1999-SE-005260

ASSISTANT SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

May 18, 1999

To: Deputy Secretary Summers

From: Ted Truman ETT

Subject: Summary of China Experts Meeting

Attached is a summary of the China Experts Meeting held on May 5, prepared by Joe Gagnon and Deborah Crane. I have also attached notes on the meeting prepared by John Fernald from the Fed.

Attachments

cc: Tim Geithner
Mike Froman
Bob Boorstin
Stephanie Flanders
Dan Zelikow
Joe Gagnon
Chris McCoy
Deborah Crane

Drafted: JGagnon, INA
Edited: DCrane, INA
5/18/99

China Experts Meeting, May 5, 1999

Participants:

Treasury: D/S Summers, U/S Geithner, A/S Truman, DAS Zelikow, DAS Lundsager, Joe Gagnon, Stephanie Flanders, Bob Boorstin, David Fischer.

Experts: Harry Harding, George Washington University; Dwight Perkins, Harvard University; E.C. Hwa, World Bank; Nicholas Lardy, Brookings Institution.

Other Agencies: Lael Brainard, NEC; Robb Wescott, NEC; Susan Shirk, State/EAP; John Fernald, Fed.

Summary:

There was rough consensus that easier monetary policy and devaluation would help address slowing growth, but is not a panacea. The government is not likely to move in this direction soon, but may do so a year from now, as the current fiscal posture is not sustainable. China is serious about reforming the SOE's and banks, but it is not clear how fast they can proceed, especially since these reforms are likely to raise unemployment in the short run. Raising fiscal revenue will be a problem.

Monetary Policy -- Countering Deflation, Spurring Growth:

The Chinese economy is experiencing sluggish domestic demand, falling prices (the retail price index fell 3.5% y/y in April), high real interest rates (real lending rates on the order of 7+%) and rising unemployment. While easing of monetary policy seems to be called for in these circumstances, experts were uncertain how effective monetary policy would be in turning the situation around. In addition, it is difficult to see how reforms that encourage more efficient allocation of resources would counter deflation.

The GOC has already attempted some easing of monetary policy. Lardy noted that the GOC has reduced interest rates (though not enough to keep pace with deflation), but capital controls are leaky and the GOC is worried that further interest rate cuts could create exchange rate pressures. M2 is growing at 20% and bank lending is growing three times faster than GDP (though Summers questioned the usefulness of these quantitative measures in deflationary circumstances). The government is allowing consumer loans for the first time, which should encourage consumption.

Lowering interest rates would not necessarily spur efficient investment in the Chinese economy. Perkins explained that interest rates do not reflect the rate at which private borrowers can obtain funds, as banks remain reluctant to lend to private firms. Thus easier credit would just go to SOE's who are not likely to use it productively (and, as Lardy noted, many of whom face an effective interest rate of zero, anyway, because they know they cannot repay the loans). High real interest rates create a credit crunch for uncreditworthy SOEs, which may help induce reform.

Fernald commented that there is some leakage of funds lent to SOEs into the private sector, but Hwa noted that most private firms fund investment with retained earnings.

Lardy argued that falling prices are due to the peg to a strong dollar and falling commodity prices. Perkins maintained that inflation had been stopped by quantitative restrictions on credit, not by higher interest rates.

Exchange Rate:

All agreed that devaluation would help exporters and import-competing firms. Hwa noted, though, that the real effective exchange rate is now lower than its pre-crisis level. The weakness in exports is due to weak demand in Europe and Japan. Fernald stated that the forward markets have not priced in much devaluation–essentially 0 over next 6 months and 5% over 12 months.

Lardy urged the USG to stop pressing China not to devalue. Asia can handle a moderate devaluation. The government is moving in that direction, but it will not happen over the next few months. The USG should be supportive of planned financial reforms and provide advice on RTC-style procedures. The first round impact of a devaluation on the CPI is close to zero. Second round effects, through greater demand, are not likely to be large in the current environment.

Financial Sector Restructuring and Fiscal Sustainability:

Lardy expressed concern that new debt recovery agencies will just park bad debt in the government and not seek liquidation and resolution (shades of Japan). Bank domination of finance is as strong as ever and initial public offerings actually declined in 1998. At the same time (and somewhat contradictorily), a huge share of central government expenditures are being financed by bonds, on the order of 70%. The central government's attempt to raise revenue through a fuel tax was defeated in Congress. This raises concerns about the fiscal situation going forward because the rate of bond issuance is unsustainable. Fully accounting for all hidden debt including in the banks would yield a debt/GDP ratio of 100%. Revenue/GDP is 12% for general government. The bad debt burden has risen from 5% to 25% of GDP in just 5 years.

Fernald said the flow of bad debts will continue to worsen until the fiscal system is strong enough to handle the whole mess. Like US S&L situation, it gets worse until you fix it. China had seemed on the brink of collapse for 6 years. They have kept afloat by reducing "static inefficiencies" in the economy, which yields real growth, but at this point the easy places to raise efficiency have already been tackled.

Slowing Growth and Social Unrest

Perkins stated that growth last year was fueled by public demand. Public infrastructure projects are useful (unlike in Japan) but the GOC is running out of ready-to-go projects and additional projects will take time to set up.

Truman noted that savings are rising now due to fears of job loss. Slower income growth is likely to outweigh lower interest rates and continue to weaken consumption, thus creating a vicious circle. Stagnation would breed its own problems -- the economy has to keep growing fast just to stay ahead of social unrest.

Possibility of Financial Crisis

Perkins believes there is no credible scenario for a South-East Asia style collapse (because of capital controls and current account surplus). The worst case would be slowing growth and rising unemployment. It was acknowledged that without a safety net, rising unemployment could be explosive. Harding noted that if the government solves its fiscal problem through inflation, that would hurt everyone and could also be socially explosive.

Lardy argued that a financial crisis (bank runs) is possible and that government support of the banks in such a crisis could prove inflationary. Perkins saw inflation more as a cause than a consequence of crisis, but he did not explain where inflation would come from.

Chinese Views of the Asian Financial Crisis:

Lardy explained that the GOC believes capital controls and its high ratio of FDI moderated the impact of the Asian crisis on China. However, the GOC also has a strong sense of the need to improve China's financial system. There is much talk of the need for bankers to assess risk in their lending. More people are questioning the Korean model of chaebols, which had been viewed as attractive before the crisis. Perkins cautioned that while the GOC has leaned some lessons from the Asian crisis, it is important not to overstate the level of economic understanding of the Chinese leadership.

WTO Accession:

Perkins argued that WTO accession would have a big positive impact on the reform process. China is much less centrally controlled than Japan and trade opening would have a big impact on the way business runs. Harding believes that a collapse of expectations about WTO accession would slow the impetus for other reforms.

(Preliminary and incomplete version)

John Fernald
May 10, 1999

Notes on an Interagency Meeting on China

Last week I attended an interagency meeting chaired by Larry Summers to discuss China. The discussion included several non-government "experts" on China, including Dwight Perkins (Harvard), Nick Lardy (Brookings), Harry Harding (GWU), and E.C. Hwa (World Bank).

Much of the discussion focused on monetary and exchange rate issues. Summers was particularly interested in how China should respond to the problem of apparently falling aggregate demand and deflation, which has led to significantly positive real interest rates in China. What is the constraint which, in a deflating economy, stops easier monetary policy from working? Why not have easier monetary policy around a "sustainable" exchange rate?

All of the "outside experts" (which included me) agreed that a more expansionary monetary policy in China would work through pumping more money into the state sector. That is, state-owned enterprises (SOEs) receive the vast majority of intermediated financing in China. In some sense, apparently high real interest rates (to the extent it reflected relatively tight restrictions on the quantity of credit available) were a microeconomic tool working to promote economic restructuring. Hence, while deflation does, indeed, reflect tight monetary policy, authorities may be loath to loosen more than they already have.

All of us were skeptical of how sensitive investment was to posted interest rates in China, since funds are rationed by quantity rather than price. SOEs that borrow from banks do not necessarily pay back the loans; hence, the shadow value of these funds may be very low, despite high posted real interest rates. Private firms may not be able to borrow at all from the bank, so the shadow value of these funds may be very high. Increasing the quantity of lending available (for example, through increased central bank lending to the banks, or increased pressure to lend out deposits rather than use the proceeds to buy government bonds) presumably would lower the shadow value of funds to non-state firms (since there are leakages in the system), but at the cost of further reducing the shadow value of funds to SOEs as well.

This perspective seems to imply a model where the IS curve is relatively interest-inelastic. That is, monetary policy works not by affecting the interest rate and hence investment. Rather, monetary policy works by affecting the quantity of investment (especially, state investment) relatively directly.

The current environment is one in which this relatively steep IS curve appears to have shifted to the left. On the household side, the saving rate has risen because of uncertainty associated with reforms, as well as the need to save to buy housing. (As a caveat, it is possible that consumption is interest elastic. Chinese consumers may have chosen to increase saving in part because the real return to saving is very high. My prior is that saving has risen for precautionary reasons, but I have not seen any evidence on this point.) Net exports have also weakened, reflecting primarily weak demand for Chinese products abroad (especially in Japan and elsewhere in Asia). Private investment has been relatively weak, in part because of tight financing (reflecting a shift in lending towards the state sector again, and reflecting a sharp slowing in the rate of growth of foreign capital inflows).

With a steep IS curve, changing interest rates will have little effect on output. Economic policy has thus emphasized fiscal policy–infrastructure, especially–and some relaxation of lending restrictions to the state sector.

During the meeting, we did not discuss the model quite so explicitly, though we talked about it implicitly. Summers seemed somewhat skeptical, although he seemed to find it food for thought. One implication of this perspective is that in such an environment, the exchange rate should be a powerful tool as well. After all, while the decline in net exports presumably reflects income effects, those income effects are what they are. Given the income effects, a devaluation would boost net exports.

CURRENT ACCOUNT DEFICIT

1998-SE-001643

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

UNCLASSIFIED/ SENSITIVE

February 10, 1998

INFORMATION

MEMORANDUM FOR **SECRETARY RUBIN**

FROM: Timothy Geithner TFG
Assistant Secretary for International Affairs

SUBJECT: **Your question on the upside risk of Treasury's current account deficit forecast**

The attached note by Brad Setser responds to your question and argues that the upside and downside risks to Treasury's current account forecast appear balanced, provided that Japan implements a significant fiscal package.

If the Japanese were to fall short, a recession in Japan would aggravate the regional slowdown in Asia and generate substantial downside risk.

CC: Deputy Secretary Summers
Under Secretary Lipton, International Affairs
Assistant Secretary Wilcox, Economic Policy
Lundsager, Atkinson

UNCLASSIFIED/ SENSITIVE

Brad Setser/ IMI
February 6, 1997

Are the risks to the Treasury's current account deficit forecast balanced?

There are significant risks to our forecast in both directions in Latin America, in East Asia and in the oil market. Provided that Japan implements a significant fiscal package, the upside and downside risks appear roughly balanced.

- Latin America and Mexico are the source of one of the biggest risk to our forecast. Extremely rapid growth in U.S. exports to Latin America and Mexico drove U.S. export growth in 1997. Our forecast assumes that this growth will slow (notably because of Brazil), but there is the possibility that U.S. export growth to Mexico and Latin America may either slow more than forecast or may not slow as much as forecast.

- In East Asia, our forecast assumes negative growth in the ASEAN-4 countries and South Korea, near zero growth in Japan and a slowdown in other East Asian countries. Given that the exchange rates of certain East Asian countries may have overshoot, there is a risk that we have marked down East Asia too aggressively. This risk is balanced by the risk that the crisis may continue to deepen, particularly in Southeast Asia, and that the regional slowdown in growth may be more severe than currently forecast.

- Our forecast presumes that Japan will implement a fiscal package and avoid negative growth, despite weaker net exports. If the Japanese package were to fall short, a recession in Japan would aggravate the regional slowdown in Asia and generate substantial downside risk.

- The oil market also is another source of risk: our forecast assumes that the substantial oil price declines observed early in 1998 will be sustained. It is possible that a crisis in the Gulf could lead to the reversal of recent oil price declines; however, it is also possible that the Gulf crisis will be resolved in a way that allows Iraq to export more oil, and this, combined with continued weak oil demand in East Asia, will lead to further oil price declines.

The Secretary of the Treasury

February 4, 1998

NOTE FOR TIM GEITHNER

FROM: BOB RUBIN

<u>Page 1 -- Third Bullet Point</u>

Is risk greatest on upside?

Attachment

Action: J Gatham – by COB Tue

cc: Atkinson

Joe: are you taking care?

98-SE-000925

ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNCLASSIFIED/ SENSITIVE

January 27, 1998

INFORMATION

to: Tim Geithner
fr: R.E.R.

INFORMATION

MEMORANDUM FOR **SECRETARY RUBIN**
DEPUTY SECRETARY SUMMERS

FROM: CA for Timothy Geithner, Assistant Secretary for International Affairs

SUBJECT: **1998 and 1999 Treasury Current Account Forecasts**

The attached note summarizes Treasury's latest trade and current account forecast.

- The **1997** U.S. goods and services trade deficit is estimated to be $112 billion (1.4% of GDP) -- only slightly larger than the 1996 deficit of $111 billion. The 1997 current account deficit is estimated to have increased to $162 billion (2.0% of GDP), up marginally from $148 billion (1.9% of GDP) in 1996.

- Falling import prices have masked significant deterioration in the 1997 real trade balance. However, in 1998 and 1999 the lagged impact of the strong dollar on both export and import volumes will prompt rapid deterioration of both the nominal and real balances.

- The **1998** U.S. goods and services trade deficit is projected to deteriorate by $68 billion (0.8% of GDP), to $180 billion (2.1% of GDP). The current account deficit is expected to widen to $240 billion (2.8% of GDP).

- The **1999** U.S. goods and services trade deficit is expected to deteriorate by $50 billion (0.6% of GDP), to $230 billion (2.6% of GDP). The current account deficit is also projected to widen to $300 billion (3.4% of GDP -- close to the record 3.6% of GDP current account deficit record in 1987).

Is risk greater on upside.

- Roughly speaking, the drag on real GDP growth from real net exports could be 1.0% of GDP in 1998 and 0.6% of GDP in 1999.

- The Federal Reserve expects a **1998** current account deficit of $210 billion, 2.5% of GDP, and the **1999** deficit of $270 billion, 3.1% of GDP.

- Roughly two-thirds of the expected deterioration over the next two years reflects the expected direct and indirect impact of the Asian financial crisis.

CC: Under Secretary Lipton, International Affairs
Jeff Frankel, CEA; Bill Helkie, Federal Reserve
Lundsager, Zelikow

EXECUTIVE

UNCLASSIFIED/ SENSITIVE

Brad Setser/Treasury/ IMI
January 26, 1997

IMI 1998 and 1999 U.S. Current Account and Trade Balance Projections

U.S. trade and current account deficits are estimated to have increased only slightly in 1997. However, IMI modeling and analysis suggest that both the trade and current account deficits will increase sharply in 1998 and 1999 in response to the lagged impact of 1997 dollar appreciation and slower growth in East Asia.

- The **1997** U.S. goods and services trade balance is estimated to be $112 billion (1.4% of GDP) -- only slightly larger than the 1996 deficit of $111 billion. However, deterioration in investment income is estimated to have led the 1997 U.S. current account deficit to increase to $164 billion (2.0% of GDP), up from $148 billion (1.9% of GDP) in 1996.

- The **1998** U.S. goods and services trade deficit is projected to deteriorate by $68 billion (0.8% of GDP), to $180 billion (2.1% of GDP). The current account deficit is expected to widen to $240 billion (2.8% of GDP).

- The **1999** U.S. goods and services trade deficit is expected to deteriorate by $50 billion (0.6% of GDP), to $230 billion (2.6% of GDP). The current account deficit is also projected to widen to $300 billion (3.4% of GDP).

- In percentage of GDP terms, the **1999** U.S. current account deficit is expected to approach the record 3.6% of GDP 1987 deficit.

- **Nominal exports** are expected to grow by only 1.2% in 1998 and by 4.2% in 1999. **Export volumes** are expected to grow slightly more rapidly, by 2.6% in 1998 and by 4.7% in 1999.

- **Nominal import** growth is expected to slow substantially in 1998, to 4.2%, before accelerating to 9.9% in 1999. The low 1998 nominal growth rate, however, is slightly misleading, since significant falls in the price of oil and in the price of non-oil imports will hide continued rapid growth in import volumes. **Import volumes** are expected to grow by 10.8% in 1998 and by 9.1% in 1999.

Comparative 1998 and 1999 Current Account Deficit Forecasts

	Treasury January 15	Fed January 15	IMF December	OECD December	Consensus January
1998 Current Account Deficit	-$240 billion 2.8% of GDP	-$210 billion 2.5% of GDP	-$230 billion 2.7% of GDP	-$213 billion 2.5% of GDP	-$201 billion 2.4% of GDP
1999 Current Account Deficit	-$300 billion 3.4% of GDP	-$270 billion 3.1% of GDP		-$233 billion 2.6% of GDP	-$210 billion 2.4% of GDP

Treasury's forecast increase in the trade and current account deficits is slightly larger than other forecasts, largely because it, like the recent Federal Reserve forecast, fully captures the expected impact of the recent strengthening of the dollar and deterioration in East Asian growth prospects. However, some other recent forecasts do predict comparable or greater deterioration in the trade and current account balances. C. Fred Bergsten predicts that the goods and services trade balance may deteriorate by $100 billion (1.2% of GDP) in 1998, to $215 billion (2.5% of GDP); this would imply a current account deficit of $275 billion (3.3% of GDP). Gavyn Davies of Goldman Sachs predicts that the current account might deteriorate by between 0.5 and 1.0% of GDP in 1998, producing a current account deficit of between 2.5 and 3.0% of GDP. We anticipate that other private sector forecasts will start to converge with our forecast as these forecasts are revised to reflect new data.

Comparison of Treasury's October and January Current Account Forecasts

	October 1997 ($ billion)	January 1998 ($ billion)
1997	$170 (2.0%)	$164 (2.0%)
1998	$210 (2.5%)	$240 (2.8%)
1999	$230 (2.7%)	$300 (3.4%)

ANALYSIS

IMI trade and current account forecasts are driven by the impact of recent dollar appreciation and the expected fall in East Asian growth. IMI analysis assumes that current levels of the dollar will be sustained through the first part of 1998 and then will gradually start to fall. However, the dollar is still expected to remain well above its summer 1997 levels at the end of 1999.[1] The Asian flu is expected to reduce world GDP growth (weighted by U.S. export shares) to 2.8% in 1998, well below average (3.3%). Recent analysis by the Federal Reserve suggest that East Asian growth will remain weak in 1999, consequently, IMI analysis assumes world GDP growth will remain below trend in 1999.

Growth in U.S. domestic demand is expected to slow from 4.4% in 1997 to 2.9% in 1998 and 2.0% in 1999 (budget forecast). Real GDP growth will grow more slowly than domestic demand, because of the substantial drag we forecast from deteriorating real net exports. IMI analysis suggests that real net exports could lower real GDP growth by 1.0% of GDP in 1998 and 0.6% of GDP in 1999.

- **Dollar Strong in Real Trade-Weighted Terms.** According to the JP Morgan index, the dollar has appreciated 11% since last December and 8.5% since the end of June. The JP Morgan trade-weighted real dollar index is at its highest level since Q4 1986. Because of the rapid increase in the share of trade in GDP over the past ten years, a strong dollar in 1997 will have a larger impact on the overall U.S. economy than in 1986.

- **Dollar Appreciation Reduces 1997 Trade Deficit.** IMI analysis concludes that recent dollar appreciation reduced the size of the 1997 current account and trade deficits by about $10 billion. The 11% appreciation of the trade-weighted dollar during the course of 1997 reduced average 1997 import prices by over 4.0%, masking a surge in real imports (the J-curve). Exports respond to the dollar appreciation with longer lags. Indeed, in 1997, the benefits U.S. exports received from the lagged impact of the weak dollar in 1995 probably exceeded the drag from dollar appreciation in 1996 and 1997.

- **Lower Oil Prices Will Reduce Trade Deficit in Q1 1998.** A positive oil price shock (a forecast $2/barrel fall in the cost of imported oil in Q1 1998) is expected to reduce Q1 1998 oil imports sharply and to reduce annual 1998 oil imports by $9 billion, or 15%.

