Wednesday, October 28, 1998

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THE WHITE HOUSE

WASHINGTON

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Lockhart
COS

October 27, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: JOE LOCKHART

SUBJECT: Specialty Press Interviews

In conjunction with Stephanie Streett, Craig Smith and Minyon Moore, the Press Office proposes that you conduct the following specialty press interviews on Monday, November 2.

BACKGROUND

Live Radio Interview with Tom Joyner

You would participate in a 15 minute interview with Tom Joyner to be broadcast live on his morning radio show (8:33-8:48 am). Interview will focus on issues of importance to African-Americans including education, health care and HIV/AIDS.

Taped Radio Interview with Hispanic Journalists

You would tape a 30 minute radio conference call with four Hispanic radio stations. Each radio station will have one journalist who will be permitted to ask one question. Topics of each question will be known in advance. The stations would broadcast the call on Monday the 2nd with possible replays on Tuesday the 3rd.

Taped Interview with Tavis Smiley of BET

You would tape a 20 minute interview with Tavis Smiley of BET. Like the interview with Tom Joyner, the BET interview would focus on issues of importance to African-Americans. The interview would be aired the night of November 2.

APPROVAL

Please find attached a draft for the day.

Are you okay with this proposed interview schedule? ✓ ________

Schedule of the President
for
Monday, November 2, 1998
Draft Schedule

8:00am	**The President** proceeds to Room 415, Old Executive Office Building
8:05am- 8:30am	**BRIEFING** ROOM 415 Old Executive Office Building Staff Contact: Joe Lockhart
8:33am- 8:48am	**LIVE RADIO INTERVIEW WITH TOM JOYNER** ROOM 415 Old Executive Office Building Staff Contact: Joe Lockhart
9:00am- 9:30am	**TAPED RADIO CONFERENCE CALL WITH HISPANIC JOURNALISTS** ROOM 415 Old Executive Office Building Staff Contact: Joe Lockhart
9:35am	**The President** proceeds to Room 459, Old Executive Office Building
9:40am- 10:00am	**TAPED INTERVIEW WITH TAVIS SMILEY OF *BET*** ROOM 459 Old Executive Office Building Staff Contact: Joe Lockhart
TBD	**MEETING** OVAL OFFICE Staff Contact: Erskine Bowles
TBD	**BRIEFING** OVAL OFFICE Staff Contact: Samuel Berger
TBD	**BRIEFING** OVAL OFFICE Staff Contact: Samuel Berger

TBD **MEETING**
OVAL OFFICE
Staff Contact: Stephanie Streett

TBD (T) **BRIEFING**
LOCATION TBD
Staff Contact:

TBD (T) **MESSAGE EVENT TBD**
LOCATION TBD
Staff Contact:
PRESS TBD

TBD (T) **CONFERENCE CALLS**
LOCATION TBD
Staff Contact: Craig Smith
CLOSED PRESS

TBD **MILITARY/PRESIDENTIAL PROTECTIVE DIVISION DEPARTURE PHOTOGRAPHS**
OVAL OFFICE
Staff Contact: Larry Cockell, Virginia Apuzzo
WH PHOTO ONLY

EVENING OFF

BC/HRC RON **THE WHITE HOUSE**
WASHINGTON, DC

The Economist

A SURVEY OF SOCIAL INSURANCE

THE PRESIDENT HAS SEEN

Private peace of mind

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FYI — BC

Privatising peace of mind

Can the private sector help resolve the welfare state's troubles? Yes, but not all of them, says Matthew Bishop

WILL I have enough to live on when I retire? Will I get proper health care when I am sick, especially in old age? If I lose my job or become unable to work, will I end up in poverty or dependent on charity? These are big questions for everyone, and across the world they are being asked with growing apprehension.

Ever since 1889, when Otto von Bismarck, Prussia's "Iron Chancellor", introduced the first state pension, people have increasingly looked to government to provide retirement income, health care and protection against poverty—which together are broadly called "social insurance". Britain got its first state pension in 1908, and its state-run National Health Service in 1948. America's Social Security (the name for its state pension) was a product of the New Deal in the 1930s.

Some countries took this further than others. Sweden went to the interventionist extreme, and America to the laisser-faire opposite. Even so, there are remarkable similarities. Throughout the OECD, gross public spending on social insurance eats up half of total government budgets, and accounts for between a sixth and a third of GDP (see chart 1, next page). But there is now a widespread sense that this system—dubbed the "welfare state" in most countries (except America, where welfare is narrowly defined as aid to the poor)—is in crisis.

Problems, problems

So far, in rich countries, policymakers have been notably reluctant to reconsider from first principles what role the state should play in pensions, health care and the rest. (Some poorer countries, out of sheer necessity, have already had to be more adventurous.) Yet the time is ripe for a fundamental rethink. Today's systems of social insurance were devised for yesterday's world. When Bismarck invented the state pension, with a retirement age of 65, average life expectancy was 45. Now, in the OECD, it is 76 and rising—yet state pensions can still be claimed at 65 or even less.

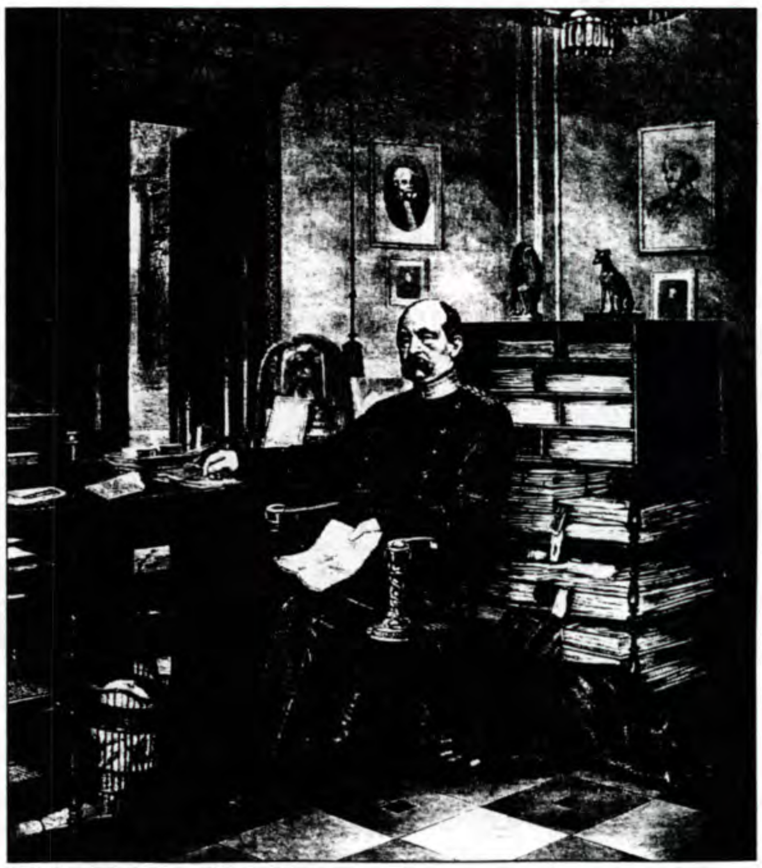
When most welfare states were created, a large proportion of their population was poor. Not so today. In developed countries, most working adults pay tax, and most taxpayers will see some of their money redistributed to people less well-off than themselves. Moreover, social insurance in its present form was designed for a world in which men went out to work, women stayed at home and few people got divorced. Jobs were plentiful, and unemployment carried a strong social stigma.

The problems that have sapped public confidence in social insurance will not go away; on the contrary, they are about to get a lot worse. The so-called "demographic time-bomb" has a short fuse. Populations in rich countries are ageing fast as the baby-boomer generation heads towards retirement and birth rates decline. If current social-insurance promises are to be honoured, spending on state pensions will have to go up steeply, which means a sharp rise in taxes. Older people are also by far the heaviest users of health care, which will increase the strain on public finances. Even in America, which relies far more on private health insurance than other OECD countries, health care for the elderly is largely paid for out of taxation.

The sort of tax rates implied by unreformed social-insurance systems threaten not just a loss of economic competitiveness, but something worse. As a new book, "Boomernomics"*, foretells it, "Generational warfare erupts as the baby boomers' children and grandchildren revolt against punitive tax increases needed to care for the elderly boomers. Inflation makes an insidious comeback as government deficits and debt explode... Young investment strategists overseas dismiss the United States along with other G7 nations as poorly run nursing homes in terminal decline."

In many countries, social insurance is being

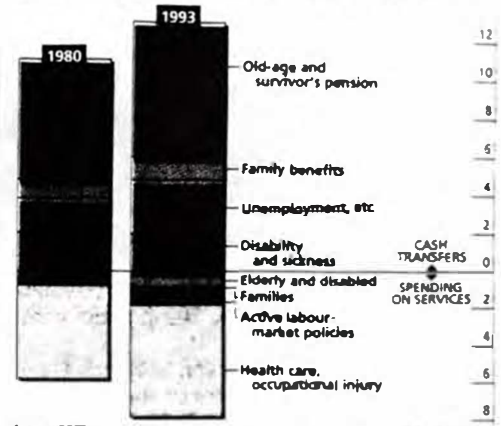
*"Boomernomics: The Future of Your Money in the Upcoming Generational Warfare", by William Sterling and Stephen Waite. Ballantine, 1998



Soft-hearted Iron Chancellor

The mighty welfare state 1

OECD average* transfers and spending as % of GDP



Source: OECD

*Unweighted

blamed for worsening some of the problems it was supposed to solve. In Germany, where over 10% of the workforce is unemployed, high social-security contributions have become a severe tax on jobs. They already equal 20% of an employee's gross income (half paid by the worker, half by the employer); at the height of the demographic squeeze, this is forecast to reach 30%.

Meanwhile, benefits for the jobless may discourage the recipients from looking for work, making them increasingly dependent on the state; and aid to single mothers has been blamed, most loudly in America and Britain, for encouraging women to have children they cannot afford, and for discouraging marriage.

The most sensible way to rethink social insurance is to get away from all the ideology and instead ask, what works? This will not necessarily produce a perfect blueprint to suit every country. Any social-insurance system involves value judgments, and different societies have different values and different cultures that need to be accommodated. Yet these differences are easy to exaggerate, and there is plenty to be learnt from comparing different systems about what does, or does not, work.

Answering that question means being open-minded about the possibility that the private sector may replace much of what is now done by government, while admitting that there may be things that government can do better than private business, or even that only government can do. Since the state's role is now largely taken for granted, this survey will concentrate on the part private firms should play in social insurance in future.

On the face of it, that part should be large. Although they do not shout about it, governments are keen to shift more welfare provision into private hands to keep public spending under control and to avoid having to raise taxes or cut benefits. In many rich countries the private share of social insurance has been edging up in recent years.

Private bonanza?

Private firms, particularly insurers and fund-management companies, are licking their lips at the prospect of all that new business. The recent wave of mergers between insurers, banks, brokerages and fund-management firms, and the rapid global expansion of American financial firms, were prompted partly by the expectation that individuals everywhere would be given more responsibility for managing their own affairs.

There are good theoretical grounds for thinking that competing, profit-seeking companies would not suffer from the more glaring weaknesses of state-provided social insurance. These range from monopoly problems, such as lack of choice, innovation and accountability to customers, to political interference. In reality, though, privatising welfare faces many obstacles. The biggest of these, everywhere, is the electorate, which is generally opposed to privatisation, even though it also disapproves of higher taxes. But even leaving the voters to one side, not everybody in the private sector is convinced. Mark Boléat, director-general of the Association of British Insurers, fears that in all the talk of opportunities, "there is perhaps a confusion between volume of business and profitability." And recent examples of private provision replacing state social insurance have been a mixed success.

Some of this may be due to teething troubles, but the business of insurance is also notoriously prone to market failure. Kenneth Arrow, a Nobel-prize-winning economist at Stanford University, argues that the distortions to the allocation of resources caused by "the inherent difficulty in establishing certain markets for insurance" is "one of the strongest criticisms of a system of freely competitive markets."

One such market failure is "adverse selection". Buyers of insurance tend to have a better idea of how risky they are than the insurer, so if the premium is based on average risk, only people of average risk and above will buy the policy. That means the insurer will lose money. Another market failure is "moral hazard". Once insured, people will worry less about that particular risk, so they may take less care to avoid it than they would without insurance. That means insurers may end up paying out more than they expected. A further difficulty is that uncertainty about the size of future claims may make it impossible to set a realistic price for the insurance. This is a particular problem for policies providing cover far into the future.

In theory, at least, governments have a unique advantage in dealing with these market failures—though putting this into practice is another matter. Adverse selection can be overcome by making the insurance compulsory for everyone, thus allowing it to be profitable when priced for an average risk. A government's legal powers may enable it to reduce moral hazard by laying down strict rules on people's conduct once they are insured, and to monitor and enforce these rules more rigorously than a private firm could. The problem of uncertainty about future costs can be reduced by committing future generations of taxpayers to pick up whatever the bill turns out to be—though one of the main reasons that welfare states are now in difficulties is that the public is no longer convinced that future taxpayers will pay up.

Because of these market failures, the privatisation of social insurance may often require some sort of government regulation to make it work. It has already become clear that getting this regulation right is crucial to the success of the transition, and that getting it wrong is all too easy.

Social insurance will always be a mixture of public and private provision. But what is the right balance between the two? There seems to be a compelling case for privatising pensions for most of the population. The market failures affecting private pensions are manageable. That would leave the state simply to provide a safety net for the poor.

Health care is much trickier. Market failures, particularly adverse selection and long-term uncertainty about costs, mean that, left alone, the private sector is likely to provide only limited health insurance that will fall short of most people's lifetime needs. There is a strong case for letting private firms provide the health care even if much of the funding comes from the taxpayer. And there may be scope for private health-care products that fall short of full insurance but give patients more choice, and confront them with some of the cost implications.

The biggest problem everywhere is to deflate the public's unrealistic expectations about how much care can be provided at a given level of expenditure, whatever the public-private split. The current crisis in the welfare state is due in large part to previous generations of voters' insistence that the state should play Santa Claus, and to politicians' unwillingness to disappoint them.

Reformers will also need to face up to some hard questions about the redistribution of wealth. In most developed countries (though least so in America) a hefty transfer of money from rich to poor is at the heart of the social-insurance system. The private sector can channel voluntary redistribution through charity, but only the state can legally take money from the rich and give it to the poor. Any reform of the welfare state must spell out how much redistribution that will involve. Here, "What works?" may not be the right question.

But before turning to what does work, the next section will take a closer look at what does not.

The end of the road

Social insurance isn't working

IN THE 200 years since Thomas Malthus forecast that population growth would result in mass starvation, dire predictions based on demographic trends have come to be taken with a pinch of salt. Yet it is hard to argue with forecasts that greying baby-boomers will wreak havoc on the rich world's social-insurance systems unless something is done fast. And in many countries there is no need to wait: the welfare state is in trouble already.

Public spending on social insurance is heavy across the OECD, though there may be arguments about the precise numbers (see box, next page). This spending has taken its toll on economic competitiveness, particularly in Europe. Yet spending money on social insurance is not necessarily a bad idea. A minimal level of protection is likely to have economic benefits, encouraging entrepreneurs by limiting their risks and maintaining social harmony in hard economic times. Little has been heard of late from the commentators who not long ago attributed the rapid growth of Asia's tiger economies to the absence of a welfare state.

Malthus redivivus

Moreover, health care, pensions and, arguably, redistribution of wealth are all examples of what economists call "luxury goods": as people, or countries, get richer, they spend a growing share of their income on them. The trick is to ensure that the cost of providing such social insurance does not exceed its economic benefits. In that respect, many countries have been failing, to varying degrees.

Social insurance need not even involve spending: it can also be delivered through laws and regulations. Many economists argue that government regulations that cause rigidities in the labour market, particularly by making it hard to fire workers or vary their hours, raise a country's unemployment rate above what it would be with greater labour-market flexibility. This helps explain why America has a much lower unemployment rate than France.

Clearly the availability of social insurance, whether delivered through spending or regulation, changes people's behaviour. If in many countries people are retiring ever earlier, they may simply be responding rationally to the financial incentives built into their particular state pension scheme. By contrast, Japan, which imposes relatively low taxes on older workers' earnings, has one of the world's highest employment rates among the over-60s.

Protection can also breed dependency. Some benefits, notably for the unemployed, have changed character, from temporary safety net to permanent support, thus discouraging self-help. In America, Charles Murray, a sociologist, leads a group of right-wingers who argue that assistance to the poor, by cushioning the short-term consequences of irresponsible behaviour, masks the long-term effects. It therefore encourages people to act against their own best long-term interests.

But similar criticisms have also come from the left. In Britain, Frank Field, a Labour MP, has slammed means-tested welfare payments, claiming

they cause people to lie about their income and encourage idleness. Although Mr Field quit his ministerial job in July, some of his ideas have been taken up by the prime minister, Tony Blair.

Some economists even blame state pensions for the breakdown of family life and the declining birth rate. If the state provides for old age, the argument goes, people do not feel the need to save or have children to look after them later in life (which was the main form of social insurance for the elderly before state pensions). A recent study of 49 countries between 1960 and 1989 found that higher state pensions went hand in hand with lower fertility, fewer marriages and more divorces, and a lower savings rate*.

The welfare state is also accused of behaving like a monopoly, depriving consumers of choice. The problems range from compulsory sharing of rooms in hospital to stipulating that everybody should retire at more or less the same age. The system suffers from inertia and lack of innovation. Mark Pauly, an economist at the Wharton School in Philadelphia, points to the example of Medicare, America's publicly funded health-care programme for the elderly. When this was created in 1965, its coverage was very similar to that of the best private health-insurance policies. It still offers the same sort of coverage today, but meanwhile the range of treatments offered by good private policies has expanded dramatically, making Medicare look mean.

In many countries, the tasks of administering benefits to the unemployed and trying to help them get a job are handled by different government departments. It is now widely accepted that these two roles should be combined, but little is being done about it, if only because those involved fear they might lose their own jobs and influence.

State-run welfare systems are also open to political manipulation. In recent years, politicians in several countries have tried to keep the official unemployment figures down by encouraging some recipients of jobless benefit to switch to disability benefit. Many of the people who made the switch were not so badly disabled that they could not work, but once they were drawing disability benefit they had no incentive to get another job.

More important, politicians have little to lose by promising generous social-insurance payments far into the future. However, when these promises are broken, public confidence in the system is undermined, and voters may become unwilling to let the government play its role in spreading risk between current and future generations, says David Moss, an economist at Harvard Business School.

Baby boom, baby bust

But it is tax and spending problems that are the biggest worry in most countries. As chart 3 on the next page shows, in countries where public spending on social insurance is high, taxes and social-security contributions account for a large slice of total labour costs. Over the past two decades, this "tax wedge" has risen in 15 out of 23 OECD countries; in Italy, Germany and several others, firms have to shell out more than twice as much in total employment costs as their workers on average earnings receive in their pay packets. That will hardly encourage them to create jobs.

But finding alternatives to taxing labour is hard, and likely to get much harder because of

*"Social Security and the Real Economy: An Inquiry into Some Neglected Issues", by Isaac Ehrlich and Jian-Guo Zhong. *American Economic Review*, May 1998

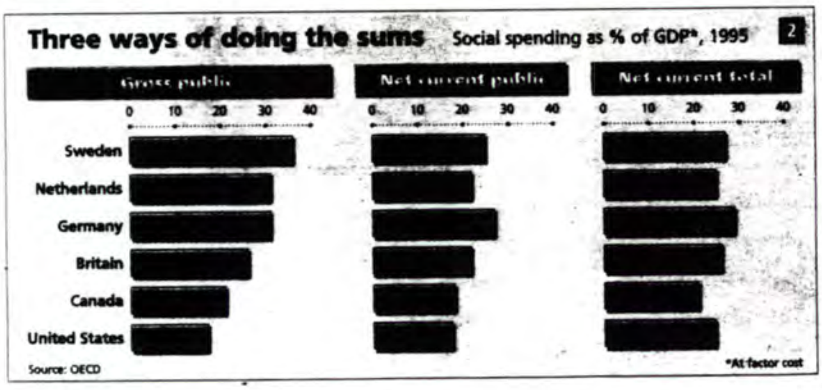
Spot the difference

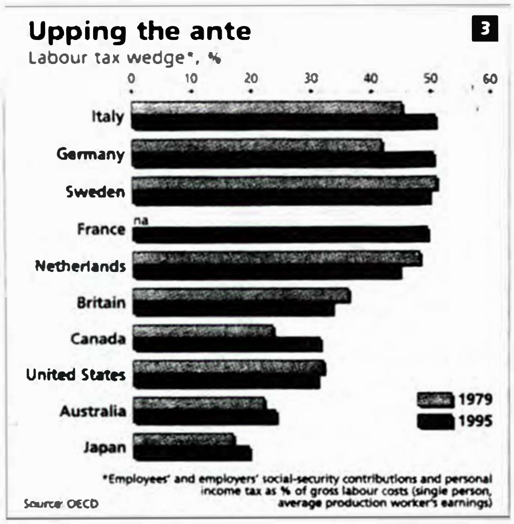
AT FIRST sight, spending on social insurance seems to vary enormously from country to country. But on closer examination, the differences seem to shrink. In "The Growing Role of Private Social Benefits", an OECD working paper published earlier this year, Willem Adema and Marcel Einerhand, two economists, challenge the conventional measures of social spending used in cross-country comparisons. Using figures for 1993 (updated in chart 2 to 1995), they calculated social spending in some of the world's richest countries in several different ways.

The usual yardstick, gross public social expenditure, showed Sweden to be much the biggest spender, at over 36% of GDP, America the smallest, at 17%, and the others in-between. However, these gross figures ignore the fact that the three continental European countries tax benefits such as unemployment pay, whereas America and Britain do not. If net current public expenditure is used instead, the gap between high and low spenders narrows.

On top of this, some governments require private companies to provide social benefits, notably sick pay and workers' compensation for industrial accidents. They also offer tax incentives to encourage firms or individuals to provide private social benefits, such as pensions. After adjusting net public benefits for the net value of these government-fostered private benefits, the gap between Sweden's and America's total social spending shrinks to a mere 2.5 percentage points, and Germany becomes the biggest social spender.

Which goes to show that total spending is only one part of the story. Who does the spending, how efficiently, and what other non-financial forms of welfare are available may be just as important in understanding a country's social-insurance system.





globalisation. Imposing new taxes on individuals is politically problematic, and trying to tax capital is likely to be unrewarding: the money will simply move elsewhere. Firms are abandoning any loyalty they may once have had to their home country in pursuit of cost-effective locations. Note how in the past few years many of Germany's best-known companies have expanded rapidly overseas. Nor would higher borrowing help. Most governments already borrow too much, and want to reduce their deficit. Besides, borrowing simply puts off hard choices; it does not solve anything.

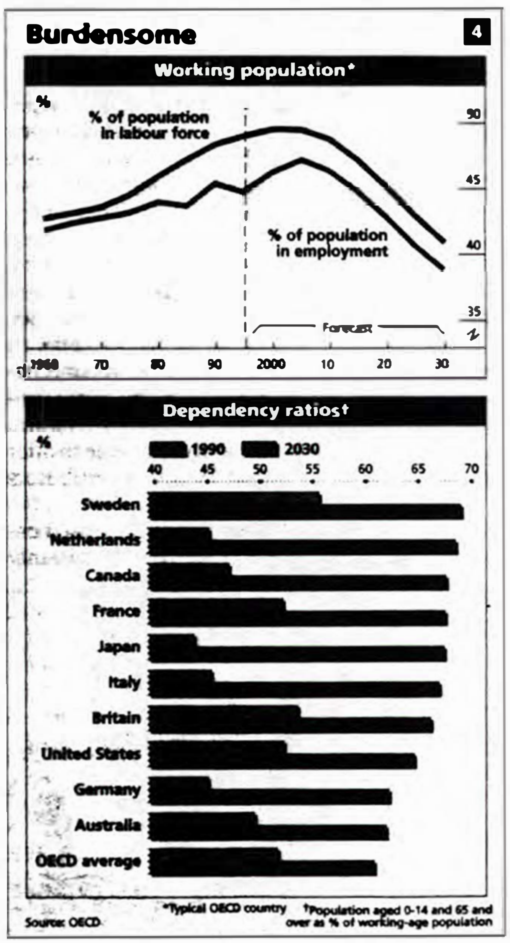
Yet demands on public-sector budgets are about to become much more pressing, creating problems even in those countries where social-insurance costs are currently manageable. Demography, after a favourable decade or so, is about to turn against the state (see chart 4). In Germany, which along with Japan faces perhaps the most severe problems in the OECD, the over-60s' share of the population is forecast to rise from 21% now to a peak of 36% in 2035. In Japan, the cost of state pensions is expected to quadruple by 2030; and in America, contributions to Social Security may rise from 11.5% of gross earnings to around 18% in 2030. Britain will largely escape such problems because it sharply scaled back increases in state pensions in the 1980s—though at the price of more pensioners in poverty.

However, pensions are not the only extra costs that countries with ageing populations will face. Health care for many more old people, and long-term care for people unable to look after themselves, will add to the bill. According to Victor Fuchs, an economist at Stanford University, health-care expenses for the average person over 65 are three times the figure for those below that age; and for the over-85s the figure is three times that for those aged 65-74. Mr Fuchs estimates that health care for the elderly could consume up to 10% of America's GDP if current trends continue, more than twice the present share. If Medicare continues to pay the bills, taxes will have to rise sharply. In Germany, too, contributions towards health care are forecast to rise from 12.5% of gross income to 17.5% at the crest of the grey wave.

Malthus was wrong. Could these gloomy projections prove equally mistaken? One way of averting them would be to crank up the birth rate in rich countries: but any reversal of the trend towards fewer children would have to be dramatic to make much difference. More plausibly, such few children as are born may turn out to be better educated, healthier and more motivated than those of previous generations, giving them much greater earnings power than is assumed in the projections. If so, however, taxing them might be tricky, as they would be just the sort of people who would nimbly side-step harsh tax regimes.

Countries with ageing populations could ease their restrictions on immigration, particularly for younger workers, but again it would take a huge influx to make much difference. For example, Axel Börsch-Supan, an economist at the University of Mannheim, calculates that to compensate for Germany's population ageing, and assuming that the new immigrants will have a similar age profile to those currently migrating there, Germany would need a net 800,000 newcomers every year until 2035. Politically, that would be a non-starter.

It is not inconceivable that tomorrow's workers will be a lot wealthier than today's, so will not mind handing over a much larger chunk of their pay to keep retired baby-boomers in comfort, but it seems unwise to rely on it. And best not to depend, either, on suggestions from the wilder fringe that voluntary euthanasia may solve the problem. There seems nothing for it but radical change. The best hope of achieving that is to harness the private sector, and the most promising area is pension reform.



Retiring the state pension

For most people, a private pension would be better

IDA MAY FULLER, who in 1940 became the first American to receive a regular Social Security pension, paid $25 into the system before she retired. By the time she died in 1975, aged 100, she had received benefits totalling $23,000. If every state pension delivered that rate of return, the private savings industry would be dead and buried. But for most people, a private pension would be an improvement on anything the state can offer.

Even so, the case for privatising state pensions is not as straightforward as is often claimed. True, switching to a private pension might well produce a bigger pension for the same money, boost savings and growth and help to defuse the demographic time-bomb; but there is no guarantee that it will do any of these things.

In most countries, the state got into the pension business to ease poverty among the elderly. As a result, state pensions—such as America's Social Security—are typically "pay-as-you-go". Unlike contributions to "funded" private pensions, the money put in by each generation of workers is not invested to pay for their own retirement, but goes straight out again to finance the pensions of those already retired. The young at any point in time pay the old. In developed countries, poverty in old age has become much less common, no doubt partly thanks to state pensions. But are they still needed?

