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TEXT:

Janet, thanks for tthe revised draft. I will get this week agency comments on the second draft (already received those by the Fed) and will work on another semi-final revision.

Nouriel

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TEXT:

Attached is a revised draft of Chapter 6 with my edits. ===== ATTACHMENT 1
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Chapter 6: Capital Flows in the Global Economy

1. INTRODUCTION

Last year international financial developments posed serious challenges for the world economy. What began in the summer of 1997 as a regional currency crisis in developing Southeast Asia, erupted into a deep, global economic crisis in 1998. By late summer, the crisis had extended to many other markets and to economies around the globe. The eruption of severe financial and economic turmoil in Russia in August immediately threatened contagion to Latin American markets. Interest rates in emerging market countries rose sharply and risk premia on their sovereign bonds increased as a consequence of large scale capital flight. Many countries experienced sharp depreciations of their currencies or severe strains on their foreign exchange reserves. Prices of stocks, bonds and other financial and real assets plummeted. Commodity prices continued to fall, engendering talk of global deflation. Ultimately the financial market turbulence led to a general flight from risky assets even within the United States and Western Europe. Japan's hopes for recovery from a long-standing slump were dashed.

A third of all world economies were in recession or experiencing markedly slower growth by late 1998. World economic growth is estimated by the International Monetary Fund (IMF) at only 2.2 percent in 1998 and is projected to remain at this depressed level in 1999, after robust growth of 4.2 percent in 1997. Ominously, projected world growth has almost declined to levels registered during the pronounced world slowdowns of 1974-75, 1980-83, and 1990-91.

The risk of a more severe worldwide economic slowdown has increased, posing new challenges to economic policy.

This widespread financial turmoil -- arguably the most severe experienced by the world economy during the last 50 years -- followed a robust period of increasing integration of world product and financial markets. World trade has increased dramatically as trade restrictions have progressively fallen and many countries have embraced historic openness to international trade. At the same time, restrictions on capital flows have been eased and financial markets have become increasingly integrated, leading to an unprecedented volume of international capital flows.

This turbulent period should not cloud the benefits of globalization. Market integration has provided greater opportunity, faster growth, and increasing standards of living for a large share of the world's population. Trade among countries has fueled growth by harnessing the benefits of comparative advantage and providing dynamic stimulus to productivity. Financial integration also has advantages. Open capital markets have promoted growth by allocating capital to countries whose domestic investment opportunities exceed domestic saving. Portfolio flows across the world have allowed diversification of risk. The knowledge that global investors are watching over their shoulders may have helped governments achieve discipline in the pursuit of responsible monetary and fiscal policies.

In response to the widespread financial turmoil in 1997-98, the United States, together with other countries and the international financial institutions, has taken steps to contain the financial crisis, to restart the engine of growth in Asia, to minimize the impact of financial

turmoil on other nations and to foster reforms of the international financial system in order to make it less crisis-prone. Positive developments during the last quarter of 1998 include: reductions in interest rates by the Federal Reserve and the central banks of many other industrial and emerging market countries designed to support growth; an IMF stabilization package for Brazil aimed at preventing a crisis in that country and stemming regional contagion; steps toward structural banking reform and stronger fiscal stimulus in Japan; and a strengthening of the yen that may reduce the risk of further currency depreciations in Asia. These measures serve to promote confidence and improve the prospects for growth in the world economy in 1999.

This chapter starts with an analysis of the factors responsible for increased global financial integration. The causes of the Asian crisis and its contagion to other economies, the policy response to the global turmoil, and the role of Japan are considered next. The chapter concludes with an analysis of the effects of the international financial crisis on the United States.

Chapter 7 is devoted to a discussion of developments in the international financial system and proposed reforms to its architecture to reduce the likelihood of future crises. The prospects for the European Monetary Union and the implications of the creation of the euro for the U.S. dollar are also discussed.

2. FINANCIAL GLOBALIZATION, EMERGING MARKETS, AND CRISES

INCREASED INTERNATIONAL CAPITAL FLOWS

The growth of international capital flows is one of the major economic developments in

the world economy since the breakdown of the Bretton Woods system of fixed exchange rates in the early 1970s. Financial intermediation on a global scale was spurred by the first oil shock of 1973-1974: surpluses in oil exporting countries had to be invested, and deficits among oil importers had to be financed. This recycling of 'petrodollars', together with the growth of Euromarkets--offshore markets for deposits and loans denominated in key currencies, particularly the dollar--led to a surge of international capital flows. In the late 1970s, many developing countries gained access to international capital markets, enabling them to finance growing external imbalances. Most of the intermediation occurred through the banking system, leading to large exposures among industrial countries' banks to developing countries.

An excessive build-up of external liabilities, together with loose monetary and fiscal policies in borrowing countries, triggered the debt crisis of the 1980s, which started with the Mexican crisis of 1982 and rapidly engulfed a large number of developing countries in Latin America and elsewhere. The 1980s were a period of retrenchment with a significant slowdown of capital flows to emerging markets as foreign debts were rescheduled, restructured, and finally reduced with the inception of the Brady Plan in 1989.

The resolution of the 1980s debt crisis led to new large-scale capital inflows to emerging markets in the 1990s. Factors encouraging the renewed surge of private capital flows included the adoption in many Latin American countries of policies emphasizing economic liberalization, privatization, market opening, and macroeconomic stability; the historic transition toward market economies in many Central and East European countries; and rapid economic growth in Asia. Net long-term private flows to developing countries increased from \$42 billion in 1990 to \$256

billion in 1997. The largest portion of these flows took the form of foreign direct investment, which totaled \$120 billion in 1997 (see Chart 6-1). However, bond flows and portfolio equity flows accounted for xx percent of lending, registering \$54 billion and \$32 billion, respectively, in 1997. In contrast, commercial bank loans represented only 21% of net flows, or \$54 billion in 1997, whereas they had accounted for about two-thirds of net capital flows to developing economies in the 1970s. This massive switch from bank lending, characterized by a small number of substantial lenders, to securitized flows brought with it new challenges relating to the management of financial crises, as the problem of coordinating the actions of a large number of creditors to restructure loans during a crisis is exceedingly difficult.

Table 6-1 reports gross inflows and outflows of foreign direct investment and portfolio investment (two of the main components of capital flows) for both developing and industrial countries. Two points are noteworthy. First, while net flows have been large and growing, the magnitude of gross flows are perhaps a better indicator of financial integration. As domestic investors diversify their portfolios by purchasing foreign assets, and foreign investors also increase their purchases of domestic assets, gross flows may increase substantially without significant changes in net flows. Gross cross-border capital inflows and outflows have in fact grown even faster than net flows. Second, the phenomenon of rising cross-border capital flows applies equally to developing and developed countries. Although the Mexican peso crisis of December 1994 led to a modest slowdown in the surge of capital to emerging markets in 1995, capital flows surged again until the explosion of the Asian crisis in the summer of 1997.

Further evidence of the strong trend towards financial integration is the sharp growth of

foreign exchange trading both in spot markets and via the use of foreign exchange derivative instruments, including forward transactions; such trading is mainly related to financial transactions and has mushroomed at a much faster rate than international trade in goods over the last two decades (Box 6-1).

Box 6-1. The explosive growth of foreign exchange trading.

The single statistic that perhaps best illustrates the dramatic increase in the size of international financial markets is the volume of trading in the world's foreign exchange markets. The Bank for International Settlements, the central banks' bank established in Basle, Switzerland, released a preliminary compilation of a triennial survey of 43 foreign exchange markets in October 1998. It shows that, after correcting for the appreciation of the dollar, the volume of foreign exchange trading grew 46 percent between April 1995 and April 1998, following a 45 percent increase between 1992 and 1995. Volume now stands at \$1.5 trillion per day, after making corrections to avoid double-counting. By way of comparison, the global volume of merchandise trade in 1997 was \$5.5 trillion *per year*, or about \$22 billion per day. In other words, foreign exchange trading was more than sixty times as great as trade in goods.

Spot transactions vs. Derivatives. Foreign exchange transactions can be divided into spot and derivative, including forward, transactions. In the new survey, spot market purchases amounted to 40 percent of foreign exchange transactions, down from 44 percent in 1995. Forward instruments continued to grow in importance relative to spot sales. Over-the-counter derivatives, though still a smaller fraction of total transactions, have been the fastest-growing

segment of the market.

Customer Composition. A striking feature of the foreign exchange market is the low percentage of trades made on behalf of ultimate customers. In the most recent survey, the share of total transactions involving non-financial customers represents 20 per cent of all turnover.

The major forex centers. Trading tends to be focused in major centers. Arguably there is a natural equilibrium consisting of one major center in each of the three eight-hour time zones.

New York is the major center in the Western Hemisphere, with U.S. volume now equal to \$351 billion per day (18 percent of world turnover). Tokyo in the 1980s established itself as the counterpart in the Asian time zone. Its turnover, however, has fallen off recently, as Singaporean markets have gained. Average daily transactions totaled \$149 billion (8 percent of world total) in Japan and \$139 billion in Singapore. London continues to handle the greatest volume of foreign exchange transactions, with the UK share of world turnover increasing to 32 percent, at an average daily volume of \$637 billion.

To summarize, the volume of world trade in foreign exchange has continued to grow. Derivatives far exceed spot market transactions. Most trades take place between professional traders at banks and other financial institutions; only a fraction of foreign exchange sales and purchases directly involve those who ultimately import and export goods, services, and securities.

UNDERLYING CAUSES OF INCREASED INTERNATIONAL FLOWS IN INDUSTRIAL AND EMERGING MARKETS

[Automated Records Management System Hex-Dump Conversion]

Several factors undoubtedly contributed to the phenomenal growth of international capital flows. First, financial markets, both domestic and international, have opened up as governments in industrial and developing economies alike have phased out restrictions on financial transactions and progressively reduced or eliminated controls on capital account transactions. In many instances, financial liberalization has been accompanied by macroeconomic stabilization, privatization, trade liberalization, and deregulation. Such structural reforms in capital-scarce developing countries have created significant investment opportunities, and a surge of foreign capital has been attracted by the promise of high rates of return. Growth of international trade has also increased the volume of trade-related financing and bolstered trade in derivative instruments to hedge exposures to currency and commercial risk.

At the same time, financial innovations in the U.S. and other advanced economies have rendered cross-border investments more accessible to international investors. Revolutionary technological advances in information and communication technology, in conjunction with significantly lower transportation and transaction costs, have underpinned this rapid financial market development. Mutual funds, hedge funds and the emergence of derivative instruments have enabled investors both to hedge some risks and to take on others. A radical increase in the available range of instruments and assets has afforded investors unprecedented opportunities to increase returns and decrease risks through global diversification. A generation ago, domestic wealth was primarily invested in domestic assets. Now, international portfolio diversification is a reality for a wide range of institutions, investors and households.

PREVIOUS FINANCIAL CRISES

Over the last twenty years, financial liberalization and the increase in global capital flows have also coincided with recurring financial crises, imposing serious real costs on the afflicted economies.

Three financial crises have struck during the 1990s. The first occurred in 1992–93, when several currencies in the Exchange Rate Mechanism (ERM) of the European Monetary System experienced speculative attacks. Britain and Italy were forced to abandon the ERM in the fall of 1992 and allow their currencies depreciate, while Sweden, whose currency was effectively pegged to the ERM currencies, was forced to follow suit shortly thereafter. Sequential devaluation of several other ERM currencies ensued, and the ERM exchange rate bands for France and the other remaining members had to be widened in the summer of 1993. A second financial crisis was touched off by the collapse of the Mexican peso in December 1994. Additional Latin American currencies came under attack via the so-called “Tequila effect.” The third crisis of the 1990s, the Asian currency and financial crisis that has now spread as far as Russia, South Africa and Latin America, was triggered by the devaluation of the Thai baht in July 1997.

While each of these crises in the 1990s had distinct characteristics and specific causes, several common elements, which factor significantly into current debates surrounding the reform of the international financial architecture, can be identified.

Increasing Volume and Sophistication of International Financial Transactions

Perhaps the most obvious element shared by all three crises during this decade is the context in which they occurred: the ongoing process of global financial integration that gained substantial momentum in the 1990s. Both the size and volatility of international capital flows have dramatically increased and the range of assets traded internationally has mushroomed.

Semi-Fixed Exchange Rate Regimes

All three crisis episodes occurred under semi-fixed exchange rate regimes: Each crisis country had attempted to stabilize the value of its currency vis-a-vis the currencies of its key trading partners, although none of the affected economies had fixed its exchange rate in a rigid way (with the exceptions of Argentina and Hong Kong, whose currency board-like exchange rate regimes have successfully withstood the crises). For example, ERM exchange rates had been permitted to move in a band (typically plus-or-minus 2 1/4 percent) vis-a-vis one another as a step along the path towards European monetary integration. Similarly, the Mexican peso had followed a narrow “crawling band” against the dollar, an arrangement which proved successful as a strategy for escaping the very high inflation rates of the 1980s. Finally, currencies of the Asian crisis countries were loosely pegged to currency “baskets” in which the dollar had a weight of around 80–90 percent. Although such arrangements may have facilitated rapid integration of the crisis countries into the world system of trade and

finance, they also, in the Mexican and Asian cases, hindered the adjustment of real exchange rates in the face of ?growing? trade deficits. The sudden abandonment of a fixed exchange rate in these crises reinforced negative market expectations, intensifying financial market pressures and producing severe adverse contractionary effects in the presence of large foreign-currency-denominated debts.

Presence of Contagion

In all three episodes, a crisis which began in one country quickly spread beyond its borders. Often the next victims were geographic neighbors and trade partners, and countries that shared other common traits, such as similar policies or common economic shocks. At times, as in the summer of 1998, changes in investors' sentiment and aversion to risk also contributed to contagion within and across geographical regions.

Recent Financial Liberalization

Most crisis episodes were preceded by significant capital account liberalization in the crisis country and progressive elimination of capital controls. Italy and France had fully liberalized their capital accounts in the years just prior to the onset of the 1992 ERM crisis. Mexico progressively liberalized its domestic and international financial regime in the early 1990s. Similarly, East Asian countries undertook processes of financial liberalization -- both domestic and international -- throughout the 1990s.

Concurrent Banking Crises

Currency crises of the 1990s have typically been associated with financial sector and banking crises. This is most clearly evident in the Asian and Mexican peso episodes, but weaknesses among financial institutions also played a role in the ERM devaluations. In Sweden, Finland and Italy, banking crises emerged in conjunction with the currency turmoil. The Asian crisis provides a stark example of the link between currency and banking crises, underscoring the profound vulnerability that results from fragile financial and banking sectors. The causal links between banking and currencies crises are complex, as financial weaknesses may contribute to a currency crisis while a currency crisis can exacerbate a financial crisis by increasing the burden of foreign currency liabilities.

3. THE ASIAN CRISIS AND THE GLOBAL FINANCIAL TURMOIL

THE ASIAN ECONOMIC MODEL

East Asian countries grew at a very rapid rate for over two decades, a phenomenon widely hailed as the “Asian Miracle.” Thirty years ago it had seemed that industrialization was a privilege reserved de facto for the European-settled regions of the world, with the sole exception of Japan. The East Asian “miracle economies” disproved this notion in a few decades. Whereas the United Kingdom took 58 years to double its income during the Industrial Revolution (starting from 1780) and the United States and Japan took almost as long (47 years, starting from 1839 and 35 years, from 1885 respectively), Korea accomplished the feat in 11

years and China in just 10 years (starting in 1966 and 1977 respectively).

The remarkable economic success achieved by many Asian countries served to greatly enhance living standards, sharply reduce poverty, and substantially expand economic opportunities for multitudes of the region's inhabitants. At the same time, East Asian countries maintained a more equal distribution of income and wealth compared to other developing countries. East Asia's success was achieved through a focus on the "fundamentals" that most economists consider critical to economic growth: high saving rates; substantial investments in education with particularly high rates of basic education and literacy; a pronounced work ethic; and an outward orientation characterized by heavy involvement in international trade and investment. The East Asian strategy also emphasized effective macroeconomic management, including the attainment of low budget deficits and inflation rates.

It is important to emphasize that the Asian recipe for economic success, with its clear focus on the fundamentals underpinning economic growth, has served and should continue to serve as an inspiration for countries seeking an escape from poverty. Indeed, as developing countries around the world increasingly opted for capitalism over state planning in the 1980s, they were reacting not just negatively to the conspicuous failures of state planning in their own economies and in the former Soviet bloc, but also positively to the inspiring example of East Asian success. Indeed, this role model is one of the many reasons why the United States continues to have a major stake in East Asian stability and prosperity.