- **Significant Falls in Import Prices Expected in Early 1998.** IMI model results predict that non-oil import prices will fall rapidly in 1998, partially offsetting rapid growth in import volume in 1998. Non-oil Import prices are expected to fall by over 4.0% in 1998, bringing the total fall in non-oil import prices between 1996 and 1998 to nearly 9.0%.

- **Deterioration in Nominal Trade Balance May Not Appear Until Q2 1998.** Both the

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[1] A more rapid fall in the dollar than the fall contained in the IMI model would not have significant impact on the nominal 1999 trade balance unless it occurred early in 1998. Because of the "J" curve, major improvement in the nominal trade balance due to dollar depreciation late in 1998 or early in 1999 would not be visible until 2000.

sharp fall in petroleum import and the expected fall in import prices in early 1998 will tend to reduce nominal imports in Q1 1998 despite rapid forecast increase in import volumes. Annualized Q1 1998 nominal imports are forecast to increase by only $5 billion (annualized), while the annualized volume of non-oil imports (real imports) is expected to increase by $40 billion. IMI model forecasts indicate that exports may remain constant in Q1 1998, though the U.S. experience following the Mexican crisis suggests that exports to East Asia may more rapidly than the IMI model predicts. Nonetheless, IMI analysis suggests that the *nominal trade balance* may not begin to deteriorate rapidly until Q2 1998.

- **Strong Dollar Will Slow Exports in Late 98 and 1999.** IMI modeling suggests a 6-7 quarter lag between dollar appreciation and the majority of the related fall in exports; the Federal Reserve model has even longer lags. Dollar appreciation in Q1 1997 is expected to slow U.S. exports in the Q3 and Q4 1998; recent dollar appreciation will have its greatest effect on Q1 and Q2 1999 export performance.

- **Dollar Depreciation in Mid-1998 Would Not Improve Trade Balance Before Late 1999.** Just as 1997 dollar appreciation improved the U.S. current account balance in 1997; dollar depreciation in 1998 initially would make the 1998 current account balance worse, since higher import prices would combine with growing import volumes to increase the nominal trade deficit. The impact on 1999 would be mixed: the nominal trade deficit in the first two quarters might be worse, but by the last two quarters improved exports should cause the nominal trade deficit to stabilize. Clear improvement might not be visible before 2000.

- **Asian Crisis Slows World Growth.** Economic and financial turmoil in Asia has prompted IMI to lower the 1998 trade-weighted world growth rate from 3.3% (80-96 average) to 2.8%. This reflects an anticipated recession in East Asia and small knock on effects in Latin America and Europe. World GDP growth is expected to improve in 1999, to 3.0%, but remain 0.3% below trend. East Asian countries account for approximately 30% of 1996 U.S. exports and East Asian countries have an aggregate weighting of nearly 30% in the IMI world GDP index.

- **Estimated Impact of Asia on Real U.S. Trade Balance Significant.** IMI analysis suggests that the dollar depreciation and slowdown in world growth stemming directly from the East Asian economic and financial crisis will reduce real U.S. net exports by 0.5% of GDP in 1998 and by an additional 0.3% of GDP in 1999.

- **Significant Differences Exist Between Expected Nominal and Expected Real Impact of East Asia.** The cumulative nominal impact of $45 billion (0.5% of GDP) by 1999 is smaller than the projected cumulative real impact of $70 billion (0.8% of GDP) because of substantial falls in import prices. In 1998, the depreciation of East Asian currencies is expected to reduce U.S. import prices by 3.0%.

- **Changes in Trade Balance Drive Changes in Current Account Balance.** IMI assumes that net unilateral transfers will remain constant at their current level. Net investment income is expected to deteriorate due to the cumulative effect of prior current account deficits. The net investment income deficit is expected to widen from $12 billion in 1997 to $20 billion in 1998 and to $30 billion in 1999 because of increasing interest payments on accumulated foreign debt and lower profits on U.S. foreign investment in East Asia.

- **U.S. Trade and Current Account Balances Would Have Deteriorated Slightly Even Without the Strong Dollar/ Asian Crisis.** The growing deficit in investment income, and discrepancies between U.S. and foreign income elasticities (also noted last August in analysis presented by the Federal Reserve) mean that even without recent dollar appreciation and slower growth in East Asia, the U.S. current account balance would have been forecast to deteriorate by between $20 billion and $30 billion (0.2-0.3% of U.S. GDP) a year, generating a current account deficit of 2.5% of U.S. GDP in 1999.

A Note on the Macroeconomic Forecast implicit in the IMI model. The broad increase in the trade deficit forecast implies a widening gap between saving and investment. This would be consistent with current macroeconomic forecasts, which assume that U.S. consumption and U.S. investment will remain strong, offsetting the expected drag from net exports. Thus, current forecasts presume continued strong domestic demand in the U.S., prompted in part by falling interest rates, and continued falls in household saving. Obviously, different macroeconomic conditions than those assumed in the model would have a significant impact of the magnitude of the U.S. trade deficit.

QUALIFICATIONS

The IMI model assumes that relationships derived from historical data can be used to predict future U.S. trade patterns accurately. There is some evidence to support the argument that these models may underpredict the future strength of U.S. exports.

IMI's trade model, like the Federal Reserve's trade model, failed to predict fully the strong performance of U.S. exports in the second quarter of 1997. If the IMI model would have been used in January 1995 to predict U.S. exports through 1997 -- with perfect knowledge of the value of the dollar and U.S. and world growth rates, but no knowledge of actual U.S. exports -- the IMI model would not have been off by more than $10 billion (out of roughly $850 billion of total U.S. exports) in any quarter of 1996 or in the first quarter of 1997. However, in Q2 97 exports were $50 billion above model predictions. This discrepancy fell to $35 billion in Q3 1997. However, errors on the export side have been matched by offsetting errors on the import side, since imports have been above model predictions.[2]

Several theories have been proposed to explain recent strong U.S. export performance:

- Strong growth in key U.S. markets in the Western Hemisphere, combined with a reduction in barriers, particularly non-tariff barriers to U.S. exports in the hemisphere.

- The lagged impact of 1995 dollar depreciation was larger than predicted.

- Boeing. U.S. civilian aircraft exports nearly doubled between Q1 96 and Q2 97. The $4.8 billion increase in quarterly aircraft exports between Q1 96 and Q2 97 accounts for over 25% of the $21 billion increase in goods exports between Q1 96 and Q2 97.

However, grounds for optimism are limited.

- The underlying real trade balance has already started to decline rapidly, as IMI model predicted. The real trade balance deteriorated by $40 billion (0.5% of GDP) in 1997. Falling import prices have prevented the nominal trade balance from registering similar deterioration (J curve).

- Key export sectors, like the civilian aircraft, are operating at or above capacity. In the short-term, civilian aircraft exports cannot increase much more. Plus, the civilian aircraft sector is extremely exposed to Asia, since orders from Asia account for 40% of Boeing's outstanding orders for its largest (and most expensive) aircraft (747, 777) and over 30% of total orders. (Wall Street Journal)

- The gap between exports and imports in the December National Purchasing Managers Report (NAPM) -- a leading indicator of manufacturing output, exports and imports -- registered the largest deficit since the NAPM survey began incorporating imports in 1990. This deficit developed quite suddenly during the last two months of 1997. This strongly suggests that the trade deficit is set to widen. (NAPM data from JP Morgan)

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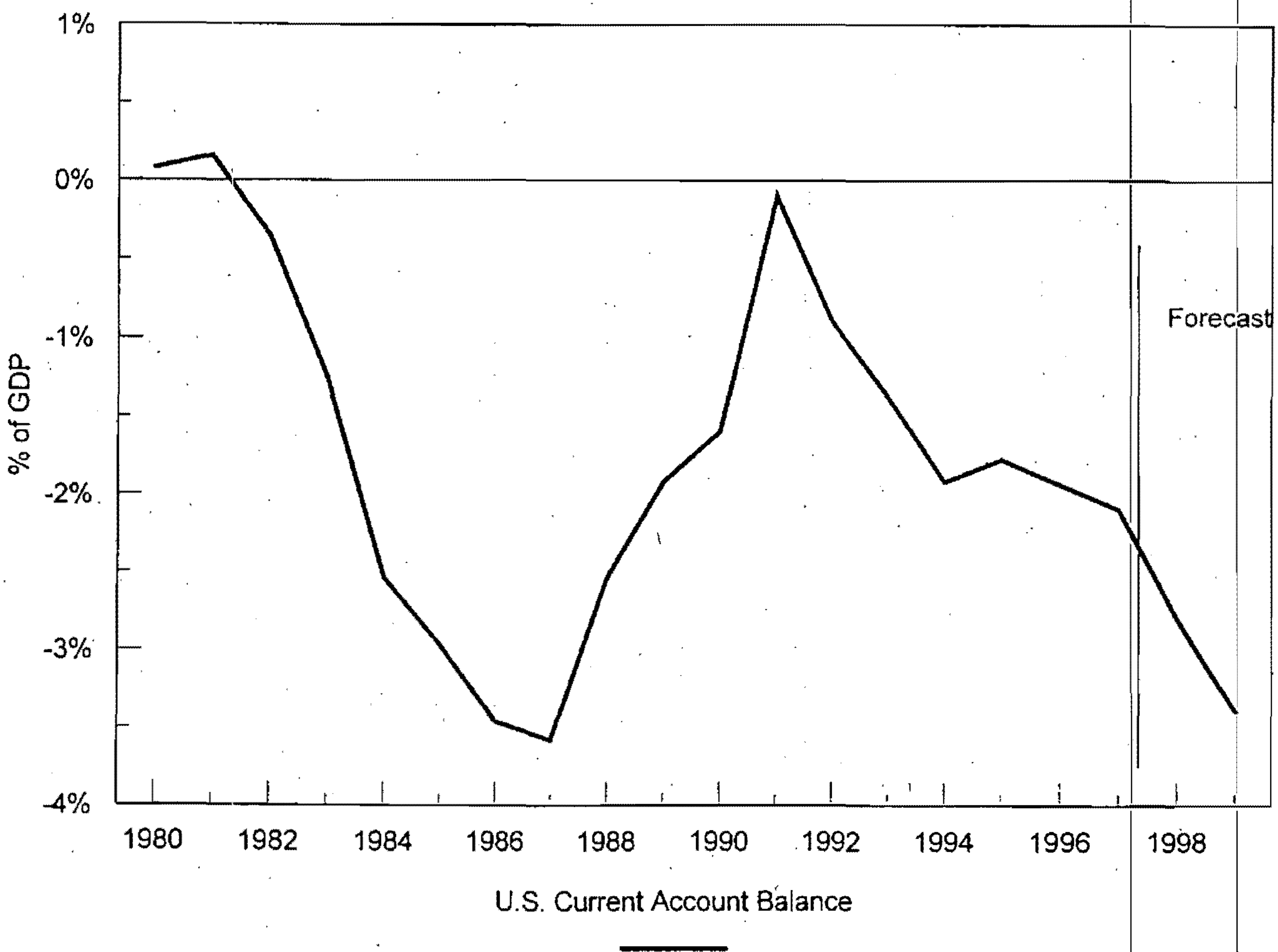
[2] If the IMI model had been used in January 1990 to predict the U.S. trade balance through 1997, with perfect knowledge of U.S. and world growth rates and the value of the dollar but no knowledge of actual levels of exports or imports, it would have done quite well. It would have predicted the overall level of the trade balance nearly perfectly. Between 1992 and 1994 actual levels of imports and exports were both below what the model would have forecast; since late 1996, actual levels of imports and exports have been above what the model would have forecast.

U.S. Current Account

In terms of percentage of GDP
1980 through 1999

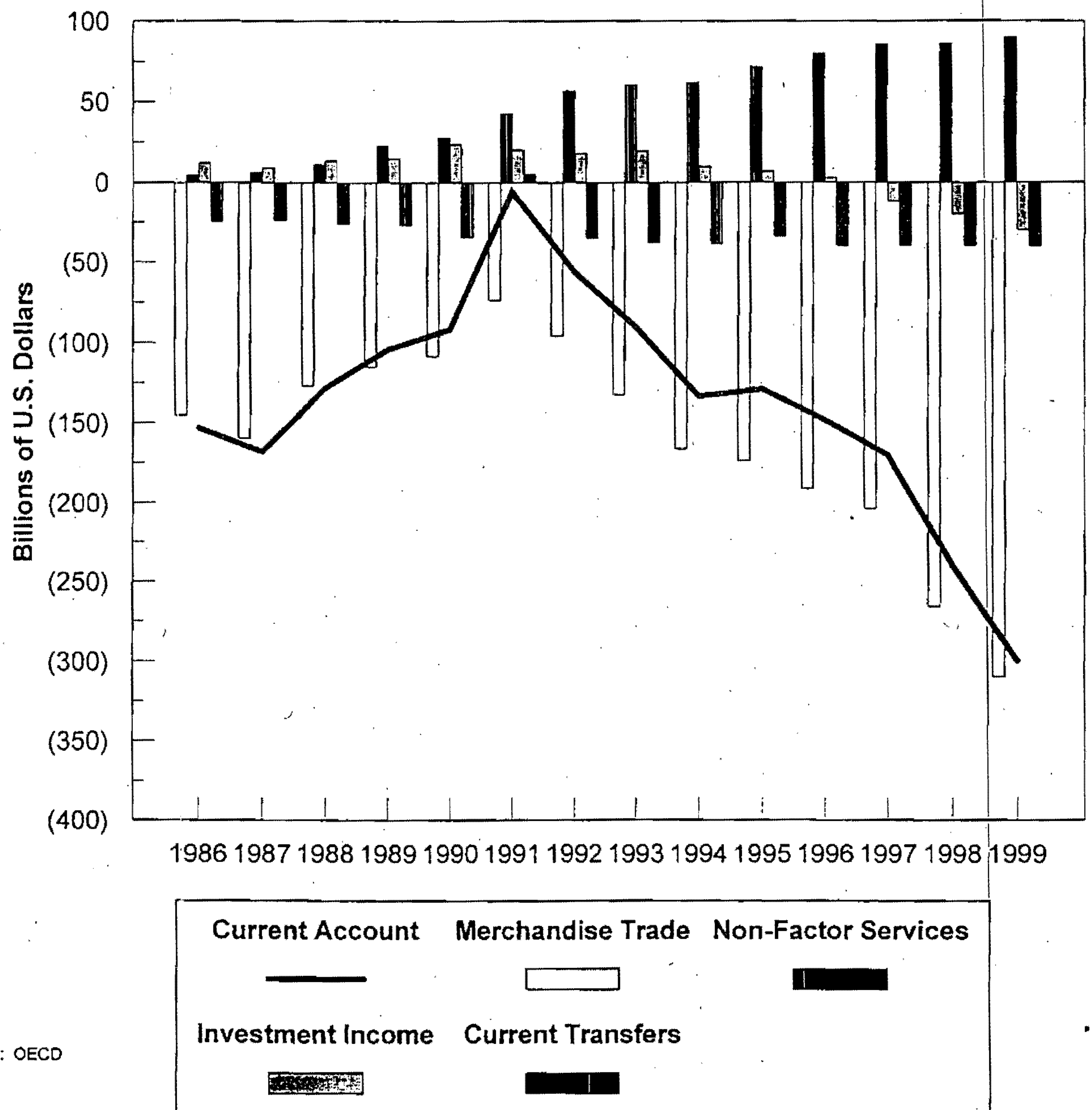


Sources: IMF data, Treasury forecasts

Treasury Forecasts are Sensitive

Components of the U.S. Current Account

1997, 1998, 1999 = Treasury Projections



Source: OECD

Dept. of Commerce data, Treasury Forecasts
Treasury Forecasts are Sensitive

TREASURY CLEARANCE SHEET

NO.__________

Date February 5, 1997

MEMORANDUM FOR: ☑ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY ☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION ☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH ☐ TESTIMONY ☐ OTHER

FROM: Timothy Geithner, Assistant Secretary for International Affairs

SUBJECT: The Secretary's Question on IMI's Current Account Deficit Forecast

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
☐ Domestic Finance
☐ Economic Policy
☐ Fiscal
☐ FMS
☐ Public Debt

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☐ Policy Management
☐ Scheduling
☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
☐ E & P
☐ Mint
☐ Savings Bonds
☐ Other ________

NAME (Please Type)	INITIAL	DATE	OFFICE/ROOM NO.	TEL. NO.
INITIATOR(S)				
Brad Setser	BWS	2/5	OASIA/IMI Room 5050	622-0145
REVIEWERS				
Joe Gagnon	JG BWS for	2/5	OASIA/IMI Room 5050	622-0138
Caroline Atkinson	CA Gl/r see cont.	2/6	OASIA/IM Room 3221	622-0656

SPECIAL INSTRUCTIONS

☐ **Review Officer** **Date** ☐ **Executive Secretary** **Date**

DO F 80-02.1 (04/89)

1998-SE-006271

ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

May 21, 1998

INFORMATION

MEMORANDUM FOR DEPUTY SECRETARY SUMMERS

FROM: Timothy Geithner, Assistant Secretary for International Affairs TFG

SUBJECT: Your Question on the Real Dollar Depreciation Needed to Reduce the Projected 1999/ 2000 U.S. Current Account Deficit below 2.0% of GDP.

The attached note by Brad Setser estimates that a real depreciation of around 25% in the second half of 1998 would be needed to reduce the projected 2000 current account trade deficit below 2.0% of GDP. A depreciation of this magnitude would substantially increase the 1998 trade and current account deficits due to the J-curve, before generating rapid improvements in the trade and current account balances in the course of both 1999 and 2000. By Q2 2000, the annualized quarterly current account balance would be down around 2.0% of GDP with further improvement continuing through the end of 2000.

ATTACHMENTS: IMI Note on real dollar depreciation needed to reduce the projected 1999/2000 Current Account deficit below 2.0% of GDP.

CC: Lipton, Lundsager

Brad Setser/ IMI
May 20, 1998

Estimated Real Dollar Depreciation Needed to Reduce the Current Account Deficit Below 2.0% of GDP in 2000.

IMI's baseline forecast assumes a relatively small, 0.75% quarterly, depreciation in the dollar's real effective exchange rate between the third quarter of 1998 and the end of 2000 (due to expected inflation differentials with Asian trade partners and some depreciation in the nominal dollar). This small depreciation (The JP Morgan dollar declines from 112 in Q2 1998 to 105 at the end of 2000) is insufficient to halt the deterioration in the trade and current account deficits until 2000, given expected U.S. and world growth rates.[1] Consequently, IMI's baseline forecast predicts a 1999 current account deficit of 3.1% of GDP and a 2000 current account deficit of approximately 3.5% of GDP in 2000.

IMI used its trade model to determine the magnitude of the one time depreciation needed to reduce the current account deficit below 2.0% in 2000. Given the deficit in the investment income and transfers accounts, reducing the current account deficit below 2.0% implies reducing the goods and services trade deficit below 1.3% of GDP. **The IMI model suggests that a one time depreciation of around 25% would be needed in the third quarter of 1998 in order to reduce the projected annual current account deficit in the year 2000 below 2.0%.**[2] A more gradual depreciation of the real dollar of the same amount would lengthen the expected adjustment process but ultimately produce the same result. [See attached chart].

- The immediate impact of a depreciation would be a huge surge in nominal imports (and a small fall in nominal exports), as prices adjust before volumes. A sudden 25% depreciation would be expected to produce a one time increase in the nominal trade deficit of nearly 1.5% of GDP.

- It will take three quarters before such a depreciation reduces the trade deficit below baseline projections. Consequently, such a depreciation would make the 1998 trade and current account deficits substantially worse.

- However, such a depreciation would generate substantial improvements in the trade balance relative to baseline projections in both 1999 and 2000 -- indeed, by the end of 2000, the annualized quarterly current account balance would be well below 2.0% of

---

[1] IMI's model assumes that U..S real GDP will grow by 3.0% in 1998, 2.0% in 1999 and 2.0% in 2000; IMI's trade weighted world GDP index is projected to grow by 2.1% in 1998, 2.8% in 1999 and 3.5% in 2000. In these projections, GDP growth rates have been left unchanged to better isolate the impact of shifts in exchange rates.

