RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:27-JAN-1999 10:37:58.00

SUBJECT: Press Release. New IIF Report on Financial Crises in Emerging Markets

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

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

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

TEXT:
The report was released today. Will try to get the full text.
Nouriel

PS: Matt could you call IIF to get the full text as the report is not yet on the Web site?

Press Release. New IIF Report on Financial Crises in Emerging Markets

New Approaches Advocated To Strengthen Global Financial System

January 27, 1999 --- The architecture of the global financial system can be strengthened by introducing new approaches for more direct and comprehensive contacts and consultation between the governments of major emerging market economies and their private sector creditors and investors, states the Institute of International Finance (IIF) today.*

In the first of a series of Working Group Reports on global financial reform the IIF stresses that the international capital markets have provided enormous opportunities for economic development by the emerging market economies. However, it warns that the market also represents the potential for sudden and harsh disciplining of economies where authorities have made serious policy mistakes and where lenders have also made their own mistakes.

The new report, Financial Crises in Emerging Markets, notes the central need for sovereign borrowers in the international capital markets to work at all times to secure the confidence of the marketplace and for lenders to ensure sound risk management. It highlights the essential requirement for governments of borrower countries to act swiftly and efficiently at times of crisis to implement policy reforms that enable them to restore market confidence.

The IIF, the global association of financial institutions with more than 300 member organizations today, outlines a series of recommendations. It stresses that government policies should be carefully evaluated and adapted to limit vulnerability to high short-term external debt, and that distortions that discriminate in favor of short-term borrowing should be removed, including obstacles to long-term borrowing and to direct foreign investment.

At the same time, the report notes that overextended and poorly supervised and regulated domestic financial systems have created key vulnerabilities and contributed to the development of crises. The Working Group says authorities need to strengthen their financial systems by implementing the "Core Principles" of the Basle Committee on Banking Supervision.

Today's report also previews recommendations of another of the Institute's Working Group Reports concerned with private sector risk management. These recommendations underline the need for financial firms to strengthen risk management by increasing the rigor of their stress testing and scenario analysis in value-at-risk analysis, implement more advanced credit risk assessment systems and better integrate their credit and market risk analysis. The Report also states that investors and lenders should differentiate more fully among sovereign issuers of international debt on the basis of the sustainability of each country's policies.

The Working Group, consisting of representatives of an array of major international financial institutions, also proposes a new approach to avoid and mitigate crises in individual emerging market economies. It suggests the development of a direct dialogue between country authorities and the private sector in crisis avoidance, and it provides for the possibility of greater private sector involvement in crisis resolution.

The IIF states that mechanisms should be put in place for regular and comprehensive consultation by sovereign borrowers with private sector creditors and investors in meetings and teleconferences. Mexico, for example, has instituted quarterly briefings with market participants since 1996 involving senior officials from its Finance Ministry and Central Bank. The IIF notes that a similar approach is now being used by numerous publicly listed companies to regularly report to analysts and investors on their performance and outlook.

The new system could help build a fabric of familiarity and trust between country authorities and private sector creditors and investors that would enhance the authorities' understanding of market views and concerns, improve the knowledge of market participants, and help avoid sharp market breaks.

A series of different types of private-public contacts are being proposed dependent upon the circumstances of individual countries. In periods when countries have normal market access, for example, the IIF proposes regular briefings where officials from emerging market economies provide their creditors and investors with comprehensive information and policy explanations and so create a stronger basis for market surveillance. Participants in the briefings would include representatives of banks, investment funds, pension funds, and other relevant private firms interested in the particular country.

In situations where a country's imbalances are growing, that could lead to a financial crisis if left uncorrected, the IIF approach aims to encourage authorities to implement policy changes before it is too late and pursue more intensive contacts with key market participants.

The IIF notes that when a country has lost market access, IMF and related official support for a comprehensive adjustment program is seen as being the prime catalyst for a resumption of private financing. In addition, the IIF proposes that at times where a country is recovering from a crisis, the IIF could assist the country's authorities to explain their reform programs and the basis for improved economic prospects, which can help to facilitate the resumption of normal market access.

Beyond this new approach to country crisis avoidance and mitigation, the Working Group advocates an important second track that would involve the private sector in consultations with policymakers in industrial countries and international financial institutions to strengthen the architecture of global financial system. For example, among the numerous specific recommendations made in today's report on the global financial system the IIF calls for:

country publication of IMF Article IV reviews and greater transparency in country economic data, including reserves positions;

provision to the public of more comprehensive and timely bank lending data, possibly from the Bank for International Settlements;

consideration by authorities of more active use of contingent lines of private sector credit (possibly associated with official lending or official guarantees) - on the basis of market terms at the time of drawdown;

opposition to IMF lending to countries with arrears to private creditors -- only in exceptional circumstances, when there is support from a broad majority of private creditors, should approval for such lending be granted;

opposition to comprehensive capital controls -- in some cases, especially in periods of capital market buoyancy, temporary price-based disincentives to short-term capital inflows may be appropriate, but these should not become a substitute for appropriate fiscal, monetary, and exchange rate policies.

In broad terms the IIF,s recommendations seek to strengthen what has emerged as the 1990s approach to financial crises. This has been premised on prompt restoration of market confidence based on policy adjustment and sizable and relatively short maturity IMF-G7 support. It has been successful in Mexico (1995), South Korea and Thailand. Domestic political conditions prevented its success in Russia and, at least initially, in Indonesia. The Mexican experience shows that when successful this approach restores capital flows much faster than the 1980s approach of comprehensive debt rescheduling.

The report also draws attention to the issue of moral hazard and recognizes the dangers of perceptions that may exist on the part of lenders that in some circumstances they may always be bailed-out of a crisis. However, the report points out that private sector losses in recent emerging markets crises have been formidable.

Based on IIF estimates, foreign equity investors experienced losses amounting to a total of about $240 billion in East Asia and Russia. Foreign banks are estimated to have experienced potential losses of about $60 billion; and other foreign creditors may have incurred potential losses of about $50 billion. These losses suggest little likelihood of future excessive lending caused by comfort from official support, and at present the opposite seems to be the case with market interest rates for emerging borrowers at extremely high levels.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:27-JAN-1999 19:13:08.00

SUBJECT:

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

TEXT:
Janet:

I just sent this memo to Gene.=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D98]MAIL418932921.036 to ASCII,
The following is a HEX DUMP:

January 27, 1999

MEMORANDUM TO GENE SPERLING

FROM: Doug Elmendorf

SUBJECT: Social Security Status Report and Agenda

TOPIC #1: $4.5 trillion vs. $4.9 trillion

The former is the surplus we say we're allocating 62/15/12/11. The latter is the baseline surplus to be announced next Monday in the budget. Two likely effects:

a. People are going to be confused and will need explanations.

b. Budgeteers will start to ask how we calculated the interest difference. Then:
   - -- Some will object to the imputed interest on equities.
   - -- Some will note that by counting interest payments on the new, transferred debt as an intergovernmental transfer, our buydown of debt will not equal the accumulated debt held by the Trust Fund down the road (the Reischauer point).
   - -- Some will start to wonder about how we're scoring equities down the road. Our original release didn't require decisions about this, but OMB's graph of long-run surpluses under this plan -- released today -- has made some implicitly.

OMB has written a memo of recommendations on some of the scoring issues; they have Jack Lew's approval of some issues but have not covered their whole list with him. After they get Jack's signoff, Joe will be happy to present this to the TWG.

Recommendation: Ask Joe to present scoring options and recommendations to the TWG, and then ask OMB to present this to the principals. These decisions are too important to be left to the experts. If we had not imputed the equity return or counted the new interest payments as intergovernmental, we would have had $3.7 trillion not $4.5 trillion to spend. The Social Security group did not give this issue enough thought in advance of the SOTU, and we're about to get behind again when the budget is rolled out next week.

TOPIC #2: First thing we do, let's kill all the lawyers.

Barbara has organized good meetings on two related topics:
- -- determining the right mechanics of transfers and equity purchases
- -- drafting legislation to set this up

Recommendation: Have Barbara present preliminary results at TWG meeting. Set deadline for completing the English (not legal) description of the mechanics.

TOPIC #3: Putting debt reduction first.

We need to finish the paper on fiscal discipline and related Qs and As.

Recommendation: Have Doug bring new draft to TWG meeting for discussion.

TOPIC #4: Are we disciplined enough?

This topic is less pressing now that OMB has produced a chart showing UB surpluses under the plan amost as far as the eye can see.

Recommendation: Have Doug keep working on possible approaches.

TOPIC #5: Could we rebalance our way to zero trust fund balance?

Yes, but there's no way to avoid it, and it's not a risk worth worrying about. There are two topics here:

- -- what are appropriate rebalancing rules?
- -- what is the true risk (so we describe it honestly)?

We've made some progress on both these fronts.

Recommendation: Have Gary and Doug bring results on these two issues to next TWG meeting.

TOPIC #6: Born in the USA

I've received some of Len's work on this subject, and they're doing a careful and imaginative job. As you've probably heard, the amounts per person are pretty large, as your intuition said. The primary concern of very large amounts is the effect on private pensions.

Recommendation: Schedule principals' meeting on USAs for Monday.

TOPIC #7: The Other Guys

CBO will release its budget numbers on Friday. Paul Van deWater says they'll only show "detailed numbers" for the first ten years, but it's hard to imagine they won't give 15-year surplus numbers after the SOTU.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:27-JAN-1999 11:59:02.00

SUBJECT: EU Bananas Fight

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:
I forward you a message forwarded to me by Ron Silberman (OMB). His message was sent to his OMB colleagues and expresses some frustration about USTR screwing up this banana negotiation by wanting to win this badly with no compromise. There has been no NEC deputies discussion on this. He suggests that the issue should be brought up by CEA and State to Lael/NEC attention. I expect that State and Treas would also be sympatetic about doing something to avoid this farcical war. Stu made a comment the other day about having to do something to find a solution to this. Maybe we can mobilize some discussion about this.
Nouriel

---------------------- Forwarded by Nouriel Roubini/CEA/EOP on 01/27/99 11:51 AM ---------------------------

Ronald L. Silberman
01/27/99 11:48:38 AM
Record Type: Record

To: Rodney G. Bent/OMB/EOP, Michael Casella/OMB/EOP
cc:
Subject: EU Bananas Fight

We could be 100% tariffs on $500 million of EU goods to the US within a few days in retaliation, possibly without a WTO authorization due to an EU ploy to refuse to approve the WTO/DSB agenda.

This whole issue area has been through a complex set of moves, countermoves, feints, etc by the US and EU. I believe we have "right" on our side but we are looking like the Goliath stomping whomever gets in our way. The EU has refused to allow the DSB (disput settlement) process work effectively. They've been aided by ambiguties in the various WTO articles.

Conversely, the Bowles letter to Lott et al. on bananas, which was engendered by congressional threats to pass trade legislation telling the Administration what to do, set a specific timeframe for US action which USTR refuses to vary from as other events move forward.

The EU has refused to allow the process to come to a conclusion when we want it, but we're now only six weks apart because of a move by Ecuador. USTR insists on sticking rigidly to our retaliation schedule, justified in part by arguments that Japan proposals effectively nullify.

It all reminded me yesterday, and I sent it in an e-mail to the USTR staff person running the 301 committee who TAKES instruction from above, of Ruff's comment in the Senate that: the House managers want to win too badly. In this case, it appears that USTR wants a total win too badly to contemplate any compromise.The EU has, in fact, compromised and clarified some things, we have not budged.

I think several agencies, especially State and CEA, would probably like to see the NEC take this issue up. I personally believe that an NEC discussion would be at a minimum helpful. Issue is whether Bob ought to raise the issue with Lael.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:28-JAN-1999 18:12:26.00

SUBJECT: draft of GDP statement

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

TEXT:
Attached is a draft of the GDP statement.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D61]MAIL49043803R.036 to ASCII,
The following is a HEX DUMP:

STATEMENT OF JANET L. YELLEN

Today, we received more evidence that the American economy is healthy and strong. Real GDP is estimated to have grown at a xx percent annual rate in the fourth quarter of 1998. For 1998 as a whole, real GDP grew xx percent.

Today's numbers indicate that our economy is still going strong. Growth is robust. Businesses continue to invest in new and better equipment -- xxx Unemployment remains low at 4.3 percent. Inflation is in check. And, consumer confidence is high.

The Administration's strategy for raising American living standards and enhancing the economy's long-run growth rate is working: our nation is currently enjoying the longest peacetime economic expansion in history. Since 1993, 18 million new jobs have been created. Unemployment and inflation are at their lowest levels in 3 decades. And, real wages have grown more over the course of this expansion then they did in the expansion of the 1980's. In fact, yesterday, we learned that real wages increased 3.9 percent in 1998, the same as in 1997 -- which means we have experienced the largest 2-year gain in real wages in over 20 years.

And, unlike previous economic expansions, this expansion is both wide and deep. All income groups have seen their incomes rise since 1993. The typical family income is up more than $3,500, adjusted for inflation. And, our nation's poorest workers have enjoyed substantial wage gains -- in fact, real hourly wages for the lowest-paid male workers have increased 5 to 6 percent since 1993. Black and Hispanic households, who were left behind during the last expansion, have also seen substantial increases in income -- for instance, between 1996 and the first 10 months of 1998, real wages for black men increased 5.8 percent and 6.2 percent for black women.

The U.S. economy is fundamentally sound and is likely to continue in the coming months on a path of solid growth with low unemployment and inflation in check -- even with the recent turmoil in the world's financial markets. To successfully address the challenges facing the 21st Century, we must continue with this Administration's proven strategy for economic growth and increased prosperity for all Americans.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:28-JAN-1999 20:50:34.00

SUBJECT: Re: Argentina trip

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

TEXT:
And do you plan to continue on to Mongolia?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:28-JAN-1999 17:43:32.00

SUBJECT: Monday budget event

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

TEXT:
Below is a description of what Monday's budget event will look like. Of course, could be subject to change....
---------------------- Forwarded by Michele Jolin/CEA/EOP on 01/28/99 05:42 PM ---------------------------

Stacie Spector
01/28/99 05:10:24 PM
Record Type: Record

To: See the distribution list at the bottom of this message
cc: Douglas B. Sosnik/WHO/EOP, Ann F. Lewis/WHO/EOP, Tracy Pakulniewicz/WHO/EOP
Subject: Monday budget event

I have talked with both Doug and Ann about Monday's event. They both like the cross hall "walk" idea very much, as do I. I also described Jake's idea as an option, with a chart that could have an arrow..... and it seems no one wants a "prop."

So, the picture goals (as of today) are as follows:

1- The cross hall walk with the Potus and VPotus leading and Podesta and the economic team falling in behind them.

2 - The VPotus and Rubin should be flanking the President, so your tight shot is primarily gold curtains, blue goose, flags, and Potus speaking with VPotus and Rubin on each side of him.

Doug agreed with the tight economic team:
Podesta, Lew, Rubin, Mathews, Sperling, Yellen, Somers, Stein

So, that is what i know. (and then again it is only thursday, who knows what changes will take place before Monday.........!!)

Message Sent
To:____

Jeffrey A. Forbes/WHO/EOP
George G. Caudill/WHO/EOP
Jake Siewert/OPD/EOP
Linda Ricci/OMB/EOP
Laura D. Schwartz/WHO/EOP
Sharon K. Gill/WHO/EOP
Lisa J. Levin/WHO/EOP
Michele Jolin/CEA/EOP
Sara M. Latham/WHO/EOP
Karen Tramontano/WHO/EOP
Lisa A. Berg/OVP @ OVP
Jennifer M. Palmieri/WHO/EOP

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:28-JAN-1999 17:42:41.00

SUBJECT: updated budget roll-out and amplification plan

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

TEXT:
---------------------- Forwarded by Michele Jolin/CEA/EOP on 01/28/99
05:42 PM ---------------------------

Chandler G. Spaulding
01/28/99 05:38:20 PM
Record Type: Record

To: See the distribution list at the bottom of this message
cc:
Subject: updated budget roll-out and amplification plan

Message Sent
To:____
Robert B. Johnson/WHO/EOP
Jena V. Roscoe/WHO/EOP
Cheryl M. Carter/WHO/EOP
Mickey Ibarra/WHO/EOP
Maria E. Soto/WHO/EOP
Lynn G. Cutler/WHO/EOP
Fred DuVal/WHO/EOP
William H. White Jr./WHO/EOP
Minyon Moore/WHO/EOP
Andrew J. Mayock/WHO/EOP
Thurgood Marshall Jr/WHO/EOP
Anne E. McGuire/WHO/EOP
Jennifer M. Luray/WHO/EOP
Kelley L. O'Dell/WHO/EOP
Martha Foley/WHO/EOP
Janet Murguia/WHO/EOP
Mindy E. Myers/WHO/EOP
Charles M. Brain/WHO/EOP
Karen Tramontano/WHO/EOP
Jennifer M. Palmieri/WHO/EOP
Barry J. Toiv/WHO/EOP

Elizabeth R. Newman/WHO/EOP
Linda Ricci/OMB/EOP
Jennifer Ferguson/OMB/EOP
Sally Katzen/OPD/EOP
Jake Siewert/OPD/EOP
Jonathan A. Kaplan/OPD/EOP
Kevin S. Moran/WHO/EOP
Ruby Shamir/WHO/EOP
Marjorie Tarmey/WHO/EOP
Sara M. Latham/WHO/EOP
Patricia M. Ewing/OVP @ OVP
Katharine Button/WHO/EOP
Audrey T. Haynes/OVP @ OVP
Michele Jolin/CEA/EOP
Charles E. Kieffer/OMB/EOP
Brian S. Mason/OMB/EOP
Clara J. Shin/WHO/EOP
Victoria A. Wachino/OMB/EOP
Kate P. Donovan/OMB/EOP

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D77]MAIL47709703N.036 to ASCII,
The following is a HEX DUMP:

BUDGET ROLL-OUT AND AMPLIFICATION
January 26-February 7, 1999
(DRAFT--January 28, 1999, at 5:30pm)

TUESDAY, JANUARY 26 (Done)
General/Print:
- Regional Press on Women Mayors' Social Security meeting

WEDNESDAY, JANUARY 27 (Done)
Leg. Affairs:
- **3:45pm**--Social Security Briefing of Ways & Means Democratic staff in 1139 Longworth HOB [Surrogates: Mathews(c), Sperling(c), Apfel(c), Summers(c)]
- **5:00pm**--Social Security Briefing of Finance Democratic staff in Dirksen 215 [Surrogates: Mathews(c), Sperling(c), Apfel(c), Summers(c)]

THURSDAY, JANUARY 28 (Done)
Cabinet Affairs:
- **11:00am**--Conference call for agency Communications Directors [Surrogates: Lockhart(T), Palmieri(c), Ricci(c), Spector(c)]
- **1:30pm**--Conference call for Regional Administrators [Surrogates: Palmieri(c), Spector(c), Lori McHugh(c)]

Leg. Affairs:
- **2:30pm**--Social Security briefing for Blue Dogs [Surrogates: Joe Minarik(c), Goss(c)]
- **4:00pm**--Social Security briefing for House and Senate Budget Democratic staff in HC-9 [Surrogates: Mathews(c), Sperling(c), Apfel(c), Wilcox(c)]

FRIDAY, JANUARY 29
General/Print:
- **10:15am**--Social Security briefing at National Press Club [Surrogate: Sperling(c)]

Leg. Affairs:
- **9:15am**--Social Security briefing for Senate Task Force Members in SD-562 [Surrogates: Lew(c), Sperling(c), Apfel(c), Stein(c)]
- **10:30am**--Joint briefing for House and Senate Democratic Budget/Appropriations/Ways & Means/Finance staff in HC-9 [Surrogates: Mathews(c), DeSeve (c), Joe Minarik(c), Dick Emery(c), PADs(c), WH Leg. Affairs(c) and OMB Leg. Affairs(c)]
- **12:00pm**--Hispanic Caucus conference call [Surrogates: Lew(c), Chow(c), Murguia(c)]
- **1:00pm**--Briefing for Senate Democratic AA's, LD's and Leadership staff in S-211, Capitol [Surrogates: Mathews(c), DeSeve(c), Joe Minarik(c), Dick Emery(c), PADS(c), WH Leg. Affairs (c) and OMB Leg. Affairs(c)]

- **2:00pm**--Social Security briefing for Finance Committee Republican staff [Surrogates: Sperling(c), Apfel(c), Stein(c)]
- **3:00pm**--Briefing for House Democratic AA's, LD's and Leadership staff in HC-5 [Surrogates: Mathews(c), DeSeve(c), Joe Minarik(c), Dick Emery(c), PADs(c), WH Leg. Affairs(c) and OMB Leg. Affairs(c)]

WEEK OF JANUARY 23-29

Television:

- (T) Interviews for news and business shows [Surrogates: Lew(T), Mathews(T), Sperling (T), Yellen(c)]

Radio:

- (T) Interviews for radio [Surrogates: Lew(T), Mathews(T), Sperling(T), Yellen(c)]

SUNDAY, JANUARY 31

Television:

- (T) Sunday morning shows [Surrogates: Lew(T), Mathews(T), Sperling (T)]

MONDAY, FEBRUARY 1

- **7:00am (embargoed until 8:00am)**--Wires get budget
- **7:30am**--OMB Leg. Affairs distribution of FY2000 Budget
- **9:00am**--Conference call with Cabinet [Surrogate: Lew(c)]
- **10:00am**--Budget and other amplification materials will be put up on WH web site
- **10:15am--BUDGET ROLL-OUT EVENT (East Room)**
- **11:45pm**--Press Budget briefing in OEOB 450 [Surrogates: Lew(c), Mathews(c), Rubin(c), Sperling(c), Yellen(c)]
- **12:00pm**--Dept. of Education and EPA begin briefings
- **1:00pm**--Cabinet Agencies begin briefings
- **1:00pm**--Roundtable with budget reporters *(OMB organizing)* [Surrogate: Lew(T)]
- **1:00pm**--OPL conference call for regional constituency group leaders *(other offices can feed in)* [Surrogate: Mathews(c)]
- **1:30pm**--Technical briefing for House and Senate bipartisan Budget/Appropriations in SD-124 [Surrogates: Chuck Kieffer(c), Dick Emery(c), Joe Minarik(c)]
- **2:00pm**--IGA briefing for DC representatives from 50 states , DC representatives for cities and counties, Tribal leaders and state legislators in the Truman Room of the White House Conference Center [Surrogate: Mathews(c), DeSeve(c)]
- **3:00pm**--White House briefing for national constituency group leaders in OEOB 450 *(OPL organizing and other offices can feed in)* [Surrogates: Lew(T) or Mathews(T), Gotbaum(c), PADs(c)]
- **4:00pm**--IGA conference call with 20 key mayors [Surrogates: Lynn Cutler(c), Gotbaum(c), Lewis(c)]

- **4:00pm**--Joint House and Senate Bipartisan Staff Briefing in SC-5 [Surrogates: Mathews(c), DeSeve(c), Joe Minarik(c), Dick Emery(c), PADS (c) and WH Leg. Affairs staff(c)]
- **4:00pm**--Climate Change Budget briefing in OEOB 450 [Surrogates: Stern(c), George Frampton(T), Elgie Holstein(T), Neal Lane(T)]
- (T) Cabinet/Sub-Cabinet conference calls on targeted issues with press [Education and Training, Health, Research and Technology, Environment, Community Empowerment, Legal Immigrants, Crime, Working Families, Defense, Tobacco, Race(T)]
- (T) Targeted calls to editorial boards, pundits [Surrogates: Lew(T), Mathews(T), Sperling(T), WH Senior Staff]