Their enormous strengths notwithstanding, it is now commonly recognized that the Asian economies concealed structural weaknesses which are credited with contributing to the financial

crisis. Arguably, Asian governments relied excessively on centralized coordination rather than decentralized market incentives. Particular examples include widespread government favoritism in promoting selected industries and exports, and anti-competitive protection of domestic industries. Practices which distorted private sector lending and investment incentives include: relationship-driven banking (see Box 6-2), hindering capital market discipline and flexibility; poor supervision and inadequate regulation of financial institutions; implicit and explicit government bailout guarantees leading to moral hazard in the financial sector; heavy dependence on bank debt rather than equity (as securities markets were underdeveloped) leading to excessive leveraging of firms; lack of transparency of the activities and balance sheets of corporations and financial institutions (reflected in the lack of weak accounting and disclosure standards); and reliance on informal as opposed to formal enforcement mechanisms (as manifested in the lack of effective bankruptcy and foreclosure laws). (See Box 6-3 for an analysis of the Asian growth model).

Box 6-2. Arms-length versus relationship (insider) banking

In financial economics, a distinction has long been recognized between market-based and bank-centered financial systems, with the United States and the United Kingdom exemplifying a market-based system and Japan and many other East Asian economies exemplifying a bank-centered system. Commercial banks figure prominently in both. A crucial distinction, however, concerns the roles that they play.

Economists believe that banks play a special role in financial markets because of the

superior information that they often possess about the firms to which they provide finance. Institutionally, this information results from the close ties between firms and their loan officers. In addition, banks often have superior information about their clients' cash flows, as a result of maintaining many of their accounts.

In a market-based system, banks are one of many sources of external finance for firms. In providing funds, they compete with public bond and commercial paper markets, along with well-established markets for equity. Thus, bank loans are provided through "arms-length" market transactions.

In the bank-centered system, on the other hand, firms tend to have strong ties to a single bank (or network of banks). These "main" banks are heavily involved in the management and "governance" of their clients, as a result of their status as the primary -- and often sole -- source of external finance. A decade ago, economists commonly emphasized the strengths of this system: for example, privileged status and information enabled banks to extend loans to firms that might have difficulty obtaining funding in a market-based system, such as young firms or firms in distress. Some economists credited the financial structures of the Japanese and East Asian economies with promoting high rates of investment and growth. The bank-centered system, it was argued, overcame the short term focus inherent in the Anglo-American market system. Banks could take chances with riskier firms, since their long term relationships promised compensation in the future from the firms that succeeded (in the form of higher-than-market rates of interest).

Along with its strengths, relationship banking regimes (sometimes referred to as "insider

banking” or “connected lending”) also possess serious weaknesses, which have now been dramatically exposed by the Asian crisis. Instead of making profitable decisions informed by longer horizons, many banks apparently took excessive and economically unprofitable risks. Borrowers who should have been cut off were allowed to continue borrowing, with the result that losses increased. The tightly-concealed system of financing enabled some bankers and managers to invest on the basis of personal rather than economic objectives, shielded from market constraints.

Corporate governance tended in some cases toward empire-building, that is maximizing capacity, sales, or market share, rather than maximizing profitability or firm value. It appears, for example, that Asian banks and firms developed excess capacity in sectors such as steel and electronics. Currently, many Asian economies are struggling to overcome the adverse real consequences of these misguided financial decisions.

Box 6-3. The Asian growth model

The Asian crisis caught most analysts by surprise. Some had warned of economic policy flaws in Asia, but few expected them to produce a sharp slowdown and no one predicted the severe crisis that has actually materialized. Until recently most observers thought that the East Asian countries possessed the strong economic fundamentals and structural characteristics necessary for sustained long-run economic growth.

If the origins of the crisis are due to structural weaknesses in the Asian economic system, a natural question is why the crisis occurred when it did. One hypothesis is that there exist natural stages of development, and the Asian financial system, with characteristics such as relationship-banking, is better suited to countries at early stages of development. After all, financial intermediation by banks (even in the context of relationship banking) is a tremendously important innovation when the alternative for a firm is to finance all investments out of family savings or retained earnings from earlier investments. Moreover, as long as growth is rapid, high leverage (that is, a high ratio of debt to equity) is sustainable. But when growth slows, the financial system needs to adapt and firms need to reduce leverage.

Some slowdown in East Asian growth was probably eventually inevitable after the breakneck pace of the preceding three decades for the simple reason that “economic convergence” served as one of the driving forces of the earlier rapid growth. A country that starts out behind the leaders in per capita income can close part of the gap over time by growing more rapidly, conditional, of course, on the presence of such fundamentals as an outward orientation and investment in physical and human capital. There are two reasons for convergence: the high rate of return on capital in labor-abundant countries, and the opportunity to emulate frontier technology and management practices of the leader countries. But as the income gap closes, further impetus to growth diminishes over time. Countries encounter diminishing returns to capital, limits on the benefits of rural-urban migration, and constraints of infrastructure. Also, as they draw closer to the frontier, they have less to learn from those who have gone before. Japan had achieved convergence by the 1980s, and Hong Kong and

Singapore by the 1990s. Korea and the others still had a ways to go -- a very long way in some cases. Nevertheless, the basic principle remains, that the smaller the remaining gap, the smaller is the particular source of growth represented by convergence.

One controversial view is that Asian economic growth was attributable more to the rapid accumulation of inputs of production -- labor (via increased labor participation rates) and especially capital (due to very high investment rates) -- rather than to growth of factor productivity. According to some studies, underlying growth rates of total factor productivity (measuring the increased efficiency in the use of factors and the rate of growth of technological progress) were modest. An implication of this view is that the very high rates of Asian growth would not be sustainable in the long run given the projected decline in the rate of growth of employment and the expected reduction in the pace of investment. However, this view would imply a gradual slowdown of growth and not the sudden and severe crisis that hit these economies in 1997-98.

As discussed below, it appears that the factors working to produce an eventual slowdown in growth interacted badly in mid-1997 with existing financial sector weaknesses, excessive corporate leverage, financial fragility resulting from poorly designed capital market liberalization, a slowdown in export markets, a worsening of terms of trade, and the development of overcapacity in many sectors. The crisis was the result.

HISTORY OF THE CRISIS AND ITS CONTAGION

In the summer of 1997, financial turmoil in Thailand spread to countries with outwardly

similar features at similar stages of economic development: Malaysia, Indonesia and the Philippines. This “contagion” took the form of declines in both stock and currency markets. Singapore and Taiwan, concerned about the competitive effects of the currency depreciation in the original four crisis countries, decided to let their currencies float rather than resist the speculative pressure against them. By October, contagion affected Hong Kong (whose return to China in the summer of 1997 had increased the political uncertainty about the future of this region), pressuring the pegged Hong Kong dollar and sharply depressing local stock markets. The first bout of truly global contagion then ensued as stock markets in the U.S. and Europe fell sharply, and as other emerging market economies were forced to raise interest rates to prevent a run on their currencies. The spread of the crisis to Korea and further deterioration in the Indonesian economy led to a worsening crisis in the winter.

Investor sentiment seemed to improve by March as Thai and Korean currencies stabilized, and Korea successfully converted short-term bank debt into longer term bonds. Also, higher interest rates and tighter monetary policy in Latin America following the October 1997 contagion episode helped to stabilize investors’ confidence in that region. In April, however, several negative developments led to a new loss of investor confidence. Plunging commodity prices, resulting in large part from the deepening recession in Asia, hurt a wide range of commodity exporters. Oil exporters such as Mexico, Venezuela, Russia and Ecuador were severely affected by plunging oil prices. Agricultural exporters such as Australia, New Zealand, Canada and Argentina were impacted (as the crisis in Asia and large global supplies of agricultural products led to a sharp fall in agricultural prices) along with mineral producers such

as Chile and Peru. Violence in May surrounding the collapse of the Suharto regime devastated confidence in Indonesia and challenged remaining confidence in East Asia. Pressures upon currencies as far from East Asia as Pakistan and South Africa, a sharp deterioration of business conditions in Japan, and the continued fall of the yen added to the pessimism. The weakness of the yen led to the concern that China might devalue its currency and that the Hong Kong peg would collapse, causing another round of currency depreciations in Asia. However, China gave assurances that it would not devalue, and the pegs held. These negative developments, however, led to another round of sharp declines in emerging market equities starting in May.

Financial turmoil spread next to Russia, due to the fall in the price of oil (the country's biggest export), a deteriorating current account balance, weak tax collections, a large fiscal imbalance financed by short-term ruble debt and disappointment in the pace of structural reforms. The manifestations included a sharp fall in the Russian stock market, pressure on the currency, and a sharp increase in the interest rate on ruble public debt. An IMF package aimed at reducing the fiscal deficit was negotiated in July. However, the IMF package failed to restore confidence as the government of Russia proved unable to implement its anti-crisis program in the face of opposition from the Duma, from powerful special interests represented by oligarchs, and from those who sought a return to communism. The deterioration in market conditions culminated in a comprehensive breakdown in confidence in the first weeks of August.

On August 17, the Russian government, faced with growing losses of foreign reserves triggered by capital outflows, decided to devalue the ruble, to restructure its short-term public debt unilaterally in a form that implied material default, and to impose a 90-day moratorium on

Russian private sector payments of foreign liabilities. These decisions led to a severe financial crisis in Russia contributing, in turn, to a dramatic spread of investor pessimism to Latin America and other emerging markets and to a sharp downturn in equity markets in the U.S. and other industrial countries. The contagious spread of turmoil from Russia to Brazil and other Latin American countries arguably signaled a degree of financial panic as investors apparently withdrew capital indiscriminately from countries differing substantially in the strength of their economies. Investors' sharp loss of confidence in emerging markets following the Russian devaluation may have been partly caused by the perception that the IMF had few resources left and/or was not willing to use them to rescue a country that, until then, had been considered "too important to fail", drawing the wrong lesson from the IMF's enforcement of conditionality in the face of unsound macroeconomic policies. The loss of confidence may also have been partly caused by the perception that other countries might follow Russia on the path of unilateral defaults, debt moratoria and capital controls.

Although Latin American economies were structurally much stronger than Russia, investors increasingly sought to avoid risk everywhere. Emerging market sovereign spreads (see Box 6-4 on sovereign spreads) over Treasuries rose to about 1500 basis points (15 percentage points) by September, likely signaling an extreme increase in the risk aversion of international investors and large scale flight from emerging markets and other risky investments in favor of "safe haven assets," notably U.S. Treasury bills. The sharp increase in the preference for liquidity and the attempt to unwind highly leveraged positions added to the pressure on the prices of a wide range of risky assets. As described in Chapter 2, capital markets within developed

countries including the United States were also affected by the “flight to quality”: while yields on safe government securities fell, the spread over Treasuries of high-yield securities (junk bonds) increased sharply. Even the spreads of high-grade corporate bonds rose to some extent, reflecting the generalized increase in investors’ risk aversion. The severe losses and near-collapse of a prominent hedge fund contributed to investor panic. By early October there were hints of a possible generalized global credit crunch: rising spreads on the entire range of bond instruments from relatively safe high-quality corporate bonds to junk bonds and emerging market sovereign instruments; an interruption of access to international capital markets for most emerging economies; a drying-up of bond financing in all emerging markets and a shrinkage in new bond issues in industrial countries; evidence of a tightening of lending standards by commercial banks in the United States; a slowdown in reported earnings growth and contraction in stock markets.

However, by the middle of November, conditions in international and domestic capital markets had improved noticeably thanks to a number of positive developments.

- The Administration, as discussed in Chapter 1, took the lead in proposing a comprehensive program to contain and resolve the crisis, including: strong growth in the industrialized countries as a prerequisite for the recovery of crisis afflicted economies; the creation of a precautionary fund within the IMF to support countries subject to speculative pressures despite good economic fundamentals; measures to support accelerated systemic restructuring of banks and corporations in Asia; significant increases in multilateral financial institutions’ support of social safety nets in crisis countries; increases in trade financing to the affected countries; and reform of the architecture of the

international financial system to make it as modern as the markets.

- On October 30 leaders of the G7 nations issued a joint statement affirming their strong commitment to growth and the resolution of the current crisis; endorsing the U.S. proposal for an enhanced IMF facility to provide contingent short-term lines of credit for countries pursuing strong IMF-approved policies; and presenting concrete proposals to implement the architectural reforms contained in an October report of 22 industrial and emerging market nations, dubbed the G22. These proposals are discussed in detail in Chapter 7.
- The Federal Reserve reduced the Federal Funds rate three times -- at the end of September, in mid-October and again in mid-November -- helping to restore confidence and liquidity. Interest rate reductions in a number of other industrial countries, including Japan, Canada, and most European countries, provided a significant easing of monetary conditions in the world economy.
- In October, Congress approved an \$18 billion funding package for the IMF, opening the way for about \$90 billion of usable resources to be provided by all the IMF members to the liquidity strapped institution.
- In November, negotiations leading to an IMF and multilateral support and stabilization package for Brazil were concluded. The commitment of the G7 and 13 other countries to support this crucial country's adjustment efforts contributed to calm in Latin American markets.
- Japan passed legislation to address the problems of the banking sector and the Japanese

government proposed a supplemental fiscal package, restoring some confidence in the Asian markets.

- The yen appreciated sharply in October, reducing the risks of a devaluation by China that might have led to another round of competitive devaluations in Asia; the stronger yen also works to stimulate the exports of other East Asian countries to Japan and third-country markets.

Box 6-4 Sovereign Spreads in Emerging Markets

Many terms normally encountered only in arcane financial discussions have been added to the lexicon of popular jargon as a consequence of the Asian crisis. One such term, the “sovereign spread,” has achieved increasing prominence. What is it, and why is it significant?

Understanding the sovereign spread begins with the basics of the government bond market. The last decade has witnessed a tremendous increase in the availability of foreign debt and equity securities. Indeed, the term “emerging market” was coined to refer to those economies that gained unprecedented access to international capital markets over this period. In general, the first securities issued by the emerging markets were government bonds, and most issued bonds promising payments either in local currency or U.S. dollars.

The advent of such securities permits two very interesting comparisons. The first--called the sovereign spread--measures the difference between the yield to maturity of dollar-denominated (or other G7 currency-denominated) emerging market bonds and U.S. (or other G7) government bonds of the same maturity. The yield to maturity is the rate of return

earned by holding a bond until it matures, taking into account all interest and principal payments.

This yield differential is the implicit risk premium the market demands to compensate for the extra *default* risk that holding the emerging market bond entails. The premium compensates only for *default* risk because payments are made in foreign currency.

During the periods of extreme market turbulence following the Mexican peso crisis and the Russian default, sovereign spreads rose sharply. By mid-September 1998, such spreads had reached about 1500 basis points. Estimates of the default probabilities incorporated in emerging market bond prices can be derived, fairly easily, from measures of their sovereign spreads under the assumption that U.S. government bonds are default-risk free. At their heights, prevailing sovereign spreads implied very high default probabilities for many countries, leading to the conclusion either that markets were irrationally pessimistic or that investors were becoming exceedingly risk averse (See Chart 6-2).

A second interesting comparison relates to the difference in yields on dollar- and local currency-denominated bonds. This differential measures the market's assessment of currency risk. Interestingly, even under most "fixed" exchange rate regimes, a positive currency risk premium can be observed suggesting either that investors either expect a devaluation with positive probability or that they require an implicit "insurance" premium to compensate for the possibility that one might occur.

CAUSES OF THE CRISIS

Identifying the cause of the 1997–98 Asian crisis has engendered heated debate.

Countries experiencing currency and debt crises in the past as, for example, in Latin America in the 1980s, typically shared several common characteristics including large budget deficits and high public debt, high inflation as a result of deficit monetization, low economic growth, and low saving and investment rates. In Asia, in contrast, most crisis countries enjoyed low budget deficits, low public debt, single digit inflation rates, high economic growth and high saving and investment rates.

The absence of the macroeconomic imbalances typical of past crises has led some to argue that the Asian crisis was due not to structural weaknesses. These analysts contend that the crisis represented an essentially irrational, but nevertheless self-fulfilling panic, akin to a “bank run”, fueled by hot money and fickle international investors. Although the crisis was exacerbated by speculative capital flight, it is now commonly agreed that, along with their many strong economic fundamentals, East Asian crisis countries also possessed some severe structural distortions and institutional weaknesses. These vulnerabilities eventually led to the crisis in the summer of 1997.

