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001. email attachment	Nouriel Roubini to Jeffrey A. Frankel and Janet L. Yellen at 10:54:38. Subject: Medley Global Advisers Meeting for 01/13/99 on Brazil. (2 pages)	01/13/1999	P4/b(4)

COLLECTION:

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RESTRICTION CODES

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

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
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P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-JAN-1999 16:21:11.00

SUBJECT: Cabinet Mtg tommorrow

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

TEXT:
Cabinet Affairs called to say that they would like you to speak for about 2 minutes on the state of the economy at tomorrow's Cabinet mtg. I will ask Steve to bring you the talking points he prepared on Friday.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-JAN-1999 10:37:20.00

SUBJECT: WP-3 resched

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

TEXT:
Hi Janet,

I just got a call from Renee Mathieu over at TRS, and she says the OECD needs to reschedule the June '99 WP-3 to be on June 11th rather than June 4th.

I told her that would probably be fine, since she wanted an answer quickly and seeing as how the CEA member who will attend probably doesn't have a firm schedule that far out yet. Is this all right, or should we try and check further with our new WP-3 person?

Best,

-Ryan

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:12-JAN-1999 13:53:45.00

SUBJECT: Chapter 1

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

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

TEXT:
Attached is a revised draft of Chapter 1. Could you print this and
distribute it as soon as possible to Becky, Jeff, Doug, Steve, Nouriel and
Howard with requests for any comments ASAP?=================== ATTACHMENT 1
===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D58]MAIL47850521O.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 is 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 the only long expansion in which fiscal policy was *contractionary* rather than expansionary, reflecting the view that a tighter fiscal policy was needed to spur long-term economic growth.

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

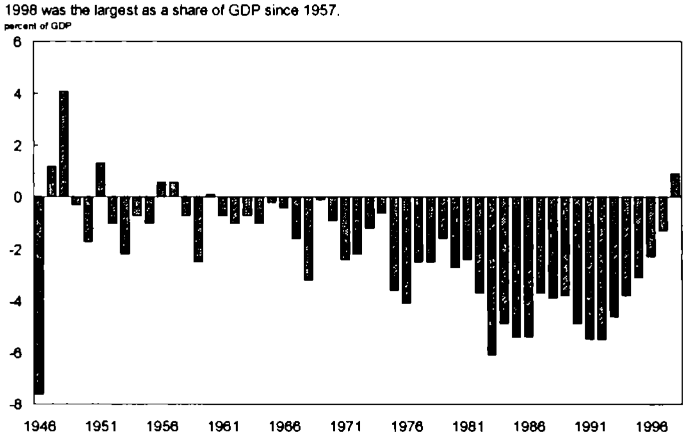
Reducing the Federal budget deficit has been a centerpiece of this Administration's economic policy. In 1993, the President pledged to cut the deficit in half by 1998; in 1997, he promised to balance the budget by 2002. In fact, the budget was in the black last year with the largest surplus as a share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

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. Use of the surplus to help workers save for retirement also adds to national 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 if needed.

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, similar to that suffered during the debt crisis of the 1980s, would be intolerable, and the administration States recognizes that more is required than simply for the industrial countries to serve as good customers 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 from companies that have shut down their plants and moved production to Mexico or Canada, and the administration has supported extending such assistance to all workers displaced by the movement of work to another country.

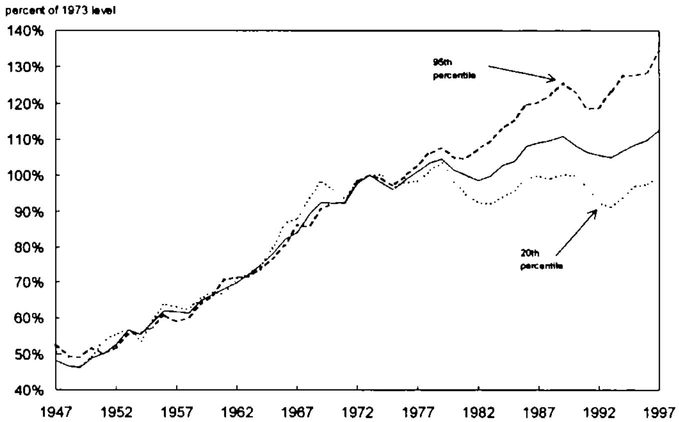
In theory, trade adjustment assistance provides compensation from the broad class of those who gain from trade (represented by the taxpayers generally) to those who lose (workers in trade-impacted industries) without interfering with the efficiency-enhancing effects of changes in the pattern of production associated with freer trade. In practice, of course, things are more complicated if adjustment assistance interferes unduly with workers' incentives to find new jobs. Nevertheless, adjustment assistance illustrates the general principal that it is desirable to address the disruption from change without stopping the change itself.

PROMOTING PROSPERITY FOR ALL AMERICANS

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

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

CREATION DATE/TIME:13-JAN-1999 14:58:19.00

SUBJECT: Chapter 7

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

TO: Nouriel Roubini (CN=Nouriel Roubini/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 just wanted to let you know that I read through Chapter 7 last night.
It looks good -- most of my responses were editorial comments of the sort
that Treadway will handle.

I did think things got a bit long between pages 16 and 30, with a bit more
detail in the policy discussions than might be needed. To the extent that
you have a number of sentences marked with brackets to indicate they might
be removed, I'd recommend you do remove them to shorten and tighten the
text.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Rhonda Melton (CN=Rhonda Melton/O=OVP [UNKNOWN])

CREATION DATE/TIME:13-JAN-1999 09:54:14.00

SUBJECT:

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

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

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

TO: apincus@doc.gov (apincus@doc.gov [UNKNOWN])
READ:UNKNOWN

TO: Jim Kohlenberger (CN=Jim Kohlenberger/O=OVP @ OVP [UNKNOWN])
READ:UNKNOWN

TO: Charles M. Brain (CN=Charles M. Brain/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: Neal Lane (CN=Neal Lane/OU=OSTP/O=EOP @ EOP [OSTP])
READ:UNKNOWN

TO: Audrey Choi (CN=Audrey Choi/O=OVP @ OVP [UNKNOWN])
READ:UNKNOWN

TO: jayne.schreibero@usdoj.gov (jayne.schreibero@usdoj.gov [UNKNOWN])
READ:UNKNOWN

TEXT:
MEMORANDUM FOR

State (Eisenstadt); Treasury (Summers); Justice (Fisher); Commerce (Pincus); FTC (Pitofsky); FCC (Kennard); USTR (Novick); CEA (Yellin); OSTP (Lane); SBA (Hochberg), WH/IGA (Mickey Ibarra), WH/Legislative Affairs (Chuck Brain)

FROM: David Beier, OVP and Sally Katzen, NEC

RE: Meeting on Electronic Commerce Agenda for 1999

Summary:

We would like to have a meeting on January 15, 1999 at 4:15pm p.m. in Room 276 OEOB (VP Ceremonial Office) to discuss the Administration,s e-commerce agenda. Please RSVP by calling Shannon Mason at 456-2800.

Promoting electronic commerce in the U.S. and abroad is a top Administration priority. Over the last several years, information technology has accounted for 1/3 of U.S. economic growth, and some experts predict that U.S. business-to-business electronic commerce alone could reach $1.3 trillion by the year 2003. The Administration is off to an excellent start on its e-commerce agenda, with major legislative victories in 1998 on Internet taxation, intellectual property, children,s privacy, and electronic signatures.

To maintain that momentum, we would like to propose a structure for managing the initiative, with responsibilities given to agencies to manage specific components of the initiative. It will be necessary to create some new inter-agency working groups to make progress on the agenda items that the President and Vice-President unveiled in the December 1998 e-commerce event.

Proposed Structure

The proposed structure builds on the interagency Working Group that was co-chaired by Ira Magaziner and David Beier, but (1) creates a senior-level Steering Committee; (2) delegates more authority and responsibility to agencies on specific e-commerce issues; and (3) creates task forces to develop and implement policy where no appropriate inter-agency mechanism exists.

1. David Beier and Sally Katzen will serve as the Chair and Vice Chair of the e-commerce initiative.

2. There will be a Steering Committee composed of senior-level officials from the relevant agencies, including State (Eisenstadt); Treasury (Summers); Justice (Fisher); Commerce (Pincus); FTC (Pitofsky); FCC (Kennard); USTR (Novick); CEA (Yellin); OSTP (Lane); and SBA (Hochberg). This group will meet to review the Administration,s e-commerce agenda and work plan, and to review cross-cutting policy issues as appropriate. This structure is generally similar to the group convened by Todd Stern to coordinate the work done on Global Climate Change. The Steering Committee on electronic commerce will, however, meet less frequently.

3. There will be an interagency Working Group that will meet more frequently to make progress on the overall execution and coordination of the e-commerce agenda.

4. There will be a limited number of task forces created to develop policy and make progress in specific areas. Although these will be chaired by particular agencies, all agencies are welcome to participate.

Consumer Protection (Commerce with FTC)

Broadband networks (Commerce and Justice)

Consumer law/payment issues (Commerce and Treasury)

Market Access (USTR)

Developing Countries (State)

Content (including gaming, cultural diversity and indecent material)(Commerce with Justice)

Standards (Commerce)

The following White House staff will be assigned to work with the Task Forces (on Developing Countries, Audrey Choi, Content, Jim Kohlenberger, and Broadband, Tom Kalil).