Television:
- (T)Interviews for morning shows, news and business shows [Surrogates: Lew(T), Mathews(T), Sperling(T), Yellen(c)]
- (T) Interview for Lehrer News Hour [Surrogates: Lew(T)]
- (T) Interview on cable news [Surrogate: Echaveste(T)]

Radio:
- (T) Interviews for radio [Surrogates: Lew(T), Mathews(T), Sperling (T)]
- (T) Interview with Bloomberg Business Radio [Surrogate: Lew(T)]
- (T) Interview with NPR Marketplace [Surrogate: Lew(T)]
- (T) Interviews with radio [Surrogates: WH Senior Staff]

Specialty Media:
- **1:45pm**--Conference call with Latino newspapers [Surrogate: Echaveste(c)]
- Interviews for Hispanic TV [Univision (**1:00pm**), Telenoticias (**1:10pm**), Telemundo (**1:20pm**)] [Surrogate: Echaveste(c)]
- Early morning and drive-time interviews for Hispanic radio [Surrogate: Echaveste(c)]
- Conference call with African American newspapers [Surrogate: Ben Johnson(T)]
- (T) Conference call with Asian American newspapers [Surrogate: Barbara Chow(T)]

Internet Media:
- **Time TBD**--Interview with Time Magazine.com on budget (story will be posted on web site and run for rest of week) [Surrogate: Mathews(T)]

<u>TUESDAY, FEBRUARY 2</u>

General/Print:
- (T) Cabinet/Sub-Cabinet conference calls on targeted issues with press [Education and Training, Health, Research and Technology, Environment, Community Empowerment, Legal Immigrants, Crime, Working Families, Defense, Tobacco, Race(T)]

Television:

- (T)Interviews for morning shows, news and business shows [Surrogates: Lew(T), Mathews(T), Sperling(T), Yellen(c)]

Radio:

- (T) Interviews for radio [Surrogates: Lew(T), Mathews(T), Sperling(T), Yellen(c)]

Specialty Media:

- Interviews for Native American media [Surrogate: Lynn Cutler(T), Mathews(T)]
- Early morning and drive-time interviews for Hispanic radio [Surrogate: Echaveste(c)]

Internet Media:

- **7:30pm(EST)**--Live interview with MSNBC On-Line on budget [Surrogate: Reed(T)]
- **Time TBD**--Q&A interview with Washington Post.com on budget (answers will be posted on web site and run for rest of week) [Surrogate: Mathews(T)]

Cabinet Affairs:

- **8:30am**--Briefing for Cabinet Chiefs of Staff [Surrogates: DeSeve(T), Gotbaum(T), Sperling(T)]

Leg. Affairs:

- **9:30am or 10:00am**--Senate Finance Hearing [Surrogates: Rubin(c)] (Mathews will accompany Sec. Rubin)
- **10:00am**--Congressional Testimony at Senate Budget Committee Hearing [Surrogates: Lew(c)]
- **1:00pm**--Democratic Senators Weekly Lunch [Surrogates: Lew(c), Stein(c)]
- **4:00pm**--Briefing for House Budget Committee Democrats [Surrogate: Lew(c), Mathews(c)]

First Lady's Office:

- (T) Briefing for Arts community [Surrogates: Verveer(T), Lovell(T)]

TUESDAY, FEBRUARY 2 or WEDNESDAY, FEBRUARY 3

Cabinet Affairs:

- (T) Two or three agency briefings for Sub-Cabinet [Surrogates: TBD]

WEDNESDAY, FEBRUARY 3

Leg. Affairs:

- **10:00am**--House Budget Committee Hearing [Surrogate: Lew(c)]
- **10:00am**--Senate Budget Committee Hearing [Surrogates: Rubin(c)] (Mathews will accompany Sec. Rubin)
- **4:30pm**--Pre-brief for House Ways & Means Democratic staff [Surrogate: Mathews(c)]

WEDNESDAY, FEBRUARY 3 or THURSDAY, FEBRUARY 4
Women's Office/Leg. Affairs:
- **2:30pm**--Budget briefing for House Women's Caucus [Surrogates: Mathews(c)]

THURSDAY, FEBRUARY 4
Leg. Affairs:
- **10:00am**--House Ways & Means Hearing [Surrogates: Rubin(c), Mathews(c)]

CEA:
- Release of the 1999 Economic Report of the President (will emphasize budget and economic agenda)

FRIDAY, FEBRUARY 5
General/Print:
- (T) Roundtable with regional outlets [Surrogates: Sperling(T), Lew(T)]
- (T) Breakfast with pundits, columnists [Surrogates: Sperling(T), Lew(T)]

Leg. Affairs:
- National Conference of State Legislators [Surrogates: Lew(c)]

WEEK OF FEBRUARY 1-7
General/Print:
- Regional editorial board mailings with State-by-States
- Roundtables with regional outlets (when State-by-States are releasable) [Surrogates: Lew(T), Sperling(T)]

Television:
- **6:00pm**--Lehrer News Hour Interview [Surrogate: Sperling(T)]

Specialty Media:
- Specialty press conference calls [Surrogates: TBD]
- Specialty press mailings to Native American, Health, Seniors, Disability, African American and Hispanic media

SUNDAY, FEBRUARY 7-TUESDAY, FEBRUARY 9
- House Democrats' Retreat (POTUS and VP attending)

SURROGATES
Gene Sperling
Jack Lew
Sylvia Mathews
Janet Yellen
Bruce Reed

Elena Kagan
Josh Gotbaum
Maria Echaveste
Sally Katzen
Larry Summers
Larry Stein
Ed DeSeve
Sec. Rubin (?)
OMB Program Area Directors (PADS)--Michael Deich, Barbara Chow, Elgie Holstein,
Dan Mendelson and Bob Kyle

PAPER NEEDED FOR BUDGET ROLL-OUT
(Communications will serve as clearinghouse for distribution of paper to WH Offices)
Overview Talking Points (NEC) **(Friday at Noon)**
Economic and Fiscal Record (NEC) **(Monday)**
Issues Paper (OMB)--**(Monday)**
Education and Training
Health
Research and Technology
Environment
Community Empowerment
Legal Immigrants
Crime
Working Families and Child Care
Defense
Tobacco
Race

Accomplishments **(Done)**
Sample Op-eds and Letters to the Editor (Communications)

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:28-JAN-1999 16:47:18.00

SUBJECT: Social Security paper

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
01/28/99 04:48 PM ---------------------------

Jonathan Orszag
01/28/99 04:22:52 PM
Record Type: Record

To: Jennifer M. Palmieri/WHO/EOP, Douglas W. Elmendorf/CEA/EOP
cc:
Subject:

One Pager:
Five-Pager:
Why Collective Investment is Good:
Greenspan Quotes:

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D26]MAIL47459603I.036 to ASCII,
The following is a HEX DUMP:

SAVING SOCIAL SECURITY NOW, WHILE MEETING AMERICA'S CHALLENGES FOR THE 21st CENTURY

In His State of the Union Address, President Clinton Put Forward His Framework To Save Social Security Now, While Meeting America's Challenges for the 21st Century. The President and Vice President's framework strengthens Social Security by:

- **Using The Budget Surplus To Help Save Social Security And Invest A Portion In the Stock Market To Seek Higher Returns.** The President proposes to transfer 62 percent of the projected budget surpluses over the next 15 years -- more than $2.7 trillion -- to the Social Security system. The President proposes to invest less than one-quarter of the transferred surpluses in the private sector to achieve higher returns for Social Security -- just as any state or local government, or private pension does -- after working with Congress to devise a mechanism to ensure that the investments are made independently and without political interference by private sector managers with minimum administrative costs.

- **This Framework Will Save Social Security Until 2055 -- And the President Will Work With Congress To Save It Until At Least 2075.** Transferring over 60 percent of the surpluses to Social Security and investing a portion in the market will keep Social Security solvent until 2055. The President believes we must work on a bipartisan basis to make the hard-headed but sensible and achievable choices to save Social Security until at least 2075. As part of this effort, President Clinton believes that we must:

  (1) ***Reduce Poverty Among Single Women.*** Reduce poverty among elderly women -- particularly widows, who have a poverty rate nearly twice the overall poverty rate for older Americans; and

  (2) ***Eliminate The Earnings Test.*** Eliminate the confusing and out-dated earnings test so that we stop discouraging work and earnings among older Americans.

After Social Security Reform Is Secured -- Consistent With the President's "Save Social Security First" Commitment -- the President Proposes To:

- **Strengthen Medicare for the 21st Century.** The President's framework will reserve 15 percent of the projected surpluses for Medicare, securing Medicare until 2020. The President further called for bipartisan reforms that would allow Medicare to be secure until 2020 while also providing prescription drug benefits.

- **Provides $500 Billion in Tax Credits to Create New Universal Savings Accounts -- USA Accounts.** The President's framework will reserve 12 percent of the projected surpluses to create new Universal Savings Accounts (USAs) so working Americans can build wealth to meet their retirement needs. To help Americans save and to strengthen our current pension system, we would provide Americans a flat tax credit to make contributions into their USA Account. In addition, we would provide additional tax credits to match a portion of an individual's savings -- with more help for lower-income workers.

- **Prepare America for the Challenges of the Future.** The President's framework will reserve 11 percent of the projected surpluses for military readiness and other pressing domestic priorities.

A FISCALLY RESPONSIBLE PROPOSAL: PUBLICLY HELD DEBT FALLS TO LOWEST LEVEL SINCE 1917

- **Debt-to-GDP Ratio Will Fall to Lowest Level Since 1917.** As a share of the economy, the publicly held debt increased from 26% in 1981 to 50% in 1993. Since President Clinton took office, the publicly held debt as a share of GDP has dropped to about 45 percent. And under the President's framework, current projections suggest that the publicly held debt, as a share of GDP, will fall from about 45% today to less than 10% in 2014 -- its lowest level since 1917.

SAVING SOCIAL SECURITY NOW AND MEETING AMERICA'S CHALLENGES FOR THE 21st CENTURY

In His State of the Union Address, President Clinton Put Forward His Framework To Save Social Security Now, While Meeting America's Challenges for the 21st Century. The President and Vice President's framework strengthens Social Security by:

- Transferring 62 percent of the projected budget surpluses over the next 15 years -- more than $2.7 trillion -- to the Social Security system.
- Investing a portion of the transferred surpluses in the private sector to achieve higher returns for Social Security -- just as any state or local government, or private pension does -- after working with Congress to devise a mechanism to ensure that the investments are made independently and without political interference. We will support using a broad-based neutral approach managed by the private sector with minimum administrative costs.
- Keeping Social Security solvent until 2055.
- Calling for a bipartisan effort to make the hard-headed but sensible and achievable choices needed to save Social Security until at least 2075. As part of this effort, President Clinton and Vice President Gore believe that we must:
    - Reduce poverty among elderly women -- particularly widows, who have a poverty rate nearly twice the overall poverty rate for older Americans.
    - Eliminate the confusing and out-dated earnings test so that we stop discouraging work and earnings among older Americans.

After Social Security Reform Is Secured -- Consistent With the President's "Save Social Security First" Commitment -- the President Proposes To:

- **Strengthen Medicare for the 21st Century.** The President's framework will reserve 15 percent of the projected surpluses for Medicare, ensuring the Medicare Trust Fund is secure for 20 years. The President further called for bipartisan reforms that would allow Medicare to be secure until 2020 while also providing prescription drug benefits.
- **Create New Universal Savings Accounts -- USA Accounts.** The President's framework will reserve 12 percent of the projected surpluses to create new Universal Savings Accounts (USAs) so all working Americans can build wealth to meet their retirement needs. To help Americans save and to strengthen our current pension system, we would provide Americans a flat tax credit to make contributions into their USA Account. In addition, we would provide additional tax credits to match a portion of an individual's savings -- with more help for lower-income workers.
- **Prepare America for the Challenges of the Future.** The President's framework will reserve 11 percent of the projected surpluses for military readiness and other pressing

national priorities.

SAVE SOCIAL SECURITY NOW: STRENGTHENING SOCIAL SECURITY FOR THE 21st CENTURY

In His State of the Union Address, President Clinton Put Forward A Framework To Strengthen Social Security Now. Since its creation more than 60 years ago, Social Security has been a bedrock of retirement security for Americans. There are 76 million baby boomers looking ahead to retirement. By 2030, there will be twice as many elderly as there are today, putting pressure on the Social Security system. After 2032, if we do nothing, the Trust Fund will be exhausted and Social Security will have only enough resources to cover 72 cents per dollar of promised benefits. President Clinton and Vice President Gore believe we must act now to tackle this tough, long-term challenge. That is why they are proposing to:

<u>Use the Budget Surplus To Save Social Security Now</u>

- **"Saving Social Security First."** Last year, in his State of the Union Address, President Clinton promised to save the budget surplus until we knew how much would be needed to save Social Security for the 21st century. This year, in his State of the Union Address, President Clinton reiterated his pledge to save Social Security first -- committing to reserve the budget surplus until Social Security reform is secured.

- **62 Percent of the Projected Budget Surpluses Will Be Used to Save Social Security.** President Clinton proposes to transfer 62 percent of the projected budget surpluses over the next 15 years -- more than $2.7 trillion -- to Social Security.

<u>Invest A Portion of the Surpluses To Achieve Higher Returns for Social Security</u>

- **Invest Portion of Surpluses To Achieve Higher Returns, Working With Congress to Devise A Mechanism to Ensure Independent and Non-Political Investments.** We want to work with Members of Congress from both sides of the aisle to craft a bipartisan Social Security plan which invests a portion of the surplus transferred to Social Security to achieve higher returns, and includes a mechanism to ensure that investments are made independently and without political interference. We will support using a broad-based neutral approach managed by the private sector with minimum administrative costs.

    - To achieve higher returns for Social Security, less than one-quarter of the transferred surpluses will be invested in the stock market.

<u>Save Social Security Until 2055 -- And Work Together To Save It Until At Least 2075</u>

- **President's Framework Keeps Social Security Solvent Through 2055.** By transferring 62 percent of the projected surpluses for the next 15 years to Social Security and investing a portion of them in the market -- just like any private or state or local government pension does -- we will ensure that Social Security is on sound footing for 55 years -- until 2055.

- **Must Work Together -- Across Party Lines -- To Make Hard-Headed, But Sensible and Achievable Choices To Save Social Security for 75 Years.** President Clinton's goal is to save Social Security for 75 years. To do so, he believes we must work together in a bipartisan way to make the hard-headed, but sensible and achievable choices to save Social Security through at least 2075.

Publicly Held Debt Will Fall To Lowest As Share of GDP Since 1917

- **Turning Around America's Fiscal Position.** Under Presidents Reagan and Bush, the debt held by the public quadrupled, rising from $785 billion in 1981 to $3.2 trillion in 1993. As a share of the economy, the publicly held debt increased from 26 percent in 1981 to 50 percent in 1993. Since President Clinton took office, the publicly held debt as a share of GDP has dropped to about 45 percent.

- **Debt-to-GDP Ratio Will Fall to Lowest Level Since 1917.** Under the President's framework, current projections suggest that the publicly held debt, as a share of GDP, will fall from about 45 percent today to less than 10 percent in 2014 -- its lowest level since 1917.

Reduce Poverty Among Elderly Women -- Particularly Widows

- **Poverty Rates Among Elderly Women -- Particularly Widows -- Remain High.** The poverty rate for all elderly women was 13.1 percent in 1997. For widowed women, poverty rates are especially high: the poverty rate is 18.0 percent for widowed women -- nearly four times the poverty rate of married women (4.6 percent) and much higher than the poverty rate of widowed men (11.4 percent).

- **President's Framework Would Lower Poverty Rates Among Elderly Women -- Especially Widows.** Currently, widow benefits vary from 50 to 67 percent of benefits for a married couple when both members were alive. The official poverty thresholds imply that a widow needs over 75 percent of a couple's income to maintain her pre-widowhood consumption. This is a key reason why widow poverty is so much higher than overall elderly poverty. The President is committed to reducing the loss of Social Security income at widowhood.

Eliminate the Out-Dated and Confusing Earnings Test

- **President Clinton Believes We Should Eliminate The Earnings Test.** President Clinton believes that the earnings test has outlived its use. Today, it primarily serves to confuse people, and to discourage them from working. We want to work with Members of Congress to eliminate the earnings test as part of a comprehensive package to strengthen Social Security for the 21st century.

- **Earnings Test Should Be Eliminated Because It Is Out-Dated And Confusing -- And It Discourages Work and Earnings Among the Elderly.** The Social Security earnings test is a confusing relic of a past era. It discourages the elderly from working. It is administratively complicated; administering the earnings test imposes significant administrative burden on the Social Security Administration. Finally, eliminating the earnings limit would have almost no effect on the long-run actuarial balance of the Social Security system.

MEETING AMERICA'S CHALLENGES FOR THE 21st CENTURY

After Social Security Reform Is Secured -- Consistent With the President's "Save Social Security First" Commitment -- The President Proposes To Meet The Following Three Challenges:

STRENGTHENING MEDICARE FOR THE 21st CENTURY

RESERVE 15 PERCENT OF THE PROJECTED SURPLUSES FOR MEDICARE, EXTENDING THE LIFE OF THE MEDICARE TRUST FUND UNTIL 2020.

- **We Must Prepare for the Health Care Challenges of the Next Century.** In its 30-year history, Medicare has contributed to longer lives and better lives for America's elderly and disabled. However, Medicare -- like Social Security -- will be impacted by the tidal wave of the "Senior Boom." Its enrollment is expected to double by 2030. In addition, Medicare -- as well as the private sector -- faces escalating health care costs. As a result, the Medicare Trust Fund is expected to run out in 2008, if no actions are taken.

- **Reserving Nearly One in Six Dollars of Surplus to Help Keep Medicare Safe Until 2020.** The President's framework would reserve 15 percent of the projected surpluses -- $650-$700 billion -- over the next 15 years for the Medicare Trust Fund. These funds would be prohibited from being used for any other purpose, ensuring that the money will go to help the health care needs of older and disabled Americans. Even in the absence of broader reforms, the President's framework would guarantee that Medicare can continue to provide its critical health services until 2020 -- doubling the life of the Medicare Trust Fund and providing the strongest outlook in the last 25 years.

- **New Funds Should Be Used To Help Achieve Broader, Bipartisan Reform.** The President believes that the Medicare Commission and Congress should utilize these new dedicated dollars as part of broader, bipartisan reforms. Such reforms, including the development of a long-overdue prescription drug benefit, are essential to provide efficient health care to the elderly and people with disabilities in the 21st century.

UNIVERSAL SAVINGS ACCOUNTS (USAs)

RESERVE 12 PERCENT OF THE PROJECTED SURPLUSES TO CREATE NEW UNIVERSAL SAVINGS ACCOUNTS (USAs) SO EVERY WORKING AMERICAN CAN BUILD WEALTH AND A NEST EGG TO MEET THEIR RETIREMENT NEEDS.

- **USA Accounts Will Help Americans Build Wealth for Their Retirement -- Strengthening Personal Savings and Pensions.** To help supplement Social Security, the President proposes to create USA accounts to help strengthen two legs of retirement security: personal savings and pensions. Under the President's framework, we will reserve 12 percent of the projected surpluses over the next 15 years -- $500 billion -- to create Universal Savings Accounts (USAs), so that every working American can build wealth and a nest egg for retirement.

- **We Want to Work With Congress And Experts To Determine Precisely How USA Accounts Will Be Structured So That They Are Progressive And Help Working Americans Save for Retirement.** President Clinton believes the government should provide most Americans with a flat contribution. In addition, the government will match a portion of each dollar an individual puts into the account -- with larger percentage matches going to lower-income workers. However, we want to work with Members of Congress and pension and personal savings experts, to ensure that USA accounts build on the current private-sector pension system, are progressive, and help working Americans save for their futures. Therefore, the exact size of the contributions, match rates, and income limits will be determined later.

MILITARY READINESS AND OTHER CRITICAL INVESTMENTS IN AMERICA'S FUTURE

RESERVE 11 PERCENT OF THE PROJECTED SURPLUSES FOR MILITARY READINESS AND OTHER PRESSING NATIONAL PRIORITIES.

- **Ensuring That America's Military Continues to be Ready for the Challenges of the 21st Century.** Early in January, President Clinton proposed a bold, new strategy to ensure that America's military continues to be fully prepared to protect our national interests as the world's most powerful fighting force. President Clinton believes this approach will provide the resources to meet his proposed detailed blueprint for military readiness.

- **Ensuring We Meet Other Critical Investments In America's Future.** In addition to military readiness, the setting aside of 11 percent of the projected surpluses -- nearly $500 billion -- will allow America to meet its other critical investment needs.

THE CASE FOR INVESTING
PART OF THE UNIFIED SURPLUSES IN EQUITIES

In his State of the Union Address, the President proposed that 62 percent of the projected budget surpluses over the next 15 years be transferred to the Social Security Trust Fund, in order to increase the ability of that Fund to meet promised Social Security benefit obligations. The President further proposed that about a fifth of the transferred surpluses be invested in equities to achieve higher returns for Social Security, helping to extend the life of the Social Security trust fund to 2055. This action does, however, raise understandable concerns about the possible extension of political influence on investment decisions and the risks that this might pose to the economy and the Trust Fund. Any system of collective investment can and must address these concerns. That is why we will work with Congress to design a system that observes five core principles:

1. **Private Sector Managers Selected by Competitive Bidding.** Social Security beneficiaries deserve the same efficient management and market returns that people receive in their private pensions and personal savings. The actual investments should be managed by private sector money-managers selected by competitive bidding.

2. **Independently Managed and Non-Political.** There would need to be wholly independent oversight of investment that was insulated from political influence. The choice of investment managers should be done by an independent board whose sole responsibility would be to pick fund managers so as to maximize the performance of the investments. This would ensure that the investment of funds was carried out with zero government involvement.

3. **Limited.** The share of Trust Fund assets invested in equities ought to be kept at a very modest level -- both to limit risk to the Fund and to ensure that collective investments never account for more than a small fraction of the stock market as a whole.

4. **Broad-based, Neutral, and Non-Discretionary.** Assets should be invested proportionately in the broadest array of publicly listed equities, with no room for discretion in adding or deleting companies and no room for active involvement in corporate decisions. Neither the government nor the private sector managers it selects to undertake investment on its behalf should be involved in "stock picking." As a shareholder the Funds should be entirely passive; one way to accomplish this would be to mandate that proxies be voted in the same proportions as other shareholders. Alternatively, if the investments were spread among a number of managers so that no one manager had a large share of the total market, the managers could vote the shares in the interests of the share holders, just as mutual fund managers do today.

    - *No Market Timing or Stock Picking.* In essence, the managers should be on autopilot in investing the funds. They should have little or no discretion in the investment of Trust Fund assets -- so they cannot "time the market" or pick individual stocks.

