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001. email	Mary Fibich to Janet L. Yellen at 16:04:33.00. Subject: Fast Facts. (partial) (1 page)	01/04/1999	b(6)

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[01/04/1999] [1]

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RESTRICTION CODES

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

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

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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]

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

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SUBJECT: Revised version of Environment Section of Chapter 5

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

READ:UNKNOWN

TEXT:

Attached is the file containing my edits.===== ATTACHMENT 1 =====

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D75]MAIL43282530I.036 to ASCII,

The following is a HEX DUMP:

ENVIRONMENTAL REGULATION AND INNOVATION

Environmental regulation addresses the problem of environmental damage that is an unintended consequence of economic activity. As long as polluters do not bear the full cost of the environmental damages they impose on others, they lack the incentive to reduce emissions adequately. Unregulated markets therefore typically generate too much pollution. Well designed environmental regulations can reduce pollution and increase the net benefits of economic activity, i.e., the value of economic output net of environmental damage.

Environmental policy may have a significant impact on the pace and direction of innovation, which over the longer-term may be of greater importance than its impact on immediate environmental outcomes. In what follows, the interaction of environmental regulation and innovation is examined. The incentive to generate new technologies under alternative forms of environmental regulation is discussed. This is followed by a discussion of the diffusion of existing technology among potential adopters and the role for policy to modify diffusion rates. Some of the major points of this discussion are illustrated in the context of policy regarding global climate change. Finally, evidence concerning the long-run impact of environmental regulation on productivity is reviewed.

Innovation Incentives under Alternative Forms of Regulation

There are two primary ways in which governments can implement environmental regulation: through economic incentives to reduce emissions, or by command and control regulations. Administration environmental policy has increasingly moved toward reliance on incentive-based approaches. The preference for an incentive-based approach is often justified on static cost-effectiveness grounds: given existing technology, any environmental goal can be

achieved at lowest cost under an incentive-based approach. Incentive-based approaches can also be justified on dynamic grounds: emitters (“sources”) may have greater incentives to develop new, low-cost methods to reduce pollution under incentive-based regulation than under command and control approaches.

Examples of incentive-based approaches include tradeable permit systems, emissions taxes, subsidies to reduce pollution, and liability rules. Under a system of tradeable permits, sources are required to obtain permits allowing them to emit. Total emissions are capped by the number of permits issued, but individual sources can choose their own emission levels by buying or selling permits. In 1998, for example, EPA introduced regulations to reduce nitrogen oxides (NO_x) emissions across 22 states plus the District of Columbia. The regulations allow for emissions trading among major industrial and electric utility sources of NO_x emissions. Under the program, sources needing additional permits to cover their emissions can buy them from sources that reduce emissions below their initial allocation.

With taxes (subsidies), sources pay a fee (or receive a subsidy) for activities that cause environmental damage (are environmentally beneficial). If the emission tax is set to approximate the environmental damages caused by pollution, sources face appropriate incentives to reduce emissions to economically efficient levels, namely, those at which the social benefit deriving from additional pollution reductions just cover their cost. Despite the theoretical appeal of emissions taxes, they have rarely been used to regulate pollution in the United States. Subsidies, on the other hand, have been used occasionally to encourage the use of more environmentally benign technologies. For example, under the Energy Policy Act of 1992, electricity produced from wind and biomass fuels receives a 1.5 cent per kWh credit.

Liability rules impose financial responsibility on sources for any environmental damage they cause, providing them with a direct incentive to reduce the adverse environmental impacts of their activities. For example, the Oil Pollution Act of 1990 makes firms liable for cleanup costs, natural resource damages, and third party damages caused by oil spills into surface waters. Similarly, the Clean Water Act makes responsible parties liable for the costs of cleaning up hazardous substance spills.

In contrast to incentive based approaches, “command and control” type environmental regulations stipulate the particular methods that sources must employ to control emissions or the emissions levels they are required to attain, with sanctions imposed for failure to comply.

Technology standards specify the pollution control techniques that sources must use whereas *performance standards* specify a maximum allowable rate of emissions, usually in terms of emissions per unit of output, but give sources the choice of how to meet the standard. Many environmental regulations combine elements of both performance and technology standards. For example, the 1972 Clean Water Act Amendments required industrial dischargers to meet an effluent performance standard but the standard was set using the “best practicable control technology currently available.” Conversely, technology standards sometimes allow sources to use different technologies if they can demonstrate that the technology will achieve the same amount of pollution reduction.

An economic advantage of incentive-based over command and control approaches is their greater efficiency: given existing technologies, they achieve specified environmental objectives at lower cost. For example, a system of tradeable permits minimizes the cost of attaining a given emissions reduction by ensuring that emissions abatement is undertaken by those sources,

and only those sources, that can reduce emissions most cheaply. This occurs because any source that can abate emissions at a cost below the market price of permits will profit by so doing through the sale of extra permits in the market. However, when the cost of emissions abatement exceeds the market permit price, sources will find it profitable to pollute beyond their allowances and buy additional permits in the market. The end result of allowing trading is that emissions are reduced in the most cost-effective manner. *Steve: Perhaps you should mention, at least in passing, that it may not always be feasible to implement a system of tradeable permits or other incentive based approaches because they require monitoring, measuring etc. as discussed in last year's ERP.*

Command and control regulation, in contrast, is not generally cost-effective because emissions reductions do not necessarily occur where abatement is cheapest. Technology standards may also lock-in pollution control technologies that are unnecessarily costly in the face of changing conditions.

Although incentive-based regulations dominate command and control approaches from the perspective of the static costs of achieving given environmental objectives, evaluations of their relative cost-effectiveness over longer-term horizons is more complex. The evolution of pollution control costs over time are affected by innovation and the two systems may differ in their incentive to innovate. Innovation may be a particularly important factor when environmental regulation is relatively new, where there are unexplored avenues of research and significant learning-by-doing effects.

Box: Recent Trends in Air Quality

Environmental regulations have generated significant benefits in the form of reduced emissions of various pollutants

in the U.S. over the past several decades. Emissions of five of six major air pollutants have fallen substantially since the Clean Air Act was passed in 1970, the exception being nitrogen oxides (see chart 5-1). The EPA regulation banning lead additives in gasoline has been largely responsible for the spectacular fall in lead emissions since the 1970s. Lead emissions in 1997 were less than two percent of 1970 emissions.

The improved record on emissions occurred during a period of considerable economic growth. From 1970 to 1997, real GDP expanded by 111 percent, so that emissions per unit of GDP have fallen dramatically since 1970. In certain sectors of the economy, the reduction in pollution per unit of output has been striking. For motor vehicles, emissions per mile of volatile organic compounds has fallen by 81% and of carbon monoxide by 73% since 1970. These impressive reductions in emissions per unit of output could not have taken place without substantial innovation in new processes and products as well as the widespread adoption of these new technologies.

Innovation incentives under incentive-based and command and control regulation

An important criticism of command and control regulations is that they may blunt the incentive to search for more cost-effective ways to reduce emissions. A technology standard, for example, provides an incentive to develop cheaper new technologies only if they can meet mandated targets and win regulatory approval. With performance standards, in contrast, there is an incentive to find lower cost ways of reducing emissions, at least to the level of the standard. However, there is no incentive for a firm to search for new methods to further reduce emissions below the standard. In addition, if the regulatory response to an innovation is to raise the bar by setting stricter standards whenever the costs of attaining stricter standards decline, sources may be discouraged from searching for innovations.

One way to increase the incentive to innovate under command and control regulation is for regulators to commit to

the implementation of a strict standard in the future. Such strict, “technology-forcing” standards raise the value of innovations that lower pollution control costs. Whereas requiring sources to meet a stringent standard immediately with existing technology may impose large costs, announcing stringent emissions targets well in advance gives sources the incentive to innovate as well as the time to adopt and implement new technologies, potentially reducing compliance costs significantly.

[Example - auto emissions regulations and the catalytic converter]

There is a downside, however, to this technology-forcing approach. Because R&D activity is risky, compliance costs may fall by less than anticipated in which case the ambitious environmental quality goal may be extremely costly to meet.

Relaxing the goal at a later date in the face of high compliance costs, thereby rewarding failure, has its own drawbacks.

In contrast to command and control regulation, incentive-based approaches reward sources financially for developing methods that reduce emissions, regardless of the level of current emissions. For example, under a system tradeable permits, any technology that reduces emissions allows a source to profit from higher net permit sales. Similarly, under emissions taxes, subsidies to reduce pollution or liability rules, innovations are rewarded through lower costs or higher subsidies. Because incentive-based approaches provide rewards for reducing emissions at all pollution levels, rather than just to a given standard, they offer incentives for innovation which are superior to those of a command and control system.

An important channel through which environmental policy may influence innovation is through its impact on relative prices. According to the theory of induced technological change, the direction and pace of technological change responds to changes in relative input prices as R&D efforts are channeled toward finding production processes that economize on the use of scarce or expensive factors of production. Induced technological change was originally used to explain the introduction of labor-saving technological change in the presence of high wages. Similarly, by raising the effective price of such inputs as greenhouse gas emitting fossil fuels, environmental regulations could arguably speed the development of technologies that economize on such fuels. For this reason, induced technological change has received attention in the context of climate

[Automated Records Management System Hex-Dump Conversion]

change policy, which is discussed below.

Alternative policies to reduce SO₂ emissions

Regulation of SO₂ emissions from coal-fired electric generating units over the past twenty years illustrates the importance of environmental regulatory structure for cost savings and innovation. The 1977 Clean Air Act Amendments required all coal-fired electric generating units built after 1971 to remove 90 percent of SO₂ from stack emissions, effectively requiring scrubbers. Title IV of the 1990 Clean Air Act Amendments established a tradeable permit program for sulfur dioxide (SO₂) emissions. In Phase I of the program, which began in 1995, permits were allocated to 110 coal-fired electric generating plants. In Phase II, which begins in 2000, the program will be extended to cover virtually all fossil-fuel electric generating plants and will reduce SO₂ emissions to 50 percent of the 1980 emission level.

Under the tradeable permits program, sources that can reduce emissions cheaply, by switching to low sulfur coal for example, can sell permits to sources for which it is more expensive to reduce emissions. Estimates of cost savings just from allowing trading range from 25 to 42 percent.

Changing regulation from command and control to tradeable permits may also spur innovation that results in additional cost savings. Estimates of the costs of reducing SO₂ emissions in 2010 have fallen substantially over time. In 1990, EPA forecast that total annual compliance costs for SO₂ emissions reductions in 2010 would amount to \$4.6 billion. A 1998 study, in contrast projected total annual compliance costs in 2010 at \$870 million. Original compliance cost estimates will be overstated when they do not adequately incorporate technological advances.

In the case of SO₂, factors other than technological change help explain the dramatic decline in expected compliance costs. Policy changes that effectively loosened the limit on total emissions were made after the initial cost forecast had been

prepared, likely explaining part of the decline in the estimated compliance cost. Perhaps the single most important factor, however, was the decline in railroad freight rates as a result of railroad deregulation. Coal from the Powder River Basin in Wyoming has the lowest production cost and lowest sulfur content of any coal in the United States. Lower railroad rates reduced the cost of transporting low-sulfur coal from the Powder River Basin in Wyoming to Midwestern utilities. Coal-fired electric generating units already dependent on coal transported from distant locations gained direct cost savings. Other coal-fired electric generating units found they could reduce emissions at lower cost by switching to low sulfur coal rather than investing in scrubbers.

The SO₂ experience reveals several advantages of relying on incentive-based approaches for environmental regulation. First, even with a given technology, allowing trading lowered compliance costs. Second, with tradeable permits, there may have been added incentives to innovate. Third, tradeable permits allowed sources the flexibility to adapt to changing circumstances rather than being locked into a prescribed abatement method. The Administration has recently adopted rules to allow trading for NO_x emissions and is a strong proponent of establishing an effective international permit trading system to meet the reductions in greenhouse gas emissions agreed to in the Kyoto Climate Change Protocol.

BOX: Estimates of Ex Ante and Ex Post Environmental Compliance Costs

Due in part to the recent experience with SO₂ emissions regulations, some environmentalists have voiced concern that initial estimates of compliance costs made prior to implementation of environment regulations systematically overstate likely costs. Recent analysis has reviewed the limited number of studies where both pre-implementation and post-implementation cost estimates exist, covering the period from 1972 through the early 1990s. Instances of both overestimation and underestimation of compliance costs exist. Prior to 1981,

compliance costs for nearly all regulations were apparently overestimated. Since 1981, however, the accuracy of estimates has improved and the balance has been more equal.

There are many challenges involved in preparing accurately estimates of compliance costs. Ex ante, analysts must inevitably base their forecasts on the policies that are proposed for implementation. Policies are often changed or relaxed in process of implementation, however, so that comparisons of initial ex ante cost estimates with actual ex post implementation costs often entails the comparison of significantly different policies. Furthermore, ex ante cost estimates typically assume 100 percent compliance with proposed regulations. Since firms that do not comply with environmental regulations are often those with the highest compliance costs, implementation cost estimates based on data covering only those firms in compliance tend to be lower than estimates based on perfect compliance. On the other hand, to the extent that cost estimates do not adequately incorporate future technological advances, the costs of compliance will be overstated.

Providing for the efficient amount of R&D

It is widely recognized that the volume of R&D activity undertaken in a market economy may be below the level that would best serve society's interest. The market failures that produce this outcome apply broadly throughout the economy. In the area of environmental technology, however, they may be particularly acute.

A critical reason that private R&D activity may fall short of socially ideal levels is that promising technologies may create economic and social benefits which exceed what the investing firms can capture for themselves. Innovators may have difficulty appropriating the benefits of innovation where patent protection is incomplete so that rival firms can quickly imitate

an innovation, or where basic research leads to advances in knowledge that are difficult to patent. There are often important knowledge spillovers from one firm to another. There is strong empirical evidence that the social rate of return from R&D greatly exceeds the private rate of return. Therefore, a strong case for public support for R&D can be made.

There are two additional concerns relating to the private provision of R&D that are specific to environmental policy. First, environmental regulations themselves may impact the appropriability problem. As noted above, under command and control regulation, sources do not receive credit for the value of environmental improvements. As a result, even abstracting from the usual appropriability problems facing innovators, there may be too little incentive for firms to generate environmental innovations.

Inappropriate incentives for innovation may also occur when environmental regulations, even when incentive-based, are either too lax or too stringent. For example, in the extreme case in which pollution is unregulated, there may be no incentive to innovate to reduce emissions or to lower abatement costs. Abstracting from the appropriability concerns common to all R&D, incentive-based approaches generate efficient innovation incentives only when they succeed in “getting prices right”—namely, insuring the prices of tradeable emissions permits or the taxes levied on emissions fully reflect the actual damages resulting from pollution. Only under these conditions will innovators appropriately weigh the cost of innovations against the expected benefits, including both expected compliance cost reductions and also the benefits due to reduced pollution.

While private sector incentives to innovate are arguably typically insufficient, it is important to note that more R&D activity is not always better. Like other investments, R&D activity is justified only when the expected benefits of innovation exceed the costs. Of course, it is difficult at the outset to predict the success of an R&D program because the returns are inherently uncertain. As Albert Einstein said, if we knew what we were doing, it wouldn't be research.

Even when regulation succeeds in “pricing” environmental damages appropriately, there remains a case for

government support of environmental research due to the large gap which likely exists between social and private returns, particularly in the area of basic research. Federal environmental research funding is concentrated in two areas -- identifying environmental threats, and basic research into solutions to those threats. Basic research into alternative energy sources, pollution abatement technologies, and remediation technologies can provide the basis for the development of cheaper means to control the environmental impact of economic activity. In 1996, direct Federal investment, amounting to \$4 billion, accounted for nearly 50 percent of the total U.S. R&D expenditure in energy, remediation, and site assessment. ***Steve: Is \$4 billion the total U.S. R&D budget or the Federal share?*** This investment is focused on areas of inquiry that are high-risk and offer long-term returns that the private sector has little incentive to fund. The majority of the government's environmental R&D investment is carried out through its system of research laboratories and competitive grants to universities and researchers.

BOX: Public-Private Research Partnerships – PNGV

The Federal government can play a particularly important role in promoting R&D in situations where the private sector's incentive to pursue innovations with environmental payoffs are distorted. For example, the automobile industry's reward from developing significantly more fuel-efficient vehicles has been dampened by low gasoline prices which have made consumers less concerned about fuel-efficiency. However, vehicle emissions are a major source of greenhouse gas emissions and other pollutants, and there are clear societal benefits from developing more fuel-efficient vehicles.

In response, the Partnership for a New Generation of Vehicles (PNGV) was established in 1993 with the goal of dramatically increasing the fuel-efficiency of cars and light-duty trucks while maintaining current performance and price.

The focus to date has been on developing technologies for a mid-sized sedan that would achieve 80 miles per gallon. The research needed to reach that goal ranges from basic study of lightweight materials and alternative power sources to applied engineering of new manufacturing processes. To entice firms to join the research endeavor, the government funds basic research, co-funds more applied research and provides access to the extensive federal laboratory system and its experts.

Environmental Policy and Diffusion of Technology

While innovation is a necessary precondition for improved technology, performance gains will not be realized unless new technology is adopted. Regulatory, informational, or other hurdles may block or delay the adoption of new technologies that are more environmentally friendly. Policy may play a useful role in encouraging the diffusion of new technology if consumers or firms do not adopt new technologies as fully or as rapidly as is socially optimal.

There is a widely observed pattern in the diffusion of new technology among the population of potential adopters of the technology. Cumulative adoption of new technology often follows a s-shaped curve. Initially there are few adoptions.

Over time, the pace of adoption increases, slowly at first and then more rapidly. Adoptions reach a peak and then *level off?* fall as the market approaches saturation. The most direct explanation of this pattern has to do with the spread of information among potential adopters. Initially, the new technology is unknown by virtually all potential adopters. A few pioneers become aware of the new technology and make the decision to adopt. Word of the new technology spreads to those in contact with the pioneers so that adoptions begin to pick up momentum. Finally, as the bulk of the population of potential adopters has learned about new technology, the rate of new adoption slows.

This pattern of diffusion, while providing important clues about adoption decisions, does not answer the policy question of whether the rate of adoption is efficient or not. Failure to adopt technology may be appropriate, reflecting the

fact that the costs of adoption exceed the benefits. Alternatively, market failures may impede adoption even when the benefits exceed the costs. For policy purposes, it is important to distinguish between these two distinct situations. Only when market failures depress the pace of diffusion can policy play a constructive role in promoting the adoption of new technology.

As in the case of innovation, the incentives for adoption of new technologies will be inadequate when market prices fail to reflect the full environmental impacts of pollution. For example, because energy prices do not reflect the full environmental consequences of energy use, consumers have inadequate incentive to purchase energy-efficient products. An obvious solution to this problem is to “get the prices right” so that consumers do face the true costs of their decisions.

A different problem is caused by incomplete information about new technologies. Incomplete information by itself, however, does not necessarily constitute a market failure. In making a private decision about what products to buy, consumers may need to acquire information. But as long as both the costs of acquiring information and the benefits of making a more informed decision accrue solely to the consumer, incomplete information does not constitute a market failure. On the other hand, in adopting a new technology, one person may spread information about the technology to others. The benefit of such information sharing is typically ignored in the adoption decision. If this problem is pervasive, the solution may entail government provision of information, or requirements on the private sector to provide information. The Energy Policy and Conservation Act of 1975 requires many household appliances to carry energy labels with the product’s energy efficiency rating and an estimate of annual energy costs. The EPA and the Department of Energy also operate the Energy Star program in which energy efficient products display the *Energy Star* label. ***Steve: Can one make the case that efficiency standards for appliance could be welfare enhancing as well?***

Residential Energy Conservation: The Energy Paradox

Studies have found that many consumers are unwilling to invest in energy-efficient products such as compact fluorescent light bulbs, improved insulation materials, and energy-efficient appliances even though studies suggest that such purchases would save them money. The failure of consumers to make investments that save energy and yield apparent cost savings for the consumer is referred to as "the energy paradox."

Consumer investment in energy-efficiency, whether that involves installing better insulation or buying more energy-efficient appliances, typically involves an initial cost followed by future benefits from lower energy bills. Studies have calculated the rate of return for a variety of potential energy efficiency investments. In many cases, these rates of return are higher than typical financing costs. Thus, consumers could expect net economic savings.

There are several possible explanations of the energy paradox. One possibility is that consumers face the wrong incentives to invest in energy-efficiency. For example, renters may not make energy-efficient investments if their utility costs are included in the rent and they do not directly reap the benefits from conservation. In such cases, there may be a constructive role for policy to correct the distortion in incentives. Another explanation is that consumers lack information about energy-efficient alternatives. For instance, there is some evidence that providing free information increases adoption rates for energy-efficient lighting. A third explanation of the paradox is that consumers are myopic. There is evidence that people are more attentive to the initial cash expense than to future savings from lower energy bills. Policies that lower the initial cost of purchase may be more effective in encouraging adoption than policies that reduce future energy costs even when the policies are of equal monetary value.

Some analysts think that findings pointing to an energy paradox are artifacts of flawed data or logic. It is argued that engineering data used to calculate estimated energy-efficiency gains are too optimistic; that actual gains for a typical consumer are far less. Consumers may not install insulation or other energy-saving investments correctly, or there may be special features that prevent the investment from performing to rated capacity. It is also argued that the costs of investing in

energy-efficiency are underestimated. The time and resources spent learning about energy-efficient investments are not usually factored into the analysis. For some consumers, these costs may be larger than the energy-efficiency savings. Finally, with significant uncertainty about the price of a new technology, consumers may be rational to delay investing even though current adoption appears to save money. By waiting, a consumer may get a better price and save even more money in the future. Because adoption decisions may take place at any time, analyses that ignore the effect of uncertainty may overstate the value of current adoption.

There is not clear evidence at present to settle the debate over the energy paradox. However, recent low energy prices combined with implementation of energy efficiency standards and various informational programs seem to have reduced the opportunities for investments that save both energy and money.

Innovation and Diffusion: An Application to Climate Change Policy

Policies to address the threat of climate change, due to the long-run nature of this environmental problem, will require the abatement of greenhouse gas emissions over decades and even centuries. Under these circumstances, the impact of environmental regulation to address the problem on the incentives to innovate cannot be ignored. The ultimate cost of global efforts to address this environmental challenge will depend importantly on the pace at which such innovation takes place. The Administration's efforts to address climate change therefore incorporate many of the principles discussed above to create appropriate incentives to promote innovation and speed diffusion of new technology. These efforts are reflected both in achievements in international negotiations and in domestic actions.

BOX: Burning down the house

Emissions of greenhouse gases, primarily from the burning of fossil fuels and deforestation, have led to a 30 percent increase in the atmospheric concentration of these gases above levels prevailing prior to the industrial revolution. If emissions continue along their projected "business as usual" path, a doubling of greenhouse gas concentrations from pre-industrial revolution levels is likely midway through the next century. According to climate models, this could lead to global warming of between 1.8 and 6.3 degrees Fahrenheit by 2100. Potential impacts include a rise in sea level, greater frequency of severe weather events, shifts in agricultural growing conditions due to changing weather patterns, changes in the availability of freshwater supplies, threats to human health from increased range and incidence of disease, and damage to ecosystems and biodiversity.

To address the risks of climate change, *UN member countries* have participated in a series of international negotiations including conferences in Rio de Janeiro in 1992, Kyoto in 1997, and most recently Buenos Aires in 1998. Building on the 1992 United Nations Framework Convention on Climate Change, the Kyoto Protocol places binding limits on emissions of greenhouse gases over the 2008 to 2012 period in industrial countries. The Agreement contains several features that promote cost-effective reductions of these gases, including the flexibility to trade emissions reductions across gases, provisions allowing for international trading of emissions allowances among countries assuming binding emissions limits, and opportunities to invest through the "Clean Development Mechanism" in clean-energy projects in developing countries that generate emissions credits for use in industrialized countries.

The Kyoto Agreement embodies the Administrations a preference for incentive-based environmental regulation through its emphasis on international emissions trading. As noted, an incentive-based approach should provide firms with strong incentives to find low-cost methods of reducing or sequestering greenhouse gas emissions. By "getting prices right"

this approach also stimulates the diffusion of existing technologies as well as providing private sector incentives for R&D for the next generation of technologies. In addition, announcing emissions targets well in advance may produce payoffs akin to those of a technology-forcing standard. This approach provides incentives for firms to innovate while allowing them time to adjust by replacing depreciating plant with equipment incorporating new technology, thereby further lowering the cost of emissions reduction.

In conjunction with the international trading system proposed under the Kyoto Agreement, the Administration supports developing a domestic greenhouse emissions trading program for the 2008 to 2012 commitment period. A domestic trading program would allow sources of greenhouse gas emissions to participate in a market, resulting in an efficient, low cost national abatement strategy. Because 85 percent of domestic greenhouse gas emissions come from the burning of fossil-fuels, the domestic trading program must eventually affect the energy sector and create incentives change in patterns of energy-use.

Box: Energy Consumption: Effect of Prices, Efficiency Gains and GDP Growth

Energy efficiency in the United States is now much greater than it was at the time of the first oil shock 25 years ago. Nevertheless, the United States consumes more energy than it did in 1973. The ratio of energy use to GDP (BTU/\$), which is a measure of the energy intensity of output, fell rapidly in the 1970s and early 1980s, though it has remained relatively flat in the 1990s (see chart 5-2). Despite these efficiency gains, total energy use rose by 27 percent between 1973 and 1997 (see chart 5-3), stimulated by population growth and rising per capita GDP. Virtually the entire increase came after 1986, a period of relatively low energy prices. Before 1986, relatively high

energy prices had kept energy use flat.

The most dramatic increase in energy use has been in the motor vehicle transportation sector, where annual energy consumption rose 54 percent between 1970 and 1995. The average fuel-efficiency of new passenger cars more than doubled between 1974 and 1996, from 14.2 to 28.7 miles per gallon. Despite this impressive gain in fuel-efficiency for passenger cars, overall fleet fuel-efficiency has not increased as much because of the shift toward light-duty trucks and sport-utility vehicles. In addition, efficiency gains were partially offset by an increase in miles traveled per vehicle and a large increase in total vehicles. The net effect of all of these changes has been a small decline in fuel use per vehicle but a large increase in energy consumption due to the increase in the number of vehicles (see chart 5-4).

In the residential sector, by contrast, energy use has declined as efficiency gains have more than outpaced increases in the number of households, in average house size, and in the average number of appliances per household. For example, the efficiency of the average new refrigerator improved 192 percent from 1972 to 1996. Per household energy use declined rapidly in the late 1970s and early 1980s but has been stable since.

Overall changes in energy use depend upon efficiency gains on the one hand, increases in population and income on the other, with shifts in consumer behavior often the determining factor. Low energy prices shift demand toward energy-intensive goods and services and result in higher energy use. High energy prices in the 1970s and early 1980s spurred efficiency gains and shifted demand away from energy-intensive goods.