5. There will be two projects that do not require task forces, one on developing a better understanding of the digital economy, and another on promoting small business use of the Internet.

6. In some areas of e-commerce policy, the work will continue to be handled as it has in the past. For example, NEC coordinates privacy policy and intellectual property rights policy. There is a separate NSC-led process on encryption policy. Tax-related issues will be handled by the Department of Treasury after appropriate consultation with other affected agencies.

Agenda for E-commerce Meeting
January 15, 1999
Room 276, OEOB

1. Review implementation plan for Electronic Commerce Steering Committee.

2. Discuss Advisory Committee on Electronic Commerce (Internet tax) and the appropriate Administration role.

3. Review likely Congressional Internet-related legislative and oversight activities.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:13-JAN-1999 11:58:37.00

SUBJECT: Goldman Sachs Emerging Market Daily Comment - 13 Jan 99

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

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

TEXT:
---------------------- Forwarded by Nouriel Roubini/CEA/EOP on 01/13/99
11:57 AM ---------------------------

"Brewster, Lynn" <Lynn.Brewster @ gs.com>
01/13/99 11:37:45 AM
Record Type: Record

To: Nouriel Roubini/CEA/EOP
cc:
Subject: Emerging Market Daily Comment - 13 Jan 99

<<emdc130199.pdf>> *This acrobat abode file contains Emerging Market
Daily
Comment - 13 Jan 99.

This file is in a .pdf format, to open you will need to have adobe acrobat
active on your computer..

To obtain a copy of this ask your systems administrator.

- emdc130199.pdf

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D68]MAIL41153831M.036 to ASCII,
The following is a HEX DUMP:

Emerging Markets
DAILY COMMENT

Goldman Sachs

Brazil: Preparing for D Day

1. The outlook for Brazil has deteriorated markedly since December. This is because of weak political commitment to expeditiously implement tough fiscal adjustment measures, a key condition to restore credibility and clamp the unsustainable hemorrhage of international reserves.
2. More recently, a default by the State of Minas Gerais (the second largest in terms of GDP) to the federal government followed by requests by other states for more lenient debt servicing conditions further undermined what was left of the credibility and viability of the fiscal program.
3. These setbacks have once again turned the odds significantly against the Real, leading to further losses of international reserves. Yesterday's FX outflows neared US$1.0 billion, reducing international reserves (net of the US$9.8 billion from the IMF and governments) to just under US$32.0 billion. Usable net foreign exchange reserves are probably below US$30 billion right now.
4. Scope for clearing the backlog of fiscal adjustment and prospects for halting the FX outflows seems quite limited. As a result, Brazil is better off to devalue while it still has some reserves, thus avoiding an exchange rate overshooting that usually occurs when a country runs out of reserves.
5. Given that the real exchange rate is less than 10% overvalued (GS-DEEMER), the pressure to devalue comes from the need to ration the remaining reserves. Therefore, it would have been advisable for the government to go for a large once-and-for-all devaluation (perhaps of about 25% or 30%) to improve its external payments position. The crawling band should have been replaced by a corridor with 15% width and no slope.
6. To be credible (and avoid a secondary speculative attack), the government must anchor the 25-30% devaluation by approving the fiscal adjustment measures and more, possibly including the privatisation of the state oil company Petrobras to reduce domestic public debt. If such measures are implemented, Brazil may keep IMF and US support, thus avoiding an exchange rate overshooting. However, had this been politically easy, it would have been done by now.
7. Instead, the government opted today to replace the crawling band for a rigid floating system. The wider band was widened to R$1.32-1.20 per U.S. dollar, eliminating the slope and the intervention miniband. Upon announcement, the exchange rate immediately went to R$1.30, effectively devaluing the Real by almost 9.0%. The width of the band will be revised every three days. No supporting credit or fiscal measures were announced, thus having no credibility. Apparently, such a move was made without consultation with Washington.
8. The government still has time to put in place "Plan B" now. However, without credible and front loaded measures, we may fall in "Plan C", which implies a depletion of reserves followed by an exchange rate overshooting.
9. In all, we believe that without a proper fiscal program and explicit Washington support, a larger devaluation is a matter of days away (Plan C), thus suggesting investors should remain defensive.

Comment: (-)

1. In case we fall in Plan B, spread widening in emerging debt markets (EDM) may reach about 400bp, with even higher spreads for Brazil. This would cause dislocation in financial markets, reducing growth prospects for Latin America to negative 2.0% (from 0.5% in the no-devaluation case). While growth would suffer, spreads in stronger credits could tighten within 3 to 6 months.
2. In case we fall in plan C, spread widening in EDM could blow up by an additional 600bp, with financial contagion being particularly strong for countries with large external financing requirements. In such a scenario, capital flows to Latin America may stop leading to debt servicing difficulties across the continent. Financial contagion to developed markets is quite likely.

PL

[Automated Records Management System Hex-Dump Conversion]

Fixed Income Strategy

Investment Recommendations:
We believe that the latest developments compounding the uncertainties surrounding Brazil and Latin America argue in favor of the following modifications to our previous trade ideas.

1. Maintain long positions in Korea and China sovereign paper. We would be a buyer on weakness.
2. Continue buy/overweight strategy in Morocco Tranche-A loan and sell/underweight Peru PDIs or FLIRBs.
3. Continue to sell/underweight Venezuela, but unwind buy/overweight position on Brazil.
4. Continue to underweight/sell Colombia 2001s, but unwind buy/overweight positions on the mid-section of the credit curve.
5. Short horizon investors may consider unwinding buy/overweight positions on UMS 2007s, but longer horizon investors should continue to overweight this credit.

Credit Considerations:
While uncertainties surrounding Brazil are clouding sentiment, there are fundamental reasons to believe that Korea has turned the corner; this warrants additional buying on contagion-related spread weakness. China's sovereign credit standing remains strong, in light of its definitive signals of distancing itself from troubled provincial government entities. In 1999, we expect that the external position of these sovereigns will remain sound and we are not concerned about their ability to service external debt. Furthermore, we expect these assets to perform as the uncertainties in Brazil resolve themselves. However, we urge caution in taking long positions on the weaker Asian credits for the time being. The Morocco – Peru trade should continue to remain attractive. Static from Brazil will likely affect Peru spreads, even though the Peruvian reserves situation remains strong. With today's widening of the Real band, Venezuela will likely come under renewed pressure. This may make Colombia's situation more difficult. A scenario in which Colombia is forced to raise interest rates to defend the Peso, would have negative implications for the health of the financial system and the Colombian economy. While there is continued risk stemming from oil prices and possible currency pressures, over the medium term we continue to maintain a constructive view on Mexico.

Sensitivity to Market Contagion:

High	**High/Medium**	**Medium**	**Medium/Low**	**Low**
Brazil	Colombia	Hong Kong	China	Hungary
Venezuela	Mexico	Peru	Thailand	Poland
Ecuador	South Africa	Panama	Philippines	Greece
Russia		Bulgaria	Korea	
Argentina		Morocco		

Diane Petan, David Cohen, Srikant Seshadri

Latin America

BRAZIL

BRAZIL AND THE ANDEANS: QUICK THOUGTHS

1. There is no doubt that the recent devaluation in Brazil will have an impact on the smaller countries of Latin America that we have grouped loosely under the heading of "Andeans": Chile, Colombia, Ecuador, Panama, Peru, and Venezuela.
2. In the very near term, the impact should be felt both on exchange rates (excluding Panama) and bond spreads, forcing in some cases the abandonment of the band system altogether (Ecuador).
3. Panama and Peru will remain useful as defensive credits in emerging markets portfolios.
4. If the Brazilian devaluation proves credible and effective, we should expect a recovery in sovereign spreads particularly Colombia. Venezuelan and Ecuadoran spread recovery will remain constrained by domestic economic policy issues.
5. If the devaluation in Brazil proves to lack credibility, the impact on the Andeans will come mostly through the capital account. Trade between Brazil and the Andeans is limited (about 5% of total Andean trade on average), but the

devaluation could possibly lead to rising import protection (higher surcharges or tariffs) particularly in Ecuador, and Colombia. Under these circumstances, capital inflows (other than from multilaterals) will likely be severely curtailed. Lower capital inflows will likely force the abandonment of band regimes elsewhere (Colombia and Venezuela) and will require severe adjustments to reduce external imbalances. In the weaker credits, it could also led to debt service difficulties in 1999. **FK**

HIGHER DOLLAR OUTFLOWS YESTERDAY

Net dollar outflows of US$1.2 million reported yesterday, of which US$917.9 million from the commercial market. This compares negatively with the 10-day moving average of total daily outflows of US$274.4 million per day. **CR**

CHILE

THE REAL DEVALUATION AND CHILE'S OUTLOOK

Recent events in Brazil caught Chile in the midst of a deep adjustment in domestic expenditures. Real domestic expenditure growth shifted to an estimated 10.0% contraction in Q4'98 from an expansion of 15.6% in Q1'98. This adjustment reflected a very tight (although volatile) monetary stance in most of 1998, and set the stage for a decline of the current account deficit in 1999 (even in a soft-copper-prices scenario). As imports declined sharply and the trade balance improved in response of the sharp deceleration in domestic demand, the BCCh lowered real overnight interest rates 670 bp to 7.8%, while widening the exchange rate band. Even in the absence of a Brazilian shock we would have expected the exchange rate to shoulder most of the adjustment in 1999 and were expecting an additional interest rate cut (50-100 bp) in Q1'99 (alternative scenario in our January 1999 Economic Quarterly). Under current circumstances, we would expect the exchange rate to adjust in the near term. However, if the shock from Brazil worsens, we would expect no further interest rates cuts in the near term. **FK**

INFRASTRUCTURE INVESTMENT EXPECTED TO RISE IN 1999

Public and private investment in infrastructure projects in Chile is expected to reach US$1.5 billion in 1999. The estimate provided by the Public Works Minister, Jaime Tohá, is 23% higher than in 1998. Private investment in infrastructure works is expected to increase 103% from a year ago to US$837 million, while public sector investment is projected to increase 18.4% to US$661.0 million. **CR**

COLOMBIA

BRAZIL DEVALUATION MAY LOWER THE PACE OF INTEREST RATES CUTS

Recent development in Brazil will likely put further interest rate cuts on hold, as the exchange rate is likely to weaken further. If the Brazilian orderly devaluation strategy fails to gain credibility, Colombia's band will be under extreme pressure. Under those circumstances, the BdR will possibly have to change the exchange rate regime before hiking interest rates, as the banking system recovery would be endangered if real interest rates fail to decline further.