5. **Lowest-Cost.** Collective investment needs to be administratively simple and achieved at the lowest available cost -- both to obtain the highest possible returns and to further enhance the system's transparency and independence.

WHY INVEST PART OF THE SURPLUSES IN EQUITIES?

1. **Investing Part of the Surpluses in Equities Would Raise the Rate of Return That Workers Would Experience on Their Contributions into the Social Security System.**

   - Historically, the Trust Fund has been invested exclusively in government bonds. While these bonds have the upside that they are essentially risk-free, they have the downside that they pay a relatively low rate of return on average. Adding equities to the Trust Fund portfolio would allow the Social Security system to enjoy a higher rate of return, on average. Between 1959 and 1996, the difference between the average annual rate of return earned on stocks and the rate earned on bonds held by the Trust Fund -- the "equity premium" -- was 3.84 percent.

   - Raising the rate of return on the Trust Fund would mean that the Social Security system could be brought into long-term actuarial balance with smaller reductions in benefits, or smaller increases in revenue, or both.

   - Investing part of the transferred surpluses in equities accounts for about one-third of the improvement in the actuarial balance achieved under the President's framework.

2. **Investing Part of the Trust Fund in Equities Would Bring Social Security into Line with the "Best Practice" of Both Private- and Public-Sector Pension Plans.**

   - The overwhelming number of private-sector defined-benefit pension plans invest part of their reserves in equities. Among large private-sector defined benefit plans (those with more than 100 participants), more than 40 percent of total assets of were invested in equities.

   - Similarly, 65 percent of the portfolio backing the defined-benefit pension plan of the Federal Reserve System is invested in equities.

   - In aggregate, state and local pension plans hold fully 10 percent of the overall stock market.

WHY IS EQUITY INVESTMENT BETTER UNDERTAKEN THROUGH THE TRUST FUND THAN THROUGH INDIVIDUAL ACCOUNTS?

1. **Administrative Costs Associated with Trust Fund Investment Would Be Much Lower.**

   - For example, the equity-fund component of the Federal Thrift Savings Plan (TSP) incurs annual investment-management costs of only about one basis point (one one-hundredth of a percentage point). Thus, for every $100 in equity assets under management, the TSP pays only about one cent per year in management fees.

- By contrast, asset management fees for individual accounts such as IRAs typically run in the neighborhood of 100 basis points or more -- or about $1 per year for every $100 under management.

  - *The asset management fees associated with IRAs are thus typically at least 100 times larger than the fees associated with centralized investment.*

- Management fees are extremely important in determining the buildup of assets. A fee of one basis point paid every year for 40 years would reduce the accumulated balance by only about 0.4 percent. By contrast, a fee of 100 basis points would reduce the accumulated balance by about 33 percent.

2. Financial Risk Can Be Spread Much More Effectively If Equity Investment Is Undertaken Through the Trust Fund than Through Individual Accounts.

- Financial risk that arises through equity-investment of the Trust Fund can be spread both across the entire population participating in the system at any given point in time, and over time. Indeed, provided equity investment is undertaken through the Trust Fund, the consequences of market fluctuations can potentially be spread over many generations.

- By contrast, in a system of individual accounts, the consequences of market fluctuations must -- by definition -- be borne by each individual. If the market happens to do well during a certain individual's lifetime, that individual can enjoy a relatively prosperous retirement. If the market does poorly, that individual's financial security in retirement may be jeopardized.

WHY CAN WE BE CONFIDENT THAT TRUST FUND INVESTMENT IN EQUITIES WON'T DISRUPT THE MARKET?

1. This Is Not Direct Government Investment -- It Is Investment Undertaken by Private-Sector Managers Selected by Competitive Bidding.

- A bedrock principle of the President's program is that the government itself should not be a participant in the market. All transactions will be executed by private-sector managers.

- The Thrift Savings Plan selects managers in a similar way, placing its portfolio with managers that bid the lowest cost. These managers also vote the shares of stock they control.

2. Institutional Rules Can Be Established to Create Very Strong "Fire Walls" Against

Political Interference.

- The experience of state and local pension funds points to several elements of institutional design that have been essential in that context in helping prevent political interference.
- Investments can be made in a broad-based, neutral, and non-discretionary way. Through passive investing in an index, private-sector managers will not be involved in "stock picking."
- History shows that political influence can be avoided. The overwhelming bulk of assets in state and local plans are invested wisely -- not in politically motivated ways.
- For example, the Federal Thrift Savings Plan (TSP) invests $77 billion in stocks and bonds, with more than half in stocks. Francis Cavanaugh, the first executive director of the Board responsible for TSP investments, says that investments have been made without political interference. Specifically, in a recent news article, Cavanaugh said, *"Can it be done? It's been done... We did it."*

3. The Equity Holdings of the Social Security System under the President's Program Would Be Modest Relative to the Holdings of Other Major Players in the Market.

- Under the President's program, the Social Security system would hold an average of about 4 percent of the aggregate U.S. stock market.
- The top 10 largest private-sector portfolio managers all have more than one percent of the market under management. Fidelity, the largest such private-sector manager, has about 4 percent of the market under its management.
- By contrast, state and local governments in aggregate already hold about 10 percent of the market.

CHAIRMAN GREENSPAN SHOWS SUPPORT FOR PRESIDENT CLINTON'S SOCIAL SECURITY PLAN

While Alan Greenspan did not endorse one aspect of President Clinton's Social Security Plan, he expressed support for most of the President's overall framework for reforming Social Security. The following are excerpts from major papers on Greenspan and his support for the President's overall plan:

Wall Street Journal **1/21/99**

- "**Federal Reserve Chairman Alan Greenspan disappointed Republicans and pleased Democrats by praising Mr. Clinton's proposal** 'to effectively keep a very large part of the unified budget surplus in place by putting most of the money in Social Security and Medicare Trust Fund. . . . My first preference is to allow the surpluses to run for awhile and unwind a good deal of the debt that we have accumulated over the years.'"

- "**For once, the Fed Chairman was explicit. He endorsed President Clinton's proposal** to let federal budget surpluses accumulate by locking up most of the money in the Social Security and Medicare trust funds."

- "**To his fellow Republicans' disappointment, Mr. Greenspan described tax cuts as a second choice to the Clinton plan.** He said Congress should use the surplus -- which President Clinton projects to total $4.5 trillion in the next 15 years -- for tax cuts only if Congress doesn't have the discipline to allow the surpluses to continue."

New York Times **1/21/99**

- "In testimony before the House Ways and Means Committee today, Mr. Greenspan, whose views on the economic matters carry considerable weight in Congress and on Wall Street, said **he supported the President's notion** of putting almost two-thirds of the Federal Budget surpluses over the next 15 years into Social Security."

USA Today **1/21/99**

- "Federal Reserve Chairman Alan **Greenspan supported President Clinton's broad strategy** Wednesday of using budget surpluses to save Social Security . . . . Greenspan said he **backed the overall strategy** because it would effectively mean that the government was using its surpluses to pay down some of its $5.6 trillion on outstanding debt. That would be **good for the economy** because it would help lower interest rates and free up money for companies."

Washington Post **1/21/99**

- "**Greenspan offered enthusiastic praise for Clinton's idea** of devoting much of the projected federal budget surpluses to Social Security . . . ."

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:28-JAN-1999 14:39:02.00

SUBJECT:

TO: Janet L. Yellen (CN=Janet L. Yellen/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.D26]MAIL40031503Z.036 to ASCII,
The following is a HEX DUMP:

STRENGTHENING SOCIAL SECURITY AND MEDICARE BY PRESERVING FISCAL DISCIPLINE

I. The Current Situation

Pre 1993: Fiscally Irresponsible Policies in the 1980s and early 1990s Left the Country in Poor Fiscal Shape to Pay Back Future Social Security Obligations. The 1983 Social Security reforms intended for the government to set aside the excess of Social Security revenues over benefits, so that the country would be strong enough fiscally to pay back the Social Security trust fund in the future. Instead, the Reagan-Bush years produced mountains of debt increasing the publicly held debt from 26 percent in 1981 to 50 percent in 1993 and was expected to rise even further. When President Clinton took office in 1993, deficits of hundreds of billions of dollars were expected to persist for decades to come, and there were serious doubts about how the country would come up with the funds to pay back the Social Security trust fund without raising taxes, cutting benefits, or letting debt reach levels that would threaten our prosperity. In other words, the government failed to use the Social Security surpluses to prepare us to meet our obligations to Social Security in the future.

Post 1993: Tough Choices and Fiscal Responsibility Put the Government on a Course to Pay Back Social Security Obligations When They Come Due -- While Still Running Surpluses into the Middle of the Next Century. The 1993 economic plan (passed without a single Republican vote), fiscal discipline in appropriations, and the 1997 balanced budget agreement put the country on a path of prosperity and fiscal responsibility. In 1998, the surplus was $70 billion instead of more than $350 billion deficit that CBO projected when President Clinton took office in 1993. Because of this hard won fiscal discipline, our nation is able to meet our Social Security Trust Fund obligations and still run surpluses for the first few decades of the 21st century.

II. Going Forward: The Debate Over How to Allocate the Surpluses

THE FUNDAMENTAL CHOICE: HOW TO ALLOCATE THE $4.4 TRILLION IN SURPLUSES OVER THE NEXT 15 YEARS AMONG SPENDING, TAX CUTS, AND DEBT REDUCTION?

PRESIDENT'S FUNDAMENTAL SOLUTION: DEBT REDUCTION WITH THE BENEFITS ALLOCATED TO EXTENDING SOCIAL SECURITY AND MEDICARE.

In His State of the Union Address, President Clinton Called for Us to Continue on This Fiscally Responsible Course that Reduces Our Debt and saves Social Security First The President called for additional fiscal responsibility and debt reduction to extend the Social Security trust fund until 2055 and the Medicare Trust fund until 2020. Our fiscal discipline of the past six years has put the nation in a position where we can meet our obligations to Social Security through 2032 and still run surpluses. The President believes we should go even further, buying down around $3 trillion in debt and allocating these savings to ensure that Social Security is secure until 2055 and that Medicare is secure until 2020.

-- The President's plan sets aside 62 percent ($2.7 trillion) of the unified budget surplus over the next 15 years to help pay Social Security benefits in the future. Another 15 percent ($680 billion) would be set aside to pay for Medicare. Rather that squandering the surpluses on a tax cut favoring the most well-off or new spending programs, President Clinton is calling for taking the responsible course of setting these funds aside to help provide for the fiscal challenges ahead caused by the aging of American.

-- The President's basic approach of paying down the debt to strengthen Social Security and Medicare has drawn support from experts including Alan Greenspan, Robert Reischauer, Henry Aaron, and Robert Greenstein.

The Plan will Reduce the Nation's Publicly Held Debt and Increase the Savings Rate. Between 1981 and 1992 our publicly- held debt as a percent of GDP rose from about 25 percent to over 50 percent. Under President Clinton's leadership that trend has been reversed and debt held by the public as a percent of GDP has dropped to 44 percent. Furthermore, under President Clinton's plan the increase in debt held by the public from the 1980s will be completely reversed by 2006 and by 2014 will only be 7.1 percent. This will be the lowest debt to GDP level since 1917. National savings has increased from 3.3 percent when President Clinton took office to 6.7 percent today. By setting aside the surpluses rather than spending them, this plan will increase the national savings rate by another 1.9 percent of GDP. The USA accounts will add even further to national savings.

Why Debt Reduction Makes Our Nation Further Able to Extend Solvency of Social Security and Medicare. Paying off debt means that the government owes less money to private individuals. Thus, it improves the government's financial position.

- **Paying Off Debt Causes New Capital Formation to Occur.** Paying off debt means that private savings go into productive private investments rather than into government borrowing. The resulting increase in the capital stock raises workers' productivity and national income. These additional real resources will increase the future standard of living, and make it easier to pay back the Social Security trust fund when it redeems its bonds.

- **Paying Off Debt Reduces Debt Servicing Costs**. Paying off debt increasing future budget surpluses and freeing up additional resources for other uses, including meeting our obligations to Social Security and Medicare.

- **Paying Off Debt Provides Government with Flexibility to Respond to Future Conditions.** Paying down debt also means that if the government later decided to finance some obligations by issuing new debt -- for example if there was a transition period before Social Security's revenues and benefits were in line -- it would be possible to do so without threatening future economic performance, and while keeping debt to GDP ratios below current levels.

The Rest of the President's Proposal Invests in the Future As Well. In addition to

Strengthening Social Security and Medicare, the President's proposal provides USA accounts to help every American build the wealth they will need to finance longer lifespans. The plan also makes important investments in military readiness and education that will enable the country to continue to be strong and prosperous.

III. Alternatives to the President's Approach

Tax Cuts. If we allocate most of the unified budget surplus to tax cuts we will not lower our debt, increase our savings, or extend the life of the Social Security or Medicare trust funds. Moreover, we will jeopardize our ability to meet our obligations to Social Security between now and 2032. While the President commits the surplus for only 15 years, any allotment we set aside for tax cuts will be permanent making it harder for future lawmakers to meet our challenges.

New Spending. Some smart targeted spending on research and education can improve the nation's productivity and leave us with more resources in the future when the time comes to pay back our obligations to Social Security. But spending the entire surpluses will have similar consequences to reckless tax cuts -- we will not lower our debt, increase our savings, or extend the life of the trust funds, and we will jeopardize our ability to meet our existing obligations to Social Security.

Take Social Security Off-budget and Divide Remaining Surplus Among Tax Cuts and Military Spending. Some would simply have Social Security come off budget and pay down $2.7 trillion of debt. Then they would battle over only how much of the remaining surplus would go to tax cuts, military spending, and individual accounts. This would not extend the life of the Social Security Trust Fund a single year, because they would not be allocating any of the benefits of debt reduction to Social Security or Medicare. This approach to debt reduction will put the country in a better fiscal situation, just as the President's plan does, but the off-budget plan would leave open the allocation of the large future surpluses -- leaving them available for various forms of spending and large tax cuts. Others should want to lock-in now that at least a good portion of the benefits from fiscal discipline be allocated to strengthen Social Security and Medicare.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:29-JAN-1999 13:51:18.00

SUBJECT: Draft of budget release statement

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

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

TEXT:
Attached is a draft of a statement for the budget release event.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D41]MAIL43473713R.036 to ASCII,
The following is a HEX DUMP:

STATEMENT OF CEA CHAIR JANET YELLEN ON
ECONOMIC ASSUMPTIONS IN THE FY2000 BUDGET

February 1, 1999

THANK YOU. I am responsible for describing the Administration's economic forecast contained in the budget document released today.

Before I do that, let me first say that: for the past 6 years, this Administration has built a record of using credible, conservative economic forecasts for budgetary purposes. The Administration's economic forecasting team was committed to ensuring that our budget balancing efforts would be based on realistic assumptions about the economy's performance--not on rosy scenarios. And, I believe that the assumptions in this year's budget are similarly credible and are consistent with the views of a consensus of economic forecasters.

The economy's performance over the past years has been extraordinary. Real GDP growth averaged 3.9 percent over the past year -- the same as last year, which was the highest growth rate in xx years. The unemployment rate has stayed below 4.5 percent for the last xx months. Over xx million jobs were created just this past year. And all this has been accomplished while inflation has declined to its lowest level in over 30 years.

Although growth over the last several years has exceeded our expectations, we believe that it would not be wise for budgetary purposes to count on a continuation of growth at its recent extraordinary pace. Looking ahead, we are projecting real GDP to continue to grow--but at a slower xx percent annual rate over the next xx years. At the same time, the unemployment rate is projected to edge up about about xxxx percentage point per year. Inflation, as measured by the CPI, is assumed to edge up slightly over the next three years. After 2001, real GDP growth is projected to resume its assumed trend growth rate of 2.4 percent, and the unemployment rate stabilizes at 5.4 percent.

Our economic projections are very similar to those in the budget we released last February. The differences stem largely from integrating the better-than-expected economic performance during the past year. Compared with where we thought we would be, the level of output is now higher--while unemployment, inflation, and long-term interest rates are lower.

The shift to more moderate growth assumed in this budget recognizes that, by mainstream assumptions, growth has exceeded the pace that can be maintained on a sustained basis without an eventual tendency for upward inflationary pressure. But, it is important to note that our assumed real growth rates are not the *best* that the Administration believes the economy can achieve--the outcome could be *better*.

Let me conclude by saying that the Administration's strategy for raising American living standards and enhancing the economy's long-run growth rate is working: our nation is currently enjoying the longest peacetime economic expansion in history. Since 1993, 18 million new jobs have been created. Unemployment and inflation are at their lowest levels in 3 decades. And, real wages have grown more over the course of this expansion then they did in the expansion of the 1980's. In fact, last week, we learned that real wages increased 3.9 percent in 1998, the same as in 1997 -- which means we have experienced the largest 2-year gain in real wages in over 20 years.

The U.S. economy is fundamentally sound and is likely to continue in the coming months on a path of solid growth with low unemployment and inflation in check -- even with the recent turmoil in the world's financial markets. To successfully address the challenges facing the 21st Century, we must continue with this Administration's proven strategy for economic growth and increased prosperity for all Americans.

the growth-oriented economic policies enacted by this Administration have clearly paid off. The Administration's 1993 deficit reduction plan helped create the climate for the current strong economic performance, and our economy is the strongest in a generation.

Today, we received more evidence that the American economy is healthy and strong.
Real GDP is estimated to have grown at a xx percent annual rate in the fourth quarter of 1998. For 1998 as a whole, real GDP grew xx percent.

Today's numbers indicate that our economy is still going strong. Growth is robust. Businesses continue to invest in new and better equipment -- xxx Unemployment remains low at 4.3 percent. Inflation is in check. And, consumer confidence is high.

ECONOMIC ASSUMPTIONS

Our forecast assumes that the budget will be in surplus .....

We project **real GDP** to grow at 2.2 percent to 2.3 percent, which reflects capacity growth under the new chain-weighted measure. These numbers are lower than our Mid-Session Review forecast, but this is more than fully accounted for by the shift to chain-weights. Our real growth assumption is very close to Blue Chip for 1996 and 1997 and to CBO's December estimate for the entire 1996-2002 period.

Consistent with our forecast of continued expansion at the economy's potential, we believe that **inflation** will remain low and stable. We project that the CPI will increase by 3.1 percent in 1996, declining to 2.8 percent by 1998. This decline reflects the technical adjustments announced by the Bureau of Labor Statistics.

Given the outlook for moderate inflation, we project the chain-weighted GDP deflator to grow at less than 3% over the forecast period. Combining this with the real GDP growth figures leads us to project **nominal GDP growth** of 5.1% over the forecast horizon. These are the GDP figures reported in this budget.

We project that the **unemployment** rate will remain low, at about 5.7% throughout the entire forecast period. We have recognized that evidence increasingly suggests that the unemployment rate consistent with stable inflation has moved down.

The combination of low inflation and the movement to a balanced budget by the year 2002 creates a very favorable environment for **interest rates**. Short rates are expected to fall -- leveling off at 4%. We also see the 10-year rate falling over the next 3 years, and leveling off at 5% in 1998. This term structure reflects the historical experience in periods of low and stable inflation.

CONCLUSION

In conclusion, let me say: for the past 6 years, the economic projections of this Administration have consistently been on target. Comparisons of our earlier projections with the economy's actual performance show only small differences. If anything, we have been too conservative; we have consistently underestimated real GDP growth and the increase in jobs, and overestimated inflation, interest rates, and the budget deficit.

We believe that the economic assumptions presented in this budget are similarly sound and realistic. And they are in line with the forecasts of the Blue Chip private forecasters and the Congressional Budget Office (CBO).

Finally, as I said at the beginning, we believe the outlook for the economy is good. The government shutdown and the blizzard that closed most of the Eastern United States may have some dampening effect on the economy. But, although we may see some variations in growth quarter-to-quarter, the economic fundamentals are sound and conducive to steady growth with continuing job creation and low inflation.

Now, let me turn to **SECRETARY RUBIN** who will talk about the tax portion of this budget.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:29-JAN-1999 17:53:32.00

SUBJECT: misc. on Social Security

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

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

TEXT:
1. Initial Treasury research suggests that Greenspan greatly overstated the average return differential between publicl and private pension plans (he said 2-3 %age pts per year). We're stating this carefully, but Treasury's look at the evidence shows a difference of 60 bps per year, and the public plans have less volatile returns, so even that small difference could just be the risk/return tradeoff.

2. Buying equities reduces the actuarial imbalance by more (proportionately) than it adds years to solvency. The reason is that actuarial imbalance shows how much you'd have to raise the payroll tax rate today to extend solvency to 2075. If we did that, we'd have a big trust fund through the 2050s and 2060s, with part earning the equity rate of return. Essentially, we'd benefit from the higher rate of return for more years under this scenario than we actually do under the plan.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:29-JAN-1999 14:06:48.00

SUBJECT: Sorry - this is the one.

TO: Steven N. Braun (CN=Steven N. Braun/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:
Ignore the other e-mails. This is the statement draft.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D70]MAIL455067132.036 to ASCII,
The following is a HEX DUMP:

STATEMENT OF CEA CHAIR JANET YELLEN ON
ECONOMIC ASSUMPTIONS IN THE FY2000 BUDGET

February 1, 1999

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Before I do that, let me first say that: for the past 6 years, this Administration has built a record of using credible, conservative economic forecasts for budgetary purposes. The Administration's economic forecasting team was committed to ensuring that our budget balancing efforts would be based on realistic assumptions about the economy's performance--not on rosy scenarios. And, I believe that the assumptions in this year's budget are similarly credible and are consistent with the views of a consensus of economic forecasters.

The economy's performance over the past years has been extraordinary. Real GDP growth averaged 3.9 percent over the past year -- the same as last year, which was the highest growth rate in xx years. The unemployment rate has stayed below 4.5 percent for the last xx months. Over xx million jobs were created just this past year. And all this has been accomplished while inflation has declined to its lowest level in over 30 years.

Although growth over the last several years has exceeded our expectations, we believe that it would not be wise for budgetary purposes to count on a continuation of growth at its recent extraordinary pace. Looking ahead, we are projecting real GDP to continue to grow--but at a slower xx percent annual rate over the next xx years. At the same time, the unemployment rate is projected to edge up about about xxxx percentage point per year. Inflation, as measured by the CPI, is assumed to edge up slightly over the next three years. After 2001, real GDP growth is projected to resume its assumed trend growth rate of 2.4 percent, and the unemployment rate stabilizes at 5.4 percent.

Our economic projections are very similar to those in the budget we released last February. The differences stem largely from integrating the better-than-expected economic performance during the past year. Compared with where we thought we would be, the level of output is now higher--while unemployment, inflation, and long-term interest rates are lower.

The shift to more moderate growth assumed in this budget recognizes that, by mainstream assumptions, growth has exceeded the pace that can be maintained on a sustained basis without an eventual tendency for upward inflationary pressure. But, it is important to note that our assumed real growth rates are not the *best* that the Administration believes the economy can achieve--the outcome could be *better.*

Let me conclude by saying that the Administration's strategy for raising American living standards and enhancing the economy's long-run growth rate is working: our nation is currently enjoying the longest peacetime economic expansion in history. Since 1993, 18 million new jobs have been created. Unemployment and inflation are at their lowest levels in 3 decades. And, real wages have grown more over the course of this expansion then they did in the expansion of the 1980's. In fact, last week, we learned that real wages increased 3.9 percent in 1998, the same as in 1997 -- which means we have experienced the largest 2-year gain in real wages in over 20 years.