Updating Bismarck

Opponents of privatisation cite three main arguments against it. First, investing in private pensions involves too much risk. If share prices were to crash, a private pension might not be enough to live on. Alternatively, the private pension provider might go bust. In either case, the state would have to step in. Second, left to themselves, people might not save enough for retirement—either because they do not know enough about investment, or because they will assume that they will not be left to starve in their old age. Third, the private sector has no mechanism to allow current generations to make unbreakable contracts with generations not yet born. Unlike a government, it is therefore unable to offer an absolute guarantee that current contributors will get a pension when they retire.

None of these arguments can be dismissed entirely. Investing in financial markets is certainly risky, as this year's volatility in share and bond prices has made painfully clear. Some Wall Street pundits predict that share prices will plunge as retiring baby-boomers pull their money out of the market, just as heavy investment by the boomers was responsible for the dizzy rises of recent years. But higher risk also offers the chance of higher returns. Moreover, as people demand more control over their risks, financial firms are starting to develop the instruments to provide it. For example, Alliance & Leicester, a British bank, sells a Guaranteed Investment Bond, promising, at a price, "the potential growth of a stockmarket investment without any of the risk."

Whether people will save enough if left to their own devices is more debatable. At present, there is some evidence that they save too little. A recent paper by Olivia Mitchell and James Moore of the Wharton School found that Americans in their 50s would typically need to save 16% more of their gross income to maintain current consumption in retirement, and the poorest among them fell 38% short. According to the Brookings Institution, a Washington think-tank, 31% of working adults in America are not saving for retirement at all.

On the other hand, many elderly people have more money than they need. According to figures from the OECD, in most rich countries the over-65s have higher incomes than the under-30s, and real living standards rise immediately after retirement. Except in America, retired people at all levels of income continue to save. Most people leave something behind when they die.

There are good reasons to expect people to be bad at retirement planning. Financial products are often complex. People buy them only rarely, and may not find out until many years later if they were any good. This can leave savers vulnerable to sharp salesmen. For example, in Britain in the late 1980s, thousands of members of company pension plans were persuaded to switch out of them into personal pensions, even though they would have been much better off staying put. Many of Britain's top pension firms have had to pay large sums in compensation.

Governments are indeed able to contract with future generations of taxpayers, but there is a risk that future generations will not honour the promises that politicians have made in the past. One sur-

Born to keep the pensions coming

vey suggests that more young Americans believe in UFOs than believe they will ever receive a dime of their Social Security pension.

One drawback of state pay-as-you-go pensions is that they offer no opportunity to hold a diversified portfolio of assets—equities, bonds, property and so on—and therefore miss out on the most efficient combination of risks and returns. A possible solution would be to allow state pension funds to invest some of the contributions in shares. This is what happens, in theory at least, in Singapore (through the Central Provident Fund, into which workers must pay 20% of their salary), and the idea is now being seriously debated in America. It could give everybody a stake in the equity market. Economies of scale mean that governments should be able to invest at lower cost than anybody else.

Against that, though, there would be huge political risks. Singapore's Provident Fund, for example, earns low returns, thanks to a politically driven investment strategy. If the stockmarket were to underperform, the government could face a tricky choice between paying lower pensions or raising taxes. Indeed, a potential bias in the system might well worsen the under-funding problem: benefits would be more likely to go up in good years for shares than come down in bad years.

At the opposite extreme, governments could simply get out of the pensions business and let people make their own retirement-savings decisions. But this seems unlikely to happen. Some people will always be too poor to make their own provision, and others will not bother. The cost of this moral hazard can be minimised, however, by requiring workers able to do so to invest enough of their salary in a pension to ensure that, barring emergencies, they will not need the safety net. Chile (among a growing number of developing countries) has such a pension scheme, which works well, if not perfectly (see box). So does Australia.

But if there is to be compulsion, to whom should it apply? And what sort of fund should the money be invested in? Pension funds come in three main varieties: defined-benefit funds, which pay a fairly predictable pension related to the worker's salary; and two sorts of defined-contribution schemes, where the pension reflects the investment returns on the money paid in. The first sort of defined-contribution scheme delegates the investment process entirely to professional managers, as is done with personal pensions in Britain. The second sort gives the saver an element of control over his investment, as in America's 401(k) plans. These typically allow him to move the money in the account among a selection of mutual funds, as well as into his own company stock.

Watch the snags

Each of these varieties carries different risks and costs. Defined-benefit schemes involve less uncertainty about the size of pensions, but may earn lower returns on the money put in than defined-contribution funds. When provided by employers, they may cause rigidities in the labour market by penalising workers who move to another company.

Defined-contribution pensions have more volatile returns, and can have higher management costs, in marketing and, for funds such as 401(k), the infrastructure to give people control over their assets. If savers lack basic investment skills, the funds they manage themselves may be riskier than professionally run funds—or else more risk-averse, which may be worse. But new technology may soon overcome such drawbacks. For example, Financial En-

From Chile, with a pinch of salt

ALAN GREENSPAN, the chairman of the Federal Reserve, and Milton Friedman, one of the world's better-known economists, are among those converted by the evangelistic fervour of Jose Pinera. In 1981, as Chile's labour minister, Mr Pinera set up a funded pension system to replace his country's bankrupt pay-as-you-go scheme. The scheme required workers to pay 10% of their income a year into a private retirement account of their choice which they owned and controlled. Although it started life under General Pinochet's military dictatorship, this is now viewed around the world as a model for privatised pensions. Mr Pinera has taken to travelling the world, exhorting others to follow in Chile's footsteps.

Yet although the system remains popular at home, thanks to average real annual returns of 13% during its first 15 years, Chileans are by no means uncritical. During the past year or so the stockmarket has performed poorly, and recent returns on the funds have been negative. Moreover, charges levied by the fund-management companies have failed to come down. According to Salvador Valdes-Prieto of the Catholic University in Santiago, these charges eat up nearly 3% of each investor's income, or around 18% of total contributions. Marketing costs have remained high.

The scheme is compulsory only for those in formal, regular jobs, so only 2.5m of the country's labour force of 5.6m are currently contributing. People in the informal sector can join, but few bother. And since many of them live in rural areas and do not earn a lot, pension-fund companies do not try very hard to recruit them either.

Fund managers used to face severe restrictions on investing overseas, and even now the funds are still 99% invested in Chile. This is largely because fund managers face a huge disincentive to doing anything different from anybody else. If a fund's return in any 12-month period is over two percentage points below the average for all funds, the management firm has to make good the shortfall from its own capital. Yet there is no reward for outperformance. Not surprisingly, therefore, all the funds have similar portfolios. This prevents investors from making prudent changes to the risk profile of their fund as they get older.

"It is the idea behind the Chilean system that people should copy, not necessarily how Chile does it in practice," concedes Mr Pinera. Many of the present problems stem from rules drawn up to make sure the transition from pay-as-you-go to funded system succeeded. They should have been scrapped years ago, he says. But the leftish democratic governments in power since General Pinochet stepped down in 1989 have been slow to make changes. "The paradox", says Mr Pinera, "is that all those who designed the system want it liberalised, whereas those who originally opposed it won't touch it. They have become more Catholic than the Pope."

gines, a Silicon Valley business co-founded by Bill Sharpe, a Nobel-prize-winning economist, has just launched SAGEIS, an Internet-based system that helps 401(k) investors work out how much risk they want to take and how much retirement income they need, then uses cutting-edge financial theory and huge computing power to tell them how likely they are to achieve their goal.

One of the simplest ways of reducing the cost of state pensions would be to raise the retirement age and make early retirement less attractive. At present, most state systems offer built-in incentives to retire early, and many workers have taken the hint. Labour-force participation of men aged 60-64 has declined from over 80% in most rich countries in 1960 to 50% in America and below 35% in Germany, Italy and France. If governments were to remove these incentives and raise the retirement age, people might simply choose to retire later rather than make private provision to fill the gap.

Done paying

Compelling people to save more than they want to is not easy. In the first five years after payments into Australia's Superannuation funds were made compulsory, contributors squirrelled away A$180 billion ($110 billion) into the funds—but increased their borrowing by almost as much, according to Vince FitzGerald of Allen Consulting in Melbourne. The Australian government has now abandoned plans to increase the rate of compulsory Superannuation contributions from 9% of salary to 12%. At the same time it has steeply raised the income threshold above which workers have to contribute, from A$5,400 a year to A$11,800.

That raises the question of what to do about pensions for people on low incomes. Forcing them into funded pensions they cannot afford would be impractical. Yet if the government were to pay towards a funded pension on their behalf, that would increase public spending in the short term and deepen the poverty trap. Low-income earners would be discouraged from looking for better-paid work, because they might have to pay their own pension contributions. Moreover, the management costs of a funded pension might eat up most of the contributions of low-income earners, giving them a lower return than people on higher pay.

Introducing new pension schemes can be expensive. The launch of Argentina's private funds in 1994 cost around $600m, most of which went on a huge advertising campaign. Starting up Mexico's new system in 1997 is estimated to have cost $500m. But Bolivia's new pension scheme, introduced this year, was launched for next to nothing. For the first year the government simply allocated every eligible adult to one of two pension funds; switching will be allowed later. In Australia, Superannuation funds run, in effect, by trade unions put pressure on the financial companies to come up with simple, low-cost investment products, driving costs down across the industry.

The biggest political obstacle to introducing funded private pensions is the transition from the current pay-as-you-go system. The generation that will lose its state pensions still has to contribute to the pensions of older baby-boomers who have already retired or are too close to retirement to build up a decent private pension. That is why American proposals to "save Social Security" by diverting some of current workers' Social-Security contributions into personal funded pensions are misleading. Every dime diverted from social-security contributions reduces the money available to pay the pensions of people still in Social Security, so worsening the funding problem.

Supporters of funded pensions have done a bit of optimistic number-crunching to suggest that this will not matter very much. Some of these calculations assume that money invested in personal pensions will go on earning the sort of soaraway returns that shares have generated in the recent bull market, which seems unlikely. But even if the transition to funded pensions could somehow be managed painlessly, it would still not resolve all the demographic problems. People in retirement will still be living off those in work; and unless older people work for longer, the ratio of pensioners to workers will still rise sharply. Or could these problems be avoided with a bit of economic magic? One idea is that buying shares in foreign countries with younger populations will reduce the demographic pain at home, although the volume of such investment would have to be huge. And there are hopes that funded pensions might increase the rate of savings in America and could do the same elsewhere, which in turn would raise the rate of economic growth.

Since Chile introduced its funded retirement accounts, its national savings rate has doubled to 25% of GDP. However, according to Klaus Schmidt-Hebbel, an economist at Chile's central bank, this was largely due to other reforms to boost savings, introduced at the same time. In Australia, as we have seen, funded pensions have so far had a negligible impact on saving. According to Olivia Mitchell, in a developed economy such as America, which has already done a great deal to encourage saving, funded pensions would probably boost private savings only modestly. The main benefits would be diversified portfolios and reduced political risk.

That may fall short of perfection, but it clearly justifies moving some way in the direction of private funded pensions. Whether the private sector can do much to solve the problems of health care is less certain. ■

Out of sorts

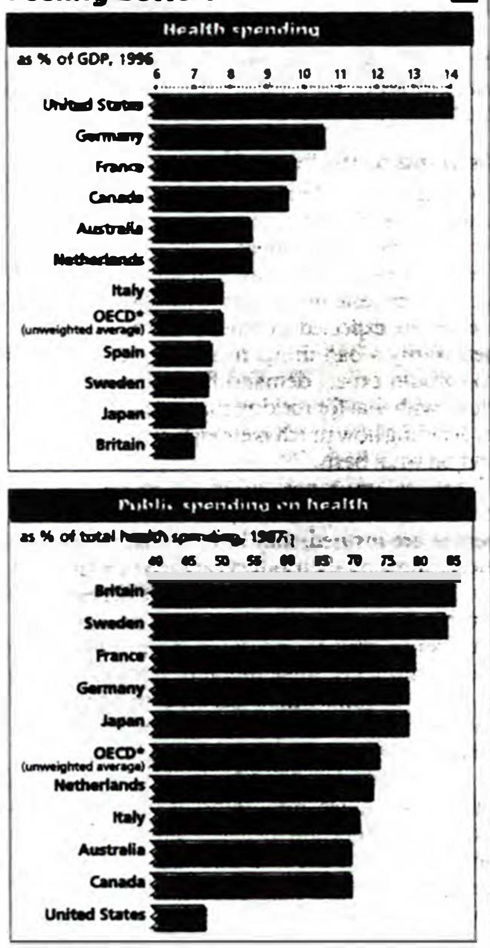
Can the private sector help to put health care right?

VIAGRA may give a lift to many an ageing Lothario, but the anti-impotence drug launched earlier this year has given health-care providers around the world a headache. In America, some private health insurers have refused to pay for the drug, and in Britain it is currently unavailable on the National Health Service, pending a government decision on its use.

The reaction to Viagra suggests that the British and American health-care systems have more in common than is often supposed. Neither system—nor any other, for that matter—seems to have good answers to the problems of ageing populations, innovation in treatments and drugs, and the need to ration supply in the face of potentially unlimited demand. Can the private sector help?

Critics of private health care like to compare Britain and America. In the red corner, Britain, with its popular state-funded National Health Service (just turned 50), spends only 7% of its GDP on health care. In the feeling-blue corner, America, with its mainly private-insurance-based system, spends 14% of GDP on health (see chart 5). Yet despite spending proportionately twice as much as Britons, Americans appear to have little to show for it.

Feeling better? 5



Source: OECD *Excluding Czech Rep, Hungary, Poland and Turkey

As always, the real world is more complicated than the statistics suggest. Every poll confirms that the British love their health service, but they also grumble endlessly about its waiting lists and its crumbling buildings. Tony Blair was elected on a promise to increase government health spending as a share of GDP. As for the American system, it may deliver better care than the headline numbers suggest. Most new medical techniques, technologies and drugs become available in America before anywhere else. When the world's rich want the best treatment money can buy, they usually head there.

Besides, America's health-care system is anything but a model of unconstrained private-sector forces at work. True, public spending on health care in America accounts for a smaller share of the total than in any other OECD country, but it has been bucking the trend by growing steadily, from only 25% in 1960 to nearly half now. As the post-war baby-boomer generation reaches retirement age, pushing up spending on Medicare (the government health-care programme for the elderly), that share is set to rise further.

Nor is that all. Tax breaks to encourage employers to buy private health insurance for their employees—which is the way most American workers obtain their health cover—amount to 0.75% of GDP. And the state has been steadily stepping up its regulation of private health care, for instance by laying down what sorts of treatment health insurance must include.

Market casualty

It is not really surprising that governments all over the world are so deeply involved in health care. A purely private market for health insurance is unlikely to work well. Poorer people may not be able to afford it (note, for example, that 40m Americans have no health insurance); and it may be subject to adverse selection, particularly among the elderly, so insurers pricing on the basis of average risk will lose money. Yet if they raise premiums, they may deter yet more lower-risk customers.

Some insurers fear that better understanding of genetics will further undermine the market for private insurance. This relies on pooling risks by selling policies to groups of people of similar riskiness, only a few of whom are likely to make claims. Genetic testing will make it harder to pool these risks, as it will reveal differences between individuals who currently seem to have similar risk profiles. Insurance companies fear that this will worsen the adverse-selection problem, because individuals are likely to know more than insurance companies about the risks they present.

Health insurance also suffers from a moral hazard: that people may not bother to look after themselves properly because they are insured. But the biggest problem is the uncertainty about long-term costs. Technological and pharmaceutical innovations have already greatly increased the range of treatments available, and the pace is likely to accel-

Doctor, doctor, there's a hole in my budget

erate further. In the past few years, it is these innovations—not demographic factors—that have driven up the cost of health care.

When insurers are uncertain about costs, they either charge higher premiums or restrict their coverage. One way for them to get round the long-term problem is to offer only short-term policies, perhaps a year at a time. Yet as people get older, they are more likely to fall ill, so they will pay more every year. In an ideal world, they would want to buy a policy that lasts a lifetime, so that the premiums could be spread evenly. Instead, they face ever-higher health insurance costs just when their income is dropping.

There is no easy way round this. Australia stops its insurers from charging the elderly more than younger people, with the predictable result that older people are buying the policies and younger people are not. The Australian government is now offering young people large subsidies—of up to 30% of premiums—to switch to private health insurance, but there are few takers. Younger people tend not to need the queue-jumping, non-emergency health care that is the main attraction of Australia's private insurance. What they want most is cover in an emergency—which the state health-care system provides free.

In most developed countries, the state is responsible for the bulk of health insurance in old age. But public health insurance does not really solve the problem of uncertain long-term costs. It merely guarantees that the amount of health care older people get and the extent to which they will benefit from technological innovation will be a political decision, depending on the generosity of taxpayers at the time. The alternative would be to invite younger people to save what they think they will need to buy health insurance when they are old, and make them go without or rely on charity if they have not saved enough; but that would create its own political problems.

For all its flaws, America's health-insurance system demonstrates how the private sector can promote efficiency and innovation. Managed-care organisations (MCOs), which have grown rapidly since the 1980s, are deeply unpopular because users dislike restrictions on the treatments available, but they have broken new ground in controlling costs, and particularly in curbing the ability of doctors to milk the system.

Their success has been emulated abroad, including in Britain, where health care is still purchased by the state but supplied by competing providers such as hospitals. The main source of market discipline has been doctors, who can choose suppliers on behalf of their patients. But this competition has been muted, perhaps because the vast bulk of hospitals and other providers remain state-owned and not driven by profit. Indeed, although the National Health Service has become the largest provider of health care to people with private insurance, the Labour government strongly discourages doctors from referring patients to private hospitals and claims—not altogether accurately—to have abolished the "internal market" in health care.

America has met similar problems in its attempt to introduce the benefits of private competition into its publicly funded programmes, Medicare (for the elderly) and Medicaid (for the poor), through the use of MCOs. Since the Balanced Budget Act of 1997, the programmes have been reluctant to pay the MCOs at market prices, and court rulings have made MCOs subject to the same bureaucratic red tape as government health-care workers. This has recently caused several MCOs to cut back their participation in Medicare programmes.

But an even more troubling trend in America is that many MCOs are now running into financial difficulties. Health-insurance premiums have risen by 5-7% this year after remaining stable for several years, as MCOs admit that they may have reached the limits of their ability to squeeze costs.

Demanding the impossible

The question underlying all this is how to ration health care. The cost pressures are enormous. In America, the Department of Health and Human Resources recently forecast that spending on health care will double in real terms by 2007. Similar increases are expected in other countries. This is not necessarily a bad thing; in an ageing population, you would expect demand for health care to rise, along with that for rocking chairs. The difficulty lies in deciding how much is enough, who should get it, and on what basis.

Private insurance, in trying to resolve these problems, is subject to twin moral hazards. Once people are insured, they have no reason to ration their claims on their policy; at the same time, doctors have an incentive to overtreat patients to get as much money out of the insurer as possible. However, since private insurance premiums are reviewed annually, these moral hazards can be controlled. Premiums will reflect the costs of treatment, and individuals can be penalised with higher premiums or rewarded with no-claims bonuses.

With government-funded health care, the moral hazards are much more problematic. There is almost no connection between how much health care individuals use and what they pay, if indeed they pay anything: young, healthy taxpayers bear much of the cost of health care for ailing pensioners, and on the whole the better-off pay for the poor.

In recent years, public health spending in many countries has been controlled by imposing an arbitrarily chosen budget cap. Rationing has been by a combination of queueing and chance. This has the advantage of being equitable, in the sense that the misery is shared. The rich are free to queue-jump via supplementary private health insurance. But it is not a particularly efficient sort of equity, because what treatments the state provides depends on random selection rather than conscious choice.

Giving people an incentive to ration their own consumption of health care may help a little in keeping down costs—though this may backfire if it discourages them from seeing a doctor if they really need to. The burden of fixed charges will fall hardest on the poor. In many rich countries, the use of co-payments (say $5 towards each visit to a doctor) and deductibles (say the first $250 of the cost of an operation) is growing fast. The government's share of health spending has declined in 16 OECD countries since 1990, in large part thanks to the increased use of this kind of cost-sharing with patients, especially for spending on drugs. The French government recently cut the portion of medical bills it reimburses from 75% to 65%.

Some American reformers have high hopes of medical savings accounts, into which a given amount would have to be paid to cover routine medical costs. Catastrophic health costs, which are less vulnerable to moral hazard, would be covered by a separate insurance policy, which could be privately or publicly financed. Any unspent money in the account would roll over to subsequent years, giving people an incentive to avoid unnecessary spending. But there is a risk that money in the accounts will prove insufficient, and they have struggled to take off in America, possibly because they offer no tax advantages.

Another way of keeping public health-care spending under control is to exclude all those rich enough to look after themselves. In Chile, people can opt out of the state system, which saves them paying the health-care element of their tax bill and allows them to spend it on a private insurance premium instead. However, this has failed to keep costs down. Many people opt out of the state system into cheap private health care, but if they become seriously ill they return to the state scheme, leaving it with the worst of all worlds: lower income as well as a higher risk profile. In Germany, the well-off are encouraged to opt out of the state system, and once out they are not allowed back in. That should avoid Chile's problem.

Means-testing publicly funded health care is a further possibility, but it would create a serious moral hazard, especially for those approaching their later years of higher spending on health care. Means-testing would discourage them from saving, or encourage them to transfer their assets to their children.

Long-term worries

In many countries, these problems have been highlighted by the refusal of governments to pay for long-term nursing care outside hospital until the funds of the patient are exhausted. This has infuriated many old people (and their children) and provided rich pickings for lawyers and accountants.

Private insurance for unlimited long-term care, like health insurance for the elderly, is expensive because of the uncertainty about costs. A policy that simply paid out an agreed sum if the insured needed long-term care would be much cheaper, but could turn out to be insufficient to cover the cost. However, it might be easier to sell if buyers were offered a higher means-testing threshold if they did have to fall back on state help—an idea mooted in Britain by the Tory government before it lost office last year. This could also be a way of tempting people to buy other sorts of health insurance if these were means-tested.

Clearly, there is scope for the private sector to play a part in health care. In particular, competing private firms may be the most efficient providers of health services. What role private insurance should play is harder to judge. If, as seems likely, public funding will continue to be the main pillar, ways must be found to give the public more influence over how much is spent, and on what.

At present, the main, sledgehammer, option is to vote out the government in a general election. One promising possibility is to hand the health budget to a separate institution, run by officials elected by the public to do only that job, and funded by a hypothecated tax raised only for that purpose. This might give voters more of a choice. More debate about which health services the government will pay for—correction of unequal leg lengths? Heart transplants? Viagra?—might also be welcome. But as long as most voters think of health care as a free good available in unlimited quantity, and politicians encourage them in that belief, nothing will change for the better.

Robin Hood Inc

How to redistribute redistribution

"CORPORATE WELFARE" was a phrase coined in the 1970s when Lockheed was bailed out by America's federal government after the cargo plane it was developing went $2 billion over budget. Now, in a neat twist, Lockheed Martin (as it now is) has set up a "welfare reform services" division, which it hopes will earn its keep by helping unemployed benefit recipients find jobs. Is this the private destiny of the non-health, non-pension bits of the welfare state?

At present, those bits are made up mostly of various sorts of income support for people of working age and their families. In most countries the bulk of it goes to the unemployed, and much of the rest to working families with low incomes. The government has become involved in providing this kind of income-protection insurance for two reasons. One is that moral hazard creates huge risks for private insurers, who want to avoid subsidising the work-shy or the fraudulent. The other is that much of it involves long-term redistribution from richer people to poorer ones. Private insurers are not in

the business of doing that.

Insurers are happy to sell cover to people who have a relatively low likelihood of becoming unemployed. There is a small but growing private market for income-protection insurance, aimed mostly at the fairly affluent. This is well-established in America and Britain, and beginning to spread to continental Europe.

Critical-illness insurance typically pays out a lump sum if the insured finds himself at death's door. Permanent health insurance, which sells nothing like as well, provides regular payments for the remaining lifetime of a policyholder who is diagnosed with a terminal illness. Creditor insurance covers debts to a pre-agreed value if the insured is unable to work. Mortgage-payment protection insurance is typically triggered if the policyholder is not working because of unemployment, accident or illness.

In many countries, government disability benefits and sick pay reduce the allure of critical-illness and permanent health insurance. Disability benefits have been among the fastest-growing areas of state assistance in much of the OECD. In Britain, the number of disabled people has doubled and the cost of providing disability benefits quadrupled in real terms over the past 20 years.

People already too severely disabled to earn a living wage would not be able to get private insurance, and a civilised society would find some other way of helping them. But for everybody else there is no obvious reason why the private market should not insure the risk of disability. There is little moral hazard, and adverse-selection problems can be minimised by medical examination.

Earlier this year the Netherlands privatised its disability insurance, much the most generous in the world. In 1993, one Dutch adult in seven received disability benefits. Attempts to tackle this with a tougher definition of disability had only a limited effect, so the government has started to charge employers premiums for their workers' disability insurance cover, based on the employers' past record. Any firm that can get a better deal in the private sector can opt out of the state scheme. But the government still sets a maximum premium for smaller firms, so it may end up retaining the bad risks and losing the good ones to the private market.

The do-it-yourself model

The Netherlands has also privatised short-term sickness insurance, and Britain has abolished state subsidies for sick pay. According to John Cunningham, of Bacon & Woodrow, a firm of actuaries, this has spurred employers to find new ways of discouraging their workers from taking time off sick, such as paying them bonuses for low absenteeism.

Creditor insurance and mortgage-payment protection policies also suffer from the drawback that those who need them most are likely to find them too expensive or not available to them. In Britain, sales of mortgage-payment insurance have soared since the government cut benefits in 1995. About a third of all housebuyers now choose this cover, compared with less than a tenth in the early 1990s.

Private income-protection insurance in the event of long-term unemployment may pose insurmountable problems. According to Harry Taylor of the Abbey National, a British bank, the nature of the risk involved may be unquantifiable.

Robs the rich, gives to the poor

Much of the income-support insurance provided by the state really amounts to redistribution of wealth to people on low or no income. This is not much talked about in the OECD but, says Andrew Dilnot of the Institute for Fiscal Studies in London, in most countries redistribution is at the heart of government welfare and social-insurance systems. To be effective, any reform of the welfare state must squarely face this issue.

It raises two separate questions: how to raise the money, and how to distribute it to the needy. The old left used to argue that money should be forcibly extracted from the rich. But nowadays rich people do not necessarily need to be coerced into handing over their money; philanthropy invariably increases as incomes rise, and flows most generously in countries where taxes are low, such as America. Forcing the rich to pay up has also become much harder, thanks to globalisation, financial planning and tax havens. And in most rich countries, a majority of the workers now earn enough to ensure that at least some of their taxes go to the poor.

When redistribution was largely about milking the rich, using the government as the milking machine was probably the least bad option. Now some politicians are beginning to ask whether it would be more efficient to tax people less and leave them to decide for themselves how best to satisfy their charitable impulses. So far, such questions are coming mostly from America's anti-government fringe. In Wisconsin, the state will soon stop giving aid to families with dependent children. Tommy Thompson, the state's governor, believes that this will prompt recipients to find work, and if they fail, they will be helped by private charity.

There is a growing consensus that simply handing money to the needy can do more harm than good. As Tony Blair, the British prime minister, has put it, welfare should aim to "give a leg-up, not a handout". Phrases such as "active labour-market policies" and "welfare-to-work" sum up the new mood. And there is increasing interest in involving the private sector in this new approach.

