TREAS
HJ
10
.A13P4
v.285

TREAS.
HJ
10
.A13P4
v.285

U.S. DEPT. OF THE TREASURY

PRESS RELEASES

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 12:00 NOON
April 1, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $8,750 million of 364-day Treasury bills to be dated April 14, 1988, and to mature April 13, 1989 (CUSIP No. 912794 RS 5). This issue will result in a paydown for the Treasury of about $1,050 million, as the maturing 52-week bill is outstanding in the amount of $9,790 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Thursday, April 7, 1988.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. This series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing April 14, 1988. In addition to the maturing 52-week bills, there are $13,959 million of maturing bills which were originally issued as 13-week and 26-week bills. The disposition of this latter amount will be announced next week. Federal Reserve Banks currently hold $2,350 million as agents for foreign and international monetary authorities, and $6,097 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rate of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $66 million of the original 52-week issue. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-3.

B-1356

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-204

FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 A.M.
March 31, 1988

STATEMENT OF THE HONORABLE CHARLES O. SETHNESS
ASSISTANT SECRETARY OF THE TREASURY (DOMESTIC FINANCE)
BEFORE THE SENATE COMMITTEE ON SMALL BUSINESS

Mr. Chairman and members of the Committee, I am pleased to be here today to discuss S. 1929, the "Corporation for Small Business Investment Charter Act."

S. 1929 would create a Government-sponsored private Corporation for Small Business Investment, COSBI, that would serve as a secondary market and warehousing facility for loans to and investments in Small Business Investment Companies. The bill would also establish a special small business investment companies (MESBIC) trust. The MESBIC trust and COSBI would operate a special SBIC subsidy program similar to the current Minority Enterprise Small Business Investment Company program.

We strongly oppose S. 1929. As Secretary Baker indicated in his October 1, 1986 letter to your Committee concerning a similar COSBI proposal, we generally are opposed to the creation of a new Government-sponsored enterprise. While S. 1929 has been described as a privatization measure, COSBI would not be a truly private enterprise, and its receipts and outlays would be included in the budget totals for the indefinite future.

The proposed "private" COSBI would assume the current role of the Small Business Administration in financing SBICs, and would do so with strong Federal financial backing as well as other benefits typically afforded to Federal agencies. At the same time, however, COSBI would not be subject to the same level of oversight and control of its spending, borrowing, lending and other activities as are SBA and other Federal agencies. Thus, COSBI may consider itself free to dissipate its resources in the belief that Congress, as in the recent Farm Credit System example, may take supportive action.

B-1357

To finance its activities, COSBI would be authorized to issue voting common stock that SBICs would be required to purchase; non-voting common stock; preferred stock; warrants to Treasury that would be convertible into common stock; senior debt obligations to the public and the Treasury; subordinated obligations to the public; and participations or pooled interests in its assets, including assets guaranteed by SBA. Although the authority to borrow from the Treasury has been described as a backstop for COSBI's financial obligations, the bill contains no restriction on the use of the borrowing authority. Thus, COSBI could borrow from Treasury for any of its authorized purposes, including salaries and administrative expenses.

We are particularly concerned that only the issuance of debt obligations would be subject to the approval of the Secretary of the Treasury. All other forms of COSBI's direct and contingent liabilities, however, would not be subject to Treasury approval. Thus, by simply changing the designation of a financial instrument from "debt" to "participation," the Corporation could escape the Treasury approval requirement, with potentially disruptive consequences for the market for Federal and federally-related securities, and the debt-to-equity limit. We also note that the aggregate amount of debt obligations issued under the bill would be limited to 15 times COSBI's capital, unless a higher ratio is established by the SBA. Even if applied to all direct and contingent liabilities, this debt-equity ratio is extremely high, particularly in light of the approximate 1-out of-3 default experience under the existing SBIC program. This will increase the likelihood of a future congressional rescue. Given the high default experience under the existing SBIC program, we would not expect COSBI to perform as well as Fannie Mae, with its 50-year long track record in the secondary mortgage market, and Sallie Mae, the assets of which are guaranteed by State agencies with Federal backing.

COSBI's initial asset base would be backed by the full faith and credit of the United States. No later than October 1, 1988, the Secretary of the Treasury would be required to sell to COSBI the Federal Financing Bank holdings of SBA-guaranteed SBIC debentures, which would continue to be guaranteed by SBA after sale. The final purchase price of the debentures could not be less than $720 million, irrespective of the value of the FFB holdings on the date of sale. This would result in windfall gains or losses to the FFB and COSBI, depending on market conditions at the time of sale. Moreover, the FFB would receive only about half of the proceeds of the sale in cash. Immediately upon sale, $150 million of the proceeds would be transferred to the MESBIC trust outside of the normal budget/ appropriations process. An additional $200 million would be in the form of COSBI preferred stock. Dividends on preferred stock would be

used to augment the resources of SBA's existing Business Loan and Investment Fund, also outside of the normal budget/appropriations process.

If the proposed sale of FFB holdings of SBIC debentures were to take place, it should be in accordance with the procedures followed in the Administration's loan asset sales program. Under such procedures, SBA would purchase the debentures from the FFB at a market price in accordance with existing contractual agreements with the FFB. The loans would then be sold by SBA to the COSBI without recourse. Thus, the costs associated with the transaction would be reflected on the books of SBA, the program agency, and not on the books of the FFB, the financing intermediary. In this way, proper program cost accountability would be achieved. Such accountability is a primary tenet of the Administration's credit reform proposal.

The above procedures were followed by the Farmers Home Administration in its sale of community development and rural housing loans in 1987. These sales were made on a nonrecourse basis. The Administration is firmly committed to nonrecourse sales of loan assets. Although the Government would receive higher proceeds at the time of sale if the loans were guaranteed, these additional proceeds would be offset in the future as defaults on the guaranteed loans occur, resulting in Federal payments under the guarantee contracts.

The MESBIC trust, which would be under the control of four industry representatives and one presidential appointee, would receive SBA's existing portfolio of MESBIC preferred stock and debentures without compensation to SBA. While the value of this giveaway cannot be determined in advance, the subsidy undoubtedly will be measured in billions of dollars when a final accounting is made following the redemption of all preferred stock and debentures.

The trust would be used to cover losses on MESBIC debentures purchased or guaranteed by COSBI, to buy down interest rates on MESBIC debentures, and to purchase MESBIC preferred securities. Since COSBI's losses on its purchases or guarantees would be covered by the trust, there would be little incentive for COSBI to scrutinize the credit worthiness of MESBIC issuers. Moreover, although the trust corpus would revert to the Treasury at the end of the trust's 50-year life, there is little reason to believe any amounts would be returned to the Treasury because the trust would be controlled by industry representatives.

Under existing budget scoring rules applicable to government-sponsored enterprises, COSBI's receipts and outlays would be included in the Federal budget. Thus, the absence of Administration and Congressional controls over the spending activities of COSBI will only exacerbate the problems of budget control and deficit reduction.

In view of the foregoing, the Department is strongly opposed to S. 1929, and would recommend that the President veto S. 1929 or any similar legislative proposals.

This concludes my prepared statement. I will be glad to answer any questions you may have.

o O o

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
March 4, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,414 **million of 13-week bills and for** $6,409 **million of 26-week bills, both to be issued on** April 7, 1988, **were accepted today.**

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 7, 1988			26-week bills maturing October 6, 1988		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	5.96%a/	6.14%	98.493	6.20%b/	6.49%	96.866
High	5.99%	6.17%	98.486	6.21%	6.50%	96.861
Average	5.98%	6.16%	98.488	6.21%	6.50%	96.861

a/ Excepting 1 tender of $1,840,000.
b/ Excepting 1 tender of $1,450,000.

Tenders at the high discount rate for the 13-week bills were allotted 41%.
Tenders at the high discount rate for the 26-week bills were allotted 76%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

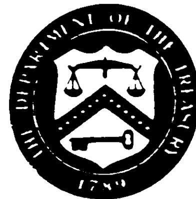
Location	Received	Accepted	Received	Accepted
Boston	$ 30,180	$ 30,180	$ 27,980	$ 27,980
New York	25,108,290	5,677,985	29,223,250	5,570,420
Philadelphia	16,235	16,235	12,520	11,520
Cleveland	35,465	35,465	28,035	28,035
Richmond	35,065	35,065	24,240	24,240
Atlanta	35,510	35,510	20,690	20,690
Chicago	1,209,175	47,855	986,300	53,750
St. Louis	17,565	17,565	11,590	11,590
Minneapolis	12,575	7,575	12,790	7,790
Kansas City	35,385	35,385	40,510	40,510
Dallas	35,955	25,955	41,105	31,105
San Francisco	942,780	73,280	893,275	43,275
Treasury	376,275	376,275	538,320	538,320
TOTALS	$27,890,455	$6,414,330	$31,860,605	$6,409,225
Type				
Competitive	$24,589,940	$3,113,815	$27,483,600	$2,032,220
Noncompetitive	1,004,285	1,004,285	995,100	995,100
Subtotal, Public	$25,594,225	$4,118,100	$28,478,700	$3,027,320
Federal Reserve	2,240,735	2,240,735	2,050,000	2,050,000
Foreign Official Institutions	55,495	55,495	1,331,905	1,331,905
TOTALS	$27,890,455	$6,414,330	$31,860,605	$6,409,225

An additional $32,705 **thousand of 13-week bills and an additional** $663,895 **thousand of 26-week bills will be issued to foreign official institutions for new cash.**

1/ Equivalent coupon-issue yield.

B-1358

TREASURY NEWS



epartment of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED
FOR RELEASE UPON DELIVERY
EXPECTED AT 7:00 P.M., E.D.T.

Remarks by
The Secretary of the Treasury
James A. Baker, III
at the 1988 Annual Meeting of the
Business and Industry Association
of New Hampshire
Center of New Hampshire/Holiday Inn
Manchester, New Hampshire
Monday, April 4, 1988

It is a great pleasure for me to be here this evening.

New Hampshire has a long tradition of citizen involvement with politics. I am sharing a table tonight with a Governor who has been an educator, an engineer, and a small businessman; a House Speaker who owns both a dairy farm and an Agway; a Senate President who has owned both a real estate company and an insurance agency; and a Congressman who is a lawyer. Any government that is representative of so many dimensions of American life is one that surely must serve its citizens well.

I am no newcomer to New Hampshire. In 1980, I spent more time here than in my home state of Texas. And I have been back a number of times since then.

Of course, New Hampshire has not only been on the leading edge of America's presidential campaigns, but also on the leading edge of the longest peacetime economic boom in America since records have been kept. And I suspect that many of the people who provided the inspiration for the great economic revival in America are sitting in this room tonight.

So I am grateful to Bill and my good friend Bonnie Newman for giving me a chance to talk with you about one of my favorite subjects -- the Administration's record of providing an environment for domestic economic growth and a forum for international economic cooperation; or to put it more simply, the facts about where we were in 1980, where we are today, and where we are going in the months and years ahead.

It wasn't so long ago that Americans were told that they were suffering from a great malaise, and that they had every reason to be despondent about the future.

When the Reagan Administration took office in January 1981 we inherited a pretty sorry state of affairs. The prime interest rate stood at 20 percent; we were mired in crippling, double-digit inflation; productivity was in a slump; and -- worst of all -- the American people were discouraged and disheartened. I think the story of our economic recovery -- and I might add, the recovery of our national spirit -- is an inspiring one.

Our progress, like any steady progress, has come in small steps. It is real progress, it is measurable, and while our critics don't like to hear it, it is making the United States more competitive.

As I'm sure all of you know, competitiveness has become a popular buzzword back in Washington. But in fact, since 1981 the overall U.S. economy has become quite competitive -- if by a competitive economy we mean a growing economy that creates jobs without inflation.

Now, we're painfully aware of economic problems in some industries and in some parts of the country, and we're working hard to overcome them. But I think you will agree with me -- and certainly the evidence in New Hampshire shows -- that things are getting better.

Record Growth and Low Inflation: Highlights

Let me give you a few highlights:

America's economic recovery began in 1982 -- 65 months ago. Since then, the U.S. has had one of the fastest growing economies in the industrial world. Growth has averaged 4 percent a year. That's slightly faster than Japan's growth and much faster than Europe's. As I mentioned earlier, this expansion is the longest peacetime period of growth since we began keeping records. And that was before the Civil War!

I'd like to think that the landmark tax cuts for the American people have had something to do with all this. New Hampshire has been a good role model for tax reformers. It is no accident that this state, which has one of the nation's lightest tax burdens, is also one of the fastest competitors in the race for economic growth. Yet, in 1980, who would have thought that low tax regimes were the wave of the future? In 1980, when the top federal rate was 70 percent, who would have thought that it would be reduced to 28 percent before Ronald Reagan left office -- particularly when you consider that one house of our federal legislature was dominated by members of an opposite political persuasion.

A low tax rate was not the only impossible dream in 1980. So was a low inflation rate. When was the last time we've had an economic expansion with a low rate of inflation? I know you all remember inflation -- it was economic enemy Number One! Nobody felt that it could be controlled. The key wasn't to control inflation; it was simply to survive it.

But during this latest expansion, the U.S. inflation rate has averaged less than 4 percent. That has been a truly remarkable achievement.

And this expansion has been accomplished in the face of almost monthly predictions of gloom. The "wheels were coming off," the critics said; the economy was going into the tank.

But the economy didn't go into the tank -- in part because interest rates came down and stayed down. The prime rate has declined nearly a dozen points from the rate we inherited that cold January 20, 1981, when we walked into the West Wing of the White House. And that's been a big help to young couples struggling to buy that first home, or families hoping to refinance a mortgage.

Ladies and gentlemen, the American economy has also become the job-creating envy of the world. Since 1982, America's unemployment rate has fallen by more than five points -- to 5.6 percent. We have created more than 15 million jobs since 1982, more than all of Europe and Japan combined.

At the end of last year, the percentage of the working-age population that was employed was at an all-time high -- 62.3 percent. In fact, that may be your greatest concern. So many Granite Staters are employed in productive jobs that I understand that you are having a difficult time trying to find available workers for all the new jobs you are creating.

I'd also like to correct a bit of economic mythology on this subject of jobs. You may have read reports that suggest that in creating jobs our economy is merely trading steel workers for hamburger flippers.

Well, the facts show otherwise. U.S. manufacturing employment has remained remarkably constant over the past 20 years. Last year, in fact, employment in manufacturing rose by 407,000.

And these 15 million new jobs are for the most part good, productive jobs. Yes, many of these new jobs are in the service sector, but nearly two-thirds of the new employment growth has been in managerial, professional, technical, sales or precision-production occupations. (And anyway I find it more than passing strange to argue that we were somehow better off without those so-called "inferior" jobs in the service sector and the paychecks they generate. I doubt if the holders of these jobs would agree.)

Furthermore, these basic industries are not the "bedraggled dinosaurs," as commentators have alleged in recent years. In fact, manufacturing productivity has been growing at a rate of almost 4 percent a year since we came to office. That's nearly twice as fast as the average of the previous three decades.

Many of our basic industries will get an added boost from a more recent trend. Personal consumption has eased somewhat, and in its place, both investment and export-driven manufacturing industries are picking up steam. Our manufacturing plants have boosted their productivity; the U.S. dollar has declined in the last three years, making our products and services more competitive in foreign markets; and foreign governments have adjusted their economic policies, allowing faster economic growth and greater demand for products from abroad.

American businesses are achieving unquestioned price-competitiveness in many places across the world. Recently, for example, America's production of steel has increased by a third from a year earlier. And we are now even exporting steel to Japan -- the modern-day equivalent of sending "coals to Newcastle."

The outlook for U.S. trade and industry has also been brightened by advances in international coordination. Three recent agreements made by the major industrial countries are paving the way for a better-balanced world economy and hence, additional export-led growth for the United States.

The U.S. has agreed to further curtail its deficit spending; Japan has agreed to pursue economic policies to sustain strong domestic growth; and Germany has taken measures to improve growth, including advancing tax cuts and providing additional investment incentives.

The world is just starting to benefit from these efforts at cooperation. The U.S. is just beginning to benefit from unprecedented trade opportunities. So we could not pick a worse time to resort to protectionism. Yet some in Washington would propose just that.

A House-Senate conference committee is now considering a major Trade Bill. The members of that committee are no doubt mindful of the lessons of the 1930 Smoot-Hawley tariff. They surely know that nothing would more likely close foreign markets than legislation that closes our own markets. Fortunately, the conference committee has taken steps to clear away some of the most flagrant provisions. But there is still a great deal of work to do.

And we are continuing to work with the Congress to craft a responsible trade bill. But the President will veto any bill which is protectionist.

The kind of trade bill we need is one that would increase U.S. competitiveness and open up markets for our exporters. The proposed Free Trade agreement with Canada -- our largest trading partner -- offers opportunities for all regions of our nation.

With your proximity to Canada, you clearly have a stake in the success of this treaty. It would eliminate all tariffs within ten years. It breaks new ground for lowering barriers to trade in the service, investment, and technology sectors. And that last area should come as good news to New Hampshire's growing high technology industry.

We Must Continue Progress on Budget Deficit Reduction

If I were to summarize the economic record of the Reagan years, I could do it in a few words: more economic growth, more jobs, and more productivity; lower inflation, lower interest rates and lower tax rates.

I don't mean to sound like there are no problems out there -- no challenges left. You and I know that's not the whole story. We have some serious challenges left, and two major ones that I'd like to touch on are the U.S. budget and trade deficits.

The future of our economy depends on continued reduction of the budget deficit. In fiscal year 1987, the deficit dropped from $221 billion to $150 billion. That's a significant drop. It's equal to almost 2 percent of the Gross National Product. What's more, after adjusting for inflation, Federal spending actually fell in FY 1987, the first such decline in 14 years. And the Administration and Congress have agreed on an additional $76 billion in deficit reduction for 1988 and 1989. This will take our federal deficit down to 2.6 percent of GNP.

The process is now firmly in place to bring the deficit down to $23 billion in FY 1993. That's just 0.4 percent of the projected GNP, a huge drop from the 1983 budget deficit, which was 6.3 percent of the GNP.

And these deficit reductions will be accomplished without any major new tax proposals.

After the Tax Reform Act of 1986, we want to give individual taxpayers some breathing room, a chance to adapt. We must not let taxpayers be whipsawed by a tax law that is continually changing. Businesses as well as individuals require a stable tax environment in order to make sensible economic decisions. There are no more important ingredients to sustained economic growth than low tax rates coupled with the promise of certainty.

But taxes aren't the source of the budget deficit anyway. The American people, simply put, are not undertaxed -- the government has overspent. I think most of us would agree -- and recent history supports us on this.

Over the last quarter century, since 1964, federal taxes have usually taken up from 18 to 20 percent of GNP. So did federal spending -- until the mid-seventies. Then spending really began to soar relative to taxes.

In the last seven years, for example, average spending has exceeded the average of the previous 15 years by 3.5 percentage points of GNP. Our current budget aims to have spending down to below 20 percent of GNP by 1992 -- the level where taxes have been all along. The focus of deficit reduction must continue to be getting a handle on spending -- not raising taxes.

The second major problem, the trade deficit, is showing definite signs of improvement. In the third quarter of 1986, the merchandise trade deficit in volume terms was at its widest. Since then, the real volume of our merchandise exports rose at an annual rate of 19 percent while imports increased at a rate of only 4 percent. In fact, improvement in the real merchandise trade balance has accounted for fully one-fifth of the growth of real GNP, since the third quarter of 1986. And in nominal terms, over the last several months the trade deficit has also been trending smaller.

Conclusion

Sure, our economy has some problems; but we must recognize how far we have come from the more serious problems of the late 1970s. We must continue to build on our progress in deficit reduction and international coordination. We must keep taxes low, rationalize regulations, and press forward in our efforts to return economic opportunity to the American people -- whose talents are the true wellspring of our national strength.

And speaking of our national strength, I'm reminded of a story our President likes to tell...

It has to do with the fellow who bought some creek-bottom land. It was all covered with rocks and brush. And he cultivated, and he fertilized, and he planted. And he had a garden spot. And one day at church, he asked the preacher if he wouldn't, after church, come on out and see what he'd done.

Well, the Reverend got out there, and he looked at that corn. And he said, "I've never seen such corn. My," he said, "how the Lord has blessed this land. Those melons -- I've never seen anything so big." He said, "God has certainly been good to this place here." And he went on that way, and the farmer was getting a little fidgety. And finally, he says, "Reverend, I wish you could have seen it when the Lord was doing it by Himself."

The point of this story is: God gave us this great land. (And when you travel abroad as much as I do, you really appreciate the blessings of being an American.) But it really is up to us to make America produce, to make it flourish, to make it grow in greatness. In that way, we can pass on our great legacy of freedom and economic opportunity to our children and to their children.

And my friends I am supremely confident that we will do just that!

Thank you very, very much.

TREASURY NEWS

partment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
April 5, 1988

CONTACT: LARRY BATDORF
202/566-2041

CHANGES IN THE DISTRIBUTION OF FEDERAL INDIVIDUAL INCOME TAX PAYMENTS SINCE 1981

Preliminary data from 1986 individual income tax returns reveal that higher-income taxpayers are paying an increasingly larger share of Federal individual income taxes.

Percentiles drawn from Internal Revenue Service Statistics of Income data show that the top one percent of taxpayers paid 26.1 percent of all Federal individual income taxes paid in 1986, a substantial increase from the 21.9 percent share the top one percent paid in 1985.

- The 1986 increase reflects in part the continuation of a long term trend. The share of taxes paid by the top one percent had increased by 21 percent between 1981 and 1985, from 18.1 percent to 21.9 percent.

- The 1986 increase also reflects the extraordinary level of capital gains realized in 1986 in anticipation of the 1987 rate increase on capital gains. The portion of capital gains subject to tax (40 percent from 1981 through 1986) represented nearly 25 percent of the adjusted gross income (AGI) of top income taxpayers in 1986, but only 15 percent in 1985 and 11 percent in 1981. For other taxpayers, taxable capital gains represented less than two percent of AGI in all three years.

The percentage increase in the share of taxes paid by the top one percent of taxpayers closely matches the percentage increase in their share of AGI. Both income and tax shares for the top one percent of taxpayers increased by about 45 percent between 1981 and 1986.

The increasing share of taxes paid by high-income taxpayers is also reflected in data by income category.

- Between 1985 and 1986, taxes paid by taxpayers with AGI of $100,000 or more (about 1.2 percent of all taxpayers) increased by $38.1 billion, from $77.3 billion to $115.4 billion. This one-year increase was larger than the total increase between 1981 and 1985 for this group of $34.1 billion (from $43.2 billion to $77.3 billion).

- Lower- and middle-income taxpayers, those with AGI under $50,000, received a net tax cut between 1981 and 1986 of over $17 billion.

- Data by income category in part reflect the effects of inflation and real productivity pushing taxpayers into higher income categories. The percentile data correct for inflation and productivity, and therefore are more meaningful.

More comprehensive data by income category will appear in the next Statistics of Income Bulletin. The attached table provides additional data by percentiles and income category on the share of Federal individual income taxes paid in 1981, 1985, and 1986.

CHANGES IN THE DISTRIBUTION OF FEDERAL INDIVIDUAL INCOME TAX PAYMENTS, 1981-1986

I. Shares of Tax Payments by Percentiles

Percentile	1981	1985	1986*	Percentage Change in Shares 1981-85	Percentage Change in Shares 1981-86*
Lowest 50%	7.5%	7.2%	6.4%	-4%	-15%
51-95%	57.6	52.9	49.3	-8	-14
95-99%	16.8	18.0	18.2	+7	+8
Top 1%	18.1	21.9	26.1	+21	+44

II. Shares of Tax Payments by Income Category

	1981		1985		1986*	
Adjusted Gross Income	Taxes Paid[1]	Share	Taxes Paid[1]	Share	Taxes Paid[1]	Share
Under $50,000	$189.9	66.8%	$170.6	52.4%	$172.4	45.7%
$50,000-$100,000	51.1	18.0	77.9	23.9	89.1	23.7
Over $100,000	43.2	15.2	77.3	23.7	115.4	30.6

Department of the Treasury
Office of Tax Analysis

* Preliminary.

[1] Dollar amounts in billions.

Source: Internal Revenue Service, Statistics of Income Division.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.
April 5, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $12,800 million, to be issued April 14, 1988. This offering will result in a paydown for the Treasury of about $1,150 million, as the maturing bills are outstanding in the amount of $13,959 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, April 11, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,400 million, representing an additional amount of bills dated January 14, 1988, and to mature July 14, 1988 (CUSIP No. 912794 QE 7), currently outstanding in the amount of $7,102 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,400 million, to be dated April 14, 1988, and to mature October 13, 1988 (CUSIP No. 912794 QQ 0).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing April 14, 1988. In addition to the maturing 13-week and 26-week bills, there are $9,790 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $2,125 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $2,191 million as agents for foreign and international monetary authorities, and $6,247 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

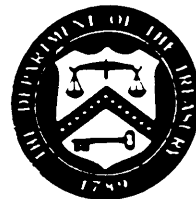
Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

10/87

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.
April 5, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION $6,250 MILLION OF 7-YEAR NOTES

The Department of the Treasury will auction $6,250 million of 7-year notes to refund $2,809 million of 7-year notes maturing April 15, 1988, and to raise about $3,450 million new cash. The public holds $2,809 million of the maturing 7-year notes, including $153 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $6,250 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average price of accepted competitive tenders.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $163 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

oOo

Attachment

B-1362

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 7-YEAR NOTES
TO BE ISSUED APRIL 15, 1988

April 5, 1988

Amount Offered:

To the public	$6,250 million

Description of Security:

Term and type of security	7-year notes
Series and CUSIP designation	F-1995 (CUSIP No. 912827 WB 4)
Maturity date	April 15, 1995
Interest rate	To be determined based on the average of accepted bids
Investment yield	To be determined at auction
Premium or discount	To be determined after auction
Interest payment dates	October 15 and April 15
Minimum denomination available ..	$1,000

Terms of Sale:

Method of sale	Yield auction
Competitive tenders	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor	None

Payment Terms:

Payment by non-institutional investors	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts ...	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions	Acceptable

Key Dates:

Receipt of tenders	Tuesday, April 12, 1988, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):	
a) funds immediately available to the Treasury ..	Friday, April 15, 1988
b) readily-collectible check ..	Wednesday, April 13, 1988

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED
EMBARGOED FOR RELEASE UPON DELIVERY
EXPECTED AT 4:00 P.M., EDT

Remarks by Secretary of the Treasury
James A. Baker, III
before the First Boston Lecture Series
at Fordham University Graduate School of Business
New York, New York
Thursday, April 7, 1988

Introduction

It is my great pleasure and honor to be the inaugural speaker of the First Boston Lecture Series at this outstanding institution of learning.

A perpetual challenge to any business is keeping up with the times. I know the Fordham Graduate School of Business recognizes that necessity -- as you have grown and diversified rapidly since the school was founded in 1969. The fact that you are sitting here in a new campus at Lincoln Center rather than at Rose Hill is eloquent testimony that those organizations that adapt are those that survive and prosper.

Perhaps this spirit of innovation and adventure has roots in the Jesuit missionary tradition. Jesuits have been among the world's first "internationalists." They carried a vision of faith and scholarship to the far corners of the earth. Saint Francis Xavier, you may recall, visited India, the Spice Islands and ultimately established a thriving Jesuit mission in Japan. And, wherever he and his fellow missionaries went, trade and cultural enlightenment were seldom far behind.

International Cooperation and Economic Progress

So I believe I am in the right place to talk about the internationalist perspective. More specifically, I want to discuss how international cooperation can bring economic progress. Like the Jesuit missionaries, we have been able to cross some new frontiers -- and some bright horizons lie ahead.

Let me begin with a story of a simple, ordinary consumer good -- the shirt.

B-1363

The typical shirt may cover more of the globe than Saint Francis Xavier did before it gets to you. Quite possibly, the shirt was designed in New York City, its materials made in Japan using German machine tools and Saudi Arabian petroleum products and cotton from the state of Georgia. It may then be cut and sewn in Taiwan, with cardboard backing coming from Canada and with buttons coming from practically anywhere, before being sent back to the United States for pressing and marketing.

All this requires cooperation between a huge number of perfect strangers from different cultures. Imagine all of the communication, planning, bargaining, agreements, and disagreements that are involved in this process. And it is repeated for millions of shirts a year.

That's how the free market works in today's global economy. I think that most of you will agree with me that capitalism, for all its flaws, is the most effective way of getting things to the consumer and bringing economic growth and other benefits.

All this raises a question to those of us in the political world: why can't governments cooperate as well as businesses?

There certainly seems to be a need for such cooperation. Governments cut a large figure in the world economy. Governments have unique and powerful authority to tax, spend, create money, and regulate. The federal budget alone represents about a fourth of the American economy, and this proportion is much higher in other countries.

But as desirable as cooperation is, we would be fooling ourselves to pretend that governments can work together like clockwork. Some less than charitable observers might even say that nations often conduct economic policy like blind elephants in an aerobics class. Each performs his own exercise without a thought to the others.

But times are changing. This highly integrated world economy is forcing even longtime international rivals to recognize the necessity of economic cooperation. Who in 1980 would have imagined that the communist nation of China would welcome a delegation from Wall Street to discuss the formation of capital markets?

So let me examine two broad areas where economic cooperation has been successful recently -- first, in trade between the industrial nations, and second, Third World debt.

Cooperation On Behalf Of Improved Trade

One key problem in the world economy is fairly obvious -- huge trade imbalances. By imbalances, of course, I mean surpluses and deficits.

For some years now, these imbalances have created political distress -- particularly in Europe and the United States.

Here at home, hundreds of measures to cut off imports have been introduced in the Congress -- covering just about every product you can imagine. You may recall one of the more infamous proposals -- the domestic content proposal earlier in the 1980's. It required that up to 90 percent of an automobile sold in America be made in America -- tires, spark-plugs, engines, interiors, you name it. And it actually passed the House of Representatives -- twice. As business managers, you know very well the bureaucratic nightmares and business disasters that domestic content legislation would create.

We fight these kinds of proposals every year in Washington. They have a certain patriotic ring -- however false -- that a lot of people find appealing. They seem to offer simple, concrete solutions to complex problems. And these proposals are gaining in popularity among some people.

Free traders must respond with more than abstract rhetoric. People are looking for concrete actions. And that is just what we have given them -- a coordination process that will enhance the ability of all countries to profit from world trade.

The seven largest industrial nations in the free world now have a coordination process firmly in place. Interestingly enough, it began with a meeting a few blocks east of here at the Plaza Hotel in September 1985, and it has been developed through several major conferences since then.

These seven nations have identified trade imbalances as a serious threat to the world economy. They have agreed to improve coordination of economic policies. They have agreed to encourage more balanced growth.

Why is balanced growth significant? Well, a root cause of the trade imbalances lies in the fact that since 1982 the U.S. economy grew strongly, while most foreign economies were relatively weaker. Weak economies don't buy many American goods. And while our own growth was certainly a good thing, this growth jacked up our demand for imports. In addition, opportunities for investment in the growing U.S. economy encouraged foreign investors to buy dollar assets -- thereby driving up the price of both our currency and our exports. All this meant a high U.S. trade deficit -- and high political tension on Capitol Hill.

So, as part of the coordination process, Japan and Germany agreed to improve growth in their economies. For its part, the United States promised to reduce its budget deficit -- a longstanding concern in foreign nations as well as here in America.

To make this process more workable, a system of economic indicators was developed -- including such statistics as growth rates, trade balances and inflation. These indicators now serve as guidelines as the countries coordinate policies.

The process, let me add, is voluntary. No nation cedes its authority to anyone else. But the process does make it easier for nations to take steps in the right direction, to close wide variations in growth rates. The process has become an effective political discipline where the leading industrial nations can sit around the table and hash out problems in a far more regular manner than before.

And we have made significant progress.

World growth is becoming more balanced -- improving overseas and remaining strong in the U.S. As promised, Japan and Germany are taking steps to raise their rates of growth and stimulate domestic demand. The United States is meeting its commitment to deficit reduction -- with a $71 billion reduction in the last fiscal year alone.

Another goal of the process was reached as exchange rates were corrected to better reflect the underlying economic fundamentals. Our exports are now cheaper overseas, and in fact, the United States is shifting from a consumer-driven economy to an export-driven economy -- with a minimal degree of dislocation. The very idea was unthinkable three years ago, but it's happening now. The United States is even exporting steel to Japan, which not long ago would have made as much sense as shipping sand to the Sahara.

The net result is that at long last, both trade surpluses and trade deficits are coming down in volume terms. Protectionism -- although by no means dormant -- has subsided from its fever pitch in the fall of 1985. In fact, in the presidential primaries this spring, candidates espousing protectionism lost, and lost big! And we are encouraged that a major trade bill now in Congress -- which I will mention again in a minute -- has been toned down.

Cooperation and Improving the Trade System

So far I've mainly talked of economic fundamentals such as growth rates. We've made progress there and the world trade system is better off for it. But we must also strengthen the trade system itself -- the rules we try to live by. That means modernizing one existing process while also creating a new one.

For the last forty years, an international code of rules has kept the trading lanes remarkably open. Now this code, the General Agreement on Tariffs and Trade -- called GATT for short -- must be expanded to cover the flourishing new trade in services, intellectual property, trade-related investment, and agriculture.

It will take time for the nearly hundred nations in the GATT to act. The final fruits of the current GATT negotiations are perhaps years away. In the meantime, two key nations have a chance to create a procedure that will support the free trade system. The proposed free trade agreement between the United States and Canada -- our largest trading partner -- offers tremendous opportunities for both countries. This agreement would eliminate all tariffs within ten years and liberalize trade in services, investment and technology. The agreement is "pro-trade" and "pro-growth."

Every trade bill should be that -- including the omnibus trade bill now in Congress. Some of the most flagrantly protectionist provisions in this bill have already been cleared away. But there is a great deal more to do and we are working with the Congress to try to craft a responsible trade bill. The bottom line is still the same: the President will veto the final product if it is protectionist.

Cooperation and Growth in the Third World

International cooperation also offers fresh hope for the developing world.

The need for this cooperative action is evident. The United States' growth, trade, investment, and currency have enormous effect on the developing world -- as their activity has on us. Many developing nations are also nurturing democracy and encouraging more tolerant political systems -- and their people need hope.

A major problem is the foreign debt burdens of 15 developing countries -- including Brazil, Mexico and Argentina. These debts are owed to U.S. and foreign commercial banks, other governments, and to organizations such as the International Monetary Fund and the World Bank.

The current strategy that we are pursuing identifies sustained economic growth in the private sector as the only permanent solution to debt problems. It wasn't all that long ago, you'll recall, that government -- not the private sector -- was seen as the creator of economic health in many developing countries. Socialism was widely considered to be the wave of the future.

But as anyone who has read the newspapers in recent years can see, many countries that have experimented with socialism -- whether in the developing or developed world -- have come to realize that market-oriented economies provide the only sure way to economic growth.

And that's what our current strategy focuses on -- market-oriented growth. In a nutshell, it proceeds this way: the debtors make economic reforms to encourage growth. In turn, these reforms are supported by new debt and equity financing -- from the IMF, World Bank, commercial banks, and the return of flight capital. Free-market reforms in return for financing -- that is the key to this cooperation.

Considerable progress has been made under this strategy during the last two years. The debtor nations are increasingly emphasizing market-led growth. They are adopting reforms to improve productivity, use resources more efficiently, and unleash the creative potential of the private sector.

Moreover, the average economic growth rate of the 15 major debtors was 2.5 to 3 percent in 1986 and 1987. That's a big turnaround from a short time ago, when those countries experienced a negative growth of 3 percent in 1983, not long after the debt crisis began. And "capital flight" is being reversed in a number of developing countries. Citizens who once sent their money abroad to places like New York and Zurich are now bringing it back, because they have new confidence in the policies and reforms of their governments.

We believe this cooperative approach is the only viable path to lasting growth and debt reduction in the Third World. There are no magic bullet cures for the debt problem. The problem took a long time to get here and will take a long time to solve.

Conclusion

The cooperative efforts I have described today have brought a good deal of progress -- from reducing trade imbalances to achieving growth in Third World nations. Nations have identified common problems, agreed on solutions, and agreed upon procedures. And they should not relax their efforts.

But governments should not try to do too much. In fact, the free market must do the lion's share of the work. Governments can't produce shirts nearly as well as private managers and workers in the United States, Japan, Taiwan, Saudi Arabia, Canada and elsewhere. Each cooperative effort I've described is designed to strengthen the private sector -- not least by giving it the breathing room it needs to operate. That's why we seek more balanced growth among nations -- to ease protectionist pressures that threaten the private sector.

In the years ahead, I'm sure you will find a greater and greater globalization of the economy. Every day, advances in technology are making it easier and cheaper to move information, goods, money, people, and even factories across national borders. Instant communication and instant capital flows are having a major impact on the way we work and live.

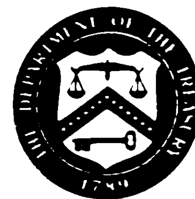
Today a button-maker in Hong Kong can make a deal in a few seconds with a shirt-maker in New York. The shirt-maker in New York can raise money about as easily in London as in New York. The shirt-maker can also get marketing information instantly from a data base on the West Coast -- or from many other places in the world. And if information seems readily available now, consider that telecommunications costs in 20 years are expected to be only 1 percent of what they are today.

As such changes take place, you'll be working more and more with other managers in plants and offices all over the world. And I know you will require government policies that create a proper environment for this world-wide economic system. International cooperation on trade and market-oriented growth policies will be vital to your ability to conduct business efficiently and profitably.

Clearly, a future full of challenge and opportunity lies ahead. I wish you the best of luck in the fascinating world of business, and I should add, good luck on your exams next week!

Thank you very much.

TREASURY NEWS



partment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
April 7, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $8,751 million of 52-week bills to be issued April 14, 1988, and to mature April 13, 1989, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	6.53%	6.97%	93.397
High -	6.59%	7.03%	93.337
Average -	6.57%	7.01%	93.357

Tenders at the high discount rate were allotted 4%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 15,425	$ 15,425
New York	20,674,785	7,348,785
Philadelphia	14,935	14,935
Cleveland	24,325	24,325
Richmond	25,850	25,850
Atlanta	24,280	24,280
Chicago	1,401,105	693,305
St. Louis	12,930	12,930
Minneapolis	19,060	19,060
Kansas City	35,355	35,355
Dallas	23,995	19,195
San Francisco	959,600	309,600
Treasury	207,605	207,605
TOTALS	$23,439,250	$8,750,650
Type		
Competitive	$20,398,500	$5,709,900
Noncompetitive	575,150	575,150
Subtotal, Public	$20,973,650	$6,285,050
Federal Reserve	2,400,000	2,400,000
Foreign Official Institutions	65,600	65,600
TOTALS	$23,439,250	$8,750,650

An additional $294,400 thousand of the bills will be issued to foreign official institutions for new cash.

B-1364

TREASURY NEWS

partment of the Treasury • Washington, D.C. • Telephone 566-2041

For Immediate Release
April 8, 1988

Contact: Charley Powers
566-8773

TREASURY DEPARTMENT ASSESSES PENALTY AGAINST
RAINIER NATIONAL BANK

The Department of the Treasury announced today that Rainier National Bank of Seattle, Washington, has agreed to a settlement that requires it to pay a civil penalty of $95,000. The settlement is based on its failure to report 430 currency transactions as required by the Bank Secrecy Act.

Francis A. Keating, II, Assistant Secretary (Enforcement), who announced the penalty, said the penalty represented a complete settlement of the civil liability of the bank for these violations. Keating said that the bank came forward voluntarily, cooperated with Treasury in developing the scope of its liability, and has instituted remedial compliance measures.

The Department of the Treasury has no evidence that Rainier National Bank engaged in any criminal activities in connection with these reporting violations.

The Bank Secrecy Act requires banks and other designated financial institutions to keep certain records, to file Currency Transaction Reports with Treasury on all cash transactions by or through the financial institution in excess of $10,000, and, under some circumstances, to file reports on the international transportation of currency or other monetary instruments in bearer form or the equivalent. The purpose of the reports and records required under the Bank Secrecy Act is to assist the Government's efforts in criminal, tax and regulatory investigations and proceedings.

B-1365

// TREASURY NEWS

partment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
April 11, 1988

CONTACT: BOB LEVINE
(202) 566-2041

DAVID R. MALPASS
APPOINTED DEPUTY ASSISTANT SECRETARY
FOR DEVELOPING NATIONS

Secretary of the Treasury James A. Baker, III today announced the appointment of David R. Malpass as Deputy Assistant Secretary of the Treasury for Developing Nations. Mr. Malpass will be responsible for economic and financial relations with developing nations, U.S. policies within the international financial institutions, and economic development policies.

Prior to this appointment, Mr. Malpass served, since 1986, as Legislative Manager for International Affairs in Treasury's Office of Legislative Affairs. From 1984-1986, he was the International Economist for the Senate Budget Committee. In both of these positions, he developed and helped implement legislative policy on trade, development assistance, and export financing.

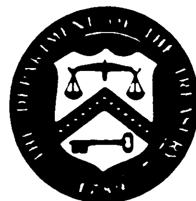
From 1977-1983, Mr. Malpass worked as a financial and systems analyst in Portland, Oregon: for Arthur Anderson & Co.; as Financial Director at Consolidated Supply; and as a private consultant. He was responsible for a broad range of corporate financial and systems activities, including business planning, accounting and systems management, creditor and auditor relations, and acquisitions.

Mr. Malpass holds a bachelor's degree in physics from Colorado College and a masters degree in business administration from the University of Denver. In 1983, he was a Fellow in Georgetown University's School of Foreign Service. He speaks Spanish, French, and Russian, and has studied abroad extensively.

Born and raised in Petoskey, Michigan, Mr. Malpass currently lives in the District of Columbia.

B-1366

TREASURY NEWS



epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
April 11, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,425 million of 13-week bills and for $6,408 million of 26-week bills, both to be issued on April 14, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 14, 1988			:	26-week bills maturing October 13, 1988		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	5.95%	6.12%	98.496	:	6.17%	6.46%	96.881
High	5.98%	6.16%	98.488	:	6.19%	6.48%	96.871
Average	5.98%	6.16%	98.488	:	6.19%	6.48%	96.871

Tenders at the high discount rate for the 13-week bills were allotted 65%.
Tenders at the high discount rate for the 26-week bills were allotted 81%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

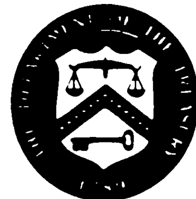
Location	Received	Accepted	:	Received	Accepted
Boston	$ 45,375	$ 45,155	:	$ 36,465	$ 36,465
New York	22,898,470	5,392,010	:	21,064,845	5,135,145
Philadelphia	22,570	22,570	:	21,200	21,200
Cleveland	48,470	45,700	:	40,165	39,215
Richmond	64,755	52,755	:	40,870	40,870
Atlanta	42,280	40,280	:	28,285	28,285
Chicago	1,548,860	88,860	:	1,171,075	237,885
St. Louis	35,285	15,285	:	41,025	21,025
Minneapolis	12,965	11,215	:	14,000	13,050
Kansas City	50,280	50,280	:	39,815	39,815
Dallas	45,895	39,145	:	32,465	26,515
San Francisco	1,436,770	237,270	:	1,147,990	312,840
Treasury	384,825	384,825	:	456,050	456,050
TOTALS	$26,636,800	$6,425,350	:	$24,134,250	$6,408,360
Type					
Competitive	$23,296,335	$3,084,885	:	$19,312,085	$1,586,195
Noncompetitive	1,161,075	1,161,075	:	1,031,525	1,031,525
Subtotal, Public	$24,457,410	$4,245,960	:	$20,343,610	$2,617,720
Federal Reserve	2,052,330	2,052,330	:	1,800,000	1,800,000
Foreign Official Institutions	127,060	127,060	:	1,990,640	1,990,640
TOTALS	$26,636,800	$6,425,350	:	$24,134,250	$6,408,360

An additional $440 thousand of 13-week bills and an additional $155,660 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1367

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
Expected at 10:00 D.S.T.
April 12, 1988

STATEMENT BY
DAVID MALPASS
DEPUTY ASSISTANT SECRETARY
FOR DEVELOPING NATIONS
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON FOREIGN OPERATIONS
COMMITTEE ON APPROPRIATIONS
UNITED STATES SENATE

APRIL 12, 1988

Mr. Chairman and Members of the Committee, I welcome the opportunity to appear before you today to discuss our MDB appropriations request and, in particular, the regional multilateral development banks (MDBs). To provide some perspective for that discussion it would be useful to review briefly U.S. participation in and policy toward the MDBs generally.

U.S. Participation in the MDBs

The United States played an important role in establishing each of the MDBs, with the exception of the African Development Bank which was entirely regional in its origin. The United States proposed at Bretton Woods the creation of the International Bank for Reconstruction and Development (IBRD) to facilitate the provision of private capital for the immediate post war reconstruction of Europe and to encourage rational economic development in the rest of the world.

The creation of the Inter-American Development Bank (IDB) and the Asian Development Bank (ADB) similarly depended in each case on a U.S. decision to participate in these institutions. Other countries were unwilling to act alone; significant U.S. participation was viewed as essential. Even in the case of the African Development Bank (AFDB), the subsequent expansion of its membership to include the United States and other non-regional countries was viewed as critical for its continued viability.

In 1982 this Administration conducted an assessment of United States participation in the MDBs. That assessment concluded that while continued U.S. participation in the MDBs was in our national interest, the operations of the MDBs needed

to be more effective and efficient. Specifically, the MDBs in our opinion had to commit themselves to promoting policy reform and to substantially improving the quality of their lending in order to better foster sustainable economic growth. More hard-headed economic and financial scrutiny of MDB loans was required.

A key element of this framework is the generation of country strategies that lay out in detail what a country's development goals should be and how they can be achieved. These strategies are then to be used to guide the Bank in selecting projects it will support. In this context, it is expected that greater effort will be given to ensuring that projects are more market-oriented, with greater attention to allowing the private sector to prosper and generate growth.

The United States and other members have a variety of opportunities to affect MDB operations and policies. The most visible vehicle and certainly the one which provides for the broadest scope is the negotiation of an MDB replenishment or capital increase. However, Board votes and comments on individual loans are equally important because they demonstrate the commitment of the United States to the policies we fight for in these negotiations.

Loan Review Process

The United States carefully reviews each MDB loan proposal, roughly 500 per year, for its economic, financial and environmental viability. The general purpose of our review is to develop a U.S. position on individual loans for use by the U.S. Executive Director which will encourage the MDBs to develop good, profitable, environmentally sound loans. The review is also used to meet certain legislative requirements and to create a feedback mechanism to our policy directions within each Bank.

U.S. votes and commentary on loans have been an effective vehicle for influencing the directions of MDB lending programs as well as their specific lending policies. In the early 1980's, we were successful in limiting the World Bank's efforts to fund oil and gas projects for which alternative sources of financing are often available. We also dissuaded the Bank from setting up a separate organizational unit devoted to such lending.

Another extremely important loan policy direction, developed in coordination with the Congress, has been the recognition that there is a strong connection between the environmental soundness of a project and its economic viability. I would note that, as in the energy sector example, this policy direction will take time and tenacity to implement. The result we are striving

toward is multilateral institutions working as a positive force in the environment by focusing in-country political and economic leaders on the importance of environmental aspects of their projects.

The United States has been successful in strengthening some regional MDB policies. The IDB, for example, is moving to establish standards regarding tariff rates for electricity, water supply, and telecommunications. In the ADB, policies concerning domestic resource mobilization -- for example, cost recovery in irrigation projects -- have received much more attention. We have stressed to all of the MDBs the need to focus on these areas.

The United States has also been successful in altering individual projects. Currently, for example, the African Development Bank is redesigning a rural development project for Benin that we objected to last month because of local institutional constraints. We have also been able to alter projects in the Fund for Special Operations, the concessional fund of the IDB, where the United States as the Fund's major contributor has a veto. There the United States can require that loans be withdrawn and the project improved. This control has been exercised 19 times in the past three years as we have insisted that the terms of the loans adhere to the Bank's own lending policies on such things as cost recovery, the environment, and interest rates for on-lending.

We will continue through the loan review process and Board comments to promote improved loan quality in the MDBs. I would now like to briefly review some of the main issues in each of the regional MDBs, beginning with the Asian Development Bank and Fund.

The Asian Development Bank (ADB) and Fund (ADF)

In April 1986, as we have reported to you previously, agreement was reached on a $3.6 billion replenishment of ADF resources. The United States share of the replenishment is $584 million (16.2 percent), to be paid in four equal annual installments of $146 million each.

The policy changes the Administration achieved in the course of negotiating this replenishment are consistent with the basic negotiating framework described in the first section of my testimony. They include:

- increased emphasis on the private sector in promoting long-term sustainable growth and development;

- greater effort to seek policy reform by borrowers in the context of lending and technical assistance activities;

-- development of country strategies to guide the lending program for each country; and

-- hardening of terms for concessional lending.

The ADB has made progress in implementing these reforms, although the implementation has not gone as fast as we would have liked. ADF lending terms have been hardened for borrowers which rely on a mix of concessional and non-concessional funds. Country strategies have been and are being prepared. New programs for making funds available to the private sector have been developed.

It is important to understand, however, that while securing such reforms in the course of this or any replenishment agreement is a significant accomplishment, that is never the end of the story. In fact, securing agreement on such issues is really just the first step -- there must be constant follow through with other members and bank management to bring actual operations into line with agreed guidelines. It should be noted that the MDBs are not that different in this regard from other large bureaucracies.

Hence, it is not unexpected at this juncture to find that, in our view, the ADB still has a considerable distance to go in living up to agreed commitments on reform. We are disappointed, for instance, that the Bank has not moved more quickly to develop country strategies, particularly for major borrowers.

We, of course, will continue to press these issues with Bank management and other members -- both at ADB headquarters in Manila and in other fora as opportunities present themselves. We hope that the reforms will ultimately be implemented more effectively than heretofore, and will keep the Committee informed on this matter.

The Inter-American Development Bank (IDB)

The dominant issue with the Inter-American Development Bank is the seventh replenishment of Bank resources. The U.S. position in the negotiations has been generally guided by recommendations of the 1982 MDB Assessment but has also included the possibility for the IDB to play a supportive role in policy-based lending aimed at promoting economic reforms in the developing countries of Latin America and the Caribbean.

After preliminary discussions in 1985 and 1986 with IDB management and other major shareholders, we were encouraged to pursue our proposal for an IDB that would join the World Bank in improving the prospects for sustainable economic growth in in the region. Based on these discussions, we put forward a

four point package of changes consistent with our general framework that we considered essential to any replenishment agreement. These included:

- -- the creation of individual country strategies/ programs to guide IDB lending;
- -- the adoption of appropriate policy conditionality in Bank lending and development of a program of well-defined well-targeted fast disbursing loans (sector lending) not exceeding 25 percent of total lending;
- -- restructuring operating departments to do country programming and sector lending; and
- -- changing the majority needed for decisions to give greater weight to the views of countries which supply the usable resources.

We were and still are prepared, if agreement can be reached on this package of changes, to seek a significant incerease in Bank resources. At the time it was negotiated, the replenishment would have supported a lending program of from $20 - $25 billion during the period 1987-90. This would have represented a doubling of lending from the Bank's hard loan window and a tripling of lending from the soft loan window when compared to the sixth replenishment. While we envisioned a program of some policy-based sector lending, the majority (at least 75 percent) of Seventh Replenishment lending would still be for projects.

As you are all aware, despite almost 2 years of negotiations agreement has not been reached on a replenishment of the IDB. With no progress in sight on the voting issue, negotiations were halted in October of 1987.

Once the voting issue is resolved, we believe final agreement could be reached quickly on:

- -- the operational definitions and procedures to guide the formulation of country programming strategies;
- -- the operational definitions and procedures to guide sector lending; and
- -- a reorganization of the Bank's internal structure to facilitate preparation of country programs and sector lending activities.

Understanding the voting issue, however, is critical to comprehending the future role of the IDB and U.S. policy towards it. As part of a reformed IDB, we were seeking a greater say for the non-borrowing member countries in the Bank's decision-making process. We were not making the request purely to assert the interests of the United States. Rather, we believe the non-regional donor countries, including the United States, which contribute the vast majority of resources to the IDB should have more discretion and greater policy influence. We believe that this change is central to reforming the IDB.

Seventy-two percent of the usable resources of the proposed capital increase were to be provided by the United States. Yet, the U.S. share of IDB votes is less than half that percentage -- 34.5 percent. Overall, the countries that would provide 95 percent of the Bank's usable resources would have only 46 percent of the vote.

In view of this imbalance, the change we were seeking is not unreasonable. We want to be sure that the loans and policies produced under an expanded lending program contribute more effectively to creating the conditions necessary for economic growth. Past experience indicates that with the simply majority voting system now in operation loan quality has been deficient in the IDB.

As of April first the IDB has a new President, Enrique Iglesias of Uruguay. His election presents the IDB with an important opportunity. Mr. Iglesias has expressed his intention to seek a redefinition of the role of the IDB which he hopes all shareholders can support. For our part, we remain committed to the IDB and are looking forward to working with the new President in this effort. However, we also believe that the fundamental changes which we were seeking in the seventh replenishment are still essential.

The African Development Bank (AFDB) and Fund (AFDF)

In November, 1987 negotiations for the fifth replenishment of AFDF were concluded. Donor governments and Fund management agreed on a three-year replenishment of $2.7 billion. The United States agreed to seek a $315 million contribution over the FY 1988-90 period -- implying an annual budget authority request of $105 million.

The Administration succeeded in convincing Fund management and other donors to adopt our positions on lending policy issues. Under the replenishment, Fund operations will focus on:

-- promoting economic policies which assure the most efficient distribution of resources, including market-based incentive systems and appropriate pricing policies;

-- meeting the primary needs of the poorest sections of the population in low income countries, including employment creation and increased incomes;

-- improving linkages between the allocation of AFDF-V resources and the policy performance of individual countries;

-- eliciting or promoting the direct involvement of the ultimate beneficiaries, including women, in the design and implementation of projects and programs; and

-- contributing to the improvement of the environment.

In working toward these objectives, the Fund will accord particular attention to the formulation of comprehensive country programs. These programs would include an overall review of country constraints and possibilities, including the adequacy of country performance; formulation of project pipelines in light of the country needs and Fund capabilities; and coordination of Fund activities with major donors.

The agricultural sector will be given the highest priority. In addition, the Fund will continue to concentrate its lending on health, education, transport and telecommunications, public utilities and energy. Increased emphasis will be placed on incorporating environmental considerations in all of the Fund's projects and programs.

While the bulk of the Fund's lending will continue to be in project loans, the Fund will begin to respond to the requirements of member countries for policy-based lending by expanding the use of sector adjustment and structural adjustment loans. Up to 20 percent of available resources under AFDF-V will be allocated for such lending, which will be done in close collaboration with the World Bank and other multilateral development institutions. This change in the Fund's lending program is consistent with a general tenet I mentioned at the beginning of my testimony, the need for the MDBs to commit themselves to promoting policy reform.

In these replenishment negotiations we also stressed the need to continue to improve the quality of Bank and Fund lending. Management recognizes that loan quality must be improved; but we are concerned that in the first quarter of this year too many loans of poor quality were brought forward for Board consideration. The Benin rural development loan which I referred to earlier is an example. We have raised our concern through our Executive Director and bilaterally, and will continue to press for an improvement in loan quality.

Before concluding, I would note that one of this year's major MDB issues is the General Capital Increase for the World Bank. The Administration's budget requests $70.1 million for FY 1989, the first of six annual subscriptions. The authorization legislation was sent to Congress in March. Since Secretary Baker addressed the GCI in detail in his March 30 testimony before this Committee, I have not included it in my statement. However, I would be happy to answer questions on it in a moment.

Conclusion

Mr. Chairman, in my testimony today I have covered three areas: first, the framework for negotiating MDB replenishments that has evolved since the 1982 Assessment of U.S. participation in the MDBs; second, the process of reviewing MDB loans within the U.S. Government; and, third, some of the main issues in the regional institutions. In discussing the latter I have given you a frank appraisal of some of the problems we face, as well as some of our accomplishments.

It bears emphasizing that our conclusion is not that the United States should "pare down" its participation in some or all of these institutions. We would not have some of these problems if we had not succeeded in getting the institutions to accept, in principal, the policy changes we sought. Even in the case of the IDB, there is agreement that country strategies will benefit the Bank, the donors, and, most importantly, the borrowers.

What is needed now is follow-through on our part so that these policy changes become a natural, accepted part of MDB operations. But this requires a judicious use of our influence in these institutions, and that cannot be done by lowering our financial participation. As Secretary Baker indicated to you in his testimony on March 30, 1988, the United States cannot use its influence to bring about better MDB policies by backing away from the institutions.

I believe that we have a clear policy direction within the MDBs, one on which Congress has had substantial influence and one which will be very effective for the United States and the developing countries. We seek your continued support as we follow through on these policies.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.
April 12, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $12,800 million, to be issued April 21, 1988. This offering will result in a paydown for the Treasury of about $14,175 million, as the maturing bills total $26,972 million (including the 22-day cash management bills issued March 30, 1988, in the amount of $4,055 million and the 17-day cash management bills issued April 4, 1988, in the amount of $9,022 million). Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, April 18, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,400 million, representing an additional amount of bills dated January 21, 1988, and to mature July 21, 1988 (CUSIP No. 912794 QF 4), currently outstanding in the amount of $8,050 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,400 million, to be dated April 21, 1988, and to mature October 20, 1988 (CUSIP No. 912794 QR 8).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing April 21, 1988. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $5,219 million as agents for foreign and international monetary authorities, and $3,537 million for their own account. These amounts represent the combined holdings of such accounts for the four issues of maturing bills. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
April 12, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 7-YEAR NOTES

The Department of the Treasury has accepted $6,257 million of $16,454 million of tenders received from the public for the 7-year notes, Series F-1995, auctioned today. The notes will be issued April 15, 1988, and mature April 15, 1995.

The interest rate on the notes will be 8-3/8%. The range of accepted competitive bids, and the corresponding prices at the 8-3/8% interest rate are as follows:

	Yield	Price
Low	8.43%	99.714
High	8.45%	99.610
Average	8.44%	99.662

Tenders at the high yield were allotted 83%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 7,560	$ 7,560
New York	14,703,729	5,676,089
Philadelphia	4,701	4,701
Cleveland	7,977	7,977
Richmond	23,972	23,122
Atlanta	9,036	9,036
Chicago	897,750	279,210
St. Louis	14,172	11,002
Minneapolis	5,073	5,073
Kansas City	13,544	13,544
Dallas	7,256	5,256
San Francisco	758,705	213,355
Treasury	966	966
Totals	$16,454,441	$6,256,891

The $6,257 million of accepted tenders includes $316 million of noncompetitive tenders and $5,941 million of competitive tenders from the public.

In addition to the $6,257 million of tenders accepted in the auction process, $500 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $254 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

B-1370

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
~~Expected at 10:00 A.M. DST~~
April 13, 1988

STATEMENT BY
DAVID R. MALPASS
DEPUTY ASSISTANT SECRETARY
FOR DEVELOPING NATIONS
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL
ECONOMIC POLICY, TRADE, OCEANS AND
THE ENVIRONMENT
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE
APRIL 13, 1988

Mr. Chairman:

I am pleased to participate in these hearings on foreign assistance and the need for environmentally sustainable development programs. I would like to focus today on what we have done to implement the Congressional mandate to promote environmentally sustainable economic growth and improved management of natural resources. This mandate has been clear and strong and it has been a major theme in our management of U.S. participation in all of the multilateral development banks.

Unfortunately, the adverse effects of unwise and unsustainable development programs and projects are only too evident in all parts of the developing world. Examples include desertification in Africa and South Asia and destruction of tropical forests in Latin America, in Central Africa and in Asia. There have also been serious problems with loss of wetlands as well as atmospheric pollution and pollution of waterways. In some cases, development is threatening the survival of indigenous peoples and their culture and causing extensive damage to wildlife, particularly to endangered species that can never be replaced.

There is be very little disagreement on the urgent need to address these issues. We share the goals that have been outlined by Congress and members of the environmental community. Our policy in the multilateral development banks has been to seek to mitigate or eliminate such adverse effects in development projects and programs and to support national and regional programs to improve environmental management. This has meant the structuring of programs that encourage growth and reduce poverty while still protecting and preserving the natural resource base.

The first Congressional mandate for environmental action in the multilateral development banks was included in the Continuing Resolution Act for 1987, Public Law 99-591. This legislation provided that the Secretary of the Treasury should instruct the U.S. Executive Directors in the Banks to promote a number of very specific and detailed reforms. These reforms included:

- addition of professionally-trained staff in the Banks.
- development of plans for systematic and thorough environmental review of projects.
- creation of line units to carry out such reviews.
- establishment of multidisciplinary planning processes.
- development of plans for rehabilitation and management of ecological resources.
- involvement of health and environmental ministers and non-governmental organizations in the project preparation cycle.
- increase in the proportion of environmentally-beneficial lending.

A report detailing progress in these areas was submitted to the Congress in January, 1988. I will return in a few minutes to the subject matter of that report and provide some of the details of the progress that is being made.

The second Congressional mandate on environmental reforms was included in the Continuing Resolution for FY 1988, Public Law 100-202. This legislation restated many of the reform objectives outlined in the previous year's Continuing Resolution and made them a part of the permanent authorization legislation. It also provided for a number of other initiatives including:

- an analysis of debt/conservation swaps.
- discussions with other donors regarding personnel and financial support for environmental programs in the regional development banks.
- enhancement of the early-warning system for identifying problematic loans.
- report on a comprehensive strategy to address natural resource problems.
- discussions with other executive directors in the banks regarding integrated pest management.
- promotion of requirement for IMF to conduct an analaysis of the impact of adjustment policies and conditionality on environment, public health, natural resources and indigenous peoples.

This legislation took effect in December, 1987. We have already begun to implement some of these initiatives but action still remains to be taken in other cases.

It is clear from this brief summary that a great deal of legislation is in place. I want to assure you that we are making a conscientious effort to implement it. In fact, I believe we should make implementation our primary objective and not seek the passage of new law on this subject.

Within Treasury, we are working to improve our oversight of environmental issues in the multilateral development banks. During 1987, we abstained on six loans, citing concerns about adverse environmental effects. These loans included agricultural rehabilitation in the Sudan, electric power in Peru, a paper mill in Nepal, an abattoir in Botswana, livestock development in Benin, and agroforestry and livestock development in Mali. In February of this year, we abstained on a loan to Burkino Faso for a road and water project because of serious environmental issues.

We are continuing close coordination with State and AID and with environmental groups in an effort to improve the early warning system for problematic projects. We plan to take a more active role in international meetings on environmental issues, particularly those that involve projects and programs funded by the multilateral development banks.

We have had particularly strong support from a number of non-governmental organizations -- the Sierra Club, Natural Resources Defense Council, Environmental Defense Fund and others -- in gathering information and developing approaches to increase the effectiveness of our efforts. These organizations have assisted in the preparation of our position on loans for cattle production in open-range savannas of sub-Saharan Africa and on standards for evalating projects that may adversely affect moist tropical forests. They have participated in the early warning system established by AID to identify projects that may adversely affect the environment. They have worked closely with us in analyzing problems associated with specific loan proposals or with projects that are being implemented.

Let me turn now to the question of where we stand with regard to provisions of Public law 99-591.

Staffing and Training

During 1987, the World Bank carried out a major reorganization of its management and staff. One of its primary aims was to strengthen the Bank's capacity for addressing environmental issues. A central environmental department was established in the Policy, Planning and Research complex. Twenty-three positions have been authorized for the three divisions in the department. In addition, environmental units have been created in the technical departments of the Bank's four regional offices. Twenty-two positions have been

authorized for these four units. The Bank has appointed a new director for the Environmental Department and a new advisor for scientific and environmental affairs. Both of these individuals appear to be well-qualified and capable, with extensive backgrounds in environmental matters. In addition to the 45 permanent staff positions, the Bank has indicated that it expects to use the equivalent of 18 man-years in consultant services for environmental issues during its current fiscal year.

The regional development banks need to hire more environmental specialists and to assign more staff to environmental issues. We have been encouraging them to do that. The Inter-American Development Bank has recently hired two senior environmentalists for positions at the Bank's headquarters and a third expert has been assigned to the Bank's field office in Brazil. The Asian Development Bank has had five staff members working on environmental issues; however, the chief of their environmental section has recently been recruited for the World Bank's Asian Environmental Unit and a well-qualified replacement is needed to fill that position. The African Development Bank has said that it will increase its environmental staff from two to four and that a well-qualified African candidate will be sought as Chief of the Unit. The unit is currently headed by a Norweigan official seconded to the Bank.

Significant progress has been made on training. In the World Bank, an environmental training program has been introduced for Bank staff. The program is designed to raise awareness of environmental issues in development, to convey new techniques, and to introduce the latest developments in the field. The integration of environmental and economic work and the importance of policy intervention is to be included in the curriculum of the Economic Development Institute.

The Inter-American Development Bank has initiated a series of seminars on environmental issues. The first of these seminars took place over a three-day period in December, 1987, with forty members of the Bank's technical staff participating. Similar seminars for other members of the staff are to be held later this year. A one-day seminar is also planned for the heads of the Bank's field offices in its borrowing countries. The African Bank has sponsored a one-day seminar on the economic valuation of environmental impacts and a two-day seminar on environmental planning in project development. A third seminar focusing on grazing issues, which have been problematic

Management Line Units

Three of the Banks have established line units to provide for a systematic and thorough review of projects affecting the environment and natural resources. As I indicated earlier, the World Bank has set up four regional units. The Asian Development Bank and the African Development Bank have established smaller units that need to be strenghened. The Inter-American Development Bank decided to create an inter-departmental Committee instead of a line unit. It reviews projects in both the preparation and implementation phases and is advised by a senior environmental specialist.

Involvement of Health and Environmental Ministers and Participation of non-Governmental Organizations

The management of the banks report that they have taken steps to emphasize the involvement of health and environmental ministries. The Asian Development Bank provides special briefing materials to its country programming teams on environmental and natural resource development projects. The environmental unit at the bank is also in contact with environmental agencies in borrowing countries regarding specific projects in the pipeline that may need assessment. The African Development Bank has issued instructions to staff for expanding consultations with health and environmental ministers.

Participation of non-governmental organizations is also being encouraged in all of the banks. In the World Bank, the focal point for relations with non-governmental organizations has been shifted from Public Affairs to Policy, Planning and Research. This shift has facilitated the exchange of views and discussions on substantive issues.

In May, 1987, the Inter-American Development Bank sponsored a conference on environmental issues in Latin America and the Caribbean. There was extensive participation by regional and non-regional NGO's. There was also very broad representation from public agencies throughout the region, responsible for environmental protection and natural resource conservation. The African Development Bank is making plans to hold a similar conference during the second half of this year.

The Asian Development Bank has completed a working paper on cooperation with non-governmental organizations. The paper was based on consultation with a number of those organizations. A final report is expected shortly. All of the banks are seeking to involve NGO's in borrowing countries more actively in the project cycle and to see that local community groups and other organizations are fully informed of project planning at an early stage of the cycle. In agriculture, this has involved wider contacts with farmers organizations, water user associations and women's groups.

Multidisciplinary Planning in Land Uses and Rehabilitation and Management of Ecological Resources

All of these banks have sought to incorporate new technologies, including remote sensing techniques, into efforts to encourage more effective land use planning. The World Bank has begun preparation of comprehensive environmental action plans in a number of selected countries. It is also preparing terms of reference for consultants to identify areas where multidisciplinary support can help improve project preparation.

The multilateral development banks are providing funds for national and international agricultural research programs and for science and technology programs that support research into eco-system management. The World Bank is working with Harvard University and the Institute for International Environment and Development to assess alternative approaches to natural resource management. Task forces have also been organized within the World Bank to address desertification, deforestation, industrial accident risk avoidance, protection of criticl eco-systems and mitigation of natural disasters in urban areas.

Other Aspects of Legislation

There are two specific legislative requirements from 1986 on which I would like to report on briefly. The creation of four environmental line units in the World Bank should lead to better review of on-going projects. The Inter-American Development Bank has issued new instructions to its field offices in borrowing countries emphasizing environmental and sociocultural issues during project supervision and monitoring visits. The Asian Development Bank and the African Development Bank both report that increased emphasis has been placed on environmental issues in monitoring and evaluating projects. None of the banks has created the position of an advisor to the President for environmental matters. The World Bank has, however, appointed a senior official as an advisor to the Vice-President for Policy Planning and Research.

As I indicated earlier, we have begun a number of initiatives as a result of the Continuing Resolution that was passed in December, 1987, Public Law 100-202.

We recently submitted to the Congress a report that had been requested on debt for nature swaps. In brief, this report recommends that the World Bank place additional emphasis on working with countries to establish priorities for conservation projects and on improving informational systems on species groups, critical ecosystems and major tropical wilderness areas. It also looks to the Bank to take a more active intermediary role in helping to arrange debt for nature swaps and to consider starting a pilot program in a country that has indicated that it is willing to establish one. An Internal Revenue Service ruling that encourages participation in such swaps was released last December.

I can also report that we have been in contact with other developed countries regarding the possibility of providing environmental experts to work in the regional development banks. Environmental experts from the United States, Norway, the Netherlands and Italy have already been seconded to the African Development Bank. Last month, we began consultations with fifteen other developed countries about improving that particular program and the possibility of seconding additional experts to the other regional development banks. Our executive directors in the Banks have been asked to talk with management about how this program might be expanded.

We have been holding regular meetings with representatives of other donor countries regarding improvements in the environmental performance of the multilateral development banks. These meetings have ranged from discussions in the Development Committee of the World Bank to more informal consultations and conversations about changes in policies and our positions on individual projects that may affect the environment. This week in Development Committee meetings, we are reviewing a number environmental issues in the World Bank. Next month we will participate in an OECD meeting in Paris seeking to promote the development of guidelines for decision-makers in evaluating environmental issues in the multilateral development banks.

We placed a particular emphasis on environmental issues at the annual meeting of the Inter-American Development Bank in Venezuela in March. We plan to continue to stress these issues at the annual meetings of the Asian Development Bank and the African Development Bank that will take place later this month and in June. All of these initiatives have been meant to involve the governments of other countries more effectively in our own efforts to improve environmental performance in the banks.

During the past year, we have worked closely with our colleagues at AID in implementing the early warning system for identifying problematic projects. We believe we can continue to enhance this system and become more influential in shaping the environmental aspects of individual loan proposals in the banks. Later in the year, we will collaborate with State and AID in analyzing more comprehensive strategies that can address natural resource problems through the multilateral development banks and in our bilateral aid program.

To sum up, Mr. Chairman, we have had a very extensive legislative mandate from Congress on environmental issues in the multilateral development banks. We have been fully engaged in implementing the provisions of that mandate. On some of the issues, particularly staffing, training and the involvement of non-governmental organizations, I believe we have been making substantial headway. In other areas, we will continue to press for further reforms.

I do not believe that we need additional legislation to assist us in seeking these reforms. I am optimistic that attitudes are changing -- both in the banks and in borrowing countries -- and that we will have continuing progress to report to the Congress as the year progresses.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED
EMBARGOED FOR RELEASE UNTIL DELIVERY

Remarks by
The Secretary of the Treasury
James A. Baker, III
at the Morning Session of
The Interim Committee
of the International Monetary Fund
Washington, D.C.
Thursday, April 14, 1988

The World Economic Outlook, IMF Quotas, and an SDR Allocation

Thank you, Mr. Chairman.

Since our meeting last September we have been given solid grounds for optimism about the underlying strength of our economies and the beneficial role of the policy coordination process in which the major industrial economies are participating.

- o The sharp October stock market declines were a source of concern to us all. But in fact real GNP growth in industrial countries grew faster in the second half of 1987 than in the first half. Clearly the underlying strength of our expansion was underestimated. Now we are seeing a new optimism about 1988 growth prospects.

- o This performance by the industrial countries created the environment in which world trade volumes grew by nearly 5 percent, the highest rate since 1984. In particular, exports of non-oil producing developing countries rose 10 percent in volume terms last year. That rise contributed to a 4-1/2 percent growth of their real GNP.

- o In addition, reductions of external imbalances have begun in the largest industrial countries. In the United States, real exports rose 18 percent over the four quarters of 1987, while imports were up only 7 percent. Furthermore, we expect that U.S. nominal dollar trade and current account deficits will decline this year. The trade figures released this morning should be seen in context. As we have said before, too much emphasis should not be placed on any one month's figures. Monthly trade figures are by their nature erratic. What is important is that we are continuing along the general path of reduced imbalances. Exports continue their very strong performance; they are 22 percent higher than a year ago, and growing at double the rate of imports.

- o Progress continues to be made in other countries as well. Japan's trade surplus, as a share of GNP, peaked in 1986 and has been coming down steadily since; Germany's stabilized last year and is expected to decline in 1988.

B-1372

There are several reasons for this positive economic growth with low inflation, and for the emerging success in adjusting external imbalances. One is the inherent strength of our economies. A second results from actions undertaken in the context of strengthened economic policy coordination among the major industrial countries. The agreements of the G-7 have provided the framework for important efforts and positive results:

- The United States reduced its federal budget deficit by $71 billion in the last fiscal year. That drop is equivalent to almost 2 percent of GNP. The general government deficit -- including state and local governments -- fell to only 2-1/4 percent of GNP in fiscal year 1987.

- The budget agreement reached by the President and the joint leadership of Congress late last year is a significant step toward assuring continued fiscal restraint.

- Furthermore, as the budget submitted by the President in February makes clear, we expect further deficit reductions in future years, with the federal deficit down to less than 2 percent of GNP by FY 1990. We have also successfully avoided protectionism, despite strong political pressures.

- Japan has been pursuing economic policies to sustain strong domestic growth and to open its markets more fully to imported goods.

- The United Kingdom is putting into place a major tax reform which includes a major reduction in marginal income tax rates.

- Germany has adopted special supports for investment and has completed the formulation of its major medium-term tax reform program.

I believe that the early effects of these and other coordinated policy efforts should provide the basis for the continued reduction of external imbalances to sustainable levels with low-inflation growth. Domestic demand in the United States grew more slowly than GNP last year, with exports expanding sharply. In Japan, by contrast, domestic demand continues to grow more rapidly than GNP. The same is true in Germany. These developments are making an important contribution to reducing external imbalances.

Since the beginning of this year there has been little change in the dollar's value against other major currencies. The generally increased exchange rate stability reflects improved policy coordination and the ongoing adjustment process. Yesterday the Ministers and Governors of the Group of Seven expressed their determination to continue to coordinate economic policies to strengthen the underlying fundamentals and thereby reinforce the conditions for exchange rate stability. In addition, they agreed to continue to cooperate closely on exchange markets.

Looking toward the medium-term, we all recognize the need for continued action to sustain growth, to reduce external imbalances, and to provide an environment favorable to world economic development and additional progress on international debt problems. As you have observed, Mr. Chairman, this medium-term focus requires renewed attention to structural changes in our economies.

In the United States, we have been encouraged by the rise in the savings rate to 4-3/4 percent in the fourth quarter of last year. That is an increase from 3-1/2 percent earlier in 1987 and 4-1/4 percent in 1986. Business savings, which account for 80 percent of U.S. private savings, should also rise as the competitive position of U.S. industry improves.

European countries have been making some progress in freeing up their labor and capital markets, and reducing the burden of regulation on business. But much more needs to be done to allow employment to grow and to generate higher growth without inflation.

Japan's progress in creating more competitive and efficient capital markets has been notable. But more action is needed to ensure greater world access to Japanese markets in order to reduce remaining rigidities in these markets.

A number of newly industrializing economies are running current account surpluses. They must also do more to open their markets and to allow the underlying strength of their currencies to be reflected more fully.

In addition to these tasks, the preservation of an open international trading system is critical in today's interdependent world. To achieve greater trade liberalization, particularly in agriculture, we strongly support the work of the Uruguay Round of multilateral negotiations. We are committed to working toward a successful round. All countries, however, are responsible for the ultimate success of the round, not simply the industrial nations.

As you know, the G-7 Ministers met yesterday. We have advanced the coordination process by developing a medium-term framework to enhance policy consistency and to clarify medium-term objectives. We then focused on near-term peformance indicators to serve as tools for evaluating our progress toward our shared goals.

As part of our coordination process, we have also agreed to develop for inclusion in the set of existing indicators a commodity price indicator as an additional analytical instrument.

We remain fully committed to continuing to strengthen the international economic policy coordination process. In this context, the Fund plays an important role in supporting multilateral surveillance. We encourage the Fund to continue to make greater use of economic indicators, in both individual countries and in the World Economic Outlook. Progress on this front can and does reinforce the progress made elsewhere.

IMF Quotas

Turning to the Ninth General Review of Quotas, the Board of Governors is currently voting on a draft resolution to extend the period for the review to April 30, 1989. The United States supports this resolution. The extension is appropriate since the IMF has ample resources to fulfill its responsibilities.

In the context of severe budget constraints, our top priority for multilateral support at this time must be a General Capital Increase for the World Bank.

I would also like to call your attention to the rapid growth in arrears to the IMF. This could make creditors less willing to provide new capital to the Fund. Steps have been taken to safeguard the IMF's financial position, but much more remains to be done.

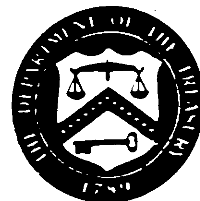
We call upon those members in arrears to make every effort to discharge their obligations promptly, and we call upon the rest of the membership to work actively to assist in the resolution of this problem.

In light of the seriousness of this problem, we believe it would be appropriate for the Executive Board to provide a report on this to the next Interim Committee, outlining steps consistent with the Fund's monetary character to eliminate existing arrears and avoid further arrears.

SDR Allocation

Regarding an SDR allocation, we remain unconvinced that the criteria specified in the Articles of Agreement for an allocation -- particularly the long term global need to supplement existing reserve assets -- have been met. Therefore, we continue to oppose an allocation.

Thank you.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED
EMBARGOED FOR RELEASE UNTIL DELIVERY

Remarks by
The Secretary of the Treasury
James A. Baker, III
at the Afternoon Session of
The Interim Committee
of the International Monetary Fund
Washington, D.C.
Thursday, April 14, 1988

THE INTERNATIONAL DEBT STRATEGY

I welcome this opportunity to review recent developments and current prospects for addressing international debt problems. In my remarks this afternoon, I will focus on two aspects of the debt problem:

- o First, the considerable progress that has been made in overcoming debt difficulties; and
- o Second, the evolution of the strategy in response to the changing circumstances of individual countries, including developments in the "menu" approach.

Recent Progress

The growth-oriented strategy which we have pursued since 1985 has helped move us a considerable distance toward our goals. Substantial progress is being made by debtor nations in putting into place policies to bring about the necessary financial stability and the structural foundations for stronger growth and external balance.

- o According to World Bank data, 8 of the 15 major debtor countries grew at 4 - 5 percent or better last year, compared with only three countries in 1985.
- o Debt service ratios for the group have fallen by one-fourth and interest service ratios by one-third since 1982.
- o Aggregate current account deficits have been sharply reduced and are in a more manageable range.

- o Export earnings have rebounded to near record highs, while imports this year should be the highest since 1982.

Despite concerns about the commercial bank component and delays in some instances, external financial support for these efforts by the major debtor nations has been provided in amounts that compare well with those needed to sustain the adjustment effort.

The support includes approximately $17 billion in new commercial bank loan commitments, over $220 billion in commercial bank reschedulings, $17 billion in Paris Club reschedulings, almost $14 billion in new World Bank loans, and $5 billion in temporary payments financing from the IMF since October 1985.

The international financial system is on a sounder footing, as commercial banks have increased capital relative to their loan portfolios, and enhanced reserves. Moreover, some debtor nations that experienced arrears are working to normalize relations with creditors. Indeed, there is now a deeper understanding of the negative repercussions of both unilateral moratoria and arrears that I believe is constructive.

While these are positive developments, we must all recognize that problems remain. A full return to creditworthiness by debtors is not a short-term process and will not be completed overnight. Additional efforts are still needed to reduce fiscal and external deficits, control inflation, encourage new investment and savings, and unleash the creative potential of the private sector within debtor nations to help catalyze new loans, equity flows, and the return of flight capital. These are essential to improving and sustaining growth.

Industrial nations must also assure stronger growth within their own economies as a stimulus to developing countries' exports. They must renew their opposition to new barriers to trade while jointly reducing existing barriers through the Uruguay Round negotiations.

The important point is that the process is working; demonstrable progress is being made; and it is vital to stay the course. There is no viable alternative.

<u>Evolution</u>

The debt strategy also provides a basis for meeting the changing circumstances of individual countries while maintaining a steady focus on the following key principles:

- o First, the importance of sustained economic growth;
- o Second, the need for market-oriented reforms in debtor countries;
- o Third, external financial support for these reforms; and
- o Fourth, a case-by-case approach to meet the individual needs of debtor countries.

I firmly believe that these basic principles should continue to guide our approach in the period ahead.

Within this context, our strategy is an evolutionary one. By emphasizing a diversity of options for commercial banks and innovative financing techniques, the "menu" approach to commercial bank financing provides a vital mechanism for sustaining commercial bank support and assisting the return to creditworthiness. The development of such "menus" is an ongoing process. The options selected in individual cases are the result of voluntary choices developed and mutually agreed upon by the debtor governments and commercial creditors themselves.

For several countries, additional borrowing will be needed to support reforms, meet external obligations, and provide a stimulus to production and growth. Such flows, if used productively, can help to strengthen the debtors' own resources, and they can be fully consistent with the objective of restoring creditworthiness and reducing the real debt burden over time. Trade credits, project loans, and onlending for specific uses in the private sector all help to target resource flows for stronger growth. New money bonds which have some of the characteristics of a senior claim may also be attractive to some banks as a way of providing additional financing.

Debt conversion techniques have also been playing an increasingly important role in the debt strategy. They can shorten the debt workout period for some countries, or reduce current debt service burdens, or permit some banks to exit from the concerted lending process, thus streamlining procedures and accelerating the conclusion of new financing packages. Such debt conversion transactions may hold benefits for all parties and can supplement -- but not supplant -- the fundamental reform and financial support elements of the current strategy.

A number of such conversions have already been negotiated. Some $7.5 billion in debt/equity swaps have been consummated in 5 debtor countries in the past 3 years alone. Other countries are developing debt/equity swap mechanisms. There is a growing interest in debt/conservation and debt/charity swaps, as well. Through these swaps, debt instruments can be retired in exchange for local currency for important conservation or other social programs in the debtor country.

We are encouraging the World Bank to provide technical advice for debt/equity and debt/conservation swap programs. The U.S. has already taken steps in both the regulatory and tax areas to facilitate such conversions. Debt/equity conversions in particular have considerable untapped potential and should be given more attention by both debtors and creditors.

The recent Mexican debt exchange offer is yet another innovative technique, which can increase flexibility for dealing with the current stock of debt. I expect that other creative financial market instruments of a similar nature will be developed in the period ahead.

To be successful, such efforts must be voluntary, privately financed, and developed within the market to benefit commercial banks and debtor nations alike. In contrast, we strongly oppose any approaches which are generalized, global, financed by creditor governments or mandatory in nature. This includes the creation of an international debt facility under the auspices of the IMF or World Bank aimed at providing a global "quick-fix" of the debt problem via debt purchases or securitization of commercial bank loans.

The "siren song" of debt forgiveness through such approaches is both impractical and counterproductive. Such schemes merely shift the risk on private commercial bank debt to the international financial institutions themselves and their member governments -- which we certainly are not prepared to accept.

We would strongly discourage all from entertaining such notions. They would not support the adoption of necessary policy changes, but in fact would only delay needed adjustment and financing. Moreover, they would undermine the restoration of access to markets that some debtor nations are now achieving. In sum, such proposals could distract attention from the real work at hand: establishing a sound foundation for sustained growth.

