RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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CREATION DATE/TIME:11-JAN-1999 23:01:55.00

SUBJECT: BA110 this summer

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TEXT:
Is anyone intersted in teaching BA110 this summer during the first 6-week summer session? Tom McCullough is interested but I wanted to make sure there wasn't any ladder interest before offering it to him. Please answer asap if you might be interested.

Severin

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:11-JAN-1999 09:06:38.00

SUBJECT: Chapter 1

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

TEXT:
Attached is a revised version of Chapter 1 which includes my revisions of the international section, a few other revisions of the other sections and a few bold faced comments and questions.=================== ATTACHMENT 1
===================

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D23]MAIL403705016.036 to ASCII,
The following is a HEX DUMP:

CHAPTER 1

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 to insure that fiscal policy plays a helpful role in preparing the country for the demographic challenges it faces in the next century. 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 a full-employment (or standardized) budget *surplus* which was too large. 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 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 offered 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. The Reagan Administration's expansionary fiscal policy collided, in the short run, with the aggressive anti-inflationary monetary policy of the Federal Reserve, contributing to an extremely 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. Budget deficits were very large once again due both to a large full-employment deficit and also the effect of the recession. 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 bring down interest rates and stimulate private investment. With increased fiscal restraint, the Federal Reserve would have ample scope to play an accomodating role. 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	7th 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. **[Chad: Shouldn't we note that an investment lead expansion promotes productivity growth, serving to better equip workers to be productive etc.? And we have already seen evidence of a payoff in the sense that capacity utilization has been low relative to unemployment, likely improving inflation performance.]**

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. **[Chad: We should add some**

more here about a rising tide lifting all boats, creating opportunity etc.]

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.

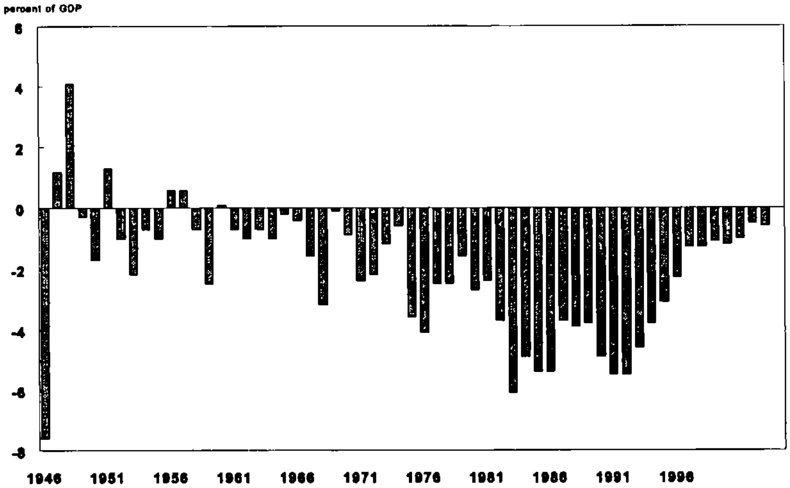
The Office of Management and Budget (OMB) now projects substantial surpluses in the unified Federal budget over the next several decades. Eventually, however, the aging of the U.S. population and continued growth in health-care spending per person are expected to push the budget back into deficit. Fortunately, 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.)

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

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.



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

Chad: The numbers in Chart 1-3 can't be right--they still show deficits rather than a surplus.

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 essential to promote growth in the world economy, to help crisis stricken economies recover, and to reform the international financial system in ways that make future crises less likely without abandoning the benefits that come with increased international trade and investment flows.

During the year and a half which has elapsed since the collapse of the Thai baht in July 1997, the "Asian currency crisis" has erupted into a global economic 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 throughout the world including the United States and other industrial countries. According to IMF projections, overall global growth is now expected to reach a modest 2.2 percent in 1999, a precipitous drop from the 4.2 percent rate attained in 1997 and 4 percent historical average.

CONTAINING THE CRISIS AND PROMOTING RECOVERY

Since the onset of the crisis, the United States has led the international community's efforts to promote world economic growth, to stabilize international financial conditions, and to implement reforms to reduce the vulnerability of the international system to crisis. These initiatives, are described in detail in Chapters 6 and 7.

A first prerequisite for recovery in the world economy is strong growth in the industrial countries which are the main customers of the crisis-afflicted economies. This need has been clearly recognized in both words and deeds by the United States and its G-7 partners. In early October, G-7 finance ministers and central bank governors issued a joint statement indicating that, in their view, the balance of risks in the world economy had shifted. With inflation low and well controlled, countries should commit to preserving or creating conditions for sustainable domestic growth. In support of this goal, monetary conditions have been eased in the key industrial countries. 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. Japan, a country in deep recession, whose recovery is particularly critical to growth prospects of its crisis afflicted Asian trade partners, has taken positive steps to provide fiscal stimulus and has committed substantial resources to strengthen its financial system. While it is premature to conclude that the world economy is out of the woods, conditions have improved substantially since October, when it appeared that the world might be headed into a generalized global credit crunch.

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 may 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 insure growth in the industrial world, the Administration has focused since the onset of the crisis on the need to contain financial contagion and to restore the confidence of market participants--a prerequisite for capital flows to continue. The Administration has supported the IMF in its goal of providing financial assistance to countries in crisis that are willing to implement the reforms needed to restore economic confidence and strengthen the underpinnings of their economies, including their financial sectors. The emphasis of IMF programs on financial sector reform reflects the growing consensus, as discussed in Chapter 6, that structural weaknesses, particularly in the process of financial intermediation, were a key element in initiating the crisis. It appears that many countries in Asia have now made considerable progress toward establishing the foundation for recovery.

As the crisis proceeded, the Administration recognized that its contagious effects threatened countries that had taken great strides in implementing sound macroeconomic and structural policies and had worked to strengthen the fundamentals of their economies. The President therefore proposed, and the G-7 leaders agreed to establish, an enhanced IMF facility to provide contingent short-term lines of credit lines that could be drawn upon by countries pursuing strong IMF approvided policies, accompanied, as appropriate, by additional bilateral finance. A Brazilian IMF stabilization package, supplemented by bilateral financing, which was implemented in December, is working to restore calm in Latin American markets and to stem a contagious spread of the crisis in this hemisphere.

As the scope of the crisis enlarged, the resources of the IMF became increasingly strained and the Administration recognized a vital need to expand them. A key step was for the U.S. to meet its own financial obligations to the Fund. The Administration proposed, and in October Congress approved, $18 billion in funding, opening the way for about $90 billion of usable resources to be provided by all the IMF members to the liquidity strapped institution.

To address the enormous toll of suffering inflicted by the international financial crisis on the citizens of the affected countries, the Administration has proposed policies to stimulate economic recovery and alleviate hardship. 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. One problem that is delaying recovery in several of the Asian crisis countries is that large numbers of companies and banks, including many that were in good health before the crisis, have become engulfed in unmanageable debt burdens. Companies and financial institutions in Indonesia, Korea and Thailand, for example, face vast overhangs of bad debt as a result of high interest rates and currency depreciations. To address such systemic problems, the President proposed the exploration of comprehensive plans to help countries restructure debt and restore the flow of credit needed for firms to operate. The Asian Growth and Recovery

Initiative, jointly announced by the U.S. and Japan in November, is designed to promote this goal. In additon, many crisis afflicted countries lack social safety nets. The Administration also sought, and agreement was reached, to establish a new World Bank emergency facility to support social safety net spending focused on the most vulnerable citizens of the crisis affected countries.

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. Chapter 7 is devoted to a discussion of potential reforms, including those proposed 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 G-22 report focuses on measures to increase transparency in the operations of individual countries, of financial and corporate institutions and of the international financial institutions themselves. The purpose is to enhance the availability, relevance and reliability of information available for evaluating risk in lending. The report also proposes a series of reforms to strengthen domestic financial institutions: improvements in prudential supervision and regulation are particularly needed in order to create stronger incentives for borrowers and lenders to weigh risk and act with appropriate discipline, thereby reducing the odds of a crisis. Finally, the report emphasizes the need for new workout procedures to handle the hopefully rare situations in which sovereign debtors suspend debt payments.

No magic 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 the United States works to contain the current crisis and help restore growth in crisis afflicted parts of the world, we will also work with the G7 and through other international fora to 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 competitivley 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 antidumping duties may be imposed in cases where foreign producers have been judged to have dumped their products (sold them below cost or at lower prices abroad than at home).

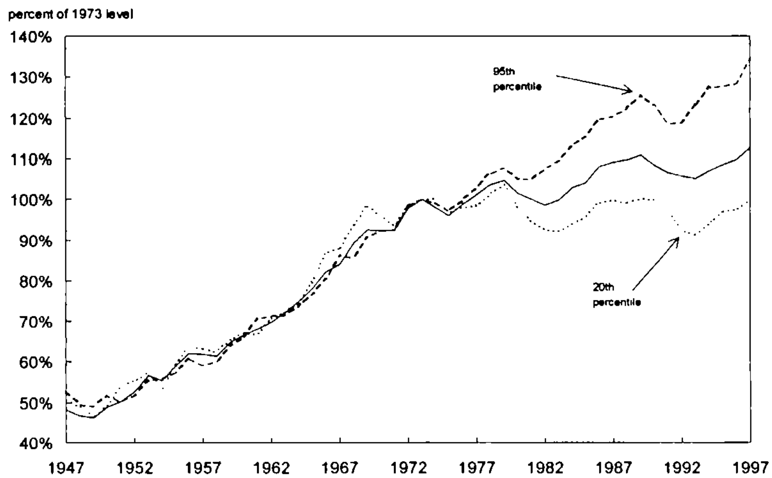
Both escape clause and antidumping measures are controversial among economists because they tend to support the status quo and may block necessary change. Less controversial, perhaps, is trade adjustment assistance. Since 1962 U.S. trade laws have provided for some kind of cash assistance for workers who have lost their jobs due to trade. In addition, the North American Free Trade Agreement (NAFTA) provides assistance to workers displaced rom 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 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

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



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 econonomic report ...

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:11-JAN-1999 19:15:38.00

SUBJECT: Mtg on Very Long-term Budget, Rm 324 @2:00pm tommorrow (Tuesday)

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

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

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

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

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

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

CC: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
OMB will brief us on the results of their long-term budget calculations
with the new revenue projections.

Alice: Please put this meeting on Janet's schedule.

Mary T. Please reserve Room 324 for us (2:00 to 3:00 pm)

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-JAN-1999 15:44:48.00

SUBJECT: Budget effects of Long-Range Economic Assumptions

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

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

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

TEXT:
I thought the OMB people were going to pass out some budget figures. As
they did not, I attach some number which they sent to me yesterday.
---------------------- Forwarded by Steven N. Braun/CEA/EOP on 01/12/99
03:42 PM ---------------------------

From: Robert B. Anderson on 01/11/99 11:47:29 AM
Record Type: Record

To: Steven N. Braun/CEA/EOP
cc:
Subject: FYI -- Effect of Long-Range Economic Assumptions

---------------------- Forwarded by Robert B. Anderson/OMB/EOP on 01/11/99
11:48 AM ---------------------------

Patrick G. Locke
01/11/99 11:27:39 AM
Record Type: Record

To: Joseph J. Minarik/OMB/EOP@EOP
cc: Susanne D. Lind/OMB/EOP@EOP, Steven E. Cahill/OMB/EOP@EOP, Justine F. Rodriguez/OMB/EOP@EOP, Robert B. Anderson/OMB/EOP@EOP
Subject: Effect of Long-Range Economic Assumptions

Steve Cahill and I have run some preliminary long-range surplus estimates
based on possible variants for the final long-range economic assumptions.
The items that are in play are:

1. GDP inflation (2.10% versus 2.14%). Bob had originally proposed 2.14%
after 2009. The 2009 jumpoff year has 2.08% inflation, and the budget
window supports 2.10%. Bob raised it to 2.14% to improve the long-run

surplus outlook. 2.14% still rounds to 2.1%, but is higher than we can really support.

