach of most readers of even the FT, though, and it's a great deal more news worthy to say "negative deposit rates."

Let me know if you would like me to continue working on this. It is very interesting, and has profound implications of which I'm sure I have just begun to scratch the surface.

The Mysteries of Negative Interest Rates and Central Bank Provision of Dollar Loans

The emergence of negative interest rates in the interbank markets seems anomalous. It is important to understand, however, the processes which have brought it about. According to a Morgan Stanley report, recent events have been &driven largely by distortions generated by the difficulties that Japanese institutions are facing in obtaining year-end financing for their dollar positions.⁸ Unfortunately, I have been unable to get clarification about exactly what type of &financing⁸ is required (assets, liabilities, or both) and what regulations and/or economic factors are driving this requirement.

Taking it as a given that Japanese banks need dollars, however, the emergence of the negative rates follows directly from many other, less mysterious aspects of the current Japanese situation. First of all, the Japanese Premium is back, that is the premium over *libor* Japanese institutions must pay. This is a straightforward credit or counter-party risk premium owing to the shaky status of the entire Japanese banking industry. So, Japanese banks have as one option borrowing dollars outright in the interbank market at *\$libor* plus one hundred basis points.

Given concerns over their creditworthiness, it stands to reason that posting some collateral might be necessary in order to obtain more favorable terms. In a sense, this is exactly what a swap accomplishes. Japanese banks swap yen for dollars at current exchange rates, make dollar interest payments and receive yen interest payments, and agree to swap back the principal (at the same exchange rate) at some point in the future. The terms of the swap are also straightforward -- Japanese banks pay *\$libor* and receive yen *libor* plus the basis on the swap amount. The basis is included basically since the contracts are priced at zero NPV, and reflect market conditions.

It is actually the basis which is quoted. As of today (Friday) average bases ranged from -34.6 for 1 year to -39 for 15 year swaps. Assume yen *libor* is 30 basis points (about where it has been lately). Now, yen interest rates on swaps enter into negative territory. The mechanics are unchanged, but with the new negative rates the yen interest that foreign banks pay Japanese banks is negative. In other words, the Japanese banks pay *\$libor* plus the 4.6 basis point negative interest accruing to them from their deposit of yen with the foreign bank.

Why on earth would Japanese banks do this? Working out the concrete example makes it clear -- the bank then obtains dollars at *\$libor* + 4.6 basis points whereas a straight loan in the interbank market comes at *\$libor* + 100 basis points. Does this make sense? Yes and no. The economic difference between the two comes from the fact that foreign banks receive yen deposits as collateral (in the initial swap of principal) in return for the dollars lent to Japanese banks. This should make borrowing cheaper for the Japanese banks and that is what we see.

The interesting implications of the swap, however, are at the systemic level of which traders are generally unaware. Interbank swaps, like most banking transactions, do not actually entail a transfer of cash. Instead, the Japanese bank receives dollar deposits in the foreign bank, and the foreign bank receives yen deposits in the Japanese counterparty. From the foreign bank's perspective, though, it isn't clear why a deposit would be preferred to a loan: if the failure of the Japanese bank is the event that is feared, deposits would be lost almost as surely as loans (since they are very similar liabilities from the Japanese bank's point of view).

Bankers are shrewd enough to realize this, so they generally have proved unwilling to leave their swap proceeds on deposit with their counterparty banks (or any other banks, for that matter). Instead, they have bought 6-month treasuries, and driven their yields negative (yet, for the most part, less negative than the 4.6 basis points identified above). From a system-wide point of view, then, the foreign banks are transferring

their claims from Japanese commercial banks to the Japanese Central Bank. They write checks from their yen accounts to purchase Japanese treasuries. If the banks fail, they still get paid and the Japanese government is stuck with the bad checks. Then, if yen convertibility is not restricted, they can cash in yen for the Central Bank's dollar reserves.

The punch line that few seem to have realized, as a result, is that this is tantamount to the Central bank directly loaning dollars to Japanese commercial banks. The only exception: under the current regime foreign bankers are being given the spread between swap rates and Treasuries. This seems like a rather unnecessary transfer, unless the market is expected to react even more negatively to an announcement of central bank dollar loans than to the bizarre advent of negative interest rates.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:16-NOV-1998 09:12:06.00

SUBJECT: Social Security reforms

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:

When we were talking about the feasibility of some of the "common reforms" that our group has suggested, you wondered about two possibilities not in our list. According to the 1994-96 Advisory Council report, their impact on the 75-year actuarial balance would be:

1. eliminate the hiatus in the currently scheduled increase in the normal retirement age: +.10
2. tax OASDI like private pension benefits (including the elimination of the current income thresholds): +.31

The former was included in the IA and PSA plans from the Advisory Council, and the latter was included in the IA, MB and (in part) PSA plans.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:17-NOV-1998 00:41:49.00

SUBJECT: Today's statement by Korea's president at Apec

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

TEXT:

NYT 11/16/98:

President Kim Dae Jung of South Korea said his country had to bear much of the responsibility for its currency collapse in July 1997, which devastated South Korea's economy and left it within a whisker of defaulting on its loans.