1. The interbank interest rate fell to 23.3% yesterday, amid a relatively liquid market. Banco de la Republica provided $613.7 billion pesos in liquidity, below the available limit of $900 billion.
2. The government of Colombia plans to do the first TES notes auction today. The 1-, 2-, and 3- year TES notes closed 1998 with an interest rate of 32.0%, 34.7%, and 34.3%, respectively.
3. Net international reserves increased by US$64 million during the first four days of 1999 to US$8.76 billion.

FK/CR

ECUADOR

REAL DEVALUATION MAY PROVE FATAL FOR THE BAND

For the last several days the exchange rate band has been under pressure, forcing the BCE to intervene in the foreign exchange market while sharply hiking overnight rates. These pressures reflected weak financial, external and fiscal fundamentals, and the lack of progress (including on a program with the IMF) in achieving a workable and credible strategy to resolve the external current account and fiscal deficit in 1999. Given the magnitude of the recent shocks, we believe that further band defense may prove futile, forcing the BCE to abandon the band regime altogether. However, even after the devaluation, it will take aggressive fiscal measures supported by multilateral financing to change our negative view on the credit. **FK**

MEXICO

MEXICAN MARKETS AND DATA

1. Interest rates on CETEs increased across the board in yesterday's auction as the yield curve steepened. The benchmark 28-day CETE interest rate rose 342bp to 32.71%, while the 91-day CETE interest rate rose 389bp to 33.18%. The six-month and one-year CETE auctions resumed yesterday after being suspended during the first week of September. The interest rates in the six-month and one-year paper was 31.55% and 29.99%, respectively.
2. Meanwhile, the peso lost $0.18 pesos per U.S. dollar yesterday as it closed at $10.17 per U.S. dollar. The sharp movement of the exchange rate activated Banco de Mexico's intervention mechanism. As a result, Banco de Mexico sold US$140 million to reduce exchange rate volatility. Demand for CETE paper in the primary auction fell from last week as domestic traders anticipate further interest rates increases. The overnight interest rate rose 190bp to 31.9% yesterday.
3. Gross international reserves increased US$220 million to US$30.36 billion during the first week of the year. Net international reserves rose US$191 million during the same week to US$23.7 billion.
4. The Lower House of Congress will start an extraordinary session during the first half of February. Some of the items that are expected to be discussed include the National Human Rights Commission (CNDH) and the Organic Law of Congress.

Comment: No major news on the domestic front this week. However, Mexico is likely to remain volatile in the near term as events abroad unravel. We expect the Mexican peso to face most of the brunt if investors reduce emerging markets exposure. **CR**

VENEZUELA

TAX COLLECTION BELOW TARGET IN 1998

1. The average price of the Venezuelan crude oil basket was US$10.63 per barrel during 1998, from US$16.3 in 1997. During the first week of 1999 the price of Venezuela's crude oil basket rose to US$8.96 per barrel, from US$8.08 during the last week of 1998. Meanwhile, Energy Minister, Erwin Arrieta, said yesterday that the OPEC has no meetings scheduled before March.
2. According to local press, tax collection met only 96.8% of the collection target for 1998. This is the first time that the National Tax Administration misses a tax collection target since its inception.

Comment: Tax collection will continue to be a key factor in the evolution of the fiscal accounts. The bias is toward further drawbacks in tax revenue as economic activity in Venezuela continues to fall. **CR**

Africa

SOUTH AFRICA

AN EARLY VICTIM OF THE REAL DEVALUATION

The exchange rate weakened 3.0% to R6.18, yields on the government benchmark long-bond (R150) widened 70 bp to 16.5%, and the Johannesburg Stock exchange index feel 4.0% by noon today (SA time). South Africa's external vulnerabilities (large forward open position, large stock of short term debt, and low stock of international reserves) render the economy vulnerable to external shocks. Expect further exchange rate weakness/volatility going forward. If the situation worsens, the SARB will likely have to reverse the declining interest rates trend observed in the past 3 months. **FK**

Central/ Eastern Europe

BULGARIA

RUSSIA IMPACT ON BULGARIA

Trade between Bulgaria and Russia has fallen by about 25% in 1998 compared to 1997. Bulgarian exports to Russia in 1998 equaled US$300 million against US$1.0 billion of imports.

Comment: The decline helps explain a bit of the slowdown in real GDP growth in Q3'98. It also makes us a touch more comfortable regarding 1999 as most of the overall decline we had anticipated has already materialized. **SN**

BANKING SYSTEM NEWS

1. Shortlisted candidate buyers for Hebrosbank will start their due diligence at the beginning of February. The candidates will be determined by the end of January from among five who have sent letters of intent for acquisition of Hebrosbank.

2. The three foreign managers of Biochim bank arrived to Bulgaria yesterday. Their main task will be to strengthen the bank in the next two years and prepare it for privatization.

Comment: (+) Further steps along the program for strengthening and privatizing the banking sector agreed upon with the IMF. **SN**

COMMITMENT TO STRUCTURAL REFORMS

Deputy industry minister Marinov announced companies under the jurisdiction of the Ministry of Industry that have not attracted investor interest by yearend will be liquidated. The ministry is determined to sell all sellable assets under its subordination by mid-1999 and complete structural reforms in its area by yearend.

Comment: (+) **SN**

HUNGARY

CPI INFLATION AGAIN BETTER THAN EXPECTED

The Central Statistical Office reported December CPI inflation at 10.3% year on year (11.2% year on year in November). In the year to December, year-on-year headline inflation declined 8.1 percentage points (pp).

Comment: Significantly better than expected. Disinflation was broadly distributed among the components of the CPI index with foods and household energy making the largest contributions. As a result, core inflation (which we define as CPI inflation excluding foods and energy) again fell less than headline, to 12.6% (12.9%). In the twelve months to December, we estimate that core inflation declined 3.5pp. **GB**

CENTRAL BANK TO CUT BASE RATE

The central bank announced that it will cut its base rate 100 bps to 16.0% effective February 1.

Comment: Of limited importance; the base rate is not the main policy interest rate, the central bank uses repos and reverse repos for that purpose. The base rate historically served as a benchmark for lending (a function now increasingly fulfilled by the interbank rate, Bubor), its use is limited primarily to government sponsored credit programs. **GB**

POLAND

GOMULKA SEES FURTHER RATE CUTS IN Q1'99

According to senior Finance Ministry adviser Stanislaw Gomulka "it seems that in the first quarter of this year there could be large cuts in interest rates," adding that inflation would fall to 7.0% by February from an expected 8.6% in December. He also called for macroeconomic policies that would weaken the zloty this year to parity from about 7%-8% strong of parity.

Comment: We believe that due to an expected further deterioration on the current account interest rate cuts in 1999 will be limited to those in line with a decline in inflation. That said, we broadly agree with Mr. Gomulka that year-on-year inflation is likely to fall to the vicinity of 7% by February due to sizeable price hikes in the first quarter of last year. We also expect a gradual easing of the zloty in direction of parity over the next 3-6 months. **AP**

RUSSIA

BASE MONEY GROWTH ACCELERATES

The monetary base increased 4.2% to Rb207.3 billion in the week ending on January 5.

Comment: This is the highest weekly increase since October 27 and puts the 1998 base money growth at 21%-26% year on year. In 1999, we forecast that the monetary base will grow 42.5%, fuelling average inflation of 105% year-on-year. **AP**

TURKEY

ECEVIT TO CONTINUE STABILIZATION POLICIES

According to Prime Minister Ecevit the new interim government will continue the efforts to reduce inflation as well as press for the passage of the 1999 budget and the banking and social security reform before early elections in April. He added that the "government will make the necessary effort to ensure that the impact of the world economic crisis on our economy is kept to a minimum."

Comment: We expect that a pace of disinflation in the first quarter will significantly depend on the stability of international commodity prices, rather than the government's active policies. Despite good intentions we foresee little progress on the legislative front before the elections in April. **AP**

SUCCESSFUL AUCTION, BUT LITTLE NEW MONEY

Yesterday, the Treasury placed record TL531 trillion (net) of a 13-month bond at an average compounded yield of 118.2%, while additional TL240.4 trillion were sold to public institutions.