The U.S. economy is fundamentally sound and is likely to continue in the coming months on a path of solid growth with low unemployment and inflation in check -- even with the recent turmoil in the world's financial markets. To successfully address the challenges facing the 21st Century, we must continue with this Administration's proven strategy for economic growth and increased prosperity for all Americans.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:29-JAN-1999 13:53:52.00

SUBJECT: whoops

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

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

TEXT:
Here is the statement.=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D21]MAIL40504713O.036 to ASCII,
The following is a HEX DUMP:

FOR IMMEDIATE RELEASE
TUESDAY, MAY 26, 1998

CONTACT: MICHELE JOLIN
CHIEF OF STAFF
(202) 395-5084

STATEMENT OF JANET L. YELLEN
CHAIR, COUNCIL OF ECONOMIC ADVISERS
ON THE ECONOMIC ASSUMPTIONS OF THE MID-SESSION REVIEW

My role today is to tell you about the budget's economic assumptions. For the past 5½ years, this Administration has built a record of credible economic assumptions. The Administration's economic forecasting team was committed to ensuring that our budget balancing efforts would be based on realistic assumptions about the economy's performance--not on rosy scenarios. The assumptions in this year's budget are similarly credible and are consistent with the views of a consensus of economic forecasters.

The economy's performance over the past two years has been extraordinary. Real GDP growth averaged 3.8 percent over the past 8 quarters--the highest growth rate in nine years. The unemployment rate has been below 5 percent for the last 10 months. Over 3 million jobs were created just this past year. And all this has been accomplished while inflation has declined to its lowest level in over 30 years.

Although growth has exceeded our expectations in recent years, we believe that it would not be prudent for budgetary purposes to count on a continuation of growth at its recent extraordinary pace. Looking ahead, we are projecting real GDP to continue to grow--but at a slower 2 percent annual rate over the next 3 years. At the same time, the unemployment rate is projected to edge up about about two tenths of a percentage point per year. Inflation, as measured by the CPI, is assumed to edge up slightly over the next three years. After 2001, real GDP growth is projected to resume its assumed trend growth rate of 2.4 percent, and the unemployment rate stabilizes at 5.4 percent.

Our economic projections are very similar to those in the budget we released last February. The differences stem largely from integrating the better-than-expected economic performance during the past 2 quarters. Compared with where we thought we would be, the level of output is now higher--while unemployment, inflation, and long-term interest rates are lower.

The shift to more moderate growth assumed in this budget recognizes that, by mainstream assumptions, growth has exceeded the pace that can be maintained on a sustained basis without an eventual tendency for upward inflationary pressure. It is important to note that our assumed real growth rates are not the *best* that the Administration believes the economy can achieve--the outcome could be *better*.

Let me conclude by saying that the growth-oriented economic policies enacted by this Administration have clearly paid off. The Administration's 1993 deficit reduction plan helped create the climate for the current strong economic performance, and our economy is the strongest in a generation. We have provided a solid foundation for sustained economic growth and rising living standards for all Americans--evident in the recent 2.9 percent increase in real wages, the largest increase in 25 years.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:29-JAN-1999 17:21:51.00

SUBJECT: Draft Budget statement

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

TEXT:
Attached is the updated budget statement.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D3]MAIL48518223Q.036 to ASCII,
The following is a HEX DUMP:

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February 1, 1999

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The economy's performance over the past years has been extraordinary. Real GDP grew 3.9 percent in each of the past 2 years -- which was the highest growth rate in 14 years. The unemployment rate has been below 4.5 percent since July of 1997. 2.5 million jobs were created just this past year. And all this has been accomplished while inflation has declined to its lowest level in over 30 years.

Although growth over the last several years has exceeded our expectations, we believe that it would not be wise for budgetary purposes to count on a continuation of growth at its recent extraordinary pace. Looking ahead, we are projecting real GDP to continue to grow--but at a slower 2 percent annual rate over the next 3 years. At the same time, the unemployment rate is projected to edge up about slightly. And, inflation, as measured by the CPI, is projected to increase at a 2.3 percent annual rate next year, about the same as the increase in the core CPI over the past year. After 2001, real GDP growth is projected to resume its assumed trend growth rate of 2.4 percent, and the unemployment rate stabilizes at 5.3 percent.

Our economic projections are very similar to those released in the Mid-Session Review last May. The differences stem largely from integrating the better-than-expected economic performance during the past year.

The shift to more moderate growth in 1999 reflects the view that most components of domestic demand are likely to slow next year. Consumption, in particular, has been growing faster than income. Consumption is likely to slow to a solid but more sustainable pace. But, it is important to note that our assumed real growth rates are not the *best* that the Administration believes the economy can achieve--the outcome could be *better*.

Let me conclude by saying that the Administration's strategy for raising American living standards and enhancing the economy's long-run growth rate is working: our nation is currently enjoying the longest peacetime economic expansion in history. Since 1993, 18 million new jobs have been created. Unemployment and inflation are at their lowest levels in 3 decades. And, real wages have grown more over the course of this expansion then they did in the expansion of the 1980's. In fact, last week, we learned that real wages increased 2.2 percent in 1998, the same as in 1997 -- which means we have experienced the largest 2-year gain in real wages in over 20 years.

The U.S. economy is fundamentally sound and is likely to continue in the coming months on a path of solid growth with low unemployment and inflation in check -- even with the recent turmoil in the world's financial markets. To successfully address the challenges facing the 21st Century, we must continue with this Administration's proven strategy for economic growth and increased prosperity for all Americans.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME:29-JAN-1999 12:12:39.00

SUBJECT: revised telecom

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

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

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

TEXT:
Attached is substantially revised text. The charts are under revision and are not attached. I am still working on the draft, but it is to a large extent done, except for footnote citations, fact checking, and new charts. Thanks.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D71]MAIL44929513B.036 to ASCII,
The following is a HEX DUMP:

DRAFT, 1/29/99 – NOT FOR CIRCULATION

Progress Report:
Growth and Competition in U.S. Telecommunications, 1993-1998

Council of Economic Advisors
February ___, 1999

EXECUTIVE SUMMARY

Since 1993 the U.S. telecommunications industry has prospered: It has helped to create over 1 million new jobs, hundreds of new firms have entered all sectors of the industry, billions of dollars have been invested in new facilities, services, and research and development. Output of services has increased dramatically. The telecommunications industry has also become increasingly intertwined with the information industry. The increase in Internet users, from fewer than 20 million three years ago to more than 70 million Americans today, has produced a surge of demand for additional telephone lines, high-speed telecommunications services, and long-distance transport of information.

The growth of the telecommunications sector has been supported by the Administration's 1993 National Information Infrastructure Initiative, which set forth market competition and regulatory flexibility as the fundamental principles for U.S. telecommunications policy. These principles are reflected in the auctioning of wireless spectrum and in many of the market-opening provisions of the Telecommunications Act of 1996. They have also guided Administration policy towards the Internet and the development of electronic commerce. The evidence from these initiatives strongly supports the continued application and enforcement of pro-competitive policy in those markets where competition has not yet developed sufficiently to yield the desired benefits for American consumers.

The benefits of a pro-competitive regulatory approach can be seen in how the telecommunications industry has developed sector-by-sector.

- Telecommunications infrastructure and the information sector: Increased demand for advanced telecommunications infrastructure and services has come from the growing need for fast and secure transport of information. From 1993 to 1998, the number of "hosts" for Internet sites grew from fewer than 3 million to over 30 million, the number of Internet users grew from about 14 million to over 41 million American adults, and the volume of electronic commerce grew from nothing to over $10 billion. As a result, consumer demand for second phone lines grew from ___ to ___, ___ percent of all households, high-speed "broadband" data services spread ___, as providers invested in infrastructure to provide a growing number of customers with cable modem, DSL, and other broadband options, and deployment of high capacity fiber grew by __ percent from 1997 to 1998. The Administration has supported this growth through its deregulatory policy for the Internet, its initiative for funding basic research in high technology, and the implementation of the President's directive on electronic commerce.

- Local telephone services: Many new competitors have entered the wireline local services market since the Telecommunications Act of 1996. Competitive local exchange companies ("CLECs") to date have created more than 50,000 new jobs and invested $20 billion in capital, and come to comprise about one-fifth of the capital market value of the local telecommunications sector since 1992. The 1996 Act is also directly responsible for the entry of new firms that provide local, high-speed data services, mostly to businesses of all sizes, but increasingly to residential customers. These new "data

CLECs" have invested hundreds of millions of dollars in new facilities in the past year and created thousands of new jobs. Altogether, new entrants into the local market have to date captured over 2% of the local business market measured by lines, and about 5% measured by revenues. The residential market remains an area of limited competitive development, due partly to the lesser economic incentives for new entrants to serve household customers, and partly to legal challenges that until recently have left unclear the scope of the FCC's exercise of authority to implement the 1996 Act's local competition provisions.

- Long-distance telephone services: Competition in long-distance services has eroded AT&T's market share from its former monopoly to about 50 percent, and the FCC no longer classifies AT&T as a "dominant carrier." With this competition has come increasing availability of low-cost calling plans for many different consumer segments. As a result, long distance usage has increased substantially while average revenue per-minute earned by carriers has been declining steadily for several years, with steeper declines in the past 2 years. As increased competition occurs in the long distance market as a result of the 1996 Act, consumers will reap further benefits.

- Wireless telephone service: Wireless telecommunications carriers directly created 100,000 new jobs between 1993 and June 1998, 40,000 of those in the past two years. Wireless telephony (cellular, PCS, and ESMR) revenues are now $30 billion, growing an average 24 percent a year since 1993. Capital investment, a leading indicator of future industry growth, has now grown to a cumulative $50 billion. Competition, leading to 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. 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, depending on usage levels, as much as 30 percent to 40 percent for residential users and 30 percent to 50 percent for business users thanks to new competition.

- Telecommunications equipment: The telecommunications equipment industry in the U.S. has grown substantially. Total production in 1997 topped $60 billion, up from $___ in 1993. There has also been a shift in the nature of that business, with a greater proportion of it consisting of innovative network equipment than of commodity equipment for the consumer market. **GET DATA TO BACK UP.** New competitors created by wireless auctions and the 1996 Act have resulted in a large demand for innovative telecommunications equipment. New entrants into the market have created thousands of jobs, invested billions of dollars 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 -- annual U.S. telecommunications equipment exports doubled from 1993 to 1997, to over $13 billion.

INTRODUCTION

This report describes developments in the U.S. telecommunications market since 1993. It presents an overview of growth of the industry as a whole, discusses key developments in the long-distance, local, wireless, and equipment sectors, and describes the dramatic rise in use of the Internet and the increasingly interdependent relationship between the information and telecommunications industries. The goal of this report is not to examine the economic issues underlying specific regulatory proceedings, nor is the purpose to analyze whether particular refinements to current laws or regulations would be useful. It is instead to discuss overall trends and to assess the broad impact of the current regulatory framework.

The evidence reviewed demonstrates that the telecommunications industry has been a substantial part of the outstanding performance of the U.S. economy -- now in the longest peacetime expansion in American history. Since 1993, the telecommunications industry has helped to create over 1 million new jobs, seen entry by hundreds of new companies, made tens of billions of dollars of new investment in infrastructure and innovation, raised exports, and fostered a revolution in the scope of communications services available to consumers.

The growth of the American telecommunications industry has been supported by a flexible, competition-oriented approach to policy and regulation. The principles of market competition and regulatory flexibility are implemented in the Omnibus Budget Reconciliation Act of 1993, through which President Clinton signed into law authorization for 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. They appear also in the Administration's initiatives to ensure the successful growth of electronic commerce and its commitment to keep the Internet, a key driver of demand for telecommunications infrastructure, free from economic regulation.

To be sure, there remain important challenges for telecommunications policy to address –

for example, ensuring that competition develops further and more quickly in certain markets and that anti-consumer tactics like “slamming” and “cramming” are stopped. But by any fair measure, the development of the telecommunications market in the United States must be considered a major success. This success provides no basis for complacency, but neither do remaining challenges provide a reason to change the current regulatory approach. Instead, both are strong reasons to adhere more strongly to the underlying principle of open competition that is bringing great economic benefits to American workers, consumers, and businesses, and to make sure that competition has the opportunity to develop in markets where it so far has been unable to do so.

Policy Developments

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 long-distance service. That market was fully opened to new entrants in 1984, when the Department of Justice's antitrust suit led to the break-up of the integrated Bell system into 7 separate local companies, the "baby bells," and one unaffiliated long-distance company, AT&T. Telecommunications markets nonetheless continued to be highly regulated. Local telephone service remained, for the most part, the province of monopolies overseen by state utility commissions. The long-distance market became more competitive but, in order to ensure that it remained so, entry into the market was barred for the regional bell companies because of their control over local network "bottlenecks" at which they could discriminate in providing access to rival long-distance providers. The nascent cellular industry started with two licenses in each service market being issued by the FCC, one to the incumbent local carrier and the other to an unaffiliated entrant. Partly due to regulatory limitations on available spectrum, the market remained a duopoly for several years.

Policy evolution. Recognizing that the telecommunications industry was changing at an increasingly rapid pace due to technological and market innovations, the Administration launched the National Information Infrastructure initiative in September 1993. To complement and advance the NII initiative, the Administration followed in January 1994 by proposing a set of principles for overhauling the regulatory framework of telecommunications and fostering investment and competition. The NII initiative envisioned advanced networks integrating hardware, software, and skills, making it easy and affordable to connect people to each other, to computers, and to a vast array of services and information resources. On the wireless side, 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.

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.

The Telecommunications Act of 1996. The principles of the NII are reflected in many instances in the Telecommunications Act of 1996, which President Clinton signed into law on February 8, 1996. The Telecommunications Act of 1996 eliminated legal barriers to entry and further opened the door to local phone competition by requiring incumbent local telephone companies to interconnect and exchange traffic with new entrants into the market on non-discriminatory terms, to lease parts of their networks ("unbundled network elements") to new entrants at cost-based prices, and to provide service at wholesale rates so that new competitors could gain a foothold in the local market through resale to customers. The FCC's authority to implement those requirements has until now been blocked by legal challenges mounted by the incumbent local companies. The litigation was recently resolved in favor of the Commission by the Supreme Court, and the federal local competition rules are now enforceable.

In addition to mandating certain entry-facilitating actions by the incumbents, the 1996 Act tries to create economic incentives to open the local market by allowing the Regional Bell Operating Companies to provide long-distance service to customers in their regions after they have complied with the Act's local-competition requirements. The Act makes provision for regulatory flexibility by granting the Federal Communications Commission (FCC) discretion to forebear from applying the Act's requirements where appropriate.

Economic Growth and Competition in Telecommunications Markets

Revenue growth and contribution to the national economy. At the time the Administration announced the NII initiative in 1993, it was estimated that industries related to the NII would create $300 billion in annual sales for the telecommunications industry and contribute a comparable amount to GNP by 2007. These estimates are being achieved and even surpassed: Communications services companies alone had revenues of $348 billion in 1997 while overall industry revenues approached $500 billion. (See chart 1.3) Telecommunications services contributed about $25 billion to GDP growth from 1996 to 1997, and increased their share of GDP by more than 20 percent.

Overall job creation. The telecommunications services sector is directly responsible for creating over 250,000 new jobs since 1993. The increased number of jobs in telecommunications since 1993 is extremely important: prior to that time, telecommunications employment was decreasing, even as the production of telecommunications services was expanding. For example, from 1981 to 1992, the number of phone lines -- "local loops" -- in the United States increased by 40 million (FCC Trends, Table 19.1), and the amount of long-distance calling tripled (FCC Trends, Table 11.3). But over that same time period, the number of workers in the U.S. telecommunications services industry fell by 200,000. Indeed, labor productivity in the telecommunications industry -- measured as output per hour -- increased by 80 percent from 1981 to 1992 (FCC Trends, Table 5.2), reducing the number of workers needed even as business grew rapidly.

Labor productivity in telecommunications has continued to grow at approximately the same rate since 1992 (FCC Trends, Table 5.2). But lower prices, new and innovative services, dramatic growth of wireless communications, and new demand for services and infrastructure from the information sector have caused the growth of the telecommunications industry to outpace productivity increases and create large numbers of new jobs. Telecommunications has been particularly important in providing crucial inputs, without which the information sector would likely have grown much more slowly. By providing the advanced infrastructure and services essential to data and information services, the telecommunications industry has contributed to creation of an additional 800,000 new jobs since 1993 in the data processing sector, not counting indirect employment effects on the software and computer industries.

Entry by new firms. The structure of the telecommunications industry today is radically different from that of 15 years ago. Numerous firms have entered each sector of the telecommunications market, with the number of public telecommunications companies swelling from under 100 in 1984 to over 200 in 1993 and surging to a peak of just under 400 in 1997. In critical sectors like local telephone service, the majority of entrants are private companies not counted in the above figures. Consolidation and acquisitions keep the number of companies in flux, but market data show that many of the fastest growing and most successful firms in the industry are unrelated to AT&T, it's Regional Bell Operating Company progeny, or any of their subsequent spin-offs. In the long-distance, local, and equipment sectors of the telecommunications market, small, recent entrants have outpaced larger and more established firms in their rate of growth of both market capitalization and revenue.

Competition and market value. When concentrated or monopoly industries become competitive, economic theory suggests that, unless the market grows, profits decline as rival firms offer lower prices and transfer more value to consumers. What is good for customers may be viewed differently by shareholders. With competitive entry into the telecommunications market, especially in wireless service, equipment manufacturing, and long-distance service, it is likely that, without substantial growth of the market, the value of firms in the industry would decline as profits eroded and investors chose to put their money elsewhere. It is thus indicative of growth and innovation in the telecommunications market that, despite increased competition, lower prices, and increased output, the market value of public telecommunications firms since 1993 has kept pace with the soaring U.S. stock market and increased by over $800 billion -- more than doubling in size. Numerous private companies have created substantial, additional value and investment. (See chart 1.2) 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.

New infrastructure. The growth of the telecommunications industry has led to construction of more advanced infrastructure. Digital signaling in the wireline telephone network and the conversion of the wireless industry to digital technology are two examples. Expanded fiber deployment is another. FCC figures show that by the end of 1997, interexchange carriers had 3.4 million fiber miles, incumbent local telephone companies had 12.2 million miles, and competitive local exchange companies (CLECs) had 1.8 million fiber miles. Those figures represent a 13 to 16 percent increase over the previous year, but are estimates based on incomplete data. Actual fiber capacity by the end of 1998 was almost certainly much higher. Moreover, the above data do not include the 800,000 fiber miles in place by the end of 1998 in systems financed by the Rural Utilities Service of the United States Department of Agriculture, or the fiber systems installed by others such as electric utility companies or state governments.

Long-Distance Telephony

Long-distance telephone service was for decades a monopoly of AT&T. That monopoly was attacked at the margins in the 1970's and early 1980's and more fully after the Department of Justice's antitrust suit successfully opened the market by breaking-up AT&T in 1984. While AT&T's share of long-distance 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.

Since the 1980's, increasing numbers of residential and business customers have been offered subscription plans and incentive programs that lower their actual long-distance prices below the basic tariff rate. While the tariff rates -- the posted, basic prices -- fell steadily through the 1980's and then, starting in 1992, began to rise slightly, the proliferation of discount options has meant that the basic tariff rate alone does not translate into real prices. With incentive programs and low-rate plans available not only to high volume callers, but to customers whose monthly long-distance bills average as little as $10, it is extremely difficult to calculate how much particular customers are actually paying per minute of long-distance use. But one indication of real prices is the FCC's data on average revenue collected by long-distance companies per minute of usage. By this measure, effective rates have declined steadily over the last five years. Long-distance usage, meanwhile, has gone from about 370 billion minutes in 1993 to over 500 billion in 1997 (see chart__ --FCC Trends, Table 11.3). 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.

The combination of increased long-distance usage and lower long-distance prices has been driven by competition. In the past five years, numerous new firms have entered the long-distance market both as resellers and by building their own facilities. Small competitors have been most responsible for reducing AT&T's market share in recent years. According to FCC data, the numerous firms with tiny individual market shares raised their collective share by 7.5 percent -- from 12.3 to 19.8 percent of the market -- from 1992 to 1997. The small firms have become more competitively significant both as a group and individually as the FCC has, over time, acknowledged by expanding the list of firms whose individual shares are reported. Most recently, there has been addition competition in long-distance from new carriers. In some cases these new carriers are deploying significant new facilities. There has also been entry into the market by 1010-xxx "dial-around" services and substitution by consumers to the Internet for data and voice traffic. Recent data show a dip in long-distance prices that corresponds to this entry.

The substantial competitive advances in the long-distance market do not preclude benefits from further entry. In addition to the possibility of even lower rates, one of the principal benefits of additional competition could arise from more widespread offerings of bundled local and long-distance service. Most observers have concluded that such bundled offerings would be attractive to consumers -- particularly residential consumers -- and may create significant cost saving opportunities (from joint marketing, billing, etc.) for carriers that would lead to lower prices. Greater availability of such bundled offerings depends on the ability of long-distance carriers to be effective providers of local service, and on the ability of the Bell companies and other local carriers to offer long-distance service. Thus, completion of the local market-opening process required by the 1996 Act, which will enable such cross-entry to occur, can yield additional consumer benefits.

Local Telephone Service

After the 1984 divestiture of AT&T, local telephone service remained a franchise monopoly throughout the United States. The regional "baby bells" and GTE were, and remain, the largest local-service providers, with over one thousand independent companies and cooperatives serving small, primarily rural, territories. The regulatory barriers to entry into the local market were substantial and, for the most part, within the jurisdiction of state utilities commissions. A variety of justifications were advanced for local monopolies: 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 eventually 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 radically changed that regulatory environment by preempting and prohibiting regulations that protect monopolies over local telephone service. The Act thus dismantled a legal and administrative structure that had evolved over decades and replaced it with a fundamental rule: local competition must be permitted. The Act pushed this principle beyond the regulatory agencies to the incumbent local service companies themselves. It requires incumbent local companies to open their networks so that competitors can "interconnect" -- *i.e.* exchange traffic -- with incumbent networks and lease "elements" of the incumbent networks -- facilities like switches and customer lines -- that the entrant lacks.

Competitive entry since the Act has focused principally on full-service, local telephony for urban business customers, and high-speed data services to those same customers. Residential local service has seen some competitive entry, 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.

<u>Competition for local business lines</u>: Competitive local exchange companies ("CLECs")

have invested more than $20 billion and have come to employ over 50,000 workers since 1992. Many of these companies started as competitive access providers which offered business customers bypass of the local exchange and connection to the long-distance network at lower cost. Since the 1996 Act, when new entrants began to offer competing switched, local voice service, they have captured between 2 and 3 percent of business lines from the incumbents. Because competitors have focused on serving the largest and most profitable customers first, the business they have won represents about 5 percent of the market measured by revenues. Current data show local telephone revenues overall to be growing about 5 percent annually, driven by the demand for data and Internet service and for "vertical features" like voice mail and caller ID. The shares the CLECs' are gaining are thus of an expanding market.