First, financial sectors of the crisis countries were prone to fragility due to the prevalence of corrupt credit practices with loans often politically directed to favored firms and sectors. In addition, regulation and supervision of crisis country banking systems were notably weak. Moreover, moral hazard derived from implicit or explicit government bailout guarantees of financial institutions (See Box 6-5 on moral hazard). Such financial sector

weaknesses contributed to a lending boom and overinvestment in projects and sectors that often were risky and of low profitability, such as real estate and other non-traded sectors; excessive capacity accumulated in some traded goods sectors. Prior to the crisis, speculative purchases of assets in fixed supply fed an asset price bubble, with equity and real estate prices rising beyond levels warranted by fundamentals. Poor corporate governance and what has now come to be called “crony capitalism” exacerbated the distortions in this system and fueled the investment boom. Domestic and international capital liberalization may have aggravated the original distortions by allowing banks and firms to borrow more and at lower rates in international capital markets.

In Thailand, regulations restricting entrance in the banking system led to the growth of unregulated, non-bank finance companies. Excessive borrowing by these firms fueled a boom in the real estate sector. Liberalization of capital account regulations, for example through the establishment of the Bangkok International Banking Facility, enabled Thai banks and firms to borrow heavily abroad, in foreign currency, at very short maturities. Fifty-six of these finance companies were distressed even before the Thai baht crisis, and were eventually closed after the onset of the crisis.

In Korea, excessive investment was concentrated among the chaebols, the large conglomerates dominating the economy. The chaebols’ control of financial institutions, together with government policies of directed lending to favored sectors, led to excessive and

low profitability investment in such traded sectors as autos, steel, shipbuilding and semiconductors. By early 1997, well before the onset of the won crisis, seven out of the thirty main chaebols were effectively bankrupt.

In Indonesia, over 80 percent of all bank credit consisted of directed credit, channeled to politically favored firms and sectors. Although Indonesia had already suffered a banking crisis in the early 1990s such practices remained prevalent. Moreover, most of the borrowing took place in foreign currency terms, compounding debtors' inability to repay when the local currency depreciated. In Indonesia, a large fraction of foreign bank lending was directly to the corporate sector rather than being intermediated through the domestic banking system.

Empirical studies confirm that the return to capital sharply fell in the East Asia region as the result of excessive investment. Studies document a rapid build-up of fixed assets throughout Asia between 1992 and 1996 with particularly rapid growth in Indonesia and Thailand. With most of the growth financed with debt (especially in Thailand and Korea), high levels of corporate leverage were already prevalent in 1996, well before the currency crisis increased the burden of foreign debt. At the same time, moderate to low profitability severely impaired the ability of many Asian firms to meet their interest payment obligations. In Korea, the average debt to equity ratio of the top thirty chaebols was over 300% by the end of 1996; and by 1997 the return on invested capital was below the cost of capital for two thirds of the top chaebols.

In spite of high saving rates, the investment boom in the East Asian region led to large and growing current account deficits financed primarily through the accumulation of short-term, foreign currency-denominated and unhedged liabilities by the banking system. The choice of exchange rate regimes entailing semi-fixed pegs to the dollar exacerbated the problem in two ways. First, they led to real currency appreciations (largely as a result of the 1995-98 appreciation of the dollar) that worsened current account deficits. Second, the promise of fixed exchange rates led borrowers to discount the possibility of future devaluation, and thereby led them to underestimate the cost of foreign capital. Also, while budget deficits were apparently low, the implicit and explicit government guarantees of a bailout of the financial system in a crisis implied large and growing unfunded public liabilities that emerged once the currency crisis triggered a wider banking crisis.

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

In 1997, the bubble started to burst. Stock markets dropped (in some cases accelerating a reversal that had started before 1997) and the emergence of wide losses and/or

outright corporate sector defaults revealed the low profitability of past investment projects; non-performing loans, already on the rise prior to the currency crisis, escalated threatening bankruptcy of many East Asian financial institutions. In addition, the firms, banks and investors that had heavily relied on external borrowing were left with a large stock of short-term, foreign currency-denominated and unhedged foreign debt that could not be easily repaid. The exchange rate crisis that ensued exacerbated this problem, as currency depreciation dramatically increased the real burden of the debt denominated in foreign currency, provoking further financial crisis for banks and firms. The free fall of currencies was intensified by the sudden rush of firms, banks and investors to cover their previously unhedged liabilities in foreign currency. Accelerated depreciation aggravated the original foreign currency debt problem, creating a vicious circle.

Concern among investors about the commitment of governments to structural reforms intensified policy uncertainty, causing widespread capital outflows which exacerbated the currency depreciation. Although fundamentals likely triggered the crisis, currency and stock markets may also have overreacted, with panic, herd behavior and a generalized increase in risk aversion producing a sudden reversal of capital flows, exacerbating the crisis.

The sharp reversal of capital flows to the East Asian region in the second half of 1997 is clearly evident in the data. Table 6-2 shows that net private flows to five Asian crisis countries (Thailand, Korea, Indonesia, Malaysia and the Philippines), which averaged \$89

billion per year in 1995–96, reversed dramatically in 1997, which saw a net outflow of \$6 billion. This sharp reversal, amounting to more than 10 percent of the GDP of the five crisis countries, occurred in the second half of 1997 as foreign investors fled and international banks sharply contracted their short term loans. Commercial banks accounted for three quarters of this reversal, withdrawing \$29 billion in 1997. While equity investments also fell in 1997, the decisions by international commercial banks not to roll over their loans to Korea, Thailand and Indonesia severely exacerbated the financial crisis and the currency collapse. In 1998, it is estimated that net private outflows were even larger than in 1997, about \$25 billion, driven again by large scale bank withdrawals.

The drastic reversal of capital flows has necessitated a severe adjustment of the current accounts of the affected countries. Current account deficits can only be sustained as long as foreign lending is available to finance them. The withdrawal of needed financing has therefore resulted in higher domestic interest rates, depreciated currencies, and sharp economic contraction, producing a substantial decline in imports and large current account swings in the crisis countries. The aggregate current account balance of the five crisis countries moved from a deficit of \$55 billion in 1996 to a deficit of \$26 billion in 1997 (with most of the adjustment in the second half of the year) and an estimated surplus of \$59 billion in 1998. As private capital flows have fallen sharply, the financing gap has been transferred to the official sector (IMF, multilateral and bilateral official creditors) and to foreign reserves:

while in 1996 the Asian five made small net transfers to official creditors, they received net official flows of \$31 billion and \$28 billion in 1997 and 1998 respectively. Moreover, while in 1995 and 1996, net private inflows in excess of current account imbalances led to sharp increases in foreign exchange reserves, the turnaround of capital flows in 1997 led to a loss of foreign exchange reserves equaling \$31 billion.

While the reversal of capital flows in 1997 was partly explained by the fundamentals and policies followed by the crisis countries, its size and concentration in the second half of 1997 confirm that investor flight, especially by commercial banks, contributed to the severity of the crisis. Calls for fairer “burden sharing” by the private sector in crisis situations, enshrined in the reports of the G22 working groups (discussed in Chapter 7), recognize that the private sector may be a cause of financial crises, needs to be involved in preventing crises and, if they do occur, must play a fair share in solving them. Collective mechanisms to coordinate creditor behavior in periods of acute borrower distress are also needed. Indeed, the Korean crisis eased in early 1998 when, in an agreement mediated by the U.S. Treasury, commercial banks agreed to roll over about \$20 billion of loans to Korean banks by turning them into medium term bonds. The G-22 report recognizes the usefulness of developing mechanisms to ensure that cooperative outcomes -- such as debt rollovers and/or loan restructurings -- occur before, not after, a currency and financial crisis triggered by sudden capital reversals places a country on the brink of

default, as threatened Korea in December 1997.

Box 6-5. Moral Hazard in Financial Institutions

“Moral hazard” is a key concept in the economics of “asymmetric” information, the study of transactions in which buyers and sellers have differential access to relevant information. It occurs whenever individuals covered by insurance pursue riskier behavior as a consequence. Examples of “moral hazard” abound: insured homeowners, for instance, are more likely to build homes in a flood plain or in an areas prone to wildfires and may avoid installing alarms and anti-theft system; insured drivers might drive more recklessly. If insurance companies can observe such behavior, they can penalize it through higher premiums. But if they can’t, they may try to regulate and monitor their clients’ behavior, and make sure that the insured also bear a portion of any losses they sustain. Sometimes these strategies mitigate moral hazard; in severe cases, moral hazard may cause insurance markets to disappear entirely.

Banks are subject to a rather unique risk that both requires insurance and creates the possibility of moral hazard. Insurance is needed to stem the systemic risk that can result if depositors of a bank suddenly lose confidence in the institution and seek to withdraw their funds *en masse*. In the face of a bank run, even a well-run bank will quickly exhaust its cash reserves.

Since most bank investments are illiquid, the attempt to liquidate them prematurely will diminish their value. As a result, even strong banks can fail if a bank run occurs. And the failure of one bank can cause runs on others.

Given the pivotal role that banks play within all modern economies, most governments provide deposit insurance to discourage bank runs and “lender of last resort” facilities to assure banks ample access to liquidity. In addition, governments frequently rescue troubled financial institutions that are deemed “too big to fail” in order to mitigate the potential economic consequences of their bankruptcy.

By reducing risk, such insurance mechanisms, however, create moral hazard on the part of banks. Since loans are largely funded from insured deposits, banks have an incentive to “gamble” by purchasing excessively risky assets. When things turn out well, shareholders reap the rewards. If things turn out badly, the cost is borne disproportionately by the government. Bank depositors are similarly subject to moral hazard: if they stand to lose nothing in the event of a bank failure, they have little incentive to monitor bank investments or compliance with capital adequacy standards.

Insurance against bank runs comes at the inevitable expense of increased moral hazard. Even so, its provision may still be justified. What is clear, however, is that the provision of either implicit or explicit government insurance necessitates effective prudential supervision and regulation of banks and the maintenance of strong capital adequacy standards to mitigate the effects of moral hazard.

In East Asia, implicit and explicit government guarantees to bail out financial institutions were coupled with inadequate prudential supervision and regulation. Perceived government guarantees also mitigated the incentive of international investors to monitor

lending decisions. Moral hazard thus led banks to borrow too much from abroad and invest at home in excessively risky projects.

THE CAUSES OF CONTAGION

The spread of market dislocations from one country to the next -- the so-called contagion effect -- has been observed in the behavior of exchange rates, stock markets, and emerging market sovereign debt spreads. As with explanations for the crisis itself, some observers interpret this contagion as proof that markets are irrational and prone to unjustified panic.

Various explanations based on economic fundamentals also exist, however.

Common Shocks

Contagion may be due to common shocks or policies. For example, the weakening of the yen negatively affected numerous Asian economies, placing pressure in turn on their currencies.

In addition, falling commodity prices hurt commodity exporter countries. Thus, the same economic shocks affected countries as distant as Russia, Mexico, Canada, Australia, New Zealand, Chile, Peru and Argentina.

Trade Linkages

When one country devalues its currency, its competitive position improves relative to that of its major trading partners. Trading partner currencies may experience pressure when speculators recognize the likely worsening of their trade balances. Another channel of

contagion occurs through income effects: a downturn in Japan depresses Asian exports to Japan and vice versa. Trade linkages fostered the spread of the currency crisis within East Asia in 1997. Evidence suggests that contagion is related to strength of trade links and regional factors.

Competitive Depreciations

Contagion may also have resulted from the real or simply feared possibility of competitive devaluations among countries competing in third-country markets. For example, the first wave of depreciations in Asia in the summer of 1997 worsened the cost-competitiveness of all countries in the region that initially maintained their nominal exchange rates fixed, causing attacks on many of these currencies. Concerns about loss of competitiveness explain, for example, the decisions of Taiwan and Singapore to allow their currencies to fall as the other regional currencies were being devalued. The weakness of the yen throughout 1997 and 1998 may have provoked fears of competitiveness-related devaluations in the East Asian region.

Other Real and Financial Linkages

Other real and financial links may also serve as a conduit for contagion. If one country invests in and lends heavily to another, negative economic news in the latter will negatively affect markets in the former. Pressures in the and currency markets of Korea, Hong Kong and Singapore, for example, were related to the fact that these economies had heavily lent to, invested in and traded with Indonesia and other Asian economies in crisis. Such losses also

affected banking institutions and other financial firms in Japan, Europe and the U.S. that had invested in East Asia and Russia, partly explaining the contagion to industrial countries' financial markets.

Imperfect Information and Investor Expectations

A final channel of contagion involves alterations in investors' perceptions concerning common structural conditions or likely policy responses. For example, the failure of financial institutions in one country may have signaled to investors that financial institutions in similar countries in the same region shared common problems (such as overinvestment, weak financial institutions, external imbalances, insufficient foreign reserves or high short-term foreign debt). Similarly, the unwillingness or inability of several Asian countries to defend exchange rate parities more aggressively may have altered investor views concerning the policy preferences of other East Asian countries.

Contagion may also have resulted from changed expectations concerning the odds of official bailouts. The news in mid-August of 1998 that Russia – the example of a country deemed too-big-to-fail – would not receive further official assistance given its inability to meet the conditions of its IMF program and its decision to devalue, default on its debt, and impose exchange controls, shook international investors' confidence and increased their concern that other emerging markets might follow similar policies and/or might not be bailed out. Spreads on emerging market sovereign instruments had not previously priced in this

possibility, and the spread of contagion to Brazil and Latin America was rapid and sharp. Also, large highly leveraged financial institutions (such as hedge funds) which lost money in one market (Russia) faced margin calls that forced them to liquidate their positions in other markets, adding to the contagious effects of the Russian default.

Shifting Risk Aversion and Investor Sentiment

Against explanations of contagion relating to fundamentals stand alternative hypotheses based on irrational investor behavior. Some argue that as volatility increased in financial markets, investors simply withdrew en masse without drawing careful distinctions concerning the strength of economic fundamentals in the various emerging markets. Phenomena such as financial panic, herd behavior, loss of confidence and a generalized increase in risk aversion may have played some role in the spread of the crisis in 1997–98 within Asia, from Asia to Russia, from Russia to Latin America and other emerging markets and eventually to G7 capital markets.

The increase in investors' risk aversion is clearly indicated by the sharp increase in sovereign spreads in the summer of 1998 (see Box 6-4). To explain such a large increase in spreads without resort to increased risk aversion requires the unlikely assumption of a perceived increase in the probability of sovereign defaults to very high values in many emerging markets. The sharp increase in spreads experienced by Argentina and Chile,

countries where it was unlikely that the probability of default was nearly that high, provides evidence of a sharp increase in the risk aversion of investors.

POLICY RESPONSE TO THE CRISIS

Role of the international community

The international community (the IMF, World Bank, Asian Development Bank and the G7) moved quickly to stem the financial crisis, formulating aid packages to support Thailand, then Indonesia and Korea, as soon as they were requested. As a condition for financial assistance, the IMF has generally required substantial economic reforms, including fiscal discipline, banking sector restructuring, and the maintenance of high interest rates to avoid capital outflows and currency attacks. The IMF's practice of negotiating, monitoring, and enforcing such policy requirements is termed *conditionality*. The objective of the reform programs has been to restore investor confidence by tackling the root causes of the crisis in each country. For this reason, the programs went beyond addressing major fiscal, monetary or external imbalances, aiming to strengthen financial systems, improve government and corporate governance and transparency, restore economic competitiveness, and modernize the legal and regulatory environment.

The targets and the tactics of the IMF evolved as the dimensions of the crisis became clearer. The Indonesian case provides a striking example of such modifications. Whereas the first aid package of October 1997 required strict fiscal discipline, the agreement of June 1998 allowed the country to run a budget deficit of as much as 8.5% of GDP. In Indonesia, economic

performance deteriorated and budget deficits automatically rose as policy uncertainty, political turmoil and violence worsened the economic outlook through the summer of 1998. The IMF recognized that, in this context, the additional fiscal stringency needed to counter such passive deterioration of the budget deficit, would prove counterproductive for the economy.

In countries that implemented IMF policy reforms most assiduously, particularly Korea and Thailand, the packages were successful in stabilizing financial markets and creating the basis for a resumption of economic growth. Following the financial turmoil in the second half of 1997, a measure of financial stability returned in these countries in 1998 as the stabilization packages were implemented. Both countries saw their currencies appreciate in the first half of 1998 after sharp drops in 1997; domestic interest rates fell back to pre-crisis levels by the summer; trade balances significantly improved; and foreign reserves began to increase again. The financial crisis produced severe real consequences in both countries, however, as economic activity dropped sharply in 1998 and severe recessions began. However, by the fall of 1998 some signals suggested that both economies had bottomed out and economic recovery might start in 1999. In particular, both economies saw an increase in real exports and signs of a recovery of industrial production.