Conclusion

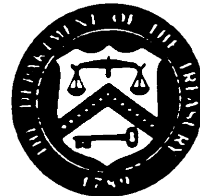
The IMF has a continuing and central role to play within the debt strategy. It must assist debtors in devising growth-oriented reform programs, support those programs with temporary balance of payments financing, and help catalyze private financial flows. This committee will be discussing in more detail this afternoon proposals on the evolving role of the Fund in the debt strategy. I am pleased that we have come this far in the short period since specific proposals were made in these areas last fall. I hope we can soon put into place strengthened mechanisms to support the debt strategy.

We consider it important that both the Fund and the Bank adapt to changing circumstances while remaining true to their basic missions. While supporting the evolution of the "menu" approach, they should avoid creating unrealistic expectations about the general availability of debt reduction, or using a debtor country to test the market on new financing techniques that might actually delay needed external support. Both institutions must steer an active but cautious course, avoiding the extreme of forcing their own predilections upon debtors and commercial banks, while spurring both to reach agreement on needed reforms and financing in a timely fashion.

As we know, this can be a real challenge. At the heart of the task, however, is continuing the cooperative approach we have been pursuing since 1982. We call upon all parties to focus on practical steps for continuing to achieve progress within this approach. I am convinced that together we can assure its success.

Thank you.

TREASURY NEWS



partment of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED
EMBARGOED FOR RELEASE UNTIL DELIVERY

Remarks by
The Secretary of the Treasury
James A. Baker, III
at the Afternoon Session of
The Interim Committee
of the International Monetary Fund
Washington, D.C.
Thursday, April 14, 1988

ROLE OF THE FUND IN ADJUSTMENT AND FINANCING

Thank you, Mr. Chairman.

The International Monetary Fund has played a central and effective role in the international debt strategy and should continue to do so. The Fund has successfully adapted to the changing needs and situations of its members. At the same time, it has adhered to the basic principles of its monetary charter that underline its real effectiveness.

As we consider steps to strengthen the IMF's capacity to address current problems, we must not lose sight of certain key points.

- Any new IMF policies or financing mechanisms must be fully consistent with the revolving character of IMF resources and the use of those resources to catalyze, not supplant, other financing.

- The key to the Fund's catalytic role is not the amount of temporary financing it provides, but the quality and effectiveness of its economic advice and programs.

- The increased focus on growth-oriented structural reforms should enhance, not weaken, the effectiveness of IMF conditionality, and should complement, not replace, the Fund's traditional focus on macroeconomic policy.

A Combined Compensatory and Contingency Financing Facility

The IMF Executive Board has reached agreement on a new combined compensatory and contingency financing facility. We welcome this agreement, which in our view represents a fair and constructive compromise that takes into account a wide range of interests. The prospects for success for this new facility are enhanced because it was born out of a consensus that reflected the spirit of cooperation and compromise that is central to the debt strategy. All told, I believe the facility will strengthen considerably the IMF's ability to help cushion members' reform programs from unforeseen adverse developments in the world economy.

By giving them greater assurance that their growth-oriented reforms will not be thrown off-track by external shocks, countries will have greater confidence to embark on bold, comprehensive economic programs. As a result, the ability of developing countries to implement corrective measures while sustaining growth will be enhanced.

Incorporation of the old Compensatory Financing Facility into this new combined facility, along with other changes to its operations, will improve its effectiveness, while reducing its size. I believe the Committee should strongly endorse the Executive Board's agreement and call for the early resolution of remaining technical issues in order that the new combined compensatory and contingency facility can enter into operation promptly.

Extended Fund Facility and Program Design

There is growing recognition that restoration of a viable balance of payments position cannot be achieved solely through macroeconomic and exchange rate policies. These are fundamental, but there is a need also for broad structural reforms that enhance growth. The specific structural measures will vary from country to country, but in general they should increase the market orientation of the economy to improve the efficiency of resource allocation. Such measures might include:

- A greater focus on market determined prices, by allowing exchange rates to reflect supply and demand, removing subsidies, and liberalizing price regimes;
- Tax reform to increase incentives to work, save and invest and financial market reform to provide for more efficient allocation of savings; and
- The liberalization of trade and foreign direct investment practices to open the economy and provide access to foreign goods, technology and capital.

The IMF's Extended Fund Facility (EFF) is designed to promote structural reforms. The United States supports efforts to revitalize the EFF, but believes that this can be accomplished within the current framework and policies of the facility.

Revitalization should proceed cautiously on a case-by-case basis as we need to ensure that the EFF is more effective than it has been in the past. Use of the EFF could be appropriate for members that have already made some progress in correcting domestic and external imbalances and that are able to spell out a strong structural reform program to complement an equally bold macroeconomic program.

In such selected cases, strong programs deserve strong external financial support, including the Fund.

In this connection, I have noted some concern that the IMF has experienced net reflows in the past 2 years. We should not be concerned about this since it is appropriate and consistent with the unique and revolving character of the IMF, and reflects, in part, the heavy IMF lending in the early 1980s. Furthermore, many of the countries that used Fund resources at that time are not now seeking IMF assistance. This development does not in any way conflict with the need for the Fund to continue to play an active role in supporting the economic programs of individual debtors.

The need for the IMF to promote structural reforms is so important and pervasive that structural objectives should be an integral part of virtually all Fund programs, not just Extended Arrangements. As I proposed at last year's Annual Meetings, structural performance criteria should be added to IMF programs to facilitate a greater structural focus. At the same time, longer term stand-by and extended programs should include semiannual performance criteria and disbursements in order to provide authorities more time to focus on their medium-term programs. I call on the Executive Board to complete its work on these issues soon in order that steps can be taken to implement agreed proposals.

The IMF and World Bank both have roles to play in promoting growth-oriented structural reforms. We view these roles as complementary, and believe that they can best be achieved through close collaboration between the two institutions. While notable progress has been made, particularly through the development of the Policy Framework Papers for the low-income countries, there is a pressing need for further improvements, especially in regard to the middle-income countries. I hope the Boards of both institutions will give further attention to these issues after the Interim and Development Committee meetings.

Conclusion

Mr. Chairman, nearly 6 years ago the IMF took up the challenge arising from the debt crisis with vigor and vision. Nearly 3 years ago, the Fund helped lead the way in the second phase by emphasizing the need for growth in resolving debt problems on a lasting basis. In both periods, the Fund contributed significantly to maintaining a sound world economy and stable financial system.

This success is, I believe, in no small measure due to the Fund's ability to adapt to changing circumstances while being true to those principles that safeguard its unique monetary character. As we look to the future, I continue to believe that the Fund should play a central and active role in the debt strategy. This does not imply a larger financial role, however, nor a more interventionist approach towards the precise elements of any particular financing package. Instead, it should continue to be a catalyst for implementing strong economic programs and for appropriate external financing in support of those programs.

Thank you.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
Expected at 10:00 A.M. DST
April 14, 1988

TESTIMONY OF FRANCIS A. KEATING, II
ACTING CHAIRMAN OF THE ENFORCEMENT COORDINATING GROUP
OF THE NATIONAL DRUG POLICY BOARD
BEFORE THE HOUSE SELECT COMMITTEE ON NARCOTICS
APRIL 14, 1988

Mr. Chairman, I am pleased to appear before you today as the Acting Chairman of the Enforcement Coordinating Group of the National Drug Policy Board to testify on the enforcement, or "supply side," Lead Agency Strategies recently presented to the Congress by the Policy Board.

With me this morning is Don Newman, Under Secretary of the Department of Health and Human Services. Mr. Newman is appearing on behalf of Policy Board Vice-Chairman Otis Bowen and will be reviewing the Policy Board's "demand-side" strategy implementation plans. Together, we will bring you up to date on our efforts to improve the national drug policy and strategy process, as the Attorney General promised you last December.

Specifically, I will describe the new comprehensive national strategy recently developed for the National Drug Policy Board by the five enforcement Lead Agency Committees, and the process by which these strategies were created.

As you know, the National Drug Enforcement Policy Board was created by the National Narcotics Act of 1984. An Executive Order of March, 1987 added to the Board responsibility for demand-side issues and to reflect this expanded focus changed the name to the National Drug Policy Board. The National Drug Policy Board is organized in three tiers:

1. The cabinet-level Policy Board, chaired by the Attorney General, meets monthly and develops overall drug program policy, facilitates coordination, and resolves interagency issues.

2. Two agency-level Coordinating Groups, one which deals with demand-side issues and one which deals with supply-side issues, translate the Board's policy decisions into an integrated strategy. Dr. Ian Macdonald chairs the Drug Abuse Prevention and Health Group, and I chair the Drug Enforcement Group.

3. Nine lead agency committees, created by the Board in May, 1987, submit strategy plans to the Policy Board for approval, implement the strategy, and work to

ensure interagency coordination within their particular area of responsibility.

As noted in the March 12, 1988, GAO report on the Policy Board--and I quote--"The Policy Board brings together...officials at several levels--cabinet members, agency heads, and program managers--enabling them to discuss, plan, and coordinate operations and programs and provides a forum to discuss and resolve interagency disputes. GAO believes that the Policy Board's efforts to facilitate coordination have been worthwhile and responsive to the requirements of the law establishing the Policy Board."

As part of its coordination effort, in May, 1987, the Policy Board issued its Lead Agency Directive designating lead agencies for the nine functional areas of the Federal drug control program. Of the nine lead agencies, five were designated for Enforcement. The Drug Enforcement Administration (DEA) is the lead Federal agency responsible for drug investigations and for intelligence. The Justice Department is the lead Federal agency for the prosecution of drug trafficking investigations and related crimes. The State Department is the lead Federal agency responsible for coordinating the U.S. drug control efforts overseas. The Customs Service is the lead Federal agency responsible for the interdiction of illicit drugs into the United States; Coast Guard is the principal deputy.

In August, 1987, the Attorney General tasked each Lead Agency Committee to develop a document detailing the policies, strategies, programs, objectives, and necessary resources for its area of responsibility. In September, 1987, the initial drafts of these strategies were provided to the Policy Board staff.

In October, 1987, the Enforcement Coordinating Group and the Prevention and Health Coordinating Group reviewed each draft strategy. After revisions were made, the Policy Board reviewed each strategy document during November and December, 1987.

In January, 1988, the Policy Board approved in principle the nine Lead Agency Strategies. In addition, the Board reviewed and discussed the President's FY89 Federal Drug Budget, which provided an overall increase of 13% over FY88. In February, the Lead Agency Committees were requested to convert their strategy planning documents into FY88-89 strategy implementation plans consistent with available resources.

Members of the House and Senate and their staffs were briefed on the strategy implementation plans on February 25 and 26, 1988. On March 9 and 15, 1988, final drafts of each Lead

Agency Strategy implementation plan were provided to over 150 members of Congress.

I will now summarize the contents of the five Enforcement Strategies beginning with the strategy developed by the Intelligence Committee chaired by DEA.

INTELLIGENCE STRATEGY

The principal objectives of this strategy are to:

- Expand and improve the collection, analysis, and dissemination of intelligence information; improve support to programs and functions of other strategies; and improve coordination.
- Assess responsibility for drug intelligence requirements.
- Improve all-agency, all-source field collection.
- Ensure full dissemination in a timely manner and in a useful format.
- Support tactical, strategic and operational requirements with increased analysis and estimation capabilities.
- Integrate systems for communication, storage, retrieval and sharing of intelligence information.

INTERNATIONAL STRATEGY

The principal objectives of the strategy developed by the International Committee are to reduce the supply of cocaine shipped from Latin America; reduce the amount of heroin shipped from Asia and Mexico; reduce the amount of marijuana entering the United States from worldwide sources; increase intolerance for drugs and stimulate focused support for effective narcotics control worldwide; eliminate major trafficking networks and cartels; and secure increased international cooperation in worldwide narcotics control matters.

Highlights of this strategy include:

- Negotiation of international agreements to provide for the reduction of the amount of coca, cannabis, and poppy cultivation through eradication and other law enforcement operations.

- o Increasing host-nation eradication and other law enforcement activities, including destruction of clandestine laboratories and airfields, through cooperation with country law enforcement agencies, enhanced training, better intelligence sharing, and tight controls on precursor chemicals.

- o Strengthening the legitimate economies of Latin American and Caribbean countries and encouraging these countries' acceptance and adoption of the U.S. Government's cocaine control efforts through additional economic support and military assistance.

- o Utilizing public diplomacy initiatives to raise public awareness and increase demand-reduction efforts worldwide.

- o Assisting countries in reducing the demand for heroin, cocaine, and marijuana through dissemination of preventic and treatment information, technical assistance, and training with host countries and international organizations.

- o Assisting nations to strengthen their legal and judicial systems to eliminate narcotics trafficking organizations.

- o Securing international cooperation on financial investigations and asset seizure and forfeiture to prohibit money laundering of narcotics profits.

- o Gaining consensus among developed nations that positive performance in narcotics control is a condition for aid to producing and trafficking countries.

INTERDICTION STRATEGY

The primary goal of the National Interdiction effort is to reduce the quantity of illegal drugs entering the United States by targeting the transportation link between drug supply and demand. More specifically, interdiction focuses on the detection, sorting, interception/tracking and apprehension of illegal drugs as they move from their departure zone in source countries, along smuggling routes (transit zone) to our borders (arrival zone). The objective of the interdiction strategy is to raise the level of risk to the point where significant numbers of organized smuggling groups will cease operation and to deter other potential smugglers from entering the trade.

The Interdiction Strategy is divided into three parts which address the separate but interrelated issues of air, land, and maritime smuggling. The following is a synopsis of the three plans:

Air Interdiction Strategy Implementation Plan

The Air Interdiction Plan is designed to interdict general aviation aircraft transporting illegal drugs into the United States. Objectives of the Plan are to:

1. Strengthen a fixed detection net in the Southeast.

2. Develop a fixed detection net in the Southwest.

3. Begin to establish a mobile detection net in departure zones near source and transit countries.

4. Improve the sorting process by establishing command, control, communications, and intelligence (C3I) Centers in the Eastern and Western United States.

5. Improve interception/tracking and apprehension capabilities to respond to improved detection and sorting.

6. Provide dedicated air detection support to the Maritime Interdiction Strategy Plan.

Land Interdiction Strategy Implementation Plan

The Land Interdiction Strategy Plan is intended to interdict illegal drugs at airports, seaports, land border ports, between ports of entry and in international mail. Objectives of the Plan are to:

1. Improve targeting through more sophisticated use of the Automated Commercial System (ACS) computer data base for every commercial importation, especially aimed at containerized cargo.

2. Increase the number of "100 percent" inspections of containers and commercial trucks.

3. Mobilize available resources along the Southwest Border through increased coordination of all agencies (Operation Alliance).

4. Expand cooperative programs and data exchange with private industries involved in international trade and travel to improve detection and sorting systems.

5. Establish an information base for interdiction targeting in departure zones through special analytical teams.

Maritime Interdiction Strategy Implementation Plan

The Maritime Interdiction Plan is intended to interdict illegal drugs being transported through the maritime region into the United States. Objectives of the Plan are to:

1. Increase maritime interdiction capabilities in departure zones off source countries to perform surge and pulse operations.

2. Increase detection and apprehension assets in Caribbean "Choke Points".

3. Address air drops in the Bahamas with helicopters, by operating existing radar balloons (aerostats) and adding aircraft detection and maritime interdiction assets in the arrival and transit zones.

4. Improve sorting of maritime drug smugglers from legitimate vessel traffic in the arrival zone.

INVESTIGATIONS STRATEGY

The principal objectives of the Investigations strategy are to immobilize trafficking organizations by arresting the most significant members; reduce the availability of illegal drugs through seizures, eradication, and precursor chemical controls; and remove drug-related assets through seizures and forfeitures. The objectives of this strategy are to:

- Emphasize multi-agency investigations.
- Target and prioritize the cartels and organizations of the highest level violators.
- Monitor distribution of precursor chemicals.
- Increase initiatives against clandestine laboratories.
- Support domestic and foreign eradication.
- Apply seizure and forfeiture statutes.

- Assign resources to priority targets.

PROSECUTION STRATEGY

The principal focus of the prosecutions strategy is to better marshal our Federal efforts to reduce the supply of illegal drugs in the United States by pro-active targeting of major traffickers, assisting state and local narcotics prosecutions, and attacking significant local and regional narcotics threats. The objectives of this strategy are to:

- Divide prosecution and assistance efforts into three categories: priority targets; state and local assistance; and regional narcotics threats.
- Direct 80% of Federal narcotics prosecution resources and virtually 100% of Organized Crime Drug Enforcement Task Force (OCDETF) resources against priority targets beginning in FY89.
- Create a high-level targeting group to maintain the focus of Federal investigative and prosecution efforts on multi-national traffickers and other priority targets.
- Support state and local anti-drug efforts through equitable sharing and adoptive forfeiture funds.
- Improve state and local training programs.
- Draft model legislation on money laundering, RICO, electronic surveillance, asset forfeiture, enhanced penalties and grand jury powers.
- Curtail the demand for drugs through the selective prosecution of users consistent with our zero tolerance policy.
- Utilize federal cross-designation, technical and laboratory facilities, and non-English language capability to improve effectiveness of Federal, state and local prosecutions.
- Prosecute selected local and state narcotics threats to maintain public confidence and avoid perception of gaps in narcotics enforcement.

Mr. Chairman, that concludes my formal statement. I will now turn our presentation over to Under Secretary Newman for a review of the "demand-side" strategy implementation plans.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED
EMBARGOED FOR RELEASE UNTIL DELIVERY

Remarks by
The Secretary of the Treasury
James A. Baker, III
at the Morning Session of
The Development Committee
of The World Bank and
The International Monetary Fund
Washington, D.C.
Friday, April 15, 1988

Chairman Chidzero, President Conable, Managing Director Camdessus:

I welcome this opportunity to discuss the challenges facing the developing countries and what the world community, including developed and developing countries, can do to address them.

We are particularly pleased with the establishment of the Multilateral Investment Guarantee Agency (MIGA) this week. We look forward to MIGA taking the lead role within the Bank Group in providing technical assistance and policy advice to stimulate the flow of new investment to developing countries.

The debt difficulties of the middle-income, heavily-indebted countries continue to be a priority concern. Cooperative efforts focused on achieving stronger, sustained growth through economic reforms and adequate international finance remain the only viable and realistic approach for addressing these problems.

While a lot more must be done, we can take heart at how far we have come. Needed reforms are being adopted in most of these countries. According to the World Bank, growth in 1987 was in the 4 - 5 percent range or higher for 8 of the 15 major debtors. Export earnings rose sharply last year; imports have increased; and debt service ratios have fallen.

The development of a "menu" approach to commercial bank financing packages provides additional flexibility for both new financing flows and new debt conversion techniques. Trade credits and project loans can help target financing for more specific end uses to boost production and growth. Debt/equity swaps and other debt conversions can help reduce debt service burdens and support new investment, environmental objectives, or research and development.

B-1375

The proposed General Capital Increase for the World Bank wi position the Bank to maintain its strong support for debtor reforms. We believe that the key contribution of the World Ban should be to encourage sound economic policies in the debtor countries that will catalyze private flows of capital. The Ban and the Fund must continue to work with debtor nations to reduc fiscal deficits, control inflation, boost domestic savings and investment, and attract both foreign equity and reflows of flig capital.

While voluntary, market-based, debt conversion techniques c be a useful part of the evolving menu approach, it is the position of the United States to oppose generalized debt relief such as through the creation of a new international facility. Shifting risk to international financial institutions and their member governments is simply not a realistic option.

Mr. Chairman, the resolution of debt problems will take tim and patient and determined effort. Clearly, we all have an important role to play in advancing progress under the debt strategy. This evolutionary approach is the only realistic framework for addressing debt problems.

Turning now to the low-income countries, we note that in comparison with the early 1980s, the economic and financial prospects of the Sub-Saharan African countries are somewhat mor favorable. During the past year, creditor countries pledged a substantial volume of resources that will support economic adjustment programs in the countries of the region, including through the Bank's new cofinancing program and the Fund's Enhanced Structural Adjustment Facility.

The Bank estimates that these resources should meet the financing needs over the next few years of the poorest and most heavily indebted of those countries that are committed to economic reform. The resources will also help ensure positive economic growth in the context of strong programs of macro-economic and structural reform. Policy Framework Papers (PFPs) should provide a focal point for Bank and Fund assistanc to borrowers in the formulation of such programs. Through this and other efforts, Bank-Fund collaboration should be greatly strengthened.

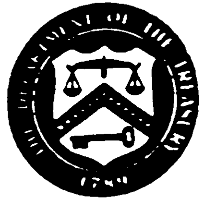
The success of the low-income Asian countries in maintainin good rates of economic growth is praiseworthy. My country has provided them substantial aid in the past, and they will remain an important priority for the future.

Environmental conservation is not only a social issue but also an economic issue. The World Bank should reinforce the understanding that economic growth, development, and environmental preservation must be approached as an integrated whole. The Bank has taken important steps to improve its management of environmental issues. But we believe there is a need for stronger action on the environmental front, particular in implementing policies already in place. And we must continu to focus closely on the environment issue in future meetings.

Mr. Chairman, our common interests are also at stake in the GATT Round. Clearly, developed countries have a responsibility to lead efforts worldwide to liberalize trade. However, developing countries, and in particular, major traders, must also assume greater responsibilities that match their growing importance in the world economy. In this context, we believe that trade restrictions that try to address balance of payments problems actually damage developing economies in the long run. GATT rules in this area should be reviewed and revised.

Finally, protectionist agricultural policies are among the most serious problems in the world trading system. The United States has proposed a comprehensive solution -- a complete phase-out over 10 years of all agricultural subsidies and barriers to trade. Mr. Chairman, the Uruguay Round is serving our common interests. I assure you that the United States will work hard for concrete results for the mid-term review, and for a successful outcome of the Round.

My delegation looks forward to further consideration of the items on our agenda as our meetings progress.

TREASURY NEWS 
epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
April 15, 1988

Contact: Bob Levine
(202) 566-2041

TREASURY RELEASES
DEBT-FOR-NATURE STUDY

On April 13, 1988, the Secretary of the Treasury submitted a report to Congress regarding possible initiatives by multilateral development banks (MDBs) to facilitate "debt-for-nature" swaps with developing countries.

"Debt-for-nature" swaps involve an exchange or cancellation of an external debt obligation in return for environment-related action on the part of a debtor nation. Typically, a conservation or environmental group buys or receives as a donation the external debt of a developing country; exchanges the debt paper for local currency from the developing nations central bank; and pledges to use the proceeds for conservation programs in that country.

The Treasury Department supports the development of private sector initiatives aimed at converting a portion of developing nations' debt into local currency for conservation and environmental use.

The Treasury report offers a description of these debt conversions, and progress to date. It also offers a description of current World Bank and other MDB environmental programs, as well as recommendations regarding World Bank initiatives and a tentative schedule for following through on these proposals.

The Treasury Department recommends World Bank initiatives in the following areas:

oo "piggy-backing" debt-for-nature conversions onto MDB loans and environmental programs,

oo having the World Bank serve as an "information broker" and help set priorities regarding conservation,

oo integrating environmental policy with the Bank's structural adjustment and sector loans,

oo considering a pilot program in countries with swap programs, in order to integrate all of the recommendations, and, in this context,

oo exploring the possibility of making new loans available for tropical forest and wetland protection, and offering technical assistance regarding the start-up of debt-for-nature programs.

B-1376

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

EMBARGOED FOR RELEASE UNTIL DELIVERY
Expected at 1:00 P.M., DST
April 18, 1988

STATEMENT OF THE HONORABLE JAMES A. BAKER, III
SECRETARY OF THE TREASURY
BEFORE THE
SENATE COMMITTEE ON APPROPRIATIONS
SUBCOMMITTEE ON TREASURY, POSTAL SERVICE
AND GENERAL GOVERNMENT
MONDAY, APRIL 18, 1988

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE:

It is my honor to appear before this Subcommittee today to discuss the operating budget request for the Department of the Treasury for Fiscal Year 1989.

In March, I testified before the Senate Budget and Appropriations Committees. At that time, we discussed the Federal budget for Fiscal Year 1989 and the Nation's economy. I noted that this President's Budget was developed to uphold the deficit reduction efforts that characterized last fall's historic Budget Summit. The Budget was crafted in accord with the spirit of the Bipartisan Budget Agreement that was produced and offers the prospect of substantive progress toward our ultimate goal of deficit elimination.

Today, my remarks focus upon that portion of the overall President's Budget that pertains to the operations of the Department of the Treasury. This Departmental budget was developed in accordance with the Bipartisan Budget Agreement. It supports the revenue targets in that agreement. It provides for the effective and efficient conduct of necessary Federal responsibilities and does so within the parameters of the governmentwide effort to contain and reduce deficit spending.

Essential governmental functions entrusted to the Department of the Treasury include:

- o Collecting the government's revenues through an efficient administration of the Nation's tax system;

B-1377

- o Combating illegal drug trafficking;
- o Conducting other enforcement activities, such as protecting the President and Vice President as well as candidates for these offices, enforcing trade laws, apprehending violators of federal firearms laws, and providing law enforcement training;
- o Maintaining government accounts and financing the public debt;
- o Producing the Nation's coin and currency; and
- o Advising the President on the economy and fiscal policies.

For Fiscal Year 1989, the Department is requesting a total budget of $7.7 billion and 153,358 total staff years. This represents an increase of $283 million and 1,557 FTE over the Fiscal Year 1988 levels contained in the Continuing Resolution. There are several overall objectives in this Budget that I would like to highlight:

I. Our key objective is to maintain an effective tax administration system and to continue the orderly transition to tax reform begun in Fiscal Year 1988.

The request for the Internal Revenue Service will promote tax compliance and continue to fund high yielding revenue programs, including enhancements begun in Fiscal Year 1988. Funding for IRS direct enforcement activities is designed to support revenue targets set in the Bipartisan Budget Agreement.

This budget provides for increased emphasis on modernizing tax administration and provides for continued support begun in earlier years for the "service side" of IRS--processing of returns and service to taxpayers--especially important during the transition to tax reform.

Finally, the IRS budget permits an expansion of international operations along with enhanced activity aimed at detecting tax fraud through criminal investigations.

II. Our second objective is to meet effectively our law enforcement and protection responsibilities and in particular to continue strong support for the President's War on Drugs. The request for Customs builds on the strong base developed in Fiscal Years 1987 and 1988 by allowing for a strengthening of drug enforcement staffing and the effective operation of air interdiction assets previously acquired or modified.

In addition to its role in drug enforcement, the Customs

Service budget provides for enforcement of the Nation's import and export laws along with rapid clearance of passengers and cargo. Corrective legislation will be forthcoming to make the ad valorem user fee consistent with provisions of the General Agreement on Tariffs and Trade. The level of resources contained in this budget will allow the Customs Service to collect an estimated $17.8 billion in revenue.

The Bureau of Alcohol, Tobacco and Firearms will oversee the collection of over $10 billion in excise taxes in Fiscal Year 1989. This budget supports the efficient collection of those revenues as well as funds the development of an improved law enforcement information system.

During the first half of Fiscal Year 1989, the Secret Service will conclude those additional protective responsibilities related to the 1988 Presidential campaign and election. This request for the Service addresses these responsibilities and includes support for better security, modernized information and communications systems and centralized headquarters administration.

In FY 1989, the budget of the Federal Law Enforcement Training Center will provide for the execution of its basic law enforcement training programs. This will include support of anti-terrorist training and training for Operation Alliance.

III. A third major objective for the Department is to effectively manage the Nation's finances and service the public debt.

This budget supports continued efforts to promote financial integrity governmentwide in the areas of cash management, credit administration and financial information. Systems modernization efforts proposed in the fiscal services area will provide more secure and efficient management of the government's financial resources.

IV. Fourth, the production of sufficient coinage and currency to meet the Nation's business transaction needs is the next important objective in this budget. The requested budget for the U.S. Mint supports the essential mission of the manufacture and supply of domestic coins, as well as research and development initiatives to improve production operations. The Bureau of Engraving and Printing does not require annual appropriations.

V. The funding request for Treasury's Departmental Offices will help secure the formulation of national economic, financial and tax policies and the management oversight of bureau operations.

In sum, our $7.7 billion request for the Department of the Treasury represents:

- o A necessary investment in the IRS to preserve the integrity of tax administration and to maintain a high level of service to taxpayers in the post-tax reform period;

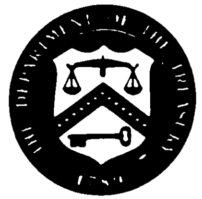
- o A continuation of effective revenue yielding activities at the IRS;

- o A continuation of the strong support of the President's War on Drugs through effective law enforcement activities; and

- o A commitment to maintain the essential governmental functions of the Department.

Mr. Chairman, that concludes my opening remarks. I will be happy to answer any questions that you or the other Subcommittee members may have.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
April 18, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,402 million of 13-week bills and for $6,409 million of 26-week bills, both to be issued on April 21, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 21, 1988			:	26-week bills maturing October 20, 1988		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	5.77% a/	5.94%	98.541	:	6.09% b/	6.37%	96.921
High	5.79%	5.96%	98.536	:	6.17%	6.46%	96.881
Average	5.78%	5.95%	98.539	:	6.14%	6.42%	96.896

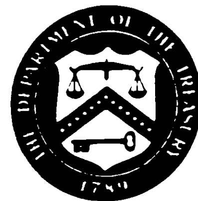
a/ Excepting 1 tender of $4,850,000.
b/ Excepting 1 tender of $4,175,000.
Tenders at the high discount rate for the 13-week bills were allotted 81%.
Tenders at the high discount rate for the 26-week bills were allotted 11%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 36,520	$ 36,020	:	$ 23,550	$ 23,550
New York	23,888,955	5,789,810	:	17,164,110	5,416,860
Philadelphia	24,525	24,525	:	20,005	20,005
Cleveland	32,470	32,415	:	26,090	26,090
Richmond	38,435	38,435	:	26,360	26,360
Atlanta	26,145	26,145	:	28,150	28,150
Chicago	1,878,185	137,240	:	1,003,580	260,780
St. Louis	10,000	10,000	:	11,850	11,850
Minneapolis	3,270	3,270	:	5,205	5,205
Kansas City	33,970	30,700	:	39,490	39,490
Dallas	29,965	19,965	:	25,620	20,620
San Francisco	1,052,495	64,495	:	1,027,580	123,440
Treasury	188,920	188,920	:	406,645	406,645
TOTALS	$27,243,855	$6,401,940	:	$19,808,235	$6,409,045
Type					
Competitive	$23,624,885	$2,782,970	:	$15,673,935	$2,274,745
Noncompetitive	871,170	871,170	:	879,900	879,900
Subtotal, Public	$24,496,055	$3,654,140	:	$16,553,835	$3,154,645
Federal Reserve	2,000,000	2,000,000	:	1,539,300	1,539,300
Foreign Official Institutions	747,800	747,800	:	1,715,100	1,715,100
TOTALS	$27,243,855	$6,401,940	:	$19,808,235	$6.409.045

1/ Equivalent coupon-issue yield.

B-1378

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

EMBARGOED FOR RELEASE UNTIL DELIVERY
Expected at 11:00 A.M., DST
April 19, 1988

STATEMENT OF THE HONORABLE JAMES A. BAKER, III
SECRETARY OF THE TREASURY
BEFORE THE
HOUSE COMMITTEE ON APPROPRIATIONS
SUBCOMMITTEE ON TREASURY, POSTAL SERVICE
AND GENERAL GOVERNMENT
TUESDAY, APRIL 19, 1988

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE:

It is my honor to appear before this Subcommittee today to discuss the operating budget request for the Department of the Treasury for Fiscal Year 1989.

In March, I testified before the Senate Budget and Appropriations Committees. At that time, we discussed the Federal budget for Fiscal Year 1989 and the Nation's economy. I noted that this President's Budget was developed to uphold the deficit reduction efforts that characterized last fall's historic Budget Summit. The Budget was crafted in accord with the spirit of the Bipartisan Budget Agreement that was produced and offers the prospect of substantive progress toward our ultimate goal of deficit elimination.

Today, my remarks focus upon that portion of the overall President's Budget that pertains to the operations of the Department of the Treasury. This Departmental budget was developed in accordance with the Bipartisan Budget Agreement. It supports the revenue targets in that agreement. It provides for the effective and efficient conduct of necessary Federal responsibilities and does so within the parameters of the governmentwide effort to contain and reduce deficit spending.

Essential governmental functions entrusted to the Department of the Treasury include:

- o Collecting the government's revenues through an efficient administration of the Nation's tax system;

B-1379

- o Combating illegal drug trafficking;
- o Conducting other enforcement activities, such as protecting the President and Vice President as well as candidates for these offices, enforcing trade laws, apprehending violators of federal firearms laws, and providing law enforcement training;
- o Maintaining government accounts and financing the public debt;
- o Producing the Nation's coin and currency; and
- o Advising the President on the economy and fiscal policies.

For Fiscal Year 1989, the Department is requesting a total budget of $7.7 billion and 153,358 total staff years. This represents an increase of $283 million and 1,557 FTE over the Fiscal Year 1988 levels contained in the Continuing Resolution. There are several overall objectives in this Budget that I would like to highlight:

I. Our key objective is to maintain an effective tax administration system and to continue the orderly transition to tax reform begun in Fiscal Year 1988.

The request for the Internal Revenue Service will promote tax compliance and continue to fund high yielding revenue programs, including enhancements begun in Fiscal Year 1988. Funding for IRS direct enforcement activities is designed to support revenue targets set in the Bipartisan Budget Agreement.

This budget provides for increased emphasis on modernizing tax administration and provides for continued support begun in earlier years for the "service side" of IRS--processing of returns and service to taxpayers--especially important during the transition to tax reform.

Finally, the IRS budget permits an expansion of international operations along with enhanced activity aimed at detecting tax fraud through criminal investigations.

II. Our second objective is to meet effectively our law enforcement and protection responsibilities and in particular to continue strong support for the President's War on Drugs. The request for Customs builds on the strong base developed in Fiscal Years 1987 and 1988 by allowing for a strengthening of drug enforcement staffing and the effective operation of air interdiction assets previously acquired or modified.

In addition to its role in drug enforcement, the Customs

Service budget provides for enforcement of the Nation's import and export laws along with rapid clearance of passengers and cargo. Corrective legislation will be forthcoming to make the ad valorem user fee consistent with provisions of the General Agreement on Tariffs and Trade. The level of resources contained in this budget will allow the Customs Service to collect an estimated $17.8 billion in revenue.

The Bureau of Alcohol, Tobacco and Firearms will oversee the collection of over $10 billion in excise taxes in Fiscal Year 1989. This budget supports the efficient collection of those revenues as well as funds the development of an improved law enforcement information system.

During the first half of Fiscal Year 1989, the Secret Service will conclude those additional protective responsibilities related to the 1988 Presidential campaign and election. This request for the Service addresses these responsibilities and includes support for better security, modernized information and communications systems and centralized headquarters administration.

In FY 1989, the budget of the Federal Law Enforcement Training Center will provide for the execution of its basic law enforcement training programs. This will include support of anti-terrorist training and training for Operation Alliance.

III. A third major objective for the Department is to effectively manage the Nation's finances and service the public debt.

This budget supports continued efforts to promote financial integrity governmentwide in the areas of cash management, credit administration and financial information. Systems modernization efforts proposed in the fiscal services area will provide more secure and efficient management of the government's financial resources.

IV. Fourth, the production of sufficient coinage and currency to meet the Nation's business transaction needs is the next important objective in this budget. The requested budget for the U.S. Mint supports the essential mission of the manufacture and supply of domestic coins, as well as research and development initiatives to improve production operations. The Bureau of Engraving and Printing does not require annual appropriations.

V. The funding request for Treasury's Departmental Offices will help secure the formulation of national economic, financial and tax policies and the management oversight of bureau operations.

In sum, our $7.7 billion request for the Department of the Treasury represents:

- A necessary investment in the IRS to preserve the integrity of tax administration and to maintain a high level of service to taxpayers in the post-tax reform period;

- A continuation of effective revenue yielding activities at the IRS;

- A continuation of the strong support of the President's War on Drugs through effective law enforcement activities; and

- A commitment to maintain the essential governmental functions of the Department.

Mr. Chairman, that concludes my opening remarks. I will be happy to answer any questions that you or the other Subcommittee members may have.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.
April 19, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $12,800 million, to be issued April 28, 1988. This offering will result in a paydown for the Treasury of about $200 million, as the maturing bills are outstanding in the amount of $12,989 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, April 25, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,400 million, representing an additional amount of bills dated January 28, 1988, and to mature July 28, 1988 (CUSIP No. 912794 QG 2), currently outstanding in the amount of $6,543 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $6,400 million, representing an additional amount of bills dated October 29, 1987, and to mature October 27, 1988 (CUSIP No. 912794 QB 3), currently outstanding in the amount of $9,284 million, the additional and original bills to be freely interchangeable.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing April 28, 1988. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $1,790 million as agents for foreign and international monetary authorities, and $3,257 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

B-1380

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.
April 20, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION $8,500 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $8,500 million of 2-year notes to refund $9,876 million of 2-year notes maturing April 30, 1988, and to paydown about $1,375 million. The public holds $9,876 million of the maturing 2-year notes, including $867 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $8,500 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average price of accepted competitive tenders.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $1,429 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

oOo

Attachment

B-1381

HIGHLIGHTS OF TREASURY OFFERING TO THE PUBLIC OF 2-YEAR NOTES TO BE ISSUED MAY 2, 1988

April 20, 1988

<u>Amount Offered:</u>

To the public	$8,500 million

<u>Description of Security:</u>

Term and type of security	2-year notes
Series and CUSIP designation	Z-1990 (CUSIP No. 912827 WC 2)
Maturity date	April 30, 1990
Call date	No provision
Interest rate	To be determined based on the average of accepted bids
Investment yield	To be determined at auction
Premium or discount	To be determined after auction
Interest payment dates	October 31 and April 30
Minimum denomination available ..	$5,000

<u>Terms of Sale:</u>

Method of sale	Yield auction
Competitive tenders	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor	None

<u>Payment Terms:</u>

Payment by non-institutional investors	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts ...	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions	Acceptable

<u>Key Dates:</u>

Receipt of tenders	Wednesday, April 27, 1988, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):	
a) funds immediately available to the Treasury ..	Monday, May 2, 1988
b) readily-collectible check ..	Thursday, April 28, 1988

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED
EMBARGOED FOR RELEASE UPON DELIVERY
EXPECTED AT 12:30 P.M., EDT

Remarks by
The Secretary of the Treasury
James A. Baker, III
to the Canadian Club of Ottawa
Chateau Laurier Hotel
Ottawa
Ontario, Canada
Thursday, April 21, 1988

CANADA-U.S. FREE TRADE AGREEMENT: THE INTERNATIONAL PERSPECTIVE

This has been a noteworthy year for Canada. Two major international events -- the Winter Olympics and the World Economic Summit -- are hosted by Canada this year. They should focus the world's attention on something that many of us already know -- that Canada is a vibrant, exciting nation that is leaving its mark on many quarters of the world.

As I watched the Olympic games, I couldn't decide who most deserved a gold medal -- the many athletes, or their Canadian hosts, whose vitality, efficiency, and courtesy ensured Calgary's top-rate performance. And I fully expect that the world leaders who gather in Toronto in June will be equally impressed with the gold-medal quality of your dynamism and international leadership.

They will certainly be aware of the tremendous economic growth that Canada has achieved over the past four years -- and of the initiatives Prime Minister Mulroney and Finance Minister Wilson have taken to encourage entrepreneurship and innovation.

I believe these policies have had much to do with Canada's impressive economic performance. Canada has led the seven major industrialized countries in real GDP growth over the past four years. Since 1984, Canada has created more than one million new full-time jobs, and reduced the unemployment rate significantly. Moreover, Canada's prospects for this year -- the sixth consecutive year of expansion -- are excellent.

I hope one of the crowning achievements of the Mulroney Government will be the Canada-U.S. Free Trade Agreement. I could expound on what the agreement will mean for Canada, but the Prime Minister and many members of his government already have stated that case eloquently and persuasively.

So instead I will focus on some international aspects of the agreement. I believe Canada and the U.S. can take the lead in offering the world a model trade agreement. This agreement can serve not only as a pattern for future bilateral agreements, but also as a catalyst for action on the multilateral front.

A Perspective from the Past

The postwar achievements of multilateralism create an understandable caution about any bilateral trading agreement. But it's useful to recall that the multilateral GATT system grew out of a bilateral initiative to overcome destructive unilateralism.

For much of the 19th and early 20th Centuries, the "tariff question" was a major topic in international and domestic politics around the world. In the United States, comprehensive tariff bills were one of Congress' most important products. This Congressional direction of trade policy culminated in the infamous Smoot-Hawley bill, the Tariff Act of 1930, the last general tariff law enacted by Congress. Smoot-Hawley amended specific tariff schedules for over 20,000 items, establishing the United States' highest general tariff rate structure.

But only four years later, Secretary of State Cordell Hull persuaded Congress to enact a very different trade law, the Reciprocal Trade Agreements Act of 1934. This law authorized the President to negotiate and implement tariff reductions through bilateral agreements. In doing so, Congress moved from a rigid statutory tariff to a "bargaining tariff" that enabled the Executive to negotiate a cooperative trading system.

Secretary Hull certainly did bargain. During the next eleven years, the United States entered into 32 bilateral agreements with 27 nations.

These bilateral achievements set a crucial precedent for the multilateral negotiations that followed World War II. Indeed, even the architects of GATT began with a bilateral model. They expected that the new trading structure would be built upon a U.S.-U.K. foundation, or later, a U.S.- European base.

The GATT system has enjoyed enormous success in lowering tariffs and reducing direct barriers to trade. GATT also has been relatively successful in defending these gains. Nevertheless, new forms of protectionism have arisen -- subsidies, restrictive government procurement rules, market-sharing schemes, voluntary export curbs, and discriminatory product standards, among others. The specialized, technical, and indirect nature of these barriers makes it harder to package reciprocal national concessions.

In the Tokyo Round, GATT responded with a "minilateral" solution: Some, but not all, GATT members agreed to special rules governing countervailing and antidumping duties, subsidies, government procurement, licensing, customs valuation, and product standards. These codes have helped create international standards -- which are effective as long as they are enforceable.

The Present Challenge

The success of the multilateral trading system has raised expectations -- and led to more difficult challenges. There are five major threats to the multilateral system today.

First, the changing patterns and volatility of capital flows have had an enormous and sometimes destabilizing effect on trade. Both short- and long-term capital now move relatively easily around the globe to locations or securities offering more attractive mixes of risk and return. These flows affect currency values, which, in turn, influence the competitiveness of exports and imports.

Second, technology and industrial processes can now be transferred around the world with relative ease. As a result, there are many highly competitive newly industrialized nations. Unfortunately, some of the new titans of production have been slow to expand consumption commensurately, thus helping to create international imbalances.

Third, many of the successful exporting nations do not have a special affinity for the postwar liberal trading regime. Their "logic," labeled by some as the "New Mercantilism," is that exports are good and imports are bad. This perspective poses a serious threat to a trading system based on the presumption that expanded trade -- measured in terms of both imports and exports -- will increase world prosperity in a mutually satisfactory and sustainable fashion.

Fourth, the "rules" of the trading system do not adequately protect some sectors of growing importance -- services, investment, intellectual property, and high technology, among others. These sectors are areas of comparative advantage for some of the key sponsors and promoters of the multilateral system.

Fifth, domestic political support for the liberal trading system has been eroding in a number of nations. In the U.S., this political trend can be traced to stiffer foreign competition, caused in part by the inevitable rise of productive efficiency in reconstructed or developing nations.

There are some notable positive developments. The most prominent is the initiation of the Uruguay Round. These negotiations presage breakthroughs in the areas of services, intellectual property, agriculture, and trade-related investment. But many of these beneficial results, if they can be achieved, are years from full fruition. Moreover, the ultimate success of these negotiations depends on the creation of incentives for many nations to conform. In the meantime, we need examples of productive government activism that invigorate internationalists, reawaken businesses and consumers to the gains of open trade, and present possible models for arrangements with other nations.

Charting a Future Course

There is no assurance, however, that we will meet this present challenge with a constructive vision of the future.

As you are all well aware, many in the U.S. Congress are frustrated by the persistent trade imbalance and are trying to legislate the problem away. One of their approaches is to return to straightforward legislative protection for industries, for example, through direct restrictions on imports. Other nations are relying on similar barriers, frequently dressed up with local political justifications.

A second counterproductive approach, perhaps more popular, has been termed "process protectionism." This type of legislation tries to conceal itself as nothing more than seemingly modest adjustments in trade laws. But each tightening twist of law chokes off trade a little more, with little or no regard for GATT rules, international standards, or the likelihood of triggering retaliatory trade wars.

The United States is not the only nation contending with powerful internal factions advocating policies that will weaken the open trading system. Some nations with large trade surpluses are disinclined to remove protection for politically powerful groups -- despite the obvious gains to their consumers and other businesses. Indeed, an odd Calvinist ethic of the trading system seems to inspire the belief in some of these nations -- whether in Asia or Europe -- that continuing surpluses are a sign of national superiority and a justification for inaction.

There is, however, an alternative approach to the future. This approach is idealistic in aim, but realistic and often incremental in method. It seeks to move nations toward a more open trading system through a strategy of consistent, complementary, and reinforcing actions on various international fronts, bilateral and multilateral. As some of these actions bear fruit, they should enhance domestic political support for other actions.

This is the approach embodied in the Canada-U.S. Free Trade Area agreement. While the international trading system has been subject to increasing stress and strain, the Canadian-U.S. economic relationship has been growing and strengthening. Indeed, after over a century of failed efforts, our governments have a sterling opportunity to complete a North American economic accord. This would cap an historical journey from hostility, based on two long-distant wars, to a high degree of economic interdependence and common purpose, while maintaining national identities.

Given similar challenges of adjustment in the face of heightened international competition, businesses in both nations will profit from secure access to a home-base market of about 270 million people. Most economists expect the benefits of this open market to be greater for Canada because its opportunities for larger scale production will grow much more. By way of example, the 1965 Auto Pact produced a rationalization that led to fewer models, much greater volume, and a sizable boost in Canada's manufacturing trade, employment, and output. And the increased income generated from more efficient production on both sides of the border should prompt additional economic activity.

If both nations accept the final agreement, this achievement will grow in stature and importance over time. Its geopolitical potential is significant. A successful economic arrangement should enhance our ability to work together on other common problems. In the 20th century, we have maintained the longest peaceful border in the world and served with one another as allies in a common defense. In the 21st century, we will also need to work closely together to better address questions concerning the environment, wildlife, ocean borders, the Arctic, outer space, disease and medical science, terrorism, communications frequencies, bank and securities regulation, taxation, and immigration -- to name a few topics.

In addition, the accord accommodates and enhances future trade liberalization efforts in six ways.

First, the agreement respects GATT and is careful not to undermine the successes of the multilateral approach. Canada and the U.S. are lowering barriers between themselves, not raising barriers to others. We are seeking a healthy, dynamic linkage between bilateral and multilateral initiatives so as to prod and reinforce the GATT.

Second, the Canada-U.S. agreement extends the reach of an open, cooperative system by negotiating solutions in the areas of services, investment, and technology -- while respecting national sovereignty. These arrangements demonstrate what can be achieved and offer conceptual approaches to which others may turn.

Third, we have lowered the cost of initiating international liberalization in these new areas by breaking ground with only one nation at a time. When more nations are involved, it is often harder to arrange a satisfactory compromise.

Fourth, the rewards of this agreement offer an incentive to other governments. If possible, we hope this follow-up liberalization will occur in the Uruguay Round. If not, we might be willing to explore a "market liberalization club" approach, through minilateral arrangements or a series of bilateral agreements. In this fashion, North America can build steady momentum for more open and efficient markets.

Fifth, this agreement is also a lever to achieve more open trade. Other nations are forced to recognize that we will devise ways to expand trade -- with or without them. If they choose not to open their markets, they will not reap the benefits. By employing this lever together, the U.S. and Canada may be able to dislodge obstacles in special areas of common concern -- such as agriculture.

Sixth, this Canadian-U.S. accord could prove to be an attractive counterweight to protectionism in both our countries. It attracts those who want government to foster growth and opportunity by breaking down obstacles to achievement and fair competition, not by creating barriers to protect special interests.

Conclusion

The Canada-U.S. FTA agreement is not yet law. In the months to come, there will be ample opportunities for naysayers to criticize the agreement. I hope they will be persuaded by logic and vision.

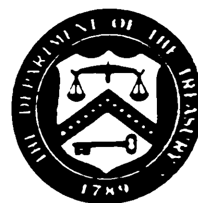
We need to enhance the resiliency of the trading system by promoting liberalization on a number of fronts. While we associate a liberal trading system with multilateralism, bilateral or minilateral regimes may also help move the world toward a more open system.

Indeed, different agreements may be complementary, each fitting a special situation and together creating a liberalized network of mutually reinforcing systems. If activity on one frontier of trade negotiation slows, we may be able to maintain momentum and achieve solutions worthy of imitation through other agreements. If all nations are not ready to liberalize trade, we will begin with those that are and build on that success.

The Free Trade Agreement provides economic opportunities for both Americans and Canadians -- and could be the catalyst for a new trade policy strategy. The inquiries it already has elicited for similar agreements are encouraging. This interest gives both our countries an opportunity to set trade policy on a creative, positive, and pragmatic international course -- one that will earn a gold medal for everyone associated with it.

Thank you.

TREASURY NEWS



epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE

April 22, 1988

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of March 1988.

As indicated in this table, U.S. reserve assets amounted to $43,186 million at the end of March, up from $43,064 million in February.

U.S. Reserve Assets
(in millions of dollars)

End of Month	Total Reserve Assets	Gold Stock 1/	Special Drawing Rights 2/3/	Foreign Currencies 4/	Reserve Position in IMF 2/
1988					
Feb.	43,064	11,063	9,761	11,795	10,445
Mar.	43,186	11,063	9,899	11,579	10,645

1/ Valued at $42.2222 per fine troy ounce.

2/ Beginning July 1974, the IMF adopted a technique for valuing the SDR based on a weighted average of exchange rates for the currencies of selected member countries. The U.S. SDR holdings and reserve position in the IMF also are valued on this basis beginning July 1974.

3/ Includes allocations of SDRs by the IMF plus transactions in SDRs.

4/ Valued at current market exchange rates.

B-1383

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
April 20, 1988

Statement by
David C. Mulford
Assistant Secretary for International Affairs
U.S. Department of Treasury
at the Conclusion of the
Yen/Dollar Working Group Meeting
April 20, 1988

Vice Minister Gyohten of the Japanese Ministry of Finance and I have just concluded a meeting of the Yen/Dollar Working Group.

During the meeting, I noted the progress made by the Japanese Ministry of Finance during the three-year program of financial market reform set out in the 1984 Yen/Dollar Report. Important achievements have been made in the internationalization of the yen through the development of the Euroyen market. In addition, access by foreign financial institutions to Japanese financial markets has significantly improved, including membership in the Tokyo Stock Exchange, trust banking activities, and participation in the Japanese government securities market. The deregulation of Japan's domestic financial markets is also proceeding in a step-by-step fashion, most recently with measures to further liberalize interest rates on large time deposits.

These developments represent an important phase in the development of open, liberal capital markets in Japan. Given Japan's status as a major world economy, these steps contribute in an important way to the free movement of capital globally and are important to the operation of an effectively functioning international monetary system. Although we are encouraged by the actions taken to date, it is important that progress continue to be made in line with Prime Minister Takeshita's recent statement regarding an acceleration in financial market liberalization in Japan.

We spent an equal amount of time discussing Japanese issues of concern about U.S. markets. Two new members were added to the U.S. delegation -- one from the Securities and Exchange Commission and one from the domestic institutions policy part of the Treasury Department. We focused in particular on issues related to interstate banking; financial market deregulation connected with possible changes in the Glass Steagall Act; and regulatory issues resulting from last October's stock market events.

B-1384

I believe the time has now come to move beyond the Yen/Dollar Talks to reflect the changes that have occurred in each of our markets and in the global financial markets. I have proposed that we rename our group "U.S.-Japan Working Group on Financial Markets" and continue the type of broadened consultations we have had today on financial market issues of mutual concern. These issues, among other things, include such topics in both countries as:

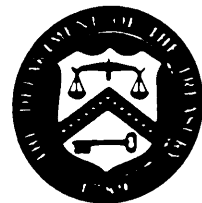
-- The functioning of government securities markets;

-- The restructuring and deregulation of the banking and securities industries;

-- The functioning and regulation of global and domestic capital markets; and,

-- Foreign access to domestic financial markets.

TREASURY NEWS



epartment of the Treasury • Washington, D.C. • Telephone 566-2041

April 25, 1988

JEANNE S. ARCHIBALD
Appointed Deputy General Counsel

Secretary of the Treasury James A. Baker, III today announced the appointment of Jeanne S. Archibald as Deputy General Counsel.

As Deputy General Counsel, Ms. Archibald will assist in administering and coordinating all of the legal activities of the Department.

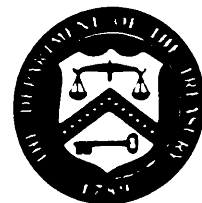
Prior to joining the Department in 1986 as Deputy Assistant General Counsel (International Affairs), Ms. Archibald served as Associate General Counsel at the Office of the U.S. Trade Representative from 1980 to 1986.

Ms. Archibald received her B.A. in 1973 from the State University of New York at Stony Brook, and her J.D. from the Georgetown University Law Center in 1977. She is a member of the D.C. Bar Association.

A native of Sag Harbor, New York, she and her family reside in Reston, Virginia.

B-1385

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
April 25, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,406 million of 13-week bills and for $6,412 million of 26-week bills, both to be issued on April 28, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 28, 1988			:	26-week bills maturing October 27, 1988		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	5.89% a/	6.06%	98.511	:	6.27% b/	6.57%	96.830
High	5.93%	6.10%	98.501	:	6.28%	6.58%	96.825
Average	5.92%	6.09%	98.504	:	6.28%	6.58%	96.825

a/ Excepting 1 tender of $200,000.
b/ Excepting 1 tender of $580,000.
Tenders at the high discount rate for the 13-week bills were allotted 22%.
Tenders at the high discount rate for the 26-week bills were allotted 38%.

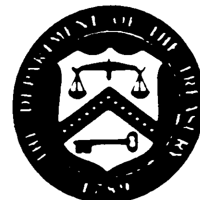
TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 22,025	$ 22,025	:	$ 29,260	$ 29,260
New York	18,666,065	5,147,065	:	22,658,535	5,591,915
Philadelphia	23,120	23,120	:	29,845	27,845
Cleveland	41,720	41,720	:	31,170	31,170
Richmond	47,560	46,000	:	35,055	35,055
Atlanta	29,425	29,425	:	26,135	24,950
Chicago	1,887,395	375,895	:	1,597,540	58,540
St. Louis	12,625	12,625	:	7,095	7,095
Minneapolis	10,855	10,855	:	14,370	9,370
Kansas City	24,670	24,670	:	32,990	31,745
Dallas	32,065	22,065	:	32,130	22,130
San Francisco	971,435	267,655	:	1,274,975	94,175
Treasury	383,240	383,240	:	448,430	448,430
TOTALS	$22,152,200	$6,406,360	:	$26,217,530	$6,411,680
Type					
Competitive	$18,978,905	$3,233,065	:	$22,504,990	$2,699,140
Noncompetitive	926,135	926,135	:	986,540	986,540
Subtotal, Public	$19,905,040	$4,159,200	:	$23,491,530	$3,685,680
Federal Reserve	1,757,360	1,757,360	:	1,500,000	1,500,000
Foreign Official Institutions	489,800	489,800	:	1,226,000	1,226,000
TOTALS	$22,152,200	$6,406,360	:	$26,217,530	$6,411,680

1/ Equivalent coupon-issue yield.

B-1386

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.
April 26, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $12,800 million, to be issued May 5, 1988. This offering will result in a paydown for the Treasury of about $425 million, as the maturing bills are outstanding in the amount of $13,222 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, May 2, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,400 million, representing an additional amount of bills dated August 6, 1987, and to mature August 4, 1988 (CUSIP No. 912794 PY 4), currently outstanding in the amount of $16,274 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,400 million, to be dated May 5, 1988, and to mature November 3, 1988 (CUSIP No. 912794 QS 6).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing May 5, 1988. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $1,534 million as agents for foreign and international monetary authorities, and $3,593 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

10/87

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
Expected at 10:00 A.M., DST
April 27, 1988

TESTIMONY OF THE HONORABLE
CHARLES O. SETHNESS
ASSISTANT SECRETARY FOR DOMESTIC FINANCE
U.S. DEPARTMENT OF TREASURY
BEFORE THE SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
APRIL 27, 1988

Mr. Chairman, Senator Garn, and Members of the Committee:

I thank you for the opportunity to testify before you today on S. 2073, the "Thrift Charter Enhancement Act of 1988," which was introduced by Senator Karnes. For some time now, the Treasury Department has supported thrift charter enhancement as a means of attracting new capital into the industry, augmenting the profitability of capital already invested, and reducing the costs of resolving cases to the Federal Savings and Loan Insurance Corporation (FSLIC).

In fact, thrift charter enhancement has been one of the components of our three-pronged strategy for assisting the troubled thrift industry and shoring up the FSLIC. Permit me to refresh the Committee's memory of that proposal. Our first prong called upon the Federal Home Loan Bank Board (Bank Board) to create new incentives for the industry to increase its capital and, concurrently, to halt the growth of the industry's problems through increased supervision. Significant steps were taken in this direction when the Bank Board issued new regulations concerning capital and examinations beginning in the summer of 1986. More work continues in this area.

The second prong of our strategy consisted of a $15 billion recapitalization plan for the FSLIC. Although a recapitalization plan was enacted last August -- after a long delay from our introduction of the proposal -- the amount was reduced to $10.0 billion net of the mandated return of FSLIC's secondary reserve on the advice of some rather less than objective parties. Since then, the situation in the industry has at least not improved. It should be pointed out, however, that the thrift industry's recent losses stem largely from the realization of costs that Treasury, the Bank Board, the General Accounting Office, and many members of Congress expected. That is, after all, why the recapitalization legislation was necessary and also why it was designed to expand or contract, depending upon what the situation warrants

-- with the clear recognition that the FSLIC cannot create commitments (of whatever sort) that exceed its available resources to honor over time. In addition, the industry's problems cannot be solved overnight, because there are capacity constraints on the amount of funds the FSLIC can utilize effectively.

This makes thrift charter enhancement -- the final prong of our strategy -- a vital means of expanding the capital base of the thrift industry and protecting depositors without dipping into the public coffers. In a 1986 legislative draft, Treasury proposed specific measures to enhance the thrift charter, many of which were eventually incorporated into the 1986 "Deposit Insurance Reform and Competitive Enhancement Act," which was introduced by Senator Garn. In general, we favor efforts that will attract outside capital while maintaining the safety and soundness of the industry and ensuring that to the extent that the powers of banks and thrifts become more similar, the regulation and supervision of the two industries are also made more similar. Thrift charter enhancement should not provide thrifts with bank-like powers and then subject those activities to less rigorous criteria in terms of capital, accounting, disclosure, supervision, etc. This could exacerbate instabilities in the financial services market, place banks at a competitive disadvantage vis-a-vis thrifts, and create undue risks.

In particular, we very much support the provisions in S. 2073 which repeal the cross marketing restrictions on thrift holding companies that purchase failing thrifts; replace the FSLIC's "conflict of interests" regulations with those promulgated by the federal bank regulators to make more uniform the regulation of banks and thrifts; and subject thrifts' affiliate transactions -- including the purchase, sale, or lease of property or assets -- to the "arm's length" restrictions applicable to commercial banks.

Charter enhancement legislation must not only serve as an incentive to attract needed, new capital into the thrift industry, from as broad a variety of sources as possible, but also be designed: (1) to reward only those thrifts which are well-capitalized, well-managed, and which meet the Bank Board's safety and soundness regulations; and (2) to make more uniform the regulation of thrifts, banks, and their respective holding companies in those cases where the activities of these entities are made more uniform.

The Karnes Bill (S. 2073)

Treasury supports most of the concepts proposed in S. 2073, but believes several changes are necessary to ensure that charter enhancement cannot be exploited by troubled thrifts and thereby expose the FSLIC to increased risk of loss. I have provided the Committee with a detailed presentation of Treasury's positions on the various sections of S. 2073 in an appendix to my testimony. At this time, however, I would like to comment briefly on several of the bill's more important provisions.

Additional Powers

S. 2073 would augment the powers of thrifts or thrift holding companies in several areas, either placing them on more of a par with banks or bank holding companies or simply enhancing authority unique to thrifts. For example, S. 2073 would permit federally chartered thrifts to increase their commercial loan limits from 10 to 20 percent of assets, provided they are in compliance with the Bank Board's capital requirements. We believe that thrifts that increase their commercial lending above the 10 percent threshold should also hold capital reserves in an amount equal to those held by banks. Such additional capital would help to offset any risks created by increased commercial lending and serve to protect the FSLIC.

Under the bill, savings and loan holding companies would be permitted to acquire up to five percent of the stock of non-affiliated savings and loans or savings and loan holding companies. Notwithstanding this limitation, securities subsidiaries of savings and loan holding companies would be allowed to underwrite and deal in these securities without regard to the five percent limitation. Under the Bank Holding Company Act, all shares of non-affiliated banks or bank holding companies must be included under the five percent limitation applicable to bank holding companies, regardless of where within the holding company such shares are technically held. We do not object to the securities subsidiary of savings and loan holding companies engaging in the activities proposed, but we believe such activities should be included under the five percent limit.

Holding Company Regulation

We support the bill's proposals to permit thrift holding companies to capitalize on some of the synergies available within the holding company framework and allow their subsidiaries to interact with each other under less onerous affiliation restrictions. For example, S. 2073 would replace the thrift industry's "conflict of interests" regulations with those applicable to banking institutions. In addition, mutual holding companies would be permitted to acquire stock FSLIC-insured institutions and to issue up to 49 percent of their common stock to the public. This authority will attract more capital into mutual holding companies and further foster their ability to convert to stock form.

We also favor allowing nondiversified savings and loan holding companies to incur debt in excess of 15 percent without prior approval. However, we would prefer raising the limit from 15 to 30 percent, rather than simply deleting the limit as proposed in the bill. Raising the limit would eliminate the prior approval requirement for a substantial number of debt transactions while at the same time ensuring the health of the thrift industry and the FSLIC.

Safety and Soundness Provisions

A few of the bill's safety and soundness provisions -- those affecting *de novo* institutions, net worth maintenance agreements, and management interlock exemptions -- may, in our judgment, serve not only to attract new capital, but also, unless amended, to increase the industry's risk of loss for the sake of short-term goals. As I have stated, both additional capital and the health of the thrift industry are of paramount importance, and any enhancement of the thrift charter must protect the industry, the FSLIC, and the taxpayer.

Under S. 2073, *de novo* institutions would be permitted to shed their special regulations after three years under certain conditions. Such a change appears reasonable on its face, but one result could be to permit *de novo* institutions to reduce their capital level below the six percent level. Current Bank Board procedures require *de novo* or newly insured institutions to maintain a seven percent capital level for one fiscal year and a six percent level thereafter. S. 2073 could allow such thrifts to adhere to those capital requirements below six

percent that currently pertain to other insured thrifts. Although competitive equity may argue for such a change, common sense surely does not. Treasury supports at least a six percent capital requirement, and last year's CEBA legislation strongly urged the Bank Board to move thrifts towards that goal. I see no reason why de novo institutions should be able to hold less capital in the interim, rather than lead the industry toward a healthier environment. Nevertheless, if any changes are to be made in this policy, they should be made by the Bank Board through the regulatory process.

The net worth maintenance provisions of S. 2073 would impose statutory requirements on the Bank Board to relieve, after three years, a savings and loan holding company which has acquired a thrift from its guarantee to maintain the net worth of the acquired institution. We believe that an acquiring institution should manage an acquired thrift so as to maintain capital at an appropriately high level. We also believe that there should be room for reasonable flexibility -- but the determination and scope of such flexibility should be made through the regulatory, rather than the legislative, process.

Treasury supports revising the restrictions of the Management Interlocks Act, but not as broadly as S. 2073. We would prefer that acquisitions made pursuant to the emergency acquisition provisions of the Garn-St Germain Act (but not any bank or thrift) be exempt, but only if the relevant federal regulator determines that no substantial conflict of interests or substantial lessening of competition would result. This would reduce S. 2073's burden on the federal regulators to review innumerable cases and preserve a concern for safety and soundness, while also attracting capital into the troubled sector of the thrift industry where it is most sorely needed.

Conclusion

In conclusion, I want to reiterate Treasury's support for thrift charter enhancement for a significant number of S. 2073's provisions, and for all of them if amended to reflect our concerns. Private solutions to the thrift industry's travails must be emphasized, especially when proposals for a taxpayer bailout are emanating from some quarters in the savings and loan industry.

That concludes my prepared remarks, Mr. Chairman. I thank the Committee again for the opportunity to testify on this subject, and I will be happy to answer any questions the members of the Committee might have.

APPENDIX

Treasury Position on S. 2073, the "Thrift Charter Enhancement Act of 1988"

Section 101 - Commercial Lending. Treasury supports increasing from 10 to 20 percent of assets the commercial lending authority of thrifts, but only if those thrifts which engage in commercial lending in excess of 10 percent of assets also hold capital reserves in an amount equal to those required to be held by commercial banks.

Section 102 - Investment in Service Corporations. Treasury supports expanded authority for thrifts to invest in service corporations, but prefers the approach taken in S. 2592, the 1986 Garn bill. S. 2592 provided for a more equitable distribution of such authority between the banking and thrift industries by permitting banks with $250 million or less in assets to invest to the same extent as thrifts in service corporations with the same powers as thrift service corporations, including real estate development and general insurance agency powers. This same service corporation investment authority would also have been extended to any bank holding company which acquired a troubled thrift. In addition, the 1986 Garn bill stipulated that thrifts not in compliance with their capital requirements at the time of enactment would have to phase in the expanded service corporation investment authority upon attaining the minimum capital level.

Section 103 - Small Business Investment Companies. Treasury supports modifying the limit on investments in small business investment companies from no more than one percent of assets to no more than either one percent of assets or five percent of capital, but only if such additional authority is limited to well-run, well-capitalized thrifts.

Section 104 - De Novo Institutions. Treasury opposes a legislative limit of three years on the requirements placed on de novo and other newly insured thrifts, particularly the six percent capital requirement. Treasury favors higher capital requirements overall for the sake of safety and soundness. In addition, any such changes (like the requirements themselves), should be addressed through the regulatory, rather than the legislative, process.

Section 201 - Definition of Affiliate. Treasury does not oppose permitting the service corporation subsidiaries of state-chartered multiple thrift holding companies to engage in state-authorized activities to the same extent as the service corporation subsidiaries of other state-chartered thrifts. The amendment would provide for competitive equality, given the likelihood that, without the amendment, a state-chartered institution which becomes part of a multiple thrift holding company may have to restrict substantially the activities of its service corporation subsidiaries.

Section 202 - Unitary Thrift Holding Company. Treasury supports allowing unitary thrift holding companies to own two healthy thrifts without additional restrictions if they have acquired at least one troubled thrift, but only if the second healthy thrift is acquired in conjunction with (or after) the acquisition of another troubled thrift. That is, any unitary thrift holding company that currently owns one healthy and one troubled thrift should not be permitted to purchase another healthy thrift, unless it also purchases another troubled thrift.

Section 203 - Affiliate Transactions. Treasury supports subjecting thrifts' affiliate transactions regarding the purchase, sale, or lease of property or assets and the contracting of management, advertising, or consulting services to the "arm's length" restrictions applicable to commerical banks. This would not only make bank and thrift regulation more uniform, but also serve to prohibit subsidiary thrifts from upstreaming funds under the guise of paying for services rendered. More in keeping with our general policy would be to apply Sections 23A and 23B of the Federal Reserve Act to all transactions between the holding company and the affiliate.

Section 204 - Activities of Thrift Holding Companies. Treasury supports permitting thrift holding companies to acquire directly up to five percent of the voting shares of a non-affiliated thrift or thrift holding company and allowing a securities firm subsidiary to underwrite and trade in such voting shares. However, Treasury opposes exempting the securities firm subsidiary's holdings of these voting shares from the five percent limit on safety and soundness grounds.

Section 205 - Interlocking Directorates. Treasury supports repealing the interlocking directorate provision of the National Housing Act. Director or officer interlocks of thrift holding companies are also governed by the Depository Institutions Management Interlocks Act, and the amendment would eliminate the unnecessary redundancy.

Section 206 - Amendment to the QTL Test. Treasury opposes increasing the amount of liquidity and loan origination investment which can count towards meeting the QTL test. The QTL test imposed by the Competitive Equality Banking Act (CEBA) intended to permit only those thrifts primarily engaged in housing finance to take advantage of expanded activities. Treasury holds that thrifts not primarily engaged in housing finance should become more, rather than less, like banks.

Section 207 - Cross Marketing. Treasury supports repealing the cross marketing restrictions on thrift holding companies that purchase failing thrifts.

Section 208 - Affiliate Investment. Treasury does not oppose permitting any thrift or other subsidiary of a thrift holding company which has acquired a troubled thrift to engage in those transactions permissible under Sections 23A and 23B of the Federal Reserve Act without regard to the activities of the affiliate. This will draw capital toward troubled thrifts.

Section 209 - Mutual Holding Companies. Treasury supports allowing mutual holding companies to acquire a stock thrift and empowering a mutual subsidiary to issue up to 49 percent of its stock to the public to increase the amount of capital available to mutual holding companies.

Section 210 - Debt Approval. Treasury opposes eliminating completely the current restriction on nondiversified thrift holding companies which prohibits them from incurring debt in excess of 15 percent of their consolidated net worth without advance approval from the FSLIC. However, Treasury supports increasing the limit to 30 percent, thereby effectively eliminating the prior approval requirement for a substantial number of debt transactions without increasing risk. On the other hand, eliminating the 15 percent debt limit with neither a phase-out nor a ceiling, and without limiting debt in excess of 15 percent to well-capitalized institutions, may increase the risk of loss to the FSLIC.

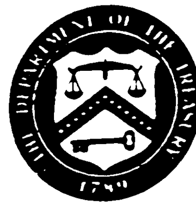
Section 211 - Net Worth Maintenance. Treasury does not oppose the concept of limiting to three years the perpetual guarantee by a thrift holding company to maintain at a certain level the net worth of newly acquired thrifts. However, we oppose making such changes through the legislative, rather than the regulatory, process.

Section 212 - Transactions With Affiliated Persons. Treasury supports replacing the FSLIC's "conflict of interest" regulations with those promulgated by the federal bank regulators to make more uniform the regulation of banks and thrifts.

Section 301 - Management Interlocks Act. Treasury opposes adding two new sections to the Depository Institutions Management Interlocks Act which would exempt companies which become holding companies upon acquiring thrifts pursuant to the emergency acquisition provisions of the Garn-St Germain Act and any bank or thrift whose interlock would not substantially lessen competition or lead to a substantial conflict of interest, as determined by the appropriate federal depository institution regulator. Treasury favors

expanding the interlock exemptions, but only to induce the acquisition of troubled thrifts. Accordingly, companies which acquire thrifts pursuant to the emergency acquisition provisions of the Garn-St Germain Act and thereby become holding companies should be exempted, but <u>only if</u> the appropriate federal depository institution regulator determines that the interlock would not substantially lessen competition or lead to a substantial conflict of interest.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR RELEASE UPON DELIVERY
Expected at 9:00 A.M., DST
April 27, 1988

Statement by the Honorable David C. Mulford
Assistant Secretary of the U.S. Treasury
for International Affairs
before the
Bankers' Association for Foreign Trade
Boca Raton, Florida
Wednesday, April 27, 1988

The Debt Strategy: Innovation and Evolution

I welcome the opportunity to share once again my thoughts on the evolving debt strategy with this broadly representative association of world banks. The international banking community has a continuing vital stake in perhaps the single most important challenge of this decade: how best to restore sustained growth and with it creditworthiness among heavily indebted developing nations.

When I last spoke to this group two years ago in Phoenix, the "Baker Initiative" was only six months old. The banking community had broadly endorsed the key elements of the "Program for Sustained Growth", which focused on the need for stronger growth in the debtor nations through the adoption of market-oriented reforms, supported by adequate international finance. There was considerable debate then about whether the needed commercial bank support would be forthcoming; whether the banking community would galvanize itself to streamline syndication procedures; and whether debtor nations would summon the political will to undertake politically difficult structural reforms necessary to strengthen their economies. These issues remain at the heart of the process now well underway.

The strategy which we embarked upon in the fall of 1985 has proved itself to be both evolutionary and innovative. In my remarks this morning, I would like to review progress during the past two years and consider with you the key issues we now have to address. I will also touch on the part being played by creditor governments, including both regulatory and tax innovations that help support this process.

Progress to Date

The current growth-oriented strategy remains the only appro which is accepted by all parties. While some countries such as Brazil or Peru have tried "shortcuts" to avoid needed policy reforms and conserve resources through debt moratoria, such policies have not worked -- indeed, have been counterproductive.

Admittedly there is fatigue among both debtor countries and commercial banks, but contrary to those who would argue that wholesale debt relief is the only solution, I believe the preser strategy is producing results and moving us toward resolution of this difficult problem. Allow me to draw your attention to the following facts:

- According to World Bank data, 8 of the 15 major debtor countries grew at 4-5 percent or better last year, compared with only three countries in 1985. We should bear in mind that growth for the 15 countries was negati by 3% in 1983.

- Debt service ratios for the group have fallen by one-fourth and interest service ratios by one-third in the past few years. This is largely due to the substantial decline in interest rates since 1982.

- Aggregate current account deficits have been sharply reduced from a peak of $50 billion in 1982 to $15 billic in 1986, and $8 billion in 1987.

- Export earnings rose by 13 percent to near record highs last year, while imports this year should be the highes since 1982.

- The adoption of debt/equity swap mechanisms in some countries, as well as broader policy reforms, has encouraged the return of flight capital, while also helping to reduce debt and debt service burdens.

Perhaps the most important change during the past two year has been in the attitudes towards macroeconomic and structural policy reforms in the debtor nations. While some are doing bet than others, virtually all of the major debtors accept the need to focus on market-led growth, restructuring their economi and removing impediments to trade and capital flows. Let me cite a few examples.

Mexico has liberalized its trade regime and continues its privatization of state enterprises. Through a market-based approach, the country has diversified its export base to the point where, for the past two years, non-oil exports have exceeded oil revenues. It has recently adopted a special

program to reduce inflation, although stronger efforts are still needed to bring its fiscal deficit under control.

Chile's comprehensive reform program, including a strong reliance on market mechanisms and a favorable business climate, has increased economic efficiency, kept inflationary pressures in check, attracted foreign direct investment and enabled strong growth. In the past two years Chile has also swapped $3.3 billion of its foreign debt into domestic equity investment, equivalent to approximately 23 percent of Chile's bank debt. If this could be accomplished in other countries, we would be well on our way to resolving debt problems.

Colombia has carried out a program of broad structural reforms supported by the World Bank and an "enhanced surveillance" arrangement with the IMF. Increased coffee revenues have been effectively utilized to finance development while avoiding inflationary pressures. However, despite its successful adjustment program and avoidance of debt rescheduling, the commercial banks failed to reward this performing country by rapidly assembling a new financing package of the size Colombia required.

Finally, Bolivia has arguably produced the greatest measure of internal reform. It is also implementing an imaginative plan for accomplishing a substantial reduction in its stock of debt.

On a more general basis, the concentration of resources on the debt problem has been impressive. Since October 1985, the World Bank has agreed to provide nearly $14 billion in new loans to support reform efforts in the major debtor nations, while the IMF has provided $5 billion in temporary balance of payments assistance to these nations. Official creditors have rescheduled some $18 billion in outstanding debt, including interest payments. Commercial banks have committed some $13 billion in new finance, or $19 billion if we were to count the new Brazilian package. Banks have also rescheduled over $220 billion in outstanding debt, reduced spreads, and provided longer grace periods and maturities.

Creditor Governments' Role

In Tokyo last week, I was advised by a nucleus of banks representing the broader banking community that creditor governments are not doing enough under the current debt strategy. Despite summarizing the broad contribution that creditor governments make, I was left with the impression that some bankers believe that the only thing that counts for the creditor governments is money on the table.

Let me respond directly to this position, because I strongly disagree. It is not the role of governments to take the banks out of their LDC exposures, or to assume for their taxpayers part of the risk on commercial bank LDC loans, or to put up massive

amounts of funds from their budgets through a new international debt facility to purchase existing commercial bank debt at what, I am sure, would turn out to be a very modest discount. Furthermore, it is not the role of the international financial institutions to offer credit enhancements more routinely; specifically World Bank guarantees are exceptional and their use will remain limited.

Commercial bank numbers in terms of reschedulings may look impressive, but we must remember that commercial banks lent more to begin with and therefore have much more debt to reschedule. Commercial banks have been rescheduling principal, while creditor governments, through the Paris Club, have rescheduled interest as well as principal.

Creditor governments have also been contributing in many other ways. First, the major industrial nations have maintained a sound international economic environment with sustained growth, low inflation, and open markets. This is especially true for the United States, which took over 50 percent of the increase in non-oil LDC exports between 1982 and 1986.

Second, the United States has provided leadership in international efforts to address the problems of various debtor countries, often providing bridge financing at key moments. This has involved helping a number of countries to resume normal relations with financial institutions and reestablish fruitful negotiations with the IMF and World Bank. Third, we have helped to remove regulatory obstacles to new loans and innovative financing techniques.

Fourth, the United States has provided sustained support for the international financial institutions. In 1983 we provided our share of a quota increase for the Fund of $33 billion and recently have agreed to support a $75 billion general capital increase for the World Bank, which we still must steer successfully through the U.S. Congress. Finally, the U.S. has also proposed and in some cases secured the implementation of important innovations to strengthen the debt strategy generally.

Recent Innovations and New Resources

Last fall Secretary Baker proposed the creation of a new IMF External Contingency Facility to help cushion the effect on IMF standby programs of unforeseen external developments, such as weaker commodity prices, natural disasters, or sustained higher interest rates that might force a performing country off its economic course. Our efforts to initiate these reforms resulted, in part, from discussions with debtor nations, who advanced the view that longer programs with stronger structural reform content and greater recognition of unforeseen contingencies are essential to the long term resolution of the debt problem.

At the IMF Interim Committee on April 14, it was agreed in principle to establish a combined Compensatory and Contingency Financing Facility to address such external contingencies while retaining the essential features of the existing Compensatory Financing Facility and improving both its conditionality and its operation. We expect the new facility to expand potential access for the fifteen major debtors by more than 25 percent, or, potentially, more than $12 billion, depending of course upon external developments. The Interim Committee also agreed to revitalize the IMF's Extended Fund Facility for use on a case-by-case basis to enhance the focus on structural reform. Here again there is potential for a significant increase in resources for selected countries.

Creditor countries have also taken a number of significant measures to assist low-income developing nations. The IMF's new Enhanced Structural Adjustment Facility will provide concessional resources totalling SDR 6 billion to low-income countries facing protracted balance of payments problems that are engaged in economic and structural adjustment. Donor governments have pledged $6.4 billion of financing to be used in cooperation with the World Bank for low-income African countries with severe debt problems that have undertaken adjustment programs. Likewise, the Continuing Resolution passed by Congress in December gives the U.S. Agency for International Development (AID) additional funds for development assistance to Africa, and greater flexibility in allocating these funds.

Finally, as you all know, we have encouraged the development of a "menu" of alternative financing options to help meet the diverse interests of both debtor nations and the banking community in devising new financing packages. Financing innovations that are developed for the mutual advantage of banks and debtors are key to the resolution of the debt work-out. But so far it seems to be the debtor governments that have taken the lead in developing menus and orchestrating new transactions. This was true in the case of the Mexican debt/bond conversion, Philippine Investment Notes, and Argentine exit bonds. In the case of Ecuador, where the government left the menu up to the banks, a great deal of time was wasted and the resulting menu showed little adaptation for Ecuador's situation, basically being warmed-up Argentinian left-overs.

I would contend that if bank involvement had been more energetic, these deals would have had more appeal and been more heavily subscribed. It follows, I believe, that bankers should become more involved in developing spin-offs of these techniques -- to better assure palatable alternatives for banks seeking to "exit" from new money obligations, or to improve the credit quality of those loans on their books.

With regard to new money packages, banks have articulated their "wish list," but it is up to you to develop the modalities to achieve your goals. For example, new money bonds which have some of the characteristics of senior debt -- non-reschedulable, liquid instruments -- should be workable. "Bells and whistles" adding appeal and marketability to new money bonds could include provisions for conversion into local equity, or linkage to commodity prices, depending upon the interests of debtor countries and the appetite of commercial banks, and market conditions.

As you know, Treasury has been a strong advocate of debt/equity conversions. Two years ago in Phoenix I urged commercial banks to give active consideration to the potential for debt/equity swaps -- and I recall speaking off the record on this issue because of the sensitivities regulators and accountants might have about changes to facilitate such swaps. We've come a long way since then with both debt/equity swaps and supportive regulatory changes. It is my view that we've barely seen the tip of the iceberg for both debt/equity swaps and other kinds of debt conversions and securitization.

Greater resort to equity financing can help strengthen the corporate sectors of many developing countries, while also enabling both domestic and foreign investors to provide risk capital to generate needed growth and development. This alternative to debt financing has, of course, the added sweetener of reducing debt service burdens and the stock of debt. All told, it is a win-win situation that helps to get countries onto the growth path. Some $7.5 billion in debt/equity swaps have taken place in five countries since 1985.

Given the scope of the benefits, it is difficult to understand why debtor countries have not moved more aggressively in this area; a major resource is being underutilized while the overall stock of debt is allowed to grow. Developing countries need to wake up to the advantages of debt/equity conversions and be much more aggressive in opening their financial markets and investment regimes, not only to foreigners but nationals as well. It is heartening to see the new Brazilian program off and running, and we hope the Mexicans will be back in the game once they get their fiscal, and consequential inflation, problems under control. It is true that the monetary effects of these swaps must be closely watched, but they can be controlled with appropriate policies in place, as we have witnessed in the case of Chile.

Other conversion techniques, such as the Mexican bond swap, also have their place. Even this idea stemmed originally from Mexico -- and probably would not have seen the light of day if it had not been taken up by a bank willing to exercise leadership outside Mexico's banking advisory committee format, and if the the U.S. Treasury had not been willing to make 20-year Treasury zero-coupons available as collateral.

I know other alternatives are now being looked at, including some that would provide for partial collateralization of interest. The key to success of these efforts is countries performing well enough to generate resources for this purpose, or alternatively, acquiring funds through the sale of state enterprises and placing the proceeds in a separate fund for this purpose. Those countries that do not have foreign reserves immediately available, nor public assets they are willing to use for such collateralization, should incorporate a plan in their medium term programs, and in the meantime focus their debt conversion efforts primarily on debt/equity swaps.

Regulatory and Tax Support for "Menu" Items

Treasury and the bank regulators have also discussed regulatory and accounting impediments to the development of "menu" options, with a view toward removing or reducing barriers while not sacrificing safety and soundness concerns. The Federal Reserve Board has subsequently broadened the scope of opportunity for banks to engage in debt/equity swaps through modifications to Regulation K. Commercial bank holding companies are now permitted to own, through debt/equity swaps, up to 40 percent of the voting shares of non-financial firms and up to 100 percent of those firms which are being privatized in troubled debtor countries. The holding period for such exchanges also has been extended.

In a less well-known development, last November the Comptroller of the Currency approved the application of a Miami bank to exchange sovereign debt for an equity position in a privately owned hotel through the "debts previously contracted" provisions of the National Bank Act. This action may open up a whole new window of opportunity for debt/equity swaps at the bank, versus the holding company, level.