"We now know why and how the crisis came," Kim said. "It was because of the collusive ties between politics and businesses, Government-controlled financing and widespread corruption."

Given what they say themselves, it is hard to argue that we are bashing the Asian model in our ERP Chapter.

Still, I will tone it down with your very good discussion about the perils of American triumphalism.

Nouriel

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:19-NOV-1998 11:13:04.00

SUBJECT: financial mkts working group 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:

1. Senator Lugar is having a hearing on Dec. 16 to:

- * review progress on the hedge fund and derivatives studies that the group is writing

- * talk about LTCM

The first panel is all of the CFTC commissioners; the second panel is Pat Parkinson, Roger Anderson (Treasury), and Richard Lindsey (SEC); the third panel is unclear.

2. There will probably be a principals' meeting the first week after Thanksgiving to discuss policy alternatives in very broad terms. Rubin is actively considering policy proposals with Gary Gensler and Roger Anderson, and I presume the Fed, CFTC and others are thinking about this too. Nobody thinks that specific proposals will be debated or adopted at this meeting, but Rubin wants to get some discussion going before the hearing. When the meeting draws closer, I'll give you various materials that have been produced by the group. I agree that this is not an issue we should devote a lot of time to, but at least I don't want you to be surprised by what comes up at the meeting.

Doug

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:20-NOV-1998 14:42:52.00

SUBJECT: Social Security 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:

Hi Janet:

1. The current plans for the WH conference on 12/8 and 12/9:
 - * several hundred attendees, by invitation, largely from interest groups that did not feel part of the previous public forums
 - * first day -- opening remarks by the President and Congressional leaders; comments by organizers of forums on what was learned; parallel meetings of small groups in which interest groups can express their views to Admin officials
 - * second day -- small groups to interact on possible reforms
2. I went to a meeting in Barbara Chow's office with the "fiscal responsibility" folks from the Hill. These were staffers for Stenholm, Breaux, Kolbe, Moynihan, etc. I'll leave a copy of my notes with Alice, but the main points that achieved rough consensus were:
 - * they want people outside of the Hill leadership to be at the table for negotiations, esp. because their Members are not in the leadership
 - * they want the Admin to "deal honestly with Soc Sec liabilities" which many plans (they mentioned Ball and Gramm) do not
 - * they think the President needs to offer more specific principles for reform (or a plan) SOON -- some suggested specific principles and then behind-the-scenes advice to some Members on plans which the Members would introduce as bills
 - * they encourage a "center out" strategy, in which the left and right are ignored (a la welfare reform)The only Admin folks there were Barbara, Jeff, David, me and some OMB leg affairs folks.
3. David testified yesterday to Ways and Means, saying that everything was on the table except an increase in the payroll tax rate (as the President had previously said).
4. The WSJ reported today that "the WH is cool to Livingston's proposal to break out the SS budget." I'll ask Jeff who said that.
5. There will be a meeting with the President on Tuesday.

Doug

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:23-NOV-1998 12:00:18.00

SUBJECT: budget policy in the ERP

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

READ:UNKNOWN

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

READ:UNKNOWN

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

READ:UNKNOWN

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

READ:UNKNOWN

TEXT:

The original outline for chapter 2 of the ERP included a section on budget policy -- the accomplishment of a balanced budget and the challenges for the future.

Chad and I discussed last week whether this material should appear instead in chapter 1. I went ahead and tried drafting it anyway, accumulating 6 pages of very rough draft. But I realized last night that chapter 2 was getting pretty long, and Chad says that Janet wanted to cover the topic in chapter 1 anyway. So I'm passing along my work to Chad, and you'll see only a brief discussion of fiscal policy in the forthcoming chapter 2 draft.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:23-NOV-1998 11:14:52.00

SUBJECT: financial-market conditions

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

READ:UNKNOWN

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

READ:UNKNOWN

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

READ:UNKNOWN

TEXT:

Two points that we did not make in last week's WEB piece about improving conditions:

1. There have been substantial re-flows into equity mutual funds and high-yield bond mutual funds after several months of heavy withdrawals.
2. The supply of funds for commercial real estate has definitely suffered, owing to troubles with REITs and low-rated commercial mortgage backed securities.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:24-NOV-1998 15:04:23.00

SUBJECT: update on ag sector economic analysis

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

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

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

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

CC: Jonathan H. Adashek (CN=Jonathan H. Adashek/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

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

TEXT:

I spoke with Margot Anderson of USDA about the status of the ag sector economic analysis promised to the Hill. She said that they hope to have a draft ready for review by CEA and CCTF within 2-3 weeks. The analysis assesses the impacts of energy price changes resulting from permit prices of \$14-\$23/ton on the ag sector. In addition, it will have some discussion on relevant topics (e.g., carbon sinks, technological innovation in the ag sector, etc.).