Comment: Heavy demand was primarily due to the tax advantage on securities with more than one-year maturity. A heavy redemption of TL598.9 trillion due today, however, indicates that little new money entered the system. The Treasury plans to auction off TL100-200 trillion (net) of 14-month bonds this Friday before a TL213 trillion redemption next Friday, January 22. Due to the stabilization of the domestic political situation, in the coming days the yields will most likely be affected by external developments, namely the news out of Brazil. **AP**

UKRAINE

PRESIDENTIAL ADVISOR EXPECTS RENEWAL OF IMF FUNDING IN FEBRUARY

Valery Lytvytsky, economic advisor to President Kuchma, said the IMF mission which arrived in Kiev Tuesday for a "review" of the EFF program would find that the country has met "almost all" conditionality and that he expected a "positive decision on disbursing new tranches" in February. Mr. Lytvytsky noted in particular that the 1999 fiscal deficit was reduced to under 2.5% of GDP, meeting the program objective.

Comment: We are less sanguine regarding the prospects for a renewal of disbursements under the EFF. The mission's visit is understood to be more of a renegotiation than a regular program review.

1. The government appears to have achieved the 1998 fiscal deficit target on a cash flow basis. According to recently published figures for January-November, the deficit amounted to Hrn1423.6 million (1.6% of GDP) on real revenue growth of -12.2% year on year (compared to -12.1% year on year in January-October) and real expenditure growth of -29.5% year on year (-29.7%). However, the "tightening" has come at the cost of rapidly increasing wage and pension arrears contrary to EFF objectives. According to UEPLAC, the stock of wage arrears in the budgetary sector increased 11.8% year on year in real terms to Hrn992 million in November and pension arrears were up 41.1% in real terms to Hrn2,151 million.
2. Insufficient progress appears to have been made on legal/structural reform objectives. Particular areas of concern include administrative reform, bank regulation, bankruptcy legislation, the central bank law, the customs code, energy sector reforms, pension reform, and privatization. **GB**

ANNOUNCEMENT ON 1999 EXCHNAGE RATE POLICY DUE BEFORE END-JANUARY

National Bank of Ukraine (NBU) Governor Yushchenko said he expected the announcement of an exchange rate policy for 1999 before the end of January but that a number of policy issues still needed to be resolved. He noted that different opinions on the currency exist within the administration but that the NBU continued to support the idea of setting a trading band (now Hrn2.5-3.5 per U.S. dollar). Mr. Yushchenko also announced that some restrictions on banks' open foreign exchange positions, introduced in 1998, would be eased effective January 15.

Comment: The exchange rate policy to be adopted is likely to hinge on the outcome of negotiations with the IMF mission. In the absence of a renewal of Fund financing the central bank's weak international reserve position and the outlook for this year's balance of payments would make the maintenance of currency "stability" unlikely. **GB**

Middle East

ISRAEL

BANK OF ISRAEL CAUTIONS AGAINST POLICY UNCERTAINTY

Bank of Israel Governor Frenkel called for the acceleration of structural reforms to accelerate economic growth and advised against and increase in the fiscal deficit, adding that "backtracking on the government's obligations to economic stability" would increase inflation and create uncertainty in financial markets. Mr. Frenkel also called for the passage of a budget for 1999. His comments came a day after Prime Minister (and Acting Finance Minister) Netanyahu said he was planning to ease fiscal policy in the pre-election period. **GB**

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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:13-JAN-1999 12:34:09.00

SUBJECT: President's statement for ERP

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

TEXT:
Janet -- I have been working on a draft of the President's statement -- based mostly on the Detroit speech. In the past, I have done a draft and then sent it down to Presidential speechwriting. They will then revise and update it and get it back to me. If it is ok with you, we will follow that procedure again. Of course, I will show you a draft before I send it down to them.
Michele
---------------------- Forwarded by Michele Jolin/CEA/EOP on 01/13/99 12:30 PM ---------------------------

Alice H. Williams
01/13/99 12:25:52 PM
Record Type: Record

To: Michele Jolin/CEA/EOP
cc:
Subject: Introductory letter to ERP

Janet says we need to get an introductory letter written for the ERP.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:13-JAN-1999 10:54:38.00

SUBJECT: Medley Global Advisers Morning Meeting for 01/13/99 on Brazil

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

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

TEXT:
---------------------- Forwarded by Nouriel Roubini/CEA/EOP on 01/13/99
10:53 AM ---------------------------

Medley_Global_Advisors @ medleyadvisors.com
01/13/99 08:44:36 AM
Record Type: Record

To:
cc:
Subject: Morning Meeting for 01/13/99

(See attached file: mmJan13.pdf)

Medley Global Advisors 212-219-9096

- mmJan13.pdf

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D80]MAIL45386631G.036 to ASCII,
The following is a HEX DUMP:

Withdrawal/Redaction Marker
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email attachment	Nouriel Roubini to Jeffrey A. Frankel and Janet L. Yellen at 10:54:38. Subject: Medley Global Advisers Meeting for 01/13/99 on Brazil. (2 pages)	01/13/1999	P4/b(4)

COLLECTION:

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

FOLDER TITLE:

[01/12/1999 - 01/15/1999]

2013-0723-F
ab1292

RESTRICTION CODES

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

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

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

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

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

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-JAN-1999 11:13:29.00

SUBJECT: Re: Chapter 1

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

TEXT:
I have not made any changes to this version, so it remains the current
version

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-JAN-1999 17:36:22.00

SUBJECT: FYI: budget accounting

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

TEXT:
---------------------- Forwarded by Douglas W. Elmendorf/CEA/EOP on 01/14/99 05:38 PM ---------------------------

Douglas_W._Elmendorf @ oa.eop.gov
01/14/99 05:31:52 PM
Record Type: Record

To: Joseph J. Minarik/OMB/EOP, alan.cohen @ treas.sprint.com, Jack A. Smalligan/OMB/EOP, Barbara Chow/OMB/EOP
cc: Douglas W. Elmendorf/CEA/EOP, Jeff B. Liebman/OPD/EOP, David.Wilcox @ ms01.do.treas.sprint.com
Subject: budget accounting

Hi all,

A few thoughts on budget accounting that may be useful:

1. I think the strength of the proposal is partly dependent on the credibility of the accounting rules that underlie it. One reason that some people want to get the money out of the government's hands is precisely the concern that the government accountants can slice and dice and re-label as they see fit. And this view is reinforced by the failure of the earlier attempt to take SS off-budget, as evidenced by our recurring agenda item about whether we should "take SS off-budget." (Since that approach has been rejected, will SS now be moved back on-budget??)

2. I'm worried that any attempt to count actual dividends or realized capital gains in UB totals would make those totals much too susceptible to financial-market developments (and our projections of those developments). First, dividends vary over time. Second, capital gains will be realized along the way, not just in the distant drawdown phase of the trust fund. Any stock buybacks, or movement of stocks in or out of the relevant market indexes (as just happened with the S&P 500) will occasion realizations. Rebalancing of the trust fund portfolio after stock-price movements will generate realizations (perhaps every day). And even if stock prices rose completely smoothly, their out-performance of bonds would require regular stock sales.

It seems to me that we do not want to get in the business of predicting these technical factors, nor of letting these factors affect year-to-year budget decisions. For example, to correctly figure by next Tuesday the available programmatic money over the next 15 years would require us (in principle) to make an immediate assumption about dividend yields and likely realization behavior.

Jack's comment today (I don't know where this idea stands in your deliberations) that we could just impute the "specials" rate of return to equities (multiplied by equities priced at historical cost) resolves this concern. But does it seem too phony to make up rates of return on assets whose rate of return is actually observable? The analogy to the reform of budgetary treatment of credit programs is not very convincing to me. Credit reform was a serious improvement in budget accounting

Another alternative is simply to ignore the equity return in the UB accounting. The budget balance is a little worse than otherwise (although no worse than Jeff's numbers at yesterday's meeting). And maybe we can view it as a small internal charge for all our new risk-taking. Without the equity return, the budget balance will no longer be the change in the government's financial position (even approximately,as it is today), but since nobody has suggested counting unrealized capital gains in the budget, that problem would arise anyway.

3. I think that referring to our new beast as the "paygo surplus" (as some document does) is a little funny. I think most people view "paygo" as rules about changes in budget policy, not rules about how to account for current policy. Even in the absence of rules that try to discourage new deficits, we still need to know what the surplus or deficit is, and it;s the meaning of the word "budget balance" that we're trying to change here.

4. Has a judgment been reached about whether transfers to SS will affect the on-budget and off-budget totals? I think logic suggests that they should, but if the transfer is an on-budget outlay and an off-budget receipt, both the total receipts and total outlays figures will be inflated.

Doug

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:14-JAN-1999 16:17:06.00

SUBJECT: SS/Medicare answers

TO: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/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:
Not in time for your meeting, but anyway, here are some answers to arcane SS/Medicare questions I found while fact-checking, for possible future reference:

Social Security earnings test -- adjustment for lost benefits:
When annual earnings go over the exempt amount, benefit reduction takes away benefits one month at a time until the correct reduction for the year is reached. For example, if you lose 60% of your benefits for the year because of earning too much, you lose benefits for 7.2 months: all of Jan-July and 20% of August. Then, if you are 62-64, your benefits are adjusted (when you reach age 65) as if you had lost 8 months of benefits; but if you are 65-69 you only get credit for losing the 7 months for which you lost the full benefit. If you are 65-69 your benefits are adjusted the following January; you don,t have to wait until you,re 70.