[2] A depreciation of 15% would reduce the estimated year 2000 nominal trade deficit to around 2.1% of GDP, generating a current account deficit of around 2.7-2.8% of GDP).

GDP.

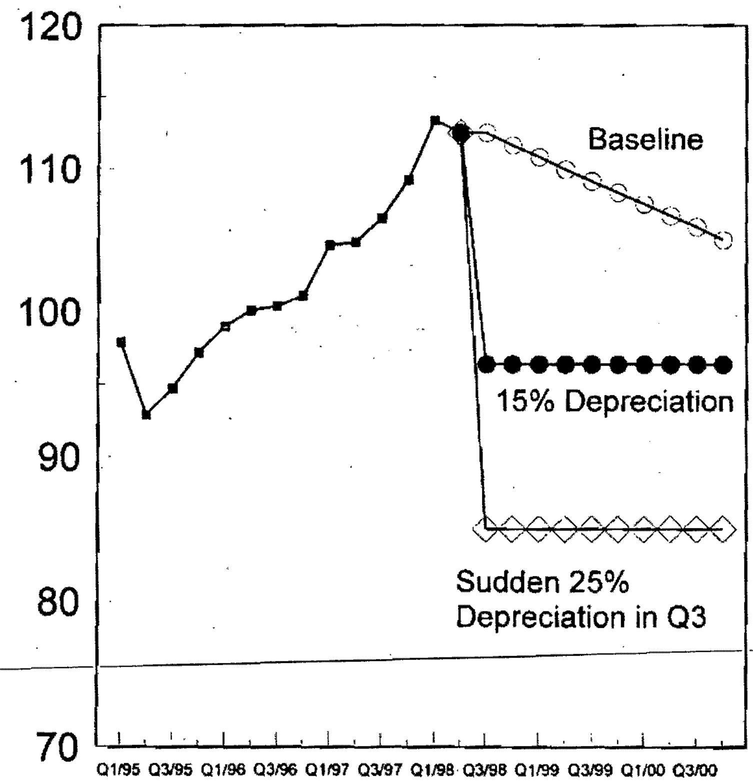
- Such large falls are consistent with the results of numerous studies which have indicated that current levels of the dollar imply growing current account deficits.

A 25% depreciation in the real effective exchange rate is likely to require that the dollar depreciate against the yen and the euro by more than 30%. The dollar is not likely to depreciate by 25% against Canada and Mexico.

Impact of Real Dollar Depreciation on U.S. Trade Balance

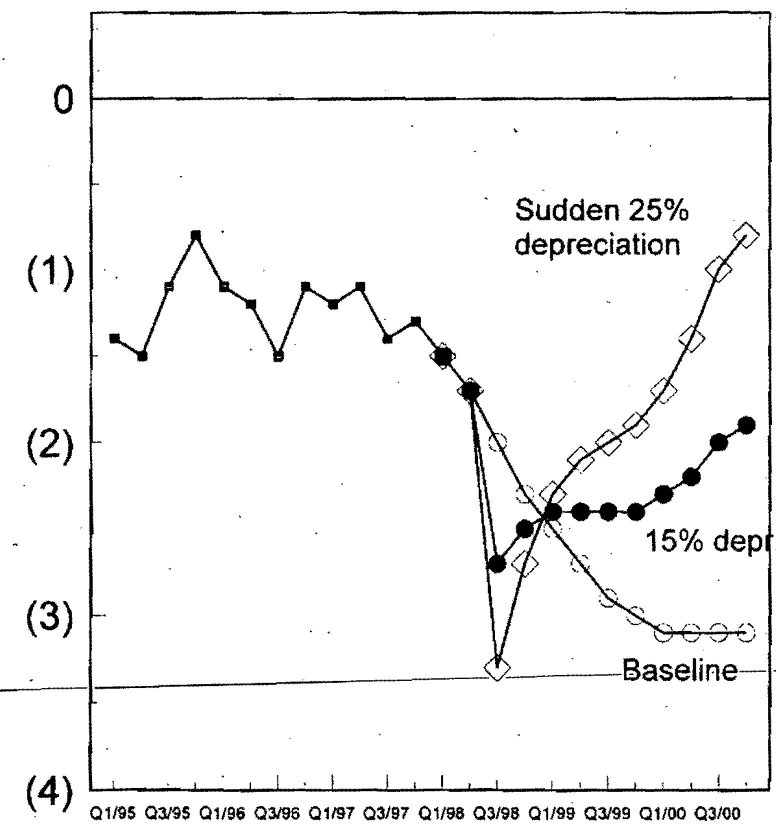
JP Morgan Dollar

Baseline Scenario= 3% annual fall in real terms
v. Sudden 15 and 25% depreciations in Q3 98



U.S. goods and services trade balance (% of GDP)

Baseline v. rapid depreciation in Q3/ 1998
Trade deficit of 1.2/1.3% of GDP = Current account deficit of 2.0% of GDP



The Deputy Secretary of the Treasury

May 12, 1998

TO: Secretary Rubin
OASIA ✓

See comments at --

Table 1: World Current Account Balance:

"This table is indeed troubling. Could OASIA give a plausible exchange rate scenario that would take it to 2% of GDP in 99/2000."

Larry

Attachment

Return to [illegible] 5/18/98

URGENT

Gaynor. Just to ensure that you get this. CA 5/18

Room 3326

622-1080

05/18/98 16:43 202 6220658 TREAS-IM & IE 001/003

Table 1: World Current Account Balance

	1996	1997	1998 Forecast	1999 Forecast	Source of Forecast
United States	-148	-161	-235	-275	IMI Estimate
European Union	91	114	118	120	IMI Estimate
Japan	66	94	124	128	IMI Estimate
Other Industrial Countries	11	-5	-10	-5	IMF
Asian NIEs	-1	9	33	44	IMI Estimate
Korea	-24	-8	20	22	
Hong Kong	-2	-3	-1	0	
Taiwan	11	6	5	8	
Singapore	14	14	9	14	
Asian Emerging Markets	-40	-12	30	35	IMI Estimate
Latin America	-39	-65	-70	-70	IMI Estimate
Africa	-10	-8	-10	-10	IMF
Middle East	7	3	-10	0	IMI Estimate
Countries in Transition	-19	-20	-26	-30	IMF
Total	-82	-51	-56	-63	Sum of Above

All forecasts are preliminary and contain a large margin of error

Note: IMI forecasts significantly larger current account surplus in Asian emerging markets than IMF

Note: IMI forecasts larger current account deficit in the Middle East than the IMF due to lower oil prices

Note: IMF forecasts that Latin current account deficit will shrink in 1998, IMI forecasts a small increase

TO: Rubin/OASIA

This table is indeed troubling. Could OASIA give a plausible exchange rate scenario that would take it to 2% of GDP in 99/2000.

L.

TREASURY CLEARANCE SHEET

NO.__________
Date May 20 1998

MEMORANDUM FOR: ☐ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER

FROM: Timothy Geithner, Assistant Secretary for International Affairs

SUBJECT: Your Question on the Real Dollar Depreciation Needed to Reduce the Current Account Deficit Below 2.0% of GDP in 2000

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
☐ Domestic Finance
☐ Economic Policy
☐ Fiscal
☐ FMS
☐ Public Debt

☐ Under Secretary (International)
☐ International Affairs

☐ Enforcement
☐ ATF
☐ Customs
☐ FLETC
☐ Secret Service
☐ General Counsel
☐ Inspector General
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC

☐ Policy Management
☐ Scheduling
☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
☐ E & P
☐ Mint
☐ Savings Bonds

☐ Other __________

NAME (Please Type)	INITIAL	DATE	OFFICE/ROOM NO.	TEL. NO.
INITIATOR(S)				
Brad Setser	BWS	5/20	OASIA/IMI Room 5050	622-0145
REVIEWERS				
Joe Gagnon	JG	5/20	OASIA/IMI Room 5050	622-0138
Caroline Atkinson	CA	5/20	OASIA/IM Room 3221	622-0656
David Wilcox	DW	5/21	EP	622-2000

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

DO F 80-02.1 (04/89)

DOLLAR

95-144306

INFORMATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 7, 1995

To: Alicia Munnell

MEMORANDUM FOR	Alicia H. Munnell Assistant Secretary for Economic Policy
FROM:	James Russel JMR
SUBJECT:	Impact of the Decline in the Dollar on Our Inflation Rate

From: Bob Rubin

Interesting.

Summary

The dollar has been falling against most other currencies since January 1994, with an interruption in the fall of last year. Most publicized have been the sharp drops against the yen and the DM. Declines against most other countries have been less, and for Canada and Mexico, two of our largest trading partners, the U.S. dollar has appreciated. Of course, declines in the dollar are not likely to be reflected fully in import prices, and all increases in import prices will not necessarily be passed through into final product prices in this country.

As a very crude rule of thumb, a 10 percent decline in the dollar in foreign exchange markets might add 1-1/2 percent or so to the price level in this country over a period of three years. On that basis, unless reversed the decline of perhaps 7 or 8 percent since January of last year in the broad J. P. Morgan ~~real~~ exchange rate index against 45 other currencies might raise the U.S. price level by 1-1/4 percent by the end of next year.

Based on all evidence to date, does this seem likely

Discussion

The table below shows that there has been a wide divergence recently in movements of the dollar against other currencies. It has fallen sharply against the yen and the DM and also against currencies tied to the DM. It is up against the Canadian dollar and the peso. (Countries shown in the table accounted for three-fourths of U.S. imports last year.)

Movements of the Dollar In Foreign Exchange Markets

	Percent Change, March 6 from: Jan. 1994	Percent Change, March 6 from: Dec. 1994	Import Share 1994 (Percent)
Germany	-19.4	-10.6	4.8
Japan	-16.6	-7.3	18.0
France	-15.9	-8.0	2.5
Italy	-2.4	1.5	2.2
United Kingdom	-8.1	-4.0	3.8
Canada	7.6	2.0	19.4
Mexico	111.6	65.4	7.5
Asian Nic's	-3.1	-0.5	10.8
China	-3.4	0.5	5.8

The Secretary of the Treasury

March 27, 1995

NOTE FOR ALICIA MUNNELL

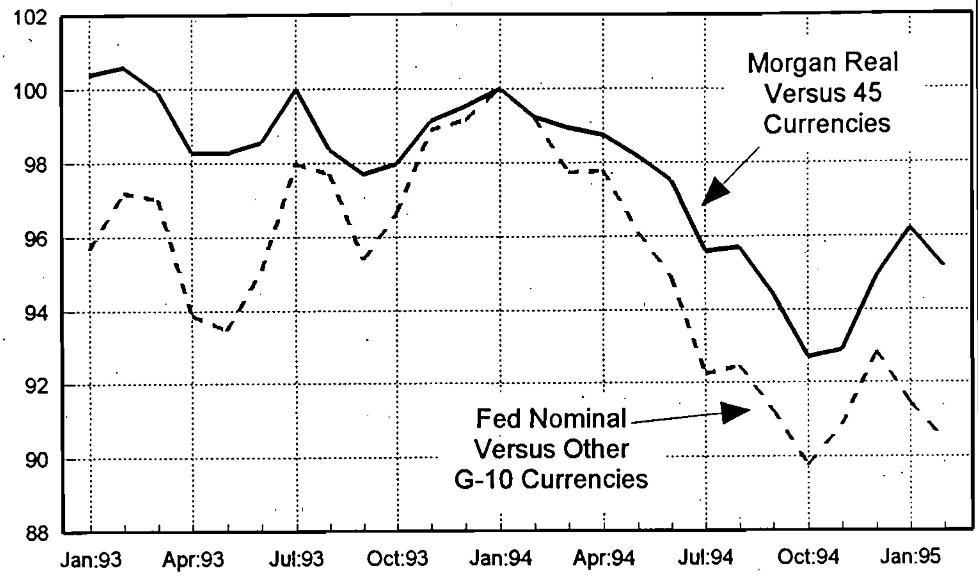
FROM: BOB RUBIN

Interesting.

Based on all evidence to date, does this seem likely?

Attachment

MEASURES OF THE EXCHANGE RATE

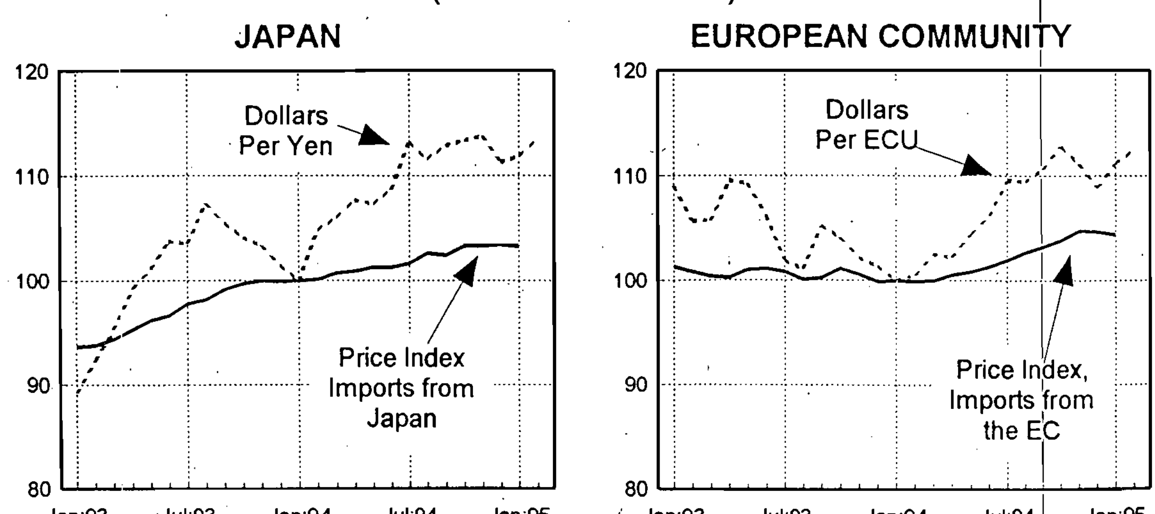


The chart above tracks monthly figures for two measures of the exchange rate -- (1) the more widely followed Federal Reserve series which is a weighted average of the dollar against other G-10 currencies, with the weights based on shares of multilateral trade in 1972-76; and (2) the real J.P. Morgan index which is based on bilateral trade weights against currencies of all other OECD countries and currencies of 23 LDC's. The latter series is far more representative of our trading patterns. Between January 1994 and this February, the Morgan series fell by 5 percent and surely has declined some more since February -- perhaps by another 2 or 3 percent, although data are not available.

It is noted that declines in the dollar typically do not feed fully into higher import prices. The left panel chart below indicates that through January of this year the yen had risen against the dollar by about 25 percent since January of 1993 (and about 11 percent

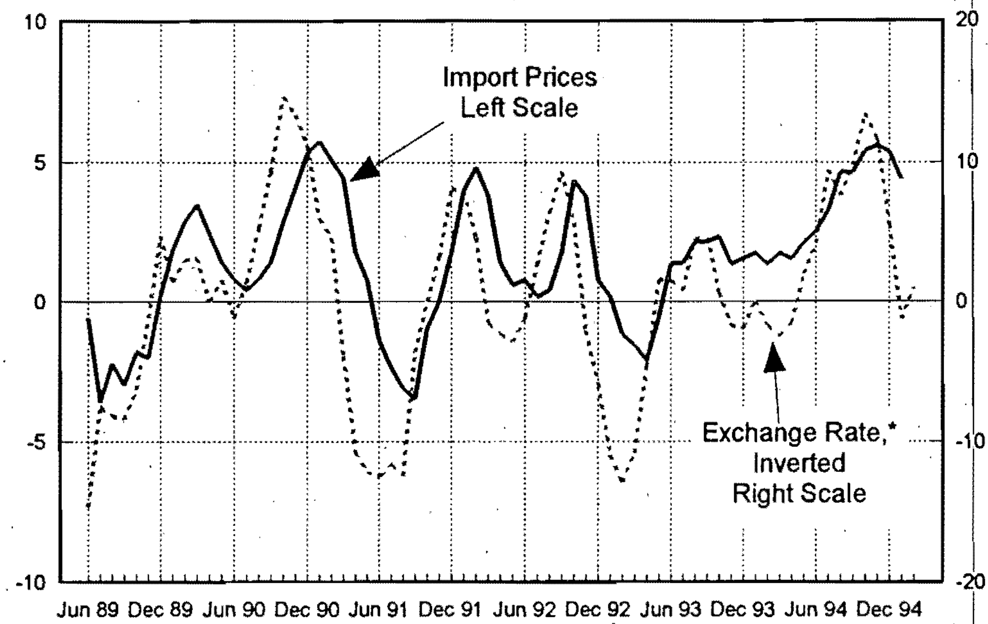
EXCHANGE RATES AND IMPORT PRICES

(JANUARY 1994 = 100)



NONPETROLEUM IMPORT PRICES AND THE EXCHANGE RATE

PERCENT CHANGE OVER SIX-MONTH SPANS, ANNUAL RATE



*Morgan real versus 45 currencies

since January 1994). The Bureau of Labor Statistics index of prices of imports from Japan has increased by about 10 percent since January 1993 (and by 3 percent since January 1994). Pass-through of exchange rate changes has been a little greater for the European Community, at least for the period since January 1994.

Nevertheless, there is clear evidence movements of exchange rates are reflected in import prices. The chart above shows six-month percent changes (at an annual rate) in the BLS index of prices for all nonpetroleum imports and of the Morgan real index. Some lags are apparent in the two series, and the variation in movements of prices is perhaps one-third as large as for the exchange rate.

A rule of thumb long used was that a 10 percent decline in the exchange rate translates into a 1 percent increase in price levels in this country by the end of about three years. That rule of thumb seems outdated, as imports have been increasing over time as a share of total gross domestic purchases. In 1994, imports of nonpetroleum products and services equaled 11-1/4 percent of gross domestic purchases, versus about 7-1/2 percent fifteen years earlier. (Petroleum is denominated in dollars.)

- On that basis, a rule-of-thumb figure of 1-1/2 percent may be more reasonable. An average of model simulations carried out some years back covering the mid-1980's placed the figure at 1.1 percent, rising to about 2 percent by the end of four years.

(The figure for the fourth year may have been biased by one outlier on the upside.) Such estimates make allowance for feed-through effects from higher prices into wage rates and back into price levels. Rule of thumb suggests that price levels are raised by about 1/2 percent by the end of one year.

By that rule of thumb, the decline in the real Morgan exchange rate index of perhaps 7 or 8 percent since January of last year might add 1-1/4 percent to the price level by the end of next year, if the recent decline in the dollar sticks. Of course, some of the sharp declines of past few days could be reversed once markets settle down.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

INFORMATION

ASSISTANT SECRETARY

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY NEWMAN

FROM: Alicia H. Munnell
Assistant Secretary for Economic Policy

SUBJECT: An Update on Impacts of the Falling Dollar on U.S. Inflation

Summary

So far, the decline in the dollar in foreign exchange markets has had little discernable impact on price levels in this country. Unless reversed however, some of the recent slide in the dollar almost certainly will feed through into consumer prices. As a crude rule of thumb, a drop in the value of the dollar in foreign exchange markets of 10 percent will add 1-1/2 percent to our price level over a three-year period. On that basis, the decline since January 1994 of a little over 8 percent in the J.P. Morgan real exchange rate index against 45 other currencies might raise our price level by 1-1/4 to 1-1/2 percent by late 1996.

Discussion

The dollar has been declining steadily since January 1994, with an interruption in the fall of last year. Focus has been on movements of the dollar against the yen and the D.M. Declines have been less steep against currencies of other leading trading partners, and in the case of the Canadian dollar and particularly the Mexican peso, the dollar has appreciated (see table on next page). Most representative of our trading patterns is the J.P. Morgan real exchange rate index which measures the dollar against currencies of other OECD countries plus those of 23 LDC's. That index fell by 6.8 percent from January 1994 to this March (the latest available) and perhaps has fallen another 1-1/2 percent through early April, which would bring the total decline since early 1994 to over 8 percent.