The logic of the IMF packages

The severity of the economic crisis in East Asia has led some critics to challenge the IMF's approach and the wisdom of the particular packages. Several criticisms can be distinguished.

Structural Reforms

One criticism relates to the breadth of the restructuring efforts required by the IMF. Critics contend that the Fund has played an excessively intrusive role in the domestic affairs of crisis countries by including in its programs structural reforms beyond its traditional macro-adjustment related areas of competence. However, an effective rescue strategy had to address the issues responsible for the crisis and these issues were primarily structural rather than macroeconomic. IMF lending would have served little purpose if the financial sector weaknesses (ranging from poor bank supervision and regulation to murky relations among governments, banks and corporations) responsible for the crisis were not addressed. Similarly, the insistence on improved corporate governance and the avoidance of “crony capitalism” represented preconditions for avoiding future crises. Arguably, halfhearted reform efforts would do little to re-establish market confidence.

The IMF’s approach to crisis management has always evolved over time in response to the changing problems faced by the world economy. For example, after 1973, the Fund turned its attention from the balance of payments problems of industrialized countries, which by then had abandoned fixed exchange rates, to the problems of developing countries, many newly independent. Similarly, it adopted new approaches in response to the international debt crisis of the 1980s, and adapted its policies to aid the transition of Soviet bloc countries to market economies after 1990. It is appropriate and desirable that an international agency adapt and evolve in response to the developments in the world economic system.

The Prescription of Tight Monetary Policies

A second criticism of the IMF's tactics relates to its insistence on high interest rates to limit currency depreciation. Critics correctly contend that high interest rates stifle growth and lead to the bankruptcy of many otherwise viable firms. The logic of the IMF's high interest rate strategy was to contain the extent of currency depreciation. Currency depreciation, like high interest rates, also stifles growth of countries with large net external liabilities by increasing the burden of the foreign currency-denominated debts of banks and firms, producing financial distress, bankruptcy, and economic contraction. Arguably, the failure of Malaysia and Indonesia to raise interest rates sufficiently following the runs on the Thai baht were responsible for the destabilizing depreciations of their currencies. Moreover, a loose monetary policy can ignite inflationary expectations, as the experience of Indonesia illustrates.

Restrictive Fiscal Policies

A third criticism which has been voiced concerning IMF policy is that the fiscal policy requirements included in the IMF plans were unnecessarily strict. At the onset of the crisis, the Asian countries under attack were running low budget deficits or even fiscal surpluses, and had achieved relatively low ratios of public debt to GDP. Arguably, loose fiscal policies at the onset of the crisis would have raised doubts about policy-makers' commitment to reduce the outstanding current account imbalances, jeopardizing the credibility of their plans. Also, while fiscal deficits and debt were typically low before the crisis, the projected fiscal costs of post-crisis financial bail-outs in several Asian countries were estimated in the range of 20 to 30% of GDP. Extra public spending of this magnitude translates into a permanent increase in the interest bill paid by Asian governments amounting to 2-4% of GDP per year. IMF fiscal plans,

on a country-by-country basis, were targeted to raise the necessary revenues to meet these extra interest costs. However, when recessions in the crisis countries materialized during 1998, the IMF progressively loosened its fiscal conditions to permit cyclical fiscal deficits to emerge. It must be acknowledged too that the year's revelations about the size and depth of the recessionary effects of the crisis surprised not only the Asian governments and the IMF board, but also the vast majority of country analysts.

The "moral hazard" of international rescue packages.

A fourth criticism of IMF-led rescue packages relates to their potential to create moral hazard by leading international investors, expecting bailouts, to lend carelessly and inducing domestic governments to engage in risky policies. Several objections can be raised against a simplistic view that IMF "bail-out" plans cause moral hazard through such mechanisms. For example, there is no direct evidence to support the charge that the surge in capital flows to Asia after 1995 was related to expectations of international bailouts in the aftermath of the Mexican rescue package. Moreover, in reality, a majority of private creditors, especially bond-holders and equity investors, have sustained huge losses in crisis situations where official assistance was provided. By the end of 1997, foreign equity investors had lost nearly three quarters of their equity holdings in some Asian markets. Only commercial banks were spared and even there, only partially. For example, foreign banks operating in Korea demanded public guarantees on bank loans as a precondition for rolling over existing loans. However, the conditions for these rollovers entailed a burden on creditors as short-term loans were converted into medium-term bonds at interest rates only a few hundred basis points above U.S. Treasury rates. Finally, it is

hard to imagine that the availability of international support in the event of a crisis does much to induce moral hazard on the part of governments. Governments have strong incentives to avoid both the economic turmoil which a crisis produces and the strict and politically unpopular conditions which attach to IMF support.

Even if the moral hazard concerns relating to international rescues were judged to have some validity, such concerns would still need to be balanced against the heavy economic and human costs attached to inaction in the event of a crisis. The alternative of non-response in crisis situations leaves countries and creditors to sort out their debts on their own, a strategy that may well result in extraordinary costs for the residents of the domestic and world economies. A lesson from the debt crises of the interwar period and the 1980s is that such a strategy requires complex negotiations over a long period of time, during which access to international markets is curtailed, long-term growth is drastically reduced, and the human toll may be exorbitant. The experience of the 1990s suggests that highly interdependent economies can be subject to the rapid transmission and the 'contagious' spread of speculative waves of financial panic across regions so that the failure to address a local crisis with an appropriate program of international assistance, restoring market confidence promptly, may greatly increase the chances of a systemic chain reaction across countries.

U. S. Support of the IMF Role

Since the onset of the crisis, the United States has supported the IMF's role in extending aid to crisis countries conditional on their implementation of strong reform programs. However,

as the crisis progressed, it became apparent that it threatened even those countries that had made great progress in implementing sound macroeconomic and structural policies and had worked to strengthen the fundamentals of their economies. To deal with such threats, the President proposed to find ways to extend IMF financing on a precautionary basis to countries with sound, IMF approved policies, thereby helping them fight off the crisis' contagious impact. ***Nouriel: Wasn't it the G7 Leaders?*** The G7 Finance Ministers and Central Bank Governors announced their endorsement of such an enhanced IMF facility in their October 30 declaration.

For the International Monetary Fund to play its critical role in countering contagion, the United States also recognized that its resources needed to be expanded. As an international institution with broad experience and appropriate skills, the IMF is the right organization to play a lead role in handling the crisis. And through the IMF, the U.S. succeeds in leveraging its own contributions toward crisis resolution. The U.S. could not expect to play a leadership role in the resolution of the crisis without meeting its own fair-share obligations. Therefore, the President requested, and Congress agreed this year, to provide \$18 billion of much-needed new funding to the IMF. \$xx billion of this amount represents the U.S. share of a quota increase applying to all IMF members. The additional \$yy billion represents the U.S. contribution to a new emergency borrowing facility called the New Arrangements to Borrow (NAB). Many observers have been confused about the consequences of IMF funding legislation for the Federal budget. Funds provided to the IMF are treated like other asset exchanges or loans and are not considered expenditures in the Federal budget.

The President urged the major economies to stand ready to activate the \$15 billion remaining in the existing emergency fund of the IMF--the General Arrangements to Borrow (GAB) -- to ensure the IMF's continued ability to support reform and fight contagion. Such emergency funds were also doubled with the approval of the New Arrangements to Borrow (NAB). Under the NAB, IMF members will be prepared to make loans to the IMF when supplementary resources are needed to forestall or cope with an impairment of the international monetary system or to deal with an exceptional situation that poses a threat to the stability of that system. The potential amount of resources available to the IMF under the GAB and NAB combined will be up to \$46 billion. The NAB was activated, shortly after it entered into effect on November 17, to help finance the IMF arrangement for Brazil, which the Executive Board approved on December 2.

New Initiatives to Restore Growth and Recovery in East Asia

In addition to its support of the IMF, the United States has recognized the need to do more to help crisis countries get back on their feet, to restore growth, and to mitigate the suffering which has been inflicted on so many citizens in the affected countries.

The Asian Growth and Recovery Initiative, jointly announced by the U.S. and Japan at the APEC Summit in November, includes innovative financing schemes aimed at accelerating efficient bank and corporate restructuring in the crisis-afflicted countries in East Asia. In Indonesia, Korea and Thailand, for example, the combination of sustained high interest rates and illiquidity has led to harsh economic contraction and a vast overhang of bad debt. Debt to equity

ratios that were already very high before the crisis subsequently became unsustainable due real currency depreciation and the burden of high real interest rates. When highly leveraged companies cannot service their debt, a self re-enforcing spiral is created in which banks' cash flows are squeezed, forcing them to contract new lending not only to illiquid corporations but even to those in better health. The object of bank and corporate restructuring is to restore the flow of credit and restructure balance sheets so that firms in these countries can get back to the business of producing output.

In an effort to ensure access of crisis-impacted countries to critical imports and to help American businesses continue selling abroad, the Export-Import Bank will establish new short-term credit facilities for critical Asian and Latin American markets. The United States will coordinate its efforts with those of our counterparts in other leading industrial nations to ensure that trade credit continues to flow during this period of financial stress. Moreover, the Overseas Private Investment Corporation (OPIC) has developed a new instrument to help emerging economies raise money from international capital markets. The aim is to keep private capital flowing to crisis-impacted but deserving economies.

The severe economic downturns experienced by the crisis countries in East Asia have caused sharp increases in unemployment and poverty, jeopardizing the substantial strides those countries had made in alleviating poverty and raising real incomes over previous decades. The social costs of the crisis have been severe and the lack of developed social safety nets, such as unemployment insurance and efficient welfare programs, has exacerbated the social costs of the crisis. The President has therefore asked the World Bank and Asian Development Bank to

double their aid through an expanded Social Compact initiative with a focus on strengthening the social safety net in crisis affected countries. The focus would be on job assistance, basic needs, children, the elderly and groups in the affected countries who are most vulnerable to economic distress.

Reform of the International Financial Architecture

Even as it worked to mitigate the impact and contain the spread of the current crisis, the Administration collaborated with other countries to find ways to strengthen the architecture of the financial system so that it is less crisis prone going forward. Discussions in 1998 concerning the reform of the international financial architecture culminated in the publication in October 1998 of reports by three working groups formed by the G22, a group of systemically significant industrial and emerging market countries which had first been brought together in April 1998. These G-22 reports are discussed in chapter 7.

4. JAPAN'S ECONOMIC AND FINANCIAL CRISIS

Japan, Asia's leading economy, has inadvertently played an unfortunate role in the emergence and spread of the Asian crisis. Since the start of the 1990s, Japan has suffered a hangover from the bursting of the stock and land bubbles of the preceding decade. In 1996, after four years of disappointing growth, it appeared that the Japanese economy was finally recovering. But a large increase in the Japanese consumption tax in April 1997, implemented to address Japan's large fiscal

deficit and longer term demographic pressures on its budget, caused the country to lapse into recession. The level of activity began to decline in the second quarter of 1997.

Japan's economic weakness likely contributed to the Asian crisis through several channels: First, weak Japanese growth reduced Japan's demand for imports from the East Asian region. In addition, loose monetary policy in Japan, pushing Japanese interest rates to extremely low levels, may have contributed to the depreciation of the yen relative to the dollar from mid-1995 to the summer of 1998. The yen's decline both exacerbated exchange rate tensions in the region and, in 1997, contributed to a steep real appreciation of the Asian currencies that were tied to the dollar.

Low Japanese interest rates also fueled heavy lending by Japanese banks in East Asia in the precrisis period. Japanese banks, in fragile condition after the bursting of the 1980s bubble, weakened by a stagnant economy in the 1990s, and facing low interest rates at home, sought higher returns through large-scale lending to the fast-growing East Asian countries. However, with the largest financial exposure of any OECD country to the Asian crisis countries, Japanese banks and securities firms were particularly hard hit when the crisis erupted. As the Asian crisis escalated, and as Japan's own economic crisis deepened in 1997-1998, many Japanese banks, faced with significant losses, recalled foreign loans in order to avoid a domestic lending squeeze.

Compared to the American role in the Mexican crisis of 1995 -- when the U.S. economy was in the midst of a strong expansion -- the weakness of Japan's economy and financial institutions has undoubtedly exacerbated the severity of the Asian crisis. At the same time, however, the significant decline in Japan's own exports to the crisis countries, along with the losses suffered by Japan's financial institutions on their Asian loans, have hit Japan's vulnerable economy hard, adding to Japan's own domestic difficulties.

Japan has now entered a full-fledged recession. Real growth over the four quarters of 1997 amounted to -0.4%. In the first half of 1998, Japanese real GDP was down 4.3% at an annual rate and by late 1998 there were still few if any signs of recovery. Japan risks descent into a deflationary spiral in which falling prices raise real interest rates, further discouraging spending.

In response to a deepening economic contraction and a growing credit crunch, the Japanese government has taken several significant policy steps. In the fall of 1998, legislation was approved providing public funds to address the problems of the Japanese banking system. Of the 60 trillion yen (about \$500 billion) in the financial package, about 30 percent has been earmarked for protection of depositors, 40 percent to recapitalize weak banks, and 30 percent to purchase the shares of nationalized banks. While questions remain concerning the implementation and effectiveness of the package, the banking reform bill is a necessary step towards restructuring Japan's financial system.

In order to stimulate economic growth, the Japanese government announced a 16 trillion yen fiscal stimulus package in April 1998, including both public works expenditures and tax reductions. Faced with intensifying economic contraction, the Japanese government proposed further expansionary fiscal measures in the fall of 1998. In November, the government announced a plan to pass a third supplementary budget aimed at implementing over 17 trillion yen in public works and other spending measures in 1999, along with more than 6 trillion yen in tax cuts.

As the world's second largest economy, Japan has a key role to play in maintaining global economic growth. The United States has urged Japan to take strong and sustained fiscal measures to stimulate domestic demand, to restore confidence, to deal promptly and effectively with the

problems of its banking system, and to open its markets and deregulate its economy. Japan's performance will help determine the prospects for Asia's recovery.

5. EFFECTS OF THE EMERGING MARKETS CRISIS ON THE UNITED STATES

MACROECONOMIC EFFECTS

The United States has enjoyed strong economic growth since the onset of the Asian crisis. Nevertheless, the crisis has produced both real and financial impacts. One consequence has been a marked decline in net exports and a widening of the U.S. trade deficit. The deterioration in the U.S. trade balance (see Chart 6-3) is largely attributable to three factors: faster growth in the United States than in most other industrial countries; outright contraction in Japan and a large part of East Asia; and a nominal and real appreciation of the U.S. dollar relative to Asian currencies, particularly the yen (from mid-1995 until September 1998). Two sectors adversely affected by the crisis were agriculture and manufacturing. Shrinking exports and low prices (partly due to the financial crisis and partly due to large global supplies of agricultural commodities following bumper harvests), on top of bad weather in some regions, led to a fall in farm incomes. In manufacturing, export sectors such as commercial aircraft suffered from the fall of exports to Asia. Import-competing sectors such as steel, textiles and apparel have also been under pressure since the dollar appreciation has reduced the price of imports from the crisis affected countries. As discussed in Chapter 2, U.S. financial markets were also impacted by the

crisis and financial institutions have suffered losses on their emerging market loans and investments.

While the 1995-98 appreciation of the U.S. dollar (see Chart 6-4) contributed to an increase of the U.S. trade deficit, it has also had a number of beneficial effects on the economy. The strong dollar has led to a fall in import prices and a further reduction in inflation. The sharp decline in import prices, particularly for oil and commodities, has improved the U.S. terms of trade, defined as an index of the prices of U.S. exports relative to an index of the prices of U.S. imports. An increase in the terms of trade translates into increased purchasing power of U.S. goods in world markets and higher real U.S. income (see Chart 6-5.) A strong dollar and subdued inflation have also supported lower short and long-term interest rates low, benefiting households, firms and other borrowers in the economy.

As discussed in Chapter 2, the continued impact of the Asian crisis on U.S. trade and financial markets is expected to contribute to the moderation in U.S. economic growth -- below the exceptionally rapid pace of the last several years, toward still solid and sustainable levels -- forecast by the Administration in 1999.

