Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	Rebecca M. Blank to Janet L. Yellen at 13:48:38.00. Subject: This morning's WH meeting. (1 page)	11/30/1998	b(6)

COLLECTION:

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

FOLDER TITLE:

[11/24/1998 - 12/14/1998]

2013-0723-F
ab1288

RESTRICTION CODES

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

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

C. Closed in accordance with restrictions contained in donor's deed of gift.
PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).
RR. Document will be reviewed upon request.

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

b(1) National security classified information [(b)(1) of the FOIA]
b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
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b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:24-NOV-1998 12:14:12.00

SUBJECT: Re: Yellen's mtg w/ Labor

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

TEXT:
---------------------- Forwarded by Janet L. Yellen/CEA/EOP on 11/24/98
12:13 PM ---------------------------

Janet L. Yellen
11/24/98 12:10:01 PM
Record Type: Record

To: Todd Stern/WHO/EOP
cc:
Subject: Re: Yellen's mtg w/ Labor

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

CREATION DATE/TIME:30-NOV-1998 07:04:05.00

SUBJECT: CEA Report

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

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

TEXT:
Thank you for providing me with an opportunity to review, and offer comments on, the CEA Economic Report of the President. In general, I thought the work was first class. I will offer more detailed comments to Michelle, but I wanted to single out for praise Chapter 6 on International Captial Flows. This particular work was extraordinary. With a clarity of style and coherent reasoning it presented a very complex set of topics in a cogent manner. The author(s) of this piece will deserve the public praise they will receive upon publication. Watch out John Gresham.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:30-NOV-1998 14:02:00.00

SUBJECT: WH Social Security Conf

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

TEXT:
I talked to Peter about your role in the Soc Sec Conf. As I'm sure you know, the Conf itself is still taking shape. But, it sounds like you will be doing what the other "Senior Administration Advisers" will be doing -- listening to panels, talking to interested parties, leading "workshops" or discussion sessions on social security issues, etc. It sounds like the one instance where you are NOT doing what your colleagues will be doing is on the first day from 3:30-5:30 -- they will be holding sessions to allow interested parties to "plead their cases." Peter assumed that you wouldn't be interested in doing that. Is that a correct assumption? If you do want to take part, you can -- Peter just assumed that you wouldn't want to. So, if you do, let me know and I'll make sure you are included.
Thanks.
Michele

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:30-NOV-1998 11:40:30.00

SUBJECT: GCC and developing countries

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

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

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

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

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

TEXT:
Here is an update on our work on developing countries. Please let me know if you would like to discuss this in more detail.

Last week, we held an interagency staff-level meeting to discuss the U.S. strategy on providing technical support to Kazakhstan and Argentina. Based on this meeting and a previous meeting we had with Todd Stern on this issue, there appear to be 3 key components to the Administration's work on this issue: 1) working with developing countries that would like to adopt emissions targets at a technical level; 2) working with developing countries on emissions targets at a diplomatic/political level; and 3) determining internally what we would consider a "reasonable" developing country target. CEA can probably play a more significant role on issues 1 and 3, but we should recognize that work on these issues will likely feed into the political/diplomatic discussions under 2.

On the issue of technical assistance, the Administration will be compiling papers to provide guidance to both countries for a workplan for the coming year. The goal is to deliver these papers by mid-December, so we hope to have a draft by the end of this week that we could then circulate for clearance. There will likely be a technical team visit to Kazakhstan in mid-January. While no trip has been planned, EPA is advocating for a December trip to Argentina, although I have pushed back on this -- it is no t clear if the Argentines actually want this trip, while it is very clear that the Administration needs to do more homework before sending a team down again.

On the issue of our own position on developing country targets, I think we should be aware of the interest by some in the Administration to push for relatively stringent targets. We use language of slightly below BAU which gets translated into "something like 10% below BAU", which I doubt we would consider slightly below. To help inform the internal discussion, I propose that we pull together a paper that describes the existing Annex B targets relative to BAU. Raymond will work on the analysis Jeff proposed on evaluating the progressivity of the Annex B targets. In addition, we should still consider pushing for an indexing approach -- and be open to variations of it. Unless there is a concern otherwise, we will get working on this.

Joe

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:30-NOV-1998 14:57:36.00

SUBJECT: Shapiro and Japan memo

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

TEXT:
I talked to Rob Shapiro re the idea of a memo to the President on the Japan trip. He seemed to think it is a good idea -- but he is off to Europe for the rest of the week, which obviously makes drafting it difficult. So, I suggested that maybe instead we could do an article for the WEB, which wouldn't be so time sensitive. He seemed to think that was a good idea. And he said that he would be willing to draft it or edit a version drafted by someone else. SO, let's talk about this. And you can either call him when he gets back or I can e-mail him with your views.
Thanks.
Michele

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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-DEC-1998 08:47:38.00

SUBJECT: Re: Shapiro and Japan memo

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

TEXT:
Frankly, I'm not sure we learned anything sufficiently novel to serve as the basis for a WEB article. I would not particularly look forward to drafting it. I think Rubin's idea was to simply tell POTUS and others we had had extensive discussions in Japan and focus on what we learned that might be new or different from established Administration thinking. Beyond the general feeling of deep pessimism, I am not certain that we did learn anything new.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-DEC-1998 20:15:30.00

SUBJECT: Re: Russia meeting

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

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

TEXT:

Larry and others from the foreign policy side are going to Moscow in the latter half with next week. Will have at least an hour with Primakov.

The discussion was mostly: Fuerth wanting to give the Russians advice, and Larry warning that they are probably interested in pretending to listen to our advice (if at all) primarily out of a mistaken belief that if they do, that they are going to be able to get disbursements without fundamental reform.

There was nothing for CEA to do.

If we have time tomorrow a.m., and you want to hear more, we can all talk.

JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-DEC-1998 13:14:06.00

SUBJECT: NEC Trade PC Agenda

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

TEXT:
Janet, here is the agenda. Ready to talk to you when you have time.
Nouriel

---------------------- Forwarded by Nouriel Roubini/CEA/EOP on 12/01/98
01:13 PM ---------------------------

Bruce McNamer

12/01/98 12:45:05 PM

Record Type: Record

To: Nouriel Roubini/CEA/EOP
cc:
Subject: Trade PC

Nouriel
Attached is annotated agenda for trade meeting. The Russia principals
meeting is hosted by Larry Summers and is scheduled for 3:30. We still
have not seen an agend from them. I'll let you know when I hear something
Bruce
---------------------- Forwarded by Bruce McNamer/OPD/EOP on 12/01/98
12:41 PM ---------------------------

Lael Brainard
12/01/98 11:22:51 AM
Record Type: Record

To: Sharon H. Yuan/OPD/EOP, Melissa G. Green/OPD/EOP, Bruce McNamer/OPD/EOP
cc:
Subject: Trade PC

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D32]MAIL432163530.326 to ASCII,
The following is a HEX DUMP:

ANNOTATED AGENDA FOR PRINCIPALS MEETING ON 1999 TRADE AGENDA

December 1, 1998

4:30 - 5:30 p.m.

The purpose of the meeting is to provide broad direction for our 1999 trade legislation agenda. Although we would not expect this meeting itself to yield final decisions, it should provide sufficient guidance to initiate a fairly targeted consultative process with the Hill and business, agricultural, environmental and labor groups.

There are four main issues for consideration. As will be clear, the four are not mutually exclusive and, indeed, the final agenda may incorporate elements of each.

Issue #1: The Fast Track Agenda

Principals need first and foremost to decide whether to make fast track the first and most immediate priority on our 1999 trade agenda, building on one of several potential coalitions:

- "Center-Right" Approach: Go for "clean" fast track with broad scope similar to previous bill.

  Pros:
  - This proposal is likely to command the greatest number of moderate votes and win the full support of business and agriculture.

  Cons:
  - This is the strategy we followed last year, which failed to secure a sufficient number of Democratic votes.
  - Now more than before, we need to make a good faith effort to work with our traditional allies in Congress -- which this option would not do.

- "Center-Left Broad" Approach: Go for fast track accord that incorporates labor and environmental conditions in the core of the trade agreements and encompasses multi-lateral (WTO), regional and bilateral trade agreements.

  Pros:
  - This would provide us an opportunity to work closely with Gephardt and other allies as we introduce fast track.
  - This would help overcome residual bad feelings among our friends in Congress from our last attempt to achieve fast track.

  Cons:
  - The business community is unlikely to support legislation including labor and environmental conditions.

- Given the Republican majority, it is likely that the labor and environmental conditions would ultimately be stripped out of the final legislation; thus, we may not want to commit our initial support to a position that we may subsequently have to alter (or then again, we may).

- "WTO-Only" Approach - Go for fast track authority that would only cover WTO (but not bilateral or regional) agreements.

  Pros:
  - This type of accord is likely to be able to command the greatest breadth of support among Democrats and our other allies in Congress. Gephardt would ultimately have to come on board, given his traditional support for the WTO.

  Cons:
  - Early readings from the business community suggest they are most animated by the prospects of concluding an FTAA, which would not be possible under a WTO-only fast track.
  - This would not allow us to fulfill our commitment to Chile, and would not provide a vehicle to negotiate FTAs for Asia.
  - This might be viewed as a loss given that it would be grant us much narrower authority than that granted to previous Presidents (e.g., this clearly would not have allowed President Bush to go forward with negotiations toward NAFTA).

<u>Issue #2: Omnibus Trade Bill</u>

Under this scenario, we would work for the introduction of an omnibus trade bill that would fold together fast track (in any of the incarnations discussed above) with any or all of: Africa trade legislation, TAA expansion, Caribbean Basin trade enhancement, GSP, ship-building, and some expansion of trade remedies such as modification of 201 and codification of Super 301and of Section 301 for agriculture.

Pros:
- We could build a broad coalition in favor of fast track by building alliances with Africa trade proponents, the steel caucus (201), etc.
- This would permit Administration to implement measures in support of Steel (e.g. 201) without sending a purely protectionist signal.
- Roth, Archer and others are already talking about an omnibus bill, so we may have to deal with one anyway.

Cons:
- This would make it more difficult to control what types of measures might be added to the trade bill, with the result that we might have to support a bill that includes provisions we wouldn't otherwise accept (e.g., changes to anti-dumping regulations).
- An omnibus measure is bound to be more comprehensive and complex than a clean fast track bill and thus take longer to negotiate, potentially taking us beyond the political window in which it is possible to achieve serious trade opening legislation.

Issue #3: "Project 5" Asia-Pacific Trade Agreement without Fast Track

This option would have us announce negotiations towards an Asia P-5 FTA (including Australia, New Zealand, Singapore, Chile and the United States) without fast track. *Since this proposal is unlikely to garner additional support for fast track, and indeed might set a precedent for legislating trade agreements absent the procedural protections associated with fast track, it might make sense to postpone consideration of this option until we have exhausted the fast track approaches outlined above.*

Pros:

- The countries involved are unlikely to be politically controversial since all but Chile are industrialized economies with high living standards and strong labor and environmental standards.
- The trade partners under consideration have indicated a willingness to go forward through "normal" legislative process if fast track is not an option.
- This would allow us to accomplish a major trade achievement this year with or without fast track.

Cons:

- From an Asian diplomacy perspective, this group of countries sends all the wrong signals. It does not include any of the Asian countries that are taking strong reforms to keep their economies open even as they struggle with financial crisis. In fact, this proposal is likely to generate ill will from countries that have been excluded. For instance, there is no strong rationale for excluding countries such as Korea that have shown strong interest other than domestic politics.
- It is not clear our agricultural community will be supportive.
- If we move forward on this initiative without fast track, we may set a precedent that will make ever achieving fast track a more remote possibility.
- Unlike with NAFTA, this group of countries does not represent a "natural" grouping of countries with strong historical patterns of trade; this group of countries does not represent a substantial amount of our trade, and so we are unlikely to get much support for this initiative (particularly absent any fast track progress) from the business community.

Issue # 4: WTO Round

To this point, USTR has been reluctant to explicitly support the launch of a WTO Round, although we have indicated our support for the launch of a set of negotiations at the next WTO Ministerial in 1999. The rationale for this reticence is largely concern about domestic political opposition. On the other hand, the agricultural community strongly favors a round as the best mechanism for achieving substantial agricultural liberalization. It might be useful to have a discussion whether or not support for a round at this juncture could be a net plus for our fast track push.

PRINCIPALS MEETING ON 1999 TRADE AGENDA

AGENDA

December 1, 1998

4:30 - 5:30 p.m.

I. Fast Track

Center-Left Broad
Center-Right Broad
WTO-Only

II. Omnibus Trade Bill

Africa
GSP
CBI
Shipbuilding
Tariff Measures
Section 201 Revision
Super 301
Section 301 for Agriculture
TAA

III. Project 5 Trade Agreement

With or Without Fast Track
Timing

IV. WTO Round

Scope
Timing

PRINCIPALS MEETING ON 1999 TRADE AGENDA

Option 1: Maximal Trade Authority with Broadest Coalition
- Broad Fast Track with Strong Labor and Environmental Conditions
- Omnibus Trade Bill:
  - Africa
  - Section 201
  - Postpone Consideration of Project 5

Option 2: Minimal Trade Authority with Maximal Trade Agenda
- Narrow Fast Track to WTO- Only for Launch of Round
- Pursue Project 5 without Fast Track

Option 3: Opportunistic
- Announce Principles for Fast Track, Look to Congress for Packaging and Breadth

Option 4: Build Center-Right Coalition
- Broad, "Clean" Fast Track-Only Bill
- Announce Launch of Round

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-DEC-1998 15:24:46.00

SUBJECT: provocative Social Security ideas

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:
I'm leaving Alice a hard copy as well.=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D28]MAIL44869553N.326 to ASCII,
The following is a HEX DUMP:

MEMORANDUM TO JANET YELLEN
FROM: Doug Elmendorf
DATE: December 1, 1998
SUBJECT: Provocative Social Security Ideas

There are several pieces here that could be rearranged or combined as desired:

1) Individual accounts have serious problems but also real advantages. (Pages 2-5)
   This is new to you, although it includes text and ideas you've seen before.

2) Is "pain-free" Social Security reform possible? (Page 6)
   I think I passed these notes on to you earlier.

3) Cutting benefits vs. prefunding benefits. (Page 7)
   I think I passed these notes on to you earlier as well.

4) Why do we want to fix Social Security? (Page 8)
   This is a summary of Larry Summers' opening comments at the meeting with the President several weeks ago. As you recall, it covers several issues we've discussed.

I'm happy to rework this material or to start again in some other direction if I've misunderstood what you're looking for.

Individual accounts have serious problems but also real advantages.

The basic problem: Social Security benefits would become defined contribution rather than defined benefit. The basic advantage: Social Security would be removed from the unified budget.

Serious Problems

1. Administrative costs

The Social Security Administration uses less than 1 cent per dollar of benefits paid out. In terms of annual fees, this corresponds to about 5 bps per year.

Vanguard--one of the mutual fund industry's leaders in cost reduction--uses 20 bps per year for indexed funds. The cost of IAs would be significantly higher:

* much smaller accounts,
* needing to keep track of *how much* money goes into *which* accounts, and
* management fees on non-indexed funds.

Alternatively, we could have more limited services.

2. Investment choices and government guarantees

Many people have no experience in making investment choices. They might make bad long-term choices (no stocks) or mis-time market moves.

We could limit portfolio choices or provide some type of guarantee.

Marty Feldstein has claimed that providing a guarantee against investment risk would not be costly to taxpayers. But he has understated the risk in several ways:

* even if the chance of needing the guarantee is small, the amount to be paid in that situation could be huge -- this is the essence of insurance
* he assumes that people hold a fixed portfolio 60:40 stocks and bonds -- but people would presumably have the option of going entirely into stocks, and might do so if there were a good guarantee -- or, people could mis-time the market by buying at peaks and selling at troughs -- both of these would raise the probability of needing a guarantee and the amount to be paid out

3. Annuitization

Social Security provides an inflation-indexed annuity, protecting beneficiaries against both longevity and inflation risk.

Annuitizing individual accounts is possible but complicated:

* government control and involvement would be large
    * Unless annuitization were mandatory, some people would run out of money, and adverse selection would be a serious problem.
    * Unless annuitization were publicly run, costs would be high and unisex pricing would be impossible.
    * Unless early access were restricted, some people would have too little money for a comfortable retirement.
    * Unless the public program were off-budget, budget numbers would be badly distorted.
* ensuring the desirable outcome on these specifics would be difficult to ensure
    * Policymakers will focus on the perceived key issues, and annuitization details are not likely to be on that list.
    * Many of the specifics involve more public rules or involvement than IA supporters are likely to support.
* volatility of payment levels owing to financial-market developments would be substantial
    * Gradual purchase of annuities helps, but equity variability is large.
    * Variable annuities could be used, but then you lose the inflation protection.

These problems would be much larger if IAs represented a larger share of total Social Security benefits.

In sum

Defined-benefit pension plans have real advantages over defined-contribution plans: they naturally spread investment and longevity risk, and they have low administrative costs and require little knowledge by participants.

DB plans have diminished in importance in the private sector because of our dynamic labor market. People don't work for the same company their entire lives, and companies come and go. So non-portable benefits that depend on consistent corporate management have a problem. But these problems don't exist with Social Security, so this is the place to have DB pensions.

Note that many of the solutions to these problems amount to making IAs behave more like DB pensions. But then what are the advantages of IAs?

Real Advantages

The primary advantage is removing Social Security from the unified budget, which would have several effects (#1-#4 below). There are also other effects (#5-#7 below).

1. Pre-funding

We could pre-fund benefits in a way that we've proven unable to do with Social Security in the unified budget. This would raise national saving, which is probably the appropriate response to an aging population. (It would probably not raise saving dollar-for-dollar, because of private saving responses.) Moreover, it would make each cohort more responsible for its own retirement, which probably is fair.

2. Equity returns without corporate governance problems

Putting equities into the public retirement system would have minimal effects on the nation as a whole: Although one can work out a variety of general equilibrium effects, the primary impact is simply to leave more bonds and fewer equities in private hands.

Still, there may be advantages to this step. For example, raising the expected return on public assets relative to private assets may be progressive, since private assets are held disproportionately by rich people. (Risk-sharing is probably not a reason to do this, contrary to Peter Diamond's claims. Efficiency of financial markets would not be improved by government risk-sharing because ownership of major equities is already sufficiently broad. Equity would not necessarily be improved either. The government already bears substantial equity risk through capital taxation, and that may be enough to achieve appropriate intergenerational risk-sharing. Poor people bear no direct risk today (or receive the higher return directly), but they bear some through the government budget, and they probably would not be the residual claimant through the Social Security system anyway.)