Only part of the drop in the dollar has fed through into prices of imported goods. The Bureau of Labor Statistics' price index for nonpetroleum imported goods rose by 4.3 percent from January 1994 through this February. For imports from Japan, prices rose by 3.6 percent, despite a 13.4 percent appreciation of the yen against the dollar. (There has been a greater impact on export prices, as U.S. producers have taken advantage of the lower dollar to raise prices. Prices of nonagricultural exported goods increased by 5.5 percent from January 1994 through this February.)

Impacts on consumer prices of the moderate acceleration of import prices are not easy to find, as the increase of the nonfood, nonenergy goods component of the CPI of 1.9 percent over the latest twelve months was almost identical to the increase a year earlier. Nevertheless, some impacts of the lower dollar will undoubtedly flow through, especially the steep declines of recent weeks. By crude rule of thumb, the decline of over 8 percent in the Morgan index since early last year could well translate into a higher level of consumer prices by 1-1/4 to 1-1/2 percent by the end of next year.

Movements of the Dollar In Foreign Exchange Markets

	Percent Change, April 3 from: Jan. 1994	Percent Change, April 3 from: Dec. 1994	Import Share 1994 (Percent)
Germany	-21.2	-12.7	4.8
Japan	-22.7	-14.0	18.0
France	-18.6	-11.0	2.5
Italy	1.4	5.5	2.2
United Kingdom	-7.8	-3.7	3.8
Canada	6.2	0.7	19.4
Mexico	117.7	70.2	7.5
Asian Nic's	-4.8	-2.3	10.8
China	-3.4	0.5	5.8

95-143875

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 16, 1995

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY NEWMAN

FROM: Alicia H. Munnell (Initialed)
Assistant Secretary for Economic Policy

SUBJECT: The Dollar: Cumulative Impact of Current Account Deficits

Summary

This memo is in response to your comment this morning linking the dollar's weakness to perceptions of the deficit. The cumulative impact of U.S. current account deficits since the 1980s has led to an enormous expansion in dollar-denominated assets held abroad. Whereas in the past the exchange rate may have been set at whatever matched the import flow to the export flow plus the desired foreign investment flow into the U.S., now the exchange rate may be set by the requirement that it be such that foreigners remain willing to hold their stock of dollar-denominated assets

Discussion

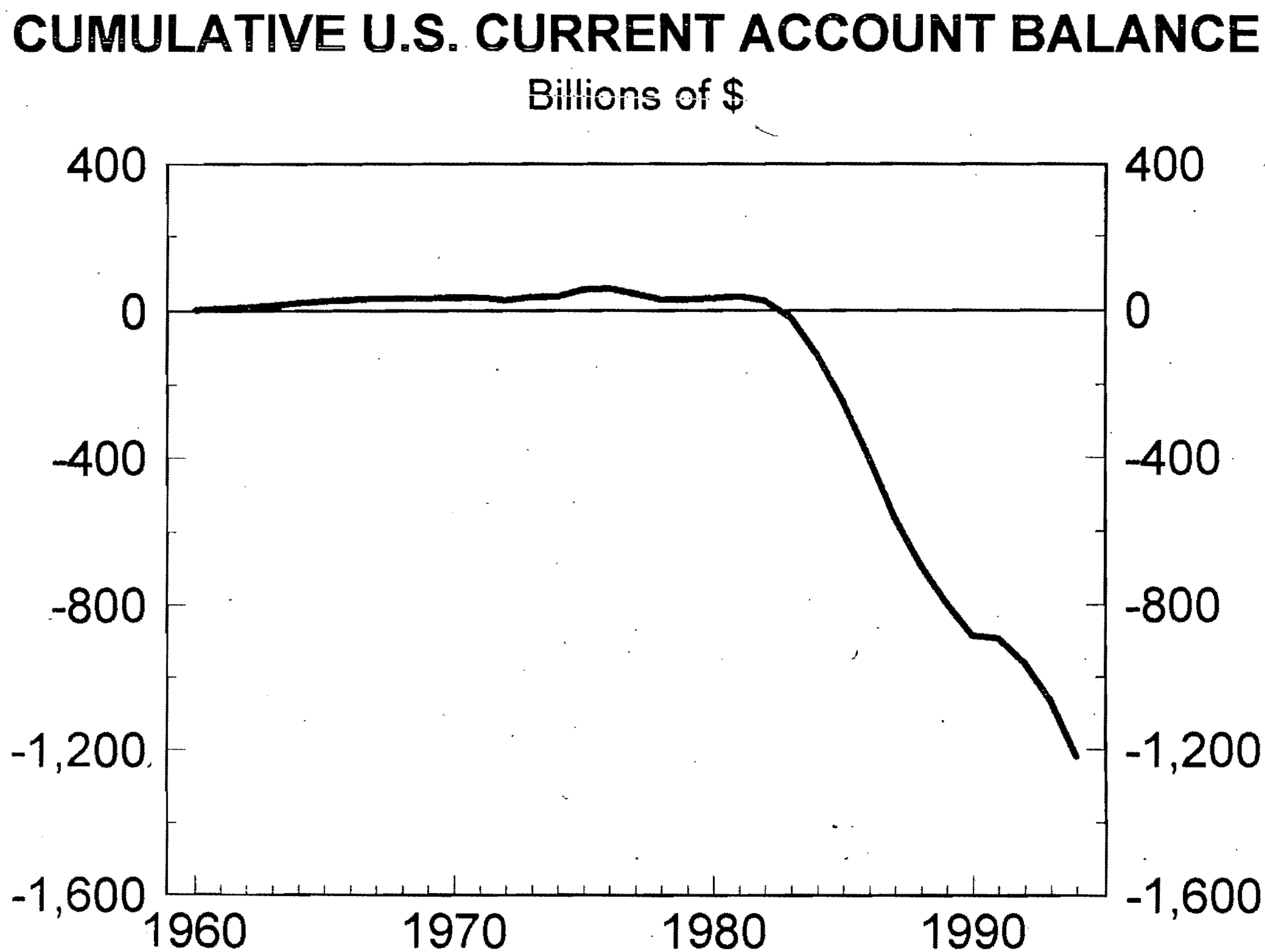
Economists tend to argue that current account deficits are the mirror image of an excess of desired domestic investment over desired saving. This view implies that a rise in the U.S. savings rate from a lower deficit would strengthen the current account, but at the price of depreciating the dollar. Holding desired investment constant, a lower deficit leads the Federal Reserve to lower rates to offset any reduction in demand; lower rates make the U.S. a less attractive place to invest; the dollar falls until the (smaller) excess of investment over saving is equal to the (smaller) current account deficit.

In this framework, deficit reduction strengthens the current account but weakens the dollar. We can see this process working in reverse in the early 1980s: deficit growth was associated with weakening of the current account and strengthening of the dollar.

This framework may no longer apply to the U.S., now the world's largest debtor nation. The attached chart shows that cumulative current account deficits have led to a $1.2 trillion shift in the U.S. net international position in the past twelve years. The exchange rate may now be set at that level that makes foreign investors willing to hold their stock of net dollar-denominated assets, which is $1.2 trillion higher than twelve years ago.

In this case the dollar might well be weakened by anything that diminishes confidence in fiscal discipline and the commitment to low inflation and thus diminishes foreigners' willingness to hold their stock of dollar assets. The I-S = M-X identity will still hold, but because domestic savings and investment would shift to conform to the exchange rate and interest rates dictated by foreigners' demand for dollar-denominated assets, rather than be the factors determining the exchange rate and the current account.

cc: Jeff Shafer


CUMULATIVE U.S. CURRENT ACCOUNT BALANCE
Billions of $
400
0
-400
-800
-1,200
-1,600
1960
1970
1980
1990

TREASURY CLEARANCE SHEET

NO. ______
Date 3/16/95

MEMORANDUM FOR: ☒ SECRETARY ☒ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER ______

FROM: Assistant Secretary Alicia H. Munnell

THROUGH: ______

SUBJECT: The U.S. Dollar: The Cumulative Impact of Current Account Deficits

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
- ☐ Domestic Finance
- ☐ Economic Policy
- ☐ Fiscal
  - ☐ FMS
  - ☐ Public Debt

☐ Under Secretary for International Affairs
- ☐ International Affairs

☐ Enforcement
- ☐ ATF
- ☐ Customs
- ☐ FLETC
- ☐ Secret Service

☐ General Counsel
☐ Inspector General
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC

☐ Policy Management
- ☐ Scheduling

☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
- ☐ E & P
- ☐ Mint
- ☐ Savings Bonds

☐ Other ______

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
John Auten	JA	3/16/95	Economic Policy	2-2070
Brad De Long	BD	3/16/95	DAS for Economic Policy	2=0563
REVIEWERS				

SPECIAL INSTRUCTIONS

☐ Review Officer ______ Date ______ ☐ Executive Secretary ______ Date ______

TREASURY CLEARANCE SHEET

NO. 95-14 3875
Date 3/16/95

MEMORANDUM FOR: ☒ SECRETARY ☒ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER

FROM: Assistant Secretary Alicia H. Munnell

THROUGH:

SUBJECT: The U.S. Dollar: The Cumulative Impact of Current Account Deficits

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
- ☐ Domestic Finance
- ☐ Economic Policy
- ☐ Fiscal
  - ☐ FMS
  - ☐ Public Debt

☐ Under Secretary for International Affairs
- ☐ International Affairs

☐ Enforcement
- ☐ ATF
- ☐ Customs
- ☐ FLETC
- ☐ Secret Service

☐ General Counsel
☐ Inspector General
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC

☐ Policy Management
- ☐ Scheduling

☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
- ☐ E & P
- ☐ Mint
- ☐ Savings Bonds

☐ Other

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
John Auten	ja	3/16/95	Economic Policy	2-2070
Brad De Long	BD	3/16/95	DAS for Economic Policy	2=0563
REVIEWERS				

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

95-146073

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

May 12, 1995

INFORMATION

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY NEWMAN

FROM: Alicia Munnell

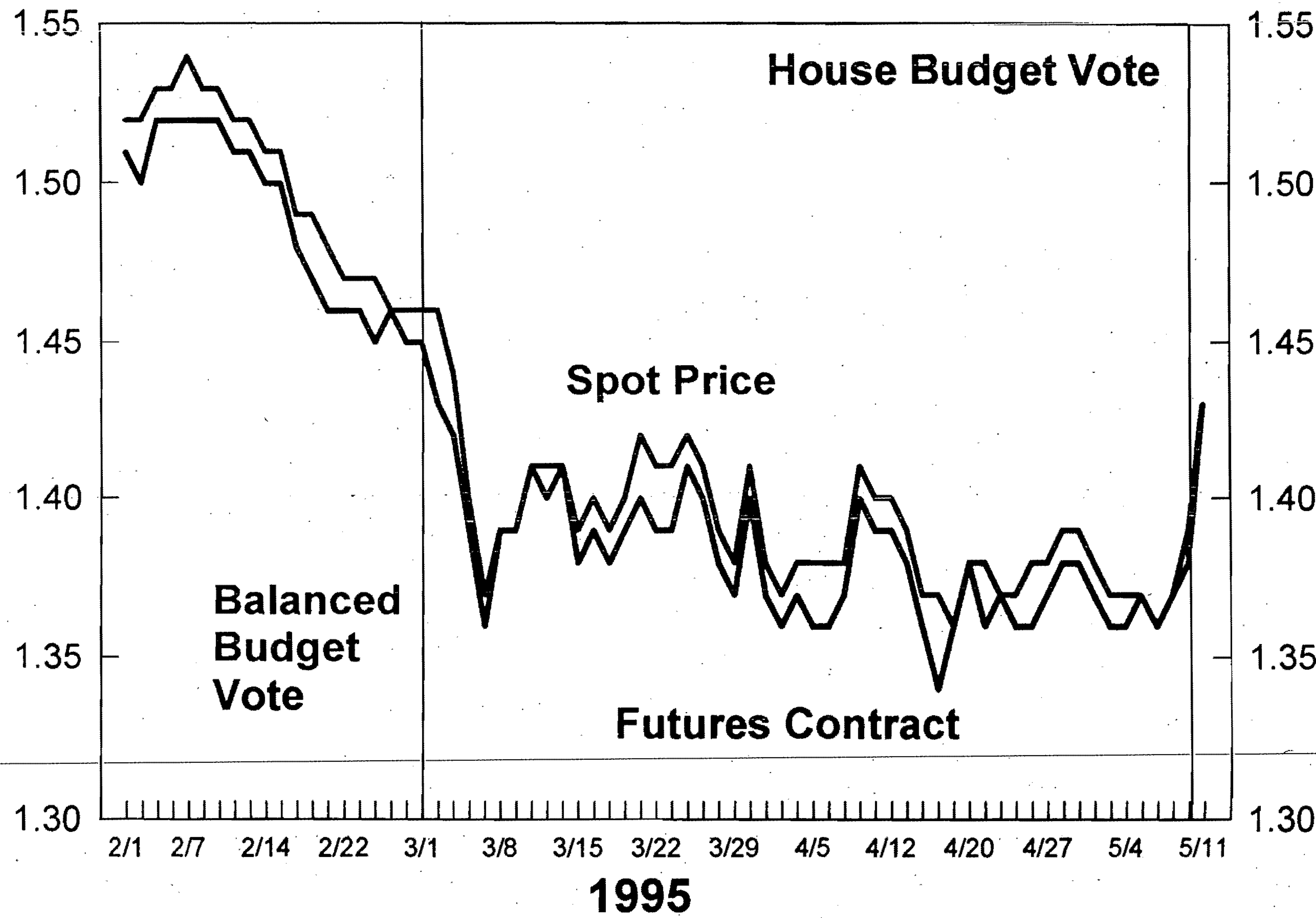
SUBJECT: Budget Deficits and the Dollar

Regardless of what we economists think about the relationship between the budget deficit and the dollar, the attached chart suggests that the exchange market may respond to "news" about how many dollars will be pumped into market over the next 5 or 10 years. The dollar-deutschemark exchange rate appears to have plummeted when the balanced budget amendment failed and to have rallied when the House passed its deficit reduction plan.

Attachments

EXECUTIVE SECRETARIAT

DM/$: SPOT AND FUTURES MARKET



FOREIGN EXCHANGE

Dollar Surges Against Yen and Mark On House Panel's Vote to Curb Deficit

By RENA S. MILLER
Special to THE WALL STREET JOURNAL

NEW YORK—The dollar surged yesterday to its highest levels in more than a month in what may be a turnaround for the battered U.S. currency, boosted by news of action in Congress to curb the U.S. budget deficit.

The dollar posted a 3.2% surge against the mark and a 2.1% gain against the yen. And it continued to draw support from Wednesday's announcement that the U.S. will pursue trade sanctions against Japan in an effort to open up that country's markets for autos and auto parts.

"There were two major factors hurting the dollar – the U.S. budget deficit and the U.S. trade deficit," said John Beerling, chief foreign-exchange dealer at Norwest Bank Corp. in Minneapolis. "And we've made headway against both in the last two days."

Budget Plan Advances

The House Budget Committee approved a balanced budget plan early yesterday that would eliminate the deficit by 2002 as well as finance a major tax cut. The Senate Budget Committee was poised to approve a similar plan last night.

Traders said the dollar began to rise strongly early in the European day, soon after news of the budget committee's decision. That rise forced large funds to buy back dollars they had sold short, in order to cover their positions, thus accelerating the dollar's gains.

The currency surged again around midday in New York, breaking through a key technical level of 1.4200 marks, which in turn triggered further dollar buying.

In late afternoon New York trading, the dollar was at 1.3880 marks, up from 1.3810 marks late Tuesday, and at 83.86 yen, up from 83.45 yen. Sterling was trading at $1.5830, down from $1.5860. About noon Friday in Tokyo, the dollar was trading at 1.4365 marks and at 85.95 yen; sterling was at $1.5575.

"Once the dollar broke through the [technical] stops, short-covering fueled the massive moves up," said David Glowacki, senior foreign-exchange trader for NBD Bank in Detroit.

Heavy buying by investment funds drove the dollar to an intraday high of 1.4375 marks, the dollar's highest since March 3, when it traded as high as 1.4550 marks. The dollar also hit an intraday high of 86.10 yen, its highest level since April 6, when it hit 86.40 yen.

Even though the currency gave up some of those gains by day's end, dealers were optimistic that the dollar's breach of key technical resistance levels at 1.4200 marks and 86 yen may indicate a new, bullish trend.

'Dollar Just Roared'

"I think we're finally seeing belief in a turnaround for the dollar," said Mr. Glowacki. "The dollar just roared."

Mr. Glowacki added that he expected the dollar to trade in a new range between 85.25-86.25 yen and 1.4250-1.4525 marks. He said the sense that the Federal Reserve won't raise interest rates again is helping stock and bond prices, which in turn is encouraging demand for dollars.

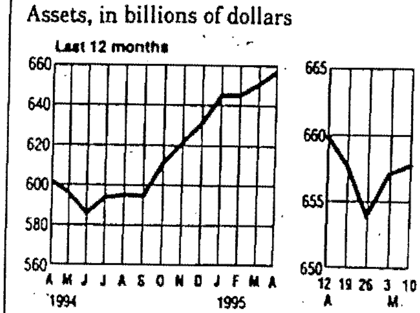
Bond and stock prices have surged recently on signs the U.S. economy is slowing, while inflation remains moderate.

Yesterday, the Labor Department reported that the producer price index (PPI) rose 0.5% in April, a little above market expectations. Excluding the volatile food and energy components, the PPI rose 0.3%, also above expectations.

But the Commerce Department said retail sales fell 0.4% in April, a bigger drop than anticipated and in line with suggestions that the economy is slowing.

Money-Market Funds

Assets, in billions of dollars



Source: Investment Company Institute

TREASURY CLEARANCE SHEET

NO. 95-14-60 73
Date 5/12/95

MEMORANDUM FOR: ☒ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER

FROM: Alicia Munnell
THROUGH:
SUBJECT: Budget Deficits and the Dollar

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
☐ Domestic Finance
☐ Economic Policy
☐ Fiscal
☐ FMS
☐ Public Debt

☐ Under Secretary for International Affairs
☐ International Affairs

☐ Enforcement
☐ ATF
☐ Customs
☐ FLETC
☐ Secret Service
☐ General Counsel
☐ Inspector General
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC

☐ Policy Management
☐ Scheduling
☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
☐ E & P
☐ Mint
☐ Savings Bonds

☐ Other

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
Alicia H. Munnell	AHM	5/12/95	Economic Policy	622-2200
REVIEWERS				

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

95-146466

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

MAY 19 1995

To: Larry Summers
From: Bob Rubin

MEMORANDUM FOR SECRETARY RUBIN

FROM: Lawrence Summers

SUBJECT: The Dollar

I think it would make sense for you to deliver the following message on the dollar the next time there is a convenient opportunity.

> "We welcome the dollar's recent recovery and we continue to believe that further appreciation would be desirable."

Can we discuss?

Trying to talk dollar up?