Joe

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:24-NOV-1998 11:31:37.00

SUBJECT: Recommendation ltr for Matt

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

READ:UNKNOWN

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

READ:UNKNOWN

TEXT:

Attached is a revised version of the recommendation letter for Matt. I made some revisions to Joe's draft, which I showed you when we were in Japan. If you are ok with it, please let me know and I will have Sandy format it for your signature. If you make changes, please e-mail it to Sandy and she will prepare it for you to sign.

Thanks.

Michele

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D36]MAIL48241582B.326 to ASCII,
The following is a HEX DUMP:

November 23, 1998

Dear Ms. Bruzelius:

Matt Weinzierl was an outstanding intern at the Council of Economic Advisers (CEA) during the summer of 1998. It is my pleasure to provide him with this recommendation.

During his time at the CEA, Matt conducted analysis, drafted memoradum and provided a range of assistance to CEA economists, primarily in the area of global climate change policy. Matt was able to identify and understand the key policy issues, use his skills and understanding of economics to analyze and evaluate the impact of these issues, and provide useful, relevant and reliable analytic materials. For instance, Matt conducted a series of regression and other quantitative analyses for a project that estimated developing countries' future greenhouse gas emissions. I used the results of this work in climate change discussions I had with Chinese and Korean government officials in June and July. Matt also made a substantial contribution to the the Administration's economic analysis on climate change, a 200+ page document that reported the Administration's conclusions about the likely economic impact of climate change policy. His assignments included compiling and charting data, fact-finding and fact-checking the document, editing, and proofreading. Matt worked long hours and late nights on many occasions in order to assist our staff on the timely and accurate completion of this report.

In addition to the impressive work Matt did for the CEA on climate change, he also worked with several CEA economists on other issues. He compiled data sets and designed charts for an article on immigration for the Weekly Economic Briefing of the President (WEB). In a related task, Matt pulled together materials for WEB briefing books to help prepare the CEA Members for our in-person Presidential briefings. He also updated the "State Pages" -- one-page documents describing the economic conditions of every state -- used by the President, Vice President and other high-ranking Administration officials as they travel around the country.

Matt has impressive intellectual talents, a strong work ethic, and a clear commitment and dedication to providing insightful, accurate and timely work. For this reason, I am enthusiastic about providing him with this recommendation. Please let me know if you have any questions or need additional information.

Sincerely,

Janet Yellen

Ms. Margaret Bruzelius

Eliot House Office
Harvard University
Cambridge, MA 02138

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:24-NOV-1998 12:12:37.00

SUBJECT: Re: Yellen's mtg w/ Labor

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

READ:UNKNOWN

TEXT:

Assuming that the permit system ends up allocating rather than auctioning permits, I think the idea of allocating some permits to communities and/or workers who are hard hit by the policy, for example coal miners, has considerable merit. Alternatively, some or all permits could be auctioned and the proceeds used, in part, to provide transition relief to coal miners or other workers who are impacted by the policy. This would be a natural source of revenue for adjustment assistance.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:24-NOV-1998 11:18:43.00

SUBJECT: Yellen's mtg w/ Labor

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

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

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

TEXT:

Below is the e-mail I sent that briefly summarizes the key issues that labor raised in Janet's meeting.

----- Forwarded by Michele Jolin/CEA/EOP on 11/24/98
11:17 AM -----

Michele Jolin
11/24/98 10:59:34 AM

Record Type: Record

To: Todd Stern/WHO/EOP, Karen Tramontano/WHO/EOP, Sally Katzen/OPD/EOP,
Dirk Forrister/WHCCTF/EOP

cc:

Subject: Yellen's mtg w/ Labor

Janet's mtg yesterday w/ David Smith and economists from the AFL-CIO went well. Labor's most serious concern was that the Administration's model does not show the impact of climate change policy on specific sectors. They pushed Janet to use "a different device" or a range of models that could measure the # of jobs that will be lost in the coal and other industries. They argued that there is no way the Administration can develop an effective transition assistance program if the Administration does not know the range of possible effects that the climate change policy could have on specific industries. Janet responded that the Administration's analysis gives some idea of the impact on various sectors and that CEA specifically looked at the impact on the coal industry. But, she said that CEA does not have the time or resources to construct a new model or do a substantial new analysis.

They also raised the following issues: 1) they believe the Administration's economic analysis is based on assumptions that are not realistic -- specifically, the large amount of trading and the gains in energy efficiency; 2) they believe that the permit trading system should be designed to provide a stream of revenue that can be used for transition