Accompanying the Mexican exchange offer were two other important initiatives on the regulatory/accounting front. The OCC issued an opinion letter which indicated that banks could hold the new Mexican bonds within their legal lending limits under an extension of a preexisting lending relationship or under certain conditions as Type III securities. At the same time, the OCC letter clarified the "contamination" issue, by indicating that the sale of Mexican paper at a discount does not require a bank to mark to market the remaining portfolio if it intends to hold the loans to maturity.

An IRS revenue ruling issued last fall, and a follow-up letter to Senator Chafee in March of this year, helped to clarify the tax implications of debt conversions, as well as debt "donations" to U.S. non-profit organizations. We hope this will help facilitate "debt/charity" swaps so as to advance health, education and conservation programs in developing countries. In early April of this year, the Treasury Department submitted

a report to Congress on possible initiatives to support debt-for-nature swaps. In May, Treasury will participate in an AID sponsored conference entitled "Debt-for-Development", which will discuss a broad range of swaps. We hope that BAFT will support this effort.

This is a long and impressive accounting of creditor government efforts to help heavily indebted developing nations. As you can see, there is substantial money on the table and much more as well -- leadership in innovation, the concentration of human talent on these problems in both the creditor governments and in the international organizations. The banks should take note of this contribution, stop complaining in ignorance about the role of creditor governments and get more firmly behind the cooperative effort to find new ways and means for making progress on a practical basis in solving this burdensome problem.

Generalized Debt Forgiveness

Our support for debt conversion techniques should not be read as support for debt forgiveness generally, or for efforts by the debtor governments to assure that they can "capture" the secondary market discount on debt paper. The Mexican exchange offer clearly indicated that such exchanges will not take place at the depressed secondary market prices we often see quoted, and that the number of banks interested in debt exchanges involving any significant discount from nominal value will be limited. Nevertheless, such exchanges can be significant at the margin, and a number of small exchanges over time can serve the interests of both debtor nations and individual commercial banks. In particular, there is a considerable advantage in enabling uncooperative banks with relatively small exposures to exit from syndicates, taking a loss in the process.

To be successful, such conversions must be voluntary, privately financed, and developed within the market. In contrast, we and other major industrialized nations strongly oppose approaches which are generalized, global in scope, financed by creditor governments or mandatory in nature. This includes creation of an international debt facility under the auspices of the IMF or World Bank aimed at providing a global "quick fix" of the debt problem via debt purchases or securitization of commercial bank loans.

Schemes to provide a "gold card" for debt relief are both impractical and counterproductive. They would shift the risk on debt originally contracted with the commercial banks to the international financial institutions and their member governments. Creditor governments are not prepared to accept such solutions both as a matter of principle and because of the severe bugetary implications and public perceptions of bailing out commercial banks. Moreover, such facilities would not achieve the adoption of necessary policy changes in debtor countries, but instead

would delay needed adjustment, discourage new private financing, undermine the restoration of access to markets, and in effect assure a political confrontation between debtor and creditor governments.

Commercial Bank Role

What is the role of the commercial banks' at this point in the long-term workout of the debt problem? You have two basic options. You can operate solely on individual interests and concerns, wait for options to be offered by debtor governments, and judge whether you want to accept them or not. You can call on creditor governments and the international financial institutions to "enhance" new commercial bank credits through guarantees or other mechanisms as the only way to improve the quality of new loans. This is a reactive, passive posture which does not advance the process. I fear it constitutes the present position of most banks.

Or banks can challenge the most creative minds among their executive leaders to develop financing options that can advance common interests in dealing with the debt problem. You can discuss with the international financial institutions and debtor governments those areas where you believe policy reforms can best assist debtors' return to creditworthiness. You can consider ways to provide more diversified financial support, particularly for those countries such as Argentina whose heavy debt service burdens will require imaginative financing techniques together with credible reforms applied in a medium-term timeframe. You can address the "free rider" problem in your ranks with more imagination and vigor.

You can also work to improve communication and to further streamline new lending processes within the banking community to help assure that new financing is made available in a more timely fashion. In short, you can lead, rather than react; work cooperatively rather than individually; support innovation while recognizing your broader interest in staying in the game.

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED
For Release Upon Delivery
Expected at 2:00 P.M. EDT

Remarks by Thomas J. Berger
Deputy Assistant Secretary for International Monetary Affairs
U.S. Department of the Treasury
before the
American Bar Association
Washington, D.C.
April 26, 1988

Foreign Investment in the U.S.: A View from the Treasury

Introduction

Mr. Chairman, ladies and gentlemen, I am pleased to have this opportunity to share my views with you on the subject of foreign investment in the United States.

Americans are of two minds when it comes to foreign investment. On the one hand, we favor foreign investment because it creates jobs and lowers the cost of capital. On the other hand, we are concerned that foreign investment not threaten vital U.S. interests. In light of this dual perception of foreign investment, we can sympathize with the difficult job facing lawmakers trying to be responsive to the wishes of their constituents.

Indeed, this situation reminds me of the case of a certain southern Congressman who got a letter from a constituent demanding to know where he stood on the issue of whiskey. The Congressman asked his staff to check the files for any hint of how the interested voter might feel on this divisive issue, but drew a blank. However, our distinguished statesman was undisturbed, and promptly dictated his reply:

"Sir, you raise one of the most important issues of our time, and one about which I feel deeply, and on which my position is clear.

"If, by whiskey, you mean the devil's brew, the poison scourge, the bloody monster that defiles innocence, dethrones reason, destroys the home, creates misery and poverty -- yes, literally takes the bread from mouths of little children -- if you mean the evil drink that topples Godfearing men and women from the pinnacles of righteous and gracious living into the bottomless pit of degradation, despair, shame, and hopelessness -- then I am against it with all my power.

"But, if you speak of whiskey as the elixir of life that is consumed when good fellows get together, that puts a song in their hearts, laughter on their lips, and the warm glow of contentment in their eyes -- the stimulation that puts a little spring into the step of an elderly gentleman -- if you mean the drink that enables man to magnify his joy and happiness, and to forget, if only for a little while, life's heartbreaks and sorrows -- if you mean the drink whose sale pours into our treasuries untold millions of dollars that provide tender care for our crippled children, our blind, our aged and infirm -- that builds our hospitals and highways and schools -- then certainly I am in favor of it.

"My stand is unequivocal, and I will not compromise."

In a more serious vein, the current public debate has demonstrated that there are a number of misconceptions concerning foreign investment in the United States, not the least of which is the belief that the Government is not active in pursuing U.S. interests in this area. If you will allow me, what I would like to do this afternoon is to first summarize my views concerning foreign investment and the need for any changes in U.S. policy toward such investment, and then to describe briefly U.S. Government efforts to liberalize restrictive investment practices abroad.

A Perspective on Foreign Investment

Open capital markets in the U.S., which invite rather than discourage investment, have been our economic trump card for over two hundred years. These open markets have played a key role in U.S. growth and development by providing a valuable supplementary source of savings. Foreign capital was important for the great industrial ventures of the 19th century -- and will be just as vital to the technological advances of the 21st century. This foreign investment has never involved a loss of either our economic or political independence.

In addition, freer investment flows produce many obvious

benefits, but these are sometimes overlooked by those who want to restrict foreign investment. For example, it:

- -- Creates jobs for Americans, particularly in manufacturing;
- -- Keeps interest rates and the cost of equity capital lower than would otherwise be the case;
- -- Benefits American consumers by promoting competition and efficiency among manufacturers;
- -- Encourages transfers of new technology to the U.S., giving us an edge in building industries for the future; and
- -- Expands U.S. access to foreign markets by giving us the chance to exploit -- through subsidiaries in the U.S. -- the business ties of foreign parent companies.

Clearly, both technology from abroad and expanded market access are highly desirable in a world where the U.S. is striving to maintain its competitive edge.

Internationally, the U.S. itself is a major foreign investor with more to gain than to lose from freer investment regimes around the world. The international economy is not a zero-sum game: both the global economy and the U.S. domestic economy stand to benefit from the growth effects of freer, more efficient capital allocation. In our efforts with developing debtor nations, we have emphasized again and again the many merits of an open investment policy that creates an hospitable environment for foreign capital. A retreat from this position at home would severely undercut our efforts with these countries abroad.

The U.S. and other developed nations do not have completely free foreign investment regimes -- although our regime is relatively free. We prohibit certain sectors to foreigners for national security reasons, as do all nations. Also, we have legal and administrative powers through which we can further protect our national interest and preserve competition. These measures include:

- -- Export control laws to protect sensitive technology;
- -- The defense industrial security program to protect classified technology, research, and production;
- -- Individual statutes restrict foreign ownership of specific industries for national security reasons, e.g., air transport, shipping, nuclear energy and communications;

-- The Committee on Foreign Investment in the United States (CFIUS) to provide an opportunity for critical appraisal of transactions that may have adverse implications for the United States; and

-- The Hart-Scott-Rodino review process and other anti-trust laws to deal with potentially anti-competitive mergers and acquisitions.

Let me say a word about the CFIUS, which the Treasury Department chairs. In CFIUS reviews, we start with the premise that foreign investment (or, indeed, investment in general) is beneficial to our economy. We identify and deal with those few specific cases which may adversely affect our national interest. The existing review process is, by design, quiet, objective and apolitical. It has, I believe, served U.S. interests well.

There is, in my opinion, no policy logic to discrimination against investment of foreign origin. We live in an interdependent world. Discouraging foreign investment by making it unwelcome -- in fact or in appearance -- hurts us at home and makes us vulnerable to retaliatory action abroad. Being pro-American -- wanting our nation to be safe and our economy strong -- doesn't mean being anti-foreign.

From this standpoint, sound investment in additional future productive capacity (as opposed to current consumption) should be viewed as beneficial. If our goal is increased investment in productive capacity -- with a larger share of this investment from domestic sources -- then policies should concentrate on increasing the domestic savings rate, not arbitrarily limiting foreign investment. Regardless of one's views on the savings/investment allocation in the United States, or on the best way to reduce the budget deficit, it won't help to choke off investment by scaring away foreign capital.

Should We Change U.S. Policy Toward Foreign Direct Investment?

By this point I think it should be clear that my view is that our policy with respect to foreign direct investment should not be changed. We believe that our current policy is appropriate and that it is sufficient to protect our national interest.

The current policy provides ample safeguards for national security. The Trade Bill's Exon provision alleviates any lingering concerns about the ability of the United States to meet real threats to the national security. To have gone further, for example to block investments on grounds of "commerce essential to the national security," would be counterproductive. It would scare off investors and undermine our efforts in the OECD and the GATT to bring greater discipline to international investment.

In this context, I should also note that we would continue to

reject legislation that imposes further reporting burdens on investors solely on the basis of their nationality. Such a provision as the Bryant Amendment was not acceptable to us in conference and is not acceptable to us as stand-alone legislation.

Confidentiality underlies all American data gathering systems and makes them among the best in the world. While reporting is mandatory, the quality of the information collected depends upon voluntary compliance and assurances of confidentiality. When businesses provide sensitive information they require confidentiality to protect themselves from official probes and to avoid revealing to competitors information concerning sales, finances, and industrial strategies. If we did not guarantee confidentiality we could not be sure that information would be correctly reported, nor could we rely on any analysis based on that information.

In a broader perspective, further attempts to change our investment policy by creating a more activist role for the government would only have us repeat the failed experiments undertaken by Western governments some 10-15 years ago. We should learn from history and from their mistakes. We could expect no better outcome in our case. It is the market, not the government, that should direct investment flows.

U.S. Efforts to Liberalize Restrictive Investment Practices

Let me now turn to the third subject: U.S. efforts to liberalize restrictive investment practices. We have traditionally been in the forefront of liberalization efforts in the OECD, the GATT and bilaterally. We are now engaged in two mutually reinforcing efforts to further liberalize investment regimes. These are the inclusion of Trade-Related Investment Measures, or TRIMs, in the Uruguay Round of the GATT and the initiative to strengthen the OECD's so-called National Treatment Instrument.

The launching of the Uruguay Round offered the most recent opportunity for the GATT to address the impact of government interference with foreign direct investment on international trade. We believe that a number of existing GATT disciplines are relevant to the growing use of investment measures that distort trade. We are also obliged to look at new measures if existing measures are inadequate. Through the negotiations, we intend to reach an agreement which will discipline the use of these measures by governments.

In addition to our efforts through the GATT, we have been active in the OECD, expressing our concern about growing protectionism here and abroad in international investment.

The OECD has moved rapidly to focus on a work program to

include:

- -- A strengthened National Treatment Instrument;
- -- Better support for GATT negotiations on Trade-Related Investment Measures; and
- -- More analytical support to understand positive and negative factors affecting investment flows to the LDCs and to encourage a healthier investment climate in developing countries.

Let me also mention some operations that are under my specific responsibility. The Treasury has continued to work in the OECD for the progressive strengthening of the OECD Codes of Liberalization of Capital Movements and Invisible Operations. We have participated actively in the two seminal OECD studies on International Trade in Services in Banking, and in Securities aimed at identifying obstacles in member financial markets.

On a bilateral basis, Treasury has had the lead role in preparing the National Treatment Study in 1979 and the two updates in 1984 and 1986. These have successfully pressed for greater liberalization and access for U.S. financial firms in foreign markets.

The Treasury also led the negotiations resulting in the Financial Services and the Investment Chapters that are part of the Free Trade Agreement with Canada. I have just returned from Tokyo, where, last week, Treasury held another round of Yen/Dollar talks seeking greater liberalization and transparency in Japanese financial markets.

We have been successful and seen identifiable progress from these efforts.

Conclusion

Let me close my remarks by noting that the current debate concerning foreign investment in America is based on several largely unfounded concerns.

Some argue that foreigners are "buying up America." It is true that foreign investment in America has increased substantially in recent years. Such investment helps to finance our current account deficit. The key point, however, is that those who wish to halt or restrict foreign investment are generally motivated by a hidden agenda of protectionism.

Another concern is that our national security is not protected. This is clearly not the case. Foreign investors must not only comply with the same laws affecting domestic investors, but they are also subject to a number of additional restrictions. In addition, a variety of mechanisms and Presidential powers

exist to protect the national security.

A third fear is that the government lacks the data necessary to understand foreign investment's impact on our economy. Actually, the data currently collected are ample for analytical and policy purposes and avoid imposing burdensome and unnecessary requirements on investors, whether domestic or foreign.

Finally, some believe that the government is not actively pursuing an agenda in the area of international investment. The record indicates otherwise. We have consistently worked to liberalize laws governing investment, and are currently pursuing this approach both multilaterally and bilaterally.

We have long been the beneficiary of foreign investment. That experience -- and our need for an internationally competitive economy -- are the strongest arguments in favor of keeping the doors open, not closing them.

Thank you very much.

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
April 27, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $8,526 million of $26,083 million of tenders received from the public for the 2-year notes, Series Z-1990, auctioned today. The notes will be issued May 2, 1988, and mature April 30, 1990.

The interest rate on the notes will be 7-5/8%. The range of accepted competitive bids, and the corresponding prices at the 7-5/8% rate are as follows:

	Yield	Price
Low	7.63%*	99.991
High	7.65%	99.955
Average	7.64%	99.973

*Excepting 1 tender of $10,000.
Tenders at the high yield were allotted 18%.

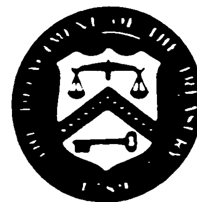
TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 43,355	$ 43,355
New York	22,632,935	7,283,175
Philadelphia	37,830	37,830
Cleveland	68,400	64,300
Richmond	116,940	96,440
Atlanta	49,935	43,375
Chicago	1,770,425	566,605
St. Louis	92,950	63,930
Minneapolis	40,275	39,975
Kansas City	127,955	125,305
Dallas	25,575	21,475
San Francisco	1,066,965	131,325
Treasury	9,080	9,080
Totals	$26,082,620	$8,526,170

The $8,526 million of accepted tenders includes $975 million of noncompetitive tenders and $7,551 million of competitive tenders from the public.

In addition to the $8,526 million of tenders accepted in the auction process, $1,235 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,434 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

Embargoed For Release Until Delivery
Expected at 10:00 a.m. EDST

STATEMENT OF THE HONORABLE
JAMES A. BAKER, III
SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON FOREIGN OPERATIONS
OF THE
COMMITTEE ON APPROPRIATIONS
U.S. HOUSE OF REPRESENTATIVES
APRIL 28, 1988

Mr. Chairman and Members of the Committee:

I welcome this opportunity to discuss with you the Administration's budgetary proposals for the multilateral development banks (MDBs) for fiscal year 1989.

Last year, as part of a bipartisan effort to reduce the federal budget deficit, the Administration and the Congress agreed on fairly tight guidelines for drawing up the FY 1989 budget request. The Bipartisan Budget Agreement stipulated an aggregate request for the Foreign Affairs (Function 150) Account of $18.1 billion in budget authority for FY 1989. The agreement also specified that the starting point for the individual Function 150 Account components would be actual FY 1988 appropriations, not the Administration's FY 1988 budget request.

Secretary Shultz, Jim Miller, and I have worked hard on the function 150 budget request which the President approved. It should be noted that the MDBs received $1.2 billion in FY 1988 appropriations and that our request for MDB funding in FY 1989 is $1,324 million. This is an increase of 9.8 percent over our FY 1988 appropriation, whereas the 150 account overall received around a two percent increase.

In arriving at the $1,324 million MDB allocation, the Administration decided to fund fully all of this year's regularly scheduled MDB installments and not request resources to make up funding shortfalls. It is our intention, however, to seek all MDB funding shortfalls in the FY 1990 budget request.

B-1302

The largest single item in our budget request ($958 million) is for the second installment for the eighth replenishment of the International Development Association (IDA-8). This is extremely important because IDA is the world's single largest source of concessional assistance to the world's poorest countries. IDA-8 resources support economic growth and development in countries where we have strong strategic, economic, and humanitarian interests. During the course of IDA-8, Sub-Saharan Africa -- where most of the world's poorest countries are located -- will receive 45-50 percent of total credit commitments.

The Administration's FY 1989 budget request also is meeting scheduled installments for the other MDBs. Details of these requests are described later in my testimony.

The World Bank General Capital Increase

Although it only requires a relatively small annual appropriation, a very important component of our request is funding for the General Capital Increase (GCI) of the World Bank (IBRD).

After carefully reviewing the current and future demand for World Bank lending, we agreed with Bank President Barber Conable's assessment that a GCI is now necessary to assure that the Bank can continue to provide the necessary support for economic growth in the developing countries. The overall size of the GCI is $74.8 billion, with a three percent paid-in component. The United States has an 18.75 percent share of the GCI, which implies a budget appropriation request of $70.1 million annually over a six year period. The callable capital program limitation would be $2.3 billion annually.

Already there has been considerable discussion and speculation in the press and here in Congress regarding U.S. participation in the GCI. One theme is that the Administration's strategy for dealing with the high level of foreign debt in developing countries has failed, and that a new approach should be agreed upon before Congress appropriates resources to allow U.S. participation in the GCI. We strongly disagree with both suggestions.

Our backing of the GCI goes far beyond simply supporting the debt strategy. While it is certainly true that a healthy and vibrant World Bank is important to our debt strategy -- as it would be for any approach to this problem -- the reasons to support the GCI are broader than the debt issue.

Let me explain why this proposal should have your support. The main role of the World Bank continues to be supporting economic development through sound project lending. At

least 75 percent of World Bank lending is for projects to promote human and capital infrastructure in areas such as energy development, development finance corporations, agriculture and rural development, urban development, and transportation.

Energy is clearly essential to development, and becomes increasingly so as economies expand. But expansion of this sector can be very expensive, often requiring large-scale investment. In its last fiscal year (1987) the World Bank made commitments of $3.5 billion for energy development projects including support for the generation and distribution of electric power to households, schools, hospitals, and industry.

In contrast to direct support for large-scale projects, the World Bank also supports small and medium-scale productive enterprises through local development finance companies (DFCs). Most DFCs lend to manufacturing enterprises, though some also specialize in particular sectors or activities, such as tourism. In FY 1987 these financial intermediaries received IBRD commitments of $2.2 billion.

The reasons for World Bank lending to agriculture and rural development are compelling. Approximately six out of every ten people in developing countries depend on agriculture and related pursuits for their livelihood. Bank projects help developing countries expand irrigation systems, provide more effective extension services, make credit available to small farmers, adopt appropriate technology, increase storage, and improve marketing and distribution facilities. The Bank committed $1.9 billion of its resources to this sector last year.

Urban development was the fourth largest recipient of IBRD commitments in Bank fiscal year 1987, receiving $1.2 billion. Urban areas now contain nearly one-third of the total population in developing countries. Urban projects usually contain major components to upgrade slums and squatter development, or to create sites for additional low-income housing.

The transportation sector received the fifth largest amount of World Bank commitments last year, $1.1 billion. These projects support the construction of thousands of miles of main, secondary, feeder, and rural access roads; railway reconstruction; and expansion of seaports, riverports, and inland waterways.

Together, these five areas account for $9.9 billion out of a total annual lending program of $14.2 billion. On a regional basis, the largest allocation went to Asia ($5.3 billion), followed by Latin America and the Caribbean ($5.0

billion). A more modest allocation ($3.9 billion) went to the Middle East and Africa.

Furthermore, much of the Bank's lending program supports countries that are strategically important to the United States. Table 1 below compares last year's (FY87) World Bank commitments to U.S. bilateral economic assistance (Development Assistance, ESF, and PL-480). As an example, Turkey received commitments of $1.1 billion from the World Bank, compared to U.S. commitments of $100 million.

Even more striking is the level of World Bank support to countries who are very important to us but where there is the virtual absence of U.S. bilateral assistance. As an example, Argentina, Brazil and Mexico received $3.9 billion from the World Bank in 1987 and virtually nothing from the United States. In total, for all of the countries listed in Table 1 below, World Bank commitments in 1987 amounted to $7.7 billion compared to $1.1 billion in U.S. commitments.

Table 1

Fiscal Year* 1987 Loan Commitments

Country	World Bank ($millions)	U.S. Bilateral ($millions)
Mexico	$1,678	**4
Brazil	1,262	**2
Argentina	965	---
Turkey	1,069	$100
Pakistan	397	325
Philippines	342	340
Morocco	577	87
Tunisia	334	84
Thailand	21	21
Indonesia	1,058	128
Totals	$7,703	$1,091

* U.S. and World Bank fiscal years differ by three months.
** Country share of regional development programs.

The U.S. portion of the paid-in capital (which is actual budget authority) that supported this $7.7 billion IBRD lending program was approximately $60 million as compared to the $1.1 billion dollar-for-dollar cost for the U.S. bilateral assistance.

These figures vividly illustrate how we cannot begin to duplicate bilaterally the amount the World Bank can lend as a multilateral institution. The cost would be prohibitive.

This funding has been put to good use:

- A $184 million loan will help Turkey improve environmental conditions in Izmir by promoting adequate water supply, sewerage, and sewage treatment facilities, as well as appropriate industrial waste-treatment policies and practices.

- A $22.3 million education loan to Morocco will improve the quality of vocational training and reduce its costs through improvements to instructor training.

- A $70 million loan will help Pakistan improve the efficiency of existing power stations, and add about 200 mega-watts of additional generating capacity.

- A $300 million loan will support Philippine economic-recovery efforts, including programs of tax reform, trade-policy rationalization, public-investment program restructuring, and rationalization of government financial institutions.

- In Brazil, an $84 million loan will benefit about 73,000 low-income farm families through construction of simple water-supply systems, construction of two fish hatcheries, provision of extension services, marketing support, funding for community subprojects, and demarcation and protection of a natural reserve.

An important aspect worth mentioning is the procurement contracts U.S. businesses receive from the IBRD. For FY 1987, the latest figures available, U.S. firms received $1.6 billion in disbursements from the IBRD for foreign procurement. In an effort to increase this amount, personnel from the Commerce Department, in conjunction with the U.S. Executive Director's office at the World Bank and Treasury staff, are working strenuously to increase the number of contracts on which U.S. firms bid.

Another important dimension of World Bank operations is the increasing effort to promote private sector development. Development finance companies, which I described earlier, channel considerable resources to the private sector. Bank projects in other areas often have specific elements to support the private sector, such as hydroelectric projects in Turkey which support joint ventures with the private sector for construction of power plants.

There is also support for the private sector through policy-based lending. Consultants financed through World Bank support are assisting governments in countries such as Kenya and the Philippines to formulate model agreements and revise legislation that affect petroleum in order to attract investment by foreign oil companies. Burkina Faso is being helped to revise mining sector tax and investment codes.

To further enhance the Bank's support for private sector development, Bank management has established a high-level task force including representatives of the private sector to propose policies, procedures, and initiatives. This task force will begin its review shortly and is expected to complete its report before summer.

As I mentioned, policy-based lending is an important element of Bank private sector development efforts. Such lending has become an important component of World Bank activity. The impact of such lending is broader than project loans, affecting the borrower's macro-economic policies rather than a specific activity. This will improve the allocation of resources, leading to increases in income and employment.

There is normally a requirement to meet pre-conditions before the loan will be submitted for Board approval. The loans are tranched, and require additional action by the borrower before a second or third tranche will be disbursed.

Currently, about three-fourths of all policy-based loans are experiencing implementation delays. Such delays are fairly unavoidable given the uncertainties in implementing politically difficult and complex reforms in such areas as public and parastatal enterprises, which account for the bulk of the delays. While the reforms that trigger release of a second tranche may be late, the reforms are only abandoned less than 10 percent of the time. Some loans have been cancelled altogether due to lack of agreement between the Bank and country over economic policy.

Hence, although the Bank has encountered some difficulties with policy-based lending, the quality of Bank operations has been quite good. However, while we have watched such lending closely and approved of the progress being made in many areas,

we still have some concerns. Therefore, as part of the GCI negotiations we asked the Bank to review policy-based loans. This review will be completed sometime this summer.

The Debt Strategy: A Progress Report

The World Bank also plays an essential role in the international debt strategy. That strategy is based on four fundamental principles:

- First, the central importance of economic growth and capital formation in easing the debt burden over time.
- Second, the need for market-oriented reforms in debtor nations to achieve such growth.
- Third, new debt and equity financing, and the return of flight capital, to help support such reforms.
- And fourth, a case-by-case approach to address the individual needs of each debtor country.

I firmly believe that this strategy remains the only viable long-term approach to solving the problems of development and debt. These nations need financial resources to grow. They also require sustained, market-oriented reform of their economic structures. These adjustments will make debtor nations more attractive for future investment -- both domestic and foreign. Together with that investment, the reforms promise stronger growth, higher standards of living, and more productive and flexible economies. These elements ultimately imply increased imports from the United States.

The strategy's key principles are constant, but its execution is dynamic within this general framework for debtor/creditor cooperation. Indeed, one of the great strengths of this approach is its adaptability.

Considerable progress has been made within this general approach. The debtor countries have made substantial efforts to restructure their economies along more market-oriented lines. As a result, the aggregate performance of the fifteen major debtors is improving:

- Their GDP growth averaged 2.5 to 3 percent in 1986-87 vs. negative growth of about 3.0 percent in 1983.

- Their export earnings rose by 13 percent last year, and their imports increased by 7 percent.

- Their interest-to-export ratios fell to about 22 percent last year, compared to an average 30 percent in the 1982-86 period. This is a key measure of their ability to service debt.

- Their reserves totaled about $40 billion in 1987, a 54 percent increase over the 1982 level of $26 billion.

- Their aggregate current account deficit fell from $15 billion in 1986 to $8 billion in 1987, well below the $50 billion deficits they were running in 1981-82.

- And several countries have made headway in reversing capital flight.

Perhaps the most important change during the past two years has been in debtor nation attitudes. The debtor nations are increasingly focusing on the importance of market-led growth, and adopting the reforms necessary to achieve it. For example:

- Colombia has been a successful adjuster in the past several years and has avoided the need for debt rescheduling or formal IMF agreements. It has carried out a program of broad-reaching reforms with the assistance of the World Bank and under the IMF "enhanced surveillance" arrangement. It has effectively utilized coffee windfall receipts to finance development while avoiding inflationary pressures.

- Mexico has opened up its economy to foreign competition by continuing the elimination of import licenses and the lowering of tariffs. Foreign investment flows have sharply increased to over $1.4 billion before the debt/equity swap program was suspended in November 1987. This compares with $900 million and $490 million in 1986 and 1985, respectively.

- Uruguay has managed to reverse the economic decline of the early 1980s through an export-based economic strategy and a competitive exchange rate. The current account of its balance of payments is expected to improve in 1988, and the inflation rate is expected to continue downward; growth prospects have also improved.

° The Philippines has liberalized imports, is implementing a comprehensive tax reform program, and has instituted major agricultural reforms.

All of these countries, with the exception of Mexico, had growth of 4 to 5 percent in 1987. Mexico's growth improved substantially from the 3.5 percent negative growth experienced in 1986 with the oil price decline.

The World Bank has provided strong support for these reforms, through both fast-disbursing, policy-based loans to support structural reforms and project loans to enhance production and development. Its loans have also helped to catalyze additional private financial flows. Together, the IMF and the World Bank have provided approximately $17 billion in new loans for these countries since October 1985.

The commercial banks have also committed some $17 billion in new finance during this period, while rescheduling some $220 billion in outstanding debt, reducing spreads, and providing longer grace periods and maturities. Official creditors have also rescheduled some $18 billion in both principal and interest payments.

Clearly, more still needs to be done. Nevertheless, the debtor countries are increasingly committed to reforms and are making progress toward sustained economic growth. We must continue to support these efforts, recognizing that a careful balance between reforms and new financing is essential to assure that debt does not increase at a faster pace than the debtor's ability to service it. While this is undoubtedly a difficult task, I believe the debt strategy now in place is the only viable approach to reach this goal.

I recognize, of course, that some critics urge another path -- the development of large scale debt forgiveness schemes. We should not be misled by the false promise of "global solutions" of one sort or another. To be direct, I believe this path leads both debtors and creditors off the cliff.

This approach would irreparably politicize the debt problem, distracting debtors and creditors alike from the difficult but fundamental economic adjustment tasks. It would encourage counterproductive debt repudiations to maximize debt forgiveness. And it would shift the risk on commercial loans to taxpayers in creditor countries, including U.S. taxpayers. I simply cannot endorse such schemes. They are also strongly opposed by the Finance Ministers of the other major industrial nations, as reflected in the April 13 G-7 communique.

Finally, we have encouraged the development of a "menu" approach to enhance the flexibility of commercial bank financing packages in meeting the diverse interests of both debtor nations and the banking community. Such "menus" can provide a variety of options for new financing, including traditional balance of payments loans, trade credits, project loans, on-lending facilities, new money bonds, and even limited, voluntary interest capitalization. They can also include a range of new instruments, including debt/equity swaps, debt/conservation swaps, and "exit" bonds. Debt conversion instruments help to reduce both outstanding debt and debt service burdens. Banks would choose among these options in supporting debtor reform efforts, as they have been able to do in last-year's Argentine new money package.

The recent Mexican debt/bond exchange provides an example of an innovative, voluntary debt conversion technique worked out between the debtor government and the commerical banks, with the principal amount of the new Mexican bonds in this case collateralized by the purchase of U.S. Treasury zero-coupon bonds. We believe the results of that exchange demonstrate that several commercial banks are interested in this kind of market-driven technique, but that most banks will only entertain such exchanges at rates well above thin secondary market values for such debt. We expect further market development of these kinds of debt conversion options in the period ahead.

World Bank and Regional MDB Environmental Lending Practices

The last issue of mutual interest I wish to address is the role of MDBs in the environment. One of our most important objectives in GCI negotiations has been to strengthen Bank policies and programs on a broad range of environmental issues. I have taken a personal interest in those issues. They are crucial to the protection and preservation of our natural resource base in all parts of the world. They are critical if we are to achieve successful and sustainable development and growth in developing countries over the longer term.

In his address at last year's annual meeting, President Conable put particular emphasis on the protection of renewable resources and pledged a substantial increase in staffing and financial resources for these purposes. Subsequently, he has sought to integrate environmental concerns more effectively into the mainstream of the Bank's work.

In negotiating the terms of the General Capital Increase, we have sought to reinforce President Conable's efforts and to extend their effectiveness for years into the future.

The report on the General Capital Increase, now adopted by the Bank's Board of Directors, calls for:

- additional emphasis on the need for better management of human and natural resources so that countries can achieve fully sustainable development;

- integration of environmental work into country development strategies, policies and programs;

- evaluation of the environmental costs of bank projects;

- mitigation or elimination of adverse effects of bank projects; and

- support for national and regional programs to improve environmental management.

Getting this language into the Report on the General Capital Increase is an important step. It commits the institution's shareholders from both developed and developing countries, not just the President of the Bank, to an overall framework for environmental work over the next several years. Our job now is to see that this commitment is turned into a series of strategy papers, policy decisions, and lending programs that will have the impact that we seek.

Let me turn now to the general issue of environmental reforms in the multilateral development banks. As you know, legislation now requires us to submit a report on progress in implementing a series of specific reforms in the Banks. The first of these reports was forwarded to the Congress in January. Follow-up reports are to be made each year hereafter.

I am pleased to report that significant progress has been made in the area of organizational and staffing reforms, especially at the World Bank. The regional MDBs have implemented reforms, but still require further strengthening in the area of staffing. This issue is being addressed through the Board of Directors and upcoming annual meetings. We also would like to see a more systematic accounting of the way the Banks report on environmentally beneficial projects as described in the legislation. To address this concern, follow-up environmental reports will seek to measure actual increases or decreases in lending devoted to energy conservation, forestry, light capital technologies and other environmentally beneficial projects.

I would like to call your attention to progress which has been made in the provision dealing with environmental staff and staff training. During 1987, the World Bank carried out a major reorganization of its management staff. One of its primary aims was strengthening the Bank's capacity to deal more effectively with environmental issues. A Central Environmental Department was created as well as environmental units in each of the Bank's four regional offices. Thus far, 45 full time permanent positions have been authorized for environmental purposes.

In addition, funds have been authorized for the equivalent of 18 full time consultants to work on various environmental issues. Use of consultants provides the Bank with greater flexibility and access to expertise on a broader range of environmental issues. Training on environmental issues is continuing in the Economic Development Institute and special training courses for staff are being introduced.

In the Inter-American Development Bank, two senior environmental experts have been added to the Bank's permanent staff, an ecologist and an expert on rainforests. A three-day seminar on environmental issues was held last December for 40 members of the Bank's project analysis staff. Additional seminars for other members of the Bank staff are planned for later this year. A one-day briefing on environmental issues is also being planned for all of the Bank's representatives in borrowing countries.

As I indicated earlier, the World Bank has established a Central Environmental Department. The Inter-American Development Bank has set up an Environmental Affairs Committee in place of a line unit. Small line units have also been set up in the Asian Development Bank and the African Development Bank. Clearly, both of these units will need to be examined and strengthened. However, a start has been made.

A start has also been made on promoting participation of non-governmental organizations in the project preparation cycle. The World Bank, the Inter-American Development Bank, and African Development Bank have issued instructions to staff to seek participation of non-governmental groups and indigenous peoples in project preparation. The Asian Development Bank has commissioned a report on how it should work with local non-governmental organizations. The World Bank and the Inter-American Development Bank have held meetings with non-governmental organizations here in Washington to facilitate the exchange of information. I readily admit however, that we need to do more to encourage improvements in the area of NGO involvement.

Within the U.S. Government we are working to improve the ability of the early warning system to monitor MDB projects with potential adverse effects. This is helping us to weigh in with bank management at an early stage and try to mitigate or correct adverse environmental effects. We are also taking a tougher stand against unsatisfactory loan proposals that reach the board, abstaining on environmental grounds on the AFDB loan to Botswana in August, on AFDB loans to Mali and Benin in October, on a World Bank loan to Sudan in December and on an AFDB loan to Burkina Faso in February. We are also beginning more systematic consultations on environmental issues with other member countries. I, myself, participated in the Development Committee's discussions this month on environmental matters.

In sum, I think we are making appreciable progress toward our objectives. Obviously, we are not where we want to be, and we will need to put continuing emphasis on all of these issues. Our priority now should be to implement the provisions of legislation already in place. I look forward to working with you in that process in the upcoming months.

Fiscal Year 1989 Budget Request

We are requesting $1.3 billion for the MDBs in FY 1989. These funding requests reflect both the need for budgetary restraint and the financial requirements for effective development programs. The stringency of the cap on international affairs funding in the Bipartisan Budget Agreement prevents the administration from requesting U.S. funding shortfalls on earlier scheduled MDB payments. Our MDB request is comprised, therefore, of MDB funding requirements currently due for payment.

These requests are composed exclusively of funding requirements negotiated by the Administration in close consultation with this Committee.

International Bank for Reconstruction and Development (IBRD)

For the IBRD (also known as the World Bank) in fiscal year 1989, the Administration is requesting $70.1 million in budget authority and $2,293 million under program limitations for subscriptions to the first installment of the 1988 GCI.

The Bank's principal role today is making long-term credit available for productive projects, at market-related interest rates, which will lead to economic growth and social development in its less developed member countries. In addition to providing project finance, the IBRD also provides policy advice and technical assistance and serve as a financial catalyst and institution builder.

International Development Association (IDA)

For fiscal year 1989, the Administration is requesting $958.3 million for the second installment for the $2,875 million U.S. share of the eighth replenishment of IDA. IDA, an affiliate of the World Bank, is the single largest source of multilateral development assistance for lending on concessional repayment terms to the world's poorest countries; over 96 percent of IDA lending goes to countries with an annual per capita income of $400 or less. We intend to seek the U.S. funding shortfall of $43.3 million in FY 1990.

International Finance Corporation (IFC)

For fiscal year 1989, the Administration is requesting $35.0 million for the third of five installments on the U.S. subscription to the $650 million IFC capital increase. The IFC provides risk capital as well as long-term loans; plays an important role as a catalyst in attracting private capital; and provides technical assistance to developing countries that want to encourage domestic and foreign private investment. We intend to seek the U.S. funding shortfall of $49.8 million in FY 1990.

Inter-American Development Bank (IDB)

There is no request of funds for the IDB in fiscal year 1989 because it has not been possible to reach agreement on a seventh replenishment for the Bank. The only outstanding U.S. funding necessary for the IDB ordinary capital is for a shortfall of $31.6 million for the sixth replenishment. The Administration is not requesting that shortfall in FY 1989 because the Bipartis Budget Agreement forced the Administration to choose between providing resources for U.S. funding shortfalls or currently scheduled MDB payments.

The Administration has decided that not funding the shortfalls will have less programmatic impact. For this fiscal year the IDB has adequate reserves to meet its lending requirements based on the list of projects now being prepared by the Bank. Contingent upon resolution of a question relating to an internal investigation in the Bank, we intend to seek the U.S. funding shortfall of $31.6 million in FY 1990. The Bank promotes economic development among developing countries in the Western Hemisphere by extending loans for specific projects on market-related terms.

Fund for Special Operations (FSO)

There is no funding request in fiscal year 1989 for the FSO through which the IDB extends concessional loans to the poorest countries of Latin America and the Caribbean. The reasons for not making a request are the same as for the IDB's ordinary

capital operations. Sufficient funds remain from IDB-6 to provide a credible concessional lending program for the region's really poor countries. Contingent upon resolution of a question relating to an internal investigation in the Bank, we intend to seek the U.S. funding shortfall of $63.7 million in FY 1990.

Inter-American Investment Cooperation (IIC)

The Administration is not requesting budget authority for the IIC for FY 1989. Sufficient funding has already been provided to enable this new organization to begin operations this year. The IIC is linked to the IDB, and is designed to support private sector activities in Latin America through equity and loan investments that focus primarily on small- and medium-scale enterprises. We plan to resume payments to the IIC in FY 1990.

Asian Development Bank (ADB)

The ADB is currently making lending commitments on the basis of a capital stock that is fully subscribed by Bank member countries, including the United States. Hence, there is no need to request funding for the ADB in fiscal year 1989. The Bank makes loans at market-related rates to developing member countries of the region to help bring about conditions necessary for political stability in a region of the world of key importance to U.S. strategic and economic interests.

Asian Development Fund (ADF)

For fiscal year 1989, the Administration is requesting $146.1 million to make a regularly scheduled installment to the fourth replenishment of ADF resources. The Bipartisan Budget Agreement prevents us from requesting the funding shortfall of $191 million to the ADF until FY 1990. However, because of exchange rate changes and lower than expected lending levels, it is expected that the $146.1 million request will enable the Fund to complete its project lending programs in calendar year 1988. The ADF is a source of concessional finance to the poorest member countries of the ADB. Pakistan, Bangladesh, Sri Lanka, and Nepal are the major borrowers from the Fund.

African Development Bank (AFDB)

For fiscal year 1989, the Administration is requesting $9.0 million in budget authority for subscriptions to paid-in capital and $134.9 million under program limitations for callable capital for the second of five installments to increase the Bank's capital base. The Bank makes loans on market-related terms for the economic and social development of fifty African member countries, individually and through regional cooperation. Membership and support of the AFDB is

an important part of the U.S. commitment to work with the countries of Africa for the achievement of their long-term development objectives.

African Development Fund (AFDF)

For fiscal year 1989, the Administration is seeking $105 million in budget authority for the first of three installments for the U.S. contribution to the fifth replenishment of AFDF resources. The Fund complements AFDB operations by providing concessional financing for high priority development projects in the poorest African countries. The United States has a strong humanitarian interest in aiding the poorest countries of the world's least developed continent through its support for the AFDF.

Conclusion

In conclusion, Mr. Chairman, I want to emphasize this Administration's commitment and full support for the MDBs.

As you know, Mr. Chairman, the Administration has made an earnest effort to consult closely with you and members of this Committee regarding the MDB replenishments it has negotiated. Moreover, President Reagan, in various fora and through letters to you, has repeatedly stressed U.S. commitment to these institutions. Now we urge your support for the Administration's MDB request so that these institutions will benefit the people for whom they were intended -- both abroad and here in the United States.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 12:00 Noon
April 29, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $8,750 million of 364-day Treasury bills to be dated May 12, 1988, and to mature May 11, 1989 (CUSIP No. 912794 RX 4). This issue will result in a paydown for the Treasury of about $1,300 million, as the maturing 52-week bill is outstanding in the amount of $10,041 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Thursday, May 5, 1988.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. This series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing May 12, 1988. In addition to the maturing 52-week bills, there are $13,980 million of maturing bills which were originally issued as 13-week and 26-week bills. The disposition of this latter amount will be announced next week. Federal Reserve Banks currently hold $3,181 million as agents for foreign and international monetary authorities, and $7,077 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rate of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $426 million of the original 52-week issue. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-3.

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million This information should reflect positions held as of one-half hou prior to the closing time for receipt of tenders on the day of th auction. Such positions would include bills acquired through "wh issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previousl offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Ban of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate ten for each customer whose net long position in the bill being offer exceeds $200 million.

A noncompetitive bidder may not have entered into an agreeme nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained o the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the differenc between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit c 2 percent of the par amount of the bills applied for must accompa tenders for such bills from others, unless an express guaranty oi payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

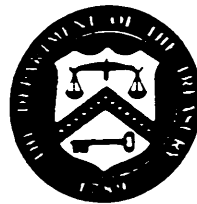
Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

10/87

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED
For Release Upon Delivery
Expected at 8:00 p.m. E.D.T.

Remarks by Secretary of the Treasury
James A. Baker, III
General Graves B. Erskine Lecture Series
United States Marine Corps Education Center
in Quantico, Virginia
Friday, April 29, 1988

The Marines are a proud organization. And I am equally proud that you've given this former Marine lieutenant a chance to participate in the General Graves B. Erskine Lecture Series this evening. General Erskine was called the "Big E", and he truly was a giant of a man -- not only physically but in intellect and in spirit. His courage in war was matched by his vision of peace. He knew his men had what it took to wage war; he made sure they had what it took to wage peace. In providing educational facilities for his men, in preparing them for life outside of the service, he attracted the attention and admiration of President Truman. In all that he did, whether as a leader in Washington or on the battlefield, General Erskine represented the very best qualities of the United States Marine Corps.

General Erskine knew that a Marine's field of vision referred not only to battlefield tactics, but to his knowledge of the world. As a former Marine who has traveled, symbolically at least, from the Halls of Montezuma to the Halls of High Finance, I'll do what I can to give you a brief perspective on the link between national security and the economy. I think we would all agree that a strong economy and a strong defense are key elements in a great nation. We cannot have one without the other.

Today I want to make two points: First, that a changing world economy poses new challenges for America's national security. And second, that our military must be supported by a strong national economy. And I'd like to add some thoughts on what the Administration has been doing to achieve economic strength.

B-1394

U.S. Defense and the Integration of the World Economy

Anyone on a routine inspection tour of the parking lots a Quantico would soon discover one thing -- that the U.S. can't wait to mount a defense of its real interests until enemy tro ships are spotted off the coast of Virginia. We have real interests all over the world. All those Hondas and Volkswage and the foreign oil that keeps them running -- should tell us the days when we saw ourselves as an "island nation" -- eithe economically or militarily -- are receding rapidly into the p The world economy is steadily becoming more interdependent -- the United States is on the leading edge of this change.

This trend may or may not lead to more formal military commitments. I am not the one to judge that. But at the ver least, it seems that certain national responsibilities will increase. As America becomes more and more dependent on trade to power its economy... as more Americans look for jobs abroad...and as more American businesses buy property abroad - there will simply be a lot more for U.S. forces to protect.

Let me illustrate this trend. Consider an ordinary but essential consumer product -- the shirt:

The typical shirt has probably seen more ports in a year's time than most Marines do in a five-year hitch -- and that's before it ever gets worn on the back of its owner. A typical shirt might have been designed in New York City, its materials made in Japan, using German machine tools and Saudi Arabian petroleum products and cotton from the state of Georgia. It m then be cut and sewn in Taiwan, with cardboard backing coming from Canada and buttons coming from practically anywhere, befc being sent back to the United States for pressing and marketir These global possibilities are endless -- and certainly this i true for many other products as well.

American companies produce as much as one-fifth of their output outside of our borders. According to Financial World magazine, if the overseas operations of General Motors were a separate company, it would rank 22nd among America's largest corporations. And American companies are not the only ones wi this world view. I understand that Honda, for example, is now making cars here in the United States and exporting them to Japan.

Recently, the Environmental Protection Agency -- which determines gas mileages of cars -- found it could no longer determine whether a car was "foreign" or "domestic." It was difficult to tell whether all of the parts that made up a car came predominantly from one country or another.

Today's reality is that America's businesspeople, its workers, and its consumers all have a share in the internatio economy. A simple number tells the story: the overall value our trade is equivalent to one-fifth of everything produced i this country.

Millions of jobs and businesses depend on stable and secure markets overseas. We also need reliable suppliers overseas because many other jobs here in the United States depend on imports -- the longshoremen who unload them, the truckers who transport them, and the people who sell them.

And our imports are not all Mercedes, wines, or fancy video-tape recorders. Over a third of our imports are industrial supplies, machinery or other items used by our factories. And that doesn't include such a strategic raw material as petroleum. America now relies on imports for 35 percent of its petroleum supplies. About 40 percent of the oil that the free world imports goes through the Persian Gulf -- and most of it goes to our allies.

That's one reason, of course, why brave Marines now patrol the Gulf.

They are patrolling the Gulf and other areas of the world not only to make the world safe for democracy -- but to protect the livelihoods of millions of Americans whose jobs depend on a safe and secure world economic system.

America needs to stand by our allies and trading partners in Europe and Asia. We need to take a strong stand against terrorism. We need to keep our shipping lanes open and communication networks secure. And to get those big jobs done, we need to maintain a strong defense.

Crucial to our National Security: A Strong Economy

But how do we pay for the defense we need?

If you took seriously some of the stories in the media or on Capitol Hill you'd think the defense budget is about to bankrupt the country. That's simply not true.

Let's put the defense budget into perspective. Defense spending under President Reagan is not going through the roof -- nor is it the burden on the economy that people have made it out to be. It has averaged about 6 percent of the Gross National Product since the President's first budget in 1982. This proportion is higher than in the late 1970's -- but is lower than the early 1970's, and much lower than in the 50's and 60's.

Moreover, our economic prospects compare well to others. Sure other countries are getting larger. But we are still by far the largest economy in the world -- and over twice the size of Japan. And we should be for the indefinite future -- not least because we have tremendous resources. A recent essay in the Washington Post listed some of the advantages that we have over Japan -- our number one economic competitor. We have 30 times as much land that can be cultivated, 1,300 times its oil reserves, 327 times its coal deposits, 170 times the iron ore reserves, and a much larger population.

In addition, America has certain legal freedoms and vast spaces that no other country has. It is generally easier to create businesses here, to hire workers, and to market new id As a result, investors from smaller, more crowded, and more r societies are pouring money into the United States.

The bottom line is that America has the physical and huma resources to sustain a strong national defense. But many gre nations have squandered their resources and forfeited their position in the world. The test of America's greatness will its ability and willingness to maintain its responsibilities long into the future.

That puts a premium on far-sighted economic policies. In 1981, President Reagan set an important economic principle in motion. This principle was simple but powerful -- put the fr market back to work. Let big government stand aside and let genius of the American people flourish. Cut tax rates, trim unnecessary regulations, restrain the growth of federal spend and restrain inflation. And finally, don't let up!

Record Growth and Low Inflation: Highlights

Let me give you a few highlights:

America's economic recovery began in 1982 -- 65 months ag Since then, the U.S. has had one of the fastest growing econo in the industrial world. Growth has averaged 4 percent a yea That's slightly faster than Japan's growth and much faster th Europe's. This expansion is the longest peacetime period of growth since we began keeping records. And that was before t Civil War!

I'd like to think that the landmark tax cuts for the Amer people have had something to do with all this. In 1980, who would have thought that low tax regimes were the wave of the future! In 1980, when the top federal rate was 70 percent, w would have thought that it would be reduced to 28 percent bef Ronald Reagan left office!

A low tax rate was not the only impossible dream in 1980. So was a low inflation rate. When was the last time we've ha an economic expansion with a low rate of inflation? I know y all remember inflation -- it was economic enemy Number One! Nobody felt that it could be controlled. The key wasn't to control inflation; it was simply to survive it.

But during this latest expansion, the U.S. inflation rate averaged less than 4 percent. That has been a truly remarkab achievement.

And this expansion has been accomplished in the face of almost monthly predictions of gloom. The "wheels were coming off," the critics said; the economy was going into the tank.

But the economy didn't go into the tank -- in part because interest rates came down and stayed down. The prime rate has declined nearly a dozen points from the rate we inherited that cold January 20, 1981, when we walked into the West Wing of the White House. And that's been a big help to young couples struggling to buy that first home, or families hoping to refinance a mortgage.

The American economy has also become the job-creating envy o the world. Since 1982, America's unemployment rate has fallen b more than five points -- to 5.5 percent. We have created more than 15 million jobs since 1982 -- more than all of Europe and Japan combined.

At the end of last year, the percentage of the working-age population that was employed was at an all-time high -- 62.3 percent.

I'd also like to correct a bit of economic mythology on this subject of jobs. You may have read reports that suggest that in creating jobs our economy is merely trading steel workers for hamburger flippers.

Well, the facts show otherwise. U.S. manufacturing employment has remained remarkably constant over the past 20 years. Last year, in fact, employment in manufacturing rose by 407,000.

And these 15 million new jobs are for the most part good, productive jobs. Yes, many of these new jobs are in the service sector, but nearly two-thirds of the new employment growth has been in managerial, professional, technical, sales or precision-production occupations. (And anyway I find it more than passing strange to argue that we were somehow better off without those so-called "inferior" jobs in the service sector and the paychecks they generate. I doubt if the holders of these jobs would agree.)

Furthermore, these basic industries are not "bedraggled dinosaurs" as commentators have alleged in recent years. In fact, manufacturing productivity has been growing at a rate of almost 4 percent a year since we came to office. That's nearly twice as fast as the average of the previous three decades.

There's other good news for our industries. Because of changes in currency exchange rates in the last three years, our exports are now much cheaper overseas. In addition, foreign economies are growing faster and demanding more American goods.

As a result, you have an all-American export boom -- which was inconceivable just a couple of years ago. We're shipping steel to Japan. That used to make as much sense as shipping sand to the Sahara desert. We're also sending machine tools to Germany and shoes to Italy.

International Cooperation and Economic Growth

A strong domestic economy is important to our national security. So is the domestic strength of our allies. Certain the North Atlantic Treaty Organization is stronger if the economies of its members are healthy as well.

The major industrial nations are now joining together to promote world growth. Recent agreements are paving the way fo more balanced growth among these nations. Balanced growth is an important goal because it serves to reduce the huge trade surpluses and deficits that cause so much political trouble.

We are having success. These trade imbalances are coming down in volume terms. Economic growth is accelerating in othe industrial nations and the United States is meeting its commitment to reduce the federal deficit.

What's more, all of us are doing what we can to promote economic growth in developing countries. These countries acco for one third of America's annual trade.

Three years ago we proposed a new partnership between the developing nations, commercial lenders, and the international financial institutions. The aim of the partnership was to strengthen the free market economies of the developing nations And the strategy is working. Fifteen major developing nations have grown in the 2 to 3 percent range in the last two years. That's good progress compared to the negative growth rates in 1982 and 1983. While problems do remain, we believe our polic represent the most promising road to real and lasting economic and political reforms.

Conclusion

Ladies and gentlemen, this evening I have discussed two ba points. First, the growing complexity of the world economy. cannot exist apart from the larger economic sphere, and we mus be ready to defend our growing economic interests in the world

Second, a healthy American economy is necessary for a stro defense. Under President Reagan there has been a new focus on the free market and growth with low inflation. Now we must continue these efforts. Those who recognize the value of a strong defense must also recognize the value of a strong econo

I appreciate the opportunity I have as Treasury Secretary help develop policies for a strong American economy. But I am just as appreciative and just as proud to have served this country as you do -- as a United States Marine.

Thank you for inviting me, good luck, and God bless you.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED
EMBARGOED FOR RELEASE UPON DELIVERY
EXPECTED AT 9:45 a.m. MDT

Remarks by
Secretary of the Treasury
James A. Baker, III
at the First Strike Ceremony
1988 United States Olympic Coins
United States Mint
Denver, Colorado
May 2, 1988

Thank you, Kay [Ortega]. I'm just delighted to finally meet this distinguished group of American athletes. You are champions, and you inspire all of us with your determination and your skill. You represent our American diversity and our passion for excellence. You embody the Olympic motto: "Citius, Altius, Fortius" -- "Faster, Higher, Stronger."

Americans respond to you with enthusiasm and affection because you represent something that binds all of us together -- our tradition of meeting challenges and overcoming obstacles. Your fans all over our great country feel intimately involved in your efforts -- the hard training, the sacrifices you and your families have made along the way, the discipline and endurance you've achieved, and -- perhaps most of all -- your joy in winning.

That's what's so great about the Olympic Coins that we are about to strike. They give those who own them a sense of being members of the team, a sense of sharing in its trials and in its triumphs. And at virtually no cost to the taxpayer, the 1988 Olympic Coins give each of us the opportunity to support America's athletes.

You know, many other countries underwrite the training of their young athletes. But that has never been the American approach. Here it is that great engine of freedom -- the voluntary energies of private citizens -- that powers our efforts.

Like our athletes, we have set an ambitious standard for ourselves. We hope to meet or even exceed a goal of $49 million in selling these Olympic Coins. That income will be the largest single source of contributions to the U.S. Olympic Committee this year. Congress has mandated that these funds are to be dedicated to one use only -- the training of present and future Olympic athletes.

The proceeds of the sale of the coins will have both short-term and long-term benefits. First of all, we'll all get a lot of pleasure from seeing our investments in these coins returned in gold, silver, and bronze medals this summer.

But that's just the beginning. The performance and the example of the Olympic athletes have a continuing effect on all of us. From the time when poets wrote of the first Olympic feats, right up to this year's Winter Games, we have drawn inspiration from your strength, your endurance, and your good sportsmanship.

And that leadership won't end when the Summer Games are over. We will continue to count on your leadership in American society in the years to come. Your achievements fire us up to stretch just a little further, to try just a little harder, and to attain just a little more.

It's that spirit of American enterprise and stamina that these coins symbolize. So let's get right down to business and get the process started. How about it?

And now, Therese [Andrews], over to you there at the newly re-designated West Point Mint. And let me just take a second here to congratulate those of you there on West Point's new status. Are you all set?

Thank you, all, very much.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 2, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,405 million of 13-week bills and for $6,410 million of 26-week bills, both to be issued on May 5, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 4, 1988			:	26-week bills maturing November 3, 1988		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.08%a/	6.26%	98.463	:	6.35%	6.65%	96.790
High	6.13%	6.31%	98.450	:	6.42%	6.73%	96.754
Average	6.13%	6.31%	98.450	:	6.41%	6.72%	96.759

a/ Excepting 1 tender of $3,000,000.

Tenders at the high discount rate for the 13-week bills were allotted 77%.
Tenders at the high discount rate for the 26-week bills were allotted 56%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

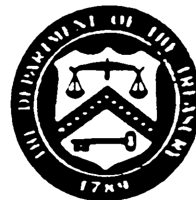
Location	Received	Accepted	:	Received	Accepted
Boston	$ 36,730	$ 36,730	:	$ 23,890	$ 23,890
New York	22,647,830	5,597,930	:	19,567,330	5,481,330
Philadelphia	35,285	35,285	:	22,345	22,345
Cleveland	53,125	47,440	:	36,655	34,455
Richmond	44,415	38,115	:	34,700	34,700
Atlanta	25,200	25,200	:	23,535	23,535
Chicago	1,657,875	58,370	:	1,521,140	135,940
St. Louis	29,485	25,485	:	20,995	18,555
Minneapolis	8,605	8,605	:	6,210	6,210
Kansas City	42,045	42,045	:	38,915	38,915
Dallas	37,855	27,855	:	28,245	21,045
San Francisco	863,755	80,005	:	1,116,810	143,010
Treasury	381,510	381,510	:	426,290	426,290
TOTALS	$25,863,715	$6,404,575	:	$22,867,060	$6,410,220
Type					
Competitive	$22,849,325	$3,390,185	:	$18,800,210	$2,343,370
Noncompetitive	1,041,830	1,041,830	:	916,985	916,985
Subtotal, Public	$23,891,155	$4,432,015	:	$19,717,195	$3,260,355
Federal Reserve	1,850,225	1,850,225	:	1,743,000	1,743,000
Foreign Official Institutions	122,335	122,335	:	1,406,865	1,406,865
TOTALS	$25,863,715	$6,404,575	:	$22,867,060	$6,410,220

An additional $45,065 thousand of 13-week bills and an additional $486,635 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1396

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE APRIL 30, 1988

CONTACT: Charles Powers
566-8773

PANAMA SANCTIONS - LIMITED PAYMENTS PERMITTED

The Treasury Department today announced that it would permit certain limited payments in Panama by U.S. persons. Executive Order 12635 of April 8, 1988, which imposes economic sanctions against Panama, prohibits direct or indirect payments to the Noriega/Solis regime from the United States and from U.S. persons (including U.S. corporations and subsidiaries) in Panama. It also blocks all assets of the Government of Panama in the United States.

The Department will issue regulations specifying the permitted payments in detail. All other payments continue to be required to be made into a specially-designated account at the Federal Reserve Bank of New York to be held for the benefit of the Panamanian people.

Permitted payments include:

- Payments by individuals other than income tax payments. Individuals who make their own social security payments may continue to do so.

- Travel-related payments by individuals, including departure fees and ticket taxes, or by U.S. firms in connection with the provision of travel services to individuals, _e.g._, landing fees and fuel.

- Payments for postal services and for telephone, telegraph and other telecommunications services.

- Payments for utilities including electricity, water, and similar municipal services.

- Payments of indirect taxes (_i.e._, those normally collected in the purchase of goods and services such as sales and excise taxes) and certain administrative fees paid in connection with basic business activity. Treasury regulations will specify which administrative fees can be paid.

B-1397

Payments other than the specified in the regulations as permitted must not be m e to the Noriega/Solis regime. They m be made to the specially-designated account at the Federal Rese Bank of New York. Treasury regulations will provide guidance o the method for making payments to this account.

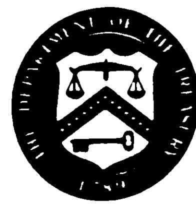
Payments that must be paid into the accour at the Federal Rese Bank of New York include: corporate and i ividual income taxe social security taxes (when paid by corporations or U.S. Government agencies, but not by individuals who ordinarily pay such taxes directly); direct taxes and fees (*e.g.*, port fees, export fees, import duties and related expenses); direct paymen of excise taxes collected as agent for the Government of Panama and rental fees. Additionally, individuals may not make paymen directly or indirectly, for or on behalf of U.S. firms.

Violations of the Panamanian sanctions are punishable by crimin penalties of up to ten years imprisonment and a $50,000 fine, o by civil penalties of up to $10,000 per violation.

Questions about procedures or payments should be directed to Treasury's Office of Foreign Assets Control at 202/376-0392.

o O o

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.
May 3, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $12,800 million, to be issued May 12, 1988. This offering will result in a paydown for the Treasury of about $1,175 million, as the maturing bills are outstanding in the amount of $13,980 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, May 9, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,400 million, representing an additional amount of bills dated February 11, 1988, and to mature August 11, 1988 (CUSIP No. 912794 QH 0), currently outstanding in the amount of $7,087 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,400 million, to be dated May 12, 1988, and to mature November 10, 1988 (CUSIP No. 912794 QT 4).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing May 12, 1988. In addition to the maturing 13-week and 26-week bills, there are $10,041 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $2,752 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $3,178 million as agents for foreign and international monetary authorities, and $7,077 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own accoun Each tender must state the amount of any net long position in th bills being offered if such position is in excess of $200 millio This information should reflect positions held as of one-half ho prior to the closing time for receipt of tenders on the day of t auction. Such positions would include bills acquired through "w issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previous offered as six-month bills. Dealers, who make primary markets i Government securities and report daily to the Federal Reserve Ba of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate te for each customer whose net long position in the bill being offe exceeds $200 million.

A noncompetitive bidder may not have entered into an agreem nor make an agreement to purchase or sell or otherwise dispose o any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained the book-entry records of the Department of the Treasury. A cas adjustment will be made on all accepted tenders for the differen between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit 2 percent of the par amount of the bills applied for must accomp tenders for such bills from others, unless an express guaranty o payment by an incorporated bank or trust company accompanies the tenders.

10/87

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

10/87

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE May 4, 1988

TREASURY MAY QUARTERLY FINANCING

The Treasury will raise about $9,475 million of new cash and refund $16,527 million of securities maturing May 15, 1988, by issuing $8,750 million of 3-year notes, $8,750 million of 10-year notes, and $8,500 million of 30-year bonds. The $16,527 million of maturing securities are those held by the public, including $2,962 million held, as of today, by Federal Reserve Banks as agents for foreign and international monetary authorities.

The three issues totaling $26,000 million are being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average prices of accepted competitive tenders.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $3,563 million of the maturing securities that may be refunded by issuing additional amounts of the new securities at the average prices of accepted competitive tenders.

The 10-year note and 30-year bond being offered today will be eligible for the STRIPS program.

Details about each of the new securities are given in the attached highlights of the offering and in the official offering circulars. The circulars, which include the CUSIP numbers for components of securities with the STRIPS feature, can be obtained by contacting the nearest Federal Reserve Bank or Branch. Financial institutions should consult their local Federal Reserve Bank or Branch for procedures for requesting securities in STRIPS form.

oOo

Attachment

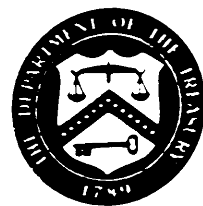
B-1399

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
MAY 1988 QUARTERLY FINANCING

May 4, 1988

Amount Offered to the Public.....	$8,750 million	$8,750 million	$8,500 million
Description of Security:			
Term and type of security........	3-year notes	10-year notes	30-year bonds
Series and CUSIP designation.....	Series S-1991 (CUSIP No. 912827 WD 0)	Series B-1998 (CUSIP No. 912827 WE 8)	Bonds of 2018 (CUSIP No. 912810 EA 2)
CUSIP Nos. for STRIPS Components.	Not applicable	Listed in Attachment A of offering circular	Listed in Attachment A of offering circular
Issue date	May 16, 1988	May 16, 1988 (to be dated May 15, 1988)	May 16, 1988 (to be dated May 15, 1988)
Maturity date....................	May 15, 1991	May 15, 1998	May 15, 2018
Interest rate....................	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids
Investment yield.................	To be determined at auction	To be determined at auction	To be determined at auction
Premium or discount..............	To be determined after auction	To be determined after auction	To be determined after auction
Interest payment dates...........	November 15 and May 15	November 15 and May 15	November 15 and May 15
Minimum denomination available...	$5,000	$1,000	$1,000
Amount required for STRIPS.......	Not applicable	To be determined after auction	To be determined after auction
Terms of Sale:			
Method of sale...................	Yield auction	Yield auction	Yield auction
Competitive tenders..............	Must be expressed as an annual yield with two decimals, e.g., 7.10%	Must be expressed as an annual yield with two decimals, e.g., 7.10%	Must be expressed as an annual yield with two decimals, e.g., 7.10%
Noncompetitive tenders...........	Accepted in full at the average price up to $1,000,000	Accepted in full at the average price up to $1,000,000	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor..............	None	To be determined after auction	To be determined after auction
Payment Terms:			
Payment by non-institutional investors.........................	Full payment to be submitted with tender	Full payment to be submitted with tender	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts....	Acceptable for TT&L Note Option Depositaries	Acceptable for TT&L Note Option Depositaries	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions..........	Acceptable	Acceptable	Acceptable
Key Dates:			
Receipt of tenders...............	Tuesday, May 10, 1988, prior to 1:00 p.m., EDST	Wednesday, May 11, 1988, prior to 1:00 p.m., EDST	Thursday, May 12, 1988, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):			
a) funds immediately available to the Treasury.....	Monday, May 16, 1988	Monday, May 16, 1988	Monday, May 16, 1988
b) readily-collectible check.....	Thursday, May 12, 1988	Thursday, May 12, 1988	Thursday, May 12, 1988

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR IMMEDIATE RELEASE
May 5, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $8,766 million of 52-week bills to be issued May 12, 1988, and to mature May 11, 1989, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	6.73%	7.19%	93.195
High -	6.74%	7.20%	93.185
Average -	6.74%	7.20%	93.185

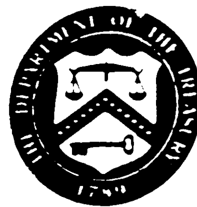
Tenders at the high discount rate were allotted 91%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 16,160	$ 16,160
New York	26,017,735	8,025,445
Philadelphia	16,645	16,645
Cleveland	44,945	19,945
Richmond	31,460	27,460
Atlanta	19,560	16,560
Chicago	1,730,545	207,895
St. Louis	15,600	11,600
Minneapolis	11,715	11,715
Kansas City	24,890	24,890
Dallas	25,040	15,040
San Francisco	1,438,965	170,865
Treasury	201,565	201,565
TOTALS	$29,594,825	$8,765,785
Type		
Competitive	$25,805,575	$4,976,535
Noncompetitive	579,250	579,250
Subtotal, Public	$26,384,825	$5,555,785
Federal Reserve	2,900,000	2,900,000
Foreign Official Institutions	310,000	310,000
TOTALS	$29,594,825	$8,765,785

B-1400

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR IMMEDIATE RELEASE May 5, 1988

TREASURY AMENDS MAY QUARTERLY FINANCING ANNOUNCEMENT

In yesterday's May Quarterly Financing announcement, the Treasury offered three new note and bond issues, including 3-year notes of Series S-1991 to be dated and issued May 16, 1988. The new 3-year notes will have the same maturity and interest payment dates as the outstanding 8-1/8% 5-year 2-month notes, Series J-1991, issued March 5, 1986. The public currently holds $7,728 million of the outstanding notes.

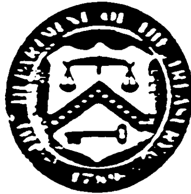
If the auction of the 3-year notes, in accordance with the circular offering the notes to the public, results in the same interest rate as the outstanding 5-year 2-month notes (8-1/8%), the 3-year notes will be considered an additional issue of the 5-year 2-month notes. If such a consolidation occurs, it would be effective May 16, 1988, and the Treasury circular governing the notes would be amended accordingly. In the event of a consolidation, accrued interest of $0.22079 per $1,000 for May 15, 1988, to May 16, 1988, would be payable in addition to the auction price of the notes. The additional issue of the 5-year 2-month notes would have the same CUSIP number as the outstanding notes.

All other particulars of the announcement remain unchanged.

oOo

B-1401

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-204

For Release Upon Delivery
Expected at 10:00 a.m.
May 9, 1988

STATEMENT OF
O. DONALDSON CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the views of the Treasury Department on possible revisions to the unrelated business income tax ("UBIT") that are contained in the list of "discussion options" released by the Committee on March 31, 1988. Last June, this Committee held five days of hearings regarding the appropriate tax treatment of income-producing activities of tax-exempt organizations. My testimony today builds upon Treasury's prior testimony before the Committee and reflects our consideration of the hearing record from last June as well as the many constructive comments submitted by interested parties.

Mr. Chairman, both you and the entire Oversight Subcommittee are to be commended for undertaking a fresh look at this important area of the law, one that has not been thoroughly reviewed by Congress since 1969. While tax laws regarding exempt organizations serve for the most part to regulate the sector rather than to raise revenue, the importance of these laws to the tax system as a whole should not be underestimated. Few areas are more important to how the American public perceives the fairness and success of our tax system. Who is not taxed -- and why -- is of the utmost concern to those who are taxed.

Both the hearings of last June and the ensuing public debate have focused a great deal of attention on the structure and administration of the UBIT. The process has been a constructive one in which individuals representing all sides of this issue have been able to express their views fully. At this time the discussion options have not been presented as a legislative package and we are not in a position to

either endorse or oppose the entire options paper. With respect to individual options, however, many are consistent with my testimony of last June (the "June testimony") and others address areas that are of concern to us. Although I indicate general support for some of these options, our support of legislation reforming the UBIT would depend on the proposals ultimately contained in such legislation. In addition, we believe the administrative burdens such legislation would place on exempt organizations and the Internal Revenue Service is an important factor to consider. We look forward to working with your Committee in producing legislation that reflects the legitimate concerns of all interested parties.

My testimony will consist of two parts. First, I will describe various tax policy considerations regarding the UBIT, with reference to my testimony from last June. Second, I will comment on each of the discussion options in light of those considerations as well as administrative and other concerns. My conclusions, very generally, are as follows.

- First, the issue of the appropriate structure of the UBIT raises fundamental questions regarding tax exemption. We recommend that Congress address these broader questions, but we recognize there is a need for improved data before such questions can be comprehensively analyzed. Thus, we support the proposal to collect needed additional data and to mandate the completion of certain studies.

- Second, in analyzing the UBIT it is important to recognize that the effort to limit "unfair competition," although the primary motivation for the original enactment of the tax, is not the only purpose served by the tax. The UBIT also serves the important goals of enhancing the efficiency of the governmental subsidy inherent in tax exemption and of helping to ensure the accountability of tax-exempt organizations.

- Third, given the need for improved data, I believe the general approach of the discussion options is sound. The options, for the most part, would leave the basic structure of the law intact and make only discrete changes in areas where information available today permits Congress to make informed judgments. A number of discussion options reflect suggestions made in my June testimony and other options reflect a codification of present administrative practice. 1/ We are generally supportive of those options. Other options would change present law, in some cases dramatically. While we would support some of these changes, we have reservations about others.

1/ With respect to several of the discussion options, I state that the option would codify present law or administrative practice. In so stating, I recognize that in some instances the administrative practice of the Internal Revenue Service is being challenged in court and that our view of present law may differ from that of others.

Policy Considerations

I. Introduction

The UBIT is an important element of the rules that define and limit the scope and rationale for tax exemption. Any comprehensive review of the UBIT thus raises questions about the policies underlying tax exemption and how these policies are served in practice. As I stated in my June testimony, tax exemption is intended to encourage the production of certain socially beneficial goods and services that would not otherwise be produced in adequate supply. There are fundamental issues, however, as to whether tax exemption is the most efficient way to encourage desirable activities, whether tax exemption continues to be necessary for certain activities, and whether tax exemption is justified for organizations that rely almost exclusively on commercial activities for support. Further questions arise as to the effect on the tax system and the economy of the growing tax-exempt sector, including both section 501(c) organizations and pension trusts, such as whether the active presence in the marketplace of exempt organizations with substantial assets and no tax on their "passive" investments can create undesirable economic distortions.

Full consideration of these issues will require the development of additional information concerning the activities of the tax-exempt sector. This Committee's hearings and the discussion options have thus appropriately been focused on the day-to-day application of the UBIT and the practical effect of taxable and exempt suppliers co-existing in the same industry. I should emphasize, however, that is important for Congress to review the broader policy issues concerning tax exemption in order to ensure that the substantial benefits of tax exemption are appropriately limited. We, of course, would be pleased to assist in that review.

II. Tax Exemption and Unfair Competition

The ability of exempt organizations to conduct income-producing activities without incurring tax liability has led to complaints from the small business community and has provided the impetus for consideration of changes in the UBIT. While complaints regarding unfair competition must be taken quite seriously, and in fact gave rise to enactment of the UBIT in 1950, we believe that tax policy toward commercial activities of nonprofit organizations should not be guided solely by such concerns. The UBIT also serves an important role in enhancing economic efficiency -- not taxing income from some commercial activities of exempt organizations may represent an inefficient use of an indirect government subsidy. Moreover, the UBIT helps to ensure the accountability of tax-exempt organizations, both to individual donors and to society as a whole. Without these other functions performed by the UBIT, it is possible that increased pursuit of commercial income by tax-exempt organizations could change the fundamental nature of the nonprofit sector.

As I discussed in the June testimony, the precise effect of income tax exemption on competition is not entirely clear. There is little empirical evidence regarding

either the behavior of exempt organizations in competition with taxable businesses or the response of taxable businesses to such competition. Even though tax exemption allows a nonprofit organization to earn a higher rate of return than a taxable company within a particular activity, some have argued that this does not necessarily create an adverse effect on the taxable business. Because the nonprofit organization enjoys a similarly higher rate of return on other uses of its capital, including passive investments, the relative "opportunity cost" of entering a particular business (which includes the revenue lost from forgoing alternative investments) can be equivalent for taxable and exempt organizations. As a result, taxable and exempt businesses may be in the same relative position with respect to the decision whether or not to enter a particular business. Thus, following this analysis, if income tax exemption were the sole benefit granted to nonprofit organizations, nonprofit and taxable organizations might well co-exist in the same business, just as such organizations co-exist in the stock and bond markets.

Nonetheless, when tax exemption is combined with other governmental subsidies -- such as the ability of some exempt organizations to issue tax-exempt bonds, access to lower postal rates, exemption from certain federal excise taxes, and exemption from certain state and local taxes -- an exempt organization's cost of producing goods and services for sale is further reduced. Hence, its profit is increased without a corresponding increase in the return available from alternative passive investments. Consequently, there exists an additional incentive to produce such goods or services as opposed to making a passive investment.

In addition, as a result of their various cost-saving benefits, it is possible that tax-exempt organizations would reduce their prices in an attempt to drive out non-exempt competitors. Engaging in this type of "predatory" pricing leads firms to forego profits in the short run, in the hope that future profits will be large enough to overcome the near-term losses. There is little agreement, however, among economists about whether such pricing is common or whether it is likely to be successful.2/

Thus, although the precise consequences are not perfectly understood, the combination of tax exemption with other governmental subsidies may create a competitive advantage for tax-exempt organizations. Such advantage could be sufficient in certain cases to discourage taxable firms from entering an industry or could encourage existing taxable firms to leave the industry. This result is of particular concern if exempt organizations impinge on activities previously carried on principally by taxable businesses. In such a situation, the taxable businesses would not have anticipated competition from tax-exempt organizations and would have made economic decisions ignoring this possibility.

2/ A further complicating factor in assessing the pricing behavior of exempt organizations is that they will often be motivated primarily by the desire to maximize the output of their exempt product, not by the desire to maximize profits. This could result in prices of such exempt products that are lower than those of their taxable competitors. The desire to maximize exempt output would depend, of course, on whether the organization views those items as part of its primary exempt function, rather than as part of an ancillary function.

III. Economic Efficiency

In addition to limiting unfair competition, the unrelated business income tax serves the goal of economic efficiency by helping to ensure that the subsidy of tax exemption is used in the manner that provides the greatest social benefit.

The effect of the UBIT on economic efficiency can best be seen by considering the impact of a system that exempts from tax all unrelated business income. Such a tax system would encourage equally the pursuit of exempt and unrelated activities by non-profit organizations. This would be an inefficient use of the grant of tax exemption, in that a subsidy is not needed to assure production of appropriate amounts of most commercial goods and services.

Tax exemption for unrelated business income would also act as an indirect subsidy to the primary exempt function of a nonprofit organization because the organization would direct some or all of its unrelated business income towards its exempt function. Subsidizing the primary exempt function of nonprofit organizations by means of a tax exemption for unrelated income, however, would simply reward those organizations that are most successful in pursuing commercial ventures. Such a system would be unlikely to provide the greatest reward to the most deserving organizations: i.e., those that provide the greatest social benefit.3/

Our current tax system does not, of course, exempt all nonprofit income from taxation. Nevertheless, the criterion of economic efficiency can be applied to those particular areas in which nonprofit commercial activities do, in fact, escape taxation in order to help determine whether such activities should remain exempt.

IV. Accountability of Tax-Exempt Organizations

A third important function performed by the unrelated business income tax pertains to the accountability of exempt organizations. As I mentioned in my June testimony, the rules limiting the scope of tax exemption require a non-profit organization to concentrate its activities on those purposes for which it was granted exempt status.4/ Unrelated business activities can divert an organization from its primary purpose and, in extreme cases, supplant that primary purpose altogether. Although the Internal Revenue Service has the authority to revoke an organization's exempt status in such cases, it can be extremely difficult to establish the primary purpose of an organization.

3/ The most efficient subsidy would be allocated to various uses so that the social benefit of the last dollar spent on each use is equalized. If this is not the case, then a reallocation of the subsidy, from low to high social benefit uses, would increase total social benefits at the same cost to the government. This goal would be accomplished by redirecting subsidies from commercial to exempt activities, and from those exempt activities with low marginal social benefits to those with higher benefits.

4/ An organization formed under section 501(c)(3) of the Code, for example, must be organized and operated "exclusively" for one of several designated exempt purposes.

Because the Internal Revenue Service does not have the ability to closely monitor the activities of all exempt organizations, and because it has few enforcement tools short of revoking exempt status altogether, some complementary form of oversight is needed to help ensure that public purposes are being served by the grant of tax exemption. At least in the case of section 501(c)(3) organizations, we believe that unrelated donors who support the organizations can help perform this function. If an organization loses sight of its exempt purpose, for whatever reason, donors will eventually cease to support the organization and they will shift their contributions to more deserving organizations.5/

If an organization is able to support itself with commercial activities, however, the role of the donor becomes less critical and the organization becomes less accountable to the very persons who are best situated to evaluate its activities. To the extent these commercial activities are central to the organization's exempt purpose -- such as education -- there is perhaps less cause for concern because Congress has determined that these activities should be subsidized by the tax system. But to the extent such income-producing activities are merely tangential to the organization's exempt purpose, we believe Congress has cause for concern and that the unrelated business income tax can help regulate the extent of such activities.

V. Conclusion

The foregoing description of various purposes served by the UBIT brings several points into focus. First, the existence of unfair competition is not always required in order to conclude that unrelated income from a particular activity should be subject to tax: considerations of economic efficiency and of accountability may independently justify such a result. Second, although tighter tax laws regarding unrelated business income may be desirable, on either equity or efficiency grounds, they would undoubtedly reduce the overall level of government support provided to activities performed by the nonprofit sector. Congress may decide that a reallocation, not a reduction, of the present subsidy for such activities is desirable. Finally, the appropriate scope of the UBIT is part of the more fundamental issue of whether particular activities should be granted tax exemption. When the necessary additional information has been gathered with respect to exempt organizations, we believe Congress should undertake a comprehensive examination of this fundamental issue.

5/ The legislation enacted as part of the Revenue Act of 1987, which requires exempt organizations to make available for public inspection their Forms 990 and application for tax exemption, helps facilitate an informed judgment by donors in this regard. State laws requiring other forms of disclosure are also beneficial. Indeed, Congress may conclude that additional disclosure requirements are appropriate if further study indicates that donors are not sufficiently informed. We are concerned, in particular, that some donors may incorrectly view the Internal Revenue Service's recognition of exempt status as being the equivalent of a governmental endorsement of the organization's management and operations.

Discussion Options

Next, I will comment on the individual discussion options. My evaluation of each option will in part turn on the purposes of the UBIT I have just described, but will also consider administrative and other concerns.

I. "Substantially Related" Test:

"Repeal "substantially related" test and replace it with a "directly related" test."

Under present law, a regularly carried on trade or business is exempt from tax if the business is substantially related to the exempt purpose of the organization, aside from the need for funds. Treasury regulations elaborate upon the meaning of the term "substantially related" by requiring that the business activity have a substantial causal relationship to accomplishment of the organization's exempt purposes, a relationship which "contributes importantly" to the accomplishment of such purposes.

In my June testimony, I stated our belief that the substantially related standard has conceptual merit as the basis for determining the scope of an exempt activity. While we share the concern that the relatedness standard has been applied in an overly generous manner, we do not support replacing "substantially related" with "directly related." Such a change would generate considerable uncertainty and confusion without necessarily changing the substance, or the administrability, of the standard in any significant way.

We remain concerned, however, with administrative and interpretive problems that the substantially related standard has created. Although we do not propose changes in the standard at this time, we do recommend more detailed reporting, as suggested in Option IX, in order to improve compliance and to provide a basis for further review.

"Determine whether each income-producing activity standing alone is tax-exempt."

Unlike the previous option, this option would represent a significant change in the substance of current law. The option has conceptual appeal in that it would limit tax exemption to those activities specifically identified by Congress. Nonetheless, numerous activities of tax-exempt organizations -- including the operation of dormitories, dining halls, and hospital pharmacies -- would likely be taxable under such a test. We believe the "substantially related" standard appropriately exempts many such activities from tax even though the activities would not warrant tax exemption standing alone. While the provision of food and lodging, for example, is not an inherently exempt activity, the operation of dining halls and dormitories contributes significantly to the educational mission of most universities and in our view is appropriately exempt from tax.

Even though we do not support this option because of its effect on certain related activities, we believe the option attempts to address a fundamental problem -- that an organization with exempt status is relatively free to embark on any number of profitable activities that it deems to be related to its exempt purpose. As my June testimony and that of others made clear, the present standard for relatedness may in operation permit activities to be treated as exempt even though their connection to the original exempt purpose is quite tenuous. Although we do not have a specific recommendation to offer at this time, there may be alternative approaches to this problem. For example, Congress could require an exempt organization to identify all activities for which it is seeking tax exemption so that the determination letter issued by the Internal Revenue Service would identify which activities are recognized as exempt, with the letter applying only to such activities. All other significant income-producing activities would remain taxable. In line with this approach, the organization might also be required to reaffirm periodically the accuracy and completeness of its application for exemption.

"Retain "substantially related" test: however, impose UBIT on specified activities (as listed in A-L below) whose nature and scope are inherently commercial, rather than charitable."

"A. Apply UBIT to gift shop/bookstore income [with exceptions for (1) on-premises sales of low-cost mementos, (2) on-premise sales of an educational nature which relate to the organization visited, (3) in the case of a hospital, articles generally used by or for inpatients, (4) in the case of a university, articles in furtherance of educational programs, or low-cost items (dollar cap), and computer sales not in excess of one sale per student/faculty per year]. In addition, apply UBIT to income from all catalog and mail/phone order or other "off-premise" sales (with exception for de minimis sales, in relation to amount of "on-premise" sales)."