Enforcement of earnings test:
SS recipients are required to report their expected earnings twice a year, so their benefits can be withheld when they are earning. SSA checks W-2s and eventually gets back any benefit overpayments, with a penalty, by withholding future benefits.

Medicare "secondary payer rule":
Medicare will only pay after your or your spouse's employer HI pays.
You can wait to enroll in Medicare part B and pay the premium until lose your coverage from your own or your spouse,s employer.
I,m still not sure how Medicare interacts with retiree HI from a former employer.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Howard A. Shelanski (CN=Howard A. Shelanski/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:14-JAN-1999 14:11:53.00

SUBJECT: Telecom report

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

CC: Bert I. Huang (CN=Bert I. Huang/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
I just want to update you on this project. We have assembled a lot of data and analysis. Attached if you are interested is the project outline. I am in the process of doing the written analysis that remains to be done. I expect we will have a full draft next week for review.
Thanks,

Howard.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D26]MAIL46865551I.036 to ASCII,
The following is a HEX DUMP:

DRAFT -- 1/13/99

OUTLINE: COMPETITION AND PROGRESS IN AMERICAN TELECOMMUNICATIONS

Message of the Report

The remarkable performance of the U.S. economy -- now in the longest peacetime expansion in American history -- has been significantly aided by the telecommunications industry. Indeed, the market value of telecommunications companies has grown much faster than the S&P 500 Index to a remarkable $1.4 trillion -- more than double what it was 5 years ago. Since 1993, the telecommunications industry has helped to create over 1 million new jobs, seen entry by dozens of competitive new companies, made tens of billions of dollars of new investment, raised exports, and fostered a revolution in the scope of communications services.

The enormous growth of the American telecommunications industry reflects the benefits of market competition and regulatory flexibility. These principles are manifest in the Omnibus Budget Reconciliation Act of 1993 which authorized auctions of spectrum for wireless communications, in the National Information Infrastructure (NII) initiative developed by the Administration in 1993 and overseen by Vice President Gore, and in the Telecommunications Act of 1996. Although there remain important challenges for telecommunications regulation that cannot be ignored – for example ensuring that competition develops further and more quickly in certain markets and that anti-consumer tactics like "slamming" and "cramming" are stopped – by any fair and forward-thinking assessment the development of the telecommunications market in the United States must be considered a major success. But we should neither take this success as the basis for complacency nor take remaining challenges as a reason to jettison the current regulatory framework. Instead, we should take both as reasons to adhere with greater strength to the underlying principles of open competition that are yielding great economic benefits to American workers, consumers, and businesses and to ensure that those principles can operate with full force in markets where they have so far been unable to do so.

I- Establishing New Principles for Growth in Telecommunications

A. **Traditional market structure and regulation.** For much of this century most telecommunications service in the United States was provided by a single, regulated monopoly. Competition first arose in the long-distance market, contributing to the break-up of AT&T into 7 separate local companies, the "baby bells", and one unaffiliated long-distance company, AT&T. Telecommunications market structure nonetheless continued to be highly regulated. Local telephone service remained for the most part a franchise monopoly and, although the long-distance market became more competitive, entry into that market was still barred for local companies, even if they wanted to provide long-distance service in areas where they did not provide local service. Competition was also limited in the nascent wireless communications market, in part because of regulatory limitations on available spectrum. Each service market contained only two cellular licensees under the original duopoly regulation of the 1980's.

B. **Policy evolution.** Recognizing that the telecommunications industry was changing at an increasingly rapid pace due to technological and market innovations, the Administration responded in January 1994 by proposing to overhaul the regulatory framework of telecommunications to foster investment and competition. The proposals for reform were designed to complement and contribute to the National Information Infrastructure initiative that the Administration launched in September 1993. The NII envisioned advanced networks integrating hardware, software, and skills, making it easy and affordable to connect people with each other, with computers, and with a vast array of services and information resources. Already, the Omnibus Budget Reconciliation Act of 1993, signed by the President, authorized the FCC to increase competition in the wireless industry by auctioning major blocks of radio spectrum across the country.

C. **Fundamental principles for regulatory reform.** Along with the need for a modern, flexible regulatory framework, the Administration promoted early-on the benefits of competition for both consumer choice and innovation. It thus established five fundamental principles to guide the study and formulation of legislative proposals for regulatory reform:

- Encouraging private investment in information infrastructure;
- Promoting and protecting competition;
- Providing open access to advanced telecommunications networks for consumer and service providers;
- Preserving and advancing universal service to avoid creating a society of information "haves" and "have nots"; and
- Ensuring flexibility so that the newly-adopted regulatory framework can adapt to rapid technological and market changes in the telecommunications and information industries.

D. **The Telecommunications Act of 1996.** The principles of the NII are reflected in the Telecommunications Act of 1996, which President Clinton signed into law on February 8, 1996. [Discussion of the broad mechanics of the Act].

II- Economic Growth and Competition in Telecommunications Markets

A. **Overall growth in telecommunications.** In the past 5 years the telecommunications market has grown at nearly twice the already strong rate of the U.S. economy as a whole. Indeed, since 1993 the market value of public telecommunications firms has increased by over $800 billion, and numerous private companies have created substantial, additional value and investment. More than half of this growth is from companies that did not exist prior to the breakup of AT&T's integrated monopoly in 1984. At the time the Administration announced the NII initiative in 1993, various sources estimated that industries related to the NII would create $300 billion in annual sales and increase GNP by that same amount by 2007. These estimates are being achieved and even surpassed: The communications services industry alone had revenues of $348 billion in 1997, increasing GNP by about $25 billion in just one year.

B. **Overall job creation.** The telecommunications services sector is directly responsible for creating over 250,000 new jobs since 1993. This figure does not count employment by many new entrants in both the services and equipment markets whose data is not yet reported. In addition, through its role in stimulating and interacting with the information services industry, the telecommunications industry has contributed to creation of an additional 750,000 new jobs since 1993. And this figure, too, is very conservative. [Discuss further indirect job creation that would not have occurred absent telecom growth] These figures are particularly important because productivity – output per worker – has increased dramatically in the industry in the past decade. Without the enormous growth created by new competitors and incumbents alike, and by the introduction of new products and services, telecommunications employment would have declined significantly.

C. **Competition and growth sector-by-sector.** Growth in each sector of the telecommunications industry reflects a pattern: competition creates new investment which creates new jobs, new services, and lower prices for consumers.

1. **Long-distance telephony.** The long-distance telephone market was for decades a monopoly of AT&T. That monopoly was attacked at the margins in the 1970's and early 1980's and was eliminated with the break-up of AT&T in 1984. While AT&T's market share (by revenues) at first eroded slowly against competition by MCI and Sprint, it has declined from over 90 percent in 1984 to under 50 percent today. In the past five years, numerous new firms have entered the long-distance market. Small competitors have been most responsible for reducing AT&T's market share in recent years.

   Throughout the 1980's the basic rates for long-distance telephone service fell steadily with the rise of competition. Although basic rates rose slightly from 1992 to 1997 according to FCC data, increasing numbers of residential and business customers were able to subscribe to plans that lowered their actual long-distance prices below the basic rates. Not surprisingly, long-distance usage has gone up considerably in the past five years. This increase is partly a function of the availability of lower rates, but also of an outward shift in long-distance demand due to increased transport of data and information. As usage has increased and effective rates, on average, declined, the average revenue per minute earned by long-distance companies has declined. Most recently, there has been sharply increased competition for long-distance carriers from new carriers, entry into the market of 1010-xxx "dial around" services, and substitution by consumers to the Internet for data and, increasingly, voice traffic. Recent data shows a corresponding dip in long-distance prices.

To be sure, the substantial competitive advances in the long-distance market do not preclude benefits from further entry. As the major incumbent, local telephone companies meet their obligations under the 1996 Act, their entry into the long-distance market is likely to bring additional benefits to consumers.

[Add a subsection on Internet backbone and transport investment by the IXCs]

2. **Local telephone service.** After the 1984 divestiture, local telephone service remained a franchise monopoly. The seven "baby bells" and GTE were, and remain, the largest local-service providers, with hundreds of independent companies serving small, primarily rural, territories. The regulatory barriers to entry into the local market were substantial and generally within the jurisdiction of state utilities commissions. A variety of rationales were used to justify local monopoly franchises: the economics of "natural monopoly," preserving geographical rate averaging or other cross-subsidies that support universal-service goals, and ensuring timely network upgrades and extensions. Competition was allowed in the provision of enhanced services and eventually in providing access to the long-distance network, but not generally in switched, local voice service.

The 1996 Act changed that regulatory environment in a firm and fundamental way by preempting and prohibiting regulations protecting monopoly franchises for local telephone service. Moreover, the Act requires incumbent local companies to open their networks so that competitors can purchase interconnection and lease elements of the incumbent networks that the entrant lacks. The interconnection and unbundling requirements in the United States surpass those of other nations undergoing telecommunications reform, for example the EU members, and are responsible for the much lower interconnection costs and telecommunications prices enjoyed by American consumers.

Local competition since the Act has focused principally on two areas: full-service, local telephony for urban business customers and high-speed data services to those same kinds of customers. Residential local service has seen some competitive entry in specific markets, but has not developed in a manner comparable to business service. We will focus first on the competition for business lines and then on the residential market.