But public equity investments raises a host of concerns:

* deciding what to buy -- some of this emerges under IAs as well, if we limit investment options
* deciding how to exercise control -- the government could hold 10% or more of total equities under some hypothetical plans (and depending on equity performance)

3. Less budget distortion

With Social Security in the unified budget, we seem flush with money now and will seem starved for money in 20 years. These swings in availability of funding for other needs are not useful.

4. Less political risk

Pre-funded benefits would be less susceptible to the whims of future political leaders.

5. More clarity about redistribution

In addition to the progressive income redistribution, Social Security redistributes money in a variety of other ways (for example, from dual-earner families to single-earner families). These issues have not been discussed openly for decades, and setting up IAs would force the country to be explicit about the types and amount of redistribution we favored.

6. Less distortion to labor supply

People tend to view current FICA "contributions" as taxes. Some of that is related to real redistribution, but some is related to the general fog around the whole system in people's minds. IAs would be clearer, so people's perceived marginal tax rates would be smaller for the same amount of actual redistribution.

7. "Double-counting" may seem less peculiar

Moving the funds out of the government would at least prevent triple counting by some future Congress.

Is "Pain-Free" Social Security Reform Possible?

- Several years ago, concern about the Social Security imbalance (and growing entitlements for the elderly in general) implied that benefits should be cut or taxes raised. These painful measures have been the standard in Social Security reform (for example, in 1983).

- Suddenly, the possibility of "pain-free" reform has emerged, stemming from two novelties:
  - the emergence of projected budget surpluses
  - a willingness to invest public funds in the stock market

- But these developments do not really offer a free lunch.

  Devoting too much of the projected surpluses to reform has costs:
  - Projected surpluses might not materialize, leaving a big fiscal gap.
  - Surpluses used to fund benefits cannot be used for spending initiatives or tax cuts.

  Investing in equities has costs:
  - Stocks may not yield the return we expect.
  - Swapping equities for bonds with the private sector contributes nothing to the nation as a whole.

- Because of population aging, the nation cannot maintain historic patterns of Social Security replacement rates, tax rates, and discretionary spending into the next century. Small adjustments in each of these areas would reduce the need for big adjustments in any one area.

- Trimming benefits or raising taxes--in addition to setting aside some of the projected surpluses--is good public policy.

Cutting Benefits vs. Prefunding Benefits

We have been viewing these options as perfect substitutes in terms of fiscal responsibility, and I think this view is mostly correct. However, several factors suggest that cutting benefits is more fiscally responsible than prefunding them--for a given projected 75-year impact:

1. Benefit cuts have better effects beyond the 75-year window.

2. Prefunding benefits has greater risk.
   If we cut benefits, they're cut. But the projected effect of prefunding depends on equities earning the return we project and yet-unrealized surpluses coming to pass.

3. Prefunding wouldn't raise saving as much as we project.
   Our calculations assume that all of the surplus devoted to prefunding represents incremental saving. In fact, some of the money placed in IAs would be offset by lower other saving (and maybe extra money placed in the trust fund would be offset too), and some of the money used for tax cuts would be saved. So the net saving could be 2/3 or so of our projections.

4. Future flows matter as well as stocks.
   Large deficits cause economic dislocations and put pressure on other spending even if the stock of debt is low. (Note that under TF in equities plans, future deficits are smaller because of equity sales.) Large amounts of dis-saving cause economic dislocations even if the stock of capital is high.

In addition, we may also prefer the equity implications of benefit cuts. If we believe that the government is already committing too large a share of its resources to older people in the next century, then we would prefer to devote some of the surpluses to other national needs. (Politics may make this difficult, however.)

These arguments suggest that devoting more of the surplus to Social Security reform in order to raise future benefits--an idea raised at the principals' meeting--is not good policy.

Also, these arguments illustrate the limitations of calculating changes in national savings. National savings is the best measure of the impact of reform on the size of the future economic pie. National savings adjusted for changes in benefit levels is the best measure of what we're doing for future generations.

Larry Summers: Why Do We Want to Fix Social Security?

First, because currently legislated taxes are insufficient to pay currently legislated benefits over the next 75 years. Social Security is essentially a pension system, and the actuaries have given us a bad report on the funding of that system. This problem could be fixed by raising the payroll tax, cutting benefits, achieving a higher rate of return, or transferring general revenue.

Second, because the share of the U.S. population over age 65 will increase sharply in the next century. Regardless of what pieces of paper are held by the Social Security Trust Fund, society will face a larger burden of caring for older people. This burden has been perceived partly as an "entitlements problem," because growing government expenditures for the elderly could direct money away from other social needs. People who have been concerned about this problem might feel that using general revenue to finance Social Security would move our fiscal system in exactly the wrong direction.

Third, because we want to block the use of the projected surpluses for a large tax cut that would mortgage our future to a greater degree. The key question here is what would happen to the surpluses in the absence of Social Security reform. If the surpluses would be eliminated by a tax cut, then using them for Social Security reform instead would improve the situation in 2030. But if the surpluses could be maintained without Social Security reform, then committing them to the Trust Fund creates a danger of making the 2030 problem worse if the surpluses do not materialize.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-DEC-1998 11:52:41.00

SUBJECT: Troika projection

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:
Mark Wasserman and Joe Minarik wish to reopen the forecast for the following reason. Any opinion?
---------------------- Forwarded by Steven N. Braun/CEA/EOP on 12/01/98 11:50 AM ---------------------------

Mark A. Wasserman
12/01/98 11:12:36 AM
Record Type: Record

To: Steven N. Braun/CEA/EOP
cc: See the distribution list at the bottom of this message
Subject: Troika projection

Steve,

There is still a problem in the latest run in the personal interest income numbers caused by the decline in interest income received by households from the Federal Government. If households are getting less and less interest income on Federal government debt, because there is less and less of it, they would increase their holdings of other debt to make up for it. Total personal interest income, therefore, should have an offset (and perhaps be more than offset since other sectors pay higher interest rates than the Federal government.)

Households are likely to increase their holdings of foreign bonds (and stocks) which would raise factor income from abroad, a component of net interest. This may be the easiest way to correct the current run (and is economically sensible.) Currently, factor income from abroad is a stable share of GDP from 2003 to 2009; it is likely to rise, however, following the logic of this argument. Higher interest income would also raise the personal saving rate which is still only about 1 percent in the current r un in the outyears.

OMB staff and Joe are concerned about the downward trend in personal interest income and hope you can correct it. Could you let us know if you can? We know that you've already shed a lot of blood getting the projection this far, can you give a pint more?

Here is a table with some of the key numbers related to this issue.

Message Copied
To:____
Joseph J. Minarik/OMB/EOP
Justine F. Rodriguez/OMB/EOP
Robert B. Anderson/OMB/EOP
Laurence R. Jacobson/OMB/EOP
Douglas A. Norwood/OMB/EOP
Patrick G. Locke/OMB/EOP
Steven E. Cahill/OMB/EOP

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-DEC-1998 07:41:43.00

SUBJECT: Re: CEA Report

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

TEXT:
Many thanks for the praise. We are lucky to have a really first rate international economist with us this year, Nouriel Roubini, who is the author of Chapter 6.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-DEC-1998 15:20:26.00

SUBJECT: Update on EITC/Minimum Wage Report

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

CC: Francine P. Obermiller (CN=Francine P. Obermiller/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

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

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

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

TEXT:
Janet, I will give you a copy of the draft report on the EITC/minimum wage by 6pm today. This draft incorporates comments by Becky and Corky, although they have not reviewed one subsection which I wrote this afternoon.

Are you available to discuss the report Wednesday morning? I would like to give NEC a copy by about noon on Wednesday, which would give us sufficient time to incorporate their comments.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-DEC-1998 12:39:56.00

SUBJECT: response to Sensenbrenner

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

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

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

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

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

TEXT:
Attached is a draft of the response to Sensenbrenner's letter. Comments are welcome. To aid in your review, the second file (sensques.wpd) includes 4 excerpts from his letter which are the main questions asked of us by Sensenbrenner.

Joe

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D90]MAIL49222353D.326 to ASCII,
The following is a HEX DUMP:

Dear Chairman Sensenbrenner:

I appreciate the opportunity to provide you with a response to your October 20, 1998 letter regarding economic analysis of the Kyoto Protocol. Your letter made requests for comments on two issues. First, I will address your interest in our comments on the Energy Information Administration report "Impact of the Kyoto Protocol on U.S. Energy Markets and Economic Activity." Second, I will respond to your question regarding implementing legislation.

Comments on EIA Report

I will present my comments on the EIA report in the context of the climate change modeling efforts by the broader economics community. In evaluating the results from any model, it is important to understand what questions are being asked. We have found in our review of the climate change economics literature over the past several years that the most significant cause for divergence in modeling results is that different modelers ask and answer different questions. In the Administration's assessment of the economic implications of the Kyoto Protocol, we have addressed a set of questions that reflect the Administration's position on the Protocol. The Administration unambiguously supports the efficient implementation of the "flexibility mechanisms" secured in the Kyoto Protocol -- international emissions trading, joint implementation, and the Clean Development Mechanism -- and we will continue to work over the coming years in multilateral fora to develop rules that ensure such implementation. In the Administration's illustrative modeling analysis, we found that these flexibility mechanisms are critical to reducing the costs of meeting emissions targets, not just for the United States, but also for the European Union, Japan, and all other Annex I countries.

Economic modeling efforts outside of the U.S. government have also found that these flexibility mechanisms can significantly reduce the cost to the United States of reaching its Kyoto target. For example, the Energy Modeling Forum (EMF) based at Stanford University, a long-running model comparison exercise involving many of the leading climate and energy models, has coordinated full scale analyses of the Kyoto Protocol. This comparison exercise of the Kyoto Protocol has included ten modeling teams from the United States, Europe, and Asia. In evaluating the Kyoto Protocol, all of the participating teams used economic models that incorporate the potential for international trading in greenhouse gas permits. By explicitly incorporating international trading, these models can evaluate the opportunities for cost-savings through trading among Annex I nations and among Annex I and developing countries were they to adopt emissions targets. Since the Kyoto Protocol enables all countries with emissions targets to trade emissions allowances among other countries with targets, these models are well-suited to assess the economic implications of the international trading component of the agreement. On average, the EMF models found that Annex I trading would cut the U.S. permit price by 53% relative to a no trading scenario. Of these models, one estimated a 72% reduction in the permit price under Annex I trading. In full global trading, the permit price would be, on average, 80% lower than the no trading price. Several models estimated permit price reductions of about 90%.

In addition, the Organization for Economic Cooperation and Development (OECD) recently hosted a climate change modeling workshop. Get from Quindi

The modeling results from these two large efforts coordinated by EMF and by the OECD clearly indicate the potential for cost-savings through an efficiently-designed international trading system. It is important to recognize that these two efforts relied exclusively on models with the capacity to explicitly model international trade in emissions allowances. We believe that it is appropriate to evaluate the Kyoto Protocol with models that can assess the opportunities for international emissions trading, since trading is embedded in Article 17 of the Protocol. Models that cannot evaluate international trading are constrained in the kinds of questions they can effectively address.

The Energy Information Administration's model, NEMS, is not capable of addressing the question of international emissions trading: it is focused only on the U.S. energy sector. EIA did not conduct any analysis of cost-effective international trading opportunities. A traditional economic analysis of international trading would assess the demand and supply of emissions allowances and, by modeling a market where costs are minimized, identify a single international permit price. This is the approach taken by the Administration as well as by the EMF and OECD modeling teams. However, the EIA analysis assesses only the demand side of the issue for the United States, and then incorporates what appear to be arbitrary assumptions about the international permit price and subsequent international transfers.

In addition to the question of international trading, there are other important questions that models should consider in evaluating the Kyoto Protocol. For example, the Protocol covers all six major kinds of greenhouse gases. While most of the models involved in the EMF and the OECD exercises did not consider these other gases in their analyses, the Administration's illustrative modeling effort did address this issue. However, the EIA analysis does not address this question, and it is assumed that the United States would achieve its target only through carbon dioxide reductions. The flexibility across gases allows countries and companies to make reductions in the most cost-effective manner possible, reducing the cost of compliance. Based on Annex I national communications, emissions growth in non-carbon dioxide greenhouse gases is expected to be much slower (and in some cases negative) than carbon dioxide between 1990 and 2010. This indicates that the U.S. six-gas target is less stringent than implied by just an assessment of carbon dioxide, and that there could be greater cost-savings through international trading of all greenhouse gases than implied by assessments of carbon dioxide trading.

As the Administration Economic Analysis on climate change noted, the period over which the initial emissions reductions occur begins and ends in a more realistic time frame than what had been proposed by other countries. By adopting a gradual and credible path of reductions in the early years, adjustment costs can be reduced. How one addresses the question of timing of reductions can affect the modeling results. For example, in EIA's study, most businesses do not take action to address climate change until 2005, and therefore only have a short time until the 2008-2012 budget window to reduce emissions. This essentially assumes that while the Administration secured this more realistic commitment period to allow for firms to more gradually undertake emissions reductions, very few firms would actually take advantage of such an opportunity. Studies have demonstrated that the amount of lead time a company takes has dramatic economic implications. For example with EIA's model in the Interagency Analytic Team draft report, a 5-year "ramp-up" (starting in 2005) would result in economic costs 65% greater than that associated with a 10-year "ramp-up" (starting in 2000). Thus, EIA's assumption that many businesses would fail to plan for the future results in higher projected costs.

While some may claim that very little action is likely to occur prior to 2005, there is reason to believe that some firms will act well before 2005. Already businesses are taking action to address climate change. For example, on September 18, British Petroleum announced its plan to reduce emissions of greenhouse gases worldwide by 10% below 1990 levels by the year 2010. In July, United Technologies announced their plan to reduce its worldwide energy consumption by 25% by the year 2007.

Finally, how an analysis addresses other policy issues that can affect the costs of abating emissions can also impact the conclusion regarding costs. In the Administration's analysis, additional elements of policy were recognized as having the potential to significantly decrease the costs of compliance and increase the amount of reductions that might be accomplished at home. These policies were not factored into the illustrative model the Administration cited, but were qualitatively taken into account in reaching the conclusion that the United States could meet its Kyoto target for a relatively modest cost. The EIA analysis, however, ignores elements such as forestry activities (covered under the Kyoto Protocol) and the Administration's electricity restructuring proposal, which could significantly lower compliance costs.

Implementing Legislation

Based on conversations with State Department staff, it is my understanding that when the Administration submits the Protocol for ratification it will also submit implementing legislation. While the Administration advocates the use of a domestic trading program during the 2008-2012 commitment period, no policy decisions have yet been made about the nature of this program. Thus, all aspects of the trading program, including the option to auction some or all permits and recycle the revenue back to the economy through cutting other taxes, are still under consideration.

Concluding paragraph

Sincerely,

Janet Yellen
Chair

Sensenbrenner Questions

"...I request your views and comments on the EIA report, taking into consideration your latest version of your March analysis, which, apparently, was not available to the EIA in preparing this report and those made by the private sector, particularly the analysis made by DRI for the United Mine Workers, and the enclosed article" (p. 2).

"...in commenting on the EIA report, please explain the basis for your optimism about these negotiations and indicate what your views will be if the EU and G77/China continue to press those views and positions over the next two years of the Administration's term" (p. 4).

"Finally, your response should identify any 'key factors' that are missing in the EIA report" (p. 5).

"In your reply, I request that you address the issue of the need for implementing legislation, if and when, the Protocol is ratified and whether the pre-Kyoto analyses about domestic programs and revenue recycling are still under consideration" (p. 4).

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-DEC-1998 13:29:23.00

SUBJECT: government ownership of private assets

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

TEXT:
I thought you'd enjoy my email to Jeff and his reply. I agree with his reply: nobody thinks the govt is really going to move past zero debt, while we might actually put equities in the trust fund.

---------------------- Forwarded by Douglas W. Elmendorf/CEA/EOP on 12/01/98 02:29 PM ---------------------------

Jeff B. Liebman
12/01/98 12:14:56 PM
Record Type: Record

To: Douglas W. Elmendorf/CEA/EOP
cc:
bcc:
Subject: Re: government ownership of private assets

I had forgotten about this. This might give us the ability to claim that a plan does not change the amount of governmnet ownership -- indeed if we squander some more of hte surplus, we are reducing the government ownership. My guess is that this would not work -- Republicans would simply say that we should give back the extra tax revenue in the form of a tax cut.

Jeff

Douglas W. Elmendorf
12/01/98 12:09:44 PM
Record Type: Record

To: Jeff B. Liebman/OPD/EOP
cc: Douglas_W._Elmendorf @ oa.eop.gov
Subject: government ownership of private assets

Under OMB projections, the government will own private capital equal to 15% of GDP in 2030. (That is, the debt-to-GDP ratio is projected to be -15% or so.) So we're going to end up owning equities whether we put them in the trust fund or not. I guess this isn't the same thing as buying equities beginning immediately, but it is sort of interesting.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-DEC-1998 12:23:47.00

SUBJECT: interview w/ Time Mag

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

TEXT:
A reporter wants to come in tomorrow at 3PM to talk to you about the policymaking process on the Asian financial crisis. And he wants to talk to you about Summers, who will be a dominant part of the story -- i.e. what his role was, what - if anything- went wrong, etc.
Are you willing to talk to him? I put it on your schedule, but could take if off if you don't feel like doing it.
Thanks.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-DEC-1998 14:20:02.00

SUBJECT: ERP Release date

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

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

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

TEXT:
OMB is planning to release the FY2000 budget on Monday Feb 1. The ERP is usually released a couple of days after that. I would suggest we set the date for Thur, Feb 4. (and based on our production schedule we could meet this date for release)
I checked w/ the POTUS calendar and, at this point, there is nothing on it that would conflict.
If it is ok with you, I would like to e-mail the POTUS scheduler's and put the ERP release on the calendar TENATIVELY for Feb 4. Then hopefully we can have the signing ceremony on either Wed or Thur. Let me know if you have any problems or concerns

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-DEC-1998 13:28:25.00

SUBJECT: Revised version of podesta memo

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

TEXT:
Below is a revised version of the memo that needs to go to Podesta and
Cabinet Affairs. Please disregard the earlier e-mail
Thanks

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D24]MAIL43254763E.326 to ASCII,
The following is a HEX DUMP:

December 1, 1998

TO: John Podesta

FROM: Janet Yellen

In response to your request at the November 10, 1998 Cabinet briefing, the following is a description of the goals of the Council of Economic Advisers (CEA) over the next two years:

1) To provide the President, Vice President and Senior White House Staff with timely and accurate advice and analysis on the performance of the U.S. economy.