While this option would codify certain aspects of present law, it would, to some extent, liberalize present law by making available some clearly defined "safe harbors." With respect to exempt college bookstores, for example, all souvenir items below a certain dollar level relating to the organization would be exempt from tax, but all other non-educational sales would generally be subject to tax. In light of the substantial administrative difficulties the Internal Revenue Service has had in this area, we believe legislative clarification along the general lines of this option is desirable. We suggest that the term "educational" in the second exception be limited to include materials such as explanatory guidebooks or other educational texts, but not include items of a primarily decorative or functional nature. In the case of an art museum gift shop, for example, sales of an exhibition guidebook, a general text on art history or low-cost prints of exhibited art would be exempt. Sales of primarily decorative items such as jewelry would be taxable. Similarly, the sale by an organization devoted to the study of Elizabethan England of an armchair modeled on one used in that era would be subject to tax because of the functional nature of the product. Finally, we suggest that the term "articles in furtherance of

education programs" in the fourth exception be limited to exclude common consumer items (such as sporting equipment and cameras).

We have some question as to the appropriateness of a special provision for sales of computers to students. In addition to administrative concerns regarding the necessity of defining a "computer" (which is in fact a system of components) and keeping track of each student's purchases, we question the policy justification for such an exception in light of the multitude of small taxable businesses that sell personal computers. In any event, we are uncertain as to why a student at a four year college would need to acquire as many as four computers -- thus, if this option is adopted, we would suggest a lower limit.

With respect to the application of the UBIT to income from all catalog, mail/phone order, or other off-premises sales, the option as stated may reach too broadly. In certain cases, for example, the use of "off-premises" sales might be the only feasible way of carrying out the organization's exempt function, such as sales of scholarly texts by a university press. In other cases, the use of such sales would be appropriate for events such as a college theatrical performance. Although we are sympathetic to the desire to reach mail order sales that have only a minimal connection to tax-exempt activities, we believe that, if appropriate limitations are developed with respect to on-premises sales, these same limitations should be sufficient with respect to off-premises sales. This is an area where a "bright-line" rule is needed. Thus, sales of items that have a primarily utilitarian or decorative function should be subject to tax whether sold on or off premises.

"B. Apply UBIT to all sales or rental income of medical equipment and devices (including hearing aids, portable x-ray units, oxygen tanks), laboratory testing, and pharmaceutical drugs and goods (with exceptions for (1) inpatients, continuous-care outpatients, or emergency treatment outpatients or (2) items not available in immediate geographic area.)"

This option would apply the UBIT when the purchaser might just as easily go to a taxable supplier of the equipment. Although the concept of a "continuous-care outpatient" is a new one in the tax law, we assume it is meant to include patients who utilize the particular piece of equipment as part of an ongoing program of medical treatment. I would emphasize that we believe the definition of this term should be carefully developed so as not to discourage efforts by hospitals to control costs by performing medical procedures on an outpatient basis whenever possible.

Notwithstanding the interpretive issues presented by the new terms, we are generally supportive of this option, which we believe represents only a moderate tightening of present law. We have reservations, however, about the exception for items not available in the immediate geographic area. This rule would present administrative difficulties in determining the meaning of "availability" and "immediate geographic area." Furthermore, it also would allow an exemption from the UBIT where the same equipment is available by mail or in certain cases in which competition from an exempt organization may have discouraged or eliminated taxable

suppliers in the immediate geographic area -- precisely the situation about which Congress is most concerned. Thus, we do not support this aspect of the option, except, perhaps, to the extent an exempt organization is providing new or experimental products.

"C. Apply UBIT to income from certain health, fitness, exercise and similar activities unless program is available to a reasonable cross-section of the general public such as by scholarship or fees based on community affordability."

This option is apparently intended to ensure that health, fitness, and exercise facilities operated by tax-exempt organizations are in fact fulfilling a charitable function.6/ While we agree with this goal, we are concerned that this option would pose substantial administrative problems because of the need to apply terms such as "reasonable cross section," "community," and "affordability." If a health club costs $500 per year, for example, how would the Internal Revenue Service be able to determine whether this fee is "affordable" in a community with an average income of $25,000?

We wish to emphasize that many tax-exempt health and fitness organizations provide services that are fundamentally different from those provided by taxable fitness centers. Exempt facilities are often located in poorer neighborhoods, have special programs for the young, the elderly, and the needy, and attempt to instill spiritual and moral values in their members. Such facilities often do not compete directly with taxable fitness centers for the same clientele.

In some instances, however, tax-exempt organizations provide similar services and do compete directly with taxable organizations. If a tax-exempt organization establishes a racquetball or weight-lifting facility in an affluent neighborhood and it is functionally indistinguishable from taxable fitness centers, for example, legitimate questions may be raised as to what charitable purpose is being served. The Committee may wish to consider modifying this discussion option to provide that each fitness or exercise facility operated by an exempt organization must independently serve a primarily charitable purpose in order for that facility to enjoy tax exemption as a charity. This charitable purpose could be demonstrated by a variety of factors, including service to the needy, the young, the elderly, and the community as a whole. The extent to which the facility is integrated with the charitable activities of the organization as a whole might also be an appropriate

6/ The option does not indicate whether the term "health" includes activities such as the operation of a hospital. Although hospitals, like health clubs, are eligible for tax exemption if they are operated exclusively for charitable purposes, we suggest that this option not be applied to traditional health care activities of hospitals. Instead, we recommend that hospitals and their related organizations be considered as part of Congress' broader review of tax exemption that we have recommended.

factor in this determination. Under this modification, programs relating to athletic skills or body-building would not per se demonstrate a charitable purpose, unless coupled with other factors indicating charitable intent. If a facility does serve a primarily charitable function, however, all of its income from general membership would be exempt because its activities would be described in section 501(c)(3). Such a standard would recognize the very important contributions made by tax-exempt health and fitness organizations, but would limit tax exemption in those few instances in which the operation of a fitness center serves primarily to raise money or to perform some other non-charitable purpose.

"D. Apply UBIT to travel and tour services (with exception for services provided by colleges/universities to students/faculty as part of a degree program curriculum, and de minimis sales to non-students/faculty.)"

This option would be fairly easy to administer and draws a reasonable line between educational travel and travel that is primarily recreational. Although the option would no doubt subject to tax some worthy tour programs, we believe that the evaluation of travel as "educational" is so inherently subjective that some clear test is required.

"E. Apply UBIT to adjunct food sales (with exception for on-premise services and/or sales provided primarily for students, faculty, employees, members, or organization visitors)."

We view this option as largely a codification of present law and administrative practice. As we understand the proposed rule, a restaurant inside a museum would not be subject to the UBIT for sales of food during museum hours if its services are directed to museum visitors. If it is open to the public when the museum is closed, however, or if it caters primarily to the general public, income from such sales would be subject to the UBIT. Presumably concession stand sales at a football game or a symphony concert would remain exempt.

"F. Apply UBIT to income from certain veterinary services such as grooming, boarding, and elective surgery (with exceptions for spaying and neutering, measures to protect the public health, and measures recommended by a veterinarian for the health of the animal)."

This option largely reflects current administrative practice of the Internal Revenue Service. We note that an exception for measures recommended by a veterinarian for the health of the animal is quite broad and could serve to eliminate much of the effect of the general rule in that even routine grooming is beneficial to the health of an animal. Thus, we would not object to a somewhat tighter formulation of this option.

"G. Apply UBIT to hotel facility income which is patronized by the public (with exception for facilities operated, but only to the extent necessary, in furtherance of the organization's exempt purpose). In addition, apply UBIT to retail sales of condominiums and time-sharing units."

We question the appropriateness of exempting from the UBIT any hotel facility income. Although the rental of dormitory rooms to students is appropriately exempt from tax, it is difficult to see how the rental of hotel rooms, per se, ever would directly further a tax-exempt purpose. Although an argument can be made that a school offering a degree in hotel management needs to allow its students to operate a hotel, a similar argument could be made for the operation of any commercial facility. If a hospital or a university desires to offer a subsidized rate for families of patients or students that are unable to afford commercial hotels, such activity may be appropriately exempt from tax as a service to low-income persons, but it would usually not be exempt as either a health-care or educational activity.

The application of the UBIT to retail sales of condominiums and time-sharing units reflects the current administrative position of the Service. We have no objection to codifying this rule so long as no inference is created with respect to the relatedness of other retail sales, which in many instances will similarly be subject to tax.

"H. Apply UBIT to routine testing income (with exceptions for Federal or State mandated activity, pre-surgical medical testing, and laboratory testing which is part of a student educational training program)."

Current Treasury regulations specify that routine testing does not qualify for the research exception to the definition of an unrelated trade or business. This discussion option does not similarly modify the research exception, but would affirmatively tax all routine testing. We believe that many organizations appropriately conduct testing as an integral part of their exempt function and should not be subject to such a rule. Thus, we suggest that this option either be directed at the definition of research or that exceptions be created for organizations whose principal exempt purpose includes testing. In addition, we recommend that if this option is adopted, the broad exception for "Federal or State mandated activity" be limited. States would have a strong incentive to "mandate," and therefore exempt from tax, many activities conducted by exempt organizations, particularly universities. Thus, the exception could to some extent swallow the rule. Also, we have a concern, similar to that noted earlier with respect to hotel facility income, that providing an exception for laboratory testing which is part of a training program may be unduly broad.

"I. Apply UBIT to income from affinity credit card/catalog endorsements."

To the extent income from credit card or catalog endorsements represents the rental of an exempt organization's mailing list, we believe it is already taxable

under present law. If such activity reflects other motivations, the proper resolution is perhaps less clear. If the activity represents the exploitation of an exempt organization's goodwill for commercial purposes, we believe it should be subject to tax. If, however, the activity is more properly viewed as a means of fostering identification by members with the organization and of facilitating contributions, and the activity is limited to the accomplishment of those goals, it may be appropriate to exempt from tax the amounts received by the exempt organization that exceed the fair rental value of its mailing list. We believe further analysis of this relatively new practice may be required in order to determine which characterization is most accurate.

"J. Apply UBIT to advertising income and allow deductions from UBIT only for direct advertising costs."

Under current Treasury regulations, organizations that sell advertising in an exempt journal are not permitted to use the costs of producing the editorial portion of the journal to create a net operating loss from the sale of advertising. Thus, a college alumni magazine, for example, may allocate the cost of producing the articles in the magazine against advertising income, but not to the extent such an allocation would produce a net operating loss that could be offset against the income from other unrelated businesses.

The discussion option would permit advertising income to be offset only by "direct" advertising costs. Such costs would presumably include administrative expenses of selling and designing advertisements as well as a pro-rata portion of the production and distribution expenses of the magazine, determined by reference to the percentage of space in the magazine taken up by advertising. Disallowed costs would include those incurred for the "readership" portion of the magazine -- e.g., the costs of producing the articles and other features.

This option reflects the view that the production of advertising income is of only secondary importance to the production of a tax-exempt journal. As such, only direct costs of producing the advertising income are properly allocated to it. We recognize that such an allocation rule treats tax exempt journals differently, and less favorably, than taxable journals with respect to the computation of taxable advertising income. Nonetheless, we believe tax-exempt journals are in fact fundamentally different from taxable journals and that Congress could appropriately adopt such a rule as one of the conditions of a journal enjoying the substantial benefits of tax exemption.

"K. Apply UBIT to theme/amusement parks."

We consider this option to be a codification of present law. While amusement parks may have some educational value, we believe the educational component is secondary to the purely recreational component. Consequently, the activity is not substantially related to an exempt function and the income is appropriately taxed. Hence, we have no objection to a codification of this rule.

"L. Apply UBIT to additional specified activities determined to be inherently commercial."

Taxing all activities that are inherently commercial would be a significant departure from current law and could create widespread confusion as to who is affected by the rule. Many tax-exempt organizations -- particularly hospitals and universities -- are "commercial" in that the great majority of their income is derived from the sale of services to the general public.7/ Thus the adoption of a "commerciality" standard would presumably require Congress to create a number of exceptions to the rule for traditional exempt activities. Although such an approach would be possible, we believe the better approach at this time is for Congress to identify the particular activities that it considers not to merit tax exemption, as it did for the sale of commercial insurance products in the Tax Reform Act of 1986, and as options A-K do.

II. Convenience Exception:

"Repeal "convenience" exception (income from activities carried on primarily for the convenience of a Section 501(c)(3) organization's members, students, patients, officers, or employees). Income from activities that are substantially related to the organization's exempt purpose would remain tax free, subject to the specific rules listed in Section I. above."

In my June testimony, I suggested that the scope of the convenience exception should be reexamined. We would support this option because we are concerned that the exception in its present form may extend to activities not meriting tax exemption and is not justified by administrative considerations. The convenience exception has had the effect of significantly broadening the range of activities exempt from the UBIT and has freed exempt organizations from the responsibility for deciding whether particular activities are in fact substantially related to the exempt function of the organization. Subjecting income from these activities to tax would not, of course, prohibit them from being undertaken. To the extent they are truly carried on for the convenience of members, it is unlikely that much, if any, tax liability would be incurred. In order to ease the administrative burden on exempt organizations of repealing the convenience exception, we would suggest creating some clearly defined safe harbors -- such as providing services at cost -- that would obviate the need for detailed tax accounting.

7/ Overall, approximately 38 percent of non-profit revenue comes from fees, charges, and dues. Hodgkinson and Weitzman, Dimensions of the Independent Sector (Wash. D.C., 1986), p.32. Data are for 1984.

III. <u>"Regularly Carried On" Test:</u>

<u>"Repeal "regularly carried on" test. Income from an activity that is not a trade or business would remain tax-free."</u>

Under current law, the UBIT applies only to income from an unrelated trade or business regularly carried on by an exempt organization. The UBIT regulations provide that even an activity taking place only once a year can be "regularly carried on" and thus subject to the UBIT if taxable businesses are carried on with similar infrequency. This option would affect activities that are typically carried on by taxable businesses on a year-around basis but, for whatever reason, are carried on by tax-exempt organizations only periodically. For example, an exempt organization under present law could conduct a once-a-year furniture sale and presumably not be subject to the UBIT. This option would cause such an event to be taxable provided that other exceptions to the UBIT, such as those for donated property or businesses operated by volunteers, did not apply. Although we do not oppose the option, we suggest that it be modified so as not to apply to periodic fund-raising events where no clear commercial analogue exists.

IV. <u>Tax Treatment of Royalty Income:</u>

<u>"Apply UBIT to royalties measured by net or taxable income derived from the property; or royalties received by an organization for use of property if such organization, or closely related organization, either: (1) created such property, or (2) performed substantial services or incurred substantial costs with respect to the development or marketing of such property. Retain present law for certain non-working property interests, and exception for products that are part of the organization's exempt function."</u>

Royalties are excluded from the calculation of the UBIT along with dividends, interest, annuities, and rents. As we noted in our June testimony, the legislative history of the enactment of the UBIT in 1950 suggests that Congress created these exceptions because such investments were passive in nature and unlikely to create competitive problems. If such Congressional intent remains valid today, we believe some change in the applicable law is desirable.

Although neither the statute nor the regulations define the term "royalties" for purposes of the passive income exception, virtually any payment for the right to use intangible property could be characterized as a royalty for tax purposes. Thus, it may be possible for a variety of fees to be called "royalties" and be treated as exempt from tax even if they do not in fact represent passive income. Hence, we believe there is a need for Congress to specify what the term "royalties" means for purposes of this exception.

The option would affirmatively subject certain kinds of royalties to the UBIT. We believe it would be undesirable, however, for Congress to tax all royalties not

meeting certain requirements; in some cases such royalties represent exempt function income and should not be taxed. We suggest instead that Congress simply delineate the bounds of the royalty exception to the UBIT. As so modified, this option would provide that royalties measured by net or taxable income, or royalties received for use of property created by the organization, not be eligible for the royalty exception to the UBIT. Other sections of the Internal Revenue Code distinguish between active and passive royalties in a similar fashion. In the case of both domestic and foreign personal holding companies, for example, certain passive income can trigger additional tax and thus taxpayers wish to avoid the characterization of royalties as passive income. In response to such concerns, sections 543 and 954 exclude from the definition of the term "royalties" those royalties derived from the active conduct of certain trades or businesses. Similarly, the passive loss provisions of section 469 distinguish royalties derived in the ordinary course of a trade or business from other royalties.

Royalties considered active under this test would not necessarily be subject to the UBIT. Such a royalty would not be taxable if it constituted exempt function income or satisfied another exception to the UBIT. For example, a university performing contract research and receiving a royalty as part of its compensation would not be subject to tax on the royalty so long as the requirements of the research exception were satisfied.

V. Deduction from Taxable UBIT:

"Increase $1,000 UBIT deduction for certain Section 501(c) organizations to $5,000 or $10,000, with phase-out beyond $50,000 income level. Limit the increased deduction to activities directly carried on by the exempt organization."

As we stated in our June testimony, we recommend that the $1,000 UBIT deduction for certain section 501(c) organizations be raised to $5,000 to adjust for inflation. We also have no objection to a $10,000 figure, with a phase-out, as part of a package of reforms to the UBIT. An increase to $10,000 would simplify the system for many small organizations with relatively small amounts of unrelated income. We would not object if the increased deduction were limited to income from activities directly carried on by the exempt organization rather than, for example, income from a limited partnership interest. We would also have no objection to Congress' distinguishing between section 501(c)(3) organizations and other exempt organizations in setting the amount of the specific deduction.

VI. Unrelated Debt-Financed Income:

"Limit the current law UBIT exception for unrelated debt-financed property to only those pension funds, educational institutions and title holding companies that make at least a 20 percent equity investment of their interest in the property. Retain character of debt-financed income received from all pass-through entities."

While we understand concerns about tax-exempt organizations engaging in leveraged real estate investments, this option adds another level of complexity to an area that is already tightly constrained. The first rule would be difficult to administer in the case of joint ventures involving numerous activities. We believe the present rules of section 514 are adequate to deal with the kinds of abusive transactions that prompted the enactment and amendment of the section. Absent a showing that exempt organizations are in fact engaging in highly leveraged real estate transactions for tax-motivated reasons, we hesitate to endorse this proposal at this time.

The part of the option pertaining to pass-through entities may affect the character of income earned by tax-exempt holders of interests in regulated investment companies ("RICs"), real estate mortgage investment conduits ("REMICs"), and real estate investment trusts ("REITs"). Such a provision would represent a significant change in the treatment of such entities. It would also impose complicated record-keeping and other administrative burdens. If the intent of the option is to prevent tax-exempt organizations from avoiding the restrictions of section 514 by investing through these entities, we suggest that any such rule be limited to avoidance situations. For example, the rule could be applied only to those cases in which a REIT is highly leveraged or is owned substantially by exempt organizations.

VII. Subsidiaries and Joint Ventures:

"Modify the definition of "control" in the case of exempt organizations having taxable subsidiaries. Define "control" as ownership directly, indirectly, or by attribution of at least 50 percent of stock, by vote or value (rather than 80 percent of combined voting stock, under present law)."

Modifying the definition of control from 80 percent to 50 percent is consistent with our June testimony.

"Extend "control" rules where exempt organizations in the aggregate own more than 50 percent of the subsidiary's stock."

We view this option as a reasonable corollary to lowering the definition of control from 80 percent to 50 percent.

"Provide that a controlled taxable subsidiary's income can be no less than its UBIT would have been if the income-producing activity had been carried on directly by the exempt parent organization."

We understand that this rule is intended to prevent an exempt organization from dropping a profitable unrelated business, together with a money-losing related business, into a taxable subsidiary. The loss from the related activity would thus offset the profit from the unrelated activity. If both businesses were carried on by the exempt organization, no such offset would be allowed. Although we are not aware that this kind of tax avoidance is in fact being practiced, the enactment of the option might prevent such schemes in the future. Thus, we do not see a pressing need for the current enactment of this option, but we have no objection to it on conceptual grounds. If the option is enacted, we believe it would be appropriate to clarify that certain payments, such as rents, royalties, and interest, to the parent organization would remain deductible.

"Aggregate income and activities of controlled subsidiaries for purposes of determining if primary purpose of parent is a tax-exempt purpose."

As we stated in our June testimony, aggregating controlled subsidiaries when determining whether the primary purpose of the parent is tax-exempt would be a useful tool in helping to ensure that unrelated business activities do not supplant an organization's exempt function. Among the factors that should be considered in determining an organization's primary purpose are its expenditures for charitable and unrelated business purposes, income from different activities, reasonable expectations of earning a profit, and staff time spent on different activities.

VIII. Allocation Rules:

"With respect to facilities used for exempt purposes as well as unrelated business purposes, allow a deduction against UBI for a proportionate share of the direct operating cost of the facility (e.g., maintenance, insurance, and utilities), but not allow a deduction for a share of the general overhead of the organization or for depreciation."

In my June testimony, I recommended that Congress clarify the appropriate allocation of shared expenses between exempt and unrelated activities. In particular, I stated that the allocation method endorsed by the Court of Appeals for the Second Circuit in Rensselaer Polytechnic Institute v. Commissioner, 732 F.2d 1058 (2d Cir. 1984), failed to properly distinguish between an organization's related and exempt activities. We continue to believe that the decision in Rensselaer results in an inappropriate allocation of expenses and that the appropriate rule would be to allocate fixed costs based on hours of use in the unrelated business compared to the total time available for use.

We have certain reservations about this discussion option, which differs from the recommendation made in my June testimony. We believe that some depreciation and some portion of general overhead may, in certain cases, be appropriately allocated to the unrelated business. For example, if a college president in fact spends five percent of his time attending to an unrelated business, it would generally be appropriate to allocate five percent of his salary to the activity.

Notwithstanding these reservations, we would prefer either the discussion option or an allocation method based on total available time to the uncertain state of current law. We would welcome legislative clarification in this area because it has proven extremely difficult for the IRS to administer and there exists evidence of liberal, and in some cases possibly abusive, allocations. The discussion option, like our June recommendation, would limit the extent to which taxable income from unrelated businesses can be reduced by means of allocating shared costs that were incurred principally for exempt purposes. Both approaches recognize that cost allocation principles applicable to two activities of a taxable business should not necessarily govern the allocation of costs between related and unrelated activities of an exempt organization.

Exempt organizations are granted substantial governmental subsidies not so they may engage in unrelated businesses, but so they may carry out their exempt purpose most effectively. To allow deductions for depreciation and overhead based on the formula approved by the court in Rensselaer suggests that the various forms of governmental subsidy were intended to benefit equally the exempt and unrelated activities. They were not.

IX. Tax Information Reporting/Internal Revenue Service (IRS) Administration:

"Expand Form 990-T reporting requirement to include more reporting on: (1) activities and income which the organization claims to be exempt or excluded from UBIT, and (2) revenue sources such as contributions, grants or other funding sources."

"Provide more detailed reporting of revenue-producing activities and income on Form 990."

"Consider "short form" reporting for small organizations, based on revenues."

We believe that options regarding improved data collection are very important to the long-term effort to analyze the UBIT and tax exemption in general. In fact, we are already working closely with the Internal Revenue Service to improve Forms 990 and 990-T so that we will be able to collect relevant data for analyzing the activities and trends in the exempt organization area. We believe that a Congressional affirmation of these steps would be appropriate.

"Require affiliated group that includes an exempt organization to file a consolidated information return."

"Recommend that IRS have an integrated examination program for exempt organizations and subsidiaries (taxable and exempt)."

We believe both these recommendations are sound. The Internal Revenue Service already has under review the possibility of an integrated examination program, which we believe would increase the efficiency of exempt organization audits. In addition, consolidated reporting should substantially increase the ability of the Service to accurately understand the business activities of affiliated groups of organizations in which some organizations are taxable and some are exempt.

"Recommend that IRS conduct the following studies and report on: (1) nonprofit exempt hospital reorganizations (examining the extent, purpose, effect of the use of subsidiaries); (2) exempt organizations that file Form 990s but do not file Form 990-T's (examining activities of a sample group to determine compliance with UBIT); (3) the feasibility of requiring State and Federal land-grant universities to file an information return; (4) the use, purpose and effect of joint ventures; and, (5) study, after five years, on effect of UBIT changes."

We have no objection to Congress mandating these studies, which we believe would be valuable resources if Congress intends to revisit this area of the law within the next five to ten years. We would hope that similar analyses, based on improved data collection on the part of the Service, would be undertaken by private groups as well.

X. Miscellaneous:

"Codify IRS position (upheld by some courts) that a social club (or other organization whose investment income is subject to UBIT) may not, in determining UBIT, reduce its net investment income by losses on sales to non-members."

The issue presented by this option is similar to that presented by the allocation rules, discussed above. We believe it is inappropriate for social clubs to be able to offset taxable investment income with losses from the use of their facilities in transactions with non-members. In 1969 Congress affirmatively acted to subject such investment income to tax. To permit a social club to avoid such tax by deducting expenses that, for the most part, would be incurred in any event as part of its exempt function seems inconsistent with the intent of Congress.

We would emphasize, however, that we have no objection to a social club engaged in unrelated business activities with non-members being permitted to carry any losses forward or back to offset income from such activities. Hence, we believe the scope of this option is appropriately limited to offsets against investment income.

"<u>Exempt from UBIT an organization's contingent rental income received through a prime tenant, where the prime tenant leases real estate from a tax-exempt organization, the prime tenant's net profits are based on fixed rents derived from subtenants, and the prime tenant does not provide services to subtenants except through an independent contractor.</u>"

This option is similar to a rule that already applies to real estate investment trusts ("REITs") which, like exempt organizations, are entitled to favorable treatment for rental income only if certain requirements are met. Among these requirements are that the rent received by the REIT or the exempt organization not be based on the net income or profits of the tenant. Under current law, REITs are allowed to utilize a "prime tenant" to serve, in effect, as a conduit for the rental of real estate, and to receive a percentage of such prime tenant's net income as rent, so long as the prime tenant itself satisfies the rules applicable to the REIT. This option would permit exempt organizations to make similar use of a prime tenant.

Although we do not object strongly to this option, we are uncertain as to the pressing need to liberalize the UBIT in this manner. Hence we propose further analysis of this option, in order to consider how its enactment would further the exempt purpose of organizations that would utilize the option.

"<u>Exempt from UBIT investment income earned from non-refundable loan commitment fees.</u>"

This option, like the preceding one, is based on the current REIT rules. REITs must receive most of their income from passive real estate related investments. Passive real estate income permitted a REIT includes amounts received or accrued as consideration for entering into agreements to make loans or to purchase or lease real property. Thus, under this REIT provision, it is not necessary that a loan in fact be made for the income from the commitment fee to be considered passive. Under current UBIT rules, in contrast, loan commitment fees are not explicitly excluded from the UBIT. We are uncertain as to the need to liberalize the UBIT rules in this area. We note that REIT rules and the UBIT rules are not identical and in fact have quite different policy justifications. REITs exist for the primary purpose of making real estate related investments, and the applicable rules are designed to encourage such purpose. Exempt organizations, of course, must have a different primary purpose.

"<u>Modify rules applicable to organizations "testing for the public safety."</u>"

Congress adopted the "testing for public safety" exception in 1954 after one organization doing such work had its exemption as a scientific organization under section 501(c)(3) revoked. The rationale for this exemption was not explained in the legislative history and is not entirely clear. The treatment of such organizations is different from that of other section 501(c)(3) organizations. They are expressly exempted from classification as private foundations, and contributions, bequests, or gifts to them are not deductible. Since the income of such organizations is not

dedicated to traditional charitable purposes, it may be appropriate for Congress to consider taxing their investment income for the same reasons I suggested last June with respect to social welfare organizations described in section 501(c)(4). Congress may also wish to consider studying the exemption granted these organizations in order to determine whether it continues to be appropriate in its present form.

"Consider modification of various piecemeal UBIT exclusions enacted since 1969."

Because this option does not specify which piecemeal exclusions are being considered, it is difficult for us to comment here with any specificity. As a general matter, however, we oppose such special exclusions from the UBIT because they create inequities between different exempt organizations and have the potential for creating unfair competition. Nonetheless, just as Congress may now find it appropriate to indicate that certain specific activities are subject to the UBIT, we realize that in some cases it is appropriate to indicate that certain specific activities are exempt from the tax. Should the Committee desire to modify any of these special exclusions, we would be happy to work with you.

XI. Options not Listed

A. Research

We stated in our June testimony with respect to the "research" exception from the UBIT that we believe additional attention should be given to the definition of research. Support of research is a national policy that reflects the critical importance of fundamental research to our economy and future. Although we are unaware of significant abuses in the area of research, we continue to believe some clarification is appropriate in this area. The UBIT statute, regulations and case law fail to define precisely the term "research," and without such a definition the full benefit, or limitations, of the exemption may not be understood or realized. The scope of the term "research" has been delineated for purposes of other Code sections, such as section 41, the credit for increasing research activities, and section 174, permitting expensing of certain research and experimental expenditures. These provisions, like the UBIT exception, are intended to provide an incentive for research. Thus, we believe that carefully considering the definition of research developed in these other contexts may prove useful in order to develop a definition of research for purposes of the UBIT.

B. Charitable Contributions

The most significant income-producing activity of many tax-exempt organizations is the solicitation of contributions from members and the public at large. Although such solicitations generally do not constitute a trade or business because they do not involve the sale of goods or services, we have some concern about charitable

solicitations that effectively involve a sale or exchange of an item of value. Our concern, however, is not so much with the taxation of the exempt organization, but with the availability of the charitable deduction to donors.

Under present law, contributions to certain charitable, educational, scientific, and other organizations are deductible from the donor's income. If an item of value is received in exchange for a charitable contribution, however, a deduction is allowed only to the extent the amount of the contribution exceeds the fair market value of the item. We believe this limitation on the amount of the allowable charitable deduction is often ignored by taxpayers, sometimes with the implicit encouragement of the charitable donee. Thus, an exempt museum will charge admission or a school will sell raffle tickets, but the payments will be described as a "contribution." Similarly, exempt organizations will conduct fundraising drives in which increasingly large contributions entitle the donee to receive increasingly more valuable articles of merchandise in return.

This present state of affairs concerns us for two reasons. First, there is a revenue loss to the government when donors fail to reduce the amount of their charitable deduction by the value of goods or services received. Second, and perhaps more importantly, such overstated deductions create disrespect for the tax system because of the perception that "everyone does it."

Congress acted in 1987 to require that exempt organizations not entitled to receive deductible charitable contributions must disclose that fact on fundraising solicitations. We believe that Congress should consider enacting a similar rule for organizations entitled to receive charitable contributions that supply goods or services as a specific <u>quid pro quo</u> for a contribution to the organization. Under such a rule, the exempt organization would be required to inform donors that the deductible amount of any contribution is limited to the difference between the amount of the contribution and the value of the property or services received. The organization would be required to place a reasonable value on such goods or services for this purpose. An alternative, or complementary, approach to this same issue would be to require that non-deductible payments, such as school tuition, to an exempt organization be paid to a designated account, the name of which would indicate its non-charitable purpose.

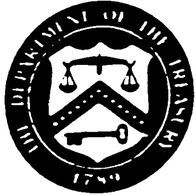
Conclusion

The discussion options and this hearing represent important contributions to the goal of developing legislation to update and reform the UBIT. As I have noted, it would be premature to make far-reaching changes to the law at this time. Nonetheless, some of the discussion options discussed above are quite specific and we support a number of them. Also, the discussion options proposing increased data collection and the completion of certain studies will enable Congress in the near future to address more fundamental questions about the appropriate scope of tax exemption as well as the structure of the UBIT. Finally, I would like to emphasize that my evaluation of the discussion options has treated each option as a separate,

independent proposal. When the proposals are incorporated into a legislative package, it will be important to assess the overall administrative impact of such legislation on tax-exempt organizations in order to determine whether the benefits of the legislation justify the imposition such burdens.

This concludes my prepared remarks. I would be pleased to respond to your questions.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED
Embargoed for Release Until Delivery
Expected at 12 p.m. E.D.T.

Remarks by
The Secretary of the Treasury
James A. Baker, III
to the Economic Club of Detroit
Detroit, Michigan
Monday, May 9, 1988

A Community of Generations: Generational Politics in Harmony

Over the last three years, I've spoken to many audiences on a variety of economic topics -- about the five-and-a-half-year economic expansion in the U.S., budget deficits, exchange rates, economic summits, trade policy, solutions to the debt problem and international economic policy coordination. And I would be pleased to address those topics with this distinguished group during the question period.

I'd like to talk about a topic from the related but slightly different discipline of political economy. The topic is generational politics -- a subject which could substantially affect America's economy in the coming years.

I figured Detroit might be especially alert to this issue. Clearly the automotive industry has been a pioneer in learning how to appeal to different generations of Americans.

Automotive companies have made an art of styling their products for different markets: You know how to appeal to the adventurous energies of the young; the practical necessities of the middle-aged; and the desire for comfort and security of the old.

Advertisers and journalists, politicians and even educators have learned how to appeal to the separate interests of each generation. But I'd like to look at the political side of this issue from a somewhat different angle -- a view of generational politics in harmony, a vision of a community of generations.

B-1403

I'm aware that generational politics may not qualify as what the press likes to call a "new idea." After all, we've heard about this in one form or another since at least the 1950s, since the "Beat Generation" and the start of the Baby Boom. Later we had the "Vietnam Generation," which helped to create the notorious "Generation Gap," which eventually gave way to the "Me Generation." And along the way, we are now told, the Baby Boom Generation has been transformed into the "Baby Boasting" Generation, and the yippies in beads have become yuppies in BMWs.

On the other side, we have always had the "older generation." This group has never been as clearly defined as the Baby Boomers, but to the extent that they have been defined, they tend to be portrayed either as Ozzie & Harriets (good-natured but slightly out-of-it) or else as Gray Panthers, the granny-on-wheels types who will fight fervently to preserve entitlement programs.

Now, if this background tends toward caricature, that's because I intend it to. I intend it to because I think our understanding of generational politics in this country has also tended toward caricature. We've had a tendency to think in terms of generations at odds with one another -- the young versus the old, the Baby Boomers versus their parents -- a zero-sum society. Unfortunately, this means that in our politics we are too often told that in order to promote the best interests of this or that generation, we simply must support this or that policy. Or else, we are told, we will lose the support of the young, the old, or whomever.

Not surprisingly, political interest groups have organized to represent the supposed common demands of different generations. Some of you may have heard of a new lobbying group in Washington, Americans for Generational Equity, or, appropriately enough, AGE. AGE was organized in part to lobby on issues said to concern the Baby Boomers. A few of its members consider that the lobbies for the elderly have effectively laid claim to a growing portion of domestic spending, regardless of need. On the other hand, some of the lobbies for the elderly accuse the lobbyists for the young of wanting to undermine Social Security or Medicare. Once again, we are told, there is a generation gap.

Meanwhile, in the 1988 Presidential campaign, several candidates have invoked the images of a youthful John F. Kennedy. They stressed the themes of youthful idealism and commitment in the hope of appealing to the Baby Boomers -- to the majority of the electorate that is now under 45 years old.

What goes unsaid is their implication that the rest of the country somehow doesn't share this same idealism or commitment. It's worth remembering that, if he were alive today, JFK would not be a Baby Boomer; he would be almost 71 years old, yet still promoting his ideals.

The point I want to stress to you today is that this politics of the Generation Gap is short-sighted at best, and may even be a threat to our national prosperity. The politics of generational envy or warfare is simply inadequate to the task of helping our country meet the complicated and very difficult issues we are going to have to confront into the 1990s and beyond. On the issues of the future (issues like better education for our children, the cost and quality of health care for the elderly, and America's political and economic influence in the world) on these and many other issues, interest-group politics based on age just isn't up to the task.

Instead of more warfare between generations we need a stronger alliance across generations -- we need a generational peace offensive that stresses our shared obligations and common ideals. Far from being a nation of two or more generations divided, we are really a community of generations with compatible interests. From our retirees who formed their values in the Depression, to those like myself who reached adulthood in the 1950s, through the Baby Boom, to the perhaps neglected group of young people who have followed the Boomers, and even to our children of the future -- still unborn but destined to inherit our economic and political legacy -- the common ideals of these generations far exceed the differences.

If I can adapt a line from the television ad, none of us can really "have it all" -- at least not if having it all means having it at the expense of some other segment of American society. Self-centeredness -- whether generational, individual, or national -- simply cannot help us address the problems of the future. And this may be a particularly good moment to acknowledge and endorse the notion of shared obligation and opportunity across generations. Baby Boomers no less than Gray Panthers seem to me to be in the mood to listen.

A Domestic Agenda for All Ages

Ladies and gentlemen, I think we can see the possibilities for a community of generations if we examine some of the issues now coming to the fore in American politics. Consider an issue that has become a talking point around the country -- the issue of excellence in education.

One of the more encouraging cultural signs has been the nonfiction best seller list. Last year the diet books, believe it or not, gave way to a book describing the failures of American education. And those of you who have read it know that the book that was for a time the number one best seller (by University of Chicago Professor Allan Bloom) is no simple list of outrageous anecdotes. It is a sophisticated, challenging work. His presence on the list suggests a deep public discomfort at America's educational performance.

Americans have made it clear that they do not like the fact that, while the average U.S. student spends 180 days in school each year, the average Japanese student spends 240 days; or that between the ages of 6 and 18, American children will spend more hours watching TV than they will attending school; or that young people can actually finish high school thinking, as a couple of recent surveys showed, that Herbert Hoover sold vacuum cleaners and Joseph McCarthy was a famous Communist.

What we are seeing with this phenomenon, I think, is that as the Baby Boom generation ages it is acquiring more of a stake in society -- in mortgages, in marriages, and in children. Naturally, these young parents and homeowners are more concerned about social trends, about cultural mores and public attitudes. And for people who care about social trends, education will always be a priority.

You know, my wife Susan learned this first hand when she and Senator Albert Gore's wife, Tipper, and a few others began to raise some concerns about rock music lyrics. Frankly, going into it they expected to be mocked and perhaps ignored. But they received an overwhelmingly positive response. The voices of the few critics were simply drowned out by the many others who agreed.

The rebels without a cause seem to have become rebels with a very great cause -- that is, the care and education of their children and the improvement of the society those children will live in. And I think it's worth noting that this suggests more or less the opposite of the theme expressed in such movies as "The Big Chill" -- in which the Baby Boomers are depicted as having lost their 1960s idealism in favor of selfish materialism.

Far from it, the Baby Boomers have discovered an excellent new place to channel that idealism -- into the values and commitments of mainstream American society. On these issues, the Baby Boom really has finally met -- and politically, even become -- the older generation.

All of this, I believe, offers an enormous opportunity to those of us who want to improve America's educational performance. And my personal view is that we have little choice but to improve -- in order to compete in the world economy, but also to ensure that our shared principles and convictions are passed on to our children. At a minimum, I believe we're going to have to consider seriously lengthening the school year, upgrading the curriculum, raising educational standards, and making schools more accountable to parents and communities.

Moreover, I encourage the increasing recognition that education is an issue that concerns generations other than parents and their children. All of us need to learn how to learn, so that we may lead fuller, productive, and more enjoyable lives. In part, continuing education is a practical necessity given the rapid pace of change in our increasingly competitive and interdependent world. And in part, continuing education is a predicate to the informed citizenry that animates our system of government. Finally, ongoing education can be the wellspring for a great deal of personal satisfaction and contentment. So from my perspective, education is indeed a topic of interest for the community of generations.

Ladies and gentlemen, I think we also have a generational obligation, if I may put it that way, on another major issue -- the budget deficit. I've long agreed with those who say that by tolerating a deficit we Americans have been voting to give ourselves goods and services that we don't have to pay for; instead our children will pay for them. In other words, we can "have it all," but only by giving our children much less.

I believe the deficit habit may even represent a failure of our constitutional system -- living generations are able to vote themselves benefits, but they can slip the bill to a future generation that is not only unable to vote but is not even party to the debate. In that sense, our constitutional system may contain a bias toward deficits -- a bias that, in my opinion requires a constitutional remedy.

My own view is that this remedy should take the form of both a balanced budget amendment with some kind of limit on taxation and a line item veto. Yes, I know that some in the political community have scoffed at the Reagan Administration for proposing these ideas. They say they can't be passed by the Congress. But it's worth keeping in mind that a century ago the income tax was an issue for 20 or 30 years before it passed, and its reformation was an issue for many years before we finally succeeded with tax reform in 1986. I think support for some kind of constitutional spending discipline will continue to increase as all adults grow more sympathetic to this obligation to their children's future.

I also think we have some cause for a harmonious cross-generational approach, even to the difficult issue of Social Security. Now, I happen to know very well how sensitive this issue is politically. I have learned this from the three Presidential campaigns in which I have been involved, and also when in 1982 and 1983 I was part of an Administration and Congressional effort to forge a compromise to strengthen Social Security. I am proud of that effort. It began and progressed in the basement of my Washington home. Our work guaranteed the integrity of retirement benefits into the 21st century, and we juggled a multitude of interests to do it.

Yet I think everyone involved in that compromise would admit that it couldn't solve all of the problems of the elderly. For one thing, in striking that compromise the payroll tax was raised, so the financial burden on American workers was increased. (My own belief is that we had better alternatives to tax increases, but that was what we had to accept to get a compromise.) For another thing, we have yet to face the fact that America's elderly are living longer, and so need retirement benefits for a growing number of years. When Social Security's retirement age was first fixed at 65 in the 1930s, most Americans -- to put it bluntly -- could be expected to die within a few years of retirement. Today, the average American lives well past 70, and (in the future) millions will live past 80.

Clearly, we will have to do more to strengthen Social Security in the future -- and, just as clearly, we will not succeed if we approach the issue as just one more battle between generations. Younger workers cannot bear ever increasing payroll taxes, any more than retirees can be expected to take cuts in benefits earned over a lifetime of hard work.

Without promoting any specific change, I believe our approach to this challenge should be to build on the common interests among various generations.

Because of progress in health care, many Americans now retain the energy and vigor to contribute significantly to American society well into their 70s. As a matter of public policy, we should not coerce these older Americans into retirement. And when they do retire, we should seek to ensure ample opportunities for them to share their wisdom and knowledge with younger Americans.

Obviously, this cannot be accomplished only with a change in laws; we will also have to change public attitudes -- attitudes about when people should retire, and stereotypes about what contributions older Americans can make. They have a wealth of experience and insight. We must ensure that their wisdom is passed on to succeeding generations.

A New Generation Abroad, New U.S. Opportunity

I believe this cross-generational approach may also provide some opportunities for American foreign policy. As Treasury Secretary, I've been able to observe what amounts to a changing of the guard in leadership around the world -- especially in the developing countries.

The generation of leaders who came to power in the anti-colonial wave after World War II is finally, gradually, leaving power. These leaders, as you know, tended to favor highly centralized regimes, whether of the left or right. Very few of them did as well as they had hoped in the task of development.

Among their successors, however, I've seen leaders struggling to find better ways of doing things -- searching for a new philosophy to guide them, opening to new ideas in a way that their nations haven't in 30 or 40 years. One prominent example is India. In 1947, at independence from Britain, India's Prime Minister Nehru praised Stalin's centralized economic control and set his country on the socialist path. Yet when his grandson, Rajiv Gandhi, became prime minister in 1984, he talked about aiding private industry, cutting taxes, and decentralizing economic power.

It is true, of course, that some harsh economic realities are also forcing countries to rethink their policies. I have in mind in particular the debt burden. The U.S. and other creditors have tried to ease that unfortunate problem, but the truth is that the only solution in the long run is for the debtors themselves to make their own countries more hospitable to private investment and initiative. Again, that means they'll have to be open to fresh ways of thinking.

And it's here, I think, where America has its opportunity -- an opportunity to promote its own ideas and project its principles to new generations around the world who are more willing than ever to listen. That's one reason, frankly, that, as part of the U.S. debt strategy, I've stressed that the debtors make reforms to open their markets and liberate their citizens from government controls and bureaucracy. Our objective has been to encourage local support for changes that will spur growth and create a welcome environment for private investment. And I've discovered a receptive audience.

As the world economy grows more integrated and interdependent, we are also going to have to depend more heavily on other nations for cooperation in promoting our interests -- in defending the West, and in maintaining open trade and steady growth, to mention only two obvious areas. A national self-centeredness -- a neo-isolationism -- will not win anyone's cooperation, and will not serve our own self-interest. American foreign policy always has been based at least in part on the promotion of our guiding principles as a nation -- and I believe that this aspect of our foreign policy may become even more important in the future.

This is a lesson, I might add, that I think the Baby Boom generation in America well understands. Raised in the turbulent Vietnam years, they understand the power of idealism, and its uses in the world. And now that they are fast becoming the leadership generation, they no doubt appreciate the value of unity, of harmony. We have it from a very good authority, Abraham Lincoln, who said in another context: "A house divided against itself cannot stand." If America wants to project its principles abroad, it must certainly be unified at home.

I would argue that the Baby Boomers are looking, and even eager, to put their zeal and commitment to work abroad -- so long as it is put to work on behalf of America's own best ideals -- the ideals of freedom and democracy, with the goal of shared prosperity.

Conclusion

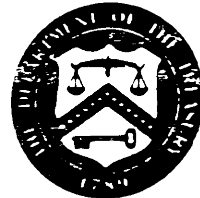
Let me leave you with this prospect for generational politics.

There is no doubt that the views of generations are in part formed by the experiences of their different times. Different epochs produce distinctive views. And even when experiences do not diverge greatly, the different expectations, hopes, responsibilities, and priorities of various stages of life of course affect attitudes and interests.

Nevertheless, I believe that these differences are far less significant than our shared values and common interests. And I believe the richness of various generations' experiences should enable us to face our mutual challenges with greater strength if we act in harmony.

Our community of generations can protect and project America's experiment in democracy -- both at home and abroad -- if we acknowlege our shared obligations to one another. That should be the aim of our political agenda as we move toward the 1990's -- so we can build a better country for all current generations, as well as for those to come.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 9, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 6,408 million of 13-week bills and for $ 6,402 million of 26-week bills, both to be issued on May 12, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 11, 1988			26-week bills maturing November 10, 1988		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	6.28%	6.47%	98.413	6.47% a/	6.78%	96.729
High	6.33%	6.52%	98.400	6.51%	6.82%	96.709
Average	6.31%	6.50%	98.405	6.51%	6.82%	96.709

a/ Excepting 1 tender of $2,840,000.

Tenders at the high discount rate for the 13-week bills were allotted 20%.
Tenders at the high discount rate for the 26-week bills were allotted 97%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 42,485	$ 42,485	$ 32,845	$ 32,845
New York	20,364,270	5,239,270	19,542,060	5,556,040
Philadelphia	28,940	28,940	24,090	22,090
Cleveland	35,060	35,060	33,215	33,215
Richmond	55,780	51,780	32,830	32,830
Atlanta	31,355	31,355	26,120	26,120
Chicago	1,975,755	327,755	1,414,005	68,405
St. Louis	28,590	25,590	25,490	22,460
Minneapolis	8,970	8,970	13,635	13,635
Kansas City	36,735	36,735	40,965	40,965
Dallas	32,565	27,565	30,380	20,380
San Francisco	805,640	158,640	1,065,210	130,110
Treasury	393,965	393,965	402,990	402,990
TOTALS	$23,840,110	$6,408,110	$22,683,835	$6,402,085
Type				
Competitive	$20,299,665	$2,867,665	$17,534,615	$1,252,865
Noncompetitive	1,080,930	1,080,930	944,920	944,920
Subtotal, Public	$21,380,595	$3,948,595	$18,479,535	$2,197,785
Federal Reserve	2,226,715	2,226,715	1,950,000	1,950,000
Foreign Official Institutions	232,800	232,800	2,254,300	2,254,300
TOTALS	$23,840,110	$6,408,110	$22,683,835	$6,402,085

1/ Equivalent coupon-issue yield.

3-1404

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.
May 10, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $12,800 million, to be issued May 19, 1988. **This offering will result in a paydown for the Treasury of about $1,050 million, as the maturing bills are outstanding in the amount of $13,838 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern** Daylight Saving time, Monday, May 16, 1988. **The two series offered are as follows:**

91**-day bills (to maturity date) for approximately $**6,400 **million, representing an additional amount of bills dated** February 18, 1988, **and to mature** August 18, 1988 **(CUSIP No. 912794** QJ 6 **), currently outstanding in the amount of $**7,131 **million, the additional and original bills to be freely interchangeable.**

182**-day bills for approximately $**6,400 **million, to be dated** May 19, 1988, **and to mature** November 17, 1988 **(CUSIP No. 912794** QU 1 **).**

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing May 19, 1988. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $1,877 million as agents for foreign and international monetary authorities, and $4,448 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

B-1405

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

10/87

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR IMMEDIATE RELEASE
May 10, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 3-YEAR NOTES

The Department of the Treasury has accepted $8,765 million of $ 25,908 million of tenders received from the public for the 3-year notes, Series S-1991, auctioned today. The notes will be issued May 16, 1988, and mature May 15, 1991.

The interest rate on the notes will be 8-1/8%. The range of accepted competitive bids, and the corresponding prices at the 8-1/8% rate are as follows:

	Yield	Price 1/
Low	8.21%*	99.777
High	8.24%	99.699
Average	8.23%	99.725

*Excepting 1 tender of $15,000.

Tenders at the high yield were allotted 30%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 42,950	$ 42,950
New York	22,782,125	7,685,025
Philadelphia	31,280	31,280
Cleveland	93,630	81,630
Richmond	193,685	69,185
Atlanta	54,210	49,510
Chicago	1,124,530	428,030
St. Louis	88,585	73,185
Minneapolis	46,960	45,750
Kansas City	113,725	113,725
Dallas	20,580	20,580
San Francisco	1,309,085	117,970
Treasury	6,490	6,490
Totals	$25,907,835	$8,765,310

The $ 8,765 million of accepted tenders includes $1,136 million of noncompetitive tenders and $7,629 million of competitive tenders from the public.

In addition to the $8,765 million of tenders accepted in the auction process, $960 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $2,963 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

Since the interest rate on these notes will be 8-1/8%, the notes will be considered an additional issue of the 8-1/8% notes of Series J-1991. The Treasury circular governing the notes will be amended, effective May 16, 1988, to provide for the consolidation.

1/ In addition to the auction price, accrued interest of $0.22079 per $1,000 for May 15, 1988, to May 16, 1988, must be paid.

B-1406

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 11, 1988

CONTACT: Office of Financin
202/376-4350

RESULTS OF AUCTION OF 10-YEAR NOTES

The Department of the Treasury has accepted $8,751 million of $22,886 million of tenders received from the public for the 10-year notes, Series B-1998, auctioned today. The notes will be issued May 16, 1988, and mature May 15, 1998.

The interest rate on the notes will be 9%.1/ The range of accepted competitive bids, and the corresponding prices at the 9% interest rate are as follows:

	Yield	Price 2/
Low	9.05% *	99.675
High	9.06%	99.610
Average	9.06%	99.610

*Excepting 1 tender of $10,000.
Tenders at the high yield were allotted 95%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 11,678	$ 11,678
New York	20,918,737	8,320,362
Philadelphia	4,818	4,818
Cleveland	12,329	12,329
Richmond	90,724	47,469
Atlanta	17,412	17,362
Chicago	1,026,511	218,511
St. Louis	25,882	14,882
Minneapolis	8,803	8,803
Kansas City	17,820	17,820
Dallas	5,360	3,360
San Francisco	743,849	71,499
Treasury	2,421	2,421
Totals	$22,886,344	$8,751,314

The $8,751 million of accepted tenders includes $454 million of noncompetitive tenders and $8,297 million of competitive tenders from the public.

In addition to the $8,751 million of tenders accepted in the auction process, $400 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

1/ The minimum par amount required for STRIPS is $200,000. Larger amounts must be in multiples of that amount.

2/ In addition to the auction price, accrued interest of $0.24457 per $1,000 for May 15, 1988, to May 16, 1988, must be paid.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 12, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 30-YEAR BONDS

The Department of the Treasury has accepted $8,505 million of $21,693 million of tenders received from the public for the 30-year Bonds auctioned today. The bonds will be issued May 16, 1988, and mature May 15, 2018.

The interest rate on the bonds will be 9-1/8%. 1/ The range of accepted competitive bids, and the corresponding prices at the 9-1/8% interest rate are as follows:

	Yield	Price 2/
Low	9.16% *	99.643
High	9.18%	99.440
Average	9.17%	99.542

* Excepting 1 tender of $15,000.

Tenders at the high yield were allotted 74%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 2,093	$ 2,063
New York	19,837,575	7,947,490
Philadelphia	960	960
Cleveland	2,401	2,401
Richmond	4,114	4,114
Atlanta	8,880	7,880
Chicago	1,141,905	480,565
St. Louis	9,568	7,568
Minneapolis	3,487	3,487
Kansas City	6,760	6,760
Dallas	4,461	1,461
San Francisco	670,571	39,471
Treasury	679	679
Totals	$21,693,454	$8,504,899

The $8,505 million of accepted tenders includes $462 million of noncompetitive tenders and $8,043 million of competitive tenders from the public.

In addition to the $8,505 million of tenders accepted in the auction process, $200 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

1/ The minimum par amount required for STRIPS is $1,600,000. Larger amounts must be in multiples of that amount.

2/ In addition to the auction price, accrued interest of $0.24796 per $1,000 for May 15, 1988, to May 16, 1988, must be paid.

B-1408

federal financing bank NEWS
WASHINGTON, D.C. 20220
Press 566-2041
FFB 566-2468

May 13, 1988

FOR IMMEDIATE RELEASE

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Acting Secretary, Federal Financing Bank (FFB), announced the following activity for the month of November 1987.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $156.8 billion on November 30, 1987, posting a decrease of $69.7 million from the level on October 31, 1987. This net change was the result of an increase in holdings of agency debt of $94.3 million, and decreases in holdings of agency-guaranteed debt of $163.7 million and in agency assets of $0.3 million. FFB made 70 disbursements during November.

Attached to this release are tables presenting FFB November loan activity and FFB holdings as of November 30, 1987.

0

B-1409

FEDERAL FINANCING BANK

November 1987 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
AGENCY DEBT					
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
+Note #451	11/3	$ 4,450,000.00	2/3/88	5.985%	
+Note #452	11/3	15,000,000.00	12/1/87	5.915%	
+Note #453	11/18	23,300,000.00	2/18/88	6.195%	
+Note #454	11/19	25,000,000.00	12/1/87	6.075%	
+Note #455	11/25	500,000.00	2/23/88	6.075%	
TENNESSEE VALLEY AUTHORITY					
Advance #811	11/4	267,000,000.00	11/9/87	5.935%	
Advance #812	11/6	156,000,000.00	11/13/87	5.875%	
Advance #813	11/9	40,000,000.00	11/16/87	5.875%	
Advance #814	11/9	238,000,000.00	11/17/87	5.875%	
Advance #815	11/13	162,000,000.00	11/20/87	6.135%	
Advance #816	11/17	200,000,000.00	11/23/87	6.175%	
Advance #817	11/17	43,000,000.00	11/27/87	6.175%	
Advance #818	11/20	154,000,000.00	11/27/87	5.965%	
Advance #819	11/23	104,000,000.00	11/30/87	6.025%	
Advance #820	11/23	60,000,000.00	12/1/87	6.025%	
Advance #821	11/23	38,000,000.00	12/2/87	6.025%	
Advance #822	11/27	209,000,000.00	2/4/88	6.005%	
Advance #823	11/30	256,000,000.00	12/7/87	5.925%	
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Greece 15	11/2	585,000.00	6/15/12	9.135%	
Greece 16	11/2	544,422.89	9/1/13	9.105%	
Philippines 11	11/12	287,827.83	9/12/96	7.995%	
Turkey 18	11/12	45,544,992.71	3/12/14	8.991%	
Greece 17	11/13	210,000.00	8/25/14	8.925%	
Greece 15	11/18	1,753,065.92	6/15/12	9.055%	
Greece 16	11/18	1,360,390.39	9/1/13	8.995%	
Niger 3	11/23	299,165.00	5/15/88	8.309%	
Greece 17	11/23	3,647,666.00	8/25/14	8.915%	
Gabon 4	11/23	2,063,710.00	1/15/88	6.025%	
Philippines 11	11/23	152,863.62	9/12/96	8.005%	
Niger 3	11/23	299,165.00	5/15/88	8.309%	
Greece 17	11/23	3,647,666.00	8/25/14	8.915%	
Gabon 4	11/23	2,063,710.00	1/15/88	6.025%	
Philippines 11	11/23	152,863.62	9/12/96	8.005%	
Niger 3	11/23	299,165.00	5/15/88	8.309%	
Turkey 18	11/30	1,711,482.00	3/12/14	9.305%	

+rollover

FEDERAL FINANCING BANK

November 1987 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
DEPARTMENT OF HOUSING & URBAN DEVELOPMENT					
Community Development					
Toa Baja, PR	11/5	$ 53,200.00	5/2/88	6.435%	
Long Beach, CA	11/6	156,400.00	8/1/88	6.665%	6.737% ann.
Rochester, NY	11/9	181,075.00	8/15/88	6.825%	6.907% ann.
Jefferson County, MO	11/12	6,260,000.00	11/30/94	8.411%	8.588% ann.
Montgomery Co. Dev. Corp.	11/18	113,430.00	5/16/88	6.695%	
Baltimore, MD	11/18	137,310.00	1/2/88	6.195%	
Florence, SC	11/18	63,009.10	7/1/88	6.845%	6.893% ann.
RURAL ELECTRIFICATION ADMINISTRATION					
*Corn Belt Power #138	11/2	94,000.00	1/2/18	9.107%	9.006% qtr.
*Colorado Ute Electric #71	11/4	2,387,000.00	12/31/15	9.097%	8.996% qtr.
*Corn Belt Power #138	11/4	41,000.00	12/31/19	9.126%	9.024% qtr.
*Sunflower Electric #174	11/6	15,000,000.00	12/31/15	8.883%	8.786% qtr.
*Central Electric Power #131	11/9	137,000.00	11/9/89	7.635%	7.563% qtr.
*Wabash Valley Power #104	11/12	2,687,000.00	12/31/15	8.955%	8.857% qtr.
*Wolverine Power #234	11/12	3,944,000.00	11/13/89	7.735%	7.662% qtr.
*Colorado Ute Electric #96	11/13	1,486,000.00	12/31/14	8.954%	8.856% qtr.
Blue Ridge Electric #307	11/16	4,000,000.00	1/2/90	7.892%	7.816% qtr.
*Wabash Valley Power #206	11/16	9,028,000.00	11/16/89	7.875%	7.799% qtr.
*Wolverine Power #101A	11/17	140,000.00	1/2/90	7.928%	7.851% qtr.
Colorado Ute Electric #152	11/18	1,080,000.00	12/31/15	9.022%	8.922% qtr.
Cooperative Power #156	11/18	1,639,000.00	11/20/89	7.855%	7.779% qtr.
Allegheny Electric #255	11/24	1,220,000.00	1/2/90	7.835%	7.760% qtr.
*Wabash Valley Power #206	11/25	694,000.00	12/31/15	9.074%	8.973% qtr.
SMALL BUSINESS ADMINISTRATION					
State & Local Development Company Debentures					
Comm. Dev. Corp. of Ft. Wayne	11/4	243,000.00	11/1/02	9.015%	
Chicago Industrial Fin. Corp.	11/4	104,000.00	11/1/07	9.108%	
Michigan Certified Dev. Corp.	11/4	116,000.00	11/1/07	9.108%	
Long Island Development Corp.	11/4	162,000.00	11/1/07	9.108%	
Mid City Pioneer Corp.	11/4	166,000.00	11/1/07	9.108%	
Opportunities Minnesota, Inc.	11/4	177,000.00	11/1/07	9.108%	
Mid City Pioneer Corp.	11/4	226,000.00	11/1/07	9.108%	
E. Central Michigan Dev. Corp.	11/4	408,000.00	11/1/07	9.108%	
Indiana Statewide CDC	11/4	500,000.00	11/1/07	9.108%	
Wilmington Indus. Dev., Inc.	11/4	119,000.00	11/1/12	9.165%	
BEDCO Dev. Corp.	11/4	142,000.00	11/1/12	9.165%	
S. Cent. Kansas Ec. Dev. Dist.	11/4	267,000.00	11/1/12	9.165%	
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-88-02	11/30	630,535,957.08	2/29/88	6.035%	

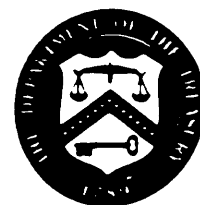
*maturity extension

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	November 30, 1987	October 31, 1987	Net Change 11/1/87-11/30/87	FY '88 Net Change 10/1/87-11/30/87
Agency Debt:				
Export-Import Bank	$ 12,463.5	$ 12,463.5	$ -0-	$ -0-
NCUA-Central Liquidity Facility	122.8	124.5	-1.7	11.4
Tennessee Valley Authority	16,688.0	16,592.0	96.0	302.0
U.S. Postal Service	4,353.4	4,353.4	-0-	-0-
U.S. Railway Association +	-0-	-0-	-0-	-0-
sub-total*	33,627.6	33,533.3	94.3	313.4
Agency Assets:				
Farmers Home Administration	64,934.0	64,934.0	-0-	-75.0
DHHS-Health Maintenance Org.	84.0	84.0	-0-	-0-
DHHS-Medical Facilities	102.2	102.2	-0-	-0-
Overseas Private Investment Corp.	0.7	0.7	-0-	-0-
Rural Electrification Admin.-CBO	4,241.2	4,241.2	-0-	-0-
Small Business Administration	19.0	19.1	-0.3	-0.8
sub-total*	69,380.9	69,318.2	-0.3	-75.8
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	18,358.2	18,483.1	-124.9	-805.8
DEd.-Student Loan Marketing Assn.	4,940.0	4,940.0	-0-	-0-
DHUD-Community Dev. Block Grant	325.1	325.3	-0.2	0.9
DHUD-New Communities	30.6	30.6	-0-	-0-
DHUD-Public Housing Notes +	2,034.9	2,074.4	-39.2	-39.2
General Services Administration +	394.6	395.5	-0.8	-0.8
DOI-Guam Power Authority	33.2	33.2	-0-	-0-
DOI-Virgin Islands	27.2	27.2	-0-	-0-
NASA-Space Communications Co. +	949.4	949.4	-0-	140.8
DON-Ship Lease Financing	1,788.3	1,788.3	-0-	-0-
DON-Defense Production Act	-0-	-0-	-0-	-0-
Rural Electrification Administration	21,214.8	21,226.2	-11.5	17.9
SBA-Small Business Investment Cos.	732.3	736.5	-4.2	-8.3
SBA-State/Local Development Cos.	899.0	898.5	0.5	-0.8
TVA-Seven States Energy Corp.	1,883.9	1,864.5	19.3	60.2
DOT-Section 511	52.8	55.4	-3.0	-3.0
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	53,841.2	54,004.9	-163.7	-638.1
grand total*	$ 156,849.7	$ 156,919.4	$ -69.7	$ -400.5

*figures may not total due to rounding
+does not include capitalized interest

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 16, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,431 **million of 13-week bills and for** $6,408 **million of 26-week bills, both to be issued on** May 19, 1988, **were accepted today.**

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 18, 1988			26-week bills maturing November 17, 1988		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	6.27%	6.46%	98.415	6.46%	6.77%	96.734
High	6.28%	6.47%	98.413	6.50%	6.81%	96.714
Average	6.28%	6.47%	98.413	6.50%	6.81%	96.714

Tenders at the high discount rate for the 13-week bills were allotted 47%.
Tenders at the high discount rate for the 26-week bills were allotted 93%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 36,350	$ 36,350	$ 30,460	$ 30,460
New York	25,426,845	5,692,300	21,110,290	5,690,015
Philadelphia	25,525	25,525	18,810	16,810
Cleveland	56,620	54,925	24,700	24,700
Richmond	66,905	40,505	38,955	38,875
Atlanta	34,275	32,680	35,760	34,635
Chicago	1,630,975	43,975	1,870,250	58,500
St. Louis	27,155	22,625	22,880	18,880
Minneapolis	13,760	8,760	12,180	7,180
Kansas City	34,320	34,320	54,545	54,545
Dallas	37,655	27,655	29,415	24,065
San Francisco	879,115	53,855	1,547,010	46,760
Treasury	358,010	358,010	362,100	362,100
TOTALS	$28,627,510	$6,431,485	$25,157,355	$6,407,525
Type				
Competitive	$25,052,400	$2,856,375	$20,494,430	$1,744,600
Noncompetitive	1,051,925	1,051,925	861,145	861,145
Subtotal, Public	$26,104,325	$3,908,300	$21,355,575	$2,605,745
Federal Reserve	2,448,110	2,448,110	2,000,000	2,000,000
Foreign Official Institutions	75,075	75,075	1,801,780	1,801,780
TOTALS	$28,627,510	$6,431,485	$25,157,355	$6,407,525

An additional $13,125 **thousand of 13-week bills and an additional** $465,920 **thousand of 26-week bills will be issued to foreign official institutions for new cash.**

1/ Equivalent coupon-issue yield.

B-1410

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR IMMEDIATE RELEASE
May 17, 1988

CONTACT: LARRY BATDORF
(202) 566-2041

RECIPROCAL TAX EXEMPTIONS OF SHIPPING AND AIRCRAFT INCOME

The Treasury Department today announced further bilateral agreements with Belgium, Jordan and Singapore for the reciprocal tax exemption of income from international shipping and aviation (aviation only in the case of Singapore). The exchanges of notes are in accordance with sections 872 and 883 of the Internal Revenue Code. In each case the exemption applies for taxable years beginning on or after January 1, 1987. Earlier such agreements with ten countries were announced in Treasury News Release B-1294 of February 24, 1988.

Copies of the notes with Belgium and Singapore and of the notes with Liberia, announced in February, 1988, are available from the Office of Public Affairs, room 2315, Department of the Treasury, Washington, D.C. 20224. The notes with Jordan will be released when they arrive in Washington and have been processed by the Department of State.

o 0 o

B-1411

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

10/87

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
Expected at 10:00 A.M., EDT
May 18, 1988

STATEMENT BY
DAVID MALPASS
DEPUTY ASSISTANT SECRETARY
FOR DEVELOPING NATIONS
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT INSTITUTIONS
AND FINANCE
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
MAY 18, 1988

Mr. Chairman and Members of the Committee:

I welcome this opportunity to appear before you this morning in support of the Administration's request for legislation to authorize U.S. participation in the general capital increase (GCI) for the World Bank and the fifth replenishment of the African Development Fund.

African Development Fund

Because the preponderance of my testimony is devoted to the World Bank GCI, I would like to briefly describe at the start our legislative request for U.S. participation in the fifth replenishment agreement of the African Development Fund (AFDF). The United States would contribute $315 million over three years, or $105 million annually.

The AFDF plays an important role in the economic and social development of Africa. During this replenishment, which was agreed to by Member governments last November, the AFDF will accord particular attention to formulating comprehensive country programs and coordinating its activities with other major donors working in Africa.

I understand that a number of Members and staff are planning to attend the annual meetings of the African Bank and Fund in two weeks. I welcome your close review of the work of these important institutions. The United States joined the AFDF in 1976 and the African Development Bank in 1983. Throughout our membership the United States has supported the progress of these two institutions. The major increase in this replenishment of the AFDF is justified by the key role this organization plays in providing development assistance to the poorest countries in Africa.

General Capital Increase

The Administration has asked that Congress authorize a large general capital increase for the World Bank. As with a stock offering by a commercial bank, this World Bank capital increase comes at a time of strength for the Bank. There are a number of reasons why we should subscribe:

° Increasingly, the Bank promotes economic development in a way which is consistent with U.S. economic ideas. It promotes private sector development, market-based economic systems, and market-based pricing mechanisms even in its project lending.

° The Bank provides progressive leadership by example in other ways as well, by focusing attention on the environment, the role of women in development, and the impact of various development techniques on the poor.

° The Bank leverages the U.S. contribution many fold by adding contributions from other countries and borrowing in world financial markets. In this capital increase, the $70 million annual U.S. contribution will be multiplied 268 times in the anticipated lending program.

° The World Bank's lending profile is extremely consistent with U.S. national interests. In fact, it provides a necessary balance to U.S. bilateral assistance programs which bypass or underfund important areas such as Mexico and Malaysia.

° Due to its multilateral character, the World Bank provides effective economic development assistance to countries which could not work as closely with the United States alone.

° The modest U.S. investment is returned many times over in procurement contracts. As Gene Rotberg pointed out last week, the U.S. cash contribution over the entire life of the Bank amounts to only $1.6 billion, whereas last year alone U.S. suppliers received disbursements from the World Bank of $1.6 billion; since the founding of the Bank U.S. suppliers have received contracts for goods and services amounting to $12.8 billion.

It is my understanding that Secretary Baker may testify before the full Banking Committee next month on our two authorization requests. Therefore, I intend to devote the remainder of my opening statement to policy-based lending -- one of the important techniques the Bank uses to achieve the results I just described. I will: (1) review the history and objectives

of policy-based lending; (2) describe the importance of such lending taking place in the context of a broad policy dialogue; and (3) put such lending into its current context of economic reform.

Policy-Based Lending

To get a better understanding of the benefits policy-based lending provides, it would be useful to look briefly at the historical antecedents of such lending.

Up until 1980 IBRD lending for other than projects was called non-project lending or program lending. Program loans were prepared and negotiated by a country in an acute balance of payments difficulty and were only made in special circumstances. Generally such lending fell into four categories:

-- reconstruction or rehabilitation of the economy after a war or severe natural calamity;

-- a sudden fall in export earnings where the economy was critically dependent on a single export item;

-- a sharp deterioration in the terms of trade resulting from a rapid rise in import prices; and

-- cases involving structural constraints or capacity under utilization.

Program loans were conceived of as one-shot operations with narrow objectives. The crisis atmosphere that prevailed while the loans were prepared often caused a focus on short-term actions to deal with immediate difficulties, leaving too little attention to underlying long-term problems.

During the 1970s the World Bank concluded that these underlying structural problems -- such as distorted prices, administrative controls, and poorly planned and executed public sector programs -- kept the Bank's projects from contributing as fully as they might to the economies they were designed to assist. Senior Bank officials concluded that sounder macroeconomic policies would improve the performance of project lending, and that the Bank could play a role in helping borrowers with these policies.

The 1979 oil price increases exacerbated the situation: it became apparent that commercial lenders -- which generally provide a sizeable portion of many developing countries' capital needs -- were paring back their lending just when oil-importing developing countries had to devote more resources to oil purchases. Hence, it became even more imperative that

countries adopt better economic policies to improve the environment for attracting and making more efficient use of capital.

The World Bank addressed the problem by altering the one-shot, episodic aspect of program loans. In 1980, the IBRD, with board approval, initiated structural adjustment lending (SAL) to provide a multi-year economic reform program supported by a succession of non-project loans. The purpose of SALs was -- and is -- to help a developing country devise and implement market oriented reforms that lead to improvements in economic performance and reduce current account deficits to sustainable levels.

These policy reforms require significant adjustments in borrowing country economies and may produce politically charged dislocations in the labor force and business sectors. Structural adjustment lending is intended to help offset these effects by providing the borrowing country with the resources to shift the focus of its economy.

It is important to be clear about this last point: SAL resource transfers support the country during the adjustment period; they do not simply pay for government compliance. Governments can of course make policy reforms on their own. But important structural changes are more likely to occur when disruptions to already fragile economies are lessened as a result of outside support.

It is in the Bank's interest, our own interest and most importantly the borrowing country's interest that these policy reforms be undertaken. The benefits that can ensue from policy reform may be just as essential to a country's productive capacity as those stemming from power generation, roads, and communications projects. Indeed, in certain circumstances, implementing structural reform may be a *sine qua non* for good project development and implementation, to which 75 percent of Bank resources are devoted.

2. Incorporating Pertinent Views when Designing Policy-based Loans

An important aspect of the SAL program at its inception was that no country would be required to use such lending. It was broadly understood that this type of lending would only be possible where a government accepted the need for such adjustments and was prepared to collaborate with the Bank in a review of its policies and the formulation of a program. Indeed, a government that does not genuinely endorse "agreed" reforms can easily thwart them. Therefore such loans are normally disbursed in tranches that are tied to meeting certain conditions. Successive loans in these multi-year programs are only arranged and disbursed pending successful completion of prior loans.

While it is essential that the Bank be able to suspend loan disbursements when loan conditions are not being honored, it is certainly not a profitable situation for the Bank or the country to have the loan fall out of compliance. Hence, it is incumbent on the Bank to make every effort to assure that government officials are "on board" before going ahead with a loan.

Designing good adjustment programs requires the contracting parties to be mindful of the views of other interested parties, including NGOs. The discussions leading to the signed contractual agreement must be limited to the Bank and the borrowing government. But it is not possible to develop a fully effective program without the Bank, and more importantly, the borrower taking considerable account of the views and priorities of affected groups.

I believe that the World Bank has internalized this view and is implementing it. Senior Bank staff have indicated both publicly and privately that more involvement by NGOs in the Bank's loan development process will improve the Bank's understanding of the loan's effect on the poor and its environmental aspects. According to Bank staff, such economic policy discussions become especially important when a government wants NGOs to help implement social components of an adjustment program.

It will take time to evaluate the results of this effort. I would like to say, Mr. Chairman, that we have welcomed your work and that of your Committee in this regard. I believe that we have a clear policy direction in this area, one which is consistent between the Congress, the Administration and the Bank. I look forward to monitoring its implementation, keeping this Committee informed, and initiating modifications when they are necessary.

3. Current Status of Policy-based Lending

Roughly eight years has elapsed since the inception of policy-based lending. In the earlier part of the period, broad structural adjustment loans dominated adjustment operations. With time, specific sector adjustment loans grew in number and total value so that in recent years they have accounted for roughly 85 percent of total policy-based lending. Last year, the Bank's lending of this type reached $3.5 billion, 24 percent of its total program.

The Bank has attempted to improve the design, conditionality, and monitorability of adjustment lending. Yet, measuring the impact of such lending is complicated by several factors: (1) the benefits take several years to be felt because of their medium to long-term character; (2) exogenous shocks make it difficult to isolate the effect of the adjustment

program; (3) in many countries, the process of adjustment is not continuous; and (4) adjustment programs contain many different policy initiatives, making it difficult to evaluate the affect of specific policy changes.

Substantial progress has been made in a few countries, while others have shown sporadic progress. The process is certainly not perfect. The Bank is learning every day and can improve its expertise in this area. The key to success, however, is the borrowing country itself.

While much progress has been made by the developed countries to make financial resources available, borrowing countries have had a difficult time actually implementing reforms. As we know from the experience in our own government, reforms in governmental systems take Herculean efforts. Such is the task at hand for many of those governments -- reforming the trade system, selling off or closing parastatals, deregulating interest rates, and reforming agriculture to rely less on subsidies and more on profit and fair markets. We are prepared to strongly support such efforts in both our bilateral and multilateral programs. The World Bank has been at the forefront of these efforts and is rapidly increasing its expertise.

We and other members requested, in the context of GCI negotiations, a thorough review of policy-based lending. We expressed a firm view to the Bank in this regard:

-- the need for more tranches;

-- more flexibility to adjust conditionality in subsequent tranches due to changing economic conditions; and

-- the need to more effectively integrate the Bank's conditionalty with that of the IMF.

The Bank is now engaged in a very comprehensive review of adjustment lending. It will gain new insights in the course of preparing this report -- insights that will materially enhance the effectiveness of adjustment lending and bolster the ability of the Bank's borrowers to achieve sustainable growth. In particular, and in accordance with last year's MDB authorization legislation, we have instructed the Bank to assess the impact on the poor of structural adjustment lending and to specify what steps will be taken to mitigate adverse effects.

Conclusion

A prime objective of the World Bank is to foster sustainable growth and development in the third world. Policy-based lending is a growing area of the Bank's operations to help

achieve this objective. In my view major structural reform is the only viable approach for the developing countries to break out of the circle of poverty that results in continued stagnation. In this regard, I am happy to say, sound economic attitudes and efforts are spreading across the developing world as countries more and more recognize the importance of market-led growth. It is all the more incumbent on us in the industrialized countries, therefore, to ensure that the World Bank has sufficient resources to support the meaningful structural reform being undertaken by developing countries.

I understand that some members may suggest changes to the current debt strategy in the course of this Committee's deliberations. One of the reasons that we have not supported these efforts is that we remain unconvinced that the proposals made to date will encourage economic reforms. This Committee has an opportunity to endorse the work of the World Bank and AFDF, including the promotion of economic reforms through policy-based lending programs. I hope that it will do so.

I look forward to discussing it with you today and working with you in the coming months on these issues.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 18, 1988

CONTACT: Larry Batdorf
(202) 566-2041

UNITED STATES AND THE COMMONWEALTH OF DOMINICA
SIGN AGREEMENT TO EXCHANGE TAX INFORMATION

The Treasury Department announced today that the United States and the Commonwealth of Dominica have signed an agreement to exchange tax information that satisfies the criteria set forth in the Caribbean Basin Economic Recovery Act of 1983. The Agreement was signed in Washington, D.C., on October 1, 1987, and it entered into force on May 9, 1988 by virtue of an exchange of notes between the two governments.

As a result of signing the Agreement, the Commonwealth of Dominica will be considered part of the "North American Area" for purposes of determining the deductibility by U.S. taxpayers of expenses incurred in attending conventions, business meetings, and seminars. Therefore, convention expenses incurred by U.S. taxpayers for meetings in the Commonwealth of Dominica beginning on or after May 9, 1988 that are otherwise deductible as ordinary and necessary business expenses will be allowed without regard to the additional limitations otherwise applicable to foreign convention deductions.

In addition, because of the signing of the Agreement, the Commonwealth of Dominica qualifies as a foreign country in which a foreign sales corporation may incorporate and maintain an office as provided in the foreign sales corporation provisions of the Tax Reform Act of 1984.

Finally, because of the Agreement, the Commonwealth of Dominica qualifies as a jurisdiction in which Puerto Rican financial institutions may make eligible investments of funds derived from U.S. section 936 companies. Such funds may be used to finance investments in active business assets and development projects in the Commonwealth of Dominica.

A limited number of copies of the Agreement are available from the Treasury Public Affairs Office, Treasury Department, Room 2315, Washington, D.C. 20220.

oOo

B-1414

Interim Report of The Working Group on Financial Markets

Submitted to
The President of the United States

May 1988

Interim Report of
The Working Group
on
Financial Markets

Submitted to
The President of the United States

May 1988

For sale by the Superintendent of Documents, U. S. Government Printing Office
Washington, D. C. 20402

213-632 0 - 88 - 1

The Working Group on Financial Markets

George D. Gould, Chairman
Under Secretary for Finance
Department of the Treasury

Wendy Gramm, Chairman
Commodity Futures Trading Commission

Alan Greenspan, Chairman
Board of Governors of the Federal
Reserve System

David S. Ruder, Chairman
Securities and Exchange Commission

May 16, 1988

The Honorable Ronald W. Reagan
The President of the United States
Washington, D.C.

Dear Mr. President:

We respectfully submit to you an Interim Report of the Presidential Working Group on Financial Markets, created pursuant to your Executive Order dated March 18, 1988.

For the past sixty days, we have reviewed and consulted together on the numerous recommendations made in the wake of last October's market decline. The Working Group has viewed its primary mission as focusing on specific actions that would substantially lessen systemic dangers to the U.S. financial system.

We are pleased to report that the Working Group has reached agreement and is making recommendations on a number of critical issues, including:

- agreement on coordinated circuit breakers to allow for a cooling-off period during times of high market volatility;

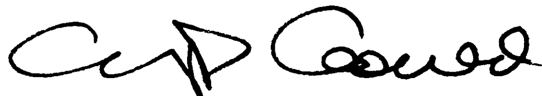
- conclusions and recommendations on the credit, clearing, and payments systems to ensure the necessary coordination within and between markets and to avoid systems gridlock;

- agreement that current minimum margin requirements provide an adequate level of protection to the financial system, although they do not cover all possible price movements, and that prudential margins appropriate for carrying an individual stock should be significantly higher than those for a stock index futures contract; and

- agreement on contingency planning, including the continuation of the Working Group, to facilitate coordination and consultation in the event of future market disturbances.

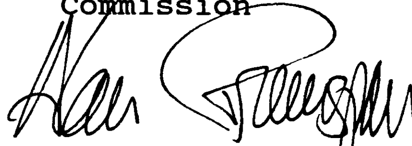
The collective actions recommended to you in our interim report are consistent with your mandate to us to enhance the integrity, efficiency, orderliness, and competitiveness of our Nation's financial markets and to maintain the confidence of investors, both large and small. In addition, our report recognizes and commends a number of significant actions taken by private market participants, self-regulatory organizations, and the regulatory agencies.

Sincerely,



George D. Gould, Chairman
Under Secretary for Finance
Department of the Treasury

Wendy Gramm, Chairman
Commodity Futures Trading
Commission



Alan Greenspan, Chairman
Board of Governors of the Federal
Reserve System

David S. Ruder, Chairman
Securities and Exchange
Commission

Interim Report
Of the
Working Group on Financial Markets

Table of Contents

		Page
I.	Introduction and Summary	1
II.	Continuing Coordination	3
III.	Coordinated Trading Halts and Reopenings	4
IV.	Margin Requirements	5
V.	Clearing and Settlement Recommendations	7
VI.	Contingency Planning	11
VII.	Summary of Actions Taken on Capital Adequacy and Systems Capacity Enhancement	12

Appendices

A. Coordinated Trading Halts and Reopenings

B. Adequacy of Prudential Margin Requirements

C. Report of Staff Subgroup on Credit, Payment and Settlement System Issues

D. Clearing and Settlement Recommendations

- I. Clarify Clearing and Settlement Obligations
- II. Facilitate Timely Payments
- III. Explore Methods to Reduce Cash Flows and Simplify Settlement Systems
- IV. Refine Relevant Legal Frameworks

E. Market Report Actions Taken (or Planned) by Federal Agencies, Self-Regulatory Organizations, Clearing Agencies, and Market Participants as of May 16, 1988

F. Working Group Participants

INTERIM REPORT OF THE WORKING GROUP ON FINANCIAL MARKETS

I. INTRODUCTION AND SUMMARY

On March 18, 1988, the Working Group on Financial Markets was established by Executive Order to provide a coordinating framework for consideration, resolution, recommendation, and action on the complex issues raised by the market break in October of 1987. The Working Group was charged with developing effective mechanisms to enhance investor confidence, to protect the quality and fairness of markets for all participants, and to preserve the continued orderliness, integrity, competitiveness, and efficiency of our nation's financial markets. This is an interim report on our progress, actions, and recommendations.

From the beginning, the Working Group has had the benefit of a number of useful studies, notably the Report of the Presidential Task Force on Market Mechanisms (Brady Report) and separate studies by the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), General Accounting Office (GAO), and others.

The Working Group reached early agreement on a number of important premises for our deliberations:

- The existence of large debt and equity portfolios held by institutions and the increased level of principal activities by investment firms have led to increased demand for portfolio hedging strategies and market liquidity.

- It is unrealistic (and perhaps counterproductive) to try to undo the changes in financial markets or market strategies brought about by improvements in telecommunications and computer technology.

- The role of fundamental economic forces should be emphasized when evaluating the October decline. Stock prices prior to the collapse had reached levels that seemed to be in excess of those justified by real earnings potential and reasonable discount factors. The inevitable reassessment of economic fundamentals by market investors was an important part of the selling pressure and price decline in October.

- The size and speed of the decline initiated by fundamental reevaluation of equity values was exacerbated on October 19 by a number of factors:

  - volume overwhelmed trade processing capacity;

- -- many participants pulled back from the markets because of fear and shock -- and because of uncertainties and concerns over (i) the accuracy and timeliness of information, (ii) counter-party solvency, (iii) credit availability, and (iv) *de facto*, *ad hoc* market closures or other market disruptions.

- -- the financial system came under great stress in the credit, clearing, and settlement area.

- o The Working Group agrees with the Brady Report conclusion that the stock, options, and futures markets are closely linked.

- o The priority goals of the Working Group, therefore, have been to address the major uncertainties and to focus on reductions in possible systemic risk. In this respect, the Working Group followed the agenda established by the Brady Report, which also assigned first priority to the systemic risks identified during the market break.