Evidence suggests that innovations in energy technology, which will be necessary to reach climate change policy

goals, respond to changes in energy prices. For example, the number of patents in energy fields is positively related to current and prior year energy prices. Of course, other factors, such as the level of federal funding for energy-related R&D, may partially explain this relationship. Other evidence lies in the statistical relationship between energy prices and the ratio of energy use to GDP (see chart 5-2). Evidence indicates that when energy prices are high, the energy to GDP ratio falls. This relationship is partly due to the tendency to substitute other inputs, such as labor and capital, for energy during periods of high prices; in addition, it reflects the tendency of consumers to conserve energy when its price is high. The fact that the energy to GDP ratio remained lower in the 1990s after energy prices had once again fallen indicates that long-lasting changes were made in response to earlier high prices. This is a good signal that innovations have occurred. [ADD: tie to Administration's Economic Analysis]

In addition to directly affecting energy prices, the Administration believes that a strong argument can be made for policies to stimulate innovation and diffusion directly through R&D and appropriate fiscal incentives. The President's Fiscal Year 2000 budget includes continued funding for the Climate Change Technology Initiative (CCTI), a program designed to spur the development and adoption of new energy-saving and carbon-saving technologies through tax incentives and R&D investments. Many of the components of the CCTI reflect recommendations made in a 1997 report by the President's Committee of Advisors on Science and Technology. The Committee found that "the inadequacy of current energy R&D is especially acute in relation to the challenge of responding prudently and cost-effectively to the risk of global climatic change from society's greenhouse gas emissions." By providing public support for energy R&D through the CCTI, the level of innovation will likely increase, offsetting in part the appropriability problems associated with this type of R&D.

The proposed FY2000 CCTI package contains \$X billion over the 1999-2003 period in tax cuts for energy-efficient purchases and renewable energy, including tax credits of \$3,000 to \$4,000 for consumers who purchase highly fuel efficient vehicles, a 15 percent credit (up to \$2,000) for purchases of rooftop solar equipment, a 20 percent credit (subject to a cap) for purchasing energy-efficient building equipment, a credit up to \$2,000 for purchasing energy-efficient new homes, an extension of the wind and biomass tax credit, and a 10 percent investment credit for the purchase of combined heat and power systems. The package also contains \$X billion over this five year period in additional research and development investments -- covering the four major carbon-emitting sectors of the economy (buildings, industry, transportation, and electricity), plus carbon removal and sequestration, Federal facilities, and cross-cutting analyses and research. The FY2000 proposal builds on the FY1999 budget which included more than \$1 billion in CCTI R&D funding. The FY1999 budget represents a 25% increase over the FY1998 climate change R&D appropriations. (CONFIRM TAX INCENTIVE PROPOSAL FOR FY2000)

Complementing these fiscal measures, the federal government can undertake other actions to promote the diffusion of climate-friendly technology. In October, 1997, the President called for a series of steps to reduce energy use in Federal buildings, transportation fleets, and other equipment purchases, and to promote the use of renewable energy sources. As the nation's largest single energy user, the federal government spends nearly \$8 billion each year for power to operate facilities, vehicles and industrial equipment, and over 90% of this energy derives from fossil fuels. The federal government plans to expand its procurement of renewable and less carbon-intensive fuels. These efforts will accelerate the diffusion of new energy efficient and

carbon-lean technologies. Further, the federal government's experience with these technologies will demonstrate their applicability and feasibility for other users thereby facilitating diffusion.

The Long-Run Costs of Environmental Regulation

While the development of new technology and widespread adoption and diffusion of available technology can make environmental protection less expensive, some analysts have argued that further environmental protection can be obtained at little or no economic cost. The energy paradox described above is perhaps one such example. If stricter environmental regulation is costless, then implementing such regulations is unambiguously desirable because environmental benefits are generated without economic cost. Though it is a difficult proposition to test, the weight of the evidence suggests there are long-run economic costs from imposing stricter environmental regulations.

Are there long-run costs from environmental regulations?

There are several possible ways in which environmental regulations might confer non-environmental benefits on regulated firms and the economy as a whole. First, environmental regulations might force firms to reconsider their methods of production, which could lead them to discover new methods that simultaneously lower both emissions and cost. By focusing on eliminating emissions, it is argued, firms may ultimately find ways to reduce resource use and lower production costs. Second, firms subject to strict environmental regulation may gain a comparative advantage vis-a-vis competitors by developing new products and technologies for which demand may later become widespread. Thus, firms subject to strict early controls may gain first-mover advantages over rivals who may also eventually be subject to strict environmental regulations. Third, regulation may stimulate additional R&D activity. With significant spillover effects across firms due to R&D activity, all firms might benefit if each undertake an active R&D program even though each firm individually might not

engage in such investments without the spur from regulation.

Many skeptics would dispute the proposition that environmental benefits can be obtained at no cost, questioning why firms would not undertake profitable investment without being forced to do so by regulators. Profit-maximizing firms gain by cutting costs and seizing strategic advantages. The profit motive itself should ensure there are no large unrealized cost savings or untapped first-mover advantages. This critique, however, does not address the benefit of additional R&D in the presence of spillover effects. Additionally, difficulties in internal organization may prevent a firm from operating in a manner fully consistent with profit maximization. However, it is not clear that policies can be designed to overcome these internal organizational problems. *Steve: Can you provide any examples of these ideas, possibly from something Michael Porter has written—e.g., an example of how an environmental regulation proved advantageous?*

Evidence on the long-run effect of environmental regulation on growth

Neither proponents nor skeptics of the proposition that environmental regulations impose no long-run costs are likely to be persuaded by the other side's appeals to abstract theories. Though it is difficult to test this proposition directly with existing data, some evidence concerning the long-run productivity consequences of environmental regulation is available. The bulk of this evidence indicates that increasing the stringency of environmental regulations entails some economic cost.

A number of studies have analyzed the proportion of the productivity slowdown in the 1970s attributable to increased environmental regulation within specific industrial sectors. These studies generally found a small negative effect of environmental regulation on productivity. Most studies found that the percentage of the overall productivity slowdown due to environmental regulation was between 8 and 16 percent. However, one recent study of productivity among oil refineries in the Los Angeles area, which are subject to strict air quality regulations, found increased productivity relative to

other refineries.

Other studies have analyzed the economy-wide effect of environmental regulations on productivity. Using data from the Census Bureau's Pollution Abatement Cost and Expenditures (PACE) Survey, studies have found a negative relationship between environmental compliance expenditures and measured productivity. One study found that a \$1 increase in environmental compliance expenditure was correlated with a decrease in measured productivity *[Steve: defined as output per manhour? Is this large or small?]* of approximately \$1.50 to \$2.00. Another study based on a multi-sector model of the U.S. economy, estimated that environmental regulations lowered GNP growth by 0.2% per year over the period from 1974 to 1985. The cumulative effect of environmental regulations amounted to a GNP decline of 1.7% below levels that would have prevailed absent these regulations.

There is reason to be cautious in interpreting the results of these studies. Estimates of the impact of environmental regulations on productivity may overstate productivity losses because some direct and indirect effects of improved environmental quality on productivity may not be captured. For example, improved environmental quality may contribute to a healthier, more productive labor force. On the other hand, these studies may understate the costs if they fail to incorporate R&D expenditures or the capital costs of investment in new plant and equipment.

BOX: Is there an environmental Kuznets curve?

Not only may environmental regulations affect productivity, but there may be an effect in the opposite direction from increasing productivity to demands for greater environmental protection. Analyzing data across countries, Simon Kuznets found that income inequality rose with per capita income for low levels of income but fell with increases in per capita income for high levels of income, describing an inverted-U relationship. Several analyses of patterns of emissions of air and water

pollutants across countries have shown a similar pattern. Although the early stages of industrialization bring increases in pollution, beyond a certain point further increases in income lead to reduced emissions, perhaps because people become willing to spend some of their higher real incomes on a cleaner environment. If the inverted-U relationship is in fact correct, countries that reach a certain level of development should experience declining pollution levels with economic growth. In other words, growth is not necessarily the enemy of the environment.

Just where the turning point in the relationship between development and environmental quality occurs is important for predicting whether total global emissions are likely to increase or decrease in the near future. If peak pollution levels occur at relatively low per capita income levels, emissions should begin to fall because many populous middle-income countries (e.g., Mexico) should begin to experience improving environmental quality. However, substantially higher peaks mean that pollution will likely get worse before it gets better. One study found that sulfur dioxide and particulate matter levels peak at per capita income levels below \$8000 [1985\$ - update to more recent figure]. A second study using slightly different data and methods found that per capita emissions of sulfur dioxide, particulate matter, nitrogen oxides and carbon monoxide peaked at substantially higher per capita income levels.

Unlike air and water pollutants that have primarily local effects, greenhouse gas emissions seem to increase with income at all income levels. Because greenhouse gas emissions contribute to changes in the global atmosphere but do not contribute to local pollution, there is little pressure to reduce emissions at the national level. Without international agreements to limit greenhouse gas emissions, the path to a more prosperous world may have ever-increasing emissions.

REGULATION & INNOVATION --

THE EXAMPLE OF ELECTRICITY RESTRUCTURING

This chapter has discussed the interplay between regulation and innovation, illustrating

how innovations often necessitate regulatory changes, and, in turn, how regulatory changes can affect the pace and direction of innovation. These themes are illustrated in this section with a discussion of electricity restructuring, an industry where technological and organizational innovations have changed the desired form of regulation.

Although other industries have been opened to competition over the past decades (e.g. banking, intrastate trucking, telecommunications), the electricity market, with sales of \$212 billion in 1996, is the largest to be targeted for deregulation. Competition has been introduced at the wholesale (generation of electricity) level, but retail electricity markets are still, for the most part, regulated monopolies. In 1998, the Administration proposed legislation to remove many of the remaining barriers to competition and encourage states to implement retail competition. The goal of the Administration's Comprehensive Electricity Competition Plan is to provide consumers access to the wholesale power market while maintaining regulated transmission and distribution systems, which probably remain natural monopolies. This is analogous to consumers' being able to choose their long distance telephone service provider. The plan has five main objectives: (1) encourage States to implement retail competition; (2) protect consumers by facilitating competitive markets; (3) assure access to and the reliability of the transmission system; (4) promote and preserve public benefits; and (5) amend existing Federal statutes to clarify Federal and State authority.

The Administration's proposed electricity deregulation plan provides an excellent example of how an enlightened regulatory approach by government can remove barriers to private innovation, resulting in both economic and environmental benefits: the competitive incentive to produce electricity more efficiently is expected to translate into lower fuel

consumption and less pollution into the atmosphere.

Innovation Caused a Re-examination of Regulation

The electricity industry has been regulated since the early 1900s, when states began to grant electricity companies exclusive service areas. Utilities were overseen by Public Utility Commissions (PUCs) and guaranteed a “reasonable” rate of return on their investments provided they set reasonable rates and met various social objectives such as universal access.

The justification for regulation was that it was less costly to have one electric utility provide service than to have competing utilities. Firms faced enormous start-up costs in installing generating units, transmission and distribution lines, and individual connections. On the generation side, coal-fired and nuclear plants needed to be very large, over 300 megawatts (MW) capacity, to exploit economies of scale. The capital demands for such a large plant needed to be spread over a large consumer base for the utility to recoup its investment. Duplication of transmission and distribution networks by competing firms caused unnecessary expense. To encourage utilities to incur these large investments and avoid wasteful duplication, states restricted competition by granting utilities monopoly status.

Technological and organizational innovations in electricity generation have removed its natural monopoly characteristics and reduced the need to restrain competition in the generation of electricity. Deregulation in the natural gas industry and the increased availability of gas caused prices to fall. This spurred innovations on the electricity generation side and made combined-cycle gas turbine plants, which can be 100 MW or smaller, competitive with much larger coal plants. In 1994, these technologies contributed to a 35 percent fall in the average size

of new fossil-fuel fired generating plants relative to the average size of the existing generators. These changes mean that large users can threaten to generate their own electricity if they are not offered lower rates by utilities. Technologies on the horizon promise further reductions in the efficient size of electricity generation, to the point where even residential users may some day be able to generate their own power.

Understanding of how to operate generating plants and the transmission grid independently of each other has also improved. To maintain the integrity of the electricity grid, the quantity of electricity supplied must always match the amount demanded. With fluctuating quantities of energy demanded, generators must be closely coordinated. Until recently, this was taken to mean that generation, transmission, and distribution services needed to be jointly owned. Recent technological and institutional innovations, however, such as computerized controls, Independent System Operators (ISOs), and electricity pools, offer ways to coordinate unaffiliated generators and provide fair, open access to transmission lines while maintaining their integrity.

BOX: Balancing Loads vs. Distribution losses & Heat Production

The trend towards smaller, cleaner, and quieter generating plants along with the physics of electricity transmission and generation have led many to claim that the days of centralized power are numbered. Generating electricity from a fuel source is never perfectly efficient -- some of the energy in the fuel source is lost in the transformation process. This energy typically takes the form of heat which can be captured and used in industrial processes or as space heating if the generator is physically close enough to consumers in need of heat. By doing so, the plant produces two valuable products -- electricity and heat -- for the price of one, a process called

cogeneration.

Secondly, even after it is generated, most electricity goes through many steps before reaching the end user. Electricity can be transmitted over high voltage transmission wires for long distances, after which it must be transformed into lower voltage to be distributed, and finally transformed again before it is delivered to consumers. On average, some 10 percent of generated electricity is lost through this chain. On-site electricity generation avoids the majority of these losses, thus increasing efficiency and lowering costs.

In the past, economies of scale in electricity generation, and the nuisance of locating loud and polluting plants nearby, outweighed the incentive for small scale local generation. This situation has begun to change, however, as very small scale plants (natural gas fired systems may some day be offered as small as 5 kw, enough to power a single family home) are becoming competitive with large scale generation, and plants are becoming quieter and less polluting. Extremely clean and nearly silent fuel cells, in which hydrogen is passed through a series of catalysts, producing electricity and water, could be the next generation of electricity production.

These changes do not necessarily imply that we will soon have no need for centralized power. One reason for having an electricity grid is that it pools plants with different production characteristics with consumers with different load profiles. For example, the commercial sector demands electricity during the day while residential demand is concentrated during the mornings and evenings. If each of these groups generated their own electricity, they would each need to have the facilities to meet their electricity requirements. By pooling the groups, the same consumers can be supplied by less generating capacity. Depending on the size of distribution

losses and the value of excess heat, it would be wasteful to have two separate plants, one at the office and another one at home when one plant could service both loads.

While electricity is governed by a mix of state and federal regulation, a series of Federal actions since 1978 began to introduce competition at the wholesale (generation of electricity) level. The Public Utilities Regulatory Policy Act of 1978 (PURPA) first opened the door by requiring public utilities to purchase power from expensive renewable and cogeneration sources -- "qualified power." While this saddled some utilities with high-cost, long-term contracts, it also demonstrated that non-utility owned generators could be integrated into the electricity system and helped spur the development of smaller scale generation technologies. The Energy Policy Act of 1992 went further by creating a new class of independent electricity generating companies who could sell power directly to utilities. In April 1996, the Federal Energy Regulatory Commission (FERC) issued Order 888 requiring public utilities to provide access to their transmission lines at reasonable, non-discriminatory rates.

At the state level, to further these policies and reap the benefits of competition, many utilities are collaborating to create regional or state-wide ISOs for transmission grids which can independently set fair transmission pricing and can contract for network services (back-up power, etc.). There are currently four ISOs in operation and seven others in the planning stages. The jury is still out on whether ISOs or a combination of industry controls and state regulatory action is the most effective way to implement wholesale and retail deregulation. The Administration plan gives states the flexibility to determine how they will implement competition, encouraging a variety of approaches.

States throughout the country are going further to provide consumer choice -- retail competition in electricity

markets. Thirteen [as of Dec.1, update] States have passed legislation to establish retail competition and a further six States have passed regulatory orders to introduce competition. Many states and utilities across the country have implemented pilot programs and statewide retail competition is currently offered in California, Massachusetts, Montana, and Rhode Island.

Even though states are moving forward, several federal regulations still hamper full competition. For example, the Public Utilities Holding Company Act (PUHCA) of 1935 makes it hard for utilities to cross state lines to compete in each other's markets. The Public Utility Regulatory Policy Act (PURPA) requires public utilities to purchase expensive "qualified power," but does not impose such costs on new competitors. The Administration's electricity competition plan would remove these and other barriers to competition.

Benefits of Deregulation

The traditional form of regulating monopolies through rate setting did not provide strong incentives for utilities to improve their efficiency or offer new services. By allowing companies to compete to provide energy to consumers, competition forces companies to search for more efficient means of producing and delivering electricity, as well as new means of providing the energy services desired by customers. In a \$212 billion industry, even small efficiency gains from competition can have large benefits.

Above and beyond direct efficiency gains from producing and delivering electricity, retail competition can encourage firms to offer new products and find innovative ways to reduce overall energy costs. The development of time-of-day metering may allow consumers to shift their purchases away from peak periods and thereby reduce capacity requirements. As discussed previously in this chapter, there appear to be barriers in the markets for energy efficiency.

Utility commissions have stepped in to force public utilities to invest in energy efficiency, requiring so-called Demand Side Management programs. In the move towards a competitive industry, utilities are now rethinking such investments. There is no way for a utility to force consumers to keep buying their power once the utility has made an efficiency investment (e.g. bought insulation for the consumer's house). New structures will develop to allow firms to pay for and install energy efficient equipment in return for a share of the subsequent savings. Restructuring, by making it easier to bundle efficiency services with the provision of electricity could provide incentives for increased growth of Energy Service Companies (ESCO's). The potential role for energy service companies is illustrated by the experience in California under deregulation, where most supply contracts for commercial and industrial customers include an energy management component.

Competition may also permit customers to express, through their purchases, their preferences for environmentally sound electricity. "Green" power marketers have sprung up in many of the states now offering retail competition and in those with pilot programs. For a premium, these marketers sell electricity that is generated with a greater portion of renewable sources than the current mix. If a sufficient number of consumers are willing to pay enough extra for such green power, this will provide a profit motive to encourage the future development of such resources.

The Challenges of a Competitive Market: Environmental and Social Objectives

Regulatory changes bring with them a host of challenges as old ways of meeting various objectives must be re-thought. In the past, Public Utility Commissions (PUCs) had direct

oversight over utilities. In some states, PUC's sought to include environmental considerations in their approval criteria for new generating assets. This encouraged the construction of less polluting generating plants than would have been the case if utilities were allowed to ignore this issue. With competition, however, PUCs lose their ability to influence the composition of electricity supply. If a utility is required to buy more expensive clean energy, its rates would have to reflect the higher costs. With competition, consumers would be able to buy power from other providers who had lower costs because they were not subject to the same provisions.

In a competitive market, unless environmental externalities are internalized through other means (such as existing environmental regulations), the government must step in to pursue them in new ways. For example, PURPA required utilities to buy power from "qualified" clean generators such as renewable and cogeneration sources. To support the same goals, the Administration proposal includes establishing a market for alternative power. In this case, tradable renewable portfolio standards would be used to promote more environmentally friendly power production. This approach would require each generator to cover a fraction of their total generation from renewable sources. If a seller did not generate enough renewable power by itself, it could purchase credits from companies that exceeded their generation requirement. The Administration's Competition Plan also includes provisions to establish a "public benefits fund" for supporting affordable electricity service to low-income customers, investing in energy efficiency measures, and other social goals. The fund would be supported by a surcharge on all electricity transmitted over the national grid.

The benefits of deregulation rely on the forces of competition to keep prices reasonable for consumers. Benefits, therefore, depend on the extent of competition in markets. The

Administration's Plan would grant authority to the FERC, the Justice Department, and the Federal Trade Commission to block anti-competitive mergers and to promote competition through divestitures and other means.

Withdrawal/Redaction Marker

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	Mary Fibich to Janet L. Yellen at 16:04:33.00. Subject: Fast Facts. (partial) (1 page)	01/04/1999	b(6)

COLLECTION:

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

FOLDER TITLE:

[01/04/1999] [1]

2013-0723-F
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RESTRICTION CODES

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

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

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

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Mary Fibich (CN=Mary Fibich/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 4-JAN-1999 16:04:33.00

SUBJECT: Fast Facts

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

READ:UNKNOWN

TEXT:

1. Fast Facts: The service is within budget, and a subscription has been ordered. As requested, MA will not fax the data to you. It can be accessed via the internet. Your id an password are as follows -- all in lower case



The numbers are up within an hour after release, and the written analyses are up by mid-morning to early afternoon (always by 12:30 p.m. central time)

Would you like MA to add you to the list of people they notify by e-mail when the written analysis is available? Or would you prefer that they not do that?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Mary Fibich (CN=Mary Fibich/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 4-JAN-1999 16:26:26.00

SUBJECT: ERP Cover and Bloomberg Status

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

READ:UNKNOWN

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

READ:UNKNOWN

TEXT:

1. GPO informs us they expect to deliver the ERP cover samples to us on January 7.
2. Bloomberg is scheduled to install their service on January 7. (They previously conducted a site survey, and our information technology support folks have been coordinating the communications link.)

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 4-JAN-1999 11:42:40.00

SUBJECT: Latest Draft Steel Report due to Congress Jan 5.

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

READ:UNKNOWN

TEXT:

----- Forwarded by Jeffrey A. Frankel/CEA/EOP on 01/04/99
11:42 AM -----

Malcolm R. Lee
01/04/99 11:39:28 AM
Record Type: Record

To: See the distribution list at the bottom of this message
cc: Nina L. Hachigian/NSC/EOP
Subject: Latest Draft Steel Report due to Congress Jan 5.

Structure has changed slightly per Sperling. Contains Lael Brainard's initial edits, she is reviewing further. Please fax (69290) and e-mail me comments as soon as possible. Thanks

Message Sent

To: _____
earp_gordana @ ustr.gov @ INET @ VAXGTWY
Meg.Lundsager @ Treas.sprint.com @ inet
Joshua Gotbaum/OMB/EOP
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===== ATTACHMENT 1 =====
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D70]MAIL475886301.036 to ASCII,

The following is a HEX DUMP:

**REPORT TO THE CONGRESS
ON A COMPREHENSIVE PLAN FOR RESPONDING TO
THE INCREASE IN STEEL IMPORTS**

I. SUMMARY

This report responds to the request from Congress contained in the omnibus spending bill for a comprehensive plan for responding to the increase in steel imports into the United States.

The Administration is deeply concerned about the recent surge in low-priced steel imports and its impact on America's steel industry and the workers, families and communities that depend on it. There is no more important challenge than to ensure the strength of the U.S. economy and to minimize the impact of the global financial crisis on all Americans.

The Global Financial Crisis and State of the Steel Industry

The financial crisis has resulted in a steep drop of demand for steel in Asia, which over the last decade had experienced a sharp increase in steel consumption and had substantially expanded steel production. Many producers diverted their sales to the strong U.S. market. U.S. steel imports surged to record levels in 1998, rising 30% in the first ten months of 1998 over the same period last year. Import penetration rose from 22.6 percent to 29.5 percent between 1997 and the same period of 1998. Steel exports from Japan, Korea and Russia together account for 82 percent of the increase. Due to currency devaluations in Asia and due to the global excess of steel, prices decreased sharply.

While the strength and resilience of the U.S. economy has withstood the global economic pressures and growth continues, increased steel imports have had an adverse impact on U.S. steel producers and workers. U.S. steel shipments declined 7.8 percent in the June through October 1998 period. The American Iron and Steel institute reports that capacity utilization has fallen to 74 percent from 90 percent a year ago. Labor statistics show a 10,000 drop in steel employment to 226,300 between November 1997 and November 1998, compared to the average ANNUAL? decline of 1,660 workers from 1992 to 1997.

Action Plan

The steel import situation has received sustained attention at the highest levels, including the President, the Vice President and members of the Cabinet, who met with industry and union representatives on a number of occasions to discuss industry and labor concerns and potential responses. The Administration has held regular, senior level, inter-agency meetings to craft an appropriate, timely and comprehensive response to alleviate the adverse impact of steel imports, and to avoid further disruption to the U.S. market. The Administration's program is based on four pillars:

- stabilizing currencies and strengthening demand around the world;
- strong enforcement of U.S. trade laws against unfair trade practices;
- an early warning system to monitor import trends
- a commitment to effective safeguards relief under Section 201 where imports have caused serious injury;
- strong bilateral pressure on our trading partners to eliminate any and all unfair trade practices and to further open their markets; and,
- assistance for affected workers and communities.

These principles have been pursued in the Administration's steel action plan through a number of specific steps which are summarized below and described in greater detail in the remainder of this report.

1. *Restoring Global Economic Growth and Ensuring Market-Based Reform:*

Stabilizing currencies, restoring Asian and Russian growth and demand, and strengthening market based reform in economies affected by the financial crisis are critical to reducing the steel import pressure on the U.S. market. The President is leading the world in these efforts. This coordinated response is focused on encouraging strong reform programs in affected countries such as South Korea, buttressed by international financial assistance to provide breathing room for the reforms to take hold. We are actively working to discourage competitive devaluations of currencies. The Administration has been urging Japan to provide adequate and sustained fiscal stimulus to restore domestic demand-led growth, a key to recovery in Asia and global economic health. We are pressing Japan and the EU to further open their markets and take their fair share of imports from the crisis economies.

2. *Strong Enforcement of U.S. Laws Against Unfair Trade Practices:* U.S. trade laws provide a strong mechanism to counter import injury from any unfair trade and subsidy practices. The Administration is vigorously, fairly and expeditiously enforcing U.S. trade laws consistent with our international obligations, and taking action to eliminate unfair trade practices.

- Expedited Investigations: Commerce has shifted resources to expedite the recent dumping cases on hot-rolled steel from Japan, Russia and Brazil which were filed by U.S. producers and workers on September 30. Imports covered by these cases account for 52 percent of the steel import growth. Preliminary dumping determinations will be announced in February.
- Critical Circumstances: On November 23, Commerce issued a preliminary ruling of critical circumstances in these investigations with respect to hot rolled sheet imports from Japan and Russia. Based on this finding, if Commerce finds dumping is occurring, importers may be retroactively assessed dumping duties on imports reaching back 90 days before the preliminary dumping determination, to imports dating back to mid-November. The critical circumstances finding has thus put importers on notice of potential dumping

duty assessments. This may already be having an impact on importers' decisions on whether to purchase Japanese and Russian hot-rolled steel.

- **Suspension Agreement Negotiations:** The dumping laws also allow the United States Government to negotiate agreements that limit imports of products covered by pending dumping cases with non-market economies, such as Russia. In appropriate circumstances, such suspension agreements can be the best and most effective way to enforce our trade laws. In this context, Commerce is exploring whether a possible suspension agreement could provide early, effective, relief from the surge of Russian steel imports consistent with statutory requirements. The Administration is committed to strong enforcement of our trade laws and Commerce will work closely with U.S. industry, unions and Congress throughout this process.
- **Existing Dumping and Countervailing Duty Orders on Steel Products:** The Department of Commerce is currently enforcing more than 100 antidumping and countervailing duty orders on steel products from a number of countries and over the past year has completed or is conducting 35 new steel investigations.
- **Strong New Countervailing Duty Regulations:** The Commerce Department recently issued strong new countervailing duty regulations that will strengthen our ability to combat unfair subsidies. Commerce carefully considered the comments received from the steel industry and members of the Steel Caucus in preparing these regulations.