TREASURY CLEARANCE SHEET

NO.
Date 5/19/95

MEMORANDUM FOR: ☐ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER:

FROM: Under Secretary Summers, International Affairs
THROUGH:
SUBJECT: The Dollar

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
- ☐ Domestic Finance
- ☐ Economic Policy
- ☐ Fiscal
  - ☐ FMS
  - ☐ Public Debt

☐ Under Secretary for Int'l Affairs
- ☐ International Affairs

☐ Enforcement
- ☐ ATF
- ☐ Customs
- ☐ FLETC
- ☐ Secret Service

☐ General Counsel
☐ Inspector General
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC

☐ Policy Management
- ☐ Scheduling

☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
- ☐ E & P
- ☐ Mint
- ☐ Savings Bonds

☐ Other

NAME (Please Type)	INITIAL	DATE	OFFICE/ROOM NO.	TEL. NO.
INITIATOR(S)				
DAS TGeithner	dictated	5/19/95	3221 MT	622-0656
REVIEWERS				
A/S Shafer	JRS		3430MT	622-0060

SPECIAL INSTRUCTIONS

☐ Review Officer Date: ☐ Executive Secretary Date

96-155500

DEPARTMENT OF THE TREASURY
WASHINGTON

INFORMATION

February 20, 1996

MEMORANDUM FOR DEPUTY SECRETARY SUMMERS
UNDER SECRETARY SHAFER

FROM: Timothy F. Geithner

SUBJECT: First Quarter Dollar Performance and Recent Euro-futures Behavior

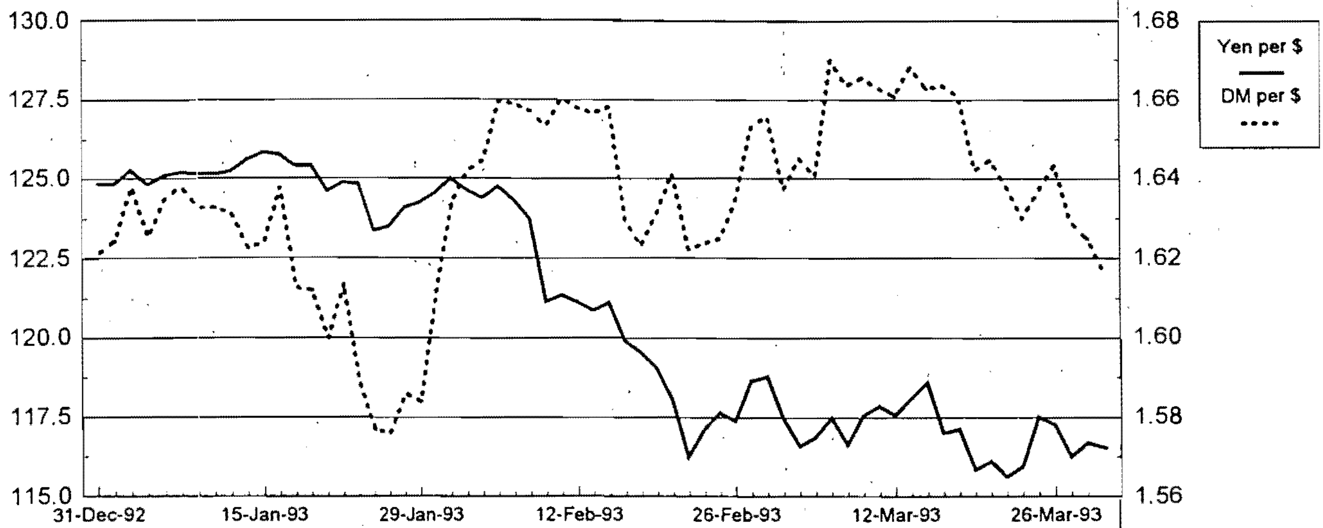
Attached are two of the chart series we discussed last night. I will give you the memo tomorrow.

Attachments

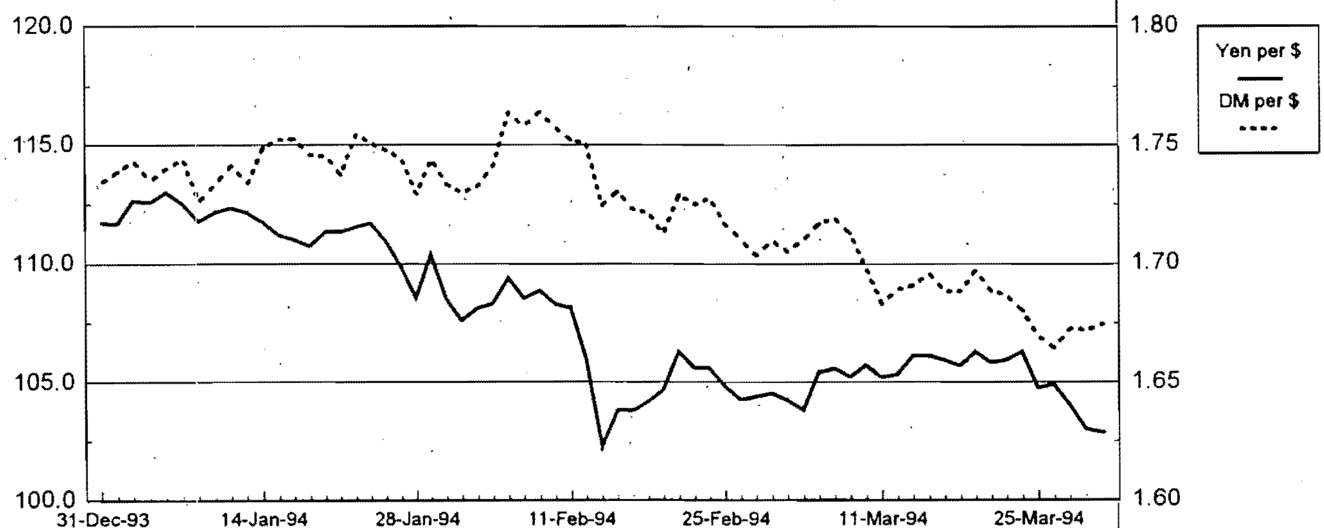
European June move is big. Let [illegible] graphs with Sept, Dec. as well. We should discuss with Japanese.

EXECUTIVE SECRETARIAT

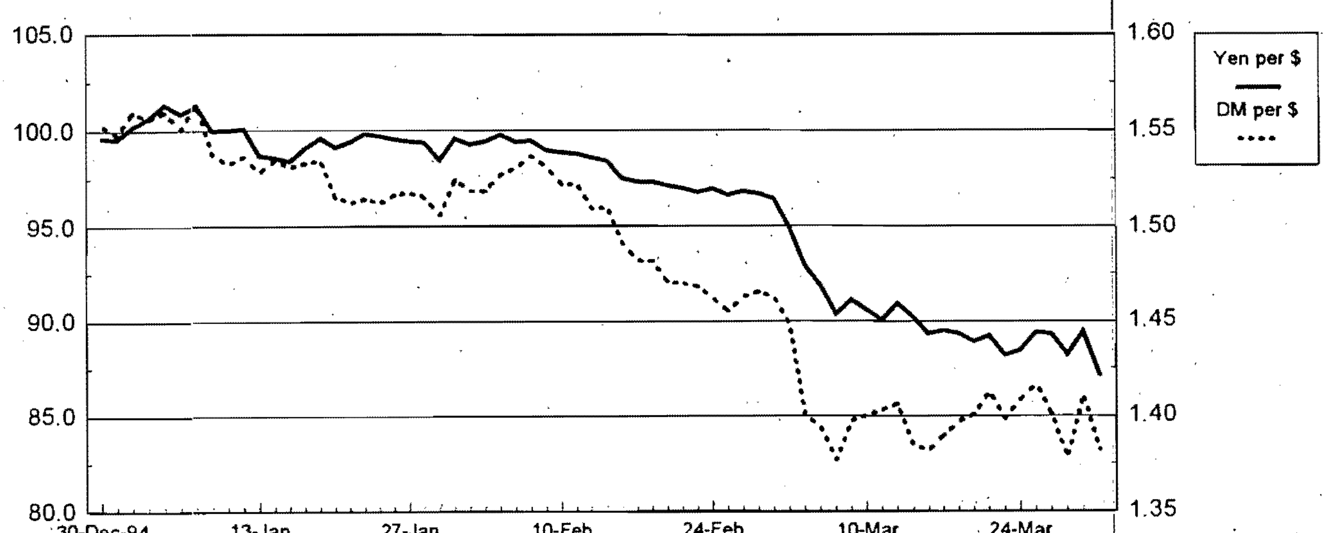
Dollar vs. Yen and Mark - Q1 1993



Dollar vs. Yen and Mark - Q1 1994



Dollar vs. Yen and Mark - Q1 1995



Stephen S. Zannetos
Office of Foreign Exchange
February 20, 1996

Eurodollar Futures

The implied yield of the June Eurodollar futures contract now stands roughly 12 bps. higher than where it was at year-end 1995. **Today's sell-off in the fixed income markets is largely responsible for this situation.**

- Although the implied yield declined in early- to mid-January, there was not much news behind this move, aside from general suspicions that the economy was slowing (remember, economic data was delayed due to the furlough and blizzard). During this period, a continuing resolution was passed and Rubin stated that the Treasury could honor its payments through late February- although the long-term budget talks stalled.

- Late January's decline in yield was due to the release of a spate of weak economic data, which caused the FOMC to ease 25 bps. on January 31. Since that time, implied yields have moved higher as last week's economic reports were not as weak as many had anticipated.

- Today, a reassessment of last week's data, technically-related selling in the cash and futures markets, sizeable hedge fund liquidations and a somewhat upbeat Humphrey-Hawkins testimony by Greenspan caused a meltdown in the U.S. fixed-income markets. Furthermore, the uncertainty over the easing cycle of Germany and the rest of Europe also weighed on market sentiment. That being said, many market participants still expect the FOMC to ease another 25 bps. during June, with a 50% chance of one more 25 bp. move by October.

Euromark Futures

The implied yield of the June Euromark futures contract now stands only 4 bps. lower than where it was at year-end 1995.

- Early in January, the Bundesbank resumed cutting the repo rate after a few fixed-rate operations. At the same time, initial 1995 German GDP came in at only 1.9% and many analysts called for further deceleration in the economy during early 1996. The low yield of 3.10% on the futures contract occurred in the wake of the last repo cut on February 1, (10 bps. to 3.30%) when the Bundesbank announced that the next few operations would be fixed.

- From that point onward, implied yields on Euromark futures contracts have gradually increased, as the Bundesbank has cautioned that January M3 growth may be quite strong.

Furthermore, comments from Bundesbank officials have recently stressed structural reforms (and not necessarily monetary easing) as the key to reviving the German economy. Throughout this entire period, the cash and futures yield curves have continued to point toward a German recovery by the second half of 1996.

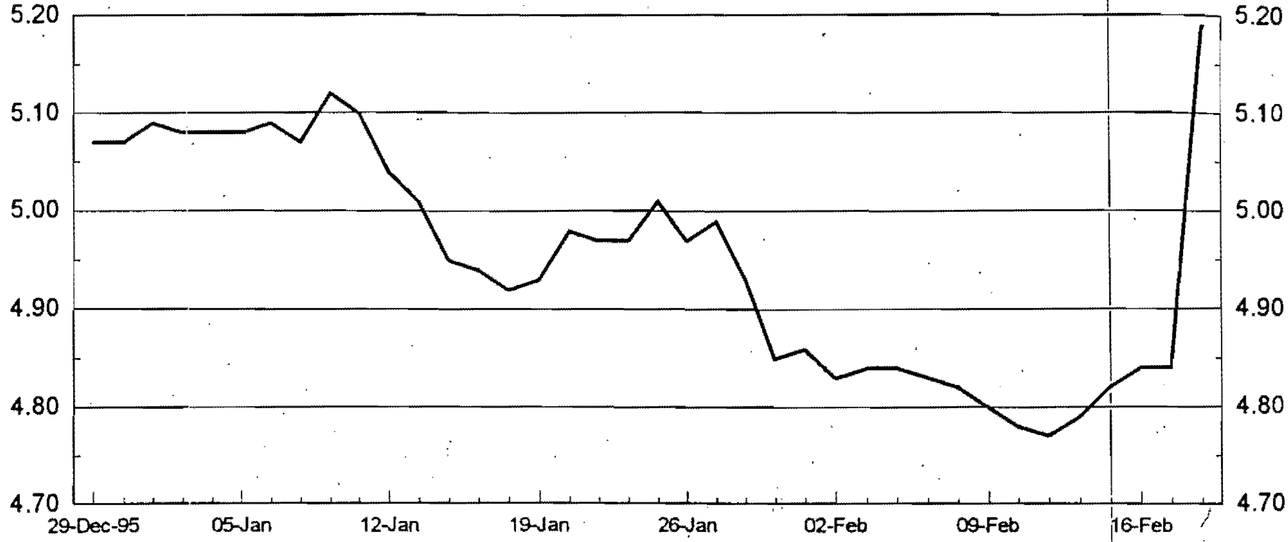
Euroyen Futures

The implied yield of the June Euroyen futures contract now stands 21 bps. higher than where it was at year-end 1995.

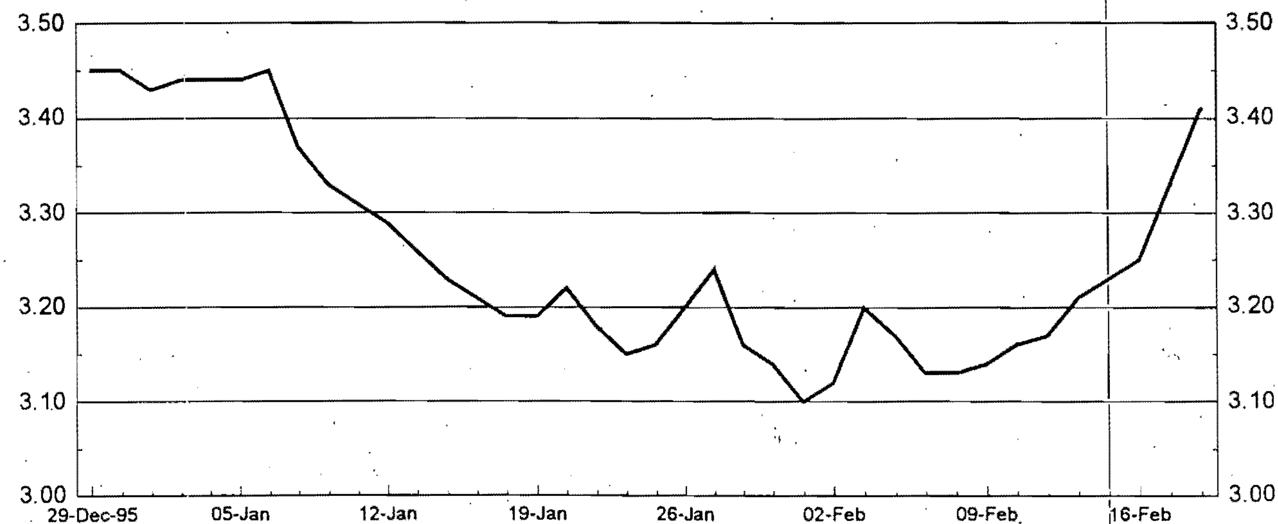
- The jump in yield in early January was largely attributed to the strengthening of the dollar and the surge in the Nikkei, reflecting hopes for a recovery in Japan's export-driven economy. The yields of near-term Euroyen futures contracts generally remained rangebound up until last week. This limited activity occurred despite increasing signs of strength in the Japanese economy (leading indicators, industrial production, etc...). Perhaps short-term traders took their cue from the BOJ, which gave every indication that it would continue to keep call money under the ODR.

- Late last week, comments by Finance Minister Kubo spooked the market, driving implied yields sharply higher. He stated that Japanese monetary authorities should consider the detrimental impact of low interest rates on pensioners' interest income. Many market participants interpreted the minister's comments as hinting that Japanese monetary policy might begin to tighten sooner than anticipated. Currently, the futures market indicates that there is a good chance of a 50 bp. tightening by the end of the summer, with another 25 bp. rate hike probable by year-end.

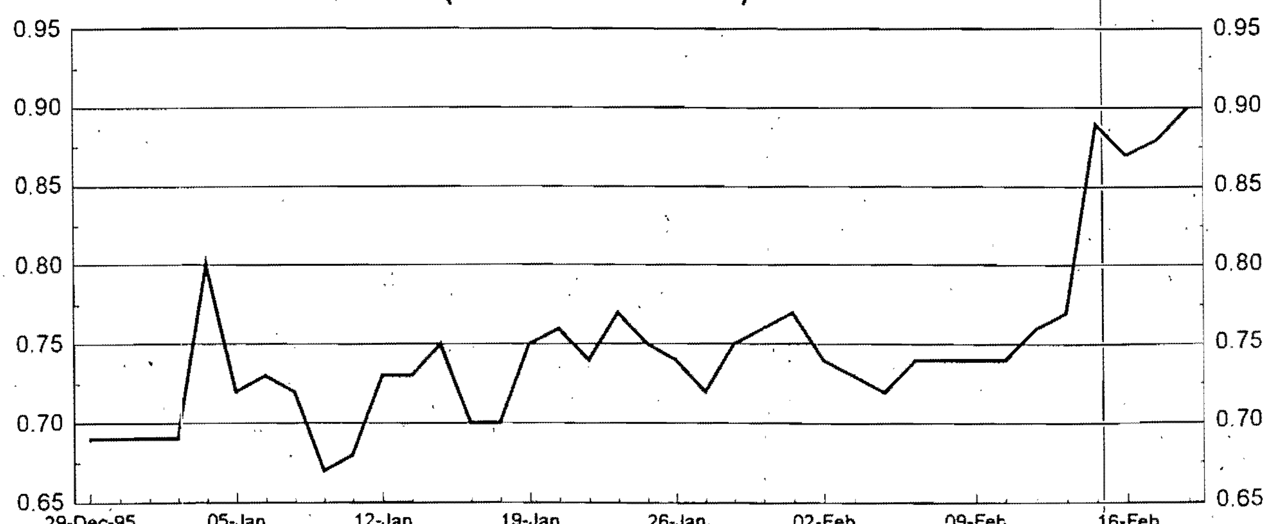
3-Month Eurodollar Future Implied Yield
(June 1996 Contract)



3-Month Euromark Future Implied Yield
(June 1996 Contract)



3-Month Euroyen Future Implied Yield
(June 1996 Contract)



DEPARTMENT OF THE TREASURY
WASHINGTON

September 20, 1996

TO: Secretary Rubin
Deputy Secretary Summers

FROM: Timothy Geithner TFG

SUBJECT: The Dollar

The attached table shows the dollar against where it was at recent G-7 meetings. I was wrong, the dollar is slightly stronger against the yen than it was in April, but about even against the mark. We are still below the recent peaks of DM 1.5488 on May 28 and ¥111.19 on July 8.

This suggests the Europeans might be comfortable with press guidance which states, "We welcomed developments in the exchange markets since our last meeting."

However, I think it is probably better to use a softer reference point, such as, "We welcomed developments in the exchange markets over the recent period."

Attachment

	Oct 95 G-7	Jan 96 G-7	Apr 96 G-7	Lyon	Current
DM/$*	1.4220	1.4798	1.5128	1.5285	1.5150
Yen/$*	100.55	105.35	107.38	108.94	109.92
French Fr/$	4.9955	5.0545	5.1255	5.1785	5.1357
F.Fr/DM	3.5131	3.4158	3.3883	3.3880	3.3900
Trade Wt $	92.8	95.4	96.4	97.2	97.2

* $'s recent intraday peaks were at DM 1.5488 on May 28 and ¥ 111.19 on July 8.

1997-SE-001126

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

January 24, 1997

MEMORANDUM FOR DEPUTY SECRETARY SUMMERS

FROM: Timothy Geithner

SUBJECT: Analytical Pieces on the Dollar

I have attached two of the analytical pieces you requested as background for our dollar discussion:

- First is an assessment of the outlook for current account imbalances in the U.S., Japan, and Europe.

- Second is an initial discussion of the right policy response for Japan and Europe, with Joe Gagnon's input.

I'll cover the rhetorical options separately.

NCC to LS
NCC CC to T3V
1/27/97 mf
SS

please
Log IN

Steven S. Saeger/IMI
January 24, 1997

Current Account Prospects for the G-3

External imbalances in the major industrialized countries are now quite small in relative terms compared to levels recorded during the last 15 years. Despite significant differences in the views of economic forecasters, it is quite likely that these imbalances will rise over the next two years. While moderate growth in the external imbalances of the U.S. and EU are not a source of policy concern, the possible re-emergence of a growing current account surplus in Japan poses serious problems.

- The U.S. current account deficit in 1996 is estimated at $161 billion, approximately 2.1% of GDP. Given the robust performance of the U.S. economy relative to Europe and Japan, as well as the recent real appreciation of the dollar, the deficit is likely to widen modestly over the next two years in dollar terms. Even pessimistic forecasts for the U.S. external imbalance suggest that the deficit is sustainable in the near-term and should not rise above 2.5% of GDP. The medium-term outlook for the U.S. current account should benefit from faster growth in our major trading partners and continued improvement in the federal government's fiscal position.

- EU members ran an aggregated current account surplus of $85 billion in 1996, only 1.0% of total GDP. Predicted increases in the surplus are small relative to GDP and do not appear to represent a major macroeconomic imbalance of concern to the U.S.

