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To:	Melanne Verveer	**Date:**	February 3, 1999
Fax #:	Via White House Sit Room	**Pages:**	7, including this cover sheet.
From:	Felix G. Rohatyn		
Subject:	Memo to the President on Global Financial Issues		

Dear Melanne,

Attached is a memo to the President I've sent to John Podesta elaborating on some of the topics we discussed during our meeting January 27th. I thought it might be of interest to you and Hillary.

Kind regards,

Felix

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EMBASSY OF THE UNITED STATES OF AMERICA
PARIS

THE AMBASSADOR

February 3, 1999

Dear Mr. President:

Attached is a memo containing elaboration on some ideas we discussed last month about the global financial situation. It is meant as an illustration of a different approach more than a hard and fast model that would neatly solve the world's economic crises. I am sure there are many ways we can try to do this, if we can agree to reverse the basic thrust of some existing policies. Incidentally, this issue, more than any other, is the one that Chirac will be pushing when he meets with you on the 19th.

On Russia, I have had some talks with Strobe and some CEO's involved with Russia, and we may come up with some ideas after further discussions later this month.

By the way, I believe the Brazilians' appointment of someone from George Soros' firm to be Governor of their Central Bank is, to say the least, a bizarre signal for a country to send out about the soundness of its policies.

I enjoyed seeing you and Hillary, and hope this charade in the Senate will be over soon.

Kind regards,

Felix

Felix G. Rohatyn

The President
William J. Clinton
The White House
Washington, DC 20500

EMBASSY OF THE UNITED STATES OF AMERICA
PARIS

THE AMBASSADOR

February 3, 1999

TO: The President

FROM: Felix G. Rohatyn

SUBJECT: A Response to the Global Financial Crisis

When I had the opportunity of meeting with you in Washington a couple of weeks ago you suggested that I might put on paper some of the ideas that I raised with you.

As I indicated to you then, I am concerned about the basic thrust of the IMF-driven restructuring programs currently in force in Korea, Thailand, Indonesia and now Brazil, as well as the suspended program in Russia. Even though Korea, Thailand and Indonesia are all essentially due to private sector failures, while Brazil represents a public sector failure, the IMF programs are all based on similar premises:

1. Repayment of Western banks;
2. Raising interest rates to protect the currency;
3. Budget austerity to stabilize capital flows; and
4. Increased exports and lower imports to reverse balance of payments.

It is essentially an austerity-based policy whereby a net liquidation of domestic assets and a lowering of the standard of living is used to repay creditors in the short-run. The combination of austerity and net exports in one country after another is creating a serious imbalance in the global trading system whereby the U.S. becomes the only major net importer. This is not sustainable politically or financially. Our growing trade deficit and foreign debt, if they coincide with a break in the U.S. stock market, could start a run on the dollar which could only be controlled by steep increases in U.S. interest rates. The result would be a serious drop in the markets and, at the very least, a painful recession in the U.S. It could be much worse.

My experience with New York City was an example of the opposite approach, one based on recovery through growth and new investment. In 1975, the City could not finance its short-term debt and had a deficit of almost 20% of its controllable expense budget; its economy was in deep recession. We took the following actions:

1. We stretched out the short-term debt by replacing it with long-term debt; it required the New York State legislature passing a moratorium for the last 10% or so of the short-term debt;

2. We provided for reasonable interest rates on the new debt (8-10%) to give the city breathing room; it helped us to be able to borrow from the public employee pension funds; most of the financing obtained in the first 2-3 years was through private placements; a sky-high interest rate of 25-30% would have put the city into bankruptcy.

3. We created a new state entity, the Municipal Assistance Corp. (MAC) to provide financing for the city with long-term bonds backed by the NYC Sales Tax;

4. We had a 4-year plan to balance the budget which had the support of the unions and the banks;

5. Simultaneously with the start of the budget balancing plan, we began an aggressive program of new infrastructure investment to improve the quality of life and stimulate employment in the city. Our public investment program grew from practically nothing to $5 billion per annum 10 years later.

6. This enabled the city's economy to participate in the economic recovery of the late 1970's and early 1980's and generated the revenues required to balance the budget in 4 years. The growth in revenues was critical since all our cuts only managed to keep expenses flat over this period. We could not have gone further without triggering serious social problems. We balanced the budget on schedule;

7. The City regained full market access for its own bonds within 5 years; MAC had an investment grade credit rating throughout.