3. *Early Warning System to Monitor Import Trends:* The Administration has developed programs to monitor steel imports, as well as foreign government subsidies and commitments under IMF programs. Such monitoring is designed to provide early warning on import trends for sensitive products, and to develop information needed to help ensure that our trading partners are fully abiding by international commitments under the WTO, and under International Financial Institution (IFI) reform programs.

4. *Section 201 Safeguards Actions:* The Administration believes that our WTO-consistent safeguards law is an important possible trade remedy to address import surges. We understand that industry is examining possible cases. We are consulting with industry on possible safeguards actions, and we are prepared to ask the International Trade Commission to expedite investigations.

5. *Bilateral Pressure:* The President and the Administration are continuing to press our trading partners at every opportunity to end unfair trading practices and subsidization, and to fairly share the burden of absorbing additional steel imports. Efforts have focused on Japan, Korea and Russia, the three countries which account for 78 percent of the increase in our steel imports, and on the European Union (EU).

- During his November visit to Japan -- which accounts for nearly a half of the increase in U.S. steel imports -- the President expressed strong concern about the extraordinary increase in Japan's steel exports to the United States and the resulting impact on the U.S. market. The President underscored the need for fair, rules-based trade, full enforcement of trade commitments and greater market opening. He pressed Japan to adopt and implement effective economic stimulus and reform measures.
- In Korea, the President pressed President Kim to place Korea's steel sector on a market footing, and President Kim agreed to work with the United States to make progress toward this goal. Our steel dialogue with Korea has already produced a Korean Government commitment that Korea's second largest steel producer would be sold and that the government would not support or direct others to support it. The bilateral dialogue has been expanded to include examination of the Korean government's role with respect to other steel producers, including POSCO, Korea's largest -- and the world's second largest -- steel producer. U.S. and Korean officials convene again in January.
- In addition to talks regarding a possible suspension agreement on steel imports, the Administration is working with Russia and the IMF to stabilize the Russian economy, promote market reforms and restore growth, in order to stimulate domestic demand and reduce excess capacity in sectors such as steel. Bilateral U.S. assistance program help develop alternatives to employment in troubled Soviet-era industries such as steel.
- The Administration has pressed the European Union to fairly share the burden of increased steel imports. During the U.S.- EU Summit in December, the President pressed President Santer to open the EU market to greater steel imports from distressed economies such as Russia. The U.S. Trade Representative pursued this issue during her recent tour of European capitals.

6. *ADD SOMETHING ON TAA*

This Administration is committed to effectively addressing the legitimate concerns of steel workers and the steel industry. Free and fair rules-based trade is essential for both global economic recovery and for U.S. prosperity. Actions taken to date have provided a comprehensive response to the steel import situation. We continue to monitor developments and consult with industry and labor representatives, members of Congress, as well as our trading partners, and will take additional action as circumstances warrant.

II. STATE OF THE U.S. STEEL INDUSTRY

Importance of the Steel Industry to the U.S. Economy

The American steel industry is critically important to our economy, including as a vital contributor to the auto, high-tech, and construction industries and many other sectors. The steel industry employs 233,200 American workers and supports employment in many related industrial and service fields.

Internationally, until 1998, the United States had been the world's third largest producer of steel after China and Japan, with production of 110 million metric tons of crude steel in 1997. In 1998, the United States may have become the world's largest steel producer. Over the last several years, due to strong demand and favorable market conditions, U.S. and foreign firms have added substantial new steel capacity in the United States, amounting to about 9 million metric tons. We have a highly competitive industry, which can compete and succeed in a market that is not distorted by subsidies, unfair trade practices and government intervention.

However, many foreign governments continue to view steel production and self-sufficiency in steel as prerequisites to industrialization. Foreign steel industries have often been supported through government subsidies to encourage expansion or forestall restructuring. Overcapacity has been a long-term problem in the industry.

Effects on the U.S. Steel Sector

The chronic problem of overcapacity in the steel sector was compounded in 1998 by the Asian financial crisis and the catastrophic drop in demand in Asia. As a result, a high volume of shipments has been diverted from Asian to North American markets. Aggravating the situation further, Russian steel exports were shifted from Asian to North American markets. Steel import quotas against Russian imports made it difficult to increase Russian exports to the European Union. As a result, steel imports to the United States have surged to the highest level ever. While demand in the United States has remained strong, U.S. steel producers and workers have been adversely affected by the sharp increase in imports and the resulting price suppression.

Through October of 1998, the United States imported 31.4 million metric tons of steel. This represents an increase of nearly 30 percent over the 24.2 million metric tons we imported in the first ten months of 1997. The import increase was particularly pronounced in the second half of 1998, with imports for the June through October 1998 period in 1998 up 52.9 percent over the same period in 1997. Imports of finished steel products grew at an even higher rate and were up 7 million metric tons. Most major foreign steel producers have contributed to this import growth. However, the increase is concentrated in three countries, which together account for 82 percent of the increase, and **[CEA/Commerce :X share of the U.S. market individually and in aggregate]**. . With respect to finished steel imports, they are:

- Japan, now the single largest source of finished steel imports at 4.9 million metric tons through October, up 161 percent or 3.0 million tons, accounts for 42.9 percent of the import growth;
- Korea, now the fourth largest source of imports at 2.5 million metric tons through October, up 132 percent or 1.4 million tons, accounts for 20.4 percent of the import growth; and
- Russia, the second largest supplier at 3.7 million metric tons, up 56 percent or 1.3 million tons through October, accounts for 19 percent of the import growth.

Measured by product category, the largest increase has been in hot rolled carbon flat steel covered by the ongoing dumping trade case, in which imports grew by 3.3 million metric tons. This growth in hot rolled imports accounts for 52 percent of the total import growth we experienced so far in 1998. Japan and Russia together account for 82 percent of this increase.
Commerce: Hot rolled sheet makes up x percent of overall steel imports.

Commerce: Overall steel? import penetration has increased from 22.6 percent in the first ten months of 1997 to 29.5 percent in the comparable period in 1998. For the June through October period, import penetration jumped from 23.5 to 33.6 percent between 1997 and 1998.

Equally dramatic as the growth in import volume has been the steep drop in prices. The average value per metric ton of **type?** steel imports **Commerce: in the U.S.?/world?** had dropped from about \$512 at the beginning of 1998 to \$400 in October 1998. This has placed substantial downward pressure on steel prices in the United States. According to "Salomon Smith Barney" (December 29, 1998): "With three major price cuts in the space of less than five months, hot-rolled sheet prices have dropped from a high of \$320 per ton to \$250 per ton – the lowest in recent history." Price declines have been evident for virtually all steel products.

During this period, U.S. steel production and employment have fallen. U.S. steel shipments declined 7.8 percent, from 41.2 million metric tons in the June through October 1998 period, to 38.0 million tons in the same period in 1998. The American Iron and Steel Institute (AISI) reports that capacity utilization has dropped to 74 percent in November 1998 as compared with 90 percent a year ago. Labor statistics show a 10,000 drop of steel employment from 236,300 to 226,000 workers between November 1997 and November 1998, compared to the average **Labor: annual?** decline of 1,660 workers in the 1992 through 1997 period.

The adverse effect on U.S. producers has been somewhat dampened by continued strong U.S. demand.

Economic recovery in Asia is the single most important cure to preventing contagion to the U.S. economy, relieving excessive import pressures and restoring exports to the region. The U.S. steel industry has experienced the direct effect of large increases in lower priced imports. In addition, our economy has been hit by the indirect effect of price pressures from an oversupply of steel exacerbated by falling demand in Asia and Russia. In the absence of international

efforts to stabilize the economies and currencies of countries affected by the crisis, it is likely that currencies would have fallen even further and the effects on our trade flows would have been even larger.

III. STEEL ACTION PLAN

1. Restoring Global demand and Ensuring Market-Based Reform [THIS SECTION NEEDS TO BE CUT DOWN AND MADE MORE DIRECTLY RELEVANT TO STEEL, SECTIONS THAT ARE NOT OR ARE REDUNDANT OF BILATERAL SECTION NEED TO BE DROPPED],

The Administration's highest priority has been restoring growth in Asia and preventing contagion from the Asian crisis on the U.S. economy. Restored growth in Asia will result in revived demand for steel in the region, and will reduce the import pressure on the U.S. market. In the context of stabilization programs of International Financial Institutions (IFIs), the Administration has also supported strong provisions for reform in beneficiary countries, designed to improve governance, increase transparency and reduce government involvement in industrial decision-making. These conditions should reduce the likelihood of future crises, and reduce policies which have lead to politically-motivated investments, such as have occurred and led to overcapacity in the steel sector.

The Administration has worked within the international community to develop a coordinated response to the Asian financial crisis, focusing on four areas.

Strong reform programs within the affected countries

The approach of the international community to the Asian financial crisis emphasized programs designed in conjunction with the IMF, World Bank, and Asian Development Bank that require nations to take concrete steps to reform their economies. The goal of these reforms is to restore financial stability, promote stronger and more stable exchange rates, attract new capital, address underlying structural weaknesses, and restore economic growth. The IMF programs were designed to address the specific issues facing each nation, and were based on strengthening financial systems, opening markets to both capital and trade, and following appropriate monetary and fiscal policies. In Korea and Indonesia, the programs have also included strong structural reforms designed to increase competition, enhance transparency and disclosure, and improve governance in the public and private sectors. The Korean government has also agreed to end its involvement in directing lending decisions by Korean commercial banks. In addition, each country has worked towards a framework for the restructuring of large debt loads and improving oversight and regulation of the banking system.

The Administration is carefully monitoring the subsidy and trade-related commitments made by IMF fund recipients as part of their IMF stabilization packages. These conditions should eliminate a wide range of practices that may confer unfair subsidies, including many

which Commerce has found actionable in past subsidy cases. The Administration is monitoring the market-opening commitments of the stabilization packages as well. These commitments include tariff reductions, removal of certain import restrictions, changes in public procurement practices and liberalization of the financial services markets, all of which should improve access to these markets for U.S. exporters, many of which use U.S.-made steel in their production process.

The Secretary of Treasury has recently certified with respect to Korea, that: “(1) no Fund resources made available pursuant to the Arrangement have been used to provide financial assistance to the semiconductor, steel, automobile, shipbuilding, or textile and apparel industries; (2) the Fund has neither guaranteed nor underwritten the private loans of semiconductor, steel, automobile, shipbuilding, or textile and apparel manufacturers under the Arrangement; and (3) officials from the Fund and the Department of the Treasury have monitored the implementation of the provisions contained in the Arrangement, and all of the conditions have either been met or the Republic of Korea has committed itself to fulfill all of these conditions according to an explicit timetable for completion.”

International financial assistance

The IMF programs adopted by these countries have been supported by temporary financial assistance from the International Monetary Fund and other international financial institutions to bolster reserves, to provide breathing room for the reforms to take hold, to help restore confidence, and to prevent a deeper, more prolonged crisis. There are careful constraints on how these resources are used. The United States also mobilized a multilateral effort to restore trade financing to Asia, in which G7 and OECD export credit agencies pledged to remain open for business in Asia.

Encouraging growth in Japan

The United States has been urging Japan to provide adequate and sustained fiscal stimulus to restore domestic demand-led growth. We have stressed the need for Japan to continue to take action to strengthen its banking system and to use public funds effectively, with appropriate conditions, including stronger disclosure and steps to clean up the banks' balance sheets and permanently dispose of bad assets. Japan's recent measures represent an important beginning to address these problems. However, lack of reform conditionality dilutes the effectiveness of Japan's actions. We have also advocated that Japan accelerate steps to deregulate its economy and open its markets. Progress in these areas is necessary to achieve a sustained resumption of growth and would help to make Japan's economy more efficient and competitive.

Support for open markets

The United States has been a strong advocate of open markets and continued international efforts to liberalize trade. We have encouraged Europe, Japan and other countries to do their fair share in permitting access to their markets for crisis countries. Central to our policy of

ensuring that other countries uphold their international commitments is the vigorous enforcement of our trade laws.

Since September 1998, the United States has worked with other G-7 industrial nations to put in place additional measures designed to enhance the global community's ability to respond to future financial crises. These include the recent decision by key G-7 Central Banks to help maintain strong growth in our economies, final agreement on the IMF quota increase and the New Arrangements to Borrow, a G-7 agreement on a new IMF mechanism for contingent finance to help other regions avoid contagion, measures to accelerate corporate debt restructuring and to revitalize private sector growth in Asia, and increased World Bank and Asian Development Bank assistance to protect the most vulnerable in society. We also are working to find better preventive measures to reduce the frequency and severity of global financial challenges and to strengthen the international financial architecture. These steps should significantly strengthen the international financial system, help to reduce the risk that this crisis could intensify, and promote the prospect of the earliest possible return to growth in emerging markets.

2. Strong Enforcement of U.S. Trade Laws

U.S. trade laws provide a strong mechanism to counter unfair trade practices, unfair subsidies and import injury from surges. This Administration is committed to aggressively enforcing U.S. trade laws to address the adverse impact that unfairly traded steel imports have on U.S. steel companies and American jobs. The Commerce Department currently enforces over 100 antidumping and countervailing duty orders covering various steel products from 30 countries.

Early Enforcement Actions

Since late 1997 Commerce has taken a number of strong enforcement actions with respect to steel. In October 1997, Commerce concluded four suspension agreements on cut-to-length plate from China, Russia, South Africa and Ukraine. These agreements provide strong relief to steel plate producers by ensuring that plate imports from these countries are fairly priced and by reducing imports of Chinese, Russian and Ukrainian plate by 45, 55 and 72 percent, respectively. During the first six months of 1998, Commerce completed or initiated 31 antidumping and countervailing duty investigations on a variety of stainless steel products, such as stainless steel wire rod, sheet and strip, plate in coils and round wire. A number of these investigations are still ongoing.

In these investigations, Commerce is looking at possible unfair pricing of exports from a range of countries as well possible subsidies provided to the stainless steel industry. One subsidy allegation considered POSCO's two-tiered pricing system in the domestic market depending upon the purchasers' anticipated export performance. On November 17, 1998, Commerce made a preliminary finding that this practice is countervailable. The final ruling on this issue currently is scheduled for early March 1999.

Expedited Investigations

On September 30, U.S. domestic producers and unions filed petitions for antidumping and countervailing duty relief on imports of hot-rolled steel products from Japan, Russia, and Brazil. The most dramatic import surges in steel imports have occurred in these products which make up the bulk of the steel trade. Imports of Japanese hot-rolled steel products in the first 10 months of 1998 have increased almost 400 percent over the same period in 1997, a record year for imports, while imports of Russian hot-rolled steel products have increased 71 percent. Commerce immediately shifted resources to ensure that our trade laws would be enforced as vigorously and as expeditiously as possible. Commerce initiated the cases five days ahead of the statutory deadline and has committed to expediting the preliminary decisions in those cases up to 20 days prior to the statutory deadline, while preserving the right of all parties to due process. This schedule would result in the issuance of the preliminary determination on February 12, an unprecedented 25 days early.

Critical Circumstances

On November 23, 1998, Commerce issued a preliminary finding of critical circumstances with respect to Russia and Japan. The finding makes clear that, if Commerce finds dumping in its preliminary determinations of dumping, importers will potentially be liable for duties retroactively. This means that, if both Commerce and the ITC make final critical circumstances findings, any dumping margin found will be applied to all imports entered as of November 14, 1998, ninety days before the preliminary dumping determination scheduled for February 12, 1999. As a result, importers are on notice now they may face increased retroactive duties. This could lead to reduced imports right away.

Strong New CVD Regulations

Over the past year, Commerce has been working on several sets of regulations that reflect the Administration's strong commitment to fighting unfair trade practices. In November, Commerce released final countervailing duty regulations that will guide its analysis and calculation of the benefit from foreign subsidies. In preparing these regulations, Commerce considered carefully the comments received, including those of the steel industry and Members of Congress. The final regulations are designed to enhance strong enforcement of the trade laws, and send an important signal to our trading partners that we will not tolerate the subsidization of imports that harm our industries and workers.

For example, one area where the subsidy rules were strengthened concerned the government's provision of equity to an unhealthy company. Consistent with many of the comments received, a final rule was adopted that treats the entire amount of the equity infusion as a grant which raises the offsetting duty. Likewise, the rules regarding government loans to uncreditworthy companies have been strengthened to better account for the increased risk associated with lending to such companies. In

addition, Commerce addressed the concerns raised by many industries and members of Congress that the transnational subsidies rule, which exempts international development assistance from the countervailing duty law, would allow recipient countries to use IMF funds to subsidize their industries with complete immunity from the U.S. countervailing duty law. The final regulations make it clear that foreign governments cannot try to exempt ordinary subsidy programs under the transnational rule by merely claiming a link to international funds.

Commerce also recently released regulations and a policy bulletin concerning sunset reviews. These reviews, which are required to be conducted every five years under U.S. law and the WTO, determine whether an antidumping or countervailing duty order is still needed to address dumping or unfair subsidies and injury. Commerce has set out tough, but fair, rules regarding sunset reviews to ensure that orders that are necessary to remedy unfair trade practices are not revoked.

Eliminating Subsidies and Directed Lending

Foreign steel industries, therefore, have often been supported through government subsidies to encourage expansion or to forestall restructuring and lay-offs. Global overcapacity remains a serious problem in the industry. Through bilateral efforts, multilateral fora such as the OECD Steel Committee and the WTO, and through strict enforcement of our countervailing duty laws, the Administration is taking forceful action to eliminate improper government involvement in important sectors such as steel.

When the financial crisis began to spread in 1997, a number of U.S. industries, particularly the steel and semiconductor industries, expressed concern that foreign governments would resort to subsidies in an attempt to export their way out of the crisis. Commerce's Subsidies Enforcement Office responded by expanding its activities and working closely with USTR to evaluate industry concerns about possible new subsidies abroad. As a result of these activities, the Administration has actively engaged a number of countries to address subsidy concerns. Our considerable bilateral efforts with respect to the subsidies in the Korean steel industry are described in the next section of this report.

Commerce, USTR and Treasury have taken numerous steps to address the problem of government directed lending (i.e., the practice of certain governments to influence commercial banks to lend to favored industries at preferred rates), particularly with respect to the Korean steel and semiconductor industries. All three agencies have been carefully monitoring the Korean government's lending practices and involvement in the Korean financial sector, and have paid close attention to banking reforms and recent government restructuring funds for Korean industries. The issue of Korean government directed lending to strategic industries such as steel or semiconductors has been raised on numerous occasions with the Korean government and Korean industries, by the President and the Secretaries of State, Treasury, Commerce and the United States Trade Representative. The elimination of directed lending is a key element of Korea's IMF program. Potential subsidies from alleged government directed lending to the steel industry are also being examined by Commerce in two ongoing Korean countervailing duty

investigations on certain stainless steel products, along with several other alleged subsidy practices. These cases are currently scheduled to be completed in March and April 1999.

III. Early Warning System: Enhanced Import Monitoring

In anticipation of potential trade problems arising out of the global financial crisis, early in 1998, Commerce put in place an extensive import monitoring program that closely tracks imports and prices in key import-sensitive sectors, such as steel, semiconductors, autos, paper, textiles and chemicals. This program was designed to provide an early warning system that the Administration could use to formulate a swift response to potential import surges. With respect to steel, we have enhanced our monitoring efforts by obtaining for internal government use preliminary Census data on steel imports 20 days prior to the official release date.

The Administration is also creating a Steel Data Task Force to monitor industry trends and support industry cases.

IV. Section 201

The Administration supports the availability to U.S. producers and workers of a strong and effective safeguards mechanism to enable them to avoid injury resulting from rapid changes in the global economy and to facilitate adjustment. This type of "safeguard" has long been sanctioned by the GATT and now the WTO. The safeguards law enables the President to fashion the remedy most appropriate to the industry involved, and, where appropriate, requires the industry to take adjustment steps to enhance its competitiveness. Obtaining relief under the U.S. safeguards mechanism, Section 201 of the 1974 Trade Act, involves a two-step process. First, the U.S. International Trade Commission (ITC) conducts an investigation to determine whether increased imports [have led to] [are a "substantial cause" of] serious injury or threat of serious injury to the domestic industry producing a like or directly competitive product. Second, if the ITC makes an affirmative determination, the President weighs a variety of factors in deciding whether relief will be granted and in what form. Expedited procedures are available.

The Administration fully supports the industry's right to avail itself of the safeguards mechanism under U.S. law, where circumstances justify such action. On December 30, 1998, the U.S. steel wire rod industry and the United Steel Workers of America filed a petition with the International Trade Commission requesting relief pursuant to Section 201. This petition will give the ITC the opportunity to evaluate the evidence, to decide whether a trade remedy is warranted, and to recommend what it should be. If an affirmative determination is reached, the President will decide on the appropriate response. Consistent with the Administration's determination to date to act expeditiously and vigorously to enforce U.S. trade laws, any affirmative ITC recommendations will be acted on in a timely manner, and in full consultation with interested parties, consistent with U.S. law.

[Administration representatives have met with steel producers and workers to review their request that the Administration be prepared to, in consultation with the industry, self-initiate

trade actions, including action under Section 201. While we actively assess the impact of steps taken to date, all options remain under review, and meetings with industry and labor representatives will continue.]

V. Bilateral Initiatives to Eliminate Unfair Trade Practices and Ensure Equitable Burden Sharing [following has been cleared by Justice]

At the outset of the steel import crisis, the Administration engaged steel exporting and importing countries in consultations aimed at ensuring fair trade and sharing of the import burden. The President personally expressed his deep concern about the impact of increased imports and the need for fair trade, both in public and in private meetings, including in his recent visits to Japan and South Korea and in recent meetings with European leaders. The Vice President expressed strong concern about the surge in imports from Russia during his recent meeting at the November APEC meeting in Kuala Lumpur with Prime Minister Primakov, and strongly urged the EU to open their markets and absorb their fair share of imports in his speech to the TransAtlantic Business Dialogue. During her recent visit to European capitals, Ambassador Barshefsky pressed the European Commission and member states to share the burden of increased steel exports, particularly with respect to Russia and Japan, two countries which account for the bulk of the existing excess steel supply, and from which the United States has taken a substantially higher share of steel imports.

The Administration has particularly urged Japan, Russia and Korea, three countries which account for eighty percent of our steel import growth, to respect established international rules and to trade fairly, including refraining from subsidization and dumping.

Japan

A weak Japanese economy continues to be one of the largest impediments to economic recovery in Asia, and a significant cause of the surge in low-priced steel imports into the United States. Japan's producers have experienced a sharp decline in domestic and regional demand for steel and for finished products that contain steel. As a result, they have re-directed a large portion of their excess steel production to the U.S. market.

Japan moved from being the third largest supplier of steel imports into the U.S. market in 1997, to being the largest source of U.S. steel imports, and was responsible for 43 percent of the increase in U.S. finished steel imports in the first ten months of 1998. While U.S. imports from Japan have surged in a number of steel products, 50 percent, or 1.5 million metric tons, of the import growth has been in hot rolled sheet products. These hot rolled steel imports are now subject to the dumping investigation described above. **Commerce/USTR/CEA: Any information on Japanese steel imports?**

Pressing Japan to take the necessary steps to achieve economic recovery has been a key element of the Administration's economic and trade policy. Specifically, the Administration has urged Japan, in the strongest terms, to stimulate its economy, reform its banking sector, and deregulate and open its market to international competition. Swift and effective implementation of these policies in Japan would be the single most effective way to restore growth and demand in Asia, thereby reducing steel import pressures on U.S. producers and workers and stimulating exports of U.S. goods and services.

During his November visit to Japan, in addition to pressing the Japanese Government to take the steps necessary to stimulate domestic demand-led growth, strengthen its financial system and open and deregulate its markets, the President expressed serious concerns about the significant increase in Japanese steel exports to the United States, both in his public statements and in his private meeting with Prime Minister Obuchi. Citing a nearly five-fold increase in U.S. imports of Japanese hot rolled sheet, the President underscored the need for fair, rules-based trade and greater market opening, as well as the need to "avoid market penetrations that have no relationship to market forces." Ambassador Barshefsky has made it clear that Japan cannot expect to export its way out of its recession; rather, it must take decisive and immediate steps to revive its economy and consequently its domestic demand for steel.

Japanese officials have argued that, based on a combination of economic stimulus programs in Japan, steps by Japanese steel producers to reduce production, and the saturation of the U.S. market, accompanied by trade actions taken by U.S. steel workers and producers, Japan's 1999 steel exports to the United States would revert close to their 1997 level. Japan's export data for November reflects exports to the United States of 97,000 metric tons of hot rolled sheet. While this level is still substantially higher than the average 1997 monthly exports to the United States of 49,000 tons in this product, it is substantially lower than the average exports of 290,000 for June through October 1998. However, this trend, if accurate, would be reflected in the U.S. Census Bureau import statistics for December 1998, which will be available towards the end of February 1999.

The Administration remains concerned about allegations by U.S. steel producers of collusive private activities in international steel trade that may have the effect of artificially diverting Japanese steel exports from European to U.S. markets. The Administration has pressed these concerns with the appropriate EU and Japanese officials to ensure that any such activities are dealt with vigorously and effectively.

Korea

The United States has pursued an intensive dialogue with Korea aimed at ensuring that the Korean steel sector operates on a market-driven basis. This dialogue has been comprehensive, sustained, and conducted at all levels of government. On November 21, President Clinton stressed to Korean President Kim Dae Jung the need for further progress in our expanded steel dialogue and emphasized that "special care" must be taken to "prevent unfair trade practices or subsidization in sensitive sectors like steel and semiconductors."

In response to a complaint from U.S. steel producers, alleging that Hanbo Iron and Steel (Hanbo), a Korean mini-mill, had been provided government subsidies, Ambassador Barshefsky and Secretary Daley engaged the Government of the Republic of Korea (ROKG) in substantive and detailed consultations on this issue. Through these consultations, the Administration obtained written assurances from the ROKG that it will not support or direct others to support Hanbo. Hanbo has now temporarily shut down production of hot-rolled sheet. We also have received assurances that the Hanbo creditors and the independent agent managing the sale of Hanbo will take all steps necessary to effectuate a market-driven sale. We continue to monitor these assurances. These ROKG undertakings constitute the most timely, direct and commercially meaningful means to address our industry's concerns about Hanbo.

The Administration also expanded the steel dialogue to encompass broader concerns about the Korean steel industry -- in particular, regarding two other Korean steel producers: Pohang Iron and Steel Company (POSCO), the world's second largest steel producer, and Dongkuk, a large producer of cut plate exports to the United States. With respect to POSCO, our goal is to ensure that the company is fully and expeditiously privatized. Effective privatization of POSCO would help ensure that its pricing, production and other business decisions are made at arm's length from the Korean government, thereby addressing industry concerns about POSCO's operations.