One of the primary functions of the CEA is to advise the President on all macroeconomic issues and developments. To this end, the CEA will continue to monitor on a daily basis critical macroeconomic data and prepare for the President, the Vice President and the White House senior staff daily memoranda interpreting these data and analyzing their effect on the U.S. economy. The CEA will also continue to monitor other indicators and policy announcements to anticipate and evaluate how this information will affect financial markets and U.S. economic performance. The CEA will also continue to prepare the *Weekly Economic Briefing* for the President, which provides detailed analysis of current economic developments and summaries of regional and international economic news.

2) To provide an accurate forecast of the performance of the macro economy for the purpose of making budget projections.

The CEA will continue to play a central role in the bi-annual "Troika" economic forecasting process. The CEA takes the lead in making the Administration's economic forecast, which includes projections of Gross Domestic Product (GDP) growth, unemployment, inflation and interest rates. These projections are then used by the OMB to make expenditure estimates, and by Treasury to make revenue forecasts.

3) To draft the annual *Economic Report of the President.*

The CEA is required by the 1946 Employment Act to prepare an annual Economic Report of the President, which provides an overview and assessment of the state of the U.S. economy and the President's economic agenda. The Economic Report of the President serves as an important compendium of data on the economy and is heavily used by analysts within and outside the government. The CEA is also responsible for preparing the monthly *Economic Indicators* for the Joint Economic Committee of the U.S. Congress.

4) To draft and release reports that provide support and analytic underpinnings for policies advocated by the President.

The CEA will continue to draft and release "whitepapers" and other reports that provide new analysis or academic validation for the Administration's domestic and international policy approaches. The CEA has produced a number of the reports over the past several years. For instance, **in September 1998, the CEA produced for the President's Initiative on Race a chartbook that presented important indicators of well-being by race and ethnicity for use by schools, news media, advocacy organizations, and policymakers.** The CEA also released a whitepaper titled "*The First Three Years: Investments that Pay,*" in conjunction with the early childhood development conference. And, as a follow-up to the White House Child Care conference, the CEA issued a report entitled *The Economics of Child Care,* which reviewed the economics literature regarding the availability, cost and quality of child care and the importance of policies to support access to affordable, quality care for children

5) **To conduct economic analysis that informs and helps shape domestic and international policy discussions and development.**

The CEA will continue to be an active participant in a wide range of interagency domestic policy discussions regarding labor issues, health care, education, child care, welfare reform, tax policy, environmental issues, farm policy, telecommunications, and regulatory reform. The CEA assists in the formulation, analysis and critique of new policy proposals, and reviews the structure and effectiveness of existing programs.

With respect to international economic issues, CEA will continue to play an active role in working with the Treasury Department to develop U.S. policy approaches toward the Asian financial crisis, including reform of the international financial institution architecture. CEA will also continue to take part in interagency policy discussions regarding trade policy and opening of foreign markets to U.S. exports. CEA will continue to take an active role in establishing and promoting the U.S. agenda in multilateral and regional fora such as the World Trade Organization and the Asia Pacific Economic Cooperation Forum. And, finally, CEA will continue to be a leading U.S. participant in the Organization for Economic Cooperation and Development (OECD), the principal forum for economic cooperation among the high-income industrialized countries. The Council heads the U.S. delegation to the semiannual meetings of the Economic Policy Committee and the CEA Chair serves as that committee's chair.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-DEC-1998 16:15:29.00

SUBJECT: Russia & Trade

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

TEXT:
Janet, if you want to be briefed on Russia for your meeting tomorrow
and/or talk about trade, let me know.
Nouriel

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-DEC-1998 10:42:01.00

SUBJECT: Memo to Podesta

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

TEXT:
Cabinet Affairs called to say that at the November Cabinet meeting, Podesta asked all of the agencies to submit a 2-page memo describing the goals and objectives for the next 2 years. Attached is a draft for CEA. Obviously, it is kind of a hard exercise for us since we have no programmatic responsibilities. But, for what it's worth, I think this provides a description of what the CEA's main functions will be over the next 2 years.
Thanks.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D93]MAIL44403463F.326 to ASCII,
The following is a HEX DUMP:

December 1, 1998

TO: John Podesta

FROM: Janet Yellen

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2) To provide an accurate forecast of the performance of the macro economy for the purpose of making budget projections.

The CEA will continue to play a central role in the so-called "Troika" economic forecasting process. The CEA takes the lead in making the Administration's economic forecast, which includes projections of Gross Domestic Product (GDP) growth, unemployment, inflation and interest rates. These projections are then used by the OMB to make expenditure estimates, and by Treasury to make revenue forecasts.

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The CEA is required by the 1946 Employment Act to prepare an annual Economic Report of the President, which provides an overview and assessment of the state of the U.S. economy and the President's economic agenda. The Economic Report of the President serves as an important compendium of data on the economy and is heavily used by analysts both within and outside the government. The CEA is also responsible for preparing the monthly *Economic Indicators* for the Joint Economic Committee of the U.S. Congress.

4) To draft and release reports that provide support and analytic underpinnings of policies advocated by the President.

The CEA will continue to draft and release "whitepapers" and other reports that provide new analysis or academic validation for the Administration's policy approach on a range of domestic and international issues. The CEA has produced a number of the reports over the past several years. For instance, in September 1998, the CEA produced for the President's Initiative on Race a chartbook that presented important indicators of well-being by race and ethnicity for use by schools, news media, advocacy organizations, and policymakers. In conjunction with the early childhood development conference, the CEA released a whitepaper title: *The First Three Years: Investments that Pay.* And, as a follow-up to the White House Child Care conference, the CEA issued a report entitled *The Economics of Child Care,* which reviewed the economics literature regarding the availability, cost and quality of child care and the importance of policies to support access to affordable, quality care for children

5) To conduct economic analysis that informs and helps shape domestic and international policy discussions and development.

The CEA will continue to be an active participant in a wide range of interagency domestic policy discussions regarding labor issues, health care, education, child care, welfare reform, tax policy, environmental issues, farm policy, telecommunications, and regulatory reform. The CEA assists in the formulation, analysis and critique of new policy proposals, and reviews the structure and effectiveness of existing programs.

With respect to international economic issues, CEA will continue to play an active role in working with the Treasury Department to develop U.S. policy approaches toward the Asian financial crisis, including reform of the international financial institution architecture. CEA will also continue to take part in interagency policy discussions regarding trade policy and opening of foreign markets to U.S. exports. CEA will continue to take an active role in establishing and promoting the U.S. agenda in multilateral and regional fora such as the World Trade Organization and the Asia Pacific Economic Cooperation Forum. Finally, CEA will continue to be a leading U.S. participant in the Organization for Economic Cooperation and Development (OECD), the principal forum for economic cooperation among the high-income industrialized countries. The Council heads the U.S. delegation to the semiannual meetings of the Economic Policy Committee and the CEA Chair serves as that committee's chair.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-DEC-1998 09:38:48.00

SUBJECT: Re:our "presumptions paper"

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

TEXT:
Janet, find attached the original Treasury Presumptions paper (AAT1.UNK)
and my comments to it (PRESUM.WPD).
Nouriel

---------------------- Forwarded by Nouriel Roubini/CEA/EOP on 12/02/98
09:37 AM ---------------------------

"SETSERB%DOM13.DOPO8" <BRAD.SETSER @ treas.sprint.com>
11/17/98 04:08:41 PM
Record Type: Record

To: Nouriel Roubini/CEA/EOP
cc:
Subject: Re:our "presumptions paper"

Date: 11/17/1998 04:58 pm (Tuesday)
From: Brad Setser
To: EX.MAIL("Nouriel_Roubini@cea.eop.gov")
Subject: Re:our "presumptions paper"

as discussed, the paper is attached. the paper is one or two steps short
of being US policy -- rather, it is an attempt to express a set of policies
we might be for that policy makers can react to.

bws

- att1.unk

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D76]MAIL48664363Q.326 to ASCII,
The following is a HEX DUMP:

SUMMARY OF CORE ARCHITECTURE PRESUMPTIONS

Crisis management

- Want to move towards a regime for crisis management that provides for a) orderly workouts when a country is "insolvent," and b) some form of lender of last resort-type official financing to allow for the provision of larger quantities of liquidity than is currently possible, more swiftly and with less post-crisis conditionality, to countries that have "pre-qualified." Determining when a country is "illiquid" rather than "insolvent" inherently will remain difficult.

- Want to move towards a system that provides for and encourages greater "pre-qualification" for swift access to liquidity support, while stopping short of a system that provides unlimited liquidity for countries which "pre-qualify" and does nothing for those which do not.

Strengthening emerging market financial systems

- Financial sector weaknesses contributed importantly to vulnerabilities of emerging market economies; need to create market and regulatory incentives for countries to improve their financial systems, linked to a stronger institutional system for the surveillance of national financial systems.

- The pace of capital account liberalization should be linked to strength of national financial systems and the development of a regime to manage short-term inflows (e.g. Chilean or Argentinian capital controls/ prudential regulation).

Regulating the suppliers of capital

- International banks provided funds to emerging markets in quantities and at prices that did not reflect the underlying risks; need to strengthen regulatory discipline, internal controls, regulatory incentives (capital charges), and market incentives for sound risk management practices.

- Stronger regulation/ disclosure should be sought for hedge funds and other institutions holding highly-leveraged positions, both internationally and in the United States.

Exchange rates

- Fixed exchange rates were an element in most recent international financial crises. Given the conflict between monetary policy autonomy and fixed exchange rate, there should be a stronger presumption in favor of exchange rate flexibility, except when there is strong political, institutional and economic backing for a fixed exchange rate.

New global institutions

- If forced to try to choose between integration, sovereignty and regulation, the U.S. traditionally has not been prepared to make a significant sacrifice of national sovereignty (e.g. monetary or regulatory).

draft 4: 11.13.98/ 3.30 p.m.

Initial presumptions on strengthening the international financial architecture

TOPIC 1. <u>EFFECTIVE CRISIS RESOLUTION</u>

Issue: Official support to a crisis country

Presumptions:

- We want to move towards a model of crisis management that would allow for an "insolvency" response/ workouts in the event of an "insolvency" crisis, but also would create some form of official financing close to an international lender of last resort (LOLR) to allow the official community to inject significant liquidity rapidly to countries experiencing a "liquidity" crisis.

- Countries are likely to continue to experience crises/ problems that the official community will want to address through the provision of significant quantities of liquidity.

- The moral hazard problem associated with access to large-scale liquidity support should be addressed in part by finding some analogue to the regulation/ supervision of financial institutions for countries (centered around pre-qualification for access to the liquidity window) rather than exclusively through post-crisis conditionality.

Comments

- The swift provision of large quantities of liquidity is difficult, given current institutional arrangements.

- The moral hazard problem associated with official support is currently addressed through post crisis conditionality, which requires tranching official support and complicates the swift provision of large quantities of liquidity.

A summary outline of a possible regime for crisis management, using the degree of financial sophistication and quality of macro/ micro policies to distinguish countries, follows.

	good policies	bad policies
financially sophisticated	– pre-qualify for LOLR window; LOLR if illiquid but solvent – lower regulatory risk weights on bank loans – [workouts, if insolvent due to policies that have gone off track]	– do not qualify for LOLR window; qualify for traditional Fund programs in a crisis – if normal Fund access insufficient, workouts, supported by lending into arrears if on the right track
financially unsophisticated	– official support, as today [or limited access to LOLR window] – carefully sequenced liberalization – higher regulatory risk weight on bank loans to restrain capital inflows	– do not qualify for LOLR – higher regulatory risk weights on bank loans to deter inflows – workouts if crisis lending into arrears if on right track – heavy conditionality on official debt relief,

Issue: Access to a LOLR type facility

Presumptions

- At one extreme, could create a system that provided unlimited liquidity in a crisis to set of countries that pre-qualified for crisis support, and no support to countries that did not pre-qualify. This would create three potential major problems:

  a) what to do with a country that has pre-qualified but whose policies have since gone, or are going, off-track;
  b) how to address a crisis in a country that is of systemically significance but has not pre-qualified;
  c) how to distinguish between a balance of payments crisis that is just a short-term liquidity problem and one that requires more fundamental change (including the possibility that problems could reflect also be an enduring shift in global economic environment and require some long-term adjustment as well as financing).

- Consequently, do not want to go extreme of strict pre-qualification for unlimited support. However, also do not want to retain current system of weak pre-crisis conditionality/ heavy post-crisis conditionality.

- Rather, want to be somewhere closer to the middle of the spectrum on ex ante/ ex poste conditionality.

- The use of pre-qualification to leverage ex ante improvements in policy is most effective if there is a clear distinction between the differences in the treatment of pre-qualified and non pre-qualified countries, and their creditors, in the event of a crisis.

- The brighter the line between countries that pre-qualify and those that do not, and the tighter the linkage between large-scale official support and pre-qualification, the worse the potential moral hazard.

- Given the need to limit moral hazard, we would need to retain a certain "constructive ambiguity" about who, among the countries that have pre-qualified for access to a "lender of last resort" window, would obtain large injections of liquidity in a crisis. Also might want to maintain some ambiguity of about the scale of "lender of last resort" financing that will be available. Pre-qualification could be a necessary but not sufficient criteria for access. This parallels the "constructive ambiguity" that central banks retain around which domestic financial institutions would be "too big to fail" in the event of a crisis.

Comments/ Concerns

- In addition to the market pressure on countries to pre-qualify for access to the LOLR window, regulatory incentives could be used to induce additional discipline in provision of capital. For example, regulators would impose a higher risk weighting for lending to countries that have not met some criteria for pre-qualification.

- Additional concerns/ difficulties include:

  - finding the right criteria and benchmarks to use for pre-qualification.
  - the ability of the official community to disqualify a country for misbehavior once a country has been granted access to a LOLR facility.
  - risk that might not use right criteria to determine access, so a country that has pre-qualified and continues to meet all criteria for pre-qualification nonetheless experiences a crisis
  - financing a LOLR facility, role of SDRs in a crisis, Amendment of Articles of Agreement.
  - use and meaning of the "collateral" or "security" provided to the lender of last resort when the borrower is a sovereign.

Issue: Regime for "insolvency" crises, i.e "bail-ins" and orderly workouts

Presumptions

- Private sector involvement in crisis resolution is critical to long-run health of the international financial system.

- Countries that have not pre-qualified and experience a crisis should enter into negotiations with their creditors (which could involve a range outcomes, from a temporary stretch-out of existing maturities to a debt exchange which contains a significant measure of debt reduction). If countries pursue a cooperative approach and adopt policies in line with IMF/MDB recommendations, they can be supported by official lending into arrears to sustain incentives for cooperative negotiations with creditors/ policy reform.

- Countries that have pre-qualified but whose policies subsequently lapse would not receive access to the lender of last resort (LOLR) facility; they also would be expected to enter into negotiations with their creditors to find a cooperation solution to their payments difficulties.

- "Voluntary" private sector involvement is less disruptive than "mandatory" private sector involvement, but will be cases when mandatory involvement is required.

- Better to introduce, ex ante, greater payments flexibility in contracts (e.g. insurance-type financing arrangements, contingency financing, and the creation of a legal basis/ procedures for restructuring) than to unilaterally alter contracts. Consequently, want to introduce bond clauses into new debt contracts and other innovations that contractually would provide for greater payments flexibility.

- Methods for involving international banks in crisis containment and crisis resolution are more advanced than methods for involving holders of tradeable securities (sovereign bonds, other new instruments). Over time, need to develop stronger mechanisms for involving a broad range of creditors in orderly workouts. No category of private creditors should be treated as de facto preferred creditors.

- In event of "insolvency," want to promote the possibility of new senior debt (like Debtor In Possession financing in U.S. bankruptcy code) for private sector. This will involve some form of official credit enhancement.

- In extreme cases, it might be necessary for a country to impose temporary, but comprehensive capital controls to backstop a mandatory debt restructuring.

- Willing to consider amending article VIII.2.b. to provide greater protection for sovereign debtors from disruptive legal action/ other steps towards creation of global bankruptcy court/ law

Comments/ Concerns

- Plan for involving private sector in Brazil focuses on (a) limiting capital flight by domestic residents by monitoring behavior of domestic financial institutions that hold Brazilian debt and (b) encouraging international banks to maintain credit lines. Holders of Brazilian Eurobonds have not been pressed to participate in Brazil's stabilization.

- Still a long way from finding ways/ creating mechanisms to "voluntarily" involve holders of internationally tradeable securities (especially bearer bonds) in a crisis -- unless the holders of the securities happen to be banks.

- May soon face question of developing mechanisms for restructuring bonds soon, due to developments in Russia/ Pakistan, which have significant Eurobond exposure. (Eurobonds = sovereign bonds, issued in foreign offerings, traded internationally, and governed by foreign law).

- Need to decide if widespread introduction of "collective action" clauses will provide sufficient basis for creation of mechanism to restructure tradeable securities if there is a need or if there is a need something stronger.

- There is a choice in a crisis, between, at one extreme, a lender-of-last resort response to restore confidence and, at the other extreme, a payments suspension/ mandatory workout that bails all creditors in.

Issue: Temporary controls on capital outflows during serious crises

Presumptions

- Controls on capital outflows are extremely disruptive.

- A country facing a choice between controls on outflows to maintain a fixed exchange rate regime and floating should choose to float.

TOPIC 2. STRENGTHENING THE EFFICIENCY AND RESILIENCE OF FINANCIAL SYSTEMS IN EMERGING MARKETS

Issue: Inadequate supervision and prudential regulations in emerging markets

Presumptions:

- Financial sector weaknesses contributed importantly to the vulnerabilities of the emerging market economies.

- Financial institutions in emerging markets need to be induced, either through stronger supervision, prudential rules, stronger disclosure or other mechanisms, to manage better their risks, particularly in the foreign currency area. For example, simply matching foreign currency asset and liability positions, without taking into account foreign currency liquidity risk, counterparty default risks, or large price and exchange rate movements, is insufficient.

- Foreign participation in the capital markets should be increased as source of capital, expertise, and competition.

- Lack of supervision or prudential regulations in emerging markets, especially in the context of inward capital mobility, induces financial institutions to engage in riskier behavior, increasing the likelihood of public sector bailouts.

- Capital inflow regimes that include linking the pace of capital account liberalization to the development of appropriate infrastructure/regulation to manage short-term flows might be considered. Such a regime might include a Chilean-style "tax" on all short-term inflows or an Argentine reserve requirement on foreign currency liabilities of banks.

- Supervision should be strengthened and become "risk-based", focusing more on the various types of risks a financial institution faces on a consolidated basis.