- While the Japanese current account surplus fell from $110 billion in 1995 to an estimated $65 billion in 1996, there are strong reasons for concern that the surplus will begin to rise significantly over the next two years. Federal Reserve and Treasury forecasts indicate that the surplus is likely to move back above 2% of GDP by 1998. A failure to establish a domestic-led recovery in Japan on firmer footing thus has the potential to generate another cycle of global macroeconomic imbalances, with serious consequences for the U.S. and the world.

The Optimistic View: Large current account imbalances among the G-3 are unlikely to re-emerge in the near-term.

Despite the major shifts in G-7 exchange rates over the last two years, both the latest Consensus and OECD forecasts predict only minor changes in the current account balances of the U.S. and Japan in 1997 and 1998. The Consensus forecast for Europe predicts a flat current account surplus, while the Federal Reserve predicts a decline in the surplus of the four European members of the G-7.

<u>U.S.</u>: The U.S. current account deficit is forecast to rise from an expected $164 billion in 1996 to $169 billion in 1997, before declining back to $166 billion in 1998. As a share of GDP, the current account balance will therefore not change significantly from its current level of 2%.

<u>Japan</u>: The Consensus and OECD forecasts predict that the Japanese surplus will remain relatively flat in both 1997 and 1998 at between $64 and $70 billion (compared to an estimated surplus of $65 billion in 1996). The projected surplus is approximately 1.5% of GDP.

EU: The Consensus forecast predicts a small increase in the current account surpluses of Western Europe (EU plus Norway and Switzerland), from $95.1 billion in 1996 to $96.3 billion in 1997. This implies that the EU's current account should remain at approximately 1% of total GDP over the next two years. The Federal Reserve forecasts a sharp decline in Italy's current account surplus in 1997, causing the aggregate EU-4 current account surplus to fall from $37 billion in 1996 to $18 billion in 1997 and $11 billion in 1998.

The forecasts for the U.S. and Europe appear to rely on the assumption that cyclical factors will dampen the impact of the exchange rate movements.

- A pick-up in growth in Canada, Mexico, Asia and Europe should at least partially offset the effects of the dollar's real appreciation since April 1995. Robust U.S. exports during October and November of 1996 suggest that the strong dollar has not had a large negative impact on the competitiveness of U.S. exports.

- Despite continued fiscal consolidation, most forecasters are predicting slightly stronger growth in most of Europe. Stronger domestic growth would tend to lead to a deterioration in European current account balances, thus reducing the impact of recent currency depreciation. The real appreciation of both the Italian lira and the UK pound are also likely to be associated with deteriorating current account positions.

- Lower oil prices will also contribute to an improvement in the current account balances of the U.S. and most European countries.

Given the real depreciation of the yen over the last two years and planned fiscal consolidation during 1997, forecasts of a continued fall or even stability in the Japanese current account surplus appear to rest entirely on the existence of changes in the structure of the Japanese economy. Among those structural changes generally cited are the shift of Japanese manufacturing production to other Asian countries, changes in Japanese consumption behavior or distribution channels, and demographic changes that are should eventually reduce the Japanese savings rate.

The Pessimistic View: Japanese and U.S. current account deficits rise back to 2.5% of GDP.

In contrast to the relatively optimistic Consensus and OECD forecasts, Federal Reserve and other model-based forecasts for the U.S. and Japan predict that current account imbalances will widen significantly. The U.S. deficit is forecast to approach 2.5% of GDP in 1998, while the Japanese surplus is forecast to rise to 2.0% of GDP in 1997 and 2.5% in 1998. While the OECD predicts the aggregate EU current account surplus will increase $33 billion to $113 billion in 1997, this still represents a surplus of only 1.3% of GDP.

The forecast deterioration in the U.S. current account can be attributed to several major factors:

- The recent real appreciation of the dollar, which Cline and others argue has contributed to the erosion of the competitive position of U.S. exporters:

- Secular deterioration of the trade balance as a result of the difference between the income elasticities of imports and exports (Houthakker-Magee asymmetry);

- Slowing growth of the surplus in services, as well as a continued deterioration in the balance on investment income resulting from the rising stock of net foreign liabilities.

Forecasters predicting a widening current account surplus for Japan point to both the sharp real depreciation of the yen and the withdrawal of fiscal stimulus as two key factors.

- Based on JP Morgan data, the yen has depreciated 25.8% in real trade-weighted terms since April 1995 and 17.3% compared to its average level in 1994. By contrast, the dollar had appreciated only 0.8% in real terms as of December 1996 compared to its average 1994 level.

- The removal of the income tax rebate, the rise in the consumption tax, and other measures represents a tightening of the fiscal stance of close to 2% of GDP. Japan's expansionary fiscal policy is thought to have contributed to the sharp decline in the current account surplus during the last two years by narrowing the output gap. Fiscal consolidation measures currently planned for 1997 are therefore expected to slow the pace of the Japanese recovery, and will tend to increase the current account surplus.

The OECD forecasts that the aggregate EU surplus will rise from $85 billion in 1996 to $113 billion in 1997 and $126 billion in 1998. This represents an increase from 1.0% of GDP in 1996 to 1.3% in both 1997 and 1998.

- More than two-thirds of the forecast rise in the EU's surplus in 1997 is attributed to the predicted increases in the trade surpluses of France, Germany and Italy. While countries such as France and Germany appear to be relying on export-led growth, this requires faster growth in Eastern Europe and other markets outside the EU to be sustainable.

Assessment of G-3 Current Account Prospects

United States: While the dollar's continued appreciation during the last two months means that there are now j-curve effects in the pipeline, we do not anticipate a substantial deterioration in the current account balance in 1997. In real trade-weighted terms, the dollar is now back in the range it has occupied most of the time since early 1988. The current Treasury forecast is for a rise in the current account deficit from $161 billion in 1996 to $165 billion in 1997 and $170 billion in 1998.

- The strong performance of U.S. exports during the fourth quarter of 1996 suggests that the strengthening of the dollar since 1995 has thus far not had a large adverse impact on export competitiveness. The most recent BLS data indicate that the U.S. continues to enjoy significantly lower unit labor costs than our major competitors, despite the strength of the dollar.

- The real, trade-weighted dollar appreciated by 9.3% between April 1995 and December 1996. This most likely overstates the impact on the U.S. trade balance, however, as the dollar depreciated 5.7% between February and April 1995. Real behavior is unlikely to have fully adjusted to this short period of extreme dollar weakness.

- The recent rise in the U.S. current account deficit is not a source of concern given the current cyclical position of the U.S. relative to our major trading partners. The medium-term outlook for the U.S. external balance looks positive given expectations of increasing external demand, as well as the improving fiscal position of the federal government.

- More moderate growth in the U.S. will tend to dampen rising imports, while stronger growth abroad, if it materializes, should underpin continued export growth. The anticipated decline in oil prices will also tend to reduce the U.S. current account imbalance.

Japan: While some of the stories of structural change in the Japanese economy appear compelling, it is difficult to believe that the sharp fall in the yen's value, in combination with a substantial fiscal contraction, will not lead to an increase in the Japanese surplus. The Treasury forecast predicts a rise in the Japanese CA balance from $65 billion in 1996 to $83 billion in 1997 and $116 billion in 1998. This represents an increase from 1.4% of GDP in 1996 to 1.8% in 1997 and 2.5% in 1998.

There is thus a substantial risk that a widening Japanese current account imbalance will once again trigger a cycle of macroeconomic imbalances with repercussions for the U.S. and the rest of the world.

- Japan's reliance on export-led growth to lead its recovery could potentially lead to a sharp swing in foreign exchange markets if growing current account surpluses cause market participants to reassess the yen's weakness. Alternatively, the nascent Japanese recovery could die out with the withdrawal of fiscal stimulus in 1997, potentially causing the yen to weaken significantly based on a continued divergence in growth prospects relative to the U.S..

Europe: Treasury forecasts for the four major European economies predict a slightly smaller rise in their combined current account surplus than the OECD. We are also somewhat more pessimistic than the OECD about growth prospects in Europe over the next two years, raising the question of whether there will be sufficient domestic demand to generate demand for exports from other European countries. While export sectors appear to be leading the recovery in Germany and France, it is unclear which markets are providing the necessary demand for this to continue.

- The OECD's prediction that Italy's surplus will rise from 3.5% of GDP in 1996 to 4.2% in 1997 is surprising given the lira's appreciation of 13.7% in real trade-weighted terms compared to its average 1994 level. The UK's current account deficit should also deteriorate somewhat in 1997 given the pound's real appreciation of 13.7% over the last year.

- While the increase in the EU current account surplus forecast by the OECD is not insignificant in dollar terms, it does not appear that a 0.3% rise in the surplus as a share of GDP represents a major macroeconomic imbalance with important consequences for the U.S.

L. Dwight
J. Gagnon
R. Harlow
January 24, 1997

Optimal Macroeconomic Policy in Japan and Europe: 1997

Summary

With virtually no prospect that output gaps in Japan and Continental Europe will be eliminated by the end of 1998, and with inflation low nearly everywhere and falling further in some countries, the case for stimulative macroeconomic policy is strong. Due to long-run budgetary concerns, fiscal policy is contractionary in both Japan and Europe, placing most of the burden for recovery on monetary policy.

- In Japan, monetary policy is already very stimulative and there is a strong case for moderating the extremely rapid fiscal contraction by phasing it in gradually.

- With Continental growth generally weak and fiscal retrenchment in train, more expansionary monetary policies are appropriate for most countries. The impact on the U.S., however, would be modest, in part because of the impact of dollar appreciation.

- The United Kingdom has enjoyed a substantial expansion with job growth and needs to guard against inflationary pressures. Monetary policy should probably be tightened.

This note reviews what we think might make sense for Japan and Europe to do. It does not consider the separate issue of what we should say to them in private, nor the impact of any public statements on financial markets. Any public advocacy on these issues should be handled with utmost discretion.

Optimal Policy Theory

The analysis of this memo is based on the following principles, which are reasonably representative of mainstream economic thinking:

Monetary policy should be geared toward a long-run goal of maintaining low inflation. In the short run, monetary policy is the primary discretionary counter cyclical policy lever. By smoothing output fluctuations around potential, monetary policy can avoid large swings in inflation, thereby improving the long-run stability of prices.

Fiscal policy should be geared toward a long-run goal of stabilizing the ratio of public debt to GDP, or even reducing it to offset the negative effect of government taxes and transfers on private saving. The best approach to fiscal consolidation is a long-run plan that is not overly front-loaded or back-loaded. By taking concrete measures initially, credibility is enhanced. By planning future measures in advance and phasing them in gradually, the economy is spared an abrupt shock. Counter cyclical fiscal policy should be limited largely to those measures that can be programmed in advance ("automatic stabilizers") due to the long lags associated with the adoption of discretionary fiscal policies.

JAPAN

Main Points

- With the FY97 budget and FY96 supplemental budget awaiting approval in the Diet, it is too late to walk MOF back on increases in the income and consumption taxes. However, we may be effective in encouraging MOF to implement an additional supplemental budget early in the fiscal year (April).

- A sensible policy mix would be continuation of accommodative monetary policy and fiscal policy that supports domestic demand led growth. In this context, we could reasonably ask Japan's government to go slower on fiscal consolidation (e.g. an additional supplemental budget early in the fiscal year), to indicate publicly a willingness to take measures to support a domestic demand led recovery and consolidate gains in reducing Japan's current account surpluses, and to support financial reform while taking steps to strengthen the banking system.

Economic Outlook

Weak private growth forecasts and stock market declines highlight the downside risks to the economy. Both the Ministry of Finance and our Financial Attache believe that the markets are overly pessimistic about economic growth[1] and there appears to be a gap between the pessimism of the markets and the reality of recent economic indicators.

- In November industrial production rose 4.0% over a year earlier and at an annualized 14.4% in the last three months. Housing starts rose 9.9% over a year earlier, while unemployment fell from 3.5% in June to 3.2% in November 1996.

- Capacity utilization rose to 76.3% in November, slightly above its average of 74.0% in the last six months. Machine tool orders in November were up 12.5% over a year earlier but retail sales fell 0.3%. Real income growth remains strong.

Nonetheless, no major forecasting group predicts that Japan's output gap will be eliminated over the next two years, and most predict that output will grow at less than potential.

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[1]The jump in Japan's 1Q96 GDP and the shift of private consumption from 2Q97 into earlier quarters exaggerates the fall in GDP from CY96 to CY97. On a 4Q/4Q basis, our Finatt forecasts smoother growth of 2.2% in 1996, 2.2% in 1997, and 2.2% in 1998.

The primary source of weakness is the extremely large fiscal contraction implied by the 1997 budget presented to the Diet this month.

- On the tax side, the elimination of the income tax rebate at year-end 1996 is estimated to reduce the general government budget deficit by ¥2 trillion (0.4% of GDP) and slow GDP by ¥1 trillion (0.2% of GDP). Raising the consumption tax from 3 to 5% is expected to raise ¥5 trillion (1.0% of GDP) in revenues but slow growth by 0.6% of GDP.

- On the spending side, the reduction in government investment in the FY97 budget is expected to reduce the government budget deficit by 1.3% of GDP and slow growth by 0.8% of GDP.[2] However, spending in the FY96 supplemental budget now before the Diet contains approximately ¥3 trillion (0.6% of GDP) in "real water" spending.

The net impact of the FY97 budget and FY96 supplemental budget is expected to be a reduction of 2.1% of GDP in the general government fiscal deficit and a 1.0% slow down in GDP growth.

Given fiscal consolidation, the main source of strength is the ongoing effect of the monetary easing in late 1995, with short-term interest rates at 0.5 %, long-term rates at 2.5%, and the exchange rate depreciated to nearly 120 ¥/$. This combination of interest rates and exchange rates should stimulate private investment and net exports.

Neither the MOF nor the Bank of Japan is forecasting a significant increase in Japan's current account balance. They echo the argument of most private-sector forecasters, as well as the IMF and OECD, that structural change will keep Japanese imports up and exports down. However, both the Federal Reserve and our Finatt are forecasting a significant increase in the current account surplus (to about 2% of GDP in 1997 and 2½% of GDP in 1998). Privately, the MOF may be concerned about the implications of excessive yen depreciation for the Japanese current account and for Japanese firms that have invested in production offshore.

Despite the prospects for slow growth and a rising current account surplus, MOF officials continue to focus on Japan's budget deficits and the impact of an aging society on the social security balance.

<u>Political Concerns</u>

Now that the Cabinet has approved a budget plan for FY97 and a supplemental for FY96, the government must focus on the near term in obtaining passage in the Diet. This is normally accomplished by the end of the fiscal year (March 31). Particularly contentious issues (e.g. last

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[2]The multiplier for tax measures is estimated to be ½. The multiplier for expenditure measures is estimated at 1. However, the reduction land purchases included in the FY97 budget will reduce the budget deficit without affecting the economy.

years' debate over jusen bailout funds) can prolong the debate, but it is very difficult to incorporate significant revisions at this stage. Even if the government wants to take more aggressive action regarding the weak economy, a spring supplemental budget is probably the earliest opportunity given the government budget cycle. By that time, fourth quarter 1996 GDP figures will have been released (early March). If these figures are strong, it will reduce pressure on the government to do something about the economy, despite the fact that the full impact of fiscal contraction will not have materialized yet.

Further Action

Officials at the MOF have emphasized Japan's high gross debt levels and the importance of fiscal consolidation rather than the need to support the economy. With Cabinet approval and presentation to the Diet of the FY97 budget and FY96 supplemental budget, there is virtually no chance of a change in policy regarding the income and consumption taxes. However, given the poor market reaction to the FY97 budget and limits to further monetary loosening, MOF may be open to or forced to consider a supplemental budget early in the fiscal year. (Note this supplemental budget would be in addition to the FY96 supplemental budget now in the Diet). Tactically, they will probably want to wait for spring economic indicators (February *Tankan* and March GDP) before deciding on whether to go forward with a spring FY97 supplemental.

In conclusion, we have a major interest in seeing that Japan not return to a period of prolonged economic stagnation, that exchange rates not become misaligned, or that Japan's current account surplus rise above 2% of GDP.

- To reach this objective, the most sensible policy mix is continuation of accommodative monetary policy and fiscal policy that supports domestic demand led growth.

We could reasonably ask Japan's government to

- Go slower on fiscal consolidation. In practical terms, this will require expenditure measures, such as an additional supplemental budget early in FY97.

- Publicly indicate a willingness to take additional fiscal measures as necessary to support a strong domestic demand led recovery.

- Publicly commit to consolidating gains in reducing Japan's current account surplus and avoiding a reemergence of large external imbalances.

- Support financial reform while taking steps to strengthen the banking system.

EUROPE

Main Points

- A further decline in German interest rates would be desirable, both to strengthen German domestic demand and -- more importantly - to allow similar demand strengthening in other European countries from follow-on easing.

- While a general Continental monetary easing would improve growth prospects via the usual effects on investment and consumer spending, France and some others see the benefits more from net export gains from the expected decline in European currencies collectively against the dollar.

- The impact of lower European interest rates and possibly weaker Continental currencies would be small for the U.S., with trade competitiveness losses balanced against export gains from somewhat stronger European growth. Under current U.S. cyclical conditions, any small gains or losses on net exports from this source would be likely to have even smaller effects on U.S. GDP and employment. In a broader, systemic, sense a stronger European upturn would be beneficial; e.g., to transformation in eastern Europe.

For most European countries 1997 will see another year of weak growth, high unemployment and low inflation. In Germany, domestic demand is weak and much of the burden of growth is being borne by export strength. The preliminary estimate for all-German growth in 1996 is 1.4%. We expect weak 4Q results after a strong third, although continuing data problems are a constant threat to reliable interpretation of German developments. The IFO index of business sentiment (for western Germany) was down in both November and December after four consecutive monthly increases following an apparent bottoming out in June.

Continuing fiscal consolidation is not the only factor, but fiscal constraints have made it difficult to respond to the renewed weakness that emerged in many countries after strong 1994 performance. Italy in particular is atoning for past fiscal sins by a 1997 fiscal tightening of 3-4 % of GDP, leading to forecasts of only about 1% growth this year after less than that in 1996.[3] Structural fiscal tightening elsewhere is considerably smaller, averaging about 1% of GDP for the EU as a whole. Nothing on the horizon suggests a rapid acceleration of growth that could move economies close to potential, eliminate slack in labor markets or create inflationary pressures.

Under these circumstances, monetary easing would be the only available tool for growth.

---

[3]Note that much of this improvement is due to the effect of lower interest rates on Italy's large net public debt. Deficit reduction from this channel is likely to have a less contractionary effect on output than increased tax rates or lower public spending.

The United Kingdom is the major exception to the general points noted above. With a longer and stronger recovery, the United Kingdom has achieved significant employment gains and has moved into a region of greater inflation risks. The question is how soon further monetary tightening is needed. Some other European countries -- e.g., Netherlands, Denmark, Norway -- are also growing at a rate that does not suggest any urgency to adopt expansionary policies.

Apart from interest rate cuts in most Continental countries, structural reforms -- particularly in labor markets -- will be needed to make a substantial dent in unemployment and to permit stronger expansion without arriving too soon at capacity limits and the zone of inflation risks.

Political Concerns

The language of the Maastricht treaty and the desire to join EMU are placing a severe constraint on fiscal policy. In most cases, however, EMU provides a plausible reason to undertake the fiscal tightening that would be desirable in any case over the medium term to prevent rising ratios of public debt to GDP and to prepare for the burdens of population aging.

Most of the EMU-elect or EMU-wannabe countries want to ease monetary policy, but are waiting for the Bundesbank to move. High debt countries such as Italy and Belgium would get an additional benefit in the form of less pressure to expand primary budget surpluses, as any target deficit ratio could be achieved via more savings in debt interest and less tightening in the primary budget. The French may be focused more on the potential of lower interest rates to engineer a general decline in European currencies against the dollar.

The Bundesbank would probably argue that enough monetary easing is already in the pipeline and that further reductions in short-term interest rates would be counterproductive because they would raise fears of future inflation and long-term interest rates. Long rates did, however, fall after the last interest rate cuts, even though the greater decline in the shorts steepened the yield curve. And it is hard to take the incipient inflation argument seriously.