THE U.S. TRADE AND CURRENT ACCOUNT DEFICITS AND THE DOLLAR

Short-term behavior of the trade imbalance

In 1998, the differential growth rate of the U.S. relative to its trade partners and the continued appreciation of the U.S. dollar exerted a significant impact on the U.S. trade balance. The U.S. trade deficit rose substantially in 1998, with a \$139 billion deficit on trade in goods and services through November as compared to a \$90 billion deficit in the comparable period in

1997. **[data to be replaced later by more up-to-date statistics]** Compared to a similar point in 1997, year-to-date goods exports in 1998 are down 0.9 percent. Year-to-date goods imports are up a modest 5.1 percent in 1998 compared to the same period in 1997. Relative to past trends, the decline in exports is the more striking of the two figures. **[data to be replaced later by more up-to-date statistics]**

A large fraction of the increase in the dollar value of the U.S. trade deficit is due to the decline in U.S. exports to Asia; the contribution of import growth to the increased nominal value of the trade deficit has been quite modest thus far. As an indication of the likely effect of the East Asia crisis, the decline in U.S. exports to six East Asian countries (Indonesia, Japan, Korea, Malaysia, the Philippines, and Thailand) in the first ten months of 1998 was \$24 billion to \$30 billion at an annual rate, depending on the seasonal adjustment and timing method used. Korea accounted for almost two fifths of the decline. U.S. imports from these countries have also risen—although these imports have been on an uptrend for several years.

The increase in the trade deficit -- and the negative contribution of increased imports -- is larger when measured in *real* rather than nominal terms because import prices have fallen so that the quantities of goods imported have increased more than their dollar value. The fall in the prices of imports from four Newly Industrialized Economies (NIES) (Korea, Hong Kong, Singapore and Taiwan) amounted to 9.4% between August 1997 and August 1998; the prices of U.S. import from Japan declined by 5.5% over the same period. Although separate import prices for other Asian crisis economies are not available, their decline was likely yet larger, because the currencies of these countries depreciated against the dollar by even more than those

of the four NIES. In addition to currency depreciations, sharp drops in the global prices of primary commodities have exerted downward pressure on U.S. import prices. Import prices for petroleum products declined 31.8% in August relative to a year earlier; import prices for agricultural goods declined 7.7% relative to the previous year. Despite their overall decline, the prices of U.S. imports from Asia have fallen by a smaller percentage than the exchange rates of these countries vis-a-vis the dollar. Thus, the pass-through from exchange rates to import prices has so far been less than full. Because U.S. export prices have also fallen, the decline in U.S. exports of goods and services was more modest during the first half of the year when measured in real rather than nominal terms.

Longer-term perspective on the current account

International trade has contributed substantially to economic welfare and growth in the United States. Nevertheless, some contend that the large and growing U.S. trade deficit costs American workers jobs, while others argue that it reflects unfair trade practices of our trading partners or signals a loss of U.S. competitiveness in world markets. Although the growing trade deficit has been associated with some sectoral dislocations, job gains in services, information technology, and other non-traded sectors have more than compensated for job losses in manufacturing. Arguments about the adverse consequences of trade deficits are largely misplaced: the rising U.S. trade deficit is primarily a reflection of strong U.S. investment, employment and output growth rather than a symptom of economic weakness.

The current account as the saving-investment balance

Unraveling misconceptions about the trade deficit requires an understanding of the trade balance and a closely related concept, the current account balance. A country's trade balance is equal to the difference between the value of its exports -- the goods and services sold by its residents to foreigners -- and the value of its imports -- the goods and services which its residents buy from foreigners. The current account balance simply adds other sources of foreign income and foreign payments to the trade balance. The most important additional items are interest and investment earnings received (paid) on foreign assets (liabilities), and aid grants and transfers. A country's current account balance equals the difference between its national income (the sum of domestic production and the net income received from abroad) and its national spending (the sum of private and public consumption and investment spending). Since national saving is the difference between national income and total consumption, the current account is also equal to the difference between national saving and national investment. If a country's national income exceeds its spending or, equivalently, if national saving exceeds investment, the current account is in surplus. Conversely, if a country spends (consumes and invests) more than its national income, investment exceeds saving and the current account is in deficit.

In order to sustain a current account deficit -- namely, for investment to exceed national saving -- a country must finance it through capital inflows (borrowing) from the rest of the world. A country's current account deficit therefore equals the increase in its net foreign debt (or the decline in its net foreign assets if the country is a net creditor). Conversely, current account

surpluses -- reflecting an excess of saving over investment -- increase a country's net foreign assets.

Business cycles, long-run growth and the current account

Note: I am bothered by the interchangeable use of levels and changes. In chart 6-6, shouldn't the relationship be between the change in the current account and the change (not the level) of the deficit? It looks to me like the 80-82 recession goes the wrong way. Theoretically, there is no definite relationship between deficits and employment and output growth because other factors, particularly the change in the real exchange rate, also matter. I have tried some modest rewriting to reflect this concern.

The argument that current account deficits inevitably cause a net loss in jobs and output conflicts with the empirical finding that rapid growth of production and employment is commonly associated with large or growing current account deficits, while slow output and employment growth is frequently associated with large or growing current account surpluses. Chart 6-6 shows, for example, that the U.S. current account improved during the recessions of 1974-75 and 1991-92, while it declined during the cyclical upswings of 1970-1973, 1983-89, and 1993-1998. This reflects both the decline in import demand during recessions and the cyclical movements of saving and investment. During a recession, both saving and investment tend to fall. Saving falls because households typically defend their consumption patterns in the face of a temporary fall in income; and investment declines because low profits reduce profitable investment opportunities. However investment, which is highly sensitive to the profitability of capital, tends to drop more sharply than saving during recessions. The current account thus tends to improve. The trade balance typically improves during a recession because imports tend to fall

with overall consumption and investment demand. The converse occurs during periods of boom when sharp increases in investment demand typically outweigh increases in saving, producing a worsening of the current account. Of course, factors other than income influence national saving and investment, so that the tendency of a country's current account deficit to decline in recessions is not ironclad. For example, a switch to a more expansionary fiscal policy beginning in 1980 produced an exceptionally large decline in national saving during the 1980-82 recession.

The relation between the current account and economic performance typically holds not only on a short-term or cyclical basis, but also on a long-term or structural basis. Often, countries with rapid economic growth possess structural current account deficits, while those with weaker economic growth possess current account surpluses. This relationship likely derives from the fact that rapid growth and strong investment often go hand in hand. Whether the driving force for growth is the discovery of new natural resources, technological progress leading to opportunities to develop and produce new products, or the implementation of economic reform (like trade liberalization, capital market liberalization, macroeconomic stabilization), periods characterized by high economic growth are likely to be periods in which new investment is also unusually profitable.

Investment must, however, be financed with saving and if a country's national saving (the sum of private and public saving) is not sufficient to finance all new profitable investment projects, the country will rely on foreign saving to finance the excess of investment over national saving, experiencing a net capital inflow and a corresponding current account deficit. The current account deficit is merely the result of thousands of individual firms issuing debt or equity

or borrowing from banks to finance investment. As long as the individual investment and financing decisions are sensible, the associated current account deficit should promote, not detract from economic welfare. If the new investment projects are profitable, they will generate the extra earnings needed to eventually repay the principal and interest owed on the foreign debt.

When current account deficits reflect strong, profitable, investment programs, they work to raise the rate of output and employment growth, not to destroy jobs and production.

Historically, countries in early stages of rapid economic development, such as the U.S., Canada and Argentina in the early part of this century, have enjoyed an excess of investment over saving, running large structural current account deficits for long periods of time. The same general pattern has held in more recent times: in comparison to their slower growing developed country counterparts, faster growing developing countries have run structural current account deficits whereas the slower-growing mature economies have, on average, experienced surpluses.

The link between current account deficits and growth is also confirmed by a comparison of the U.S. trade balance with those of its G7 partners since the cyclical recovery of 1992 (Charts 6-7 and 6-8). A negative correlation between output growth and the current account and between employment growth and the trade balance is evident. The U.S. enjoyed the fastest output and employment growth and the largest trade deficit. Conversely, Japan had the second slowest rate of growth of output and the largest trade surplus. Trade surpluses are also the norm in Europe where growth of output and employment has been disappointing. Similarly, unemployment in the U.S. has been low and falling since 1993 while in the 1990s the unemployment rate in Europe has remained high and has been rapidly growing in Japan.

Budget deficits and the current account

Although current account deficits are not usually a cause for concern when they reflect strong investment opportunities, they may be a cause for concern if they instead reflect a decline in national saving. Since national saving includes the government's own saving or dissaving, a growing current account deficit can result from rising government budget deficits. Such deficits may be harmful, resulting in an unsustainable buildup of foreign debt, when the government spending they permit is devoted to current consumption rather than productivity-enhancing public investments.

For example, in the late 1970s many developing countries ran large budget deficits, borrowing heavily in world capital markets to finance them (either directly from international banks or indirectly by issuing bonds purchased by foreign investors), and accumulating large stocks of foreign debt in the process. The purpose of this borrowing was to support excessive government spending in the face of insufficient tax revenue. By 1982, however, many governments encountered difficulties in repaying interest and/or principal on their foreign liabilities. A severe 'debt crisis' erupted forcing many countries to negotiate a rescheduling of their foreign liabilities to avoid default.

The large current account deficits experienced by the United States during the 1980s, driven by large fiscal deficits, were a matter of concern for this same reason. High budget and current account deficits, the so called "twin deficits", led to high real interest rates, a crowding out of productive investment (as evidenced by the fall in the investment rate after its recovery from the 1982 recession) and a reduction in long-run growth opportunities. Chart 6-9 presents the

United States current account deficit, the national and public saving rates, and the national investment rate. By definition, the current account is the difference between national saving and national investment; this identity, however, is obscured by measurement errors, which have been particularly large in recent years due to a substantial statistical discrepancy between the income- and the product-side measures of GDP. Because of this widening discrepancy, the current account deficit has recently widened in spite of a narrowing gap between official measures of saving and investment.

The chart clearly shows the “twin deficits” of the 1980s: as fiscal deficits increased in an environment of tight monetary policy in the early 1980s, the U.S. dollar appreciated in real terms and the current account moved into substantial deficit. The crowding out of productive investment due to the high real interest rates associated with the fiscal deficit is suggested by the fall in the investment rate between 1984 and 1990. The current account improved during the 1990-1991 recession as the investment rate slumped sharply during the economic downturn.

During the 1990s the Federal budget deficit first declined, then disappeared, and finally turned to surplus in 1998. National saving increased as a consequence, in spite of a decline in the personal saving rate. Even so, the current account deficit has again increased. However, this increased deficit can be viewed as “virtuous” because it has been driven by an even stronger increase in the pace of national investment. The U.S. gross investment rate rose from a low of 12.2% of GDP in middle of 1991 to 16.0% in the third quarter of 1998.

The investment boom enjoyed by the United States since 1993 contributed to expanding employment and output during that period and will provide payoffs for many years to come. It

could not, however, have been financed by domestic saving alone: a current account deficit provided the additional capital inflow needed to finance that boom. In the absence of foreign lending, U.S. interest rates would have been higher and investment would inevitably have been constrained by the supply of domestic saving. Therefore, the accumulation of capital and the growth of output and employment would all have been smaller if the U.S. had not been able to run a current account deficit in the 1990s. Rather than choking off growth and employment, the large current account deficit, perhaps paradoxically, allowed faster growth in the U.S. economy.

The Asian crisis and the current account deficit

The experience of the Asian crisis countries demonstrates that current account deficits can be dangerous not only when they finance unsustainable budget deficits but also when they finance low profitability investments. As noted in this Chapter, the crisis afflicted East Asian countries all enjoyed high saving rates. Their large current account deficits were attributable to their even higher investment rates. Even so, the build-up of debt deriving from these current account imbalances became unsustainable because, as discussed in Section 3, distortions in the operation of East Asian financial systems led to excessive investment in low profitability projects. Investment driven current account deficits only enhance economic welfare when expected investment returns exceed the cost of the borrowed funds. Throughout the East Asian region the rate of return to capital, while still positive, appeared to be falling in the 1990s signaling a deterioration in the quality of the investment projects.

Moreover, foreign debt must be serviced and, at some point, repaid. Therefore, debtor countries must ultimately run trade surpluses, potentially necessitating adjustments in their real exchange rates. Borrowing in world capital markets is perhaps least problematic when the new investments it permits augment a country's capacity to produce goods for sale in foreign markets.

In contrast, many Asian countries borrowed abroad to finance commercial and residential investments, producing goods (offices and housing services) that are not usually traded internationally.

The U.S. international investment position

If current account deficits continue year after year, creditor countries eventually become net debtors: every year the stock of net foreign liabilities rises by an amount equal to the current account deficit, ignoring valuation effects. Because the capital inflows which finance current account deficits can take the form of equity investment, such as foreign direct investment, rather than simply foreign loans, an increase in a country's net foreign liabilities does not automatically, however, translate into an increase in "foreign debt."

The relationship between the U.S. current account and the change in the U.S. net foreign asset position is shown in Chart 6-10. In the 1970s, the U.S. was a net creditor country. However, the string of current account deficits in the 1980s led to a reduction of net foreign assets and eventually, in 1987, turned the U.S. into a net debtor country. Because U.S. current account deficits of the 1980s were primarily driven by fiscal deficits and low national saving rates, the accumulation of net foreign liabilities by the U.S. was greeted with some concern. The large fiscal deficits were financed by government bonds, some of which were bought directly by

foreign investors. Since 1993, however, current account deficits have been driven by increases in national investment with foreign financing taking the form of both direct and portfolio investment (see Chart 6-11 for trends in inward and outward foreign direct investment). At present, U.S. net foreign liabilities amount to a relatively modest 10 percent of U.S. GDP.

Policies towards the external imbalance

Calls for protection from import competition by domestic industries typically increase when the U.S. trade deficit burgeons, as it has since the onset of the Asian crisis. Although the crisis has caused dislocations in some export and import competing industries, jobs remain readily available in the U.S. economy. According to the argument of this section, the growing U.S. trade imbalance primarily reflects strong U.S. investment and growth opportunities in comparison with our trade partners rather than increased barriers to trade in foreign markets. Looked at another way, the crisis countries have been forced to reduce their own current account imbalances due to their sudden inability to finance such deficits through foreign borrowing. The worsening of the U.S. trade balance thus far in 1998 primarily reflects falling exports to these East Asian countries--declines in their imports engendered by the sharp economic contractions those countries have suffered.

The maintenance of open markets by the United States and other industrial countries is essential to the restoration of world economic growth. Higher barriers to trade in the U.S. would not only hinder recovery in Asia and other crisis countries but provoke retaliation, hampering our own growth prospects. Indeed, it is worth remembering that the Great Depression of the 1930s was exacerbated by a dramatic switch to protectionist policies in the United States and other

industrial countries. As the crisis economies recover, their demand for U.S. goods and services will increase as well, once again fueling our own export growth.

6. CONCLUSION

During a period of great turmoil in the global economy the first imperative of the Administration has been to work with the international community to sustain growth in the world economy, a prerequisite for the recovery of the crisis afflicted countries. No country, including the United States, is an island in the world economy. The growth prospects of all industrial nations will suffer unless all do their part. This need has been clearly recognized by the United States and its G7 partners.

The United States remains committed to opening markets to international trade, recognizing that an open trade environment will support the recovery of crisis-afflicted countries and ensure continued growth of the world economy. At the start of his Administration in 1993, President Clinton declared: "The truth of our age is this - and must be this: Open and competitive commerce will enrich us as a nation...And I say to you in face of all the pressure to do the reverse, we must compete, not retreat." Then, as now, the Administration remains strongly committed to such outward-looking, internationalist policies.

Beyond working to ensure growth in the industrial world, the United States has focused since the outset of this crisis on the need to contain financial contagion and restore the confidence of market participants so that capital flows can continue, and on the necessity of

promoting recovery and alleviating suffering in the crisis afflicted countries. The Administration has supported the IMF in its mission of providing financial assistance to countries in crisis that are willing to implement the often tough reforms needed to strengthen the underpinnings of their economies. At the same time the Administration is collaborating with other countries to strengthen the architecture of the international financial system with the goal of enhancing the stability of the international financial system in a world of continued integration of global product and financial markets. These reforms of the international financial architecture are discussed in Chapter 7.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 4-JAN-1999 09:09:39.00

SUBJECT: Re: Chapter 6

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

READ:UNKNOWN

TEXT:

The edits I have made are rather substantial. You should see if you agree with them. I have also raised some questions, highlighted in the file in boldface. I will be happy to discuss the changes with you today or later this week if you like.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 4-JAN-1999 16:04:30.00

SUBJECT: draft of chapter one

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

READ:UNKNOWN

CC: James M. Treadway (CN=James M. Treadway/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Here's an almost complete draft (I gag on extolling our accomplishments and can only do so much in a day). the section on global challenges needs pruning and integration with the evolving chapters 6 and 7. The end needs to grow (though the chapter is already rich in fertilizer) and I will keep working on that.