2. Productivity growth (1.3% versus 1.334%). Bob had originally pegged productivity growth at 1.334%, based on the revisions we made to the economic assumptions, which provide a 2009 jumpoff growth in output per hour of 1.34%. Although we can argue that 1.334% is supported by our jumpoff rule, the average toward the end of the budget window is much less than this, arguing for a rate of only about 1.3% or even less.

In estimating the effects of these variants, we are using an early version of the budget database that incorporates the higher revenue estimates that we have from Treasury, but does not incorporate technicals in outlays. These do not appear to be large at this point. We are also reflecting the decision to inflate the discretionary baseline at the "current services" inflation rate rather than the CPI. This results in long-run discretionary growth of 2.7%, versus the 2.3% if we were just using CPI.

The results of our runs are shown in the chart and table below, both of which are contained in the attached 1-2-3 spreadsheet file. Compared to the MSR, using 2.14% deflator growth and 1.334% productivity growth (as Bob originally put them) raises surpluses throughout the long-range horizon. In 2030, the surplus is $77 billion above the MSR. The NPV of the gain from the MSR is $522B for 2000-2030 and $1.8 trillion for 2000-2070. (Note: NPV's are not shown in the table below, but are contained in the spreadsheet file.)

Dropping the deflator growth to a more defensible 2.1%, but leaving productivity growth at 1.334%, yields surpluses that are only slightly above the MSR through about 2025, and then slightly lower the rest of the way out. The surplus is $1 billion lower than the MSR in 2030 (but who's counting). In NPV terms, the gain from the MSR is $339B for 2000-2030 and $291B for 2000-2070.

Finally, holding deflator growth at 2.1% and dropping productivity growth to 1.3% (closer to the in-year average) yields surpluses slightly above the MSR through only about 2015 and then lower by growing amounts. In 2030 the surplus is $71B below the MSR. In NPV terms, this scenario is still a gain from the MSR over 2000-2030 (by $169B), but the NPV over 2070 is a loss of $1.1 trillion. Most of the NPV gain in this scenario is due to the higher surpluses in the 2000-2009 budget window, which are the same for all three scenarios.

In the chart below, the green line is the 2.14/1.334% scenario. The blue line, which is hardly distinguishable from the red line for the MSR, is the 2.10/1.334% scenario. The magenta line is the 2.10/1.30% scenario.

Steve and I would propose going with the middle line -- i.e. setting the deflator at 2.10% and output per hour at 1.334%. This can be justified as jumping off from our 2009 values, and at this point appears to slightly improve our position from the surpluses in the MSR. If we can settle on this as our long-range forecast, we will provide it to Steve Goss later today. Steve is anxious to get the data so that he can prepare for crunching on his part of the current Social Security reform drill, and we are anxious to get them to him, so that we can hold him to his offer to

run long-range trust fund results to use in our long-ragne estimates of
2000 Budget policy.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D3]MAIL47545621Q.036 to ASCII,
The following is a HEX DUMP:

FOIA Number: 2013-0723-F

Clinton Presidential Records Automated Records Management System [EMAIL]

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

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

File Name: p_p1265456_cea_html_1.xls

Attachment Number: [ATTACH.D3]MAIL47545621Q.036

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-JAN-1999 11:43:37.00

SUBJECT: Re: WP-3 resched

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

TEXT:
I think that's fine. Bob Lawrence won't even know it was rescheduled.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-JAN-1999 09:48:35.00

SUBJECT: latest ch1 draft

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

TEXT:
I am still working on the very last section on education and health initiatives=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D94]MAIL434451211.036 to ASCII,
The following is a HEX DUMP:

CHAPTER 1

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 on record. By December 1998, the 93rd month of this expansion, 18.8 million jobs had been created (17.7 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 almost 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 grow and develop 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 to insure that fiscal policy plays a helpful role in preparing the country for the demographic challenges it faces in the next century. 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. A popular recession indicator is two consecutive quarters of decline in real GDP, but the NBER does not use this approach. Rather, it defines a recession as 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 trying to stabilize short-run economic fluctuations, promote balanced and non-inflationary economic growth, and foster 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 Act was passed.

Comment [COMMENT1]: "Trade" is confusing. Maybe we should list the four series that are used, taken from the Hall article that Steve Braun has

Comment [COMMENT2]: Look at the language of the Act and make this consistent with the 1946 Act, don't want to cite Humphrey Hawkins explicityly, see last year's ERP for language p. 21

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.

Comment [COMMENT3]:
Chart on standardized budget from last year's budget

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, these economists diagnosed the economy at the time as suffering from "fiscal drag" arising from a full-employment (or standardized) budget *surplus* which was too large. 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—this 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 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 early in 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 offered 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. The Reagan Administration's expansionary fiscal policy collided, in the short run, with the aggressive anti-inflationary monetary policy of the Federal Reserve. The budget deficit ballooned in the extremely deep recession of 1981-82, and it stayed large even after 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. Budget deficits were very large once again due both to a large full-employment deficit and also the effect of the recession. 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 President's program was based on the idea that reducing the Federal budget deficit would bring down interest rates and stimulate private investment. With increased fiscal restraint, the Federal Reserve would have ample scope to play an accomodating role. Demographic change and other factors have resulted in changes in the NAIRU over time, and the unemployment rate has not come down quite so 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 decline in the unemployment rate to less than 5 percent did not lead to interest rate hikes that could have choked off the expansion 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, inflation is tame rather than rising.

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

	First 6 Years	7th 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 low 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 continuing sharp decline in computer prices, a drop in oil prices, rapid growth of industrial capacity, and downward pressure on traded goods prices due to weakness in the world economy. And, as discussed in Chapter 2, 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 the early 1970s, 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, prior to the productivity slowdown.

Comment [COMMENT4]:
[Chad: Shouldn't we note that an investment lead expansion promotes productivity growth, serving to better equip workers to be productive etc.? And we have already seen evidence of a payoff in the sense that capacity utilization has been low relative to unemployment, likely improving inflation performance.] capacity is now mentioned in the causes of low inflation. The future payoff is mentioned at the end of this section.

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 3, however, the sustained tight labor market that this expansion has produced in the past few years has brought benefits to the vast majority of American workers, including groups that had fallen behind over the past two decades or so. Such a sustained tight labor market has numerous benefits. It increases the confidence of job losers that they will be able to return to work; it lures discouraged workers back into the labor force; it enhances the prospects of those already at work to get ahead; it enables those who want or need to switch jobs to do so without a long period of joblessness, and it lowers the duration of the typical unemployment spell. It can ameliorate long-term structural unemployment by providing jobs and experience to younger and less skilled workers that can increase their longer-run attachment to the labor force. In short, a sustained tight labor market helps the rising tide of economic growth lift all boats.

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 generally rising net national investment remaining greater than generally 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). Strong investment has already been associated with the strong growth in capacity that has helped keep inflation in check and may have contributed to the continued growth of productivity as the expansion has matured. 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 will 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

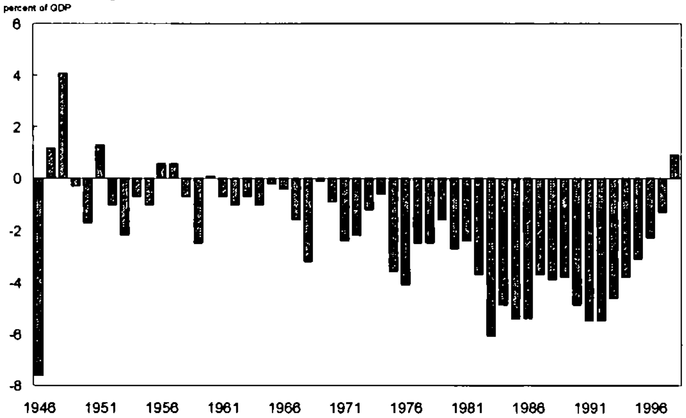
Reducing the Federal budget deficit has been a centerpiece of this Administration's economic policy. In 1993, the President pledged to cut the deficit in half by 1998; in 1997, he promised to balance the budget by 2002. In fact, the budget was in the black last year with the largest surplus as a share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

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.



years in this section are fiscal years running from October through September, unless otherwise noted.)

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 are 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 the 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 retained two important rules first adopted in the 1990 Budget Act to ensure budget discipline: caps on discretionary spending and "pay-as-you-go, or PAYGO provisions for taxes and mandatory programs (such as Social Security, unemployment compensation, and Medicare and Medicaid). PAYGO requires that any policy change that would increase mandatory spending or lower revenues compared with existing law must be offset by spending cuts or revenue increases. In 1997 the President and Congress finished the job of getting to budget surplus by passing the Balanced Budget Act, which incorporated additional deficit reduction measures.

A 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 of the increase also reflects capital gains, and more of it probably depends on capital income broadly construed; both have been boosted by the strong stock market of the last few years. 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.

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 surplus by $70 billion—a dramatic improvement over 1997.

Part of this surprise was, once again, stronger growth than was anticipated in the Administration's (and others') economic forecast. This 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 no significant changes were made in the tax law. Detailed data on 1998 tax receipts are not yet available, but a tentative explanation for the ongoing "revenue surprise" is ...

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 with its implications for future imbalances in Social Security and Medicare.

Social Security is an extremely successful social program. For almost 60 years, it has provided Americans with income security in retirement and protection against loss of family income due to disability or death. Social Security retirement benefits are indexed for inflation and provide a lifetime annuity--a package that is difficult if not impossible to obtain in private markets. In fact, less than half of all individuals aged 65 and older received any private pension benefits in 1994. As a result, Social Security benefits are the largest source of income for 2/3 of those in this age group and the only source of income for 18 percent of them. The system has enjoyed dramatic success in reducing the poverty rate among retirees, helping to lower the elderly poverty rate from 35 percent in 1959 to 11 percent in 1996. Social Security is also more than just a pension plan: It is a family protection plan, and nearly 1 in 3 beneficiaries are not retirees. For the average wage earner who dies and leaves a spouse and two children, Social Security provides survivors benefits equivalent to a $300,000 life insurance policy; one in six 20 year olds will die before retirement age. Social Security also provides disability protection, and 3 in 10 20 year olds will become disabled for some period before retirement.

The most commonly used yardstick to measure the financial soundness of the Social Security system is the 75-year actuarial balance. The Social Security actuaries now project that the current balance in the Trust Fund together with projected revenues over the next 75 years will be insufficient to fund the benefits promised under current law. By 2013, payroll contributions are expected to fall short of benefits; by 2021 the shortfall is expected to exceed Trust Fund interest earnings, so the Trust Fund will begin to decline; and by 2032, the Trust Fund is expected to be depleted, after which time contributions would still be sufficient to pay about 75 percent of current law benefits. Of course, future taxes and benefits depend on a variety of economic and demographic factors that cannot be predicted perfectly, so the actual problem may be smaller or larger than we now believe. Nevertheless, the intermediate projections of the actuaries imply that the imbalance in the Old Age, Survivors' and Disability Insurance (OASDI) program over the next 75 years amounts to around 2-1/4 percent of taxable payroll, or about 1 percent of GDP. That is the most common way to scale the current problem. The 75-year actuarial balance actually understates the financial imbalance over the very long term because the actuaries' projections show surpluses in the early years of the 75 year horizon and growing deficits later on when demographic forces have their full effect.