A more serious argument against German monetary easing is the view that the combined effects of past interest rate cuts and the DM decline are equivalent to a large cut in interest rates. The attached Fed Monetary Conditions Index charts show a strong decline in the MCI since spring 1995, mainly because of the DM fall. Still, over half of the MCI change is now a year old, and one might expect clearer signs of an upturn if this impact is really powerful.

With regard to structural reform, France and Germany have taken steps in the wrong direction recently with proposals to reduce the number of hours in the workweek and to lower the retirement age. What is needed are measures to reduce the cost of employing people, not raise it.

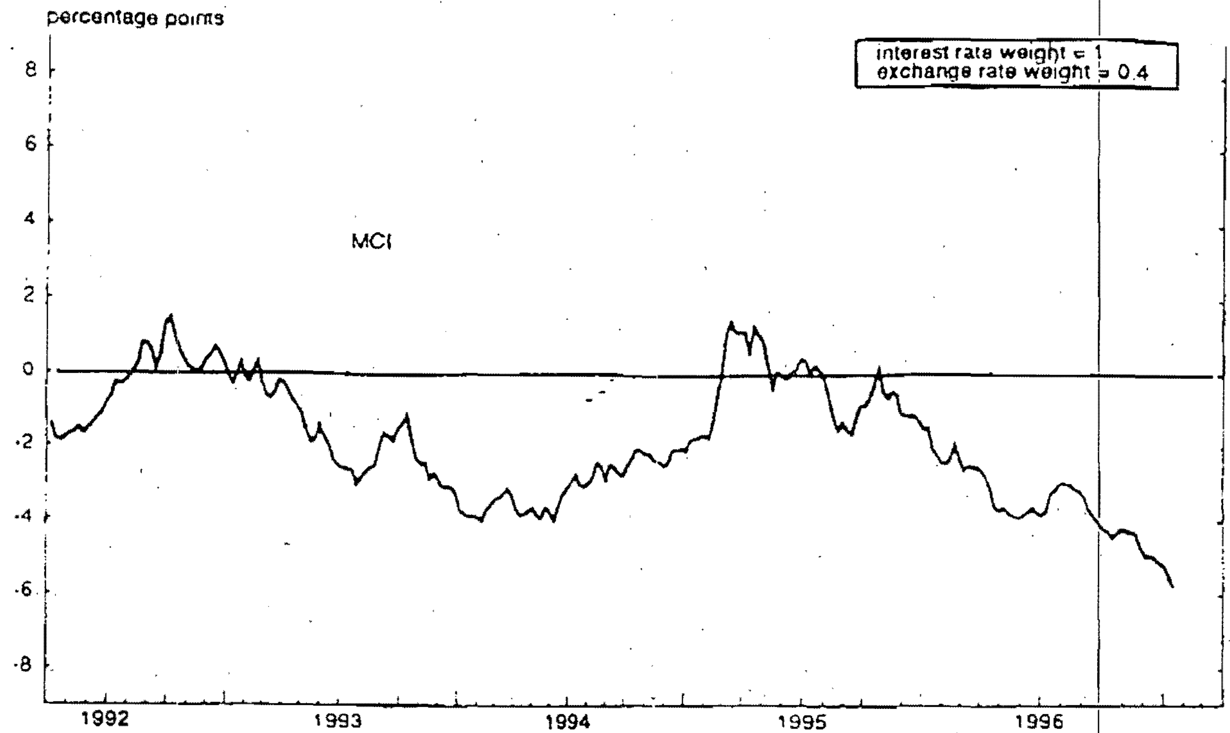
Effects on the United States

U.S. exports would benefit from stronger European domestic demand growth, but any currency depreciation in Europe would work in the opposite direction. The net effect of European monetary expansion on U.S. output would be small. Lower U.S. import prices would help to hold down inflation. Given the current high U.S. output and employment levels, the net effect of tight fiscal and easier monetary policies in Europe could be mildly beneficial.

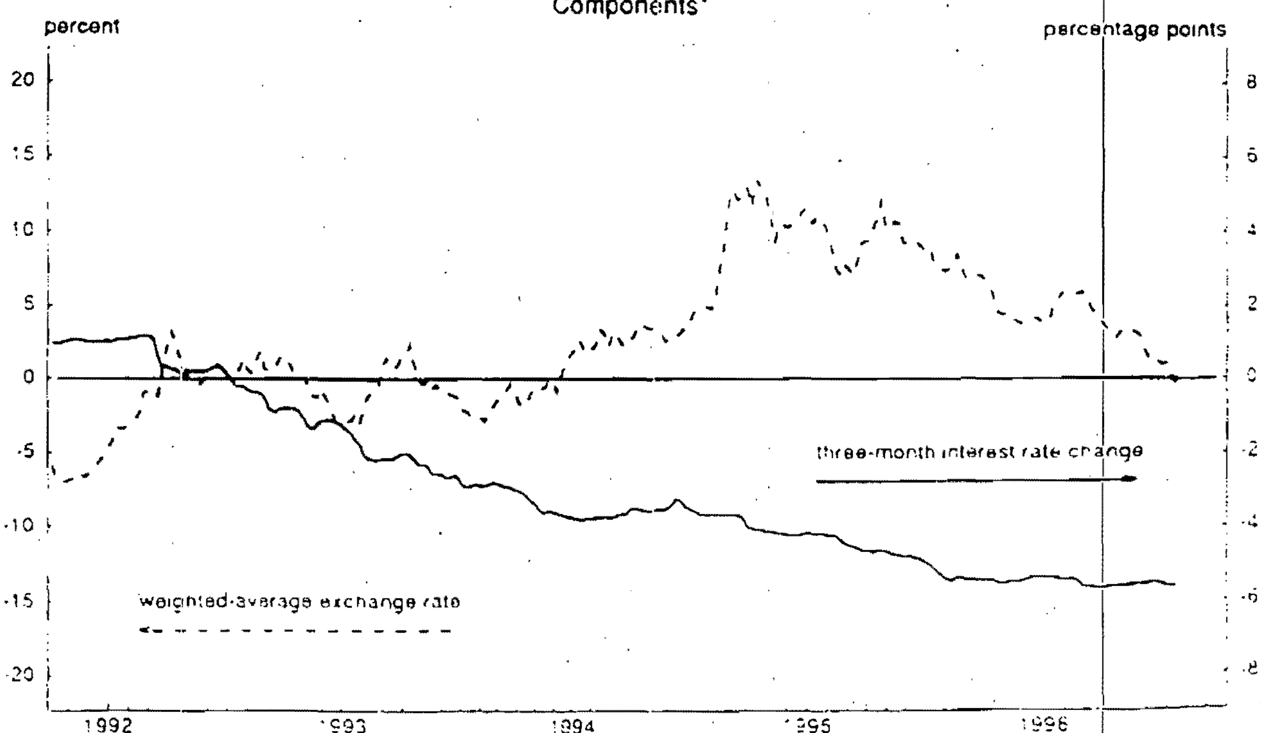
JGagnonIMI#jpneur

JANUARY 21, 1997

Monetary Conditions Index (MCI): Germany



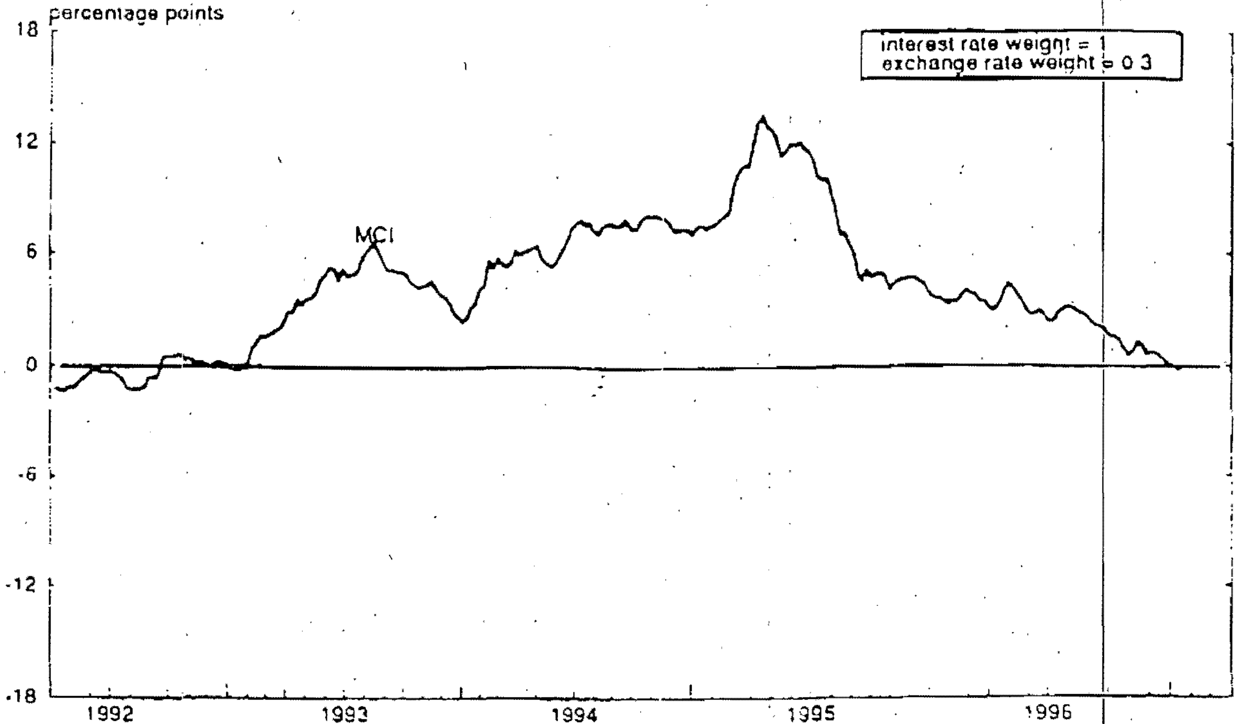
Components*



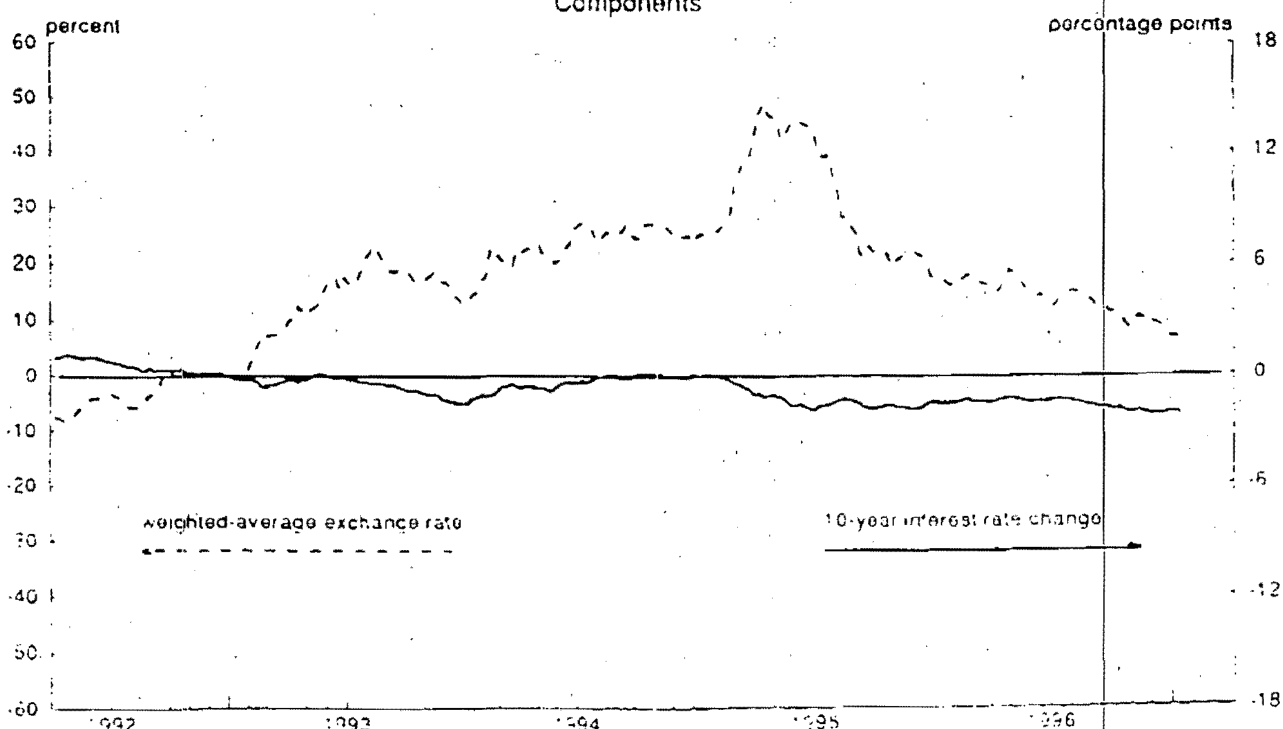
*Interest Rate Component: change in 3-month rate since Jan. 10, 1992
Exchange Rate Component: percentage change since Jan. 10, 1992 in G-[illegible] weighted-average DM using 1993 German export weights (weights: US .2[illegible] JA [illegible] FR .31 UK .21 CA .02, [illegible] .19)

JANUARY 21, 1997

Monetary Conditions Index (MCI): Japan



Components*



*Interest Rate Component: change in 10-year rate since Jan. 10, 1992
Exchange Rate Component: percentage change since Jan. 10, 1992 in G-7 weighted-average yen using 1993 Japanese export weights (weights: US .72, GE .12, FR .04, UK .08, CA .04, IT .07)

COMPARATIVE FORECASTS: TREASURY, IMF, OECD, FED, CONSENSUS

	1996E	1997F					1998F				
		Treas	IMF	OECD	Fed	Cons.	Treas	IMF	OECD	Fed	Cons.
Real GDP Growth											
U.S.	2.3%	2.2%	2.3%	2.2%		2.4%	2.0%	N.A	2.0		2.1%
Japan	3.3	1.8	2.5	1.6	1.9	1.4	2.7		3.7	2.1	2.3
Germany	1.4	2.0	2.5	2.2	2.4	2.2	2.4		2.6	2.2	2.5
France	1.2	2.1	2.4	2.5	1.9	2.1	2.2		2.6	2.2	2.6
Italy	0.8	1.1	1.1	1.2	0.9	1.2	1.4		2.1	1.4	2.1
UK	2.3	3.2	3.3	3.3	3.0	3.4	2.4		3.0	2.6	2.6
Canada	1.3	2.7	3.2	3.3	3.0	3.2	2.2		3.3	3.1	2.9
G-7	2.1	2.1	2.4	2.2	2.2	2.2	2.2		2.5	2.1	2.3
Inflation (CPI % change)											
U.S.	2.9A	2.7	2.8%			2.9%	2.7%	N.A			3.1%
Japan	0.1	1.8	1.3		1.1	1.2	0.8			0.5	0.9
Germany	1.5A	1.7	1.6		1.5W	1.7	1.9			1.6W	2.0
France	1.9	1.8	1.5		1.8	1.6	1.9			1.8	1.9
Italy	3.8A	2.6	2.7		2.6	2.6	3.0			2.8	2.5
UK	2.4	2.5	2.5[1]		2.9	3.2	2.8			2.9[1]	3.5
Canada	1.6	1.8	1.9		1.4	1.7	2.0			1.3	1.9
G-7	2.2	2.3	2.3		2.2	2.3	2.2			2.1	2.5
Current Account ($ billions)											
U.S.	-$161	-$165	-$150	-$161	-$186	-$169	-$170	N.A	-$161	-$207	-$166
Japan	+65	+83	+68	+64	+90	+67	+116		+70	+125	+65
Germany	-20	-10	-16	-5	-20	-13	-1		-1	-20	-11
France	+17	+13	+19	+24	+21	+16	+13		+27	+21	+15
Italy	+42	+45	+52	+53	+24	+44	+45		+57	+17	+44
UK	-2	-6	-8	-3	-6	-9	+6		-7	-7	-13
Canada	1	+4	+1	+2	+1	+4	+6		+3	+0	+4
G-7	-59	-36	-33	-26	-76	-60	+16		-12	-71	-53

[1] Excludes mortgage interest

E = Estimate; A = Actual; F = Forecast; W = western Germany only *1995 PPP Weights*

December forecasts. (January 1997 for Consensus). Treasury, IMF, and Fed forecasts sensitive.

Treasury/IMI:RHarlow
1/24/97
weoall#comp. for

1997-SE-003124

DEPARTMENT OF THE TREASURY
Washington

February 6, 1997

INFORMATION

TO: SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: Timothy Geithner

SUBJECT: The Dollar

Here are a few more thoughts on the dollar for tomorrow.

NCC to RER (faxed)
NCC to LS (faxed)
NCC cc to MF
2/6/97 JJN
SS
Please
Log In

EXECUTIVE SECRETARIAT

We believe in a strong dollar. That will always be our policy. We are pleased that the dollar has been strong for some time now.

Our view is that exchange rates should reflect fundamentals, that over time they will adjust to fundamentals, and that strong fundamental forces are largely responsible for recent developments.

This meeting will provide an important opportunity to discuss the concerns expressed by the Japanese and German authorities about the recent movements in their currencies. As my central bank colleagues have observed on occasion, no country can afford to be indifferent to a sustained fall in its currency.

This is something we will all have to continue to watch closely.

An important part of our discussion on these issues will be efforts by the G-7 to strengthen the fundamentals for achieving sound, balanced, non-inflationary growth and open markets and sustaining external imbalances at low levels.

1997-SE-005031

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

ACTION

MEMORANDUM FOR SECRETARY RUBIN

FROM: **DEPUTY SECRETARY SUMMERS**

SUBJECT: **Note to President Clinton and Vice President Gore**

ACTION FORCING EVENT:

You requested that we prepare a note for President Clinton and Vice President Gore discussing the recent rise in the dollar's value. The attached memorandum discusses the factors underlying current exchange rates and the policy implications of these rates in the context of macroeconomic conditions in the G-7.

RECOMMENDATION:

Send the attached memorandum to President Clinton and Vice President Gore.

Agree ___ Disagree ___ Let's Discuss ___

BACKGROUND:

In recent meetings with the Vice President, U.S. automakers have expressed strong concerns about the recent rise in the dollar's value. Exchange rate issues were also discussed in President Clinton's recent meeting with Prime Minister Hashimoto of Japan. This memo provides background to help the President and Vice President understand Treasury's current stance on exchange rate policy, as well as the factors underlying the dollar's strength.

ATTACHMENTS:

Memorandum for President Clinton and Vice President Gore.

cc: Assistant Secretary Lipton

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

MEMORANDUM FOR PRESIDENT CLINTON
VICE PRESIDENT GORE

FROM: Robert E. Rubin

SUBJECT: The Dollar's Recent Rise

I thought it would be helpful to discuss some of the issues raised by the dollar's appreciation over the last two years, particularly given the concerns expressed by some U.S. manufacturers recently.

Factors Underlying the Rise of the Dollar

The dollar's strength reflects a combination of factors, including a high degree of market confidence in our economic prospects and pessimism concerning the outlook for Japan and much of Europe.

- Our remarkable recent economic performance, combining strong employment and output growth with low levels of inflation, has naturally attracted foreign investors to our financial markets, increasing demand for the dollar.

- Investors remain concerned about the pace of economic recovery in Japan and the weak condition of the financial system. Growth will slow sharply in 1997 as a result of tax increases and expenditure cuts intended to reduce the budget deficit.

- With slow growth, persistently high levels of unemployment and little threat of inflation, monetary policy in Europe is likely to remain accomodative. This has contributed to the dollar's strength against European currencies. In addition, market uncertainty about the future stability of the euro has prompted flows out of the German mark and into the dollar and other currencies as monetary union (EMU) approaches.

- The relative pace of fiscal consolidation currently underway in Japan and much of Europe has also contributed to the strong dollar. While we are attempting to cut our deficit by about 1.5 percent of GDP over five years, Japan and many European countries are proposing to cut their budget deficits by that amount in 1997. These budget cuts tend to weaken currencies through their effect on interest rates and domestic demand.

These factors have been reflected in a widening of interest rate differentials favoring the dollar over the last six months.

The Role of Exchange Rate Intervention

Exchange rate intervention played a significant role in reversing the dollar's fall in early 1995, but has not been a factor over the last year. U.S. monetary authorities have not intervened in foreign exchange markets since August 1995, while there has been no Japanese intervention since the first quarter of 1996.