Chad===== ATTACHMENT 1 =====

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

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D16]MAIL45737240L.036 to ASCII,
The following is a HEX DUMP:

CHAPTER I

Meeting Challenges and Building for the Future

THE ECONOMIC POLICIES of the past 6 years have nurtured and sustained what is now the longest peacetime expansion in the Nation's history. By December 1998, the 93rd month of this expansion, more than 18 million new jobs had been created (more than 17 million of them since January 1993). More Americans are working than ever before, the unemployment rate is the lowest it has been in a generation, and inflation remains tame. This record of achievement is especially noteworthy in light of the troubles experienced in the international economy in 1998. The United States has not entirely escaped the effects of this turmoil, but the fundamental soundness of the U.S. economy has prevented it from foundering in the storm.

A strong policy foundation was laid in 1993 when the President put in place an economic strategy grounded in deficit reduction, investment, and opening markets abroad. Since then, the deficit has come down steadily, and in 1998 the Federal budget was in the black for the first time since 1969. This policy of fiscal discipline, together with an appropriately accommodative monetary policy by the Federal Reserve, produced a favorable climate for business investment and a strong investment-led recovery. While reducing overall Federal government spending as a share of GDP, the Administration has pushed for more spending in critical areas such as education and training, children, the environment, health care, and research and development. And although international economic conditions have led to a dramatic widening of the trade deficit, the United States has nevertheless been successful in expanding its real exports by more than 8 percent per year since 1993.

Clearly, there is much to be proud of in the economic accomplishments of the past 6 years. But as the events in the international economy this year have reminded us, our prosperity is threatened when the global economy does not function well.

Our immediate challenge on the international economic front is to help ensure that the global economy rebounds and begins to regain strength. Our longer run challenge going into the 21st century will be to continue the process of developing international arrangements that encourage countries to embrace opportunities to advance their own economic development through international trade and investment.

Challenges remain at home as well. The restoration of fiscal discipline is one of the most important accomplishments of the past 6 years. One very important challenge going forward will be to maintain that discipline and avoid squandering the future surpluses that this discipline has produced. That is why, in his 1998 State of the Union Address, the President called for reserving the budget surplus until Social Security was reformed for the 21st century. A second major development in the past 6 years has been the reform of the Nation's welfare system, which, together with the strong economy, has produced a dramatic reduction in welfare caseloads. The challenge going forward will be to continue to make work pay for all Americans who play by the rules and want to work, while preserving an adequate safety net for the truly disadvantaged. Finally, the overall strength of the American economy over the past 6 years should not blind us to the inevitability of change and the possibility of disruption that is always present in a dynamic market economy. For example, difficult agricultural conditions in 1998 raised questions about whether the new market-oriented farm policy enacted in 1996 provides an adequate safety net for small farmers. Similarly, the wave of mergers among financial, telecommunications, and other large companies has raised questions about disruptions to communities and workers that go beyond traditional antitrust concerns. The challenge here is to capture the long-run gains from productivity-enhancing change without ignoring the short-run costs to specific groups that are hurt by the change.

This chapter provides an overview of these challenges and Administration responses. The next section provides background by putting the current economic expansion in historical context.

POLICY LESSONS FROM THREE LONG EXPANSIONS

The current economic expansion is the third one that has lasted at least 7 years, based on National Bureau of Economic Research reference dates going back to 1854 (Box 1-1). This section provides a brief overview and comparison of each of these long expansions in order to understand the role of macroeconomic policy in promoting balanced and non-inflationary growth.

Although all signs indicate that the current economic expansion has continued into 1999, its precise length will not be known until some time after it has ended. The dating of business cycles is not an official U.S. government function. Instead, once it has become clear that the economy has reversed direction, the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) meets to determine the turning point. For example, the July 1990 business cycle peak was announced April 25, 1991 and the March 1991 trough was announced December 22, 1992. The NBER does not define a recession in terms of two consecutive quarters of decline in real GDP. Rather, a recession is a recurring period of decline in total output, income, employment, and trade, usually lasting from 6 months to a year.

The Employment Act of 1946 (which created the Council of Economic Advisers) established a policy framework in which the Federal government is responsible for stabilizing short-run economic fluctuations, promoting balanced and non-inflationary economic growth, and fostering low unemployment. Although the economy has continued to experience fluctuations in output and employment in the subsequent half century, the United States has avoided anything like the the prolonged contraction of 1873-79 or the one-fifth contraction in output and the rise in the unemployment rate to 30 percent that characterized the Great Depression. Moreover, the three longest expansions of the past century--including the current one--have occurred since the government was given an explicit mandate to stabilize economic fluctuations and promote economic growth.

Each of the long post-Employment Act expansions can be interpreted as an experiment in macroeconomic policy. The longest--the Kennedy-Johnson expansion of 1961-69, which lasted 106 months--was associated with the first self-consciously Keynesian approach to economic policy. It was also associated with Vietnam War spending. The longest (completed) peacetime expansion--the Reagan-Bush expansion of 1982-90, which lasted 92 months-- represented an anti-Keynesian, supply-side approach to policy. The current expansion is not readily characterized ideologically, but it represents the only long expansion in which fiscal policy was *contractionary* rather than expansionary.

KEYNESIAN ACTIVISM IN THE 1961-69 EXPANSION

The Kennedy Administration Council of Economic Advisers advocated activist macroeconomic policies based on the ideas of the British economist John Maynard Keynes. Ironically in light of subsequent developments, the Kennedy Administration economists diagnosed the economy at the time as suffering from "fiscal drag" arising from too large a budget *surplus*. In particular, the high marginal tax rates in effect then were seen as causing tax revenues to rise rapidly as the economy approached full employment, draining purchasing power and slowing demand before full employment could be achieved. The problem was not the sensitivity of Federal government receipts and expenditures to changes in economic activity--that automatic stabilizer role was recognized as valuable, particularly when economic activity faltered. The problem was that the automatic stabilizers kicked in too strongly on the upside, not only preventing the economy from reaching full employment but also preventing the actual budget from balancing. Thus, President Kennedy proposed a large tax cut designed to reduce the full-employment (or standardized) budget surplus and restore full employment.

The tax cut passed in 1964 provided further stimulus to the economic recovery that had begun in 1961. The unemployment rate continued to fall, dropping below the 4 percent rate that was considered full employment at the time in early 1966. Inflation had been edging up as the unemployment rate came down, but it then began to rise sharply (Chart 1-1). Although conditions

appeared to call for fiscal restraint, President Johnson was reluctant to raise taxes or scale back his Great Society spending initiatives. Meanwhile Vietnam War spending continued to provide further stimulus.

At the time, it was believed that the rise in inflation could simply be unwound by moving the economy back to 4 percent unemployment, but when restraint was finally applied it produced a rise in unemployment with little reduction in inflation. In general, the mainstream consensus among economists that they could fine-tune economic performance in order to achieve the goals of the Employment Act was dealt a serious setback by the stagflation, productivity slowdown, and oil price shocks that characterized the 1970s.

THE REAGAN REVOLUTION AND THE 1982-90 EXPANSION

By the time Ronald Reagan took office in 1981 the economy was bouncing back from the short 1980 recession but it was also experiencing high inflation. President Reagan's program for

economic recovery called for large tax cuts, increased defense spending, and reduced domestic spending. The justification for this policy was not Keynesian demand stimulus, but rather the expectation that substantial cuts in marginal tax rates would call forth sufficient new work effort and investment that the economy's potential output would grow rapidly, easing inflationary pressure and bringing in sufficient new revenue to keep the budget deficit from increasing. In the short run, the aggressive anti-inflationary monetary policy of the Federal Reserve contributed to a deep recession in 1981-82. The budget deficit ballooned and stayed large even as the Fed eased and the economy began to recover.

Compared with the 1961-69 expansion, the 1982-90 expansion was characterized by higher levels of both inflation and unemployment. But the main distinguishing feature of this expansion was almost certainly the large budget deficits and their macroeconomic consequences. The combination of an expansionary fiscal policy and a tight monetary policy produced high real interest rates, an appreciating exchange rate, and a large current account deficit. Although foreign borrowing offset the drain on national saving from the budget deficit and prevented the very sharp squeeze on domestic investment that would have taken place in a closed economy, the net effect of this policy choice was low national saving and relatively low national investment. As in the 1961-69 expansion, inflation began to rise as the unemployment rate dropped. By this time, however, the prevailing view was that inflation could not be reversed simply by returning to the full-employment unemployment rate (Box 1-2). Instead the economy would have to go through a period of subnormal growth in order to squeeze out inflation.

DEFICIT REDUCTION AND THE CURRENT EXPANSION

Box 1-2. Full Employment and the NAIRU

Maintaining full employment is a major goal of macroeconomic policy, but how exactly is that objective defined? The prevailing view in the 1960s was that lower unemployment rates were associated with higher rates of inflation, and that full employment was the unemployment rate associated with a tolerable inflation rate. At the time, the full-employment unemployment rate was thought to be about 4 percent. Ideas changed during the 1970s, and economists came to believe that, once the unemployment rate dropped below a certain level, prices would not just rise but accelerate (that is, inflation would rise). The full-employment unemployment rate came to be defined as the Non-Accelerating Inflation Rate of Unemployment, or NAIRU. Statistical studies suggest that the NAIRU was higher from the mid-1970s through the 1980s (about 6 percent) than it was in the 1960s (about 5 percent) and that it has come down some in the late 1990s. Although indicative of the risk of inflation, estimates of the NAIRU have a wide band of uncertainty and should be used carefully in formulating policy. The NAIRU implicit in the Administration's forecast has drifted down in recent years and now stands at 5.3 percent.

Technically, the economy was out of the 1990-91 recession when President Clinton took office, but the recovery was weak and job growth appeared slow. And, of course, the recession had produced very large budget deficits once again. The Clinton economic program sought to get the economy moving again while bringing the budget deficit under control. Rather than relying on tax cuts to provide the stimulus, the Clinton program was based on the idea that reducing the Federal budget deficit would allow the Fed to ease monetary policy, which would bring down interest rates and stimulate private investment. Because the NAIRU (the unemployment rate at which rising inflation becomes likely) was higher in the early 1990s than it was in the 1960s, the unemployment rate could not come down as low in this expansion as it did in the 1960s. But with a responsible fiscal policy in place and favorable inflation and productivity developments, the Federal Reserve was able to exercise forbearance as the unemployment rate fell and the expansion was not choked off prematurely. The combination of low inflation

and low unemployment in this expansion is comparable to the low "misery index" achieved in the late 1960s. This time, however, the balance between inflation and unemployment is better and inflation is tame rather than rising.

TABLE 1-1--*Stabilization Policy Indicators in Three Long Expansions*

	First 6 Years	7 th Year	Last 12 months
1961-69			
Core inflation rate	1.8	4.4	5.9
Unemployment rate	5.1	3.8	3.5
1982-90			
Core inflation rate	4.4	4.4	5.1
Unemployment rate	7.2	5.3	5.3
1991-present			
Core inflation rate	3.1	2.3	2.4
Unemployment rate	6.3	4.8	4.5

Judged by the objectives of stabilization policy (inflation and unemployment), the current economic expansion is one of the most successful in the Nation's history (Table 1-1). Three-quarters of the way through the eighth year of expansion, inflation remains tame even though the unemployment rate has been below most economists' estimates of the NAIRU for almost 2 years. This situation stands in marked contrast to the sharply rising inflation experienced at the end of the 1960s expansion and the milder price acceleration seen at the end of the 1980s expansion. To be sure, this good inflation performance has been aided by favorable conditions such as the long-run decline in computer prices, low oil prices, and downward pressure on traded goods prices due to weakness in the world economy. And, as discussed in Chapter Two, the Administration (and consensus private forecasts) project a moderating of growth over the next 2 years. What is significant, however, is that the actions taken over the past 6 years to reduce the budget deficit created conditions in which the Federal Reserve could accommodate steady non-inflationary growth without raising interest rates.

This expansion appears weaker than the others in terms of growth in GDP (Table 1-2). But with slower growth in the working-age population and lower trend productivity growth since 1973, it is understandable that aggregate GDP has grown more slowly than it did in the 1960s. Moreover, growth over the

1980s expansion partly reflects how far below potential output the economy was at the start of the expansion rather than a particularly strong underlying growth trend. Finally, growth in aggregate income matters for some purposes, but productivity growth is what matters for real wages and a rising standard of living over the longer term. And productivity growth has continued relatively strong well into this expansion (rather than exhibiting the decline that often occurs late in expansions). Nevertheless, the rate of productivity growth over this expansion remains well below that achieved in the 1960s.

TABLE 1-2--*Economic Growth Indicators in Three Long Expansions*

		from trough	from previous peak
1961-69			
Real GDP	4.8	4.3	
Population		1.5	1.5
Labor force		1.7	1.7
Non-farm productivity		3.0	2.8
1982-90			
Real GDP	3.7	2.6	
Population		1.2	1.2
Labor force		1.6	1.6
Non-farm productivity		1.3	1.0
1991-present			
Real GDP	3.0	2.6	
Population		1.0	1.0
Labor force		1.2	1.1
Non-farm productivity		1.5	1.4

Relatively slow productivity growth continues to prevent the kind of wage and income growth that produced a doubling in living standards between 1948 and 1973. As discussed in Chapter Three, however, the high-pressure economy of the past few years has begun to pay off for workers at the bottom of the earnings distribution, who have seen their wages stagnant or falling since the early 1970s.

In terms of lessons for policy, this expansion has illustrated the importance of getting the mix of monetary and fiscal policy correct. Unlike the expansion of the 1980s, which saw an expansionary fiscal policy restrained by tight monetary policy, the current expansion has taken place under conditions of fiscal restraint and an accommodative monetary policy. The 1980s policy mix brought with it relatively high real interest rates, low national saving, dampened net investment, and a large current

account deficit that changed the United States from the world's largest creditor nation to its largest debtor. Strong performance by the U.S. economy in the 1990s has continued to be associated with a strong dollar and, most recently, a widening trade deficit as the United States has continued to absorb foreign goods while weakness abroad has reduced demand for U.S. goods. On balance, however, the current account deficits of the 1990s have

been the result of rising net national investment remaining greater than rising net national saving.

The current account depends only on the gap between saving and investment. But the implications for future growth depend on the levels of saving and investment. The current expansion has been distinguished by the large contribution of private investment to growth in GDP, and the relative unimportance of government spending (Chart 1-2). Chapter Two discusses this investment boom in greater detail

CONCLUSION

Through a combination of sound policy and other favorable conditions, the current economic expansion has achieved both high employment and low inflation. Longer run trends in productivity and population growth ultimately determine how fast the economy grows. But the investment that has driven the current expansion should pay off in stronger growth and productivity and higher future standards of living than otherwise would have been the case. With the Federal budget once more under control, large deficits will not constrain future policy choices.

PRESERVING FISCAL DISCIPLINE

Reducing the Federal budget deficit has been a centerpiece of this Administration's economic policy. In 1993, the President pledged to cut the deficit in half by 1998; in 1997, he promised to balance the budget by 2002. In fact, the budget was in the black last year with the largest surplus as a share of GDP in over 40 years.

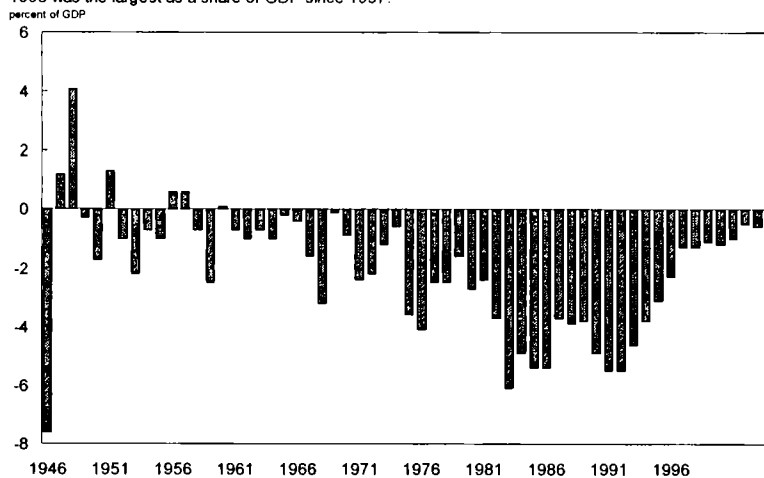
The Office of Management and Budget (OMB) now projects substantial surpluses in the unified Federal budget over the next several decades. Eventually, however, the aging of the U.S. population and continued growth in health-care spending per person are expected to push the budget back into deficit. Fortunately, the favorable near-term outlook provides an important opportunity to address these longer-term problems.