- Implicit guarantees for domestic banks that encourage riskier behavior should be replaced with more explicit, transparent financial safety nets. These include national LOLR, deposit insurance schemes (with individual depositor limits, risk-based premiums, and co-insurance features), early structured intervention (i.e., strong prompt corrective action capability), and strong bank resolution techniques (with conditioned open bank assistance and with "constructive ambiguity" on the "too big to liquidate" issue).

- There also needs to be better procedures and mechanisms for resolving systemic banking crises, where the extent of the problem is greater than would have been caused by reckless individual bank behavior or poor supervision.

- The development of capital markets should be encouraged as an alternative to bank financing.

Comments/Concerns:

- Capital market liberalization should be appropriately sequenced with stronger supervision. Stronger domestic financial systems will not necessarily prevent banking or financial crises, but may reduce the risk and make the resolution more effective.

- The degree of openness is relevant: the more controlled are capital flows, the more scope there is for inadequate regulations/supervision; the more liberalized, the better the internal "controls" need to be.

- Chilean- or Argentine-style measures only address certain types of risk, including foreign currency risk, and the temptation of cheaper sources of funding, but are no substitute for stronger supervision and stronger internal controls to address interest rate risk, liquidity risk, credit risk, general market risk.

Issue: How to induce better behavior and promote stronger standards

Presumptions:

- Various types of incentives could be employed to induce authorities in emerging market economies to strengthen their supervisory regimes. These include:

  – market access to the major financial centers (justified on the basis of risk reduction);

  – strengthening international institutional supervisory arrangements, such as official "supervising the supervisors" arrangements;

  – an officially-sponsored, but independent, accreditation agency

  – peer review;

  – a financial sector policy forum (that brings together national and international regulators, IFIs, and finance ministries);

– IFI financial sector surveillance and conditionality for access to funds (already being used);

– or Tietmeyer's upcoming proposals (to the extent that they are not already noted).

- The development and enforcement of strong, minimum standards in a number of regulatory and legal areas, which are presently lacking in many jurisdictions, could help improve supervision and reduce riskier institutional behavior, in the context of these other incentives.

TOPIC 3. REGULATING THE SUPPLIERS OF CAPITAL

Issue: Excessive lending by international banks

Presumptions:

- International banks lent more funds, and with higher risk, to emerging markets than would have been prudent *ex ante*.

- The current Basle risk-weighted capital regime needs to be reexamined since it creates incentives or biases toward: (a) short-term interbank lending (capital charges for lending to non-OECD banks are only 20% for short-term instead of 100% for long-term); (b) riskier corporate borrowers (C-rated corporates have the same capital charge as triple A-rated); and (c) riskier sovereign borrowers (all non-OECD borrowers are treated the same at 100%; lending to Japan and Korea is treated the same as to the U.K. at 0%).

- Other regulatory incentives (prudential rules), such as stronger provisioning rules (and possibly single country limits and open foreign currency exposure limits) should be considered to encourage banks to strengthen their risk management practices.

- Market incentives, such as requiring banks to issue subordinated debt to create an extra capital buffer and to utilize the market signaling effect of debt yields, should also be considered to strengthen risk management practices. This could also be adopted for emerging market banks.

Comments:

- The Basle Committee is currently undertaking a major review of the risk-weighted capital regime and had been reluctant to make changes on the margin, but its new chairman, Bill McDonough, is sympathetic to these issues, so it may be a good opportunity to examine the biases.

Issue: Excessive nonbank flow of funds into emerging markets/ Regulation of non-bank financial institutions

Presumptions:

- Investment funds, portfolio investors, and other nonbank institutional investors invested in more emerging market country debt and equities due to higher yields, than would have been prudent *ex ante*, in light of the realized risks.

- There is no equivalent counterpart to the Basle risk-weighted capital regime for nonbanks, though perhaps existing capital rules for securities firms and other institutional investors need to be reexamined to determine any biases toward risk-taking activities.

- Stronger direct regulation of investment funds and other regulatory incentives (such as single country limits and open foreign currency exposure limits) might be considered to encourage nonbanks to strengthen their risk management practices. The "prudent man" versus portfolio allocation rules might be reexamined to determine whether any changes could be made.

- Full and more accurate reporting requirements to regulators and creditors and disclosure requirements to the public by nonbanks, especially more of what would be considered proprietary information would dampen trading activity and excessive risk-taking.

- More and complete information disclosure by certain emerging market borrowers *ex ante* could also discourage investment in some borrowers.

Comments/Concerns:

- There needs to be careful consideration of proposed measures on suppliers of capital to ensure that they do not have the equivalent effect of controls on capital outflows, which as noted earlier, would be extremely disruptive.

- There is still a role for asymmetrical information in markets. The release of too much propriety information might deter players from taking legitimate positions and interfere with the price discovery role of markets.

- A move away from the "prudent man" concept to portfolio allocation rules would reduce the efficiency of capital allocation and may penalize emerging market economies who have good policies. There is also still a role for a Russia fund or an Indonesia fund, as long as investors recognize the risks.

Issue: Systemic effects of hedge funds and other highly-leveraged financial institutions

Presumptions:

- Disorderly defaults of large hedge funds and other unregulated, highly-leveraged financial institutions could have systemic consequences for creditor counterparties and, through major market disruptions, for unrelated investors.

- Creditors to hedge funds should have in place better risk-management practices; risk-models should be stressed-tested for large price movements and default (credit) risk.

- Consideration could be given to "hedge-fund lite" regulation to improve disclosure and transparency to regulators, investors, and creditors and to limit excessive leveraging.

- Any consideration of hedge fund regulation needs to be done in concert with the other major financial centers and off-shore banking centers to avoid a flight to unregulated havens. Need a multi-jurisdictional approach for even "hedge-fund lite" regulation.

Comments/Concerns:

- In addition, the current philosophy of regulation in the United States concerns itself with the protection of depositors and the insurance fund, in the case of banks, and with the protection of investors and the orderly markets, in the case of securities firms. Systemic stability is currently not a key feature. With the functions of the two types of intermediaries becoming increasingly intermingled, the two regulatory philosophies can clash and result in regulatory gaps over certain types of institutions.

TOPIC 4. **<u>EXCHANGE RATE REGIMES</u>.**

Issue: Exchange rate regimes in emerging markets

Presumptions

- The recent crises have shown the vulnerability of fixed exchange rates, particularly if not backed by institutional arrangements like a currency board.

- There is conflict between monetary policy autonomy and a fixed exchange rate

- Small countries that participate in the international financial system that currently maintain a fixed, but adjustable exchange rate should move towards either to one end of fixed v. floating spectrum over time, (i.e. either a pure float or a currency board/ dollarization).

Comments/ Concerns.

- Difficulty with dollarization/ currency board is that a country ties its currency to one major currency, despite real and financial linkages to all three major currency zones (dollar, euro, yen). A dollarized country or a country with a currency board consequently may experience difficulties stemming from fluctuations in the dollar/ yen and dollar/ euro. The absence of exchange rate flexibility requires additional flexibility in real economy to allow wages and prices to adjust in lieu of the exchange rate. Currency boards do not prevent crisis in themselves.

- Costs of exchange rate volatility in world of pure floats may be high for many emerging markets both because there may be a great deal of volatility and because many emerging market economies may be very sensitive to exchange rate fluctuations as a result of exports dependence.

Issue: Exchange rate regimes among the industrial countries

Presumptions:

- Sufficiently common economic and political policy making to support successful target zones among the G-3 is neither feasible nor desirable in today's markets.

- Exchange rate target zones between the major reserve currencies (dollar, euro, yen) are an inappropriate constraint on macroeconomic policy flexibility.

TOPIC 5. CREATION OF ASPECTS OF A GLOBAL CENTRAL BANK/ EXCHANGE RATE REGIME/REGULATOR/ BANKRUPTCY REGIME

Issue that applies to all proposals to create a new global institution: reconciling power granted to the new global institution and national sovereignty

Presumptions:

- If forced to choose between integration, sovereignty and regulation, the U.S. traditionally has not been prepared to make a significant sacrifice of national sovereignty, in this case monetary or regulatory autonomy.

- Want to think about if, and how, the international financial system should be modified to perform certain of the possible functions of a global central bank/ global regulator/ global bankruptcy regime without creating an new, overarching, powerful global institution.

Issue: Lender of last resort

Presumptions:

- Addressed in presumptions on crisis management

Issue: Global monetary union

Presumptions:

- Global monetary union creates more problems than it solves. Do not want to eliminate exchange rate flexibility between major regions of the world economy.

Issue: Regional Monetary Unions

Presumptions:

- Not opposed to regional monetary unions that do not include the United States.

- Opposed to a regional monetary union that would involve the dollar, since a monetary union typically gives all countries in the monetary union some say in the management of the common currency and we would not support any reduction in U.S. monetary policy autonomy. For example, the institutional arrangements to support EMU involve granting the ECB control over monetary policy, a power previously held by national central banks.

Comments/ concerns:

- Should we actively promote regional monetary unions among groups of "small" countries – for example, a Southeast Asian or Latin American Monetary Union?

Issue: "Dollarization" in select emerging markets

Presumptions:

- Neutral on dollarization. Dollarization (adopting the dollar or other major currency as legal tender) implies countries giving up independent monetary policy/ capacity for exchange rate adjustment. It may contribute to stability in dollarized countries, who give up their own ability to manage their currency by importing someone else's currency and credibility. However, difficulties in a large dollarized country may create pressure on the Fed to consider impact of its decisions on the "dollarized" zone as well as United States.

Comments/ Concerns

- If we wanted to encourage dollarization, might do so by offering to split the seigniorage revenue from dollarization with dollarized country -- though this creates technical and legal problems that would have to be resolved.

Issue: Currency Boards (Strong institutional commitment to fixed exchange rate)

- As indicated in section on exchange rate regimes, we are in presumptively in favor of countries moving towards one end of fixed v. floating spectrum – i.e. currency boards or pure floats -- rather than staying in the middle.

- Do not oppose countries that decide to unilaterally tie their currency to the dollar through a currency board, provided appropriate domestic institutions are in place to make a currency board credible.

Issue: Global liquidity adjustment

Presumptions:

- May be some circumstances when global liquidity adjustment is appropriate – but would not want to give the IMF power to increase unilaterally the global supply of liquidity.

- Some reserve creation might be positive, but do not want to go to far both because of concern about impact of overall increase in global money supply and concerns about a country's creditworthiness.

Issue: Global fund to regulate and insure capital flows

Presumptions:

- Do not want to shift decisions about credit allocation to an international body. Also might not be able to avoid providing official assistance/ support to country that borrowed more than officially authorized and insured to limit contagion/ avoid negative impact on financial system. Cannot credibly commit to only assist certain, insured creditors and not others (analogous it issue of country pre-qualification and the lender of last resort).

Issue: Global regulator

Presumptions:

- Even if, in principle, a global financial regulator for global financial institutions may make sense, practical and political problems are likely to be insurmountable.
- Support increased coordination/ information exchange among national regulators, through mechanisms like the Financial Sector Policy Forum.

- Need to improve surveillance of national financial systems

Issue: Global "Tobin" tax

Presumptions:

- A small tax on all transactions would need to be established on a global basis to be effective. This is not likely to be feasible at the present time.

- A tax on all transactions might not be desirable, as it would reduce, if effective, the depth and liquidity of some markets.

- A small tax on transactions is no panacea, as even its advocates acknowledge. A small transactions tax would not deter speculation against a fixed exchange rate, since the possible profits from successfully shorting the currency would dwarf the small transaction tax.

Issue: Global Chapter 11

Presumptions

- Do not want to/ politically cannot support granting international authority to alter private legal contracts during a crisis/ and force creditors to accept debt reduction if there is not an agreement in the shadow of the court.

- Main concern in country "bankruptcy" is possible contagion, not potential legal action. Contagion stemming from a major country entering into Chapter 11 could be significant.

- Need to explore other ways (as in WG 3 report) to stimulate key features of Chapter 11, including DIP financing and stays on disruptive legal action by creditors

Comments on the "Core Architecture Presumptions" paper
Nouriel Roubini, CEA 11/24/98

Topic 1: Effective Crisis Resolution

The idea of some form of lender-of-last-resort official financing is interesting and I like it in principle. The paper considers all the relevant issues. However, I am not fully convinced that the rationale for this idea is fully fleshed out and that such facility could play an important in preventing financial crises and panic.

One main concern in designing an international lender of last resort (ILLR) is the tradeoff between the benefits of avoiding self-fulfilling runs on a country and the moral hazard created by any form of lender of last resort. These problems are already difficult in a domestic banking context but they are even more difficult in an international context.

Who should pre-qualify for ILLR support?

To avoid the moral hazard problem of countries misbehaving once they know they might have access to such a facility, one could be very strict about the which countries would pre-qualify. To set an example, let us think of which emerging market countries would pre-qualify in the present time. I would say very few, at most Argentina, Brazil, Hungary and Poland. Should Brazil have pre-qualified for this facility rather than for a traditional IMF package with lots of conditionality? My simple answer is no if pre-qualification means to have access to funds on the basis current macroeconomic conditions. 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 the stabilization package. Under such conditions, it is very hard to argue that Brazil should pre-qualify and should have access to a ILLR fund. A more traditional conditionality package (centered around fiscal adjustment) appears more warranted with the only new twist being an early and more rapid disbursement of the funds in the package.

Similarly, should East Asian countries such as Thailand, Korea and Indonesia have pre-qualified for such a facility in 1997 if one had existed? If we take the traditional usual suspects (inflation, budget deficits, growth, savings and investment rates) we could have argued that all Asian crisis countries should 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 a clear no. So, if we agree that the Asian crisis was due to weak fundamentals, it would have been a 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.

So, one problem with a ILLR facility is that if the pre-qualification criteria are tight, as they should be in my view, very few countries would pre-qualify and those same countries would not need the facility in the first place. As recent experience shows, countries such as Argentina, Chile, Hungary, Poland have weathered the crisis quite well and have not had the need to access IMF funds. It is not clear that the existence of such a facility would have made any difference to them. One could argue that, having such a facility would have helped these "good" countries to avoid the painful increase in domestic interest rates that they were forced to implement to avoid destabilizing outflows. But even such argument is not obvious: if you are under attack, it might be better to signal your toughness by having a temporary increase in interest rates rather than signal weakness by drawing on reserves and/or an ILLR facility. The latter strategy may be dangerous as ILLR funds are limited and costly and you may undermine you credibility by drawing excessively on them. So, while painful, a temporary increase in interest rate in a sound country may be the right policy response. After all, Argentina weathered this crisis with much smaller spikes in its sovereign spread than other Latam countries because in 1995 it had showed its commitment to the CB and reform by holding tight and keeping interest rates high.

So, in the best scenario the few countries who would pre-qualify may not really need these funds and all the other who may need such funds may not pre-qualify and/or should not pre-qualify.

Are runs due to self-fulfilling equilibria or fundamentals?

Also, one should be careful about pushing the argument that a ILLR is needed to prevent irrational, self-fulfilling bad multiple equilibria runs on a country. Even in a domestic context, while the possibility of a pure "irrational" run on a healthy bank is possible in theory, in reality all known runs have occurred on banks that on the basis of fundamentals had some serious weaknesses. A pure bank panic and run not justified by any fundamental is mostly a theoretical curiosity as banks that are run on have usually serious problems. In other terms, this means that investors are not irrational and do to attack banks just for the sake of it.

In technical terms, the multiple equilibria literature is somewhat flawed because, once an economy is in the region where such bad equilibria may occur, nothing in the model explains why investors focus their expectations on the bad equilibrium rather than the good one. They are all as likely as the other. In reality, instead, the probability of ending up in the bad equilibrium would depend on fundamentals; if fundamentals are weak, the probability that agents attack is higher. In the bank context, it is weak banks that are attacked; solid, healthy banks are almost never attacked. If one takes this analogy to countries, then the message is clear. It is unlikely that a country that has good fundamentals (pre-qualifier) would be attacked, save for extreme cases of contagion that such countries can deal on their own. Countries that are attacked are usually countries that, in some dimension or the other, have weak fundamentals. If that is the case, such countries should in general not pre-qualify for a ILLR facility and would therefore get little benefit from the existence of such a facility. For such countries, traditional conditionality or, at most, a Brazilian variant of it (i.e. early and substantial disbursements of funds conditional on a strong fundamentals adjustment) would be the maximum that is warranted.

Moreover, in a domestic context, the moral hazard problems created by deposit insurance and LOLR support are (or should be) compensated with strict regulation and supervision of the banking system and strong capital adequacy standards. When the latter are not effectively implemented, we repeatedly observe systemic bank crises that are very costly (fiscally and in terms of the output loss that a financial crisis triggers). However, in the international context sovereignty implies that we cannot directly regulate an economy or impose capital adequacy standards. The most we can do is to give some incentives for good behavior and hope that countries follow them. This means that the carrot of ILLR cannot be directly linked, as in the domestic-context, to the sticks of regulating banks/countries. The best we can do is to promise some ILLR if the country behaves on the basis of pre-qualification criteria. But that may not be enough to ensure a stable system. In the domestic context, an efficient system provides explicit incentive-compatible deposit insurance and certain LOLR support while imposing at the same time explicit regulatory and capital constraints. In the international context, we risk to provide deposit insurance and LOLR that is uncertain (maybe we will rescue you, maybe not; maybe we will give you enough funds to avoid a run, maybe not) in exchange of "self-regulation" (i.e pre-qualification if the country behaves on its own). It is not clear that this is an ideally designed setup that will be stabilizing.

ILLR and insuring banks' foreign liabilities

There is another dimension in which the domestic and international dimension of ILLR are related. In a domestic context, the logic of deposit insurance is based on the idea that small depositors do not have the resources to monitor what the bank is doing with their deposits. To avoid irrational panic, we insure their deposits. The same does not hold for large investors who can and should be careful about the banks' action. That is why there are limits to the amount of deposit insurance (say $100 K). In an international context, it is not clear why foreign depositors in the domestic banking system should be insured. More specifically, since a large fraction of the foreign currency liabilities of commercial banks in emerging markets are short-term cross-border interbank loans, there is no reason why such large investors should be insured. In reality, we already know that, even without formal insurance, such liabilities have ended up to be insured ex-post, exacerbating moral hazard issues. While the G22 recommend that government should not guarantee, either ex-ante or ex-post such liabilities, this is never the case. Now, since we are pushing in the direction of trying to make such a "no guarantee of foreign liabilities of the banks" goal stick, we risk to undermine that with a ILLR facility. If a country can borrow from such a facility, international investors (as well as domestic ones) can be sure that they can liquidate their liquid positions in the banking and financial system of the emerging market without a loss. Such a loss will be zero under fixed exchange rates. Even under flexible exchange rates the loss would be limited because a country that dips into that facility will do so to use the funds to limit currency depreciation and thus allow investors/depositors who do want to get out semi-risk free. Then, how can we design a ILLR facility that does not imply implicit or explicit bailout of interbank cross-border loans? There is no simple answer to this issue. We may end up exacerbating the moral hazard problem rather than mitigating it.