One obvious way to do this is to subsidise jobs in private firms. This makes more sense than hiring people to work for the government because the jobs

Would a privatised dole queue be shorter?

concerned are more likely to be "real". If the subsidy falls short of covering the full cost of employing the worker, firms must think that the work has some economic value. But there is a downside: employers may use the handout to cut the pay of existing workers rather than create new jobs, or they may sack existing workers in favour of subsidised ones. That creates a large deadweight cost which is hard to get rid of.

Moreover, subsidising jobs can cost far more than paying benefits. As well as the subsidy, there may be other overheads to pay. Several countries have recently made special efforts to return welfare-dependent single parents (usually mothers) to the workforce. This has often required state help with the cost of child care while the parent is at work. According to a survey of global trends in social services by the Social Market Foundation, a London think-tank, Wisconsin has doubled its spending per case since it introduced reforms designed to help lone mothers find work. And all the subsidies in the world cannot guarantee that firms will take people who are unsuited to the workplace.

But there is great potential for using profit-seeking firms to help people on unemployment benefit find work, by building on the success in many countries of competitive tendering for other government services, such as computing and refuse collection. More often than not, such contracting-out has generated a mixture of cost savings and improved service quality.

Governments have not proved adept at dealing with the moral hazard created by offering insurance against unemployment. One big reason is that public employees lack the motivation; those who must decide if somebody is really looking for work are rarely offered any reward for getting the decision right. They often earn little, and may fear a violent reaction if they refuse benefit. By contrast, private companies have every reason to motivate their employees properly because they are paid for getting benefit recipients into work.

Earlier this year, Australia privatised its public employment service by auctioning off the franchises for different parts of the country. The results so far have been decidedly mixed, according to Bob Gregory of the Australian National University in Canberra. Several of the new franchisees have run into financial difficulties, both because they found it harder than expected to place some of the unemployed, and because there is a time lag before they get paid.

But in America Lockheed Martin's new agency seems to be doing well. It now has 23 contracts to get welfare recipients into work, and says it has placed some 17,000 people in unsubsidised jobs, one in three of all those referred to it. Those who have not yet been found jobs do some other kind of work to earn their benefits, such as collecting litter in parks. When people find jobs, Lockheed Martin helps them keep them, not least because it gets paid more if they stay.

The firm failed to win approval in Texas for a contract under which it would also have decided whether claimants were eligible to receive benefit, but despite that setback it has now bid for a similar contract in Arizona. Gerald Miller, who runs the division, feels ready for it. "We are more accountable than the public sector; if it was perceived that we were turning people away unfairly, there would be outrage."

Mr Miller used to be in charge of Michigan's welfare-reform programme, one of the most go-ahead in the country. But he claims that he is able to do far more in a private firm. "The big difference is the ability to be innovative, to take a less bureaucratic approach to getting people a job," he says. His staff, many of whom come from the public sector, are paid the same basic salary as the public-sector norm, but can earn performance bonuses of up to 30-40% on top of that.

Governments everywhere will keep a close eye on these Australian and American experiments. They hope to find proof that by combining competitive, profit-seeking private firms with taxpayers' money, they can greatly improve the results of redistribution.

In search of a way

Can politicians sell privatisation?

TWENTY years ago, selling state-run businesses such as airlines and telephone companies to the private sector seemed politically impossible. Now governments everywhere are privatising, whether they lean right or left. It is the commercial enterprise run by the state that seems out of place today, not the privatised one.

Will the next two decades bring a similar change in attitudes to the privatisation of social insurance? There are at least three striking similarities between nationalised industries then and welfare states now: a widespread conviction that the old way has failed; plenty of good reasons to suppose that privatisation could help solve at least some of the problems; and hostility to that apparently promising solution from a majority of the public.

Governments have chosen to ignore voter hostility to selling off state-run commercial firms. So far, there is no sign that today's politicians are willing to go against the public mood on social insurance. The thoughts of Britain's Labour government on the subject, published earlier this year under the title "A New Contract for Welfare", explicitly contrasted its "third way" ("opportunity not dependence") with "a privatised future". In America, Mr Clinton has considered every option to "save Social Security", but has come out against full privatisation. In Germany and Sweden, recent elections were won—more convincingly in one country than in the other—by left-of-centre parties reaffirming their belief in the welfare state.

The long and the short of it

When politicians needed to muster the courage to privatise state-run companies in the face of public opposition, they had a powerful short-term incentive. Revenues from the sales gave a handy boost to the public coffers, providing scope for tax cuts or higher public spending to please the voters and cancel out the unpopularity of privatisation. In the same way, selling off state-run hospitals and unemployment-benefit agencies, although it would generate plenty of flak, would also offer politicians the immediate benefit of extra cash to spend on things voters really want. The hardest question might be how to regulate these services, once privatised, in a way that promotes efficient competition but also ensures that quality is maintained.

However, the short-term political benefits that can be reaped from privatising the supply side of social insurance do not extend to privatising the demand side. Here the pain is immediate, whereas the rewards may not be enjoyed until long after today's politicians have gone. Consider, for example, a proposal by Michael Orszag and Dennis Snower, two London-based economists, that every adult be required to pay into a series of "welfare accounts", including one for a pension, one for health care and one for unemployment benefit*. The money built up in these accounts would be used when the need arose. That might make sense in the long term, but it would mean that workers would have less disposable income because they would still have to finance pension, health and other welfare-state spending for the current dependent generation, as well as paying money into their own accounts.

Privatised pensions might just be politically marketable, on the argument that their owners will be acquiring an asset potentially much more valuable than the existing pay-as-you-go state pension. With pre-funded health-care accounts, that argument would be much more difficult to sustain, because of the big uncertainties about long-term costs and the differences in the cost of treating different people. Nobody could be sure that the money in an account would be enough to guarantee the expected level of health care. That does not necessarily make funded health-care accounts a bad idea; but it suggests that the question politicians most urgently need to resolve is how to ration care in a way that the public finds acceptable, yet which demonstrates clearly that resources are finite.

Privatised unemployment accounts would also be politically contentious. Many people would not need them because they will be out of work only for short periods and can keep going on their savings. Those likely to spend long periods out of work and who have few savings would not be able to afford to pay for their own contributions. The state would probably have to pay in on their behalf, or revert to traditional forms of means-tested handouts for the jobless. Privatisation may not be the answer here.

What is clear is that a debate about the fundamental reform of social insurance is overdue. The longer it is delayed, the more older voters there will be, and the greater the risk that attempts at sensible reform will be lost in intergenerational conflict. Much hangs, therefore, on whether today's politicians can find the courage to rise above their short-term interests and tell the truth; and on whether the voters, for their part, are willing to hear it.

Another helping of private charitable impulse, please

*"Expanding the Welfare State: A Proposal for Reform". Centre for Economic Policy Research, London, 1997

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Harry P. Kamen
Chairman of the Board and
Chief Executive Officer (Retired)

October 27, 1998

The Honorable William J. Clinton
The White House
Washington, D.C.

Dear Mr. President

I just returned from a visit to Egypt during which time you personally advanced the cause of peace and security in the Middle East. By all accounts, this giant step would not have occurred but for your tenacity, commitment, knowledge and personal peacemaking abilities. Thank you. I am proud to have you as my president and honored to hold you as a friend. By the way, I was also quite pleased to see the very positive reaction by the Egyptian press and people to your very determined peace initiatives.

I am not able to join you for dinner this evening, but I do have a request of you involving your forthcoming meeting with President Jiang Zemin at the APEC meeting. I recognize that, generally, it is a U.S. policy not to favor one American company over another in such issues as requesting that another country open up its market to a foreign company. I support this policy and my request is on behalf of the American insurance industry generally.

My request is for you to encourage President Jiang to open China's market to the American life insurance industry. We in the industry believe that such large, economically powerful corporations as MetLife are an important source of investment to the Chinese, that we will be good corporate citizens, and that we can play a positive role in China's developing economy. However, China must open its markets to allow us to do such. Given China's need for foreign investment and the economic uncertainty in Asian markets, your meeting at APEC provides a timely opportunity to urge President Jiang to take this step.

Vince Reusing will be pleased to discuss the timeliness of this issue with you, or Vince could discuss with John Podesta further details concerning this request.

Best wishes to you and Mrs. Clinton. I look forward to our next visit together.

Sincerely

Harry

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Sperling
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NSC for reply
Berger

pln

Park Ave., Ste. 5700, New York, NY 10166-0144

rry P. Kamen
rman of the Board and
f Executive Officer (Retired)

MetLife

The Honorable William J. Clinton
The White House
Washington, D.C.

MetLife®

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THE PRESIDENT HAS SEEN
10-28-98

Sandy

see me re Tien
Stephen Chen

Bc

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Berger
COS

highlights the importance of training to be provided by the U.S. for Taiwan's F-16 pilots.

(6) The greatest PRC military threats to Taiwan come from missile attack and naval blockade. To meet these two threats, Taiwan's future military purchase needs will stress anti-missile and anti-submarine capabilities. For this reason, Taiwan's future military purchase items will include long-range early-warning radar, P-3 anti-submarine aircraft, and a TMD system. All these are defensive weapons systems, so they not only are in conformity with the Taiwan Relations Act, but also complement and strengthen the defense and reconnaissance capabilities of the U.S. and Japan in the Western Pacific. Taiwan hopes the U.S. will favorably consider its request.

Travail at Wye

10-23-98

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Sec Cohen

The struggle to get Yasser Arafat and Binyamin Netanyahu to agree, cont'd

SUPPOSED to last a long weekend, by Thursday the Middle East summit at the Wye conference centre in Maryland had dragged on beyond a week. Bill Clinton has assiduously commuted each day from Washington, staying late and cancelling a two-day fund-raising trip to California. Jordan's King Hussein, who is being treated in America for cancer, was wheeled in for a day of persuasion: he had helped to broker the Hebron deal in 1997. The Israelis tried brinkmanship: Binyamin Netanyahu threatened to walk out on Wednesday night. But after so much American effort, which will continue long after a deal is signed, it was virtually impossible that the affair should end without some sort of agreement, however imperfect. Moreover, the current travails are over relatively minor arrangements. Far greater turbulence is yet to come.

The peculiarly American form of torture, sequestering old foes in isolated semi-luxury until they are forced to agree on something, does work rather well. Jimmy Carter, Anwar Sadat and Menachem Begin were locked up for two weeks in 1978 at Camp David, a resort in another part of Maryland which, according to Boutros Boutros-Ghali, who was with the Egyptian delegation, came to seem "more and more like a prison camp". The Egyptians several times packed their bags to storm off home but, in the end, they and the Israelis made a deal. So did the Serbs, Croats and Bosnians after three weeks at Dayton, Ohio, in 1995. The Syrians and Israelis, who met at Wye in early 1996, came close to agreement but were let out without concluding one. This, as it has subsequently turned out, was a mistake: the two are now farther apart than ever.

The Israelis and Palestinians are unlikely to be allowed to go home until they have, at the very least, committed themselves to stick by the things that have already been largely agreed at Wye. America's compromise proposal—Israel's phased withdrawal from another 13% of the West Bank, giving the Palestinians civilian or military control over 40% of the territory, in return for a packet of rules about what the Palestinians have to do to protect Israelis from terrorism—seems to have been accepted by Yasser Arafat. The Israelis, at mid-week, were still standing out for stricter and more comprehensive security instructions.

The grenade assault on Beersheba's bus station on Monday, which injured more than 60 Israelis, added immediacy to Israel's worries. A Palestinian from Hebron, a city cruelly divided between 400 Israelis and 120,000 Palestinians, confessed both to this atrocity and to the murder of a rabbi in Hebron in August. He was not, it seems, acting on his own: the military wing of Hamas, which has been quiet for some time, has claimed responsibility for the Beersheba incident.

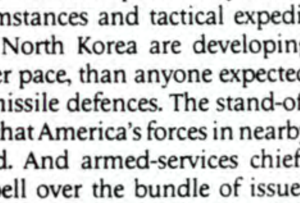
The Israelis want Mr Arafat to go after Hamas, not only disarming it and hunting down militants but, much more controversially, attacking the Islamic movement's hold on mosques, schools and clinics. There would be no surer way of rallying support for the Islamists. The Palestinian Authority is already unpopular in the territories for its undemocratic and arbitrary ways. If it followed Israel's instructions, without any reciprocal action being taken against Palestinian-hating Israeli extremists, it would do itself in. And, for Israel, no alternative to Mr Arafat's government, bad though it may be, is likely to be an improvement.

No guarantee

Israelis want to get from Mr Arafat the same assurance that they once got from Sadat. The Egyptian told them in 1978 that there would be no more war; they want Mr Arafat to tell them there will be no more terrorism. But this is not a pledge that the Palestinian, or indeed any leader, can deliver. As in Northern Ireland, terrorism by the violently discontented cannot be eradicated. But, as in Northern Ireland, continuing terrorism should not deflect the search for peace: bombers must not be given the power of veto. A just peace is no guarantee against terrorism, but it is the very best there is.

New wars and old

John P / Sandy / Sec Cohen
Fgl- BC



Yes, America should spend more on defence. But only where it is needed

IF THE Pentagon's masters were doing all the right things to adapt their forces for the 21st century, military spending would probably have to rise in the short term. Does that mean, then, that supporters of a strong America should be rejoicing over this week's news of an upwards blip in funding for the Pentagon? Not necessarily. As well as well-founded concern over new challenges—terrorism, cyber-warfare, rogue ballistic missiles—the ballooning defence budget reflects a reluctance to set priorities and grasp nettles.

In political terms, the unexpected $9 billion boost to next year's spending on defence and related areas (such as embassy security and intelligence) was made possible by a mixture of changing global circumstances and tactical expediency. The fact that Iran and North Korea are developing longer-range missiles, at a faster pace, than anyone expected has boosted the case for anti-missile defences. The stand-off in Kosovo makes it imperative that America's forces in nearby Bosnia are adequately funded. And armed-services chiefs have sounded a loud alarm bell over the bundle of issues which they lump under "readiness"—ranging from their abil-

THE PRESIDENT HAS SEEN

MARINE ONE

10-28-98

Sandy

David Chang says
he still hasn't heard
from you re:
North Korea
He's been a good friend
to me and HC
appreciate it if you'd
hear him out

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BC

10-23-98

Insurance by Milton Jones

Medical Savings Accounts *(the dogs aren't eating it)*

It seemed like a great idea. Allow people to make tax-deductible deposits to a savings account for small, predictable medical expenses that could be budgeted; and rely on health insurance only for the big ticket items, such as trips to the hospital. It was predicted that people so empowered would become savvy consumers, who would shop for good deal in medical services, since they would be "spending their own money." Such was the promise of Medical Savings Accounts (MSA's).

So, in the 1996 Health Insurance Portability and Accountability Act (HIPAA), Congress created the tax-deductible MSA on an experimental basis. First called Medical IRA's, these accounts would be available on a limited basis to the self-employed and to small employee groups. If you don't fit in one of the above, you need not apply. Only 750,000 would be available. It was predicted they would sell like hotcakes. So far, they haven't. It was thought the 750,000 quota would be snapped up in the first few months. Almost two years later, they are still available. The public is not exactly breaking down the door to buy these plans.

Let's take a good look at the concept. First (if you qualify) you buy a specially designed high deductible policy. For families, the smallest deductible allowed is $3,000 per family per year, and the highest is $4,500. Notice that this is a *family deductible*. So, if there are 4 in the family, when the sum of eligible expenses for all 4 exceeds the chosen deductible, the policy pays the excess. For single individuals, deductible parameters are 1/2 the deductibles available to families. In its simplest form, the policy pays 100% of everything over and above the deductible (80/20 policies are also available). The policy cannot have many frills. Forget about prescription drugs cards, office visit co-pays, etc. Plan on paying those "small" expenses out of your MSA funds. You can only set up the tax-deductible MSA savings account if you have taken out a qualified policy as outlined above (your old high-deductible policy won't do!).

So how much can you contribute to the MSA? For family policies, the maximum is 75% of the chosen policy deductible. For a $3,000 deductible, you may contribute (and deduct) a maximum of $2,250 annually. Single individuals are limited to 65 % of the chosen deductible. To qualify for the maximum amount, you must be in the plan a full 12 months. Otherwise, you must pro-rate the maximum deductible deposit by the number of months of participation. Example.. ..you take out a qualified policy Oct 1st, and you can contribute only 3/12 of the annual maximum.

Insurance agents, accountants, financial planners (and Republican Congressmen) all seem to think this is a great idea! We know it's more economical to self-insure the small stuff while paying less money in premium to your insurance company. You get a full tax deduction for the MSA deposit. Any money left over at retirement is yours to keep. So why aren't you self-employed guys buying? I think it's because your wife likes the drugs card and office visit co-pays in your regular policy, and is not willing to give them up.

I'm reminded of the story of the sales meeting at the Ajax Dog Food Company. The sales manager is saying "..boys, how come when we have the most modern dog food factory, the prettiest packaging, the best price....with all this, why aren't you guys selling more dog food? A salesman on the back row volunteered.. *"Boss, the dogs aren't eating it!"*

Some ideas, while good in the abstract, never seem to take off. Republicans want to expand this idea. Democrats say "over our dead body!" MSA's may be a terrific idea, but agents get paid less. We only get paid on the size of the Insurance Premium, and earn nothing on the MSA deposits. So keep buying the big ticket plans with the drugs cards and other frills. We love you!

Milton Jones, CLU, ChFC is an Independent Agent and a member and past president of the Northwest Arkansas Life Underwriters Association , and the Quadrant Chapter of American Society of CLU.

Thought Hillary would enjoy this.

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C Jennings

Fyi BR

10-23-98

Joschka Fischer, Germany's reluctant statesman

HE CAME late to the election-night party, looked glum and did not stay long. For almost the first time in his life, he seemed lost for words. One of the losers, surely. Not at all: a winner, if ever there was one. Joseph Martin Fischer, popularly known as Joschka: former taxi-driver, factory worker, scourge of the establishment and street-fighter against American imperialism—and now, at the age of 50, on the brink of becoming vice-chancellor and Green foreign minister of united Germany.

Small wonder that a lot of conservatives are wringing their hands. They are not, they snort, taken in by Mr Fischer's new taste in three-piece designer suits and silk ties; nor by the copies of *Foreign Affairs*, and similar weighty journals, lying ostentatiously on his desk; nor by his claim, perhaps ironic, that his favourite bedtime reading is the Bible—especially the "Song of Solomon". To his foes, Mr Fischer is still deeply suspect: a man once so anarchic that he opposed the foundation in 1980 of the Greens, the party he now leads; who used to turn up in parliament in gym shoes (ugh!); and who was once ejected from it after calling the speaker an "arsehole".

Odd, then, that Mr Fischer's crumpled features rarely break into a once-habitual impish grin these days. The vigorous jogging that has lost him more than 30 kilos (66 pounds) in the past 18 months has become even more compulsive, almost as if he were trying to run away from his new responsibilities. Yet the foreign ministry has long been his aim; the books he has written, such as "Die globale Revolution", hint as much, even if he used to deny it. So why this growing gloom?

Part of the answer is that the pragmatic Mr Fischer knows his party all too well: its pacifist, as well as ecological, origins; its still-hefty minority of fundamentalists, who would like to scrap NATO and reject the idea of German soldiers playing any part abroad, even as peacekeepers. In a vote in the Bundestag, the lower house of parliament, on October 16th, 17 Green deputies, more than a third of the parliamentary party, failed to back a motion approving German participation in possible NATO strikes against Serbia. True, the absence of an explicit United Nations mandate to do so bothered even Mr Fischer, a convert to the principle of a German part in peacekeeping since the 1995 Srebrenica massacre in Bosnia. But last week, despite his qualms, he voted in favour, well aware of the intense scrutiny the incoming government is under from Germany's sceptical allies, especially the Americans. This time, he carried most of the Greens with him. And next time?

Even leaving aside his fractious friends, Mr Fischer will have trouble making his weight felt. Top Social Democrats who look bound to nose into his patch include Rudolf Scharping, the incoming defence minister, who fancied himself in the foreign-affairs job, and the acquisitive Oskar Lafontaine at finance, who is carving out a role for himself as the new government's Mr Europe. Besides, Mr Fischer is inheriting a traditional "dynamic tension" between the foreign ministry and the chancellor's office, which became increasingly marked during Helmut Kohl's 16-year spell in office. Joachim Bitterlich, Mr Kohl's string-puller, who is set to become ambassador to NATO, was often called Germany's "secret foreign minister"—much to the fury of the actual minister, Klaus Kinkel. Now the incoming chancellor, Gerhard Schröder, has drafted in Michael Steiner, a workaholic ex-ambassador to the Czech Republic, to be his own Bitterlich. Mr Fischer will have to watch his back, and he knows it.

That alone might seem quite enough to wipe the smirk off the face of even the keenest would-be foreign minister. But, in this case, there is more to it. You do not have to be around Mr Fischer long to realise that behind the quirky wit lurks a melancholy, even tortured, personality typical of many leftist intellectuals in post-Hitler Germany. He still kicks himself for his biggest mistake: underestimating the chances, and overestimating the dangers, of German unity in 1990. Later it was the argument that "it took a foreign army to free Auschwitz" which convinced him, reluctantly, that German soldiers too had a duty to take part in peacekeeping. He reckons that leading his party into Germany's first ever Red-Green government lands him with a double responsibility, and he feels all the weight of it.

Part of the burden is domestic. Mr Fischer belongs to the rebellious 1968 generation, one bit of which (such as the Baader-Meinhof gang) later turned to terrorism while the other, which eventually included most of the Greens, embarked on what was known as "a long march through the democratic institutions". After three decades, the radical left at last has the chance to prove to sceptical conservatives that it has the ideas and realism to make a success of national office. It is a chance Mr Fischer has spent much of his life working for, as environment minister in the state of Hesse and most recently as the Greens' parliamentary leader in Bonn, and he is desperately anxious it should not slip away.

And in foreign affairs? Mr Fischer's parents, originally well-to-do, were driven west from Hungary to Germany in poverty at the end of the war. His father struggled to make a living as a Stuttgart butcher, and died at his work. This background helps to explain why Mr Fischer feels passionately that the misery caused by Hitler's war has landed the Germans with a special responsibility to help unite the continent. Curiously, to those who expect to hear from Greens the voice of introversion, when he broaches the topic he sounds like no one so much as the great European himself, Mr Kohl—"120 kilos of the past made flesh", as Mr Fischer unkindly calls him. The trouble is that enlarging the European Union to the east, which Mr Fischer strongly endorses, implies solving a whole heap of budget and farming problems first. And these will all be landing on his plate when Germany takes over the EU presidency next January. No wonder he looks glum in his hour of triumph.

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10-28-98

Alan Greenspan's miracle cure

NEW YORK

A surprise cut in interest rates has lifted financial markets off their death-beds. Our first article assesses whether this will ease strains in capital markets; the second looks at the health of the banks

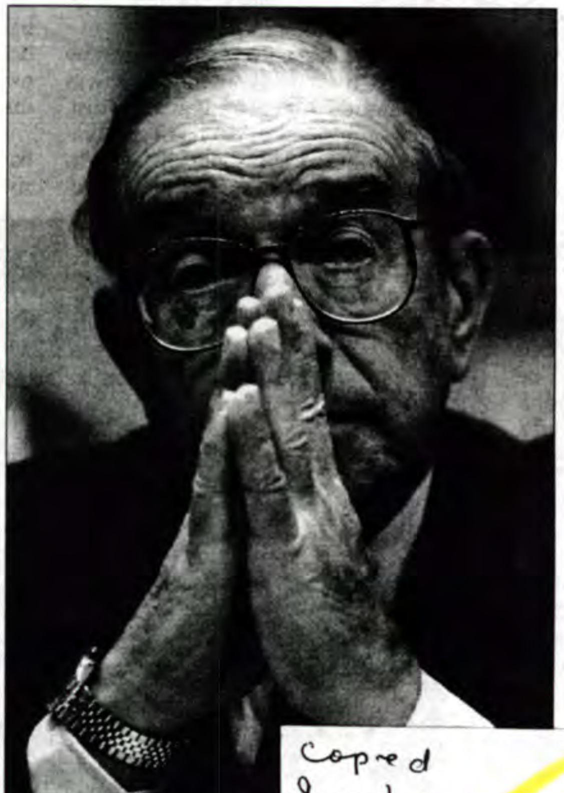
SELDOM have so many owed so much to so little. The Federal Reserve's emergency cut in interest rates on October 15th, even though it was by a mere quarter of a percentage point, seems to have unleashed a fresh bout of financial optimism around the world. The Dow Jones Industrial Average shrugged off a bearish summer and rose by 300 points in a day. European stockmarkets followed Wall Street's lead. Merger activity, which had been all but dead for a couple of months, burst back to life.

In financial markets everywhere, hopes are growing that the worst of the recent turmoil may be over. That looks premature. It is not even certain that the first aim of the Fed's emergency rate cut—to end a rapidly worsening liquidity crisis—will be achieved. In the past, a credit crunch resulted from the unwillingness, or inability, of banks to lend. But more recently, the capital markets have become the main source of credit for big firms, and an important one even for individuals. Banks and savings institutions now account for only 30% of lending to non-financial companies in America. This is a capital-markets, not a banking, crunch.

And worryingly, the recovery in the worst-affected capital markets has been more hesitant and fragile than the exuberance of the stockmarket might suggest. These markets dried up alarmingly after the Russian government, in effect, defaulted on its debts in August. Alan Greenspan, chairman of the Fed, feared that this would push the American economy and perhaps others into severe recession.

Since August, investment banks and securities firms seem to have become extremely averse to taking risks. Rather, they want to rebuild balance sheets hurt by losses on lending to emerging markets and hedge funds. Their resulting unwillingness to trade has turned markets illiquid: bid-ask spreads in all but the least risky assets have risen sharply. There have been few new borrowings, because bond prices are unattractive to issuers, and few traders want to buy them. This phenomenon, which started in Asia, arrived in America with a vengeance in the past two months—paralysing markets.

Thus, spreads on high-risk American corporate ("junk") bonds nearly doubled between January and the eve of Mr Greenspan's surprise cut. New issues of junk slowed to a trickle: $4 billion in August and September combined, compared with a monthly average of $15 billion earlier in the year. Several new issues were postponed. Similarly, spreads on asset-backed bonds (such as mortgage-backed securities) have tripled since the end of August. Credit-card companies, and "sub-prime" lenders, which rely on selling bundles of old loans to finance their lending, especially to the less creditworthy, have found few takers.



The prayer or the answer?

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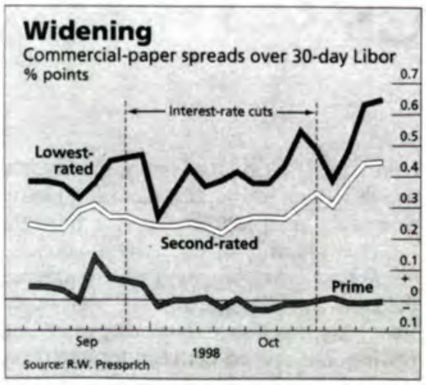
The liquidity squeeze has also affected the commercial-paper market—that is, the least risky, most short-term corporate borrowing. The spread between top-rated paper and slightly riskier borrowing has widened to unprecedented levels, and some borrowers, including commercial banks, have been pushed out of the market altogether. By October 15th, things had reached such a pass that, according to David Horner, a financial strategist at Merrill Lynch, "there were literally occasions when you could not get a bid of any kind for debt that was a reasonable risk."