REACHING SURPLUS

Except during wars and economic downturns, the Federal budget was roughly balanced for most of the Nation's history. Yet the large budget deficits that emerged in the early 1980s persisted throughout that decade's economic expansion, and then worsened in the recession of the early 1990s (Chart 1-3). In fiscal year 1992, outlays exceeded receipts by \$290 billion, or 4.7 percent of GDP, and many observers expected the deficit to increase over time. However, by 1998, receipts exceeded outlays by \$70 billion, or 0.9 percent of GDP. (All references to years in this section are fiscal years running from October through September, unless otherwise noted.)

Chart 1-3 The Federal Budget Balance, 1946-1998

After a period of persistent large deficits in the 1980s, the Federal budget surplus in 1998 was the largest as a share of GDP since 1957.



Between 1992 and 1998, the Federal budget balance improved by 5.6 percent of GDP. In an accounting sense, this remarkable change is attributable in almost equal parts to an increase in receipts as a share of GDP and a decline in outlays as a share of GDP. In 1998, receipts were equal to 20.5 percent of GDP, up from 17.8 percent in 1992. Outlays were equal to 19.8 percent of GDP, down from 22.5 percent in 1992 and now the smallest as a share of GDP since 1974. More fundamentally, three forces have been at work: policy changes, faster-than-anticipated economic growth, and more tax revenue as a share of income (without an increase in tax rates). In 1993, the President and Congress enacted a 5-year deficit reduction package comprising more than \$500 billion of spending reductions and revenue increases. Taxes were raised on only the top 1.2 percent of taxpayers by income. Both defense and non-defense discretionary spending--a wide array of programs that include education, training, science, housing, transportation, and foreign aid--have fallen as a share of GDP. The Administration has cut the civilian Federal work force by over 300,000 employees, creating the smallest work force in 35 years and, as a share of total civilian employment, the smallest since 1931. (These are full-time equivalents, or FTEs.)

In addition to the changes enacted right away, the law extended two important rules to ensure continued budget discipline that had first been adopted in the 1990 Budget Act. First, discretionary spending remained subject to caps. Second, "pay-as-you-go, or PAYGO provisions were maintained. These require that any policy change that would raise spending on mandatory programs (such as Social Security, unemployment compensation, and Medicare and Medicaid) or that would lower revenues--compared with existing law--must be offset by spending cuts or revenue increases. In 1997 the President and Congress took the further step to finish the job by passing the Balanced Budget Act, which incorporated additional deficit reduction measures.

The second factor contributing to deficit reduction was that the economy performed better than most observers had expected.

This increased taxable income. It also reduced unemployment insurance benefits as well as some means-tested entitlement programs, though the effect of better economic performance is considerably smaller on the spending side than on the tax side.

Finally, two technical factors have boosted receipts and depressed outlays over and above what has been due to policy changes and macroeconomic conditions. Most important, tax receipts have been coming in higher than expected. Although tax rates have not changed since 1993, tax receipts have increased as a share of GDP. Some of the increase in personal income tax receipts, which account for almost half of all Federal revenue, reflects real bracket creep. Even though tax brackets are indexed for inflation, rising real incomes move more taxpayers into higher tax brackets. Some reflects capital gains, and more of it probably depends on capital income broadly construed. Increases in the "average effective tax rate" in 1996 and 1997 were attributable to a combination of larger-than-usual capital gains, a greater share of aggregate income appearing in higher tax brackets, and other factors. Corporate income tax receipts have also increased, due to the strong runup in corporate profits.

Expenditures in Medicare and Medicaid have also been restrained by slower growth in ...

The pattern of surprises continued last year. In early 1998, both OMB and the Congressional Budget Office (CBO) projected that the Federal government would record a small

deficit in 1998. By the end of the fiscal year in October, the budget was in fact in surplus by \$70 billion—a dramatic improvement over 1997.

Part of this surprise was, once again, stronger-than-anticipated economic growth. The economic forecast on which OMB's budget forecast was based was deliberately chosen to be conservative, and stronger-than-projected economic growth boosted household disposable income (and hence tax receipts) substantially. In addition, the ratio of income tax revenue to disposable income rose again, even though there were no significant changes in the tax law. Because detailed data on 1998 tax receipts are not yet available, the explanation for this rise is unclear. Corporate tax receipts also increased strongly last year, owing to robust corporate profit growth.

FISCAL POLICY IN AN ERA OF SURPLUSES

Achieving a surplus in the Federal budget has laid the groundwork for tackling longer-term problems. Indeed, balancing the budget now is the important first step to improving the fiscal situation later. The most important of the longer-term problems is posed by the aging of the population.

The rapid aging of the U.S. population is due to both lower fertility and lengthening lifespans. Since 1970, the average lifespan has increased by almost 5 years, and it is projected to rise another 4 years by 2050. Longer lifespans imply that more people will live to receive health and retirement benefits (and to pay taxes) and that they will receive those benefits for a longer time.

In addition to the pressure on the financial health of the Social Security and Medicare systems, the aging of the population puts pressure on the economy. With a smaller share of the population expected to be in the labor force, there are several steps we can take. First, ensure that people aren't forced out at age 65 (have we done anything to ensure that?). Second, make sure that tomorrow's workers are as efficient as possible, meaning that they have lots of capital and education and training.

But we also need to own a lot of capital, so we earn the return, and can sell the principal. Or, we can create more productive capacity through more investment.

Social Security has been financed primarily on a pay-as-you-go basis. Currently, there are almost 3.5 workers for every retiree, but projections suggest that this ratio will decline steadily until, in 30 years, it will be only about 2 workers per retiree. If there were no advance funding, this demographic change would require sharp reductions in benefits or increases in taxes. But the 1983 reform instituted changes that provided advance funding to cushion the future adjustments that will be required. The buildup in the trust fund is now projected to be inadequate, however. Note that this is not just a baby boom problem. Although the Social Security actuaries expect that the baby boomers' retirement will hurt the system, they do not expect demographic trends to improve markedly in later periods.

Achieving a budget surplus is important for the country's long-run future, as is discussed more fully below. But this should not preclude the possibility of running a short-run deficit if needed for business cycle purposes. Indeed, having reached a more defensible general position gives us more options if we need them. Automatic stabilizers are important, and a smaller deficit reduces the impetus for fiscal rules (like a balanced budget amendment) that might have eliminated or reduced these.

Discretionary fiscal policy is not generally a good idea (Japan being a current exception), but it is possible.

Shifting from deficits to surpluses means that the outstanding federal debt will no longer increase the way that it had been (chart 1-4). Nevertheless, debt held by the public is close to \$4 trillion (the equivalent of 46 percent of GDP), so the government will continue to borrow substantial amounts in order to redeem maturing securities. The management of that debt has important implications for federal finances and the functioning of financial markets.

First, the Treasury has reduced the number of separate issues.

The Treasury hopes that by concentrating future coupon offerings in larger, less-frequent auctions will maintain the liquidity of these securities while still allowing for sufficient issuance of bills to maintain their liquidity as well. In other words, the Treasury hopes to "maintain offering sizes in selected securities by paring back the range of offerings." The government also wants to prevent further upcreep in the average maturity of the outstanding debt held by private investors, now standing at 65 months.

Second, the government continues to increase its issuance of Treasury Inflation-Protected Securities. The government issued a 30-year indexed bond last April to complement the five-year and ten-year indexed notes issued for the first time in 1997. [will there be a regular auction schedule for these notes? Check quarterly refunding announcement]

MEETING THE INTERNATIONAL CHALLENGE

This Administration has been committed from the start to outward looking trade and investment policies. The general principal is that open domestic markets and an open global trading system are superior to trade protection and isolationism in raising wages and living standards over the longer term. Recent strains to the fabric of the international economy have increased the allure of protectionism in some quarters. But the main lesson should be that it is important to reform the international financial system in ways that make such crises more unlikely without abandoning the benefits that come with increased international trade and investment flows.

A year and a half has elapsed since the Asian crisis began with the collapse of the Thai baht in July 1997. Unfortunately, what started as a regional economic and financial crisis in East Asia subsequently developed into a larger global crisis, spreading to financial markets around the world, impacting global commodity markets, impairing economic development and imposing extraordinary hardship in the crisis-afflicted countries, and posing risks to growth in the United States and other industrial countries. In its most recent *World Economic Outlook* (issued in October), the International Monetary Fund (IMF) forecast 2.0 percent world real growth in 1998, a precipitous drop from the 4.3 percent growth the IMF had expected in October 1997. Forecasted world growth for 1998 is now comparable to levels that have not been seen since the pronounced world slumps of 1974-75, 1980-83, and 1990-91. Japan's economy is expected to decline by 2.5 percent. The newly industrialized Asian economies (Hong Kong, Taiwan, Singapore, and Korea) are predicted to contract by 2.9 percent. The economies of the ASEAN-4 nations (Indonesia, Malaysia, Philippines, and Thailand) are now expected to shrink by a staggering 10.4 percent. Moreover, expected growth in the

developing countries in the Western Hemisphere is now 2.8 percent, down from 5.1 percent a year ago; and Russia is expected to contract by 6 percent this year.

CONTAINING THE CRISIS AND PROMOTING RECOVERY

With such dim growth prospects, it is premature to conclude that the world economy is out of the woods. But conditions have improved substantially since October, when it appeared that the world might be headed into a generalized global credit crunch. Several positive developments have contributed to the turnaround.

First, monetary conditions were eased in the key industrial countries. Here in the United States, the Federal Reserve reduced the Federal funds rate three times, helping to restore confidence and liquidity. Japan, Canada, and most European countries also lowered interest rates. Second, concern that the United States would not meet its commitment to the International Monetary fund was relieved in October when the Congress approved \$18 billion, opening the way for about \$90 billion of usable resources to be provided by all the IMF members to the liquidity-strapped institution. Third, negotiations leading to a support package for Brazil helped calm Latin American markets.

Fourth, Japan passed legislation to address the problems of its banking sector and the government proposed a supplemental fiscal package, restoring some confidence in Asian markets. An appreciating yen reduced the risk of a devaluation by China that could have led to another round of competitive devaluations in Asia.

In a series of speeches, President Clinton presented a number of proposals to deal with the crisis: an emergency fund within the IMF to support countries subject to speculative pressures despite good economic fundamentals; measures to support accelerated systemic restructuring of banks and corporations in Asia; significant increases in multilateral financial institutions' support of social safety nets in crisis countries; increases in trade financing to other affected countries; and support for the reform of the international financial architecture.

The commitment of industrial countries to sustaining or promoting growth in their own economies has been important in containing the crisis and will be crucial to restoring the health of

the international economy. Industrial countries are the main customers of the crisis-afflicted countries and are vital to their recovery. Japan in particular has a key role to play in maintaining world economic growth, and its performance will determine the prospects for Asia's recovery. Japan is not only the world's second largest economy, but also the most important customer of, investor in, and lender to the crisis afflicted countries in Asia. However, Japan fell into a full fledged recession. Real growth over the four quarters of 1997 amounted to -0.4 percent. In the first half of 1998, Japanese real GDP was down 4.3 percent at an annual rate--far worse than expected. Japan risks descent into a deflationary spiral in which falling prices raise real interest rates, further discouraging spending. To play its necessary role, Japan must take strong fiscal measures to stimulate domestic demand, to restore confidence, to deal with the problems of its banking system, to open its markets, and to deregulate its economy.

It is important to emphasize that in serving as an engine of global growth, the United States will inevitably see an increase in its already sizeable trade deficit, and some sectors, particularly those that are heavily exposed to trade, will experience disproportionate impacts. As a result, over the next year or so, calls for protection will be on the rise, and it will be important to find more constructive approaches to the disruptions caused by trade. The United States has urged the crisis impacted countries to keep their own markets open, and this country must itself remain committed to outward looking, internationalist policies.

Beyond working to promote growth in the industrial world, the United States has been focused since the outset of this crisis on the need to contain financial contagion and to restore the confidence of market participants--a prerequisite for capital flows to continue. As discussed in greater detail in Chapter Six, for example, the United States has supported the IMF in its goal of providing financial assistance to countries that are in crisis, contingent on their willingness to implement the often tough reforms needed to restore economic confidence and strengthen the underpinnings of their economies.

The current crisis has many unique features that make it different from crises past. Historically, crisis prone countries had large budget deficits, high public debt, high inflation rates, slow growth and low savings and investment rates. By contrast,

the crisis stricken Asian countries had low budget deficits, low public debt, single digit inflation rates and high savings and investment rates. In light of these differences, some critics of the IMF have claimed that the crisis was purely due to irrational panic and speculative capital flight. And they have faulted the IMF for mindlessly applying traditional medicines. The IMF has had to learn as it has proceeded throughout this crisis. But it seems to be widely agreed now that structural weaknesses, particularly in the process of financial intermediation, and not simply irrational capital flight, was central in initiating the crisis.

And that is why IMF programs, in addition to stressing the necessity for countries to eschew inflationary finance in responding to the crisis, have particularly stressed the need to take steps to strengthen weak banking systems by closing or recapitalizing inefficient or insolvent banks, to end cronyism in lending, to reduce corruption, and to strengthen the financial system.

Although structural problems thus played a key role in igniting the financial crisis, contagion is also at work, and it now threatens countries that have made great progress in implementing sound macroeconomic policies and have worked to strengthen the fundamentals of their economies. To deal with such threats, the President has proposed, and the G-7 has agreed to explore, creating a precautionary financial facility based in the IMF whose goal would be to provide assured access to assistance in the event of need (a credit line, in effect) to countries with sound policies which have acted responsibly, thereby helping them fight off the contagious impact of the ongoing crisis.

Finally, it has long been apparent that the IMF's resources had to be expanded for it to play its critical role in countering contagion. And the key roadblock was the failure of the U.S. to meet its own financial obligation to the International Monetary Fund. This Administration argued tirelessly to Congress to fund the IMF and the budget agreement reached in November at long last contains authorization for the U.S. to pay its IMF dues and provide its contribution to the New Agreement to Borrow. Meeting its own international commitments also strengthens the ability of the United States to lead in this crisis.

The United States supports the basic IMF approach, which entails asking countries to take responsibility for improving economic fundamentals as a condition for lending. But it also

recognizes the need to do more to help crisis-stricken countries get back on their feet, restore growth, and mitigate the suffering that has been endured by many citizens in the affected countries. A decade of lost growth would be intolerable, and the United States recognizes that more is required than simply being a good customer for those countries' products.

Many of the crisis afflicted countries lack adequate social safety nets. For that reason, the President has asked the World Bank and Asian Development Bank to double their aid in support of strengthening the social safety net in crisis affected countries. The focus of the new lending is on basic needs, children, the elderly, the unemployed, and groups in the affected countries who are most vulnerable to economic change.

A problem that is delaying recovery in several of the crisis countries is that many Asian companies and banks, including many that were in good health before the crisis, have become engulfed in massive debt problems due to systemic national economic problems. For example, in Indonesia, Korea and Thailand, the combination of sustained high interest rates and illiquidity has led to harsh economic contraction and a vast overhang of bad debt. Debt to equity ratios that were already very high before the crisis (about 300 percent in Korea for the top 30 chaebols) have become unsustainable now (over 500 percent in Korea, 400 percent in Thailand and even higher in Indonesia) due to the real devaluation of their currencies and the burden of high real interest rates. The World Bank estimates that 20 to 65 percent of firms in these three countries have balance sheet losses greater than equity. When insolvent, highly leveraged companies cannot service their debt, a self reenforcing spiral is created in which banks' cash flows are squeezed, forcing them to contract new lending not only to troubled corporations but even to those in better health. To address this problem, the United States is working with the World Bank, the IMF, and individual countries to see if comprehensive restructuring plans can be devised to restore the flow of credit so that firms in these countries can get back to the business of producing output and creating jobs.