The key factors contributing to the projected OASDI imbalance are improvements in life expectancy and a reduction in birth rates, which have put the United States on a path of rapid decline in the number of employed workers for every retired American. When the Social Security Act was passed in 1935, the life expectancy of a 65 year old American was about 13 years. Today, life expectancy for a 65 year old is 18 years and rising. At the same time, people are retiring earlier. In 1950, the average age for first receiving Social Security retirement benefits was 68; today it is 63. As a consequence of these changes, the ratio of employed workers to retirees has fallen from about 5 to 1 in 1960 to 3-1/2 to 1 today. In only 30 years time, it will be just 2 to 1 and still falling.

In addition to the aforementioned effects on Social Security retirement and disability benefits, this demographic transition will have important effects on the Medicare and Medicaid programs as well as on the economic environment outside the government. For the nation as a whole, the central problem is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving, a goal to which continued fiscal discipline would contribute.

National saving increased from 3.4 percent of net national product in 1992 to 7.6 percent in the first half of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output. If the projected budget surpluses are saved, they will add to national saving; moreover, $130 billion of surplus placed in the Trust Fund and invested in government bonds would extend the expiration date of the Trust Fund by roughly a year or reduce the taxable payroll gap by about 0.1. National saving could also increase if the surpluses are used to fund individual accounts and such accounts add to private saving. But if the surpluses are dissipated, they will neither help to strengthen Social Security nor add to national saving.

In his 1998 State of the Union address, the President proposed to reserve every penny of the surplus until there was agreement on a plan to secure the financial viability of Social Security. To accomplish this task, the President proposed a process of public education and debate followed by the forging of a bipartisan agreement. He and the Vice-President participated in a number of Social Security forums, whose purpose was to afford Americans the opportunity to understand better the problems facing the Social Security system and to explore alternative solutions to these problems. This process of public discussion culminated in a White House conference in December 1998. In his 1999 State of the Union address, the President announced a plan for bipartisan negotiations with the

Congress to devise a comprehensive plan to strengthen Social Security.

The President has set forth five principles to guide the reform process:

- *Strengthen and protect Social Security for the 21st century.* This is an overriding goal, and it warns against proposals that fail to provide a comprehensive solution to the solvency problem. For example, a proposal that simply diverts existing payroll taxes into a new system of individual accounts would not qualify as a comprehensive solution because it reduces Social Security's revenues and makes the existing imbalance even larger.

- *Maintain fiscal discipline.* This is important to insure that surpluses are not drained before addressing Social Security reform, and that fiscal policy plays a helpful role in preparing for the retirement of the baby boomers.

- *Maintain universality and fairness.* The current program provides benefits on a progressive basis, and ensuring progressivity is an important standard by which reform proposals should be judged.

- *Provide a benefit that people can count on.* This is important so that people have a secure base for retirement planning.

- *Preserve financial security for low-income and disabled beneficiaries.* This highlights the commitment to preserving the disability and survivors' insurance aspects of the OASDI program.

The plan the President announced in his 1999 State of the Union address embodies these principles (Box 1-3)

Box 1-3. The President's Plan for Social Security

Achieving a budget surplus is important for the country's long-run future. 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 will continue to be the most important instrument of fiscal policy for muting short-term fluctuations in economic activity. But as Japan's current troubles should remind us, the economy can sometimes become mired in stagnation to such an extent that discretionary fiscal stimulus may be worthwhile. The elimination of large structural budget deficits frees fiscal policy to undertake such a role.

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 essential to promote growth in the world economy, to help crisis stricken economies recover, and to reform the international financial system in ways that make future crises less likely without abandoning the benefits that come with increased international trade and investment flows.

During the year and a half that has elapsed since the collapse of the Thai baht in July 1997, the "Asian currency crisis" has erupted into a global economic 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 throughout the world including the United States and other industrial countries. According to IMF projections, overall global growth is now expected to reach a modest 2.2 percent in 1999, a precipitous drop from the 4.2 percent rate attained in 1997 and 4 percent historical average.

CONTAINING THE CRISIS AND PROMOTING RECOVERY

Since the onset of the crisis, the United States has led the international community's efforts to promote world economic growth, to stabilize international financial conditions, and to implement reforms to reduce the vulnerability of the international system to crisis. These initiatives, are described in detail in Chapters 6 and 7.

A first prerequisite for recovery in the world economy is strong growth in the industrial countries that are the main customers of the crisis-afflicted economies. This need has been clearly recognized in both words and deeds by the United States and its G-7 partners. In early October, G-7 finance ministers and central bank governors issued a joint statement indicating that, in their view, the balance of risks in the world economy had shifted. With inflation low and well-controlled, countries should commit to preserving or creating conditions for sustainable domestic growth. In support of this goal, monetary conditions have been eased in the key industrial countries. 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. Japan, a country in deep recession, whose recovery is particularly critical to growth prospects of its crisis afflicted Asian trade partners, has taken positive steps to provide fiscal stimulus and has committed substantial resources to strengthen its financial system. While it is premature to conclude that the world economy is out of the woods, conditions have improved substantially since October, when it appeared that the world might be headed into a generalized global credit crunch.

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 may 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 insure growth in the industrial world, the Administration has focused since the onset of the crisis on the need to contain financial contagion and to restore the confidence of market participants--a prerequisite for capital flows to continue. The Administration has supported the IMF in its goal of providing financial assistance to countries in crisis that are willing to implement the reforms needed to restore economic confidence and strengthen the underpinnings of their economies, including their financial sectors. The emphasis of IMF programs on financial sector reform reflects the growing consensus, as discussed in Chapter 6, that structural weaknesses, particularly in the process of financial intermediation, were a key element in initiating the crisis. It appears that many countries in Asia have now made considerable progress toward establishing the foundation for recovery.

As the crisis proceeded, the Administration recognized that its contagious effects threatened countries that had taken great strides in implementing sound macroeconomic and structural policies and had worked to strengthen the fundamentals of their economies. The President therefore proposed, and the G-7 leaders agreed to establish, an enhanced IMF facility to provide contingent short-term lines of credit lines that could be drawn upon by countries pursuing strong IMF approvided policies, accompanied, as appropriate, by additional bilateral finance. A Brazilian IMF stabilization package, supplemented by bilateral financing, which was implemented in December, is working to restore calm in Latin American markets and to stem a contagious spread of the crisis in this hemisphere.

As the scope of the crisis enlarged, the resources of the IMF became increasingly strained and the Administration recognized a vital need to expand them. A key step was for the U.S. to meet its own financial obligations to the Fund. The Administration proposed, and in October Congress approved, $18 billion in funding, opening the way for about $90 billion of usable resources to be provided by all the IMF members to the liquidity strapped institution.

To address the enormous toll of suffering inflicted by the international financial crisis on the citizens of the affected countries, the Administration has proposed policies to stimulate economic recovery and alleviate hardship. 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. One problem that is delaying recovery in several of the Asian crisis countries is that large numbers of companies and banks, including many that were in good health before the crisis, have become engulfed in unmanageable debt burdens. Companies and financial institutions in Indonesia, Korea and Thailand, for example, face vast overhangs of bad debt as a result of high interest rates and currency depreciations. To address such systemic problems, the President proposed the exploration of comprehensive plans to help countries restructure debt and restore the flow of credit needed for firms to operate. The Asian Growth and Recovery Initiative, jointly announced by the U.S. and Japan in November, is designed to promote this goal. In additon, many crisis afflicted countries lack social safety nets. The Administration also sought, and agreement was reached, to establish a new World Bank emergency facility to support social safety net spending focused on the most vulnerable citizens of the crisis affected countries.

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. Chapter 7 is devoted to a discussion of potential reforms, including those proposed 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 G-22 report focuses on measures to increase transparency in the operations of individual countries, of financial and corporate institutions and of the international financial institutions themselves. The purpose is to enhance the availability, relevance and reliability of information available for evaluating risk in lending. The report also proposes a series of reforms to strengthen domestic financial institutions: improvements in prudential supervision and regulation are particularly needed in order to create stronger incentives for borrowers and lenders to weigh risk and act with appropriate discipline, thereby reducing the odds of a crisis. Finally, the report emphasizes the need for new workout procedures to handle the hopefully rare situations in which sovereign debtors suspend debt payments.

No magic 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 the United States works to contain the current crisis and help restore growth in crisis afflicted parts of the world, we will also work with the G7 and through other international fora to 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 replace the farm income safety net based on government-managed price and income supports with a system in which farmers manage their own risk through diversification, futures markets, and government-subsidized crop and revenue insurance. 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 he reiterated 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 addtion, farmers benefited from the transitional payments provided by the 1996 Farm Act. In 1996 and 1997 these AMTA payments boosted farm income by $4.6 and $6.3 billion respectively. In 1998, farm income declined dramatically as a result of a sharp drop in commodity prices and a number of weather-related production problems. In response, 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 disasters.

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 over $1.6 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 is roughly equal to 1988's 12 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 competitivley 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 or at lower prices abroad than at home). Both escape clause and antidumping measures should be applied with caution, because they tend to support the status quo and may impede necessary change. In the case of escape clause relief, for example, the protected industry should be fundamentally competitive and the surge of imports should be clearly temporary.

Trade adjustment assistance is an alternative way of dealing with disruptions associated with trade. 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 rom 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.

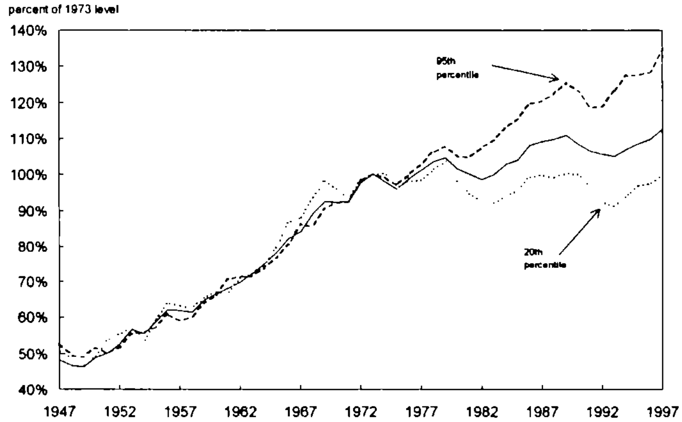
In theory, trade adjustment assistance provides compensation from the broad class of those who gain from trade (represented by the taxpayers generally) to those who lose (workers in trade-impacted industries) without interfering with the efficiency-enhancing effects of changes in the pattern of production 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 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

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



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 econonomic report ...

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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TEXT:
=================== ATTACHMENT 1 ===================
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[Note to Mike Treadway, editor: Sentences in square brackets may be dropped in the final revision to shorten the chapter]

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

INTRODUCTION

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

This turmoil followed a robust period of increasing integration of world product and financial markets. The trend toward increasing integration is perhaps best epitomized by the long-anticipated realization of European Monetary Union in January 1999. Even as this historic monetary union takes place, repeated episodes of financial turmoil in the 1990s have generated concern about the possible adverse consequences of financial and monetary integration.

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

Broad international consensus now exists that reforms of the global financial architecture are needed to increase 'transparency', namely to improve the availability of information; to strengthen and reform domestic financial institutions; and to improve the mechanisms available to resolve crises that do occur. This chapter starts with a description of proposals that have been advanced in each of these three areas. It then provides an analysis of the next steps to be considered in the redesign of the international financial system. Finally, it considers European Monetary Union, the prospects for the euro as an international currency, and possible implications for the U.S. dollar.

1. REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

As explained in Chapter 1, the international community, under U.S. leadership, responded to the prolongation of the crisis in 1998 with a series of initiatives in the Fall. Those reforms to the international system designed to reduce the incidence of future crises are referred to as the "new international financial architecture." The aim is to create an international financial system for the 21st century that captures the full benefits of global markets and capital flows, minimizes the risk of disruption, and better protects the most vulnerable. At the same time the system must promote international financial stability. The work done in 1998 was only the latest stage in an evolutionary process that had been underway for some years.

FROM HALIFAX TO THE G22 REPORTS

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

The report noted recent changes in financial markets that, in some cases, have altered the characteristics of currency and financial crises in emerging markets. It indicated that neither debtor countries nor their creditors should expect to be insulated from adverse financial consequences in the event of a crisis. It also stressed the need for better market-based procedures for the workout of debts when countries and firms are under financial distress. Specific reforms of bond contracts were proposed to encourage the cooperation and coordination of bondholders when the financial distress of a country or corporation requires the restructuring of the terms of a bond contract. It also suggested a review of IMF rules on "lending into arrears" in order to extend the scope of this IMF policy to include new forms of debt. Such rules on "lending into arrears" would allow the IMF to continue lending, in certain unusual and extreme circumstances, to countries that had temporarily suspended debt-serviced payments but continued to maintain a cooperative approach towards their private creditors and to comply with IMF adjustment policies.

A number of important additional innovations came out of the Halifax process: the development of international standards for making economic data publicly available (under the IMF's Special Data Dissemination Standard); international standards for banking supervision (the so-called Basle core principles for banking supervision); an emergency financing mechanism in the IMF, the Supplemental Reserve Facility, to help members cope with sudden and disruptive loss of market confidence; and the decision to expand the IMF's backup source of financing under the New Arrangements to Borrow (25 potential participants to the NAB agreed 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 the system).

Despite some progress in strengthening the system, the eruption of the Asian crisis in 1997 demonstrated the need to consider important further questions pertaining to the operation of the international system. In November 1997, on the occasion of the APEC (Asian Pacific Economic Cooperation) Leaders Summit in Vancouver, a number of Asian leaders proposed a meeting of finance ministers and central bank governors to discuss the crisis and broader issues. They suggested that the meeting be global, that is, that it should include emerging-market countries, and not just the usual small number of major industrialized countries. President Clinton responded by calling on Secretary Rubin and Chairman Greenspan to convene such a meeting. Finance ministers and central bank governors from twenty-two countries (informally dubbed the G22) thus gathered in Washington on April 16 to explore ways to reform the international financial system that could help reduce the frequency and severity of crises. Ministers and governors created three working groups to consider: measures to increase transparency and openness; potential reforms to strengthen domestic financial systems; and mechanisms to facilitate appropriate burden sharing between the official and private sector in times of crisis. The three working groups of the G22 presented their reports in October 1998 on the occasion of the annual meetings of the IMF and World Bank.

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

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

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

The G-22: Ad hoc group with membership same as the G-10, plus...

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

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

GREATER TRANSPARENCY AND OPENNESS

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

The report of the G22 working group on transparency and accountability recommended that national authorities publish timely, accurate and comprehensive information on the external liabilities of private financial and corporate sectors as well as their own foreign exchange positions. The latter information would include both foreign exchange reserves and implicit liabilities deriving from government intervention in forward exchange rate markets. It recommended adherence to existing international standards for transparency and agreed that standards in additional areas, including monetary policy and accounting and disclosure by private financial institutions, need to be developed. The report called for better monitoring of countries' compliance with such standards, including through IMF reporting on countries' adherence to internationally recognized standards. It also recommended that a working party be established to examine the potential for greater transparency of the positions of investment banks, hedge funds and institutional investors.

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

Increased transparency can help prevent the build-up of countries' financial and macroeconomic imbalances. For example, more information concerning the external debt of firms and banks might have limited investors' willingness to lend to such institutions in the first place. Transparency can also induce prompter policy adjustment by governments and help limit contagion by enabling investors to distinguish countries with sounder from those with weaker policies. Nonetheless, transparency alone is unlikely to be sufficient to prevent another major crisis from occurring. In Asia, greater transparency of information about net reserves and offshore liabilities of the financial and corporate systems might well have helped attenuate the crisis. But it is also true that many warning signals, found in data that were widely available, were missed. More is needed than just information.

REFORMING AND STRENGTHENING DOMESTIC FINANCIAL INSTITUTIONS

As discussed in Chapter 6, financial sector weaknesses in borrowing countries now appear to have been a central cause of the Asian, as well as some previous financial crises. [JY: **I would omit this bracketed part: it is repetitious of Chapter 6.** Commercial banks and other financial institutions borrowed excessively from abroad and lent excessively at home, channeling funds toward projects that were not always profitable. Insufficient expertise in the regulatory institutions led to weak regulation of the financial system, and particularly to lax supervision of banks. Insurance of residents' bank deposits was poorly designed or only implicit. What is termed "connected lending" was widespread: banks and other financial firms in a business group would make loans to other firms in the same group without objectively evaluating or monitoring their soundness. The result was often distorted incentives for project selection and monitoring. All these factors contributed to the build-up of severe structural weaknesses in the financial system. The most visible manifestation was a growing share of non-performing loans. The problem was exacerbated by the increased supply of funds from abroad, the latter in part facilitated by the process of capital account liberalization and financial market deregulation in the region during the 1990s.]

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

- strong prudential regulation and supervision of banks and other financial institutions;
- design of explicit and effective deposit insurance schemes to protect bank depositors;
- design and implementation of bankruptcy and foreclosure laws for insolvent firms;
- development of liquid and deep financial markets, especially markets in securities (bonds and equities);
- national implementation of the Basle core principles of banking supervision and of the

objectives and principles of securities regulation set by IOSCO (the International Organization of Securities Commissions);

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

BETTER CRISIS RESOLUTION, INCLUDING APPROPRIATE ROLES FOR THE OFFICIAL COMMUNITY AND THE PRIVATE SECTOR

While strengthening financial systems may prevent some crises from occurring or make those that do occur less virulent, it cannot be expected to eliminate them altogether. As a result, it is essential to establish means of resolving crises at minimum cost to economic growth without undermining appropriate incentives for prudent private and public behavior. This very important task constitutes the third and final pillar of the set of international financial reforms proposed in October by the G22 working groups.

The G22 report identified policies that could help promote the orderly resolution of future crises, including policies and procedures that could facilitate appropriate private sector involvement in crisis resolution. Private sector burden-sharing, i.e. private sector assistance in crisis resolution, is critical. In many crisis circumstances, official money will not be available in large enough quantities. Moreover, the perception that sufficient official assistance will be made available to allow a country to meet all contractual obligations without commensurate commitments from the private sector could distort the incentives of both creditors and debtors. Therefore, appropriate private sector involvement helps to induce market discipline and reduce potential moral hazard problems that might otherwise be associated with official assistance. [**JY: Omit this.** While the international community will continue to provide assistance -- conditioned on economic reform -- to deal with the problems that gave rise to economic crises, it is important to develop mechanisms to allow the private sector to participate constructively to the containment of crises and their resolution over time.] Constructive ways must be found to "bail in" private investors, rather than bailing them out.

When banks accounted for the majority of international capital flows, troubled debtors could more easily resolve a crisis through joint negotiations with a small number of banks and the international financial institutions. Such negotiations often entailed agreements to postpone debt repayments (debt restructuring) and/or to reduce the overall value of the obligation (debt write down). However, the recent proliferation of creditor institutions and instruments and the growth of international bond markets has increased the difficulty of coordinating the actions of creditors during a crisis. As a result, troubled debtors may now be more likely to take such highly disruptive unilateral actions such as mandatory debt restructurings and moratoria on repayment of debt. Unfortunately, such unilateral actions can themselves lead to contagion, if they increase investors' concern that other countries may follow similar policies. This might explain why Russia's unilateral debt restructuring in August 1998 produced financial market disruption as far away as Latin America.

Recognizing that new procedures, suitable to modern markets, must be developed to contain and resolve crises, the G22 report includes a number of recommendations.

- **A range of policies to help prevent crises and limit the scope of those crises that do occur.** The report emphasizes the need for countries to limit the scope of government guarantees, including those covering the liabilities of financial institutions, and to make explicit and price appropriately those guarantees which are offered. As discussed in Chapter 6, implicit and explicit governmental guarantees create the potential for moral hazard and encourage excessive risktaking, contributing to the chances of a crisis. The development of liquid domestic bond markets is recommended to avoid excessive reliance on bank-intermediated financing and to allow greater scope for long-term financing in local, rather than foreign, currency terms. In addition, the report calls for the development of innovative financing techniques to permit increased flexibility in payments, greater risksharing among debtors and creditors, or the assurance of new financing in the face of adverse market developments. For example, debt contracts calling explicitly for repayments that are contingent on the prices of key primary commodities or indices of emerging market risk could provide countries with an automatic reduction in debt burdens in the face of adverse export or financial market developments. In order to provide assured access to liquidity in the event of liquidity crisis, Argentina negotiated contingent credit lines with a number of private financial institutions. The report also stresses the need for countries to implement effective insolvency and debtor-creditor regimes, including bankruptcy, restructuring and foreclosure laws. Workable procedures in these areas are needed to insure the prompt recovery of economic activity following a debt crisis.

- **Measures that could improve creditor coordination in the event of a crisis.**
  Following the recommendations of the 1996 Rey Report, the G22 report proposes to include creditor coordination clauses in bond contracts among debtors and creditors. These clauses are designed to create an environment in which all parties - creditors, debtors and IFIs - can work together to reach the best resolution to a crisis. "Collective action clauses" in bond contracts are needed to overcome the problem

inherent in having a large number of creditors. For example, a clause for the collective representation of creditors (such as the formation of a creditors' committee) can facilitate efficient coordination among a large group of creditors. Also, a "majority action clause" prevents a small minority of creditors from impeding a debt restructuring agreement, by allowing a qualified majority of creditors to alter the payment terms of the debt contract. Currently, most contracts require unanimity to restructure the terms of the contract. Similarly, "sharing clauses" mandate the equal treatment of creditors by imposing a fair division of payments among them. This discourages disruptive legal action and preferential settlements that benefit a few creditors at the expense of others.

- **New methods of crisis management in the extreme case of a temporary suspension of debt payments.** Recent experience (as in Russia in 1998) underscores the fact that suspensions of debt payments and restructuring actions can be highly disruptive, especially if they substitute for policy reform and adjustment. The report argues that a temporary suspension of debt payments (the interest due on bonds and loans and/or repayment of the principal) should not, and normally would not, be undertaken by countries until all other reasonable alternatives have been exhausted. However, such a suspension might nonetheless occur in the event of severe, unanticipated adverse market developments. In these exceptional cases, the report emphasizes the need for countries to rely on orderly and cooperative approaches, rather than unilateral actions, in negotiating the restructuring of contractual obligations. Unilateral actions may entail significant economic and financial costs.

If a country suspends its debt payments to private creditors, it is technically "in arrears." The report argues that, in those exceptional cases when a country experiences a severe crisis and a temporary suspension of debt payments cannot be avoided, the international community and private creditors still have an interest in providing countries with incentives for strong and sustained policy adjustments and structural reforms. It therefore suggests that the international community can signal its conditional willingness to provide financial support, under appropriate conditions, even if the country has imposed a temporary payments suspension. Official support should be provided only if the decision to suspend payments reflects the absence of reasonable alternatives, if the government is willing to undertake strong policy adjustment, and if the government is engaged in good faith efforts with creditors to find a cooperative solution to the country's payments difficulties. An IMF policy of lending to a country that has suspended payments and has not yet cooperatively restructured its debt with private creditors is referred to as IMF "lending into arrears".[**JY--Omit this material.** Under these circumstances, to insist that a country clear up its arrears as a prerequisite for becoming eligible for IMF funding, might amount to an attempt to minimize the burden on creditors, at unreasonable cost to the debtor.]