Money infusion

Has Mr Greenspan's magic now broken the evil spell? At the very least, the squeeze is no longer intensifying. The flight to the safety of Treasury bonds has been stemmed. True, the troubled commercial-paper market has not noticeably improved (see chart overleaf). But Dennis Hynes of R.W. Pressprich, a New York broker-dealer, says that without last week's cut, spreads might have widened further. And there are signs that issues of debt are about to increase. On October 16th, Ford's credit business raised $150m more than it had originally planned.

Most of the extra liquidity is likely to be in shorter-term and less risky securities. There is no sign that investors have any appetite yet for telecoms junk bonds, say. According to Bob Hugin, head of fixed-income syndication at J.P. Morgan, sentiment has improved, but conditions remain difficult. Mr Hugin does not expect liquidity to increase much, because with the financial year coming to an end, investors will concentrate on beautifying their portfolios. They will not want to take many new risks; any narrowing of spreads is likely to be used to sell loss-making assets at slightly better prices.

Investors may also wait to see how serious Mr Greenspan is about increasing liquidity. The market is expecting a further rate cut at the Fed's November meeting—and is looking for total cuts of a percentage point from today's levels by next March. If these cuts do not happen, fragile confidence may leak away again. Ethan Harris, an economist at Lehman Brothers, reckons that Mr



Greenspan is already being too slow in cutting rates. He says it would be better to ease sharply now, even if some cuts have to be reversed later. The current troubles are the result of financial panic—and so are more like the 1987 stockmarket crash than the traditional bank-led credit crunch that slowed the economy in 1989-92.

Gradual reductions in interest rates fixed it that time. But they are a blunt tool for improving confidence in the financial system, which remains vulnerable to shocks. Were, say, Brazil to default on its debts, even Mr Greenspan would be powerless to stop market meltdown. Even now, "the market needs to become confident there is no ticking time-bomb out there, which will take a while," says Mike Ryan, a strategist at PaineWebber.

If capital-market liquidity recovers only slowly, what does that mean for the American economy? There will be huge pressure for traditional banks to pick up the slack left by weakening capital markets. In September, the Fed reported that banks had sharply tightened their lending standards to larger companies. But commercial and industrial lending rose sharply during the third quarter, as banks stepped in where the capital markets had pulled back.

Some pressure is also being felt by central banks in Europe to follow Mr Greenspan's lead. Hans Tietmeyer, president of Germany's central bank, the Bundesbank, is standing by his view that unnecessary interest-rate cuts could be dangerous. Yet the calls for the Bundesbank to follow the Fed and cut rates to head off a global slowdown grow louder. Among those supporting such a move is Karl-Otto Pöhl, one of Mr Tietmeyer's predecessors at the Bundesbank's helm.

The Bundesbank is, however, unlikely to take this advice in the run-up to the launch of the European single currency, the euro, in January. Thomas Mayer, an economist at Goldman Sachs, likens France and Germany to an aircraft carrier holding steady for the planes to land. "The last thing they want is to have to mess around with the controls and jeopardise the landings, even with a storm coming from the other direction."

Moreover, in Europe there are few signs pointing to a credit crunch, though some banks do seem to be lending less. And on October 21st, the European Commission cut its growth forecast for the euro zone in 1999 by 0.6%, to 2.6%. More gloom may yet force the central banks' hands.

Mr Greenspan's decisions remain the ones that matter most. And even he is not a miracle worker. The more he cuts interest rates to boost liquidity in the capital markets, the more he risks reinflating the stockmarket bubble. He will also be reducing the pressure on banks to lend more sensibly. The danger is that by avoiding bust now, he could simply ensure another bust, of a more conventional sort, in a couple of years' time.

Banks

Still living

ESCHATOLOGISTS may be disappointed, but Armageddon in the banking system has been postponed. In the past few months, worries about the stability of the system have meant that investors have given shares in rich-country banks the leper treatment. From their peak in June, bank shares in America and Europe fell, on average, by about half. Now they are rising again. And with good reason: for all their problems, rich-country banks are generally (with the inevitable exception of Japan) in not too bad a shape.

Before the latest rally, sparked in part by talk that Germany's Deutsche Bank was sniffing around America's Bankers Trust, the collapse in share prices had been dramatic and unexpected. Shares in Bankers Trust, for example, like those in France's Société Générale and Banque Paribas—big banks all—were trading below book value. Yet neither America nor Europe is in recession; and none of these banks is laden with mountains of bad loans.

There have been three fears. The first is banks' exposure to emerging markets. Russia has, in effect, defaulted; Asia is deep in recession; Brazil has teetered on the brink. Of late, China, too, has become a worry. American and Spanish banks lend heavily to Latin America. French and German ones lend lots in Asia. Investors have been wondering how many of their loans to troubled markets will be repaid.

Yet most lending to emerging markets is by big banks with deep pockets. In America, for example, three-quarters of lending to emerging markets comes from the six biggest banks. Raphael Soifer, an analyst at Brown Brothers Harriman, an American investment bank, reckons that even if all the sickly borrowers defaulted, the most these banks would lose would be some $40 billion: nasty, but not life-threatening. And with some signs of progress in fixing Japan's banks, and an IMF rescue for Brazil imminent, the world looks less bleak.

Investors are also less worried about their second, related, fear: that recession in emerging countries would spread to America and Europe. For banks, that would mean a fall in lending and an increase in problem loans. Europe is still growing briskly and, although America's economy is slowing, few expect it actually to contract. Even in a recession banks might not do too badly, for their lending has generally not been marked by the same idiocies—such as overlending to property companies—as in the giddy days of the late 1980s.

Which leaves the third fear: commercial banks' rush into investment banking and risk-taking. Investment banking is less prof-

But we know you have the capital

itable than it was. New deals and trading in share and bond markets have shrivelled. But that again means merely smaller profits for the banks that have gone into investment banking. More worrying is the amount that banks have lost in risk taking. Trading in derivatives, particularly options, is one such area. In the main, banks are net sellers of options; profitability thus depends largely on banks' accuracy in predicting that a market will be less volatile than buyers have assumed. If it is more so, the banks lose money. And of late, many markets have been vastly more volatile. Although it is a safe bet that they will calm down—so banks' losses may end up rather smaller—the experience will have put up sharply the price of insuring portfolios by buying new options from others.

In the short term the biggest worry is the money that banks have risked punting their own capital. Many, notably UBS and BankAmerica, have lost huge amounts (and sometimes their bosses). Nobody knows how badly other banks, particularly in Europe, have fared, nor how much more they would lose were markets to go haywire again. But Bankers Trust, which announced big trading losses this week, is not talking to Deutsche Bank from a position of strength. Still, such punting is mostly limited to the big banks with other sources of income. Although they have lost heavily on this business, for most that has merely meant slimmer profits overall.

Set against all these worries is the fact that banks are far better capitalised than they were at the beginning of the 1990s. Although some American and British banks had started to return capital to shareholders, David Hilder, an analyst at Morgan Stanley Dean Witter, reckons that the average American bank has 30-40% more capital than it did at the start of the decade. And this is echoed, with some exceptions (French banks, for example) in Europe.

For commercial banks that have stuck to their knitting, there are opportunities in the recent turmoil. Banks hold large quantities of government bonds, and the flight to quality has increased the worth of these. America's Chase Manhattan, for instance, has seen the value of its government-bond portfolio double to $1 billion in September. The flight to cash has meant that investors have plonked money in big banks, giving them cheap financing. Moreover, the drying up of securities markets has meant that demand for bank loans is expanding sharply. Brisk demand has meant that, for the first time in years, banks are charging more for their loans. It may not be such a bad time to be the staider sort of banker. ■

Crock of gold

MOSCOW

WILL Russians trust newly minted gold coins more than newly printed roubles? The cash-strapped government, which owes billions of dollars in wages and pensions, hopes that they will. According to the head of the state precious-metals reserve, Dmitri Ignatyev, the government wants to use up to 40 tons of gold for coins by the end of the year; the first ones should be circulating by next month.

As a means of saving, gold coins are quite common. Plenty of central banks issue them as a sideline (although a simple ingot, if you can afford one, is better value). Russians hold almost all their savings in dollar bills: $40 billion is one common estimate. Some may feel a need to diversify into gold. If they did, it could make a profit for the central bank, and also make better use of a part of the country's illiquid gold reserves.

That assumes, however, that Russians will buy gold coins issued locally—doubtful, given the population's corrosive, and usually justified, distrust of all public institutions. This will make marketing the coins tricky. "If they underprice the gold, people will melt it. If they overprice it, nobody will want it," points out Eric Kraus, a Moscow-based investment banker. Even if this riddle were solved, the effect would be small—40 tons of gold is worth a mere $400m.

But the government's plans are more ambitious. Mr Ignatyev says that gold coins could be issued to pay wages and pensions, and could even be used for ordinary transactions. This would in effect create a parallel currency to the paper rouble, which would be hazardous. For a start, if coins are issued as currency rather than sold to savers, the effect will almost certainly be inflationary. There are also big practical difficulties. Russians have become expert at spotting fake banknotes. The new gold coins, however, could be a forger's dream; and, being heavy, a nightmare for weaklings.

German stockmarkets

Seven sisters

BERLIN, FRANKFURT AND HANOVER

IF THERE is a Cinderella among Europe's stock exchanges, it is surely Frankfurt. Once scorned by snooty London, it is now preparing for a marriage of equals with its bigger British rival. But not everyone in Germany is cheering Frankfurt's happy ending. Among the hecklers are Frankfurt's ugly sisters: Germany's regional stockmarkets (Berlin, Bremen, Dusseldorf, Hamburg, Hanover, Munich and Stuttgart).

As Frankfurt's star has waxed, these outposts' stars have waned. Their share of German trading in equities has halved since 1992 (see chart overleaf). Even Dusseldorf, once by far the biggest of the seven, has lost market share to Frankfurt.

Frankfurters scoff at the regional exchanges as anachronisms that survive only because of Germany's federal structure, and the political arm-twisting that brings them local business. As trading in European equities consolidates around the big centres, Frankfurt's financial elite thinks it will soon be handling the DM430 billion ($265 billion) traded annually on the regional bourses. Small wonder that relations between Frankfurt and the others are frosty. Jörg Walter, head of the Berlin exchange, says Frankfurt is a relative, not a friend, adding "You can't choose your relatives."

Mr Walter insists that the regional exchanges can survive by selling small, risky shares that "are not welcome in Frankfurt". Some exchanges have even prospered in niches. A couple of years ago, Stuttgart boosted turnover by allowing private investors to trade smaller packets of shares than they could in Frankfurt, and by guaranteeing them competitive commissions. Berlin has also increased turnover by promoting a second, lightly regulated market, mainly for foreign and high-tech shares. Two-thirds of German trading in East European shares is done there. Over 40 Athens-based shares are listed, for the benefit of Berlin's large Greek community.

But Frankfurt is now chasing some of the business that has kept its sisters going. It has extended its trading hours to match

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COS
Feb-'98

Feingold versus foul gold

WISCONSIN is normal, abnormally normal: four of America's top five test markets for new products are crowded into this one state. Russ Feingold, the younger of Wisconsin's two Democratic senators, seems equally normal: he is clever without being ostentatious, friendly but not ingratiating, diligent but not dour. Yet his campaign for re-election tests a proposition that is not remotely normal: that a candidate can stick by high-minded campaign-finance principles and win. "It is an honour to be a senator; but the pursuit of that position must be honourable," Mr Feingold declared in a debate recently. The question is whether such sentiments will cost him his seat.

At the start of his campaign, Mr Feingold promised to spend only $3.8m, one dollar for each of Wisconsin's voters. (He claims to be the only Senate incumbent to adopt such limits, though William Proxmire, a senator for Wisconsin for many years, spent just $62 in 1982, his last campaign.) Mr Feingold also said he would discourage others from spending money for him. He called his party's campaign committee in Washington, and told it not to run ads in Wisconsin; he called the local union headquarters, and told them not to butt their heads in either. In this way, Mr Feingold is living up to the campaign-finance reform he and Senator John McCain have pushed, unsuccessfully, in Washington. But he is also ensuring that his Republican opponent, Mark Neumann, can outspend him; he puts the money gap at "three to one, perhaps more". Even allowing for exaggeration, Mr Feingold has made himself into a strange animal: an incumbent-underdog.

Mr Neumann has served up a volume of eyebrow-raising advertisements. One shows a white-coated scientist chasing after cows, attempting to capture the emissions from their backsides in a jar. "This scientist is hard at work spending your tax dollars," explains the narrator, saying that Mr Feingold voted for research into methane emissions. The truth is that Mr Feingold supported a vast budget bill that had cow farts buried in the small print; and that Mr Neumann once voted for the programme too. Another ad shows astronaut-monkeys, and infers that Mr Feingold voted money to put them into orbit. But Mr Feingold drafted a measure to kill this programme.

The Neumann advertisements have dovetailed, in a suspiciously neat way, with ads paid for by the Republican Party's national campaign committee. Under the law, these are supposed not to be co-ordinated with spending by candidates, and are meant to be aimed at "party-building" rather than at winning votes. But the day that Mr Neumann began airing a series of ads on Social Security, the Republican Party launched its own campaign on the same issue; and the day that Mr Neumann kicked off a television campaign on education, the party, by remarkable coincidence, happened to do likewise. The "unco-ordinated" "party-building" ads featured pictures of Mr Neumann, and urged viewers to support him. They even included a picture of his daughter on graduation day, no doubt obtained by some method involving no co-ordination whatsoever with the Neumann campaign.

Two ripostes come from Mr Neumann. He has relied, he says, upon a network of ordinary contributors. More than 37,000 individuals have "sat down at their kitchen tables", as he likes to put it, and written him a cheque, usually for less than $50. "If you could be in my office," Mr Neumann says, a little sentimentally, "if you could read some of the 400 or so letters that come in each day from people who send a few dollars because they care about the issues . . . that's the real America out there. That means so much to me."

Second, Mr Neumann accuses Saint Feingold of hypocrisy. The senator may have called the trade unions and asked them not to buy ads for him. But the unions ran a few ads anyway, and their local officials make no bones about their preferences. The senator has also been assisted by environmental groups: "Tell Mark Neumann to withdraw his Wetlands Destruction Bill," urged a radio ad paid for by the Sierra Club. Unions and environmentalists plan to flood their supporters with pamphlets and calls during the campaign's last fortnight.

And yet, even though his halo is not without blemishes, Mr Feingold is running a fairly clean campaign. The interest groups that support him have spent a fraction of the large sums spent by those that oppose him. He can justifiably argue that, even though Mr Neumann's own fund-raising is based on small contributors, his "unco-ordinated" supporters represent corporate donors. Seeking to trump his opponent's populism, Mr Feingold denounces "big-money, out-of-state interests" which, he says, are bent on stealing the election from "Wisconsin families". "They're trying to take away your democracy," he informed one wide-eyed student at a recent campaign stop.

In the end, Mr Feingold may beat foul gold. He is no wimp ("Always attack, never defend" runs a slogan on the wall of his chaotic campaign office); and he boasts of holding 432 town hall meetings up and down Wisconsin over the past six years. His clean-politics theme appeals to his state's political culture: anti-money progressivism flourished in Wisconsin at the turn of the century, and still colours local attitudes. His attack on out-of-state meddling may also win votes: Wisconsin is proud of its distinctive culture, of its beer and the traces of German in its accent, of its footballers and fine cheese.

All this may save Mr Feingold's seat in the Senate. Whether a Feingold victory would boost the cause of campaign-finance reform in Washington is a different question. Mr Feingold says it would: his re-election will be a "springboard" for his legislation, he insists. But Wisconsin's indignation towards political money is not shared by all the country. Campaign-finance reform may be one product which, despite scoring well in Wisconsin's test market, flops when it goes national.

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Will China be next?

MUCH of the outside world's preoccupation with China in recent years has been with that country's strengths: would a rich China be a threatening one, could such a China be absorbed comfortably in regional and global institutions, how much money might be made from selling goods to a billion richer Chinese, how many jobs lost to imports from that same productive billion? It is time, however, for the focus to shift. The most important question today is not how strong China might become but rather how weak it now is. The danger of an economic collapse is growing. Such a collapse would hurt Asia directly, and would damage the rest of the world too. The biggest potential danger, however, is of economic trouble leading to political chaos. If that transpires, all bets would be off.

Will it? Officially, China is destined to enjoy economic growth of 8% both this year and next, and the government tells anyone and everyone that it will hit that target, come what may. Against signs of slowdown, it has launched a big programme of public spending on infrastructure. China's economic leaders are determined and impressive people, popular on the international circuit for their frank talk, their willingness to hand their e-mail addresses to anyone with a complaint, and, most particularly, for their promises not to devalue the Chinese yuan or the Hong Kong dollar. And then there is the stalwart Chinese worker: having at last achieved a higher standard of living in the 1980s and 1990s after 30 disastrous and painful years, surely he is not going to take to the streets at the first sign of economic trouble?

The force of reality

To try to assess the situation in China, and to understand its wider importance, it is as well to begin there: with the stalwart Chinese worker. The past two decades certainly have brought new opportunities, new freedoms and new wealth to many urban Chinese, at least in the coastal region. It is also true that in other countries, most notably Russia, predictions of popular unrest have frequently proved wide of the mark, as ordinary people showed themselves reluctant to take to the streets despite severe hardships.

The same could well prove true in China. But one group that is far from confident about this is the Chinese leadership itself. On the face of it, what China most needed in 1997-99 was an economic pause. After the helter-skelter growth of the previous five years, when property booms and speculation were rife and structural reforms of state-owned enterprises and dodgy banks were rare, the emphasis needed to shift to reform. Last year, President Jiang Zemin made such reform his slogan; so, last March, did his new premier, Zhu Rongji. Such reform must by its nature be painful, since it involves closures, mergers, privatisation, unemployment. This year, President Jiang and Premier Zhu lost their nerve, and reform has been postponed. Slow growth and large-scale unemployment was a risk they felt unable to take. They, at least, do not believe the Chinese worker is as stalwart as all that.

Their belief, it seems, is that slow growth would be disastrous, both for China and for their own jobs. No one can be sure in advance, but their worries could well be justified. The legacy of 50 years of communism is that the party has no intellectual or moral hold on its people, just a material and a nationalistic one. Prosperity is its chief source of legitimacy; once that is endangered, there is only nationalism to fall back on. This summer, after three years of more open political discourse, the party's rhetoric reverted to its old form, with calls to rally against national threats from floods and from the Asian financial crisis. The 8% target is the rallying point.

So will it be achieved? It looks highly unlikely (see pages 23-26). Official statistics are becoming more and more dubious, but even on the basis of official growth of 7.2% in the first nine months of the year, an annualised rate of 10.4% needs to be achieved in the next three months if the target is to be met. Instead, exports are sagging, deflation is taking hold and unsold inventories are ballooning. Despite the counter-blast from public works spending, an annualised rate of 5% or so looks more plausible.

The prospects next year look just as tough: the debate about the outside world is whether it will get a bit bleaker or a lot bleaker, so either way exports will again be under pressure. Foreign firms have been cutting their new investment plans, while foreign banks, worried about the recent closure of the Guangdong International Trust & Investment Corporation, with debts of $2.4 billion, are cutting their lending. Although China has more of a domestic debt problem than an international one, its foreign debts are larger than they appear (see page 26) and official worry about this foreign exposure is now a powerful argument against devaluing the yuan.

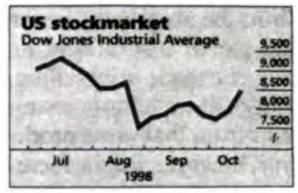
A bright future, frustratingly out of reach

Against this, it can be argued that China has a bright future ahead of it. With entrepreneurial vigour of the Chinese sort, every problem in the Chinese economy can plausibly be redefined as an opportunity. Every bust, inefficient, polluting state enterprise is a potential efficiency gain if it could only be managed by different hands. Every sign of the wasteful allocation of capital in the state-run financial system is evidence of how well things would proceed if only capital was allocated more efficiently. If it has grown this fast while being run badly, think how well China could do if it were run better.

The question, though, is how to get from here to there. That is what is dogging the Chinese leadership, and it should worry outsiders, too. Long-term growth will require privatisation of the state enterprises and banks; a freer flow of labour through the abolition of the household registration system; the legalisation of private property; and more. Such moves will involve economic and social pain. There will anyway soon be 18m-20m unemployed. Meanwhile, falling fertility and the one-child policy mean that China is greying rapidly, with a baby-less baby-boom generation fearing for its future. The well of actual and potential resentment is deep. Hence the leadership's reluctance to risk (or admit to) slow growth, or to take the political decisions necessary to move to a brighter future.

Lately, worries about China have focused on the will-they, won't-they question of devaluation, accompanied by fears that this would trigger a new financial panic in East Asia. Yet this is to miss the point. The real issues are whether China's growth is slowing or even grinding to a halt; whether the resulting unemployment will prompt political unrest, or a power struggle among the leadership; and then whether that will send China in a disturbingly nationalistic direction. The right bets, on current evidence? Yes, yes and probably.

Once upon a time on Wall Street



Do not be fooled by the past week's rally in share prices: the world's financial and economic troubles are not over

STOCKMARKET investors are fond of fairy tales. Until this summer, their favourite was Goldilocks: the American economy, they claimed, was neither too hot, nor too cold, but just right. Their belief in perpetual growth seemed to justify ever-rising share prices. Pity they forgot that, in the story, Goldilocks was eventually chased away by the bears.

After the markets fell back in July, the favourite tales changed: the recent talk has been of something nasty in the woodshed. But as in all good stories, a fairy godmother has arrived in the nick of time. With a flick of his magic wand, and two swift cuts in interest rates, Alan Greenspan has saved the day. Stockmarkets have rallied; America's economy will, after all, continue to boom. Or so ever-optimistic investors hope.

By mid-week, the Dow Jones Industrial Average had gained 13% from its low at the end of August, leaving it only 9% below its July peak. Share prices have also bounced back in Asia and Europe. Hong Kong and Bangkok have risen by half since August. As well as lower American interest rates, there have been other bits of (apparently) good news to cheer. The Japanese parliament has, at long last, approved a plan to make ¥60 trillion ($500 billion) available to help the ailing banking system. America's Congress has agreed to top up the IMF's coffers by $18 billion, which should bring in over $70 billion more from other countries and make it easier to arrange a rescue package for Brazil. There are glimmers of hope in East Asia, where interest rates have fallen sharply. And a weaker dollar has eased fears about a devaluation of the Chinese yuan. All in all, investors might conclude, the world is no longer coming to an end—so goodbye, bears.

But take off the rose-tinted spectacles and the monsters still loom large. One bank has now said it will apply for Japan's bank bailout, but it is unclear whether others will follow. Financial panic may be over in East Asia, but the region's economic troubles remain daunting. And now a credit crunch threatens in the United States, and perhaps in Europe, as firms have found raising new money far harder in securities markets that have all but dried up (see page 75). Even a few more quarter-point cuts would not solve these problems.

More pertinently, American share prices remain substantially overvalued by historic measures. Some bullish analysts have argued that recent falls in bond yields and the expectation of further falls in interest rates justify higher share valuations. They have even been advising investors to put more money into shares. Yet the main reason that bond yields and interest rates have come down is concern about financial turmoil and a growing risk of recession. That points to shrinking profits—which can hardly be good for share prices. It is striking that, even as equity strategists talk up share prices, economists, often employed in the same firms, are becoming gloomier about world growth. Many forecasters now expect the world economy to expand by less than 1.5% next year, which by past standards counts as a recession.

Alan in bubbleland

The truth is that financial bubbles, unlike fairy tales, never have happy endings. Mr Greenspan cannot prevent a bear market with a mere wave of his wand. From the 17th-century Dutch tulip mania through to emerging-market madness and today's Wall Street, bubbles always burst eventually—and the result is always painful.

Wall Street's tumble since the summer has been widely blamed on financial troubles in emerging markets. If so, goes the argument, brighter prospects in Asia and an IMF package to rescue Brazil should push share prices back up where they were. Yet in truth, America's bubble was inflated at home. For over two years the Fed all but ignored the explosion in share prices and lax credit conditions. And to the extent that America's rapid economic growth in recent years has been fuelled by a splurge of credit and by large capital gains, both its economic and its financial boom remain unsustainable. A sharp slowdown is inevitable; a recession is distinctly possible.

Some commentators now seem to view Wall Street as a gauge of whether the Fed has got things right. A rise in share prices is taken to mean that Mr Greenspan has understood what needs to be done to avoid troubles ahead. But this is a bad test. Central banks cannot and should not try to prevent an overdue correction in share prices. They should only cushion the economy from the worst consequences. The zeal with which Wall Street has cheered Mr Greenspan's latest rate cut shows that investors still miss the point: even in fairy tales, what goes up does eventually come down.

CHINA'S ECONOMY

Red alert

BEIJING

China may be about to catch the Japanese disease. The consequences would be bad not only for China but for all of Asia; and also explosive politically

THE battered leather sofa in the library of Hong Kong's China Club, its horsehair stuffing spewing out, was once Winston Churchill's. Its value at auction was raised by the amorous liaisons he is said to have conducted on it. Perhaps he also found time to lie back and think of China. Many books in the library's magnificent collection, bearing titles such as "Crisis in China", "China in Transition" and "China's Challenge", are the sofa's contemporaries. Those by modern scholars fall back on similar titles. For, as usual, there is plenty to worry about in the Middle Kingdom.

The concern now is that China's economy is entering a dangerous period of sluggish growth. Behind the smog of official statistics the economy may well be growing at only 3-4% a year. For this vast, chaotic land such a slowdown amounts, in effect, to a recession. That threatens China's ability to be able to generate enough new jobs to reduce the growing army of unemployed laid off by the rusting state sector, or to employ the millions of young people who enter the workforce every year.

This has the potential to make China a far more worrying place. Add to the picture a combination of an insolvent banking system, mounting domestic deflation and a sharp divide between the relatively wealthy parts of the country and the poor regions, and China's stability could be threatened. This year, most regional leaders have been praising China for holding the line in a region devastated by financial turmoil. Such praise is not always blinkered. An unstable China would be among the neighbours' worst fears, not least because it threatens their own ability to recover.

It is remarkable how, in a general sense, China is grappling today with many of the same problems it faced a century ago. Since 1949 the Communists have imposed internal order, at least in comparison with anything that came before them. A powerful brand of nationalism is now backed by a strong national defence. But the biggest difference has been the staggering economic change of the past 20 years which has delivered perhaps the greatest reduction in poverty the world has ever seen.

Yet it took a long time for China to wake. Angus Maddison, an economic historian, estimates in a new paper* that between 1820 and 1952, when world economic output rose eightfold, China's product per head actually shrank. Its share of world GDP fell from one-third to one-twentieth. China's income per head fell from the world average to a quarter of it. This historic perspective is important; it is the humiliation of the past that even today drives China's quest for rapid growth.

Since Deng Xiaoping set China on the path of liberalisation in 1978, its GDP has grown, on average, by 9% a year (see chart on next page). Income per head has grown by 6% a year, faster in that period than any other Asian country except South Korea. China's GDP per head has risen from a quarter to half the world average. And its share of world GDP has doubled, to 10%. China, by some measures that use purchasing-power parity, is now the world's second-biggest economy after the United States.

What matters, however, is how long this advance can continue. Mr Maddison estimates that even if China's GDP growth slowed to 5.5% a year—a realistic goal given higher rates of growth in Japan, Taiwan and South Korea at comparable stages of their development—China would match America's level of GDP by 2015. Its economy would then account for 17% of the world total, while income per head would match the world average. Since a China more integrated into the world economy would presumably be a country more at ease with itself and with its neighbours, the prospect of such an outcome should be welcomed.