(a) Competition for local business lines:

- Data for the third quarter of 1998 show that CLECs have invested more than $20 billion and created over 50,000 jobs in the past few years. New entrants have so far captured about 2 percent of business lines from the incumbents. Because competitors have been targeting the highest revenue customers first, entrants have captured about 5 percent of the market measured by revenues. Recent data show the CLECs to be gaining roughly 600,000 lines per quarter. At that rate, CLECs would have approximately half the market for business lines in 10 years (assuming 50 million business lines). By comparison, it took nearly 15 years – from 1984 to the present – for long-distance competitors to take 50 percent of AT&T's market share. Publicly held CLECs, although still in the early stages of accumulating market share, already represent 20 percent of the market value of local telephone companies.

- Employment by competitive local service companies has grown dramatically since the 1996 Act. A sample of 23 local entrants who reported employment data to ALTS, not including large firms like MFS, Teleport or AT&T, shows that the number of jobs provided by those companies increased by over 100 percent in 1998 alone -- from roughly 9000 jobs on 1/1/98 to over 18,000 jobs at the year's end.

- Competition for business lines has been increasingly facilities-based. Although the majority of competition is still through resale or use of the ILEC's unbundled network elements (UNEs), an increasing proportion of lines newly added by the CLECs are "on net." As new entrants continue to build out their (mostly fiber) networks, the shift to facilities-based service will accelerate.

(b) Data CLECs:

- A major area of local competition has been in the market for high-speed data services. Numerous companies have taken advantage of the 1996 Act to lease loops and collocation space and offer customers digital subscriber line (DSL) service, primarily for high-speed access to the Internet. Most of the data CLECs are still small, privately held companies. But competition in data services has been a local-competition success story. Data CLECs have invested hundreds of millions of dollars into facilities, pushed DSL prices down, and created thousands of new jobs in the services and manufacturing sectors.

(c) Competition for residential lines:

- Competition in the provision of local telecommunications services to residential customers has proceeded much more slowly and tentatively than competition to serve business customers. There are several possible explanations. There is no question that we must remain vigilant that incumbent local companies meet their obligations under the 1996 Act. The benefits of competition are well-proven, and American consumers must receive those benefits in *all* telecommunications markets.

- While complacency towards impediments to competition is unacceptable and contrary to long-standing Administration policy, the answer is to ensure compliance with the pro-competitive principles underlying the 1996 Act, not to jettison the current regulatory approach. Critics often point to the low number of competitively served lines as evidence that the Act is failing. This argument, however, discounts the evidence of competitive developments, assumes away the economics of the local market, and forgets the history of entry and roll-out in the telecommunications market.

    - Data CLECs and other facilities-based CLECs are serving primarily business customers, but are beginning to pursue residential markets for both voice and data services. Lines, revenues, investment, and market capitalization all point to growing competition.

- Business customers are a good place to start, and pursuing that market will lead to eventual roll-out to residential customers. The economics of local service arguably do not make pursuit of the average residential customer an interesting prospect when there is lower-hanging fruit. The exceptions exist -- *e.g.* Allegiance and RCN -- and prove that where competitors want to provide residential service and are willing to invest, they can.

- History indicates that roll-out takes time and generally starts, as one would expect, with the higher-revenue areas. The Bell System itself is a lesson in the move from commercial centers to more rural areas. And Bell was merely repeating a strategy followed decades before by Western Union in building out its telegraph network. MCI is another good example. It started with private business service, went to public business service, and eventually to residential offerings. Roll out rates of competitive local service are similar (check this) to the roll-out rate of MCI's competing long-distance service in the early 1980's.

- There is clearly a further need to ensure that artificial barriers to local competition are eradicated. Specific regulatory challenges remain in the areas of network pricing, smooth transfer of customer accounts, provision of advanced services, and other issues. Those challenges must be addressed carefully and swiftly. But even the best of intentions and sharpest of policies will not bring about immediate reversal of nearly a century of radically different regulatory and industry structure. Preservation of incentives to invest in advanced technology and of competitive access to the marketplace are the surest route to further growth and improvement.

3. **Wireless Communications.** The FCC first assigned licenses for cellular telephone spectrum in 1983, following a "duopoly rule" under which one license in each market was given to the incumbent local telephone provider and another to an unaffiliated competitor. By 1985, there were just over 200,000 subscribers, 600 cell sites, and about 1700 people directly employed by wireless telephone providers. By the middle of 1998, there were nearly 61,000,000 cellular subscribers, over 57,000 cell sites, and over 113,000 Americans holding jobs with wireless telephone companies. This dramatic growth has been spurred by policies that

increased competition in the wireless market. Indeed, the wireless communications industry may serve as a model for regulatory policy in rapidly innovating technological industries.

- By 1995, the FCC had successfully auctioned the first major blocks of spectrum for personal communications services, making possible fast market entry by new, wireless competitors across the country. Altogether, more than 200 million Americans, or over 80 percent of the population, live in wireless service areas with at least 1 new competitor to the 2 original cellular systems, and more than half of all Americans live in areas with at least 3 new competitors.

- This new competition has caused prices to plummet. The average monthly bill across the mobile telephone industry has fallen to $40 from nearly $100 a decade ago, and down almost 20 percent from $50 just two years ago. Median prices per minute -- what the typical user pays -- have also fallen 30 percent to 40 percent for residential users and 30 percent to 50 percent for business users thanks to new competition.

- Wireless telecommunications is now a nearly $30 billion industry, growing on average 24 percent a year since 1993. Capital investment, a leading indicator of future industry growth, has now grown to a cumulative $50 billion. Extraordinary growth in subscribership is the cause: 60.8 million Americans, or roughly 1 in 4 American adults, now subscribe to a mobile service. That is nearly 60 percent higher than in 1996 and five times the number in 1993.

- Wireless telephone service is beginning to substitute on the margins for wireline service, and may do so increasingly in the future as technology improves, competition and subscribership increase, and prices fall.

4. **The Equipment Market.** The telecommunications equipment industry in the U.S. has grown substantially. Total production in 1997 topped $60 billion. New competitors created by wireless auctions and the 1996 Act have created a large demand for innovative telecommunications equipment. The number of small entrants into the field, some of whom have become important players (e.g. Ascend, just acquired by Lucent, and independents like Copper Mountain), have created thousands of jobs, invested billions in producing novel solutions to technical challenges faced by new entrants and incumbents alike in providing new services, and made the United States the leading exporter of telecommunications equipment in the world -- U.S. telecommunications equipment exports doubled from 1993 to 1997 to a total of over $13 billion.

5. **The Internet.** The pace of technological advance, the importance of forward-looking infrastructure, and growing desire for information are all manifest in the rapid growth of the Internet and its associated industries. This relatively young sector of telecommunications exemplifies successful relationships among government stewardship, private investment and innovation, and the public interest.

- Regulatory forebearance and continuing investment in the National Information Infrastructure has made possible unprecedented growth in both the development and adoption of this telecommunications medium. The Internet has evolved from its roots in a government research project into a public-private partnership and, now, into a global network truly owned by the public at large. Propelled by the increasing amount of computing power possible at ever-falling prices, the transmission of data from computer to computer, from user to user, has become ever more useful and cost-effective. No amount of technological innovation, however, could have made the Internet possible without the existing and growing grid of telephone lines, cables, optic fibers, and routing equipment that forms the backbone of the NII.

- At the same time, the increasing public demand for -- and provision of --- fast and ready information has driven this "backbone" equipment industry, motivating tremendous private investment and market capitalization as well as job creation. The growing need for carrying capacity, or "bandwidth," has pushed the roll out of yet more physical equipment and wiring, as well as the invention of such technologies as symmetric and asymmetric digital subscriber lines and new methods of digital compression. Indeed, the digitization of information has blurred the lines between data, video, and voice, with information of all these types available for transmission at ever lower cost: the cost of transmitting one bit of data over a kilometer of fiber optic cable fell by three orders of magnitude between the mid-1970s and the early 1990s.

- Altogether, nearly 30 million sources of information on the Internet, or "hosts," were active by early 1998, up from 20 million only six months earlier and from fewer than 3 million in 1993. Thanks to tremendous investment in infrastructure, the United States ranks far above the Japan, Germany, and the United Kingdom in public participation in the Internet, as measured by the number of hosts per capita. In 1993, there were roughly 5 Internet hosts in this country for every 1000 Americans. By 1997, the ratio had increased to 45 hosts for every 1000 people, which is nearly 1 host for every 20 people -- or about 1 Internet information source for every 4 adult Internet users in America. Just in the two years between 1995 and 1997, adult Internet users in the United States grew from about 14 million to over 41 million, or about one in five adults. This year, nearly one in three American adults is expected to be "online."

- The broad reach of the Internet has made it suitable for an increasing variety of applications. Many businesses see a future in online transactions, or "e-commerce," and the overall U.S. Internet economy is projected to accelerate to over $100 billion this year. At the same time, widespread and growing public participation in this medium heralds new possibilities for the dissemination of public interest information, whether political discourse, health resources, or academic research.

III. Challenges for Telecommunications Regulation

- Continue to promote competition by enforcing the competitive principles of the NII and the 1996 Act. Address specific issues like pricing and advanced services.
- Preserve incentives for investment in new services, facilities, and R&D.
- Continue to reformulate and promote universal services and to ensure that access to the NII is available to all, urban and rural, rich and poor.
- Address consumer issues like cramming and slamming.
- Maintain regulatory flexibility to address future challenges, such as how to resolve disparities in the rules applying to different systems (e.g. telephone vs. cable) that, through convergence, come to provide the same services.