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

Nouriel: I don't understand what this section is about. Is this just related to external debt, as the title suggests, or is it about domestic lending as well? This is extremely confusing.

Although national insolvency regimes (such as bankruptcy and corporate restructuring laws) are intended to provide an appropriate legal and institutional framework for the restructuring of corporate debt, corporate sector crises, as in Asian crisis, may occasionally achieve sufficient scale as to threaten the solvency of the entire financial system of a crisis country. Several measures can be undertaken to facilitate the orderly workout of external debt. One such measure is available in domestic insolvency regimes --such as corporate restructuring under the U.S. Chapter 11 -- that allow firms under financial distress to obtain new, senior credits to assure their ongoing operations during the restructuring of their debt. (Seniority means that the new lenders will be first in line to get repaid. Without such assurance they are unlikely to come forward.) Analogously in the international context, the report suggested that means of encouraging the private sector to provide new credits, in the event of a debt crisis or suspension of debt payments, should be considered. Otherwise, loans for basic purposes such as working capital for production and exports can become unavailable. Moreover, the government may also need to develop a framework for encouraging out-of-court negotiations between private debtors and their creditors. [Such a framework might include: (i) the establishment of creditors' committees; (ii) the removal of country-specific legal and regulatory obstacles to debt restructuring; and (iii) in certain extreme cases, the establishment by the government of exchange rate insurance schemes to reduce the foreign exchange rate risk borne by firms. These schemes could also be designed to provide incentives for firms to restructure their outstanding foreign currency liabilities.] Moreover, international support can also be harnessed to support restructuring efforts. For example, one goal of the Asian Growth and Recovery Initiative recently launched by the U.S. and Japan is to support implementation of more comprehensive and accelerated restructuring of banks and corporations in the crisis-afflicted countries in Asia.

Implementation of the international financial architectural reforms proposed in the G22 reports will take time. But they also promise to reduce the likelihood of future crises and the severity of those that do occur. For its part, the G7 strongly signaled its commitment to begin implementing some reforms in its October 30 Declaration, a subject considered next.

[ADOPTION OF MEASURES TO REFORM THE INTERNATIONAL FINANCIAL ARCHITECTURE

Considering the work of the G22 reports and following detailed discussions, including with officials from other industrial and emerging market economies, the Finance Ministers and Central Bank Governors of the G7 countries agreed, in a statement issued on October 30, 1998, on specific reforms to strengthen the international financial system. In the words of their communique, they *agreed to carry these forward through our own actions and in the appropriate international financial institutions and forums. These reforms are designed to: increase the transparency and openness of the international financial system; identify and disseminate international principles, standards and codes of best practice; strengthen incentives for countries and economic agents to meet these international standards; and strengthen official assistance to help developing countries reinforce their economic and financial infrastructures. They also include policies and processes to ensure the stability and improve the surveillance of the international financial system. Finally, they aim at reforming the International Financial Institutions, such as the IMF, while deepening cooperation among industrialized and developing countries.*]

2. FURTHER STEPS TO STRENGTHEN THE INTERNATIONAL FINANCIAL ARCHITECTURE

In its October 30 statement, the G7 committed to a number of reforms consistent with the recommendations of the G22 working groups as well as a great deal of additional analysis and research. The G7 also stressed the need for the international community to widen its efforts to strengthen the international financial system. The G7 thus committed to initiate further work on a number of other important areas to identify additional concrete steps to strengthen the international financial architecture. These include:

- examining the additional scope for strengthened prudential regulation in industrial countries.
- further strengthening prudential regulation and financial systems in emerging markets.

- developing new ways to respond to crises, including new structures for official finance and new procedures for greater private sector involvement in crisis resolution.
- assessing proposals for further strengthening of the IMF.
- seeking to minimize the human cost of financial crises and encouraging the adoption of policies that better protect the most vulnerable in society.
- consideration of the elements necessary for the maintenance of sustainable exchange rate regimes in emerging markets.

Each of these steps poses a number of issues and challenges. Many of these are inter-related and are addressed in the sections below.

STRENGTHENED PRUDENTIAL REGULATION AND SUPERVISION IN INDUSTRIAL COUNTRIES

The crises of the past year have revealed some gaps in the international regulatory infrastructure promoting financial stability and overseeing national financial systems. Global financial integration has led to a proliferation of financial institutions making cross-border financial transactions, the emergence of off-shore financial centers and hedge funds, and the development of a wide range of derivative instruments. In this new environment, investors may underestimate risks during periods of market euphoria, and thus contribute to an excessive build-up of exposures during the upswing.

Such developments pose significant challenges to financial regulators and supervisors. Creditors and investors in industrial countries need incentives to act with greater discipline, i.e., to analyze and weigh risks and rewards appropriately in their lending and investment decisions. Thus, there is a more urgent need to examine the scope for strengthened prudential regulation and supervision in industrial countries. Three aspects of these regulatory challenges are explored below.

Enhanced international financial supervision and surveillance

While, traditionally, supervision and regulation of financial systems have been *domestically*-based, the increased global financial integration and the proliferation of institutions doing cross-border transactions suggest the need for enhanced *international* financial supervision and surveillance. Accordingly, appropriate supervisory regimes for the international financial system need to be devised. Better national and international procedures are needed to monitor and promote stability in the global financial system. **Nouriel: Are these Administration views, G-7 views or G-22 views? This needs to be clarified in what follows.**

The International Financial Institutions, working closely with international supervisory and regulatory bodies, need to conduct surveillance of national financial sectors and their regulatory and supervisory regimes with all relevant information accessible to them. Processes of peer review could be utilized in conjunction with the IMF's regular surveillance of its member countries.

Although good financial supervision must start at the domestic level, international institutions and national authorities involved in financial sector stability must work jointly to foster financial stability and reduce systemic risk. They will need also to exchange information more systematically on the risks that exist in the international financial system. In this regard, the design of a policy-oriented forum including finance ministries, central banks and securities regulators from the major G7 countries, key emerging markets, relevant international organizations and international financial institutions would be useful.

Strengthened bank capital regulation

At the heart of the issue of bank regulation are banks' capital adequacy standards. As discussed in chapter 6 (see Box 6-5), banks may have an incentive to make excessively risky investments, since much of the cost of failure may be borne by either depositors or the government. To mitigate this tendency, banks are required to hold a certain amount of their own capital in reserve against the loans they make.

That many banks are currently active on a global scale leads to good reasons for international bank capital standards. First, globally active banks headquartered in countries with low requirements would otherwise be at an advantage with respect to those headquartered elsewhere. In addition, by virtue of their global scale, the impact of global bank failures would likely extend well beyond national borders.

The 1988 Basle Capital Accord (named after Basle, Switzerland where representatives of industrialized-country central banks meet regularly) established an international standard by recommending that globally active banks maintain capital equal to at least 8 percent of their assets. In addition, the Accord sought to distinguish between more and less risky assets, and required that more capital be held against investments with greater risk. As a result, the Accord called for banks to maintain capital equal -- not to 8 percent of their *total* assets -- but to 8 percent of their *risk-weighted* assets. Safe government bonds or cash, for example, receive a zero weight in calculating aggregate risk exposure, while long-term lending to emerging markets banks receives a 100% weight. Such minimum capital standards were meant to work in conjunction with direct supervision of banks and basic market discipline to restrain excessive risk-taking by banks with access to the safety net.

Even at the time of their adoption, it was recognized that the standards called for in the Accord might need to be reviewed and strengthened in the face of developments in the international financial environment. Effective capital regulation is an evolutionary process and the standards have already been improved in a number of ways in the decade since their initial adoption. However, some shortcomings of the system have become more apparent as a result of recent developments. First, the risk weights mirror only crudely the actual risk associated with different types of bank assets; moreover, a number of financial innovations have made it easier for banks to assume greater risk without being subject to increased capital charges [, contrary to the intent of the Accord]. Second, traditional assessments of credit risk might fail to account for some extreme circumstances. Third, current standards may have encouraged banks in developed countries to make short-term rather than longer-term loans to banks in emerging markets, since risk weights on the former assets are lower than those on the latter. Recent experience, however, suggests that short-term cross-border interbank flows are in fact subject to greater volatility. A fourth shortcoming concerns the treatment of off-balance sheet items such as derivative positions, committed credit lines, and letters of credit, which create new types of risk that current standards inadequately address. These off-balance sheet items, like bets on football games, are not assets and are thus recorded "off balance sheet." Stock in a football team, on the other hand, is an asset and is recorded "on balance sheet." Nevertheless, both pose risks. Finally, different standards of regulation may be appropriate for sophisticated international banks than regional or community banks.

The task of improving further the Basle Capital Accord has just started. No consensus has yet emerged concerning reform of bank capital regulation. But it is likely that a strong and effective system of bank regulation will need to rely on several components: strengthened capital standards; improved internal risk-management controls in banks, including greater reliance on banks'own models of risk assessment; and increased reliance on market discipline. [For example, a useful approach may be value-at-risk models, already used internally by some banks. These are sophisticated models that consider the risk and correlation of returns on all the assets and liabilities of a bank to derive a measure of market risk in a bank's portfolio (i.e, how much a bank may lose because of a change in prices of assets and liabilities). However, such models can be improved by testing them for their robustness to a range of different kinds of stress in order to assess the many other risks faced by banks in addition to market risk. In fact, extreme market conditions and financial crises create additional risks (such as credit risk, counterparty risk and liquidity risk) that traditional models of the type and distribution of risks cannot assess well.] For example, market discipline over risk-taking by banks could be strengthened by requiring banks to issue subordinated debt equal to a specified proportion of their risk-weighted assets. Since holders of subordinated debt receive payments only paid after more senior claims are satisfied, the holders of such debt would have a strong incentive to monitor the risk taking behavior of banks issuing it. In this sense, market discipline could be used to complement direct regulation. The price of traded, subordinated debt would also serve as a signal to regulators of the markets' perception of financial soundness.

A broad debate is certain to be waged on the issue of how to provide effective capital regulation of banks in the globalized environment in which they now operate. The Basle standards were designed for G10 banking institutions, but the proliferation of financial institutions in emerging markets poses the question of whether the same standards adequately address the risks faced by institutions operating in emerging markets. One proposal is to restrict access to major financial centers to banks that -- not only meet the usual specific regulatory requirements -- but also reside in countries with adequate bank supervision. The purpose would be to help limit the risks deriving from the activities of developing-country banks, as well as to encourage good supervision in their home countries. This proposal is controversial, however, as emerging economies may perceive it as limiting competition and stunting their ability to develop their own banks and other international financial institutions. To address these concerns, these new standards will have to be developed by an appropriately diverse group of national authorities.

The rapid development of derivative instruments and their widespread use in international financial markets poses another host of difficult regulatory issues. Derivatives are contracts that are written in terms of the price of an underlying asset, such as options or futures contracts written in terms of stock prices. Derivatives can be used to hedge risks and thus have been very useful in risk-management by banks, other financial institutions, and corporate firms. However, they can also be used for taking speculative positions (increasing risk rather than decreasing it). Moreover, the fact that derivative positions are recorded off-balance sheet makes it more difficult for the market and regulators to assess their contribution to the risks taken by the institution using them. If the creditworthiness of the counter-party is uncertain, firms or banks who believe they are hedged (e.g. against currency risk) may effectively not be.