As a result, the Working Group was able to concentrate its initial efforts on developing the most important system protections, in close consultation with self-regulatory organizations and market participants. The Working Group's conclusions and recommendations, more fully described in the body of the Report and its appendices, are as follows:

1. A "circuit-breaker" mechanism should be put in place that operates in a coordinated fashion across all markets, using pre-established limits broad enough to be tripped only on rare occasions, but which are sufficient to support the ability of payment and credit systems to keep pace with extraordinarily large market declines.

2. A significant number of important initiatives should be implemented in a timely fashion to improve further the operation of the credit, clearing, and settlement system -- beyond the notable and valuable changes the markets have made already. Although these initiatives are complex and technical, they would result in highly significant improvements in the vital linkages within the credit markets.

3. Current minimum margins for stocks, stock index futures, and options provide an adequate level of protection to the financial system. Prudential

maintenance margin percentages required for carrying an individual stock should be significantly higher than the percentage margin required for a futures contract on a stock index.

4. Contingency planning, including the continuation of the Working Group, is an important, ongoing responsibility that the Working Group members are implementing.

5. Capital adequacy is being addressed in material ways by the markets and should continue to be reviewed and improved whenever necessary.

6. Markets already are making -- and should continue to make -- significant efforts to enhance the operational capacity of trade-processing systems and to improve the fairness and quality of order executions for all investors, large or small.

7. The Working Group should continue to function as a coordinating and consulting mechanism for intermarket issues.

The Working Group can continue to be effective by monitoring the progress of its recommendations, by serving as a consultative and coordinating forum, and by expediting resolution of the remaining issues. The Working Group also believes that the structural weaknesses exposed by the October break can be overcome through cooperative efforts of the relevant government agencies, self-regulatory bodies, market participants, and the Congress.

II. <u>CONTINUING COORDINATION</u>

The Working Group believes that its continuation, in its existing configuration, is an excellent way to continue the process of addressing intermarket issues. Much has been accomplished in a short time frame, but work on a number of issues has not been completed. The Brady Task Force and others have recommended that some additional regulatory mechanism be established to resolve these continuing issues. Recognizing this concern for coordination, the Working Group believes that cooperative efforts under the existing regulatory structure will be more effective and less disruptive than more formal, additional legislated structure.

The Working Group believes that private market solutions, where feasible, are preferable to legislation because the private sector is closer to the problems and can address them in a more flexible manner. The Working Group has established a cooperative framework in which regulators, self-regulatory organizations (SROs), and market participants can work together to resolve intermarket issues.

The Working Group already has made progress on the issues deemed most critical to the market's smooth functioning and investor confidence. Equally important, it has created a process for (i) further interagency cooperation on intermarket issues such as clearing and settlement and contingency planning, (ii) monitoring implementation of its recommendations, and (iii) resolving the remaining issues -- and that process is working.

Continuation of the Working Group would be consistent with the spirit and intent of the intermarket coordination bills introduced by Senators Proxmire and Leahy. Both bills are designed to achieve coordinated resolution of intermarket issues by the appropriate agencies. That is precisely what the Working Group is doing, while avoiding the divisive and difficult questions of legal authority, structure, and independence presented by the current bills. The Working Group believes its efforts are succeeding and should be allowed to continue.

There are a number of additional intermarket issues that have been identified that the Working Group believes deserve attention. These issues, as well as continued work on the conclusions and recommendations already reached, will be addressed and progress on them reported in the months ahead.

III. COORDINATED TRADING HALTS AND REOPENINGS

The Working Group recommends coordinated trading halts and reopenings for large, rapid market declines that threaten to create panic conditions. In broad outline the Working Group recommends that all U.S. markets for equity and equity-related products -- stocks, individual stock options, and stock index options and futures -- halt trading for one hour if the Dow Jones Industrial Average (DJIA) declines 250 points from its previous day's closing level. The Working Group also recommends that the New York Stock Exchange (NYSE) use reopening procedures, similar to those used on so-called Expiration Fridays, designed to enhance the information made public about market conditions. Under the Working Group's recommendations, a second closing, this time for two hours, and reopening would occur if the DJIA declines 400 points below its previous day's closing level. The recommendations are detailed in Appendix A.

In designing these procedures, the Working Group has focused on market events that are so dramatic as to trigger _ad hoc_ and destabilizing market closings. This was manifest during the market break through systems breakdowns, reduced liquidity, and concerns over trading because of fears of counter-party and even clearing corporation failure. The Working Group recognizes that trading disruptions are undesirable. Thus, its proposal is designed to substitute planned for unplanned, _ad hoc_ trading halts without increasing the overall frequency of such disruptions. The Working Group's recommendation also recognizes the need for reopening procedures designed to limit the duration of the halt while providing for information dissemination to permit consideration of buy or sell decisions during periods of stress.

Members of the Working Group have consulted with the SROs, as well as with knowledgeable industry participants, about the design of these procedures. The Working Group believes that its recommendations can be implemented most effectively and expeditiously by SRO-initiated rule changes, with appropriate notice, comment, and agency review.

IV. MARGIN REQUIREMENTS

The Working Group considered the appropriate levels of "prudential" margins for stocks, stock index futures and options, defined as the maintenance margin levels needed to protect broker-dealers, futures commission merchants, and clearing corporations from investor and trader defaults on their margin obligations. Based upon the past price movements of stocks and stock indexes, the Working Group calculated the likelihood that prices would move to a point where various margin levels would not satisfy prudential concerns. _See_ Appendix B.

On the basis of these statistical measures, the Working Group concludes as follows. First, current minimum margin requirements provide an adequate level of protection to the financial system, although they do not cover all possible price movements. Because margin levels sufficient to provide protection against all possible price movements would impose unacceptable costs to market participants and the liquidity and efficiency of markets, the Working Group agreed that means other than margins to protect against extreme price movements should be considered. In this connection, the Working Group recognized that other mechanisms are in place that address the risk of large price movements relative to margins, such as capital requirements, clearing-fund guarantee deposits, and intra-day variation margin payments. Moreover, the Working Group's

recommendations on a circuit-breaker mechanism and credit, clearing, and settlement improvements should add significant protections against financial system risks from extreme price movements.

Second, the prudential maintenance margin percentages required for carrying an individual stock should be significantly higher than the percentage margin required for a futures contract on a stock index. This conclusion follows from the facts that stock indexes have a smaller percentage price variability than do individual stocks and the payment period for margins in the futures market is shorter than the period for stocks. The extent to which stock margins should exceed those for futures depends not only on measured volatilities and stated grace periods, but also on (i) actual margin settlement and position sell-out practices, (ii) portfolio strategies, such as the diversification of stock portfolios and the combination of stock, futures, and options positions, and (iii) the application of margin exemptions.

These conclusions concerning minimum margins relate only to minimum levels of margin set by regulatory or self-regulatory organizations. The Working Group notes that financial intermediaries typically require an amount in excess of these minimums for less credit-worthy customers and those with concentrated positions. Furthermore, capital requirements of firms and clearinghouse guarantee funds further enhance the stability of the securities and futures clearance and settlement systems.

The Working Group was not able to agree on whether or not it is appropriate or effective to raise margins above prudential levels in an attempt to reduce leverage or dampen volatility. Chairman Ruder believes that certain futures-related trading strategies have resulted in a dramatic increase in the size and velocity of institutional trading which, in turn, has resulted in substantially increased price volatility. For this reason, Chairman Ruder believes that, at least as an interim measure, margins on futures and options should be increased, in order to increase investor confidence, decrease derivative market speculative activity, and reduce the illusion that the derivative markets provide sufficient liquidity to allow investors and traders to liquidate quickly large portions of their entire portfolios. Chairman Gramm, the Treasury, and Chairman Greenspan, on the other hand, do not believe that the evidence supports the conclusion that higher margins will reduce volatility. Moreover, higher margins raise transaction costs and could have a negative effect on market liquidity and efficiency, possibly increasing volatility, and risking the movement of futures trading into off-shore markets.

The members of the Working Group disagreed about the appropriate scope and form of federal oversight of margins.

Chairman Gramm believes, based on the historical record, the different function and practices of futures margins, and the interest of individual firms and clearinghouses in protecting their capital, that the current approach to futures margins -- set by SROs, with emergency authority at the CFTC -- is entirely appropriate. Chairman Gramm also believes that it may be reasonable to have different regimes for equities since such cash market investments can involve purchases on credit and, in many cases, have lengthy settlement periods.

Chairman Greenspan and the Treasury believe that, while the primary responsibility for setting margins in all markets should be with the SROs, which have the superior expertise and economic stake to perform this role most effectively, there should be authority for each SRO's regulator to disapprove margin rule changes. There is sufficient possibility that at some point SROs might establish margins that were inconsistent enough to present market problems or set them at levels that might present potential costs to other parties that regulatory approval should be established in all markets. Chairman Greenspan and the Treasury do not feel that there is sufficient justification for adding any further levels or mechanisms for federal oversight beyond the primary regulator.

Chairman Ruder agrees with Chairman Greenspan and the Treasury on the need for regulatory rule disapproval authority, but feels that it is important to add a mechanism (i) by which any unresolved disputes that might arise between the SEC and the CFTC over margin levels established by their respective SROs and not disapproved by the relevant regulator would be settled by decision of the Federal Reserve, and (ii) by which the Federal Reserve would have residual authority to adjust margins taking into account leverage and investor protection concerns.

V. CLEARING AND SETTLEMENT RECOMMENDATIONS

The Working Group reviewed existing audit, clearing, and payments systems to identify and set priorities for actions that could be taken to reduce uncertainty, increase coordination, assure confidence in the integrity of such systems, and facilitate their smooth operation in volatile markets. In undertaking its review, the Working Group also interviewed major market participants, including large commercial and investment banks, exchanges, and clearing organizations. (The views of these market participants are summarized in Appendix C.)

Based on these interviews and on its own analysis, the Working Group endorses the view that the coordinated functioning of these systems is integral to the proper functioning of the financial markets as a whole and is pleased to report that significant progress has been made. In this connection, and as more fully set forth in Appendix D, the Working Group recommends the following agenda of additional measures to achieve the goal of more perfectly coordinated systems.

First, it is necessary that parties to the clearing and settlement process have a clear, consistent understanding of their obligations and those of other parties and that all parties make arrangements to have the financial capacity and the information necessary to assure timely compliance with those obligations. To this end, the Working Group recommends a number of incremental actions, which generally can be undertaken by federal regulators within the scope of their existing authority. (See Appendix D, Parts I and II.)

The Working Group believes that the system refinements based on these actions, a number of which are already underway, will go a long way toward coordinating the clearing and settlement process, can be undertaken in the short term without legislation, and should be undertaken without delay.

Second, the Working Group believes that the securities, futures, and banking industries should explore and pursue initiatives to ease potential cash flow stress by reducing the size of payment obligations. Experience during October 1987 indicates that large intra- and intermarket payments could add strain to the financial system during periods of volatility. As a result, the Working Group believes that ways to reduce such cash flows must be explored. The Working Group believes that this effort can be accomplished by immediate incremental actions that would facilitate evaluation of the necessity for, and the relative costs and benefits of, more profound structural changes to securities and derivative markets clearing and settlement systems. One potential method for reducing cash flows is cross-margining. Coupled with futures-style margining for options, this method may have particular promise and should be tested. Other approaches to netting obligations also should be pursued, including netting member settlements at clearing banks. In the near term, the Working Group recommends efforts to set up pilot programs. In the longer term, the Working Group believes that the securities and futures markets should explore the costs and benefits of a wider range of initiatives, including shortened settlements in the cash market that, if implemented on a coordinated basis with expanded linkages with the derivative markets, could reduce system risks and payments.

In summary, the Working Group recommends specific actions in the following areas:

(1) clarification of the obligations of participants in the clearing and settlement process;

(2) facilitation of timely payments;

(3) exploration of methods to reduce cash flows and simplify settlement systems; and

(4) refinement of relevant legal frameworks.

1. <u>Clarification of the obligations of participants in the clearing and settlement process</u>. The Presidential Task Force on Market Mechanisms identified events in October 1987 that apparently caused some market participants to question previous assumptions concerning the set of obligations of the various parties to the clearing and settlement process. The Working Group believes that uncertainty concerning these rights and obligations may not only diminish overall confidence in such processes, but also could lead to unilateral actions that are inconsistent with such obligations and that could adversely impact the willingness or ability of other market participants to satisfy their own obligations.

CONSEQUENTLY, THE WORKING GROUP RECOMMENDS THAT EFFORTS BE MADE TO CLARIFY AND CONFIRM THE RIGHTS AND DUTIES OF PARTIES TO THE CLEARING AND SETTLEMENT PROCESS. (See Appendix D, Part I.)

2. <u>Facilitation of timely payments</u>. Increased clarity of clearing and settlement obligations should be accompanied by efforts to ensure the capacity of those who are obligated to make or finance such payments to do so on a timely basis. The Working Group has identified several features of existing clearing and settlement systems relevant to payment capacity that can be enhanced to facilitate the timely satisfaction of payment obligations.

CONSEQUENTLY, THE WORKING GROUP ADVOCATES MEASURES TO ENHANCE THE CAPACITY OF EXISTING SYSTEMS TO ASSURE TIMELY FLOWS OF FUNDS INCLUDING:

-- Reviewing facilities to support payments;

- -- Augmenting the ability of clearing organizations to satisfy the obligations of defaulting market participants;
- -- Consider increasing Fedwire availability in highly volatile markets;
- -- Coordinating settlement processes across markets; and
- -- Increasing the availability of timely information to participants in the settlement process concerning payment obligations and cash flows. (See Appendix D, Part II.)

3. Exploration of methods to reduce cash flows and simplify settlement systems. The Working Group reviewed a number of potential means of modifying existing clearing and settlement systems to reduce the necessity for cash payments on an intra-market and intermarket basis. Such measures may require material structural changes and may affect legal relationships that reflect the distinctive functions of and regulatory protections applicable to the affected financial markets and thus raise substantial legal, policy, and administrative issues. The Working Group believes that these issues have not been explored sufficiently to warrant a determination as to whether to recommend full-scale implementation of these measures at this time. Nonetheless, the Working Group does recommend a cross-margining pilot program for non-customer accounts.

THE WORKING GROUP ALSO RECOMMENDS THAT SEVERAL SPECIFIC INITIATIVES BE EXPLORED TO DETERMINE THE DESIRABILITY AND FEASIBILITY OF VARIOUS APPROACHES TOWARD MORE EXTENSIVE MODIFICATIONS OF EXISTING CLEARING AND SETTLEMENT ARRANGEMENTS TO REDUCE CASH TRANSFERS, SIMPLIFY SETTLEMENT SYSTEMS, AND UNIFY CLEARING, INCLUDING:

- -- Futures style margining for options;
- -- Netting of cash flows on a contractual basis;
- -- Shortening the five-day settlement process for securities transactions; and
- -- Integrated clearing. (See Appendix D, Part III.)

4. **Refinement of relevant legal frameworks**. The Working Group, recognizing the very complex legal and federal issues involved, is also proposing that consideration be given to harmonization of transfer, delivery, and pledge requirements for options and uncertificated securities at the federal level. Further, the Working Group recommends that bankruptcy provisions relevant to securities and commodity brokers be reviewed to assure appropriate coordinated bankruptcy protection of such market participants. (See Appendix D, Part IV.)

VI. CONTINGENCY PLANNING

The Working Group believes that the purpose of contingency planning is to ensure that regulatory agencies and the self-regulatory organizations have in place systems that will allow them to identify emerging problems quickly and to react appropriately in the event of a market crisis. In an important sense, the Working Group recommendations for implementing circuit breakers, improving information flows, clarifying credit arrangements, and strengthening the clearing and settlement process can be viewed as a key part of contingency planning; by improving the market system's ability to withstand and react to shocks, these measures will enhance the system's first line of defense.

Going beyond this, the Working Group has given high priority to enhancing channels of communication among staffs of the respective regulatory agencies. The first step in this process has been to improve each agency's awareness of the existing information flows available from routine surveillance systems and to identity more clearly the existing regulatory mechanisms available to each agency to act in crisis situations. Further steps include the distribution of a contact list of names and telephone numbers of key officials at the regulatory agencies and the securities and futures exchanges. Similar efforts to improve communications and share information among the exchanges and their respective clearing organizations are being implemented by the SRO's. In particular, the securities and futures exchanges have developed a hot-line capability that allows simultaneous communication between all relevant markets. Moreover, the clearing organizations are working on procedures for sharing information both on a routine basis and during periods of market stress.

In addition, staffs of the four agencies are working jointly to improve information sharing across the agencies, with particular emphasis on a framework for coordinated monitoring of exposures and developments at major market participants. This is expected to incorporate a framework for identifying their

activities in each of the various markets, for monitoring intra-company financial interrelationships, and for assessing the extent of credit and funding interrelationships among such participants. It also will include coordinated efforts to encourage further improvements in the scope and quality of information available to such market participants, and hence to the regulators, from their internal exposure control systems. It is expected that this will enhance prospects for coordinated actions by the authorities and SRO's to protect the integrity of markets and clearing systems in extreme situations.

As with all of these issues, the Working Group recognizes that there are international dimensions to policy coordination. In this regard, steps are being taken by the various agencies to strengthen existing contacts with their counterpart authorities in other major market centers to improve further this aspect of market surveillance.

Beyond such efforts, contingency planning does not lend itself to pre-determined responses. Our financial markets have experienced various difficulties in the past, and each has raised different concerns and required a different response by regulators and market participants. Recognizing this, the Working Group believes that contingency planning must provide a flexible framework for addressing problems in a way which does not create unreasonable expectations of government intervention in a crisis. Continuation of the Working Group could enhance this flexibility by providing a forum for informed discussion and resolution of problems as they are identified.

VII. SUMMARY OF ACTIONS TAKEN ON CAPITAL ADEQUACY AND SYSTEMS CAPACITY ENHANCEMENT

Market participants, SROs, and regulatory agencies have taken or are planning a number of significant actions to enhance capital and improve automated systems -- two of the issues the Working Group and others have identified as critical to the financial integrity and smooth functioning of the markets. This section summarizes developments regarding: (A) specialist capital; (B) broker-dealer capital; (C) financial integrity in the futures markets; and (D) systems capacity. A more complete listing of actions taken is found in Appendix E. The Working Group will continue to monitor developments in these areas to ensure that needed improvements are made.

A. Specialist Capital

Because of the unique responsibility of specialists to maintain fair and orderly markets, it is important that specialists have sufficient capital during periods of high volume

and market turmoil. A specialist's ability to take the other side of a transaction when no one else is willing to do so depends on liquidity. During the October break some specialists on the NYSE and the American Stock Exchange (Amex) reached the limits of their buying power or encountered serious solvency concerns. This contributed to the market's difficulties and to problems faced by investors seeking to execute orders.

During the October break the NYSE required specialists to have minimum capital of the greater of $100,000 or a percentage of the value of shares of the stock assigned to them. The last time the NYSE changed its specialists' capital requirements was in 1977. Since then, of course, specialists' exposure has risen with the bull market and increased volume and volatility.

The President of the NYSE and the Brady Task Force have suggested that no amount of capital could enable a specialist in effect to stand in front of a stampeding market. The SEC's Staff Report, The October 1987 Market Break (February 1988), concurs, pointing out that it is unlikely that increased levels of specialist capital could have retarded to any degree the market decline of October 19 and 20. The SEC also stated that it is unrealistic to expect any one group of market participants to have or commit sufficient capital to retard extraordinary selling pressures. Nevertheless, the SEC Staff Report concluded that minimum specialist capital requirements imposed by the exchanges do not reflect the actual capital needed to maintain fair and orderly markets in securities with different trading characteristics. Accordingly, the SEC has urged the exchanges to consider revising the minimum financial requirements imposed on specialists to reflect more closely the requirements of today's markets.

The Working Group is concerned that past requirements for specialist capital may not be sufficient. The SEC and securities SROs are best suited to resolve these issues because they are closest to the problem. Indeed, they already have made substantial progress to bolster the capital of specialists:

- The SEC has recently approved a proposed rule change by the NYSE to raise the minimum dollar amount for specialists' capital to $1 million from $100,000 and to increase the measure based upon the trading unit position to three times its current level. (For example, the current 5,000 share position requirement for common stock has been increased to 15,000 shares.)

- The NYSE has increased its monitoring of both specialists' capital and positions by requiring that such information be filed with the NYSE by 9:00 a.m. daily.

- In an effort to attract more capital, the NYSE has revised its Rule 98 to suspend a prohibition on securities underwriting firms acquiring specialists. The proposed rule change was approved by the SEC on a temporary, emergency basis. A proposed rule change to make this modification permanent has been filed with the SEC.

The Amex and regional exchanges also have taken or are considering actions to enhance specialists' capital and the exchanges' surveillance of specialists' financial condition (as described more fully in the appendix).

The Working Group encourages the SEC and its constituent self-regulatory bodies to continue to review these efforts and to enhance specialists' ability to continue their function during volatile market conditions whenever necessary.

B. Broker-Dealer Capital

In addition to specialists' capital, the Working Group considered the capital adequacy of options firms and firms conducting a public business and/or trading for their own accounts.

The SEC's report found that, although the largest upstairs firms suffered substantial losses as a result of the October break, none fell below the Commission's net capital early warning levels. Of the approximately 6700 upstairs firms, about 60 were at some time in violation of the net capital rule. Of that number, only three carried customer accounts and only one of those had to be liquidated under the Securities Investor Protection Act.

The SEC's report also found that some options market makers experienced substantial losses, which created severe liquidity problems at some of their clearing firms.

The SEC concluded that, in light of the increased volatility in the market, it would reexamine the minimum net capital required of certain types of broker-dealers as well as the level and structure of haircuts for equity securities and futures. In addition, the Commission plans to review financial activities conducted in affiliates of broker-dealers to determine whether these financial activities create undue risk exposure for the

broker-dealers and the financial markets generally. The Commission also will examine regulatory requirements regarding the amount of equity an options market maker should have in its account and the amount of market maker business a clearing firm should carry without additional resources.

The securities clearing houses also are making significant progress in this area:

- The Options Clearing Corporation (OCC) has undertaken a special study of its systems that will include eight broad areas for review, including those identified in the SEC Staff Report. The objective of the OCC study is to identify any structural weaknesses or areas that can be improved.

- OCC has been considering increasing its net capital requirements and will analyze the costs and benefits of such increases as part of its study.

The Working Group encourages the SEC, SROs, and clearing houses to continue this process of evaluating the sufficiency of broker-dealer capital and finding ways to improve existing practices and requirements.

C. Capital Adequacy in the Futures Markets

The CFTC has taken a number of actions to assess the operation of CFTC and futures SRO financial regulatory systems during the market break, to identify measures that could be taken to reinforce the capacity of existing financial systems, to respond to extreme market volatility, and to stimulate SROs to review and enhance their own programs to augment available financial protection. These recommendations were made, notwithstanding the fact that there were no defaults of futures commissions merchants (FCMs) nor significant problems at such firms. These actions include:

- Establishment of a centralized computer base for futures commission merchant financial data; and

- Enhancement of market financial surveillance programs.

In response to the CFTC's recommendations, the futures exchanges have taken a number of actions to enhance the financial security of the futures markets. These actions include the following:

- The Chicago Mercantile Exchange's (CME) pool of security deposits, which are liquid funds to be used in the case of a default, was increased from $4.5 million to $42 million. This fund is but one source to which the Exchange would look in the event of a default. The Exchange also has a common-bond system that provides for the allocation among its clearing members of any loss to the Clearing House caused by a default. The aggregate capital of all Exchange firms is approximately $17 billion.

- The CME has passed a rule requiring guarantees from the owners of clearing members. The rule essentially requires each owner of 5 percent or more of the equity securities of the clearing member to guarantee all obligations arising out of the non-customer accounts (house and proprietary) of the clearing member.

- The CME's Clearing House is in the process of negotiating a substantial committed line of credit with major banks. This will provide added liquidity to the Clearing House to allow it to meet its obligations in the event of unusual conditions in the financial markets.

- Over the past year, the CME significantly increased the number of memberships that each clearing member must have in order to maintain clearing privileges. (These memberships may be sold by the Exchange in the event of a default by the firm.) As of May 6, 1988, all clearing members must have at least six memberships, two in each of the three divisions of the Exchange. Clearing members with a large number of branch offices or guaranteed introducing brokers have an additional membership requirement. Based on membership prices at the end of March 1988, the value of these memberships is $1.6 million per clearing member.

The foregoing actions are highlighted from a more extensive list contained in Appendix E. The Working Group encourages the CFTC and its SROs to continue to evaluate and improve further their programs.

D. Systems Capacity Enhancements

The GAO, in its "Preliminary Observations on the 1987 Crash," concluded that enhancement of the SROs' automated operational systems is a critical action that needed to be taken immediately. The SEC's Report also concluded that the October break demonstrated a need to expand the capacity of the NYSE to

meet the increased liquidity demands created by today's trading strategies and market structures. The Brady Report also cited the need to improve overall computer and communications performance.

The Working Group notes that substantial progress has been and is being made, but agrees that further improvements are needed in this area. Among the enhancements already in process are the following:

The New York Stock Exchange (NYSE)

- The NYSE is planning to have the capacity to handle a peak of 600 million shares by June of this year, and it believes that if it were to experience a 600-million-share day now, it would be able to process it with significantly fewer delays than the Exchange experienced last October.

- On April 30, the NYSE conducted a test of its 11 computer systems to determine whether it already could handle a 600 million share day. The preliminary results of the test indicated that core portions of the NYSE's order handling systems generally operated effectively.

- Beyond this, the NYSE is planning to have the capacity by late 1989 to process a billion shares.

- The NYSE is initiating an independent audit of its trading systems by an outside firm every 12 to 18 months to further ensure their proper operation. As the audits are conducted, the NYSE is going to share the findings with the SEC.

- In November 1987, the NYSE increased the Designated Order Turnaround (DOT) system's memory and separated several of the system's data files to allow more efficient processing. Further system enhancements are scheduled to be completed by July 1988 to improve DOT's processing capability even more.

- In January 1988, program changes were completed in the Limit Order System to reduce system bottlenecks discovered during the October market break. A major upgrade of the system with more efficient computers was completed in March 1988, resulting in a 40 percent increase in capacity.

- The NYSE had begun to replace completely its Automated Pricing and Reporting System prior to October 1987, but only a small fraction of the new system was operational by the week of the 19th. An entirely new system was completed on February 22, 1988.

- The ability of the NSYE's Universal Floor Device Controller to store and process data has been increased. To add additional capacity, major portions of data normally routed through the Universal Floor Device Controller are being re-routed to other systems, a process that will be completed by the end of June 1988.

- On January 19, 1988, the NYSE opened its expanded Blue Room, adding 30 more high speed printers for an increase of 20 percent. Seventeen more high speed printers were added to the trading floor in March 1988. In addition, the NYSE currently is working to double the speed of all existing printers.

- The NYSE also has increased the number of electronic display books on the trading floor by 70 percent, reducing the overall need for printers. In addition, it has increased the number of stocks on display books by over 140 percent since October 19th, so that currently there are approximately 1,150 stocks on 376 display books.

- The NYSE recently announced the formation of an Operations Advisory Committee to evaluate problems encountered during peak processing periods and to recommend synchronized corrective actions that would enhance the entire process.

- In March, the NYSE established a Pension Managers Advisory Committee to help make the NYSE more aware of the investment needs of fund managers and help keep the fund managers better informed of the system capabilities of the Exchange now and in the future.

The American Stock Exchange (Amex)

- The Amex is working with those specialists who have touchscreen execution (AutoPer) terminals located behind them to provide space to relocate the terminals in front to the front of the specialists post.

- In addition, the Amex is in the process of redesigning the AutoPer screen to eliminate the need, in some instances, to use an additional page to complete execution of an order. The redesigned screen will permit specialists to execute orders even more quickly and reduce the possibility of having orders print and being executed out of sequence.

- Amex has a pilot program underway with respect to the implementation of an electronic book that will provide smoother integration of AutoPer and booked limit orders.

- The Amex is developing systems to allow same-day floor-derived points of sale comparison for equities and options. It is well into the design phase of this system and plans to implement the first stage in the last quarter of 1988.

- The exchanges' examination of ways to upgrade order delivery systems to improve the capacity of Amex's systems to execute all orders -- including Intermarket Trading System (ITS) commitments -- is ongoing. The Amex and other exchanges are in the process of implementing such upgrades, and believe such developments will permit it, under reasonably anticipated high volume conditions, to execute incoming ITS commitments in a timely manner.

- An arrangement has been decided upon whereby OPRA will regularly update the vendor/user committee of the Information Industry Association on volume and capacity projections to assist the vendor community in its efforts to have facilities keep pace with growth and provide for unexpected spikes in activity.

- The Amex has adopted a policy of delisting selected series of puts and calls within an options class when no open interest exists.

- The Amex and the Chicago Board Options Exchange (CBOE) have proposals, currently awaiting SEC action, that will expand the use of their small order execution systems for options. In addition, the CBOE has filed with the SEC a number of proposed rule changes to increase market participation in its system.

National Association of Securities Dealers (NASD)

- The NASD has responded to problems encountered during the market break by proposing a number of initiatives:
  - raising the penalty of unexcused withdrawals by market makers from National Association of Securities Dealers Automated Quotation System (NASDAQ);
  - requiring all NASDAQ market makers to participate in its Small Order Execution System (SOES);
  - providing that SOES executions will continue in an Over-the-Counter (OTC)/National Market System security when quotes are locked or crossed;
  - eliminating preferencing of market makers when a locked or crossed market exists; and
  - establishing the Order Confirmation Transaction service that will permit firms to access market makers over the computer without voice contact.
- During and after the week of October 19, the NASD expanded the hours of operation of its Trade Acceptance and Reconciliation Service, which allows firms quickly to reduce the number of uncompared transactions.
- The NASD agrees with the SEC's suggestion that the SROs accelerate their efforts to generate same-day compared trades, thereby enabling members to know their positions and market exposure before trading commences the next day. The NASD plans an Automatic Confirmation Transaction System that, together with the Small Order Execution System, Order Confirmation Transaction Service, and the Trade Acceptance and Reconciliation Services, would provide an almost total same-day comparison capability for the NASDAQ market.
- The regional stock exchanges also have taken or are planning a number of actions to enhance their systems (as described more fully in the appendix).

Amex, NYSE, NSCC Committee

- A committee composed of representatives of the Amex, NYSE and National Securities Clearing Corporation (NSCC) has been formed to explore the possibility of shortening the comparison cycle with the intent of

increasing the amount of time available to process "don't knows" (DKs) and "questionable trades" (QTs) by one full day.

Option Price Reporting Authority

- The Options Price Reporting Authority (OPRA) Technical Committee immediately began to design system modifications that will allow the announcement of new series through computer formatted messages. Such modifications will in turn enable vendors to implement computer automatically programs to add these new series to their systems, eliminating the time-consuming and error-prone process of transcribing the administrative messages that is currently used. The Committee reached agreement on the message type at a meeting on December 9th, and implementation of the system modifications is expected to be completed this summer.

The Working Group encourages the securities SROs and clearing agencies to continue to make progress to help the market function smoothly and to provide prompt, quality executions for all market participants.

APPENDIX A

COORDINATED TRADING HALTS AND REOPENINGS

I. 250 Point Dow Jones Industrial Average (DJIA) Decline

A. Price Limits

1. Stock Index Futures Price Limits: Stock index futures markets will set downward price limits at levels comparable to a 250 point Dow Jones Industrial Average (DJIA) decline below its previous day's closing value. When the limit is reached, the markets will trade only within the limit, unless there is a trading halt as described in Section B or a reopening following a trading halt as described in Section C.

2. Broad-based Stock Index Options: Broad-based stock index options markets (OEX, NYA, XMI, FNCI, XVL) will establish either comparable price limits or procedures under which all trading in the index options will cease at levels comparable to a 250 DJIA decline.

B. Trading Halt

If the DJIA falls 250 points below its previous day's closing value, all broker-dealer intermediated equity security 1/ trading in the United States, including all standardized individual stock and stock index options trading, and all stock index futures trading in the United States, will halt.

C. Reopenings

1. Halts initiated prior to 3:00 p.m. EST or EDT

   a. The New York Stock Exchange (NYSE): If the halt occurs prior to 3:00 p.m. EST or EDT, procedures similar to those used to open stocks on the NYSE on Expiration Fridays will be used in order to reopen trading on the NYSE 60 minutes after the initiation of the halt. Thus:

1/ "Equity security" is defined in Section 3(a)(11) of the Securities Exchange Act of 1934 and Rule 3a11-1 thereunder.

(i) 30 minutes after the halt occurs, market order imbalances for major stocks will be publicly disseminated (at present it is not feasible to include limit orders).

-- As a logistical matter, it may be necessary to have some size threshold for order imbalance dissemination (e.g., 50,000 shares) to facilitate prompt dissemination of key order imbalances. In addition, some limitation on the total number of stocks for which imbalances are disseminated may be necessary.

(ii) 45 minutes after the halt, quote indications will be provided indicating the expected range in which each stock would reopen.

(iii) 60 minutes after the halt, each stock will either:

AA. reopen, or

BB. if new orders substantially change the order imbalance, new quotations will be disseminated

-- this presumes that orders can be cancelled at any time prior to the reopening

CC. subsequent quote indications will be disseminated on an as needed basis in 10 minute intervals (or 5 minutes if the subsequent quote indication overlaps the prior quote indication).

b. <u>Other Markets</u>:

(i) Other markets will use any appropriate reopening procedures designed to permit them to recommence trading one hour after the initiation of the stock trading halt, except that trading in

standardized options on individual stocks will not recommence until trading in the underlying stock has recommenced in the stock's primary market.

(ii) After a one hour halt, trading in stock index futures and options could occur (at the option of each futures or options exchange) below the 250 limits (see Section I.A.), unless the markets decline to levels equivalent to 400 DJIA points below their previous day's closing levels (see Section II).

2. Halts initiated between 3:00 - 3:30 p.m. EST or EDT:

   If the 250 level is reached between 3:00 - 3:30 p.m. EST or EDT, abbreviated reopening procedures will be used in order to permit markets either to reopen or to establish closing prices by the markets' normal closing times.

3. Halts Initiated After 3:30 p.m. EST or EDT:
   If the 250 level is reached after 3:30 p.m. EST or EDT, the market will close for the rest of the trading day.

II. 400 Point DJIA Decline

A. Similar price limit, halt, and reopening procedures will be used for DJIA declines of 400 points, except that the halt will last two hours instead of one. Thus, if the 400 level is reached after 2:00 p.m. EST or EDT, the markets will close for the rest of the trading day.

III. Trigger Readjustments

A. Based upon current index levels, 250 and 400 point DJIA declines are approximately equivalent to 12% and 20% declines. The 250 and 400 point triggers and the comparable triggers for the stock index futures and options markets will be reviewed at least quarterly to determine if changes in index levels necessitate changes to these triggers in order to maintain percentages approximately equivalent to 12% and 20%.

APPENDIX B

ADEQUACY OF PRUDENTIAL MARGIN REQUIREMENTS

While margins requirements may be thought to serve a variety of purposes, the crucial one analyzed in this appendix is the setting of margin requirements to yield a reasonable level of protection against default, i.e., prudential maintenance margins. The purpose of prudential margins is maintaining the financial integrity of the obligation, i.e., assuring that market participants who take positions in securities, futures, or options can fulfill their obligations to brokers and other intermediaries so that brokers and clearinghouses can fulfill their obligations as well. Default can occur only if an adverse price change, after the margin call but before the position is sold out, is larger than the remaining margin and the customer avoids paying the resulting liability. Whether a particular margin level is considered adequate to protect brokers and futures commission merchants (FCMs) depends, among other things, on the level of default risk exposure that will be tolerated. Margins of 100 percent would fully assure the solvency of the brokers or FCMs, but would also tend to reduce the benefits experienced by investors from trading on margin or hedging with stock-index futures and options. Generally, much lower margin levels are adequate to provide protection against 90, 95, or even 99 percent of expected price movements. Very low margin levels, however, could leave the broker or FCM open to an unacceptable risk of failure. The margin level ultimately chosen will reflect the risk exposure tolerance of the exchange or clearinghouse.

Another important factor relevant to the adequacy of margin requirements is the period of time the broker or the FCM is exposed to default risk on a customer's open positions--the amount of time expected to lapse between the margin call and the customer's response. This grace period depends on the liquidity of the relevant investor group and the efficiency of the clearing and settlement system. In the futures markets, where investors are primarily institutions and settlement occurs at least daily, margins that will cover the vast majority of one-day price movements would be considered adequate. In the cash markets, however, where individual investors are relatively more important and settlement takes as long as five days, margins should be adequate to cover price movements over three or five-day periods. A broker is allowed to give an investor up to 15 business days to meet a margin call. In practice, however, most brokers demand payment over a shorter period.

Experimental Design

This analysis of margin adequacy takes two different, but related, approaches. The first is a non-parametric approach in which actual frequency distributions in price movements are calculated over various sample periods. These distributions are then employed to determine the margin required to cover price changes given various levels of exposure.

213-632 0 - 88 - 2

The second is a parametric approach following Figlewski (Stephen Figlewski, "Margins and Market Integrity: Margin Setting for Stock Index Futures and Options," The Journal of Futures Markets, 1984, pp. 385-416). Assuming that stock prices follow a logarithmic diffusion process with a constant drift parameter (r) and volatility (v) per unit of time, one can calculate the probability that a security price will change enough, following a maintenance margin call, such that the remaining margin is insufficient (i.e., the margin is violated). While this probability obviously depends on r and v, it also depends on the level of the maintenance margin and the length of the grace period. In particular, the higher the maintenance margin, the lower the probability of a margin violation; the higher r (which can be thought of as an annualized rate of return due to price movements during the grace period), the lower the probability of a margin violation; the higher v (the standard deviation of price movements), the higher the probability of a margin violation; and, the longer the length of the grace period, the higher the probability of a margin violation.

Non-Parametric Results

Frequency distributions were calculated (a) only for price declines and (b) for all price changes over six sample periods:

(1) January 1986 - April 1988,

(2) January 1986 - September 1987,

(3) October 1987 - April 1988,

(4) November 1987 - April 1988,

(5) June 1984 - April 1988,

(6) June 1984 - September 1987.

Tables 1-6 indicate the minimum levels of maintenance margins necessary to protect brokers and futures clearinghouses against losses that might be incurred should stock prices decline and investors fail to meet margin calls. In particular, the tables show margins required to cover most of the recent price declines in the Standard and Poor's 500 stock index and price declines in the 75 individual stocks that compose the Institutional index, that is, stocks of large companies favored by institutional investors. Block 2 in tables 1-6 indicates the margins necessary to protect against price declines on 50 percent of the 75 individual stocks composing the Institutional Index that demonstrated the least variability during this sample period for varying grace periods and levels of exposure. Blocks 3-5 indicate similar margins for larger percentages of the stocks in

this index. Tables 7-12 contain comparable information for _all_ price changes in the nearest to expire S&P 500 and MMI maxi futures contracts.

The two key factors relevant to judging the adequacy of margin requirements--the acceptable level of exposure and the length of the grace period--are highlighted in the tables. For example, the first three lines of each of the first twelve tables indicate the margins necessary to protect FCMs and broker/dealers against possible price movements of the S&P 500 index over periods of one, three and five days. (Price declines for the cash index in tables 1-6; price declines and increases for the futures index in tables 7-12). The three columns indicate the 90, 95, and 99 percent confidence intervals or levels of exposure associated with the indicated margins. For example, the first line in the S&P 500 index block in table 1 indicates that, during the January 2, 1986 to April 29, 1988 period, a one-day price decline greater than 4.40 percent or a five-day price decline greater than 10.09 percent occurred in only one percent of the observations. In other words, if the distribution of price declines were assumed to remain the same in the future as it was during this period, a margin of 4.4 percent when margin calls must be met on the next day, or of just over 10 percent when margin calls do not have to meet until 5 days have passed, would be expected to provide adequate protection against 99 percent of all price declines of the S&P 500 index. From table 7, comparable, though slightly larger, margins would be required to provide adequate protection against 99 percent of all price declines or 98 percent of all price changes (i.e., increases and decreases) for the S&P 500 futures index. Furthermore, as exhibited in blocks 2-5 of tables 1-6, since individual stocks typically exhibit larger variability than either cash or futures indexes, margin requirements are accordingly higher for individual stocks given the same grace period and level of exposure.

To summarize, for each sample period, tables 1-12 demonstrate three important characteristics concerning the adequacy of prudential maintenance margins:

(1) The lower the level of exposure (i.e., the higher the desired level of protection against price changes), the higher the level of margins.

(2) The longer the grace period, the higher the necessary margin level for a given level of exposure.

(3) Indexes (cash or futures) exhibit less price volatility than do individual stocks, implying that lower margins on index products than on individual stocks are adequate to achieve the same protection against price changes.

Given the sample specificity of the calculated frequency distributions, a comparison of the margins required over different samples sheds light on the robustness of "adequacy of margins" calculations over time. Various permutations of time periods were chosen--short and very recent periods, long periods, and periods including and excluding the October 1987 stock market crash and the recent period of price volatility. Because of differences in price volatility over time, the actual levels of margins required to cover price movements are very sensitive to the time period of analysis. In particular, inclusion of the October 1987 market break uniformly and markedly increases the "adequate" margin level. For example, table 3, which contains only observations from the market break and the recent period, indicates much higher margin levels than table 2, which contains only pre-crash observations. For each of the periods, however, the level of prudential margins still depends on the level of exposure, the length of the grace period, and the volatility of indexes versus individual stocks, as discussed above.

Parametric Results

Determining an "adequate" margin requirement using the parametric approach outlined above requires knowledge of r and v in addition to the length of the grace period and the acceptable level of exposure. Reasonable ranges of values for r and v can be obtained by calculating these two variables over various sample periods. Table 13 contains these calculations annually for the S&P 500 and the NYSE Composite indexes for the period 1975-87, for the first 63 business days of 1988, and for four of the six sample periods examined in tables 1-12. The tables reveal that the annual values of r range from -0.126 (i.e., -12.6 percent) to 0.281 for the S&P 500 index and range between -0.100 and 0.284 for the NYSE Composite index. Annual values of v range between 0.092 and 0.342 for the S&P 500 index and between 0.087 and 0.318 for the NYSE Composite index. Note that the annual values of v for 1987 are by far the largest during the more than thirteen years examined. Furthermore, the value of v for the first 63 business days of 1988 has remained somewhat above pre-1987 levels. Consequently, higher than historically normal values of v may now be appropriate for setting prudential margins.

Also, since an objective of this analysis is the examination of margin adequacy for individual stocks as well as for cash and futures indexes, it is necessary to obtain values of v for individual stocks. Chicago Research and Trading Ltd. (CRT) has provided estimates of v for three categories of stocks: (a) low volatility stocks (e.g., utilities), (b) medium volatility stocks (e.g., conglomerates), and (c) high volatility stocks (e.g., computer software companies). During approximately the last two years (including October 19, 1987), CRT's highest calculated value of v is 1.10. This value is used as the upper extreme in the margin calculations that follow.

The parametric approach enables the analysis of margin adequacy from two angles. First, given a required margin level, values for r and v, and a particular grace period, the probability of a margin violation can be calculated. Alternatively, given values of r and v, a particular grace period, and a desired probability of margin violation (i.e. one minus the level of exposure in decimals), the necessary margin requirement can be calculated. To conform to the format of the non-parametric exercise the latter approach was chosen.

Tables 14-17 contain the margin requirements necessary to achieve a desired probability of a margin violation 0.01 (one percent) in tables 14 and 15, 0.05 (5 percent) in tables 16 and 17) for two values of r (0.00 in tables 14 and 16, 0.10 in tables 15 and 17) and for a wide range of grace periods and values of v. (The margin calculation was found to be relatively insensitive to r. Hence, results using two representative values are the only ones reported.) Grace periods of less than one day were included to examine the impact of intra-day margin calls, a common phenomenon in futures markets.

The calculated margins from the Figlewski model conform quite closely with those calculated in the non-parametric exercise. For example, from table 14, for daily settlement and v=0.35 (just above the calculated value of v for 1987 for the two indexes), a margin requirement of 5.4 percent would be expected to provide adequate protection against 99 percent of all price declines. This is essentially the same as the 4.4 percent contained in table 1 for the S&P 500 index. Furthermore, as the volatility increases, so does the margin requirement given the same level of exposure. Also, as before, if the grace period is 5 days (and v=0.35), the required margin rises to 11.8 percent in table 14, again comparable to the 10.09 percent in table 1. Finally, for a higher level of exposure (table 15 compared with table 17), a lower margin requirement will suffice.

Thus, the parametric exercise yields the same general conclusions as did the non-parametric approach: adequate prudential margins vary inversely with the level of exposure, directly with the length of the grace period, and directly with price volatility.

Conclusion

The existing structure of maintenance margins appears to be adequate for prudential purposes even if one were to assume that protection against 95 or 99 percent of all price declines was required. This conclusion is supported by both the non-parametric exercise conducted across a variety of sample periods and the parametric exercise using historically reasonable values for return and volatility parameters.

An important additional conclusion is that "harmonious" or "consistent" margins across cash and futures markets do not imply

equal margins across cash and futures markets. The analysis here indicates clearly that margin adequacy depends critically on price volatility and the length of the grace period following the margin call. These relationships are clearly evident in the attached tables (e.g., tables 1 and 14), but are visually apparent in figure 1. Figure 1 plots the maintenance margin necessary to achieve protection against 99 percent of all price declines assuming r=0.00 for various grace periods and volatilities. To the extent that the volatility of indexes (cash or futures) is lower than those of individual stocks and that grace periods are longer in the cash market than in the futures market, maintenance margins in the futures market (e.g., point A in figure 1 where v=0.25 and the grace period is one day) are consistent with much higher margins in the cash market (e.g., point B or C where v=0.5 and 1.0, respectively, and the grace period in five days).

Table 1

MAINTENANCE MARGIN REQUIRED TO COVER POTENTIAL PRICE DECLINES

Period: 1/2/86 - 4/29/88

		Exposure tolerance		
		90%	95%	99%
1. S&P 500 Index				
	One-Day	1.33	2.03	4.40
	Three-Day	2.53	3.73	7.09
	Five-Day	3.30	4.82	10.09
2. 50% of Institutional Index Stocks*				
	One-Day	2.06	2.94	5.44
	Three-Day	3.89	5.19	9.27
	Five-Day	4.85	6.60	11.75
	Fifteen-Day	7.28	10.41	24.66
3. 80% of Institutional Index Stocks*				
	One-Day	2.36	3.26	6.52
	Three-Day	4.20	5.78	11.66
	Five-Day	5.38	7.30	17.22
	Fifteen-Day	8.55	12.41	30.62
4. 90% of Institutional Index Stocks*				
	One-Day	2.53	3.48	7.29
	Three-Day	4.47	6.20	13.19
	Five-Day	5.61	7.62	19.12
	Fifteen-Day	9.05	13.60	33.45
5. 100% of Institutional Index Stocks*				
	One-Day	3.55	5.29	8.87
	Three-Day	5.82	8.04	19.16
	Five-Day	7.61	10.24	29.21
	Fifteen-Day	11.96	17.39	42.80

* 75 Individual Stocks Composing the Institutional Index

Table 2

MAINTENANCE MARGIN REQUIRED TO COVER POTENTIAL PRICE DECLINES

Period: 1/2/86 - 10/2/87

		Exposure Tolerance		
		90%	95%	99%
1. S&P 500 Index				
	One-Day	1.07	1.65	2.56
	Three-Day	1.94	2.80	4.85
	Five-Day	2.35	3.69	6.35
2. 50% of Institutional Index Stocks*				
	One-Day	1.84	2.47	3.95
	Three-Day	3.29	4.46	6.85
	Five-Day	4.12	5.54	8.25
	Fifteen-Day	5.98	8.26	12.41
3. 80% of Institutional Index Stocks*				
	One-Day	2.09	2.77	4.45
	Three-Day	3.66	4.98	7.90
	Five-Day	4.61	5.94	9.52
	Fifteen-Day	6.92	9.27	14.66
4. 90% of Institutional Index Stocks*				
	One-Day	2.23	2.96	5.00
	Three-Day	3.85	5.12	8.23
	Five-Day	4.78	6.29	10.88
	Fifteen-Day	7.26	10.44	16.78
5. 100% of Institutional Index Stocks*				
	One-Day	3.21	4.47	6.54
	Three-Day	5.22	6.96	11.78
	Five-Day	6.26	8.31	13.49
	Fifteen-Day	10.50	13.80	22.12

* 75 Individual Stocks Composing the Institutional Index

Table 3

MAINTENACE MARGIN REQUIRED TO COVER POTENTIAL PRICE DECLINES

Period: 10/5/87 - 4/29/88

		Exposure Tolerance		
		90%	95%	99%
1. S&P 500 Index				
	One-Day	2.29	3.82	14.98
	Three-Day	4.36	6.08	23.85
	Five-Day	5.12	9.05	26.25
2. 50% of Institutional Index Stocks*				
	One-Day	3.19	4.79	16.77
	Three-Day	5.69	7.68	24.53
	Five-Day	7.38	10.37	26.65
	Fifteen-Day	10.68	17.35	30.53
3. 80% of Institutional Index Stocks*				
	One-Day	3.65	5.51	19.80
	Three-Day	6.66	9.87	28.47
	Five-Day	8.52	13.71	31.37
	Fifteen-Day	13.77	26.65	37.26
4. 90% of Institutional Index Stocks*				
	One-Day	4.02	6.25	21.83
	Three-Day	7.37	10.72	31.38
	Five-Day	9.59	16.09	34.61
	Fifteen-Day	16.24	28.50	44.21
5. 100% of Institutional Index Stocks*				
	One-Day	5.63	7.87	26.80
	Three-Day	10.25	17.02	37.00
	Five-Day	13.24	27.47	41.64
	Fifteen-Day	23.17	35.46	56.03

* 75 Individual Stocks Composing the Institutional Index

Table 4

MAINTENANCE MARGIN REQUIRED TO COVER POTENTIAL PRICE DECLINES

Period: 11/2/87 - 4/29/88

		Exposure Tolerance		
		90%	95%	99%
1. S&P 500 Index				
	One-Day	1.93	2.65	6.16
	Three-Day	3.66	4.53	6.43
	Five-Day	4.64	5.10	7.55
2. 50% of Institutional Index Stocks*				
	One-Day	2.57	3.74	7.08
	Three-Day	4.63	5.83	8.67
	Five-Day	5.72	7.03	9.31
	Fifteen-Day	7.09	8.77	12.40
3. 80% of Institutional Index Stocks*				
	One-Day	3.02	4.28	8.63
	Three-Day	5.50	6.86	10.62
	Five-Day	6.80	8.37	12.00
	Fifteen-Day	9.48	12.10	15.17
4. 90% of Institutional Index Stocks*				
	One-Day	3.26	4.76	9.74
	Three-Day	5.91	7.76	12.04
	Five-Day	7.23	8.99	13.21
	Fifteen-Day	11.46	14.07	19.12
5. 100% of Institutional Index Stocks*				
	One-Day	5.08	7.01	11.42
	Three-Day	7.92	10.99	20.87
	Five-Day	11.05	13.60	17.38
	Fifteen-Day	14.52	20.12	25.97

* 75 Individual Stocks Composing the Institutional Index

Table 5

MAINTENANCE MARGIN REQUIRED TO COVER POTENTIAL PRICE DECLINES

Period: 6/1/84 - 4/29/88

		Exposure Tolerance		
		90%	95%	99%
1. S&P 500 Index				
	One-Day	0.96	1.53	3.12
	Three-Day	1.87	2.84	6.07
	Five-Day	2.27	3.83	7.41
2. 50% of Institutional Index Stocks*				
	One-Day	1.89	2.66	4.72
	Three-Day	3.37	4.65	7.74
	Five-Day	4.12	5.80	9.66
	Fifteen-Day	6.08	8.59	19.53
3. 80% of Institutional Index Stocks*				
	One-Day	2.10	2.92	5.46
	Three-Day	3.78	5.15	9.07
	Five-Day	4.68	6.46	11.35
	Fifteen-Day	7.12	10.21	27.28
4. 90% of Institutional Index Stocks*				
	One-Day	2.27	3.12	6.34
	Three-Day	4.07	5.47	10.59
	Five-Day	5.08	6.89	13.76
	Fifteen-Day	8.18	11.45	28.76
5. 100% of Institutional Index Stocks*				
	One-Day	3.38	4.79	7.88
	Three-Day	5.76	7.80	14.04
	Five-Day	7.35	9.73	17.28
	Fifteen-Day	11.28	15.04	36.29

* 75 Individual Stocks Composing the Institutional Index

Table 6

MAINTENANCE MARGIN REQUIRED TO COVER POTENTIAL PRICE DECLINES

Period: 6/1/84 - 10/2/87

		Exposure Tolerance		
		90%	95%	99%
1. S&P 500 Index				
	One-Day	0.84	1.21	2.32
	Three-Day	1.60	2.18	3.89
	Five-Day	1.93	2.83	5.19
2. 50% of Institutional Index Stocks*				
	One-Day	1.73	2.36	3.82
	Three-Day	3.02	4.07	6.20
	Five-Day	3.74	5.03	7.88
	Fifteen-Day	5.33	7.30	11.70
3. 80% of Institutional Index Stocks*				
	One-Day	1.96	2.69	4.37
	Three-Day	3.37	4.60	7.27
	Five-Day	4.14	5.55	8.91
	Fifteen-Day	6.17	8.54	14.23
4. 90% of Institutional Index Stocks*				
	One-Day	2.10	2.76	4.60
	Three-Day	3.61	4.86	8.23
	Five-Day	4.59	6.33	10.12
	Fifteen-Day	7.39	10.00	16.29
5. 100% of Institutional Index Stocks*				
	One-Day	3.15	4.44	6.61
	Three-Day	5.41	7.32	11.15
	Five-Day	6.77	8.86	12.86
	Fifteen-Day	10.62	13.05	27.78

* 75 Individual Stocks Composing the Institutional Index

Table 7

MAINTENANCE MARGINS REQUIRED TO COVER POTENTIAL PRICE MOVEMENTS

Period: 1/1/86 - 4/22/88

	Exposure Tolerance					
	Price Declines			Price Increases		
	90%	95%	99%	90%	95%	99%
1. S&P 500 Futures						
One-day	-1.57	-2.39	-5.33	1.57	1.96	3.87
Three-day	-2.74	-4.08	-7.88	2.73	3.47	7.03
Five-day	-3.74	-5.03	-11.08	3.36	4.45	6.51
2. MMI maxi Futures						
One-day	-1.57	-2.34	-4.85	1.58	2.21	3.87
Three-day	-2.64	-3.88	-7.03	2.75	3.70	5.96
Five-day	-3.50	-5.11	-10.40	3.65	4.59	6.62

Table 8

MAINTENANCE MARGINS REQUIRED TO COVER POTENTIAL PRICE MOVEMENTS

Period: 1/1/86 - 10/1/87

	Exposure Tolerance					
	Price Declines			Price Increases		
	90%	95%	99%	90%	95%	99%
1. S&P 500 Futures						
One-day	-1.19	-1.92	-2.98	1.36	1.77	2.76
Three-day	-2.24	-2.99	-5.25	2.50	3.17	4.12
Five-day	-2.76	-4.04	-7.15	3.25	4.08	5.27
2. MMI maxi Futures						
One-day	-1.16	-1.85	-2.81	1.42	1.99	2.78
Three-day	-2.07	-2.96	-4.94	2.56	3.28	4.35
Five-day	-2.62	-3.89	-5.97	3.50	4.21	5.91

Table 9

MAINTENANCE MARGINS REQUIRED TO COVER POTENTIAL PRICE MOVEMENTS

Period: 10/1/87 - 4/22/88

	Exposure Tolerance					
	Price Declines			Price Increases		
	90%	95%	99%	90%	95%	99%
1. S&P 500 Futures						
One-day	-2.52	-3.95	-20.01	2.06	3.54	14.22
Three-day	-4.72	-6.47	-31.17	3.83	5.10	17.95
Five-day	-5.34	-9.43	-33.68	4.85	5.69	13.76
2. MMI maxi Futures						
One-day	-2.84	-4.53	-17.39	2.29	3.81	11.32
Three-day	-4.90	-6.93	-26.19	3.97	4.80	15.19
Five-day	-6.12	-9.72	-29.39	4.37	6.28	14.02

Table 10

MAINTENANCE MARGINS REQUIRED TO COVER POTENTIAL PRICE MOVEMENTS

Period: 11/1/87 - 4/22/88

	Exposure Tolerance					
	Price Declines			Price Increases		
	90%	95%	99%	90%	95%	99%
1. S&P 500 Futures						
One-day	-2.35	-2.95	-7.70	1.79	2.24	4.17
Three-day	-3.77	-5.03	-7.11	3.41	4.50	10.37
Five-day	-4.84	-5.22	-7.92	4.77	5.47	15.43
2. MMI maxi Futures						
One-day	-2.45	-2.92	-7.16	2.06	2.47	3.90
Three-day	-4.10	-5.18	-6.92	3.72	4.67	9.02
Five-day	-5.14	-5.93	-9.18	4.49	6.32	15.41

Table 11

MAINTENANCE MARGINS REQUIRED TO COVER POTENTIAL PRICE MOVEMENTS

Period: 6/1/84 - 4/22/88

	Exposure Tolerance					
	Price Declines			Price Increases		
	90%	95%	99%	90%	95%	99%
1. S&P 500 Futures						
One-day	-1.07	-1.84	-3.41	1.33	1.79	3.37
Three-day	-2.07	-3.06	-6.31	2.42	3.08	4.97
Five-day	-2.56	-4.10	-8.12	3.08	3.99	6.27
2. MMI maxi Futures						
One-day	-1.13	-1.82	-3.93	1.36	1.99	3.81
Three-day	-2.01	-3.03	-6.52	2.48	3.35	4.91
Five-day	-2.60	-4.15	-6.92	3.12	4.13	6.52

Table 12

MAINTENANCE MARGINS REQUIRED TO COVER POTENTIAL PRICE MOVEMENTS

Period: 6/1/84 - 10/1/87

	Exposure Tolerance					
	Price Declines			Price Increases		
	90%	95%	99%	90%	95%	99%
1. S&P 500 Futures						
One-day	-1.00	-1.43	-2.58	1.25	1.68	2.64
Three-day	-1.82	-2.37	-4.64	2.30	2.90	4.16
Five-day	-2.15	-3.12	-5.24	2.93	3.37	5.41
2. MMI maxi Futures						
One-day	-0.94	-1.46	-2.57	1.23	1.65	2.70
Three-day	-1.64	-2.41	-3.88	2.33	2.92	4.15
Five-day	-2.00	-2.94	-4.71	2.94	3.84	5.88

Table 13

MEAN RETURN AND VOLATILITY CALCULATIONS FOR STOCK INDEXES

Period	N*	S&P 500 Index		NYSE Composite Index	
		r	v	r	v
1975	253	0.281	0.156	0.284	0.153
1976	253	0.180	0.112	0.200	0.109
1977	252	-0.126	0.092	-0.100	0.087
1978	252	0.010	0.127	0.021	0.125
1979	253	0.119	0.110	0.148	0.110
1980	253	0.235	0.166	0.234	0.164
1981	253	-0.105	0.136	-0.093	0.133
1982	253	0.141	0.184	0.134	0.173
1983	253	0.163	0.140	0.165	0.126
1984	250	0.014	0.128	0.013	0.119
1985	252	0.241	0.102	0.239	0.095
1986	253	0.140	0.153	0.134	0.141
1987	253	0.020	0.342	-0.002	0.318
1988	63	0.192	0.233	0.242	0.209
6/1/84-10/2/87	844	0.239	0.137	0.230	0.127
1/2/87-10/2/87	191	0.413	0.158	0.381	0.146
10/2/87-3/31/88	126	-0.484	0.472	-0.457	0.439
11/2/87-3/31/88	105	0.068	0.258	0.099	0.234

* Number of business days.

Table 14

MAINTENANCE MARGIN REQUIREMENTS NECESSARY TO SET PROBABILITY OF MARGIN VIOLATION BELOW ONE PERCENT
(r = 0.00)

Grace Period (days)	Values of v								
	0.10	0.15	0.20	0.25	0.35	0.50	0.75	1.00	1.10
0.2	0.7	1.1	1.4	1.8	2.5	3.5	5.2	6.9	7.6
0.5	1.1	1.7	2.2	2.8	3.9	5.5	8.1	10.7	11.7
1	1.6	2.4	3.1	3.9	5.4	7.7	11.3	14.8	16.1
2	2.2	3.3	4.4	5.5	7.6	10.7	15.6	20.2	22.0
3	2.7	4.1	5.4	6.7	9.2	12.9	18.7	24.2	26.2
5	3.5	5.2	6.9	8.5	11.8	16.4	23.5	30.0	32.5
10	4.9	7.3	9.6	11.9	16.2	22.3	31.5	39.7	42.6
20	6.9	10.2	13.3	16.4	22.1	30.0	41.5	51.1	54.4

Table 15

MARGIN REQUIREMENTS NECESSARY TO SET PROBABILITY OF MARGIN VIOLATION BELOW ONE PERCENT (r = 0.10)

Grace Period (days)	Values of v								
	0.10	0.15	0.20	0.25	0.35	0.50	0.75	1.00	1.10
0.2	0.7	1.1	1.4	1.8	2.5	3.5	5.2	6.9	7.6
0.5	1.1	1.7	2.2	2.8	3.9	5.5	8.1	10.7	11.7
1	1.6	2.3	3.1	3.9	5.4	7.6	11.3	14.7	16.1
2	2.2	3.3	4.4	5.4	7.5	10.6	15.5	20.2	22.0
3	2.6	4.0	5.3	6.6	9.1	12.8	18.7	24.1	26.2
5	3.3	5.1	6.7	8.4	11.6	16.2	23.4	29.9	32.4
10	4.6	7.0	9.3	11.6	15.9	22.1	31.3	39.5	42.4
20	6.3	9.6	12.7	15.8	21.6	29.6	41.1	50.7	54.1

Table 16

MARGIN REQUIREMENTS NECESSARY TO SET PROBABILITY OF MARGIN VIOLATION BELOW FIVE PERCENT (r = 0.00)

Grace Period (days)	Values of v								
	0.10	0.15	0.20	0.25	0.35	0.50	0.75	1.00	1.10
0.2	0.5	0.8	1.1	1.3	1.9	2.7	4.0	5.3	5.8
0.5	0.9	1.3	1.7	2.1	3.0	4.2	6.2	8.2	9.0
1	1.2	1.8	2.4	3.0	4.2	5.9	8.7	11.4	12.5
2	1.7	2.5	3.4	4.2	5.8	8.2	12.1	15.8	17.2
3	2.1	3.1	4.1	5.1	7.1	10.0	14.6	19.0	20.7
5	2.7	4.0	5.3	6.6	9.1	12.7	18.4	23.8	25.8
10	3.8	5.6	7.4	9.2	12.6	17.5	25.0	31.9	34.5
20	5.3	7.8	10.3	12.7	17.3	23.8	33.5	41.9	45.0

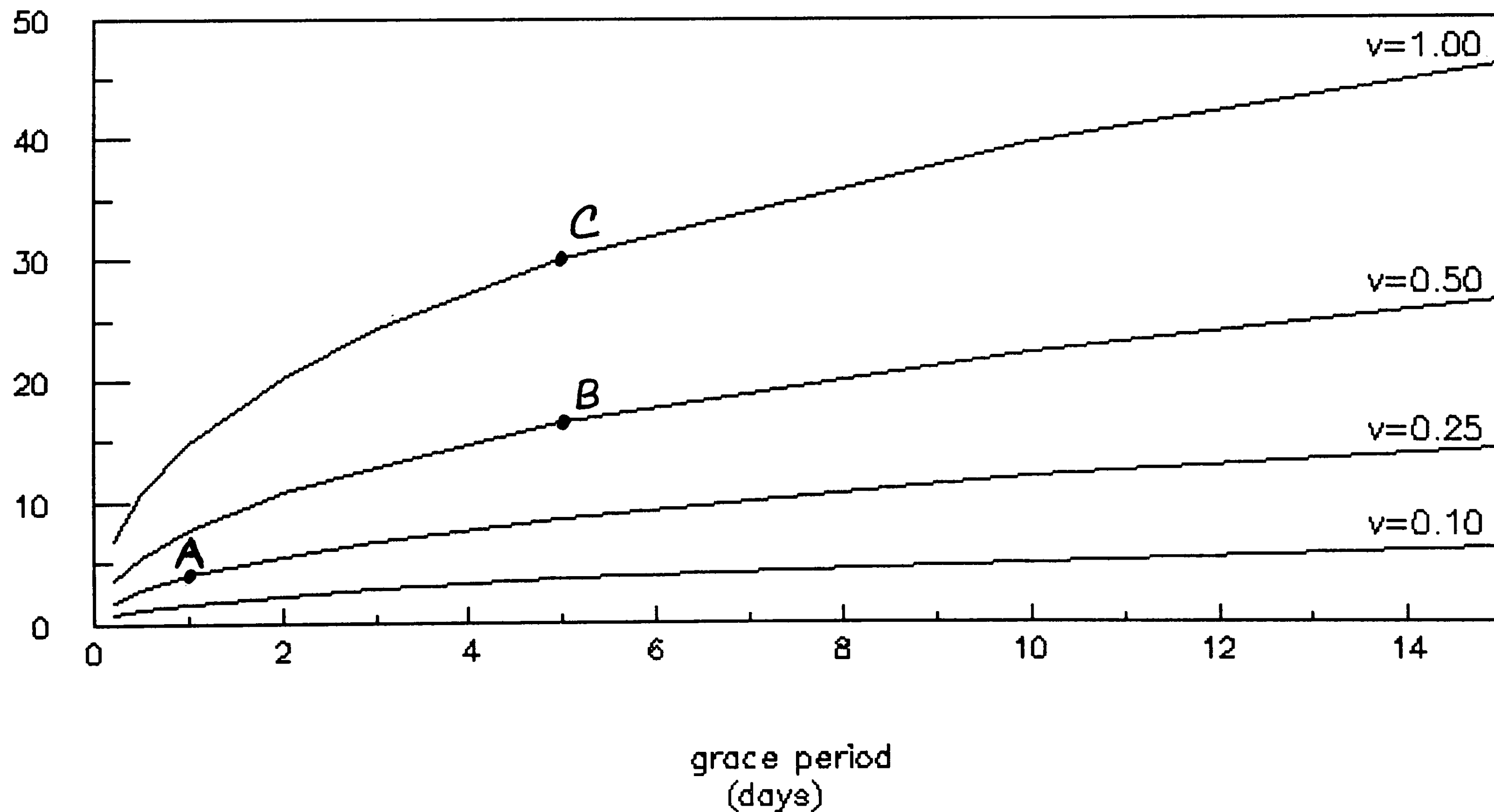
Table 17

MARGIN REQUIREMENTS NECESSARY TO SET PROBABILITY OF MARGIN VIOLATION BELOW FIVE PERCENT (r = 0.10)

Grace Period (days)	Values of v								
	0.10	0.15	0.20	0.25	0.35	0.50	0.75	1.00	1.10
0.2	0.5	0.8	1.1	1.3	1.9	2.7	4.0	5.3	5.8
0.5	0.8	1.3	1.7	2.1	2.9	4.2	6.2	8.2	9.0
1	1.2	1.8	2.4	3.0	4.1	5.9	8.7	11.4	12.5
2	1.6	2.5	3.3	4.1	5.8	8.2	12.0	15.7	17.2
3	2.0	3.0	4.0	5.0	7.0	9.9	14.5	18.9	20.6
5	2.5	3.8	5.1	6.4	8.9	12.6	18.3	23.7	25.7
10	3.5	5.3	7.1	8.9	12.3	17.2	24.8	31.7	34.3
20	4.7	7.2	9.7	12.1	16.8	23.3	33.1	41.6	44.7

Figure 1
Relationship between Maintenance Margin and Grace Period for Probability of Violation of 0.01
(r=0.00)

Maintenance margin (%)



APPENDIX C

REPORT OF STAFF SUBGROUP ON CREDIT PAYMENT AND SETTLEMENT SYSTEM ISSUES

I. INTRODUCTION AND SUMMARY OF KEY ISSUES

The staff subgroup working on credit and payment system issues has completed interviews with market participants--including SROs, banks, and investment firms--in New York and Chicago. The primary purpose of the visits was to ask senior management of these institutions about weaknesses in the current system that may have impeded the smooth flow of credit and payments in October and to elicit their views on possible steps to strengthen the system. A complete summary of these interviews is contained in Section II below.

The views expressed by the market participants did not imply a need for major reform of the structure of systems for clearing and settling securities and their derivative instruments. Given the magnitude of the payments flows and stresses imposed on the clearing systems in October, most felt that the market mechanisms had held up quite well. Nonetheless, there are areas where it was felt that improvements could be made. In broad terms, these areas include better coordination of payment timing and linkages among the exchanges to ease cash flow problems, clarification of responsibilities of clearing organizations and their members, the application of the Uniform Commercial Code to pledges of securities as collateral for loans, and procedures to ensure adequate information flows on which to base decisions.

Improvements have been made in some of these areas already, and ongoing discussions among the exchanges, regulators, and financial institutions are seeking solutions to others. The following summarizes issues viewed as important in the payment and settlement process and notes those issues viewed as less important.

TO IMPROVE THE COORDINATION AND TIMING OF CASH FLOWS AMONG EXCHANGES:

1. Timing of variation margin pays and collects should be coordinated to ease liquidity problems. Steps already have been taken by the exchanges: intraday

margin pays and collects now are done concurrently on the Chicago Mercantile Exchange (CME), and the CME and Board of Trade Clearing Corporation (BOTCC) have coordinated the timing of daily and intraday settlements. There may be other steps that can be taken, but the private sector appears to be addressing this issue.

2. Efforts to reduce the volume of cash flow by netting payment obligations arising from securities and futures positions across different markets with different settlement procedures and time frames is attractive in concept. Nevertheless, there are difficult practical problems involved in implementing such arrangements. Netting, in effect, would link clearinghouses in risk sharing pools. Of particular concern are legal and economic questions of who bears what risk in the event of a default of one or more parties.

   Formal netting arrangements may be viewed as steps toward longer-run unification of the clearing process under a single clearing structure. Market participants generally were skeptical of the utility and feasibility of creating a single clearing structure in the near future.

3. Cross-margining of futures and options positions would lower initial margin requirements for a given position and consequently would reduce cash or securities behind a given volume of gross positions. The implications of cross-margining for risk exposures is uncertain.

4. The availability of Fedwire during periods of crisis, which may fall outside normal operating hours, is very important. But Fedwire is useful only to the extent that knowledgeable lending officers at banks are available to make credit decisions when funds transfers are needed. Procedures should be established in advance for early opening of Fedwire, if needed, in unusual situations. Such procedures should provide for good communication among the clearing organizations and their members as well as the settlement banks and the Federal Reserve Banks, with informed personnel at banks available to make credit decisions.

TO REMOVE UNCERTAINTY CONCERNING LENDER RESPONSIBILITIES IN CREDIT ARRANGEMENTS:

5. "Finality" of the settlement process prior to the opening of trading is important to market participants. Contractual arrangements between settlement banks and clearing organizations should clarify the responsibilities of each party when clearing member funds are insufficient and determine when payments to the clearing organization are final and irrevocable. To this end, discussions between banks and clearing organizations are underway.

6. Futures commission merchants' (FCMs) responsibilities to their customers in the event of non-payment by a clearing organization should be clarified.

7. Legal means of establishing a "perfected security interest" in an option instrument should be investigated. Existing ambiguities in the Uniform Commercial Code and bankruptcy laws concerning the status of options as collateral inhibit the willingness of some banks to finance options positions. More broadly, efforts to strengthen the legal rights of banks lending against options under federal bankruptcy laws and differing versions of the Uniform Commercial Code would ease lending and collateral processes.

8. The desirability of developing collateral arrangements other than those currently provided by "agreements-to-pledge" (APs) should be investigated to see if greater security can be achieved at reasonable costs. Most market participants, however, suggested that flexibility, competitive pressures, and cost considerations necessitated reliance on APs and expressed concern that requiring delivery of collateral could be destabilizing during times of stress.

9. On the issue of "committed" versus "uncommitted" lines of credit, there appears to be little advantage to recommending greater reliance on "committed" lines. "Material adverse change" clauses may permit creditors to escape such commitments during periods of stress. The cost of a paid line that assured access to credit during crisis periods likely would be prohibitive for borrowers that need it the most.

TO IMPROVE INFORMATION FLOWS AMONG FINANCIAL MARKET PARTICIPANTS:

10. Sharing of information on variation margin pays and collects is important to the exchanges, and systems are in progress to provide this service.

11. Commercial banks do not feel a need to have information on margin pays and collects for their lending decisions. The major banks also do not see a need for margin surplus and deficit data or aggregate position data from the exchanges on a routine basis. Typically, they can get this information quickly from their customers, as needed. Formal arrangements for sharing information with market participants raised concerns about confidentiality problems among those interviewed.

II. SUMMARY OF INTERVIEWS WITH MARKET PARTICIPANTS

On April 11 and 12 staff from the four agencies conducted interviews with senior management at a number of major commercial banks, investment banks, and clearing organizations for equity-related products. The purpose of these interviews was to solicit views of senior market participants at these institutions about what actions, if any, should be taken to strengthen market mechanisms and to ensure the adequacy of information necessary to support credit decisions for financing market positions and funding settlement obligations. To provide a framework for these discussions, a list of questions was sent to the participating institutions prior to the interviews focusing on three broad areas: information to support credit decisions; clearing and settlement system characteristics; and credit facility characteristics.

The questions on "Information to Support Credit Decisions" were intended to evaluate the adequacy of current information flows to creditors; the ability of financial institutions to monitor on a current basis their aggregate credit exposures to customers in different markets as well as their own positions; and the need for greater sharing of position data and other information collected by the futures and options exchanges. "Clearing and Settlement System Characteristics" questions dealt specifically with the operation of margining and clearing arrangements and steps that might be taken to ease or speed the flow of cash across exchanges and among institutions and to remove potential ambiguities in credit transactions among clearinghouses, clearing members, and banks concerning who must pay and when. And finally, a number of questions on "Credit

Facility Characteristics" addressed concerns about specific lending arrangements, including collateral control procedures, financing of options, lines of credit, and the overall effect of the stock market crash on terms of lending. The results of these interviews are summarized below.

Information to Support Credit Decisions

The New York bankers interviewed stated that they are selective in their customer base. Their securities customers comprise a limited number of large, well-established institutions, as well as some major regional firms and specialists. The Chicago banks generally had a somewhat broader customer base. All the banks, however, asserted that maintaining close knowledge of, and relationships with, their customers is the keystone for their lending and credit policies. In this regard, all the bankers interviewed believe that they have ample information to support their credit decisions, that is, they "know their customers." They obtain this knowledge through the process of screening prospective clients, monitoring financial reports, reviewing capital and management structure, routinely reviewing data on items such as online deposit records, credit records, and balance sheets from their customers. When additional or more current information is needed, they call the customer directly. In a crisis, the ability to contact key personnel in the borrowing institution is deemed vital.

Because of customer-bank relationships, the lending institutions do not attach much value to additional information, such as daily variation margin pays and collects data, that might be supplied by futures exchanges. Pay and collect data already are available to the Chicago settlement banks but are not viewed as terribly useful in credit decisions involving large customers. No banks routinely get margin surplus and deficit data or aggregate position data from the exchanges, but they may seek it selectively from customers. While, in some circumstances, the ability to confirm positions through access to a third party source might be useful, it was not deemed necessary.

Although the banks feel that they have adequate information on their customers to make credit decisions, this information did not include full knowledge of individual customers' aggregate exposures across markets. Most of the banks either have, or are seeking to install, procedures for monitoring the bank's aggregate exposure to any one customer, but such systems typically do not track intra-day exposures. Intra-day risk monitoring requires the ability to track positions during the day, which is now done

in only a few markets. Integration of global credit exposures also is done on a less regular basis; several banks noted that information on international position exposures could be obtained through foreign office contacts with a delay of a few hours or a day. The banks are becoming more vigilant in this direction; New York banks, in particular, emphasized concerns about increasing global involvements and efforts to monitor such exposures. For some, global exposures and exposures in non-regulated markets outweigh concerns about domestic futures, options, and securities activity.

The investment banking firms that were interviewed also confirmed the importance of customer relationships in determining credit decisions. These firms may attach somewhat more importance than banks to margin pays and collects and other information that might be provided by the exchanges. Nonetheless, they indicated it would be difficult to implement formal cross-market sharing systems that provide information on a timely basis. Banks, securities firms, and clearinghouses expressed concerns about confidentiality of a formal arrangement; they think that, for competitive reasons, customers and financial institutions might not like to have information shared. A concern was also expressed that current intraday information might be interpreted inappropriately if recipients lacked the expertise and historical background for analysis. Some indicated they would have difficulty handling large volumes of daily data.

Clearing and Settlement System Characteristics

The heavy volume of transactions in October highlighted problems that occur when flows of cash through the system are imperfectly coordinated. Institutions were asked about possible steps to alleviate discrepancies in timing or to reduce the need for funds transfers. Specifically, views were solicited on the substitutability of capital for margins, the timing of variation margin pays and collects, benefits and costs of cross-margining proposals, and systems of netting cash flows. Respondents also commented on the clarity and possible ambiguities in contractual relationships between clearing organizations and clearing banks and between clearing firms and their customers. The importance to creditors and other market participants of knowing that daily margin settlements of the clearing houses are final before the markets open and the adequacy of Fedwire operations for this purpose were discussed.

Substitutability of Capital and Margins. Capital is not viewed by market participants as a substitute for margin deposits or collateral. Both capital and margin play an

important role. Banks and investment houses emphasized that while capital is the ultimate buffer against losses and a major factor affecting credit decisions, it is used to support a variety of activities. Margin deposits or collateral, on the other hand, apply to specific transactions and are a first line of defense against counterparty risk. Margin is not subject to competing claims, and is typically more liquid than capital.

Some of the New York institutions expressed the view that margin on futures and options should be higher. Some said that they set customer futures margins consistently higher than the minimum set by the exchanges; nonetheless, they did not see a need for federal regulation of futures margins.

Timing of Variation Margin Pays and Collects. All the organizations agree that coordinated timing of daily and intra-day margin collections would be helpful. Release of margin collects as well as demands for pays intra-day also is favored. Several changes introduced by the exchanges since October move in these directions. Currently, the CME clearinghouse and the BOTCC make regular daily and intra-day settlements that are coordinated in time. The CME has altered its intra-day practices so that gains are paid out at the time losses are collected. BOTCC already had such a policy. At least one investment bank believed that intra-day distributions by the clearinghouses should be based on the most up-to-date information available to avoid affecting the security of the clearing system. The Options Clearing Corporation's (OCC) daily settlements do not occur until 9:00 a.m., two hours after those of the CME and BOTCC. This discrepancy, however, was not viewed as a significant problem by banks.

Cross-margining and netting proposals. There was less uniformity in views on the benefits and costs of cross-margining, and methods of implementing such proposals. The prospect of lower original margin requirements for a combined futures/options position through cross-margining is viewed as a potential benefit by some clearing organizations and banks. Chicago institutions noted that, in the aggregate, positions might increase in response to reduced margin costs. Possible increases in clearing risk are a concern in cross-margin arrangements.

Some advocate cross-margining as a method of increasing the ability of lenders to finance margin payments; the OCC, for example, suggests that the current cross-margining proposals, which apply to posting of original margins, would create a position that banks can use as collateral. Others noted, however, that cross-margined positions stand as security to the clearing organization. The positions would

be double-pledged if banks relied on them as security for lending.

The futures clearinghouses that were interviewed believe that proposals for cross-margining do not address the problem of funding options positions and the issue of the differential cash flows generated by basic differences in margining systems of futures and options. Cross-margining, as currently described, would reduce only original margin requirements. Even in a unified options/futures clearinghouse, there would be a need for daily margin flows where a trader had a long option coupled with a short futures position, for example. The futures clearinghouses would like to see options markets shift to a margining system similar to that for futures in terms of providing daily cash flow to cover changes in market values. The OCC feels option market participants would oppose such a change. Investment banks also noted that cross-margining does not relieve the cash flow differences between derivative and cash stock positions.

None of the respondents provided concrete suggestions for implementing other netting arrangements to reduce cash flows. While the concept of netting is appealing, it requires coping not only with differences in settlement time frames and different procedures applicable in futures, options, and securities markets, but also with a host of legal questions associated with bankruptcy treatment of netting agreements.

On the issue of unified clearing in general, most of the organizations questioned the utility and feasibility of establishing a single clearing organization. Existing clearing organizations embody considerable expertise geared to the specific needs of the various stock, futures, and options markets. In addition, a single clearing organization would lead to a concentration of risk which currently is diversified across multiple clearinghouses. Some offered the opinion that many of the benefits of unified clearing could be obtained by operating within the existing structures to improve information sharing and to coordinate funds flows and other operating procedures.

Clarifying Ambiguities in Contractual and Lending Relationships. The clearinghouses are working on legal documents that more clearly delineate their responsibilities and those of the settlement banks. For example, the OCC already has an arrangement that, unless the bank notifies the clearinghouse otherwise, the bank is committed to providing funds to cover margin settlements. Bankers view this as a question that can be resolved by agreement between the banks and the clearing organizations.

Two investment banks identified as an important issue the ambiguity surrounding a futures clearing member's obligations to its customers for the payment of margin funds in the absence of the receipt of funds from the clearinghouse. One firm questions whether it is responsible for the clearinghouse to its customers and is reviewing its contracts with its customers as it relates to this point.

Finality of Margin Settlements Prior to Market Opening. There was strong agreement among most of those interviewed that "finality" of the settlement process before the opening of trading was critical to the integrity of the system. (The OCC, which settles after the opening of trading, did not feel pre-opening to be critical, but did want "finality" early in the day.) Otherwise, clearinghouses could face potentially large financial exposures.

Market participants in Chicago stressed the importance of access to Fedwire in this process, with several advocating earlier opening of the wire. Clearinghouses tend to favor routine earlier opening, while banks viewed occasional (as needed) early openings acceptable, perhaps contingent upon exceeding pre-determined price or volume parameters. The Chicago institutions suggested a need to better educate the New York bankers about the futures clearing process and the importance of having knowledgeable persons available to make credit decisions early in the day. Several pointed to the inaccessibility of New York bankers on October 20 prior to the opening of the futures markets.

New York banks had little to say about the question of "finality," while the investment banks viewed "finality" as very important. The issue of altering Fedwire hours generally was not viewed as critical by New York respondents.

Credit Facility Characteristics

The commercial banks reported that their own credit policies and terms of lending have not changed significantly as a result of the stock market turbulence, and the investment banks confirmed that their borrowing arrangements with large banks were largely unaffected. But several institutions remarked that foreign banks and small regional banks have cut back lending to securities firms since October. Some of the interviewed banks discussed changes in their internal procedures for assessing credit exposures, including more formal global communications structures and developing comprehensive measures of risk exposure to individual customers.

213-632 0 - 88 - 3

None of the respondents saw any benefit of increasing reliance on "committed" versus "uncommitted" lines of credit. Committed lines generally have "material adverse change" clauses which may permit the creditor to escape its commitment during periods of stress. The availability of credit will ultimately depend on the lender/customer relationship.

Two credit areas where some of the banks expressed dissatisfaction with current systems are collateral pledging arrangements and financing of options positions. Each of these is discussed briefly below.

Collateral Control Procedures. Collateral for secured loans may be held in a number of ways. It may be delivered to the bank lender or a third party custodian. It may be held at the Depository Trust Company (DTC) on a book entry basis and transferred from one member's account to another upon instruction. Or, it can be maintained in a segregated account at the borrower's office under an agreement-to-pledge arrangement (AP). With AP arrangements, creditors usually conduct periodic audits of the securities firms' procedures to ensure the adequacy and safety of the pledged collateral.