Criteria for pre-qualification

The papers considers only two categories of countries, those that would pre-qualify and would have access to the ILLR facility and those that would not. This may not be an ideal scheme and one could suggest better alternative. An alternative is to score each country on the basis of a number of criteria (macroeconomic variables, debt management variables, financial sector weaknesses) and give a graduated grade for each of these criteria. Then, the access to the ILLR facility will be graduated, in terms of the amounts and conditions for access, depending on how many criteria for good behavior are satisfied. This smoother, more continuous classification may have advantages over the more discrete (in or out) classification proposed in the paper. The reasons are as follows. To avoid moral hazard, pre-qualification based on and in or out classification would imply that only very few countries would pre-qualify. Then, a country that is very far (in terms of the criteria) from qualifying would have very little incentives to improve its performance since even some improvement would not lead to qualification. Instead, with a more graduated classification, there would be some substantial carrot from improving performance. As a country scores better and better on more and more criteria, its access to the facility would be larger and at better terms. This may give better incentives for more countries to behave than a straight qualified/not-qualified list. It would be akin to a form of bank deposit insurance where the amount of insurance premia depends on the riskiness of actions taken. Here, instead of just higher premia (graduated penalty interest rates), the country will also have gradually greater access to the size of the facility (i.e. a greater amount of insurance) depending on the riskiness of its actions.

Illiquidity versus insolvency

Another subtle caveat regards the distinction between countries that are **insolvent** and countries that are **illiquid**. As discussed above, some countries may be illiquid but still be characterized by weak fundamentals that do not make them insolvent. So, ILLR support should be given only to countries that are illiquid and have strong fundamentals. Moreover, the distinction between insolvency and illiquidity is ambiguous. Some countries with poor fundamentals are not strictly insolvent; they may need strong macro adjustment but that does not make them insolvent. They actually may become illiquid just because investors flee in face of the perceived weak fundamentals. Note also that the concept of insolvency is a bit ambiguous. To specify the meaning of 'solvency' or `sustainability', consider a country running a current account deficit and accumulating foreign debt relative to its GDP, so that solvency requires the country to run trade surpluses at some point in the future. Consider sustainable a path of current account deficits and foreign debt accumulation when the reversal in the trade balance consistent with solvency can be expected to materialize without a sharp change in current policies and/or an external crisis. An external crisis could come in the form of a currency crisis --- a run on the central bank's foreign exchange reserves and/or a rapid depreciation of the exchange rate --- or a foreign debt crisis --- the inability to obtain further international financing, or to meet repayments, or an actual default on debt obligations. The notion of 'solvency' or 'sustainability' raises interesting macroeconomic and political economy issues in the analysis of external imbalances. For instance, sustainability can be related to both the country's `willingness to pay', and the creditors `willingness to lend'. Willingness to pay can become an issue when a country is technically solvent (given its expected path of trade balances) but it is not politically feasible to divert output from domestic to external use to service the debt. Creditors' willingness to lend on current terms is a maintained assumption in the theoretical solvency criterion, but such presumption may not be realistic if, for any reason, foreign creditors come to believe that the country will renege on its liabilities, thus requiring a higher default premium, or stop lending altogether. All this to say that the distinction between insolvency and illiquidity is ambiguous.

A few other minor points on Topic 1:
Page 5, second bullet: there is a reference to countries that do not pre-qualify, experience a crisis and enter into negotiations with their creditors. Shouldn't they enter in such negotiations before rather than after a financial/currency crisis has already caused a lot of disruption. Example: Korea should have negotiated a rollover before the panic in November rather after the panic than January. Of course, this is easier said than done but we should think of how countries such as Pakistan, Ukraine and so on might find way to negotiate restructuring of debt before rather than after doomsday collapses.

Page 5, second from last bullet: I do not see the logic for some form of official credit enhancement. If there is true DIP financing or some other form of superpriority financing, we may not need official credit enhancement. Rather regulatory/legislative changes allowing such superprior financing may be needed.

Page 4: need to think more carefully about constructive ambiguity and its implications. In a domestic context where deposits are insured, constructive ambiguity means only that LOLR support may or may not occur so that the bank may be liquidated but depositors will still be fully paid. In an international context, such ambiguity may lead to excessive uncertainty and panic. If a country has pre-qualified, why should we be ambiguous about whether they will have access to the LOLR window?

Page 6, first bullet: it seems to suggest that we may support step leading eventually to the creation of a global bankruptcy court/law. This seems to be in contrast with the rest of the paper (topic 5) where you rule out that. I am in favor of amending VIII.2.b.

Page 6: capital controls on outflows during crises. I agree with that with a small caveat. Minor capital controls have been introduced by Korea, Thailand and Philippines after the crisis. We do not want Russian or Malaysian kind of controls but if a crisis was due to a very poorly regulated financial sector, the reintroduction of some controls may just be the reintroduction of prudential regulation.

Topic 2:
Capital account liberalization
The discussion in this issue is good. There seems to be a consensus that prudential standards may require limiting short-term cross border interbank flows a la Argentina. Much more controversial is the idea of Chilean style controls on are all short-term inflow. The Treasury documents leaves open the issue of whether we would support limited Argentinean controls or much broader Chilean style controls on are all short-term inflows. At some point, we will need to come up with a clearer answer as the two approaches are quite different. My personal view is that Chilean style of controls may be warranted, especially when the supervision and regulation of the banking and financial system is still weak.

Use of "risk-based" supervision.
That is all nice but if these emerging markets would even just start with old fashioned

supervision and regulation and leave to a later stage the use of fancy VAR models, we would already make a lot of progress.

Explicit deposit insurance schemes.

See my caveats above about not insuring big players and foreign banks cross-border liabilities.

Page 7: Did not clearly understand the point about how the degree of openness is relevant. Clarify.

Page 9 on IFI financial sector surveillance and conditionality. What about a new IMF Article of Agreement where the liberalization of capital flows is linked to countries adoption of Basle core principles of bank supervision. This will also give a stick to "force"countries to progress on structural financial reform. For example, satisfaction of the Core Principles could be a necessary but not sufficient condition for access to ILRR and/or to SRF.

Topic 3:

How do we go about deciding how much the prudential controls should be on the lending banks in G10 countries as opposed to be imposed on the borrowing banks in emerging markets? Do we want both? The former if the latter is not implemented? Not the former if the latter is implemented? Need to think about this.

I am not sure that sub-debt idea a la Calomiris would work for emerging markets. There is still plenty of controversy on whether this is a good ideas for the G10. So I would put it in a comments/issues/concerns category rather than in a "Presumptions" category.

We should start thinking seriously about how supervision/regulation is affected when/if we break the links between commercial and investment banking in a post-Glass-Steagall world.

We should be careful to suggest single country limits and/or open foreign currency exposure limits for non-banks. Country funds (even a pure Belarus fund today) and highly risky/speculative funds have a role in the system. We should just make sure that the banking institutions carefully manage their risks when they lend to such institutions.

Topic 4: Exchange Rate Regimes.

I am sympathetic with the bias in favor of more flexible exchange rates. There are few caveats on this that I discussed in my previous (11/7/98) paper on the Asian crisis. I will refer to that discussion.

Topic 5

I am in agreement with most presumptions.

Why not NAMU?

Just a provocation. Why should we be against a NAMU (North American Monetary Union) including Mexico and Canada? I see the arguments against it in the paper; they will have a say in US monetary policy.... But, given their size, they would each have only one seat in the FOMC meetings. After all, we do not worry about California or Texas determining US monetary policy. Should we worry about Canada or Mexico doing so? We could certainly live with Canada in the union. And Mexico is always tempted to dollarize. Anyhow, this is just an intellectual provocation. Don't want to push the idea any further.

Dollarization
Splitting the seignorage in the case of dollarization is too little a carrot. Sovereignty and controls on the banking system are more important than seignorage as: a) seignorage is small change nowadays; and b) controls on banks and LOLR issues are more relevant to the decision of dollarizing.

Contagion and Chapter 11
I agree that contagion from Chapter 11 is an issue. However, in Russia we did not have Chapter 11; we had instead unilateral coercive default on public debt. This is very different from a Chapter 11 where the debt payment suspension is semi-voluntary, sanctioned by the IMF and aimed at reaching a cooperative deal between creditors and debtor. I see our sensitivity on this after the debacle in Russia and the ensuing contagion. However, smaller countries that do not have systemic effect and do deals that are closer to a true cooperative Chapter 11 should not necessarily cause panic and contagion.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 3-DEC-1998 15:19:31.00

SUBJECT: Press interviews

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

TEXT:
I have tenatively put the following reporters on your schedule and if you do NOT want to talk to them, I would be happy to cancel any of the interviews:

1) AP (Marty Crutsinger): Monday, Dec 7 at 10:30. He is doing a story on the longest peacetime expansion in history. He wants to talk to you about the state of the economy, why it has been so strong, and where the economy is going.

2) Business Week (Mike McNamee): Monday, Dec 7 at 4PM: He is doing an end-of-the-year story on the state of the economy -- wants to assess where it has been and where it is going.

3) Time (Josh Ramo): lunch on January 6 from 1-2. He is NOT going to do the story on Larry. Instead, he is going to focus on his story on Greenspan/Rubin and on the strength of the US economy.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 4-DEC-1998 11:08:26.00

SUBJECT: response to Sensenbrenner letter

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

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

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

TO: 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:
Here is the revision based on comments from Jeff, Steve, and Quindi.
Michele, could you take a look at (and revise where necessary) the
concluding paragraph. Are we comfortable circulating this for interagency
review? Should it go through OMB review? Should we circulate to some WH
folks prior to OMB review?

Joe

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D86]MAIL497654931.326 to ASCII,
The following is a HEX DUMP:

Dear Chairman Sensenbrenner:

I appreciate the opportunity to provide you with a response to your October 20, 1998 letter regarding economic analysis of the Kyoto Protocol. Your letter made requests for comments on two issues. First, I will address your interest in our comments on the Energy Information Administration report "Impact of the Kyoto Protocol on U.S. Energy Markets and Economic Activity." Second, I will respond to your question regarding implementing legislation.

Comments on EIA Report

I will present my comments on the EIA report in the context of the climate change modeling efforts by the broader economics community. In evaluating the results from any model, it is important to understand what questions are being asked. We have found in our review of the climate change economics literature over the past several years that the most significant cause for divergence in modeling results is that different modelers ask and answer different questions. In the Administration's assessment of the economic implications of the Kyoto Protocol, we have addressed a set of questions that reflect the Administration's position on the Protocol. The Administration unambiguously supports the efficient implementation of the "flexibility mechanisms" secured in the Kyoto Protocol -- international emissions trading, joint implementation, and the Clean Development Mechanism -- and we will continue to work over the coming years in multilateral fora to develop rules that ensure such implementation. In the Administration's illustrative modeling analysis, we found that these flexibility mechanisms are critical to reducing the costs of meeting emissions targets, not just for the United States, but also for the European Union, Japan, and all other Annex I countries.

Economic modeling efforts outside of the U.S. government have also found that these flexibility mechanisms can significantly reduce the cost to the United States of reaching its Kyoto target. For example, the Energy Modeling Forum (EMF) based at Stanford University, which has a long-running model comparison exercise involving many of the leading climate and energy models, has coordinated full scale analyses of the Kyoto Protocol. This comparison exercise of the Kyoto Protocol included ten modeling teams from the United States, Europe, and Asia. The Kyoto Protocol enables all countries with emissions targets to trade emissions allowances among other countries with targets. In evaluating the Kyoto Protocol, all of the participating teams used economic models that incorporate the potential for international trading in greenhouse gas permits. These models are well-suited to assess the economic implications of the international trading component of the agreement. On average, the EMF models found that Annex I trading would cut the U.S. permit price by 53% relative to a no trading scenario. Of these models, one estimated a 72% reduction in the permit price under Annex I trading. In full global trading, the permit price would be, on average, 80% lower than the no trading price. Several models estimated permit price reductions of about 90%.

In addition, the Organization for Economic Cooperation and Development (OECD) recently convened modelers from around the world for a climate change modeling workshop. While many of the modeling teams at OECD also participate in the EMF exercise, the

workshop included four non-EMF teams. The results from non-EMF models reinforce the importance of international emissions trading in lowering permit prices. These models also found that Annex I trading can significantly reduce costs, and global trading can result in even more substantial cost-savings.

The modeling results from these two large efforts coordinated by EMF and by the OECD clearly indicate the potential for cost-savings through an efficiently-designed international trading system. It is important to recognize that these two efforts relied exclusively on models with the capacity to model explicitly international trade in emissions allowances. We believe that it is appropriate to evaluate the Kyoto Protocol with models that can assess the opportunities for international emissions trading, since trading is embedded in Article 17 of the Protocol. Models that cannot evaluate international trading are constrained in the kinds of questions they can effectively address.

The Energy Information Administration's model, NEMS, is not capable of addressing the question of international emissions trading: it is focused only on the U.S. energy sector and has no international component. Thus, EIA did not conduct any analysis of cost-effective international trading opportunities. A traditional economic analysis of international trading would assess the demand and supply of emissions allowances and, by modeling a market where costs are minimized, identify a single international permit price. This is the approach taken by the Administration as well as by the EMF and OECD modeling teams. However, the EIA analysis assesses only the demand side of the issue for the United States, and then incorporates what appear to be arbitrary assumptions about alternative possibilities for the international permit price and subsequent international transfers. The scenarios that attempt to include international trading overstate the cost of permits because they fail to take into account the way that an international market, bidding to a single international permit price, lowers cost.

In addition to the question of international trading, there are other important questions that models should consider in evaluating the Kyoto Protocol. For example, the Protocol covers all six major kinds of greenhouse gases. While most of the models involved in the EMF and the OECD exercises did not consider these other gases in their analyses, the Administration's illustrative modeling effort did address this issue. The EIA analysis does not address this question. EIA assumed that the United States would achieve its target only through carbon dioxide reductions. The flexibility across gases allows countries and companies to make reductions in the most cost-effective manner possible, reducing the cost of compliance. Based on Annex I national communications, emissions growth in non-carbon dioxide greenhouse gases is expected to be much slower (and in some cases negative) than carbon dioxide between 1990 and 2010. This indicates that the U.S. six-gas target is less stringent than implied by just an assessment of carbon dioxide alone, and that there could be greater cost-savings through international trading of all greenhouse gases than implied by assessments of carbon dioxide trading alone.

Another crucial aspect concerns the time frame of emissions abatement. As the Administration Economic Analysis on climate change noted, the Administration advocated and secured in the Kyoto Protocol a later and more realistic time frame for the initial emissions target than what had been proposed by other countries. By adopting a gradual and credible path of reductions in the early years, adjustment costs can be reduced. How one addresses the question of timing of reductions affects the modeling results. In EIA's study, most businesses do not take action to address climate change until 2005, and therefore only have a short time until the 2008-2012 budget window to reduce emissions. This essentially assumes that even though the Administration secured this more realistic commitment period to reduce the burden on firms by allowing them to more gradually undertake emissions reductions, very few firms would actually take advantage of such an opportunity. Studies have demonstrated that the amount of lead time a company takes has dramatic economic implications. For example with EIA's model in the Interagency Analytic Team draft report, a 5-year "ramp-up" (starting in 2005) would result in economic costs 65% greater than that associated with a 10-year "ramp-up" (starting in 2000). Thus, the assumption that many businesses would fail to plan for the future results in higher projected costs.

While some may claim that very little action is likely to occur prior to 2005, there is reason to believe that some firms will act well before 2005. Already businesses are taking action to address climate change. For example, on September 18, British Petroleum announced its plan to reduce emissions of greenhouse gases worldwide by 10% below 1990 levels by the year 2010. In July, United Technologies announced their plan to reduce its worldwide energy consumption by 25% by the year 2007.

Finally, how an analysis addresses other policy issues that can affect the costs of abating emissions can also impact the conclusion regarding costs. In the Administration's analysis, additional elements of policy were recognized as having the potential to significantly decrease the costs of compliance and increase the amount of reductions that might be accomplished at home. These policies were not factored into the illustrative model the Administration cited, but were qualitatively taken into account in reaching the conclusion that the United States could meet its Kyoto target for a relatively modest cost. The EIA analysis, however, ignores elements such as forestry activities (covered under the Kyoto Protocol) and the Administration's electricity restructuring proposal, which could significantly lower compliance costs.

Implementing Legislation

Based on conversations with State Department staff, it is my understanding that when the Administration submits the Protocol for ratification it will also submit implementing legislation. While the Administration advocates the use of a domestic trading program during the 2008-2012 commitment period, no policy decisions have yet been made about the nature of this program. Thus, all aspects of the trading program, including the option to auction some or all permits and recycle the revenue back to the economy through cutting other taxes, are still under consideration.

The Administration continues to believe that the costs of achieving our Kyoto target will be modest if we are successful in securing rules for efficient international trading, joint implementation, and the Clean Development Mechanism, and key developing countries meaningfully participate in the international effort to address climate change. Again, I appreciate this opportunity to share with you some of the latest insights from the economic modeling community and our perspective on the recent EIA analysis. If you have any questions, please feel free to follow-up with my staff at 202-395-5084.

Sincerely,

Janet Yellen
Chair

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 7-DEC-1998 19:31:34.00

SUBJECT: Treasury Architecture memo: latest version attached

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

TEXT:
Janet, here is attached the latest version, just in case.
Nouriel

---------------------- Forwarded by Nouriel Roubini/CEA/EOP on 12/07/98
07:26 PM ---------------------------

"ATKINSONC%DOM13.DOPO8" <CAROLINE.ATKINSON @ treas.sprint.com>
12/05/98 08:03:07 PM
Record Type: Record

To: alexandl @ frb.gov, Nouriel Roubini/CEA/EOP
cc:
Subject: work in progress; comments welcome

Date: 12/05/1998 08:39 pm (Saturday)
From: Caroline Atkinson
To: roubini, lew
Subject: work in progress; comments welcome

on attached note (I think Brad earlier circulated a version)

<WP Attachment enclosed>

- att1.unk

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D90]MAIL45625424N.326 to ASCII,
The following is a HEX DUMP:

Overview

More than $1 trillion dollars has flowed from developed to developing countries since the start of the 1990s, bringing new expertise and new investment in the developing countries -- and helping to increase returns and diversify risks in the developed ones. Yet for all the opportunities that large-scale capital flows bring with them, recent events have reminded us that they also bring new risks. Financial crises such as those we have seen in Mexico in 1994 and, more recently, in Asia and Russia, have inflicted immense economic and social damage on the affected countries, imposed heavy direct and indirect costs on the international community as a whole, and threaten to undermine political support for closer global integration.