Is this approach applicable to an IMF-sponsored program such as Brazil? I believe the answer is yes; I also believe that there is no really practical alternative. Unless the emphasis of these programs is shifted from austerity and exports to investment and internal growth, the global financial and trading system will become completely unbalanced and an inevitable crisis will occur. A growth and investment approach to a case like Brazil might have the following characteristics:

1. Tough, credible multi-year budget plan coming into balance in, say, 4 years;

2. Letting the currency float;

3. Stretching out the short-term debt either by negotiation, or by forced exchange or by moratorium;

4. Lowering interest rates instead of raising them;

5. Setting up a massive IMF standby-credit ($75-80 billion or more) to be used from time to time for market intervention to maintain a ``reasonable'' economic exchange rate for the real. That rate would not be fixed in advance, but would be based on the judgment of the Brazilian Monetary authorities, together with the IMF.

A program with growth as its objective, a tough budgetary program and massive standby credits available to the Central Bank, has a better chance of limiting currency depreciation, despite lower interest rates, as opposed to a high-interest rate austerity program which guarantees steep recession.

Internal growth is a necessity in these countries in order to maintain reasonable levels of imports with which to keep the global trading system from tipping over. They also need growth to maintain living standards and minimize social costs which are considerable in any case.

There are a number of different technical initiatives being discussed now which would clearly be positive (i.e., enhanced credit oversight; accounting transparency; early warning of credit deterioration, etc.) and some which sound plausible but don't really work (i.e., short-term credit controls; foreign exchange target zones, etc.). None of these really deal with what I see as the fundamental flaws in the whole system, namely the commitment to austerity and high interest rates instead of growth and low rates. The international community has committed $180 billion through the IMF and we are facing recession in 40% of the world and a rising level of social strife. Thailand and South Korea are showing faint signs of recovery but it is not nearly enough. One has to stop and think about continuing on this path.

What I am suggesting is difficult and risky. A fundamental problem in this approach is the basic requirement to compel the stretch out of short-term debt. This might be done with new bond covenants or by legally giving the IMF the right to impose the equivalent of a moratorium. It might be done by an international convention. It is totally fundamental to any growth-oriented recovery program. It is the equivalent of what Bob Rubin calls ``bailing the banks in.''

Private sector restructurings, such as those in Korea or Indonesia, should have the same objectives, namely growth instead of austerity, with different mechanisms. The model of Roosevelt's Reconstruction Finance Corporation (RFC) would be appropriate. This would be a domestic development bank, managed by a mix of local and foreign reputable bankers and managers, in charge of the restructuring plan agreed upon between the IMF and the government. Financing for the local RFC would be provided by the IMF. The RFC would then negotiate appropriate restructuring plans with local banks and enterprises as well as social protection programs which could be financed by the World Bank. Politically, I believe a domestic RFC, with professional management, would create significantly less hostility to the West than direct IMF authority. The IMF would finance the RFC, but would be further removed from the local politics. The hostility to the IMF and to the U.S. in these countries must be taken into account.

The case of Russia seems to me an entirely separate problem requiring quite a different approach.

In a conversation we had last summer, you asked whether I could be in favor of a new Bretton Woods Conference. I told you emphatically yes and I am even more of that view now. A large part of the world, both developed and in development, is demanding a new look at the global system. President Chirac has called for a summit meeting later this year and is likely to find considerable support in Europe, in Japan, and elsewhere. We can either oppose the whole idea in the face of a lot of international pressure to go forward, or we can seize the initiative for ourselves. You could call for a Bretton Woods II conference, ***at Bretton Woods***, under your leadership and make reforming the international financial system the overseas counterpart of your ``saving social security'' initiative. That combination would be a great legacy for your Presidency.

There are some broad issues to be discussed at a New Bretton Woods. First, the whole issue of growth vs austerity and how to achieve it; second, the broad issue of fixed vs floating rates for developing countries; third, the possibility of single currencies for regional groups (i.e., Latin America); fourth, a real division of roles between World Bank and IMF, in addition to the technical questions now under discussion.

I realize that what I am suggesting is both very sketchy and extremely difficult technically, as well as risky conceptually. I am quite convinced, however, that we should at least look at alternative approaches because the path we are on is likely to lead to a crisis which might not be controllable. As that time, there might be no viable alternative to turn to.