Recent data show the publicly traded CLECs – for whom several sources collect data – to be gaining between 600,000 and 700,000 customer lines per quarter. At that rate, CLECs would have approximately half the market for local service to businesses in 10 years, assuming the current level of about 60 million business lines does not grow faster than the rate of CLEC line additions. As a benchmark, it took more than a dozen years after the 1984 divestiture for long-distance competitors to reduce AT&T's share of market revenues below 50 percent, and AT&T's share of presubscribed lines and access minutes remained well above that level at the end of 1996, the latest date for which the FCC has published statistics.

The majority of competition -- more than 70 percent of lines served by CLECs -- is still through resale of the incumbents' services or though combination of the ILEC's unbundled network elements with the CLECs' own facilities. Competition by new entrants serving customers wholly on their own networks -- "facilities-based" competition -- accounts for the remainder. However, it is estimated that more than one third of the lines added by the CLECs in the third quarter of 1998 were on the CLECs' own networks. This very slightly raised the proportion of total CLEC lines that are independent of the ILECs' facilities to 27 percent, and suggests that competition for business lines is becoming increasingly facilities-based. The trend away from resale and towards competing facilities is also documented by the

Telecommunications Resellers Association, which reports that, from 1995 to 1998, the proportion of its members that owned or leased facilities (as opposed to competing through pure resale) increased from 34 percent to 54 percent. As new entrants continue to build out their networks and to add on-net lines at a higher rate, the shift to facilities-based service will accelerate.

Several sources of data show the CLECs to be building out their fiber networks at a fast clip, although the data are sketchy and incomplete. Merrill Lynch estimates from its survey of public CLECs that those companies added over 40,000 route miles of fiber to their networks in each of the first three quarters of 1998, and that the rate of deployment was increasing through that period. FCC data similarly show fiber deployment by CLECs growing rapidly from 1990 to 1997, with particularly rapid deployment from 1994 to 1997. (FCC Fiber Deployment Update, 9/4/98, Table 14).

The marketplace clearly anticipates that local competitors will flourish. Although CLECs are still in the early stages of accumulating market share, and only one has so far posted a profit, they have created nearly 20 percent of the growth in local telecommunications market value since 1993. The market capitalization of CLECs has gone from almost nothing to about $30 billion (not counting Worldcom) since 1993. (See Chart ____). The value of the numerous privately held CLECs is not captured by the above figure, and there are at least ___ such companies in the current market. Moreover, CLECs are plying there trade in all of the top 100 urban markets in the United States and in many smaller centers as well.

Employment by competitive local service companies has grown dramatically since the 1996 Act. Data from 23 local entrants that voluntarily reported employment figures to the Association for Local Telephone Services ("ALTS") show employment increasing by over 100 percent in 1998 alone -- from roughly 9000 jobs in January 1998 to over 18,000 jobs at year's end in the sample companies alone. The ALTS sample did not include employment data for large companies like MCIWorldcom or AT&T that have entered the local market, nor does it account for the vast bulk of CLECs.

Data CLECs. A developing 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 customer lines ("loops") and space in the incumbents' switching centers ("collocation" space) in order to offer customers digital subscriber line (DSL) service, primarily for high-speed access to the Internet. DSL technology uses special modems to transmit digital information over existing copper lines. Most of the data CLECs are still small, privately held companies. Although there is little available data on DSL deployment, it is estimated that only about 30,000 lines are so far being served. By comparison, about ten times that number of customers receive broadband service from cable companies over "cable modems." But competition in data services over the telephone network shows promise. Data CLECs have invested hundreds of millions of dollars in facilities, pushed DSL prices down, and created thousands of new jobs in the services and manufacturing sectors. Several competitive DSL providers have entered multiple markets in which they compete against each other, the ILECs, and cable modem providers. For example, intense competition among broadband providers in the San Francisco area have recently pushed DSL service prices down to about $40 per month.

Competition in DSL service faces several challenges. First, DSL suffers from certain technological impediments. Transmission via DSL is generally most effective for customers located a short distance, for example about three miles, from the central switching office. Performance of DSL transmission declines with loop length, but varies also with condition of the loop and the quality of equipment attached to the loop. Technological advances are starting to provide improvements, but for now DSL remains an option primarily in densely populated areas where loops are short.

A second challenge for DSL CLECs is obtaining collocation space in the incumbents' central offices, where customer lines are connected to the switch. As more competitors have entered the market and sought collocation in central offices serving the most desirable regions, entrants have reported difficulty in negotiating collocation arrangements. Collocation at remote terminals outside of central offices, which is necessary to serve customers who do not have a direct copper line to the central office, is another unresolved problem for CLECs. DSL providers, like other CLECs, thus face a challenge in getting collocation everywhere they need it, and therefore in gaining access to some customers lines they want to compete for. A third challenge, and one the FCC is currently addressing, is that incumbent local service providers both offer DSL service themselves and control inputs -- notably loops and collocation space -- needed by their DSL competitors. For competition to survive, the DSL CLECs should be able to purchase inputs from the ILECs on non-discriminatory terms. **[Footnote here on NTIA's 706 filing]** The DSL market is growing and, if the above challenges can be met, DSL CLECs could grow into a substantial competitive presence in a greater number of markets than is the case today.

Competition for residential lines. Competition in the provision of local telecommunications services to residential customers has proceeded more slowly and tentatively than competition to serve business customers. Comptel, an industry association representing CLECs, recently surveyed its members about local competition. Twelve of seventeen respondents reported providing residential service in at least one state. The United States Telephone Association, the industry association for incumbent local carriers, reports that about 1.3 million residential lines are being resold by CLECs. [ADD STUFF FROM FCC LOCAL COMP. REPORT].

Resale remains the primary means by which CLECs are serving residential customers. The Telecommunications Resellers Association represents numerous competitors, 175 of whom provide local phone services through a combination of resale and deployment of their own facilities. Of the customers served by TRA's members, 21 percent are reported to be residential. And 94 percent of the residential business is through pure resale rather than through use of facilities that the CLECs either own or lease from the incumbent.

There are several possible explanations for why competition in residential local service has been slow to develop. Some place the blame on the incumbent carriers for not meeting the local competition requirements of the 1996 Act. But, while the Act should be firmly enforced where non-compliance is demonstrated, the pace of residential competition is strongly affected by underlying economic factors. The economics of local service -- with its regulated rates, universal service requirements, and lower sales of profitable, vertical services -- arguably do not make pursuit of the average residential customer as interesting a business prospect when there is lower-hanging fruit in the business market. A reflection of the relative desirability of business customers is that the switching centers in which CLECs have collocation arrangements serve 44 percent of ILEC business lines, but only 25 percent of residential lines. Moreover, those switching centers serve 57 percent of the incumbents' high-capacity lines, which are connected to the largest and most profitable business and government customers.

Regulation keeps rates for residential local service low – the average bill is about $20 per month according to recent FCC figures. Regulation also keeps rates for long, costly, rural loops in line with rates for much shorter, less costly urban loops. Urban loops may cost as few dollars per month to operate, whereas rural loops may cost $100. Entrants leasing loops at cost-based prices thus have an obvious incentive to choose the less-costly urban lines, which also happen to be more likely to serve lucrative business customers. The FCC and state regulators are moving quickly to restructure the current system of implicit subsidies for telephone service in such a way that serving residential customers will become more attractive for competitors. But until subsidies for residential and rural rates are made explicit, entry incentives will be skewed.

The residential market remains an area in which competition needs to develop further to meet the goals of the 1996 Act. But local competition developments so far are not necessarily as dire as often portrayed. History indicates that roll-out takes time and generally starts, for sound economic reasons, with higher-revenue customers. The construction of the original 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's entry into the long-distance market similarly started with private business service, went to public business service, and eventually to residential offerings. The aggressive entry by CLECs into the business market, and their construction of facilities for both voice and data, are likely to have benefits for residential customers. For example, CLECs that have been constructing urban fiber networks pass not only business, but apartment houses as well. Once the infrastructure is in place, serving residential customers in "multiple dwelling units" becomes easy and entails only incremental cost. As the most profitable customers fund the investment necessary for effective entry into the local market, competitors will be able to offer services to an increasing range of customers on which they earn less return.

Because of the long institutional history of local monopoly and the economic complexity of entry into the local residential market, the uneven development of competition does not in itself show that the 1996 Act's local competition provisions are a failure or should be changed. Indeed, the developments in the business market suggest otherwise. To ensure that the potential for residential benefits is realized, continued and firm enforcement of the Act's proven principles seems to be the course better supported by the economic evidence. And now that litigation against the FCC's implementation of the Act's local competition provisions has for the most part concluded, in favor of the Commission, operation of those provisions is likely to bring additional competition to local markets.

Wireless Telephony

The wireless telephone industry has experienced growth in the past 5 years that can only be described as stunning. This growth is the direct result of policies that set the stage for increased competition in the wireless market and fostered investment in advanced digital technology. The FCC assigned the first licenses for cellular telephone usage of certain spectrums of airwave frequencies in 1983, introducing competition by implementing 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 June 1985, cellular companies altogether had just over 200,000 subscribers, 600 "cell sites" (each site contains the transmission equipment that serves a local cell), and 1700 employees. In June 1995, subscribership had climbed to 28 million, a total of 20,000 cell sites were operative, and the number of people employed by wireless service companies was 61,000.

In 1995, as authorized by the President and Congress in the Omnibus Budget Reconciliation Act of 1993, the FCC held the first auctions for broadband spectrum to be used for digital "personal communications services" (PCS), creating new wireless licensees in U.S. markets. As the successful bidders entered the market, and as subsequent licenses were auctioned, the duopoly market structure gave way to full-fledged competition among multiple 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. The average monthly bill for wireless telephone service fell by half, probably reflecting both declining prices and changes in average monthly usage as more individual, as opposed to business, customers subscribed to wireless service.

- Today, 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, as well as increased investment in new technology, has caused prices to plummet while increasing the variety of available calling plans. Though reliable data on revenues per minute are inaccessible, existing price and billing data indicate that wireless telephony is becoming ever more affordable. One study finds that in 1997, median prices per minute -- what the typical user pays -- fell as much as 30 percent to 40 percent for residential users and 30 percent to 50 percent for business users, thanks primarily to new PCS competition. 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.

- Wireless telephony (cellular, PCS, and ESMR) is now a nearly $30 billion industry, as measured by service revenues, growing an 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 traditional (wireline) telephone service, and may do so increasingly in the future as technology improves, competition and subscribership increase, and prices fall. Pricing became even more competitive in the second half of 1998. Wireless companies have excess capacity on their digital networks and have been able to offer package deals that provide a maximum number of minutes -- whether local or long-distance, and from anywhere in the country -- for a fixed price. Prices for these packages have fallen as low as $50 for 500 "anytime, anywhere" minutes, making them feasible alternatives to wireline for some users, particularly those who desire a second line from home.

In addition to the main wireless telephone technologies of cellular, PCS, and ESMR discussed above, wireless communications also encompass such services as paging, SMR, and fixed point-to-point, as well as such new services as fixed wireless local loop and Third Generation mobile that could have a profound effect on growth and competition in telecommunications.

Further challenges remain for the wireless industry. As Americans increasingly demand information services and mobile access to those services, data traffic will become an increasing component of wireless telephony. As wireless use grows and services expand, technologies to manage increased traffic demands will need to be developed. But the success of the industry so far in innovating and growing to the benefit of American consumers leaves little doubt that wireless communications will be a central and growing part of telecommunications into the future.

Telecommunications Equipment

The telecommunications equipment industry in the U.S. has grown substantially. Total production in 1997 topped $60 billion, a growth of $____ since 1993. New service markets created by wireless auctions, the 1996 Act, and the Internet have in turn created a large demand for innovative telecommunications equipment. The many new entrants into the field, some of whom have become very large, have created thousands of jobs (see chart ___), 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.

[PARAGRAPH ON SHIFT TO HIGHER VALUE-ADDED OUTPUT]

[PARAGRAPH ON DYNAMICS OF INNOVATION AND COMPETITION]

There are now well over 100 publicly traded companies that list telecommunications equipment as their primary line of business. Nearly 50 additional public companies list their primary line of business as data networking equipment. The joint market capitalization of traditional telecommunications equipment manufacturers and data networking equipment makers has more than tripled since 1993. (See chart ___). Again, numerous private companies add economic value that is not captured by the market capitalization data. The telecommunications equipment market as a whole is responsible for about one third of the value created in the telecommunications market in recent years, with data networking equipment companies growing faster than traditional equipment companies since 1994.

The telecommunications equipment industry will play a crucial role in solving the myriad technical problems faced by new service providers, whether they be cable systems, DSL CLECs, or full service CLECs seeking to build out their proprietary facilities. The equipment industry in the United States also faces substantial global competition, particularly in the area of mobile communications, and U.S. policy is working through appropriate channels to prevent harm to American manufacturers from the technical standards adopted in various international markets.

The Internet

The pace of technological advance, the importance of forward-looking infrastructure, and the growing desire for information are all manifest in the rapid growth of the Internet and its associated industries. This relatively young sector of the U.S. economy has been boosted by the successful confluence of government policy, private investment and innovation, and the public interest. Regulatory forbearance and policies to encourage usage, as well as continuing investment in the National Information Infrastructure has made possible unprecedented growth in both the development and adoption of this communications medium. For example, the Administration has successfully opposed taxation on Internet usage: the Internet Tax Freedom Act creates a 3-year moratorium on taxation of Internet access and e-commerce, and the World Trade Organization has agreed to place a moratorium on duties on electronic transmission. Furthermore, the Next Generation Internet Research Act authorizes an initiative to connect universities with the Internet at unprecedented speeds and to support long-term research on Internet technologies.

From its origins in a government-sponsored research project decades ago, the Internet has evolved into a global network that connects individuals, businesses, and institutions of all kinds. Propelled by increasing computing power at ever-falling prices, the transmission of data from computer to computer, from user to user, has become ever more useful and cost-effective. Indeed, the digitization of information has blurred the lines between data, video, and voice, with 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. [New Economy Index, p.19] The cost of processing one million instructions per second (MIPS) was $480 in 1978. By 1995 that figure had tumbled to $4 per mips. An the cost of information processing continues to plummet, increasing the capability of the information industry and expanding the demand for information services.

No amount of technological innovation, however, could have made the recent growth trajectory of the Internet possible without the grid of telephone lines, cables, optic fibers, and routing equipment that forms the "backbone" of the national telecommunications infrastructure. The increasing public demand for -- and provision of --- fast and ready information has driven this "backbone" industry, motivating tremendous private investment and market capitalization as well as job creation. The growing demand for carrying capacity, or "bandwidth," has pushed the roll-out of yet more physical equipment and wiring, as well as the deployment of such technologies as cable modems, ISDN lines, symmetric and asymmetric digital subscriber lines (xDSL services), and new methods of digital compression.

Investment in high-capacity fiber by telecommunications systems has also grown rapidly to meet new infrastructure demands. The number of "fiber miles," calculated by multiplying the number of miles of sheathed fiber times the number of fibers in the sheathed bundle, is a good measure of system capacity. As mentioned previously, the number of such fiber miles constructed by telecommunications carriers in the United States grew by 13 to 16 percent in 1997 according to FCC estimates. On the consumer end, increasing numbers of American households are purchasing second telephone lines. Although some of these lines are probably used mostly for voice service, many are undoubtedly used for dedicated data lines. The number of households with second lines grew from 8.8 million in 1993 (9.4 percent of residences) to 15.7 million in 1996 (16.5 percent of residences). **GET MOST RECENT FIGURES]** Although more recent data has not yet been published by the FCC, those numbers have most likely grown sharply in the past two years with soaring Internet access by American consumers. Co-axial cable used by cable television systems, which increasingly now offer Internet access, are another major source of information infrastructure that will be important for bringing broadband access to residential customers.

The equipment industry has also been driven by the need for more advanced information transport. The number of companies manufacturing data networking equipment has soared in recent years. A recent list of public companies primarily engaged in data network manufacturing counted 46 such entities. These companies are developing the innovative equipment for broadband transmission and routing of digital material -- whether voice, video, or data -- that innovative service providers are using to construct their networks that link users to information on the Internet and other sources.

And such advanced links are increasing in demand. Altogether, nearly 30 million Internet "hosts" -- computers that store sources of information on the Internet -- 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 Japan, Germany, and the United Kingdom in public participation in the Internet, as measured by the number of hosts per capita. Only

Finland has a higher concentration than the U.S. 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 for every 20 people -- and about 1 Internet host for every 4 American adults that use the Internet. Just in the two years between 1995 and 1997, adult Internet users in the United States grew from about 14 million [NEW ECON] to over 41 million [NEW ECON], or about one in five adults. This year, nearly one in three American adults is expected to be "online." A recent Pew survey finds that the total number of American users today is over 70 million [PEW], indicating the medium is an important one for Americans of all ages.

Recent data also show that Internet use is reaching a broader spectrum of society. In 1995 the average household income of an Internet user was about $50,000. By 1997 that figure had fallen to about $ 40,000. A recent Pew Center survey shows that the fastest growing groups of new Internet users are those with much lower income and educational levels than in the past. As use expands to all economic segments of society, so too will the types of services and uses available through the Internet.

Challenges nonetheless remain. There is evidence of a "digital divide" whereby some racial and ethnic groups in the United States use the Internet disproportionately less than others. The spread of Internet to people with lower average incomes indicates that the cause of the divide is not purely economic. It may stem from decreased familiarity with the medium due to lack of access or exposure in the community. The "e-rate" program for wiring schools and public libraries, created under the Telecommunications Act of 1996, will be an important means of bridging the digital divide and ensuring that access to information is not the province of some Americans more than others. To date, the e-rate program has disbursed over $1.9 billion to connect up to 40,000 American public schools and 7,000 libraries to the Internet. [Classroom access still lags however, at ___%. DO WE HAVE THIS?] As that number grows with continued implementation and refinement of universal services policy, an increasing spectrum of young Americans will grow up with the skills to participate in an increasingly technological and information-driven economy.

The broad reach of the Internet has made it suitable for an increasing variety of applications. "Distance learning" and telemedicine, for example, are already flourishing. Many businesses see a future in online transactions, or "e-commerce." The volume of retail sales over the Internet passed $10 billion dollars in 1998 and is forecast to reach $300 billion by 2002. 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, community news, health resources, or scientific research. The telecommunications system is the foundation upon which these possibilities will develop.

Future Challenges

[SECTION IN PROGRESS]

- 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.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-FEB-1999 08:43:39.00

SUBJECT: FYI from Elmendorf- 1 of 2

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

TEXT:
---------------------- Forwarded by Alice H. Williams/CEA/EOP on 02/01/99
08:43 AM ---------------------------

Peter A. Weissman

01/31/99 07:05:43 PM
Record Type: Record

To: See the distribution list at the bottom of this message
cc: Sandra Yamin/OMB/EOP, Ophelia D. West/OMB/EOP
Subject: FYI from Elmendorf- 1 of 2

David Wilcox- can you please get this to appropriate folks at Treasury?
Alice Williams- can you please get this to Dr. Yellen?

thanks
Pete 6-2807

Message Sent
To:____
Douglas W. Elmendorf/CEA/EOP
Melissa G. Green/OPD/EOP
Jonathan Orszag/OPD/EOP
Jeff B. Liebman/OPD/EOP
Alice H. Williams/CEA/EOP
DAVID.WILCOX @ MS01.DO.treas.sprint.com@INET@LNGTWY
Barbara Chow/OMB/EOP
Jack A. Smalligan/OMB/EOP
stephen.c.goss @ ssa.gov @ inet
belsgoss @ connext.net @ inet
Joseph J. Minarik/OMB/EOP

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

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D69]MAIL45616723G.036 to ASCII,
The following is a HEX DUMP:

TOUGH Q&A'S ON FISCAL DISCIPLINE
revised 1/31/99

Q: Aren't you double-obligating or double-counting the same money?

A:

- Since 1983, the Social Security trust fund has experienced a growing excess of annual receipts over expenditures. This excess is used each year to purchase special Treasury securities. The resulting buildup in the trust fund is the intended result of the 1983 reforms, which set out to build up a large reserve before the baby boom retires.

- At the same time, the difference between Social Security receipts and expenditures represents an extra inflow of cash each year, which contributes to the unified budget surplus.

- The critical problem during the 1980s and the early 1990s was that Government simply spent those funds on current needs. This did nothing to ensure that we could pay off those securities in the future without huge spending cuts, tax increases, or borrowing more money.

- Hard-won fiscal discipline during the past 6 years means that the government can pay back bonds in the trust fund and still run surpluses.

- The question now is whether to use the current unified budget surplus to finance our existing commitment to pay future Social Security and Medicare benefits further into the future. The President's plan would channel almost $3 trillion into debt reduction, and would lock in some of the gains from this fiscal discipline to pay Social Security benefits until 2055 and Medicare benefits until 2020.

Q: How will the government meet its new obligations to Social Security and Medicare?

A:

- The President's plan does not create new obligations of the government. We always expected to pay Social Security benefits beyond 2032 and Medicare benefits beyond 2008. The President's plan just sets aside the resources to make that possible.

- The President's plan would generate a dramatic decline in the national debt. By 2006, the debt-to-GDP ratio would be below its level in 1980; by 2014, it would be about 7%, below its level when the U.S. entered World War I in 1917; by 2017, it would be below 0. In absolute nominal terms, the debt held by the public in 2014 would be only 30 percent of its current value.

- By buying back such a large amount of debt, the government would substantially boost national saving and national wealth. Compared to a policy of spending the surpluses, government saving would average about 2% more of GDP from 2000 through 2014. The USA accounts would boost saving even more. In 1992 net national saving was 3.1% of GDP; in the first three quarters of 1998, it was 6.7%, a doubling that was more than accounted for by the increase in Federal government saving. Thus, a 2% of GDP difference is quite substantial, and if sustained for 15 years would produce a large increase in national wealth.

- If the unified budget surpluses were not dedicated to Social Security and Medicare, it would be very difficult to sustain them for 15 years. Thus, the economic benefits of debt reduction are closely linked to the President's decision to commit some of these benefits to Social Security and Medicare.

- Even if one focuses on the non-Social Security part of the budget, and ignores the unfunded liability of the Social Security trust fund, the President's plan is very fiscally responsible. The extra debt held by the trust fund raises the debt service costs of the on-budget government, but reduced debt service to the public offsets 3/4 of that cost in 2014. (It does not offset all of the cost because debt held by the public does not decline as rapidly as debt held by the trust fund increases. This differential is an artifact of the way that intergovernmental interest payments are scored.) The increase in national wealth would also increase national income and therefore tax revenue. Crude estimates suggest that this could offset another 15% of the increased interest payments to the trust funds in 2014.

- Under the President's plan, we project on-budget surpluses for decades to come.

Q: Won't the government have to cut spending, raise taxes or borrow more in the future to pay for the extension of Social Security benefits to 2055 and Medicare benefits to 2020?

A:

- No. Our projections show that if we simply maintain current tax rules, we will be running surpluses until the middle of the next century even after paying Social Security and Medicare benefits.

- By setting aside funds now, the President's plan produces the resources to pay Social Security and Medicare benefits in the future. It does this in four ways:

    - First, by investing some the surplus in equities, the plan builds up real assets that can be sold when the time comes to pay benefits.