A difficult issue concerns the type of regulatory oversight that should be put in place for derivative instruments. For example, excessive regulation of derivatives could lead the derivative business to move to unregulated offshore markets. The Administration is currently undertaking a long-term study of over-the-counter derivative instruments, including their potential risks and effects. This study will review recent market developments and existing regulation, and consider what regulatory or legislative changes may be appropriate. It will investigate possibilities for reducing systemic risk and eliminating legal uncertainty. It will also assess the potential use of derivatives for fraud or manipulation, and methods for curtailing regulatory arbitrage, i.e., the situation in which market participants seek to exploit differences that exist in regulation among different jurisdictions.

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

Hedge funds represent a relatively recent innovation in the financial markets. The near-failure of a prominent hedge fund (LTCM -- Long Term Capital Management) in September 1998 focused renewed attention on the role and activities of hedge funds and other highly leveraged entities.

It is challenging enough simply to define "hedge fund" in a precise way. The label is usually applied to investment funds that are unregulated because they restrict participation to a small number of wealthy investors (see Chapter 2 for a broader discussion of their activities). [They generally use sophisticated techniques to make very targeted investments. In addition, some of them use significant "leverage" -- that is, they make investments not only with their own funds but with sizable amounts of borrowed funds as well.]

The impact of hedge funds and other highly leveraged entities on financial markets certainly needs to be better understood. Accordingly, Treasury Secretary Rubin has called upon the President's Working Group on Financial Markets to prepare a study of the potential implications of the operation of firms such as hedge funds and their relationships with their creditors. A primary concern for regulators is that lenders manage the risks associated with extending credit to hedge funds appropriately. Regulation of the hedge funds themselves may not be easy or even appropriate. Regulation might, for example, lead such funds to move to unregulated offshore markets, in the same way in which the Eurocurrency markets in the 1960s emerged to get around regulation of U.S. financial markets.

The Administration-commissioned hedge fund study will examine a number of issues including questions relating to the disclosure of information by entities such as hedge funds and the potential risks associated with highly leveraged institutions. The study will examine whether the government needs to do more to discourage excessive leverage and, if so, what the appropriate steps might be. A number of the Working Group agencies are also participating in several studies on the international aspects of these questions.

[The hedge fund study is just one example of a concrete initiative consistent with the G7's commitment to further the work of the three Working Groups and strengthen prudential regulation and supervision in their own financial systems. In its October 30 Declaration, the G7 governments also committed themselves to make progress on additional fronts. In their own countries, they pledged to investigate both the adequacy of risk management systems in financial institutions and existing prudential standards, and the efficacy with which they are monitored and enforced. The G7 also agreed that appropriate means should be sought to encourage off-shore centers to comply with internationally agreed standards, and called upon other countries that participate in the global capital markets to take similar action. Finally, the G7 also called for the BIS (Bank for International Settlements), in conjunction with national authorities, emerging market countries, and other relevant private and public sector bodies, to examine the question of appropriate transparency and disclosure standards for private sector financial institutions involved in international capital flows, such as investment banks, hedge funds and other institutional investors.]

STRENGTHENING PRUDENTIAL REGULATION AND FINANCIAL SYSTEMS, ENSURING ORDERLY LIBERALIZATION OF CAPITAL FLOWS, AND IMPROVING ECONOMIC POLICIES IN EMERGING MARKETS

The recent Asian financial crisis has focused attention upon a wide variety of financial policies, both international and domestic in scope. Considering the central role played by financial sector weaknesses in the crisis (see Chapter 6), the case for re-examination is particularly strong in the case of emerging markets. Accordingly, the second area for further work called for by the G7 is the identification of concrete steps to further strengthen prudential regulation and financial systems in emerging markets. Clearly, this is an ambitious undertaking, and will require a vast number of issues to be considered and challenges to be overcome. Some of the most significant are addressed in the sections below.

Some nations have apparently been tempted to turn inward as a result of the financial crisis. Instead of facing the challenges of strengthening their financial institutions, a few have in effect decided to eschew the benefits of international capital flows. The arguments for free capital mobility are numerous, however, especially when domestic financial systems are strong and properly supervised and regulated. First, with unrestricted capital mobility, the market is free to allocate saving to the best investment opportunities. Investors can earn a higher rate of return abroad than they could if limited to the domestic market. Second, firms and other borrowers in high-growth countries can obtain funds more cheaply abroad than if they had to finance their investments at home. Third, free capital mobility allows investors and households to diversify risks and to have access to a larger pool of assets; the benefits of portfolio diversification are enhanced by access to foreign investment opportunities. Fourth, the scrutiny of global investors can provide an important discipline on policy-makers. Well-functioning capital markets can discourage excessive monetary and fiscal expansion, since inflation, budget deficits and current account deficits quickly lead to reserve outflows and currency depreciation. Logically, a case for restricting capital mobility requires the identification of distortions in the market allocation of capital.

Increasing the Resilience of Financial Systems

Nonetheless, international capital inflows can reverse suddenly, and openness potentially makes emerging economies more vulnerable such reversals. As a result, policies to increase the resilience of financial systems need to be identified. These include effective prudential regulation and supervision of financial markets. The G7 has suggested investigating concrete means of encouraging emerging economies to adopt international standards and best practices. In addition, countries could potentially reduce financial system vulnerability by: encouraging greater participation in their markets by foreign financial institutions; developing a better credit culture in the banking system; and relying more on equity and other financing that does not result in the build-up of excessive debt burdens. This includes efforts to develop local/regional capital markets.

Orderly liberalization of capital flows

Most emerging economies have historically had heavily restricted capital markets. One result of the recent crisis is a growing consensus that capital market liberalization needs to be carried out in a careful and well-sequenced manner if countries are to benefit from closer integration into the global economy. As noted above, the benefits of free capital flows are numerous. The United States and most other leading industrial countries, for example, do well without capital controls. As discussed in Chapter 6, if domestic financial systems are weak, poorly regulated and subject to institutional distortions, however, rapid capital account liberalization can lead to excessive short-term borrowing and lending, and a mismatch of maturities and currency denominations of assets and liabilities of financial institutions and corporate firms. Such tendencies have proven to be destabilizing in the many episodes of financial and currency crises. Effective regulatory and supervisory regimes must be in place and the financial sector must be poised to deal adequately with these risks as the capital account is liberalized. International financial institutions should play a constructive role in facilitating this orderly opening of the capital account.

It may prove useful to develop principles to help guide countries that are liberalizing and opening their capital markets so as to help reduce the vulnerability of their financial systems to sudden shifts in capital flows. Possible measure could include, for example, an open policy to foreign direct investment and promotion of longer-term equity financing. Conversely, it might be beneficial to discourage cross-border short-term interbank flows, which are likely both to be volatile and vulnerable to distortions arising from financial safety nets. There is now some support for a prudent management of these flows, at least within the sphere of prudential banking regulation.

Prudential regulation of short-term interbank cross-border inflows

One approach to ensure the stability of short-term cross-border interbank flows is through enhanced prudential banking standards. On the borrower side, a range of possible measures could be considered to help discourage imprudent foreign currency borrowing, while relying on market mechanisms to the extent possible. Prudential bank standards, such as limits on a bank's open foreign currency positions, if enforced effectively, could reduce the riskier kinds of foreign borrowing by banks.

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

More prudent short-term cross-border interbank flows could also be encouraged on the lender side, i.e., via the banks in the industrial countries. As already noted, current Basle capital adequacy standards provide incentives to lending banks in developed countries to prefer short-term to long-term loans to banks in emerging markets, since risk weights on short-term loans are lower than those on supposedly "more risky" long-term bank loans. Some have suggested adjusting risk weights on such loans to encourage more careful bank lending to emerging market entities that operate in weak financial systems.

Broader controls on all short-term capital inflows?

More controversially, some have suggested wider use of market-based, Chilean-style restraints on all short-term capital inflows to deter short-term foreign borrowing, not just via banks but by other means as well. Corporate firms are reported to have undertaken large-scale risky cross-border borrowing directly, rather than via the banking system, leading up to the crisis in Southeast Asia, for example. It has been argued, e.g., in support of Chile's approach, that regulation on inflows to banks alone will lead to evasion through corporate borrowing. Controls on general inflows have also been said to help in the management of monetary policy when surges in inflows create difficult problems (how to "sterilize" their impact, avoiding an inflationary surge in the money supply).

The effectiveness of such controls has been questioned. Evasion and leakages tend to make capital controls less effective over time. Also, the apparent success of Chile may have been due more to the very effective prudential regulation and supervision of the financial system than to capital controls. Finally, such controls have favored large corporations (who are more capable of raising funds directly in international financial markets) at the expense of small and medium ones.

The available empirical evidence from countries that have imposed controls on a broad range of short-term capital inflows shows that they do appear to have affected the composition of inflows (away from short-term maturities and towards the longer-term, and towards foreign direct investment), even though they do not appear to have affected the overall volume of capital inflows. Some argue that, if the rationale for controls is to reduce particularly risky short-term borrowing, the evidence can be seen as supportive. Opponents of such controls point out that, during the recent financial turmoil, Chile, Colombia and Brazil have all reduced their controls in order to stimulate urgently needed capital inflows and reduce pressures against their currencies. Proponents of Chilean-style controls reply that these moves do not undermine the rationale of slowing down short-term capital inflows temporarily during a cyclical phase where such inflows are feared to be excessive, in contrast to the crisis or outflow phase of the cycle where it is sensible to remove the controls.

Evidence is not only mixed, but preliminary and based on the experience of a limited set of countries. Given the numerous arguments against them, policies to restrict all short-term inflows remain quite controversial.

Controls on capital outflows

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

However, many arguments against capital controls in a crisis have been advanced. First, controls on outflows are often in practice administered in institutional frameworks in which they are used to extract rents and delay necessary reforms. Elaborate foreign exchange controls lead to rent-seeking behavior and corruption, and distort international trade. Over time, investors often find ways to avoid them. Moreover, capital controls may divert attention from the need to address policy distortions that lead to excessive borrowing, such as inadequate prudential supervision and regulation of the financial system. Reliance on targeted controls might also lead countries to use capital controls indiscriminately, thus insulating unsound macroeconomic policies from the discipline of the marketplace. Capital controls and other restrictions domestic capital market restrictions also serve as a form of financial repression -- a distortionary type of taxation -- that reduces the incentive to save. Studies show that capital controls in Latin America in the aftermath of the 1980s debt crisis led to negative real interest rates that eventually provoked more flight of capital out of the country rather than less. Finally, controls on outflows may discourage capital *inflows*, since foreign investors fear they may not be able to repatriate the proceeds of their investments in the future. And fears of controls on capital outflows can accelerate a crisis, rather than postponing it, and can lead to perverse international contagion. In this regard, it has been suggested that the news of capital controls in Russia and Malaysia in August 1998 was a factor in the spread of financial panic to Latin America and the other emerging markets.

Moreover, if the goal is to allow a reduction in interest rates in the context of Asia today, it should be recognized that interest rates have already fallen substantially relative to the peaks of the crisis. (By the second half of 1998, they were back to pre-crisis levels in Korea.) However, in spite of interest rate reductions, severe distress of many financial institutions, combined with widespread corporate debt problems have produced credit crunches. Capital controls and lower interest rates would do little to promote lending in this situation.

Improving macroeconomic and other policies in emerging markets

In addition to policies needed to strengthen financial systems, a number of policies are needed in developing countries to enhance financial stability, foster long-term economic growth and limit vulnerability to shifts in global capital:

S*ound macroeconomic policies.* Countries need consistent monetary and exchange rate policies and fiscal policies that avoid excessive accumulation of government debt.