Behind the figures

Yet the immediate challenges to this are daunting. For a start, although the government denies it, China appears to be on the brink of a prolonged slump. Growth has already fallen from an annual peak of 13.4% in 1992-94 to an annualised rate of 7.2% for the year so far, making a nonsense of the government's often repeated claims that it will reach the 8% growth target for 1998 that Zhu Rongji, the prime minister, famously "guaranteed" in March.

The difference might appear to be hair-splitting of highly imprecise figures. But to create those vital new jobs, China needs robust economic growth. A rough rule of thumb is that every percentage-point fall in GDP means 5m more unemployed. As it is,

* "Chinese Economic Performance in the Long Run", by Angus Maddison, OECD, 1998.

Got a job yet?

around 70m, almost the population of Germany, are less than gainfully employed on farms or, increasingly, in cities. Hu Angang, a Beijing economist, predicts 18m fully unemployed urban Chinese next year. It is this rising unemployment which helps explain the scramble by President Jiang Zemin and his cohorts since early this summer to find growth, if necessary at the expense of longer-term structural reform.

It is impossible to know exactly how bleak things are. China's growth figures have always been overstated by one or two percentage points, at least. Now there is growing confirmation that China's GDP statistics have become almost meaningless. Although the government reports healthy growth this year in industrial output, electricity output (usually a good proxy for production) has barely risen. Meanwhile, it is hard to square claims of growth in consumer spending of 6.3% in the first nine months of the year with price deflation of around 3%, or with flat or even falling freight volumes. Suspiciously, reports that state-sector profits have fallen by 82% in the first quarter of this year were revised sharply upwards on October 16th, with little explanation.

Last year, when Chinese domestic demand was showing signs of slowing, a 20% spurt in exports helped take up the slack. This year export growth, which looked strong at first, has slowed to less than 4% for the year so far, buckling in the face of collapsed demand from the Asian region. Many exporters have switched to selling their goods at home. That, coupled with a fresh wave of imported goods from the region, many of them smuggled in, has put pressure on manufacturers for the domestic market, most of them state-owned. China's industry is probably working at about half its full capacity. But still factories are churning out goods. Unsold inventories have been growing at double-digit rates. The *China Analyst*, a Montreal-based publication, reckons that, if growth provided by the contribution from inventory accumulation is set aside, China's underlying GDP growth could fall to an annualised 2% in the final quarter of this year.

Though China is at a very different stage of development, its current predicament brings to mind Japan's experience in the 1990s. As in Japan, company profits have collapsed because of over-investment. Both countries have banking systems that are riddled with bad debts. China's banks are burdened with dud loans both to state enterprises and to property speculation made during the boom years of the early 1990s. Having had their fingers burnt twice over, they are in no hurry to lend again. And recent stipulations that threaten to penalise Chinese banks that make ill-judged loans provide a further disincentive to lend to anything but state-sanctioned entities.

As with Japan, China's leaders recognised the deflationary threat too late. They have failed to cut interest rates fast enough (real rates are about 10%) to boost domestic demand, perhaps because they fear that domestic savers will panic and seek hard-currency havens, despite an officially closed capital account. Instead, the government is relying upon additional infrastructure spending, equivalent to a combined 3.5% of GDP for this year and next, to pull the economy up. Yet there is little to suggest that a centrally mandated infrastructure splurge in China will provide much more than a short-term benefit. It will lean against the wind, but that wind, pushing back domestic demand, is a strong one.

Plenty of mainland and foreign economists are cheerier than this; they have an enduring faith in the government's ability to keep the economy growing. But China's structural problems may now be too deep-seated for the government to be able to deliver. Worried about the consequences of unemployment, or about the rising social costs (pensions, schooling, health care) that state companies used to bear, people are becoming afraid to spend—just as they have in Japan.

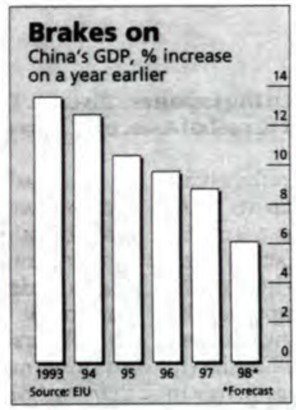
Several years of Japan-like slow growth, not to mention recession, would be disastrous for the welfare of ordinary Chinese. It would put China's long-term growth assumptions in serious doubt. It would threaten the legitimacy of a leadership whose claim to power is its ability to deliver growth. And it could precipitate a banking crisis that would make Japan's look like a picnic.

Among the most daunting problems is China's sharp west-east divide. This also has echoes from former times, when China was unable to react effectively to the western challenge, backed, as it was, by superior arms. Though many reformers argued for it, China was unable to absorb western, wealth-creating technology and skills. Missionaries aside, the foreigners all lived in extra-territorial "concessions": so-called treaty ports along the east coast.

Across the divide

Rhoads Murphey, a historian, has written that the thriving port city of Tianjin had closer links with the outside world than it had with its own hinterland, and "the foreigners remained outsiders". The biggest reason for this was that China's bureaucratic system held back the emergence of an independent commercial and industrial bourgeoisie. The bureaucracy and the landed gentry of imperial China were not producers of wealth, but consumers of it: they were quintessential rent-seekers.

Today, the eastern cities that Deng Xiaoping threw open to foreign investment are almost exactly those of the treaty ports. Booming foreign investment and the lively international trade that followed have transformed the coastal region, which has become wealthy, outward-looking and cosmopolitan: part of a network of international exchange. Yet the age-old problem remains; the benefits of western investment, technology, management and marketing skills have not spread beyond a coastal zone that threatens to become rigidly divorced from the rest of China (see map on next page).

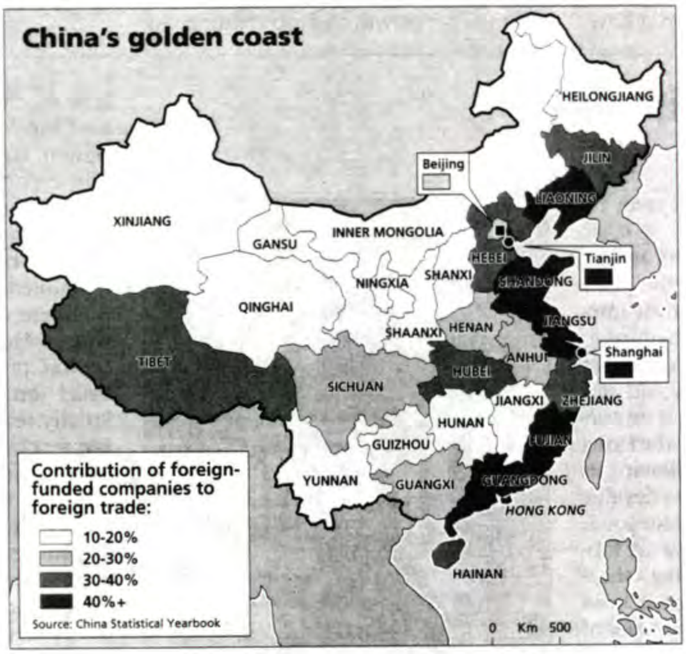


This coastal region is what many westerners refer to when they talk of the Chinese economy. But it is worth putting China's foreign-investment miracle in context. China's cumulative $270 billion of foreign direct investment has indeed transformed the country's external trade. Foreign investment in 1996 was involved in over 47% of foreign trade, up from just 5.6% a decade earlier. Some 120,000 foreign enterprises or joint ventures employ about 17m people, equivalent to one-tenth of the urban workforce. Yet more than half the multinationals operating in China are not making money, according to A.T. Kearney, a firm of management consultants.

Nevertheless, some observers argue that China's economy has become amongst the world's most open, with exports equal to 18% of GDP. But Mr Maddison argues that the figure, based on current exchange rates, is misleading. On a purchasing-power parity basis, Mr Maddison calculates, China's export ratio is just 4.3% of GDP. This puts into perspective the penetration of foreign investment in China's economy. It also helps explain why genuine private enterprise accounts for no more than 10% of China's national product. Agriculture still represents the biggest part of the economy, and various forms of state-ownership or collectives the remainder.

The impediment to free enterprise, as ever, is a rent-seeking state bureaucracy in much of the rest of the country. Today, it represents the interests of an industrial system of publicly owned enterprises, built by the Communists along Soviet lines. In what François Gipouloux, writing in *China Perspectives*, calls the "state planners' special reserve"—the inland provinces of Shaanxi, Guizhou, Yunnan, Qinghai, Ningxia and Xinjiang—the state controls about 60-80% of industrial output. This is a region of satanic pollution, shoddy products, mounting state losses—and little private investment to speak of.

Even if the government in Beijing officially welcomes foreign investment in China's central and western regions—or investment from other parts of China, for that matter—the dead weight of rigid state enterprises stifles the development of the various strands (subcontracting, flexible work practices, competition) that go to make up a modern industrial fabric. In these regions, Mr Gipouloux argues, the debate about development has become nothing less than one of Chinese versus foreign sovereignty. The regions' inhabitants are the losers.



The sharp dividing-line in China between two incompatible models of development is already a political headache for China's leaders, and is likely to become more of one. They have, in the past year, become more committed to "reforming" the state enterprises, as well as to cleaning up the state banking system that bears the burden of enterprise losses and is, as a consequence, insolvent. Yet the leaders lack the resources to impose their will: the central government's ability to collect taxes, for instance, has shrunk alarmingly. Tax revenues were 30% of GDP in 1989. They are barely 12% today.

Besides, the thrust of reforms is still aimed at improving the socialist "efficiency" of the state system, not at embracing full capitalism. Privatisation of heavy industry, telecoms, energy and the banks is out of the question, even if smaller enterprises are being let go. The legal underpinnings for free enterprise, notably adequate property rights and an impartial judiciary, are still lacking, both in the hinterland and on the coast.

That is not to say that China's enterprises are shunning "reform". Heeding the central government's call for efficiency, workers are being laid off in droves, while many millions more have been sent home with little or no pay. "Reform" has been an opportunity for state managers and their godfathers in local government to swipe incalculable quantities of public property for their own use; what Xiao Geng, of Hong Kong University, calls the "privatisation of profits and socialisation of losses." During two decades of reform, state-enterprise losses have risen 20-fold, to 74 billion yuan ($10 billion) by the government's own, understated reckoning. Surging unemployment, sluggish domestic demand, rising levels of unwanted inventories and an uncertain international economy: the attempted reforms could scarcely be taking place against a harsher backdrop.

The coastal region provides problems of a different kind for a Chinese leadership perennially concerned about national unity and control. The region's pull has attracted the bulk of China's 100m or so migrant workers, roaming the country in search of higher pay. These workers fall increasingly outside the state's supervision. The 3m-odd migrant workers in Shanghai are, for instance, officially non-persons; nevertheless their daily needs strain the city's resources to breaking-point.

Then there are the provincial political powers themselves to contend with. Recently, the Communist Party secretary of Guangdong was suddenly recalled, under a cloud. Reining in China's most gung-ho province has long been a challenge for Beijing, which is on guard against centrifugal forces in the coastal region. The collapse earlier this month of Guangdong International Trust & Investment Corporation (GITIC) the province's investment arm, highlighted a problem that is as much political as it is financial. Local "warlordism" is a challenge to the central leaders, albeit not on the scale of earlier this century.

Follow the money

The costs of delaying meaningful reform (ie, in most cases, closure) of the state enterprises are being met today in China's banking system. Since 1984, when the government said it would phase out financing enterprises through the central budget, state companies have been borrowing from the banks. By 1988, according to Nicholas Lardy of the Brookings Institution in Washington, DC, state industrial firms' debt-equity ratio had risen to 82%. By 1995, the figure had risen to 570%; it is assuredly higher today, were the figures available.

This means that Chinese companies are more heavily indebted than South Korea's *chaebol*, even before taking into account either their overvalued assets and inventories or their unfunded pension liabilities, which the World Bank puts at 50% of GDP. Such high indebtedness makes China's state enterprises acutely vulnerable to an economic slump. But slump or no, China's state enterprises as a group are efficient destroyers of wealth. It would be cheaper to close them all down, and still keep paying the workers.

The condition of the big four state banks mirrors the appalling state of the enterprises, to whom over four-fifths of their lending is directed. The reported profitability of the four banks—which together have 150,000 branches and 1.7m staff—has fallen by five-sixths over the past decade. They have a return on assets of just 0.3% (HSBC's return on assets is 1.6%).

The real picture is undoubtedly much bleaker, for China has a lax system of accounting for bad loans, and unpaid interest on non-performing loans is usually booked as profit. On generally accepted accounting standards, concludes Mr Lardy, at least three of China's four state banks—the Industrial & Commercial Bank of China, the Agricultural Bank of China and the China Construction Bank—are insolvent by a very wide margin indeed. Bad loans, if they were properly accounted for, might be $270 billion-360 billion, equivalent to 30-

40% of GDP. One of the gloomiest estimates of Japanese banks' bad loans is 30% of GDP, and Japanese banks are well-capitalised by Chinese standards.

If a meltdown has so far been averted, it is because the stability of China's financial system has been underwritten by a high rate of savings, of almost 40%. Inflows of household savings have ballooned, rising from 18% of all bank deposits in 1980 to around 60% today, and banks are sitting on nearly $600 billion-odd of household deposits—liabilities for the banking system that are matched by a dud pile of assets. This hugely inefficient intermediation of funds, in effect, represents the massive bilking of urban and (particularly) rural households by the state sector. Presumably, barring serious reform, there will one day have to be a reckoning. Either the government will try to inflate its way out of its obligations, or there will be a run on state banks—or both.

Plenty of mainland and overseas economists are scathing about crisis-mongers who write paragraphs such as those you have just read. How, they ask, can there be a banking crisis if the government stands four-square behind deposits? Besides, has not the banking system survived crises before, notably during the high inflation of the early 1990s? Yet this assessment is blinkered, for a number of reasons. First, a banking crisis, even if today it is a hidden one, already carries great costs for the real economy; by providing capital only for the undeserving, it greatly constrains China's potential for growth and job-creation. Further, it might not take more than a few jolts for China's savers to lose confidence in the banking system; already, there is resentment by depositors told they are unable to withdraw funds at short notice.

No one knows how far China might be from a full-blown domestic banking crisis. But a further slowdown in the country's economic growth will surely bring one closer. The possibility of China devaluing its currency and the level of its foreign debt continue to raise concern, especially as nearly all foreign banks have now stopped lending (see box). This might be just the sort of nudge that can turn nagging doubts about an economy into a crisis. And a crisis big enough to provide the China Club's library with a whole new set of volumes. ■

Reading their lips

BEIJING

"STATESMANLIKE" is the term for which editorial-writers reach when describing Chinese leaders' resolve not to devalue their currency, the yuan. China's selflessness, Britain's prime minister, Tony Blair, has said, is something to which tribute should be paid. People fear that if China devalued, Asia would succumb to another round of debilitating devaluations, bringing down even the Hong Kong dollar. In fact, China is following its own self-interest. It knows that to devalue the yuan could do more harm than good.

Certainly, some inside China are lobbying hard for devaluation: China's shipbuilders, for instance, which have been clobbered by the fall in the currencies of South Korea and (until recently) Japan. Moreover, some foreign observers argue that deflationary pressures will make devaluation irresistible, for lower export prices would help combat them. They also point to growing capital flight this year, and a weakening yuan on the black market, as signs that the government's nerve is not expected to hold.

Currency controls, over $140 billion in foreign reserves, and a trade surplus of probably over $50 billion this year: all are reasons for believing that the government will not devalue. Now there is a new reason: concern about China's foreign debt.

This issue has been brought into sharper focus by the recent closure of Guangdong International Trust & Investment Corporation (GITIC), with $2.4 billion in foreign debts. GITIC is one of a network of such groups, mostly owned by provincial governments, that have combined foreign debts of over $10 billion and a history of squandered investments. Now, the central government is set to close more of them. That makes foreign lenders even more nervous; most are stopping new loans altogether. A devaluation would worry them more, because it would undermine the ability of all Chinese entities to pay back debt.

Worried about their money

By the official count, neither China nor its lenders should have all that much to worry about. The country's debt ratio—the ratio between external debt and hard-currency income—stands at a comfortable 75% or so, well below the 100% level that starts to ring alarm bells. Moreover, foreign direct investment accounts for four-fifths of all capital inflows to China. The country is not as reliant on short-term borrowing as were its neighbours.

Yet one lesson from the past 15 months is that official debt figures can be gross understatements. The question is how much bigger than the official count are China's reported debts of around $120 billion. Half as much again is a reasonable first guess. Several types of borrowing do not show up in the data. For instance, lending by mainland branches of foreign banks does not, though it amounted to $27 billion in mid-1998.

There are also borrowings by "red chips"—Hong Kong-registered arms of central, provincial or local governments listed on the territory's stockmarket. Strictly, red chips are not mainland firms. But much of what they borrow has been invested in China, so part of their debt ought to count in China's foreign-currency exposure. Also, some foreign direct investment, particularly from Hong Kong, is actually lending in disguise. In several mainland infrastructure projects, the lenders get guaranteed foreign-currency returns: debt by any other name.

China's rising foreign debts clearly worry the authorities. Early this year they tightened rules on the amounts mainland companies can borrow. The State Administration for Foreign Exchange (SAFE) has rattled off a series of measures to plug the holes in China's (officially closed) capital account. One official estimates that a quarter of outflows through the current account is in fact disguised capital flight: dollars earned from false invoicing, illegal foreign-exchange deals and other nefarious activities. With capital flight reckoned to be as big as inward flows of foreign investment ($35 billion-45 billion a year), this official says that plugging just half of the foreign-exchange leaks would be a signal victory.

Further instances of ill-judged lending may well emerge. But a yuan devaluation would greatly aggravate China's foreign-debt problem. It is another reason to think that Communist rhetoric, this time at least, has a ring of sincerity to it.

10-23-98

two communist parties, one ex-communist party, three ex-socialist parties, four ex-Christian Democratic parties (three to the left, one to the right), one ex-fascist party and one fascist party. Among the big parties, only the Northern League and Forza Italia are new. One is separatist; the other belongs to Mr Berlusconi, still under investigation for corruption, and convicted of some charges already.

All this said, however, Mr D'Alema has appealing qualities. He is a dry military-style tactician, who dislikes the theatrical side of politics, and is given to quiet reflection. He chaired a commission that tried, though it failed, to change the creaky constitution—and the electoral rules, so as to stop so many small parties entering parliament, creating successive shaky coalitions.

As prime minister, he may be able to try to resurrect some of these ideas. Already, he has boldly installed Mr Amato, one of the quickest brains in the country, as minister for reforms. Much depends, though, on the backing of Mr Cossiga. He and Mr D'Alema have been at odds in the recent past. Now Mr D'Alema's new job, and its future, rest on Mr Cossiga's support. Given half a chance, Mr D'Alema might usefully change the present system, even though it helped to put him where he is. Another of his books is called "A Normal Country". This is his chance to make Italy one.

Spain

The Aznar touch

MADRID

WHEN you compare the two big countries of Mediterranean Europe, Italy and Spain, you can see how excessively modest Jose Maria Aznar was being a couple of years ago when, as Spain's new prime minister, he humbly told an early cabinet meeting that "our job is to hold on." He has done far better than that. These days, Spain looks a steadier place than Italy.

Spain's first achievement under Mr Aznar was to get its economy into shape in time to join the single European currency next January. The sceptics reckoned it could not meet the tests for membership. It has done so, with room to spare. As a result, business and consumer confidence has soared. The global financial turmoil of the past few weeks has done less damage to Spain than to many other European countries. The government expects the economy to grow by a healthy 3.8% both this year and next. Inflation, at 1.6%, is lower than it has been since the dismantling of Franco's centralised economy began two decades ago. So are interest rates.

Mr Aznar has pressed on with the reform of Spain's welfare and tax systems, and tried to slim down the state's bulky bureaucracy. There is still, to be sure, a way to go. Despite changes to labour laws, hiring and firing remain complicated and expensive. Some profitable state concerns have been privatised, but loss-makers like the Iberia airline and state radio and television continue to devour public money. Unemployment, at 18.7% of the

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upport his conservative People's Party in the Madrid parliament. Those concessions flew in the face of the Spanish right's centralising instinct; but Mr Aznar handled the matter with skill, and looks set to stay in office until the next election, due by 2000.

His foreign policy has not been stumble-free. His attempt to use Spain's historic links with Cuba to press Fidel Castro into adopting democratic and economic reforms ended ignominiously. It infuriated Spaniards who thought that the tie with their last colony should be above politics. It also annoyed businessmen with interests on the island. So Mr Aznar has made it up with the Cuban leader, who forgivingly came to Madrid this week.

The prime minister may now even have a chance to tackle the problem of Basque nationalism. The ceasefire declared last month by the Basque separatist movement, ETA, has raised the possibility of an end to the 30-year-long campaign of terrorism that has cost around 800 lives. Mr Aznar has offered "to be generous" to ETA if it will agree to abandon violence for ever. He may even call an election before 2000 to ask the voters for their approval of the terms on which he might negotiate a final settlement. These could include the release of imprisoned terrorists, and some vague form of words that acknowledged the separatists' right to seek an independent state without actually granting it.

As things stand, Mr Aznar cannot assume victory in the next election. Many Spaniards acknowledge his achievements but do not care for his chill, calculated efficiency. His main opponents, the Socialists, although they are in trouble over corruption scandals and the dirty war their government fought against ETA, still have a strong appeal to those Spaniards old enough to remember Franco and who suspect any party of the right.

This has led Mr Aznar to make some personnel changes designed to win over such doubters. His spokesman, a loyal but rough spin-doctor, was replaced earlier this year by a smooth-talking Catalan who is not even a member of Mr Aznar's party. The deputy prime minister, another hardliner, is being pushed to the sidelines. The cool Mr Aznar has a canny instinct for what it takes to keep a country on course. It is not impossible that, by the early 2000s, Spain will start to look like one of the more solid parts of southern Europe.

Germany

Napoleon strikes

Gene S | FYI — BL

BONN

It is becoming increasingly clear who will really run the new government

WELCOME to the Berlin Republic of Oskar Lafontaine. For quite a lot of people—fans of the nanny-state, foes of atomic power and foreigners wanting to become German—it looks near-ideal. The trouble is that it may have as many jobless people as the Bonn Republic, now in its last year, and maybe even more.

Just a moment, though. Surely Mr Lafontaine is merely Germany's finance minister-designate and chairman of its Social Democratic Party, senior partner in the incoming Red-Green coalition government. The chancellor, due to be elected in parliament on October 27th, will be Gerhard Schröder, pal of industry bosses and proponent of a "new centre" in politics.

In principle, that is true. But if the programme signed on October 20th by the two prospective government partners proves anything, it is that Mr Lafontaine, "the Napoleon of the Saarland" (his home state) and darling of the left, has won the decisive battles and emerged as the man who counts most.

Nothing shows this more plainly than the decision the previous day of Jost Stollmann, a non-party computer entrepreneur, not to take the job of economics minister offered to him four months ago by Mr Schröder. Supposedly, Mr Stollmann stepped down (or rather back) because Mr Lafontaine won his demand that key planning and Europe departments be hived off from the economics ministry and added to the Lafontaine finance empire.

But there is more to it than that. During the campaign for last month's general election, the Social Democrats followed a highly successful twin-track strategy. Mr Schröder calmed bosses, urged modernisation and touted Mr Stollmann as proof that he meant business. Mr Lafontaine pledged to roll back the (modest) cuts in social welfare made by the previous centre-right government, make energy dearer, close tax loopholes misused by the rich, and boost domestic demand to create jobs.

As the post-election coalition talks neared their end, Mr Stollmann concluded that the new government would be roaring down the Lafontaine track after all, and he would have precious little chance to change the points from his truncated signal-box. This does not seem to bother his last-moment replacement, Werner Müller, an amiable (non-party) energy specialist expected to concentrate on easing Germany out of atomic power and not to mope over lost fiefs.

Schröder here, Lafontaine there, some of the new programme makes a lot of sense. For instance, the integration of foreigners should become smoother thanks to the long-overdue decision to modify an 85-year-old law that made ancestry, not residence, the determinant of who is German. Despite qualms among Germany's allies, used to the steadiness of Helmut Kohl's departing administration, foreign policy should bring few alarms under Joschka Fischer (see page 53), one of three Green ministers; the others are at environment and health. Even the pledge to drop all nuclear power one day has brought few signs of industrial alarm, and many sighs of relief from Germans, increasingly angst-ridden since the Chernobyl nuclear accident.

As usual, though, keep an eye on Mr Lafontaine, who thinks little of central bankers and wants governments to pool their efforts to steady currencies and create jobs. Not classical foreign ministry stuff, of course, but full of tricky international implications, not least for the euro.

The real question-mark looms over the incoming administration's chief pledge: to cut the horrendous number of jobless, now 4m, more than 10% of the workforce. Mr Schröder aims to bring together right away bosses, trade unions and even the churches in an "alliance for work". But on October 20th Germany's six leading economic-policy institutes gave warning that real growth in GDP would slip from 2.7% this year to 2.3% next year, and that the 1999 jobless total would still average just over 4m. The Asian and Russian economic crises got the main blame, but the new government's tax plans were said to fall far short of what was needed to boost growth and employment.

True, family allowances are to be raised and modest earners given tax relief in line with Mr Lafontaine's aim to boost domestic demand. But these steps will take full effect only after four years, and in the meantime, starting next January, a total of DM36 billion ($22 billion) will be added to the price of petrol, gas, heating oil and electricity. The aim is to use revenue from this "ecological tax reform" to cut soaring welfare costs, which help to make German labour among the world's dearest. But the result could be to fuel inflation and subsidise the welfare system, not to give it the trim it badly needs. Indeed, the government plans early on to restore the cuts Mr Kohl made to pensions, sick pay and other benefits.

Lafontaine steers Schröder on to his track

As for business, in the short-run it will lose more from the closure of tax loopholes than it will gain from the planned gradual cut in ultra-high corporate tax rates. The smaller firms will be among the hardest-hit—a point implicitly recognised by Mr Schröder, who began promising improvements in the tax package even as it appeared. Mr Lafontaine, so far, stays mum.

Correction

Last week Charlemagne incorrectly quoted John Maynard Keynes. The economist said: "When the facts change, I change my mind—what do you do, sir?" *The Economist* wrote: "When I am wrong, I change my mind—what do you do?" When *The Economist* is wrong, it corrects the error.

Kosovo

A long way to go

DOLOVO AND JABLANICA

SNOW is falling on the Cursed Mountains, a range that divides Albania from Serbia's province of Kosovo. Lowland tracks are churned into mud, and rivers are swollen by rain. A week after President Slobodan Milosevic agreed to pull most Serbian troops out of Kosovo, thousands of ethnic-Albanian refugees, sheltering in makeshift tents, are too frightened to return to the blackened ruins of their villages.

Dolovo, in western Kosovo, was torched in May when Serbian forces began their summer offensive against the separatist Kosovo Liberation Army (KLA). Now, about 20 heavily armed policemen still occupy houses, and check all traffic passing along the track that leads into no-man's-land and the rebel-held territory beyond.

This village used to be home to both Albanians and Serbs. Some Serbs are back, but nobody else is. Cornfields running down to the river are untended. Most houses have been gutted by fire. The signs of abandonment are eerie. A pink lacy dress is draped around a tree trunk. On front doors, Serbian police have daubed the four Cyrillic letters that stand for the motto: "Only unity saves the Serbs." Another scrawl runs: "Serbia as far as Tokyo."