- Second, by reducing the ratio of publicly-held debt to GDP from 44 percent to 7 percent, the plan reduces debt servicing costs -- leaving more resources available for other purposes, including paying Social Security and Medicare benefits.

- Third, by paying down debt, we increase capital formation. The resulting increase in the capital stock raises workers' productivity and national income. These additional real resources will increase the future standard of living, and make it easier for society to pay Social Security and Medicare benefits in the future.

- Fourth, by nearly eliminating the national debt by 2014, the plan leaves us in a position to do a limited amount of additional borrowing, if necessary, without threatening economic prosperity.

Q: How does paying down the debt help us to pay Social Security benefits in the future?

A:

- First, a little history. The 1983 Social Security reform act aimed to prepare the nation to meet its future commitment to Social Security recipients by having the system collect more revenue than it paid in benefits for a couple of decades. These extra funds were supposed to be used to put the country on a fiscal trajectory to be able to pay back the Social Security trust fund when the trust fund needed to redeem its bonds.

- Unfortunately, irresponsible fiscal policy in the 1980s and early 1990s squandered these Social Security surpluses. By the time President Clinton took office in 1993, large deficits were forecast as far as the eye could see, and there were serious doubts about how the country would be able to pay back what it owed to Social Security,.

- Six years of tough choices and fiscal discipline have turned things around. Because of the 1993 budget act, disciplined appropriations, and the 1997 budget agreement, we are now projecting large surpluses well into the next century, even after paying back every penny we owe to Social Security.

- The President believes we should go even further, buying down around $3 trillion in debt and allocating these savings to ensure that Social Security is secure until 2055 and that Medicare is secure until 2020.

- By setting aside funds now, the President's plan produces the resources to pay back

Social Security in the future. It does this in four ways: [SUMMARIZED ABOVE]

Q: Why not just pay down the debt without incurring extra obligations?

A:

- The President's plan does not create new obligations of the government. We always expected to pay Social Security benefits beyond 2032 and Medicare benefits beyond 2008. The President's plan just sets aside the resources to make that possible.

- Some people would simply take Social Security out of the budget and pay down $2.7 trillion of debt without extending the life of the Social Security or Medicare trust funds by a single year. Then they would debate only how much of the remaining surplus would go to tax cuts, military and other spending, and individual accounts.

- If this approach truly managed to keep the Social Security surpluses from being spent, and thereby left them for debt reduction, then this approach would put the country in a better fiscal situation, just as the President's plan does. However, this approach would leave open the allocation of the large future surpluses for various forms of spending and large tax cuts.

- We believe that we should take advantage of today's prosperity to prepare for the aging of America, and therefore that we should lock in much of the benefits of an improved fiscal outlook for Social Security and Medicare.

Q: You said that debt held by the public falls under the President's plan, but since the government is giving additional bonds to the trust funds, doesn't the government's total indebtedness stay the same?

A:

- No, that is not the right way to think about the economic impact of the President's plan.

- Debt held by the public is the most important measure of government indebtedness because it tells us the extent to which government borrowing crowds out private capital formation. Under the President's plan, the ratio of debt held by the public to GDP will fall from 44 percent today to 7 percent in 2014 -- the lowest level since 1917. This will unleash a tremendous amount of new private sector investment and will make the government much more able to meet our commitment to Social Security and Medicare recipients in the future.

- The President's plan essentially gives Social Security and Medicare a "first call" on the gains from reducing debt. We think it makes perfect sense to allocate part of the gains from our fiscally responsible policies to extending the lives of the Social Security and Medicare trust funds.

- In any event, a more comprehensive measure of the government's future obligations would include promised Social Security and Medicare benefits. The excess of those benefits over expected revenues is an unfunded liability comparable in some respects to the explicit national debt.

- The President's plan does not increase promised benefits by one dollar. Instead, it finances the existing commitment to pay benefits by paying down publicly-held debt and directing some of the benefits if that debt reduction to the Social Security and Medicare trust funds.

Q: A column in last week's *Newsweek* argues that the President's budget allocates 150 percent of the budget surplus. Is that true?

A:

- No, it is not. The President's plan allocates 100 percent of the unified budget surplus. In focusing on the unified budget surplus, we are doing exactly what every President since Lyndon Johnson has done in formulating budget policy.

- The fundamental budget policy choice we are facing is how to allocate $4.5 trillion in surpluses over the next 15 years among debt reduction, new spending, and tax cuts. The President's plan allocates the bulk of these surpluses to debt reduction, and gives Social Security and Medicare claims on the wealth created by our current fiscal discipline.

- Under the *Newsweek* type of accounting, every budget in the last 30 years would be guilty of "double counting" or spending more than 100 percent of the surplus. The crucial difference is that during the 1980s and early 1990s, the extra inflows from Social Security were spent on current needs. Under the President's plan, they would be dedicated to debt reduction, which would strengthen our economy for the future.

Q: Isn't this plan based entirely on double counting of money that is already dedicated to Social Security?

A:

- This is not the right way to think about the economic impact of the President's plan.

- Currently, the government as a whole is running a surplus -- it is bringing in more in revenue than it is paying out. The fundamental question for our budget policy is what to do with the excess.

- The President is proposing that most of the excess be set aside to pay for future retirement and health needs stemming from the aging of America. This will add to national savings and improve the country's wealth -- in contrast to the effect of plans that propose to use the surplus for tax cuts or immediate spending needs.

- The President's plan allocates the unified budget surplus to different uses, just as every budget has done for the last 30 years. The funds the President is setting aside for Social Security and Medicare are real and would presumably go to tax cuts or new spending if they were not set aside for debt reduction. This is the first time a President has called for some of the surplus to be set aside for debt reduction.

- We believe that it is sensible to allocate some of the benefits of fiscal responsibility to Social Security and Medicare. In addition, by allocating the gains from debt reduction to Social Security and Medicare it locks away the surpluses and prevents them from being squandered on tax cuts or new spending.

Q: What will happen when the trust funds redeem assets to pay benefits?

A:

- When Social Security revenue from the payroll tax and the taxation of benefits falls short of what is needed to pay benefits (around 2013), the Social Security trust fund will start redeeming assets.

- Some of these assets will be stocks that it can simply sell without having to find other financing.

- The rest of the assets will be government bonds. Redeeming these bonds means that Social Security gets money to pay benefits from the general fund of the government. Thus the government must come up with the cash for Social Security.

    - If the government is running a unified budget surplus at the time, it can simply use the surplus to pay off the bonds. This will reduce the surpluses available to pay for other things. Under our current projections, we will be running surpluses <u>even after paying back Social Security</u> well into the next century.

    - Otherwise, the government has three standard choices for how to obtain the cash for Social Security -- it can issue debt, raise taxes, or reduce other spending.

- The ratio of debt held by the public to GDP is projected to be close to zero at the time when we start paying back Social Security. Thus we could issue debt to pay back Social Security and still keep debt-to-GDP ratios below those that we have today. (This is also why it doesn't help to have the trust fund buy even more equities today--even leaving aside questions of risk and equity market involvement. Such a strategy would reduce the need to issue debt in the future, but only because it would leave even more debt today.)

- Moreover, after we make the tough, bipartisan choices to extend the system for 75 years we will likely have closed the gap between taxes and spending in the period before 2055.

STRENGTHENING SOCIAL SECURITY AND MEDICARE BY PRESERVING FISCAL DISCIPLINE

BEFORE 1993: **A Surge in Deficits and Debt Left the Country in Poor Fiscal Shape to Meet Future Social Security Obligations.**

Before President Clinton took office, CBO projected that the budget deficit would increase from $290 billion in 1992 to over $600 billion in 2003 and would keep growing after that. Publicly-held debt had jumped from 26 percent of GDP in 1981 to 50 percent in 1993, and it was expected to rise much further. At the same time, the country had a commitment to pay future Social Security benefits so that people could enjoy secure retirements. Yet, with persistent, massive deficits, there were serious doubts about how the country could meet that commitment without boosting taxes, cutting benefits, or raising debt to levels that would threaten our economic health.

1993 TO 1998: **Tough Choices and Fiscal Responsibility Put Government on Course to Meet Social Security Obligations And Still Run Surpluses.**

The President's 1993 economic plan and the bipartisan balanced budget agreement of 1997 put the country on a path of prosperity and fiscal responsibility. In 1998 the surplus was $70 billion, and the mid-session outlook from both OMB and CBO projected substantial surpluses for decades to come. By turning the government's budget situation around, we have now created the financial capacity to meet our obligations to Social Security. In contrast to the outlook before 1993, we will be able to pay back bonds in the Social Security trust fund and still run surpluses.

BEYOND 1998: **President Clinton Proposes to Pay Down 2.9 Trillion Dollars of Debt and Allocate Most of the Savings to Social Security and Medicare.**

We face a fundamental choice about how to allocate the $4.5 trillion in projected surpluses over the next 15 years among spending, tax cuts, and debt reduction. The President's plan focuses on debt reduction while giving Social Security and Medicare a "first call" on the gains from reducing debt -- essentially, the plan creates a "debt-reduction lockbox" for these programs.

The dramatic decline in national debt would increase private capital investment, raise future national income, and free up government resources by reducing debt servicing costs. Some of the gains from this fiscal discipline would be locked in to finance our *existing* commitment to pay future Social Security and Medicare benefits. By not increasing that commitment -- but setting aside the resources to meet it -- we extend the solvency of the Social Security trust fund until 2055 and the Medicare trust fund until 2020. Because of the proposal's fiscal discipline, the government could meet all of our obligations to these programs while running surpluses for decades to come. On the other hand, if we devoted these surpluses to tax cuts or spending, we would not reap the economic benefits of debt reduction or extend the solvency of the trust funds, and we would endanger our ability to meet our existing obligations to the funds.

WHY DEBT REDUCTION IS IMPORTANT

The Plan Will Reduce the Nation's Publicly-Held Debt and Increase National Saving.

Between 1981 and 1993 our publicly-held debt rose from 26 percent to 50 percent of GDP. That trend has now been reversed, and debt has dropped to 44 percent of GDP. Under President Clinton's plan the runup in the debt-to-GDP ratio during the 1980s will be completely reversed by 2006, and by 2014 the publicly-held debt will only be 7 percent of GDP. This will be the lowest level of debt relative to GDP since 1917. National saving has increased from 3.1 percent of GDP when President Clinton took office to 6.7 percent today. By setting aside the surpluses rather than spending them, the extra government saving will raise national saving by about 2 percent of GDP over the next 15 years (leaving aside any private sector response). The USA accounts will add even further to national saving.

Debt Reduction Improves Our Nation's Ability to Meet the Existing Obligations of Social Security and Medicare.

Paying off debt means that the government owes less money to private individuals. Thus, it improves the government's financial position.

- **Paying Off Debt Generates New Capital Formation.** Paying off debt allows private savings to go into productive private investments rather than into government borrowing. The resulting increase in the capital stock raises workers' productivity and national income. These additional real resources will increase Americans' future standard of living, and make it easier to pay back the trust funds when they redeem bonds.

- **Paying Off Debt Reduces Debt Servicing Costs**. Paying off debt increases future budget surpluses and frees up additional resources for other uses, including meeting the obligations of Social Security and Medicare.

- **Paying Off Debt Gives the Government the Flexibility to Respond to Future Conditions.** Paying off debt now allows the government to issue new debt if necessary -- for example, if there was a transition period before Social Security's revenues and benefits were in line -- without threatening future economic performance, and while keeping the debt-to-GDP ratio below its current level.

The Rest of the President's Proposal Invests in the Future As Well.

In addition to strengthening Social Security and Medicare, the President's proposal provides USA accounts to help Americans build the wealth they will need to finance longer lifespans. The plan also makes important investments in military readiness and pressing national priorities that will enable the country to continue to be strong and prosperous.

ALTERNATIVES TO THE PRESIDENT'S APPROACH

Cut Taxes.

If we allocated most of the unified budget surplus to tax cuts, we would not lower our debt, increase our saving, or extend the life of the Social Security or Medicare trust funds. Moreover, we would jeopardize our ability to meet our obligations to Social Security between now and 2032. While the President commits the surplus for only 15 years, any allotment for tax cuts would be permanent, making it even harder for future lawmakers to meet the coming demographic challenges.

Increase Spending.

Some smart, targeted spending can improve the nation's productivity and create more resources in the future when the time comes to meet the obligations of Social Security and Medicare. But spending the entire surpluses would have similar consequences to reckless tax cuts -- we would not lower our debt, increase our saving, or extend the life of the trust funds, and we would jeopardize our ability to meet our existing obligations to Social Security.

Take Social Security Out of the Budget and Divide the Remaining Surplus Among Tax Cuts, Military Spending, and Individual Accounts.

Some people would simply take Social Security out of the budget and pay down $2.7 trillion of debt. Then they would battle over only how much of the remaining surplus would go to tax cuts, military spending, and individual accounts. This approach would not extend the life of the Social Security or Medicare trust funds by a single year, because it would not allocate any of the benefits of debt reduction to these programs. Social Security would then be able to pay only 72 cents per dollar of promised benefits after 2032. This approach would put the country in a better fiscal situation, just as the President's plan does, but it would leave open the allocation of the large future surpluses for various forms of spending and large tax cuts. In contrast, the President proposes to lock in much of the benefits of an improved fiscal outlook for Social Security and Medicare.

PRAISE FOR THE PRESIDENT'S DEBT-REDUCTION PLAN

The President's basic approach of paying down the debt to strengthen Social Security and Medicare has drawn support from experts including Alan Greenspan, Robert Reischauer, Henry Aaron, and Robert Greenstein.

Need to add quotes here ...

How Can We Meet Our New Obligations to Social Security and Medicare?
January 31, 1998

Best Answer: **We don't really have any new obligations, because we always expected to pay Social Security benefits beyond 2032 and Medicare benefits beyond 2008.**

- This is the best answer because the other rely on the advantages of debt reduction, which we could do (in principle) without giving new bonds to SS and M.

- This focuses on the obligations of the unified government: debt held by the public and promised future benefits.

<u>Wrong</u> Answer: **The increase in debt held by the trust funds is exactly matched by a decrease in debt held by the public.**

- This answer focuses on the obligations of the on-budget government: debt held by the public and debt held by the trust funds.

- The plan swaps public debt and trust fund debt dollar-for-dollar in the initial transfers, but because interest on the transferred debt does not reduce the surplus, the cumulated increase in trust fund debt is much larger than the cumulated drop in public debt.

- The top of the next page has an example: under the plan, debt held by the public falls by $205 but debt held by the trust fund rises by $210.

- By 2014, the President's plan reduces debt held by the public (compared to a "spend the surpluses baseline") by about 2/3 the increase in trust fund debt.

- The example also shows an alternative scoring of interest which would be equivalent to taking the transferred amounts "out of the budget." This approach would have reduced the available net surpluses by about $750 billion over 5 years. (For comparison, not imputing a return to equities would have reduced the available net surpluses by about $150 billion.)

debt held by public (start of yr)	primary surplus	net interest	change in debt	principal transfer	interest transfer	surplus	trust fund balance
BASELINE							
1000	150	50	100				
900	150	45	105				
795							
PLAN							
1000	150	50	100	100		0	100
900	150	45	105	105		0	210
795							
ALT. SCORING							
1000	150	50	100	100		0	100
900	150	45	105	100	5	0	205
795							

Another Answer: **The reduction in debt held by the public increases national saving and national wealth.**

- This effect is linked to the transfers to Social Security and Medicare by arguing that without those transfers, the surpluses would be spent.

- Compared to a policy of spending the surpluses, the unified budget surpluses--government saving--would average 1.8% of GDP more from 2000 through 2014. (This ignores the transfers and equity purchases in calculating the surpluses.) By 2014, extra national wealth would represent between half and all of the increased debt held by the trust funds. The USA accounts would add even more to national saving.

- One simple assumption is that each dollar of debt reduction adds one dollar to private capital owned by Americans and thus to national wealth. In contrast, CBO has assumed only 50-80 cents of extra national wealth because private saving falls as government saving rises. (This range from the January 1997 *Economic and Budget Outlook* apparently differs little from the results of their long-range model.) Private saving might fall under the President's plan because: a) people have greater confidence that they'll receive SS and M benefits; b) people are less worried about huge tax increases when the baby boom retires; or c) declining interest rates discourage saving.

- We assume that extra national wealth compounds at a 5% real rate per year. (This corresponds to a 5% marginal product that is entirely saved, because otherwise we'd have to keep track of increases in consumption along the way. It is the pre-tax return to capital as a whole and is below the after-tax return to equities (6.75%) as a conservative assumption.) Because this rate exceeds the compounding rate of debt, extra national wealth exceeds the reduction in debt held by the public over time.

Another Answer: **The on-budget government can <u>almost</u> cover the extra debt service to the trust funds through reduced interest on debt held by the public and extra tax revenue from greater national income.**

- Compared to spending the surpluses, the on-budget under the President's plan is only $15 billion worse off in 2014.

- Debt service to the public falls for two reasons: less debt and lower interest rates. CBO reports that reducing the deficit by 2 percent of GDP would reduce interest rates by .7 percentage point. Compared to spending the surpluses, the President's plan raises the surplus by 1.8% of GDP on average between 2000 and 2014, which would imply a rate reduction of .63 %age point. But this relationship is not likely to be linear, so I round to .5 %age point for simplicity.

- In 2014, interest payments by the on-budget government are up $41 billion under the President's plan compared to a policy of "spend the surpluses":
  * extra expense:
    interest payments on extra debt held by trust fund = (.058-.005)*3811 = $202 b
  * reduced expense:
    reduced interest payments because less debt held by public = .058*2681 = $155 b
    reduced interest payments because of lower rates = .005*1168 = $6 b

  (Note that this calculation does not incorporate the effect of compounding debt at a lower interest rate.)

- Under the midpoint of CBO's assumptions, national wealth in 2014 would be $2578 billion higher under the plan than if we spent the surpluses. With a marginal product of .05, GDP would be $129 billion larger and federal taxes would be .2*129 = $26 billion larger.

- Engaging in dynamic scoring may open Pandora's box to tax cuts, etc.

Another Answer: **Under the President's plan, we project on-budget surpluses through**

204x.

- This claim is tricky, because future surpluses depend on both policy and scoring decisions that have not yet been made:
  * what happens to USA contributions after 2014?
  * how do equity redemptions count in the surplus?

- Another complication is that we project bigger on-budget surpluses without the President's plan.

Another Answer: **Under the President's plan, debt falls so low that if we needed to issue new debt in the future, we could do so without damaging the economy or raising the debt-to-GDP ratio above its current level.**

- By 2006, the debt-to-GDP ratio would be below its level in 1980; by 2014, it would be about 7%, below its level when the U.S. entered World War I in 1917; by 2017, it would be below 0. In absolute nominal terms, the debt held by the public in 2014 would be only 30 percent of its current value.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-FEB-1999 16:19:50.00

SUBJECT: Q&A for Intenational Chapters of the ERP

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

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

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

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

TEXT:
I attach a WP file containing my proposed Q&A for the two international chapters of the ERP. For what concerns the chapter summaries, I think that the summaries in last week's WEB should do (I do not have the original files on these).

If you need elaboration on the Q&As and/or further discussion of other issues, let me know.

Nouriel

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D75]MAIL40115733X.036 to ASCII,
The following is a HEX DUMP:

Questions and Answers on the International Chapters of the ERP

What do you think of the idea of capital controls on inflows and outflows?

The report discusses the arguments for and against controls on capital inflows. There is now a growing consensus that cross-border interbank flows may be excessively volatile and that they may have to be moderate in the framework of prudential regulation and supervision of the financial system. For example, Argentina has high required reserve ratios on all, domestic and foreign short-term liabilities of the banking system.

Controls on all short term capital inflows, to banks as well as other financial intermediaries and non-financial firms, are much more controversial. There are arguments in their favor and against them. The report presents the pros and cons without taking a stand on them.

Capital controls on outflows, especially during a crisis, are counterproductive as the experience of Russia and Malaysia suggests. While introducing controls on outflows is not the appropriate response to crises, international capital inflows can reverse suddenly, and openness potentially makes emerging economies more vulnerable to such reversals. As a result, policies to increase the resilience of financial systems might be usefully identified, so that are less vulnerable to these crises. These include effective prudential regulation and supervision of financial markets.

One result of the recent crisis is a growing consensus that capital market liberalization has to be carried out in a careful, orderly and well-sequenced manner if countries are to benefit from closer integration into the global economy. If domestic financial systems are weak, poorly regulated and subject to institutional distortions, rapid capital account liberalization can lead to excessive short-term borrowing and lending, and a mismatch of maturities and currency denominations of assets and liabilities of financial institutions and corporate firms. To reduce the risk of financial and currency crises, effective regulatory and supervisory regimes must be in place and the financial sector must be poised to deal adequately with these risks as the capital account is liberalized.

Does the report suggest that Europe may not be an optimal currency area? Are you critical of EMU?

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

The report discusses the theoretical criteria for an optimal currency area and finds that the American States satisfy such criteria better than the European nations. However, there is good hope for a successful EMU. The degree of integration among EU countries is increasing decade by decade. The degree of international labor mobility, for example, is likely to be higher in the future than in the past. The Schengen convention now allows free movement of citizens among a subset of European countries. Thus the European countries may come to fully satisfy the textbook criteria of an optimum currency area in the future, even if they do not fully now.

Also, the political benefits of a united Europe go beyond the economic benefits of EMU.

How do you evaluate the IMF stabilization programs in the Asia, Russia and Brazil? Did the IMF get it wrong?

The US has supported the role played by the IMF in stabilizing the crisis-afflicted economies in Asia. Many of the criticisms of the IMF programs are misguided and the Report discusses such criticisms. We believe that, on balance, the IMF, has made sensible choices in confronting these complex and difficult crises, adjusting its judgments as appropriate.

In the Asian countries that followed the IMF stabilization policies, Korea and Thailand, the crisis has bottomed out and there are signs of economic recovery.

Rubin in Davos on IMF: "I believe that, on balance, the international community, including the IMF, has made sensible judgments in confronting these complexities, adjusting its judgments as appropriate. Having said that, by examining and re-examining our experiences in this crisis with an open mind, we can better prepare ourselves for decisions going forward, and I think it likely that much will change in maintaining or restoring financial stability in the years ahead. However, one thing is clear: there are no easy answers and no magic wands, and each of us must do our part."

Europeans and Japanese are pushing the idea of target zones to stabilize the relative values of dollar, euro and yen. Are you skeptical about such ideas?

Yes, we are against the idea of target zones. For the major currencies, the best regime is floating exchange rates supported by sound policies. Target zones and similar exchange rate intervention regimes are no substitute for sound underlying policies.

Rubin in Davos: "For major currencies, I believe that means floating rates supported by sound policies. Target zones and similar measures are no substitute for sound underlying policies and suffer from the defect that they could be pro- rather than counter-cyclical, thereby exacerbating, rather than countering adverse economic developments. To paraphrase Winston Churchill's famous statement about democracy, the floating exchange rate system is the worst possible system, except for all the others."

What is the best exchange rate regime for developing countries?