In the wake of these crises, we all have a responsibility to build a better world financial system, one more adept at avoiding crises and more effective in containing them when they strike. Key elements in such a system include:

- stronger incentives for emerging market economies to adopt policies which will improve their ability to capture the benefits of global capital markets, while withstanding its risks;
- incentives in industrial countries to encourage more disciplined investment and credit decisions, and to reduce leverage and limit systemic risk;
- a more effective regime for crisis management which aims to minimize the severity of crises while maintaining incentives for prudent private credit and investment decisions.

The following sets out how we see the main issues, and what steps should be considered going forward. In some cases, work is sufficiently advanced to press for specific actions. In other areas the note points more tentatively to ideas that should be considered, both here and in our international discussions.

I. Improved policies in developing countries

Better policies in emerging markets are needed to promote their domestic stability and limit vulnerability to crisis caused by shifts in global capital. We should press--bilaterally and through the international agencies--for the following:

A. *Sound macroeconomic policies.* Countries need consistent monetary and exchange rate policies as well as fiscal policies that avoid excessive accumulation of government debt.

B. *Prudent public debt management.* Borrowing short-term, and in foreign currencies, can be very appealing: it is cheaper and often easier in the short-run. But too much of this kind of borrowing makes governments and countries vulnerable to sudden shifts in investor confidence. In the long-run it can be very costly. Sound debt management is important to provide some "insurance" against the risk of temporary market disruptions.

C. *Stronger financial systems.* The following steps could all improve financial systems: adherence to the Basle Core Principles for Effective Banking Supervision and other international standards now being developed; greater foreign participation in emerging markets, to spread better regulatory and risk management practices; the development of a better credit culture in the banking system; and prohibitions on directed lending and on "non-arms length relationships" between lenders and borrowers.

D. *Development of capital markets in emerging economies.* Greater reliance on equity and other financing that does not result in the build up of excessive debt burdens should limit vulnerability to crises. This could include efforts to develop local/regional capital markets.

E. *Stronger legal infrastructure.* The Asian crisis demonstrated that for private markets to work effectively, better financial regulation is not enough. There must, for example, also be clear and enforceable bankruptcy laws, so that a crisis in a single bank or company can be dealt with before it spreads; sound corporate governance, so that investors' and shareholders' rights are clear; and strong judicial systems, so that laws in these areas can be enforced.

II. Measures to induce emerging market economies to undertake sound policies

Global, private capital markets should play a key role in encouraging emerging markets to strengthen their policy regimes, with investors less willing to lend where policies are poor, and insisting on higher returns to compensate for the greater risk when they do lend. But recent events have demonstrated that market discipline is often sporadic, with periods of easily available capital and little apparent attention to risks, followed by swift and sudden reversals. Official action is needed to give incentives for market discipline to work better and for countries to follow good policies.

A. *Developing codes and standards of good international practice, against which countries' policies can be judged*

- We would support a major international effort to develop and agree international codes and standards across the range of areas now understood to be critical for financial stability. Standards in some areas, such as disclosure of countries' foreign exchange reserves and how these measure up against short-term liabilities, are already close to being agreed and can soon be implemented. In other areas--ranging from bankruptcy regimes, to corporate governance, to ways to deal effectively with weak banks before the entire banking system is crippled--much work is still needed.

As standards and codes are developed and agreed, countries need to be encouraged to implement them. There are a variety of ways to do this:

B. *Higher profile to countries' adherence to international standards*, with greater disclosure and transparency about how countries measure up against such standards. The G7 has proposed, for example, that the IMF publicly and regularly report on countries' compliance with the international data disclosure standards developed since the Mexican crisis . The G22 called for a transparency report to be prepared, and published, by the IMF on each country. We should press forward with these proposals.

C. *Stronger international surveillance.* Also key is a strengthening of international capacity to monitor financial systems. This could include a strengthened capacity in the IMF and World Bank to review country performance, including compliance with new international standards as they are developed. As a complement, some form of new international accreditation by the private sector could also be explored.

D. *Financial market access.* We could also explore whether we should seek international agreement to link access to our markets, and those of other major financial centers, to emerging markets' adherence to appropriate international standards. While this could be a powerful tool, it may be difficult to achieve. Possible measures to consider could include:

  - Linking the ability of foreign sovereign borrowers to issue bonds in US and other capital markets to their meeting international standards, e.g. for disclosure.

  - Linking the ability of banks to do business in major financial centers to their meeting internationally-agreed minimum standards for disclosure and to adequate home-country bank regulation and supervision.

E. *Additional ways of creating incentives for strong policies before, rather than only after, a crisis.* Conceptually, it could be attractive to link treatment of countries in crisis to how they had behaved beforehand, encouraging some to pursue better policies and avert crisis.

  - Creating an on/off switch for favorable access to official financing to countries that have met certain key "qualification" criteria would not be workable. It would be difficult to avoid politicizing the process of qualification; bureaucrats in international institutions are not likely to be better than markets at judging in advance when a country is likely to run into crisis; and the international community will probably want to help systemically important countries in a crisis even if they failed to "qualify." Moreover, creditors may be less prudent in their lending to countries that have "qualified," in expectations of a bailout.

- But it may be worth considering further work to develop a matrix that shows how countries perform across a range of economic and financial areas. We could explore whether this could be a guide to the terms of official finance provided in a crisis: better performers may, for example, be likely to need less conditionality. We could also explore the possibility of incentives for private creditors and investors to pay attention to a countries' performance, and add to the pressure for stronger policies. An obvious question mark over such ideas is why the official sector should perform better than private rating agencies.

F. *Carrots as well as sticks.* The G7 has asked the IMF and World Bank to develop a strategy to provide technical assistance to supervisors and financial institutions in emerging markets, to help improve their capacity to meet stronger international standards.

III. Measures to induce creditors and investors in industrial counties to analyze and weigh risk appropriately

Measures to induce creditors and investors in industrial countries to act with greater discipline – i.e. to analyze and weigh risk appropriately in their lending and investment decisions – are also needed to dampen investors' tendency to underestimate certain risks during periods of market euphoria. Industrial countries as well as emerging market economies should live up to the internationally-agreed standards and codes and be subject to an improved mechanism for international financial sector surveillance.

An international task force, as called for in the APEC and G7 communiques, to examine the measures to promote safe and sustainable capital flows, including questions related to "hedge funds" and off-shore centers, should be set up to take forward work in these broad areas.

A. *Strengthened risk management systems.* There is a clear need for increased focus on the quality of risk management systems in financial institutions. These systems should also be systematically stress-tested to show the potential impact of unusual changes in financial markets. Regulators should consider whether risk management models should be standardized or if each financial institution should have its own model (which regulators would examine).

B. *Greater differentiation in bank capital standards.* A review of the existing Basle Capital standards is already underway. This will consider greater differentiation in the capital charges on different assets and retuning the existing standards, e.g. to address current biases in favor of short-term interbank lending and riskier corporate borrowers. Higher regulatory charges on riskier assets should prompt lenders to demand higher returns and help focus management attention on risky lending.

- Consideration could be given, for example, to higher capital charges on lending to countries judged to be risky, eg with poorly-regulated or unsophisticated financial systems, or on loans to highly leveraged financial entities.

- The first would require the official community to make more judgements about the riskiness of different countries, both politically and technically difficult. However, a more refined, if admittedly imperfect structure, would be better than the present crude distinction embedded in the Basle standards, which favor loans to OECD countries over loans to non-OECD countries. It could draw on the matrix that measures a countries' performance against international codes and standards described earlier.

We could also explore whether to seek regulatory and disclosure changes aimed more broadly at reducing leverage and systemic risk in financial markets Possible changes would put greater regulatory focus on the systemic risk that can be created by a wide range of institutions, including institutions that are not currently regulated. For example, the regulatory net could be extended to cover all institutions above a certain size. But far-reaching changes would be politically difficult in the United States – indeed, more difficult in the U.S. than elsewhere given the diversity of our financial markets and existing regulatory structure.

Measures that have been suggested include:

C. *Higher overall capital adequacy standards.* If financial institutions are made to hold more capital overall in relation to the total risks in their balance sheet, the total amount of risky lending activity that can be supported by the existing capital base would go down. (Higher capital standards in emerging markets may also be appropriate, even if we not pursue this in major industrial countries.)

D. *Broader margin requirements.*
Consideration could also be given to whether some existing gaps in the margin system should be closed, and more broadly, whether current margin requirements, eg on OTC and listed derivatives, are sufficient. Since in some cases margins can be borrowed, they may not by themselves margin requirements decrease leverage.

E. *Disclosure standards.* Greater disclosure by industrial country banks and investors of their exposure to higher categories of risks could increase market discipline and discourage the buildup of imprudent exposures. Disclosure is not without its difficulties; open disclosure of actual positions would undermine financial markets.

  - One potential approach is to demand additional disclosure from the banks and other financial institutions that lend to the highly-leveraged institutions ("hedge funds").

– The G7 has agreed to consider the questions raised by disclosure and transparency standards for highly leveraged institutions themselves. It may be more promising to explore whether to extend to other markets (and encourage in other countries) reporting to regulators of large positions in a particular market.

F *Measures to limit the scope for off-shore regulatory and tax havens (for example, the Cayman Islands).* Strengthened regulation in major centers would be undercut if financial and capital market activity merely moved offshore. This is a very difficult area: effective action would need widespread international agreement. Some possible, but controversial, measures that have been suggested include:

– Preventing major financial institutions from establishing branches or subsidiaries in off-shore centers, so that the financial institutions in such centers have to borrow on the basis of the strength of their own balance sheets.

– Conditioning the access of unregulated foreign financial institutions and hedge funds to the major financial centers on their compliance with key regulatory and disclosure standards.

IV. Limitations on the flow of capital

The recent experience of a number of countries has underscored the risk of capital account liberalization that is not paced to the maturity and development of the domestic financial system and broader economy – and, in particular, the danger created when governments in emerging markets actively encourage risky short-term borrowing. We should consider the scope for developing principles to guide countries that are liberalizing and opening up their capital markets on how reduce the vulnerability of their financial systems to sudden shifts in capital flows. These could include, for example, a focus on encouraging longer-term, equity financing with an open policy to foreign direct investment.

A. *Restraints on capital inflows.* A range of possible measures could be considered that may help to discourage imprudent foreign currency borrowing, while relying on market mechanisms to the extent possible.

- Prudential bank standards, such as limits on a bank's open foreign currency positions, if enforced effectively, should reduce the riskier kinds of foreign borrowing by banks.

- Some countries have experimented with regulatory requirements that force their banking systems to maintain a "liquidity buffers" to protect against the risk of a sudden shift in funds out of the banking system. Argentina, for example, has required banks to maintain large, liquid reserves against their short-term liabilities, including their short-term foreign liabilities.

- More controversially, some have suggested wider use of market-based, Chilean-style restraints on all capital inflows to deter short-term foreign borrowing by both banks and domestic corporations. The effectiveness of such controls has been questioned, in particular for countries with weaker economic policies than Chile. Moreover, Chilean controls are only relevant if a country in fact wants to slow down inflows; most countries that have recently experienced trouble have instead sought to encourage capital to flow in.

B. *Limits on capital outflows.* Controls on capital outflows differ fundamentally from well-designed restraints on capital inflows, aimed to curb the borrowing that makes countries vulnerable to market shifts. Temporary controls on capital outflows are likely to repel new capital inflows, create inefficiencies, are difficult to sustain for long and may make policy errors that worsen long-term prospects more tempting in the meantime.

C. In addition to considering whether measures to help restrain capital inflows make sense, we may want to explore whether *reducing the amount of trading activity* -- e.g. as a side effect of higher capital charges or stronger margin requirements, or even, as some have suggested, in response to a tax on trading activity (Tobin tax) – would make the international financial system more stable, or only less liquid.

- Some argue that reducing the overall volume of trading activity would make it easier for countries to maintain macroeconomic stability and avoid sharp surges in inflows/ sudden outflows. Small emerging market economies are particularly vulnerable to big swings in capital markets.

- Others argue that limiting trading activity would make it more difficult for markets to allocate risk efficiently and therefore reduce the benefits associated with the free domestic and international capital markets, without offsetting increases in stability. Liquid markets may be necessary for successful hedging – i.e. protecting yourself against certain risks. A small tax on trading activity, even if feasible, would also be unlikely to deter the major swings in capital that occur in financial crisis.

V. Exchange rate regimes

Devising appropriate exchange rates regimes, both for individual countries and for the system as a whole, is one of the central issues for the international system.

A. *Currency arrangements between the major industrial countries.* The major currencies in the system have floated against each other since the collapse of the Bretton Woods fixed exchange rates in the early 1970s. This has allowed the US and other major industrial nations with floating rates to aim domestic monetary policy at domestic objectives alone. It has also produced large swings in the exchange rates of major currencies, which at times do not seem to have reflected changes in the underlying economic fundamentals.

  - This volatility in the exchange rates between the currencies of the major industrial countries has led to proposals to create target zones for the three major currencies, to limit the size of fluctuations.

  - However, we believe that the current system provides the best policy option for the United States and that a shift away from floating would likely involve an unacceptable loss of monetary policy flexibility.

B. *Appropriate exchange rate regimes for smaller countries.* Given that large fluctuations between the currencies of major countries economies are likely to continue, that many emerging markets have extensive trading ties to a number of major industrial economies, and that the credibility of the policy environment in many emerging markets will take time to establish, the choice of an appropriate exchange rate for emerging markets economy is particularly difficult. Rigid exchange rates have been a common feature in recent crises, yet most emerging markets have been reluctant to accept the vagaries of a pure float.

- Exchange rate regimes are institutional choices that signal policies, priorities, and commitments. There is not single exchange rate regime that is best for all countries: rather the choice must be based on a country's circumstances.

- No matter what exchange rate an emerging market economy chooses, it is critical that it be backed by a consistent policy regime. Macroeconomic stability is based on good policies, irrespective of the exchange rate regimes. Adjustable exchange rate regimes can be used to help absorb external shocks, but they cannot substitute for sensible policy making.

- Moving from one exchange rate regime to another, particularly in a crisis, can be particularly destabilizing. A key question is how to reduce the risks associated with such movements. Countries which have adopted fixed exchange rates to eliminate inflation have often held on to fixed exchange rates for too long.

- During periods of crisis and financial chaos, experience shows that it may be better to select a regime that is at one or the other end of the exchange rate spectrum, either extremely flexible (a pure float) or extremely rigid, such as a currency board. Such clarity facilitates policy-making during difficult times.

C. Some have suggested that more far reaching changes in the international monetary system could be considered for the longer-term, such as the development of regional currency blocks and/or "dollarization."

- The experience of Europe has shown that both extensive economic integration to support a common monetary and exchange rate policy and a strong political commitment are needed for a successful currency union. Adopting the dollar or another international currency as the legal local currency provides more exchange rate stability than a currency board, but requires an explicit and transparency loss of monetary sovereignty.

VI. Crisis Response

There is a spectrum of crises, from those that stem primarily from poor policies to those that stem primarily from contagion. In practice, most fall somewhere in the middle. A regime for crisis response should provide for some combination of financial assistance and policy changes. The provision of large-scale official international finance raises difficult questions: what criteria should be used for access to large scale assistance, and on what terms; how should it be linked to private sector involvement; and where will the required resources come from.

A. *Provision of official finance.* Just as there is a role for the government to intervene to prevent a domestic financial crisis from destabilizing the domestic financial system, there is a role for the international community to intervene in an international financial crisis to help limit contagion and global instability.

- The proposed new IMF precautionary facility will allow large-scale international assistance in the form of a line of credit rather than a traditional, highly-tranched package, so as to facilitate the rapid restoration of confidence for those cases where problems stem more from contagion than from poor policies.

- It may often make sense in today's world of large and sudden liquidity needs for more official money to be available up-front in return for more up-front policy changes, than in traditional IMF programs.

The current crisis has demonstrated that the official community needs, at times, to be able to provide huge financing packages to quell potential contagion and instability. Congressional support for a increase in the IMF quota will provide the IMF with an important pool of new, uncommitted funds. The World Bank currently has the capacity to provide additional resources, but its lending capacity is not unlimited. Still, the resources available to the International financial institutions in the foreseeable future are dwarfed by the scale of current cross-border capital flows. They are also smaller in relation to GDP and world trade than envisaged at the time of Bretton Woods.

- Two bolder and politically difficult measures that could be put on the agenda to increase sharply the available official resources would be:

  - Dramatically increasing IMF quotas, perhaps indexing them to growth of the world economy to assure their continued relevance. Countries have automatic and unconditional right to use their "reserve tranche" or paid in capital, but because the size of most countries' quotas is currently small relative to the potential demands this is not a significant benefit in times of financial difficulty today.

  - Another possible, but politically difficult, idea that could perhaps be explored for increasing the amount of liquidity in the system would be to allow the IMF to issue additional SDRs (perhaps at a higher interest rate to discourage unnecessary use). This would also require Congressional approval.

B. *Private sector involvement.* Private sector participation in the resolution of international financial crises is critical to the long-run health of the international financial system, both because of limits on the availability of official funds and of concerns about moral hazard. The type of private sector involvement required by the official sector as a condition for its assistance should vary, depending on the nature of the countries' difficulties.

- The theoretical ideal towards which the international financial system should move over time is that private sector creditors and investors should bear as fully as possible the consequences of the risks that they voluntarily assumed.

  - We could consider if there are ways to develop the system so that it is clear that investors who have made risky international investments, and would earn large risk premiums in the best case, will not be repaid in full if the country experiences a crisis that requires official intervention.

  - We need to examine how to avoid creating categories of debt that are treated as senior (paid even when other debts are not being paid) because of difficulties associated with its restructuring. Russia, for example, has defaulted on wide range of domestic and foreign debts, but wants to continue to maintain payments on its Eurobonds, by, in part, using the debt relief it obtains from other creditors to maintain Eurobond payments.

- In practice, finding appropriate ways to involve the full range of private creditors in the cooperative resolution of a crisis can be difficult. Concrete options for involving the private sector will continue to need to be explored. Already different models are being developed for different circumstances (Korea, Brazil, Ukraine).

  - It can be difficult to convince the private sector to participate voluntarily – particularly if the relevant private creditors are not large international banks.