- With U.S. encouragement, our G-7 counterparts in Europe and Japan ceased talking up the value of the dollar last fall. The G-7 also shifted its public stance in February to indicate that previous exchange rate misalignments had been corrected.

Risks of Overshooting

There does exist a risk that the dollar will overshoot the value justified by fundamentals, particularly given market perceptions of the relative strength of the U.S. economy. Our capacity to prevent or respond to a further appreciation of the dollar is restricted somewhat by the desire to maintain growth-oriented monetary policies in Europe and Japan.

Impact of Recent Exchange Rate Movements

Although the dollar has appreciated significantly from its extraordinarily low levels two years ago, this rise has been relatively modest compared to longer-term trends.

- On a trade-weighted, inflation-adjusted basis, the dollar was only 5.6% stronger in April 1997 than its average value between 1987 and 1996.

More generally, a strong dollar is associated with several positive effects on the United States.

- A strong dollar increases consumer purchasing power and helps to maintain confidence in our financial markets.

- A strong dollar helps to fight inflation and enables the

Federal Reserve to keep interest rates lower than otherwise. Rising interest rates tend to have a much broader negative impact on economic activity than dollar appreciation.

At this point, the dollar's rise does not seem to have imposed a significant burden on the U.S. economy.

- Trade data indicate that our exporters remain competitive on world markets. Exports in February were the highest on record and were 6 percent higher than a year ago. Capital goods exports are 7 percent higher year-to-date compared to 1996.

- The most pessimistic forecasts of our current account deficit are for a deficit of approximately 2.5 percent of GDP in 1998. This is far smaller as a share of the economy than our current account deficit in 1987, which reached 3.5 percent of GDP.

- While the market shares of the Big Three automakers declined during the first quarter of 1997 as a result of stiffer foreign competition, all three still recorded significant increases in profitability compared to the first quarter of last year. U.S. automotive exports in the first two months of 1997 are up nearly 12 percent compared to 1996.

Implications of the Yen's Fall

While the magnitude of recent dollar appreciation is significant, there has been a much larger change in the value of the yen. The yen has depreciated nearly 25 percent in inflation-adjusted, trade-weighted terms between the first half of 1995 and March 1997.

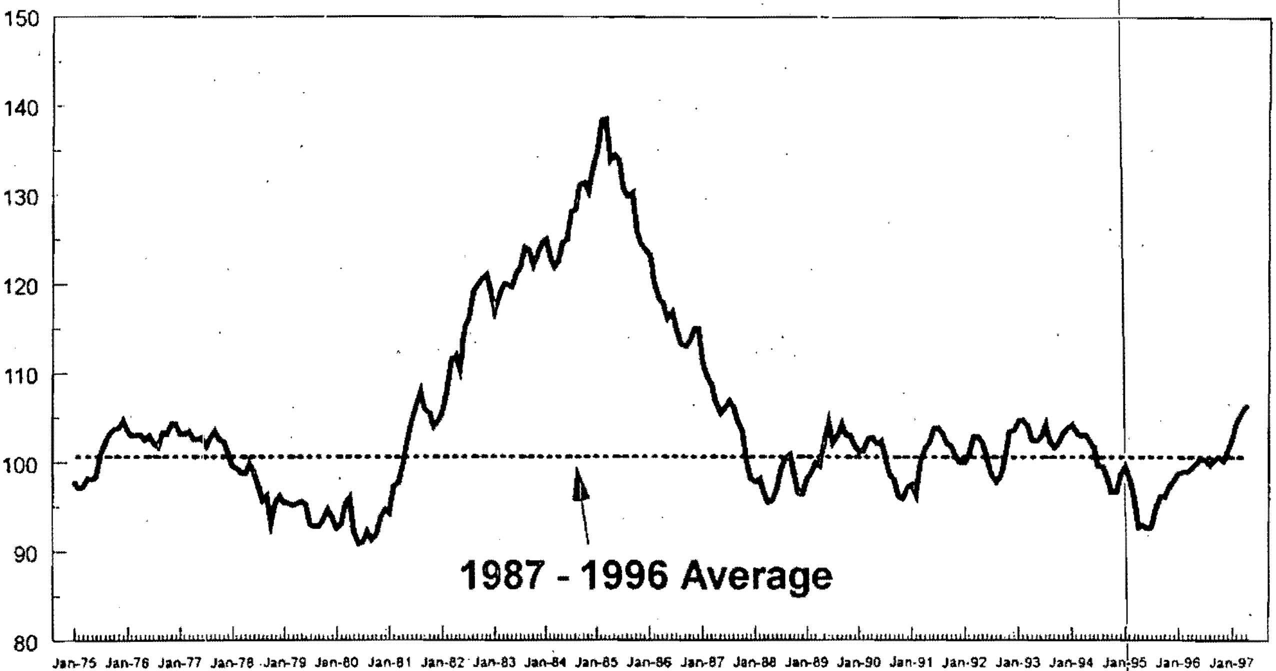
- Treasury and Federal Reserve forecasts indicate that the yen's depreciation, combined with weak domestic demand in Japan, will contribute to a substantial rise in the Japanese external surplus in 1997 and 1998.

This underscores the importance of the message you conveyed to Prime Minister Hashimoto about the need for strong domestic demand-led growth. A further decline in the yen and the resulting increase in Japan's external surplus pose a much greater risk for the United States than the current strength of the dollar.

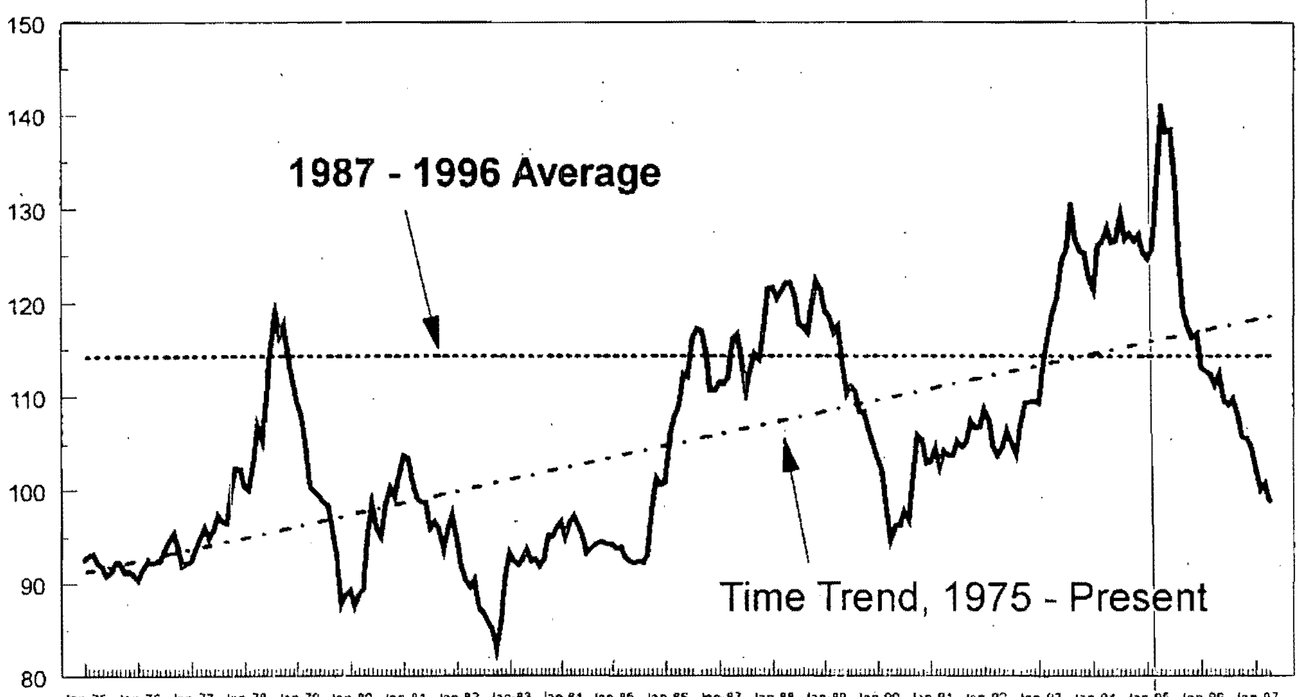
Real Trade Weighted Exchange Rates

Average Monthly Levels, 1975 - Present

U.S. Dollar



Japanese Yen



Source: J.P. Morgan

1998-SE-006271

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

May 21, 1998

ASSISTANT SECRETARY

INFORMATION

MEMORANDUM FOR DEPUTY SECRETARY SUMMERS

FROM: Timothy Geithner, Assistant Secretary for International Affairs TFG

SUBJECT: Your Question on the Real Dollar Depreciation Needed to Reduce the Projected 1999/ 2000 U.S. Current Account Deficit below 2.0% of GDP.

The attached note by Brad Setser estimates that a real depreciation of around 25% in the second half of 1998 would be needed to reduce the projected 2000 current account trade deficit below 2.0% of GDP. A depreciation of this magnitude would substantially increase the 1998 trade and current account deficits due to the J-curve, before generating rapid improvements in the trade and current account balances in the course of both 1999 and 2000. By Q2 2000, the annualized quarterly current account balance would be down around 2.0% of GDP with further improvement continuing through the end of 2000.

ATTACHMENTS: IMI Note on real dollar depreciation needed to reduce the projected 1999/2000 Current Account deficit below 2.0% of GDP.

CC: Lipton, Lundsager

Brad Setser/ IMI
May 20, 1998

Estimated Real Dollar Depreciation Needed to Reduce the Current Account Deficit Below 2.0% of GDP in 2000.

IMI's baseline forecast assumes a relatively small, 0.75% quarterly, depreciation in the dollar's real effective exchange rate between the third quarter of 1998 and the end of 2000 (due to expected inflation differentials with Asian trade partners and some depreciation in the nominal dollar). This small depreciation (The JP Morgan dollar declines from 112 in Q2 1998 to 105 at the end of 2000) is insufficient to halt the deterioration in the trade and current account deficits until 2000, given expected U.S. and world growth rates.[1] Consequently, IMI's baseline forecast predicts a 1999 current account deficit of 3.1% of GDP and a 2000 current account deficit of approximately 3.5% of GDP in 2000.

IMI used its trade model to determine the magnitude of the one time depreciation needed to reduce the current account deficit below 2.0% in 2000. Given the deficit in the investment income and transfers accounts, reducing the current account deficit below 2.0% implies reducing the goods and services trade deficit below 1.3% of GDP. **The IMI model suggests that a one time depreciation of around 25% would be needed in the third quarter of 1998 in order to reduce the projected annual current account deficit in the year 2000 below 2.0%.**[2] A more gradual depreciation of the real dollar of the same amount would lengthen the expected adjustment process but ultimately produce the same result. [See attached chart].

- The immediate impact of a depreciation would be a huge surge in nominal imports (and a small fall in nominal exports), as prices adjust before volumes. A sudden 25% depreciation would be expected to produce a one time increase in the nominal trade deficit of nearly 1.5% of GDP.

- It will take three quarters before such a depreciation reduces the trade deficit below baseline projections. Consequently, such a depreciation would make the 1998 trade and current account deficits substantially worse.

- However, such a depreciation would generate substantial improvements in the trade balance relative to baseline projections in both 1999 and 2000 -- indeed, by the end of 2000, the annualized quarterly current account balance would be well below 2.0% of

[1] IMI's model assumes that U..S real GDP will grow by 3.0% in 1998, 2.0% in 1999 and 2.0% in 2000; IMI's trade weighted world GDP index is projected to grow by 2.1% in 1998, 2.8% in 1999 and 3.5% in 2000. In these projections, GDP growth rates have been left unchanged to better isolate the impact of shifts in exchange rates.

[2] A depreciation of 15% would reduce the estimated year 2000 nominal trade deficit to around 2.1% of GDP, generating a current account deficit of around 2.7-2.8% of GDP).

GDP.

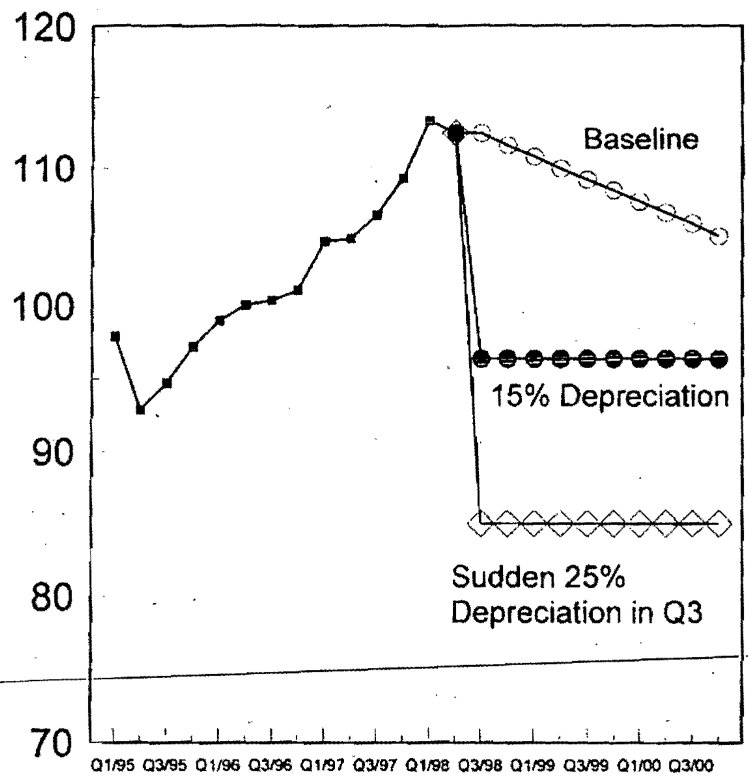
- Such large falls are consistent with the results of numerous studies which have indicated that current levels of the dollar imply growing current account deficits.

A 25% depreciation in the real effective exchange rate is likely to require that the dollar depreciate against the yen and the euro by more than 30%. The dollar is not likely to depreciate by 25% against Canada and Mexico.

Impact of Real Dollar Depreciation on U.S. Trade Balance

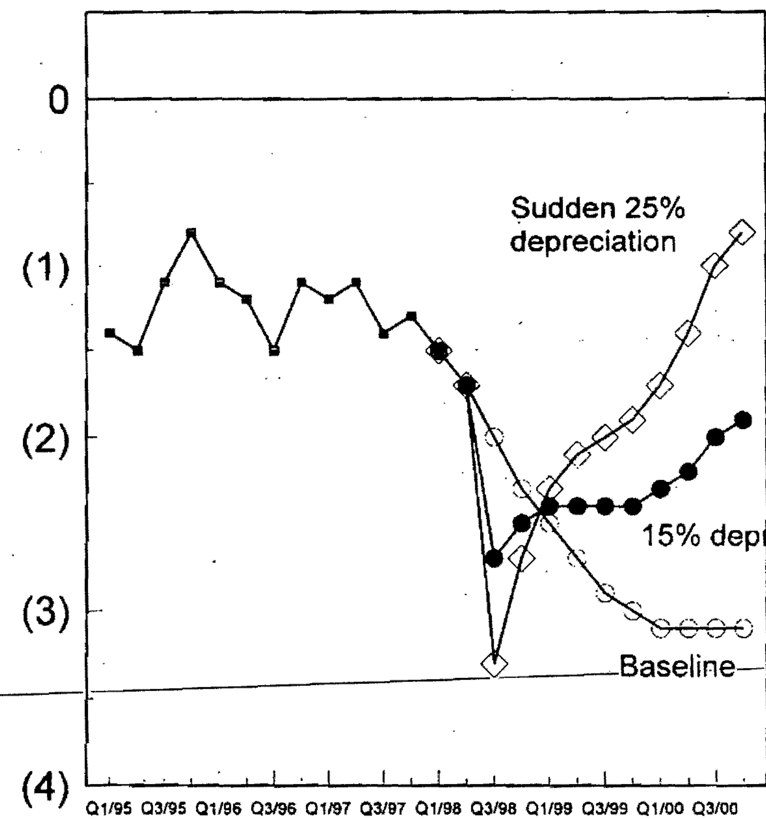
JP Morgan Dollar

Baseline Scenario= 3% annual fall in real terms
v. Sudden 15 and 25% depreciations in Q3 98



U.S. goods and services trade balance (% of GDP)

Baseline v. rapid depreciation in Q3/ 1998
Trade deficit of 1.2/1.3% of GDP = Current account deficit of 2.0% of GDP



The Deputy Secretary of the Treasury

May 12, 1998

TO: Secretary Rubin
OASIA

See comments at --

Table 1: World Current Account Balance:

"This table is indeed troubling. Could OASIA give a plausible exchange rate scenario that would take it to 2% of GDP in 99/2000."

Larry

Attachment

URGENT

Gagnon

Just to ensure that you got this.
CA 5/18

Room 3326 **622-1080**

Table 1: World Current Account Balance

	1996	1997	1998 Forecast	1999 Forecast	Source of Forecast
United States	-148	-161	-235	-275	IMI Estimate
European Union	91	114	118	120	IMI Estimate
Japan	66	94	124	128	IMI Estimate
Other Industrial Countries	11	-5	-10	-5	IMF
Asian NIEs	-1	9	33	44	IMI Estimate
Korea	-24	-8	20	22	
Hong Kong	-2	-3	-1	0	
Taiwan	11	6	5	8	
Singapore	14	14	9	14	
Asian Emerging Markets	-40	-12	30	35	IMI Estimate
Latin America	-39	-65	-70	-70	IMI Estimate
Africa	-10	-8	-10	-10	IMF
Middle East	7	3	-10	0	IMI Estimate
Countries in Transition	-19	-20	-26	-30	IMF
Total	-82	-51	-56	-63	Sum of Above

All forecasts are preliminary and contain a large margin of error

Note: IMI forecasts significantly larger current account surplus in Asian emerging markets than IMF

Note: IMI forecasts larger current account deficit in the Middle East than the IMF due to lower oil prices

Note: IMF forecasts that Latin current account deficit will shrink in 1998, IMI forecasts a small increase

To: Rubin/OASIA

This table is indeed troubling. Could OASIA give a plausible exchange rate scenario that would take it to 2% of GDP in 99/2000.

L.

TREASURY CLEARANCE SHEET

NO.________
Date May 20 1998

MEMORANDUM FOR: ☐ SECRETARY ☐ DEPUTY SECRETARY ☐ EXECUTIVE SECRETARY
☐ ACTION ☐ BRIEFING ☐ INFORMATION ☐ LEGISLATION
☐ PRESS RELEASE ☐ PUBLICATION ☐ REGULATION ☐ SPEECH
☐ TESTIMONY ☐ OTHER

FROM: Timothy Geithner, Assistant Secretary for International Affairs

SUBJECT: Your Question on the Real Dollar Depreciation Needed to Reduce the Current Account Deficit Below 2.0% of GDP in 2000

REVIEW OFFICES (Check when office clears)

☐ Under Secretary for Finance
☐ Domestic Finance
☐ Economic Policy
☐ Fiscal
☐ FMS
☐ Public Debt

☐ Under Secretary (International)
☐ International Affairs

☐ Enforcement
☐ ATF
☐ Customs
☐ FLETC
☐ Secret Service
☐ General Counsel
☐ Inspector General
☐ IRS
☐ Legislative Affairs
☐ Management
☐ OCC

☐ Policy Management
☐ Scheduling
☐ Public Affairs/Liaison
☐ Tax Policy
☐ Treasurer
☐ E & P
☐ Mint
☐ Savings Bonds

☐ Other ________

NAME (Please Type)	INITIAL	DATE	OFFICE/ROOM NO.	TEL. NO.
INITIATOR(S)				
Brad Setser	BWS	5/20	OASIA/IMI Room 5050	622-0145
REVIEWERS				
Joe Gagnon	JG	5/20	OASIA/IMI Room 5050	622-0138
Caroline Atkinson	CA	5/20	OASIA/IM Room 3221	622-0656
David Wilcox	DW	5/21	EP	622-2000

SPECIAL INSTRUCTIONS

☐ Review Officer Date

☐ Executive Secretary Date

DO F 80-02.1 (04/89)