IV. Conclusion

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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READ:UNKNOWN

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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--and calm has not been restored completely. But the fundamental soundness of the U.S. economy prevented it from foundering in 1998's storms.

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 over the past 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 under which countries can 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 is 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 put stress on the new market-oriented farm policy enacted in 1996. 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 historical and statistical purposes. 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 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

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 explicitly, see last year's ERP for language p. 21

three longest expansions of the past century—including the current one—have occurred since the Act was passed.

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—was a supply-side approach to policy that was represented as anti-Keynesian. The current expansion is the only long expansion in which fiscal policy was *contractionary* rather than expansionary, reflecting the view that fiscal discipline would lower interest rates and spur long-term economic growth.

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 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 dollar, 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 **I**nflation **R**ate of **U**nemployment, 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 accommodating 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.

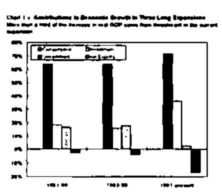
TABLE 1-2--*Economic Growth Indicators in Three Long Expansions*

		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

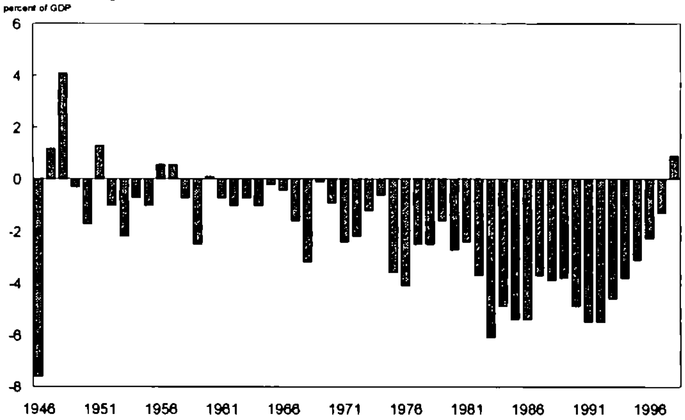
Reducing the Federal budget deficit has been a centerpiece of this Administration's economic policy. In 1993, the President pledged to cut the deficit in half by 1998; in 1997, he promised to balance the budget by 2002. In fact, the budget was in the black last year with the largest surplus as a share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

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, 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 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 example, one in six 20-year olds will die before they reach retirement age. 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. In addition, 3 in 10 20-year olds will become disabled for some period during their working lives, and Social Security also provides disability protection.

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 will 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.

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. Use of the surplus to help workers save for retirement also adds to national 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 if needed.

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. Subsequently, monetary conditions were 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 the growth prospects of its crisis afflicted Asian trade partners, has taken 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 corporate and 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 East 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 approved policies, accompanied, as appropriate, by additional bilateral finance. An IMF stabilization package for Brazil, supplemented by bilateral financing, was implemented in December, partly in order to reduce reduce the risk of 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, similar to that suffered during the debt crisis of the 1980s, would be intolerable, and the administration recognizes that more is required than simply for the industrial countries to serve as good customers 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 effective 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 recent reports by working groups of central bank governors and finance ministers from a group of industrial and key emerging market countries, informally dubbed the G-22.

The G-22 reports focus on measures to increase transparency and accountability 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 reports also propose 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 reports identify policies which could improve creditor coordination in crises and promote the orderly, cooperative and equitable resolution of international financial crises that may occur in the future.

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 visibly harmed, 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 rose from 1995 levels. In addition, farmers benefitted 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, however, 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 competitively neutral. But the minority that would reduce competition and harm consumers have been challenged. The current approach, which is aggressive without being heavy handed, stands in contrast to both the strong anti-merger bias of the 1960s and 1970s and the much laxer enforcement of the 1980s.

Antitrust enforcement does not and probably should not encompass the broader range of possible economic and social effects that may be associated with mergers, such as job loss, change in ownership structure, including reduced diversity of ownership, and localized service disruptions. Such effects are not confined to mergers but arise in the case of other forces as well, including technological change, deregulation, and international competition. Indeed, mergers may be more a symptom of broader change in the economy than a cause. The policies that are best for dealing with these changes include promoting full employment and macroeconomic stability, developing a skilled and well-trained workforce, providing adequate unemployment insurance and other safety net programs, and helping communities adapt to economic change. All of these have been part of the Administration's overall economic strategy of the last 6 years.

INTERNATIONAL TRADE

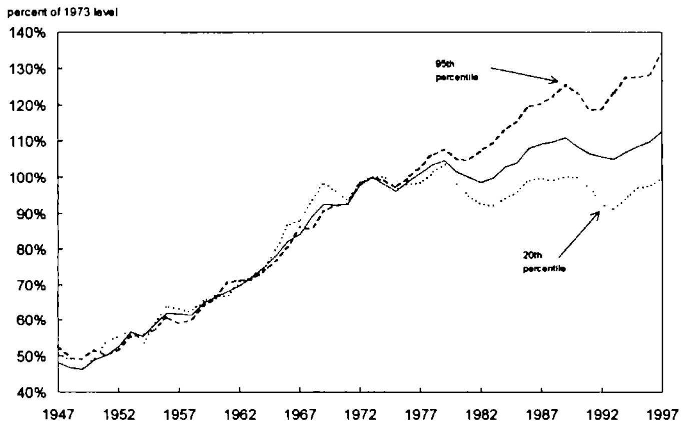
International trade policy has long been a laboratory for addressing the challenge of balancing efficiency and fairness and for providing political safeguards for those who might be hurt by change and would otherwise work to block it. For example, U.S. trade law recognizes that imports can sometimes be associated with labor displacement and other disruptions and provides for several kinds of relief. Escape clause relief allows tariffs to be imposed temporarily in cases where a surge of imports is judged to have caused serious 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 from companies that have shut down their plants and moved production to Mexico or Canada, and the administration has supported extending such assistance to all workers displaced by the movement of work to another country. In theory, trade adjustment assistance provides compensation from the broad class of those who gain from trade (represented by the taxpayers generally) to those who lose (workers in trade-impacted industries) without interfering with the efficiency-enhancing effects of changes in the pattern of production associated with freer trade. In practice, of course, things are more complicated if adjustment assistance interferes unduly with workers' incentives to find new jobs. Nevertheless, adjustment assistance illustrates the general principal that it is desirable to address the disruption from change without stopping the change itself.

PROMOTING PROSPERITY FOR ALL AMERICANS

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

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



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

This Administration has recognized from the start that the stubborn problems of slow productivity growth and rising income inequality were among the greatest challenges it would face. And there are heartening signs that we may have turned the corner. As mentioned earlier, productivity growth has remained relatively strong in this expansion, whereas it has tended in the past to flag as the expansion matures. Moreover, as detailed in Chapter Three, low-wage and minority workers are enjoying some of the best labor market conditions they have seen in years. Standard measures of income inequality have declined in the past two years, and the poverty rate, which was 15.1

percent in 1993, had fallen to 13.3 percent by 1997. Despite these encouraging trends, however, it is difficult to know how much of the improvement that has taken place since 1993 reflects cyclical effects from the particular strength of this expansion and how much reflects an improvement in longer term effects.

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

The Administration has made investments in education one of its highest priorities, and the 1998 budget agreement reflected some key education initiatives. In his 1998 State of the Union Address, the President called for 100,000 new, well-prepared teachers to help reduce class sizes in grades 1-3 to a national average of 18. The final budget provided the first down payment on that promise. It also included funding for the GEAR UP program that will expand mentoring efforts by states and provide new grants to provide intensive early intervention services to help prepare up to 100,000 students at high poverty middle schools for college. Funding was increased by 20 percent for education technology to ensure that every child has access to computers, the Internet, high-quality education software, and teachers who can use technology efficiently in the classroom. Finally, the budget agreement included funding for a new initiative to help ensure that all children read well and independently by the end of the third grade. This year's budget contains proposals to ...

In October the President signed legislation extending for 5 years the Higher Education Act, originally enacted in 1965, which authorizes many of the federal government's programs to increase access to college, including federal Pell grants, student loans, work study, as well as programs to improve teacher training, strengthen developing institutions, and promote innovation. The reauthorization included a cut in the student loan rate from 8.25 to 7.46 percent, saving students $11 billion over the next 5 years.

Finally, In the face of a rapidly changing global economy and the increased reward to more highly skilled workers, the Administration has sought to strengthen America's workforce development system and to promote lifelong learning. These policies are discussed more in Chapter 3.

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. Chapter 2 of this report provides a review of domestic macroeconomic developments in 1998 and presents the Administration's forecast for 1999 and beyond. Chapter 3...

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:15-JAN-1999 17:49:57.00

SUBJECT: President's letter for ERP

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

TEXT:
Attached is a DRAFT of the President's letter for the ERP. It is based on the President's Detroit speech. It is not very good -- but I don't think you should spend too much time on it. In the past, speechwriting has taken whatever we give them and they completely re-write it. So I don't think it is worth putting too much effort into improving it. I told speechwriting that I would send this down to them after the SOTU.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D47]MAIL47703171B.036 to ASCII,
The following is a HEX DUMP:

To the Congress of the United States:

Today the American economy is healthy and strong. Indeed, today is a time of American economic renaissance. Our nation's budget is balanced, for the first time in a generation, and we are entering the second year of an era of surpluses: our projections show that we will close out the year 1999 with a surplus of no less than $76 billion, the largest in the history of the United States.