Some 200 villages have been similarly destroyed, and most remain similarly deserted. Few of the estimated 250,000 displaced people are going home. Large areas of central and western Kosovo are empty. Those coming down from the hills and forests head towards what they hope is the safety of larger towns. Torrential rain and temperatures close to zero are doing the work of negotiators and aid workers: getting Albanians into some kind of shelter.

On the road out of Dolovo, in the no-man's-land littered by spent tank-shells, Albanian women and children are moving towards the next village, Glodjane. Occasional gunfire resounds a few miles away. "We've been on the move for months," says one mother, wrapped in a scarf against the chill October wind. "We are looking for somewhere to sleep." There is no room in the first farm they try. Some 40 gypsies from Dolovo are crammed inside. They may have better luck in Glodjane. In happier times, it was inhabited mainly by Roman Catholic Albanians. Its prim white church and houses are unscathed.

Farther on, across two rivers, lies Jablanica, a former KLA stronghold. It was attacked and occupied twice by the Serbs. Now, however, unable to hold every village, the police have gone, and the KLA is back. The only woman to be seen is in KLA uniform and carries a rifle. One rebel, emerg-

10-28-98

VP-Fghr - BZ

SCIENCE Every Tuesday: Discoveries, breakthroughs and trends

NASA's discoveries have earthbound applications

From cooling suits to X-rays, agency offers a preview of medical advancements

By Tim Friend
USA TODAY

A walk in the park for Mikie Walker of Virginia Beach, Va., might as well be on the moon.

This 6-year-old boy has a genetic condition called porphyria, which makes his skin extremely sensitive to solar radiation. A few minutes' exposure to ordinary sunlight causes severe sunburn, blistering, painful nerve inflammation and abdominal pain.

But in April, NASA provided Mikie with a protective ultraviolet suit similar to those worn by astronauts who walked on the moon and in the hostile environment of space. Now Mikie can safely explore Earth, which had been just as hostile to him during the day.

Since the beginning of the space program, modern medicine has been a key beneficiary of its technological advances. NASA uses its technology transfers and stories like the one about Mikie to justify the investment by taxpayers and to show that it has practical value.

Since the instant orange breakfast drink Tang and ballpoint pens, the transfer of technology, particularly to the medical arena, has been NASA's public relations mainstay.

The space shuttle launch Thursday, which will carry John Glenn into orbit again after 36 years, is focusing attention on NASA public relations perhaps like no other mission in its 40-year history.

Glenn's mission is being widely criticized as a public relations ploy and a payback for key votes he made as a Democratic senator. Nevertheless, it will produce new information about the effects of near-zero gravity on an aging body. The information will contribute to a better understanding of bone loss, muscle wasting and neurological degeneration.

Public relations or not, most space missions have contributed significant technology transfers that have touched the lives of millions of people worldwide. Mikie and two boys in England, who are allergic to sunlight and also require protective suits, will spend the rest of their lives wrapped in NASA technology. Every time a person sees a doctor or undergoes a medical test, some small aspect is likely to have come from the space program.

From the beginning, manned space flight has been generating medically oriented technologies. Glenn's 1962 orbit of the Earth required NASA to develop remote monitors for heart, blood pressure and oxygen levels. Today, these monitors make the emerging field of telemedicine possible. Telemedicine monitoring technologies tested in May on Mount Everest, for example, were based on these early devices.

With John Glenn about to make medical history, USA TODAY highlights some of the key technologies that arrived on Earth from outer space:

Cool suits

Astronauts' spacesuits and the UV suits developed for children with sun-sensitive conditions on Earth require cooling systems for the head and body. Robert Dotts, assistant director of Technology Transfer and Commercialization at the Johnson Space Center in Houston, says the latest version consists of a vest made of materials similar to those used in cold packs. Original suits employed a battery-powered cooling system of tubes that carried water.

The outer UV reflective garment is made of a prototype material that is being developed for future astronaut spacesuits.

It is a two-layer suit that blocks 99.9% of UV rays.

The outer layer consists of a jacket, pants, gloves, helmet and visor. The inner layer consists of the new passive-cooling vest.

The vest is manufactured by MicroClimate Systems Inc. of Sanford, Minn. The UV outer garment is made by Solar Protective Factory of Carmichael, Calif.

The cool suits are being used by children with hyphidrotic ectodermal dysplasia (HED) (missing sweat glands), multiple sclerosis, spina bifida, cerebral palsy and numerous genetic disorders that affect the skin.

Sarah Moody of Hampton, Va., provides NASA's cool suits to children through her HED Foundation.

Implantable pumps

A pump developed for the Mars Viking lander provided the design for the Programmable Implantable Medication System, which is placed in the abdomen to deliver a continuous supply of insulin for people with Type I diabetes.

NASA satellite technology provided the engineering foundation for miniaturization of the device's features.

It has a refillable reservoir, the pump, a tube that leads to the intestines, a microcomputer and a battery. It is encased in a titanium shell that is 3 inches in diameter and three-quarters of an inch thick.

The patient can program the device by holding a radio transmitter above the abdomen and selecting one of 10 codes. The codes can change the rate of insulin flow, provide an extra dose, allow physicians access to data from the pump's stored memory and generate computer data on pump performance.

The external MiniMed 504 insulin infuser pump is the size of a credit card and contains a computer, battery and insulin syringe attached to a thin catheter that is 30 inches long. The tip of the catheter holds a needle that is placed under the skin and delivers insulin based on preprogrammed rates.

Advanced imaging

Studying distant galaxies through special devices that visualize the universe with X-ray vision led to the development of the Low Intensity X-ray Imaging Scope.

The portable device is being used to make X-rays for injured players on a football field or at the scene of an accident. One of these devices, FluoroScan by HealthMate Inc., weighs only 20 pounds and occupies only 2 square feet. It can operate on batteries.

About 500 hospitals have replaced their standard high-intensity X-ray machines with the FluoroScan. The low radiation levels make the device particularly useful for real-time imaging during surgery.

A third-generation device is used commonly for airport and building security and quality control industrial inspections.

Heart-imaging devices, excimer lasers, microbe detectors, programmable pacemakers and diagnostics for cataracts are just a few more of the advances for which NASA claims responsibility. It also has made inroads into the study of osteoporosis, drug development and balance disorders.

Public relations? Sure. But people like Mikie aren't complaining.

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HONORARY PARTICIPATION REQUEST

Please return to Neal Sharma, Room 97

Today's Date: October 27, 1998

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Date of Request:	6/5/98
Request for:	POTUS/FLOTUS
Type of Request:	Honorary Chairs
Requestor Name:	Mr. A. Scott Bolden
Title:	President
Address:	District of Columbia Chamber of Commerce 1301 Pennsylvania Avenue, N.W. Washington, D.C. 20004
Contact Tel. #:	202 347 7201
Event Date:	11/13/98
Event Description:	Sixtieth Anniversary of the DC Chamber of Commerce
Notes:	The DC Chamber of Commerce is celebrating 60 years of building bridges to the community and government of the city. Established in 1938 as the Negro Business League, the DC Chamber has worked to improve the economic climate for minority businesses. The dinner will recognize key members within the local business community over the past year. Approximately one thousand leading business men and women from the District are expected to attend. Secretaries Shalala, Herman, and Daley have been invited, but have not committed. The organization is non-profit, classified as a 501(c)6. Normally we regret local organizations, but the Chamber of Commerce is a leading organization in the District. The President and First Lady should ACCEPT.
Recommendations:	MV ________ PC OK Kw 10/28

(Unless otherwise noted, a yes answer will automatically generate a message as well as acceptance of the honorary position).

Comments:

cc: Meredith Cabe, 136

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District of Columbia
Chamber of Commerce

June 5, 1998

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

Dear Mr. President and Mrs. Clinton:

The DC Chamber of Commerce is celebrating 60 years of building bridges for business to the community and government of the city. Established in 1938 as the Negro Business League, the DC Chamber has grown from a small coalition directed toward improving the economic climate for minority businesses. The Chamber is now the most racially and genderally diverse and influential organization that concentrates on the business and economic development agenda in the District of Columbia. Our members and leadership include such major companies as Bell Atlantic, Arthur Anderson, PEPCO, Medlantic Healthcare Group, and KPMG Peat Marwick, as well as small, minority, and women owned businesses throughout the city.

In celebration of our 60th Anniversary, our Annual Business Awards Dinner will be held on Friday, November 13, 1998, at the Washington Hilton Hotel. This black tie dinner recognizes the achievements of key members within the local business community over the past year. Among the major awards that will be presented will be the Business of the Year, Small Business of the Year, and Business Leader of the Year. Historically, the dinner has attracted over 1,000 of the leading business men and women from the District as well as our political leaders.

We would be very grateful if you and Mrs. Clinton would agree to serve as Honorary Chairs for this milestone occasion. We hope you will be able to join us for what will be truly a spectacular landmark event. We would be honored by your acceptance of your invitation. Your support and presence would greatly enhance the evening.

Sincerely,

A. Scott Bolden

A. Scott Bolden
President

JUN 8 1998

1301 Pennsylvania Avenue, N.W. • Washington, D.C. 20004 • (202) 347-7201 • Fax (202) 638-6764

THE PRESIDENT HAS SEEN
10-28-98

THE WHITE HOUSE
WASHINGTON

October 25, 1998

MR. PRESIDENT:

Attached are the following weekly reports:

(A) **Weekly Economic Briefing**

(B) **Interest Rates/Update on Global Markets**

(C) **DPC Report**

(D) **NEC Report**

(E) **CEQ Report**

(F) **OSTP Report**

(G) **Climate Change Report**

(H) **Upcoming Speeches/Communications Report**

(I) **Legislative Report**

(J) **Public Liaison Report**

(K) **Intergovernmental Report**

(L) **Cabinet Affairs Report**

(M) **Political Report**

Phil Caplan PM

Tab A - copied Yellen, Bowles
copied page 4 to Sperling, Stern, Yellen, Bowles

Tab C - copied Begala, Reed, Kagan, Bowles

Tab D - copied Sperling, Bowles

Tab E - copied McGinty, Bowles

Tab H - copied communic. weekly report to Lewis, Spector, Bowles, Street

Tab I - copied Stein, Bowles

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THE WHITE HOUSE

WASHINGTON

October 23, 1998

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MEMORANDUM FOR THE PRESIDENT THE PRESIDENT HAS SEEN
10-28-98

FROM: **GENE SPERLING**

RE: **NEC WEEKLY REPORT**

cc: **ERSKINE BOWLES**

Response To Question on COLA and Effect on Actuarial Imbalance: Last week, you asked what impact this year's low COLA will have on the 75-year actuarial balance of the Social Security system. Since the actual COLA (1.3 percent) was only slightly below what SSA projected (1.5 percent) for this year in the Social Security Trustees' Report, the low COLA will have essentially no impact on the actuarial balance. This low inflation would have to persist for many years for it to have a noticeable impact on the financial status of Social Security. You should know that the Bureau of Labor Statistics has recently made a number of permanent technical improvements to the Consumer Price Index, which are expected to have a long-term reduction in the rate of increase in the CPI of about 0.20 percent. These improvements have not yet been incorporated into the forecasts of the Social Security Actuaries. When they are, they will likely improve the actuarial imbalance by about 0.10 percent of payroll, which extends the life of the Trust Fund by less than one year.

This would have been a good public event

Record Homeownership Rate In Third Quarter: On Thursday (10/22), the Census Bureau reported that the homeownership rate rose to another all-time high, increasing from 66.0 percent in the second quarter to 66.8 percent in the third quarter. For the first time in American history, more than two thirds of American families own their own homes. Since you took office, 7.4 million American families have become homeowners. The gains were broadly shared too, with the homeownership rates of African American and Hispanic families climbing faster than the overall rate. However, their levels still remain far below the rate for whites (about 45 percent for minorities compared to over 70 percent for whites). We put out a statement from you highlighting the fact that much of this rise in homeownership was due to the virtuous cycle of lower deficits, lower interest rates, and stronger growth your 1993 Economic Plan helped create.

SEC Chairman Levitt Speech on Social Security: On Monday (10/19), SEC Chairman Arthur Levitt made public remarks, for the first time, on Social Security reform. He emphasized the issue of investor protection, noting that any proposal to invest in securities -- whether through individual accounts or the Trust Fund -- would raise new challenges to regulators and the investing public. He stated that half of all Americans did not know the difference between a stock and a bond and only 16 percent have a clear understanding of what an IRA is. Levitt also cited the experience of private accounts in the United Kingdom in which high-pressure sales tactics were used to mislead unwitting investors -- leading to billions of dollars of loses for the investors. The SEC is forming an internal group to examine these regulatory issues. You should know that two of my former staff members helped Levitt on his speech: Russell Horwitz, who is now Levitt's speechwriter, and Peter Orszag, who is consulting for the SEC from California.

State-by-State Amplification of Unfinished Agenda: On Wednesday (10/21), we released a state-by-state analysis of the impact of the Republican's inaction on school modernization, a Patients Bill of Rights, tobacco legislation, a minimum wage increase, and your child care initiative. We distributed copies to every member of Congress and released them on the wire. Working with the press and communications shops, we pushed the state-by-states out to the Cabinet agencies, interest groups, and state and local officials. Craig Smith also distributed them through his networks and the press office was sending them to the editorial boards of each state's major papers.

Social Security: In preparation for your event on Friday -- which, as you know, was postponed until Tuesday afternoon -- we prepared a report on the key facts and issues regarding women and retirement security. The report will be released at your event on Tuesday. This week, I also convened a meeting of White House staff to discuss plans for the December White House Conference on Social Security. You will announce the dates of the conference -- December 8th and 9th -- in your weekly radio address. Our Social Security working group met twice this week to continue our discussions of comprehensive reform options.

Privacy: The European Union is meeting on Monday to decide whether or not to negotiate with the U.S. and other countries on the issue of privacy. They have a more regulatory approach to protecting privacy than the we do, and there is some concern that they will disrupt the flow of data to countries that they view as not having an "adequate" regime for the protection of personal information. We believe that they will agree to negotiate with us, but it is possible that the member states will not be able to reach consensus on this.

Anti-Bribery Bill: Dorothy Robyn, on my staff, was deeply involved in crafting the House-Senate compromise that allowed for passage on Wednesday of the "International Anti-Bribery and Fair Competition Act of 1998." This Act implements an agreement by OECD member countries to enact criminal laws against bribery of foreign government officials. Such activity has been illegal in the U.S. since passage of the Foreign Corrupt Practices Act in 1977; it is not only legal but also tax deductible in most other countries (the Commerce Department estimates that U.S. firms lose up to $30 billion a year in sales as a result). Although there was nothing controversial about the anti-bribery bill itself, Rep. Bliley tacked on an extraneous provision to limit the privileges and immunities of two intergovernmental satellite organizations, INTELSAT and Inmarsat, which the Senate refused to accept. NEC and Commerce staff conducted shuttle diplomacy last weekend between the two sides, and on Monday they reached an agreement. The U.S. is the first OECD member to enact implementing legislation for the anti-bribery agreement; had we not gone first, other countries would have been unlikely to accept the agreement at all.

Meeting with Mayor of Long Beach: NEC staff joined Mickey Ibarra and John Podesta in a meeting on Wednesday with Mayor Beverly O'Neill of Long Beach. We will work with DoD to try to resolve a concern she raised having to do with tradable emissions credits that currently are assigned to the Long Beach Naval Complex but that the Navy wants to transfer to San Diego.

Tax Cuts: As you know, a tax extenders package was included in the omnibus bill. It included many of the extenders from our budget. While House Republicans tried to omit an extension of the welfare-to-work tax credit, we were able to add it back into the final bill. House Republicans refused to include our extensions of the wind and biomass provision and the rum cover over provision for Puerto Rico and the Virgin Islands rum tax provisions.

THE PRESIDENT HAS SEEN
10-28-98

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THE WHITE HOUSE

WASHINGTON

October 23, 1998

Copied
Begala
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MEMORANDUM FOR THE PRESIDENT

FROM: Bruce Reed
Elena Kagan

RE: DPC Weekly Report

1. Education -- Class Size Reduction: To ensure that we capitalize on your victory on class size reduction, the Vice President and the Education Department released state-by-state figures showing the funding levels and estimated number of new teachers to be hired with the $1.2 billion in the omnibus appropriations bill. The Education Department has provided members and the press county-level funding numbers as well. In addition, we have distributed widely the attached chart showing that the final class size reduction agreement comes very close to your original proposal.

2. Education -- After School Programs: We are working with the Education Department to determine if it will be possible to award a portion of the $200 million in new after-school program grants to cities such as Boston and Chicago which didn't make the cut this past year. The remainder of the funds would be used to fund a new competition, with grants to be awarded in the spring. Making some awards now would give us an opportunity to take credit for our victory and would allow students to participate in after-school programs during this school year. However, in order to take this step, we must make certain that the awards will be made consistent with new report language in the appropriations bill directing the Education Department to target the funds to communities with high poverty levels, high juvenile crime and low academic achievement.

3. Health Care -- Final Report on Federal Compliance with Patients' Bill of Rights: Late next week, you are scheduled to release a report showing that while the Congress failed to pass a Patients' Bill of Rights, you have taken action to implement these protections for the 85 million Americans in Federal health plans. Last February you issued an Executive Memorandum directing the five Federal agencies with jurisdiction over health care to come into compliance with the Patients' Bill of Rights. This report details the steps those agencies have taken to come into compliance. You can also reiterate your strong commitment that passing a Patients' Bill of Rights that guarantees these protections for all Americans will be one of your top priorities in the next Congress.

cc Begala [illegible]

4. Health Care -- AIDS/Congressional Black Caucus (CBC) Event: Next Wednesday, at Rep. Waters's request, you will take part in an event with the CBC to celebrate the $130 million budget increase targeted to HIV/AIDS for minorities. African-Americans represent 44 percent of all new HIV/AIDS cases. Securing new targeted funding for minorities through a range of programs -- including new investments in prevention, women and children, and substance abuse -- was the top priority for the CBC in the budget. They are thrilled they received their full request and greatly appreciate the Administration's efforts in fighting for these increases. They are also pleased that there were significant increases in funding for Ryan White, as well as a new commitment to pay for programs designed to reduce health care disparities among the minority populations.

5. Health Care -- Safeguarding Medicare Beneficiaries who Lose HMO Coverage: On Friday, HCFA released a letter to state insurance commissioners outlining the rights of Medicare beneficiaries who have been involuntarily terminated from Medicare HMOs to access supplemental "Medigap" insurance. The letter made clear that insurers must provide such beneficiaries access to certain Medigap plans now offered regardless of health status, prior claims history, or medical condition. Although the letter will be well received by the aging groups (such as AARP), two issues will attract dissatisfaction from the disability community. First, because of concerns about adverse selection, the law does not give us the authority to mandate that Medigap plans with prescription drug coverage be guaranteed issued. Second, under current law we do not have the authority to require insurers not now offering Medigap plans to disabled Medicare beneficiaries to do so. As a consequence, in the 35 states that do not mandate offering Medigap to the disabled, disabled beneficiaries who were dropped from HMOs will not have guaranteed access to affordable Medigap plans. However, the HCFA letter does urge states to pass legislation to require a Medigap offering to the disabled. Moreover, you have been on record since last year as supporting bipartisan legislation in the Congress to require all insurers offering Medigap plans to seniors to also offer such an option to the disabled population.

6. Drugs -- Medical Marijuana: ONDCP and the Justice Department have tentatively scheduled a press conference early next week in D.C., at which General McCaffrey and Attorney General Reno will call on voters to reject medical marijuana ballot initiatives pending in six states (AK, AZ, WA, OR, NV, CO) and the District of Columbia. McCaffrey will urge voters not to change drug laws until scientific facts can confirm that the benefits of marijuana outweigh the risks. ONDCP also hopes to release a letter signed by former Presidents Ford, Carter, and Bush opposing these ballot initiatives.

7. Crime -- Law Enforcement: Last week, just prior to adjourning, the Congress passed legislation to provide college scholarships to the dependents of slain state and local law enforcement officers. You called on Congress to enact such legislation at last year's NAPO Top Cops event. Two years ago in a Rose Garden ceremony, you signed similar legislation, which provides scholarships to the children and spouses of slain federal law enforcement officers.

8. Immigration -- Budget Victories: The budget bill contains several significant achievements for your immigration agenda. We asked for and received a $171 million increase to address the two-year backlog of pending naturalization applications at the INS. With help from the Hispanic Caucus, labor unions, and religious groups, we were able to delete provisions that would have reduced job opportunities, wages, and work standards for legal U.S. farmworkers by creating a new agricultural guestworker program. Finally, we were able to grant amnesty -- automatic eligibility to adjust to permanent legal status -- to approximately 48,000 Haitians who were paroled into this country after the 1991 overthrow of President Aristide or who applied for asylum prior to 1996. You temporarily suspended deportation of these Haitians last December and called on Congress to grant them permanent relief.

9. Immigration/Welfare -- Public Charge: The Justice and State Departments have agreed to issue guidance instructing INS inspectors and State Department consular officers to disregard prior or current receipt of Medicaid, CHIP, and/or Food Stamps when determining whether an immigrant is likely to become a public charge (unless an alien has received institutionalized care funded by Medicaid). In recent months, there have been documented instances of aliens being denied re-entry to the U.S. because they had received Medicaid and of aliens being told by immigration officials that receipt of Medicaid or Food Stamps could negatively affect their immigration status. Our goal is to have the new guidance issued by November 1st, when provisions which restore Food Stamp benefits to 250,000 elderly, disabled, and other needy legal immigrants go into effect.

10. Civil Rights -- EEOC: Your FY 1999 budget included $279 million -- a $37 million increase over the previous year -- to expand EEOC's alternative dispute resolution program and reduce the backlog of private sector discrimination complaints. The final budget fully funds your request, providing the first real increase for EEOC in several years.

CLINTON VICTORY ON SMALLER CLASSES WITH QUALITY TEACHERS

PRESIDENT CLINTON'S GOAL	ADMINISTRATION'S PROPOSAL	FINAL AGREEMENT IN OMNIBUS APPROPRIATIONS BILL	PRESIDENT'S GOAL MET
CLEAR PURPOSE	• Reduce class size to 18 in the early grades	• Reduce class size to 18 in the early grades	✔
FIRST STEP TOWARD HIRING 100,000 TEACHERS	• $1.1 billion in first year • Help school districts hire more than 30,000 teachers in the first year of a seven year-initiative to hire 100,000 teachers	• $1.2 billion in first year • Help school districts hire more than 30,000 teachers in the first year	✔
TARGETING NEEDIEST STUDENTS	• Targeted to high poverty communities using Title 1 formula	• Targeted to high poverty communities, with 80% of funds allocated by poverty and 20% by population count	✔
GETTING DOLLARS TO LOCAL SCHOOL DISTRICTS	• 99.4% of funds to local school districts • 0.0% for federal administration; 0.5% for costs to state of program administration and testing of new teachers; 0.1% for evaluation	• 100% to local school districts • 0.0% for federal administration; 0.0% for costs to state of program administration and testing of new teachers 0.0% for evaluation	✔
ENSURING TEACHER QUALITY	• Requires that local school districts spend at least 10% of funds on improving teacher quality • New teachers must meet state certification requirements • New teachers must pass state-selected competency test	• Establishes 15% cap for local school district expenditures on improving teacher quality • New teachers must meet state certification requirements • School districts may use funds for teacher competency tests	✔
ACCOUNTABILITY FOR RESULTS	• Must produce annual school report card to parents and the public on student achievement and class size	• Must produce annual school report card to parents and the public on student achievement and class size	✔

Preserve the Citizen Service Tradition

By Stephen E. Ambrose

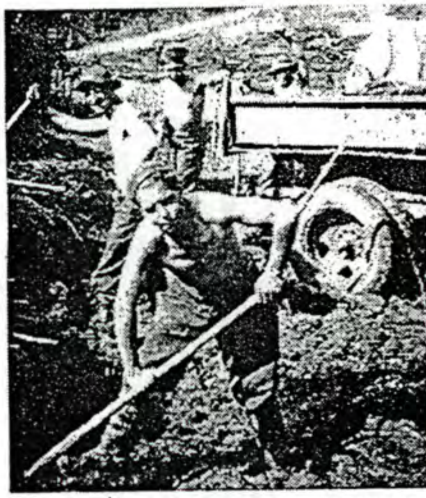
It is the nature of youth to want to explore. Youngsters yearn for challenge and new experiences and the sense of belonging to something larger than themselves. They are idealistic and want to advance their ideals through service.

It is one of the principle misfortunes of our time that we do not provide our 18- and 19-year-olds with enough opportunity to do these things, and it is one of the chief differences between America today and America a half-century ago. Then, service of some sort to the nation by the young was taken for granted, along with the notion that society would provide them with a place to serve.

In the Depression, it was the Civilian Conservation Corps, universally praised for the projects it undertook and completed and for the way it provided impoverished youngsters with a chance to serve, to travel, to get to know other young Americans from different backgrounds and parts of the country. In the Second World War and during much of the Cold War it was the armed forces, where millions of young Americans served. President John F. Kennedy tapped the same vein to create the Peace Corps. Today AmeriCorps is extending that tradition of citizen service, giving young people opportunity to serve their country here at home.

The generation of Americans now in retirement faced and overcame great challenges, starting with the Depression and including the Nazis, the Japanese militarists, and the Communists in Korea, Vietnam, and the Soviet Union. The challenges of today are not so clear, or terrifying, or dramatic. Nor are they as unifying: During World War II, a popular saying, used to respond to a complaint about this or that shortage, was "We are all in this together." Today's youth have never had that feeling. They have missed the experience of working together for a common goal as much as they have missed the chance to serve others.

It seems to me that one of the great things that came out of World War II, and to a lesser extent out of Korea and even Vietnam, was the way in which millions of young men learned to work together, to take responsibility, to become part of a team. They learned, too, to savor deferred gratification, and to take pride in contributing to their fellow man.



Michigan Historical Museum

CCC workers near Camp Au Sable, Mich.

Today, too often, our youngsters hardly know one another. Middle class kids have little or no contact with inner-city kids. As we become a more diverse society, it is critical that we provide our youth with experiences that bring Hispanic-Americans and European-Americans, Jewish-Americans and Muslim Americans, Asian-Americans and African-Americans together, working, living, serving side-by-side. Lord knows there are plenty of challenges out there and much to be done, improving education, fighting poverty, and protecting the environment.

In Europe, several nations require that, at 18, young people give a year of service to their country. In the U.S. it is not required, but AmeriCorps provides a voluntary opportunity to make a similar commitment. Instead of fighting enemies abroad these young Americans battle against the everyday enemies of illiteracy, poverty, and violence that plague our nation. In four years, AmeriCorps members have taught, tutored and mentored more than 2.2 million children, provided after-school programs to more than a million at-risk youth, removed close to 70,000 tons of trash from neighborhoods, and recruited more than 1.8 million volunteers to assist in these and other efforts.

AmeriCorps members, most of whom are between the ages of 18 and 24, receive a loan living allowance, and after a year of service a stipend of almost $4,800 to help pay for college. This is similar to the 1944 GI Bill of Rights, which was the best piece of legislation Congress ever enacted. The GI bill sent hundreds of thousands of GIs to college—guys who never dreamed it would be possible for them to get a higher education—and after earning their degrees they went out and built modern America. They were part of the best educated, best disciplined, hardest working, most innovative generation of Americans ever. Today's young people, through AmeriCorps and other volunteer groups, can emulate them.

Our young people are our future. Our very soul as a nation is at stake. I cannot imagine a better investment than in youth who want to work for others and then go on with their education, taking a hand up rather than a hand out. Since 1994, more than 100,000 young men and women have pledged to "get things done" for America. This month, as AmeriCorps celebrates this milestone, let us congratulate them for their service to our country—and hope that future generations have the opportunity to follow in their footsteps.