In response to the Korean government's announcement of its plans to privatize POSCO, and U.S. industry's interest in seeing the ROKG's ties with POSCO severed, USTR officials initiated detailed bilateral discussions about Korea's plans in this regard, and strongly urged the ROKG to expeditiously complete this process. On December 9, 1998, the ROKG sold 5.1 percent of its 33 percent stake in POSCO through a stock offering on the New York and London exchanges, and further steps are anticipated shortly. The Administration is also seeking to ensure that other Korean steel producers, including Dongkuk, a large exporter of cut plate to the United States, are not benefitting from ROKG support. Additionally, the Administration has emphasized that Korean steel exports to the United States from companies such as Dongkuk, which are supplied with inputs from POSCO, must be traded fairly and must not be afforded an unfair advantage over U.S. companies through market-distorting subsidies. Over the coming months, the Administration will continue the dialogue with the ROKG with a view to addressing

concerns U.S. steel producers and workers have raised about possible unfair trade practices. The next round of bilateral discussion is scheduled for January.

Separately, on November 17, 1998, the Commerce Department made a preliminary finding in a CVD investigation on POSCO's stainless coil sales, that the company's practice of charging different prices for the coil based upon the purchaser's anticipated export performance meets the definition of an export subsidy under U.S. law and, therefore, is countervailable. The final ruling on this issue currently is scheduled for early March 1999. HOW MANY ORDERS ARE NOW IN PLACE AGAINST KOREA?

Russia

The economic crisis in Asia and Russia have seriously depressed demand for Russian steel. By September 1998, Russia's GDP had declined 9.9% compared with September 1997 and industrial output had declined 14.5% in the same period. GDP and industrial output are now roughly half of their 1989 levels. GDP may further decline by as much as 5% in 1999. The slump in exports to Asia, and European Union import quotas restricting steel imports from Russia, increased exports to the United States as Russian producers sought new markets for their steel. The OECD estimates that consumption of steel in Russia has declined to 26% of 1992 levels, and that Russia exported 51% of its steel production in 1998, compared to 12% in 1992. It also notes that pricing of Russian steel exports has often been uneconomic because of a lack of standard accounting principles, the use of barter and a lack of familiarity by producers with market conditions and established distribution channels in export markets. [At the November 4-5 OECD Steel Committee meeting, OECD member states recommended, inter alia, training for Russian steel mill managers in pricing and marketing principles and in use of steel-intensive technologies like steel-frame housing to boost domestic demand and improve pricing..]

U.S. imports of finished steel products from Russia increased 56 percent or 1.3 million metric tons in the first ten months of 1998 over the same period in 1997. Imports of hot rolled sheet accounted for 1.1 million metric tons or 85 percent of that growth. Hot rolled sheet imports are now subject to a dumping investigation by the Department of Commerce, pursuant to a petition filed on September 30, 1998 by U.S. producers and workers. The Commerce Department critical circumstances finding described above can lead to the retroactive application of dumping duties.

The dumping law allows the United States Government to negotiate agreements that limit imports of products covered by pending dumping cases with non-market economies, such as Russia. In appropriate circumstances, such suspension agreements can be the most effective way to enforce our trade laws. In this context, Commerce is exploring whether a possible suspension agreement could provide early and effective relief from the surge of Russian steel imports. The Administration is committed to strong enforcement of our trade laws and Commerce will work closely with U.S. industry, unions and Congress throughout this process.

At the same time, the Administration is continuing efforts to stabilize the Russian economy, promote market based reforms, and restore growth, all of which will over the longer term reduce excess capacity in sectors such as steel and stimulate domestic demand. The President, at his summit meeting with Russian President Yeltsin in Moscow, the Vice President, in his meeting with Prime Minister Primakov in Kuala Lumpur, and other U.S. officials including the Secretaries of State and Treasury have all urged Russia to stay engaged with the IMF and to push ahead with stabilization and growth-oriented reform.

European Union

The Administration has been concerned that the EU quotas on steel imports from several former Soviet Republics, and Russia in particular, may be causing a diversion of Russian steel exports into the United States. We are also concerned that the EU may not be bearing an equitable burden of the Asian steel export surge and, in particular, that the EU's imports from Japan are only a fraction of ours. U.S. industry representatives have alleged that a primary reason for the low rate of Japanese exports to the EU may be the existence of anticompetitive understandings between European and Japanese producers.

The Administration has undertaken a detailed comparison of U.S. and EU steel trade data, and U.S. government officials have discussed this issue at various levels with officials of the European Commission, the EU Presidency and with member states. Similar to the United States, the EU experienced a substantial increase of steel imports following the Asian crisis, as well as a drop in steel exports. Through August of 1998 (the most recent import data available in the EU), U.S. and EU imports grew by an equivalent amount -- 4.7 million metric tons for the United States compared to 4.8 million for the EU. The EU has traditionally been a net steel exporter, and its imports grew from a lower base, and thus the growth has been higher in percentage terms (53 percent compared to 24 percent in the United States). At 24 million metric tons through August 1998, U.S. steel imports were about double the EU imports of 13 million tons.

However, due to import quotas and licensing requirements on imports from Russia, EU imports from that country through August 1998 remained flat from the year before, at 1.1 million metric tons. This compares to U.S. imports from Russia of 2.9 million metric tons in the same period. Due to the substantial steel overcapacity in Russia and the strong demand in the EU, we believe that Russia's exports to the EU would also have grown substantially, were it not for import restraints. We have therefore urged the European Commission to review its import licensing and quota arrangements with Russia and other former Soviet republics, with a view to accommodating additional tonnage. We understand that the government of Russia is seeking quota increases.

The Administration pressed the European Union to bear its share of absorbing the excess supply of steel in the world market on various occasions. President Clinton raised the issue during the U.S.-EU Summit in Washington on December 18. In her recent visit to Brussels, Germany, France and Britain, Ambassador Barshefsky underscored that the EU's steel imports from Russia are less than half the volume of U.S. imports from Russia, and its steel imports from Japan are only a tenth of Japan's shipments to the United States, and asked that barriers to imports be reviewed. [Quote from VP]

In addition, we have pressed the EU to examine the reasons for the low levels of imports from Japan. The Administration will be alert to evidence of possible collusive private activities in international steel trade that may have the effect of artificially diverting Japanese steel exports from European to U.S. markets.

6. Adjustment Assistance for Steelworkers and their Communities

Steel Task Force and Steel Coordinator

This Administration believes it is important to help workers and communities adversely affected by international trade get back on their feet. No adjustment plan can avoid the pain of layoffs and dislocation altogether, but rapid action to provide workers and communities with adjustment assistance can limit the dislocation and speed the pace of economic recovery.

Because the trade-related problems affecting steelworkers and their communities are so severe, the Administration will appoint a high-level White House official to coordinate adjustment assistance. Borrowing a page from the Administration's successful adjustment effort for base closure communities, this individual will convene an interagency task force on steel adjustment assistance to help workers and communities identify and access the full range of federal resources. The task force will include the Departments of Labor, Commerce, Housing and Urban Development, Transportation, Education, Health and Human Services, Energy and Interior, as well as the Small Business Administration.

Key Adjustment Assistance Programs

Two federal departments, Labor and Commerce, play particularly important roles in trade-related adjustment assistance. The Department of Labor has two programs to assist dislocated workers, including steelworkers harmed by increased foreign imports. *Title III of the Job Training Partnership Act (JTPA)* provides funds to states and local grantees to support:

- On-site assistance when major layoffs are announced ("rapid response");
- Readjustment services such as skill assessment and job search assistance;
- Retraining in demand occupations; and

- Support services such as child care and income support that allow workers to participate in training.

Workers whose jobs are lost to an important degree as a result of increased imports are eligible for the *Trade Adjustment Assistance (TAA) program*. TAA provides an array of benefits and services, including up to 104 weeks of approved training; job search and relocation allowances; and “trade readjustment allowances” (income support) while in training following exhaustion of Unemployment Insurance. (Workers who are subject to recall by their former employers may qualify for trade readjustment allowances, even without entering training, after their UI has been exhausted.)

Since October 1, 1997, the Department of Labor has received petitions seeking TAA certification from workers in 33 steel and steel products plants. DOL has certified 20 of the 33 petitions, covering approximately 3300 workers. DOL is still reviewing the remaining 13 petitions (all of which were received in the last three months), which cover approximately 2600 workers.

The Department of Commerce’s Economic Development Administration (EDA) is the major source of assistance for communities hurt by steel imports. Under its Economic Adjustment Program, EDA can provide: 1) strategy or technical assistance grants, to help a community develop an economic adjustment strategy; 2) Revolving Loan Funds (RLFs), to help support small business start-up or expansion activities; and 3) grants for physical infrastructure improvements, including development of a business incubator or industrial park. EDA can respond to an application for a strategy grant in as little as 2-4 weeks. And through its 12 regional Trade Adjustment Assistance Centers, EDA can provide technical and consultant assistance to small firms affected by foreign competition (e.g., supplier firms to a large steel plant).

In its FY99 budget, the Administration requested \$50 million for a new EDA Office of Community and Economic Adjustment, specifically to assist communities harmed by foreign competition. Although Congress did not approve the new office, it did provide the additional \$50 million for EDA’s Economic Adjustment Program, and those funds are now available for, among others, communities harmed by increased steel imports.

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develop an economic adjustment strategy; 2) Revolving Loan Funds (RLFs), to help support small business start-up or expansion activities; and 3) grants for physical infrastructure.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 4-JAN-1999 11:25:23.00

SUBJECT: Re: revisions in Chapter 7

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

READ:UNKNOWN

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

READ:UNKNOWN

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

READ:UNKNOWN

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

READ:UNKNOWN

TEXT:

----- Forwarded by Jeffrey A. Frankel/CEA/EOP on 01/04/99
11:21 AM -----

Jeffrey A. Frankel

01/04/99 08:56:50 AM

Record Type: Record

To: Nouriel Roubini/CEA/EOP

cc:

Subject: Re: revisions in Chapter 7

I have made a lot of revisions in Chapter 7, to improve the accessibility of the material to a broad audience, at Janet's request. Things that need to be filled in: full definition of IOSCO, G22 and G2_ members in box (what do you think of the box?),

There are a number of places that you should make sure that my attempt to introduce more user-friendly language won't get us into trouble by crossing over the line of plain-spokenness into the territory of bluntness. To take one example, on page 12, where I have put the title "lending into arrears" on a paragraph, I have added a sentence at the end: "Under these circumstances, to insist that a country clear up its arrears as a prerequisite for becoming eligible for IMF funding might amount to a (possibly-futile) attempt to minimize the burden on creditors, at unreasonable cost to the debtor." To take another example, is an awkward section-title like "STRENGTHENING PRUDENTIAL REGULATION AND FINANCIAL SYSTEMS AND IMPROVING POLICIES IN EMERGING MARKETS" the result of Treasury-sensitive wording? Because I have split and reworded it to make it intelligible.

Also "Exit Strategies".

Make a list of specific places where you see likely direct conflicts between Treasury-desired dullness and the language I have put in. Perhaps we can then go through the list at some point, with Janet (and maybe Matt).

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

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D60]MAIL444866308.036 to ASCII,
The following is a HEX DUMP:

[Note to Mike Treadway, editor: Sentences in square brackets may be dropped in the final revision to shorten the chapter]

Chapter 7: The Evolution and Reform of the International Financial System

1. INTRODUCTION

The financial problems which began in Asia in the second half of 1997 have exposed weaknesses in emerging market countries and in the international financial system. In response to the widespread financial turmoil, the United States has taken steps, jointly with the international community, not just to contain the financial crisis, but also to foster reforms of the international financial system to try to make it less-crisis prone in the future.

This turmoil followed a robust period of increasing integration of world product and financial markets. The trend toward increasing integration is perhaps best epitomized by the long-anticipated realization of European Monetary Union in January 1999. Even as this historic monetary union takes place, repeated episodes of financial turmoil in the 1990s have generated concern about the possible adverse consequences of financial and monetary integration. Speculative attacks on Asian currencies in 1997-98 have some elements in common with speculative attacks on European currencies in 1992-93, as well as the Mexican peso crisis in 1994.

The recurrence of currency and financial crises in the world economy poses major

challenges to policy makers. Is the process of financial integration and globalization partly to blame for the observed instability? What are the causes of these recurrent crises, instability, and financial market volatility? Does integration into modern global financial markets require the surrender of macroeconomic sovereignty? Should free capital mobility be restricted with capital controls? What regime of exchange rates in small countries is best-suited for the new world of global capital mobility? Can the Bretton Woods institutions (the IMF and the World Bank), which were designed for a world of fixed exchange rates and limited capital mobility, still maintain stability in a radically different environment? What institutional framework provides stability for the international financial system? Answers to these questions are necessary to strengthen the stability of the international financial system and ensure that the process of global financial integration will continue to sustain prosperity and growth in the world economy.

The chapter starts with the main elements of the proposed reform of the international financial architecture. It then provides an analysis of the next steps to be considered in the redesign of the international financial system, including the question of exchange rate regimes (fixed, floating, or in between). Finally, it considers European Monetary Union, the prospects for the euro as an international currency, and possible implications for the U.S. dollar.

1. REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

As explained in Chapter I, the international community, under U.S. leadership, responded to the prolongation of the crisis in 1998 with a series of initiatives in the Fall. Those concerning reforms to the international system to reduce the incidence of such severe crises in the future go under the name of the “new global financial architecture.” However this was only the latest stage in an evolutionary process that had been underway for some years.

FROM HALIFAX TO THE G22 REPORTS

After the Mexican peso crisis a broad debate ensued on the steps needed to strengthen the international financial architecture. Although the debate preceded the onset of the December 1994 devaluation, the ensuing crisis gave it considerable impetus and pertinence. The annual Summit of G7 leaders in 1995 held in Halifax, Nova Scotia, initiated work in a number of areas. One such area was the need for additional means to achieve an orderly resolution of future financial crises. The Finance Ministers and Central Bank Governors of the G10 countries were asked to review ideas. The G10 established a working party that submitted a report – informally known as the Rey Report, after its chairman – to the ministers and governors in May 1996.

The report suggested that domestic moral hazard can potentially contribute to crises (see Box 6.) and stressed the need for better market-based procedures for debt workout. Workouts between debtors and creditors in the domestic context are required when firms are in financial distress and cannot meet their obligations. Procedures exist to avoid a chaotic

and inefficient dismantling of the firm's operations by its creditors. These procedures may entail restructuring the terms of debt contracts and/or simply writing downs of the value of the obligations. Something analogous is required at the international level, even though no legal framework exists to do it. The report suggested specific reforms of bond contracts to facilitate coordinated renegotiation of the terms when there is danger of international default. Changes in IMF rules to permit "lending into arrears" were also considered. This means enabling the IMF to continue lending to debtor countries (that have continued to comply with IMF adjustment policies) even if they have temporarily suspended debt-service payments, which would otherwise disqualify them from access to such lending. **Recent financial turmoil** has underscored the importance of implementing these and other reforms.

A number of important additional innovations did follow the Halifax process: the development of international standards for making data publicly available (under the IMF's Special Data Dissemination Standard); international banking standards (the so-called Basle core principles for banking supervision); an emergency financing mechanism in the IMF; and the decision to expand credit facilities under the New Arrangements to Borrow, beyond the amount of capital subscribed by IMF member countries.

Box 7.__: Membership in some steering groups of the international financial system

The G-7 (including annual summits of national leaders): United States, Japan, United Kingdom, Germany, France, Italy, and Canada

The G-10 (which has 11 members): Same as the G-7, plus the Netherlands, Belgium, Sweden, and Switzerland

The G-22: Same as the G-10, plus...

The G- (an expanded version that met __, 1998): Same as the G-22, plus...

[Omit: IMF Interim Committee, BIS, OECD...?]

The 1997 eruption of the crisis in Asia demonstrated that the need still existed to reconsider important questions about the operation of the international system. In November 1997, on the occasion of the APEC (Asian Pacific Economic Cooperation) Leaders Summit in Vancouver, a number of Asian leaders expressed a desire for a meeting of finance ministers and central bank governors to discuss the crisis and broader issues, and a desire that the meeting should be global, that is, that it should include emerging-market countries, not just the usual small number of major industrialized countries. President Clinton responded by calling on Secretary Rubin and Chairman Greenspan to convene such a meeting. Finance ministers and central bank governors from twenty-two countries (the G22) thus gathered in Washington on April 16 to resume exploring ways to reform the international financial system, with the objective of reducing the frequency and severity of crises. (See box, for membership in the G22.) Ministers and governors created three working groups to examine three central sets of issues: greater transparency and openness; stronger financial systems; and appropriate burden sharing between the official and private sector in times of crisis. The three working

groups of the G22 presented their reports in October 1998 on the occasion of the annual meetings of the IMF and World Bank.

GREATER TRANSPARENCY AND OPENNESS

There is a broad consensus on the need for greater transparency by debtor countries and international financial institutions. The Asian crisis made clear anew that it is important for countries to provide sufficient information about macroeconomic and financial conditions. This includes data on the size, maturity and currency composition of external liabilities, as well as accurate and comprehensive measures of the level of foreign exchange reserves. The crisis also underscored the need for countries' private sectors to provide accurate information about the financial accounts of banks and corporate enterprises. Without such information outsiders are unable to assess adequately the true conditions of governments and private sector firms. The crisis also made clear the importance of transparency on the part of international institutions themselves, and led to calls for the IMF and other international financial institutions to be more open and transparent about their activities, economic analysis, policy advice and recommendations.

The report of the working group on transparency and accountability makes several recommendations. First, it calls upon the IMF to examine and publicize widely countries' adherence to international standards of data availability as well as, more broadly, standards of

transparency in the conduct of fiscal and monetary policy. Second, the report urges the adoption of international agreements on better accounting and disclosure standards for private financial institutions -- including sound practices for how bank loans are evaluated, how banks provision (set aside) reserves against loans that might go bad, and how they disclose credit risks associated with borrowers who may experience financial distress. Third, the international community (including national authorities, international bodies and the private financial sector) is called upon to consider appropriate measures for disclosure of international exposures of all types of financial institutions, including hedge funds and other highly leveraged financial institutions.

Finally, the IMF and other international financial institutions (IFIs) were called upon to be more open and transparent. Accountability is always important, and unnecessary secrecy would be particularly inappropriate in institutions that are telling others to be more transparent. For example, the report recommends that IFIs adopt a presumption in favor of the release of information, except where release might compromise confidentiality. It also calls for publication of program documents, background papers to reports following the regular yearly visit by the IMF to a member state and Press Information Notices (PINS) following the IMF Executive Board discussion of reports on member countries economic conditions, retrospective program reviews, and other policy papers.

While undoubtedly important, transparency alone will not be enough to prevent

another major crisis from occurring. Information in Asia on statistics such as the countries' net foreign reserves (including central banks' forward transactions) and the offshore liabilities of the financial and corporate system would have certainly been useful. The incompleteness of this information may well have exacerbated investors' uncertainty. It is hard to argue, however, that the most important information was hidden. Current account balances and overall figures on foreign liabilities, as well as myriad other data, were regularly published. Until the onset of the crisis, investors apparently ignored the warning signals coming from a number of indicators. More is needed than just information.

REFORMING AND STRENGTHENING DOMESTIC FINANCIAL INSTITUTIONS

Financial sector weaknesses in borrowing countries now appear to have been a central cause of the Asian crisis, as well as some previous financial crises. Banks and other financial institutions borrowed excessively from abroad and lent excessively at home, channeling funds toward projects that were not always profitable. Insufficient expertise in the regulatory institutions led to weak regulation of the financial system, and particularly to lax supervision of banks. Banks held insufficient capital against risky loans (i.e. their capital adequacy ratios were low), and insurance of residents' bank deposits was poorly designed or only implicit. Connected lending practices were widespread: financial firms in a business group made loans to other firms in the group without objectively evaluating or monitoring their soundness. The

result was often distorted incentives for project selection and monitoring. All these factors contributed to the build-up of severe structural weaknesses in the financial system. The most visible manifestation was a growing share of non-performing loans. The expansion of the problem was prolonged by the increased supply of funds from abroad, the latter in part facilitated by the process of capital account liberalization and financial market deregulation in the region during the 1990s.

The recurrent link between currency, debt and banking crises is now clear. Strengthening domestic financial systems will thus be a central element of ongoing systemic reform. The list of specific measures required is long, and will take years to complete. A partial list of the reforms recommended by the G22 includes:

- strong prudential regulation and supervision of banks and other financial institutions;
- application of enhanced capital adequacy ratios;
- design of explicit and effective deposit insurance schemes to protect depositors;
- design and implementation of disclosure rules, bankruptcy and foreclosure laws;
- development of liquid and deep financial markets, especially markets in securities (bonds and equities);
- national implementation of the Basle core principles of banking supervision and of the objectives and principles of securities regulation set by IOSCO (the International Organization of Securities _ _);

- coordination and cooperation among international organizations and international supervisory entities in strengthening financial systems;
- technical assistance for and training of government official and regulators;
- improvement of corporate governance in both the financial and non-financial sectors, so that investment decisions respond to market signals rather than to personal relationships; and
- implementation of efficient insolvency and debtor-creditor regimes that would facilitate workouts for corporations in financial distress.

BETTER CRISIS RESOLUTION, DEBT WORKOUT MECHANISMS AND PRIVATE SECTOR BURDEN SHARING

While strengthening financial systems may prevent some crises from occurring or make those that do occur less virulent, it cannot be expected to eliminate them altogether. As a result, it is essential to establish means of resolving crises at minimum cost to economic growth without undermining appropriate incentives for prudent private behavior. This very important task constitutes the final pillar of international financial reform.

The G22 report suggested that responses to crises need to include mechanisms for appropriate private sector burden-sharing. In other words, banks and securities investors should supply their fair share of the new financing needed when contagion threatens. While

the international community will continue to provide assistance -- conditioned on economic reform -- to deal with the problems that gave rise to economic crises, appropriate private sector burden sharing is a factor in the orderly resolution of a financial crisis. It is important to develop mechanisms to allow the private sector to participate constructively to the containment of crises and their resolution over time. Private investors should be "bailed in," not "bailed out." Private sector burden sharing is critical, not only because there will not be sufficient official money for all circumstances, but also because it helps to induce market discipline and reduce potential moral hazard problems deriving from official assistance. The perception that sufficient official assistance might be made available to allow a country to meet all contractual obligations without commensurate commitments from the private sector could distort the incentives of both creditors and debtors.

New procedures suitable to modern markets need to be developed for effective management of financial difficulties. When banks accounted for the majority of international capital flows, it was easier to coordinate private sector efforts to restructure and reduce debt burdens where necessary, in parallel with official sector support efforts. Today, the proliferation of creditor institutions and instruments and the growth of international bond markets makes it more difficult to coordinate the actions of creditors during a crisis. Moreover, unilateral actions such as mandatory debt restructurings and moratoria on repayment of debt can be highly disruptive. They can themselves lead to contagion, as they

increase investors' perceived probability that other countries may follow similar policies. For example, the contagion from Russia to Latin America in August 1998 followed the unilateral debt restructuring imposed by Russia on its ruble debt creditors.

Pursuant to the goals of developing orderly workout regimes and private sector burden sharing, the report called for a number of recommendations.

- **A range of policies to help prevent crises and limit the scope of those crises that do occur.**

Recommendations include: maintaining appropriate exchange rate regimes; developing liquid domestic bond markets; limiting the scope of government guarantees; and developing insurance schemes that protect borrowers against sudden liquidity shortages and explicitly provide for greater automatic risk-sharing between debtors and creditors inside the terms of contracts.

- **Measures that could improve creditor coordination in the event of a crisis.**

Following some of the recommendations of the 1996 Rey Report, the G22 proposed to include creditor coordination clauses in bond contracts among debtors and creditors to foster mechanisms for coordination among creditors, debtors and the international official community. "Collective action clauses" in bond contracts are needed to provide for: (i) collective representation of creditors to facilitate the efficient coordination of a

large group of creditors; (ii) majority action to alter the payment terms of the contract so that unanimity is not required to restructure bond debt; and (iii) sharing of payments among creditors to discourage disruptive legal action and preferential settlements that benefit a few creditors at the expense of others.

- **New methods of crisis management, including methods to reduce the disruption associated with the extreme case of a temporary suspension of debt payments.**

A temporary suspension of debt payments (the interest due on bonds and loans and/or the principal value of the debt contract) should not, and normally will not, be undertaken until all other reasonable alternatives have been exhausted, because of the significant economic and financial costs associated with it. Recent experience has underscored the fact that unilateral mandatory suspensions of debt payments and restructuring actions, especially if they substitute for reform and adjustment, are highly disruptive. However, temporary suspensions of debt payments may occur, particularly in the event of unanticipated adverse market developments (e.g., the collapse in the global price of a key export commodity). In these cases, it will be important to have orderly and cooperative approaches for negotiating the restructuring of contractual obligations rather than unilateral actions that disrupt markets and shatter investors' confidence.

- **Lending into arrears** When a country in crisis and is forced to suspend debt payments temporarily, the international community and private creditors have an interest also in

providing the country incentives for strong and sustained policy adjustments and structural reforms. The international community can signal its conditional willingness to provide financial support, when appropriate, even if the country has imposed a temporary payments suspension and is therefore “in arrears” in its payments to private creditors. Such a policy of IMF “lending into arrears” (i.e., IMF lending to a country that has suspended payments and has not yet cooperatively restructured its debt with private creditors) should be provided only if a government’s decision to suspend payments reflects the absence of reasonable alternatives, if the government is willing to undertake strong policy adjustment and if the government is engaged in good faith efforts with creditors to find a cooperative solution to the country’s payments difficulties. Under these circumstances, to insist that a country clear up its arrears as a prerequisite for becoming eligible for IMF funding might amount to a (possibly-futile) attempt to minimize the burden on creditors, at unreasonable cost to the debtor.

- **Measures to help facilitate prompt and orderly workouts of external debt.**

Several measures can be undertaken to facilitate this process. First, domestic insolvency regimes --such as corporate restructuring under the U.S. Chapter 11 -- generally provide a mechanism for the provision of new, senior credits to assure the ongoing operation of the firm and the restructuring of existing debt. (Seniority means that the new lenders

will be first in line to get repaid, without which assurance they are unlikely to come forward.) Analogously in the international context, means of encouraging the private sector to provide new credits, in the event of a debt crisis should be carefully considered. Otherwise loans won't be available for such basic purposes as working capital for production and exports. Either formal or informal assurances, for example, could be granted by the debtor country that greater payment seniority would be given to certain new credits. Second, it also might be possible to create, *ex ante*, a standing, privately-funded mechanism to provide new credits before a crisis or in the event of a crisis or payments suspension. For example, Argentina arranged for lines of credit with international banks that can be activated if speculative capital outflows lead to a loss of foreign reserves. Third, while national insolvency regimes should, where adequate, provide the appropriate legal and institutional framework for the restructuring of corporate debt, a crisis in the corporate sector can nevertheless be of sufficient magnitude to threaten the solvency of the entire financial system in the crisis country. Standard bankruptcy laws, for example, did not seem to operate successfully in some Asian countries in 1988. Consequently, there may be occasions when the government will need to develop a framework for encouraging negotiations between private debtors and their creditors. Such a framework might include: (i) the establishment of creditors' committees; (ii) the removal of legal and regulatory obstacles to debt restructuring; and (iii), in certain extreme cases, the establishment of exchange rate insurance schemes providing an inducement to negotiate and facilitating the valuation and adjustment of

outstanding claims. The Asian Growth and Recovery Initiative recently launched by the U.S. and Japan represents an effort to support implementation of more comprehensive and accelerated restructuring of banks and corporations.