Prudent public debt management. Although short-term borrowing, in foreign currency terms, can be very appealing to a government because it is cheaper and often easier in the short-run, too much of this kind of borrowing makes countries vulnerable to sudden shifts in investor confidence. Sound debt management is important to insure against the risk of market disruptions.

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

NEW WAYS TO RESPOND TO CRISES, INCLUDING NEW STRUCTURES FOR OFFICIAL FINANCE AND NEW PROCEDURES FOR GREATER PRIVATE SECTOR INVOLVEMENT IN CRISIS PREVENTION AND RESOLUTION

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

Any regime for crisis response must involve some combination of financial assistance and policy changes. The provision of large-scale official international finance raises difficult questions concerning the criteria that should govern access to such assistance, appropriate terms, the links, if any, to private sector involvement, and the sources of funding.

The logic of a precautionary facility

In their October 30 statement, the G7 called for an enhanced IMF facility to allow large-scale international assistance in the form of a precautionary lines of credit, as opposed to traditional packages that are highly tranched (i.e., disbursed in successive rounds to keep borrowers on [a short leash of] strict policy conditionality). The rationale for a precautionary facility available to countries with sound economic policies which may be subject to attack is based on the possibility of "international bank runs" [, analogous to, but more complex than, domestic bank runs of the sort discussed in Box 6-5 in Chapter 6].

An international bank run can occur if many bank depositors -- both foreign and domestic -- simultaneously seek to exercise their claims on financial institutions' foreign currency holdings. In such an event, a rapid loss of reserves and strain on the exchange rate is likely. In a domestic context, deposit insurance and the general "lender of last resort" role played by central banks are aimed at preventing self-fulfilling bank runs. However, such insurance creates moral hazard: if banks' deposits are insured and/or liquidity support is guaranteed in the case of a run, banks will have an incentive ex ante to make risky loans that they would not make in the absence of insurance. The solution to this problem is strong capital adequacy standards and prudential supervision and regulation of banks.

In the international context, the expected provision of official liquidity may also lead to distorted incentives: expectations of official emergency financing may cause international investors to lend carelessly and domestic governments to engage in risky policies. Moral hazard in the domestic context can be mitigated if insolvent banks can be distinguished from illiquid ones. Analogously in the international context, precautionary financial support should ideally be given to countries with good policies who are innocent bystanders in episodes of contagion and withheld from countries with weak policies. Drawing this distinction is even more difficult among countries than among banks. In practice there is a spectrum of crises, from those that stem primarily from poor policies to those that stem primarily from contagion. Most fall somewhere in the middle.

Just as there is a role, at times, for the government to intervene to prevent a domestic financial crisis from destabilizing the domestic financial system, so there is a role for the international community to intervene in an international financial crisis to help limit contagion and global instability, when appropriate. The current crisis has demonstrated that the official community needs, at times, to be able to provide large financing packages to quell potential contagion and instability. Congress' agreement in 1998 to support an increase in the IMF quota will -- highly leveraged by means of the waiting contributions of other countries -- provide the IMF with an important pool of new, uncommitted funds.

It may make sense in today's world of large and sudden liquidity needs for more official money to be available up-front in return for more up-front policy changes. In their October 30 Declaration, the G7 agreed that, in response to the current exceptional circumstances in the international capital markets, strengthened arrangements for dealing with contagion are needed. The central element would be the establishment of an enhanced IMF Facility that would provide a contingent short-term line of credit for countries pursuing strong IMF-approved policies, i.e., those cases where problems stem more from contagion than from poor policies. This facility could be drawn upon in times of need and would entail appropriate interest rates along with shorter maturities. The facility would be accompanied by appropriate private sector involvement.

Continued need for greater private sector participation

As described earlier in this chapter, The G22 Working Group report on international financial crises pointed to the need for future work to develop new procedures for orderly and cooperative crisis resolution. The G7 has called for similar work as part of the next steps identified in its October 30 Declaration. Old methods of crisis resolution were developed in a world dominated by banks. There is now a need to develop innovative ways for holders of new financial instruments to participate constructively in crisis containment and resolution. This is one of the key challenges going forward. Pre-negotiated contingent credit lines (such as those negotiated by Argentina with commercial banks) and financial provisions that provide greater explicit sharing of risk between creditors and debtors are two avenues worth exploration.

IMF REFORM

Proposals for strengthening the IMF, so as to improve its country programmes and procedures in crisis prevention and resolution, need to be assessed. This goes as well for proposals to strengthen the Interim Committee, in effect and IMF steering committee composed of representatives of member governments, and the Development Committee, which plays the analogous role for the World Bank.

MINIMIZING THE HUMAN COSTS OF FINANCIAL CRISES

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

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

SUSTAINABLE EXCHANGE RATE REGIMES FOR EMERGING MARKETS

Exchange rate regimes vary in the degree of rigidity. There are more choices than simply "fixed" vs. "floating." They range from institutional arrangements like monetary unions, dollarized regimes, and currency boards, to conventional fixed exchange rates, crawling pegs, basket pegs, managed floats, and free floats.

There is no single exchange rate regime that is best for all countries at all times; rather the choice must be based on a country's circumstances. Exchange rate regimes are institutional choices that signal policies, priorities, and commitments. Given that large fluctuations between the currencies of major countries economies are likely to continue, that many emerging markets have extensive trading ties to a number of major industrial economies, and that the credibility of the policy environment in many emerging markets will take time to establish, the choice of an appropriate exchange rate for emerging markets economy is particularly difficult. No matter what exchange rate a country chooses, it is critical that it be backed by strong financial regulation and appropriate monetary and fiscal policies. Macroeconomic stability is based on good policies, irrespective of the exchange rate regime. Policy mistakes that contribute to a currency crisis can occur in the context of any exchange rate regime.

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

Benefits of fixed exchange rate regimes

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

By eliminating exchange rate risk, a fixed exchange rate regime may encourage international trade and finance. However, the evidence on the effects of exchange rate stability on trade volumes is mixed. The effects on trade and finance may be greater if a country goes beyond fixing its exchange rate and literally adopts the currency of a neighbor (monetary union or dollarization). The advantage of eliminating exchange rate volatility may look especially attractive to the extent that large market movements appear on occasion not to be founded on economic fundamentals.

Another potential benefit of fixed rate regimes is that they can provide monetary discipline. The loss of monetary autonomy under fixed exchange rates limits the ability of monetary authorities to pursue excessively expansionary and inflationary monetary policies. Relatively rigid fixed exchange rates can be an important signal of policy commitment to achieving and maintaining low inflation, especially when countries are seeking rapid disinflation from conditions of high inflation or hyperinflation, as part of a consistent plan for macroeconomic stability.

In some cases, fixed rates may contribute to greater fiscal discipline: reducing the ability of monetary authorities to monetize fiscal deficits may restrain tendencies to have loose fiscal policies. Adopting a fixed exchange rate does not, however, automatically provide policy discipline. Instead, adopting a fixed exchange rate and/or a currency board requires fiscal discipline and a strong financial system to be credible.

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

Benefits of exchange rate flexibility

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

Fixed exchange rates may undesirably reduce the perceived risk of foreign currency-denominated borrowing by banks and firms, by inducing the false belief that they face only one-sided uncertainty on the movements of the exchange rate. In contrast, more flexible exchange rates explicitly introduce two-way risk; the currency may depreciate as well as appreciate. This may help discourage the accumulation of unhedged foreign currency liabilities.

The three episodes of currency crisis in the 1990s occurred under regimes where exchanges rates were either fixed or kept in a narrow band. Semi-fixed exchange rate regimes and policies of exchange-rate based stabilization -- no less than floating regimes -- have at times led to real currency appreciations that worsened a current account deficit, and contributed to triggering a crisis. Exchange rate-based stabilizations may be more successful if the initial fixed rate anchor regime is followed by a crawling peg regime where the exchange rate is allowed to depreciate on the basis of the inflation differential between the domestic economy and the world. Experience suggests that maintaining protracted fixed rates in the aftermath of exchange rate-based stabilizations can lead to real appreciation (due to residual inflation) and deteriorating trade balances, which can eventually undermine fixed-rate regimes not supported by consistent policy regimes. Some countries have made strong institutional commitments to a rigid fixed exchange rate regime; other countries could benefit from increasing flexibility during periods of macroeconomic and financial stability, when the move to flexibility may be less disruptive.

More work must be done to determine whether certain exchange rate regimes provide more stability in the presence of high capital mobility and the potential for sudden reversals of capital flows following changes in investors' expectations. In no case, can the choice of a particular exchange rate regime substitute for sound macroeconomic policies and strong financial systems as the foundations of true stability.

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

Box 7-1. - Currency Boards

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

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

By maintaining a strict unyielding exchange rate and100 percent reserves, the government hopes to ensure credibility.

The first currency board was established by the British in Mauritius in 1849. The use of currency boards eventually spread to 70 British colonies. The purpose was to provide the colonies with a stable currency without the associated difficulty of issuing sterling notes and coins that were costly to replace if lost or destroyed. The colonies also benefitted from this approach in that they could earn interest on the foreign currency assets being held in reserve. The use of currency boards peaked in the 1940s and declined thereafter. [In the 1960s, many newly independent African countries replaced their currency board with a central bank, and most other countries followed suit in the 1970s.]

The introduction of currency board-like arrangements in Argentina (1991), Hong Kong (1983), Estonia (1992), Lithuania (1994), and Bulgaria (1997) constitutes a small resurgence in their use worldwide. A currency board can help to create a credible policy environment by removing from the monetary authorities the option of printing money to finance government deficits. Argentina, for example, has benefited from such credibility. Argentina was prompted to adopt a currency board [which it calls the convertibility plan] because of a dramatic hyperinflation in the 1980s and the absence of a credible monetary authority. Since 1991, Argentina has become a model of price stability and has achieved laudable growth rates, aside from the Mexican peso "Tequila"-induced recession in 1995, from which Argentina soon rebounded strongly. By most accounts, the currency board has worked for Argentina.

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

Currency board supporters have pushed for their wider use—in particular, for Indonesia, Russia, and Ukraine. But proclaiming a currency board does not automatically guarantee the credibility of the fixed rate peg as sometimes asserted. [Little credibility is gained from putting an exchange rate peg into the law, in a country where laws are not heeded or are changed at will.]

A currency board is unlikely to be successful without the solid fundamentals of adequate reserves, fiscal discipline, and a strong and well-supervised financial system, in addition to the rule of law.

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3. EUROPEAN ECONOMIC AND MONETARY UNION

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

THE EMU SCHEDULE

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

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

The remarkable convergence of financial conditions in the European countries is clear from the data on the 11 EMU countries' short-term and long-term interest rates (see Charts 6-3 and 6-4), showing that both sharply converged after 1996. Differences in interest rates across countries can be due to two major factors: a currency premium related to the risk of devaluation, and a country premium related to the possibility of default on the public debt. With monetary union starting in January 1999, short term interest rates converged as currency risk was eliminated and default risk is close to zero for very short-term public debt. Even after monetary union, differences among long-term interest rates may remain, as different EMU countries with different stocks of public debt may be perceived as having different default probabilities. However, long-term interest rates in the euro-11 area converged quite sharply by the fall of 1998 as well.