  - More coercive means, including support for official lending into accumulated "arrears" on private debt payments, can be employed to generate stronger incentives for broad-based private sector participation. Such coercive measures risk prompting additional contagion, so must be used cautiously.

- The expanded use of "collective action clauses" in sovereign bonds issued in foreign offerings also could facilitate the orderly, cooperative restructuring of these bonds. The members of the G-7 have committed to examine whether to introduce such clauses into their own sovereign bonds issued in foreign offerings.

- IT may also be useful to explore ways to encourage emerging markets to purchase more "insurance" against adverse developments, through contingent facilities and debt contracts that contained contractual arrangements that provided greater payments flexibility. Such changes would help emerging markets avoid the need to unilaterally alter payment terms in a crisis.

VII. Social Safety Nets

Possibilities for helping to minimize the social impact of financial crises include

A. Granting the World Bank a larger role in the design of international economic policy programs, which would bring both the financial resources and social sector expertise of the World Bank to the table quickly in a crisis.

B. Development of a code of best practices in social policy, as called for in the G7 statement, which could be drawn upon in the design of IMF and MDB programs.

VIII. Institutional Reforms to Carry Forward the Agenda

There are a series of institutional changes worth considering. It may be possible to obtain consensus for a set of institutional changes that would help both implement our architecture agenda and improve international monetary and financial coordination.

Three institutional changes we support are:

A. *A new financial stability policy forum to improve financial-sector policy coordination.* We are proposing the creation of a Financial Stability Policy Forum that would meet semi-annually to discuss regulatory policy issues in an inclusive forum that would bring together financial regulators, the relevant international organizations and national finance ministries from both industrial countries and key emerging markets. It would create an informal, cooperative mechanism at the global level to discuss financial regulatory policy issues that affect the international system, replacing the series of ad hoc groups that have been set up over the last few years. We will be discussing this proposal with Hans Tietmeyer, who was asked by the G7 to look into this issue, and other members of the G7 members.

B. *A G-7 plus process (similar to the G22).* We want to consider how best to retain the ad hoc and informal nature of the G7 process while including systemically significant emerging markets on a regular basis.

- A number of major emerging markets could be invited to join every other G-7 meeting.

- A permanent G7 plus group could be created, which would include a flexible group of participants from outside the G-7. There would be meetings of this group at the Ministers and Governors level and more frequent Deputies level meetings.

C. *Strengthening the IMF's Interim Committee and the World Bank's Development Committee.*

- The Europeans are seeking to strengthening Interim Committee where European nations are have extensively represented and can exert extensive influence. The Interim Committee as currently constructed has many problems, but it is worth trying to develop reforms that could minimize these problems and capitalize on the Interim Committee's potential strengths (notably, its inclusive, constituency based system).A major overhaul of the current constituencies, to make them more representative of emerging markets and less dominated by EU countries (which are spread out across many constituencies) could make the IMF a more effective body. Change along these lines would involve a major political effort.

<u>Additional proposals for institutional reform include</u>

D. *Redrawing the lines between the IMF and the World Bank.*

- One possible reorganization would transform the IMF into an "International Finance Organization," responsible for macroeconomic and financial policy surveillance and the provision of financing to systemically significant economies, and the World Bank into a "World Development Organization," centered around development advice and subsidized lending to the poorest countries. However, this would raise the question o f how to draw a dividing line between different categories of countries.

- Another proposed reorganization that may be worth exploring would refocus IMF surveillance and program conditionality on exchange rate regimes, balance of payments, macroeconomic policy and the soundness of the financial sector. The IMF would get out of the business of structural reform and subsidized lending, while the World Bank would transfer all responsibility for financial sector surveillance and restructuring to the Fund.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 8-DEC-1998 12:27:11.00

SUBJECT: Interview w/ David Wessel

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

TEXT:
David Wessell wants to talk to you on Friday about inflation and living in a world without inflation (he specifically mentioned some work that you did with George). I scheduled it for 11:30. Please let me know if you would rather not do it, and I'll call and cancel.
Thanks.
Michele

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 8-DEC-1998 08:09:59.00

SUBJECT: Editing ERP 1999

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

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

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

TEXT:
Below is a message from Mike Treadway. I told him that the 2nd round of chapters will go out to the agencies at the end of this week/ beginning of next week and that I'd give him those versions to start editing. It sounds like he would like us to identify one chapter that is ready for "line editing" (definition below) and then he will take a look at the others and give broader comments on structure, ideas for deleting sections that are too long, etc.
Do you think any of the chapters will be ready for line editing when we send them out for agency review at the end of the week?? Or do you think all of them will still be in the broad review category? Let's evaluate this at the end of the week and provide Mike w/ guidance on what level of editing we would like him to do at this stage.
Thanks.
Michele
---------------------- Forwarded by Michele Jolin/CEA/EOP on 12/08/98 08:04 AM ---------------------------

MTreadway @ aol.com
12/08/98 07:58:35 AM
Record Type: Record

To: Michele Jolin/CEA/EOP
cc: Mary Fibich/CEA/EOP
Subject: Editing ERP 1999

Hi Michele,

I got your message. I'm ready to start editing chapters whenever you all have
chapters ready. I'm not clear from your message whether the chapters that are

coming imminently are ready for me to take the baton on and edit line by line,
or whether you just want detailed comments, with line editing to start with the next draft.

Since I can only edit one chapter at a time, the best approach may be to identify, if possible, a chapter that is ready for line editing starting about
12/22 (when I get back from a long weekend in Arkansas) and for me to provide
comments (including, for chapters like the international chapter, suggestions
for cuts) on the others in time for the next draft. "Ready for line editing"
means organizationally basically sound and with relatively little rewriting,
if any, still to be done. If a chapter is that far along already by next week,
I could even do it then.

Maybe another chapter could be ready for line editing right after Christmas. Then we'd be in good shape to get the remaining 4 chapters edited
by 1/25 (roughly one per week), which Cathy says may be the date when everything must go for desktopping.

Regarding budget, I actually think the editing could stay within last year's dollar amount, despite my proposed rate increase, if indeed there are
only 6 chapters this year. In fact, ceteris paribus, the report would only have to be about 20 pages shorter than last year (i.e., about 250 pages for all chapters plus the Activities section) to come in at the same dollar amount. A shorter report seems desirable both for the CEA staff's sake and for
readers' sake, as well as for editorial budget reasons.

I project that the 4 chapters that Cathy gave me last week--labor, elderly,
regulation, and international--would fill about 212 pages if printed as is. (The breakdown is 27, 32, 54, and 99, respectively; these are very rough estimates.) But the labor and retirement chapters have way too many charts for
such short chapters--you'd save about a dozen pages by cutting their charts to
6 or 8 each. The sprawling, rambling international chapter clearly needs cutting--it would probably be the longest ERP chapter ever if left as is. The
regulatory chapter could stand some tightening as well. If this is done, and
if the intro and macro chapters come in at reasonable lengths, keeping below
250 pages total should not be difficult.

By the way, in calculating my proposed rate increase, I based it on what my
hourly rate would be in 1999 if I had raised it by 4% or 5% every year since I
started editing the ERP in 1994. I have not sought a rate increase from CEA every year, with the result that my rate has fallen considerably below

what I
and other editors get on similar projects like World Development Report.

Looking forward to another ERP season,

Mike Treadway

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 8-DEC-1998 11:13:24.00

SUBJECT: Sensenbrenner letter

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

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

TEXT:
Janet,

Attached is the most recent version of the response to Sensenbrenner reflecting Michele's comments. Once I receive your comments, I will circulate this through OMB interagency review. Thanks,

Joe

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D19]MAIL43125824P.326 to ASCII,
The following is a HEX DUMP:

Dear Chairman Sensenbrenner:

I appreciate the opportunity to provide you with a response to your October 20, 1998 letter regarding economic analysis of the Kyoto Protocol. Your letter made requests for comments on two issues. First, I will address your interest in the Council of Economic Advisers' (CEA) views on the Energy Information Administration (EIA) report "Impact of the Kyoto Protocol on U.S. Energy Markets and Economic Activity." Second, I will respond to your question regarding implementing legislation.

CEA Views on EIA Report

In evaluating the results from any economic modeling effort, it is important to first identify and understand what questions are being asked by using that particular model. The most significant cause for divergence in modeling results is that different modelers ask and answer different questions.

In the Administration's assessment of the economic implications of the Kyoto Protocol, a set of questions that reflect the Administration's position on the Protocol are addressed. For instance, the Administration unambiguously supports the efficient implementation of the "flexibility mechanisms" secured in the Kyoto Protocol -- international emissions trading, joint implementation, and the Clean Development Mechanism -- and we will continue to work over the coming years in multilateral fora to develop rules that ensure such implementation. In the Administration's illustrative modeling analysis, these flexibility mechanisms are critical to reducing the costs of meeting emissions targets, not just for the United States, but also for the European Union, Japan, and all other Annex I countries.

Economic modeling efforts outside of the U.S. government have also found that these flexibility mechanisms can significantly reduce the cost to the United States of reaching its Kyoto target. For example, the Energy Modeling Forum (EMF) based at Stanford University, which has a long-running model comparison exercise involving many of the leading climate and energy models, has coordinated full scale analyses of the Kyoto Protocol. This comparison exercise of the Kyoto Protocol included ten modeling teams from the United States, Europe, and Asia. The Kyoto Protocol enables all countries with emissions targets to trade emissions allowances among other countries with targets. In evaluating the Kyoto Protocol, all of the participating teams used economic models that incorporate the potential for international trading in greenhouse gas permits. These models are well-suited to assess the economic implications of the international trading component of the agreement. On average, the EMF models found that Annex I trading would cut the U.S. permit price by 53% relative to a no trading scenario. Of these models, one estimated a 72% reduction in the permit price under Annex I trading. In full global trading, the permit price would be, on average, 80% lower than the no trading price. Several models estimated permit price reductions of about 90%.

In addition, the Organization for Economic Cooperation and Development (OECD) recently convened modelers from around the world for a climate change modeling workshop. While many of the modeling teams at OECD also participate in the EMF exercise, the

workshop included four non-EMF teams. The results from non-EMF models reinforce the importance of international emissions trading in lowering permit prices. These models also found that Annex I trading can significantly reduce costs, and global trading can result in even more substantial cost-savings.

The modeling results from these two large efforts coordinated by EMF and by the OECD clearly indicate the potential for cost-savings through an efficiently-designed international trading system. It is important to recognize that these two efforts relied exclusively on models with the capacity to model explicitly international trade in emissions allowances. We believe that it is appropriate to evaluate the Kyoto Protocol with models that can assess the opportunities for international emissions trading, since trading is embedded in Article 17 of the Protocol. Models that cannot evaluate international trading are constrained in the kinds of questions they can effectively address.

The Energy Information Administration's model, NEMS, is not capable of addressing the question of international emissions trading: it is focused only on the U.S. energy sector and has no international component. Thus, EIA did not conduct any analysis of cost-effective international trading opportunities. A traditional economic analysis of international trading would assess the demand and supply of emissions allowances and, by modeling a market where costs are minimized, identify a single international permit price. This is the approach taken by the Administration as well as by the EMF and OECD modeling teams. However, the EIA analysis assesses only the demand side of the issue for the United States, and then incorporates what appear to be arbitrary assumptions about alternative possibilities for the international permit price and subsequent international transfers. The scenarios that attempt to include international trading overstate the cost of permits because they fail to take into account the way that an international market, bidding to a single international permit price, lowers cost.

In addition to the question of international trading, there are other important questions that models should consider in evaluating the Kyoto Protocol. For example, the Protocol covers all six major kinds of greenhouse gases. While most of the models involved in the EMF and the OECD exercises did not consider these other gases in their analyses, the Administration's illustrative modeling effort did address this issue. The EIA analysis does not address this question. EIA assumed that the United States would achieve its target only through carbon dioxide reductions. The flexibility across gases allows countries and companies to make reductions in the most cost-effective manner possible, reducing the cost of compliance. Based on Annex I national communications, emissions growth in non-carbon dioxide greenhouse gases is expected to be much slower (and in some cases negative) than carbon dioxide between 1990 and 2010. This indicates that the U.S. six-gas target is less stringent than implied by just an assessment of carbon dioxide alone, and that there could be greater cost-savings through international trading of all greenhouse gases than implied by assessments of carbon dioxide trading alone.

Another crucial aspect concerns the time frame of emissions abatement. As the Administration Economic Analysis on climate change noted, the Administration advocated and secured in the Kyoto Protocol a later and more realistic time frame for the initial emissions target than what had been proposed by other countries. By adopting a gradual and credible path of reductions in the early years, adjustment costs can be reduced. How one addresses the question of timing of reductions affects the modeling results. In EIA's study, most businesses do not take action to address climate change until 2005, and therefore only have a short time until the 2008-2012 budget window to reduce emissions. This essentially assumes that even though the Administration secured this more realistic commitment period to reduce the burden on firms by allowing them to more gradually undertake emissions reductions, very few firms would actually take advantage of such an opportunity. Studies have demonstrated that the amount of lead time a company takes has dramatic economic implications. For example with EIA's model in the Interagency Analytic Team draft report, a 5-year "ramp-up" (starting in 2005) would result in economic costs 65% greater than that associated with a 10-year "ramp-up" (starting in 2000). Thus, the assumption that many businesses would fail to plan for the future results in higher projected costs.

While some may claim that very little action is likely to occur prior to 2005, there is reason to believe that some firms will act well before 2005. Already businesses are taking action to address climate change. For example, on September 18, British Petroleum announced its plan to reduce emissions of greenhouse gases worldwide by 10% below 1990 levels by the year 2010. In July, United Technologies announced their plan to reduce its worldwide energy consumption by 25% by the year 2007.

Finally, how an analysis addresses other policy issues that can affect the costs of abating emissions can also impact the conclusion regarding costs. In the Administration's analysis, additional elements of policy were recognized as having the potential to significantly decrease the costs of compliance and increase the amount of reductions that might be accomplished at home. These policies were not factored into the illustrative model the Administration cited, but were qualitatively taken into account in reaching the conclusion that the United States could meet its Kyoto target for a relatively modest cost. The EIA analysis, however, ignores elements such as forestry activities (covered under the Kyoto Protocol) and the Administration's electricity restructuring proposal, which could significantly lower compliance costs.

Implementing Legislation

Based on conversations with State Department staff, it is my understanding that when the Administration submits the Protocol for ratification it will also submit implementing legislation. While the Administration advocates the use of a domestic trading program during the 2008-2012 commitment period, no policy decisions have yet been made about the nature of this program. Thus, all aspects of the trading program, including the option to auction some or all permits and recycle the revenue back to the economy through cutting other taxes, are still under consideration.

The Administration continues to believe that the costs of achieving our Kyoto target will be modest if we are successful in securing rules for efficient international trading, joint implementation, and the Clean Development Mechanism, and key developing countries meaningfully participate in the international effort to address climate change. Again, I appreciate this opportunity to share with you some of the latest insights from the economic modeling community and our perspective on the recent EIA analysis. If you have any questions, please feel free to follow-up with Joe Aldy on my staff at 202-395-1455.

Sincerely,

Janet Yellen
Chair

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-DEC-1998 17:43:12.00

SUBJECT: Re: JEDG dates

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

TEXT:
Yes, I did intend to send it to Nouriel. Thanks.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Alan S. Polasky (CN=Alan S. Polasky/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-DEC-1998 15:55:12.00

SUBJECT: green bonds

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

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

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

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

TEXT:
Janet: I was contacted by Chuck Marr of NEC, and have since talked with Paul Weinstein of DPC, regarding Environmental Improvement/Green Infrastructure Bonds. DPC would very much like to include this proposal in the President's Budget. They had an impression that you might be opposed to the idea and wanted to check where you stood before they pushed the idea much further. Steve

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-DEC-1998 17:41:45.00

SUBJECT: Re: JEDG dates

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

TEXT:
Did you intend to send this reply to Nouriel?
JF

Janet L. Yellen
12/02/98 07:48:40 PM
Record Type: Record

To: Jeffrey A. Frankel/CEA/EOP
cc:
Subject: Re: JEDG dates

Why don't we check with Michele and make sure it's alright for you to go
to Israel. I'd be delighted to have you along. If she agrees you can
tell Ranz that both of us plan to go.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 9-DEC-1998 17:41:03.00

SUBJECT: Re: green bonds

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

TEXT:
Treasury has serious reservations about this proposal and I share those
reservations.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:11-DEC-1998 17:10:51.00

SUBJECT: Feldstein plan and misc.

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

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

TEXT:
Jeff Liebman will get us a copy of Goss's analysis of the Feldstein plan on Monday. This analysis does not include the fiscal tables that we have done for our hypothetical plans. Jeff and I tried to talk through what those table would show, but it's tricky. We guess that Feldstein's benefits are 8-10% higher than current law, which is on the high side of the plans we've looked at. Also, he is funding this excess through a higher assumed rate of return, so it is not paid for through extra saving.

FYI on other topics:

I attended a long meeting this week on bankruptcy reform, which the Admin. is trying to formulate a position about for the new Congress. And I attended a long financial mkts meeting, in which various regulators reported on hedge funds and their counterparties. The good news: LTCM was really unusual in its size and leverage. The bad news: lenders have not been following their written procedures on lending to hedge funds, although this may be changing.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jon Haveman <jon@endeavour.mgmt.purdue.edu> (Jon Haveman <jon@endeavour.mgmt.purdue.edu> [UNKNOWN])

CREATION DATE/TIME:11-DEC-1998 08:27:22.00

SUBJECT: California Public Policy Institute

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

TEXT:
Thanks so much. I really appreciate you making that phone call. It is
good
to hear that he is hopeful, but I won't get my hopes up.

I will let you know what happens just as soon as Michael lets me know.

Thanks again - Jon

Begin forwarded message:

From: Janet_L._Yellen@cea.eop.gov
X-Envelope-To: <jon@haveman.org>
X-Lotus-Fromdomain: EOP
To: jon@haveman.org
Date: Thu, 10 Dec 1998 16:58:22 -0500
Subject: California Public Policy Institute

I talked to Michael Teitz right after I spoke with you. He indicated that they were in the process of making a decision this week. I gather there is a budgetary problem related to your visit, but he seemed hopeful that things would work out. Good luck. Let me know what happens.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:11-DEC-1998 15:58:33.00

SUBJECT: some thoughts on the Feldstein plan

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:
TO: DAVID
FROM: DOUG

Potential Feldstein line:

1. Relative to current policy, he's doing more pre-funding of the defined benefits in Social Security. This is classic Marty on Social Security and saving.

2. Plus, he's pre-funding additional benefits. This doesn't raise future resources available for others, but neither does it reduce them.