Implementation of the reforms of the international financial architecture suggested by the G22 reports will take time. But it will reduce the likelihood of future crises and reduce the severity of those that do occur.

ADOPTION OF MEASURES TO REFORM THE INTERNATIONAL FINANCIAL ARCHITECTURE

Following the G22 reports and detailed discussions, including with officials from other industrial and emerging market economies, the Finance Ministers and Central Bank Governors of the G7 countries agreed, in their October 30 Declaration, on specific reforms to strengthen the international financial system. They agreed to carry these forward through their own actions and in the appropriate international financial institutions and forums. These reforms are designed to: increase the transparency and openness of the international financial system; identify and disseminate international principles, standards and codes of best practice; strengthen incentives to meet these international standards; and strengthen official assistance to help developing countries reinforce their economic and financial infrastructures. They also include policies and processes to ensure the stability and improve the surveillance of the international financial system. Finally, they aim at reforming the International Financial Institutions, such as the IMF,

while deepening cooperation among industrialized and developing countries.

2. NEXT STEPS IN THE REFORM OF THE INTERNATIONAL FINANCIAL SYSTEM

In addition to the measures already agreed upon to strengthen the fundamentals of the international financial system and assist crisis-affected countries to find a route out of their current difficulties, the international community needs to widen its efforts to strengthen the system. The aim is to create an international financial system for the 21st century that captures the full benefits of global markets and capital flows, minimizes the risk of disruption, and better protects the most vulnerable. At the same time the system must promote international financial stability.

In the October 30 Statement of the G7 Leaders and the Declaration of the G7 Finance Ministers and Central Bank Governors, the G7 committed to initiate further work on a number of other important areas, to identify additional concrete steps to strengthen the international financial architecture. These include:

- examining the scope for strengthened prudential regulation in industrial countries, rather than focusing solely on banks in the borrowing countries.
- further strengthening prudential regulation and financial systems in emerging markets.
- consideration of the elements necessary for the maintenance of sustainable exchange rate regimes in emerging markets.
- developing new ways to respond to crises.
- assessing proposals for further strengthening of the IMF.

- seeking to minimize the human cost of financial crises and encouraging the adoption of policies that better protect the most vulnerable in society.

The additional issues involved and challenges faced in achieving these goals are considered next.

STRENGTHENED PRUDENTIAL REGULATION AND SUPERVISION IN INDUSTRIAL COUNTRIES

The crises of the past year have revealed some gaps in the international regulatory infrastructure for promoting financial stability, overseeing national financial systems and coordinating the response to crises. The proliferation of international financial institutions making cross-border financial transactions, the emergence of off-shore financial centers and hedge funds, and the development of a wide range of derivative instruments have posed significant challenges to devising appropriate supervisory regimes of the international financial system.

With these challenges, however, have also come a more urgent need to examine the scope for strengthened prudential regulation in industrial countries. New mechanisms might be needed to encourage sound analysis and careful weighing of risks and rewards. New standards for appropriate transparency and disclosure might also need to be considered for all financial market participants.

Enhanced international financial supervision and surveillance

Although good financial supervision must start at the domestic level, there is a need for greater international coordination of supervisory and financial surveillance activities. The International Financial Institutions, working closely with international supervisory and regulatory bodies, need to be able to conduct surveillance (monitoring) of national financial sectors and their regulatory and supervisory regimes with all relevant information accessible to them. National and international regulatory and supervisory expertise could be effectively harnessed for strengthened financial sector surveillance. A process of peer review could be utilized as well as the IMF's regular surveillance of its member countries. [To that end the IMF's own resources for monitoring countries' financial sectors should be strengthened and structured to take better advantage of existing resources and expertise, including that of the World Bank and banking and securities regulators from other countries.]

Cooperation and coordination would be useful. Key international institutions and national authorities involved in financial sector stability will need to work jointly to foster financial stability and reduce systemic risk. They will need also to exchange information more systematically on the risks that exist in the international financial system. In this regard, the design of a forum including finance ministries, central banks and securities regulators from the major G7 countries, key emerging markets, relevant international organizations and international financial institutions would be useful. Given the increasingly important role of emerging markets in the global financial system, an inclusive forum would be appropriate.

Strengthened bank capital regulation

An important international regulatory issue relates to capital standards for globally active banks. The 1988 Basle Capital Accord called for the maintenance of bank capital equal to at least 8 percent of risk-weighted assets. (Representatives of industrialized-country central banks meet regularly in Basle, Switzerland.) By weighting individual bank assets according to risk, the Accord sought to make sure that banks investing in riskier assets maintained larger capital reserves. For example, holdings of safe government bonds or cash have a zero weight in calculating aggregate risk exposure, while long-term lending to emerging markets banks has a 100% weight.

Even at the time of their adoption, it was recognized that the standards called for in the Accord might need to be reformed and strengthened in face of financial innovations and developments in the international financial environment. Effective capital regulation is an evolutionary process and the standards have already been improved in a number of ways in the decade since their first adoption. Developments have confirmed some shortcomings that were feared from the beginning. First, a number of financial innovations now allow banks to assume more risk while showing no change in capital ratios. Second, as the recent experience with systemic currency financial crises suggests, traditional credit risk assessment may not be robust to extreme systemic contingencies. (Statistical estimates of risk based may not give due weight to the possibility of crises that did not happen to occur during the sample period used in the statistics.) Third, current standards have encouraged banks in developed countries to make short-term rather than longer-term loans to banks in emerging markets, as risk weights on the former assets are lower than those on the latter; recent

experience, however, suggests that short-term cross-border interbank flows are in fact subject to great volatility. Fourth is the matter of off-balance sheet items such as derivative positions, committed credit lines, and letters of credit. (These, like a bet on a football game, are not assets and thus are “off balance sheet”. Stock in a football team is “on balance sheet.” Yet both pose risks.) They create new types of risk that the current standards are not fully capable of managing. This includes counterparty credit risk in derivatives. (Derivatives are contracts that are written in terms of the price of an underlying asset, such as options or futures contracts written in terms of stock prices. Counterparty risk is the risk that your counterparty might default or not honor the contract.) Finally, uniform standards for all types of financial institutions may not be efficient. The risks faced by large international banks are very different from those faced by national and regional banks;.

The task of reforming the Basle Capital Accord has just started and will take years to accomplish. There is not yet a consensus on how to reform bank capital regulation. But it is likely that a strong and effective system of capital regulation will need to rely on several components: strengthened capital standards, greater reliance on robust internal models of risk assessment and market discipline. Capital adequacy ratios will have to be reformed and enhanced to address the new and different risks faced by banks in the globalized economy. A complementary approach is to emphasize less externally imposed standards and rely more on banks’ internal models and assessment of risks. For example, a useful approach may be value-at-risk models, already used internally by banks. These are sophisticated models that consider the risk and correlation of returns on all the assets and liabilities of a bank to derive a measure of market risk (i.e, how much a bank may lose because of a change in market interest rates). However, such models should be tested for their robustness to conditions of stress in order

to assess the many other risks faced by banks in addition to market risk. In fact, extreme market conditions and financial crises create additional risks (such as credit risk, counterparty risk and small probability of extreme events) that traditional models of the type and distribution of risks cannot assess.

[It may also be beneficial to rely more on market discipline for bank capital regulation. For example, some have suggested a scheme whereby certain types of debt (subordinated to other claims on bank assets) may be issued by banks and purchased by other banks at interest rates that are capped at some maximum as a way to ensure that financial institutions monitor each others' risk taking. The logic of this approach is as follows: if bank A has to hold subordinated debt issued by bank B at a capped interest rate, it will monitor the risks undertaken by B in order to ensure that it does not end up defaulting on the bonds that A is holding as a result of excessively risky loans made to others by bank B. This is an example of how greater market discipline may be provided.]

There is going to be a broad debate on how to provide effective capital regulation of banks in the globalized environment in which they operate. The Basle standards were designed for G10 banking institutions, but the proliferation of financial institutions in emerging markets poses the issue of whether such standards, or even an enhanced version of them, should also be imposed on banks in emerging markets. One proposal intended to limit the risks deriving from the activities of developing-country banks is to regulate their access to business in industrialized countries and to restrict international lending activities to large institutions that satisfy rigorous standards. This proposal is controversial, however, as emerging economies perceive it as limiting competition and stunting their ability to develop their

own banks and other international financial institutions.

The rapid development of derivative instruments and their massive use in international financial markets poses another host of difficult regulatory issues. Derivatives can be used to hedge risks and thus have been very useful in the management of volatility by banks, other financial institutions, and corporate firms. However, they can also be used for taking speculative positions (increasing risk rather than decreasing it). Moreover, as they are off-balance sheet items it may be hard to assess their contribution to the risks taken by the institution using them. If the creditworthiness of the counter-party is uncertain, firms or banks who believe they are hedged (e.g. against currency risk) may effectively not be. Also, in an international context, derivatives can be used to evade risk-control or prudential regulation, circumvent capital controls, or undermine the statistical usefulness of balance of payments capital account categories.

A difficult issue concerns the type of regulatory oversight that should be put in place for derivative instruments. For example, excessive regulation of derivatives could lead the derivative business to move to unregulated offshore markets. The Administration is currently undertaking a long-term study of over-the-counter derivative instruments, including their potential risks and effects. This study will analyze how the markets work, how they are regulated, and what changes, regulatory or legislative, may be appropriate to reduce systemic risk, to eliminate legal uncertainty, to address the potential use of derivatives for fraud or manipulation, and to curtail regulatory arbitrage (which is when market participants seek to exploit differences that exist in regulation among different jurisdictions).

[An important group of questions addressed in the derivatives study concerns leverage. Some market participants may have an appetite for risk out of proportion to their capital. This could pose risks to global financial markets and ultimately prove damaging to the U.S. and global economies.]

Issues posed by hedge funds and other highly-leveraged investment funds

The near-failure of a prominent hedge fund (LTCM -- Long Term Capital Management) in September 1998 focused renewed attention on the role and activities of hedge funds and other highly leveraged investment funds. The impact of hedge funds on financial markets certainly does need to be understood better. The administration has called for a study of hedge funds and their relationship with their creditors. Regulation of hedge funds may not be easy or even appropriate. Regulation might, for example, lead such funds to move to unregulated offshore markets, in the same way in which the Eurocurrency markets in the 1970s emerged to get around regulation of U.S. financial markets.

It is challenging enough simply to define "hedge fund" in a precise way. The label is usually applied to investment funds that are unregulated because they restrict participation to a small number of wealthy investors. They often make simultaneous combinations of transactions -- including the use of derivatives -- to hedge extraneous kinds of risk, allowing them to focus on whatever is the "pure play" on which they wish to bet.

The Administration-commissioned hedge fund study is looking at a number of issues, including the topics of disclosure and leverage. More disclosure of information by entities such

as hedge funds, particularly to their counterparties and creditors, would be useful and appropriate. It appears that market participants are already demanding more disclosure from hedge funds. Among the questions being explored are: what additional disclosure is needed, to whom such disclosures should be made (counterparties, creditors, investors, regulators, the public, or some combination of the above), and does the government need to do more to require disclosure.

The study will also focus on the issue of leverage. The study is evaluating how the risks of what might be excessive leverage in financial markets can be minimized. It appears that creditors to hedge funds are reducing the amount of leverage they are willing to provide. There also seems to be a consensus among U.S. banking regulators in favor of using existing regulatory tools to encourage banks to make more prudent decisions. [Along these lines, the study is asking whether the government needs to do more to discourage excessive leverage and, if so, what the appropriate steps might be.] The study also considers the international aspects of these questions, and a number of the Working Group agencies are participating in several international studies.

In their October 30 Declaration, the G7 committed themselves to strengthen, in their own countries, the regulatory focus on risk management systems and prudential standards in financial sector institutions; in particular, examining the implications arising from the operation of leveraged international financial organizations including hedge funds and offshore institutions. The G7 agreed that appropriate means should be sought to encourage off-shore centers to comply with internationally agreed standards, and called upon other countries that participate in the

global capital markets to take similar action. They also called for the appropriate committees headquartered in the BIS (Bank for International Settlements), in conjunction with national authorities, emerging market countries, and other relevant private and public sector bodies, to examine the question of appropriate transparency and disclosure standards for private sector financial institutions involved in international capital flows, such as investment banks, hedge funds and other institutional investors.

STRENGTHENING REGULATION RELATING TO FINANCIAL FLOWS

The G7 agreed upon the need to further strengthen banking and financial systems in emerging markets. It endorsed an examination of measures to increase the resilience of financial systems and to promote the adoption of international standards and best practices. A central question concerns the freedom of international flows of capital.

The arguments for free capital mobility, especially when domestic financial systems are strong and properly supervised and regulated, are numerous. First, with unrestricted capital mobility, the market is free to allocate saving to the best investment opportunities. Investors can earn a higher rate of return abroad than they could if limited to the domestic market. Second, firms and other borrowers in high-growth countries can obtain funds more cheaply abroad than if they had to finance their investments at home. Third, free capital mobility allows investors and households to diversify risks and have access to a larger pool of assets; the benefits of portfolio diversification are enhanced by access to foreign investment opportunities. Fourth, the scrutiny of global investors provides an important discipline on policy-makers. Well-functioning capital

markets discourage, for example, excessive monetary and fiscal expansion, since inflation, budget deficits and current account deficits quickly lead to reserve outflows and currency depreciation. Fifth, there should be a general presumption in favor of allowing economic transactions among consenting adults. A case for restricting capital mobility would require the identification of distortions in the market allocation of capital.

Orderly liberalization of capital flows

Most emerging economies have historically had heavily restricted capital markets. Liberalization must be carried out in a careful and well-sequenced manner if countries are to benefit from closer integration into the global economy. Effective regulatory and supervisory regimes must be in place and the financial sector must be poised to deal adequately with risk. International financial institutions should play a constructive role in facilitating this orderly opening of the capital account.

Countries with capital account restrictions need to proceed in an orderly and progressively manner in opening their capital markets. As noted, there are strong benefits of free capital flows. The United States and most other leading industrial countries, for example, do well without capital controls. If domestic financial systems are weak, poorly regulated and subject to institutional distortions, however, rapid capital account liberalization can cause problems, as we have seen. It can lead to too much accumulation of foreign debt, excessive short-term borrowing and lending, and a mismatch of maturities and currency denominations of assets and liabilities of financial institutions and corporate firms. All have proven to be destabilizing in the many episodes of financial and currency crises. These potential pitfalls, however, underscore the need to strengthen the

financial system as the capital account is progressively liberalized, not to eschew liberalization altogether.

It may prove to be necessary to develop principles to guide countries that are liberalizing and opening their capital markets on how to reduce the vulnerability of their financial systems to sudden shifts in capital flows. These could include, for example an open policy to foreign direct investment and promotion of longer-term, equity financing. Conversely, it might be necessary to discourage cross-border short-term interbank flows which are likely both to be volatile and to be affected by distortions arising from financial safety nets. There is now some support for some sort of moderation of these flows, at least within the sphere of prudential banking regulation.

Prudential regulation of short-term interbank cross-border inflows

One approach to ensure the stability of short-term cross-border interbank flows is through enhanced prudential banking standards. On the borrower side, a range of possible measures could be considered to help 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, could reduce the riskier kinds of foreign borrowing by banks. Some countries have experimented with regulatory requirements that force their banking systems to maintain "liquidity buffers" to protect against the risk of sudden shifts 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. One could consider requiring higher reserve requirement ratios on bank liabilities representing cross-border interbank loans and deposits.

One could also try to dampen volatile short-term cross-border interbank flows on the lender side, i.e., via the banks in the industrial countries. As already noted, current Basle capital adequacy standards provide incentives to lending banks in developed countries to prefer short-term loans to banks in emerging markets over long-term loans, since risk weights on short-term loans are lower than those on supposedly “more risky” long-term bank loans. One could change the standards to affect short-term bank lending to emerging markets via a careful use of risk weights on this type of loans.

Broader controls on all short-term capital inflows?

More controversially, some have suggested wider use of market-based, Chilean-style restraints on all short-term capital inflows to deter short-term foreign borrowing, not just by banks but by other means as well. Corporate firms are reported to have undertaken large-scale risky cross-border borrowing directly, rather than via the banking system, leading up to crisis in Southeast Asia, for example. It has been argued, e.g., in support of Chile’s approach, that regulation on inflows to banks alone will lead to evasion through corporate borrowing.

[Controls on general inflows have also been argued to help in the management of monetary policy when surges in inflows create difficult problems of how to sterilize their impact and avoid an inflationary surge in the money supply.]

The effectiveness of such controls has been questioned, in particular for countries with weak economic policies. First, evasion and leakages tend to make capital controls less effective over time. Second, it has been argued that the apparent success of Chile in avoiding a major currency crisis has been due more to the very effective prudential regulation and supervision of the financial system than to the existence of controls on short-term inflows. Third, such controls have favored large corporations (who are more capable of avoiding controls) at the expense of small and medium ones.

[Automated Records Management System Hex-Dump Conversion]

The available empirical evidence from countries that have imposed controls on a broad range of short-term capital inflows shows that they do appear to affect the composition of inflows (away from short-term maturities and towards the longer-term, and towards foreign direct investment) but they do not appear to affect the overall volume of capital inflows. If the rationale for controls is to reduce particularly risky short-term borrowing, such evidence can be seen as supportive. Opponents of controls, however, point out that, during the recent financial turmoil, Chile, Colombia and Brazil have all reduced their controls in order to stimulate urgently needed capital inflows and reduce pressures against their currencies. Another point of view is that these moves do not undermine the rationale of slowing down short-term capital inflows temporarily during a cyclical phase where such inflows are feared to be excessive, in contrast to the crisis or outflow phase of the cycle where it is sensible to remove the controls. In this view, controls may be seen as a temporary tool to be used during episodes of a surge in inflows rather than a permanent policy instrument restricting the flow of capital.

Given the mixed and limited evidence on their effectiveness and the numerous arguments against them, policies to restrict all short-term inflows remain quite controversial. The experience of Argentina could be interpreted as suggesting that a strong system of prudential regulation rather than more widespread controls on all short-term inflows might be sufficient to ensure system stability when an effective system of prudential regulation and supervision of the financial system is in place.

Controls on capital outflows

In the aftermath of the Asian crisis, some have suggested that countries should introduce controls on capital outflows as a way to prevent “destabilizing” capital flight. One argument presented in their favor is that they could help to stimulate growth, for example in East Asia, by lowering nominal interest rates. With a high degree of capital mobility, a reduction in interest rates leads to capital outflows, and in turn currency devaluation. Like high interest rates, currency depreciation can be recessionary because of the high burden of foreign currency debt. Capital controls therefore have been advocated to break the link between interest rates and exchange rates, allowing lower interest rates *without* the costs of a currency devaluation.

However, many arguments against capital controls in a crisis have been advanced. First, controls on outflows are often administered in institutional frameworks in which they are used to extract rents and delay necessary reforms. Elaborate foreign exchange controls lead to rent-seeking behavior and corruption, and distort international trade. Second, the correct policy response to the structural problems underlying the Asian crisis is a sound, well-regulated and effectively supervised financial system, thus avoiding the policy distortions that lead to excessive borrowing. Capital controls divert attention from that remedy. Third, approval of targeted controls might lead countries to use capital controls indiscriminately, thus insulating unsound macroeconomic policies from the discipline of the marketplace. Fourth, over time, investors tend to find ways to avoid controls. Fifth, capital controls and other restrictions of domestic capital markets are often a form of financial repression -- a distortionary form of taxation -- that reduces the incentive to save. Studies point out that capital controls in Latin America in the aftermath of the 1980s debt crisis led to negative real interest rates that eventually provoked more

flight of capital out of the country rather than less. Sixth controls on outflows may discourage capital inflows, since foreign investors fear they may not be able to repatriate the proceeds of their investments in the future. Finally, fears of controls on capital outflows can accelerate a crisis rather than postpone it and can lead to perverse international contagion. In this regard, it has been suggested that the news of capital controls in Russia and Malaysia in August 1998 was a factor in the spread of financial panic to Latin America and the other emerging markets.

Moreover, if the goal is to allow a reduction in interest rates in the context of Asia today, it must be pointed out that interest rates have already fallen substantially relative to the peaks of the crisis. (By the second half of 1998, they were back to pre-crisis levels in Korea.) In spite of this lowering of interest rates, there is still a severe credit crunch in a number of countries; many financial institutions are in severe financial distress and unwilling to lend to corporate firms suffering from severe debt overhang. If this analysis is correct, capital controls and lower interest rates would do little to ease the credit crunch. Instead, what Asia may need now is an accelerated debt restructuring process that will recapitalize banks, reduce the corporate debt overhang, and provide firms with working capital and trade financing to allow them to produce and export again. Capital controls would not address these impediments to a recovery of economic growth in the region.

IMPROVING MACROECONOMIC AND OTHER POLICIES IN EMERGING MARKETS

In general, better policies in developing countries are needed to promote their domestic

stability and limit vulnerability to crises caused by shifts in global capital. In particular:

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

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. Sound debt management is important to insure against the risk of market disruptions.

Stronger financial systems. Countries can reduce their financial system vulnerability by adopting any of the following measures (in addition to others already mentioned): encouraging greater participation in their markets by foreign financial institutions, to spread better regulatory and risk management practices; developing a better credit culture in the banking system; and prohibiting directed lending and other “non-arms length relationships” between lenders and borrowers.

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 includes efforts to develop local/regional capital markets.

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. There must also be sound corporate governance, so that investors’ and shareholders’ rights are clear, and strong judicial systems, so that laws in these areas can be

clearly enforced.

NEW STRUCTURES FOR OFFICIAL FINANCE

The recent global financial turmoil pointed to the need to develop new ways for the international community to respond to crises. This entails exploring the possibilities of new structures for official finance that better reflect the evolution of modern markets. It includes examining new procedures for coordination of the relevant international bodies and national authorities, alongside greater participation by the private sector.

The United States has proposed a new IMF precautionary facility to allow large-scale international assistance in the form of a pre-approved line of credit, as opposed to a traditional package that is highly tranching (i.e., doled out in successive slices, to keep borrowers on a short leash of policy-conditionality). This proposed facility is intended to facilitate the rapid restoration of confidence in those cases where problems stem more from contagion in a world of large and finicky capital flows, than from poor policies.

International bank runs

The rationale for a precautionary facility for countries subject to an attack in spite of their good economic policies is based on the possibility of “international bank runs”. Currency crises are formally analogous to, but more complex than, domestic bank runs of the sort discussed in Box 6-5 in Chapter 6. With unrestricted capital markets, domestic banks are free to accept deposits from both domestic and foreign residents, in both domestic and foreign currency. As in a closed economy, these liabilities are used primarily to fund longer-term, illiquid investments

that cannot be readily converted to cash. If bank depositors -- both foreign and domestic -- seek to exchange their claims on financial institutions for foreign currency, an “international bank run” can result. In such an event, a rapid loss of reserves and strain on the exchange rate is likely.

[The provision of liquidity in a currency crisis poses a problem not faced in domestic bank runs. Both types of crisis begin with a widespread attempt to convert short-term claims into currency. In a closed economy, the central bank can satisfy these claims if it wishes by issuing an unlimited supply of domestic currency. In an open economy, on the other hand, the central bank can only provide foreign currency up to the extent of its stock of foreign reserves. Since all short-term domestic currency assets of the country (not just dollar deposits in banks) can in principle be converted into foreign currency during an attack, the domestic central bank may not be able to cover all potential claims. This consideration supports the rationale for a large precautionary facility for countries that have been unjustifiably hit by financial contagion.]

The logic of a precautionary facility

In a domestic context, deposit insurance and the general “lender of last resort” role played by central banks are aimed at preventing self-fulfilling bank runs. However, such insurance creates moral hazard: if banks’ deposits are insured and/or liquidity support is guaranteed in the case of a run, banks will have an incentive to make risky loans that they would not make in the absence of insurance. The solution to this problem is strong capital adequacy standards and prudential supervision and regulation of banks.

In the international context, the expected provision of official liquidity may also lead to distorted incentives: expectations of official emergency financing may lead international investors to lend carelessly and domestic governments to engage in risky policies. Moral hazard in the domestic context can also be mitigated if insolvent banks can be distinguished from illiquid ones. Ideally, in the international context, precautionary financial support should be given to countries with good policies who are innocent bystanders in episodes of contagion and be withheld from countries with weak policies. Drawing this distinction is even more difficult among countries than among banks. [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 also difficult questions in itself: 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.

However, just as there is a role for the government to intervene to prevent a domestic financial crisis from destabilizing the domestic financial system, so there is a role for the international community to intervene in an international financial crisis to help limit contagion and global instability. 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 an increase in the IMF quota -- highly leveraged with the waiting contributions of other countries -- will provide the IMF with an important pool of new,

uncommitted funds. The proposed new IMF precautionary facility may allow large-scale international assistance for those cases where problems stem more from contagion than from poor policies. It may 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.

In their October 30 Declaration, the G7 agreed that, in response to the current exceptional circumstances in the international capital markets, strengthened arrangements for dealing with contagion are needed. The central element would be the establishment of an enhanced IMF Facility that would provide a contingent short-term line of credit for countries pursuing strong IMF-approved policies. This facility could be drawn upon in times of need and would entail appropriate interest rates along with shorter maturities. The facility would be accompanied by appropriate private sector involvement.

IMF REFORM

Proposals for strengthening the IMF, so as to improve its country programmes and procedures in crisis prevention and resolution, need to be assessed. This goes as well for proposals to strengthen the Interim Committee, which is a sort of IMF steering committee composed of representative member governments, and the Development Committee, which does the same for the World Bank.

MINIMIZING THE HUMAN COSTS OF FINANCIAL CRISES

The sharp recessions in East Asia have led to a steep increase in both the unemployment and poverty rates in that part of the world, inflicting severe social costs. Thus strengthening social safety nets in crisis countries is also an important goal of stabilization packages. Ways must be found to minimize the human cost of financial crises and encourage the adoption of policies that better protect the most vulnerable in society.

More attention must be given in times of crisis to the effect of economic adjustment on the most vulnerable groups in society. The World Bank should develop as a matter of urgency general principles of good practice in social policy, in consultation with other relevant institutions. These should be drawn upon in developing adjustment programmes in response to crises.

EXCHANGE RATE REGIMES FOR SMALL COUNTRIES

The last of the topics to be addressed under possible next steps in the reform of the international monetary system is a big one: the desirable degree of flexibility in countries' exchange rates. It is important to consider the elements necessary for the maintenance of sustainable exchange rate regimes in emerging markets. Many of the lessons carry over to small industrialized economies as well.

[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.] Exchange rate regimes vary in the degree of rigidity. They range from institutional arrangements like monetary unions, dollarized regimes, and currency boards, to conventional fixed exchange rates, to crawling pegs, basket pegs, managed floats, and free floats. Exchange rate regimes are institutional choices that signal policies, priorities, and commitments.