For emerging market economies , the choice of the exchange rate regime is more complex than for major currencies. Fixed rate and flexible rate regimes have been successful and unsuccessful in different countries. No matter what exchange rate a country chooses, it is critical that it be backed by strong financial regulation and appropriate monetary and fiscal policies. Macroeconomic stability is based on good policies, irrespective of the exchange rate regime. Policy mistakes that contribute to a currency crisis can occur in the context of any exchange rate regime.

What do you think of the current currency crisis in Brazil?

In Brazil the key is to have a good, sound, solid stabilization program and to implement it effectively. There are some political challenges to do that. The Brazilian authorities need to determine what set of policy measures they will need in order to both deal with their underlying problems and regain the confidence of the global financial markets.

Brazil has put in place almost all of the fiscal measures it needs; they have really done a great deal in this area.

Also, unlike some of the other countries which have experienced problems over the last two years, Brazil's financial system is in pretty shape.

The real's sharp decline "overdone" and it will strengthen as soon as the government adopts a clear monetary policy to restore confidence in the country.

Is globalization of trade and finance to be blamed for this recurrent global financial turmoil?

Openness to innovation and change - in technology, trade, open markets, flexible labor and capital markets - is absolutely necessary to ensure overall progress in job creation and increased standards of living.

The widespread financial turmoil in the last two years followed a robust period of increasing integration of world product and financial markets. World trade has increased dramatically as trade restrictions have progressively fallen and many countries have embraced historic openness to international trade. At the same time, restrictions on capital flows have been eased and financial markets have become increasingly integrated, leading to an unprecedented volume of international capital flows.

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

The maintenance of open markets by the United States and other industrial countries is essential to the restoration of world economic growth. Higher barriers to trade in the U.S. would not only hinder recovery in Asia and other crisis countries but provoke emulation and retaliation, hampering our own growth prospects. Indeed, it is worth remembering that the Great Depression of the 1930s was exacerbated by a dramatic switch to protectionist policies in the United States and other industrial countries. As the crisis economies recover, their demand for U.S. goods and services will increase as well, once again fueling our own export growth.

The United States remains committed to opening markets to international trade, recognizing that an open trade environment will support the recovery of crisis-afflicted countries and ensure continued growth of the world economy. The Administration remains strongly committed to such outward-looking, internationalist policies.

Rubin in Davos: "Openness to change -- from technology, open markets, and flexible labor and capital markets -- is absolutely central to overall progress in job creation and increased standards of living. But, openness to change also increases dislocations. And that is a hard reality of change and progress that cannot be avoided. The constructive reaction to that reality is to provide robust programs to equip and enable people to succeed in the global economy -- with special emphasis on those who experience dislocations -- and to provide social safety net support where needed. This is not an easy path politically -- quite the contrary. But it is the essential path for enduring growth and a strong economy....

Today there is the almost universal tendency to extol the benefit of exports, and to ignore the benefit of imports or even disparage them. And that leads to distorted trade policy. Imports reduce prices and increase choice for consumers; reduce prices and increase choice for producers, which should lead to greater job creation and higher wages; increase competition and productivity; and, for all these reasons, reduce inflation and presumably reduce market interest rates. Moreover, trade is not a zero-sum game; but one of mutual advantage. The increased efficiencies deriving from each country specializing where it has the greatest comparative advantage raise standards of living for all."

How should the international financial system be reformed to prevent recurrent crises?

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

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

Major reforms of the international financial architecture must occur to ensure the stability of the system. There are six important areas that have to be addressed

[The points below are mostly my elaborations of the 5 points discussed by Rubin at Davos.]

1. The most important factor in preventing crises from occurring is for developing countries to develop and follow sound policy regimes. Strong, well supervised and regulated financial sectors

are of critical importance. Sound fiscal and monetary policies are crucial. Transparency, accountability, codes of fiscal and monetary policy and adherence international standards in all these areas are important.

2. We must develop measures with respect to providers of capital in industrial countries to reduce the volatility of capital flows. A few words on hedge funds, leverage, derivatives and proper risk assessment by financial institutions.

3. We need more effective means of dealing with crises when they arise. The international financial community has taken a series of useful steps to better equip the IMF to deal with crises, including the precautionary facility proposed by the G-7 and the Supplemental Reserve Facility already in place. The private sector must also play an appropriate role in sharing the crisis burden for two reasons: first, because of moral hazard concerns -- i.e. creditors should bear the consequences of the risks they take if capital markets are to work effectively; second, because there will never be sufficient official finance to deal with the crises of today's vast markets.

4. Emerging economies should have sustainable exchange rate regimes. See question above for details.

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

The Administration has been working with the Multilateral Development Banks (MDB) to provide increased social safety nets in the countries in crisis to help the least advantaged citizens in those countries who are experiencing hardship. The World Bank should develop as a matter of urgency general principles of good practice in social policy, in consultation with other relevant institutions. These should be drawn upon in developing adjustment programmes in response to crises. The World Bank and Asian Development Bank are well positioned to provide adequate government spending in the areas of health and education -- two of the most crucial areas in which the MDBs should focus their resources.

Rubin in Davos: "We must do far better in enabling all of our citizens to participate in the growth and economic well being produced by the global economy. That means not only strengthening social safety nets for those in greatest need and promoting core labor standards around the world, but also greatly increasing investment in education and health care to provide all of our citizens with the requisites for economic success." (Rubin)

6. Strengthening the IMF. The IMF's own transparency could also be further improved by such steps as more widespread public release of information on the policy deliberations of the Executive Board along the lines of the procedures for the periodic country reviews, whereby the country reviewed may assent to a press release. In all these areas, the IMF will need to ensure that its work continues, as warranted, to be closely coordinated with other international entities,

such as the World Bank. It will also be important to ensure that the Interim Committee, as the body designed to provide ministerial level guidance to the work of the IMF on a regular basis, is able to continue to provide effective political level oversight and direction of the IMF in a manner that reflects the evolving nature of the challenges of the international financial system. Consideration of proposals to achieve this objective are in progress.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-FEB-1999 10:04:06.00

SUBJECT: Telecom report

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

TEXT:
Janet:

Reed Hundt read the report over the weekend and was very pleased with it, according the V.P.'s office. He had only two very minor comments that have now been incorporated. Joe Farrell also read it and he and I will talk today about his comments. I am at work on a third draft to be circulated at the end of the day tomorrow, 1/2. That will be pretty much a final draft, I hope. Fact checking starts today.

Howard.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Howard_Rosen@jec1.senate.gov@INET@LNGTWY (Howard_Rosen@jec1.senate.gov@INET@LNGTWY [UNKNOWN])

CREATION DATE/TIME: 1-FEB-1999 16:18:09.00

SUBJECT: - no subject (01J78H3FTS4Y008Q88) -

TO: Janet L. Yellen@eop (Janet L. Yellen@eop [CEA])
READ:UNKNOWN

TEXT:
Janet:

The Drager Foundation, one of Germany's largest private German foundations, and ZEIT, the foundation of the German newspaper Die Zeit, are co-sponsoring a conference on "Innovative Approaches to Employment Problems in Europe, Japan and the USA" in Berlin this April. I have been asked by the conference organizers to help them identify potential American participants.

As always, the Germans plan to have a high level delegation,
including
President Herzog and Helmut Schmidt, former Chancellor of the FRG. The current Ministers of Labor (Walter Reister) and Economics and Technology (Werner Muller) will also participate.

I know the US-German employment debate can get a bit tiring, but I thought this meeting might provide some high visibility for the US success story. I will spare you any hard sell. Might you be interested in participating in such an event? If so, are you available April 19 and 20?

If you are interested, I would be more than happy to send you more information. If you are not interested or if you are not available,
I
would be grateful if you would pass on this information to Becky. It would be nice if we could find a senior Administration official who might be willing to tell our success story and bring some reality
into
the discussion with the Europeans and Japanese. I am also in contact with people at the Labor Department.

I hope you don't mind this invitation, especially since this is probably the busiest week of the year for you. I just thought it might be a great opportunity.

With warm regards,

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

TEXT:
RFC-822-headers:
Received: from conversion.pmdf.eop.gov by PMDF.EOP.GOV (PMDF V5.1-9 #29131)
id <01J78H39PTJK006P0C@PMDF.EOP.GOV> for yellen_J@a1.eop.gov; Mon,
1 Feb 1999 16:00:18 EST
Received: from storm.eop.gov by PMDF.EOP.GOV (PMDF V5.1-9 #29131)
with ESMTP id <01J78H35VB1S008QX1@PMDF.EOP.GOV> for yellen_J@a1.eop.gov; Mon,

01 Feb 1999 16:00:15 -0500 (EST)
Received: from MAILSENT.senate.gov ([198.78.181.133])
by EOP.GOV (PMDF V5.2-29 #34437) with ESMTP id <01J78H2ZOMC20009MR@EOP.GOV>
for yellen_J@a1.eop.gov; Mon, 01 Feb 1999 16:00:04 -0500 (EST)
Received: from IMAEXCH.senate.gov by MAILSENT.senate.gov; (8.8.2/SCO5)
id PAA17363; Mon, 01 Feb 1999 15:51:58 -0500 (EST)
Received: from ccMail by IMAEXCH.senate.gov (IMA Internet Exchange 3.11)
id 00076E4E; Mon, 01 Feb 1999 15:59:39 -0500
Content-description: cc:Mail note part

================= END ATTACHMENT 1 =================

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-FEB-1999 11:54:42.00

SUBJECT: contact info in Argentina

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

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

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

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

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

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

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

TO: Rosalind V. Rasin (CN=Rosalind V. Rasin/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

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

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

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

TEXT:
I will depart tonight for Argentina. I will be staying at the Marriott Plaza at Florida 1005, Buenos Aires, 54-1-318-3000 (54 is country code). The fax is 54-1-318-3008. Our meetings end on Thursday afternoon, and I am in the process of checking out with friends the possibility of staying through the weekend. I will let you know once my plans are finalized. If I do stay, I will return to DC on Monday morning.

Joe

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-FEB-1999 08:44:27.00

SUBJECT: FYI from Elmendorf 2 of 2

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

TEXT:
---------------------- Forwarded by Alice H. Williams/CEA/EOP on 02/01/99
08:44 AM ---------------------------

Peter A. Weissman

01/31/99 07:05:47 PM
Record Type: Record

To: See the distribution list at the bottom of this message
cc:
Subject: FYI from Elmendorf 2 of 2

Message Sent
To:____
Douglas W. Elmendorf/CEA/EOP
Melissa G. Green/OPD/EOP
Jonathan Orszag/OPD/EOP
Jeff B. Liebman/OPD/EOP
Alice H. Williams/CEA/EOP
DAVID.WILCOX @ MS01.DO.treas.sprint.com@INET@LNGTWY
Barbara Chow/OMB/EOP
Jack A. Smalligan/OMB/EOP
stephen.c.goss @ ssa.gov @ inet
belsgoss @ connext.net @ inet
Joseph J. Minarik/OMB/EOP

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D91]MAIL44426723T.036 to ASCII,
The following is a HEX DUMP:

How Does Rebalancing Affect Portfolio Risk?

Suppose that 15% of the trust fund were invested in equities and equity prices fell to 0.

- With no rebalancing, the value of the trust fund would fall by 15%.
- With frequent rebalancing and a protracted drop in equity prices, the value of the trust fund could fall by 100%, because rebalancing causes the fund to keep buying into the declining market.

Examples:

1. Start with $15 in equities and $85 in bonds (earning 5.8% annually).

Daily equity return	Total return after 25 days	Value of portfolio based on frequency of rebalancing: never	weekly	alternate day	daily
-.01	-.22	$97.15			$96.78
-.02	-.40	$94.53			$93.21
-.04	-.64	$90.89	$87.33	$86.66	$86.45
-.20	-.996	$85.54			$46.93

2. Start with $15 in the Nikkei 225 in Dec. 1989 and $85 in bonds (earning 5.8% annually). Over the following 3 years, the Nikkei lost 57%. By Dec. 1992 this portfolio would be worth:

No rebalancing:	$107.19
Annual rebalancing:	$104.48
Monthly rebalancing:	$103.86

3. Start with $15 in equities and $85 in bonds (earning 6.4% annually).

Equity return (annual rate)	no rebal.	daily rebal.
9.5% for 40 days	$95.73	$94.88
11.5% for 40 days	$108.26	$107.04
9.5% for 20 days, 11.5% for 20 days (any order)	$100.74	$100.78

Implications:

1. Rebalancing lowers returns when the market moves steadily up or down. But it raises returns when the market moves up *and* down, because it essentially leads to buying low and selling high.

2. Even with frequent rebalancing, the trust fund loses more than the target share of equities only for huge, protracted declines in equity prices.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-FEB-1999 16:52:32.00

SUBJECT: MBA talk - notes

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

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.D49]MAIL47504833G.036 to ASCII,
The following is a HEX DUMP:

State of the Economy

Would like to talk briefly about the state of the American economy and the forecast going forward and say a bit about one of the key policy challenges that top the Administration's economic agenda: saving Social Security and formulating fiscal policy in a new era of surpluses.

The World Economy

- The last year has been an extraordinarily tumultuous one for the world economy. As you know, what seemed like currency crisis confined to developing Southeast Asia in the summer of 1997, erupted during 1998 into a deep, global economic crisis.

  A third of all world economies were in recession or experiencing markedly slower growth by late 1998. World economic growth is estimated by the International Monetary Fund (IMF) at only 2.2 percent in 1998 and is projected to remain at this low level in 1999, after robust growth of 4.2 percent in 1997. Projected world growth has almost declined to levels registered during the pronounced world slowdowns of 1974-75, 1980-83, and 1990-91. Japan's hopes for recovery from a long-standing slump have been dashed. And the U.S. and other industrial countries have not escaped without impacts. The financial market turbulence led to a general flight from risky assets raising spreads and interest rates on riskier debt, in the United States and effectively tightening monetary conditions. In addition, our trade deficit has burgeoned, with our exports falling absolutely in real terms as a consequence of reduced demand from impacted Asian economies.

- The United States has been focused since the outset of the crisis on the need to take steps to spur growth throughout the industrial world, to contain the crisis through IMF-lending cum reform programs in crisis countries; to provide precautionary loans to countries like Brazil that have implemented serious reform programs but are nevertheless threatened by capital outflows; and on the need to take steps to alleviate suffering in crisis afflicted countries through safety net spending and also through lending to help countries recapitalize their banking systems and emerge from debt.

- Beyond that, the Administration is focused on the need for an ongoing, serious program of reform to strengthen the international financial system to make it less crisis prone and to improve the mechanisms available for dealing with any crises that may nevertheless occur. Unfortunately, it turns out that there is just 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. Last fall, the central bank governors and finance ministers from a group of industrial and key emerging market countries, informally dubbed the G-22. formed three working groups, which issued reports on aspects of international financial reform. One report focuses 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. A second working group proposed 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. A final report sough to identify policies to make the system less crisis prone--for example, through reducing implicit and explicit government guarantees which create moral hazard and exacerbate risktaking. For example, deposit insurance, the implicit promise of bailouts of corporations considered too big to fail, and semi-fixed exchange rate regimes which reduced the perceived riskiness of foreign currency exposure--all increased the exposure of crisis countries and created fragility. 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. The reform agenda will be advanced at the next G-7 summit and in a variety of international fora.

The U.S. Economy

- In spite of all of the turmoil that has occurred, and, unfortunately is continuing to occur in the world economy, the U.S. economy is nevertheless doing extraordinarily well. Net exports have been a drag on our growth but we have had favorable offsets in the form of more accommodative financial conditions. Prior to the Russian crisis, interest rates had fallen considerably, stimulating housing and consumer durable spending; the general financial turmoil following the Russian default caused a disappearance of liquidity and seizing up of our own financial markets, threatening our expansion. But the Fed and other industrial country central banks took steps to ease monetary conditions, restoring calm. So, we are finishing the year on a strong note and have an expansion that is headed for the record books.

- The December employment report was nothing short of spectacular: 378,000 new jobs for a total of 17.7 million since the beginning of this Administration and an unemployment rate of 4.3%.

- December marks the 93rd month of an expansion that began in March 1993. If history decrees, as the job report makes almost certain that it will, that the expansion continued through December, this expansion will achieve a record as the longest peacetime expansion on record and the record begins back in 1855. The longest previous record expansion was 92 months, from December 1982 to July 1990. If the expansion continues through February of 2000, it will become the longest American expansion, bar none, in American history.

- Judged in terms of overall economic performance this expansion has been not only long but excellent. Employment is at an all-time high, and all measures of unemployment are at 30 year lows. Inflation, by all measures remains tame even though the unemployment rate has been very low for almost 2 years, shattering long held views and simple textbook theories about the possibility of combining low unemployment and inflation. In fact, the misery index, which is the sum of inflation and unemployment, is lower at this stage of the current expansion than in either the expansion of the 60s or the 80s.

  - If one compares the current situation to that of the other two long postwar expansions we see a striking contrast. By this time in the expansion of the 1960s inflation was rising sharply and was much higher than now, at about 5%. In the 80s expansion, inflation was also rising at this stage and had reached 5%. Inflation is much lower now and has been coming down. Since the need to combat high or rising inflation is what typically brings an expansion to an end, this greatly raises the prospects for a continuing expansion.

  - This is also an expansion which is investment driven--to a far greater extent than in either of the other two long expansions. This is a contribution to future growth and it is working to hold inflation down. It is the only one of the three major expansions in which government has contracted as a share of GDP. And of course we have had spectacular success in achieving a budget surplus.

- It was once commonly accepted that an economic expansion is a rising tide which lifts all boats, so that the most surefire way to alleviate poverty and help disadvantaged groups was to keep the economy expanding. However, in the late 1970s, a new, long-term trend toward widening inequality began to afflict the economy, most likely as a consequence of pervasive technological changes raising the demand for skilled labor and lowering the demand for unskilled workers. In addition, productivity growth declined substantially, for reasons which are still not well understood. During the expansion of the 1980's, real wages declined. Men were disproportionately impacted. During this expansion, we saw real wages stagnate for the first five years of the expansion. However, this has finally become an expansion in which a rising tide is lifting all boats.

  - Real wages have grown very strongly over the last two years and have are now up about five and a half percent on average over the expansion.

  - The long term slide in the real wages of men (over 11 percent in median earnings between 1979 and 1996) has finally been checked with strong increases in the last two years.

- Low wage workers have finally seen gains. Real hourly wages for the lowest two tenths of the distribution of men and women have increased 5-6 percent since 1993.

- Median real wages of blacks and Hispanics, both men and women, have risen especially rapidly in the past two years.

- Employment gains have been substantial for high school dropouts, immigrants, blacks and Hispanics and of course for women with young who head households, suggesting that a good share of those who have left the welfare rolls have found jobs.

- There is also good news on the job displacement front. Job losses due to layoffs skyrocketed in the last recession and remained unusually high even in 1993-95, during the recovery. However, the most recent evidence, covering the 95-97 period shows that displacement has declined substantially since 1993-95 and among those who have been displaced the share that have found new work increased and wage losses are the smallest on record.

- The Forecast: We will come out with our official forecast for growth and inflation when the budget is released in early February, but going forward, our most likely forecast is for a moderation of growth to a pace below the spectacular pace we have been enjoying--3.75% for the last 12 quarters even including the first three quarters of 1998.

Fiscal Policy

Let me turn to a discussion of one of the key challenges facing the American people at this point.

- Fiscal discipline has been a centerpiece of this Administration's economic policy and it has worked to accomplish what seemed unthinkable in 1993--namely we finally have a budget in the black last year with the largest surplus as a share of GDP in over 40 years. (The success in balancing the budget is also due to strong economic growth and lower interest rates, and favorable surprises on the tax side: namely tax revenues are coming in higher than we have expected even allowing for unusually favorable economic conditions.)

- As we go forward from here, the budget situation will improve dramatically. The Office of Management and Budget (OMB) now projects substantial surpluses in the unified Federal budget amounting to almost $5 trillion over the next fifteen years. Eventually, however, the aging of the U.S. population and continued growth in health-care spending per person will combine to raise Social Security, Medicare and Medicaid expenditures and this is expected to push the budget back into deficit.

- For example, with respect to Social Security, the key factors contributing to the projected Social Security imbalance are improvements in life expectancy and a reduction in birth rates, which have put us on a path of rapid declines 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's 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. The same demographic effects on work to threaten the finances of Social Security also impact Medicare and Medicaid.

- 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.

- In his State of the Union on Tuesday night, the President proposed a plan for how to use the currently projected unified budget surpluses and how to address the financial imbalance of the Social Security system. He proposes: devoting 62% of the surpluses over the next 15 years--more than $2.5 trillion--to strengthening the Social Security system. He proposed using 15% of the projected surpluses for Medicare, ensuring the Medicare Trust Fund is secure for another 20 years. And he proposed to create a new system of universal savings accounts (USA Accounts) with 12 percent to help working Americans build wealth to meet their retirement needs--a way of strengthening the current pension system and helping Americans save. The government would provide an equal dollar contribution for most working individuals and provide matches for individual contributions with larger matches going to lower income workers. Finally, the President would reserve 11 percent of the projected surpluses for military readiness and education and research.

- Evaluated from a macroeconomic perspective--from the perspective of national savings--this is a plan that, in essence, saves between 77 and 89% of the surpluses, depending on one's evaluation of the saving impact of the USA accounts. Only 11% of the surpluses are devoted to additional government spending. The allocations to social security and Medicare, are pure additions to national saving, amounting, on their own, to 2% of GDP. In addition, the USA accounts could be viewed as a tax cut which is highly likely to add to personal saving. So this is a fiscally conservative, pro growth plan which meets the criterion of fostering national saving. It comes close to a plan of simply paying off debt and it is projected to lower the U.S. publicly-held debt to GDP ratio from its current level of about 45% today to 7.1% in 2014--its lowest level since 1916.

- Beyond using the surplus in a way that fosters national saving in a general way, to help prepare for an aging population, the President wanted to dedicate the surplus in way that would specifically aid Social Security. So let me say a bit more about Social Security and its financial situation and how the President's plan would augment its solvency.

- 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. Logically speaking, there are only a few distinct ways of bridging this 2.19% gap: payroll tax revenues can be increased or benefits cut (traditional remedies/tough medicine); the Trust Fund's resources can be augmented through non traditional funding sources such as the budget surplus (general revenue); or the rate of return on Trust Fund assets can be increased.

- 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. At the beginning of the process, the President urged everyone involved to keep an open mind about possible social security fixes, and he laid out five principles to guide reform efforts.

- *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.

• In his 1999 State of the Union address, to advance the reform effort the President announced a plan which we hope can serve as a starting point for bipartisan negotiations with the Congress.

  • Transfer 62% of the projected budget surpluses over the next 15 years--almost $2.7 trillion to the Social Security system. (The Congress would write checks to SS that would be treated like outlays and these would augment the resources of the Trust Fund. Even if these are invested in Treasury special bonds, these transfers would significantly augment the life of the Trust Fund.)

  • The President called for investing a portion (about 20%) of the transferred surpluses in equity investments, just as any state, local or private pension plan would. The President recognizes the dangers associated with government ownership of private firms, so he proposes to work with Congress to devise a mechanism to ensure that the investments are made independently, without political interference and with low administrative costs by the most efficient private-sector managers. Under the approach the President has proposed, the overall share of stock owned by the Trust Fund would average about 4%.