In July 1998, the European Central Bank came into existence. On January 1, 1999 the single currency, the euro, was created as the currency of the 11 EMU countries. The European Central Bank took control of monetary policy in all EMU countries. Existing national notes and coins will continue to circulate until euro cash is introduced although they are no longer separate currencies - they are "non-decimal denominations" of the euro, locked in at permanent conversion rates. (By analogy, most American dollar bills carry a circular seal with a letter inside denoting the Federal Reserve District from which they come. However, Europeans will continue for some time to be far more aware of the geographic origin of the currency they carry than Americans are.) Only in 2002, will euro cash (coins and notes) enter into circulation with national currencies being phased out. This transition period is necessary because central banks need time to print the banknotes and mint coins; retailers and banks also want time to prepare; and the public sector needs time to prepare as governments have to consider how to change their services over to the use of the euro.

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

BENEFITS AND POTENTIAL COSTS OF EMU

There are several potential benefits of EMU. Transaction costs in trade will be lowered as exchange rate risk and currency transactions within Europe will both be eliminated; and the ensuing goods market integration and price competition will be beneficial to consumers. Integrated European financial markets will be broadened and deepened. Inflation discipline will be preserved by an independent European Central Bank committed to price stability. It is hoped that fiscal discipline will also result since, as agreed in a Growth and Stability Pact, membership requires maintenance of disciplined fiscal policy. (According to the Pact, fines may be imposed on countries found to be running excessive deficits.) Participation in EMU eliminates national monetary policy and limits the scope of fiscal policies as a tool of stabilization policy. This loss of macroeconomic tools to address cyclical unemployment makes more urgent the need for European structural reforms, e.g., to increase flexibility in the labor market. In this sense, it is to be hoped that EMU might serve as a discipline tool to nudge European countries to implement structural reforms more rapidly and eliminate impediments to sustained economic growth.

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

However, EMU may also entail some potential costs. Most important, it entails a loss of monetary autonomy and the ability to use this tool to respond to "asymmetric" national shocks, unexpected economic developments that affect some countries differentially than others (i.e., idiosyncratic or country-specific events). Exchange rate changes are another instrument for coping with such shocks, but with EMU this tool will also no longer be available. Absent these tools, flexibility of wages and labor mobility across regions and industries are the major mechanisms of adjustment. But labor mobility is much lower among the nations of Europe than, for example, among the American states. Fiscal policy can also play a stabilization role but the rules for EMU membership constrain countries' ability to use such a tool. Finally, in Europe there is also little in the way of a central system of federal taxes and transfers to cushion against regional/national shocks as compared to the United States. Limited labor mobility, structural labor market rigidities, and decentralized and constrained fiscal policy could imply that Europe does not satisfy the criteria for an "optimal currency area" as well as do the regions of the United States. (These points are elaborated in Box 7-2 on Optimum Currency Areas).

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

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

Common rather than national shocks. Why do countries ever need independent currencies? If a country (or other geographic region) suffers an adverse "shock," such as a fall in demand for its products, it may want to follow a more expansionary monetary policy, in order to stimulate demand and head off unemployment. Yet, if it does not have an independent currency, it will not be able to undertake monetary expansion. Conversely, only common shocks can be properly addressed by a union-wide monetary policy change.

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

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

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

Existence of a federal system of fiscal transfers. When disparities in income do arise in the United States, federal fiscal policy helps to narrow them. One recent estimate suggests that when a region's per capita income falls by one dollar, the final reduction in its disposable income is only 70 cents. The difference, a 30 percent federal cushioning effect, includes both an automatic decrease in federal tax receipts plus an automatic increase in unemployment compensation and other transfers. The cushioning effect has been estimated at 17 percent in the case of Canadian provinces. European countries have greater scope for domestic fiscal stabilization than do American states. Furthermore there are some cross-country fiscal transfer mechanisms. Nevertheless, neither the fiscal transfer mechanisms that are already in place within the European Union nor those that are contemplated under EMU -- so-called "structural funds" -- are as large as those in the U.S. or Canadian federal fiscal system.

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

Prospects for EMU. There is good hope, however, for a successful EMU. The degree of integration among EU countries is increasing decade by decade. The degree of international labor mobility, for example, is likely to be higher in the future than in the past. The Schengen convention now allows free movement of citizens among a subset of European countries. Thus the European countries may come to satisfy the textbook criteria of an optimum currency area in the future, even if they do not fully now.

While such potential costs of EMU have some relevance, some of the objections to EMU have been exaggerated. For example, monetary policy is a potent policy tool for mitigating cyclical unemployment caused by shocks affecting the aggregate demand for a country's goods and services; but it has little long-run impact on unemployment caused by such structural rigidities as labor market inflexibility or real wage rigidity. Such conditions result in high levels of "NAIRU" -- namely, full-employment unemployment rates -- in many European countries and in such depressed regions as southern Italy. These problems must be addressed through structural reforms with or without monetary union.

Second, the scope for fiscal expansion is also limited in Europe, because fiscal deficits and debt-to-GDP ratios remain high in a number of several countries. Fiscal consolidation must therefore continue with or without EMU; in this sense, EMU may not be a strong constraint. Third, asymmetric shocks and limited factor mobility may diminish over time as EMU leads to greater real integration among European economies (see Box 7-2). For example, as intra-European trade continues to grow in response to European integration and EMU, the creation of a common free market for goods, services and factors of production could make idiosyncratic national shocks less prevalent if it reduces the degree of spatial concentration of individual industries.

Finally, it has been argued that EMU is likely to exert discipline in favor of structural reform. As there will be no national monetary and exchange rate policies and fiscal policy autonomy will be constrained, the ability to use macro instruments to delay structural market reforms will be reduced; governments will have stronger incentives to pursue policies that further long-run economic growth. Critics of this view contend, however, that EMU could slow the drive for structural reforms: Since reforms are socially costly, the flexibility deriving from monetary, exchange rate and fiscal discretion can ease the transition costs as resources are reallocated. With EMU, the absence of these social "shock absorbers", may slow down the structural reform process. [In that scenario, the absence of the structural reform would continue, creating detriments to EMU.]

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

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

With the development of an open and integrated economic area in Europe, the United States will benefit. American producers will be able to export to a very large, integrated European market with no cross-national restrictions to trade. U.S. firms producing in Europe will benefit from the lack of exchange rate volatility, common European standards for goods and services and a large open market. Indeed, U.S. corporations have more experience selling into a large unified market than do European corporations. American financial institutions in particular, who are already quite competitive in commercial and investment banking services and securities products, can benefit from the opportunities provided by the broadening and deepening of integrated European financial markets.

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

The functions of an international currency

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

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

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

A *unit of account* is a reference scale for quoting prices, which is distinguishable from the actual currency in which assets are held or payments made. On the private sector side of the unit of account function, an international currency is used to invoice imports and exports. Presently, the U.S. dollar plays a dominant role in invoicing around the world, especially for primary commodities like oil. But invoicing will be mostly in euros within Europe. Also, the euro may be used widely in Central and Eastern Europe, the Middle East and Africa, areas of high and increasing trade with Europe.

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

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

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

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

Is it good or bad to be an international currency?

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

Advantages of having a key currency

There are at least five advantages to a country of having its currency used internationally.

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

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

(3) Political power and prestige. The benefits of "power and prestige" are decidedly nebulous. Nevertheless, historians and political scientists have sometimes associated key currency status [and international creditor status], along with such non-economic factors as colonies and military power, as trappings of great powers.

(4) Seigniorage. This is thought by some to be perhaps the most important advantage of having other countries hold one's currency. They must give up real goods and services, or ownership of the real capital stock, in order to add to the currency balances that they use.

Seigniorage derives from the fact that the U.S. effectively gets a zero-interest rate loan when dollar bills are held abroad. Just as American Express reaps profits whenever people hold its travelers' checks, which they are willing to do without receiving interest, so the United States profits whenever people in Argentina or Russia hold dollars that do not pay interest. Wherever hyperinflation or social disorder undermine the public's faith in the local currency, the American dollar is the preferred alternative. (Illegal activities are another source of demand, of course).

A way to compute cumulative seigniorage is to estimate the stock of dollars held abroad, and multiply by the interest rate. Foreign holdings of U.S. currency are conservatively estimated at 60 per cent of total dollar currency in circulation. With total currency outstanding in mid-1998 at $441 billion, foreign holdings are about $265 billion. One simply multiplies by the Treasury bill interest rate, to derive the estimate that seigniorage currently runs about $13 billion a year. [This is implicitly a tax on foreign transactions that are intensive in dollar cash.]

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

The fact that borrowing may occur in domestic or foreign currency has little to do with such sustainability. [Financing the foreign debt in one's own country currency gives, in principle, the potential advantage of being able to debase the real value of such debt through inflation. But no one would recommend deliberately following such a destructive economic strategy, given the loss of credibility and the economic costs of high inflation that it would entail.]

Disadvantages of having a key currency

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

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

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

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

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

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

Other major measures of international currency status, on the eve of the birth of the euro, are shown in Table 7.1. Overall, they tend to show the same thing: the dollar still on top, despite a gradual decline in its use versus the mark and yen over the last thirty years. The dollar is still more important than its three or four rivals combined.

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

• 87 percent of trades in the foreign exchange market in April 1998 involved the dollar, as the currency either bought or sold (see third column of the table). This figure (like the share of reserves held in dollars) should automatically go up in 1999, as EMU eliminates intra-European transactions among member currencies.

• The various measures of use of currencies to denominate private international financial transactions -- loans, bonds, and deposits -- still showed the dollar as the dominant currency, with a 54 percent share.

• Figures on the use of international currencies as substitutes in local cash transactions, are not generally available. The two leaders have been the dollar, for which internationally-circulating cash has been estimated by the Fed at 60 percent of U.S. currency outstanding, and the mark, for which international circulation has been estimated by the Bundesbank at 35-40 percent of German currency outstanding.

What are the determinants of international currency status?

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

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

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

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

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

The monetary authorities in Japan, Germany and Switzerland, in the 1970s established a better track record of low inflation than did the United States, which helped their currencies to achieve greater international currency status. Given the good U.S. inflation performance more recently, this is no longer such a concern.

What is the prognosis for the dollar and the euro?

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

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

While the widespread use of the U.S. dollar as international currency -- for holding reserves, pegging minor currencies, invoicing imports and exports, and denominating bonds and lending -- is testimony to the strength of the U.S. economy and the confidence with which it is viewed around the world, the direct economic benefits deriving from this international role are limited. The welfare of a country is measured by its ability to produce a large quantity of goods and services and provide a sustained increase in real income and consumption opportunities for its citizens. Whether a country's currency is an international currency or not has little to do with such long-run well-being, as the experience of many successful economies whose currencies do not have international roles attests. A strong and healthy U.S. economy that is a leader and champion of sound economic policies has led - as a by-product- to a strong international role for the U.S. dollar.

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

5. CONCLUSION

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

The United Stated has worked intensively with key emerging markets, other industrialized nations, and the relevant international organizations, to put in place the building blocks of this new architecture. The reforms recommended by the G22 and adopted by the G7 are an important starting point. The United States and its G7 partners also agreed to do more to build a modern framework for the global markets of the 21st century and to limit the swings of boom and bust that destroy hope and diminish wealth. Thus, they also committed to initiate new work on a number of other important areas to identify additional steps to strengthen the international financial architecture. All these reforms will ensure that the unprecedented growth, increase in welfare and opportunity experienced in the 50 years after the creation of the Bretton Woods system are maintained in the future.

Meanwhile, the United States salutes the formation of the European Monetary Union. The United Stated has much to gain from the success of this momentous project. Now more than ever, America is well served by having an integrated and prosperous trading partner on the other side of the Atlantic. Europe should benefit from a single currency that supports these ends -- and if Europe benefits, this will greatly benefit the United States.