There is no single exchange rate regime that is best for all countries: rather the choice must be based on a country's circumstances. [Smaller more open countries, for example, are better candidates for a fixed exchange rate.] The discussion of the theory of "optimal currency areas" in the next section elaborates on this point (see Box 7-2). For some countries, there may also be no single exchange rate regime that is best for all time. A discussion of "exit strategies" below elaborates on this point.

No matter what exchange rate a country chooses, it is critical that it be backed by strong financial regulation and appropriate monetary and fiscal policies. Macroeconomic stability is based on good policies, irrespective of the exchange rate regime. Policy mistakes that contribute to a currency crisis can occur in the context of any exchange rate regime.

Benefits of exchange rate flexibility

Exchange rate flexibility has important benefits. Most succinctly, it allows monetary independence.

Flexible rate regimes allow for more macroeconomic policy flexibility than more rigid exchange rate regimes. They can allow a country to pursue a different monetary policy than that of its neighbors, as it might want to do, for example, when it is at a different stage of its business cycle. In addition they can facilitate a country's adjustment to external shocks. Examples of such shocks are the swings in capital flows and terms of trade shocks that have been factors in recent crises.

The three goals of financial market openness, monetary policy independence, and exchange rate stability are not conceptually consistent -- a general principal known as the "impossible trinity". In other words, a country can have any two out of the three, but not all three; it must give up at least one. As we have seen, most countries have moved in the direction of increasingly open capital markets. Under perfect capital mobility, a country choosing a fixed exchange rate loses its ability to pursue an independent monetary policy; conversely, autonomous monetary policy can be pursued at the cost of being unable to peg the exchange rate. Therefore, a choice must be made between exchange rate fixity and monetary policy autonomy if free capital mobility is to be maintained.

Benefits of fixed exchange rate regimes.

Why would a country ever choose to fix its exchange rate, if it must give up its monetary independence to do so? There are a variety of reasons.

By eliminating exchange rate risk, a fixed exchange rate regime may encourage

international trade and finance. [There is some evidence of positive effects of exchange rate stability on trade volumes. Fixed exchange rates also clearly help bring international interest rates into equality. The effects on trade and finance are even greater if a country goes beyond fixing its exchange rate and literally adopts the currency of a neighbor (monetary union).] The advantage of eliminating exchange rate volatility looks particularly attractive to the extent that large market movements appear on occasion to be founded more on speculative excess than on economic fundamentals.

The other major advantage of fixed rate regimes is that they can provide monetary discipline. The loss of monetary autonomy under fixed exchange rates limits the ability of monetary authorities to pursue excessively expansionary and inflationary monetary policies. Relatively rigid fixed exchange rates can be an important signal of policy commitment to achieving and maintaining low inflation, especially when countries are seeking rapid disinflation from conditions of high inflation or hyperinflation, as part of a consistent plan for macroeconomic stability. [The fixed rate provides an anchor for expectations and can accomplish a sharp reduction of inflation as it helps economic agents to focus expectations on stable prices by eliminating price increases for foreign goods.]

It is possible that fiscal discipline is also enhanced under fixed rates. The limited ability of monetary authorities to monetize fiscal deficits with seigniorage might in turn curb any tendency toward loose fiscal policies. Adopting a fixed exchange rate does not, however, automatically provide fiscal discipline.

[Some argue that flexible exchange rates may provide more fiscal discipline because, under such a regime, large budget deficits – that are expected to be monetized – lead to a politically punishing currency depreciation. Then, the threat of depreciation under flexible rates can be a deterrent to policymakers trying to pursue loose fiscal policies. Under fixed exchange rates, instead, policymakers do not pay right away the costs of bad fiscal policies. As the currency is pegged, an expansionary fiscal policy does not immediately lead to a costly currency depreciation. Instead, such fiscal behavior can for awhile be hidden behind a bond-financing of the deficits with no devaluation. Even if the deficit is financed through a monetary increase in domestic credit the devaluation can be postponed with a loss of foreign reserves. Either way, the market discipline against excessive fiscal deficits may be loosened.

Russia in 1996-98 may be an example of the problems of incomplete fiscal discipline under fixed exchange rates.]

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Currency boards, an extreme form of fixed exchange rates, may be capable of preventing currency crises, under certain conditions. (See Box 7-1 for a definition and discussion of currency boards.) But they limit the ability of the monetary authority to perform its function of lender of last resort if bank runs occur, an issue that is exacerbated when a fraction of the liabilities of the banking system is denominated in foreign currency. Strong financial systems with well-supervised banks (such as those in Hong Kong and Argentina) are thus necessary conditions for a successful currency board.

Box 7-1. - Currency Boards

Until recently a forgotten relic of colonial history, currency boards [and currency board-like arrangements] are increasingly advocated by a small group of economists. They have had positive results in Argentina [where it goes by the name convertibility], Hong Kong and elsewhere. However, currency boards are probably an excessively restrictive method of achieving monetary control for most countries.

A currency board is a monetary institution that only issues currency that is fully backed by foreign assets. Its principal attributes include the following:

- an exchange rate that is fixed not just by policy, but by law
- a reserve requirement stipulating that each dollar's worth of domestic currency is backed by a dollar's worth of foreign reserves
- a self-correcting balance of payments mechanism, in which a payments deficit automatically contracts the money supply, resulting in a contraction of spending.

[By maintaining a strict unyielding exchange rate, the government hopes to ensure credibility. By holding 100 percent reserves, it hopes to insure convertibility.]

The first currency board was established by the British in Mauritius in 1849. The use of currency boards eventually spread to 70 British colonies. The purpose was to provide the colonies with a stable currency without the associated difficulty of issuing sterling notes and coins that were costly to replace if lost or destroyed. The colonies also benefitted from this approach in that they could earn interest on the foreign currency assets being held in reserve. The use of currency boards peaked in the 1940s and declined thereafter. [In the 1960s, many

newly independent African countries replaced their currency board with a central bank, and most other countries followed suit in the 1970s.]

*** The introduction of currency board-like arrangements in Argentina (1991), Hong Kong (1983), Estonia (1992), Lithuania (1994), and Bulgaria (1997) constitutes a small resurgence in their use worldwide. The major attraction of a currency board is the credibility it lends to monetary policy, by removing the option of printing money.

Characteristics that suit countries to be candidates for currency boards are: a small open economy, a craving for further close integration with a particular neighbor or trading partner, a desperate need to import monetary stability due to a history of hyperinflation or an absence of credible public institutions, access to an adequate level of reserves, and a strong, well supervised and regulated financial system.

Although currency boards are generally deemed more appropriate for smaller, more open economies, Argentina was prompted to adopt one because of a dramatic hyperinflation in the 1980s and the absence of a credible monetary authority. Newfound credibility helped reduce interest rates from 12 percent to 2 percent per month in very short order, as well as reducing inflation dramatically. Since 1991, Argentina has become a model of price stability and has achieved laudable growth rates. The presence of a currency board probably also helped to resist the pressures on the Argentine peso unleashed after the 1994 Mexican peso crisis (the “Tequila” contagion), though the experience also illustrated the adverse effects on the banking system and real economic activity when adjustment to balance of payments pressure comes through the mechanism of automatic monetary contraction. ** Assistance from the IMF helped to provide

the reserves that were necessary initially, and to weather the 1995 storm. Argentina subsequently rebounded strongly from its recession. GDP growth was 4.4 percent in 1996 and about 7 percent in 1997. By all accounts, the currency board has worked for Argentina. [Currency boards have also been credited with reducing inflation dramatically in Hong Kong, Estonia, and Lithuania.]

Currency board supporters are pushing for their wider use—in particular, for Indonesia, Mexico, Russia, and Ukraine. In general, proclaiming a currency board does not automatically guarantee the credibility of the fixed rate peg as sometimes asserted. [Little credibility is gained from putting an exchange rate peg into the law, in a country where laws are not heeded or are changed at will.] A currency board is unlikely to be successful without the solid fundamentals of adequate reserves, fiscal discipline, and a strong and well-supervised financial system, in addition to the rule of law.

Exit strategies

[For some countries, a particular exchange rate arrangement, whether fixed or floating, may be appropriate on a permanent basis. For others, there may be no single exchange rate regime that is best for all time. As an empirical matter, many countries switch among different regimes regularly.]

Nothing makes evident the limitations of a fixed exchange rate regime quite as vividly

as switching to one. Each of the three episodes of currency crisis in this decade [1992–93, 1994, and 1997–98] occurred under regimes where exchange rates were either fixed or kept in a narrow band. Semi-fixed exchange rate regimes, as well as floating regimes, have at times led to real currency appreciations that worsened a current account deficit, and contributed to triggering a crisis. **The experience suggests that, although the expectations-anchor role of fixed rates can be useful, maintaining protracted fixed rates in the aftermath of exchange rate-based stabilizations can lead to real appreciation (due to residual inflation) and deteriorating trade balances, which can eventually undermine the fixed-rate parity.**

[Monetary discipline under fixed rates may not always be automatic and binding. Under fixed exchange rates, domestic credit expansion will lead to a loss of reserves. If the contractionary effect on the monetary base of such a loss of reserves is sterilized with compensating open market operations, such sterilized intervention will eventually deplete the reserves, as the experience of East Asia in 1997 suggests. So, while fixed rates should provide monetary discipline by constraining the ability to increase domestic credit, governments at times do otherwise, thus eventually undermining the pegged parity.]

[Fixed exchange rates may also have reduced the perceived risk of foreign currency-denominated borrowing by banks and firms, by inducing the false belief that they face only one-sided uncertainty on the movements of the exchange rate. In fact, while a depreciation is ruled out, the currency might be allowed to strengthen benefitting agents who

have borrowed in foreign currency. In this regard, more flexible exchange rates explicitly introduce two-way risk: the currency may depreciate as well as appreciate. This may prevent the accumulation of unhedged foreign currency liabilities as investors will consider that borrowing in foreign currency may lead to an increase in the burden of such debt if the domestic currency depreciates.]

If a country has truly made an irrevocable fixed-rate commitment -- which probably requires monetary union -- then (for better or worse), its decisionmaking is finished. For others, it is never finished. Exchange rate-based stabilizations may be more successful if the initial fixed rate anchor regime is followed by an "exit strategy." One such exit strategy is a switch to a crawling peg regime, where the currency is allowed to depreciate at a gradual rate determined by the inflation differential between the domestic economy and the world. Such a policy may help prevent real appreciation and external imbalances that often eventually undermine rigid fixed rate regimes. It is tempting for a country to cling to a fixed exchange rate regime that has delivered good economic performance, especially if it was the means of ending an earlier period of high inflation. But the instability can be much worse if the government waits for a crisis before introducing a degree of currency flexibility.

Consider three countries, all of whom underwent highly successful exchange-rate-based stabilizations in the 1980s. Mexico ultimately paid a high price in 1995 for clinging to its exchange rate strategy too long, while Argentina's commitment was

sufficiently strong that it was able to maintain it successfully. Israel exited successfully, by increasing flexibility subsequent to the initial stabilization.

More work needs to be done to determine whether certain exchange rate regimes provide more stability in the presence of high capital mobility and the potential for sudden reversals of capital flows following changes in investors' expectations. The choice of a particular exchange rate regime cannot, however, substitute for sound macroeconomic policies and strong financial systems as the foundations for true financial stability.

One extreme form of fixed exchange rates, which solves the problems of credibility and speculation automatically, is a monetary union. The next section discusses the prospects of the European Monetary Union and whether Europe represents an "optimal currency area."

3. EUROPEAN ECONOMIC AND MONETARY UNION

The European response during the 1990s to the challenges presented by exchange rate volatility and financial globalization has been to accelerate the economic and financial integration of the continent. As part of this process, eleven members of the European Union embarked in a project of monetary unification that took effect on January 1, 1999, with Stage Three of the process of European Monetary Union (EMU). As noted at the outset of the chapter, European integration raises some of the same analytical issues and policy challenges as integration of the emerging market countries into the world financial system.

THE EMU SCHEDULE

In the spring of 1998, a summit of European Union (EU) heads of government decided that EMU should proceed, as envisioned in the Maastricht Treaty of 1991. Initial members were selected upon assessments by the European Monetary Institute (the forerunner of the European Central Bank) and the European Commission, as to which countries met the Maastricht Treaty's convergence criteria. The criteria for membership in the single-currency were as follows: Government deficits and total debt had to be no more than 3 percent and 60 percent of gross domestic product, respectively. Inflation rates and long-term interest rates also had to be within 1.5 percentage points and 2 percentage points of the average of the three countries with the lowest inflation. Finally, members' currencies must also have stayed within the Exchange Rate Mechanism bands for two years.

These criteria had to be met in 1997 for a country to qualify as a founding member of EMU on January 1, 1999. Twelve of the fifteen members of the EU wished to participate, and eleven of these were found to satisfy the criteria for membership. This, in part, reflected remarkable progress at fiscal consolidation, since the targets had seemed out of reach for members such as Italy a mere year or two in advance. Of the countries desiring membership, only Greece was deemed not to satisfy the criteria. Of the other three EU countries, United Kingdom and Denmark opted not to join for the time being, while Sweden chose not to qualify by remaining out of the Exchange Rate Mechanism.

The remarkable convergence of financial conditions in the European countries is clear from the data on the 11 EMU countries' short-term and long-term interest rates (see Charts 6-3 and 6-4), showing that both sharply converged after 1996. Differences in interest rates across countries can be due to two major factors: a currency premium related to the risk of devaluation, and a country premium related to the possibility of default on the public debt. With monetary union starting in January 1999, short term interest rates converged as currency risk was eliminated and default risk is close to zero for very short-term public debt. Even after monetary union, differences among long-term interest rates may remain, as different EMU countries with different stocks of public debt may be perceived as having different default probabilities. However, long-term interest rates in the euro-11 area converged quite sharply by the fall of 1998 as well. [This convergence depends on two factors. First, the fiscal adjustment required by the Maastricht criteria led to a significant reduction of the country risk premium. Second, the equality in future short-term rates after monetary union implies that long-rates, which should reflect an average of expected future short rates, should also substantially converge.]

In July 1998, the European Central Bank came into existence. On January 1, 1999 the single currency, the euro, was created as the currency of the 11 EMU countries. The European Central Bank took control of monetary policy in all EMU countries. While the euro was formally created on January 1, existing national notes and coins will continue to circulate until euro cash is introduced. Different forms of cash still exist in EMU member states. But they are no longer separate currencies - they are "non-decimal denominations" of the euro, locked in at permanent conversion rates. (By analogy, most American dollar bills carry a circular seal with a letter inside

denoting the Federal Reserve District from which they come. However, Europeans will continue for some time to be more aware of the geographic origin of the currency they carry than Americans are.) Only in 2002, will euro cash (coins and notes) come in and national currencies be phased out. This transition period is necessary because central banks need time to print the banknotes and mint coins; retailers and banks also want time to prepare; and the public sector needs time to prepare as governments have to consider how to change their services over to the use of the euro.

While euro cash will be introduced only in 2002, in the three years between now and then many changes will occur. Government bonds issued after 1999 will have to be denominated in euro. Also, almost all existing issues of marketable government debt by the participating countries is expected to be redenominated in euros at the end of 1998. Moreover, several large European companies plan to begin accounting in euros in 1999. Such a move may lead smaller firms to follow. Even businesses who do not switch their internal accounting to euro may quote prices in euro for trading before 2002. Consumers and the public sector are likely to be using national currency units until 2002. In general, European governments agreed that there will be "no compulsion" and "no prohibition" in the use of the euro between 1999 and 2002.

BENEFITS AND POTENTIAL COSTS OF EMU

There are several potential benefits of EMU. Transaction costs in trade will be lowered as exchange rate risk and currency transactions within Europe will both be eliminated; and the ensuing goods market integration and price competition will be beneficial to consumers.

Integrated European financial markets will be broadened and deepened. Inflation discipline will be preserved by an independent European Central Bank committed to price stability. It is hoped that fiscal discipline will also result since, as agreed in a Growth and Stability Pact, membership requires maintenance of disciplined fiscal balance. (According to the Pact, fines may be imposed on offending countries.) The lack of independent monetary policies and the limited role of fiscal policies will make more urgent the need for European structural reforms, e.g., to increase flexibility in the labor market. In this sense, it is to be hoped that EMU might serve as a discipline tool to nudge European countries to implement structural reforms more rapidly and eliminate impediments to sustained economic growth.

Finally, creation of a stable area of monetary stability is a commendable culmination of the 50-year economic, social and political integration that has taken place in Europe. Indeed, the original motivation for economic integration in Europe was to make sure that the countries in the heart of Europe, which had fought three wars over the preceding 100 years, never did so again. This is one reason why, in historical perspective, European integration has always been in the political interest of the United States. Even in an economic sense, the U.S. will benefit as a trading partner from strong economic growth and performance in Europe, which may be enhanced by the single currency project in the long run. What is good for Europe economically is good for us.

However, EMU may also entail some potential costs. First, there will be no national monetary autonomy that might be needed to respond to "asymmetric" national shocks, meaning unexpected economic developments that affect some countries differentially than others [i.e.,

idiosyncratic or country-specific events]. Such shocks may require national exchange rate adjustment, but this tool will no longer be available in a monetary union. Second, labor market flexibility and labor mobility is required to adjust to asymmetric shocks in the absence of independent monetary policies. But labor mobility is much lower among the nations of Europe than it is, for example, among the American states. Third, although fiscal policy can play a stabilization role in the absence of independent monetary policy, the rules for EMU membership constrain the national ability to use such a tool. Finally, in Europe there is also little in the way of a central system of federal taxes and transfers to cushion against regional/national shocks as compared to the United States. Limited labor mobility, structural labor market rigidities, and decentralized and constrained fiscal policy might imply that Europe may not fully satisfy the criteria for an “optimal currency area”. (These points are elaborated in Box 7-2 on Optimum Currency Areas).

Box 7-2 - Is Europe an Optimum Currency Area?

The theory of **optimum currency areas** provides a set of criteria to indicate what countries should become members of a common monetary union. Some research suggests that the nations of the EU are less well-suited to a common currency than are, for example, the states of the United States. Nevertheless, Europe is becoming increasingly integrated over time, and this may tip the balance in the direction of satisfying the optimum currency area criteria in the future.

The need for monetary independence. Why do countries ever need independent

currencies? If a country (or other geographic region) suffers an adverse "shock," such as a fall in demand for its products, it may want to follow a more expansionary monetary policy, in order to stimulate demand and head off unemployment. Yet, if it does not have an independent currency, it will not be able to undertake monetary expansion.

To take an example, in the early 1990s Germany experienced a sudden increase in interest rates (which arose out of the re-unification of the country and the associated increase in West German spending in the Eastern lander). It was difficult for other European countries to accept this increase in German interest rates, because it did not suit their own economic conditions. The resultant strains broke apart Europe's Exchange Rate Mechanism in 1992-93.

Labor mobility. Now consider a country or other geographical unit that gives up its monetary independence. Subsequently, in the event of an adverse shock, it might still have other ways of adjusting. One way of adjusting is that workers may move out, to other countries or regions with stronger economies. While this might not sound like an attractive solution, it turns out that inter-state migration is the most rapid means of adjustment to economic downturns within the United States (e.g., more rapid than adjustment of wage levels). Labor mobility is an important criteria for an optimum currency area: if a region has this means of adjustment, then it has less need for monetary independence.

Labor mobility among European countries is much lower than in the United States. Thus, by the labor mobility criterion, European countries are less well-suited to a common currency than are American states.

Fiscal transfers. When disparities in income do arise in the United States, federal fiscal

policy helps to narrow them. One recent estimate suggests that when a region's per capita income falls by one dollar, the final reduction in its disposable income is only 70 cents. The difference, a 30 percent federal cushioning effect, includes both an automatic decrease in federal tax receipts plus an automatic increase in unemployment compensation and other transfers. The cushioning effect has been estimated at 17 percent in the case of Canadian provinces. European countries have greater scope for domestic fiscal stabilization than do American states.

Furthermore there are some cross-country fiscal transfer mechanisms. Nevertheless, neither the fiscal transfer mechanisms that are already in place within the European Union nor those that are contemplated under EMU -- so-called "structural funds" -- are as large as those in the U.S. or Canadian federal fiscal system.

Judged at least by these two optimum currency area criteria (labor mobility and fiscal transfers), the European Union is not as good a candidate for a monetary union as is the United States. European countries may be less adaptable than American states. This suggests that, if there are shocks in the coming decade that affect EU members differentially as did the German unification shock of 1990, those adversely affected could experience popular resentment against what -- for them -- will be the insufficiently expansionary monetary policies of the rest.

Prospects for EMU. There is good hope, however, for a successful EMU. The degree of integration among EU countries is increasing decade by decade. The degree of international labor mobility, for example, is likely to be higher in the future than in the past. The Schengen convention now allows free movement of citizens among a subset of European countries. Thus the European countries may come to satisfy the textbook criteria of an optimum currency area in

the future, even if they do not fully now.

While such potential costs of EMU have some relevance, some of the objections to EMU have been exaggerated. First, while monetary policy can affect real economic activity in the short-run, it does not in the long-run. Therefore, monetary policy can do little to address structural rigidities, such as labor market inflexibility and real wage rigidity that are generally thought to keep unemployment rates high in Europe in general and in depressed regions such as southern Italy in particular. These problems will have to be addressed by structural reforms with or without monetary union.

Second, the role of fiscal policy is also inherently limited in Europe, since fiscal deficits and debt-to-GDP ratios are still high for several countries. Fiscal retrenchment will continue in Europe with or without EMU; therefore EMU may not be much of a constraint. Third, asymmetric shocks and limited factor mobility will diminish over time as EMU leads to greater real integration among European economies (see Box 7-2). For example, as intra-European trade has grown and will further grow in response to with European integration and EMU, the creation of a common free market for goods, services and factors of production is likely to make idiosyncratic national shocks less prevalent.

Finally, it has been argued that EMU is likely to exert a strong discipline in favor of structural reform. As there will be no national monetary and exchange rate policies and fiscal policy autonomy will be constrained, the ability to use macro instruments to delay structural market reforms will be reduced; governments will have a stronger incentives to pursue policies

that further long-run economic growth. The opposite has also been argued by some who fear that EMU will slow the drive to structural reforms. Since reforms are socially costly, the flexibility deriving from monetary, exchange rate and fiscal discretion can ease the transition costs as resources are reallocated. With EMU, the absence of these social “shock absorbers”, may slow down the structural reform process. In that scenario, the absence of the structural reform would continue, creating detriments to EMU.

4.THE EURO AS AN INTERNATIONAL CURRENCY, AND IMPLICATIONS FOR THE U.S. DOLLAR

The formation of a monetary union in Europe is a positive development that could simultaneously benefit the continent, the United States and the world economy. Some have raised a concern, however, that a strong European economy and the emergence of the euro as an alternative ‘rival’ international currency to the dollar is likely to harm the United States. Such concerns are mostly misguided. The U.S. has long benefitted from a prosperous, growing Europe, and since the Marshall Plan after WWII has supported the development of strong market economies on the continent.

With the development of an open and integrated economic area in Europe, the United States will benefit. American producers will be able to export to a very large, integrated European market with no cross-national restrictions to trade. U.S. firms producing in Europe will benefit from the lack of exchange rate volatility, common European standards for goods and services and a large open market. Indeed, U.S. corporations have more experience selling into a

large unified market than do European corporations. American financial institutions in particular, who are already quite competitive in commercial and investment banking services and securities products, can benefit from the opportunities provided by the broadening and deepening of integrated European financial markets.

The emergence of the euro as a rival international currency should not be viewed with alarm for a number of reasons. Even if the euro emerges as an international currency strong enough to rival the dollar, the negative effects on U.S. economic welfare are likely to be small. Furthermore, it is not obvious that the euro will rapidly displace the U.S. dollar as a major international currency. International currency status does not automatically follow from a currency's possession of a large home-base. It is also necessary that the issuers of the currency maintain stable monetary policies with low inflation rates. One might even argue that it is healthy for the world to have two or more currencies competing for the status of international currency, as a discipline on each.

The functions of an international currency

What does it mean to be a major international currency, and is it likely that the euro will become one? A currency has three main uses: it can be used as a means of payment; a unit of account; and a store of value. An international currency is simply one that is also used outside its home country for these three purposes. Within each of the three functions, an international currency has both official and private uses.

In money's *store of value* function, investors decide how much of their wealth to hold in

the form of assets denominated in various currencies. Will public and private investors hold a fraction of their portfolio in assets denominated in euros? If yes, beyond the sum of the fractions previously occupied by the German mark and other disappearing European currencies, there may be large portfolio shifts leading to greater demand for euros. This could in turn possibly cause an appreciation of the euro. However, a higher use of euros in portfolios will depend on economic factors such as inflation rates in the euro area, confidence in the value of the euro relative to the U.S. dollar and the Japanese yen, the rate of return on euro assets, and economic growth in Europe, as well as political factors.

The official side of the store-of-value use is that currencies are held as foreign reserves by central banks. There is a possibility of greater diversification away from U.S. dollar towards the euro. In the 1970s and 1980s, the dollar's share of reserve currency holdings gradually shrank to make room for the mark and yen. This trend was suspended, or even reversed, in the 1990s, but could resume in the 2000s to make room for the euro. Such diversification away from the dollar would depend in part on the same risk-reward considerations as matter for private use. Countries with strong economic fundamentals, sound currencies and low inflation are more likely to have their currency used as an international currency. As long as the U.S. maintains a strong economy, the international demand for U.S. dollar will remain strong.

A unit of account is a reference scale for quoting prices, which is distinguishable from the actual currency in which assets are held or payments made. On the private sector side of the unit of account function, an international currency is used to invoice imports and exports. Presently, the U.S. dollar plays a dominant role in invoicing around the world, especially for primary

commodities like oil. But invoicing will be mostly in euros within Europe. Also, the euro may be used widely in Central and Eastern Europe, the Middle East and Africa, areas of high and increasing trade with Europe.

One official use of international currencies that can be classified under the unit of account function is a major currency to which smaller countries can peg their exchange rate. Non-EMU European countries, particularly those in the East, are likely to consider pegging their currencies to the euro for two reasons: they undertake more of their trade and finance with the EU than with the U.S., and they aspire to eventual membership in EMU. If this happens, greater use of the euro as an intervention currency will increase official demand for euros. The unit-of-account, store-of-value, and means-of-payment functions are interrelated.

Currently, the dollar is used as the primary vehicle currency in foreign exchange trading which is one example of *means of payment*. A trader who wishes to exchange one minor currency for another is more likely to go through the dollar than to go through some other major currency, or to be able to find a counterparty for a direct “cross trade.” (see Box 7-3 on the role of different international vehicle currencies.)

The private use of a currency as a means of payment in international trade and finance depends on thickness externalities in payments systems. As in the case of a domestic currency, there are significant increasing returns to scale in payments: it is easier and cheaper to use the currency that is used by everyone else. In this regard, the advantages of incumbency and inertia will favor the U.S. dollar even as the euro’s natural home grows to be as large as that of the dollar.

Overall, while it is likely the euro will become an international currency, it is unlikely that the U.S. dollar will be replaced anytime soon in its role as leading international currency.

Is it good or bad to be an international currency?