Mr. Ambrose is author, most recently, of "Citizen Soldiers" (Simon & Schuster, 1997).

THE WALL STREET JOURNAL

FRIDAY, OCTOBER 23, 1998

THE WHITE HOUSE

WASHINGTON

THE PRESIDENT HAS SEEN
10-28-98

October 23, 1998

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Bowles

MEMORANDUM FOR THE PRESIDENT

FROM: **LARRY STEIN** LJS

SUBJECT: **LEGISLATIVE WEEKLY REPORT**

United States House of Representatives

- On Tuesday and Wednesday, the House approved thirteen bills under Unanimous Consent Agreement, all of which were non-controversial.

- **Omnibus Appropriations Conference Report:** As you know, on Tuesday, the House passed (333-95) H.R. 4328, the Omnibus Appropriations Conference Report. The bill contains, among ~~other things~~, the eight bills which were not enacted individually. Thirty-one Democrats and sixty-four Republicans voted against the measure (see attachment).

- **Miscellaneous Tariff Amendments Act:** On Tuesday, the House passed by Unanimous Consent, H.R. 4856, the Miscellaneous Tariff and Technical Amendments Act. The Administration supports several provisions in H.R. 4856 including provisions on silk markings, normal trade relations with Mongolia, Customs merchandise processing fees, and extensions of the U.S. insular possession program which responds to an Administrative initiative. These provisions are consistent with Administrative policy. However, the Senate did not consider this bill prior to adjourning.

- ***Sine Die* Adjournment Resolution:** On Wednesday, in concurrence with H.Con.Res. 353, the House adjourned *Sine Die*. The adjournment resolution contains two provisions which could result in Congress reassembling prior to January 6th, 1999. First, both the House and Senate could be called back into session by the Speaker of the House and Senate Majority Leader in consultation with the House and Senate Minority Leaders. The second provision enables the Speaker of the House in consultation with the Minority Leader to reconvene the House without the Senate having to assemble. In both instances, the Congressional leadership would have to give members a two-day notice and conclude that "the public interest shall warrant it."

United States Senate

- **Omnibus Appropriations Conference Report:** On Wednesday, the Senate passed (65-29) H.R. 4328, the Fiscal 1999 Omnibus Appropriations. Nine Democrats and twenty Republicans voted against the measure (see attachment).

- **Vacancies Act:** Senator Byrd (D-WV) included language in the Omnibus Appropriations Bill which limits the time the Administration can utilize "Acting" Officers to fill vacant positions. Compromises were reached in a number of areas; for example, the original bill limited the time that "Acting" officers could serve to 150 days, that time period has been extended to 210 days. Also, once a nomination is made for such a position, the "Acting" Officer may serve for the entire time period that the nomination is pending.

- ***Sine Die* Adjournment Resolution:** The Senate adjourned *Sine Die* on Wednesday, October 21, 1998 until Wednesday, January 6, 1999 at 12:00 PM.

- **Nominations:** Before adjourning, the Senate confirmed 122 nominees by unanimous consent (see attachment).

cc: The Vice President
Erskine Bowles
John Podesta
Maria Echaveste

THE PRESIDENT HAS SEEN
10-28-98

ATTACHMENT I.

HOUSE VOTE: H.R. 4328 - Omnibus Appropriation Conference Report, FY 1999

NAYS (95)

DEMOCRATS (31)

Barrett T (WI)	Holden T (PA)	Miller G (CA)
Blumenauer E (OR)	Johnson J (WI)	Minge D (MN)
Boyd A (FL)	Kanjorski P (PA)	Peterson C (MN)
Cardin B (MD)	Kaptur M (OH)	Rivers L (MI)
Condit G (CA)	Kind R (WI)	Skaggs D (CO)
Costello J (IL)	Kleczka J (WI)	Smith A (WA)
DeFazio P (OR)	Klink R (PA)	Stupak B (MI)
DeGette D (CO)	Lee B (CA)	Taylor G (MS)
Doggett L (TX)	Luther W (MN)	Thurman K (FL)
Filner B (CA)	McDermott J (WA)	Yates S (IL)
Goode V (VA)		

REPUBLICANS (64)

Bachus S (AL)	Hefley J (CO)	Riggs F (CA)
Ballenger C (NC)	Hoekstra P (MI)	Rohrabacher D (CA)
Barr B (GA)	Hostettler J (IN)	Roukema M (NJ)
Bartlett R (MD)	Hyde H (IL)	Royce E (CA)
Barton J (TX)	Inglis B (SC)	Salmon M (AZ)
Bilbray B (CA)	Istook E (OK)	Sanford M (SC)
Brady K (TX)	Johnson S (TX)	Scarborough J (FL)
Burr R (NC)	Jones W (NC)	Schaffer B (CO)
Campbell T (CA)	King P (NY)	Sensenbrenner F (WI)
Castle M (DE)	Klug S (WI)	Shays C (CT)
Chabot S (OH)	LaHood R (IL)	Smith C (NJ)
Christensen J (NE)	Largent S (OK)	Smith L (WA)
Coble H (NC)	Manzullo D (IL)	Smith N (MI)
Coburn T (OK)	McIntosh D (IN)	Stearns C (FL)
Collins M (GA)	Mica J (FL)	Stump B (AZ)
Crane P (IL)	Miller D (FL)	Upton F (MI)
Deal N (GA)	Neumann M (WI)	Wamp Z (TN)
Duncan J (TN)	Pappas M (NJ)	Weldon C (PA)
Ehlers V (MI)	Paul R (TX)	Weldon D (FL)
Ensign J (NV)	Petri T (WI)	White R (WA)
Frelinghuysen R (NJ)	Portman R (OH)	Wolf F (VA)
Graham L (SC)		

THE PRESIDENT HAS SEEN
10-28-98

ATTACHMENT II.

SENATE VOTE: H.R. 4328 - Omnibus Appropriation Conference Report, FY 1999

NAYS (29)

DEMOCRATS (9)

Baucus M (MT)	Kerrey B (NE)	Moynihan D (NY)
Byrd R (WV)	Kohl H (WI)	Reid H (NV)
Feingold R (WI)	Levin C (MI)	Wellstone P (MN)

REPUBLICANS (20)

Allard W (CO)	Grassley C (IA)	Santorum R (PA)
Ashcroft J (MO)	Hagel C (NE)	Sessions J (AL)
Coats D (IN)	Inhofe J (OK)	Smith R (NH)
~~Collins S~~ (ME)	Kyl J (AZ)	Snowe O (ME)
Enzi M (WY)	Lugar R (IN)	Specter A (PA)
Gramm P (TX)	McCain J (AZ)	Thomas C (WY)
Grams R (MN)	Nickles D (OK)	

ATTACHMENT III.

List of Individuals Confirmed

Sylvia M. Mathews to be Deputy Director of the Office of Management and Budget

Jane E. Henney to be Commissioner of Food and Drugs, Department of Health and Human Services

Kenneth Prewitt to be Director of the Census

Rebecca Pallmeyer to be United States District Judge for the Northern District of Illinois

Jeanne Scott to be US District Judge for the Central District of Illinois

Nora M. Manella to be United States District Judge for the Central District of California

David R. Herndon to be United States District Judge for the Southern District of Illinois

Alvin K. Hellerstein to be United States District Judge for the Southern District of New York

Richard M. Berman to be United States District Judge for the Southern District of New York

Colleen McMahon to be United States District Judge for the Southern District of New York

William H. Pauley III to be United States District Judge for the Southern District of New York

Thomas J. Whelan to be United States District Judge for the Southern District of California

Robert S. Lasnik to be United States District Judge for the Western District of Washington

Yvette Kane to be United States District Judge for the Middle District of Pennsylvania

James M. Munley to be United States District Judge for the Middle District of Pennsylvania

David O. Carter to be United States District Judge for the Central District of California

Margaret B. Seymour to be United States District Judge for the District of South Carolina

Aleta A. Trauger to be United States District Judge for the Middle District of Tennessee

Norman A. Mordue to be United States District Judge for the Northern District of New York

Alex R. Munson to be Judge for the District Court for the Northern Mariana Islands

Edward J. Damich to be Judge of the United States Court of Federal Claims

Nancy B. Firestone to be Judge of the United States Court of Federal Claims

Emily Clark Hewitt to be Judge of the United States Court of Federal Claims

Lynn Jeanne Bush to be Judge of the United States Court of Federal Claims

Lawrence Baskir to be Judge of the United States Court of Federal Claims

Francis M. Allegra to be Judge of the United States Court of Federal Claims

Patricia A. Broderick to be Associate Judge of the Superior Court of the District of Columbia

Natalia Combs Greene to be Associate Judge of the Superior Court of the District of Columbia

Neal E. Kravitz to be Associate Judge of the Superior Court of the District of Columbia

Harry Litman to be United States Attorney for the Western District of Pennsylvania

Denise O'Donnell to be United States Attorney for the Western District of New York

Margaret Ellen Curran to be United States Attorney for the District of Rhode Island

Byron Todd Jones to be United States Attorney for the District of Minnesota

Robert Bruce Green to be United States Attorney for the Eastern District of Oklahoma

Scott Richard Lassar to be United States Attorney for the Northern District of Illinois

Jose de Jesus Rivera to be United States Attorney for the District of Arizona

James A. Tassone to be United States Marshal for the Southern District of Florida

Donnie R. Marshall to be Deputy Administrator of Drug Enforcement

Thomasina V. Rogers to be Member of the Occupational Safety and Health Review Commission

Paul M. Igasaki to be Member of the Equal Employment Opportunity Commission

Ida L. Castro to be Member of the Equal Employment Opportunity Commission

Paul Steven Miller to be Member of the Equal Employment Opportunity Commission

Henry L. Solano to be Solicitor of the Department of Labor

Bernard Daniel Rostker to be Under Secretary of the Army

Eligah Dane Clark to be Chairman of the Board of Veterans' Appeals

Edward A. Powell, Jr. to be Assistant Secretary of Veterans Affairs for Management

Leigh A. Bradley to be General Counsel, Department of Veterans Affairs

Greta Joy Dicus to be Member of the Nuclear Regulatory Commission

Jeffrey S. Merrifield to be Member of the Nuclear Regulatory Commission

David Michaels to be Assistant Secretary of Energy (Environment, Safety and Health)

Isadore Rosenthal to be a Member of the Chemical Safety and Hazard Investigation Board

Andrea Kidd Taylor to be a Member of the Chemical Safety and Hazard Investigation Board

William Clifford Smith to be a Member of the Mississippi River Commission

Joseph E. Stevens, Jr. to be a Member of the Board of Trustees of the Harry S Truman Scholarship Foundation

Michael M. Reyna to be a Member of the Farm Credit Administration Board, Farm Credit Administration

Ira G. Peppercorn to be Director of the Office of Multifamily Housing Assistance Restructuring

William C. Apgar, Jr. to be an Assistant Secretary of Housing and Urban Development

Saul N. Ramirez, Jr. to be Deputy Secretary of Housing and Urban Development

Cardell Cooper to be an Assistant Secretary of Housing and Urban Development

Harold Lucas to be an Assistant Secretary of Housing and Urban Development

Patricia T. Montoya to be Commissioner on Children, Youth, and Families, Department of Health and Human Services

David C. Williams to be Inspector General, Department of the Treasury

Gregory H. Friedman to be Inspector General of the Department of Energy

John U. Sepulveda to be Deputy Director of the Office of Personnel Management

Joseph Swerdzewski to be General Counsel of the Federal Labor Relations Authority

Eljay B. Bowron to be Inspector General, Department of the Interior

Dana Bruce Covington, Sr. to be a Commissioner of the Postal Rate Commission

Edward Jay Gleiman to be a Commissioner of the Postal Rate Commission

David M. Walker to be Comptroller General of the United States

D. Bambi Kraus to be a Member of the Board of Trustees of the Institute of American Indian and Alaska Native Culture and Arts Development

Asish Sen to be Director of Bureau of Transportation Statistics for the Department of Transportation

John Moran to be Commissioner of the Federal Maritime Commission for the Department of Transportation

Harold Creel, Jr. to be Chair of the Federal Maritime Commission for the Department of Transportation

Pamela Ferguson to be Member of the National Science Board, National Science Foundation

Anita Jones to be Member of the National Science Board, National Science Foundation

Romulo L. Diaz, Jr. to be an Assistant Administrator of the Environmental Protection Agency

J. Charles Fox to be an Assistant Administrator of the Environmental Protection Agency

Norine E. Noonan to be an Assistant Administrator of the Environmental Protection Agency

Nikki Rush Tinsley to be Inspector General, Environmental Protection Agency

Robert W. Perciasepe to be an Assistant Administrator of the Environmental Protection Agency

Terrence L. Bracy to be a Member of the Board of Trustees of the Morris K. Udall Scholarship and Excellence in National Environmental Policy

Charles G. Groat, to be Director of the United States Geological Survey

Arthur A. McGiverin to be a Member of the Board of Directors of the State Justice Institute

Rebecca Blank to be a Member of the Council of Economic Advisors

Peter J. Basso, Jr. to be an Assistant Secretary of Transportation

Eugene A. Conti, Jr. to be an Assistant Secretary of Transportation

Michael Sullivan to be Ambassador to Ireland

Robert Finn to be Ambassador to the Republic of Tajikstan

C. Donald Johnson, Jr. for the Rank of Ambassador during his tenure of service as Chief Textile Negotiator

Harold H. Koh to be Assistant Secretary of State for Democracy, Human Rights, and Labor

William Bader to be an Associate Director of the US Information Agency

R. Rand Beers to be an Assistant Secretary of State for International Narcotics and Law Enforcement Affairs

E. William Crotty to be Ambassador to Barbados

Stuart Eizenstat to be US Alternate Governor for the International Bank of Reconstruction and Development for a term of five years; US Alternate Governor of the Inter-American Development Bank for a term of five years; US Alternate Governor of the African Development Bank for a term of five years; US Alternate Governor of the African Development Fund; and US Alternate Governor of the European Bank for Reconstruction and Development

Robert C. Felder to be Ambassador to the Republic of Benin

Simon Ferro to be Ambassador to the Republic of Panama

Richard H. Jones to be Ambassador to the Republic of Kazakhstan

Alan Greenspan to be US Alternate Governor of the International Monetary Fund for a term of five years (reappointment)

James Ledesma to be Ambassador to the Garbonese Republic and to serve concurrently as Ambassador to the Democratic Republic of Sao Tome and Principe

Frank Loy to be an Undersecretary of State (for Global Affairs)

Joseph H. Melrose, Jr. to be Ambassador to the Republic of Sierra Leone

George Mu to be Ambassador to the Republic of Cote d'Ivoire

B. Lynn Pascoe to be Ambassador to Malaysia

Robert C. Perry to be Ambassador to the Central African Republic

John Pikarski to be a Member of the Board of Directors of the Overseas Private Investment Corporation (Reappointment).

Robert Randolph to be an Assistant Administrator of the Agency for International Development

Kathryn Dee Robinson to be Ambassador to the Republic of Ghana

John Shattuck to be Ambassador to the Czech Republic

George Staples to be Ambassador to the Republic of Rwanda

Joseph Sullivan to be Ambassador to the Republic of Angola

David Welch to be Assistant Secretary of State for International Organization Affairs

John Yates to be Ambassador to the Republic of Cameroon; and to serve concurrently as Ambassador to the Republic of Equatorial Guinea

Eric David Newsom to be Assistant Secretary of State for Political-Military Affairs

Bert T. Edwards to be Chief Financial Officer, Department of State

David G. Carpenter to be an Assistant Secretary of State

David G. Carpenter to be Director of the Office of Foreign Missions, and to have the rank of Ambassador

Mary Beth West to be a Career Member of the Senior Executive Service, for the rank of Ambassador

THE PRESIDENT HAS SEEN
10-28-98

'98 OCT 26 PM2:19

THE WHITE HOUSE

WASHINGTON

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Lewis
Spector
Bowles

October 23, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: AFL SS **ANN LEWIS AND STACIE SPECTOR**

SUBJECT: **COMMUNICATIONS WEEKLY REPORT**

Amplification

For each of your message events we worked to ensure that the message got to our key networks.

- **First Lady's Breast Cancer Event.** Distributed sample op-ed and related information to the 204 mayors who have joined the Mayors' Campaign Against Breast Cancer; 150 breast cancer advocates, health care organizations, cancer advocacy groups, hospitals, physicians, allied health care groups, women's health care groups, and women's advocacy organizations. In addition, press secretaries for Sen. Jeffords (R-VT), Sen. Mikulski (D-MD) and Cong. Sherrod Brown (D-OH) have been asked to write op-eds for their local papers.

Speaking Engagements

- **Women's History.** Ann was in Chicago earlier this week for the third meeting of your Commission on the Celebration of Women in American History.

Week Ahead

write my [illegible] [illegible] letters Monday?

We are working on plans to amplify the following events:

- **AmeriCorps.** You were scheduled to swear in the new class of AmeriCorps members, including the 100,000th member, and present the Presidential Service Awards. We are working with AmeriCorps to reschedule the event. Prior to the cancellation, we had partnered with the Corporation for National Service to perform outreach to our networks.

- **Social Security**. Last weeks's event has been rescheduled for next Tuesday, in cooperation with the SSA.

- **Women and Pensions/Surplus.** You are scheduled to hold a roundtable discussion on women and retirement plans, in addition to making an economic announcement. Women's organizations are working with us on Monday to place press calls about the importance of this issue and your leadership, both on Social Security and Family Medical Leave Act.

- **AIDS/HIV.** On Wednesday, you will host the Congressional Black Caucus at the White House for a health care announcement.

Friends

- Butler Derrick will be making a number of radio appearances in the coming week.

Attachments

- **Presidential Priorities for the Next Congress.** Document is posted on the White House web site.

- **School Safety.** Regional coverage of the White House Conference on School Safety.

[Text Version]

President Clinton: Setting Priorities For The Next Congress

Throughout 1998, President Clinton and Vice President Gore fought for policies that help working families: from more modern schools to higher quality health care. On each of these policies, the Congressional majority said "no", blocking school modernization, a Patients Bill of Rights, comprehensive tobacco legislation, an increase in the minimum wage, child care investments, and our best hope for real campaign finance reform in a generation.

To get more information on what was lost because of partisanship, click on any of the 50 states below.

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ARKANSAS

President Clinton and Vice President Gore Are Fighting For Policies That Help Working Families, But Congressional Republicans Said "No"

Throughout 1998, President Clinton and Vice President Gore fought for policies that help working families in Arkansas, from more modern schools to higher quality health care. On each of these policies, the Republican Congressional majority said "no" to the families of Arkansas, blocking school modernization, a Patients Bill of Rights, comprehensive tobacco legislation, an increase in the minimum wage, and child care investments. In addition, Republicans in Congress killed our best hope for real campaign finance reform in a generation.

- **School Modernization: Congressional Republicans Blocked Tax Credits on $145.9 Million of Bonds To Help Build and Modernize Arkansas Schools.** President Clinton's school modernization initiative would have helped build and renovate more than 5,000 schools nationwide, without adding a single Federal employee. In Arkansas, this proposal would have provided tax credits on $145.9 million of bonds to help build or modernize an estimated 45 schools. However, the Republicans in Congress blocked school modernization and even claim stopping it as one of their top 10 victories in the final budget agreement. [Source: National Economic Council]

- **Patients Bill of Rights: The Congressional Republican Leadership Blocked Quality Health Care for 1,000,000 People -- Including 500,000 Women -- in Arkansas.** President Clinton and Vice President Gore repeatedly urged the Congress to pass a strong, enforceable Patients Bill of Rights. Without this legislation, 1,000,000 people -- including 500,000 women -- in Arkansas are not ensured the enforceable patient protections they need, even if Arkansas has enacted health care quality legislation. The Congressional Republican leadership blocked a Patients Bill of Rights, which means accountants, instead of doctors, will continue to make health care decisions in Arkansas. Every major health care consumer and physician organization, including the American Medical Association, supports a strong, enforceable Patients Bill of Rights. [Source: Department of Labor]

- **Comprehensive Tobacco Legislation: The Congressional Republican Leadership Blocked Efforts That Would Have Saved 9,000 Young People in Arkansas from A Premature Death.** President Clinton and Vice President Gore made passage of legislation to reduce youth smoking a top priority, in order to stop kids from smoking before they start. According to the Department of Treasury, in Arkansas, this legislation would have stopped 28,000 young people from smoking over the next five years, saving the lives of 9,000 young people in Arkansas from a premature death. But the Congressional Republican leadership killed this year's effort to pass bipartisan comprehensive tobacco legislation to reduce youth smoking. [Source: Department of the Treasury]

- **Minimum Wage: Congressional Republicans Blocked A Raise For 145,000**

Workers in Arkansas. President Clinton and Vice President Gore called for a one dollar increase in the minimum wage over two years -- to raise the wages of 12 million workers nationwide. In Arkansas, this increase would have raised the wages of 145,000 workers. For someone who works full-time, this increase would have meant an additional $2,000 per year. However, Congressional Republicans voted to block a minimum wage increase. [Source: Based on data from the Bureau of Labor Statistics.]

- **Child Care Initiative: Congressional Republicans Blocked Critical Child Care Assistance for Families in Arkansas.** President Clinton proposed an historic child care initiative to make child care better, safer and more affordable for working families in Arkansas. The President's plan would have wiped out Federal income taxes for families of four in Arkansas making less than $35,000 and saddled with high child care bills. And Arkansas would have received $10.5 million in new funding to help low-income working families with child care costs. But, the Republican Congress blocked these critical child care investments. [Source: Department of Health and Human Services.]

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send feedback to the Web Development Team.

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Akron officia s hear Clintons' take on safety

By DONNA ROBB
PLAIN DEALER REPORTER

The Cleveland Plain Dealer 10/1/98

AKRON -- Akron school and police officials met around a big-screen television yesterday to discuss children, violence and school safety.

A White House satellite conference, led by Bill and Hillary Rodham Clinton, was broadcast to more than 700 sites nationwide, including the John S. Knight Center in Akron, where officials shared ideas on how to prevent school violence and rescue children headed for trouble.

The Akron School District is among the 90 percent of districts nationwide that have not experienced serious violent crimes, such as rapes, robberies, shootings and knifings, said Deputy Superintendent Bill Spratt.

"But we are taking this issue very, very seriously. Even threats of violence are not being tolerated," said Connie Hathorn, director of security for the district.

Lt. Drew Alexander of the Akron Police Department said officers are involved in 11 programs to prevent violence in the schools.

A tip line and reward fund were established to get anonymous reports from students and parents. Metal detectors and drug-sniffing dogs are used in the schools, alongside specially trained police officers who develop personal relationships with students.

Several character-development programs are offered that reward children for "doing the right thing." And three retired police officers visit the homes of at-risk children and involve them in community service projects, Alexander said.

Superintendent Brian Williams said building administrators, bus drivers and security guards are armed with cellular telephones, cameras and video cameras to discourage misbehavior. "Kids hate having their pictures taken while they are acting up," he said.

Local officials took notes as the Clintons and Vice President Al Gore explained programs that have worked to cut school violence in other parts of the country, like the inexpensive yet highly effective "Security Dads" program in which about 40 fathers wearing "Security Dad" T-shirts keep the peace at school sporting events and other functions.

Secretary of Education Dick Riley said recent research showed children are safest and learn best in smaller schools with smaller class sizes.

Suzanne Wilson, whose 11-year-old daughter was gunned down by a fellow student in a Jonesboro, Ark., school seven months ago, pleaded with the nation's adults to keep their guns "locked away where a child cannot reach them."

She said parents should talk to other parents and not be afraid to ask how guns are stored in the homes their children visit.

SEE SCHOOL/6-B

School officials hear Clintons' take on safety

SCHOOL FROM 1-B

Riley said that 6,000 students were expelled last year for bringing a gun to school. "Half of them were not placed in an alternative school for intervention," he said, advocating for alternative schools for students with discipline problems.

A mental health specialist working in the Los Angeles schools said children who experience fear and violence release stress hormones that alter their brains and inhibit their ability to learn.

One researcher asked parents to ask themselves, "When is violence appropriate in your family? When does a child's kicking, pushing or screaming cease to be cute and funny?"

Two Akron high school seniors who attended the conference were pleased when Clinton announced during the teleconference that agreement had been reached on the national budget, and it would include funding to hire new teachers to reduce class sizes, which has been shown to reduce violent behavior and increase learning.

"We need more adults in the schools to deal with the different problems students bring with them to school," said Michael Dalton of Firestone High School.

"And more ways to involve students in the community," classmate Mary Drey said.

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL ON ENVIRONMENTAL QUALITY
WASHINGTON, D.C. 20503

'98 OCT 23 PM6:20

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10-28-98

October 23, 1998

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Bowles

MEMORANDUM FOR THE PRESIDENT

CC: ERSKINE B. BOWLES

FROM: KATHLEEN A. McGINTY NPN for KAM

SUBJECT: CEQ WEEKLY REPORT

PROTECTING COMMUNITIES FROM TOXICS

Sierra Blanca Controversy

On Thursday, the Texas Natural Resource Commission denied a permit for a highly controversial low-level nuclear waste site ("Sierra Blanca") in predominantly Latino Hudspeth County, Texas. Both local and national Hispanic and environmental groups had raised significant safety and environmental justice concerns about the site, and had strongly urged you to veto a low-level nuclear waste compact among Maine, Vermont, and Texas, which is required before the Sierra Blanca facility may lawfully accept waste from out-of-state. You recently signed the compact, which had passed Congress by a veto-proof margin despite the opposition of the Congressional Hispanic Caucus. After you signed the bill, I sent and released a letter to Governor Bush urging him to address the community's concerns.

The Texas decision may for now take away an issue that had prompted harsh criticism by Gary Mauro of Governor Bush. This decision may also spark another round of criticism by communities of the Administration's failure to oppose the compact. Yesterday's decision can be appealed, however, and some community groups fear that the decision is calculated merely to postpone a license approval until after the election.

RESOURCE STEWARDSHIP

American Heritage Rivers Symposium

This weekend in Atlanta, we are hosting an American Heritage Rivers Symposium for all the communities that nominated a river, regardless of whether or not they received a designation. Representatives from local, state, tribal, and federal government will join the various groups that nominated rivers. The purpose of the Symposium is to provide groups with guidance on how to help revitalize their river communities and to furnish the tools necessary to do so. You and the Vice President each sent messages that will be read at the Symposium lauding all the extraordinary and thoughtful nominations that were received.

Coral Reef Task Force

On Monday and Tuesday, we convened the first meeting of the Coral Reef Task Force. This task force fulfills one of the elements of the Coral Reef Executive Order that you signed this summer at the National Ocean Conference. The task force is co-chaired by Secretaries Babbitt and Daley and works to expand research, preservation and restoration of coral reefs. The task force will produce a report next summer on action items to protect these fragile ecosystems.

SUSTAINABLE COMMUNITIES

Energy Conservation

The *New York Times* did an extensive feature story Thursday on energy use patterns in the U.S. The story reports that the U.S., on average, has returned to consuming nearly as much energy as ever before. The article goes on to illustrate the history of energy consumption as well as past and present federal efforts, including our Climate Change Technology Initiative, to curb the nation's energy appetite.

The story does a good job of pointing out what challenges we have, and will continue to face, with respect to creating a more energy efficient nation. Hopefully, the heightened public attention to this issue will help us build the case for moving forward on some of your energy efficiency initiatives.