- Beyond governance issues, we should recognize that investing in equity is not risk-free. Presumably, risk explains in part why the S&P between, for example, 1959 and 1996, returned an average of 3.84% more per year than bonds in the Social Security Trust Fund. Certainly, there is substantial risk over shorter time periods. But investing equities (up to about 20%) in the Trust Fund is a cautious move in the direction of reaching for a higher return. Even in the worst case, the lion's share of benefits (95%) would still be paid out of payroll tax revenues and the sure return from government bonds.

- As an approach for investing in the stock market, equity investments in the Trust Fund, rather than in individual accounts has many advantages: one is substantially lower administrative expenses and another is that this approach permits greater sharing of the risks of market fluctuations both within and across generations. In Chile and the UK, the administrative costs associated with individual accounts ended up reducing retirement income by 20% or more. In the US, even passively managed index funds incur expenses that average around 60 bp per year, according to a recent Dept. Of Labor study.

- The transfers and equity investments would leave the system solvent until 2055. However, 75-year actuarial balance is the usual measure of solvency and the President wants to achieve more than solvency through 2055.

- He proposes a bipartisan effort to make the hard-headed, painful, but sensible choices needed to go the last 20 years, to 2075. Many ideas have surfaced, from including S&L uncovered workers, to raising the taxable wage base, to raising the normal or early retirement age and so forth. The President has ruled out an across the board payroll tax increase. Each of these choices available are somewhat painful and require bipartisan support to succeed. Nevertheless, the gap can be bridged without excessive pain and any changes that are implemented could be phased in very gradually.

- The President also proposes to eliminate the "earnings test" in SS, whereby workers who earn more than a base amount lose between 30 and 50 cents of social security benefits for each extra dollar they earn with higher payments, in compensation, later on. This is the worst form of tax--it is not any tax at all (or at least won't be very soon) in a present value sense; but it is confusing and burdensome and probably discourages work. In fact, it may be a factor, although not the major factor, contributing to early retirement.

- The President also wants to do something to reduce poverty among elderly women who are widows. The poverty rate for all elderly women was 13.1 percent in 1997. For widowed women, poverty rates are significantly higher than for men: the poverty rate is 18.0 percent for widowed women--nearly four times the poverty rate of married women (4.6%) and much higher than for widowed men (11.4%). Currently, widow benefits vary from 50-67% of benefits for a married couple when both were alive. But, using the official poverty thresholds, a widow needs 79% of a couple's income to maintain her pre-widowhood consumption. This is a key reason why widow poverty is so much higher than overall elderly poverty.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 1-FEB-1999 09:44:07.00

SUBJECT: my absence Friday

TO: BLANK_R (BLANK_R @ A1 @ CD @ VAXGTWY [UNKNOWN]) (CEA)
READ:UNKNOWN

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

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

CC: WILLIAMS_A (WILLIAMS_A @ A1 @ CD @ VAXGTWY [UNKNOWN]) (WHO)
READ:UNKNOWN

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

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

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

TEXT:
I am planning on being out of the office this Friday, Feb. 5 (in Cambridge, to attend an NBER conference on currency crises and to give the "Clayton Lecture" at Tufts University).

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-FEB-1999 17:56:55.00

SUBJECT: draft statement on '99 ERP

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

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

CC: Rebecca M. Blank (CN=Rebecca M. Blank/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.D0]MAIL43149453F.036 to ASCII,
The following is a HEX DUMP:

STATEMENT OF JANET YELLEN
Release of the 1999 *Economic Report of the President*

Thank you all for coming in today to hear about the 1999 *Economic Report of the President*. Each year, one of the most closely watched aspects of the Report's release is the color of the cover. And, as you can see, unlike this year's budget document, the Economic Report is in red -- symbolizing our Nation's "red hot economy." [Or, as one of our economists suggested "After so many years of Republican red ink, the Government Printing Office had a surplus of red -- and the CEA is helping them out."]

In any case, as you all know, the President is required to submit to Congress each year a *Report* that describes the state of the US economy. But the *Report* has also traditionally been a vehicle for presenting a broad range of analyses of current economic policy issues. This year, in addition to a chapter on macroeconomic policy and performance, the *Report* contains: a chapter on the benefits of a strong labor market; a chapter on the aging American population; a chapter on regulation and innovation; and two chapters on international issues -- one discussing the recent world-wide financial turmoil and one describing reform of the international financial architecture.

Let me first talk briefly about the current state of our economy, and then talk about the direct and measurable benefits that American workers are enjoying from our strong and healthy economy. Finally, I will touch briefly on the challenges that remain as we move into the 21st Century.

STATE OF THE ECONOMY

Our Nation's economy is healthy and strong. As Chapter 2 of the *Report* details, our Nation is currently enjoying the longest peacetime expansion in history. In 1998, the US economy remained strong, despite a serious weakening in the international economy. Unemployment remained at historically low levels -- staying below 5% for the past 18 months. Job creation was vigorous -- with 2.9 million jobs created in 1998 and almost 18 million since 1993. Growth has been strong -- with our economy growing at 3.9% in 1998 as well as in 1997. And inflation remained at historically low levels.

As 1999 begins, our economy is fundamentally sound and I am confident that we will continue to experience solid economic growth with high employment and low inflation. There is no evidence of domestic imbalances that would threaten the outlook for continued growth.

The exceptionally strong economy that we are enjoying today is due in part to the sound and credible economic strategy put in place by the Clinton Administration. The Administration's strategy has focused on getting the fundamentals right -- that is, fiscal discipline, investing in education and technology, and opening markets abroad. These were the right policies to stimulate the job creation needed to move the economy to full employment.

THE BENEFITS TO AMERICAN WORKERS OF A STRONG ECONOMY

Because of our Nation's strong and healthy economy, American workers are enjoying direct and measurable progress. In the *Report,* we describe the CEA's analysis of real wage growth. Let me talk briefly about some of these findings:

These trends are particularly strong for historically disadvantaged groups. After years of decline, the real wages of black men began to increase in 1993, and they have risen by 5.8 percent in the last 2 years (since 1996). Black women and Hispanic men and women have also experienced recent gains. The tight labor market of the 1990s appears to be helping even young minority workers, who suffered greater wage declines than others in the 1980s. In 1998 alone, the real wages of young black men aged 16-24 rose by 6.2 percent.

It is well known that less-skilled men have experienced long-term wage decline since the later 1970s. In 1998, real wages among men aged 20 and over who are high school dropouts rose by 7 percent. This was the first time since at least 1979 that their wages rose.

Immigrants, too, are earning more. Mexican- and Central American-born immigrants -- who account for about 30 percent of new immigrants since 1980 -- have had real wage growth since 1995 of almost 7 percent for men and almost 4 percent for women.

In addition to these direct and measurable benefits, American workers are benefiting from our strong economy in other ways. An economy with strong job creation and low unemployment makes broad and lasting changes in our labor market and in the well-being of the American people.

A high-employment economy can *reduce long-term joblessness.* A tight labor market encourages participation by those who might otherwise be forced to sit on the sidelines, and makes it easier to absorb less skilled or younger and more inexperienced workers into the labor force. For example, the unemployment rate of black youth aged 16-24 was lower in 1998 than in any year since the data series began in 1973. These new workers gain much-needed job experience, building the skills they will need to hold down a job in the future.

A strong, high-employment economy will *help move welfare recipients into the workforce*. Keeping the unemployment rate low and job growth high is necessary if we are to move current welfare recipients into the work force. Early evidence on this point is encouraging: employment and labor force participation rates among single mothers with children under 18 have increased rapidly in the past few years. In just the 4 years from 1993 to 1997, the participation rate of single mothers aged 16-45 increased by almost 9 percentage points. This is partly the result of recent welfare reform: the greatest acceleration in employment rates has occurred among those single women most likely to be affected by welfare reform, namely, those with young children. The rise in employment among single mothers is also strongly related to the expansion of the Earned Income Tax Credit, which since 1993 has rewarded work by low wage earners more than ever before. Nevertheless, it is obvious that a strong economy in which job opportunities are plentiful is an important complement to programs and policies that encourage work.

A high-employment economy *enhances personal economic security*. Knowing that work is available to those who seek it, at wages sufficient to keep them and their families out of poverty, is a key to personal economic security. A tight labor market increases the confidence of job losers that they will be able to return to work, lures discouraged workers back into the labor force, enhances the prospects of those already at work to get ahead, enables those who want or need to switch jobs to do so without a long period of joblessness, and lowers the duration of a typical unemployment spell.

And, finally, a high-employment economy *improves the well-being of low-income Americans*. From the 1980s until the early 1990s, the benefits of an expanding economy were offset by the sustained declines in wages at the low end of the earnings distribution. Since 1993, living standards for all Americans are on the rise, especially for those at the bottom of the income distribution. The poverty rate fell to 13.3 percent in 1997, from 15.1 percent in 1993; the poverty rate for black Americans is at a historical low, and in 1998 unemployment among blacks fell to its lowest rate since 1973. Maintaining a full-employment economy is essential if this progress is to continue.

CHALLENGES IN A CHANGING ECONOMY

Yes, our economy is strong and Americans are working in record numbers. And there are broad and lasting benefits to sustaining a healthy economy with strong job creation and low unemployment.

But our Nation still faces other, broader challenges as we move into the 21st century. The Clinton Administration's agenda is designed to deal with these changes and the challenges they pose. It is designed to equip the American people with the strength, the skills, the security and the flexibility needed to reap the rewards of our growing, changing economy.
The President recently laid out this broad agenda in his State of the Union and again in his FY2000 budget.

First, we must maintain fiscal discipline by saving Social Security for the 21st Century--thereby laying the foundations for future economic growth. By the year 2030, the number of elderly Americans will double, a seismic demographic shift with great consequences for our nation. That is why the President proposed in the State of the Union Address that we commit 62% percent of the budget surplus for the next 15 years to Social Security, with a small portion invested in the private sector. This will allow the Trust Fund to earn a higher return and keep Social Security sound until 2055. But, we must also work on a bipartisan basis to put Social Security on a sound footing for the next 75 years. And, we must work to reduce poverty among elderly women, and to eliminate the limits on what Seniors on Social Security can earn.

Once we have saved Social Security, we must fulfill our obligation to save and improve Medicare, and invest in long-term medical care.

By saving the money we will need to save Social Security and Medicare, over the next 15 years we will achieve the lowest level of publicly-held debt since 1917. This debt reduction will help keep future interest rates low or drive them even lower, thus fueling economic growth well into the 21st Century.

To spur future growth, we must also encourage savings. In the State of the Union address, the President proposed that we use 11 percent of the surplus to establish new Universal Savings Accounts--USA Accounts--to give all Americans the means to save. With these accounts, Americans can invest as they choose, and receive funds from the Federal government to match a portion of the savings. This is the right way to provide tax relief to the American people.

Education is also key to our nation's future prosperity. That is why the President proposed in the State of the Union address a plan to create 21st Century schools through greater investment and more accountability. Among other things, the President proposed that states and school districts that accept federal resources will be required to end social promotion, turn around or close failing schools, support high-quality teachers, and promote innovation, competition and discipline.

Finally, at this time of continued turmoil in the international economy, we must do more to help create stability and open markets around the world. We must press forward with open trade. At this time of economic fragility in so many regions, the United States must not build new walls of protectionism, that could set off a chain reaction around the world that would imperil the world's growth. We must also continue to work to strengthen the architecture of our international financial system. The United States must continue to lead in stabilizing the world financial system.

CONCLUSION

Let me conclude by saying that over the past year the performance of the U.S. economy has been strong -- we have enjoyed solid growth, strong job creation, low unemployment and low and stable inflation. And there are broad and lasting benefits that American workers are enjoying as a result of strong economy. Even so, there are still long-term challenges facing our nation as we enter the 21st Century. The Clinton Administration has an agenda for helping to equip the American people with the skills and flexibility and security to take advantages of the opportunities and possibilities in this new economic era.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-FEB-1999 19:48:37.00

SUBJECT: SPR

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

TEXT:
Janet: Ron Minsk at NEC held a meeting for OMB, Treasury and CEA staff to discuss a proposal to add 28 million barrels to the strategic petroleum reserve. The decision has not been made yet, but Ron made it sound as if it is already a done deal. Treasury does not favor adding to SPR but can live with it. OMB's view is similar. NEC knows that we are not in favor. However, they want to know if we can live with it. If we cannot, we need to get back to them ASAP.

If it goes forward, the justification will be along the lines of:

a) prices are low so it is not a bad time to buy;

b) this is just to replace the amount sold last year (i.e., this is not a general justification for adding to the SPR - which will be an issue that will probably come up next fall after DOE completes a study of the SPR).

The justification will not be that this action will raise oil prices.

My own view is that I can live with it. This is a relatively small amount and prices are low. The more important issue is that DOE is likely to request a much larger and more expensive expansion later in the year. There is some danger that allowing this to proceed will make that expansion more likely (so how this purchase is justified is important).

Steve

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

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

CREATION DATE/TIME: 2-FEB-1999 10:42:36.00

SUBJECT: ERP Q&A Chapter 6&7

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

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

TEXT:
Janet, here is a revised Q&A with a few revisions made by Jeff on the first question.
Nouriel

---------------------- Forwarded by Nouriel Roubini/CEA/EOP on 02/02/99 10:40 AM ---------------------------

Jeffrey A. Frankel
02/02/99 10:35:06 AM
Record Type: Record

To: Nouriel Roubini/CEA/EOP
cc:
Subject: ERP Q&A

I entered a few revisions on the first one, but then stopped.

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

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D86]MAIL457506430.036 to ASCII,
The following is a HEX DUMP:

Questions and Answers on the International Chapters of the ERP

What do you think of the idea of capital controls on inflows and outflows?

The report discusses the arguments for and against controls on capital inflows. There is now a growing consensus that cross-border interbank flows may be excessively volatile and that they may have to be moderated in the framework of prudential regulation and supervision of the financial system. For example, Argentina has high required reserve ratios on short-term liabilities of the banking system.

Controls on all short term capital inflows, applied not only to banks but also to other financial intermediaries and non-financial firms, are much more controversial. There are arguments in their favor and against them. The report presents the pros and cons without taking a stand on them.

Capital controls on outflows, especially during a crisis, are counterproductive as the experience of Russia and Malaysia suggests. While introducing controls on outflows is not the appropriate response to crises, international capital inflows can reverse suddenly, and openness potentially makes emerging economies more vulnerable to such reversals. As a result, policies to increase the resilience of financial systems might be usefully identified, so that are less vulnerable to these crises. These include effective prudential regulation and supervision of financial markets.

One result of the recent crisis is a growing consensus that capital market liberalization has to be carried out in a careful, orderly and well-sequenced manner if countries are to benefit from closer integration into the global economy. If domestic financial systems are weak, poorly regulated and subject to institutional distortions, rapid capital account liberalization can lead to excessive short-term borrowing and lending, and a mismatch of maturities and currency denominations of assets and liabilities of financial institutions and corporate firms. To reduce the risk of financial and currency crises, effective regulatory and supervisory regimes must be in place and the financial sector must be poised to deal adequately with these risks as the capital account is liberalized.

Does the report suggest that Europe may not be an optimal currency area? Are you critical of EMU?

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

The report discusses the theoretical criteria for an optimal currency area and finds that the American States satisfy such criteria better than the European nations. However, there is good hope for a successful EMU. The degree of integration among EU countries is increasing decade by decade. The degree of international labor mobility, for example, is likely to be higher in the future than in the past. The Schengen convention now allows free movement of citizens among a subset of European countries. Thus the European countries may come to fully satisfy the textbook criteria of an optimum currency area in the future, even if they do not fully now.

Also, the political benefits of a united Europe go beyond the economic benefits of EMU.

How do you evaluate the IMF stabilization programs in the Asia, Russia and Brazil? Did the IMF get it wrong?

The US has supported the role played by the IMF in stabilizing the crisis-afflicted economies in Asia. Many of the criticisms of the IMF programs are misguided and the Report discusses such criticisms. We believe that, on balance, the IMF, has made sensible choices in confronting these complex and difficult crises, adjusting its judgments as appropriate.

In the Asian countries that followed the IMF stabilization policies, Korea and Thailand, the crisis has bottomed out and there are signs of economic recovery.

Rubin in Davos on IMF: "I believe that, on balance, the international community, including the IMF, has made sensible judgments in confronting these complexities, adjusting its judgments as appropriate. Having said that, by examining and re-examining our experiences in this crisis with an open mind, we can better prepare ourselves for decisions going forward, and I think it likely that much will change in maintaining or restoring financial stability in the years ahead. However, one thing is clear: there are no easy answers and no magic wands, and each of us must do our part."

Europeans and Japanese are pushing the idea of target zones to stabilize the relative values of dollar, euro and yen. Are you skeptical about such ideas?

Yes, we are against the idea of target zones. For the major currencies, the best regime is floating exchange rates supported by sound policies. Target zones and similar exchange rate intervention regimes are no substitute for sound underlying policies.

Rubin in Davos: "For major currencies, I believe that means floating rates supported by sound policies. Target zones and similar measures are no substitute for sound underlying policies and suffer from the defect that they could be pro- rather than counter-cyclical, thereby exacerbating, rather than countering adverse economic developments. To paraphrase Winston Churchill's famous statement about democracy, the floating exchange rate system is the worst possible system, except for all the others."

What is the best exchange rate regime for developing countries?

For emerging market economies , the choice of the exchange rate regime is more complex than for major currencies. Fixed rate and flexible rate regimes have been successful and unsuccessful in different countries. No matter what exchange rate a country chooses, it is critical that it be backed by strong financial regulation and appropriate monetary and fiscal policies. Macroeconomic stability is based on good policies, irrespective of the exchange rate regime. Policy mistakes that contribute to a currency crisis can occur in the context of any exchange rate regime.

What do you think of the current currency crisis in Brazil?

In Brazil the key is to have a good, sound, solid stabilization program and to implement it effectively. There are some political challenges to do that. The Brazilian authorities need to determine what set of policy measures they will need in order to both deal with their underlying problems and regain the confidence of the global financial markets.

Brazil has put in place almost all of the fiscal measures it needs; they have really done a great deal in this area.

Also, unlike some of the other countries which have experienced problems over the last two years, Brazil's financial system is in pretty shape.

The real's sharp decline "overdone" and it will strengthen as soon as the government adopts a clear monetary policy to restore confidence in the country.

Is globalization of trade and finance to be blamed for this recurrent global financial turmoil?

Openness to innovation and change - in technology, trade, open markets, flexible labor and capital markets - is absolutely necessary to ensure overall progress in job creation and increased standards of living.

The widespread financial turmoil in the last two years followed a robust period of increasing integration of world product and financial markets. World trade has increased dramatically as trade restrictions have progressively fallen and many countries have embraced historic openness to international trade. At the same time, restrictions on capital flows have been eased and financial markets have become increasingly integrated, leading to an unprecedented volume of international capital flows.

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

The maintenance of open markets by the United States and other industrial countries is essential to the restoration of world economic growth. Higher barriers to trade in the U.S. would not only hinder recovery in Asia and other crisis countries but provoke emulation and retaliation, hampering our own growth prospects. Indeed, it is worth remembering that the Great Depression of the 1930s was exacerbated by a dramatic switch to protectionist policies in the United States and other industrial countries. As the crisis economies recover, their demand for U.S. goods and services will increase as well, once again fueling our own export growth.

The United States remains committed to opening markets to international trade, recognizing that an open trade environment will support the recovery of crisis-afflicted countries and ensure continued growth of the world economy. The Administration remains strongly committed to such outward-looking, internationalist policies.

Rubin in Davos: "Openness to change -- from technology, open markets, and flexible labor and capital markets -- is absolutely central to overall progress in job creation and increased standards of living. But, openness to change also increases dislocations. And that is a hard reality of change and progress that cannot be avoided. The constructive reaction to that reality is to provide robust programs to equip and enable people to succeed in the global economy -- with special emphasis on those who experience dislocations -- and to provide social safety net support where needed. This is not an easy path politically -- quite the contrary. But it is the essential path for enduring growth and a strong economy....

Today there is the almost universal tendency to extol the benefit of exports, and to ignore the benefit of imports or even disparage them. And that leads to distorted trade policy. Imports reduce prices and increase choice for consumers; reduce prices and increase choice for producers, which should lead to greater job creation and higher wages; increase competition and productivity; and, for all these reasons, reduce inflation and presumably reduce market interest rates. Moreover, trade is not a zero-sum game; but one of mutual advantage. The increased efficiencies deriving from each country specializing where it has the greatest comparative advantage raise standards of living for all."

How should the international financial system be reformed to prevent recurrent crises?

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

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

Major reforms of the international financial architecture must occur to ensure the stability of the system. There are six important areas that have to be addressed

[The points below are mostly my elaborations of the 5 points discussed by Rubin at Davos.]
1. The most important factor in preventing crises from occurring is for developing countries to develop and follow sound policy regimes. Strong, well supervised and regulated financial sectors

are of critical importance. Sound fiscal and monetary policies are crucial. Transparency, accountability, codes of fiscal and monetary policy and adherence international standards in all these areas are important.

2. We must develop measures with respect to providers of capital in industrial countries to reduce the volatility of capital flows. A few words on hedge funds, leverage, derivatives and proper risk assessment by financial institutions.

3. We need more effective means of dealing with crises when they arise. The international financial community has taken a series of useful steps to better equip the IMF to deal with crises, including the precautionary facility proposed by the G-7 and the Supplemental Reserve Facility already in place. The private sector must also play an appropriate role in sharing the crisis burden for two reasons: first, because of moral hazard concerns -- i.e. creditors should bear the consequences of the risks they take if capital markets are to work effectively; second, because there will never be sufficient official finance to deal with the crises of today's vast markets.

4. Emerging economies should have sustainable exchange rate regimes. See question above for details.

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

The Administration has been working with the Multilateral Development Banks (MDB) to provide increased social safety nets in the countries in crisis to help the least advantaged citizens in those countries who are experiencing hardship. The World Bank should develop as a matter of urgency general principles of good practice in social policy, in consultation with other relevant institutions. These should be drawn upon in developing adjustment programmes in response to crises. The World Bank and Asian Development Bank are well positioned to provide adequate government spending in the areas of health and education -- two of the most crucial areas in which the MDBs should focus their resources.

Rubin in Davos: "We must do far better in enabling all of our citizens to participate in the growth and economic well being produced by the global economy. That means not only strengthening social safety nets for those in greatest need and promoting core labor standards around the world, but also greatly increasing investment in education and health care to provide all of our citizens with the requisites for economic success." (Rubin)

6. Strengthening the IMF. The IMF's own transparency could also be further improved by such steps as more widespread public release of information on the policy deliberations of the Executive Board along the lines of the procedures for the periodic country reviews, whereby the country reviewed may assent to a press release. In all these areas, the IMF will need to ensure that its work continues, as warranted, to be closely coordinated with other international entities,

such as the World Bank. It will also be important to ensure that the Interim Committee, as the body designed to provide ministerial level guidance to the work of the IMF on a regular basis, is able to continue to provide effective political level oversight and direction of the IMF in a manner that reflects the evolving nature of the challenges of the international financial system. Consideration of proposals to achieve this objective are in progress.