Does it matter whether the dollar remains the leading international currency? One should not overemphasize the decidedly modest benefits that having an international currency provides to a country. Central banks' reserve currency holdings may have important implications for the determination of the exchange rate. But this is another question. What about the global role of the dollar per se?

Advantages of having a key currency

One can think of five advantages to a country of having its currency used internationally.

(1) Convenience for residents. It is certainly more convenient for a country's exporters, importers, borrowers and lenders to be able to deal in its own currency than foreign currencies. The global use of the dollar, as with the global use of the English language, is a natural advantage that American business tends to take for granted. [But the benefits from having one's country's currency used as a unit of account should not be overemphasized. Having invoiced imports in domestic currency is beneficial if the domestic currency depreciates, but harmful - relative to foreign currency invoicing - if the domestic currency appreciates. Invoicing in domestic currency does not necessarily shift the currency risk from the buyer to the seller, as the dollar price of imported goods sometimes can change quickly when the exchange rate changes.]

(2) More business for the country's banks and other financial institutions. There need be

no firm connection from the currency in which banking is conducted to the nationality of the banks (nor from the nationalities of the savers and borrowers to the nationality of the intermediating bank). British banks, for example, continued to do well in the Eurodollar market long after the pound's international role waned. Nevertheless, it stands to reason that U.S. banks have a comparative advantage at dealing in dollars. Only U.S. banks have access to the safety net provided by U.S. regulatory authorities (access to the discount window, and so forth).

(3) Political power and prestige. The benefits of "power and prestige" are decidedly nebulous. Nevertheless, the loss of key currency status and the loss of international creditor status have sometimes been associated, along with such non-economic factors as the loss of colonies and military power, in discussions of the historical decline of great powers.

(4) Seigniorage. This is thought by some to be perhaps the most important advantage of having other countries hold one's currency. They must give up real goods and services, or ownership of the real capital stock, in order to add to the currency balances that they use. Just as American Express reaps profits whenever people hold its travelers' checks, which they are willing to do without receiving interest, so the United States profits whenever people in Argentina or Russia hold dollars that do not pay interest. Seigniorage derives from the fact that the U.S. effectively gets a zero-interest rate loan when dollar bills are held abroad. Wherever hyperinflation or social disorder undermine the public's faith in the local currency, the American dollar is the preferred alternative. (Illegal activities are another source of demand, of course).

A way to compute cumulative seigniorage is to estimate the stock of dollars held abroad, and multiply by the interest rate. Foreign holdings of U.S. currency are conservatively estimated

at 60 per cent of total dollar currency in circulation. With total currency outstanding in mid-1998 at \$441 billion, foreign holdings are about \$265 billion. One simply multiplies by the Treasury bill interest rate, to derive the estimate that seigniorage currently runs about \$13 billion a year. [This is implicitly a tax on foreign transactions that are intensive in dollar cash.]

(5) Ability to borrow in international capital markets in one's own currency. Some have argued that the U.S. ability to finance its current account deficit via foreign borrowing has been facilitated by the ability to issue dollar denominated liabilities. The concern has been expressed that such ability may be hampered by a loss of reserve currency status. This concern is probably overdone. First, many industrial countries whose currency is not a key currency are able to borrow in domestic currency. Second, countries with larger current account deficits than the U.S. (as a share of their GDP) have regularly and persistently financed such imbalances with borrowing in foreign currency rather than their own domestic currency. Countries become unable to borrow to finance current account imbalance when such imbalances become unsustainable. The fact that borrowing may occur in domestic or foreign currency has little to do with such sustainability.

[The ability of the U.S. to borrow in dollars rather than a foreign currency is also of limited value. Foreign debt needs to be serviced, both principal and interest, regardless of its currency of denomination. A currency depreciation increases the real burden of foreign-currency-denominated debt, but a dollar appreciation would decrease the burden of any U.S. foreign debt denominated in foreign currency. So borrowing in domestic or foreign currency may or may not be beneficial depending on how the exchange rate moves. Financing the foreign

debt in one's own country currency gives, in principle, the potential advantage of being able to debase the real value of such debt through inflation. But no one would recommend deliberately following such a destructive economic strategy, given the loss of credibility and the economic costs of high inflation that it would entail.]

Disadvantages of having a key currency

One can think of two disadvantages from the viewpoint of a key-currency country. They explain why Japan, Germany and Switzerland, have in earlier decades been reluctant to have their currencies held and used widely.

(1) Larger fluctuations in demand for the currency. Having one's currency held by a wide variety of people around the world might result in greater variability of demand, although [this is not automatically clear;] such instability is more likely to follow from the increase in the degree of capital mobility than from key currency status per se. In any case, central banks are particularly concerned that internationalization will make it more difficult to control their money stocks. This problem need not arise if they do not intervene in the foreign exchange market. But the central bank may view letting fluctuations in demand for the currency be reflected in the exchange rate as being just as undesirable as letting them be reflected in the money supply.

(2) An increase in the average demand for the currency. This is the other side of seigniorage. In the 1960s and 1970s, the Japanese and German governments were particularly worried about the possibility that if assets were made available to foreign residents, an inflow of

capital would cause the currency to appreciate and render exporters uncompetitive on world markets. Some Europeans today express the same concern about the euro.

Box 7-3. How does the dollar rank against other international currencies (pre-euro)?

Most measures show a gradual decline in international use of the dollar. Reserve currency use, perhaps the most important measure, is shown in Table 7-1. The dollar's share of central bank reserve holdings declined from 76.1 % in 1973 to 56.0 % in 1990. Central banks gradually shifted their portfolio shares into marks and yen. But the dollar's share in reserve holdings has been relatively flat in the 1990s, amounting to 61 % in 1997.

Other major measures of international currency status, just prior to the birth of the euro, are shown in Table 7-1. Overall, they tend to show the same thing: the dollar still on top, despite a gradual decline in its use versus the mark and yen over the last twenty years. The dollar is still more important than its three or four rivals combined.

- The first column reports the popularity of major currencies among smaller countries choosing a peg for their currencies. It is still the case that no currencies anywhere are pegged to the yen. Three currencies (those of Estonia, Bulgaria, Bosnia) were pegged to the mark last year, however. Elsewhere (Africa) the French franc was still the most common choice as a peg (29 per cent of peggers) owing to a special set of arrangements with the French Treasury, after the dollar (39 per cent). The euro is inheriting this role of the mark and franc. The dollar share should automatically go down in 1999 as the EU-11 are for the first time counted as pegging to each other.

- 87 percent of trades in the foreign exchange market in April 1998 involved the dollar, as the currency either bought or sold (see third column of the table). This figure (like the share of reserves held in dollars) should automatically go up in 1999, as EMU eliminates intra-European transactions among member currencies.
 - The various measures of use of currencies to denominate private international financial transactions -- loans, bonds, and deposits -- still showed the dollar as the dominant currency, with a 54 percent share.
 - Figures on the use of international currencies as substitutes in local cash transactions, are not generally available. The two leaders have been the dollar, for which internationally-circulating cash has been estimated by the Fed at 60 percent of U.S. currency outstanding, or \$240 billion, and the mark, for which international circulation has been estimated by the Bundesbank at 35-40 percent of German currency outstanding, or \$47 billion.
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What are the determinants of international currency status?

Will the dollar in the future maintain its global role? There are four major sorts of conditions that determine whether a currency is used internationally.

(1) Patterns of output and trade. The currency of a country that has a large share in international output, trade and finance has a natural advantage. The U.S. economy is still larger than the euro-11 economies combined. If Britain and the other remaining EU members (Sweden, Denmark and Greece) join in the future, however, the two currency areas will then be very close in size.

(2) History. There is a strong inertial bias, in favor of using whatever currency has been the vehicle currency in the past. An individual (exporter, importer, borrower, lender, or currency trader) is more likely to use a given currency in his or her transactions if everyone else is doing so. For this reason, the world's choice of international currency is characterized by "multiple stable equilibria." The pound remained an important international currency even after the United Kingdom lost its position as an economic superpower early in the century. In the present context, the inertial bias favors the continued central role of the dollar.

(3) The country's financial markets. Capital and money markets must be not only open and free of controls, but also deep, well-developed and liquid. The large financial marketplaces of New York and London clearly benefit the dollar and pound relative to the deutschemark and yen. It remains to be seen whether EMU will turn Frankfurt or Paris into one of the top few financial centers.

(4) Confidence in the value of the currency. Even if a key currency were used only as a unit of account, a necessary qualification would be that its value not fluctuate erratically. As it is, a key currency is also used as a form in which to hold assets (firms hold working balances of the currencies in which they invoice, investors hold bonds issued internationally, and central banks hold currency reserves). Here confidence that the value of the currency will be stable, and particularly that it will not be inflated away in the future, is critical.

The monetary authorities in Japan, Germany and Switzerland, in the 1970s established a better track record of low inflation than did the United States, which helped their currencies to achieve greater international currency status. Given the good U.S. inflation performance more

recently, this is no longer such a concern.

What is the prognosis for the dollar and the euro?

In light of these desiderata for a would-be international currency, is it likely that the euro will rival the dollar as the leading international currency? The euro automatically inherits the roles of the ecu, DM, french franc, and other EMS currencies. Subsequently, the euro's share will probably gradually rise, to move in the direction of "Euroland"'s share of output.

The odds are against the euro's rapidly supplanting the dollar as the world's premier currency. It is not that the dollar is ideally suited for the role of everyone's favorite currency. At least one characteristic mars its appeal: The United States is a debtor country with a large current account deficit. But an international currency is one that people use because everyone else is using it. Two of the four determinants of reserve currency status -- developed financial markets and historical inertia -- support the dollar over the euro. The third, economic size, is a tie. The fourth determinant is a tie as both Euroland and U.S. have pursued stable monetary policies aimed at maintaining a low rate of inflation.

While the widespread use of the U.S. dollar as international currency -- for holding reserves, pegging minor currencies, invoicing imports and exports, and denominating bonds and lending -- is testimony to the strength of the U.S. economy and the confidence with which it is viewed around the world, the direct economic benefits deriving from this international role are limited. The welfare of a country is measured by its ability to produce a large quantity of goods and services and provide a sustained increase in real income and consumption opportunities for

its citizens. Whether a country's currency is an international currency or not has little to do with such long-run well-being, as the experience of many successful economies whose currencies do not have international roles attests. A strong and healthy U.S. economy that is a leader and champion of sound economic policies has led - as a by-product- to a strong international role for the U.S. dollar.

[To summarize, the introduction of the euro in January 1999 instantly created an international currency that potentially rivals the dollar. The standard measures of international currency use will show a euro that inherits roughly the sum of its constituent currencies. Subsequently the dollar will probably lose share gradually, as it lost share in the 70s and 80s to the mark and yen. There will be some small associated costs for the U.S.. But there is no reason to expect the euro to surpass the dollar anytime soon, nor for the costs from the U.S. viewpoint to outweigh the political and economic advantages to a successful EMU.]

5. CONCLUSION

Reforms are necessary to create a strengthened international financial architecture for the global market-place in the next millennium, one that captures the full benefits of international capital flows and global markets, minimizes the risk of disruption, and better protects the most vulnerable.

The United States has worked intensively with key emerging markets, other industrialized nations, and the relevant international organizations, to put in place the building blocks of this new architecture. The reforms recommended by the G22 and adopted by the G7 are

an important starting point. The United States and its G7 partners also agreed to do more to build a modern framework for the global markets of the 21st century and to limit the swings of boom and bust that destroy hope and diminish wealth. Thus, they also committed to initiate new work on a number of other important areas to identify additional steps to strengthen the international financial architecture. All these reforms will ensure that the unprecedented growth, increase in welfare and opportunity experienced in the 50 years after the creation of the Bretton Woods system are maintained in the future.

Meanwhile, the United States salutes the formation of the European Monetary Union. The United States has everything to gain and little to lose from the success of this momentous project. Now more than ever, America is well served by having an integrated and prosperous trading partner on the other side of the Atlantic. Europe should benefit from a single currency that supports these ends -- and if Europe benefits, this will greatly benefit the United States. [The United States has an enormous stake in Europe emerging under EMU with the capacity to play a more active and constructive role on the world stage -- and with the capacity to be an even stronger economic ally to the United States in the century to come. As ever, Europe is a partner, not a rival. And as our partner succeeds, so will we.]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 4-JAN-1999 11:41:44.00

SUBJECT: Latest Draft Steel Report due to Congress Jan 5.

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

READ:UNKNOWN

TEXT:

Janet, this draft was just sent to me by NEC.

Nouriel

----- Forwarded by Nouriel Roubini/CEA/EOP on 01/04/99
11:41 AM -----

Malcolm R. Lee

01/04/99 11:39:28 AM

Record Type: Record

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

cc: Nina L. Hachigian/NSC/EOP

Subject: Latest Draft Steel Report due to Congress Jan 5.

Structure has changed slightly per Sperling. Contains Lael Brainard's initial edits, she is reviewing further. Please fax (69290) and e-mail me comments as soon as possible. Thanks

Message Sent

To:

earp_gordana @ ustr.gov @ INET @ VAXGTWY

Meg.Lundsager @ Treas.sprint.com @ inet

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

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D23]MAIL46278630N.036 to ASCII,
The following is a HEX DUMP:

**REPORT TO THE CONGRESS
ON A COMPREHENSIVE PLAN FOR RESPONDING TO
THE INCREASE IN STEEL IMPORTS**

I. SUMMARY

This report responds to the request from Congress contained in the omnibus spending bill for a comprehensive plan for responding to the increase in steel imports into the United States.

The Administration is deeply concerned about the recent surge in low-priced steel imports and its impact on America's steel industry and the workers, families and communities that depend on it. There is no more important challenge than to ensure the strength of the U.S. economy and to minimize the impact of the global financial crisis on all Americans.

The Global Financial Crisis and State of the Steel Industry

The financial crisis has resulted in a steep drop of demand for steel in Asia, which over the last decade had experienced a sharp increase in steel consumption and had substantially expanded steel production. Many producers diverted their sales to the strong U.S. market. U.S. steel imports surged to record levels in 1998, rising 30% in the first ten months of 1998 over the same period last year. Import penetration rose from 22.6 percent to 29.5 percent between 1997 and the same period of 1998. Steel exports from Japan, Korea and Russia together account for 82 percent of the increase. Due to currency devaluations in Asia and due to the global excess of steel, prices decreased sharply.

While the strength and resilience of the U.S. economy has withstood the global economic pressures and growth continues, increased steel imports have had an adverse impact on U.S. steel producers and workers. U.S. steel shipments declined 7.8 percent in the June through October 1998 period. The American Iron and Steel institute reports that capacity utilization has fallen to 74 percent from 90 percent a year ago. Labor statistics show a 10,000 drop in steel employment to 226,300 between November 1997 and November 1998, compared to the average ANNUAL? decline of 1,660 workers from 1992 to 1997.

Action Plan

The steel import situation has received sustained attention at the highest levels, including the President, the Vice President and members of the Cabinet, who met with industry and union representatives on a number of occasions to discuss industry and labor concerns and potential responses. The Administration has held regular, senior level, inter-agency meetings to craft an appropriate, timely and comprehensive response to alleviate the adverse impact of steel imports, and to avoid further disruption to the U.S. market. The Administration's program is based on four pillars:

- stabilizing currencies and strengthening demand around the world;
- strong enforcement of U.S. trade laws against unfair trade practices;
- an early warning system to monitor import trends
- a commitment to effective safeguards relief under Section 201 where imports have caused serious injury;
- strong bilateral pressure on our trading partners to eliminate any and all unfair trade practices and to further open their markets; and,
- assistance for affected workers and communities.

These principles have been pursued in the Administration's steel action plan through a number of specific steps which are summarized below and described in greater detail in the remainder of this report.

1. *Restoring Global Economic Growth and Ensuring Market-Based Reform:*

Stabilizing currencies, restoring Asian and Russian growth and demand, and strengthening market based reform in economies affected by the financial crisis are critical to reducing the steel import pressure on the U.S. market. The President is leading the world in these efforts. This coordinated response is focused on encouraging strong reform programs in affected countries such as South Korea, buttressed by international financial assistance to provide breathing room for the reforms to take hold. We are actively working to discourage competitive devaluations of currencies. The Administration has been urging Japan to provide adequate and sustained fiscal stimulus to restore domestic demand-led growth, a key to recovery in Asia and global economic health. We are pressing Japan and the EU to further open their markets and take their fair share of imports from the crisis economies.

2. *Strong Enforcement of U.S. Laws Against Unfair Trade Practices:* U.S. trade laws provide a strong mechanism to counter import injury from any unfair trade and subsidy practices. The Administration is vigorously, fairly and expeditiously enforcing U.S. trade laws consistent with our international obligations, and taking action to eliminate unfair trade practices.

- Expedited Investigations: Commerce has shifted resources to expedite the recent dumping cases on hot-rolled steel from Japan, Russia and Brazil which were filed by U.S. producers and workers on September 30. Imports covered by these cases account for 52 percent of the steel import growth. Preliminary dumping determinations will be announced in February.
- Critical Circumstances: On November 23, Commerce issued a preliminary ruling of critical circumstances in these investigations with respect to hot rolled sheet imports from Japan and Russia. Based on this finding, if Commerce finds dumping is occurring, importers may be retroactively assessed dumping duties on imports reaching back 90 days before the preliminary dumping determination, to imports dating back to mid-November. The critical circumstances finding has thus put importers on notice of potential dumping

duty assessments. This may already be having an impact on importers' decisions on whether to purchase Japanese and Russian hot-rolled steel.

- Suspension Agreement Negotiations: The dumping laws also allow the United States Government to negotiate agreements that limit imports of products covered by pending dumping cases with non-market economies, such as Russia. In appropriate circumstances, such suspension agreements can be the best and most effective way to enforce our trade laws. In this context, Commerce is exploring whether a possible suspension agreement could provide early, effective, relief from the surge of Russian steel imports consistent with statutory requirements. The Administration is committed to strong enforcement of our trade laws and Commerce will work closely with U.S. industry, unions and Congress throughout this process.
- Existing Dumping and Countervailing Duty Orders on Steel Products: The Department of Commerce is currently enforcing more than 100 antidumping and countervailing duty orders on steel products from a number of countries and over the past year has completed or is conducting 35 new steel investigations.
- Strong New Countervailing Duty Regulations: The Commerce Department recently issued strong new countervailing duty regulations that will strengthen our ability to combat unfair subsidies. Commerce carefully considered the comments received from the steel industry and members of the Steel Caucus in preparing these regulations.

3. ***Early Warning System to Monitor Import Trends:*** The Administration has developed programs to monitor steel imports, as well as foreign government subsidies and commitments under IMF programs. Such monitoring is designed to provide early warning on import trends for sensitive products, and to develop information needed to help ensure that our trading partners are fully abiding by international commitments under the WTO, and under International Financial Institution (IFI) reform programs.

4. ***Section 201 Safeguards Actions:*** The Administration believes that our WTO-consistent safeguards law is an important possible trade remedy to address import surges. We understand that industry is examining possible cases. We are consulting with industry on possible safeguards actions, and we are prepared to ask the International Trade Commission to expedite investigations.

5. ***Bilateral Pressure:*** The President and the Administration are continuing to press our trading partners at every opportunity to end unfair trading practices and subsidization, and to fairly share the burden of absorbing additional steel imports. Efforts have focused on Japan, Korea and Russia, the three countries which account for 78 percent of the increase in our steel imports, and on the European Union (EU).

- During his November visit to Japan -- which accounts for nearly a half of the increase in U.S. steel imports -- the President expressed strong concern about the extraordinary increase in Japan's steel exports to the United States and the resulting impact on the U.S. market. The President underscored the need for fair, rules-based trade, full enforcement of trade commitments and greater market opening. He pressed Japan to adopt and implement effective economic stimulus and reform measures.
- In Korea, the President pressed President Kim to place Korea's steel sector on a market footing, and President Kim agreed to work with the United States to make progress toward this goal. Our steel dialogue with Korea has already produced a Korean Government commitment that Korea's second largest steel producer would be sold and that the government would not support or direct others to support it. The bilateral dialogue has been expanded to include examination of the Korean government's role with respect to other steel producers, including POSCO, Korea's largest -- and the world's second largest -- steel producer. U.S. and Korean officials convene again in January.
- In addition to talks regarding a possible suspension agreement on steel imports, the Administration is working with Russia and the IMF to stabilize the Russian economy, promote market reforms and restore growth, in order to stimulate domestic demand and reduce excess capacity in sectors such as steel. Bilateral U.S. assistance program help develop alternatives to employment in troubled Soviet-era industries such as steel.
- The Administration has pressed the European Union to fairly share the burden of increased steel imports. During the U.S.- EU Summit in December, the President pressed President Santer to open the EU market to greater steel imports from distressed economies such as Russia. The U.S. Trade Representative pursued this issue during her recent tour of European capitals.

6. *ADD SOMETHING ON TAA*

This Administration is committed to effectively addressing the legitimate concerns of steel workers and the steel industry. Free and fair rules-based trade is essential for both global economic recovery and for U.S. prosperity. Actions taken to date have provided a comprehensive response to the steel import situation. We continue to monitor developments and consult with industry and labor representatives, members of Congress, as well as our trading partners, and will take additional action as circumstances warrant.

II. STATE OF THE U.S. STEEL INDUSTRY

Importance of the Steel Industry to the U.S. Economy

The American steel industry is critically important to our economy, including as a vital contributor to the auto, high-tech, and construction industries and many other sectors. The steel industry employs 233,200 American workers and supports employment in many related industrial and service fields.

Internationally, until 1998, the United States had been the world's third largest producer of steel after China and Japan, with production of 110 million metric tons of crude steel in 1997. In 1998, the United States may have become the world's largest steel producer. Over the last several years, due to strong demand and favorable market conditions, U.S. and foreign firms have added substantial new steel capacity in the United States, amounting to about 9 million metric tons. We have a highly competitive industry, which can compete and succeed in a market that is not distorted by subsidies, unfair trade practices and government intervention.

However, many foreign governments continue to view steel production and self-sufficiency in steel as prerequisites to industrialization. Foreign steel industries have often been supported through government subsidies to encourage expansion or forestall restructuring. Overcapacity has been a long-term problem in the industry.

Effects on the U.S. Steel Sector

The chronic problem of overcapacity in the steel sector was compounded in 1998 by the Asian financial crisis and the catastrophic drop in demand in Asia. As a result, a high volume of shipments has been diverted from Asian to North American markets. Aggravating the situation further, Russian steel exports were shifted from Asian to North American markets. Steel import quotas against Russian imports made it difficult to increase Russian exports to the European Union. As a result, steel imports to the United States have surged to the highest level ever. While demand in the United States has remained strong, U.S. steel producers and workers have been adversely affected by the sharp increase in imports and the resulting price suppression.

Through October of 1998, the United States imported 31.4 million metric tons of steel. This represents an increase of nearly 30 percent over the 24.2 million metric tons we imported in the first ten months of 1997. The import increase was particularly pronounced in the second half of 1998, with imports for the June through October 1998 period in 1998 up 52.9 percent over the same period in 1997. Imports of finished steel products grew at an even higher rate and were up 7 million metric tons. Most major foreign steel producers have contributed to this import growth. However, the increase is concentrated in three countries, which together account for 82 percent of the increase, and **[CEA/Commerce :X share of the U.S. market individually and in aggregate]**. . With respect to finished steel imports, they are:

- Japan, now the single largest source of finished steel imports at 4.9 million metric tons through October, up 161 percent or 3.0 million tons, accounts for 42.9 percent of the import growth;
- Korea, now the fourth largest source of imports at 2.5 million metric tons through October, up 132 percent or 1.4 million tons, accounts for 20.4 percent of the import growth; and
- Russia, the second largest supplier at 3.7 million metric tons, up 56 percent or 1.3 million tons through October, accounts for 19 percent of the import growth.

Measured by product category, the largest increase has been in hot rolled carbon flat steel covered by the ongoing dumping trade case, in which imports grew by 3.3 million metric tons. This growth in hot rolled imports accounts for 52 percent of the total import growth we experienced so far in 1998. Japan and Russia together account for 82 percent of this increase.
Commerce: Hot rolled sheet makes up x percent of overall steel imports.

Commerce: Overall steel? import penetration has increased from 22.6 percent in the first ten months of 1997 to 29.5 percent in the comparable period in 1998. For the June through October period, import penetration jumped from 23.5 to 33.6 percent between 1997 and 1998.

Equally dramatic as the growth in import volume has been the steep drop in prices. The average value per metric ton of **type?** steel imports **Commerce: in the U.S.?/world?** had dropped from about \$512 at the beginning of 1998 to \$400 in October 1998. This has placed substantial downward pressure on steel prices in the United States. According to "Salomon Smith Barney" (December 29, 1998): "With three major price cuts in the space of less than five months, hot-rolled sheet prices have dropped from a high of \$320 per ton to \$250 per ton – the lowest in recent history." Price declines have been evident for virtually all steel products.

During this period, U.S. steel production and employment have fallen. U.S. steel shipments declined 7.8 percent, from 41.2 million metric tons in the June through October 1997 period, to 38.0 million tons in the same period in 1998. The American Iron and Steel Institute (AISI) reports that capacity utilization has dropped to 74 percent in November 1998 as compared with 90 percent a year ago. Labor statistics show a 10,000 drop of steel employment from 236,300 to 226,000 workers between November 1997 and November 1998, compared to the average **Labor: annual?** decline of 1,660 workers in the 1992 through 1997 period.

The adverse effect on U.S. producers has been somewhat dampened by continued strong U.S. demand.

Economic recovery in Asia is the single most important cure to preventing contagion to the U.S. economy, relieving excessive import pressures and restoring exports to the region. The U.S. steel industry has experienced the direct effect of large increases in lower priced imports. In addition, our economy has been hit by the indirect effect of price pressures from an oversupply of steel exacerbated by falling demand in Asia and Russia. In the absence of international

efforts to stabilize the economies and currencies of countries affected by the crisis, it is likely that currencies would have fallen even further and the effects on our trade flows would have been even larger.

III. STEEL ACTION PLAN

1. Restoring Global demand and Ensuring Market-Based Reform [THIS SECTION NEEDS TO BE CUT DOWN AND MADE MORE DIRECTLY RELEVANT TO STEEL, SECTIONS THAT ARE NOT OR ARE REDUNDANT OF BILATERAL SECTION NEED TO BE DROPPED],

The Administration's highest priority has been restoring growth in Asia and preventing contagion from the Asian crisis on the U.S. economy. Restored growth in Asia will result in revived demand for steel in the region, and will reduce the import pressure on the U.S. market. In the context of stabilization programs of International Financial Institutions (IFIs), the Administration has also supported strong provisions for reform in beneficiary countries, designed to improve governance, increase transparency and reduce government involvement in industrial decision-making. These conditions should reduce the likelihood of future crises, and reduce policies which have lead to politically-motivated investments, such as have occurred and led to overcapacity in the steel sector.

The Administration has worked within the international community to develop a coordinated response to the Asian financial crisis, focusing on four areas.