STRENGTHENING THE INTERNATIONAL FINANCIAL ARCHITECTURE

The most important question raised by the recent international crisis is, what can we do to make sure the world never again faces another one like it? Unfortunately, there is no silver bullet--no simple solution that would guarantee countries the benefits of global capital flows while eliminating the risk that a crisis of confidence could once again result in the painful withdrawal of that access. Even so, international agreement is finally emerging on the steps that can and should be taken to strengthen the architecture of the financial system so that it is less crisis prone going forward. A plethora of useful recommendations to strengthen the international financial system is contained in a recent report by a working group of central bank governors and finance ministers from a group of industrial and key emerging market countries dubbed the G-22. The report focuses on measures to increase transparency and strengthen financial systems, and it proposes strategies for orderly workouts in the event of a future crisis.

First, there is broad consensus on the need for greater transparency and openness both on the part of debtor countries and official institutions such as the IMF. The report stresses the need to enhance the relevance and reliability of information disclosed by the private sector through compliance with high-quality accounting standards. It calls for broadening the public disclosure of data on foreign exchange reserves, external debt and financial sector soundness. And it recommends greater disclosure of data on the international exposure of investment banks, hedge funds and other international investors.

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

Accordingly, the report proposes a series of reforms to strengthen domestic financial institutions and to create stronger incentives for borrowers and lenders to weigh risk and act with appropriate discipline, thereby reducing the odds of a crisis.

Most analyses of the crisis point to financial sector weaknesses as a central cause. National banks and other financial institutions borrowed excessively from abroad and lent excessively at home, thus playing a key role in channeling funds toward projects that were marginal if not outright unprofitable. Lax supervision and weak regulation of the financial system, low capital adequacy ratios, lack of well designed deposit insurance schemes, insufficient expertise in the regulatory institutions, distorted incentives for project selection and monitoring, and outright corrupt lending practices, all contributed to the build-up of severe structural weaknesses in undercapitalized financial systems. The most visible manifestation was a growing share of non-performing loans prior to the crisis. The distortions generated by such behavior were enhanced by the rapid process of capital account liberalization and financial market deregulation in the region during the 1990s, that dramatically increased access to funds from abroad.

The task of strengthening financial systems is long-term and daunting. It is clear that strong prudential regulation and supervision of banks is needed in emerging markets, and the report recommends national implementation of core principles of banking supervision devised by the so-called Basle supervisory group. In addition, changes will be considered to the supervisory treatment of loans by industrial country banks to emerging market borrowers. (At present, for example, the capital required against short-term foreign currency denominated loans to foreign banks is well below the capital required on longer term loans.) However, the challenges involved in supervising and regulating banks, even in industrialized countries, should not be underestimated; and it should be remembered that most industrialized countries including many with strong supervisory regimes have also suffered the debilitating economic impacts of banking crises. Beyond banking, steps must be taken to improve national bankruptcy and foreclosure laws, to improve corporate governance in both the financial and non-financial sectors; and to develop liquid and deep securities (bond and equity) markets, so that there can be less reliance on banks in the process of financial intermediation. Prices in stock and bond markets adjust to changes in perceived risk automatically and in ways that can pose substantially less

systemic risk than foreign-currency-denominated short-term loans. The problem with this solution is that in order to function well, stock and bond markets require a transparent, well-regulated, and well-functioning set of public capital markets.

The experience of Asia suggests that an excessive accumulation by a country's financial system of short-term, foreign currency denominated, and unhedged foreign liabilities was an important cause of the financial fragility that triggered and exacerbated the crisis. Mismatches between the maturity and currency composition of financial institutions' assets and liabilities and an incorrect assessment of liquidity and currency risks aggravated the problem. The risk and associated economic vulnerability stemming from these exposures was enormous. There is now broad agreement that such borrowing by banks should be addressed in a strengthened regime of prudential supervision. However, foreign currency borrowing by firms also played a destabilizing role in some countries. There is consequently some agreement now among G-7 countries, as reflected in a statement at the most recent summit in Birmingham, on the need for countries to proceed carefully in liberalizing capital account transactions. With strong financial systems, the arguments in favor of unfettered capital flows are strong. But during such a transition, the liberalization of the capital account should be gradual and carefully managed. Agreement has not yet emerged, and debate is certain to continue, on whether even stronger measures are needed to prevent potentially destabilizing capital inflows in advance of a crisis--in the form, for example, of controls on capital inflows.

Beyond policies to strengthen financial systems, the G-22 report proposes measures to strengthen the incentives for prudent behavior by debtors and creditors. In recent crisis episodes, governmental guarantees at many levels probably reduced the perception of risk by lenders and borrowers. In many countries, there was an expectation that corporations and banks would be bailed out by governments in the event of trouble. In many instances, too, the incentive of private parties to hedge exchange risk was diminished by the prevalence of fixed or semi-fixed exchange regimes. Such implicit and explicit guarantees likely distorted incentives, encouraging both debtors and creditors to take on excessive risk, to fail to hedge that risk, and to ignore

available information pointing to potential problems. Therefore, limiting such guarantees, and making those which are offered as explicit as possible, and pricing them appropriately could also contribute to crisis prevention.

While strengthening domestic financial systems may prevent some crises and make those that do occur less virulent, it is still likely that crises will not be eliminated altogether. And while a well designed bankruptcy regime can facilitate orderly workouts of private debt, the G-22 report emphasizes the need for new workout procedures to handle the, hopefully rare situations in which sovereign debtors suspend debt payments.

In instances of sovereign liquidity crises, private sector burden sharing is desirable, first because official money is unlikely to be sufficient in all circumstances, and second because it is essential in inducing market discipline and reducing potential moral hazard problems deriving from official assistance. In spite of its importance, private sector burden sharing is more difficult to achieve now than in the days when banks accounted for the bulk of international capital flows. Today, the proliferation of creditor institutions and instruments and the growth of international bond markets makes the problem of coordinating the actions of creditors during a crisis extremely difficult. Thus, a key recommendation of the Working Group is to include "collective action clauses" in bond contracts to provide for: collective representation of creditors; majority action to alter the payment terms of a contract; and sharing of payments among creditors. All of these provisions work to facilitate speedy and orderly workouts.

No magical formula can be devised to prevent future currency and financial crises. But there are things that can be done to limit their frequency, the magnitude of their effects, and their pernicious, contagious spread. So, at the same time that we work to contain the current crisis and help restore growth in crisis afflicted parts of the world, we must also implement the reforms of the international financial architecture that would help to achieve this longer term goal. Such reform is crucial for restoring support in an international economic regime based on trade and investment flows that can contribute to rising global living standards in the 21st century.

EMBRACING CHANGE WHILE PROMOTING FAIRNESS

The trade-off between efficiency and fairness is a classic problem in formulating economic policy. Policies that confer benefits broadly sometimes impose relatively high costs on a relatively small group of identifiable individuals. In well-functioning markets, the broadly distributed gains are usually larger in the aggregate than the concentrated losses. But those who are hurt often make claims for relief through the political process, and the widespread substitution of political remedies for market outcomes can dissipate these gains.

Increases in the Nation's standard of living over the longer-term require that we embrace change and do not retreat from the constant succession of new opportunities and challenges of an ever-changing world. However, fairness considerations require that we ensure that particular groups are not bearing disproportionate costs even if there are net gains in the aggregate.

More pragmatically, achieving political consensus to embrace worthwhile change can sometimes require looking out for the interests of those who are harmed and visible, even if that means sacrificing some portion of the potential gains. Three current policy areas illustrate these difficult choices: agriculture, mergers, and international trade.

AGRICULTURE

For more than a decade bipartisan farm policy has directed producers to seek income increasingly from markets rather than from Federal subsidies. The 1994 Crop Insurance Reform and 1996 Farm Acts sought to create a farm income safety net based on market-oriented crop insurance and commodity marketing loan programs rather than price supports and ad hoc disaster intervention. However, when the President signed the 1996 Farm Act he expressed his concern that it failed to provide an adequate safety net for family farmers and his commitment to work with the Congress to strengthen the farm safety net.

Farmers prospered in the first few years under the new Farm Act. Farm income rose in 1996 and then reached a record \$60.8 billion in 1997 as export demand grew and world commodity prices tightened from 1995. In contrast to the price

support programs that had been in place in one form or another since the Great Depression, the 1996 Farm Act provided fixed payments to farmers that would decline over time. Thus, farm income was boosted by Federal payments that were greater than they would have been under the old system. In 1998, however, commodity prices began to fall and a number of crop-insurance and weather-related problems threatened farm income. The Administration negotiated a \$6 billion disaster assistance package in the fiscal year 1999 Omnibus Appropriations Bill to boost farm income. All told, Federal farm assistance for fiscal year 1999 is likely to be nearly \$18 billion, or about twice the level assumed in the 1999 budget. Farm income (including Federal payments) in 1998 is expected to be near the 1997 record level (chart ?).

The experiences of 1998 reflect the tension inherent in a market-oriented farm policy that tries to provide an adequate safety net for family farmers. Current farm policy encourages farmers to make economic decisions about what to plant, and it helps them manage risk by subsidizing insurance against both poor harvests and low prices. But as long as farmers have a reasonable expectation that the government will step in to provide emergency assistance in the event of weather problems or particularly low prices, they are unlikely to take all appropriate risk management steps themselves. This "moral hazard" problem cannot be escaped entirely, however, because the government will be under strong pressure to address what are perceived to be legitimate region-wide problems such as those afflicting the upper Great Plains in the past few years.

MERGERS

The United States is currently in the midst of its fifth merger wave of the century. The value of all deals announced in 1997 was almost \$1 trillion, and activity in 1998 was well over \$1.5 trillion. By almost any quantitative standard the current boom is substantial. Measured relative to the size of the economy, it is matched only by the spurt of trust formations at the turn of the century. Measured relative to the market value of all U.S. companies, this year's merger activity will likely match or surpass 1988's 12.2 percent.

Qualitatively, the current merger wave is similar to those that occurred prior to the 1980s in that it has taken place in a strong stock market, with stock rather than cash the preferred funding source. But unlike the pre-1980s transactions, many recent mergers are neither purely horizontal (as in the 1890s and 1920s) nor purely conglomerate (as in the 1960s and 1970s). Rather, they represent market-extension mergers (companies in the same industry that serve different and non-competing markets) or mergers seeking “synergy,” in which companies in related markets expect to take advantage of economies of scope. In contrast to the 1980s, when many mergers were primarily motivated by financial considerations, today’s mergers are primarily motivated by business strategy and the need to respond to fundamental developments in a rapidly changing economy.

The main reason managers give for undertaking mergers is to increase efficiency. Mergers can encourage greater efficiency by reducing excess capacity, taking advantage of economies of scale and scope, and encouraging technological progress. Over time, such efficiencies translate into lower prices and better products and services for consumers. However, mergers that increase market concentration can lead to higher prices and reduced consumer benefits. In addition, mergers, like other forms of economic change, can disrupt established patterns of economic and social activity.

When the antitrust agencies review mergers they do so with an eye to protecting competition for the benefit of consumers. Considerable attention is paid to market definition, so that the effects are evaluated in the proper context. Antitrust enforcement has been rigorous in this Administration, and mergers receive careful scrutiny. Most have been found to be procompetitive or competitively neutral. But the minority that would reduce competition and harm consumers have been challenged. The current approach, which is aggressive without being heavy handed, stands in contrast to both the strong anti-merger bias of the 1960s and 1970s and the much laxer enforcement of the 1980s.

Antitrust enforcement does not and probably should not encompass the broader range of possible economic and social effects that may be associated with mergers, such as job loss, change in ownership structure, including reduced diversity of ownership, and localized service disruptions. Such effects are

not confined to mergers but arise in the case of other forces as well, including technological change, deregulation, and international competition. Indeed, mergers may be more a symptom of broader change in the economy than a cause. The policies that are best for dealing with these changes include promoting full employment and macroeconomic stability, developing a skilled and well-trained workforce, providing adequate unemployment insurance and other safety net programs, and helping communities adapt to economic change. All of these have been part of the Administration's overall economic strategy of the last 6 years.

INTERNATIONAL TRADE

International trade policy has long been a laboratory for addressing the challenge of balancing efficiency and fairness and for providing political safeguards for those who might be hurt by change and would otherwise work to block it. For example, U.S. trade law recognizes that imports can sometimes be associated with labor displacement and other disruptions and provides for several kinds of relief. Escape clause relief allows tariffs to be imposed temporarily in cases where a surge of imports is judged to have been a cause of injury to an industry. And countervailing duties may be imposed in cases where foreign producers have been judged to have dumped their products (sold them below cost).

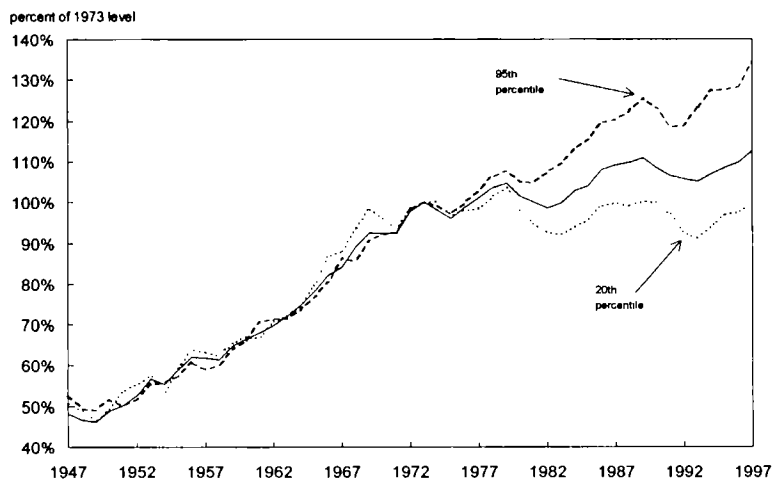
Both escape clause and antidumping measures are controversial among economists because they tend to preserve the status quo and block necessary change. Less controversial, perhaps, is trade adjustment assistance. Since 1962 U.S. trade laws have provided for some kind of cash assistance for workers who have lost their jobs due to trade. In addition, the North American Free Trade Agreement (NAFTA) provides assistance to workers displaced from companies that have shut down their plants and moved production to Mexico or Canada, and the administration has supported extending such assistance to all workers displaced by the movement of work to another country. In theory, trade adjustment assistance provides compensation from the broad class of those who gain from trade (represented by the taxpayers generally) to those who lose (workers in trade-impacted industries) without interfering with the

efficiency-enhancing effects of changes in the pattern of production associated with freer trade. In practice, of course, things are more complicated if adjustment assistance interferes unduly with workers' incentives to find new jobs. Nevertheless, adjustment assistance illustrates the general principal that it is desirable to address the disruption from change without stopping the change itself.

PROMOTING PROSPERITY FOR ALL AMERICANS

From the end of World War II until the early 1970s, the rising tide of economic growth raised wages and incomes relatively uniformly across the income distribution. For example, median

Chart 1-4 Growth in Family Income, 1947-1997
Growth in family income has slowed and inequality has increased since 1973.



family income as well as family income at the 20th and 95th percentiles all approximately doubled between 1947 and 1973 (Chart 1-x). Since the early 1970s, however, the overall pace of income growth has slowed and income inequality has increased. Median family income is about 10 percent higher than it was in 1973; income at the 95th percentile is more than a third higher, whereas income at the 20th percentile is virtually unchanged.

This Administration has recognized from the start that the stubborn problems of slow productivity growth and rising income inequality were among the greatest challenges it would face. And there are heartening signs that we may have turned the corner. As mentioned earlier, productivity growth has remained relatively strong in this expansion, whereas it has tended in the past to flag as the expansion matures. Moreover, as detailed in Chapter Three, low-wage and minority workers are enjoying some of the best labor market conditions they have seen in years. Standard measures of income inequality have declined in the past two years, and the poverty rate, which was 15.1 percent in 1993, had fallen to 13.3 percent by 1997. Despite these encouraging trends, however, it is difficult to know how much of the improvement that has taken place since 1993 reflects cyclical effects from the particular strength of this expansion and how much reflects an improvement in longer term effects.

Maintaining macroeconomic stability is an important necessary condition for making sure that all Americans participate in the country's growing prosperity. But it is also important to continue to develop policies that address the challenges of a changing economy and a changing society.

EDUCATION AND TRAINING

MEDICAL CARE

???

CONCLUSION

The U.S. economy remained strong in 1998 despite a serious weakening in the international economy and considerable financial turmoil between July and November. The economy's ability to weather these storms is testimony to the soundness of the policies that have been followed over the past 6 years and to the underlying strength of the current economic expansion. While there is much to be proud of in this economic success, the Nation continues to face important challenges preparing for the 21st century. The remainder of this economic report ...