Agreement-to-pledge arrangements are quite common. From the borrower's perspective, AP is preferable because it costs less than pledging collateral through DTC. Also, when stocks or securities are put into a pledge account at DTC, they cannot be released without the permission of the lender. A firm that finances equity holdings (its own inventories or customer debits) through DTC pledging worries that the lender will not release the stocks in time for the securities firm to get them to the next party.

Most banks indicated that competitive pressures and cost considerations necessitated reliance on APs and recognized that a change to require delivery of collateral would be destabilizing during a crisis. If one bank suddenly demands delivery of collateral, others would do the same and the result would be a "disaster." Some of those interviewed suggested that the Depository Trust Company may not have the capacity currently to handle all collateral should lenders require it.

While banks recognized the needs served by AP arrangements, several indicated dissatisfaction with these arrangements. Auditing the status of collateral is difficult and, thus far, no court has ruled on the validity of the creditor's lien on collateral under APs. Several banks indicated that if they have a concern about the counter-party, they will not use this system. One bank

reported that, because of these legal ambiguities, it has over time reduced the volume of its AP lending.

One investment banking firm identified problems surrounding the original margin deposits of registered investment companies as an important issue. Currently, such an investment company is required to post original margin in a bank or other third party custodial account, and the FCM must provide funds from its own account to meet the customer's margin obligations with the clearinghouse. These third party custodial requirements reportedly create liquidity problems in volatile situations, and it is not clear how such accounts would be treated should the FCM go bankrupt. This investment banking firm suggested review of SEC regulations prohibiting investment companies engaged in futures trading from depositing original margin with their FCMs.

Financing Options Positions. Bankers, other than two Chicago banks, are reluctant to extend credit for options positions because of the volatility of these instruments and ambiguities in the Uniform Commercial Code and bankruptcy laws about their status as collateral. Most of the banks stated they generally do not finance options positions for these reasons and one bank indicated, in addition, that it did not have the expertise to dispose of the collateral in the event of defaults. The question of obtaining additional financing for options was not seen as a regulatory issue, but as a legal question of how to establish a "perfected security interest" in an option instrument.

APPENDIX D

CLEARING AND SETTLEMENT RECOMMENDATION

I. Clarification of Clearing and Settlement Obligations

The Working Group believes that the reduction of uncertainty concerning the obligations of participants in the clearing and settlement process and concerning the ability of such participants to discharge their obligations is an important improvement that can be made to address the impact of the stock market decline of October 1987 upon clearing and settlement mechanisms. Both the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) reports on the October 1987 market events identify instances in which margins owed or payable on options and futures positions were not paid within normal time frames. These delays have led some market participants to question previous assumptions concerning the obligations of various parties in the settlement chain. While the issues they raise are, in many instances, at odds with settled law and practice, the Working Group believes that efforts should be made to establish a clear, uniformly held understanding of the obligations of each party in the settlement process. The Working Group therefore recommends that steps be taken to confirm existing law and to dispel ambiguities in the following areas:

A. Clearing banks' obligations to honor their confirmations of variation payments. The SEC and CFTC have recommended that contracts between clearing organizations and their clearing banks be clarified to assure certainty that bank confirmations of payments to the clearing organization are irrevocable. A further point that may require clarification is the extent to which clearing banks that confirm variation margin payments for defaulting customers may claim rights to original margin deposits held by the clearing organization on behalf of such customers. The Board of Trade Clearing Corporation, Chicago Mercantile Exchange Clearing House and the Options Clearing Corporation are currently reviewing draft agreements designed to afford greater clarity as to the relationships between clearing banks and clearing organizations.

Action items:

The CFTC and SEC should monitor the options and futures self-regulatory organizations' (SROs) progress toward finalizing revised settlement agreements with their clearing banks.

The Working Group supports conclusion of agreements which specify that payment obligations are final once confirmed.

B. Clearing organization guarantees and timely payment. Generally, clearing organizations are required to make variation margin payments without regard to whether they have "received" variation payments from clearing firms. It is important to confirm that clearing organizations guarantee payment of profits and losses accrued as of each day's settlement. Such payments should ordinarily be backed by final confirmations received by futures clearing organizations prior to the opening of trading or, in the case of the Options Clearing Corporation, prior to 9:00 a.m. Central Time. In any event, such payments are guaranteed by the clearing organization and therefore do not depend upon the clearing organization's receipt of funds from the clearing firms from which such funds are owed. Further, clearing organizations should release such payments promptly in accordance with their rules and by-laws.

Action items:

The SEC and CFTC should confirm that futures and options clearing organization guarantees assure payments owed collecting firms in accordance with their rules and that such payments should be released timely in accordance with such rules and by-laws.

Clearing organizations should review their by-laws and rules in this regard and consider whether further specificity concerning payment guarantees and timing of those payments would be desirable.

II. Facilitate Timely Payments

The SEC and CFTC Reports on the October Market Break describe the crucial role of payment systems in securities and futures markets. Those markets depend on payment systems to move funds and provide financing to meet clearing member and clearing organization payment obligations within established time-frames. Experience during the market break indicates that enhancements to existing payment systems to assure coordinated intermarket payments should be pursued.

The Working Group believes that assurance of the full and timely satisfaction of clearing and settlement obligations can be fostered by increasing the coordination of settlement processes, the information available to market participants concerning their payment obligations and other payment-related data, the accessibility of wire transfer systems, and the financial resources available to clearing organizations to fulfill their guarantee obligations in the event of a clearing firm default. The Working Group therefore recommends that actions be taken in the following areas to increase the ability of market participants to fulfill their payment obligations on a timely basis.

A. **Review of arrangements to support payments by clearing members to settlement banks**. Clarifying the obligation of settlement banks to honor commitments to clearing organizations is just one step in the process and must be supported by a review of the arrangements in place to support the making of such commitments. During times of stress, settlement banks may be called upon early in the morning to "confirm" to clearing organizations large payments by clearing members. In the absence of good funds from those firms on hand at the bank, the settlement bank may determine that the payment called for exceeds its prudential limit for unsecured transfers and therefore refuse to "confirm" the payment before the market opens. In this event, consequences which could ensue include unwarranted liquidation of a firm's positions or continued trading by a firm which may later be found to be insolvent. Mechanisms should be established that allow clearing firms to be assured that their payments to clearing organizations will be "confirmed" and that provide comfort for banks to make the desired confirmations.

Action item:

Federal regulators should review current facilities and consider what further prudential measures are necessary, including requiring that the relevant market participants have secure facilities in place that will support large payments to clearing organizations.

B. **Increase the liquidity and security of clearing organizations**.

1. Review the adequacy of clearing organization guarantee funds, and where appropriate, increase member contribution requirements. Futures and securities clearing organizations collect from and

pay to clearing members significant dollar amounts each day (routinely ranging from $50 million to $500 million in the aggregate and, on particularly volatile days, exceeding $1 billion). Futures and securities clearing organizations, generally, are obligated to make those payments regardless of member defaults. An important back-up source of funds (in addition to individual member margin deposits) in the event of default is the clearing organization's guarantee fund (also known as clearing or participants' fund), to which clearing members are required to contribute.

Action item:

Clearing organizations should review the adequacy of clearing member guarantee fund contributions, in light of other financial protections and system safeguards. Federal regulators should assess the results of these reviews.

2. Enhance the liquidity of guarantee funds. Futures and securities clearing organizations currently maintain high proportions of their guarantee funds in letters of credit and other non-cash interests. Because of the potential urgency of demands for cash flows generated in volatile markets, the immediate availability of sufficient clearing funds in cash and cash-equivalents in conjunction with credit lines to redress the expected counterparty risk assumed by the clearing organization under the traditional clearing organization guarantee is desirable.

Action item:

The SEC and the CFTC should encourage securities and futures SROs to explore the desirability of converting portions of existing securities and futures clearing organizations' guarantee funds to cash or cash equivalents on an incremental basis.

C. Increase the availability of payment-related information. The Working Group believes that in addition to assuring that market participants have a clear understanding of their payment obligations, measures should be taken to assure that market participants have access on a timely basis to information concerning the specific size and nature of those obligations so that they can make appropriate arrangements to fulfill them. Critical to reducing

risks and increasing confidence in the stock futures and options markets are efforts to monitor clearing firm risk more effectively on a coordinated basis. During the market break, clearing corporations effectively communicated on an ad hoc basis regarding firms suspected of being in financial difficulty. Nevertheless, the Working Group strongly supports the development of regularized systems which allow all clearing corporations to identify the system-wide payment obligations and position exposures of all clearing firms. The Working Group recommends that information systems be enhanced in three key respects to increase the timeliness and availability of margin and position data.

1. Maximize cross-market input into the existing futures pay, collect, and margin surplus data system. The Board of Trade Clearing Corporation (BOTCC) has in place a system for the routine, electronic exchange of pay and collect data which will include all futures clearing organizations and, when formatting issues are resolved, will also include Options Clearing Corporation (OCC) data pursuant to agreements already in place. The addition of National Securities Clearing Corporation (NSCC) data also is under discussion. Inclusion of margin surplus and deficit data in the pay and collect system is being explored as well. Appropriate securities data should be integrated into this system to maximize its usefulness as a tool for monitoring inter-market exposures.

Action items:

Procedures should be implemented fully for centralized collection and availability of pay and collect information.

Subject to appropriate control, cost, confidentiality and oversight procedures, NSCC and OCC should be encouraged to provide data to the BOTCC pay and collect system. BOTCC should be encouraged to develop appropriate software to accommodate such data.

Users of the system should consider, collectively, how the system should be operated and paid for.

2. <u>Enhance trade matching capacity to supply increased data concerning intra-day exposures and foster development of on-line trade matching systems</u>. The Working Group believes that the capacity of market participants to satisfy the large cash demands generated in volatile markets such as occurred in October 1987 may be materially affected by their ability to monitor their exposures on a daily and intra-day basis and consequently to ascertain their payment obligations on a timely basis. In addition, such data should enhance the security of clearing organizations by permitting them to respond to intra-day position changes that increase financial risk and could assist lenders in making earlier credit assessments, potentially reducing the credit judgments required to be made at the time of daily margin settlements. Futures contract markets and options exchanges currently complete initial trade comparisons on a same-day basis. Securities and over-the-counter ("OTC") trades are compared on a same-day and a next-day basis. The BOTCC currently has intra-day trade matching systems that match trades at 11:30 a.m. and 1:30 p.m. Central Time, as well as at the close of trading each day; the Chicago Mercantile Exchange (CME) also has developed intra-day trade matching capacity. The SEC has recommended that the New York Stock Exchange, American Stock Exchange, and the National Association of Securities Dealers accelerate the development of systems to compare all trades on the trade date. That process has already begun.

<u>Action items</u>:

<u>Near Term</u>: The SEC, should continue to encourage affected national securities exchanges and the National Association of Securities Dealers, to establish systems and procedures necessary for same-day trade comparison of inter-dealer corporate equity transactions.

<u>Far Term</u>: The SEC and CFTC should foster progress toward on-line trade matching systems at securities, futures and option exchanges.

3. <u>Increase availability of securities position data</u>. The CFTC currently receives on a daily basis for each futures market data detailing the aggregate positions of each clearing firm and the positions

of individual traders that exceed specified reporting levels (large traders). Similarly, the securities SROs have access to data for broker-dealer proprietary positions. In addition, the SEC has recommended to Congress establishment of a comparable large-trader reporting system for the securities markets to identify customers engaging in large securities transactions. OCC position data, for which reporting systems are currently being developed, could be used in the initial phase of such a system. Such data and other available securities data on cash market positions eventually could be incorporated in the position data base currently under development by the CFTC to produce aggregate position data for clearing firms and large traders in securities as well as futures markets. Such data would be useful in analyzing the combined risk positions of firms across markets on an "as needed" basis in periods when augmented surveillance is desirable. Consideration must be given to the specific data to be collected; controls surrounding that data to address, among other things, confidentiality concerns (particularly with respect to foreign investors); and allocation of costs associated with collecting and maintaining position data.

Action items:

Near Term: Immediate development of a trial reporting system of large-trader data for OCC positions, perhaps through incorporation in the existing CFTC database with direct SEC access;

Far term: Consider legislative changes to the securities laws necessary to obtain large-trader data.

D. Arrangements to support payments

1. Increase coordination of margin calls and settlements. The Working Group believes that the effectiveness of clearing and settlement systems is enhanced by the use of settlement procedures that occur at consistent times and that use daily intra-day margin calls to reduce the volume of funds required to be transferred at settlement. Since October 1987, Chicago futures clearing organizations and OCC have increased their use of intra-day margins calls. Currently, BOTCC and CME

daily and intra-day settlements occur on the same schedule. Daily morning settlements occur at 7:00 a.m. Central Time and intra-day calls are made on a routine basis by both clearing organizations at 2:00 p.m. Central Time. OCC's daily settlement, however, occurs at 10:00 a.m. Central Time. The CFTC's Financial Follow-up Report recommended increased use of routine intra-day margin calls to reduce the burdens of effecting large daily margin settlements in volatile markets. Particularly in volatile markets, predictable intra-day margin flows, coordinated across markets, and consequent reduction in the size of daily settlements, would be facilitated by the use of an intra-day call on a consistent basis in options and futures markets. The SEC Division of Market Regulation's Report on the October market break urged OCC to review its pay/collect system, including the adequacy of its variation margin collection system. The Working Group recommends that the timing of settlements on the BOTCC, CME and OCC be harmonized to facilitate orderly cash flows and credit decisions.

Action items:

The SEC and CFTC should encourage OCC and commodity clearing organizations to complete their system reviews with a view to harmonized settlement time frames.

In particular, OCC should ensure that its revised procedures for intra-day margin calls to the extent used are coordinated with intra-day margin calls of futures clearing organizations.

2. Increase Fedwire availability, at least in extremely volatile markets, and coordinate operations during banking or market center holidays. The Fedwire currently opens at 7:30 a.m. Central Time, a half hour after daily settlement confirmations are due on the BOTCC and CME. Although clearing banks generally confirm margin payments without reliance upon Fedwire funds transfers prior to the market's opening, a number of market participants have expressed the view that earlier availability of Fedwire transfers could help assure the availability of funds in circumstances in which credit extensions

of unusual magnitude are required and could reduce daily settlement pressures. In addition, bank holiday schedules vary among market centers and may not coincide with trading market holiday schedules.

Action items:

The Federal Reserve Board should explore earlier opening of the Fedwire as needed during volatile markets. Earlier opening of the Fedwire would be useful only to the extent that knowledgeable officers at banks are available to make credit decisions and approve funds transfers. Futures and securities SROs should establish arrangements with member firms to ensure that early opening procedures for Fedwire can be effectively used.

SROs, regulators and market participants should review and augment existing mechanisms to assure smooth market operations when banks in one market center are closed but are open in other market centers and when markets are open but banks are not.

3. Establish framework for periodic meetings of clearing organizations, clearing banks, federal regulators and SROs. A round-table discussion forum, which includes representatives of the BOTCC, CME, OCC, NSCC and the Depository Trust Company, clearing banks, securities SROs and federal regulators, has been established to address means of enhancing coordination of settlement processes. The monitoring coordination group, which is composed of all securities clearing organizations, also met recently in Washington concerning measures to enhance clearing agency oversight of members and coordination with marketplace SROs. Periodic meetings, including additional securities SRO participants, to discuss coordination of and assure appropriate contingency planning with respect to settlement processes, should be encouraged.

Action item:

The Working Group should encourage establishment of a regular schedule of meetings among participants in futures and securities clearing and settlement processes and federal regulators.

III. Explore Methods to Reduce Cash Flows and Simplify Settlement Systems

The Working Group believes that the above measures to increase the certainty and reliability of clearing and settlement payment systems should be taken on a priority basis. These measures are designed to ensure that existing systems operate effectively even in volatile markets. The Working Group has also reviewed proposed measures to reduce the size of cash transfers required to be made in volatile markets and to further coordinate clearing and settlement systems. The Working Group believes that efforts to explore measures that could reduce the size of net cash flow obligations should be a priority. Although an important goal, the Working Group is cognizant of the many difficulties in increasing coordinated clearing of related stock, futures and options products. These difficulties range from differences in margining procedures and settlement time-frames to inconsistent treatment of securities and futures for bankruptcy purposes. Consequently, the Working Group recommends that measures which address possible structural modifications in existing systems and that could potentially reduce the cash flows through settlement systems and simplify clearing and settlement processes be explored to provide a basis for determining whether more profound systems changes are appropriate. The Working Group recommends that the following actions be taken to address the potential costs and benefits of structural modifications of existing clearing and settlement systems:

A. Explore the utility of cross-margining, through a pilot program limited to non-customer funds. Current cross-margining proposals are designed to reduce initial margin requirements but do not reduce the necessity for variation margin transfers. However, as discussed below, modification of option margin systems to resemble futures-style margin systems could permit cross-margining systems to further reduce cash flows. Alternatively, mechanisms for facilitating lending against the excess value of long options positions could also generate cash for such purposes. A trial cross-margining program is appropriate to permit evaluation of the capacity of cross-margining systems to simplify payment structures and reduce cash flows in a controlled environment.

Action items:

Near Term: CFTC and SEC should expedite consideration of current rule proposals before them which would establish a pilot program for cross-margining of house positions cleared by the

Intermarket Clearing Corporation for the Philadelphia Board of Trade, and the New York Futures Exchange.

Other clearing organizations should be encouraged to consider, and the SEC and CFTC should facilitate, cross-margining proprietary position pilot programs for products such as stock index options and futures.

The CFTC should evaluate whether there are mechanisms to permit floor traders and market makers to participate in cross-margining pilot programs consistent with its segregation rules and, if not, the desirability of changing those rules.

Far Term: The SEC and CFTC should work with the Securities Investor Protection Corporation (SIPC) and other federal agencies, as necessary, to resolve relevant legal issues, and to determine what legislative changes are necessary and desirable to facilitate a broader cross-margining program.

B. **Explore use of futures-style margin settlements for options**. A number of market participants interviewed by the Working Group staff stated that cross-margining systems would have limited utility in reducing cash flows because futures gains and losses are paid on a daily basis but securities and option gains and losses are not. For example, although the changes in clearing margins need not necessarily be passed on to customers, buyers of options could be permitted to margin the premium. If futures-style margining were adopted, all option positions would be marked to the market, and gains and losses on those positions would be transferred at least on a daily basis. Any options margin system which transfers cash daily would significantly change current contractual obligations and may pose new risks. Currently, the purchaser of an option who does not use the value of the option for collateral does not pose any financial risks to clearing organizations or clearing members because the entire premium due with respect to that position is paid in full the morning after acquiring the option. Until the option holder exercises the option (to buy or sell), the holder has no obligation with respect to

that position. Although a futures style system would change this and also would alter the pricing of options, such a system could make cash flows between options and futures symmetrical and thus could have benefits.

Action item:

> The practical impediments to and risk implications of modifications of option margin systems should be studied in light of potential liquidity gains that might be achieved. This study should focus on the desirability of experimenting with futures-style margining of options as part of the development of pilot programs for coordinated clearing of professional positions in stock index options and futures products.

C. Explore means of netting cash flows on a contractual basis. To a limited extent, netting occurs on the basis of clearing firms' use of a single bank as the settlement bank for more than one market in which such firm maintains offsetting positions.

Netting of settlements among clearing organizations may raise questions in the event of member defaults. Among other things, clearing organizations, clearing members and their bankers would need certainty concerning security interests to protect against financial losses due to member defaults and other questions with respect to the various rights of the parties to the netting arrangements. Nevertheless, the risks and benefits of netting cash flows on a contractual basis should be studied.

Action item:

> The Working Group should encourage the SROs, in conjunction with clearing banks, to explore approaches to netting of payment obligations.

D. Shortening the five-day settlement time frame for routine transactions in corporate equity securities. Transactions in equity securities generally entail three distinct contracts: two contracts between broker-dealers and their customers -- the buyer, the seller and their broker-dealers -- and another contract between the buying and selling broker-dealers. Settlement between institutional customers and their broker-dealers generally occurs at securities depositories; settlement of contracts between

broker-dealers generally occurs through netting at clearing corporations (excess delivery or receipt obligations are settled through book-entry movements at securities depositories with payments at the clearing corporation).

Currently, transactions in corporate securities settle five business days after the trades are executed. This time-frame allows completion of tasks associated with settling those trades: inter-dealer trade comparison and, through stock clearing corporations, inter-dealer netting of delivery and payment obligations; dealer confirmation of trade terms to investors (particularly money managers acting on behalf of institutional investors); money manager acknowledgement of the trade and issuance of instructions to the institution's custodian bank concerning the delivery of securities and payment of funds; and settlement of the transaction between the dealer and the custodian bank through securities depositories. The vast majority of institutional trades in corporate securities (exceeding 90%) now settle within the five-day time frame, primarily because parties to these trades routinely use securities depository facilities for confirmation, affirmation and book-entry settlement of dealer-institutional transactions.

Establishing an earlier settlement time frame depends, among other things, on the ability of dealers, money managers and custodian banks to communicate trade terms and settlement instructions and respond to those communications quickly. Because many custodian banks and money managers access securities depositories through other institutions, communicating confirmation, affirmation and settlement data often requires two to three days. Accordingly, any significant reduction in settlement time frames would entail costs and changes to operational procedures but these costs and changes should be evaluated relative to the potential benefits of reduced settlement time-frames.

Action item:

> The New York Stock Exchange, National Association of Securities Dealers, the American Stock Exchange, clearing organizations and market participants should identify costs and benefits of

an earlier settlement time-frame and identify how a shorter time-frame can be implemented consistent with reducing clearing system exposure and facilitating coordinated clearing of equities, options and futures.

E. <u>Integrated clearing of stock and related options and futures products</u>. Currently, options contracts are cleared and settled at OCC, futures contracts and futures options con-tracts are cleared and settled at clearing organizations affiliated with or designated by contract markets trading specific futures products; and securities transactions are cleared and settled at interfaced clearing corporations and securities depositories. Existing clearing organizations serve the needs of the stock, options, and futures markets and allocate default and credit risks differently to meet the requirements of those markets.

Consolidation of clearing systems would raise substantial questions regarding CFTC/SEC customer segregation requirements and bankruptcy law treatment of commodities and securities positions. For example, SEC segregation requirements may have to be augmented or CFTC requirements diminished in order to integrate the two systems.

However, consolidation of stock and derivative market clearing organizations may offer potential for reduced cash flows and simplified payment and operational procedures. Whether consolidation would reduce risk through central control of positions or increase risk because of concentration of positions is unclear. Asynchronous settlement time-frames, different margin procedures and distinct clearing organization responsibilities with respect to issuer-based as opposed to exchange-based instruments, as well as concerns for competition among clearing organizations, raise questions as to the cost-effectiveness of consolidation of stock and derivative clearing facilities. Consolidated clearing of related futures and options positions may raise somewhat different questions.

<u>Action item</u>:

Futures and securities clearing organizations should identify costs and benefits of integrated clearing and determine how integrated clearing could be achieved. This analysis may be facilitated by data generated by any

cross-margining or netting pilot programs established by futures and option clearing organizations. The SEC and CFTC should monitor the progress of these studies and address public interest and competitive issues that any proposals for integrated clearing may raise.

IV. Refine Relevant Legal Frameworks

The Working Group also identified several aspects of existing legal frameworks that should be reviewed to assure that a lack of uniform or coordinated legal standards does not increase market uncertainty or reduce the security of clearing and settlement systems.

A. Develop bankruptcy framework for FCM/broker-dealers. Currently, different bankruptcy frameworks apply to insolvencies of FCMs and those of securities broker-dealers. In view of the substantial intermarket trading activities of certain dual registrants, a uniform or integrated bankruptcy framework for such entities may be desirable. Development of such a bankruptcy framework for dual registrants could be accomplished through coordinated rule-making by the SEC and the CFTC if the SEC were granted rule-making authority comparable to that of the CFTC to define customer property and to determine other matters relevant to broker-dealer bankruptcy distributions.

Action item:

The CFTC and SEC should review existing bankruptcy laws and regulations to formulate a coordinated approach toward FCM/broker-dealer bankruptcies and identify areas requiring legislative action.

B. Consider harmonizing state commercial laws to establish uniform transfer, delivery and pledge requirements for options and uncertificated securities. The laws of the various states do not have uniform requirements for transfers and pledges of options, and transfers and pledges of certificated and uncertificated stocks. State requirements are set forth in commercial statutes (adapted from Articles 8 and 9 of the Uniform Commercial Code) that vary significantly from jurisdiction to jurisdiction. Approximately 25 states do not have statutory standards recognizing uncertificated securities. Judicial interpretation of those laws also varies among states, and determining which law to apply in multi-state transactions can often be difficult. If the substantial legal obstacles

can be overcome, investors, market professionals and their lenders should have a single, clear set of rules for the transfer and pledge of securities, similar to those being developed by the United States Treasury Department for trans-actions in United States Government Securities.

Action Item:

> Consideration should be given to whether legislation authorizing the appropriate regulators to establish federal rules for the transfer and pledge of stock and securities options would be desirable.

APPENDIX E

Market Reform Actions Taken (or Planned) by Federal Agencies, Self-Regulatory Organizations, Clearing Agencies, and Market Participants as of May 16, 1988

I. Federal Agencies

A. Securities and Exchange Commission (SEC)

Actions by the SEC--Extensive Study of the Market Break and Recommendations for Market Reform

o On February 2, 1988, the SEC published a staff study prepared by its Division of Market Regulation entitled The October 1987 Market Break. This study detailed, among other things, the role of program trading in the market break; the capacity of the self-regulatory organizations (SROs) to meet the volume and other demands placed on their trading systems by the heightened volatility; and an analysis of market break related investor complaints. This study also contained recommendations for market reform on both an individual exchange basis and across all markets.

o Thereafter, pursuant to recommendations made by the Commission and staff, the Commission engaged in a continuing dialogue with the SROs to encourage SRO action in the following areas:

- increased operational capacity through order handling system enhancements;

- increased market liquidity through new specialist capital requirements and the development of new trading techniques;

- increased financial integrity of market participants through, for example, increases in derivative market margins and reassessment of the manner and timing of variation margin calls;

- improvements in post-execution trade processing; and

- enhanced clearing agency safeguards against member default.

Actions by the SEC--Coordination Efforts

- o Coordination of inter-market issues with the Commodity Futures Trading Commission, Federal Reserve Board, and the Department of the Treasury.

- o Contingency planning with the other regulators and the SROs.

- o Coordination of international issues with foreign regulators; meetings with officials of the Japanese Ministry of Finance, the Tokyo Stock Exchange (February 1988), the Department of Trade and Industry, Securities Investment Board, and the International Stock Exchange of the United Kingdom and the Republic of Ireland Ltd. (March 1988) to discuss the global impact of market volatility.

Actions by the SEC--Surveillance Data

- o The Commission believes that the collection and dissemination of market, information related to program trading is necessary for the detection of frontrunning (both intra- and inter-market) and is of vital importance in maintaining market integrity. Toward this end, consideration is being given to proposals that would require securities traders to report large transactions to the Commission.

- o The SEC has also suggested to the New York Stock Exchange (NYSE) that it give consideration to augmenting its audit trail procedure to obtain by electronic means the identity of member firms' customers. Currently, the NYSE audit trail tracks the time of stock executions and the brokers involved in the trade, but requests for customer names must be made separately to member firms.

Actions by the SEC--Systems Enhancements

- o The SEC has reviewed plans by the securities SROs to increase the capacity of their order routing and execution systems to handle the volume of message traffic experienced on October 19 and 20.

- o The Commission is reviewing stress tests of SRO order routing and execution systems.

B. Commodity Futures Trading Commission (CFTC)

Actions by the CFTC--Financial Integrity of Futures Markets

- o Since the October market break, the CFTC has completed four studies of futures activity during October, 1987; made recommendations to futures SROs concerning program

enhancements to strengthen protections in volatile markets; monitored SRO progress in responding to the CFTC recommendations; initiated improvements in its own data collection processes and data bases; coordinated and consulted with other federal regulatory agencies in addressing contingency planning and other post-market break responses; and communicated with foreign regulators to promote information-sharing and cross-border financial surveillance.

Post-Market Break Studies

- Following October 19, the CFTC thoroughly assessed the operation of regulatory and self-regulatory financial protection systems during the market break. The staff's preliminary conclusions were summarized in the Interim Report on Stock Index Futures and Cash Market Activity During October 1987, which was prepared on an expedited basis and presented to the Commission on November 9, 1987.

- Subsequently, the CFTC developed additional data concerning the financial impact of the October market break upon futures firms and futures customers. The staff's findings based upon this data were summarized in its Follow-up Report on Financial Oversight of Stock Index Futures and Cash Market Activity During October 1987. Although the CFTC staff concluded that the financial safeguards of the futures markets operated effectively during the market break, aspects of financial systems that could be strengthened to provide added protection against extreme volatility were identified.

- Separately, the CFTC staff reviewed October 20, 1987 trading in the Major Market Index futures contract on the Chicago Board of Trade and found no reasonable basis for concluding that manipulative activity had occurred.

- The CFTC staff's Final Report on October 1987 futures market events was issued in January 1988. In addition to providing a detailed analysis of futures trading activity during the relevant period, the Final Report set forth recommendations for additional system enhancements to facilitate more effective financial and market surveillance.

Post-Market Break Recommendations

- While the CFTC's staff reports reflect that existing regulatory and self-regulatory protections functioned effectively during October 1987, the CFTC has carefully reviewed SRO programs as well as its own systems, to identify areas in which each can be strengthened to assure that it remains effective even in highly volatile markets.

The CFTC staff initiated this process directly following the market break, writing to all futures exchanges and clearing organizations on November 12, 1987, to request that they review existing programs and consider potential enhancements to provide added protection against future periods of volatility. The staff preliminarily identified seven program areas for SRO consideration. Subsequently, the CFTC staff reviewed these recommendations with the Joint Audit Committee, a coordinating group on which all futures exchanges and clearing organizations are represented and formulated additional recommendations for SRO program improvements, which are more fully set forth in the CFTC's post-market staff reports. In brief, the CFTC staff has recommended:

- Expedited implementation of the pay and collect data-sharing system. Culminating efforts that were commenced well before the market break, the futures SROs entered into an agreement on October 21, 1987, for the routine, electronic exchange of pay and collect data with respect to dual and multiple clearing members. The CFTC staff recommended implementing this system on a priority basis.

- Clarification of legal relationships between clearing organizations and banks. To assure the unimpeded flow of variation margin payments between clearing organizations and clearing firms, the CFTC staff recommended that the legal relationships between clearing organizations and clearing banks be clarified to establish the irrevocability of clearing bank confirmations of variation margin payments in the daily settlement process.

- Intra-day margin calls. The CFTC staff recommended increased use of intra-day margin calls on a routine basis to enhance the capacity of the settlement system to function smoothly in times of extreme volatility.

- Integration of market and financial surveillance data. the CFTC staff recommended that the SROs, all of which now have large-trader systems, give priority consideration to enhancement of their computer systems to integrate large-trader data into their financial surveillance systems on an automated basis.

- Intra-month capital compliance systems. The CFTC staff recommended that the SROs review the feasibility of enhancing their audit programs to ensure that their member firms have the capability to monitor and maintain continuous capital compliance.

- Lines of Credit. The CFTC staff recommended that firms be required to provide confirmation to their SROs of the availability of and any conditions to their existing lines of credit and that all firms be required to have adequate local banking relationships.

- Internal controls by member firms over guaranteed floor traders. The CFTC staff encouraged the SROs to review the capacity of their member firms to control their exposure as guarantors of floor traders.

- Review and consider enhancement of margin security against risks of extreme volatility. The CFTC staff recommended that the SROs review the adequacy of margin levels to assure that there is an appropriate cushion against aberrant price spikes and extreme volatility.

o The CFTC has actively monitored the activities of the futures SROs in response to these recommendations and encouraged enhanced coordination among futures exchanges, securities exchanges, and clearing banks involved in the futures and securities settlement processes. As Part II of this summary reflects, the futures SROs have effected many system improvements since the market break which respond to recommendations by the CFTC and have taken steps toward more formal inter-market coordination.

Enhancement of CFTC Data and Surveillance Systems

o Following the market break, the Commission initiated efforts to improve its own data systems to provide more complete and timely data for analysis in the event of continued volatility in the stock market and to enhance its financial surveillance data base.

o Trade identification. Each futures exchange currently maintains a daily record of each trade (trade register) which contains certain identifying information. This information includes the name of the firm clearing the trade and a customer-type indicator (CTI) that shows the type of account for which the trade was executed. The CFTC staff is exploring ways to use this daily record of trades to identify more rapidly and accurately specific types of transactions involving both futures and stock trades, such as index arbitrage.

  - In the short run, consideration is being given to requiring additional CTI codes for stock index futures transactions to identify various types of transactions.

- For the longer term, the Commission is exploring with the exchanges and futures commission merchants (FCMs) changes and additions to account-number information.

o With respect to the CFTC's large-trader reporting system, the Commission staff has implemented a special identification system for trading institutional accounts. The staff is also reviewing the levels at which the positions of large traders in stock index futures are currently reported to the Commission in terms of the proportion of open interest represented by reporting traders and the number of traders being reported.

o Financial surveillance data systems. The Commission staff is also exploring ways in which data currently collected and used by the CFTC and the futures exchanges for market and financial surveillance can be refined to enhance financial surveillance. Specifically, the CFTC staff is developing refinements of the Commission's existing large-trader and clearing member data base to produce aggregate position data for all futures markets. Aggregate position data could be made available to exchanges and other regulators during periods of volatile markets, and, once established, such a system could provide a model for data systems that would reflect all market exposures, including domestic and foreign securities positions.

The CFTC is also exploring development of a centralized computer data base for financial information relating to FCMs. The Commission currently maintains financial information filed by the FCMs in hard copy and computerizes a limited amount of such data. The Commission contemplates development of a computer data base that would be accessible to the SRO financial surveillance staffs as well as to the Commission.

Coordination With Other Regulators

o The CFTC has consulted extensively with the SEC, the Federal Reserve Board, and the Department of the Treasury to address inter-market coordination and contingency planning issues raised by the market break.

International Coordination

o The CFTC is coordinating with foreign regulators in a number of areas, including financial surveillance and information sharing:

- The Securities and Investments Board has proposed that a lead regulator be designated for firms operating in the United States and the United Kingdom. The CFTC has

responded in writing to this proposal following discussions between the CFTC and SRO officials and discussion of the issue by the Joint Audit Committee. The CFTC is also coordinating with the SEC on this matter.

- Information sharing meetings have been held with officials in England, Japan, France, Singapore, Canada, Australia, and Switzerland.

Frontrunning

o At the direction of the CFTC staff, all exchanges that trade stock index futures are reviewing rules relevant to frontrunning. Each exchange has indicated that it would interpret frontrunning as a violation of existing rules relating to just and equitable principles of trade. The CFTC and the futures exchanges are participating in a subgroup of the Intermarket Surveillance Group formed to discuss intermarket frontrunning and other intermarket offenses. The exchanges and the CFTC are also working toward unified standards and interpretations of frontrunning with the securities exchanges and appropriate information-sharing to facilitate surveillance, as well as considering the possibility of a regulation establishing a more specific futures industry standard for the prohibition of intermarket frontrunning activity involving transactions on futures exchanges.

Customer Complaints

o The Commission investigated the number and kinds of customer complaints filed with respect to stock index futures activity during the October market break. The futures exchanges which trade stock index products, the National Futures Association (NFA) and the CFTC's reparation forum, reported a total of only 35 customer complaints relating to stock index trading on futures exchanges during the period October 16-23, 1987.

C. Federal Reserve Board

o In conjunction with the other federal bank regulatory agencies, the FRB conducted interviews with the major banking organizations to determine their lending policies and practices during the market crisis.

o The FRB reviewed the functioning of Fedwire and daylight overdraft caps and is continuing to evaluate the hours of operation of Fedwire, and to assess the costs and benefits of potential changes.

- The FRB has continued contingency planning for market emergencies, including co-ordination with the other regulators.

D. Treasury Department

- Closely monitor financial market developments, promote better communication and coordination among the agencies, and work through the Working Group to correct market weaknesses.

II. Self-Regulatory Organizations and Clearing Agencies SEC Oversight:

A. New York Stock Exchange (NYSE) Specialist System

- The NYSE has reallocated the stocks of J.P. Morgan and Co., Gould, Inc., Neiman-Marcus Group, Carter-Wallace, Inc., and Pansophic Systems, Inc., away from six specialist units.

- There may be additional disciplinary actions resulting from the week of October 19th, and, when appropriate, additional stocks will be taken away from other specialists that fail to meet Exchange standards.

- The SEC has approved revisions to NYSE Rule 103A concerning evaluation of specialist performance. The revised rule establishes, among other things, specific objective standards for measuring specialist performance in the areas of specialists' Designated Order Turnaround (DOT) system order handling and reporting, timely opening of securities, handling of administrative message traffic and market share. *See* Securities Exchange Act Release No. 25681, May 9, 1988. The development of additional specialist performance standards utilizing objective measures is currently being considered.

- The NYSE Board of Directors on April 7 approved a proposal to enhance their procedures for allocating stocks to specialist units. The NYSE expects to submit the proposal to the Commission shortly.

- The SEC has approved an NYSE proposal to increase specialist capital requirements, as an interim measure, to the greater of $1 million from $100,000 or 25% of the trading unit position requirements, which would be increased to three times their current levels. (For example, the current 5,000 share position requirement for common stock has been increased to 15,000 shares.) *See* Securities Exchange Act Release No. 25677, May 6, 1988.

The NYSE has increased its monitoring of both specialists' capital and positions by requiring that such information be filed with the NYSE by 9:00 a.m. daily.

The NYSE is exploring the need for specialists to maintain additional lines of credit and other lending arrangements.

Over the next several weeks, the NYSE staff will meet with a number of its largest member firms to discuss their credit and banking arrangements, including the number and types of banking relationships and efforts to obtain other financing.

- In an effort to attract more capital, the NYSE has revised its Rule 98 to suspend temporarily a prohibition on securities underwriting firms acquiring specialists. The proposed rule change has been filed with the SEC for approval.

Initiatives To Increase Trading Capacity

- In November 1987, the DOT's system's memory was increased and several of the system's data files were separated to allow more efficient processing. Further system enhancements are scheduled to be completed by July 1988 to improve DOT's processing capability even more.

- In January 1988, program changes were completed in the Limit Order System to reduce system bottlenecks discovered during the October market break. A major upgrade of the system with more efficient computers was completed in March 1988, resulting in a 40 percent increase in capacity.

- The NYSE had begun to completely replace its Automated Pricing and Reporting System prior to October 1987, but only a small fraction of the new system was operational by the week of the 19th. An entirely new system was completed on February 22, 1988.

- The ability of the NYSE's Universal Floor Device Controller to store and process data has been increased. To add additional capacity, major portions of data normally routed through the Universal Floor Device Controller are being re-routed to other systems, a process that will be completed by the end of June 1988.

  A problem associated with the Universal Floor Device Controller during the week of October 19th was a backlog of orders directed to printers on the trading floor. On January 18, 1988, the NYSE opened its expanded Blue Room, adding 30 more high speed printers for an increase of 20 percent. Seventeen more high speed printers were added to the trading floor in March 1988. In addition, the NYSE

213-632 0 - 88 - 4

currently is working to double the speed of all existing printers.

At the same time, the NYSE also has increased the number of electronic display books on the trading floor by over 85 percent, reducing the overall need for printers. In addition, it has tripled the number of stocks on display books, an increase of over 140 percent since October 19th, so that currently there are approximately 1,251 stocks on 373 display books.

- The capacity of the NYSE's Post Support System to store and process orders has been increased through the use of additional computer power for the system.

- Enhancements in the NYSE's Universal Floor Device Controller and its printers currently underway will reduce the potential for delays in the Exchange's link with the Intermarket Trading System (ITS).

- As of November 1987, the computers running the Consolidated Tape System have been replaced. As a result, the Consolidated Tape System now has the capacity to process efficiently a peak volume in excess of 600 million shares.

- Computer enhancements were made to the As-Of-Status-System on October 24th and 25th, 1987.

- On a broader scale, the NYSE is planning to have the capacity to handle a peak of 600 million shares by June of this year, and it believes that if it were to experience a 600-million-share day now, it would be able to process it with significantly fewer delays than the Exchange experienced last October.

- On Saturday, April 30, 1988, the NYSE conducted a test of its 11 computer systems to determine whether the systems could process adequately 600 million shares in one day. Preliminarily, the NYSE was very satisfied with the test results; the NYSE is currently analyzing the data generated by the test.

- Beyond this, the NYSE is planning to have the capacity by late 1989 to process a billion shares.

- The NYSE recently announced the formation of an Operations Advisory Committee, headed by NYSE President Robert Birnbaum and made up of experts in trading operations from member firms of various sizes. The purpose of the Committee is to evaluate problems encountered during peak processing periods and to recommend synchronized corrective actions that would enhance the entire process.

In March the NYSE established a Pension Managers Advisory Committee in order to help make the NYSE more aware of the investment needs of fund managers and help keep the fund managers better informed of the system capabilities of the Exchange now and in the future.

Last January, the NYSE formed an Individual Investor Advisory Committee to serve as a liaison between individual shareholders and the NYSE Board to enhance communications between individual investors and the Exchange. Its charter is to advise the Board on policies and programs that affect individual investors in equities, options, futures and fixed income securities.

o The NYSE is initiating an independent audit of its trading systems by an outside firm every 12 to 18 months to enhance the system's proper operation. As the audits are conducted, the NYSE is going to share the findings with the SEC.

Program Trading

o The NYSE required, as of May 15, the daily submission of information relevant to all program trading activity engaged in by its members or member organizations either on a proprietary or agency basis.

o A new procedure is being implemented by the NYSE to enable it to identify accurately all types of trading, including program trading.

Circuit Breakers

o In early February, the NYSE adopted a procedure and proposed a rule to the SEC to take index arbitrage out of its automated order routing system whenever the Dow Jones Industrial Average moves 50 points up or down from the previous day's close. The NYSE's proposal was approved by the SEC on a six-month pilot basis on April 19, 1988, See Securities Exchange Act Release No. 26699, 53 FR 13371.

The NYSE is working toward a proposal that could provide for a coordinated all-market circuit breaker in the event of a precipitous market decline. The Exchange is hopeful that agreement on this issue can be reached in the near future.

Frontrunning

o The NYSE has sent a letter to its members stating that inter-market frontrunning -- or trading futures contracts to profit on knowledge of impending orders in the stock market -- may violate just and equitable principles of

trade, and could be a violation of the Exchange's trading rules. See NYSE Information Memo No. 88-9, April 13, 1988.

In addition, the NYSE plans to provide the futures exchanges with audit-trail information on stock trading that would enable the Chicago futures markets to conduct ongoing surveillance for front-running. See NYSE Information Memo, April 21, 1988.

Environmental Impact Statement

- The NYSE Chairman Phelan has proposed development of a financial version of an environmental impact statement that can provide guidance, or even an early warning, regarding the potential consequences of new financial instruments, new trading technologies and new forms of risk management.

Communications

- On January 11th, the heads of several SROs met at the NYSE to discuss a variety of methods to improve communications. Similar meetings involving all equities futures and options exchanges were also held on February 24th, March 24th and May 3rd.

- The NYSE also is supporting a proposal to include the stock index futures as associate members of the Intermarket Surveillance Group (ISG), which provides access to an integrated database of inter-market surveillance instruments.

  The NYSE is also heading up a sub-group of the ISG to better identify inter-market trading violations and promote information sharing.

  - On April 5th, there was a meeting of all the members of the ISG. The stock index futures contract markets attended that meeting, and the CFTC participated as an observer.

Compared Trades

- The NYSE is working on (1) a shortened comparison cycle, and (2) an on-line automated Questioned Trade process. The exchange is developing an electronic Floor Derived Comparison (FDC) system to accomplish these objectives. The NYSE plans to implement FDC in three phases during 1988. The NYSE and the American Stock Exchange report that they have been working closely on these projects with the National Securities Clearing Corporation (NSCC), the Securities Industry Automation Committee (SIAC), and others.

The NYSE intends to amend its rules by May 1989 to require its members to resolve all trades by the evening of the day after trade-date.

B. American Stock Exchange (Amex)

Surveillance Technology

- In 1986, the Amex began in 1986 a broad effort to upgrade surveillance technology. These efforts run the spectrum from on-line, intraday market monitoring to post-trade tools for investigations. In the last year, the Amex has implemented:

  - A new StockWatch system to monitor trade-by-trade activity for comparison versus historic trading patterns.

  - An Amex Trade Information Center (ATIC) for more efficient data gathering for ad hoc investigations.

  - A NewsAlert system that uses voice synthesis to notify market operations personnel of listed company announcements that may require trading halts.

  - A DowScan system that reads all the Dow stories and captures those that are related to Amex listed equity options for later reference by surveillance analysts.

  - A new capability to monitor electronically trading for Rule 193 ("Chinese Wall") violations by firms engaging in specialist activities.

  - Systems to monitor automatically option trading for front running, mini-manipulation, pegging and capping.

- In 1988 and 1989, the development program will expand to include:

  - An expert system that uses artificial intelligence software to analyze potential insider trading market and manipulation cases and estimate the likelihood that a case will eventually result in charges. This will allow surveillance analysts to handle case loads more accurately and productively.

  - An upgrade of ATIC software and hardware to include a relational database and network access to Intermarket Surveillance Group files. This will reduce the amount of time required to build up case information during investigations.

- An OptionWatch system to duplicate for options the services provided by StockWatch for equities.

Specialist Performance

- The Commission is currently considering an Amex proposal that would require that non-regulatory trading halts, or a reopening following a non-regulatory halt, be approved by a Floor Governor or Exchange Official. Currently, only the approval of a Floor Official or, in some instances, a Floor Governor, is required in such situations. The Amex is also considering making the same change for approval of gap openings beyond specified limits.

- In addition, the Exchange is currently considering a mandatory requirement that all specialists prepare a form indicating the pre-halt condition of the specialist's book and any orders represented in the trading crowd prior to and subsequent to any halt in trading. This form would be submitted for the Floor Official's review prior to any stoppage, resumption of trading for gap openings beyond specified limits so that a speedy analysis could be made of specialist pricing, timing and proprietary trading activity. It could be subsequently used by Exchange staff for surveillance purposes. Currently, the use of such forms by specialists is optional.

- The Amex has examined trading in every security traded on the exchange during the market break period. To date, the Amex's review of specialist performance has resulted in the reallocation of two stocks from two specialist units.

Capital Requirements

- The Amex has thoroughly reviewed the current capital requirements for specialists under Amex Rule 171, and is in the process of detailed analytical work on a proposal to its board to increase specialist capital requirements.

- Based on a review of its system of specialist capital surveillance, the Amex concludes that several changes should be made in routine surveillance procedures as well as in monitoring during periods of market turbulence.

  The Amex is intensifying surveillance through the following action:

  - requiring firms' clearing specialist accounts to provide, on a daily basis, standardized account information for specialists and traders. For dual members this would include account statements, or a summary thereof, for trading activity on other

exchanges where they are members. Standardizing the information received and obtaining it for positions other than the Amex will eliminate reporting gaps that currently impede overall evaluation of specialist financial condition;

- requiring daily information from self-clearing specialists who now are subject to monthly reporting. Because most of these specialists are designated to the NYSE for financial oversight, the Amex will develop a plan for obtaining and sharing information on dual members; and

- closely monitoring the effects of increased capital requirements following their implementation to determine whether higher standards create a need for additional capital to maintain a comfortable cushion over early warning levels;

o During times when closer monitoring becomes necessary, the Amex is considering requiring specialists identified as most susceptible to damage to provide daily position and profit and loss estimates shortly after the close of business. The Amex is also prepared to dispatch examiners to review specialists' books and records, on a daily basis if needed, to obtain information not otherwise available.

Market Operations

o The Amex is working with those specialists who have touch screen execution (AutoPer) terminals located behind them to provide space to relocate the terminals in front.

o In addition, the Amex is in the process of redesigning the AutoPer screen to eliminate the need, in some instances, to use an additional page to complete execution of an order. The redesigned screen will permit specialists to execute orders even more quickly and reduce the possibility of having orders printed and being executed out of sequence.

o Finally, a pilot program is underway with respect to the implementation of an electronic book that will provide smoother integration of AutoPer and booked limit orders.

o A committee composed of representatives of the Amex, NYSE and NSCC has been formed to explore the possibility of shortening the comparison cycle with the intent of increasing the amount of time available to process "don't knows" (DKs) and "questionable trades" (QTs) by one full day. The Amex is also developing systems to allow same-day floor-derived points of sale comparison for equities and options. It is well into the design phase of this system

and plans to implement the first stage in the last quarter of 1988.

- As a result of an extensive review of the events of the week of October 19 from an equity comparison standpoint, several proposed enhancements to the NSCC Equity Comparison System are being considered.

Inter-market Trading System

- The Exchange is examining ways to upgrade order delivery systems to improve the capacity of the Amex's systems to execute all orders, including ITS commitments. The Amex, and other exchanges, are in the process of implementing such upgrades, and believe such developments will permit execution, under reasonably anticipated high volume conditions, incoming ITS commitments in a timely manner.

- The Amex specialists generally have used ITS Plan pre-opening application procedures following both regulatory and imbalance trading halts. The Amex would support an initiative by ITS participants to apply uniform pre-opening procedures following both these trading halt situations.

- The Amex supports defining procedures for communication among the exchanges and identifying an ITS contact person in each market who will be available during market emergencies.

Options

- The Exchange has adopted a policy of delisting selected series of puts and calls within an options class when no open interest exists.

- The Amex is considering the possibility of using its authority in the event of another dramatic market break to introduce new strike prices only at levels immediately surrounding the market price of the underlying stock or index. In such situations, as the market in the particular underlying instrument turns around, new strikes could be introduced to fill in the gaps between those added earlier and current levels. The Amex is carefully examining the possibility of modifying its policy in this manner, and plans to discuss it with the appropriate Exchange committees when its analysis is complete.

- The Exchange has a number of proposals currently awaiting SEC approval which will expand the use of the Amex's automated execution system (AutoEx). These proposals include the use of AutoEx in select equity options on a full-time basis. See File Nos. SR-Amex-88-6 and Amex-88-9.

It is the Exchange's intention, upon approval of these proposals, to broaden Registered Options Trade (ROT) participation in a variety of ways, including allowing ROTs to 1) sign on the AutoEx system at any time during the day; 2) choose whether they will participate in either calls, puts or both; and 3) participate on the AutoEx system for more than one option (provided the ROT is able to be considered in the trading crowd for each option).

The Amex is seeking ways in which to improve both the speed and quality of opening rotations.

- The Amex is examining the feasibility of introducing an opening rotation in the Major Market Index that would allow for the opening and free trading of the more actively traded options series in a more timely fashion than afforded by the current system. The more actively traded series are generally the near term months with strikes at or near the money. The proposed rotation would allow for first opening those options which qualify for AutoEx. Immediately upon completing the opening rotation in these strike prices, they would become available for free trading.

- Additionally, the AutoEx system would be turned on simultaneously with free trading. This would allow for all AutoEx qualified orders (currently market orders or executable limit orders of 10 contracts or less) entered via the Amex automated system to receive instantaneous execution.

  The benefits are that more actively traded options would be opened and free traded on a more timely basis. Because of the time reduction, disproportionate changes in opening sale prices and next sale prices should be reduced, and AutoEx would be available sooner than currently possible. If this proposal proves to be more efficient than current methods, the feasibility of using this system floor-wide can be examined.

- The Amex proposes to monitor closely and review option specialists' participation each month, with an increased emphasis on specialists' performance in maintaining tight, liquid markets.

- Despite the difficulties of using traditional performance measures for derivative markets, the Exchange's review of the market break has caused the Amex staff to begin consideration of more formal standards. The Amex believes that such guidelines should be based primarily on quote spread differentials, and that a determination of unsatisfactory performance on this basis should lead quickly

to the imposition of appropriate sanctions, up to and including reallocation.

- The Amex is also considering the feasibility of imposing a modified firm quote policy in options. Under such a policy, option specialists would be expected to disseminate timely quotations markets that reflect actual market conditions with consideration given to supply and demand in the trading crowd. Both of these initiatives must be fully reviewed and adopted by committees and the Exchange Board prior to implementation.

- A special study of the Major Market Index (XMI) specialist and ROT performance for trade date October 20 was undertaken by the Exchange and has been completed.

- The Exchange reviewed and compiled customer complaints and all materials associated with XMI trading, including options journals, cash index values, MMI Futures trading time and sales, component stock data and other relevant documentation. This review involved a number of meetings and a special study regarding volatility in XMI and the Major Market Index generally.

  The Performance Committee determined that a number of put executions -- specifically, those that occurred at a volatility factor exceeding 325 -- were improperly priced, and that, with respect to these executions, the Unit's performance was unsatisfactory. The Committee severely admonished the specialist unit for substandard performance and advised it that any recurrence of inadequate performance in XMI would leave the Committee with no alternative other than to consider strongly reallocation. The Committee instructed the specialist to develop a plan to ensure adequate performance in the future.

- Consistent with the Performance Committee's action, the XMI specialist and member firms representing customer executions that exceeded the volatility factor have been negotiating adjustments. These negotiations are continuing.

- As a result of the October market break, margin requirements for broad-based index options were increased effective November 2, 1987. <u>See</u> Securities Exchange Act Release No. 25081, 52 FR 42751. The Exchange subsequently filed a proposal to increase further the margin on broad-based index options and equity options. <u>See</u> File No. SR-Amex-88-12, noticed in Securities Exchange Act Release No. 25646, May 3, 1988.

- The Exchange believes that margin action dealing with changes in price volatility levels of stocks and indexes

underlying options could be better dealt with if Exchanges were given authority to adjust margin levels above an SEC-approved floor without the necessity of filing for rule changes as is the current practice.

C. National Association of Securities Dealers (NASD)

o The NASD has responded to problems encountered during the market break by proposing a number of initiatives:

- raising the penalty for unexcused withdrawals by market makers from the National Association of Securities Dealers Automated Quotation (NASDAQ) system;

- requiring all NASDAQ/NMS market makers to participate in Small Order Execution System (SOES);

- providing that SOES executions will continue in an Over the Counter (OTC)/National Market system security when quotes are locked or crossed;

- eliminating preferencing of market makers in the SOES when a locked or crossed market exists;

- establishing the Order Confirmation Transaction (OCT) service that will permit firms to access market makers through NASDAQ without voice contact. See Securities Exchange Act Release No. 25263 January 11, 1988, 53 FR 1430 (granting accelerated approval for 90 days.)

o The NASD states that its hotline, which at present can be used to contact 50 of the largest market makers, remains in place and continues to be part of its routine operational procedures, including apprising market makers whose quotes are locked or crossed that they must take remedial action.

o The NASD agrees with the Commission's suggestion that the NASD review with broker-dealers the desirability of establishing diverse lending relationships with a number of banks, as well as the feasibility of obtaining more committed lines of credit than currently exist. The NASD will discuss these suggestions with its members.

o During and after the week of October 19, the NASD expanded the hours of operation of its Trade Acceptance and Reconciliation Service (TARS) which allowed firms quickly to reduce the number of uncompared transactions. See Securities Exchange Act Release No. 25088, November 3, 1987, 52 FR 43141.

o The NASD closely monitored the adequacy of capital of its

member firms during the period of the market crisis to assure their continuing liquidity.

- The NASD has in place a substantial customer complaint investigation program and will investigate and take disciplinary action where appropriate in response to these complaints.

- The NASD agrees with the SEC's suggestion that the SROs accelerate their efforts to generate same-day compared trades, thereby enabling members to know their positions and market exposure before trading commences the next day. The NASD plans an Automatic Confirmation Transaction System that, together with the SOES, Order Confirmation Transaction service, and the on-line TARS, would provide an almost total same-day comparison capability for the NASDAQ market. The NASD also filed, and the SEC approved, a rule change that requires all NASD members to use TARS. See Securities Exchange Act Release No. 25595, April 18, 1988, 53 FR 93370.

- The SEC has granted the NASD the authority to halt OTC trading of NYSE-listed and Amex-listed securities when an important news announcement is made, thus matching the authority of the NYSE and the Amex. Current rules permit the NASD to halt only the dissemination of stock quotations pending a news announcement.

D. Regional Exchanges

Contingency Planning and Information Sharing

- The Pacific Stock Exchange ("PSE") has established a Contingency Planning Task force. The Task Force's primary objective is to improve both internal and external communications when a market disruption occurs. This includes formalizing internal procedures to communicate effectively within the staff and with other markets, the SEC, members and public customers, the news media and the general public. The PSE also sponsored a meeting with the other regional markets on March 28 to discuss, among other things, specialist capital requirements, inter-market trading systems performance, communication linkages and contingency planning for market emergencies.

Specialist Performance

- Four regional stock exchanges, the Cincinnati Stock Exchange ("CSE"), Midwest Stock Exchange ("MSE"), Philadelphia Stock Exchange ("Phlx"), and PSE, have examined individual specialist performance during the market break and have not identified any questionable actions that would require disciplinary actions or reallocation proceedings.

These exchanges note that they have not received any formal complaints regarding specialist performance during the market break.

- The Boston Stock Exchange ("BSE") is currently investigating one matter that relates indirectly to the market break.

- Individually, the MSE supports the development of objective, relative standards to evaluate specialists and will be filing with the Commission, in the near future, a new set of criteria for specialist evaluation based on a relative standard of performance.

- The PSE is currently examining the market making obligations of regional specialists and has agreed to explore this issue with each of the other regional markets.

Improved Systems

- The BSE does not currently have an automated routing and execution system. The BSE, however, is in the process of developing the BEACON system -- Boston Exchange Automated Communications and Order-Routing Network. The BSE expects that when BEACON is in place it will be able to process at least 10 million shares per day, which is approximately three times the BSE's current average daily volume. The BSE expects the BEACON to be fully operational by year end.

- The CSE has been in the process of implementing major hardware and software improvements to its trading system to accommodate volume surges and higher volume levels. The CSE states that the implementation of these enhancements is progressing expeditiously at this time and should increase capacity by approximately 50%. The CSE believes these enhancements will enable it to process volume such as occurred during the week of October 19 without any problem or delay.

- The MSE has increased the capacity of its automated order execution system (MAX) system from 36,000 trades per day to 54,000 trades, a 50% increase, since the market break. According to the MSE, this increase means that, assuming a normal mix of orders, its system could process, with no delays or problems, the volume of orders experienced during the market break. Additional changes are being implemented through June 30, 1988, that will increase capacity further to 60,000 trades. The MSE also has developed a "performance management measurement methodology" to improve MSE capacity forecasting and obtain increased capacity with their

current systems on an as needed basis. Both staff and software tools have been added to implement this program throughout 1988.

- The Phlx estimates the capacity of its automated order execution system (PACE) has been increased from approximately 12,500 orders per day to 17,000-17,500 orders per day since the market break. The Phlx states that further enhancements that are expected to be in place by June 1988 should increase system capacity to over 20,000 orders per day without queuing. The Phlx also has accelerated its plans to replace its current computer system for PACE by year end. The Phlx estimates this change will increase capacity to 40,000 orders per day and will allow the Phlx to handle its anticipated share of volume on an 800 million to 1 billion share day. Further, when its new computer system is in place the Phlx believes it will be able to increase capacity to accommodate volume surges with less than 24 hour turnaround time. The Phlx conducted a series of tests on PACE's capacity after these improvements were made.

- The Phlx has also made modifications that permit automatic reporting to continue when the automatic execution feature of the system is disengaged. This will allow the Phlx to switch to manual execution of orders, which was done on October 20-22, without encountering the reporting delays that occurred at that time.

- The Phlx has also increased the capacity of its CENTRAMART System, which processes incoming quotation and transaction information, by approximately 20% since the market break. By year-end, computer enhancements should increase CENTRAMART capacity to the 800 million to 1 billion share level and allow additional capacity to be added quickly when needed.

- The PSE states that it has doubled the capacity of its automated execution system (SCOREX) since the market break to 50,000 messages per day. "Messages" would include incoming orders, order status report requests, and order cancellations. On October 19 and 20 SCOREX received 47,000 messages per day. The PSE achieved this increased capacity primarily by adding two additional data communications lines between the San Francisco and Los Angeles trading floors, which expanded capacity of this component of the system by 50%. The PSE believes that with this increased capacity it would now be able to handle the volume levels experienced during the October market break without problems. The PSE notes that further enhancements still underway, such as the elimination of unnecessary trade and quote data received from SIAC and the possible addition of two communication

processors, should provide reserve capacity to accommodate even higher volume levels. Finally, the PSE expects that its on-going computer replacement project, to be completed within the next two years, will increase capacity to 100,000 messages per day. On March 5, 1988, the PSE conducted a test of SCOREX capacity. The PSE has hired an independent consultant to examine and verify the test results.

ontingency Plans for Dealing with Unusual Volume

- The BSE has stated that once it has implemented the BEACON system, it also will create a back-up system. As to training, floor operations personnel currently trained to supplement floor brokerage functions will also be trained in the BEACON system. The BSE non-floor personnel also are trained in a variety of clerical floor functions.

- The CSE has upgraded its staff with more qualified employees to improve overall competence. The CSE also notes it is continually reviewing and upgrading the quality of its back-up systems.

- In 1988, the MSE intends to improve back-up capabilities including a communications link between the MSE and large member firms and service vendors. Further back-up capabilities are being planned for future years. The MSE is also developing a contingency capacity fall back plan for 1988 that will identify any non-essential MAX activity that could be eliminated during unusual volume surges to accommodate more volume.

- The MSE also has developed a program to train upstairs personnel to supplement floor staff in "volume breakout situations." The staff will be trained in Trade Input and MAX customer interface functions. The MSE procedures provide for the additional staff to be on the trading floor within 15 minutes when needed.

- The Phlx believes that it currently has adequate back-up personnel at all levels including data processing, operations and marketing/customer communications. In addition, the Phlx notes that the PACE system will have two important back-up systems when the computer changes noted above are implemented by year end. First, all computer functions will be performed in duplicate and cross-checked so that any system breakdown will be detected immediately. Second, because the new computers are modular, additional temporary capacity can be added within a day.

- The PSE is refining its contingency plans to re-route orders manually to floor booths if its other enhancements prove

insufficient at a particular time. The PSE also has formed a working group to plan the training of staff to meet the requirements of market disaster, such as providing relief for regular staff. A list of former options staff who have assumed other responsibilities at the exchange is regularly updated and these employees will be receiving refresher courses. Other staff will be trained in equities floor operations and receive regular training updates to supplement the equity floors when needed.

Improved Communications with Retail Firms

- The BSE intends to notify the BEACON users of delays and other system problems through administrative messages, supplemented by direct contact with member firms. In addition, the BSE has recently appointed a new officer who, among other things, will be responsible for improving communications with member firms.

- The CSE has made certain improvements, including a direct line to retail firms, to expedite communication concerning system problems and delays.

- The MSE recently has implemented procedures to shorten the amount of time it takes to notify retial firms of problems or changes to MAX by both administrative message and telephone. Under the procedures, the MSE will first notify firms of problems, delays or changes to MAX through administrative message and will follow-up with phone calls to the firms.

- The Phlx has developed procedures to ensure there is adequate notice to PACE users and Phlx marketing personnel of any changes to system execution parameters.

- The PSE currently is upgrading and formulating its current procedures for contacting retail firms when system operational problems or delays occur. The PSE will also be notifying SCOREX users that during periods of extremely heavy volume the automatic execution feature may be disengaged to enable additional "throughput". Both firms and the SEC would be notified prior to any actual disengagement of the automatic execution features.

Improved Coordination between Exchanges Concerning Problems with Small Order Systems

- The CSE states it is committed to timely communication, by both telephone and administrative message, with other markets on problems with CSE systems.

- The MSE has implemented the procedures necessary to use the ITS broadcast administrative message capability at the SIAC to notify other Exchanges of problems or shut-down of small order systems, as agreed upon with the other exchanges.

- The PSE is contacting other exchanges to explore the development of better communications among the markets during a market break. The PSE believes better SRO communications and coordination of activities for the benefit of the market as a whole would be particularly beneficial concerning the exchanges' automatic execution systems.

Intermarket Trading System Improvements

- The exchanges unanimously agreed that developing pre-opening procedures that would apply after order imbalance halts was of great importance to the efficient operation of ITS. Several exchanges noted that they would initiate the proposal at the next meeting of ITS representatives.

- At the last ITS Operating Committee meeting in early February, the communication issue was discussed and all exchanges agreed to designate the operating committee member as the contact person for each exchange. The contact person in turn was to designate a back-up person and communicate the information to the other participants. Furthermore, each participant is to provide current names and phone numbers for key members familiar with ITS operation and policy.

- The CSE further recommended that the ITS Operating Committee identify certain situations that adversely impact the effective operation of ITS and develop procedures for decision-making in such situations.

Specialist Capital

- The Phlx, MSE and PSE are currently reviewing the adequacy of their respective specialists' capital.

- The BSE, effective December 31, 1987, increased specialists' equity capital requirements from $80,000 to $100,000 and effective June 30, 1988, will increase the requirements to $125,000.

- The MSE is studying requiring specialists to file financial reports on a more timely basis (from quarterly to monthly for self-clearing specialists and from annually to quarterly for introducing specialists). The MSE is developing a mechanism to review specialists' inventory positions on an intra-day basis, rather than on an overnight basis only.

- The PSE believes that its existing procedures worked effectively during the market break. The PSE is reviewing specialist capital surveillance systems to determine if they capture in a timely manner all the desired information for adequate monitoring. Based on the current status of the review, it appears that some modifications to the current daily reports and monitoring process will be implemented.

- The MSE and the Midwest Clearing Corporation (MCC) are reviewing the possibility of imposing higher capital requirements on self-clearing specialists firms.

- The PSE will consider whether to require higher capital for specialists that do not have bank credit lines.

- The CSE states that requiring lines of credit or higher capital requirements for dealers without such accommodations is an issue that needs further review. The CSE will soon file a proposed rule change that will establish an optional minimum net liquidating equity requirement for those dealers who do no customer business and maintain letters of guarantee with CSE clearing members.

Options

- The Phlx and other OPRA participants have worked and will continue to work with vendors to address current capacity problems, plan for future capacity expansion, increase message capacity, and devise contingency plans for potential future problems.

- The Phlx received SEC approval to implement its options order routing system, the Automatic Options Market System, as a 90-day pilot program, on March 31, 1988. See Securities Exchange Act Release No. 25540, 53 FR 11390.

- The PSE indicated that present margin levels, for index and equity options, may not be adequate as permanent standards and expressed its willingness to join other exchanges and the SEC in further reviewing margin levels. The PSE submitted a proposal to increase index and equity option margin requirements that was noticed in Securities Exchange Act Release No. 25666 May 5, 1988.

- The Phlx notes that it currently is working with the other options exchanges to value the adequacy of stock and index option margin levels. The Phlx concludes from a preliminary review of trading data that current margin levels are adequate to ensure credit worthiness and performance of obligations even during periods of increased market

volatility on the scale of last October. According to the Phlx, serious consideration should be given, however, to whether current margin levels are adequate to avoid excess speculation or curb excess market volatility. The PSE submitted a proposal to increase index and equity option margin requirements that was noticed in Securities Exchange Act Release No. 25679 May 9, 1988.

E. Chicago Board Options Exchange (CBOE)

Circuit Breakers

- The CBOE is considering policies to limit the addition of new strike prices for both stock and index options during periods of extreme volatility. In particular, the CBOE would limit new series to those necessary to bracket the prevailing index value or underlying stock price and to a limited number of new series farther in- or out-of-the-money. The CBOE believes that further study is required to define the scale of market volatility that would trigger implementation of this policy and to determine appropriate emergency strike price increments.

Systems

- The CBOE is evaluating methods to ensure high levels of market maker participation in its automated execution system (RAES) during volatile periods. Efforts are focused on reducing disincentives to continued participation in RAES and establishing sanctions for leaving the system. To that end, the CBOE has submitted a proposed rule change that will give the CBOE authority to require market maker participation in RAES in designated equity options classes and in the Standard & Poor's 500 index option (SPX) through the next following expiration. See Securities Exchange Act Release Nos. 25620 April 27, 1988 and 25621 April 27, 1988.

- The CBOE has recently submitted a proposed rule change to clarify that market maker performance includes participation in and support for Exchange-sponsored automated programs, including RAES and Auto Quote. See Securities Exchange Act Release No. 25570 April 11, 1988.

- The CBOE has communicated with vendors that experienced capacity problems during the market break and has advised them to delete less active option series as necessary.

- The CBOE has been reviewing its opening rotation procedures since last October. Since December, the Standard and Poor's 100 index options (OEX) opening has been informally modified by dividing OEX series into three groups that are opened separately and simultaneously. See Securities Exchange Act

Release No. 25627 April 29, 1988. According to the CBOE, these procedures, combined with recent low volume and volatility levels, have resulted in opening rotations of not longer than 10 to 15 minutes. In February, the CBOE Board of Directors approved in principle a plan to divide OEX into seven zones, six of which would be opened simultaneously with one or more lead market makers charged with establishing opening prices and facilitating imbalances. The CBOE is working with Commission staff to develop an exchange rule filing that would implement this measure.

- The CBOE also received approval from the SEC of a proposed rule change providing that trading may be halted and the opening rotation in index options delayed when unusual market conditions exist. See Securities Exchange Act Release No. 25600 April 19, 1988, 53 FR 13458.

- The CBOE also has plans to test hand-held radio communication terminals that would enable trade data input and comparison to be accomplished at the time of the trade. The current system compares trades in the evening after trading closes.

Market Maker Performance

o The CBOE's Market Performance Committee is examining the adequacy of the CBOE's rules relating to market obligations. In particular, the CBOE is examining its policies respecting modification of these rules during unusual market conditions. The CBOE is focusing on determining which rules should be waived during unusual market conditions and whether back-up rules should be imposed to ensure that orders are handled fairly and efficiently during market stress periods.

o A special panel of CBOE members and persons associated with CBOE members firms has reviewed October 20, 1987 OEX pricing. The panel report characterized options pricing on the morning of the 20th as "extreme but understandable in light of the chaos and extreme volatility then prevailing in all markets." The CBOE notes that as a "goodwill gesture" it will make refunds to member firms based on the difference between the premiums actually paid by public customers for certain November OEX options during the market break and the prices they would have paid if premiums had been based on an implied volatility of 300. The total amount to be paid (approximately $1.2 million) will be recovered by assessing a voluntary fee of $.01 per contract on market makers' future OEX transactions. As a result of a number of customer and member firm complaints, the CBOE regulatory staff also is reviewing market maker performance during the

market break, with special emphasis on October 30. The CBOE expects to complete this review in the near future.

Margin Levels

- The CBOE has been reviewing the adequacy of index and equity option margin levels and suitability standards in consultation with major retail firms, other options markets, and the Commission. At its February meeting, the CBOE Board of Directors decided to retain the current "Premium plus" margin methodology and to increase the "add-on" component of such margin calculation from 10 to 15 percent for index options and from 15 to 20 percent for equity options. The minimum margin for out-of-the-money options (both index and equity) would be increased to 10 percent. The CBOE proposes to conduct more frequent monitoring of the adequacy of these margin levels. The CBOE is also considering imposing a minimum equity requirement for accounts approved to write naked short options, straddles, and combinations. These minimums could be established as part of additional suitability guidelines, which currently are under review by the CBOE and other options exchanges. The CBOE filed proposals to increase margin requirements for index and equity options that were noticed in Securities Exchange Act Release Nos. 25552 April 7, 1988, and 25600 April 21, 1988.

F. Options Price Reporting Authority

- Within two or three days of the market break most vendors had expanded their files sufficiently to make their systems current with each exchange as to all existing options series.

- Representatives of the Options Price Reporting Authority (OPRA) Technical Committee immediately began to design system modifications that will allow the announcement of new series through computer formatted messages. Such modifications will in turn enable vendors to implement computer programs to automatically add these new series to their systems, eliminating the time-consuming and error-prone process of transcribing the administrative messages that is currently used. The Committee reached agreement on the message type at a meeting on December 9th, and implementation of the system modifications is expected to be completed this summer.

- An arrangement has been decided upon whereby OPRA will regularly update the vendor/user committee of the

Information Industry Association on volume and capacity projections to assist the vendor community in its efforts to have facilities keep pace with growth and provide for unexpected spikes in activity.

G. Clearing Agencies

- The National Securities Clearing Corporation (NSCC), Depository Trust Company (DTC) and the Options Clearing Corporation (OCC) support the reconvening of the Monitoring Coordination Group (MCG) for purposes recommended in the SEC Report. The NSCC further has suggested, among other things, that: (1) each participant provide to the Commission in advance of the first meeting a list of areas where the events of October 1987 might have shown improvement as a result of better inter-clearing agency and Designated Examining Authority (DEA) cooperation; (2) each participant provide the SEC with an emergency call list that it will update; and (3) the MCG be chartered, provided an administrator, required to meet at least quarterly and provide annual reports to the SEC. The MCG met at the SEC on April 26, 1988, and agreed to meet again in Chicago on May 25, 1988.

- The NSCC has analyzed daily marks-to-the-market of guaranteed trades prior to settlement in connection with its earlier trade guarantee. The NSCC believes that daily marks would pose financial difficulties for NSCC members, because NSCC members would be required to fund those marks themselves for customers that customarily are not required to pay for securities until delivery under "delivery versus payment" arrangements. The NSCC is enhancing its ability to monitor and collect marks by establishing daily computerized reporting of parameter breaks that will be available within two to three months. If a parameter is crossed the NSCC will collect an immediate mark from the member through an increased clearing fund deposit.

  The NSCC and DTC indicate that the idea of cross-liens on joint assets of clearing agencies is worth exploring further. The NSCC suggested bringing the matter before the MCG, and the DTC advised consultations with bankruptcy experts on possible legal ramifications. The OCC intends to study the concept of cross-liens as part of its Special Study of the OCC's systems.

- As a general matter, the OCC has undertaken a special study of its systems, which will include eight broad areas for review, including those identified in the SEC Staff's Report. The objective of the OCC's study is to identify any structural weaknesses or areas that can be improved. The OCC's margin committee has commissioned a sub-committee,

including margin committee members and industry representatives, which will complete the study over the next three months.

- As part of the special study noted above, the OCC will address, among other things, the failure of H. B. Shaine and Company. While the OCC believes its margin and concentration monitoring systems worked well during the October market break, it also believes further examination is warranted, particularly where concentrations exist in the form of uncovered short positions and directly affect the financial strength of a member.

- The OCC has been considering increasing its net capital requirements and will analyze the costs and benefits of such increases as part of its study. Although the OCC believes that strengthening its capital requirements could provide significant risk reduction benefits, the OCC notes that currently its monitoring system recognizes an OCC member's net capital as a limiting factor in the amount of risk a member can pose to the OCC.

- The OCC has improved the process by which intra-day variation margin calls are issued. System enhancements have shortened the time needed to issue calls from an original 30-45 minutes to a maximum of 15 minutes. The OCC has also shortened the time for delivery of debit instructions to clearing banks. The OCC also is investigating the possibility of automating the transmittal of call instructions to clearing banks, which, if effected, would further reduce the time needed to issue calls.

- The OCC believes that its monitoring system worked extremely well during the market break. The OCC, however, intends to review its monitoring system as part of its study. The OCC also believes that improvements should be made in the sharing of information among the OCC and commodities clearing organizations. Currently, the OCC is negotiating an agreement whereby the OCC would join commodities clearing organizations in a centralized system that would collect and disseminate pay and collect information concerning firms that belong to multiple clearing organizations.

- The OCC agrees that improvements should be made in the options money settlement process and recently has discussed this subject with several OCC clearing banks. The OCC, among other things, has: (1) begun investigating whether banks can be given earlier notice of settlement instructions; (2) completed startup of providing facsimile notification of settlement instructions with one clearing bank; and (3) undertaken an examination of banking and legal issues concerning the OCC's ability to make timely payment

to members in the event of default or delay by other members, including examination of the OCC's use of its clearing funds and bank lines of credit.

- The OCC supports expanded use of its pledge program and believes greater use of that program could improve liquidity. The OCC notes, however, that it is in the process of requesting the Federal Reserve Board to consider expansion of current regulations concerning loan values of options positions. The OCC also states that it would be willing to explore with the DTC whether combined reports covering options and securities positions could be provided to banking institutions.

CFTC Oversight:

Chicago Mercantile Exchange (CME)

Chicago Board of Trade (CBT)

New York Futures Exchange (NYFE)

Kansas City Board of Trade (KCBT)

Clearing Agencies

Actions by Exchanges and Clearing Agencies--Financial Integrity of Futures Markets

- Since October 19, 1987, the CFTC has monitored the actions of futures exchanges in response to its post market break recommendations. The actions summarized below, which include actions responsive to the CFTC's recommendations as well as independent actions of the SROs, should enhance the financial security of the futures markets, particularly in periods of high volatility, and advance related objectives, such as increasing the efficiency of and coordination among clearing and settlement facilities.

- Margin pay and collect data-sharing system. In accordance with previous CFTC staff recommendations, as of October 21, 1987, all futures exchanges and clearing organizations had entered into a formal agreement for the routine, electronic exchange of margin pay and collect data with respect to dual and multiple clearing members. The system is now operational for 90 percent of futures market volume. Planned enhancements include securities options premium data from the OCC, securities data from the NSCC, and surplus margin data.

- Clarification of contractual relationships between clearing organizations and clearing banks. Meetings have been held

among the interested parties and regulators. The Chicago Mercantile Exchange (CME) Clearing House, the Chicago Board of Trade Clearing Corporation (BOTCC) and the OCC are currently reviewing draft agreements designed to afford additional clarity and standardization in this area.

- <u>Measures to increase, as appropriate, the security afforded by the margin system against aberrant price spikes and extreme volatility</u>. In accordance with the CFTC recommendations to review margins, CME margins on the Standard & Poor's 500 futures contract have been increased to $19,000 speculative initial margin ($10,000 maintenance margin and initial hedge margin). The CME also has established a policy of resetting its initial speculative margins for stock index futures to approximately 15 percent of the value of the contract on a quarterly basis. Chicago Board of Trade (CBT) margins on the Major Market Index (MMI) futures contract have also been increased, to $15,000 initial speculative margin ($10,000 for maintenance margin and for hedge positions).

  - The CME Clearing House has taken a number of measures to enhance its security and liquidity. The Clearing House is in the process of acquiring a $250 million line of credit to be used in the event of a clearing firm default. The CME has also adopted a rule change to increase clearing members' security deposits (which are standing security in addition to margin deposits). The rule is designed to increase the available pool of security deposits from $4.5 million to $42 million. The CME also has a common-bond system that provides for the allocation among its clearing members of any loss to the Clearing House caused by a default. The aggregate capital of all Exchange firms is approximately $17 billion.

    The CME has also adopted rules requiring the parent company of a CME clearing member to guarantee losses on non-customer positions carried by such clearing member.

  - The CME has proposed a rule change to impose additional financial requirements on clearing member firms maintaining 16 or more branch offices or a combination of 32 or more branch offices and guaranteed introducing brokers. As of May 6, 1988, each CME member firm is required to have at least two memberships in each CME division, or a total of at least six memberships.

  - The CME has submitted a rule proposal designed to establish a margin system for option positions that more effectively identifies positions that carry

greater risk and should, therefore, incur higher margins. This new option margin system, which was submitted to the Commission in early February, is currently under review. The BOTCC has also taken action with regard to option margins, increasing the amount of margin collected for deep out-of-the-money options.

- o <u>Standardized margin deposits</u>. In January 1988 the CME conformed instruments considered acceptable as margin with other major U.S. clearing organizations by accepting U.S. Treasury notes and bonds in addition to Treasury bills for margin deposits. This should reduce the possibility of financial gridlock by expanding what is acceptable as margin.

- o <u>Increased use of intra-day margin calls</u>. The CME has adopted a rule amendment to facilitate implementation of a new policy of its Board of Governors to make intra-day margin calls on a daily basis when a specified dollar threshold is crossed and to pay out gains as well as collect payments for losses on an intra-day basis. In March 1988, the CME began making routine intra-day calls for settlement variation. The CME procedures for intra-day collection and payment of variation margin now provide for issuance of intra-day calls for settlement variation to any clearing member owing more than $500,000 and for intra-day payments of up to 80 percent of gains when $1 million or more is owed a clearing member.

  - The CME and BOTCC have now coordinated intra-day pay and collect procedures. The CME is holding discussions with the OCC in order to further standardize procedures.

  - The BOTCC, which had a pre-existing policy of making routine intra-day margin calls based on the open interest at the previous day's close, adopted additional margin collection procedures following the October market events to enhance its margin collection process. Under these new procedures, the previous evening's trades and all trades submitted to the BOTCC by approximately 1:30 p.m. each day are matched, and appropriate variation margins are collected by 2:30 p.m. each day on all open positions as of 2:00 p.m. In addition, the BOTCC established procedures to ensure that afternoon variation margin payments are paid to a clearing member only if the clearing member's required margins, based on intra-day positions, are sufficient to cover the newly calculated risk of those positions. These rules have helped to make it easier to handle

high volumes of margin flows on volatile days since October.

- Enhanced clearing and settlement bank financial data. The CME has organized a roundtable discussion forum to facilitate better coordination, information-sharing, and contingency planning among participants in clearing settlement processes. Members include representatives of the BOTCC, OCC, Federal Reserve Bank of Chicago, CFTC, SEC, the four clearing banks used by the BOTCC and the CME Clearing House, NSCC, the DTC and New York settlement banks. Two meetings have been held thus far, and additional meetings are planned.

  The CME also hosted a meeting on Friday, March 25, 1988, for financial surveillance staff representing the CBT, BOTCC, the NASD, NFA, NSCC, the International Securities Clearing Corp., the CBOE, Amex, OCC, KCBT, and the NYSE.

  Among other things, participants reviewed what additional information should be shared routinely and during emergencies and discussed the CME's existing audit plan for emergency situations. The NYSE hosted the next meeting of this group.

- Integration of market and financial surveillance data. The CFTC staff recommended that futures SROs, all of which now have large-trader reporting systems, give priority consideration to enhancing their computer systems to integrate large-trader data into their financial surveillance systems on an automated basis. In response to these recommendations, a number of SROs stated that they either had such systems or would consider program enhancements to do so. For example, the BOTCC reported that it currently has such a system and the CME Clearing House has since augmented its risk management procedures to refine it surveillance data.

- Clearing member capital. The CME has stated that it intends to enhance the security of its Clearing House by establishing additional minimum capital prerequisites for membership in the CME Clearing House.

- Trading capacity. Most futures markets appear to be capable of clearing twice the number of transactions that they currently clear. For example, as a result of recent enhancements to their computer capability to meet the Commission's audit trail requirements, the Chicago exchanges (CME and CBT) have clearance systems capable of handling as much as two and one-half times the current number of transactions. The exchanges monitor the volume of transactions throughout the day, and if there are

indications of heavier-than-usual volume, emergency procedures can be put into effect. These procedures are generally designed to ensure that clearing firms submit trade data to the clearing organization more quickly throughout the day to process the increased volume on a timely basis. Longer processing hours by the exchanges and the clearing firms may also be required in such circumstances.

Most New York futures exchanges also have the capacity to handle above-average volume.

The largest New York exchange, in terms of volume, the New York Mercantile Exchange (NYMEX), has experienced significant growth over the last few years, almost doubling its volume on a year-to-year basis. The NYMEX average volume is approximately 130,000 contracts per day so far this year. The exchange has previously handled 300,000 contracts in a single day and is working towards being able to accommodate as many as 1 million contracts per day. NYMEX also plans to implement an on-line system later this year which will allow brokers to verify and correct the details of trades during the day.

The Commodity Exchange, Inc. (COMEX) is in the process of implementing a new clearing system which, when implemented, should increase its ability to handle high volume.

In a continuing effort to further improve the processing of orders at the exchange level, the CBT has funded and is actively working to implement an automated order entry system that would permit orders to be entered electronically from terminals at member firms and quotation vendors. The CBT expects to introduce the system next year.