Strong reform programs within the affected countries

The approach of the international community to the Asian financial crisis emphasized programs designed in conjunction with the IMF, World Bank, and Asian Development Bank that require nations to take concrete steps to reform their economies. The goal of these reforms is to restore financial stability, promote stronger and more stable exchange rates, attract new capital, address underlying structural weaknesses, and restore economic growth. The IMF programs were designed to address the specific issues facing each nation, and were based on strengthening financial systems, opening markets to both capital and trade, and following appropriate monetary and fiscal policies. In Korea and Indonesia, the programs have also included strong structural reforms designed to increase competition, enhance transparency and disclosure, and improve governance in the public and private sectors. The Korean government has also agreed to end its involvement in directing lending decisions by Korean commercial banks. In addition, each country has worked towards a framework for the restructuring of large debt loads and improving oversight and regulation of the banking system.

The Administration is carefully monitoring the subsidy and trade-related commitments made by IMF fund recipients as part of their IMF stabilization packages. These conditions should eliminate a wide range of practices that may confer unfair subsidies, including many

which Commerce has found actionable in past subsidy cases. The Administration is monitoring the market-opening commitments of the stabilization packages as well. These commitments include tariff reductions, removal of certain import restrictions, changes in public procurement practices and liberalization of the financial services markets, all of which should improve access to these markets for U.S. exporters, many of which use U.S.-made steel in their production process.

The Secretary of Treasury has recently certified with respect to Korea, that: “(1) no Fund resources made available pursuant to the Arrangement have been used to provide financial assistance to the semiconductor, steel, automobile, shipbuilding, or textile and apparel industries; (2) the Fund has neither guaranteed nor underwritten the private loans of semiconductor, steel, automobile, shipbuilding, or textile and apparel manufacturers under the Arrangement; and (3) officials from the Fund and the Department of the Treasury have monitored the implementation of the provisions contained in the Arrangement, and all of the conditions have either been met or the Republic of Korea has committed itself to fulfill all of these conditions according to an explicit timetable for completion.”

International financial assistance

The IMF programs adopted by these countries have been supported by temporary financial assistance from the International Monetary Fund and other international financial institutions to bolster reserves, to provide breathing room for the reforms to take hold, to help restore confidence, and to prevent a deeper, more prolonged crisis. There are careful constraints on how these resources are used. The United States also mobilized a multilateral effort to restore trade financing to Asia, in which G7 and OECD export credit agencies pledged to remain open for business in Asia.

Encouraging growth in Japan

The United States has been urging Japan to provide adequate and sustained fiscal stimulus to restore domestic demand-led growth. We have stressed the need for Japan to continue to take action to strengthen its banking system and to use public funds effectively, with appropriate conditions, including stronger disclosure and steps to clean up the banks' balance sheets and permanently dispose of bad assets. Japan's recent measures represent an important beginning to address these problems. However, lack of reform conditionality dilutes the effectiveness of Japan's actions. We have also advocated that Japan accelerate steps to deregulate its economy and open its markets. Progress in these areas is necessary to achieve a sustained resumption of growth and would help to make Japan's economy more efficient and competitive.

Support for open markets

The United States has been a strong advocate of open markets and continued international efforts to liberalize trade. We have encouraged Europe, Japan and other countries to do their fair share in permitting access to their markets for crisis countries. Central to our policy of

ensuring that other countries uphold their international commitments is the vigorous enforcement of our trade laws.

Since September 1998, the United States has worked with other G-7 industrial nations to put in place additional measures designed to enhance the global community's ability to respond to future financial crises. These include the recent decision by key G-7 Central Banks to help maintain strong growth in our economies, final agreement on the IMF quota increase and the New Arrangements to Borrow, a G-7 agreement on a new IMF mechanism for contingent finance to help other regions avoid contagion, measures to accelerate corporate debt restructuring and to revitalize private sector growth in Asia, and increased World Bank and Asian Development Bank assistance to protect the most vulnerable in society. We also are working to find better preventive measures to reduce the frequency and severity of global financial challenges and to strengthen the international financial architecture. These steps should significantly strengthen the international financial system, help to reduce the risk that this crisis could intensify, and promote the prospect of the earliest possible return to growth in emerging markets.

2. Strong Enforcement of U.S. Trade Laws

U.S. trade laws provide a strong mechanism to counter unfair trade practices, unfair subsidies and import injury from surges. This Administration is committed to aggressively enforcing U.S. trade laws to address the adverse impact that unfairly traded steel imports have on U.S. steel companies and American jobs. The Commerce Department currently enforces over 100 antidumping and countervailing duty orders covering various steel products from 30 countries.

Early Enforcement Actions

Since late 1997 Commerce has taken a number of strong enforcement actions with respect to steel. In October 1997, Commerce concluded four suspension agreements on cut-to-length plate from China, Russia, South Africa and Ukraine. These agreements provide strong relief to steel plate producers by ensuring that plate imports from these countries are fairly priced and by reducing imports of Chinese, Russian and Ukrainian plate by 45, 55 and 72 percent, respectively. During the first six months of 1998, Commerce completed or initiated 31 antidumping and countervailing duty investigations on a variety of stainless steel products, such as stainless steel wire rod, sheet and strip, plate in coils and round wire. A number of these investigations are still ongoing.

In these investigations, Commerce is looking at possible unfair pricing of exports from a range of countries as well possible subsidies provided to the stainless steel industry. One subsidy allegation considered POSCO's two-tiered pricing system in the domestic market depending upon the purchasers' anticipated export performance. On November 17, 1998, Commerce made a preliminary finding that this practice is countervailable. The final ruling on this issue currently is scheduled for early March 1999.

Expedited Investigations

On September 30, U.S. domestic producers and unions filed petitions for antidumping and countervailing duty relief on imports of hot-rolled steel products from Japan, Russia, and Brazil. The most dramatic import surges in steel imports have occurred in these products which make up the bulk of the steel trade. Imports of Japanese hot-rolled steel products in the first 10 months of 1998 have increased almost 400 percent over the same period in 1997, a record year for imports, while imports of Russian hot-rolled steel products have increased 71 percent. Commerce immediately shifted resources to ensure that our trade laws would be enforced as vigorously and as expeditiously as possible. Commerce initiated the cases five days ahead of the statutory deadline and has committed to expediting the preliminary decisions in those cases up to 20 days prior to the statutory deadline, while preserving the right of all parties to due process. This schedule would result in the issuance of the preliminary determination on February 12, an unprecedented 25 days early.

Critical Circumstances

On November 23, 1998, Commerce issued a preliminary finding of critical circumstances with respect to Russia and Japan. The finding makes clear that, if Commerce finds dumping in its preliminary determinations of dumping, importers will potentially be liable for duties retroactively. This means that, if both Commerce and the ITC make final critical circumstances findings, any dumping margin found will be applied to all imports entered as of November 14, 1998, ninety days before the preliminary dumping determination scheduled for February 12, 1999. As a result, importers are on notice now they may face increased retroactive duties. This could lead to reduced imports right away.

Strong New CVD Regulations

Over the past year, Commerce has been working on several sets of regulations that reflect the Administration's strong commitment to fighting unfair trade practices. In November, Commerce released final countervailing duty regulations that will guide its analysis and calculation of the benefit from foreign subsidies. In preparing these regulations, Commerce considered carefully the comments received, including those of the steel industry and Members of Congress. The final regulations are designed to enhance strong enforcement of the trade laws, and send an important signal to our trading partners that we will not tolerate the subsidization of imports that harm our industries and workers.

For example, one area where the subsidy rules were strengthened concerned the government's provision of equity to an unhealthy company. Consistent with many of the comments received, a final rule was adopted that treats the entire amount of the equity infusion as a grant which raises the offsetting duty. Likewise, the rules regarding government loans to uncreditworthy companies have been strengthened to better account for the increased risk associated with lending to such companies. In

addition, Commerce addressed the concerns raised by many industries and members of Congress that the transnational subsidies rule, which exempts international development assistance from the countervailing duty law, would allow recipient countries to use IMF funds to subsidize their industries with complete immunity from the U.S. countervailing duty law. The final regulations make it clear that foreign governments cannot try to exempt ordinary subsidy programs under the transnational rule by merely claiming a link to international funds.

Commerce also recently released regulations and a policy bulletin concerning sunset reviews. These reviews, which are required to be conducted every five years under U.S. law and the WTO, determine whether an antidumping or countervailing duty order is still needed to address dumping or unfair subsidies and injury. Commerce has set out tough, but fair, rules regarding sunset reviews to ensure that orders that are necessary to remedy unfair trade practices are not revoked.

Eliminating Subsidies and Directed Lending

Foreign steel industries, therefore, have often been supported through government subsidies to encourage expansion or to forestall restructuring and lay-offs. Global overcapacity remains a serious problem in the industry. Through bilateral efforts, multilateral fora such as the OECD Steel Committee and the WTO, and through strict enforcement of our countervailing duty laws, the Administration is taking forceful action to eliminate improper government involvement in important sectors such as steel.

When the financial crisis began to spread in 1997, a number of U.S. industries, particularly the steel and semiconductor industries, expressed concern that foreign governments would resort to subsidies in an attempt to export their way out of the crisis. Commerce's Subsidies Enforcement Office responded by expanding its activities and working closely with USTR to evaluate industry concerns about possible new subsidies abroad. As a result of these activities, the Administration has actively engaged a number of countries to address subsidy concerns. Our considerable bilateral efforts with respect to the subsidies in the Korean steel industry are described in the next section of this report.

Commerce, USTR and Treasury have taken numerous steps to address the problem of government directed lending (i.e., the practice of certain governments to influence commercial banks to lend to favored industries at preferred rates), particularly with respect to the Korean steel and semiconductor industries. All three agencies have been carefully monitoring the Korean government's lending practices and involvement in the Korean financial sector, and have paid close attention to banking reforms and recent government restructuring funds for Korean industries. The issue of Korean government directed lending to strategic industries such as steel or semiconductors has been raised on numerous occasions with the Korean government and Korean industries, by the President and the Secretaries of State, Treasury, Commerce and the United States Trade Representative. The elimination of directed lending is a key element of Korea's IMF program. Potential subsidies from alleged government directed lending to the steel industry are also being examined by Commerce in two ongoing Korean countervailing duty

investigations on certain stainless steel products, along with several other alleged subsidy practices. These cases are currently scheduled to be completed in March and April 1999.

III. Early Warning System: Enhanced Import Monitoring

In anticipation of potential trade problems arising out of the global financial crisis, early in 1998, Commerce put in place an extensive import monitoring program that closely tracks imports and prices in key import-sensitive sectors, such as steel, semiconductors, autos, paper, textiles and chemicals. This program was designed to provide an early warning system that the Administration could use to formulate a swift response to potential import surges. With respect to steel, we have enhanced our monitoring efforts by obtaining for internal government use preliminary Census data on steel imports 20 days prior to the official release date.

The Administration is also creating a Steel Data Task Force to monitor industry trends and support industry cases.

IV. Section 201

The Administration supports the availability to U.S. producers and workers of a strong and effective safeguards mechanism to enable them to avoid injury resulting from rapid changes in the global economy and to facilitate adjustment. This type of "safeguard" has long been sanctioned by the GATT and now the WTO. The safeguards law enables the President to fashion the remedy most appropriate to the industry involved, and, where appropriate, requires the industry to take adjustment steps to enhance its competitiveness. Obtaining relief under the U.S. safeguards mechanism, Section 201 of the 1974 Trade Act, involves a two-step process. First, the U.S. International Trade Commission (ITC) conducts an investigation to determine whether increased imports [have led to] [are a "substantial cause" of] serious injury or threat of serious injury to the domestic industry producing a like or directly competitive product. Second, if the ITC makes an affirmative determination, the President weighs a variety of factors in deciding whether relief will be granted and in what form. Expedited procedures are available.

The Administration fully supports the industry's right to avail itself of the safeguards mechanism under U.S. law, where circumstances justify such action. On December 30, 1998, the U.S. steel wire rod industry and the United Steel Workers of America filed a petition with the International Trade Commission requesting relief pursuant to Section 201. This petition will give the ITC the opportunity to evaluate the evidence, to decide whether a trade remedy is warranted, and to recommend what it should be. If an affirmative determination is reached, the President will decide on the appropriate response. Consistent with the Administration's determination to date to act expeditiously and vigorously to enforce U.S. trade laws, any affirmative ITC recommendations will be acted on in a timely manner, and in full consultation with interested parties, consistent with U.S. law.

[Administration representatives have met with steel producers and workers to review their request that the Administration be prepared to, in consultation with the industry, self-initiate

trade actions, including action under Section 201. While we actively assess the impact of steps taken to date, all options remain under review, and meetings with industry and labor representatives will continue.]

V. Bilateral Initiatives to Eliminate Unfair Trade Practices and Ensure Equitable Burden Sharing [following has been cleared by Justice]

At the outset of the steel import crisis, the Administration engaged steel exporting and importing countries in consultations aimed at ensuring fair trade and sharing of the import burden. The President personally expressed his deep concern about the impact of increased imports and the need for fair trade, both in public and in private meetings, including in his recent visits to Japan and South Korea and in recent meetings with European leaders. The Vice President expressed strong concern about the surge in imports from Russia during his recent meeting at the November APEC meeting in Kuala Lumpur with Prime Minister Primakov, and strongly urged the EU to open their markets and absorb their fair share of imports in his speech to the TransAtlantic Business Dialogue. During her recent visit to European capitals, Ambassador Barshefsky pressed the European Commission and member states to share the burden of increased steel exports, particularly with respect to Russia and Japan, two countries which account for the bulk of the existing excess steel supply, and from which the United States has taken a substantially higher share of steel imports.

The Administration has particularly urged Japan, Russia and Korea, three countries which account for eighty percent of our steel import growth, to respect established international rules and to trade fairly, including refraining from subsidization and dumping.

Japan

A weak Japanese economy continues to be one of the largest impediments to economic recovery in Asia, and a significant cause of the surge in low-priced steel imports into the United States. Japan's producers have experienced a sharp decline in domestic and regional demand for steel and for finished products that contain steel. As a result, they have re-directed a large portion of their excess steel production to the U.S. market.

Japan moved from being the third largest supplier of steel imports into the U.S. market in 1997, to being the largest source of U.S. steel imports, and was responsible for 43 percent of the increase in U.S. finished steel imports in the first ten months of 1998. While U.S. imports from Japan have surged in a number of steel products, 50 percent, or 1.5 million metric tons, of the import growth has been in hot rolled sheet products. These hot rolled steel imports are now subject to the dumping investigation described above. **Commerce/USTR/CEA: Any information on Japanese steel imports?**

Pressing Japan to take the necessary steps to achieve economic recovery has been a key element of the Administration's economic and trade policy. Specifically, the Administration has urged Japan, in the strongest terms, to stimulate its economy, reform its banking sector, and deregulate and open its market to international competition. Swift and effective implementation of these policies in Japan would be the single most effective way to restore growth and demand in Asia, thereby reducing steel import pressures on U.S. producers and workers and stimulating exports of U.S. goods and services.

During his November visit to Japan, in addition to pressing the Japanese Government to take the steps necessary to stimulate domestic demand-led growth, strengthen its financial system and open and deregulate its markets, the President expressed serious concerns about the significant increase in Japanese steel exports to the United States, both in his public statements and in his private meeting with Prime Minister Obuchi. Citing a nearly five-fold increase in U.S. imports of Japanese hot rolled sheet, the President underscored the need for fair, rules-based trade and greater market opening, as well as the need to "avoid market penetrations that have no relationship to market forces." Ambassador Barshefsky has made it clear that Japan cannot expect to export its way out of its recession; rather, it must take decisive and immediate steps to revive its economy and consequently its domestic demand for steel.

Japanese officials have argued that, based on a combination of economic stimulus programs in Japan, steps by Japanese steel producers to reduce production, and the saturation of the U.S. market, accompanied by trade actions taken by U.S. steel workers and producers, Japan's 1999 steel exports to the United States would revert close to their 1997 level. Japan's export data for November reflects exports to the United States of 97,000 metric tons of hot rolled sheet. While this level is still substantially higher than the average 1997 monthly exports to the United States of 49,000 tons in this product, it is substantially lower than the average exports of 290,000 for June through October 1998. However, this trend, if accurate, would be reflected in the U.S. Census Bureau import statistics for December 1998, which will be available towards the end of February 1999.

The Administration remains concerned about allegations by U.S. steel producers of collusive private activities in international steel trade that may have the effect of artificially diverting Japanese steel exports from European to U.S. markets. The Administration has pressed these concerns with the appropriate EU and Japanese officials to ensure that any such activities are dealt with vigorously and effectively.

Korea

The United States has pursued an intensive dialogue with Korea aimed at ensuring that the Korean steel sector operates on a market-driven basis. This dialogue has been comprehensive, sustained, and conducted at all levels of government. On November 21, President Clinton stressed to Korean President Kim Dae Jung the need for further progress in our expanded steel dialogue and emphasized that “special care” must be taken to “prevent unfair trade practices or subsidization in sensitive sectors like steel and semiconductors.”

In response to a complaint from U.S. steel producers, alleging that Hanbo Iron and Steel (Hanbo), a Korean mini-mill, had been provided government subsidies, Ambassador Barshefsky and Secretary Daley engaged the Government of the Republic of Korea (ROKG) in substantive and detailed consultations on this issue. Through these consultations, the Administration obtained written assurances from the ROKG that it will not support or direct others to support Hanbo. Hanbo has now temporarily shut down production of hot-rolled sheet. We also have received assurances that the Hanbo creditors and the independent agent managing the sale of Hanbo will take all steps necessary to effectuate a market-driven sale. We continue to monitor these assurances. These ROKG undertakings constitute the most timely, direct and commercially meaningful means to address our industry’s concerns about Hanbo.

The Administration also expanded the steel dialogue to encompass broader concerns about the Korean steel industry -- in particular, regarding two other Korean steel producers: Pohang Iron and Steel Company (POSCO), the world’s second largest steel producer, and Dongkuk, a large producer of cut plate exports to the United States. With respect to POSCO, our goal is to ensure that the company is fully and expeditiously privatized. Effective privatization of POSCO would help ensure that its pricing, production and other business decisions are made at arm’s length from the Korean government, thereby addressing industry concerns about POSCO’s operations.

In response to the Korean government’s announcement of its plans to privatize POSCO, and U.S. industry’s interest in seeing the ROKG’s ties with POSCO severed, USTR officials initiated detailed bilateral discussions about Korea’s plans in this regard, and strongly urged the ROKG to expeditiously complete this process. On December 9, 1998, the ROKG sold 5.1 percent of its 33 percent stake in POSCO through a stock offering on the New York and London exchanges, and further steps are anticipated shortly. The Administration is also seeking to ensure that other Korean steel producers, including Dongkuk, a large exporter of cut plate to the United States, are not benefitting from ROKG support. Additionally, the Administration has emphasized that Korean steel exports to the United States from companies such as Dongkuk, which are supplied with inputs from POSCO, must be traded fairly and must not be afforded an unfair advantage over U.S. companies through market-distorting subsidies. Over the coming months, the Administration will continue the dialogue with the ROKG with a view to addressing

concerns U.S. steel producers and workers have raised about possible unfair trade practices. The next round of bilateral discussion is scheduled for January.

Separately, on November 17, 1998, the Commerce Department made a preliminary finding in a CVD investigation on POSCO's stainless coil sales, that the company's practice of charging different prices for the coil based upon the purchaser's anticipated export performance meets the definition of an export subsidy under U.S. law and, therefore, is countervailable. The final ruling on this issue currently is scheduled for early March 1999. HOW MANY ORDERS ARE NOW IN PLACE AGAINST KOREA?

Russia

The economic crisis in Asia and Russia have seriously depressed demand for Russian steel. By September 1998, Russia's GDP had declined 9.9% compared with September 1997 and industrial output had declined 14.5% in the same period. GDP and industrial output are now roughly half of their 1989 levels. GDP may further decline by as much as 5% in 1999. The slump in exports to Asia, and European Union import quotas restricting steel imports from Russia, increased exports to the United States as Russian producers sought new markets for their steel. The OECD estimates that consumption of steel in Russia has declined to 26% of 1992 levels, and that Russia exported 51% of its steel production in 1998, compared to 12% in 1992. It also notes that pricing of Russian steel exports has often been uneconomic because of a lack of standard accounting principles, the use of barter and a lack of familiarity by producers with market conditions and established distribution channels in export markets. [At the November 4-5 OECD Steel Committee meeting, OECD member states recommended, inter alia, training for Russian steel mill managers in pricing and marketing principles and in use of steel-intensive technologies like steel-frame housing to boost domestic demand and improve pricing..]

U.S. imports of finished steel products from Russia increased 56 percent or 1.3 million metric tons in the first ten months of 1998 over the same period in 1997. Imports of hot rolled sheet accounted for 1.1 million metric tons or 85 percent of that growth. Hot rolled sheet imports are now subject to a dumping investigation by the Department of Commerce, pursuant to a petition filed on September 30, 1998 by U.S. producers and workers. The Commerce Department critical circumstances finding described above can lead to the retroactive application of dumping duties.

The dumping law allows the United States Government to negotiate agreements that limit imports of products covered by pending dumping cases with non-market economies, such as Russia. In appropriate circumstances, such suspension agreements can be the most effective way to enforce our trade laws. In this context, Commerce is exploring whether a possible suspension agreement could provide early and effective relief from the surge of Russian steel imports. The Administration is committed to strong enforcement of our trade laws and Commerce will work closely with U.S. industry, unions and Congress throughout this process.

At the same time, the Administration is continuing efforts to stabilize the Russian economy, promote market based reforms, and restore growth, all of which will over the longer term reduce excess capacity in sectors such as steel and stimulate domestic demand. The President, at his summit meeting with Russian President Yeltsin in Moscow, the Vice President, in his meeting with Prime Minister Primakov in Kuala Lumpur, and other U.S. officials including the Secretaries of State and Treasury have all urged Russia to stay engaged with the IMF and to push ahead with stabilization and growth-oriented reform.

European Union

The Administration has been concerned that the EU quotas on steel imports from several former Soviet Republics, and Russia in particular, may be causing a diversion of Russian steel exports into the United States. We are also concerned that the EU may not be bearing an equitable burden of the Asian steel export surge and, in particular, that the EU's imports from Japan are only a fraction of ours. U.S. industry representatives have alleged that a primary reason for the low rate of Japanese exports to the EU may be the existence of anticompetitive understandings between European and Japanese producers.

The Administration has undertaken a detailed comparison of U.S. and EU steel trade data, and U.S. government officials have discussed this issue at various levels with officials of the European Commission, the EU Presidency and with member states. Similar to the United States, the EU experienced a substantial increase of steel imports following the Asian crisis, as well as a drop in steel exports. Through August of 1998 (the most recent import data available in the EU), U.S. and EU imports grew by an equivalent amount -- 4.7 million metric tons for the United States compared to 4.8 million for the EU. The EU has traditionally been a net steel exporter, and its imports grew from a lower base, and thus the growth has been higher in percentage terms (53 percent compared to 24 percent in the United States). At 24 million metric tons through August 1998, U.S. steel imports were about double the EU imports of 13 million tons.

However, due to import quotas and licensing requirements on imports from Russia, EU imports from that country through August 1998 remained flat from the year before, at 1.1 million metric tons. This compares to U.S. imports from Russia of 2.9 million metric tons in the same period. Due to the substantial steel overcapacity in Russia and the strong demand in the EU, we believe that Russia's exports to the EU would also have grown substantially, were it not for import restraints. We have therefore urged the European Commission to review its import licensing and quota arrangements with Russia and other former Soviet republics, with a view to accommodating additional tonnage. We understand that the government of Russia is seeking quota increases.

The Administration pressed the European Union to bear its share of absorbing the excess supply of steel in the world market on various occasions. President Clinton raised the issue during the U.S.-EU Summit in Washington on December 18. In her recent visit to Brussels, Germany, France and Britain, Ambassador Barshefsky underscored that the EU's steel imports from Russia are less than half the volume of U.S. imports from Russia, and its steel imports from Japan are only a tenth of Japan's shipments to the United States, and asked that barriers to imports be reviewed. [Quote from VP]

In addition, we have pressed the EU to examine the reasons for the low levels of imports from Japan. The Administration will be alert to evidence of possible collusive private activities in international steel trade that may have the effect of artificially diverting Japanese steel exports from European to U.S. markets.

6. Adjustment Assistance for Steelworkers and their Communities

Steel Task Force and Steel Coordinator

This Administration believes it is important to help workers and communities adversely affected by international trade get back on their feet. No adjustment plan can avoid the pain of layoffs and dislocation altogether, but rapid action to provide workers and communities with adjustment assistance can limit the dislocation and speed the pace of economic recovery.

Because the trade-related problems affecting steelworkers and their communities are so severe, the Administration will appoint a high-level White House official to coordinate adjustment assistance. Borrowing a page from the Administration's successful adjustment effort for base closure communities, this individual will convene an interagency task force on steel adjustment assistance to help workers and communities identify and access the full range of federal resources. The task force will include the Departments of Labor, Commerce, Housing and Urban Development, Transportation, Education, Health and Human Services, Energy and Interior, as well as the Small Business Administration.

Key Adjustment Assistance Programs

Two federal departments, Labor and Commerce, play particularly important roles in trade-related adjustment assistance. The Department of Labor has two programs to assist dislocated workers, including steelworkers harmed by increased foreign imports. *Title III of the Job Training Partnership Act (JTPA)* provides funds to states and local grantees to support:

- On-site assistance when major layoffs are announced ("rapid response");
- Readjustment services such as skill assessment and job search assistance;
- Retraining in demand occupations; and

- Support services such as child care and income support that allow workers to participate in training.

Workers whose jobs are lost to an important degree as a result of increased imports are eligible for the *Trade Adjustment Assistance (TAA) program*. TAA provides an array of benefits and services, including up to 104 weeks of approved training; job search and relocation allowances; and “trade readjustment allowances” (income support) while in training following exhaustion of Unemployment Insurance. (Workers who are subject to recall by their former employers may qualify for trade readjustment allowances, even without entering training, after their UI has been exhausted.)

Since October 1, 1997, the Department of Labor has received petitions seeking TAA certification from workers in 33 steel and steel products plants. DOL has certified 20 of the 33 petitions, covering approximately 3300 workers. DOL is still reviewing the remaining 13 petitions (all of which were received in the last three months), which cover approximately 2600 workers.

The Department of Commerce’s Economic Development Administration (EDA) is the major source of assistance for communities hurt by steel imports. Under its Economic Adjustment Program, EDA can provide: 1) strategy or technical assistance grants, to help a community develop an economic adjustment strategy; 2) Revolving Loan Funds (RLFs), to help support small business start-up or expansion activities; and 3) grants for physical infrastructure improvements, including development of a business incubator or industrial park. EDA can respond to an application for a strategy grant in as little as 2-4 weeks. And through its 12 regional Trade Adjustment Assistance Centers, EDA can provide technical and consultant assistance to small firms affected by foreign competition (e.g., supplier firms to a large steel plant).

In its FY99 budget, the Administration requested \$50 million for a new EDA Office of Community and Economic Adjustment, specifically to assist communities harmed by foreign competition. Although Congress did not approve the new office, it did provide the additional \$50 million for EDA’s Economic Adjustment Program, and those funds are now available for, among others, communities harmed by increased steel imports.

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