We have created a new economy -- with 17 million new jobs, wages rising at twice the rate of inflation, the highest home ownership ever, and unemployment and inflation at their lowest levels in a quarter century.

Our nation is enjoying the longest peacetime economic expansion in history. And this time, the expansion is different from earlier expansions. This time, the economic expansion is both wide, and deep. This is a truly inclusive expansion. All income groups, from the richest to the poorest, have seen their incomes rise since 1993. The typical family income is up $3,500, adjusted for inflation, since 1993. We have seen big gains for African-American and Hispanic households, who were left behind during the last expansion.

These economic successes are not an accident. They are a result of a new economic vision. They are a result of a strategy that recognized the importance of fiscal discipline, investments in education and technology, and expanding exports to the growing world market.

The Clinton Administration's Economic Agenda

Our new economic strategy was rooted first and foremost in fiscal discipline. We cut the deficit and balanced the budget. And by doing so, by making the hard choices, interest rates dropped -- helping more people buy homes, more entrepreneurs to start businesses, and more businesses to invest in new technology and equipment. America's economic success has been fueled by the biggest boom in private sector investment in decades -- more than $1 trillion in capital was freed for private-sector investment. And, unlike past expansions, where government bought more and spent more to drive the economy, during this expansion government spending as a share of the economy actually has fallen.

The second part of our strategy has been to invest in our people. A high-tech, global economy places ever greater demand for skilled workers. That is why we are continuing to make critical investments in our people and our future. Even as we have balanced the budget, we have nearly doubled our annual investment in education and training. Even as we closed the budget gap, we have expanded the Earned Income Tax Credit for 15 million low-income working families, giving them hope and helping lift them out of poverty. Even as we cut government spending, we have raised investments in a welfare-to-work jobs initiative and invested $24 billion in our children's health initiative.

Third, to build a new American economy, we have focused on opening foreign markets and expanding exports to our trading partners around the world. Fully one third of the strong economic growth America has enjoyed in the 1990s came from trade. Opening markets abroad and expanding trade means that the base of customers for American goods and services expands dramatically. That is why we signed more than [240] trade agreements during the past 6 years.

Addressing Our Nation's Economic Challenges

We have created a strong, healthy and truly global. Our economy is a leader for growth in the world. But common sense, experience, and the example of our competitors abroad show us the perils of resting on our laurels. Now, at this moment of great plenty, is precisely the time to face the challenges of the 21st Century.

First, in the next year and beyond, we must remain vigilant and maintain our hard-won fiscal discipline. That means no tax cuts and no spending programs, that would reverse our hard fought fiscal discipline. Our fiscal responsibility gives us an unparalleled opportunity to address the challenge of an aging nation. Soon the number of elderly Americans will double, a seismic demographic shift with great consequences for our nation. We need to set aside the surplus until we have saved Social Security for the 21st Century. We must also strengthen and secure Medicare for the decades to come.

Second, we must do more to invest in our people. Today the income gap is above all a skills gap. As I said in the State of the Union Address, I will advance a new training agenda to give the American people the skills they need to compete in the growing global economy.

Third, at this time of continued turmoil in the international economy, we must do more to help create stability and prosperity in markets around the world. We must press forward with open trade. It would be a terrible mistake, at this time of economic fragility in so many regions, for the United States to build new walls of protectionism, that could set off a chain reaction around the world, imperiling the growth upon which we depend. At the same time, we must do more to make sure that working people are lifted up by trade. We must do more to ensure that spirited economic competition among nations never becomes a race to the bottom, in the area of environmental protections or labor standards.

Strengthening the foundations of trade means strengthening the architecture of international finance. The United States must continue to lead in stabilizing the world financial system. When nations around the world descend into economic disruption, consigning populations to poverty, it hurts them and it hurts us. These nations are our trading partners; they buy our products and can ship low-cost products to American consumers.

The U.S. proposal for containing financial contagion has been taken up around the world: interest rates are being cut here and abroad, America is meeting its obligations to the International Monetary Fund, there is a new facility at the World Bank to strengthen the social safety net in Asia. And there is now a new precautionary line of credit so nations with strong economic policies can quickly get the help they need before financial problems mushroom from concerns to crises.

Fourth, we must do more to renew our cities. My administration has pursued a new urban strategy, based on empowerment and investment, and we have seen its success. With the critical assistance of Empowerment Zones, unemployment rates in cities across the country have dropped dramatically. But we have more work to do to bring the spark of private enterprise to neighborhoods that have too long been without hope.

Finally, we must do more to protect the environment while promoting economic growth. We have shown that we can indeed pursue greater growth while having cleaner air and cleaner water, and while tackling challenges like global climate change.

Going Forward Together in the 21st Century

Now, on the verge of another American Century, our economy is at the pinnacle of power and success, but challenges remain. Technology and trade and the spread of information have transformed our economy, offering great opportunities but posing great challenges. All Americans must be equipped with the skills to succeed and prosper in the new economy. America must have the courage to move forward and renew our ideas and institutions to meet new challenges. There are no limits to the world we can create, together, in the century to come.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:15-JAN-1999 14:38:12.00

SUBJECT: Chapter 1 - revised version

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

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D4]MAIL40596761O.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 is 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 the only long expansion in which fiscal policy was *contractionary* rather than expansionary, reflecting the view that a tighter fiscal policy was needed to spur long-term economic growth.

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

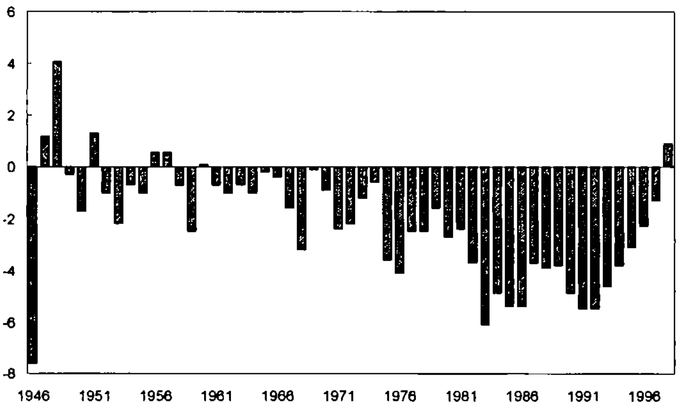
Reducing the Federal budget deficit has been a centerpiece of this Administration's economic policy. In 1993, the President pledged to cut the deficit in half by 1998; in 1997, he promised to balance the budget by 2002. In fact, the budget was in the black last year with the largest surplus as a share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

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. Use of the surplus to help workers save for retirement also adds to national 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 if needed.

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. Subsequently, monetary conditions were 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 the growth prospects of its crisis afflicted Asian trade partners, has taken 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 corporate and 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 East 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 approved policies, accompanied, as appropriate, by additional bilateral finance. An

IMF stabilization package for Brazil, supplemented by bilateral financing, was implemented in December, partly in order to reduce reduce the risk of 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, similar to that suffered during the debt crisis of the 1980s, would be intolerable, and the administration recognizes that more is required than simply for the industrial countries to serve as good customers 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 effective 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 recent reports by working groups of central bank governors and finance ministers from a group of industrial and key emerging market countries, informally dubbed the G-22.

The G-22 reports focus on measures to increase transparency and accountability 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 reports also propose 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 reports identify policies which could improve creditor coordination in crises and promote the orderly, cooperative and equitable resolution of international financial crises that may occur in the future.

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 substantial cause of serious 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.

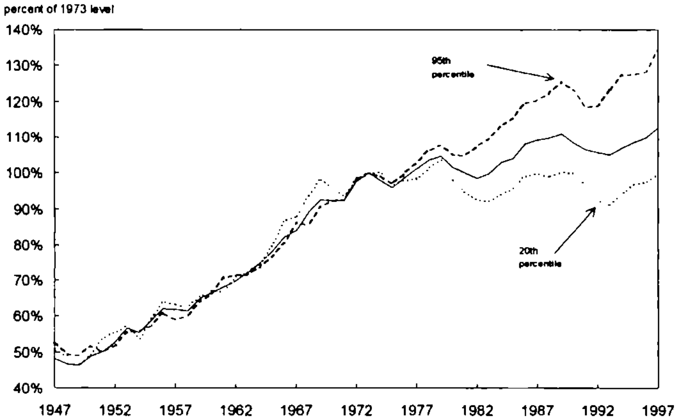
Trade adjustment assistance is an alternative way of dealing with disruptions associated with trade. Since 1962 U.S. trade laws have provided for some kind of cash assistance for workers who have lost their jobs due to trade. In addition, the North American Free Trade Agreement (NAFTA) provides assistance to workers displaced from companies that have shut down their plants and moved production to Mexico or Canada, and the administration has supported extending such assistance to all workers displaced by the movement of work to another country. In theory, trade adjustment assistance provides compensation from the broad class of those who gain from trade (represented by the taxpayers generally) to those who lose (workers in trade-impacted industries) without interfering with the efficiency-enhancing effects of changes in the pattern of production associated with freer trade. In practice, of course, things are more complicated if adjustment assistance interferes unduly with workers' incentives to find new jobs. Nevertheless, adjustment assistance illustrates the general principal that it is desirable to address the disruption from change without stopping the change itself.

PROMOTING PROSPERITY FOR ALL AMERICANS

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

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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 ...