- Circuit Breakers. On October 19, 1987, there were no price limits in effect for any actively traded stock index futures contract. By October 23, however, the CME, NYFE, and KCBT, by emergency actions, had put into effect price fluctuation limits for their actively traded stock index contracts. The fourth exchange with stock index futures trading activity, the CBT, did not implement limits on an emergency basis. Subsequently, the CFTC approved permanent limits for the CBT's, CME's, and KCBT's actively traded stock index contracts. More recently, both the CME and CBT proposed further rule amendments that were approved by the Commission in February 1988. (The emergency action taken by NYFE in mid-October regarding price limits expired in January, and no permanent rules have been implemented to replace those limits for the NYSE Composite futures contract.)

On March 29, 1988, the CFTC approved CME rules establishing opening range price limits in the Standard & Poor's futures contract. Specifically, the rule provides that there shall be no trading during the opening range of 10 minutes at a price more than 5.00 index points above or below the previous day's settlement price. In addition, the rules provide for a two-minute trading halt under certain circumstances.

The CFTC also approved the CME rules to provide for a trading halt in options on the Standard & Poor's 500 futures contract when the Standard & Poor's 500 futures contract is limit bid or offer at the opening range price limit; or trading in the futures contract has been halted as set forth above.

- Trade Practice Review. The CME has participated in various ISG matters over the last three years. Recently, there have been three special meetings at which the focus has been on inter-market abuses, including frontrunning, between the futures and security exchanges. These discussions are ongoing to enhance inter-market surveillance efforts.

  - The CME recently indicated expressly that its existing rules would prohibit a member from frontrunning a customer's securities or options order in futures or option equity index contracts. On May 4, 1988, the CME Board reviewed a draft of this interpretation in written form, and intends to solicit comment thereon from its members shortly.

  - Inter-market meetings also have been held to improve coordination and communications among the various related exchanges in the area of trading and market information. The first such meeting occurred on Wednesday, February 24, 1988, at the NYSE; the second one took place at the CBOE on Thursday, March 25, 1988; and the third occurred on Tuesday, May 3, 1988, at the Pacific Stock Exchange. The purpose of these meetings is to:

    - Enhance the type of information that the NYSE disseminates regarding the percentage of stocks open, those in which trading has been halted or delayed, bid/ask indications, etc.

    - Establish an inter-exchange hotline linking the various trading floors and board rooms for the exchange of non-standard information;

    - Identify what other types of information should be exchanged among the various parties; and

  - -- Improve and standardize the manner in which financial data is displayed.

- The entities represented at these meetings include the Amex, CBOE, CBT, MSE, PSE, Phlx, NASD, KCBT, NYSE and the CME.

APPENDIX F

Working Group on Financial Markets

Participants

U.S. Department of the Treasury

George D. Gould
Charles O. Sethness
Michael R. Darby
Robert B. Zoellick
Gregory P. Wilson
Dallas S. Batten
Gordon Eastburn
Mark G. Bender
Gerald B. Hughes
Angelo Mascaro
Juhan Jaakson
Brian S. Tishuk

Federal Reserve System

Alan Greenspan
E. Gerald Corrigan
Donald Kohn
Michael Prell
Thomas Simpson
Martha Scanlon
Patrick M. Parkinson
Mark Warshawsky
Patricia White
Steven G. Thieke
Christopher McCurdy
Betsy White

Securities and Exchange Commission

David S. Ruder
Alden Adkins
Richard G. Ketchum
Brandon Becker
Mark D. Fitterman
Jonathan Kallman
Kenneth Lehn
Jeff Davis
Sandra A. Sciole

Commodity Futures Trading Commission

Wendy Gramm
Andrea Corcoran
Paula Tosini
Robert Mackay
Susan Ervin
Eugene Moriarity

Support Staff Provided by the U.S. Treasury Department

Linda Johnson
Betty Hunt
Annabella Mejia
LaSean Hudgens
Nancy Hawkins

U.S. GOVERNMENT PRINTING OFFICE : 1988 O - 213-632

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED

Remarks by
The Secretary of the Treasury
James A. Baker, III
on The Role of Economic Policies
in Improving the Prospects for Global Growth
at the OECD Ministerial
Paris, France
May 18, 1988

Chairman Feldt, Secretary-General Paye, and Distinguished Colleagues:

This morning's agenda topic -- the pursuit of economic policies to improve global growth and employment -- is basically a job description for Finance Ministers around the world. It poses the fundamental question we should ask ourselves: What policies should we pursue in order to strengthen our economies and improve the well-being of our citizens?

As the world economy becomes more integrated, our success as Finance Ministers in fulfilling our job descriptions increasingly requires a cooperative approach. Major changes in the global economy have intensified the need for economic policy coordination among the leading industrial countries. In particular:

- o The globalization of financial markets has reduced the independence of domestic policymakers.
- o The liberalization of international trade and investment has increased the importance of the external sector in all countries.
- o Finally, the greater balance in economic size among the major countries requires that effective external adjustment be a shared responsibility.

Clearly we need an ongoing process to promote a convergence of policies and performance that can benefit all. The coordination process developed since the Plaza Agreement -- endorsed and reinforced at the Tokyo and Venice Summits -- is designed to meet this need. It seeks to promote a sound world economy and stable international financial system. It seeks the adoption of compatible, consistent, and mutually supporting policies by seven of the major industrial countries.

The process has been developed on a step-by-step basis over the last 2-1/2 years. And we are about to take another step forward -- with the agreement to use a commodity price indicator as an additional analytical instrument in our coordination effort.

The agreements of the G-7, I believe, have provided the framework for important efforts and positive results:

- The United States reduced its federal budget deficit by $71 billion in the last fiscal year. That drop is equivalent to almost 2 percent of GNP. The general government deficit -- including state and local governments -- fell to only 2-1/4 percent of GNP in 1987, a figure below the OECD average.

- Furthermore, the unique Budget Summit Agreement between the President and the Congress guarantees a $76 billion, two-year package of budget savings in FY 1988 and 1989. We expect further deficit reductions in future years, with the federal deficit down to less than 2 percent of GNP by FY 1990. We have also avoided protectionism, despite strong political pressures.

- Japan has pursued a set of monetary and fiscal policies including last year's important six trillion yen stimulus package, resulting in the sharpest domestic demand growth of the industrial countries. This growth, coupled with efforts to open its markets more fully to imported goods, is helping to reduce external imbalances.

- The United Kingdom has put into place a major tax reform which includes a big reduction in marginal income tax rates.

- Germany has adopted special supports for investment and has formulated an important medium-term tax reform program.

I believe that these and other coordinated efforts will help reduce external imbalances and promote low-inflation growth. Indeed, since our meeting last May we have been given solid grounds for optimism. To illustrate:

- The financial turmoil last October, of course, was a source of concern to us all. But in fact real GNP in industrial countries grew faster in the second half of 1987 than in the first half. Clearly, the strength of our expansion was underestimated. Now we are seeing a new optimism about 1988 growth prospects.

- Moreover, the volume of world trade grew by over 5 percent in 1987, the highest rate since 1984. Exports of non-oil producing developing countries rose 10 percent in volume terms -- and that helped their real GNP grow by 4-1/2 percent.

- o In addition, reductions of external imbalances have begun in the largest industrial countries. In the United States, real exports rose 18 percent in 1987, while imports were up only 7 percent. And, we expect that U.S. nominal dollar trade and current account deficits will decline this year, as reflected by the results for the month of March which were announced yesterday.

- o Progress continues to be made in other countries as well. Japan's trade surplus, as a share of GNP, peaked in 1986 and has come down steadily since; Germany's stabilized last year and is expected to decline in 1988.

Remaining Challenges

Lest I be charged with having rose-colored glasses, I want to emphasize that we still have important work to do. While the near-term economic situation looks encouraging, we need to maintain this momentum in the medium-term. We must act to sustain growth, reduce external imbalances, and provide a good environment for economic development and amelioration of international debt problems.

The OECD has recognized the need for structural reforms to complement sound macroeconomic policies. In February 1984 it sponsored a Mini-Ministerial focused on how structural adjustment can reduce barriers to growth. Such rigidities prevent market signals from being translated into economic responses by labor, business, and consumers. They prevent or slow the rate of adaptation to new economic conditions and business environments. We must all commit our governments to policies that unshackle our economies.

Many of us have already significantly reduced barriers that inhibit the flexibility of our economies. Tax reform for individuals and businesses has become a widely accepted policy in OECD countries. Marginal income tax rates have been significantly reduced in many countries and modestly cut in others. Incentives to work, save, and invest are being created through positive governmental actions.

Financial deregulation is also spreading. The United Kingdom and Canada, with their "big" and "little" bangs have led the way. Others are following suit. In the United States, we are seeking to expand on the significant deregulation that took place several years ago. The Congress is now rethinking the law that separates our banking and securities businesses. The Senate has passed a bill which would substantially revise the Glass-Steagall Act. Our Administration strongly supports this long overdue move to modernize our financial system.

We also recognize the need to strengthen savings in the United States. Therefore, we were encouraged by the rise in the household savings rate to 4-3/4 percent in the fourth quarter of last year. The rate remained above 4-1/2 percent in the first quarter. That is an increase from 3-1/2 percent earlier in 1987 and 4-1/4 percent in 1986.

European countries have made some progress in freeing up labor and capital markets and in reducing the burden of regulation on business. But much more needs to be done to reduce high unemployment and generate higher growth without inflation.

Japan's progress in creating more competitive and efficient capital markets has been notable. But more action is needed to reduce remaining rigidities and ensure greater world access to Japanese financial markets.

The Role of the NICs

The newly industrializing countries of Asia must also participate more fully in the external adjustment process. Their external surpluses, particularly in the case of Korea and Taiwan, are impeding the adjustment of global imbalances and adding to protectionist pressures. Significant structural changes are required to improve the balance between domestic and foreign demand.

Specific reforms are required in the areas of exchange rates, trade, taxation, deregulation, investment, and capital market access, particularly in Korea and Taiwan. These changes are in the long-term best interests of those countries. The changes are also necessary if they are to assume a degree of responsibility for maintaining the international trading system that is commensurate with their own rapidly growing economic strength.

Cooperation in Trade and in Science and Technology

In addition to these tasks, preserving an open trading system is crucial in today's interdependent world. To achieve greater trade liberalization, particularly in agriculture, we strongly support the work of the Uruguay Round and are committed to working toward a successful round. All countries, however, are responsible for the ultimate success of the round, not simply the industrial nations.

I want to take a moment to bring your attention to the policy recommendation to member states on a "General Framework of Principles for International Cooperation in Science and Technology" which was adopted by the OECD Council last month. Adequate investment in dynamic research and development programs will play an increasingly important role in assuring the sustainability of economic growth in the OECD countries. This Framework represents a major achievement for this Organization. It has the potential for a far-reaching impact on an increasingly important aspect of international economic relations. I urge you to join me in endorsing this document in our final communique tomorrow.

International Debt

Let me turn to our cooperative efforts in another area -- easing the burden of international debt. The growth-oriented, case-by-case approach we have pursued since 1985 has helped move us a considerable distance toward our goals and remains the only practical approach acceptable to all parties. Our strategy is an evolutionary one and this has been reflected in the further development during the past year of a "menu" of financing options for commercial bank packages. In contrast, we strongly oppose any approach -- including the creation of an international debt facility -- which is generalized, global, financed by creditor governments or mandatory in nature. Such schemes are both impractical and counterproductive. With respect to the poorest countries, we welcome the positive steps that have been taken this year to support their adoption of economic reform programs.

Conclusion

In conclusion, Mr. Chairman, although we have accomplished much in recent years, major tasks are still before us. The agenda remains a challenging one and further progress will require continued cooperation.

The great French social philosopher, Alexis de Tocqueville, observed in 1835 that the advantage of each individual member of a community consisted in working for the good of all -- a principle he called "self-interest rightly understood." Let us follow de Tocqueville's advice and put aside narrow self-interests for the general good of the international community.

So let us use this meeting to revitalize our spirit of cooperation. Let us enhance policy coordination, eliminate trade barriers, and remove structural impediments to growth. Let us move forward together toward a more properous and hopeful world.

Thank you.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 18, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION 2-YEAR AND 5-YEAR 2-MONTH NOTES TOTALING $15,250 MILLION

The Treasury will raise about $5,100 million of new cash by issuing $8,250 million of 2-year notes and $7,000 million of 5-year 2-month notes. This offering will also refund $10,144 million of 2-year notes maturing May 31, 1988. The $10,144 million of maturing 2-year notes are those held by the public, including $1,017 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $15,250 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average price of accepted competitive tenders.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $761 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders.

If, under Treasury's usual operating procedures, the auction of 5-year 2-month notes results in the same interest rate as the outstanding 8-5/8% bonds of August 15, 1993, the new notes will be issued with an 8-1/2% or an 8-3/4% coupon. The 8-3/4% coupon will apply if the auction results in a yield in a range of 8.68% through 8.85%.

Details about each of the new securities are given in the attached highlights of the offerings and in the official offering circulars.

oOo

Attachment

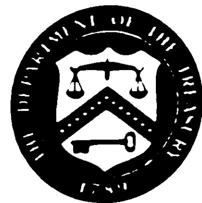
B-1416

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
OF 2-YEAR AND 5-YEAR 2-MONTH NOTES

May 18, 1988

Amount Offered to the Public	$8,250 million	$7,000 million
Description of Security:		
Term and type of security	2-year notes	5-year 2-month notes
Series and CUSIP designation	Series AB-1990 (CUSIP No. 912827 WF 5)	Series L-1993 (CUSIP No. 912827 WG 3)
Issue date	May 31, 1988	June 1, 1988
Maturity date	May 31, 1990	August 15, 1993
Interest rate	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids
Investment yield	To be determined at auction	To be determined at auction
Premium or discount	To be determined after auction	To be determined after auction
Interest payment dates	November 30 and May 31	February 15 and August 15 (first payment on February 15, 1989)
Minimum denomination available	$5,000	$1,000
Terms of Sale:		
Method of sale	Yield auction	Yield auction
Competitive tenders	Must be expressed as an annual yield, with two decimals, e.g., 7.10%	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders	Accepted in full at the average price up to $1,000,000	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor	None	None
Payment Terms:		
Payment by non-institutional investors	Full payment to be submitted with tender	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts	Acceptable for TT&L Note Option Depositaries	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions	Acceptable	Acceptable
Key Dates:		
Receipt of tenders	Wednesday, May 25, 1988, prior to 1:00 p.m., EDST	Thursday, May 26, 1988, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury	Tuesday, May 31, 1988	Wednesday, June 1, 1988
b) readily-collectible check	Thursday, May 26, 1988	Friday, May 27, 1988

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
Expected at 9:30 A.M., EDT

TESTIMONY OF THE HONORABLE
GEORGE D. GOULD
UNDER SECRETARY FOR FINANCE
U.S. DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE
OF THE
COMMITTEE ON ENERGY AND COMMERCE
U.S. HOUSE OF REPRESENTATIVES
THURSDAY, MAY 19, 1988

GOOD MORNING, MR. CHAIRMAN, AND MEMBERS OF THE SUBCOMMITTEE. IT IS A PLEASURE TO RETURN HERE TO DISCUSS THE PROGRESS MADE BY THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS.

DURING THE PAST TWO MONTHS, THE PRINCIPAL MEMBERS OF THE WORKING GROUP AND OUR RESPECTIVE STAFFS HAVE ANALYZED AND DISCUSSED THE EXTENSIVE INFORMATION AND RECOMMENDATIONS EMANATING FROM LAST OCTOBER'S MARKET DECLINE. FAR FROM BEING A STALLING DEVICE AS SOME HAVE CRITICIZED, THE WORKING GROUP HAS MOVED FORWARD, AFTER MUCH DELIBERATION, ON A NUMBER OF CRITICAL ISSUES TO PRESERVE THE INTEGRITY, COMPETITIVENESS AND EFFICIENCY OF OUR NATION'S FINANCIAL MARKETS. COLLECTIVELY, THESE RECOMMENDATIONS ADDRESS BASIC SAFETY AND SOUNDNESS ISSUES, SHOULD LESSEN THE RISK OF SYSTEMIC PROBLEMS, AND AS A RESULT, WORK TO THE BENEFIT OF ALL INVESTORS. THE KEY ISSUES -- IDENTIFIED BY THE BRADY COMMISSION, THE GENERAL ACCOUNTING OFFICE (GAO), THE SECURITIES AND EXCHANGE COMMISSION (SEC), THE COMMODITY FUTURES TRADING COMMISSION (CFTC), AND OTHERS -- ON WHICH THE WORKING GROUP HAS TAKEN CONSTRUCTIVE ACTION INCLUDE:

- o AN AGREEMENT ON COORDINATED "CIRCUIT BREAKERS" ACROSS MARKETS TO ALLOW FOR COOLING-OFF PERIODS DURING TIMES OF EXTREME PRICE DECLINES;

- o RECOMMENDATIONS AND CONCLUSIONS ON THE CREDIT, CLEARING, AND PAYMENTS SYSTEM TO ENSURE THE NECESSARY COORDINATION OF INFORMATION AND OPERATIONS WITHIN AND BETWEEN MARKETS AND TO AVOID SYSTEMS GRIDLOCK;

- O AGREEMENT THAT CURRENT MINIMUM MARGIN REQUIREMENTS PROVIDE AN ADEQUATE LEVEL OF PRUDENTIAL PROTECTION TO THE FINANCIAL SYSTEM; AND

- O AGREEMENT ON CONTINGENCY PLANNING, INCLUDING THE CONTINUATION OF THE WORKING GROUP, TO ENSURE COORDINATION AND CONSULTATION IN THE EVENT OF FUTURE, RAPID MARKET DISTURBANCES.

I ALSO AM PLEASED TO REPORT THAT THE SECURITIES, FUTURES, AND OPTIONS INDUSTRIES ALREADY ARE MAKING -- AND SHOULD CONTINUE TO MAKE -- SIGNIFICANT EFFORTS TO ENHANCE OPERATIONAL CAPACITY, TO INCREASE INDIVIDUAL FIRM AND CLEARINGHOUSE CAPITAL, AND TO IMPROVE THE FAIRNESS AND QUALITY OF ORDER EXECUTIONS FOR ALL INVESTORS, LARGE AND SMALL.

THE NEED TO REDUCE SYSTEMIC PROBLEMS

THE SPECIFIC CONCLUSIONS AND RECOMMENDATIONS ARE CONTAINED IN THE WORKING GROUP'S INTERIM REPORT TO THE PRESIDENT, WHICH ACCOMPANIES MY TESTIMONY. IT IS ESSENTIAL, HOWEVER, TO UNDERSTAND THE PREMISE FROM WHICH THESE CONCLUSIONS EVOLVED.

THE WORKING GROUP VIEWS ITS PRIMARY MISSION AS TAKING COLLECTIVE, SAFETY AND SOUNDNESS ACTIONS WHICH WOULD SUBSTANTIALLY LESSEN POSSIBLE SYSTEMIC DANGERS TO THE U.S. FINANCIAL SYSTEM IF WE WERE AGAIN TO ENCOUNTER A SEVERE STOCK MARKET DECLINE. CONSEQUENTLY, THE WORKING GROUP -- ACTING ON THE MOST SIGNIFICANT SUGGESTIONS OF THE BRADY REPORT AND OTHERS -- VIEWS COORDINATED CIRCUIT BREAKERS, PRUDENTIAL MARGINS ACROSS MARKETS, THE PROPER FUNCTIONING OF CREDIT, CLEARING, AND PAYMENT SYSTEMS, AND CONTINGENCY PLANNING AS KEY INGREDIENTS TO PREVENT STOCK MARKET DECLINES FROM DEGENERATING INTO SELF-FEEDING PANICS.

WHILE MARKETS WILL ALWAYS REACT TO CHANGES IN FUNDAMENTAL ECONOMIC INFORMATION, IT IS IMPORTANT TO ASSURE ALL INVESTORS AS TO THE PROPER FUNCTIONING OF THE FINANCIAL SYSTEM WHILE SUCH INFORMATION IS BEING DIGESTED IN TERMS OF MARKET PRICING. INDEED, REDUCING CONCERNS OVER THE VIABILITY OF THE MECHANICS AND INFRASTRUCTURE OF THE SYSTEM COULD MITIGATE THE EXTENT OF MARKET DECLINES BY REDUCING THE RISK PREMIUM INHERENT IN THOSE EXTREME SITUATIONS WHERE MARKET PARTICIPANTS WORRY ABOUT RECEIVING FULL AND TIMELY PAYMENTS. HENCE, OUR EMPHASIS ON SAFETY AND SOUNDNESS ISSUES FIRST DURING THESE PAST 60 DAYS.

DAILY VOLATILITY IS NOT A SYSTEMIC THREAT

THE ISSUE OF DAILY VOLATILITY, ALTHOUGH AN EXPRESSED PUBLIC CONCERN, IS NOT IN THE CATEGORY OF SYSTEMIC THREAT, IN MY OPINION. HOWEVER DISCONCERTING SUCH VOLATILITY CAN BE ON A

SHORT-TERM BASIS, IT IS IMPORTANT NOT TO ATTEMPT CURES THAT CAN DO MORE HARM THAN GOOD. MARKETS MUST BE ALLOWED TO ADJUST TO NEW PRICE LEVELS WITHOUT IMPEDIMENTS TO EFFICIENCY THAT IN THEMSELVES CAUSE DISRUPTIVE MARKET ACTION. NARROW PRICE LIMITS FOR CIRCUIT BREAKERS, CAUSING FREQUENT MARKET SHUT DOWNS, WOULD BE AN EXAMPLE OF SUCH SELF-DEFEATING "CURES".

MOREOVER, VOLATILITY IS A SUBJECT WHICH OFTEN HAS BEEN TREATED PUBLICLY WITH MORE EMOTION THAN ANALYSIS. IT MUST BE NOTED THAT, WITH THE EXCEPTION OF THE PERIOD OCTOBER 1987 THROUGH JANUARY 1988, THERE IS NO EVIDENCE OF ANY INCREASE IN DAILY VOLATILITY. VOLATILITY FROM 1983 THROUGH 1986, DURING WHICH TIME THE FUTURES MARKET WAS GROWING RAPIDLY, WAS MODERATE TO LOW AS COMPARED TO SIMILAR PRIOR PERIODS. THIS IS ILLUSTRATED IN EXHIBIT A. I SHOULD NOTE THAT SINCE FEBRUARY 1988, DAILY PRICE VOLATILITY HAS RETURNED TO LEVELS SUCH AS WERE SEEN IN 1973, 1974, 1975, 1980, AND 1982, AND WHICH ARE STATISTICALLY INDISTINGUISHABLE FROM THE NORM FOR 1971 THROUGH 1986. IN ANY CASE, WE MUST BE CAUTIOUS IN ASCRIBING EVENTS OF THOSE FEW MONTHS OF EXTRAORDINARY VOLATILITY TO CHANGES WHICH HAVE BEEN IN PLACE FOR SOME TIME OR IN EXTRAPOLATING THAT THOSE EVENTS WILL BE THE NEW NORM IN THE FUTURE.

SOME OBSERVERS BELIEVE THE INDIVIDUAL INVESTOR HAS LEFT THE MARKET BECAUSE OF A PERCEPTION OF INCREASED VOLATILITY. IT IS EQUALLY POSSIBLE THAT MUCH OF THE RETREAT IS IN FACT INVESTORS' COLLECTIVE VIEWS THAT THE BULL MARKET HAS PAUSED OR THAT MORE ATTRACTIVE ALTERNATIVE INVESTMENTS ARE AVAILABLE. INDIVIDUAL INVESTORS HAVE "LEFT THE MARKET" IN THE WAKE OF OTHER MAJOR MARKET DECLINES (E.G., IN THE MID 1970S). THOSE INDIVIDUALS WHO WANT TO OWN EQUITIES BUT ARE CONCERNED ABOUT COMPETING WITH LARGE, SOPHISTICATED POOLS OF CAPITAL CAN, IF THEY WISH, INVEST THROUGH THEM (E.G., MUTUAL FUNDS AND PENSION FUNDS) RATHER THAN TRYING TO COMPETE WITH THEM.

WE MUST RECOGNIZE THAT INVESTOR WITHDRAWAL DURING SUCH BEAR MARKETS IS A FACT OF LIFE, REAFFIRMED RECENTLY IN A <u>NEW YORK TIMES</u> ARTICLE WHICH STATES IN PART:

> INVESTOR DISILLUSIONMENT WITH THE STOCK MARKET IS NOT A NEW PHENOMENON. TYPICALLY, INVESTORS WITHDRAW EACH TIME THERE IS A BEAR MARKET -- CONTRIBUTING TO THE BLEAK MOOD. AFTER THE ALMOST 50 PERCENT DROP IN THE VALUE OF STOCKS DURING THE 1973-74 BEAR MARKET, FOR INSTANCE, MANY INDIVIDUALS FLED THE MARKET AND STAYED OUT UNTIL THE BULL MARKET OF THE 1980'S.
>
> THE NUMBER OF INDIVIDUAL SHAREHOLDERS WHO OWNED STOCKS ON THE NEW YORK STOCK EXCHANGE FELL TO 25.2 MILLION IN 1975 FROM 30.8 MILLION IN 1970. THE NUMBER OF

SHAREHOLDERS OF MUTUAL FUNDS DROPPED TO 7.8 MILLION IN 1980 FROM 8.4 MILLION IN 1970, ACCORDING TO ESTIMATES BY THE INVESTMENT COMPANY INSTITUTE.

NUMEROUS FACTORS CAUSE MARKETS TO REACT MORE QUICKLY TODAY

THERE ARE NUMEROUS FACTORS THAT HAVE MADE MARKETS REACT MORE QUICKLY TODAY TO CHANGES IN THE FUNDAMENTAL DETERMINANTS OF STOCK PRICES. FIRST, THE NATURE OF STOCK OWNERSHIP HAS CHANGED SUBSTANTIALLY OVER THE PAST TWENTY YEARS, LED BY PRIVATE AND PUBLIC PENSION FUNDS. THERE HAVE EVOLVED VERY LARGE INDIVIDUAL AGGREGATIONS OF CAPITAL OF A SIZE UNKNOWN IN AN EARLIER PERIOD.1/ THIS, IN TURN, HAS LED TO CHANGES IN THE TECHNIQUES OF MANAGING SUCH CAPITAL, OFTEN WITH AN EMPHASIS ON THE MARKET AS A WHOLE (E.G., THE S&P 500) RATHER THAN INDIVIDUAL STOCKS. IN THE CASE OF MAJOR BROKER/DEALERS, THE NEED FOR TRADING LIQUIDITY BY LARGE BODIES OF CAPITAL HAS ALSO INCREASED THE NEED FOR HEDGING TECHNIQUES BY CORPORATE TREASURERS AND MONEY MANAGERS. THUS, THE STOCK INDEX FUTURES MARKETS HAVE EVOLVED AS THE LOWEST COST, MOST EFFICIENT RESPONSE TO THESE CHANGED NEEDS. "TRADING THE MARKET" AND HEDGING ARE NOT IN AND OF THEMSELVES EITHER GOOD OR BAD -- THEY ARE ECONOMIC FACTS THAT ARE NOT GOING TO GO AWAY.2/

SECOND, BENEFITS OF ACTIVE FUTURES MARKETS ARE REAL: FOR EXAMPLE, THEY APPLY DIRECTLY TO THE TREASURY SECURITIES MARKET. TREASURY FUTURES ARE USED AS HEDGING VEHICLES AND AS A COST-SAVING MEANS TO ADJUST POSITIONS IN THE UNDERLYING SECURITIES. THESE RISK-REDUCING BENEFITS OF FUTURES MARKETS LEAD TO A REDUCTION OF THE RISK PREMIUM INVESTORS REQUIRE ON THE UNDERLYING TREASURY SECURITIES AND THUS TO LOWER INTEREST COSTS FOR THE FEDERAL GOVERNMENT.

FOR AN EXCELLENT DISCUSSION OF THE INCREASINGLY SIGNIFICANT ROLE OF DERIVATIVE PRODUCTS -- PARTICULARLY FUTURES ON STOCK INDEXES -- IN THE SECURITIES MARKETS, MEMBERS OF THE SUBCOMMITTEE

1/ AT THE END OF 1987, U.S. PRIVATE PENSION FUND ASSETS TOTALLED ALMOST $L.5 TRILLION AND U.S. PUBLIC PENSION FUND ASSETS WERE APPROXIMATELY ANOTHER $500 BILLION. BY COMPARISON, TOTAL PENSION FUND ASSETS WERE APPROXIMATELY $820 BILLION AT THE END OF 1980.

2/ 1987 STATISTICS FOR THE LARGEST 200 PENSION FUNDS SHOW THAT A GROWING PERCENTAGE OF THEIR ASSETS (11.8%) IS IN STOCK INDEX FUNDS. A GROWING PERCENTAGE OF THESE PENSION FUNDS (36%) ALSO USES STOCK INDEX FUTURES.

REALLY SHOULD REVIEW CHAPTER THREE OF THE SEC'S STAFF REPORT "THE EFFECTS OF DERIVATIVE PRODUCTS" (THE OCTOBER 1987 MARKET BREAK) WHICH I HAVE ATTACHED AS EXHIBIT B OF MY STATEMENT.

THIRD, WITH THE INDEX FUTURES MARKETS HAVING EXHIBITED GREATER VOLUME IN THE UNDERLYING STOCKS THAN THE CASH MARKET EXCHANGES, IT CAN BE ARGUED THAT THE CHICAGO MERCANTILE EXCHANGE (CME) HAS BECOME A LEADER -- RATHER THAN A FOLLOWER -- IN PRICE DISCOVERY OF EQUITY MARKET VALUE LEVELS. CASH MARKET PRICES ARE NOW OFTEN FOLLOWING, RATHER THAN LEADING, THE SO-CALLED DERIVATIVE MARKET. THE BRADY REPORT AND OTHERS HAVE UNDERSCORED THE CLOSE ECONOMIC LINKAGE BETWEEN THESE MARKETS. THUS, THE PUBLIC DEBATE OVER THE ROLE OF INDEX ARBITRAGE IS OFTEN MISDIRECTED. INDEX ARBITRAGE ONLY TAKES PLACE WHEN THERE IS A DIFFERENCE OF PRICE LEVEL BETWEEN THE CASH AND FUTURES MARKETS, AND SUCH ARBITRAGE, AS IN ITS AGE OLD ROLE, HELPS EQUATE THOSE PRICE LEVELS.

FOURTH, WHILE IT IS TRUE THAT INDEX ARBITRAGE CAN TRANSLATE BUYING OR SELLING PRESSURE FROM ONE MARKET TO ANOTHER, IF THOSE MARKETS ARE TRULY ECONOMICALLY LINKED AND RESPONDING TO THE SAME FUNDAMENTALS, THEN SUCH ARBITRAGE SERVES THE USEFUL PURPOSE OF QUICKLY EQUALIZING THE PRICE LEVELS BETWEEN THE MARKETS. IT IS WORTH NOTING IN THIS CONTEXT THAT THE PROPOSAL OF THE NEW YORK STOCK EXCHANGE (NYSE) FOR TRADING BASKETS OF STOCK ON THE NYSE WOULD ITSELF PRODUCE "INDEX ARBITRAGE" BETWEEN THE VALUE OF THE BASKET AND THE UNDERLYING STOCKS -- BUT THIS ARBITRAGE WOULD BE WITHIN THE NYSE. WHAT OFTEN IS OVERLOOKED IN DISCUSSIONS OF ARBITRAGE IS THAT IF THERE WERE NO LINKAGE OF THE MARKETS, THEN MORE SELLING OR BUYING COULD SPILL OVER INTO THE CASH MARKETS DIRECTLY. THE BRADY REPORT TAKES NOTE OF SUCH SELLING WHEN THE LINKAGE BROKE DOWN IN OCTOBER.

MUCH PUBLIC CRITICISM OF INDEX ARBITRAGE IS A CLASSIC CASE OF WANTING "TO SHOOT THE MESSENGER" THAT BRINGS THE BAD NEWS OF SELLING ON THE CME TO THE FLOOR OF THE NYSE. IF SELLING IS GOING TO TAKE PLACE TO A DEGREE THAT PUSHES PRICES DOWN SHARPLY, THEN CASH MARKETS WILL NOT BE MADE IMMUNE BY ELIMINATING INDEX ARBITRAGE. THE EMPHASIS, THEREFORE, SHOULD BE ON INCREASING THE CAPACITY OF SYSTEMS LIKE THE DESIGNATED ORDER TURNAROUND (DOT) SYSTEM OF THE NYSE SO THAT THE PUBLIC HAS FAIR AND EQUAL ACCESS TO ORDER TRANSMISSION, RATHER THAN ON RESTRICTING MECHANICAL LINKAGES BETWEEN ECONOMICALLY-LINKED MARKETS.

PUT ANOTHER WAY, IF THERE WERE NO INDEX FUTURES MARKET, THEN THERE WOULD BE NO INDEX ARBITRAGE. BUT THERE IS NO EVIDENCE THAT SUCH A CONDITION WOULD GIVE THE CASH MARKETS IMMUNITY FROM

SELLING PRESSURE GENERATED BY RESPONSES TO FUNDAMENTAL EVENTS -- AND NO LIKELIHOOD THAT HAVING DEVELOPED TO MEET A LARGE AND IMPORTANT INVESTMENT NEED THERE WILL NOT BE A VIABLE INDEX FUTURES MARKET, WHETHER HERE OR ABROAD.

FIFTH, THE VOLATILITY MANY PEOPLE BLAME ON INDEX ARBITRAGE COULD ALSO BE EVIDENT FROM DIRECT SELLING IN THE CASH MARKET. IN FACT, PRESSURES DIRECTLY ON CASH MARKETS ARE CLEAR FROM HISTORY. EARLIER IN THE POSTWAR PERIODS BEFORE THE INDEX FUTURES MARKETS CAME INTO EXISTENCE IN 1982, THE DOW JONES INDUSTRIAL AVERAGE (DJIA) HAD A NUMBER OF SIGNIFICANT DECLINES AS OUTLINED IN EXHIBIT C OF MY TESTIMONY. IN FACT, THE 1973-74 BEAR MARKET WAS WORSE THAN THE 1987 DECLINE; WHILE IT TOOK LONGER, THE END RESULT WAS THAT PRICE LEVELS REACTED TO FUNDAMENTAL PERCEPTIONS AND ADJUSTED ACCORDINGLY. WHILE INDIVIDUAL SHARE OWNERSHIP IS AN IMPORTANT PART OF OUR FINANCIAL SYSTEM AND SHOULD BE ENCOURAGED, WE CANNOT EXPECT TO BE ABLE TO LEGISLATE NORMAL HUMAN BEHAVIOR -- ANY MORE THAN WE SHOULD BE EXPECTED TO PROTECT THE REVENUES OF BROKERAGE FIRMS BY ATTACKING SYMPTOMS RATHER THAN CAUSES.

SIXTH, THE AGGREGATION OF CAPITAL IS A FACTOR IN TODAY'S GLOBAL MARKETS, JUST AS THE PHENOMENON OF RAPID INFORMATION DISSEMINATION ALSO IS IMPORTANT TO RECOGNIZE. THE WORLD NOW HAS THE TECHNOLOGICAL SYSTEMS -- AND THEREFORE THE ABILITY --- FOR ALMOST INSTANTANEOUS RESPONSE TO ANY EVENT. THIS PROVIDES ANOTHER TYPE OF AGGREGATION IN THE FORM OF CONCERTED BUYING OR SELLING. WHILE MARKET LIQUIDITY HAS INCREASED GREATLY IN RECENT YEARS, CLEARLY SOME GREATER VOLATILITY CAN BE INTRINSIC TO CONCERTED ACTION. ELIMINATING INFORMATION TECHNOLOGY -- EITHER BY LEGISLATION OR REGULATORY FIAT -- HARDLY SEEMS LIKE A REALISTIC REACTION TO CONCERNS ABOUT VOLATILITY.

FINALLY, THE WALL STREET BROKER/DEALER/SPECIALIST BUSINESS HAS BECOME INCREASINGLY CAPITAL-INTENSIVE. SINCE 1975, WHEN FIXED-RATE COMMISSIONS WERE ENDED, A NOTABLY LARGER PERCENTAGE OF REVENUES ARE NOW A FUNCTION OF CAPITAL RETURNS RATHER THAN COMMISSION INCOME. WITH CAPITAL RISK THUS LESS PROTECTED BY A CUSHION OF COMMISSION INCOME, THERE IS A TENDENCY FOR BLOCK HOUSES AND SPECIALISTS TO BECOME MORE RISK AVERSE IN THEIR BIDS DURING UNCERTAIN TIMES. THIS, TOO, CAN LEAD TO GREATER VOLATILITY.

EVOLUTION IN THE FACE OF CHANGE IS NECESSARY

IF I MAY BE PERMITTED A PERSONAL COMMENT, I WOULD LIKE TO POINT OUT THAT WHEN I STARTED IN WALL STREET IN 1951, A MILLION SHARES TRADED ON THE NYSE IN ONE DAY WAS A BIG EVENT. WALL STREET WAS LIKE A PRIVATE CLUB, AND A RATHER EXCLUSIONARY CLUB AT THAT. NO ONE WORKED TOO HARD, COMPETITION WAS LIMITED, INDIVIDUALS WERE AS IMPORTANT AS INSTITUTIONS, THE U.S. ECONOMY

WAS DOMINANT, AND THE NYSE WAS THE MARKET OF THE WORLD. THERE IS MORE THAN A LITTLE NOSTALGIA FOR THOSE TIMES THAT INFLUENCES TODAY'S DEBATES ABOUT HOW MARKETS SHOULD FUNCTION. I WOULD SUGGEST, HOWEVER, THAT THE WALL STREET OF AN EARLIER TIME ALSO HAD ITS DRAWBACKS AND NEVER COULD HAVE ACCOMMODATED THE DEMANDS OF A GROWING U.S. ECONOMY WITHOUT ITSELF CHANGING. THOSE CHANGES CONTINUE, PARTICULARLY IN AN INTERNATIONALLY COMPETITIVE WORLD. IT WOULD BE A MISTAKE TO FOCUS ONLY ON THE FALL-OUTS OF THOSE FUNDAMENTAL CHANGES WHEN ATTEMPTING TO DETERMINE WHETHER STRUCTURAL MODIFICATIONS ARE NEEDED FOR THE MARKETS THEMSELVES.

Strong Agency and SRO Action Needed Against Frontrunning and Market Manipulation

BEFORE I TURN TO OUR RECOMMENDATIONS, I WANT TO TAKE A MINUTE TO COMMENT ON AN ISSUE ABOUT WHICH I FEEL STRONGLY. VIRTUALLY ALL OF THE REPORTS VOICED CONCERNS ABOUT CUSTOMER PROTECTION, PARTICULARLY IN THE AREAS OF INTERMARKET FRONTRUNNING AND MARKET MANIPULATION. FOR EXAMPLE, THE BRADY REPORT RECOMMENDED DEVELOPMENT OF AN EXTENSIVE TRADING INFORMATION SYSTEM FOR THE STOCK MARKETS TO BETTER DIAGNOSE DEVELOPING PROBLEMS AND UNCOVER ABUSES. THE COMMODITY FUTURES TRADING COMMISSION (CFTC) STAFF URGED ESTABLISHMENT OF STANDARDS FOR IDENTIFYING POTENTIAL INTERMARKET FRONTRUNNING TRADING PATTERNS AND A MECHANISM -- PERHAPS THE INTERMARKET SURVEILLANCE GROUP -- FOR THE TIMELY AND EFFECTIVE COMMUNICATION OF MARKET SURVEILLANCE DATA RELATED TO POSSIBLE FRONTRUNNING ACTIVITY AMONG ALL EXCHANGES WITH COMMON SELF-REGULATORY INTERESTS. THE SECURITIES AND EXCHANGE COMMISSION (SEC) RECOMMENDED STRENGTHENING CURRENT PROHIBITIONS AND WORKING WITH THE CFTC AND SELF-REGULATORY ORGANIZATIONS (SROs) TO ENSURE THAT ADEQUATE INTERMARKET INFORMATION IS AVAILABLE TO PURSUE SUCH MATTERS.

THE ADMINISTRATION FULLY AGREES THAT VIGOROUS ACTION AGAINST PROBLEMS OF INTERMARKET FRONTRUNNING AND MARKET MANIPULATION IS ESSENTIAL. ALONG WITH THE BENEFITS OF NEW PRODUCTS, TECHNOLOGIES, AND TRADING STRATEGIES HAVE COME INCREASED OPPORTUNITIES FOR ABUSE BY MARKET PROFESSIONALS AND INSIDERS. THESE ABUSES HAVE HIDDEN ECONOMIC COSTS IN ADDITION TO THEIR MORE OBVIOUS EFFECT ON SMALLER INDIVIDUAL AND INSTITUTIONAL INVESTORS WHO COME TO BELIEVE THAT THE RULES ARE RIGGED AGAINST THEM. WE DEPLORE THIS SITUATION AND EXPECT THE REGULATORS AND SROs, WHO ARE IN THE BEST POSITION TO TAKE AFFIRMATIVE ACTION, TO CONTINUE TO DO SO. THEY ALREADY HAVE MADE SIGNIFICANT PROGRESS:

- THE CME HAS JUST CIRCULATED A PROPOSED DEFINITION OF FRONTRUNNING TO FUTURES INDUSTRY REPRESENTATIVES;

- THE NYSE RECENTLY NOTIFIED ITS MEMBERS THAT TRADING FUTURES BASED ON KNOWLEDGE OF IMPENDING ORDERS IN THE

STOCK MARKET IS A VIOLATION OF EXCHANGE RULES. THE NYSE PLANS TO PROVIDE THE FUTURES EXCHANGES WITH AUDIT TRAIL INFORMATION ON STOCK TRADING THAT WOULD ENABLE THE CHICAGO FUTURES MARKETS TO CONDUCT ONGOING SURVEILLANCE FOR FRONTRUNNING; AND

o THE AMERICAN STOCK EXCHANGE (AMEX) HAS RECENTLY IMPLEMENTED SYSTEMS TO AUTOMATICALLY MONITOR OPTION TRADING FOR FRONTRUNNING, MINI-MANIPULATION, AND PEGGING AND CAPPING. THE AMEX ALSO IS DEVELOPING AN EXPERT SYSTEM WHICH USES ARTIFICIAL INTELLIGENCE SOFTWARE TO ANALYZE POTENTIAL INSIDER TRADING MARKET MANIPULATION CASES.

IT IS IN THE BEST INTEREST OF ALL INVESTORS CONCERNED THAT THE PROBLEMS OF FRONTRUNNING AND MARKET MANIPULATION BE RESOLVED QUICKLY AND EFFECTIVELY BY THE AGENCIES AND SROs. SUCH ACTION IS CRUCIAL IF WE TAKE SERIOUSLY THE CHARGE THAT MARKETS ARE RIGGED TO THE DISADVANTAGE OF THE SMALL INVESTOR.

RECOMMENDATIONS

LET ME NOW BRIEFLY SUMMARIZE THE WORKING GROUP'S RECOMMENDATIONS AND CONCLUSIONS. OUR EFFORTS HAVE FOCUSED SO FAR ON SIX SUBJECTS WHICH ARE DESCRIBED IN MORE DETAIL IN OUR REPORT TO THE PRESIDENT.

1. CONTINUING COORDINATION

THE WORKING GROUP BELIEVES THAT ITS CONTINUATION IS AN EXCELLENT WAY TO COORDINATE WHAT SHOULD BE AN ON-GOING PROCESS TO ADDRESS INTERMARKET ISSUES. THE BRADY REPORT AND OTHERS HAVE RECOMMENDED THAT SOME ADDITIONAL REGULATORY MECHANISM BE ESTABLISHED TO RESOLVE THESE ISSUES. RECOGNIZING THIS CONCERN FOR COORDINATION, WE BELIEVE COOPERATIVE EFFORTS UNDER THE EXISTING REGULATORY STRUCTURE WILL CONTINUE TO BE EFFECTIVE, AND IN LARGE MEASURE, FULFILL THE INTENT OF SEVERAL LEGISLATIVE PROPOSALS. THE VERY EXISTENCE OF THIS GROUP HAS HELPED TO KEEP THE PRESSURE ON THE VARIOUS SROs AND MARKET PARTICIPANTS TO DEVISE AND IMPLEMENT NECESSARY REFORMS ON THEIR OWN.

2. CIRCUIT BREAKERS

IN ADDRESSING COORDINATED TRADING HALTS AND REOPENINGS, SO-CALLED CIRCUIT BREAKERS, THE WORKING GROUP HAS FOCUSED ON MARKET EVENTS THAT ARE SO DRAMATIC AS TO TRIGGER *AD HOC* CLOSINGS OF EQUITY MARKETS AND TO POSE POTENTIAL SYSTEMIC RISKS TO OUR FINANCIAL SYSTEM. THE WORKING GROUP HAS DEVISED A CROSS-MARKET MECHANISM TO AVOID *AD HOC* AND DESTABILIZING MARKET BREAKS, RECOGNIZING THAT ANY DISRUPTION OF TRADING IS UNDESIRABLE.

Our proposal is designed to substitute planned for unplanned, ad hoc trading halts, without increasing the overall frequency of such disruptions. Planned halts should allow time for the dissemination of information and consideration of decision to buy or sell in rare situations in which panic conditions threaten.

3. Prudential Margin Requirements

The Working Group reached agreement on several key points regarding prudential margins and concluded that:

- current minimum margin requirements provide an adequate level of protection to the financial system, although they do not cover all possible price movements, and that margins sufficient to cover all possible price movements would have unacceptable costs for the liquidity and efficiency of markets;

- there are additional protective cushions in place from capital requirements and surveillance for firms and clearinghouses; and

- given differences in price volatility of stocks and indexes and grace periods for settling margins, a consistent and harmonious margin regime among markets would produce significantly higher levels of margin for stocks than for futures.

The positions of the Working Group members on the need for margins in excess of the prudential level, and of the need for federal oversight, are set forth in the report to the President.

4. Credit, Clearing, and Settlement

As former Senator Nicholas Brady, who chaired the President's Task Force on Market Mechanisms, indicated recently, extreme stress on our clearing and credit systems came close to damaging our financial system last October. While a complicated and technical area, our financial system's network of clearing, credit, and settlement procedures truly is the nuts-and-bolts that allow hundreds of millions of transactions to be conducted and financed on a daily basis.

The Working Group has reviewed existing clearing, payments, and settlement systems to identify and set priorities for measures that they recommend be taken to reduce uncertainty,

INCREASE COORDINATION, TO ASSURE CONFIDENCE IN THE INTEGRITY OF SUCH SYSTEMS, AND TO FACILITATE THEIR SMOOTH OPERATION IN VOLATILE MARKETS.

THE WORKING GROUP ENDORSES THE VIEW THAT THE PROPER FUNCTIONING OF THESE SYSTEMS IS INTEGRAL TO THE PROPER FUNCTIONING OF THE FINANCIAL MARKETS AS A WHOLE AND IS PLEASED TO REPORT THAT SIGNIFICANT PROGRESS HAS BEEN MADE IN THIS AREA. AS MORE FULLY SET FORTH IN THE REPORT TO THE PRESIDENT, THE WORKING GROUP IS PROPOSING AN AGENDA OF ADDITIONAL MEASURES TO BE PURSUED TO ACHIEVE THE GOAL OF MORE PERFECTLY COORDINATED SYSTEMS.

5. CONTINGENCY PLANNING

THE WORKING GROUP BELIEVES THAT THE PURPOSE OF CONTINGENCY PLANNING IS TO ENSURE THAT REGULATORY AGENCIES AND THE SROS HAVE IN PLACE SYSTEMS WHICH WILL ALLOW THEM TO IDENTIFY EMERGING PROBLEMS QUICKLY AND TO REACT APPROPRIATELY IN THE EVENT OF A MARKET CRISIS. IN AN IMPORTANT SENSE, THE WORKING GROUP RECOMMENDATIONS FOR IMPLEMENTING CIRCUIT BREAKERS, IMPROVING INFORMATION FLOWS, CLARIFYING CREDIT ARRANGEMENTS, AND STRENGTHENING THE CLEARING AND SETTLEMENT PROCESS CAN BE VIEWED AS A KEY PART OF CONTINGENCY PLANNING. BY IMPROVING THE MARKET SYSTEM'S ABILITY TO WITHSTAND AND REACT TO SHOCKS, THESE MEASURES WILL ENHANCE THE SYSTEM'S FIRST LINE OF DEFENSE.

GOING BEYOND THIS, THE WORKING GROUP HAS GIVEN HIGH PRIORITY TO ENHANCING CHANNELS OF COMMUNICATION AMONG STAFFS OF THE RESPECTIVE REGULATORY AGENCIES AND THE TREASURY. IN ADDITION, STAFF OF THE THREE AGENCIES ARE WORKING JOINTLY TO IMPROVE INFORMATION SHARING ACROSS THE AGENCIES, WITH PARTICULAR EMPHASIS ON A FRAMEWORK FOR COORDINATED MONITORING OF EXPOSURES AND DEVELOPMENTS AT MAJOR MARKET PARTICIPANTS. FINALLY, REGARDING INTERNATIONAL POLICY COORDINATION, STEPS ARE BEING TAKEN BY THE VARIOUS AGENCIES TO STRENGTHEN EXISTING CONTACTS WITH THEIR COUNTERPART AUTHORITIES IN OTHER MAJOR MARKET CENTERS TO FURTHER IMPROVE THIS ASPECT OF MARKET SURVEILLANCE.

6. CAPITAL ADEQUACY AND SYSTEMS CAPACITY ENHANCEMENT

MARKET PARTICIPANTS, SROS, AND REGULATORY AGENCIES HAVE TAKEN OR ARE PLANNING A NUMBER OF SIGNIFICANT ACTIONS TO ENHANCE FINANCIAL INTEGRITY AND IMPROVE AUTOMATED SYSTEMS -- TWO OF THE ISSUES THE WORKING GROUP, THE BRADY REPORT, THE GAO AND OTHERS HAVE IDENTIFIED AS CRITICAL TO THE FINANCIAL INTEGRITY AND SMOOTH FUNCTIONING OF THE MARKETS. OUR REPORT TO THE PRESIDENT CITES THE MANY CONSTRUCTIVE STEPS ALREADY TAKEN IN THESE AREAS. THE WORKING GROUP ENCOURAGES THESE EFFORTS AND WILL CONTINUE TO MONITOR DEVELOPMENTS TO ENSURE THAT NEEDED IMPROVEMENTS ARE MADE.

CONCLUSIONS

In summary, Mr. Chairman and Members of the subcommittee, the Working Group has commenced action on a number of significant steps that collectively will work to reduce systemic threats to our financial markets. In so doing, we have pursued a sizeable portion of the agenda defined in large measure by the Presidential Task Force on Market Mechanisms, the GAO, the SEC, the CFTC and other market observers. Indeed, Senator Brady concluded his recent public letter with a position that in fact has been the operating basis of the Working Group:

> We are not attempting to legislate against decline or interfere with the smooth functioning of the markets. The market will always seek its level ground; we are only trying to assure that it gets there safely.

The collective and coordinated actions recommended by the Working Group -- and corrective steps already taken by others -- help to assure that the market does in fact "get there safely" when it moves for whatever reasons.

We cannot legislate against market declines. Regulatory dictates cannot eliminate volatility. Executive fiat is no more effective. Price controls and capital controls have never worked effectively in this country and no amount of government control can sway markets if underlying economic fundamentals -- or investor perceptions of those same fundamentals -- take the market one direction or another.

Moreover, it is unrealistic and ultimately counterproductive to attempt to roll back developments in financial markets brought about by advancements in telecommunication and computer technology and by changes in investment needs. We cannot go back to the days of the abacus or mechanical adding machines. If we did -- by trying to legislate against particular products or investor preferences or market strategies, for example -- then we would ultimately lose whatever competitive edge we now have to places like Toronto, Tokyo, or London.

Mr. Chairman, I would be remiss if I did not commend the cooperative actions and constructive dialogue on the part of the Working Group members. As you requested at our last hearing, we have spent considerable time and energy to arrive at our initial recommendations. The members of the Working Group have demonstrated that it is possible to address major, complex issues in a cooperative fashion -- even though we bring different

PERSPECTIVES AND PREFERENCES TO THE TABLE -- AND IN A REASONABLY SHORT TIME FRAME. DISAGREEMENTS ON SOME MATTERS HAVE NOT BLOCKED SIGNIFICANT AGREEMENTS THAT ARE APPARENT UPON CAREFUL EXAMINATION OF THE PACKAGE WE HAVE PRESENTED TO THE PRESIDENT.

THE PUBLIC ALSO HAS BEEN WELL SERVED BY THE WORKING GROUP'S HIGH CALIBER STAFF AND THEIR PROFESSIONAL ANALYSES, AND I SALUTE THEM.

WE HAVE MADE PROGRESS ON BASIC ELEMENTS THAT ARE ESSENTIAL TO THE SAFETY AND SOUNDNESS AGENDA THAT WE VIEW AS A PRIORITY. MORE WORK WILL BE DONE, AND WE WELCOME THE CONTINUING CHALLENGE.

* * * * * * * * * * * * * *

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

Text as Prepared
For Release Upon Delivery
Expected at 10:00 a.m. EST

Testimony of James E. Ammerman
Director, Office of International Banking and Portfolio Investment
U.S. Department of the Treasury
before the
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C.
May 20, 1988

Financial Services in the U.S.-Canada Free Trade Agreement

Mr. Chairman, I appreciate this opportunity to appear before your Committee to discuss the Financial Services Chapter of the Canada Free Trade Agreement (FTA). Let me say in advance that if you, Mr. Chairman, or any members of your Committee, have any questions which can't fully be answered this morning, I will be more than happy to follow up.

The U.S.-Canada Free Trade Agreement is the most comprehensive trade agreement ever negotiated between two countries, and it is one that breaks new ground with respect to financial services, other services, investment, and technology. The agreement on financial services is by itself a landmark in that it is the first binational agreement entered into by the United States covering the entire financial sector. And the investment agreement is the first of its type entered into by Canada with any country, as my colleague, Mr. Canner, will shortly discuss.

The Financial Services Negotiations

Let me now turn to the Financial Services section of the Free Trade Agreement and discuss its background, what it means and what the implications are for the financial sectors in our two countries.

Our objective in these negotiations was to make significant progress in obtaining equality of competitive opportunity for U.S. financial firms operating in or wishing to enter Canada. Put in another way, we sought treatment equivalent to that accorded domestic Canadian financial institutions. In a Treasury Depart-

ment report prepared for this Committee in December 1986, we highlighted the barriers that existed in Canada's financial sector. This document, the "National Treatment Study," served as the road map in our quest for equal treatment for U.S. firms. We strove for, and believe we have achieved, an agreement yielding highly satisfactory results.

Mr. Chairman, let me now summarize the actual agreement and the commitments made by each country.

Canadian Commitments

For the U.S., there will be a substantial removal of discriminatory treatment in Canada. U.S. commercial banks operating in Canada will be relieved from onerous limits on their ability to compete and grow. Currently, the domestic assets of foreign bank subsidiaries operating in Canada (known as Schedule B banks) are limited to 16 percent of all domestic assets of the Canadian banking system. In addition, foreign bank subsidiaries face individual capital and leveraging limits and other restraints such as restrictions on the sale of loans to the parent bank. When the Financial Services Chapter of the Free Trade Agreement goes into effect, U.S. commercial bank subsidiaries in Canada will be exempt from the current discriminatory restrictions on market share, asset growth, and capital expansion, in the same way as Canadian banks are exempt. U.S. commercial banks will also be allowed to establish or acquire securities firms or federally-regulated Canadian insurance and trust companies, again in the same manner as Canadian banks.

In addition to helping U.S. commercial banks compete on a more equal basis in Canada, the agreement also has substantial benefits for U.S. financial institutions other than commercial banks. In particular, all U.S. financial institutions will be better able to grow and take full advantage of Canada's financial market liberalization due to removal of the so-called "10/25" rule. This rule prevents a nonresident from acquiring more than a 10 percent ownership interest in certain types of Canadian financial services companies; a group of nonresidents is limited in the aggregate to a 25 percent interest. Under current regulations, U.S. and other foreign insurance companies have perhaps been the most disadvantaged because of the "10/25" rule; under this agreement, U.S. firms will receive the same rights as Canadian companies to diversify in the financial sector by establishing or acquiring federally-regulated insurance companies, trust companies, Schedule B banks, or securities firms.

While Ontario, Quebec, and other provinces have liberalized their securities markets and have welcomed foreign investors, the federal government implemented a policy of reciprocity which has held up the applications for entry by U.S. securities firms and banks. Under this agreement, these applications will be reviewed strictly on a prudential basis, just as for Canadian firms, and not on a reciprocity basis.

To summarize the Canadian commitments, U.S. commercial banks, securities firms, insurance companies, and other financial institutions will be granted significantly better treatment that will allow them to compete more effectively in Canada with domestic firms.

U.S. Commitments

Under the agreement, the U.S. also made a number of specific commitments. First, the U.S. agreed to guarantee the right of Canadian banks to retain their multi-state branches in the United States that were grandfathered under the International Banking Act of 1978.

Second, if the Glass-Steagall Act is amended, we committed to extend the same benefits we grant our own firms to Canadian financial institutions in the United States.

Third, in an effort to be responsive to reasonable Canadian concerns regarding the treatment of U.S. subsidiaries of Canadian banks and securities firms which merge in Canada, the U.S. agreed to allow Canadian banks, as well as U.S. and other foreign banks, in the United States to underwrite and deal in debt obligations guaranteed by the Government of Canada, or its political subdivisions. This is a new measure for U.S., Canadian and other foreign banks that is consistent with the existing ability of banks to deal in securities of the U.S. Government or its political subdivisions.

Commitments by Both Countries

In addition to these specific measures, the United States and Canada both made an important commitment to continue liberalizing our markets and extending the liberalization to firms of the other party after the Free Trade Agreement goes into effect, contingent upon the other party fulfilling its commitment to liberalize. We have established a formal consultative mechanism between the U.S. Department of the Treasury and the Canadian Department of Finance to oversee this liberalization and to resolve disputes arising from commitments already concluded in the Financial Services Part of the Free Trade Agreement.

Dispute Settlement for Financial Services

The Financial Services Chapter is excluded from the overall FTA dispute settlement mechanism. In its place, we created a consultative mechanism between the U.S. Treasury and the Canadian Department of Finance to serve both as the vehicle for resolving disputes and for seeking further liberalizations. We felt that a different mechanism from that in the overall FTA was necessary in the financial services area. In our view, financial services are fundamentally different from most other services and from the tradeable goods sector because prudential and regulatory concerns

play such an important role. Accordingly, we tried to tailor a consultation and dispute settlement mechanism that reflected the different and special nature of the financial services sector.

I would be happy to answer any questions at this time.

Thank you very much.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

Text as Prepared

Remarks by Secretary of the Treasury
James A. Baker, III
To the Council on Foreign Relations
Paris, France
Friday, May 20, 1988

Economic Policy Coordination and International Monetary Reform

It is my privilege to join representatives of a group that has done so much to promote international understanding and cooperation in the 20th century. The Council on Foreign Relations has a unique blend of scholarly and practical perspectives which has made it an especially useful forum for considering key issues in international affairs. So I'm delighted to have a chance to discuss international economic policy coordination and international monetary reform with you today.

The Development of Economic Policy Coordination

We have just concluded the 1988 Ministerial meeting of the OECD, an organization founded on the principle of close cooperation among the industrial countries.

Economic cooperation takes many forms, of course. Today, however, I would like to focus my remarks on economic policy coordination -- placing it in the context of the search, since the second World War, for a better international monetary system.

This search led our predecessors to create the Bretton Woods institutions and the post-war monetary system in the 1940s. They put together and open trade and payments system that provided a solid framework for growth and reconstruction.

Strains in the system emerged, however, in the late 1950s and 1960s prompting renewed efforts to improve it. These efforts notwithstanding, the rigidities of the adjustment process under the Bretton Woods system, along with divergences in economic performance, ultimately resulted in the breakdown of the system in the early 1970s.

B-1419

This led to an intensive effort to define a new international monetary order. The huge imbalances which emerged following the oil price increases of the early 1970s, however, terminated this effort and thus was born the flexible or floating exchange rate system. This system was based on the principle that global growth and international economic stability basically derived from sound domestic economic and financial policies in the major countries, rather than external constraints imposed through rigid exchange rates.

The principle was sound and remains valid today. But this was not enough to make the new system effective. Its implementation lacked a sense of direction and discipline. There was no political mechanism to encourage needed policy actions, and there were very few rules of the game. Countries were able to focus on domestic objectives, without adequate incentive to give due regard to international implications. These weaknesses in the flexible rate system allowed the development of large, unsustainable imbalances which threatened continued global growth and financial stability.

Given these developments, interest in international monetary reform began to grow once again in the early 1980s. Progress on this front did not emerge, however, until efforts were initiated in 1985 to strengthen international economic policy coordination among the industrial countries. Why have these efforts to strengthen coordination taken on added importance and urgency? I would offer four main reasons why this might be the case:

- First, the global integration of capital markets and increased trade linkages have heightened our awareness of the interdependence of our economies. This, in turn, reinforced the need to take international considerations more into account when formulating domestic economic policies.

- Second, it became increasingly clear that the flexible rate system did not have mechanisms to identify problems at an early stage and prompt efforts to resolve them. Some discipline and structure were needed.

- Third, more and more people recognized that in spite of the shortcomings of the flexible rate system, a return to a rigid system of fixed rates was impractical. Thus, coordination was a practical way forward that could avoid the pitfalls of either extreme.

- Fourth, this effort went beyond the notion of international economic <u>cooperation</u> which had characterized international discussions for years, to the more demanding task of <u>coordination</u> -- entailing additional commitments to active and close collaboration.

Against this background, enhanced international economic coordination became a pragmatic approach to reforming and strengthening the flexible or floating exchange rate system. And now I think we have mustered the necessary political will to give this process impetus and meaning.

Building the Process

The 1985 Plaza Agreement represented the first major step in this coordination effort. It involved an agreement in the G-5 on the direction national economic policies and exchange rates should take to facilitate growth and external adjustment. More fundamentally, it represented a new commitment by the major industrial countries to work together more intensely to achieve global economic prosperity, and thereby to enable each country to better achieve its own domestic objectives.

The success of the Plaza Agreement created momentum that led to further progress. At the Tokyo Summit, we developed a framework for multilateral surveillance of our economies using economic indicators. The IMF Managing Director was invited to participate in these meetings, thus assuring that a truly global perspective is taken. Further, a new group was formed, the G-7, in order to bring to bear the political leadership of the Heads of State or Government on the coordination effort. This commitment at the highest political levels has been crucial to progress to date, and it will be essential for maintaining momentum in the period ahead.

At the Venice Summit last year, the coordination process was strengthened further by the adoption of arrangements involving the development of medium-term objectives and performance indicators to assess policies and performance.

Thus the major industrial countries have now developed a political mechanism to enhance their ability to coordinate economic policies. And although the process is still very young, there is already ample evidence that it is bearing fruit. Both fiscal and monetary policies are being framed in an international as well as a domestic context. As a consequence, the United States has taken measures to reduce the budget deficit, increase domestic savings and improve competitiveness. The major surplus countries, Japan and Germany, have taken steps to improve domestic demand and reduce reliance on export-led growth. There have been coordinated interest rate actions. Cooperation in exchange markets has been intensified based on specific understandings.

As a result, the world economy is on a much more solid footing. Growth continues, but is now more balanced and is supportive of the adjustment process. Inflation remains low, and external imbalances are being reduced. The U.S. trade figures for March provide evidence that these imbalances are now declining in nominal as well as real terms.

The Louvre Accord and G-7 Statement of this past December both marked important milestones in the coordination effort. At the Louvre, we strengthened our commitments on underlying policies, while promoting greater exchange rate stability. This has produced results which furthered the credibility of the process.

The coordination process was seriously tested this fall in the wake of the October stock market crash. It would have been easy for each of us to turn inward, and focus on short-term measures to address immediate domestic needs. Instead, the G-7 pulled together and intensified its efforts to find a compatible and reinforcing set of policies to achieve common goals. These efforts (which were conducted privately between Ministers and Governors over a period of weeks) were reflected in the December statement of the G-7, thereby demonstrating the resilience of the coordination process in the face of adversity. Since that time, strengthened underlying policy actions have been reflected in enhanced stability of exchange markets.

Strengthening Coordination and Reforming the System

As this process of coordination has been developing, questions continue to be raised about the need for "more fundamental monetary reform." This is natural. We certainly do not have a perfect monetary system, nor total coordination of our policies. We cannot afford to rest on our laurels and become complacent. We need further strengthening and reform of the system, but what form and direction should this take? It is tempting, and in fact can be instructive, to consider sweeping, revolutionary changes in the system -- particularly the exchange rate part of the system. But it is far from clear that such changes are desirable or practical.

While it may be difficult to recognize reform when it emerges gradually in a step-by-step fashion, I think that further strengthening of our process of coordination is the best means of achieving further reform of the monetary system.

What are the characteristics of this step-by-step or incremental approach to monetary reform which make it the best option available?

- First, it combines flexibility with greater commitment and obligation. Countries have committed to this process at the highest political level, and they have obligations to develop medium-term economic objectives, along with performance indicators to assess progress toward the objectives. At the same time, it involves no ceding of sovereignty.

- Second, it recognizes that reform of the system is not simply a matter of exchange rates or reserve assets. Exchange rates certainly are a key variable. Ultimately, however, the test of an international monetary system is whether it can help foster an open and growing world economy. This involves appropriate fiscal, monetary and structural policies as well as exchange rates. The indicator system we have developed covers this full range of policies.

- o Third, the system can encourage corrective policy action through the use of indicators and peer pressure without relying on automatic trigger devices.

- o Fourth, the burden of adjustment is not biased toward or away from domestic policies or exchange rates, as was the case in the par value and early flexible rate regimes, respectively. In 1985 and 1986, coordination stressed the role of exchange rates. In 1987 and so far in 1988, the emphasis has shifted to changes in underlying policies. It is no mean feat that this shift was conducted without a major breakdown in the system.

- o Fifth, the coordination and indicator process contains symmetry by focusing on surplus as well as deficit countries. Symmetry is a long sought after -- and necessary -- element in international monetary arrangements. Efforts to build it into the system through various automatic techniques have failed in the past, and would likely fail again. In contrast, the indicator system now in place provides a structured but judgmental framework for accessing the need for actions by deficit and surplus countries alike.

This brings me to the sixth and final attribute that I would cite -- credibility. In today's era of global economic integration and instant communications, credibility is key. An attempt to make an abrupt or major change in the structure of the system by imposing a detailed set of formal constraints might well be viewed by the markets as overly ambitious and unsustainable, and such an approach might not give adequate regard to political realities or the force of financial flows.

The global economy is too dynamic, and the forces of change too strong, to be able to look ahead with great certainty and envision a highly defined international monetary structure that will fit the world economy of 1995 as well as that of 2005.

We must therefore move cautiously but steadily ahead, always alert to further improvements in the process and the system. In this connection, the major industrial countries agreed last month to develop a commodity price indicator. This indicator will supplement the existing national indicators in assessing and reaching judgments about economic policies and performance. It will be used as an analytical tool in examining global price trends, not as an automatic trigger for policy action or an anchor for currencies.

We will need to continue to consider other measures to advance coordination on a step-by-step basis and to further institutionalize the process.

- o For instance, we need to consider broadening the coordination process to cover structural reform. The Summit countries are identifying priority areas where structural reforms need to be pursued. These include such areas as tax reform, financial market liberalization, and deregulation of labor markets.

- o We should refine the means of assessing whether an economy's performance is significantly deviating from an appropriate path, suggesting the need for consultation and possible actions. This might involve consideration of "monitoring zones" for key indicators such as growth, trade balances and so forth.

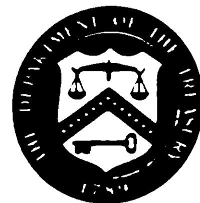
Conclusion

So to conclude, I would submit that our process of international economic policy coordination has reformed and strengthened the floating rate system. We have created a political mechanism that has brought discipline and structure to international economic policy-making. And our approach has worked -- not perfectly of course. But I strongly suspect the world economy is better off today than we would have been had we not followed this course. And I think additional progress will be achieved in the future.

Many of those who earlier had doubted this process have seen its benefits. As a result, coordination now has broader support and momentum that should carry it into the future, well beyond the terms of current administrations in the G-7 countries. We have come a long way in a few short years, and policy coordination should provide a sound framework for achieving meaningful and effective reform during the years ahead.

Thank you.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 23, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,420 million of 13-week bills and for $6,425 million of 26-week bills, both to be issued on May 26, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 25, 1988			:	26-week bills maturing November 25, 1988		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.33%	6.52%	98.400	:	6.69%	7.02%	96.599
High	6.34%	6.53%	98.397	:	6.71%	7.04%	96.589
Average	6.34%	6.53%	98.397	:	6.71%	7.04%	96.589

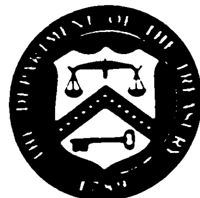
Tenders at the high discount rate for the 13-week bills were allotted 86%.
Tenders at the high discount rate for the 26-week bills were allotted 35%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 38,415	$ 38,395	:	$ 25,205	$ 25,205
New York	23,751,135	5,593,280	:	21,281,615	5,702,365
Philadelphia	26,490	26,490	:	17,695	15,695
Cleveland	37,005	36,930	:	28,615	28,615
Richmond	47,500	32,500	:	132,065	67,065
Atlanta	29,700	29,700	:	26,085	26,085
Chicago	1,882,850	54,150	:	1,079,445	55,195
St. Louis	18,470	18,470	:	17,900	17,900
Minneapolis	6,095	6,095	:	8,425	8,425
Kansas City	40,190	36,540	:	34,065	34,065
Dallas	37,210	27,210	:	28,110	18,110
San Francisco	1,524,320	189,320	:	1,104,960	93,460
Treasury	330,765	330,765	:	333,060	333,060
TOTALS	$27,770,145	$6,419,845	:	$24,117,245	$6,425,245
Type					
Competitive	$24,337,105	$2,986,805	:	$19,427,200	$1,735,200
Noncompetitive	939,955	939,955	:	778,545	778,545
Subtotal, Public	$25,277,060	$3,926,760	:	$20,205,745	$2,513,745
Federal Reserve	2,437,885	2,437,885	:	2,100,000	2,100,000
Foreign Official Institutions	55,200	55,200	:	1,811,500	1,811,500
TOTALS	$27,770,145	$6,419,845	:	$24,117,245	$6,425,245

1/ Equivalent coupon-issue yield.

B-1420

TREASURY NEWS 

Department of the Treasury • Washington, D.C. • Telephone 566-2041

Text as Prepared
For Release Upon Delivery
Expected at 2:00 p.m. EST

Testimony of Thomas J. Berger
Deputy Assistant Secretary for International Monetary Affairs
U.S. Department of the Treasury
before the
Committee on Banking, Finance and Urban Affairs
United States House of Representatives
Washington, D.C.
May 24, 1988

Financial Services in the U.S.-Canada Free Trade Agreement

Mr. Chairman, I appreciate this opportunity to appear before your Committee to discuss the Financial Services Chapter of the Canada Free Trade Agreement (FTA). Let me say in advance that if you, Mr. Chairman, or any members of your Committee, have any questions which can't fully be answered this morning, I or my staff will be more than happy to follow up.

The U.S.-Canada Free Trade Agreement is the most comprehensive trade agreement ever negotiated between two countries, and it is one that breaks new ground with respect to financial services, other services, investment, and technology. The agreement on financial services is by itself a landmark in that it is the first binational agreement entered into by the United States covering the entire financial sector. And the investment agreement is the first of its type entered into by Canada with any country, as my colleague, Mr. Cornell, will shortly discuss.

The Financial Services Negotiations

Let me now turn to the Financial Services section of the Free Trade Agreement and discuss its background, what it means and what the implications are for the financial sectors in our two countries.

Our objective in these negotiations was to make significant progress in obtaining equality of competitive opportunity for U.S. financial firms operating in or wishing to enter Canada. Put in another way, we sought treatment equivalent to that accorded domestic Canadian financial institutions. In a Treasury Depart-

ment report prepared for the Congress in December 1986, we highlighted the barriers that existed in Canada's financial sector. This document, the so-called "National Treatment Study," served as our road map in our quest for equal treatment for U.S. firms. We strove for, and believe we have achieved, an agreement yielding highly satisfactory results.

Mr. Chairman, let me now summarize the actual agreement and the commitments made by each country.

Canadian Commitments

For the U.S., there will be a substantial removal of discriminatory treatment in Canada. U.S. commercial banks operating in Canada will be relieved from onerous limits on their ability to compete and grow. Currently, the domestic assets of foreign bank subsidiaries operating in Canada (known as Schedule B banks) are limited to 16 percent of all domestic assets of the Canadian banking system. In addition, foreign bank subsidiaries face individual capital and leveraging limits and other restraints such as restrictions on the sale of loans to the parent bank. When the Financial Services Chapter of the Free Trade Agreement goes into effect, U.S. commercial bank subsidiaries in Canada will be exempt from the current discriminatory restrictions on market share, asset growth, and capital expansion, in the same way as Canadian banks are exempt. U.S. commercial banks will also be allowed to establish or acquire securities firms or federally-regulated Canadian insurance and trust companies, again in the same manner as Canadian banks.

In addition to helping U.S. commercial banks compete on a more equal basis in Canada, the agreement also has substantial benefits for U.S. financial institutions other than commercial banks. In particular, all U.S. financial institutions will be better able to grow and take full advantage of Canada's financial market liberalization due to removal of the so-called "10/25" rule. This rule prevents a nonresident from acquiring more than a 10 percent ownership interest in certain types of Canadian financial services companies; a group of nonresidents is limited in the aggregate to a 25 percent interest. Under current regulations, U.S. and other foreign insurance companies have perhaps been the most disadvantaged because of the "10/25" rule; under this agreement, U.S. firms will receive the same rights as Canadian companies to diversify in the financial sector by establishing or acquiring federally-regulated insurance companies, trust companies, Schedule B banks, or securities firms.

While Ontario, Quebec, and other provinces have liberalized their securities markets and have welcomed foreign investors, the federal government implemented a policy of reciprocity which has held up the applications for entry by U.S. securities firms and banks. Under this agreement, these applications will be reviewed strictly on a prudential basis, just as for Canadian firms, and not on a reciprocity basis.

To summarize the Canadian commitments, U.S. commercial banks, securities firms, insurance companies, and other financial institutions will be granted significantly better treatment that will allow them to compete more effectively in Canada with domestic firms.

U.S. Commitments

Under the agreement, the U.S. also made a number of specific commitments. First, the U.S. agreed to guarantee the right of Canadian banks to retain their multi-state branches in the United States that were grandfathered under the International Banking Act of 1978.

Second, if the Glass-Steagall Act is amended, we committed to extend the same benefits we grant our own firms to Canadian financial institutions in the United States.

Third, in an effort to be responsive to reasonable Canadian concerns regarding the treatment of U.S. subsidiaries of Canadian banks and securities firms which merge in Canada, the U.S. agreed to allow Canadian banks, as well as U.S. and other foreign banks, in the United States to underwrite and deal in debt obligations guaranteed by the Government of Canada, or its political subdivisions. This is a new measure for U.S., Canadian and other foreign banks that is consistent with the existing ability of banks to deal in securities of the U.S. Government or its political subdivisions.

Commitments by Both Countries

In addition to these specific measures, the United States and Canada both made an important commitment to continue liberalizing our markets and extending the liberalization to firms of the other party after the Free Trade Agreement goes into effect, contingent upon the other party fulfilling its commitment to liberalize. We have established a formal consultative mechanism between the U.S. Department of the Treasury and the Canadian Department of Finance to oversee this liberalization and to resolve disputes arising from commitments already concluded in the Financial Services Part of the Free Trade Agreement.

Dispute Settlement for Financial Services

The Financial Services Chapter is excluded from the overall FTA dispute settlement mechanism. In its place, we created a consultative mechanism between the U.S. Treasury and the Canadian Department of Finance to serve both as the vehicle for resolving disputes and for seeking further liberalizations. We felt that a different mechanism from that in the overall FTA was necessary in the financial services area. In our view, financial services are fundamentally different from most other services and from the tradeable goods sector because prudential and regulatory concerns

play such an important role. Accordingly, we tried to tailor a consultation and dispute settlement mechanism that reflected the different and special nature of the financial services sector.

I would be happy to answer any questions at this time.

Thank you very much.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
Expected at 10:00 A.M., EDT

TESTIMONY OF THE HONORABLE
GEORGE D. GOULD
UNDER SECRETARY FOR FINANCE
U.S. DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
TUESDAY, MAY 24, 1988

Good morning, Mr. Chairman, Senator Garn, and Members of the Committee. It is a pleasure for me to testify on the progress made by the President's Working Group on Financial Markets.

During the past two months, the principal members of the Working Group and our respective staffs have analyzed and discussed the extensive information and recommendations emanating from last October's market decline. Far from being a stalling device as some have criticized, the Working Group has moved forward, after much deliberation, on a number of critical issues to preserve the integrity, competitiveness and efficiency of our nation's financial markets.

Our focus has been on positive actions that can be taken now -- immediately -- as contrasted with possible legislative restructuring that is subject to protracted debate and possible delay. Fortunately, the Working Group identified ways to act affirmatively, without legislation. Although this Committee has an enviable record of moving legislation, Mr. Chairman -- as witnessed by the 94 to 2 vote on the Proxmire Financial Modernization Act -- the Members of this Committee will recall that it took two years to enact the Administration's proposal to recapitalize the Federal Savings and Loan Insurance Corporation. Even then, we did not get the full amount requested to resolve insolvent institutions and today we hear numerous cries for a taxpayer bailout.

Collectively, the Working Group's action proposals address basic safety and soundness issues, should lessen the risk of systemic problems, and as a result, work to the benefit of all investors. The key issues -- identified by the Brady Commission, the General Accounting Office (GAO), the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and others -- on which the Working Group has agreed unanimously and has taken constructive action include:

- an agreement on coordinated "circuit breakers" across markets to allow for cooling-off periods during times of extreme price declines;

- recommendations and conclusions on the credit, clearing, and payments system to ensure the necessary coordination of information and operations within and between markets and to avoid systems gridlock;

- agreement that current minimum margin requirements provide an adequate level of prudential protection to the financial system; and

- agreement on contingency planning, including the continuation of the Working Group, to ensure coordination and consultation in the event of future, rapid market disturbances.

I also am pleased to report that the securities, futures, and options industries already are making -- and should continue to make -- significant efforts to enhance operational capacity, to increase individual firm and clearinghouse capital, and to improve the fairness and quality of order executions for all investors, large and small.

THE NEED TO REDUCE SYSTEMIC PROBLEMS

The specific conclusions and recommendations are contained in the Working Group's interim report to the President, which accompanies my testimony. It is essential, however, to understand the premise from which these conclusions evolved.

The Working Group views its primary mission as taking collective, safety and soundness actions which would substantially lessen possible systemic dangers to the U.S. financial system if we were again to encounter a severe stock market decline. Consequently, the Working Group -- acting on the most significant suggestions of the Brady Report and others -- views coordinated circuit breakers, prudential margins across markets, the proper functioning of credit, clearing, and payment systems, and contingency planning as key ingredients to prevent stock market declines from degenerating into self-feeding panics.

While markets will always react to changes in fundamental economic information, it is important to assure all investors as to the proper functioning of the financial system while such information is being digested in terms of market pricing. Indeed, reducing concerns over the viability of the mechanics and infrastructure of the system could mitigate the extent of market declines by reducing the risk premium inherent in those extreme situations where market participants worry about receiving full and timely payments. Hence, our emphasis on safety and soundness issues first during these past 60 days.

Daily Volatility Is Not A Systemic Threat

The issue of daily volatility, although an expressed public concern, is not in the category of systemic threat, in my opinion. However disconcerting such volatility can be on a short-term basis, it is important not to attempt cures that can do more harm than good. Markets must be allowed to adjust to new price levels without impediments to efficiency that in themselves cause disruptive market action. Narrow price limits for circuit breakers, causing frequent market shut downs, would be an example of such self-defeating "cures".

Moreover, volatility is a subject which often has been treated publicly with more emotion than analysis. It must be noted that, with the exception of the period October 1987 through January 1988, there is no evidence of any increase in daily volatility. Volatility from 1983 through 1986, during which time the futures market was growing rapidly, was moderate to low as compared to similar prior periods. This is illustrated in Exhibit A. I should note that since February 1988, daily price volatility has returned to levels such as were seen in 1973, 1974, 1975, 1980, and 1982, and which are statistically indistinguishable from the norm for 1971 through 1986. In any case, we must be cautious in ascribing events of those few months of extraordinary volatility to changes which have been in place for some time or in extrapolating that those events will be the new norm in the future.

Some observers believe the individual investor has left the market because of a perception of increased volatility. It is equally possible that much of the retreat is in fact investors' collective views that the bull market has paused or that more attractive alternative investments are available. Individual investors have "left the market" in the wake of other major market declines (e.g., in the mid 1970s). Those individuals who want to own equities but are concerned about competing with large, sophisticated pools of capital can, if they wish, invest through them (e.g., mutual funds and pension funds) rather than trying to compete with them.

We must recognize that investor withdrawal during such bear markets is a fact of life, reaffirmed recently in a New York Times article which states in part:

> Investor disillusionment with the stock market is not a new phenomenon. Typically, investors withdraw each time there is a bear market -- contributing to the bleak mood. After the almost 50 percent drop in the value of stocks during the 1973-74 bear market, for

instance, many individuals fled the market and stayed out until the bull market of the 1980's.

The number of individual shareholders who owned stocks on the New York Stock Exchange fell to 25.2 million in 1975 from 30.8 million in 1970. The number of shareholders of mutual funds dropped to 7.8 million in 1980 from 8.4 million in 1970, according to estimates by the Investment Company Institute.

Numerous Factors Cause Markets to React More Quickly Today

There are numerous factors that have made markets react more quickly today to changes in the fundamental determinants of stock prices. First, the nature of stock ownership has changed substantially over the past twenty years, led by private and public pension funds. There have evolved very large individual aggregations of capital of a size unknown in an earlier period.1/ This, in turn, has led to changes in the techniques of managing such capital, often with an emphasis on the market as a whole (e.g., the S&P 500) rather than individual stocks. In the case of major broker/dealers, the need for trading liquidity by large bodies of capital has also increased the need for hedging techniques by corporate treasurers and money managers. Thus, the stock index futures markets have evolved as the lowest cost, most efficient response to these changed needs. "Trading the market" and hedging are not in and of themselves either good or bad -- they are economic facts that are not going to go away.2/

It is not the futures products themselves that are called into question; rather, it is the behavior of large institutional investors and large traders (e.g., Fortune 500 companies, union pension funds, mutual funds, etc.) that comes into play. I must admit, too, that I have some difficulty in my own mind when it comes to legislating behavior modifications of that magnitude.

1/ At the end of 1987, U.S. private pension fund assets totalled almost $1.5 trillion and U.S. public pension fund assets were approximately another $500 billion. By comparison, total pension fund assets were approximately $820 billion at the end of 1980.

2/ 1987 statistics for the largest 200 pension funds show that a growing percentage of their assets (11.8%) is in stock index funds. A growing percentage of these pension funds (36%) also uses stock index futures.

Second, benefits of active futures markets are real: for example, they apply directly to the Treasury securities market. Treasury futures are used as hedging vehicles and as a cost-saving means to adjust positions in the underlying securities. These risk-reducing benefits of futures markets lead to a reduction of the risk premium investors require on the underlying Treasury securities and thus to lower interest costs for the Federal Government.