3. The national savings estimates of the Technical Working Group assume that pre-funding raises national saving only during the surplus era; after that, the contributions to IAs are offset by larger deficits. But an alternative political economy rule says that those deficits would force tax increases or spending cuts, so the savings impact of moving to a funded system is larger than we estimate.

4. The national savings estimates of the TWG stop at 75 years. But his plan is pre-funding not just the first 75 years of benefits (like most trust fund-style plans) but benefits in years beyond that.

Rebuttal:

1. Raising expected benefits based on projected surpluses and projected equity returns is dangerous. (In fact, Marty wants to assume a higher return than the actuaries.) We're committing to future benefits and taking on large risk.

2. Instead of saving resources for oldsters, we should spend them now (or save them) for youngsters.

3. The national saving effects of pre-funding are not as large as they appear because there are savings offsets (some of tax cuts would be saved, and some of IA contributions would reduce other saving -- we don't

calculate these) and because the equity stuff is asset-swapping with the private sector (we do calculate these).

4. Pre-funding benefits is not a substitute for cutting benefits. I think I sent you my one-pager on this before. My arguments:
  a. benefits cuts have better effects beyond the 75-year window -- true for trust fund plans but not IA plans
  b. prefunding has greater risk -- already made in #1
  c. prefunding wouldn't raise saving as much as we estimate -- already made in #3
  d. future flows matter as well as stocks -- large deficits and dis-saving cause economic dislocations even if debt is low and the capital stock is high

Re-rebuttal:

1. The risk of the Feldstein plan is not substantially different than the risk of any other politically feasible plans (i.e., benefits are not going to be cut and equities are going to be used). Any greater commitments are matched by greater pre-funding.

[I'd need to see our estimates of the plan to see if this is true. But I can imagine some version of the following: The Feldstein plan uses more surplus early and less in the out-years than other suggested plans (e.g., our 68% of surplus into the trust fund for equities plan), which reduces risk. In any case, political economy rules will force future tax and spending adjustments if the deficit or stock market do badly. However, the Feldstein plan buys more equities than other plans. Also, the plan assumes a higher return than the actuaries say, but Summers and Wilcox think the actuaries are too low also.]

2. Saving in the government is never going to really work. You'll never be able to really pre-fund in the trust fund, even if current budget rules for equities imply that you can. Thus, the key to more saving via pre-funding is moving really and truly out of the budget.

3. Nobody is going to save or spend more on youngsters anyway.

My summary:

I think that raising expected benefits would be about the worst possible outcome of the reform process. At the same time, pre-funding benefits in a way that is not offset by other government borrowing would be about the best possible outcome of the reform process. The Feldstein plan does both -- so it is hardly my favorite, but I can imagine worse. (And I don't think it is really the antithesis of earlier Feldstein, as you suggested.) I'd really like to see one of our budget/national savings tables for this plan -- guess I'll ask Jeff.

One way to rephrase this is that I don't mind the Feldstein structure so much (assuming we did a TSP variant), but I don't like the amount of surplus they're throwing into it. I'm concerned that political compromise is going to end up raising benefits -- not because of a bidding war for oldsters, but in order to both shore up traditional SS for the Dems and give IAs to the Repubs. A simple rearrangement of the Feldstein flows would cover the 2.19 shortfall AND set up small IAs (a hybrid with much higher expected benefits). But this directs even more resources to the elderly.

****

TO: DOUG
FROM: DAVID

I'll look at this more carefully over the weekend. Here's a quick reaction.
If the base line is save the surpl, Feldst is appalling (lower taxes at every
point, more benefits.) Under his baseline (spend the surpl), his baseline is better than baseline. How much of the surp doe you need to spend or taxcut away for his plan to be neutral relative to baseline on natl saving?

****

TO: DAVID
FROM: DOUG

That's a good question.

I know it won't have any effect on the policy process, but I'd be curious to re-estimate our saving effects incorporating crude estimates of:
some fraction of the surplus paying down debt
some fraction of tax cuts being saved
some fraction of IAs crowding out other private saving

For example, we now assume that every dollar moved out of the surplus into IAs increases national saving by one dollar. But suppose that: 1) The true baseline is 50% tax cuts, 30% spending increases, and 20% pay down the debt. 2) 10% of tax cuts (which would be 5% of surplus) would be saved. 3) 25% of IA contributions would be offset by less other saving.

Then, every dollar moved into IAs would increase saving by 50 cents. This is much smaller, but of course nontrivial. To get the whole picture, we need to look at future benefits, etc.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-DEC-1998 19:35:25.00

SUBJECT: BEA methodology: the wedge & potential GDP growth

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

TO: Joseph J. Minarik (CN=Joseph J. Minarik/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

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

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

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

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

TEXT:
BEA made several changes to deflation methodology in both the 1997 and 1998 annual revisions. All of these changes ought to be evaluated for their effects on the wedge and potential GDP. Thus far, I have been able to work out the effects of two of these changes: The switch to PPIs from CPIs for 1) physician's services and 2) government and for-profit hospitals. (These two changes were introduced in July 1997, but not discussed in any of BEA's documentation. I only became aware of them in November while investigating the wedge.) Together, these two changes lower inflation as measured by the price index for GDP, raise the wedge, and raise potential real GDP growth by about 0.06 percentage point per year.

In qualitative terms, I raised this issue in our discussion of the wedge. I regret that it did not occur to me that it would have an offsetting effect on potential GDP growth. Nevertheless, we are projecting 2.5 percent potential GDP growth for 1999, 2000, and 2001 (during the pergatory period)-which I had thought was a bit of a stretch, but I now feel comfortable with it.)

I raise this issue now because of its relevance to our discussion of the long-run (post-2010) projection. Having given this issue some thought, I think it is entirely proper (even optimal) to bump up the growth rate of productivity and real GDP in the out-years.

Raising the wedge from 0.1 to 0.2 was correct, but should have been (at least partially) offset by raising potential real GDP growth.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: John A. Koskinen (CN=John A. Koskinen/OU=WHO/O=EOP [WHO])

CREATION DATE/TIME:14-DEC-1998 22:03:03.00

SUBJECT: Report

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

TEXT:
Thanks for sharing with me the materials you submitted to the President.
The biggest problem we face domestically continues to be the risk of
overreaction by the public. We'll see how we do handling this in the
months ahead.

All the best for the holidays if I don't see you.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-DEC-1998 11:09:21.00

SUBJECT: Sensenbrenner letter

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

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

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

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

TEXT:
Here is the latest version reflecting interagency review.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D18]MAIL41451694Z.326 to ASCII,
The following is a HEX DUMP:

Dear Chairman Sensenbrenner:

This letter responds to your October 20, 1998 letter regarding economic analysis of the Kyoto Protocol. Your letter requested comments on two issues. First, I will address your interest in the Council of Economic Advisers' (CEA) views on the Energy Information Administration (EIA) report "Impact of the Kyoto Protocol on U.S. Energy Markets and Economic Activity." Second, I will respond to your question regarding implementing legislation.

CEA Views on EIA Report

In evaluating the results from any economic modeling effort, it is important to first identify and understand what questions are being addressed by using that particular model. The most significant cause for divergence in modeling results is that different modelers ask and answer different questions.

In the Administration's assessment of the economic implications of the Kyoto Protocol, a set of questions that reflect the Administration's position on the Protocol are addressed. For instance, the Administration unambiguously supports the efficient implementation of the "flexibility mechanisms" secured in the Kyoto Protocol -- international emissions trading, joint implementation, and the Clean Development Mechanism -- and we will continue to work over the coming years in bilateral and multilateral fora to develop rules that ensure such implementation. In the Administration's illustrative modeling analysis, these flexibility mechanisms are critical to reducing the costs of meeting emissions targets, not just for the United States, but also for the European Union, Japan, and all other Annex I countries.

Economic modeling efforts outside of the U.S. government have also found that these flexibility mechanisms can significantly reduce the cost to the United States of reaching its Kyoto target. For example, the Energy Modeling Forum (EMF) based at Stanford University, which has a long-running model comparison exercise involving many of the leading climate and energy models, has coordinated full scale analyses of the Kyoto Protocol. This comparison exercise of the Kyoto Protocol included ten modeling teams from the United States, Europe, and Asia. The Kyoto Protocol enables all countries with emissions targets to trade emissions allowances among other countries with targets. In evaluating the Kyoto Protocol, all of the participating teams used economic models that incorporate the potential for international trading in greenhouse gas permits. These models are well-suited to assess the economic implications of the international trading component of the agreement. On average, the EMF models found that Annex I trading would cut the U.S. permit price by 53% relative to a no trading scenario. Of these models, one estimated a 72% reduction in the permit price under Annex I trading. In full global trading, the permit price would be, on average, 80% lower than the no trading price. Several models estimated permit price reductions of about 90%.

In addition, the Organization for Economic Cooperation and Development (OECD) recently convened modelers from around the world for a climate change modeling workshop. While many of the modeling teams at OECD also participate in the EMF exercise, the

workshop included four non-EMF teams. The results from non-EMF models reinforce the importance of international emissions trading in lowering permit prices. These models also found that Annex I trading can significantly reduce costs, and global trading can result in even more substantial cost-savings.

The modeling results from these two large efforts coordinated by EMF and by the OECD clearly indicate the potential for cost-savings through an efficiently-designed international trading system. It is important to recognize that these two efforts relied exclusively on models with the capacity to model explicitly international trade in emissions allowances. We believe that it is appropriate to evaluate the Kyoto Protocol with models that can assess the opportunities for international emissions trading, since trading is embedded in Article 17 of the Protocol. Models that cannot evaluate international trading are constrained in the kinds of questions they can effectively address.

The Energy Information Administration's model, NEMS, is not capable of addressing the question of international emissions trading: it is focused only on the U.S. energy sector and has no international emissions trading component. Thus, EIA did not conduct any analysis of cost-effective international trading opportunities. A traditional economic analysis of international trading would assess the demand and supply of emissions allowances and, by modeling a market where costs are minimized, identify a single international permit price. This is the approach taken by the Administration as well as by the EMF and OECD modeling teams. However, the EIA analysis assesses only the demand side of the issue for the United States, and then incorporates what appear to be arbitrary assumptions about alternative possibilities for the international permit price and subsequent international transfers. The scenarios that attempt to include international trading overstate the cost of permits because they fail to take into account the way that an international market, equilibrating to a single international permit price, lowers cost.

Even if one were to ignore international trading completely, the EIA analysis generates higher U.S. permit prices than nine of the ten models participating in the EMF exercise. This implies that EIA may be making more pessimistic assumptions about the responsiveness of the economy to changes in relative prices in reducing emissions than most of the rest of the climate change modeling community.

In addition to the question of international trading, there are other important questions that models should consider in evaluating the Kyoto Protocol. For example, the Protocol covers all six major kinds of greenhouse gases. While most of the models involved in the EMF and the OECD exercises did not consider these other gases in their analyses, the Administration's illustrative modeling effort did address this issue. The EIA analysis does not address this question. The model used by EIA cannot assess the opportunities for abating non-carbon dioxide greenhouse gas emissions. EIA makes an assumption that moving from 1990 -7% to 1990 -3% reflects the opportunities for emissions abatement in non-carbon dioxide gases and carbon sinks based on a misinterpretation of a State Department paper describing how the 1990 -7% target agreed to in Kyoto is roughly equivalent to 1990 -3% under the accounting system used in the President's October 1997 proposed target of returning to 1990. Under EIA's interpretation, sinks and other greenhouse gases would provide only 57 MMTCE annually, irrespective of the price of greenhouse gas permits. This implies that the United States would achieve its target almost exclusively through carbon dioxide reductions and international trading. However, economic theory predicts that as permit prices increase, as they do across the various scenarios in the EIA report, higher levels of abatement of these other greenhouse gases would become cost-effective and would occur.

The flexibility across gases allows countries and companies to make reductions in the most cost-effective manner possible, reducing the cost of compliance. Based on Annex I national communications, emissions growth in non-carbon dioxide greenhouse gases is expected to be much slower (and in some cases negative) than carbon dioxide between 1990 and 2010. This indicates that the U.S. six-gas target is less stringent than implied by just an assessment of carbon dioxide alone, and that there could be greater cost-savings through international trading of all greenhouse gases than implied by assessments of carbon dioxide trading alone.

Another crucial aspect concerns the time frame of emissions abatement. As the Administration Economic Analysis on climate change noted, the Administration advocated and secured in the Kyoto Protocol a later and more realistic time frame for the initial emissions target than what had been proposed by other countries. By adopting a gradual and credible path of reductions in the early years, adjustment costs can be reduced. How one addresses the question of timing of reductions affects the modeling results. In EIA's study, most businesses do not take action to address climate change until 2005, and therefore only have a short time until the 2008-2012 budget window to reduce emissions. This essentially assumes that even though the Administration secured this more realistic commitment period to reduce the burden on firms by allowing them to more gradually undertake emissions reductions, very few firms would actually take advantage of such an opportunity. Studies have demonstrated that the amount of lead time a company takes has dramatic economic implications. For example with EIA's model in the Interagency Analytic Team draft report, a 5-year "ramp-up" (starting in 2005) would result in economic costs 65% greater than that associated with a 10-year "ramp-up" (starting in 2000). Thus, the assumption that many businesses would fail to plan for the future results in higher projected costs.

While some may claim that very little action is likely to occur prior to 2005, there is reason to believe that some firms will act voluntarily well before 2005. Already businesses are taking action to address climate change. For example, on September 18, British Petroleum announced its plan to reduce emissions of greenhouse gases worldwide by 10% below 1990 levels by the year 2010. In July, United Technologies announced their plan to reduce its worldwide energy consumption by 25% by the year 2007. Moreover, once a the Protocol is ratified with the advice and consent of the Senate, we would expect more firms to respond and undertake more actions to abate emissions.

Finally, how an analysis addresses other policy issues that can affect the costs of abating emissions can also impact the conclusion regarding costs. In the Administration's analysis, additional elements of policy were recognized as having the potential to significantly decrease the costs of compliance and increase the amount of reductions that might be accomplished at home. These policies were not factored into the illustrative model the Administration cited, but were qualitatively taken into account in reaching the conclusion that the United States could meet its Kyoto target for a relatively modest cost. The EIA analysis, however, ignores elements such as afforestation and reforestation (covered under the Kyoto Protocol) and the Administration's electricity restructuring proposal, which could significantly lower compliance costs.

Implementing Legislation

The Administration will seek any necessary new implementing legislation at the appropriate time. While the Administration advocates the use of a domestic trading program during the 2008-2012 commitment period, no policy decisions have yet been made about the nature of this program. Thus, all aspects of the trading program, including the options to allocate permits based on historical emissions or to auction some or all permits and recycle the revenue back to the economy through cutting other taxes, are still under consideration.

The Administration continues to believe that the costs of achieving our Kyoto target will be modest if we are successful in securing rules for efficient international trading, joint implementation, and the Clean Development Mechanism, and key developing countries meaningfully participate in the international effort to address climate change. Again, I appreciate this opportunity to share with you some of the latest insights from the economic modeling community and our perspective on the recent EIA analysis. If you have any questions, please feel free to follow-up with Joe Aldy on my staff at 202-395-1455.

Sincerely,

Janet Yellen
Chair

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-DEC-1998 20:14:18.00

SUBJECT: Two comments on financial architecture

TO: Timothy.Geithner (Timothy.Geithner @ treas.sprint.com @ inet [UNKNOWN])
READ:UNKNOWN

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

TO: Lael Brainard (CN=Lael Brainard/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TO: CAROLINE.ATKINSON (CAROLINE.ATKINSON @ treas.sprint.com @ inet [UNKNOWN])
READ:UNKNOWN

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

TEXT:
Following today's meeting on architecture, two minor observations on:
1) bond contracts contingent on the prices of raw materials being sold;
2) collateralized bond offerings.

1) While the idea of a bond contract with payment contingent on the price of the good sold by the country/firm (say oil) is appealing in some ways, there are a number of serious difficulties:

a. Major producers who can affect such prices with their production choice will not be able to get such insurance because of the obvious moral hazard problem: get insured, dump big quantities and get the insurance benefits.

b. Smaller players without market power may get insurance but the number of countries that can get insurance on a product must be limited. Otherwise, a critical mass of insured countries can again collude to dump quantities, push down prices and get the insurance ex-post.

c. Even insurance against so-called Acts of God is hard at times because often enough they are actually Act of Man. The disaster in Honduras was made worse by too much building in flood planes. Same thing for flood plains along the Mississipi River and construction along the Florida Coast. Private insurance markets/firms do not provide such hurricane/flood risks because of the obvious moral hazard problem. This is why we end up with government insurance of expensive home along Florida beaches or of lands along flood plains. The result is that moral hazard is exacerbated by such public insurance: people keep on building along the coast and in flood plains over and over again as we fools (taxpayers) keep on paying for such insurance after every "natural" disaster. There may be a lesson here for proposals of an international lender of last resort that do not deal carefully with moral hazard issues.

d. Debt contracts that are contingent on the price of the commodity are effectively equivalent to equity/stock as the return is contingent on the main determinant of profitability, i.e. the price. But if I buy such a debt instrument, I would rather buy common stock that gives me voting power and, potentially, control over the firm. Why should I settle for a contract that gives me only all the costs/risks of stocks, i.e. contingent returns and none of the benefits, i.e. vote and control? I guess that there may be room/demand for such "preferred stock" but it is likely to be limited. So, the right question is not: "why dont we see contracts contingent on price?" but rather: "why don't emerging market privatize raw material industries and allow foreign investors to take an state-contingent equity position rather than a state-uncontingent debt position?"

2) On collateralized bond contracts (a la Feldstein) there are similar problems:

a. The exports of a country are already the implicit collateral for the debt service of the country foreign debt. That is why investors look at measures such as debt to export ratio and debt service to export ratio. Then, sovereign spreads already implicitly reflect the fact that, on average, exports are this collateral.

b. So, if we securitize some component of this foreign debt liability, we are not really reducing the economic country risk. The spread on the securitized part of the debt will fall and the spread on the unsecured part will rise. On average, rational financial pricing will imply that the net spread will not change and there will be no benefit for the country.

c. Worse can happen if making some component of the debt secure make the other parts less secure and leads to panic: instead of just spreads going up on the unsecured part, lenders may not want to roll over assets that are obviously tagged as first to be defaulted on. So, the results may be instability and contagion to unsecured debt.

d. The critique above may also apply to arguments in favor of contingent credit lines that increase gross foreign reserves but maintain net reserves constant. In this case, however, a war chest of gross reserves may help to stave off a pure international bank run.

e. Economic punch line: markets are mostly rational and there is no free lunch!

Nouriel