Los Angeles Community Meeting

On Thursday, CEQ convened a second community meeting focused on environmental justice concerns presented by community leaders in Latino and Asian communities in Los Angeles. This meeting, which was joined by Congressman Xavier Becerra, brought together community leaders, the business community, local elected officials, and state and local agency representatives. We identified a number of areas of agreement among these groups, as well as areas where the business community and community groups plan to work together on urgent community problems. This meeting was a follow-up to a well-publicized and well-received July meeting, in which Federal agencies made a series of commitments to address local public health concerns. The Federal spotlight on these problems also has generated a series of responses by state and local agencies.

Our work in Los Angeles is part of a broader effort to demonstrate both that we remain committed to our policies on environmental justice, and that those policies are compatible, rather than in conflict, with your agenda for economic opportunity and empowerment in distressed low-income and minority communities.

THE PRESIDENT HAS SEEN
10-28-9

EYES ONLY

cc Gene / Todd Stern

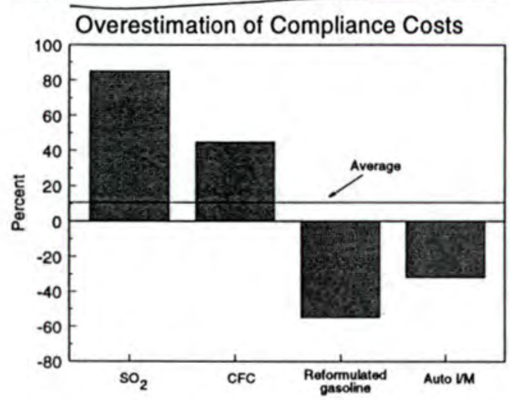
Strong argument re approach to Climate Change — See last paragraph

SPECIAL ANALYSIS

Evaluating Environmental Compliance Cost Estimates

Estimates of what it will cost to comply with new environmental regulations are subject to considerable uncertainty. But are these estimates biased, as some critics claim, in the direction of overestimating costs and hence discouraging stricter environmental standards that would in fact confer net economic benefits?

The record. Comparisons between pre-implementation estimates of compliance costs and reported post-implementation costs have been done for four EPA regulations. In two cases, reported costs were underestimated (automobile inspection/maintenance and reformulated gasoline); in the other two (the SO_2 program and the CFC phaseout) they were overestimated (see chart). For the four cases taken together, the average discrepancy was a modest 11 percent overestimate of actual costs.



Changes in technology and market conditions. Forecasting future costs is a difficult task that involves predicting future technologies and market conditions. Changes in market prices may either raise or lower the costs of compliance. In the case of reformulated gasoline, for example, costs may have been underestimated because the EPA did not foresee that methanol prices would increase. In the case of SO_2, declines in rail cos allowed utilities to abate more cheaply by switching to low-sulfur western coal. T the extent that cost estimates do not adequately incorporate future technologic advances, the costs of compliance will be overstated. For example, the installed cos of scrubbing sulfur from utility smoke stacks has fallen nearly 40 percent sin implementation of the acid rain program. Early cost estimates did not foresee th dramatic drop in scrubbing costs.

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Bowles

Compliance. Cost estimates are typically based on the assumption of 100 perce compliance with regulations. Since firms with the highest compliance costs tend t be those who do not comply, actual costs calculated from data that include only complying firms will tend to be lower than estimates based on perfect compliance.

Policy changes. Another reason why actual compliance costs differ from pre-implementation estimates is that policies tend to change between the proposal and the implementation stages. In phase 1 of the SO_2 program, for example, additional allowances were allocated to firms that installed scrubbers. Further, other firms were allowed to opt into the program and receive permits. Firms would only do so if they expected to sell permits. Both of these changes expanded the supply of permits and lowered the permit price.

THE PRESIDENT HAS SEEN
10-28-98

EYES ONLY

'98 OCT 23 AM8:40

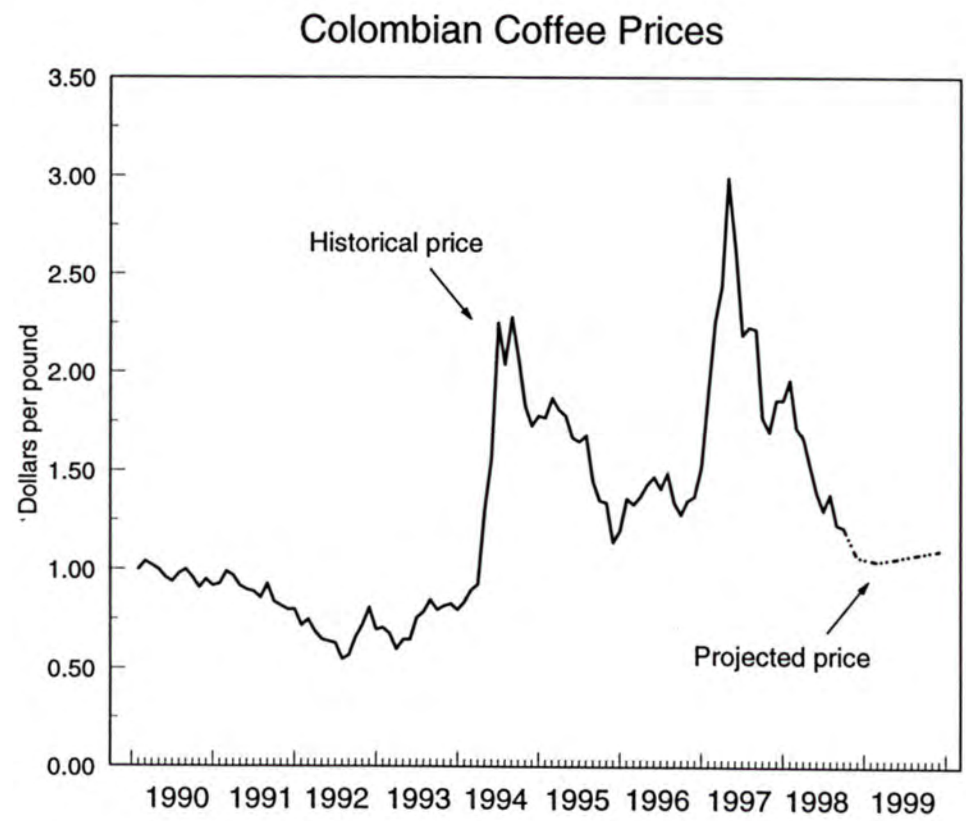
WEEKLY ECONOMIC BRIEFING OF THE PRESIDENT OF THE UNITED STATES

Prepared by the Council of Economic Advisers
with the assistance of the Office of the Vice President

Copies to
Yellen
Bowles

October 23, 1998

CHART OF THE WEEK



The price of Colombian coffee is down about 60 percent from its peak of almost $3.00 per pound in May 1997 and futures markets expect coffee prices to remain around current levels over the next year. (The projected price is based on coffee produced in several countries; Colombian coffee trades at a slight premium.) An international roundup discusses the role of coffee in the Colombian economy.

EYES ONLY

CONTENTS

"I love the convenience, but the roaming charges are killing me."

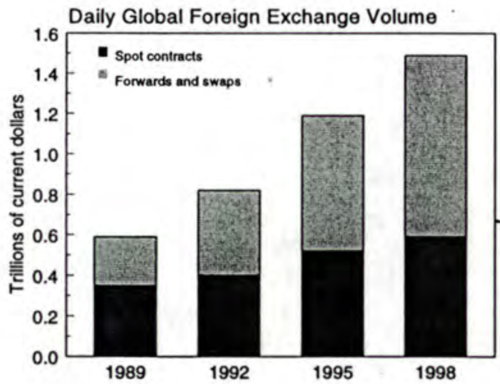
THE PRESIDENT HAS SEEN
10-28-98

EYES ONLY

CURRENT DEVELOPMENT

Daily Trading in Foreign Exchange Reaches $1.5 Trillion

The Bank for International Settlements in Basle, Switzerland, has just released its triennial compilation of 43 central bank surveys of foreign exchange markets. It shows that global foreign exchange trading has continued to grow substantially—to a daily volume of $1.5 trillion in April 1998 (see upper chart).

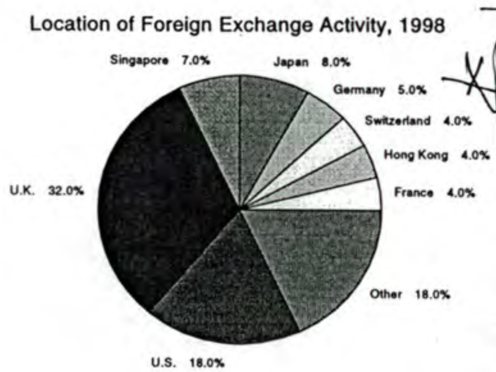


Growth in volume. Measured in current dollars, the growth rate between 1995 and 1998 was 26 percent. The volume of foreign exchange trading is roughly 100 times greater than the volume of global merchandise trade.

What is traded? Spot market purchases amounted to 40 percent of foreign exchange transactions, down from 44 percent in 1995. Forward instruments (contracts to buy or sell foreign exchange at a future date) continued to grow in importance relative to spot sales.

Who trades? Most trades take place between professional traders at banks and other financial institutions; only a fraction of foreign exchange sales and purchases directly involve those who ultimately import and export goods, services, and securities. In the most recent U.S. survey, the share of total transactions involving non-financial customers was 20 percent of all turnover. Though this proportion has increased substantially, it still suggests that each foreign exchange dollar is passed along five times before ultimately finding its way to someone willing to hold it.

Where does trading take place? Trading tends to be focused in major centers. Arguably, there is a natural equilibrium consisting of one major center in each of three 8-hour time zones. London continues to handle the greatest volume of foreign exchange transactions, with the U.K. share of world turnover increasing to 32 percent (see lower chart). New York is the main center in the Western Hemisphere, with U.S. volume now accounting for 18 percent of world turnover. Tokyo's turnover has fallen off recently, and its dominance in the Asian time zone is being threatened by Singapore.



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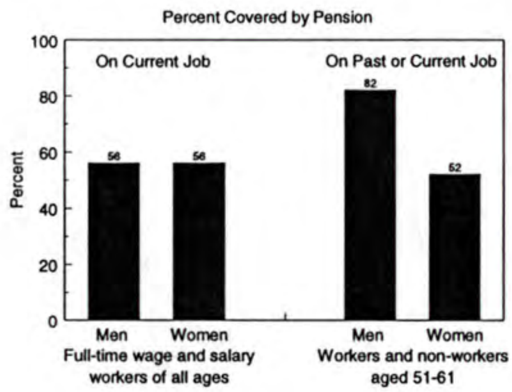
SPECIAL ANALYSIS

Gender Differences in Pension Wealth

Among those approaching retirement age, a smaller proportion of women than men have pension coverage, and the women's accumulated pension benefits are smaller. However, the increasing prevalence of defined contribution plans is likely to reduce the pension gender gap at retirement somewhat.

Coverage and vesting. In 1993 (the most recent year for which data are available) 56 percent of both male and female full-time wage and salary workers were covered by a pension on their current job (see chart). When part-timers are included, 51 percent of men and 46 percent of women were covered (coverage rates are lower for part-timers generally, and a larger fraction of women work part-time). Among full-time workers in the private sector only, 39 percent of men and 36 percent of women reported that they were vested in a pension plan. The gap in prospective pensions between women and men nearing retirement age is much larger, however, because of women's lower lifetime labor force participation and shorter job durations. An analysis of Health and Retirement Survey (HRS) data for men and women aged 51 to 61 in 1992 shows that 82 percent of men but only 52 percent of women expected to receive a pension from *some* job.



Wealth. The gender gap is larger for pension wealth than it is for pension coverage, because pension amounts increase with earnings and job tenure and women are at a disadvantage in both. For example, in the HRS survey of people approaching retirement, men's median pension wealth from their current job was 1.8 times what it was for women.

DB versus DC plans. Pension coverage has been shifting rapidly from defined-benefit (DB) to defined-contribution (DC) plans. Between 1975 and 1992, the share of active participants who were in DC plans rose from 29 to 60 percent. This shift is likely to narrow the gender gap in retirement wealth, because DC plans have advantages for those who change jobs frequently (such as women). Typically, when workers leave a job after being vested in a DB plan, their benefits are frozen in nominal terms. With a DC plan, by contrast, accumulations continue to earn a rate of return after the worker moves on. Thus, a succession of jobs with DC plans is likely to produce a larger lifetime pension benefit accumulation than a succession of jobs with DB plans. Among the 51-61 year olds in the HRS who had DB plans, women's median pension wealth was 45 percent of men's; but among those who had DC plans, women's pension wealth was 60 percent of men's.

EYES ONLY

Conclusion. The difference in employer pension wealth is even larger than the earnings difference between men and women. But the shift away from DB plans toward DC plans should reduce the pension disparity for future cohorts—especially if women "roll over" their DC and 401(k) pension funds when they change jobs.

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10-28-9

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cc Gene / Todd Stern
strong argument for our approach to climate change — see last paragraph

SPECIAL ANALYSIS

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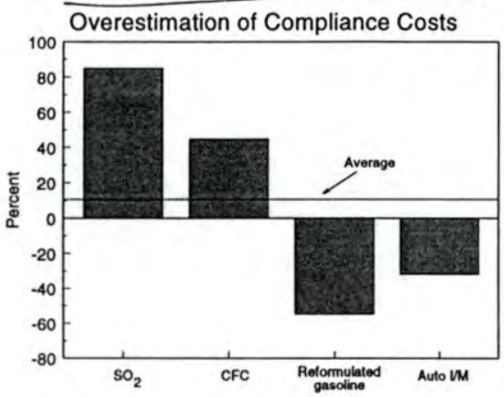
Estimates of what it will cost to comply with new environmental regulations are subject to considerable uncertainty. But are these estimates biased, as some critics claim, in the direction of overestimating costs and hence discouraging stricter environmental standards that would in fact confer net economic benefits?

The record. Comparisons between pre-implementation estimates of compliance costs and reported post-implementation costs have been done for four EPA regulations. In two cases, reported costs were underestimated (automobile inspection/maintenance and reformulated gasoline); in the other two (the SO_2 program and the CFC phaseout) they were overestimated (see chart). For the four cases taken together, the average discrepancy was a modest 11 percent overestimate of actual costs.



Changes in technology and market conditions. Forecasting future costs is a difficult task that involves predicting future technologies and market conditions. Changes in market prices may either raise or lower the costs of compliance. In the case of reformulated gasoline, for example, costs may have been underestimated because the EPA did not foresee that methanol prices would increase. In the case of SO_2, declines in rail cos[ts] allowed utilities to abate more cheaply by switching to low-sulfur western coal. T[o] the extent that cost estimates do not adequately incorporate future technologic[al] advances, the costs of compliance will be overstated. For example, the installed cos[t] of scrubbing sulfur from utility smoke stacks has fallen nearly 40 percent sin[ce] implementation of the acid rain program. Early cost estimates did not foresee th[e] dramatic drop in scrubbing costs.

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THE PRESIDENT HAS SEEN
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EYES ONLY

Conclusion. While estimates of compliance costs for specific environmental programs are inherently subject to considerable uncertainty, they do not seem to be systematically overestimated. Though the total number of cases studied is small, it is interesting to note that the two cases of overestimated costs occurred with market-based policies. These policies give firms the flexibility to take advantage of unexpected circumstances, such as declining rail costs in the SO_2 case, which may result in lower-than-predicted costs.

EYES ONLY

ARTICLE

Competition in Markets for Network Products

Underlying the Microsoft trial that began this week are questions about competition in network markets.

Network externalities. A "network externality" arises when a product's value to consumers increases with the number of users. Each new telephone subscriber is an additional person current and future subscribers can call. Each new buyer of a word-processing system is another person with whom earlier purchasers can exchange documents. Products displaying network externalities are generally called "network goods." In the competition among network products, an early lead can reinforce itself: new customers buy the more popular good because of the larger externality, which then grows and makes the product yet more attractive to additional purchasers. This dynamic makes network markets prone to "tipping" toward monopoly.

Risks and benefits of dominance. A network monopoly has benefits not generally found in conventional markets because dominance can maximize the network externality for consumers. But network dominance also poses hazards that compound the usual concerns about monopoly. First, the best product will not always win. Because consumers want the good that will have the largest externality, expectations of a product's success can be at least as important to buyers as price and quality. No one wants a Betamax video system, even if it might be superior to VHS. Second, network markets can be particularly hard for new competitors to enter. Once customers invest in learning a system from which they derive large network benefits, they face high costs in switching to a different standard. And third, a network monopolist may have advantages in selling complementary goods—for example software for an operating system—that allow it to extend dominance from one market to another.

The challenge for antitrust. Even if an inferior standard dominates or if dominance results from anticompetitive tactics, it may be impractical or undesirable to remedy network monopolies. Innovation incentives diminish if honestly earned dominance can be second-guessed by regulators. And once customers have adopted a standard, it is costly to reduce the accrued network externality no matter how it has come about. Hence, the reduced feasibility of after-the-fact remedies makes early injunction of anticompetitive practices in network markets essential. Such quick action can be difficult, however, because competitive strategies that are inherently suspect in a conventional goods market may be reasonable given the winner-take-all potential of network rivalry. Pricing below cost, for example, is usually presumed to be predatory and undesirable because its intention is to drive rivals from the market and create a monopoly. But in network markets, the intention may be simply to gain customers quickly and raise expectations about a product's network externality. Antitrust authorities must decide if such low prices are a legitimate competitive strategy or if they instead undermine competition.

Similarly, authorities must determine whether a network monopolist's advantage in markets for complementary products stems from genuine efficiencies or from anticompetitive arrangements. A Federal appeals court, for example, recently ruled that Microsoft's joint provision of the Windows operating system and Explorer web browser was a legitimate integration rather than an anticompetitive bundling or tying strategy against rival browsers. In the trial starting this week, the court will examine other allegations that Microsoft abused its monopoly in operating systems to foreclose competition in the browser market. Did Microsoft use legitimate competitive tactics, regulation of which will reduce innovation incentives and consumer welfare? Or, has Microsoft engaged in predatory and exclusionary conduct that forecloses competition and innovation to the ultimate detriment of consumers? Where the boundary lies is the difficult question to be explored in court.

Conclusion. Network monopolies offer benefits when they maximize network externalities to consumers. They can also be very costly when barriers for new entrants into network markets are high and the potential for leveraging market power into complementary markets exists. Network markets thus pose a continuing challenge for antitrust enforcement.

EYES ONLY

BUSINESS, CONSUMER, AND REGIONAL ROUNDUP

Study Analyzes Who Is Leaving the District of Columbia. The conventional wisdom on the decline of central cities is that population losses have been especially heavy for middle- and upper-income households. But a recent case study of income and population in the DC metropolitan area found that it was the District's lowest- and moderate-income taxpayers who were leaving, as well as two-earner couples of relatively modest means. Higher-income households have generally stayed. The study finds that substantially more Federal tax filers who leave DC move to Maryland than move to Virginia. Between 1987 and 1995 about 7,000 Federal tax filers per year moved from DC to Montgomery County, MD, and between 3,000 and 4,000 per year moved to Prince George's County, MD; whereas fewer than 2,000 per year have moved Arlington County, VA, and even fewer to Fairfax County, VA. The author speculates that because overall taxes are considerably lower in Virginia than they are in the District, whereas Maryland taxes are more comparable, factors other than taxes are probably determining the pattern of out migration.

Home Care Increases for the Seriously Ill. Medicare policy changes in the 1980s provided incentives for increased use of home health services rather than prolonged hospital stays. The result, according to a new study, has been a dramatic increase in hospice and home care for the seriously ill and a modest decrease in hospital care—generally the most expensive form of health care. Growth in hospice and home care also increased Medicare utilization. The study finds that the percent of recipients who died in hospice care rose from about 2 percent to 10 percent during the 1989-95 period; those dying in an acute care hospital fell from 42 to 35 percent over a similar period. Meanwhile, the percentage of recipients who died without any Medicare services fell substantially, from 40 to 25 percent, and monthly Medicare expenditures before death rose from about $5,500 in 1988 to more than $7,000 in 1995 (in 1995 dollars). The study concludes that the growth of non-hospital care may have improved the well-being and satisfaction of dying patients and their families, but it does not appear to have slowed the growth of Medicare expenditures.

Surviving Shoe Companies Eschew Piece Rates. A tradition of piece-rate methods of pay was once a distinguishing characteristic of the American shoemaking industry. But companies that have survived in an industry that has shrunk dramatically in the face of import competition have turned increasingly to time rates of pay. A new study finds that establishments in which labor costs were a large share of total costs were disproportionately likely to close down over time. Looking at detailed internal data for a single firm that survived, the study found that the shift to time rates was part of a move toward continuous-flow methods of production, with job rotation and rapid changes in work tasks to introduce new styles and "just-in-time" products to retail stores. Although the change to time rates reduced labor productivity, it appears to have lowered costs even more through mechanisms such as lower workers' compensation insurance costs, smaller inventories, lower monitoring costs, lower wages and fewer grievances over wages during the labor contract, and the ability to produce an increased number of new styles of shoes.

EYES ONLY

INTERNATIONAL ROUNDUP

Coffee Contributes to Colombia's Highs and Lows. Like other developing countries, Colombia has been under pressure recently from international financial markets. The surprise devaluation of the peso in September took little pressure off the currency and had to be supplemented by successive increases in interest rates. In addition, President Pastrana's fiscal reform proposals pledge to reduce the deficit to 2 percent of GDP by 1999. Nonetheless, the peso has continued to trade at a value near the lower edge of its exchange band. Colombia's difficulties have been compounded by changing global prices of primary commodities, particularly coffee, which accounts for one-fifth of the country's exports. In August exports were a third off the pace of a year earlier, and coffee prices have continued to decline (see Chart of the Week). Historically, Colombia has exhibited a classic commodity price cycle. During the phase of high world coffee prices—most recently in 1997—Colombia's increased export revenues have tended to increase foreign exchange reserves, thereby putting upward pressure on the money supply, and, in turn, domestic prices. The danger is that rising wages and production costs affect all Colombian exporters and impair competitiveness in the non-commodity sector. (Sometimes the effect can come more directly, via upward pressure on the currency, but either way it is a "real appreciation.") This economic phenomenon is widely known as "Dutch Disease," after an earlier natural gas boom in the Netherlands. With the recent decline in coffee prices and uncertain financial market conditions, Colombia is squarely in the down-phase of the cycle, featuring an outflow of reserves and a tightening of monetary conditions at home.

Hyundai Wins Bid for Kia, Faces Challenges of Corporate Restructuring. The fate of the Korean car maker Kia illustrates some of the problems underlying the Asian crisis and the challenges that remain. Arguably, the magnitude of Kia's troubles resulted from an extreme case of "connected" lending. Kia's former chairman was sentenced earlier this week for embezzlement and he reportedly used the money for bribes to obtain preferential bank loans and keep Kia afloat. Since defaulting on an estimated debt of about $9 billion, Kia has been put on the auction block three times. The first two failed over the issue of whether the bidders would assume Kia's large debt. Hyundai's winning bid in the most recent auction this Monday awaits creditor approval. Press reports indicate that Hyundai is currently demanding that about 60 percent of the debt be written off, including some that will be swapped for equity. Even if its creditors approve, Hyundai will face an uphill battle to return Kia to viability. Redundant investments in saturated industries like autos are generally thought to have been the fundamental factors underlying the Korean crisis. To be successful, companies must strengthen their financial structure and redeploy their productive assets. Although Kia's labor union, which has a reputation for toughness, is likely to resist any large-scale layoffs, some analysts think that Hyundai has the necessary clout to rationalize production. Moreover, if Samsung ceases automobile production in the wake of its failed bid for Kia, as some analysts think it will, some of the excess capacity that has plagued the Korean car industry may well be eliminated.

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RELEASES THIS WEEK

Housing Starts

Housing starts fell 2 percent in September to 1.576 million units at an annual rate. During the first 9 months of this year, housing starts were 9 percent above the same period a year ago.

U.S. International Trade in Goods and Services

The goods and services trade deficit was $16.8 billion in August; it was $14.5 billion in July.

MAJOR RELEASES NEXT WEEK

Consumer Confidence—Conference Board (Tuesday)
Advance Durable Shipments and Orders (Wednesday)
Employment Cost Index (Thursday)
Gross Domestic Product (Friday)

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U.S. ECONOMIC STATISTICS

	1970-1993	1997	1997:4	1998:1	1998:2
Percent growth (annual rate)					
Real GDP (chain-type)	2.7	3.8	3.0	5.5	1.8
GDP chain-type price index	5.4	1.7	1.1	0.9	0.9
Nonfarm business (NFB) sector:					
Productivity (chain-type)	1.5	1.7	0.9	3.5	0.1
Real compensation per hour:					
Using CPI	0.6	1.9	2.8	4.1	2.0
Using NFB deflator	1.3	2.0	3.9	4.3	3.4
Shares of Nominal GDP (percent)					
Business fixed investment	10.9	10.6	10.7	11.0	11.2
Residential investment	4.5	4.0	4.1	4.2	4.3
Exports	8.2	11.9	12.0	11.6	11.3
Imports	9.2	13.1	13.2	13.1	13.1
Personal saving	5.2	1.5	1.2	0.9	0.3
Federal surplus	-2.7	-0.3	0.0	0.7	0.9

	1970-1993	1997	July 1998	August 1998	Sept. 1998
Unemployment Rate (percent)	6.7**	4.9**	4.5	4.5	4.6
Payroll employment (thousands)					
increase per month			118	309	69
increase since Jan. 1993					16745
Inflation (percent per period)					
CPI	5.8	1.7	0.2	0.2	0.0
PPI-Finished goods	5.0	-1.2	0.2	-0.4	0.3

**Figures beginning 1994 are not comparable with earlier data.

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FINANCIAL STATISTICS

	1996	1997	August 1998	September 1998	Oct. 22, 1998
Dow-Jones Industrial Average	5743	7441	8479	7910	8533
Interest Rates (percent per annum)					
3-month T-bill	5.01	5.06	4.90	4.61	3.90
10-year T-bond	6.44	6.35	5.34	4.81	4.62
Mortgage rate, 30-year fixed	7.80	7.60	6.92	6.72	6.73
Prime rate	8.27	8.44	8.50	8.49	8.00

INTERNATIONAL STATISTICS

Exchange Rates	**Current level October 22, 1998**	**Percent Change from Week ago**	**Percent Change from Year ago**
Deutschemark-Dollar	1.641	0.9	-8.0
Yen-Dollar	117.9	0.3	-2.3
Multilateral $ (Mar. 1973=100)	93.41	0.5	-4.7

International Comparisons [1/]	**Real GDP growth** (percent change last 4 quarters)	**Unemployment rate** (percent)	**CPI inflation** (percent change in index last 12 months)
United States	3.6 (Q2)	4.6 (Sept)	1.5 (Sept)
Canada	3.1 (Q2)	8.3 (Aug)	1.0 (Aug)
Japan	-1.8 (Q2)	4.2 (Jul)	-0.2 (Aug)
France	3.1 (Q2)	11.7 (Jul)	0.7 (Aug)
Germany	2.5 (Q2)	[2/] 7.4 (Aug)	0.7 (Aug)
Italy	1.1 (Q2)	12.4 (Apr)	1.9 (Aug)
United Kingdom	2.6 (Q2)	6.2 (Jun)	3.3 (Aug)

1/ For unemployment data, rates approximating U.S. concepts as calculated by the U.S. Department of Labor, Bureau of Labor Statistics.

2/ Rate for former West Germany. Using OECD standardized unemployment data, the unemployment rate for unified Germany for August 1998 is 9.6 percent.