For an excellent discussion of the increasingly significant role of derivative products -- particularly futures on stock indexes -- in the securities markets, members of the subcommittee really should review Chapter Three of the SEC's Staff Report "The Effects of Derivative Products" (The October 1987 Market Break) which I have attached as Exhibit B of my statement.

Third, with the index futures markets having exhibited greater volume in the underlying stocks than the cash market exchanges, it can be argued that the Chicago Mercantile Exchange (CME) has become a leader -- rather than a follower -- in price discovery of equity market value levels. Cash market prices are now often following, rather than leading, the so-called derivative market. The Brady Report and others have underscored the close economic linkage between these markets. Thus, the public debate over the role of index arbitrage is often misdirected. Index arbitrage only takes place when there is a difference of price level between the cash and futures markets, and such arbitrage, as in its age old role, helps equate those price levels.

Fourth, while it is true that index arbitrage can translate buying or selling pressure from one market to another, if those markets are truly economically linked and responding to the same fundamentals, then such arbitrage serves the useful purpose of quickly equalizing the price levels between the markets. It is worth noting in this context that the proposal of the New York Stock Exchange (NYSE) for trading baskets of stock on the NYSE would itself produce "index arbitrage" between the value of the basket and the underlying stocks -- but this arbitrage would be within the NYSE. What often is overlooked in discussions of arbitrage is that if there were no linkage of the markets, then more selling or buying could spill over into the cash markets directly. If the futures market were to disappear from this country, pressures on the stock market would only increase. The Brady Report takes note of such selling when the linkage broke down in October.

Much public criticism of index arbitrage is a classic case of wanting "to shoot the messenger" that brings the bad news of selling on the CME to the floor of the NYSE. If selling is

going to take place to a degree that pushes prices down sharply, then cash markets will not be made immune by eliminating index arbitrage. The emphasis, therefore, should be on increasing the capacity of systems like the Designated Order Turnaround (DOT) system of the NYSE so that the public has fair and equal access to order transmission, rather than on restricting mechanical linkages between economically-linked markets.

Put another way, if there were no index futures market, then there would be no index arbitrage. But there is no evidence that such a condition would give the cash markets immunity from selling pressure generated by responses to fundamental events -- and no likelihood that having developed to meet a large and important investment need there will not be a viable index futures market, whether here or abroad.

Fifth, the volatility many people blame on index arbitrage could also be evident from direct selling in the cash market. In fact, pressures directly on cash markets are clear from history. Earlier in the postwar periods before the index futures markets came into existence in 1982, the Dow Jones Industrial Average (DJIA) had a number of significant declines as outlined in Exhibit C of my testimony. In fact, the 1973-74 bear market was worse than the 1987 decline; while it took longer, the end result was that price levels reacted to fundamental perceptions and adjusted accordingly. While individual share ownership is an important part of our financial system and should be encouraged, we cannot expect to be able to legislate normal human behavior -- any more than we should be expected to protect the revenues of brokerage firms by attacking symptoms rather than causes.

Sixth, the aggregation of capital is a factor in today's global markets, just as the phenomenon of rapid information dissemination also is important to recognize. The world now has the technological systems -- and therefore the ability --- for almost instantaneous response to any event. This provides another type of aggregation in the form of concerted buying or selling. While market liquidity has increased greatly in recent years, clearly some greater volatility can be intrinsic to concerted action. Eliminating information technology -- either by legislation or regulatory fiat -- hardly seems like a realistic reaction to concerns about volatility.

Finally, the Wall Street broker/dealer/specialist business has become increasingly capital-intensive. Since 1975, when fixed-rate commissions were ended, a notably larger percentage of revenues are now a function of capital returns rather than commission income. With capital risk thus less protected by a

cushion of commission income, there is a tendency for block

houses and specialists to become more risk averse in their bids during uncertain times. This, too, can lead to greater volatility.

Evolution in the Face of Change is Necessary

If I may be permitted a personal comment, I would like to point out that when I started in Wall Street in 1951, a million shares traded on the NYSE in one day was a big event. Wall Street was like a private club, and a rather exclusionary club at that. No one worked too hard, competition was limited, individuals were as important as institutions, the U.S. economy was dominant, and the NYSE was the market of the world. There is more than a little nostalgia for those times that influences today's debates about how markets should function.

I would suggest, however, that the Wall Street of an earlier time also had its drawbacks and never could have accommodated the demands of a growing U.S. economy without itself changing. Those changes continue, particularly in an internationally competitive world. It would be a mistake to focus only on the fall-outs of those fundamental changes when attempting to determine whether structural modifications are needed for the markets themselves.

Strong Agency and SRO Action Needed Against Frontrunning and Market Manipulation

Before I turn to our recommendations, I want to take a minute to comment on an issue about which I feel strongly. Virtually all of the reports voiced concerns about customer protection, particularly in the areas of intermarket frontrunning and market manipulation. For example, the Brady Report recommended development of an extensive trading information system for the stock markets to better diagnose developing problems and uncover abuses. The CFTC staff urged establishment of standards for identifying potential intermarket frontrunning trading patterns and a mechanism -- perhaps the Intermarket Surveillance Group -- for the timely and effective communication of market surveillance data related to possible frontrunning activity among all exchanges with common self-regulatory interests. The SEC recommended strengthening current prohibitions and working with the CFTC and self-regulatory organizations (SROs) to ensure that adequate intermarket information is available to pursue such matters.

The Administration fully agrees that vigorous action against problems of intermarket frontrunning and market manipulation is essential. Along with the benefits of new products, technologies, and trading strategies have come increased opportunities for abuse by market professionals and insiders.

These abuses have hidden economic costs in addition to their more obvious effect on smaller individual and institutional investors who come to believe that the rules are rigged against them. We deplore this situation and expect the regulators and SROs, who are in the best position to take affirmative action, to continue to do so. They already have made significant progress:

- o The CME has just circulated a proposed definition of frontrunning to futures industry representatives;

- o The NYSE recently notified its members that trading futures based on knowledge of impending orders in the stock market is a violation of exchange rules. The NYSE plans to provide the futures exchanges with audit trail information on stock trading that would enable the Chicago futures markets to conduct ongoing surveillance for frontrunning; and

- o The American Stock Exchange (Amex) has recently implemented systems to automatically monitor option trading for frontrunning, mini-manipulation, and pegging and capping. The Amex also is developing an expert system which uses artificial intelligence software to analyze potential insider trading market manipulation cases.

It is in the best interest of all investors concerned that the problems of frontrunning and market manipulation be resolved quickly and effectively by the agencies and SROs. Such action is crucial if we take seriously the charge that markets are rigged to the disadvantage of the small investor.

RECOMMENDATIONS

Let me now briefly summarize the Working Group's recommendations and conclusions. Our efforts have focused so far on six subjects which are described in more detail in our report to the President.

1. Continuing Coordination

The Working Group believes that its continuation is an excellent way to coordinate what should be an on-going process to address intermarket issues. The Brady Report and others have recommended that some additional regulatory mechanism be established to resolve these issues. Recognizing this concern for coordination, we believe cooperative efforts under the existing regulatory structure will continue to be effective, and in large measure, fulfill the intent of several legislative proposals. The very existence of this group has helped to keep

the pressure on the various SROs and market participants to devise and implement necessary reforms on their own.

2. Circuit Breakers

In addressing coordinated trading halts and reopenings, so-called circuit breakers, the Working Group has focused on market events that are so dramatic as to trigger ad hoc closings of equity markets and to pose potential systemic risks to our financial system. The Working Group has devised a cross-market mechanism to avoid ad hoc and destabilizing market breaks, recognizing that any disruption of trading is undesirable.

Our proposal is designed to substitute planned for unplanned, ad hoc trading halts, without increasing the overall frequency of such disruptions. Planned halts should allow time for the dissemination of information and consideration of decision to buy or sell in rare situations in which panic conditions threaten.

3. Prudential Margin Requirements

The Working Group reached agreement on several key points regarding prudential margins and concluded that:

- current minimum margin requirements provide an adequate level of protection to the financial system, although they do not cover all possible price movements, and that margins sufficient to cover all possible price movements would have unacceptable costs for the liquidity and efficiency of markets;
- there are additional protective cushions in place from capital requirements and surveillance for firms and clearinghouses; and
- given differences in price volatility of stocks and indexes and grace periods for settling margins, a consistent and harmonious margin regime among markets would produce significantly higher levels of margin for stocks than for futures.

The positions of the Working Group members on the need for margins in excess of the prudential level, and of the need for federal oversight, are set forth in the report to the President.

4. <u>Credit, Clearing, and Settlement</u>

As former Senator Nicholas Brady, who chaired the President's Task Force on Market Mechanisms, indicated recently, extreme stress on our clearing and credit systems came close to damaging our financial system last October. While a complicated and technical area, our financial system's network of clearing, credit, and settlement procedures truly is the nuts-and-bolts that allow hundreds of millions of transactions to be conducted and financed on a daily basis.

The Working Group has reviewed existing clearing, payments, and settlement systems to identify and set priorities for measures that they recommend be taken to reduce uncertainty, increase coordination, to assure confidence in the integrity of such systems, and to facilitate their smooth operation in volatile markets.

The Working Group endorses the view that the proper functioning of these systems is integral to the proper functioning of the financial markets as a whole and is pleased to report that significant progress has been made in this area. As more fully set forth in the report to the President, the Working Group is proposing an agenda of additional measures to be pursued to achieve the goal of more perfectly coordinated systems.

5. <u>Contingency Planning</u>

The Working Group believes that the purpose of contingency planning is to ensure that regulatory agencies and the SROs have in place systems which will allow them to identify emerging problems quickly and to react appropriately in the event of a market crisis. In an important sense, the Working Group recommendations for implementing circuit breakers, improving information flows, clarifying credit arrangements, and strengthening the clearing and settlement process can be viewed as a key part of contingency planning. By improving the market system's ability to withstand and react to shocks, these measures will enhance the system's first line of defense.

Going beyond this, the Working Group has given high priority to enhancing channels of communication among staffs of the respective regulatory agencies and the Treasury. In addition, staff of the three agencies are working jointly to improve information sharing across the agencies, with particular emphasis on a framework for coordinated monitoring of exposures and developments at major market participants. Finally, regarding international policy coordination, steps are being taken by the

various agencies to strengthen existing contacts with their counterpart authorities in other major market centers to further improve this aspect of market surveillance.

6. Capital Adequacy and Systems Capacity Enhancement

Market participants, SROs, and regulatory agencies have taken or are planning a number of significant actions to enhance financial integrity and improve automated systems -- two of the issues the Working Group, the Brady Report, the GAO and others have identified as critical to the financial integrity and smooth functioning of the markets. Our report to the President cites the many constructive steps already taken in these areas. The Working Group encourages these efforts and will continue to monitor developments to ensure that needed improvements are made.

CONCLUSIONS

In summary, Mr. Chairman and Members of the Committee, the Working Group has commenced action on a number of significant steps that collectively will work to reduce systemic threats to our financial markets. In so doing, we have pursued a sizeable portion of the agenda defined in large measure by the Presidential Task Force on Market Mechanisms,3/ the GAO, the SEC, the CFTC and other market observers. Indeed, Senator Brady concluded his recent public letter with a position that in fact has been the operating basis of the Working Group:

> We are not attempting to legislate against decline or interfere with the smooth functioning of the markets. The market will always seek its level ground; we are only trying to assure that it gets there safely.

The collective and coordinated actions recommended by the Working Group -- and corrective steps already taken by others -- help to assure that the market in fact does "get there safely" when it moves for whatever reasons.

3/ See, for example, the summary comparison of the recommendations in the Brady report and the actions taken by the Working Group in Exhibit D.

We cannot legislate against market declines, regulatory dictates cannot eliminate volatility, and executive fiat is no more effective. Price controls and capital controls have never worked effectively in this country and no amount of government control can sway markets if underlying economic fundamentals -- or investor perceptions of those same fundamentals -- take the market one direction or another.

Moreover, it is unrealistic and ultimately counterproductive to attempt to roll back developments in financial markets brought about by advancements in telecommunication and computer technology and by changes in investment needs. We cannot go back to the days of the abacus or mechanical adding machines. If we did -- by trying to legislate against particular products or investor preferences or market strategies, for example -- then we would ultimately lose whatever competitive edge we now have to places like Toronto, Tokyo, or London.

Mr. Chairman, I would be remiss if I did not commend the cooperative actions and constructive dialogue on the part of the Working Group members. As you requested at our last hearing, we have spent considerable time and energy to arrive at our initial recommendations. The members of the Working Group have demonstrated that it is possible to address major, complex issues in a cooperative fashion -- even though we bring different perspectives and preferences to the table -- and in a reasonably short time frame. Disagreements on some matters have not blocked significant agreements that are apparent upon careful examination of the package we have presented to the President.

The public also has been well served by the Working Group's high caliber staff and their professional analyses, and I salute them.

We have made progress on basic elements that are essential to the safety and soundness agenda that we view as a priority. More work will be done, and we welcome the continuing challenge.

* * * * * * * * * * * * * * *

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.
May 24, 1988

CONTACT: Office of Financing
202/376-4350

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $12,800 million, to be issued June 2, 1988. **This offering will result in a paydown for the Treasury of about $800 million, as the maturing bills are outstanding in the amount of $13,592 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern** Daylight Saving time, Tuesday, May 31, 1988. **The two series offered are as follows:**

91 **-day bills (to maturity date) for approximately $6,400 million, representing an additional amount of bills dated** September 3, 1987, **and to mature** September 1, 1988 **(CUSIP No. 912794** PZ 1 **), currently outstanding in the amount of $16,647 million, the additional and original bills to be freely interchangeable.**

182 **-day bills for approximately $6,400 million, to be dated** June 2, 1988, **and to mature** December 1, 1988 **(CUSIP No. 912794** QV 9 **).**

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing June 2, 1988. **Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $1,594 million as agents for foreign and international monetary authorities, and $4,316 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).**

B-1423

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

10/87

TREASURY NEWS

partment of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery

Address by
Gerald L. Hilsher
Deputy Assistant Secretary
(Law Enforcement)
U.S. Department of the Treasury

American Banker's Association:
National Operation and Automation Conference

May 24, 1988

Taking the Starch out of Money Laundering: The Role of the Bank Secrecy Act

Introduction

Thank you for asking me to speak with you today on the subject of the Bank Secrecy Act. It is my intention to explore with you the application of the Bank Secrecy Act against the professional money launderers that support organized criminal activity, such as drug trafficking. Contrary to the popular perception of many banking professionals, the Bank Secrecy Act truly is a "tool" against the illegal activities of narcotics traffickers, money launderers, and tax evaders. Enforcement of the Bank Secrecy Act is not meant to "pick on" the financial industry. The purpose of Bank Secrecy Act compliance examinations by your regulators, and the criminal and civil penalties levied for noncompliance is to ensure that the tool is kept sharp and that the financial database captures information of use to law enforcement. Through careful compliance with the Bank Secrecy Act, you can help take the starch out of money laundering and help to remove the profits from the dope dealers.

I will also discuss the efforts of Treasury's Office of Financial Enforcement to provide informative educational materials to the financial industry on the requirements of the Act through administrative rulings and government publications, such as the soon to be published Exemption Handbook.

I will also share with you the findings of the IRS pilot project on magnetic tape filing of CTRS, Project "Merit" which acronym stands for Magnetic/Electronic Reporting of Information Transactions. The success of the pilot project resulted in its being made a permanent method of filing CTRs, as announced last December.

Overview of Reporting Requirements

First, by way of background, it was in 1970, that the U.S. Congress passed the Currency and Foreign Transactions Reporting Act, which, together with certain recordkeeping provisions, has become popularly known as the Bank Secrecy Act. The Bank Secrecy Act is really a misnomer. A better name would probably be the Anti-Bank Secrecy Act. The Act requires the disclosure of information regarding large currency transactions and is specifically designed to aid in the attack against organized criminal activity by creating a "paper trail" to trace drug and other proceeds back to their illegal sources.

The Act provides that the Secretary of the Treasury shall promulgate regulations requiring the filing of reports, as well as the maintenance of records, that are determined to have a high degree of usefulness in criminal, tax, and regulatory investigations or proceedings. The Secretary has delegated to the Assistant Secretary (Enforcement) overall responsibility for Bank Secrecy Act enforcement. By further delegation, the responsibility for coordination of Bank Secrecy Act enforcement and policymaking rests with the Office of Financial Enforcement, which reports to me, the Deputy Assistant Secretary (Law Enforcement). The Office of Financial Enforcement is also responsible for the imposition of civil penalties for noncompliance with the Bank Secrecy Act, which I will discuss shortly.

The Bank Secrecy Act, through the implementing regulations that Treasury has issued, require the routine filing of several types of reports:

1. The Currency Transaction Report or ("CTR"). A financial institution, other than a casino, must file a CTR, IRS Form 4789, for "each deposit, withdrawal, exchange of currency, or other payment or transfer by, through, or to such financial institution which involves a transaction in currency of more than $10,000."

"Financial institution," as that term is used in the statute and regulations, includes not only banks, but also securities brokers, currency exchange houses, check cashers and even

individuals who provide services traditionally conducted at financial institutions. A similar report, called a "Currency Transaction Report by Casinos, or CTRC, is required to be filed by casinos when they engage in transactions like those described above.

2. The Report of International Transportation of Currency or Monetary Instruments ("CMIR"). A person must file a CMIR, Customs Form 4790, when he "physically transports, mails, ships, or causes to be physically transported, mailed or shipped, currency or other monetary instruments in an aggregate amount exceeding $10,000 on any one occasion," whether that transportation is into or out of the United States; or when he receives in the United States currency or other monetary instruments in an aggregate amount exceeding $10,000 that have come from outside the United States and on which no CMIR was filed.

3. The Report of Foreign Bank and Financial Accounts ("FBAR"). A person subject to the jurisdiction of the United States (including a U.S. citizen residing abroad) must file an FBAR, Treasury Form TD F 90-22.1, if that person had, at any time during the year, a financial interest in, or signature or other authority over, one or more bank accounts, securities accounts, or other financial accounts in foreign countries, and the aggregate value of the accounts exceeded $10,000.

Finally, the Act and the regulations require financial institutions to maintain a variety of records (such as copies of signature cards, bank statements, and checks drawn for more than $100) for a five-year period. Records required to be kept under the Act, unlike the BSA reports, generally may be examined by law enforcement authorities only for the purpose of assuring compliance with the Act's requirements; in other cases, the authorities must obtain subpoenas or comply with other legal provisions.

The Financial Database

The CTRs, CTRCs, and the FBARs are all filed with the Internal Revenue Service and placed on computer at the IRS Detroit Data Center. The CMIR reports are filed with the U.S. Customs Service and are processed in Newington, VA. These reports, when combined, form what we call the Treasury Financial Database. The Financial Database is accessible to Customs and IRS agents and financial analysts for targeting suspicious currency transactions, investigative case support, tax examination and collection, and a host of other law enforcement uses.

Both Customs and the IRS have rule-based, artificial intelligence systems massaging the data contained in the financial database,

along with data received from the field. These A-I systems are based on rules of suspicious indicators, for instance, persons whose many CTRs list differing occupations, social security numbers, and addresses, and whose transactions involve multiple accounts at a variety of financial institutions. Certain occupations are more suspicious than others, according to the expert rules used by the A-I system, and these more suspect occupations are measured against the levels of financial transactions. CTRs filed by financial institutions for amounts below the $10,000 reporting threshold, e.g. a $9,900 CTR, is a suspicious circumstance to the A-I computer, drawing on our experience that the bank filing such a report believes the currency transaction to be suspicious.

The A-I computer applies these and other rules against the database automatically and highlights certain "targets" for further analysis by human financial intelligence analysts, and ultimately for referral to the field for further investigation. To date, over 270 targets representing reportable CTR activity exceeding $201.9 million and reportable CMIR activity exceeding $21.6 million have been generated by the A-I systems.

The Treasury Financial Database can be used for law enforcement purposes unrelated to tracking suspicious financial transactions. Project Warrant is an operation being conducted through the Customs Financial Intelligence Division which seeks to match information on fugitives against the database in hopes of locating escapees, and persons under indictment or for whom an arrest warrant has been issued. One notable success story for Project Warrant was the arrest, in November of 1987, of an escaped convicted murderer who had been a fugitive since 1984. The leads provided to the state police from the financial activity identified in the Project Warrant report culminated in the subject's arrest at the residence of one of his children. The address was obtained from a CTR filed in 1984 when the subject conducted a financial transaction.

I have been asked by many in the financial community, "Does anyone even look at the information that we send to Detroit?" I hope you can see now that we do, and furthermore, how very important it is that the identity of your customer be verified and that the CTR is filled in completely, including the occupation and address blanks.

Utility of Bank Secrecy Act

Now that I have described how the financial intelligence divisions of IRS and Customs review and analyze this information, I would like to describe how these reports have proved highly useful for civil and criminal law enforcement purposes.

Particularly in recent years, these reports have provided law enforcement authorities with investigative leads, information that corroborates other sources of information about criminal activities, and probative evidence in Federal criminal cases. Perhaps the most prominent example of the reports' utility can be found in United States v. Badalamenti (also known informally as the "Pizza Connection" case). That case involved the smuggling of substantial quantities of heroin into the United States by members of Italian and U.S. organized criminal groups. In the course of their investigation of heroin trafficking, Federal authorities discovered a number of CTRs that reflected large cash transactions by a Swiss national with stockbrokers in New York. These reports eventually led to the discovery of an extensive money-laundering operation that involved the transfer of tens of millions of dollars through investment houses and banks in New York City to financial institutions in Switzerland and Italy.

Ultimately, twenty individuals involved in the heroin network and money laundering enterprise were convicted in Federal court on various charges, including heroin trafficking, conspiracy, racketeering and Bank Secrecy Act violations. All received prison sentences ranging from fifteen to forty-five years. In addition, the Swiss national was convicted and imprisoned by Swiss authorities for violations of Swiss law relating to his money laundering activities.

The Government has also made substantial use of the Bank Secrecy Act to prosecute a number of leading money launderers in the United States and abroad. In recent years, for example, the Government has successfully prosecuted Isaac Kattan-Kassin, whose money laundering organization handled gross proceeds estimated at $200 million to $250 million per year; Ramon Milian-Rodriguez, who transported approximately $146 million in cash from the United States to Panama over a nine-month period; Eduardo Orozco, whose money laundering organization laundered more than $150 million over a four-year period; and Barbara Mouzin, who masterminded and operated a large West Coast money laundering business for cocaine traffickers.

In some instances, even a single CTR can provide significant investigative leads for criminal investigators. In one case, the Internal Revenue Service ("IRS") analyzed a single CTR and determined that the individual listed on the CTR had not filed a tax return. Subsequent investigation disclosed the existence of a massive heroin distribution and money laundering organization, operating primarily throughout southern California, which provided false information to the financial institutions that filed CTRs on their transactions. Eventually, the IRS arrested more than a dozen persons associated with the organization, seized in excess of $2 million in currency at various domestic banks, and charged the organization with income tax evasion

involving $27 million in income over a three-year period.

Although many of the examples cited above involved large-scale money laundering for drug traffickers, Bank Secrecy Act reports are also highly useful in identifying or proving other types of financial crimes, for instance bank fraud and embezzlement. In one recent case, for example, analysis of reports filed by a bank provided a number of leads as to the disposition of tens of millions of dollars that had been embezzled from the bank through such devices as illegal loans. In another recent case, Federal investigators discovered that a husband and wife had failed to file a CMIR form for the $125,000 in cash that they took out of the United States. Further investigation determined that the wife had embezzled millions of dollars from the savings and loan association in Texas at which she had been employed.

These examples amply demonstrate the substantial utility of Bank Secrecy Act reports. In addition, unlike grand jury subpoenas or court orders, the reports provide a constant stream of data on large domestic and international movements of cash and ensures that law enforcement agents obtain valuable information on suspicious transactions in a timely fashion.

Bank Secrecy Act Dissemination

Treasury has taken a number of administrative actions to make the Financial Database more readily accessible to law enforcement and supervisory agencies. The Office of Financial Enforcement is now working out arrangements with the regulatory agencies to provide those agencies with "on-line" access as well.

Treasury has also extensively revised the guidelines under which the U.S. Customs Service and the Internal Revenue Service may disseminate Bank Secrecy Act Data, to minimize procedural difficulties for other law enforcement agencies and make those data more readily available. In addition, Treasury has concluded an agreement with the Office of the Attorney General in California for transmission of magnetic tapes of Currency Transaction Reports that have been filed by California financial institutions. This agreement will allow the State of California to carry out its responsibilities under its anti-money laundering law, without requiring California financial institutions to file duplicate copies of CTRs with the State.

Enforcement of the Bank Secrecy Act

As I mentioned in my introduction, I view the Bank Secrecy Act as a law enforcement "tool," and the enforcement of its provisions as the "grinding wheel" that sharpens the tool. Thus, in the past three years, Treasury has been more vigorous than ever

before in initiating investigations and levying civil penalties against financial institutions for civil violations of the Bank Secrecy Act. Since June, 1985, Treasury has levied civil penalties totalling approximately $16 million for Bank Secrecy Act violations in thirty-eight cases involving financial institutions. It is important to note that in a number of cases, the civil penalty was negotiated with a bank holding company that owned more than one bank that had violated the Act. This means that these thirty-eight penalties actually involved one hundred and seven banks that Treasury concluded had violated the Act. Moreover, twenty-nine of these penalties exceeded $100,000 -- an indication that the violations to which the penalties pertained were neither isolated nor infrequent.

The Internal Revenue Service - Criminal Investigation Division has been delegated the authority for criminal enforcement of the CTR provisions of the Bank Secrecy Act. In the past five years, the IRS-CID has steadily increased the number of investigations and prosecutions for criminal violations of the Bank Secrecy Act. The number of indictments have increased from 29 in 1982 to 236 in 1987 and convictions have also increased from 25 to 153 during that same time period.

I believe there is a real salutary effect in the imposition of civil and criminal penalties against noncompliant financial institutions. Since the criminal conviction of the Bank of Boston in 1985 and the imposition of civil penalties against other financial institutions, the phenomenon of cardboard boxes full of cash arriving at the back doors of banks in South Florida has been virtually eliminated. The publicity of a few multi-million dollar penalties is a great deterrent against laxity in complying with the Bank Secrecy Act. The increased compliance with the requirements of the Bank Secrecy Act by financial institutions is mirrored by the increased number of CTRs filed annually. In 1984, before the Bank of Boston case, 706,000 CTRs were filed; in 1985--1,832,000 CTRs were filed; in 1986--3,700,000; and in 1987 4,974,000. Currently, approximately 600,000 are being filed each month.

Another aspect of Bank Secrecy Act enforcement that is sometimes overlooked, but is no less vital for an effective compliance program, is the commitment of the United States Customs Service to enforcement of the Bank Secrecy Act requirements for Reports of International Transportation of Currency or Monetary Instruments (also known as the "CMIR" requirements). During Fiscal Year 1987, Customs conducted a total of 2138 seizures of currency and monetary instruments totalling $192,382,985 for violations of the CMIR requirements. Through April, in Fiscal Year 1988, Customs has conducted a total of 641 seizures totalling $56,323,737, for violations of the CMIR requirements.

Although Treasury is firmly committed to rigorously enforcing the Act, in order to obtain information on large currency transactions and create the necessary evidentiary paper trail for prosecution, we are equally committed to fostering a partnership between financial institutions and the Federal law enforcement authorities and to seeking creative solutions to the problem of money laundering. Your institutions should not be the unwitting accomplice of international drug lords and money launderers. By identifying, seizing, and otherwise interrupting the flow of narco-dollars, we can remove a vital component of the trafficking operation. Many of you have recognized this essential fact, as evidenced by the general improvement in Bank Secrecy Act compliance, and also by the ever-increasing, timely reports of suspicious transactions to IRS and Customs.

Rather than rely exclusively on mere compliance with the Bank Secrecy Act to take on the money laundering problem, Treasury has been advising financial institutions that observe suspicious financial activity to telephone the local office of the IRS and report that activity in conformity with the Right to Financial Privacy Act. Some of the Banking regulators now impose a duty on your institutions to report suspicious activity as well. This is particularly important for suspected incidents of structuring transactions to evade the reporting requirements of the Bank Secrecy Act, which is now a criminal offense under Title 31, USC, section 5324.

Treasury and the IRS believe that the availability of a toll-free number will enhance the ability of financial institutions to report possible structuring or money laundering activities on a timely basis, and allow the IRS to coordinate its responses to these contacts more efficiently. Such a toll-free number will soon be installed at the Detroit Data Center - the number is 1-800-BSA-CTRS. A press release will be issued when the number is operational.

In addition, Treasury recently sent letters to the chief executive officers of U.S.-based financial institutions with foreign branches. These letters call to the attention of the financial institutions the risks associated with international money laundering, identify certain patterns of activity that should be considered suspicious, and encourage the foreign branches of those institutions to report any suspicious transactions to overseas Treasury law enforcement representatives in a manner consistent with the laws of the country where the branch operates. These initiatives, may well provide U.S. law enforcement authorities with additional leads in money laundering and Bank Secrecy Act cases, and should help to persuade U.S. financial institutions abroad that expanded cooperation with Federal law enforcement authorities is in their interest and the interest of their legitimate customers.

That concludes that portion of my talk on the "why" of the Bank Secrecy Act. I hope that I have convinced you that like your own neighborhood watch programs, we need your support in watching out for the financial transactions and transactors that keep this terrible drug plague alive and operating. Now let me tell you a little about the educational programs we have undertaken at Treasury to make your dealing with the requirements of the Act more efficient and effective.

Guidelines on Exemptions

Treasury has completed the drafting of a booklet that will explain to banks the process for exempting certain types of customers and currency transactions from the CTR reporting requirements, as permitted under the regulations. Treasury and the IRS have observed that many banks, largely because of their concern that they may be heavily penalized if they mistakenly place ineligible customers on their exemption lists, have sharply reduced or eliminated their exemption lists and file CTRs on all currency transactions over $10,000. This practice has caused these banks to file more CTRs that the regulations require. The exemption handbook is now being printed by the Government

Printing Office. Information on ordering copies of the exemption handbook will be forthcoming through the regulatory agencies and, hopefully, the ABA. This handbook should help to alleviate banks' concerns about the use of the exemption provisions of the regulations, and minimize confusion about the application of these provisions in the more common situations that banks encounter in handling reportable currency transactions.

Administrative Rulings

Treasury has begun to draft and will soon issue a series of formal administrative rulings on various provisions of the Bank Secrecy Act regulations. These rulings are being issued pursuant to a revision in the Bank Secrecy Act Regulations, issued on September 22, 1987, that explains the process for seeking administrative rulings from Treasury. As Treasury responds to various requests for rulings, or issues rulings on its own initiative, it will be able to develop an expanding range of explanations of the regulations and provide the financial community with clearer guidelines on the meaning of regulations.

Training Seminars

The Office of Financial Enforcement is pleased to send representatives to training seminars to speak on the subject of the Bank Secrecy Act. We do have to be selective and will accept

only those invitations that offer a broad audience. Many professional associations have offered to compensate members of my staff for appearances before association members, however, the Office can only accept reimbursement for travel expenses from certified 501 (c) (3) organizations and must decline honorarium.

<u>PROJECT MERIT</u> (Magnetic/Electronic Reporting of Information Transactions)

Although Treasury is committed to achieving full compliance with the Bank Secrecy Act in all sectors of the financial community, we also recognize that we should take appropriate measures to ensure that the reporting and recordkeeping burden on financial institutions is no greater than necessary to provide law enforcement authorities with the information they need.

In March, 1987, Treasury announced a pilot program (Project Merit) in which financial institutions could file CTRs on magnetic tape. Over the next few months, twenty-five banking organizations have passed the technical standards for acceptance of their magnetic tape filings, and were certified to file on magnetic tape by the end of July, 1987. I would like to emphasize that the fact that a bank has been approved for magnetic filing does not mean that their system for insuring compliance with the BSA has been approved. Approval means only that the format on the tape meets the requirements necessary for magnetic as opposed to paper filing.

The major purposes of Project Merit were to confirm the benefits of magnetic filing of CTRs, that is, an increase in the accuracy of data being reported with a reduction in processing costs; to gauge the receptivity of the financial institutions to this method of filing; and to identify and test the modifications to IRS systems and procedures necessary for magnetic filing.

The following are IRS' findings from its evaluation of Project Merit:

a. The magnetic tape reporting system reduced the processing time of CTRs, measured from date of transaction to date first available for agent review, from approximately 45 days to 18 days, an overall reduction of 27 days.

b. Based on projections over a 10-year period, magnetic filing will provide an estimated cumulative net savings to the Federal government of over $22,000,000.

c. Less than 5% of the CTRs filed by magnetic tape contained data inconsistencies or format errors. In the paper system, approximately 52% of all CTRs received by the Data Center

require some manual perfection. Of these 52%, approximately 15% require further correction or result in correspondence seeking clarification.

d. Magnetic filing enabled the IRS to automate the front-end of the manual pipeline; i.e., the labor-intensive steps required to receive, control, number, code and edit, and transcribe CTRs. Magnetic filing also enabled the IRS to acknowledge to the filer receipt of the reports, and to automate the correspondence process and the storage and retrieval of the reports.

e. Twenty-five of the 45 organizations which applied for admission to Project Merit passed the acceptance standards and were certified to file magnetically by the end of July, 1987.

There are two banks and a multi-bank corporation on magnetic tapes- Commercial National Bank, Shreveport, LA, Branch Bank & Trust Co., Raleigh, NC.; and First Security Service Company of Utah.

f. Benefits to the participating financial institutions were automation of internal processes, improving Title 31 compliance controls, and providing a better historical file complete with an acknowledgement record from the IRS. Although savings for the participating financial institutions were difficult to quantify absolutely, one bank estimated the cost benefit to be in excess of $50,000 annually.

g. No major systemic flaws in magnetic filing were revealed during the pilot program. Those flaws that were discovered have been or are capable of being corrected easily.

h. The pilot program confirmed that the filing of CTRs by magnetic tape media will provide cost benefits and other advantages to the government and to participating financial institutions.

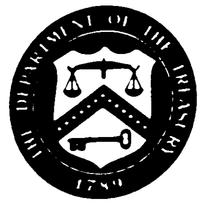
As a result of these findings, Treasury published a Federal Register notice on December 31, 1987, that announced the establishment of a permanent program for participating financial institutions to file CTRs on magnetic tape with the IRS Data Center. We encourage as many financial institutions as possible to participate in the program. You should contact the Detroit Data Center for further information on how to qualify.

Contact: Roger Hatcher
CTR Magnetic Media Coordinator
IRS Data Center
1300 John Lodge Drive
Detroit, Michigan 48226

Closing

Thank you again for asking me to speak with you today. Together, as active partners, we can take the starch out of money laundering. I wish you much success with the remainder of your conference.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE May 25, 1988

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of April 1988.

As indicated in this table, U.S. reserve assets amounted to $42,730 million at the end of April, down from $43,186 million in March.

U.S. Reserve Assets
(in millions of dollars)

End of Month	Total Reserve Assets	Gold Stock 1/	Special Drawing Rights 2/3/	Foreign Currencies 4/	Reserve Position in IMF 2/
1988					
Mar.	43,186	11,063	9,899	11,579	10,645
Apr.	42,730	11,063	9,589	11,275	10,803

1/ Valued at $42.2222 per fine troy ounce.

2/ Beginning July 1974, the IMF adopted a technique for valuing the SDR based on a weighted average of exchange rates for the currencies of selected member countries. The U.S. SDR holdings and reserve position in the IMF also are valued on this basis beginning July 1974.

3/ Includes allocations of SDRs by the IMF plus transactions in SDRs.

4/ Valued at current market exchange rates.

B-1425

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

Text as Prepared
For Release Upon Delivery
Expected at 2:00 p.m. EST

Testimony of Stephen J. Canner
Director, Office of International Investment
U.S. Department of the Treasury
before the
House Committee on Banking, Finance and Urban Affairs
Washington, D.C.
May 24, 1988

Investment in the U.S.-Canada Free Trade Agreement

Thank you, Mr. Chairman.

I am pleased to be here today to discuss with you and other members of this Committee the investment provisions of the U.S.-Canada Free Trade Agreement. The Agreement dramatically reduces barriers and establishes rules of conduct for a broad range of economic activities. When implemented, it will provide greater opportunities for U.S. traders and investors, higher paying jobs for producers, and lower priced but higher quality goods for consumers. By opening our markets, our economies will prosper and our goods will become more competitive internationally.

We are especially pleased with this Free Trade Agreement in that it is the first of its kind to include provisions governing investment in the two countries. This is an historic breakthrough which will benefit us in our bilateral economic relations with Canada and serve to strengthen our efforts in the Uruguay Round of trade negotiations in the GATT to reduce and eliminate distortions to trade arising from host country investment policies.

Let me share with you our thinking as we approached the task of negotiating an Investment chapter.

WHAT WE FACED

We and the Canadians brought very different perspectives to the negotiating table. The United States has for two centuries maintained an open investment policy. That policy has meant capital flows to the United States, and with it increased employment, more efficient production, and better and less expensive products for the consumer. Our open investment policy has meant that, over the past five years, foreigners have made about $20 billion of equity investments annually. Cumulative foreign investment in the U.S. rose from $108 to $209 billion from 1981 to 1986 -- a significant figure but still a small percentage of our total investment and still less than the $260 billion which U.S. investors have placed abroad.

President Reagan indeed reaffirmed the importance of an open investment climate in his investment policy statement of September 3, 1983. In my own experience as the Director of the Office of International Investment in the Treasury, I can tell you that this policy has worked. I know of no "downside" risks of foreign investment which cannot be adequately taken care of under existing laws.

The Canadians brought a very different viewpoint to the bargaining table. In the 1970's -- for nationalistic and political reasons -- Canada decided to adopt a restrictive policy toward foreign investment, and to screen foreign investment under the auspices of the Foreign Investment Review Agency. Bureaucrats would second-guess the market and would decide which investments would be admitted, which would be blocked, and which would be admitted on condition that the investor fulfilled various performance requirements. And the Trudeau Administration added even more restrictive policies, such as the discriminatory and expropriatory provisions of the National Energy Program (NEP).

The market told Canada what it thought of these and other restrictive, inward-looking economic policies. In large part due to FIRA, net foreign direct investment into Canada declined from an annual average of C$684 million in 1970-75 to C$372 million in 1976-80. Promulgation of the NEP in 1980 compounded the disincentives, and in fact triggered disinvestment (i.e., net outflows of foreign direct investment) of C$1.275 billion per year on average from 1981 to 1985.

A study conducted by the Conference Board of Canada in 1984 further revealed the negative impact of the government's policies. Some 33 companies (11 percent of the survey sample) stated that they had been deterred from investing in Canada because of foreign investment controls. And one-half of the respondents indicated that their perceptions of the screening process worsened while their applications were under consideration. They cited a number of reasons, the most important of which were delays, perceived rigidity of the format, lack of transparency, and alleged unreasonable demands and political interference.

Since being elected in late 1984, the Mulroney Administration has taken steps to liberalize Canada's economic and foreign investment laws and policies. From the outset, it ceased blocking foreign investments. In 1985, the Mulroney Administration replaced FIRA with a new agency, Investment Canada, that is formally charged with promoting foreign investment. Foreign investors making greenfield investments and smaller acquisitions no longer require official approval. Rather, they need only to notify the authorities of their intention to invest. The Mulroney Administration also systematically dismantled most of the NEP. At least partly in response to these significant shifts in policy, net foreign

investment rebounded sharply, to C$1.6 billion in 1986 and a record C$4.3 billion in 1987. After further liberalization in connection with the FTA, Canada will retain the right to review only very large direct acquisitions by U.S. investors and investments of a particularly sensitive nature in the cultural and energy sectors.

WHAT OUR OBJECTIVES WERE

Our investment objectives in the FTA therefore were first, to prevent any backsliding by the Canadians and second, to build upon the liberalization already effected by the Mulroney Administration. We wanted to push the Canadians as far as we could to liberalize their standards, policies, and laws regarding foreign investment. We obviously did not achieve as much as we would have liked....nor for that matter did the Canadians, who resisted further liberalization mightily. But we achieved a substantial and important -- even critical -- measure of success which will significantly benefit the citizens and workers of both Canada and the United States.

WHAT WE GOT

Each side agreed to a standstill on existing restrictions that would treat foreigners worse than domestic investors. Simply put, this means that neither side will adopt more restrictive discriminatory laws, rules, and regulations regarding existing investments in each of our countries. One aspect of this is to freeze in the current Canadian practice of not screening new greenfield investments. This commits Canada to maintain its "hands off" policy with respect to greenfield investment.

Since the screening provisions for takeovers and acquisitions constitute a significant portion of the investment chapter, I would like to address those provisions in detail.

Screening of Foreign Investment

The agreement limits greatly the screening and blocking of direct acquisitions by U.S. investors. Specifically, Canada agrees that, after a phase-in period, the asset threshold for screening direct acquisitions will rise from the existing level of $5 million (Canadian, current dollars) to $150 million (Canadian, constant dollars). For a country that was screening greenfield investments and virtually all takeovers just three years ago, Canada has taken a giant, step forward. When fully phased-in, this liberalization means that direct takeovers of only about the 600 largest firms in Canada will be subject to screening. Viewed alternatively, the higher threshold removes U.S. direct takeovers of some 6900 Canadian firms from screening; this is a reduction of over 90 percent from the universe of Canadian firms whose direct acquisition is currently screened.

It is important to note that, while the existing threshold for screening of takeovers is denominated in current Canadian dollars, the new threshold will be denominated in constant Canadian dollars. This means that we do not accept a decreasing level of threshold imposed upon us over time by the eroding effects of inflation.

Most of the attention in the press has focused on the screening liberalization for takeovers by U.S. firms. Yet there is another equally important aspect regarding sales of Canadian subsidiaries by U.S. parents. Under existing law, if a U.S. parent were to sell its subsidiary to another foreign firm, that foreign firm would be subject to the screening and blocking authority of Investment Canada if the subsidiary were larger than existing thresholds (C$5 million for direct and C$50 million for indirect takeovers). Under the FTA, the higher screening thresholds will apply to direct and indirect sales by U.S. firms of their Canadian subs. This provides fairness and symmetry for our investors on both the buying and selling side of the takeover transactions.

The provisions for indirect takeovers also merit attention. An indirect takeover occurs when a U.S. firm, firm "A", acquires another U.S. firm, firm "B", and firm "B" has a Canadian subsidiary. Under existing law, the indirect acquisition of the Canadian subsidiary would be screened if the subsidiary's assets exceeded $50 million (Canadian current dollars). By the terms of the agreement, there will be no screening -- or blocking -- of the indirect acquisition of the Canadian company after a three year phase-out.

Performance Requirements

Let me now turn to the matter of performance requirements, which are placed on the U.S. (or other foreign) investor at the time an investment is reviewed by Investment Canada. These performance requirements have consisted of commitments to export a certain amount of production, to acquire a certain portion of inputs from the local market, to produce products that substitute for imports in the local market, etc. The list has been fairly long and imaginative. These performance requirements were a very disturbing element for U.S. investors, often involving changes in product line and location of production. We have been told that, in many instances, they were costly to the U.S. investor, but that the cost was grudgingly accepted by U.S. investors as a hidden cost of doing business in Canada.

Under the FTA, we made significant progress in reducing or eliminating the use of performance requirements. First, Canada (and the U.S.) agree not to impose export, local content, local sourcing, or import-substitution performance requirements on each other's investors. Second, both countries will refrain from placing such requirements on third country investors when any

significant impact on U.S.-Canadian trade could result. The operative word here is could; it is not necessary for our side to prove injury in the classic trade sense. A reasonable charge by us that a performance requirement on a third country trade could have a significant impact on bilateral trade is sufficient to make our case. Third, all performance requirements on those transactions not subject to screening by Investment Canada at the new, higher threshold, will *ipso facto* be eliminated.

Given the estimate that all indirect acquisitions and sales and direct acquisitions and sales of some 6900 firms will be taken out of the screening net when the agreement is fully phased-in, and that no greenfield investments will ever be screened, the overall burden of performance requirements on the U.S. economy is drastically reduced by the provisions of the FTA. We are proud of this accomplishment.

National Treatment

By the provisions of the agreement, the U.S. and Canada agree not to adopt any new discriminatory measures, with respect to each other's investors, restricting the establishment of new businesses; the acquisition of existing businesses; and the conduct, operation and sale of businesses after establishment. This "national treatment" provision is extremely important. In economic and legal parlance, it means that each party is to treat investors of the other party at least as favorably as its own investors in like circumstances with respect to the establishment of new businesses and the acquisition of existing businesses and with respect to the conduct, operation, and sale of business enterprises located in its territory. The FTA gives concrete meaning to this principle in two areas that have been problematic in the past. It provides that neither party can force divestiture by reason of the investor's nationality or establish minimum equity requirements for nationals of the host country.

We were particularly pleased with this comprehensive national treatment provision. It assures that investment and investors can respond to market forces, and that U.S. and Canadian investors can compete on virtually the same terms free from discriminatory government action. In today's day and age, we need more of this type of liberalizing and strengthening of market forces, not less.

Other Provisions

There are numerous other provisions which go a long way towards enhancing the flow of investment and commerce between the two countries. Regarding expropriation, we agreed that expropriation can only be taken in accordance with international law standards. Those standards provide for, *inter alia*, payment of prompt, adequate and effective compensation at the fair market value of the expropriated properties. There are also provisions prohibiting either party from preventing an investor from

transferring profits, earnings from an investment, or sales and liquidation proceeds (with only limited exceptions relating, for example, to limitations on dividend payments set by bankruptcy laws).

EXCEPTIONS

Certain measures are excluded from the agreement. In general, existing measures are grandfathered, such as U.S. laws restricting foreign investment in atomic energy and communications and the Canadian laws restricting foreign investment in communications.

While these and other grandfathered measures remain in force, they cannot be made more restrictive. And if any liberalization measures occur in these grandfathered sectors in the future, that new level of liberalized measures cannot then be made more restrictive. We thus have built in an upward "ratchet" for liberalization of existing grandfathered measures both here and in Canada.

The cultural industries in Canada were exempted from the FTA as a whole, including the investment chapter. However, the Agreement greatly alleviates a key problem for U.S. investors: it commits Canada, when an indirect acquisition occurs and Canada wants to Canadianize the Canadian cultural subsidiary involved, to fully indemnify the acquiring U.S. parent firm by outright GOC purchase of the subsidiary at a fair international market price independently and impartially determined. This is significant in that it removes a long-standing irritant of U.S. investors who recently acquired cultural industries through indirect acquisitions. This irritant pressured U.S. investors to sell at less than market prices. Should this occur in the future, the U.S. parent will no longer face this pressure; he can be assured of a market price for his asset.

RECIPROCITY

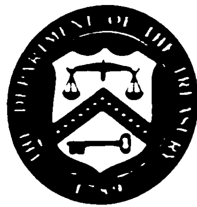
At this point, Mr. Chairman, I would like to address head-on the question of reciprocity. Some have suggested that, because Canada can block any direct acquisitions over the threshold level by a U.S. firm, the United States should be able to block comparable direct acquisitions of a U.S. company by a Canadian firm. To put it more bluntly, some have suggested that, if Canada retains the rights to keep a "restrictive" investment climate, we should retain comparable rights to have a "restrictive" climate.

That approach, in my view, is contrary to our national interests. We have had an open investment climate for two centuries, and it has worked for us. Canada, on the other hand, has learned first-hand the costs of a restrictive investment climate, and, recognizing those costs, has moved quickly to liberalization, even if it has not gotten to the point of total liberalization.

It simply does not make sense to abandon an open investment climate -- which has helped stimulate economic growth in the U.S. -- because a treaty partner has chosen, for nationalistic reasons, to sacrifice some of the benefits of foreign investment flows.

That concludes my formal statement. I would be happy to answer any of your questions.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 25, 1988

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $8,266 million of $23,519 million of tenders received from the public for the 2-year notes, Series AB-1990, auctioned today. The notes will be issued May 31, 1988, and mature May 31, 1990.

The interest rate on the notes will be 8-1/8%. The range of accepted competitive bids, and the corresponding prices at the 8-1/8% rate are as follows:

	Yield	Price
Low	8.15%*	99.955
High	8.18%	99.900
Average	8.18%	99.900

*Excepting 1 tender of $10,000.
Tenders at the high yield were allotted 72%.

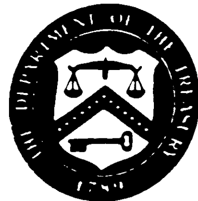
TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 76,155	$ 76,155
New York	19,693,190	6,770,630
Philadelphia	45,430	45,150
Cleveland	115,620	97,820
Richmond	130,950	93,790
Atlanta	80,905	68,625
Chicago	1,607,025	545,145
St. Louis	130,950	99,310
Minneapolis	47,080	47,080
Kansas City	146,675	145,295
Dallas	29,520	29,520
San Francisco	1,403,770	236,490
Treasury	11,295	11,295
Totals	$23,518,565	$8,266,305

The $8,266 million of accepted tenders includes $1,330 million of noncompetitive tenders and $6,936 million of competitive tenders from the public.

In addition to the $8,266 million of tenders accepted in the auction process, $547 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $761 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED
EMBARGOED FOR RELEASE UPON DELIVERY
EXPECTED AT 1:00 P.M., EDST

Remarks by
The Honorable Charles H. Dallara
Senior Deputy Assistant Secretary for International Economic Policy
United States Department of the Treasury
Before the U.S.-Korea Society
New York, New York
May 26, 1988

KOREA'S CHANGING ROLE IN THE WORLD ECONOMY

Introduction

It's an honor to be the guest of the U.S.-Korea Society, and to have the opportunity to speak before a group that has done so much to build mutual understanding and friendship between these two important countries and societies. Of course, it may seem presumptous of me even to speak of these two societies in the same breath. By the time Columbus arrived on the shores of this continent near the end of the 15th century, Korea had over 750 years of a unified political structure, and was well into the fourth dynasty in its rich history.

Our two nation-states have a much briefer history, but as we approach the 40th anniversary of the Republic of Korea -- which will be celebrated on August 15 of this year -- we can take pride in the friendship and alliance which has developed between the United States and the Republic of Korea. During a time of changing economic relationships and occasional economic tensions, it is useful to remind ourselves of the strong bonds of friendship and mutual respect which characterize our relationship today, and which we expect will grow and deepen in the future.

I will concentrate my remarks on Korea's economy. Three decades ago, this economy was struggling to find a path toward self-sustained growth. It was agriculturally based, and therefore largely reliant upon the outside world for

manufactured goods and technology. Korea's per capita income level and standard of living were relatively low, and the international trade position weak, leaving it heavily dependent upon external capital.

The ensuing three decades have brought dramatic changes in the Korean economy. Real economic growth has been high and sustained. Korea is now industrially based, exporting manufactured goods throughout the world. Its trade position has improved tremendously, to the point that Korea now exports capital as well as goods, and is building a large external surplus. These changes have been accompanied by a rapid expansion of jobs and income, as well as improvements in economic welfare.

Korea's dynamism has also transformed its role in the world economy. It is now a major economic force globally, a leader among developing nations, and an economy whose policies and performance have implications which extend well beyond its borders. This new reality implies new opportunities, new challenges, and the new responsibilities for Korea. How Korea responds will have an impact not only on the future of the Korean economy, but on the world economy as well.

Evolution of the Korean Economy

In order to understand Korea's economic role today, one must first appreciate the full extent and pace of Korea's impressive economic progress over the last three decades. The following facts illustrate this progress.

- Real GNP Growth. Korea's real GDP growth has been one of the highest in the world, averaging 8.7% from 1961 to 1985. This compares with an average of 4.7% for all non-oil developing countries. Remarkably, since 1961, Korea has experienced only one year of negative real growth, in 1980.

- Per Capita Income. Given this steady real growth in the economy and moderate population growth, per capita income has grown from less than $100 at current exchange rates in 1961, to $2,800 in 1987.

- Structure of Economy. The structure of the economy has also changed dramatically. In 1960, agriculture accounted for 37% of GDP, and manufacturing only 14%. By 1987, the ratios were reversed, with manufacturing accounting for 35% and agriculture only 12%.

- Growth of Exports. The growth of Korea's exports has also been striking. In 1961, its exports accounted for less than 0.1% of total non-oil developing countries' exports. By 1986, Korea's share in this

total had grown to 9.1%. There has been a steady shift in the composition of exports from items such as processed foods, textiles, and other processed raw materials with low value added, to increasingly sophisticated capital equipment, heavy machinery, and finished consumer goods.

Of course, this progress was not achieved without some adverse developments.

First, Korea became excessively dependent upon exports for growth. In 1971, exports of goods and nonfactor services accounted for only 16% of GDP. By 1986, this ratio had grown to 41%.

Second, Korea accumulated substantial external debt to finance its current account deficits and high rates of investment. By 1985, external debt had reached $46.8 billion, nearly 56% of GNP, and the fourth highest nominal debt among all developing countries.

Both of these developments have a bearing on Korea's current policy stance, a point to which I will return.

Korea's Economic Policy Framework

Korea's tremendous progress has brought to it special status and recognition throughout the world, generating commendation and acclaim from many quarters. I wish to join those who have expressed deep admiration for the accomplishments of the Korean people. These accomplishments are all the more extraordinary when one considers that they have been achieved in spite of the constant presence of the military threat from the North.

These accomplishments -- and the praise they have generated -- are not by chance. They have been earned. Although external conditions have generally been favorable, Korea -- like other developing countries -- has at times faced adverse interest rates, high oil prices, low foreign demand and protectionism. It was Korea's persistent commitment to an outward-looking development strategy, generally supported by sound macroeconomic policies and combined with its disciplined and committed work force, that has made the difference.

This strategy was oriented toward promoting exports while restraining imports and domestic consumption in order to strengthen the external accounts. A range of specific policies have played a role in this strategy.

- Fiscal policy has generally been conservative to restrain domestic demand and support the objective of strengthening the balance of payments. Since 1973, the central government deficit has averaged only 1.8%

of GDP in Korea, compared with 4.3% for the non-oil developing countries as a whole.

- Wages and incomes policies have also been geared in part toward strengthening competitiveness.

- The government has also controlled interest rates to discourage consumer and mortgage lending. High excise taxes have also been used to discourage consumption.

- Industrial policy has played a central role, with the government providing a wide variety of incentives for industries targetted for export development. The government has channeled capital at preferential rates to major exporters for investment, plant expansion, export financing, and debt service. Foreign direct investment in certain sectors has also been prohibited or limited.

- Trade policy has been used to protect Korea's growing industrial capacity and to discourage imports. A wide range of bans, restrictive quotas, tariffs, and licensing requirements has been employed. Industry associations have been influential in decisions on approval of import licenses. Tariff levels have been skewed in favor of inputs for exports, and away from consumption and possible competition for exports.

- Lastly, exchange rate policy has provided special incentives for exports and disincentives for imports, particularly in this decade. Since 1978, the real exchange rate has depreciated by over 18%.

These policies have certainly contributed to Korea's achievements, but a number of them have outlived their usefulness and are inappropriate in light of the changing circumstances of Korea's economy, and its role in the world economy.

New Opportunities, Challenges, and Responsibilities

Since 1985 there has been an important and rather fundamental change in Korea's economic performance. The savings/investment gap has been reversed, with savings now exceeding investment, resulting in the emergence of current account surpluses. From 1980 to 1985, Korea had made steady progress in reducing the size of its current account deficits. Therefore, the shift into surplus was not a total surprise, The magnitude and speed of this shift, however, was unexpected. The current account surpluses in both 1986 and 1987 were roughly double the government's initial forecasts, reaching $4.6 billion in 1986 and $9.8 billion in 1987, following a deficit of about $900 million in 1985.

These surpluses have permitted Korea to reduce its external debt to an extent unparalleled in the developing world. By the end of 1987, Korea's external debt had dropped $11.2 billion from the level at the end of 1985, and stood at only 30% of GNP, a reduction of some 26 percentage points compared with 1985.

But this rising surplus also suggests the pressing need for Korea to review and adapt its policies. Such action is needed for the Koreans to meet their own objectives in the years ahead, and also for the correction of global imbalances. In 1986, Korea's current account surplus was equal to 4.9% of GNP compared with 4.4% for Japan and Germany. In 1987, Korea's current account surplus grew to the equivalent of 8.3% of GNP, more than double the corresponding ratios for Germany and Japan. At a time when other major imbalances in the world economy are starting to shrink,the continued growth of Korea's current account surplus -- more than 39% in the first three months of the year -- is a particular source of concern.

The trade imbalance between the United States and Korea has also grown rapidly. From near balance in 1980, the trade account showed a U.S. trade deficit of $9.4 billion in 1987, up 34% over 1986 alone. In the first three months of 1988, the U.S. trade deficit with Korea has continued to grow at a rate of 17%.

Korea's global current account surplus has, in fact, come to symbolize the opportunities, challenges, and responsibilities that lie ahead. This surplus is unsustainable and undesirable for the Korean people, the Korean economy, and the global economy. It has inhibited growth in income domestically and added to protectionist pressures and market strains globally.

- The principal opportunity is for much faster liberalization of the trade and exchange rate regimes and for broad deregulation of the economy, including its financial sector. Such liberalization and deregulation will enable Korea to rid itself of restrictions and rigidities, advance the pace of improving the economic welfare of the Korean people, and position the economy to take advantage of global opportunities in the 1990s.

- The principal challenge is to implement these with policy changes with sufficient speed and breadth, while avoiding disruption in the Korean economy and altering the "deficit mentality," which will not disappear overnight.

- The major responsibility is to assume a larger international role in contributing to the process of global

adjustment and in preserving the open world trading system from which it has benefited so greatly. The magnitude of global adjustment that is necessary requires Korea's full cooperation and participation.

In referring to Korea's changing responsibilities, I would like to make clear that this is not meant to suggest that the United States does not have an essential and major role to play in the reduction of global imbalances -- a role that is obviously much larger and more demanding than that of Korea. Indeed, without strong efforts on our part -- and on the part of the other industrial nations -- the desired contribution to the process of global adjustment that Korea can make would be largely lost.

The main focus of U.S. efforts has been and will continue to be reducing the fiscal deficit, resisting protectionism, and bringing the growth of domestic demand below the growth of real GNP. These efforts are being carried out within the framework of international economic policy coordination that has been developed since 1985. Important progress has been achieved by the United States and other industrial countries within this context, but continued efforts will be needed.

This being said, the importance of Korean efforts should not be minimized. Korea can no longer afford to view itself as a small developing country whose actions are largely irrelevant to the world economy, and which therefore can pursue policies solely with domestic considerations in mind. Rather, it must recognize that Korea not only benefits from an open and growing world trading system, but will also have a hand in determining whether that system is preserved.

I am encouraged by indications that Korea not only understands these new realities, but is beginning to come to grips with their practical implications. Senior economic policymakers have made clear Korea's own self interest in controlling the size of its external surpluses to restrain monetary and inflationary pressures, and to allocate resources more efficiently. The government has announced its intention to implement a broad range of trade and other measures to control the size of Korea's external surpluses. Although actual implementation of these measures has fallen short of what is needed, in part due to rapidly changing political conditions, there have been some important signs of progress.

- The government has accelerated implementation of its 1983 program to remove non-tariff barriers, ease onerous licensing requirements, and reduce the level and dispersion of tariffs. Recently, a proposal was announced for a broad tariff reform program, to be implemented starting in 1989 with the objective of moving to OECD average tariff levels by 1992.

- The Korean won has appreciated noticeably against the U.S. dollar, including 8% since the beginning of this year.

- Restrictions on some invisibles transactions have been eased somewhat, consistent with the government's stated desire to move to OECD standards in that area as well by 1992.

- There has also been some liberalization of capital flows, with the government increasing the size of the offshore funds through which foreign investors can participate in the Korean equities market. In addition, controls on investment abroad by Koreans are to be eased.

- Finally, excise taxes on some consumer goods have been reduced, and I understand that tax reform may be under consideration which could foster consumption.

These various measures should facilitate the reduction of Korea's surplus, enhance the efficiency of the Korean economy, and help pass on more of the benefits of Korea's success to the Korean people. But the efforts already underway must be reinforced and broadened, particularly given the government's stated objective of reducing the current account surplus to $7 billion this year. A three-part strategy is required, involving greater trade liberalization, further exchange rate appreciation, and domestic restructuring and liberalization. Let me address each of these in turn.

Trade Liberalization

Bolder action is required on the trade liberalization front. We welcome the government's commitment to obtain the National Assembly's approval of a new tariff liberalization program. However, stretching the reductions out over a five-year period seems unnecessarily slow and is unlikely to have the required significant near-term impact on the external surplus.

Other actions in the trade area also appear desirable and feasible.

- In anticipation of implementation of the new tariff reform program, the so-called "surveillance list," which gives the Korean Foreign Traders' Association veto power over import licenses, should be eliminated immediately rather than at the end of the year as currently planned.

- Special laws and various administrative procedures affect 20% of imports and allow some industry associations to review import licenses. This kind of protection is inconsistent with the government's stated

intention to liberalize trade and unnecessary in light of Korea's economic conditions.

- o Although the imports affected by bans and quantitative restrictions has been significantly reduced, key items remain controlled, including some 20% of agricultural products. We recognize the political difficulty of lifting such controls, but more rapid progress is in order.

- o Despite the gradual reduction in the average unweighted tariff, scope exists for further reductions in anticipation of the 1989 reform. For example, import tariffs on items that are among Korea's most competitive exports, such as footwear and steel, remain in the range of 20-30% This is very difficult to understand for an economy running a surplus over 8% of GDP.

- o Export incentives have also been progressively dismantled, but there is room for further action in this area, too. For example, special export financing for small and medium-sized enterprises, import duty drawbacks, and other tax incentives remain. Do Korean exporters continue to need such special incentives?

Exchange Rate Appreciation

More rapid appreciation of the won must accompany trade liberalization. Although the Korean won has appreciated against the dollar, this appreciation is much less than that of key competitors. Since late 1985, for example, the won has appreciated 22% compared to 42% for the new Taiwan (NT) dollar and 95% for the yen. This disparity has resulted in clear competitive gains, nothwithstanding the wage increases that have occurred in 1987 and this year. It also helps account for the continued expansion of the U.S. trade deficit with Korea, while our deficits with Japan and Taiwan are showing signs of reduction. Exchange rate appreciation can be an important tool to promote structural change in Korea's economy, increasing the demand for imports and encouraging investment for domestic as well as foreign markets. It can also help dampen inflationary pressures, and pass on more of the benefits of Korea's strong economic performance to the Korean people.

At a time when protectionist pressures remain strong in the United States and other countries, it is important that Korea deny its critics the charge that it has an undervalued exchange rate. Korean producers do not need any extra advantages to remain competitive in the world economy.

We were heartened by the faster pace of appreciation during the first quarter of the year, which helped to

offset the lack of exchange rate movement in the second half of last year. However, the pace of appreciation appears to have slowed again, a move that appears to run counter to the need to redress the growing external balance. We encourage the authorities to allow the exchange rate to reflect the underlying strength of the Korean economy. Further delay will only increase the difficulty of the adjustment process.

Domestic Restructuring and Liberalization

Additional steps aimed at domestic restructuring and liberalization are necessary to complement these trade and exchange rate measures. These steps fall into the areas of easing exchange controls on capital and invisibles transactions; liberalizing the banking sector, including improved treatment of foreign banks; further modernization of the equities market; and other measures to permit more balanced growth.

o Capital and Invisibles Transactions

Reinforcing the measures already adopted to ease foreign exchange controls, both for capital and invisibles transactions, should be an important element of Korea's adjustment strategy. Steps taken to date have involved changes at the margin; for example, a lowering of the minimum wage for overseas tourism travel from 45 to 40 years.

More significantly from the perspective of increasing Korea's integration into the world economy, a variety of restrictions affecting the freedom of Korean businesses and other entities to invest overseas have been eased. The size of overseas investments automatically approved has been increased from $500,000 to $1 million, and those under $5 million no longer require approval by the Committee on Overseas Investment Projects.

In contrast to the easing of controls on capital outflows, restrictions on capital inflows have generally been tightened. Recently, the only easing of capital inflows has been through an increase in the number of sectors open to foreign direct investment. However, more than 20% of Korea's industrial sectors still remain closed to foreign direct investment, including such important service industries as banking.

Even in the sectors that are nominally open to foreign investment, important restrictions remain. For example, licenses for activities not involving technology transfer are increasingly difficult to obtain. In addition, foreign investors are generally limited to a minority role in joint ventures. Foreign companies are also finding it difficult to acquire credit, due to the prohibition on borrowing abroad, the government's requirement that Korean banks increase their

credit allocations to small and medium-sized Korean enterprises, and foreign bank branches' own inability to obtain adequate won to maintain their operations.

These impediments to capital inflows hinder access to new technologies -- in services as well as in manufacturing -- and raise the cost of capital to Korean businesses. They also retard the correction of the value of the won that is required to achieve the necessary structural shifts in the Korean economy. This elimination could greatly benefit the Korean economy.

o <u>Banking Sector Reforms</u>

Liberalizing and modernizing the banking sector is another key reform. As the economy advances apace, the financial sector is being left behind and is becoming a constraint on growth, unable to provide capital in an efficient manner to an increasingly sophisticated economy.

Controls on interest rates and on the allocation of credit are incompatible with the development of a modern, market economy that is fully integrated into the world economy. They have contributed to distortions in the Korean economy, and encourage proliferation of an unregulated informal financial sector that poses unnecessary risks for savers and increases the costs of financial intermediation in the economy as a whole. The bias against consumer and mortgage finance are also slowing the process of structural adjustment that is required.

Treatment of foreign banks should also be improved within the framework of a broad program to dismantle government intervention in the domestic banking sector. A key area to address is giving foreign bank branches access to local currency funding on a par with domestic banks, allowing foreign banks greater freedom with respect to establishing new branches, and creating an interbank money market to which all banks, domestic and foreign, would have equal access. We are encouraged that the government appears to have these issues under review, and hope that it will take speedy and positive action.

o <u>Equity Market Reforms</u>

Further modernization of the Korean equities market is also desirable. This market has already seen substantial growth, partly in response to the liberalization program announced by the government in 1984 and partly in response to the unavailability of other equities investment opportunities for Koreans until recently. The number of listed companies increased 14% over 1986 and 1987, compared with less than 2% in 1985, and the number of shareholders increased 300%,

compared with less than 7% in 1985. The stock price index, which rose only 15% in 1985, jumped 67% in 1986, and another 93% in 1987.

Other recent developments have also been positive. The size of the offshore closed-end funds through which foreigners can invest indirectly in Korean equities is to be increased and a closed-end fund is also to be established to enable Koreans to invest indirectly in foreign stocks.

The next significant step will be to allow foreigners direct access to the Korean equities market. I understand the government's concern that such an opening might result in a sudden influx of capital that could destabilize the stock market and create monetary and inflationary pressures. However, it seems that the limits the government has established on the share of a company's outstanding stock that a single investor may hold goes a long way toward addressing the first problem. The second conern could be addressed through more rapid appreciation of the exchange rate and liberalization of imports to reduce the monetary and inflationary pressures resulting from the external surplus.

o <u>Other Reforms</u>

Other structural changes are required to permit faster growth of domestic consumption and aid in the reduction of Korea's external surpluses. Excise taxes still range as high as 70%, leaving considerable room for further progress in this regard. The reduction of interest rates on mortgage finance and on consumer lending would also be beneficial in this regard.

The climate for opening up Korea's economy and integrating it into the international economy appears to be improving. I have noted reports of support among businessmen and academicians for a lightening of the government's hand in the economy, and for somewhat greater economic liberalization. The government's own efforts to publicize the benefits of greater liberalization have, no doubt, contributed to this support, just as the process of democratization in Korea has allowed such support to find greater and more open expression. I understand that the prestigious Korean Development Institute is to undertake a broad study of the need for and modalities of economic deregulation in Korea. I would hope that this study will contribute to a consensus within Korea that economic liberalization and greater integration into the world economy will be beneficial, not harmful, to the Korean economy.

CONCLUSION

In concluding, I would note that Korea finds itself in an apparently perplexing, even paradoxical, situation. It has made tremendous economic strides over the last three decades. For this it has justifiably received acclaim throughout the world.

Like other surplus countries before it, however, Korea now finds itself being called upon to accept greater global responsibilities, and being criticized, some might say, for having been "too successful." The export orientation that was at the heart of this success is now called into question, and long-established patterns of production, investment, and consumption have become prime candidates for change. Suddenly, the international community is directing attention and concern toward what must seem to many Koreans to still be a relatively poor and small economy.

In such circumstances, there is an inevitable temptation to respond to these developments and pressures by turning inward, becoming defensive, deflecting criticisms, maintaining traditional policy stances, and stressing the responsiblities of others which are, after all, much greater. It would be understandable if this temptation were not fully resisted.

And yet to succumb to it would be a serious mistake. Circumstances have changed, and what once bred success may now only lead to difficulty. The drive, determination, and soundness which have characterized Korea's economic policies and performance for many decades must now be directed away from export-led growth, and toward a more diverse base that emphasizes domestic consumption and investment, as well as foreign markets.

Fortunately, there are persuasive reasons to believe that Korea can and will make the necessary adaptations in its policies to meet the challenges and responsibilities that lie ahead. Two reasons in particular come to mind.

- First, there is now a confluence of Korea's domestic needs and its changing international responsibilities. Korea's economic strength provides the ideal opportunity for structural changes to liberalize and deregulate its economy, spreading the benefits of its growth more widely and laying the foundation for continued prosperity. The policies which will help seize this opportunity will also enable Korea to fulfill its growing responsibility to the global adjustment process.

- Second, the Korean authorities have increasingly moved toward adopting a course of action that will bring the full range of macroeconomic and structural policies to bear on the tasks at hand. Indeed, policy actions to date in 1988 have gone some distance to convince the Korean people and the world at large that Korea remains more than equal to the economic challenges it faces.

There is, however, a third factor that gives confidence. It is less tangible than the others, but in the long run probably more important. It is the sense of balance and harmony which has long been part of the Korean character and philosopy. This sense is perhaps best symbolized by the Korean flag, with a circle of red and blue centered over a white background. As most of you are undoubtedly aware, the upper red portion represents the _yang_ and the lower blue portion the _um_. Author Edward B. Adams, who has written much on Korea, explains that this is an ancient symbol of the universe in perfect balance and harmony, with the two opposites expressing the dualisms such as day and night, heat and cold -- and I might add exports and imports, surpluses and deficits. This duality recognizes that life is often full of contradictions -- of paradoxes, if you will, such as Korea faces today.

As we strive together to reduce imbalances in the world economy, I am comforted in the knowledge that we have a partner in Korea which brings a special sense of balance and harmony to all things. I am sure the Koreans will bring this perspective to bear on the difficult issues we face in the global economy. And from this, we will all benefit.

Thank you.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

MAY 31 3 44 PM '88
DEPARTMENT ...
0310

EMBARGOED FOR RELEASE UPON DELIVERY
Expected at 7:30 p.m. May 28 in Hawaii
(1:30 a.m. EDT, May 29, 1988)

Remarks by David C. Mulford
Assistant Secretary for International Affairs
Department of the Treasury
at the Association Cambiste Internationale
Honolulu, Hawaii
May 28, 1988

Economic Policy Coordination and the Foreign Exchange Market

It is a pleasure to be here for the 30th anniversary of the ACI. Profound changes have taken place in financial markets in recent years which have dramatically altered the scope of the foreign exchange market and the role of the currency trader.

Foreign exchange trading is now a 24-hour global business with a daily turnover approaching $500 billion, thus dwarfing all other financial markets. The linkages between foreign exchange and domestic money and securities market have become so pervasive that developments in one sector create immediate responses in the others. And, the currency trader has become a significant force, both positive and negative, affecting the bottom lines of the largest financial institutions.

Tonight I want to speak about economic policy coordination and the foreign exchange market. This is a subject of vital importance to your day to day business on a year round basis. But we all know that some business days are more important -- and more difficult -- than others, especially in your business. Sometimes these are associated with major public events such as a Summit or Ministerial meeting; other times it is the release of sensitive economic data. With the Economic Summit only three weeks away, we are perhaps entering one of those periods where market attention may be directed away from the fundamentals.

In recent years, the Economic Summits have produced an important impetus for new approaches to economic issues. The Reagan years in particular have produced a profound change in thinking worldwide regarding the role of the government in the economy. A consensus has emerged in the industrial nations in a number of broad policy areas: tax reforms that increase incentives to work, save, and invest; deregulation in various economic sectors; and elimination of subsidies and other measures that distort market forces. Most important, the past two Summits

have produced a remarkable degree of consensus on the need for the major countries to coordinate economic policies in order to achieve a sound world economy and stable financial system.

Summit meetings, however, pose major problems of public diplomacy with financial markets. They have become enormous media events. The need to satisfy the headline writers and to meet the limitations of the 30 second TV bite has created undesirable pressures to oversimplify complex issues and to come up with new initiatives and overnight success. Confrontations and controversy have been manufactured where none exist. Expectations are created that cannot be satisfied and financial markets respond to the myriad of perceptions which are generated without any real knowledge or assessment of underlying policies and policy changes.

Before the pre-Toronto hype begins in earnest, let me indicate what I believe the main economic focus at Toronto will be. A key Summit objective will be continued expansion of the global economy and the maintenance of an open world trading system. I expect, therefore, that much of the discussion will center on the coordination of economic policies by the major industrial countries as a means of promoting growth, reducing trade imbalances, and fostering greater currency stability. This process of coordination, which is still in its infancy, has major implications for world currency markets and for the international monetary system.

Process, policies and performance

At the 1986 winter meeting of the FOREX USA, I suggested that the global financial revolution had forced governments to formulate economic policies on a worldwide basis. Events since that time have reinforced that judgment. We have seen an intensification of efforts to strengthen and give better definition to the process. The Tokyo Summit produced the first step towards creating a formal framework for the economic policy coordination process. The Louvre Accord in February 1987 was the first public evidence within that framework of successful policy coordination. The Venice Summit provided clear signals of important refinements and better definition to the process, and the G-7 statements of December 22, 1987, and April 13, 1988, demonstrated that incremental improvements to the process are being carried forward.

You will recall that the coordination process involves a regular dialogue at the political level on key economic issues by the major industrial countries. It seeks to instill greater accountability by each participant for the international ramifications of domestic policies. Greater discipline and rigor is achieved by establishing mutually consistent medium-term objectives and projections for each country and the group as a whole. Indicators are used to assess whether current performance

is compatible with the agreed objectives and projections and to determine whether there is a need to consider possible remedial actions.

The participants have agreed on the basic indicators that will be used, focusing this year on growth, external balances and exchange rates. In addition, the necessary national economic data has been compiled with the assistance of the IMF and procedures for regular reviews have been established. In effect, we now have an annual cycle for developing objectives and projections, assessing performance and considering policy requirements.

The development of a coordination process with rules and discipline serves to focus attention on the compatibility and consistency of national policies and performance with international adjustment requirements. As governments have become more comfortable with the process and instances of successful coordination emerge, confidence among the participants in the process is building. This in turn is reinforcing the commitment of participants to the process, thereby strengthening the discipline and credibility of the coordination effort. Yet national sovereignty has not been ceded and the political realities in the participating countries have been recognized and accommodated. Finally, success not only breeds success, but also highlights more clearly the downside of a failure to continue the coordination process.

Thus, the coordination process is in place and functioning. The G-7 Finance Ministers and Central Bank Governors have agreed on concerted economic and exchange rate policies to reduce external imbalances while maintaining noninflationary growth. Commitments on specific measures have been made and implemented to achieve the intended redirection of our economies. Following the events of last October, Ministers consulted regularly and a number of important policy actions, such as the two year deficit reduction package of the United States, were put in place.

These policy changes, whether fiscal or monetary, took time to negotiate and, more importantly, to implement. The process last autumn allowed these political realities to be dealt with effectively and I would remind you that all this took place, including the December 22 statement, without a formal meeting of the G-7 Ministers. As a result, today the world economy is on a much more solid footing than many at that time had thought possible.

The industrial countries in fact grew faster in the second half of 1987 than in the first half. For 1988, there is a new optimism about growth prospects with both the IMF and OECD forecasting another year of 3-percent growth.

Just as importantly, the composition and pattern of growth among the major industrial countries has shifted to support balance of payments adjustment. Domestic demand in Japan is now growing at 5.5 percent, nearly four times as fast as in the United States. In Europe, demand is growing twice as fast as in the United States. This follows several years in which rapid U.S. growth fueled the global recovery, but also contributed importantly to the trade imbalance.

For its part, the United States is embarked on a multiyear program to reduce and eliminate the Federal budget deficit. The $71 billion deficit reduction achieved last year was equivalent to nearly 2 percent of GNP. Implementation of the unprecedented agreement between the President and the Congress last December will provide $76 billion in budget savings in fiscal 1988 and 1989. By the end of fiscal 1990, our budget deficit should be down to less than 2 percent of GNP, with the general government deficit below 1 percent of GNP.

The United States is also experiencing an improvement in private savings. The personal savings rate rose sharply in the fourth quarter of last year to 4.8 percent. The rate remained above 4.5 percent in the first quarter of this year. Business savings, which accounts for 80 percent of private savings, is also growing and should improve further as U.S. competitiveness strengthens. Improved savings and budget deficit reduction are creating a better balance in domestic savings and investment which is reducing the need for foreign borrowing.

The substantial change in exchange rates that have taken place since the dollar peaked in February, 1985 has resulted in a significant improvement in the U.S. competitive position. The dollar has depreciated in real, price adjusted terms by nearly 25 percent against our 13 largest trading partners which together account for two-thirds of U.S. trade. As a result, U.S. price competitiveness now exceeds the level at the beginning of 1981, the last year in which the United States had a current account surplus. This enormous change has been accomplished in the context of the longest peacetime expansion in U.S. history, 66 months and continuing.

The combination of present growth patterns and exchange rate changes are producing the desired adjustment of external imbalances. In the United States, the volume of exports rose 31 percent from the third quarter of 1986 through the first quarter of 1988, while import volume increased only 6 percent. The latest trade figures confirm that the deficit in value terms is on a downward trend. We are also witnessing the correction of external imbalances in the principal surplus countries.

I do not understate the difficulties in achieving a sustainable external position. With U.S. imports over half again as large as exports, it will take time and continued effort to restore a better balance. But markets focus on emerging trends and there are a number of reasons for optimism in this regard.

Admittedly, trade imbalances have not declined as far as we would have expected in light of the substantial exchange rate changes that have taken place. However, I believe that the dire predictions of imbalances on the present scale far into the future and a loss of momentum in the adjustment process miss the mark considerably. In part, the absence of greater adjustment to date is due to the fact that, until recently, U.S. demand growth substantially exceeded that of our major trading partners. As I have already noted, that situation is now rapidly changing.

Moreover, price data indicates that foreign producers have absorbed much of the potential loss of competitive position by reducing profit margins and cutting costs. Their ability to do so in the future has diminished significantly.

Furthermore, projections by international institutions and private forecasters of large external imbalances into the 1990's are based on the assumption of a continuation of current economic policies. It is highly improbable, however, that the G-7 countries will take no further actions. Indeed, all are committed to take the measures necessary to achieve sustainable external positions. I have no doubt that additional actions will be forthcoming.

The forecasting models are also not well suited to picking up the effects of the important structural changes taking place in the world economy -- what I call the dynamics of structural change. These are not well understood and are probably substantially underestimated. The very large exchange rate changes are having a positive impact on U.S. attitudes toward trade, with business now much more willing to look to exports as a source of future growth. Indeed, the increase in U.S. exports is playing a significant role in the overall growth in the economy this year.

Similarly, foreign producers are expanding production in the United States. And U.S. companies that went abroad to diversify production during the dollar's earlier rise are experiencing greater incentives to invest and expand production in this country. These developments will take time to be reflected in the trade figures but are nevertheless real.

Finally, we are beginning to see a change in the situation of the developing countries. The four Asian NICs, which had a combined current account surplus last year of $32 billion, can no longer expect to have a free ride. There is a growing awareness and acceptance in the NICs that they must participate positively in the balance of payments adjustment process by opening their markets and allowing their currencies to fully reflect the underlying strength of their economies.

We are also seeing improvements in the situation of those developing countries that have experienced major debt problems. Growth is stronger, debt and interest service ratios have fallen, and imports this year should be the highest since 1982.

I do not mean to suggest that the problem is solved or that the hardest part is behind us. The United States must continue its efforts to reduce the budget deficit, improve domestic savings and strengthen competitiveness by keeping inflation under control. The major surplus countries need to continue to pursue monetary, fiscal and structural policies to foster growth and reduce reliance on exports. The NICs must do their part in global adjustment before they lose the benefits of the open trading system that has fueled their remarkable growth. And, we must continue to encourage the debtor nations to implement growth-oriented reforms, supported by adequate external financing. But very real progress is being made and more is in store.

Foreign Exchange Markets

As currency traders, you have naturally focused on the exchange rate aspects of the coordination process. A foreign exchange pundit is reputed to have said that the only thing worse than excessive currency volatility is excessive stability. I read a snippet in the London press last week that quoted a foreign exchange trader as saying: "If volatility doesn't increase I won't be able to make my mortgage payments."

The economic policy coordination process seeks to eliminate the excesses while recognizing that in markets, as in life, change is inevitable.

The achievement of more consistent policies and compatible performance is the starting point for achieving greater currency stability. It has already served to enhance effective cooperation by the participants in the currency markets. There is, of course, considerable controversy regarding the effectiveness and desirability of government intervention in currency markets. Clearly, the monetary authorities neither could nor should seek to prevent exchange rates from playing their appropriate part in the adjustment process. Hopefully, all of us have learned the lesson

of King Canute that you can't hold back the tide or capital flows by wishing it so. At the same time, however, it is unrealistic to expect governments to ignore exchange market developments given the pervasive impact they have on other financial markets and the domestic economy.

Recent experience suggests that exchange market operations can play a useful, albeit limited, role in complementing our economic policy coordination efforts. For official intervention to have a positive effect, however, it must meet certain criteria. First and foremost, official intervention must be supportive of and consistent with other economic policies. It makes little sense to attempt to stabilize exchange rates through intervention if economic policies, including monetary policies, suggest that underlying conditions are shifting in a manner that warrants a change in currency values.

A second, and related, point is that market participants must have confidence that authorities are prepared to adjust their policies if they do not appear to be achieving their intended effect. If markets have this confidence, they will react with greater caution to aberrations in monthly data or indications that one or another real or financial variable is moving less rapidly than expected in the desired direction.

Third, the major countries need to operate in exchange markets on a concerted and cooperative basis that reflects clear agreements regarding the objectives and responsibilities of each participant in particular operations. One reason that our cooperative efforts have become more effective is that they are the result of close, frequent consultations and reflect specific understandings that are reviewed regularly and adjusted as necessary in light of market conditions.

In these circumstances, we believe that intervention can have a positive affect on market expectations. The achievement of greater currency stability can also have important spillover effects in domestic securities and money markets.

The greater stability in exchange markets that has emerged since the beginning of the year is a welcome development, reflecting both prospects for improved economic fundamentals and more effective cooperation by governments. It remains the view of the G-7 countries that either excessive exchange rate fluctuations, a further decline of the dollar, or a rise that is destabilizing to our adjustment efforts could be counter-productive. We have a common interest in stable exchange rates and are committed to implementing policies that strengthen the economic fundamentals to foster continued exchange rate stability. Let me assure you also that close exchange market cooperation will continue.

Improving the international monetary system

In recent years attempts to improve the international monetary system have been seen as separate from the question of international monetary reform. In particular, this is the result of the breakdown in the Bretton Wood's system in the early 1970's, which has left a body of opinion hankering after a formal system of fixed exchange rates and automatic disciplines. Meanwhile, the freely floating system which has had important strengths during the period of rapid and extensive structural change in our world has come in for heavy criticism because of extensive swings in exchange rates and the associated rise of large global imbalances.

Most discussion on the subject leads to the conclusion that it is not possible, practical, or even desirable that in today's world we return to a system of fixed rates with a high degree of automaticity and discipline. I find few people who believe, for example, that the EMS system -- as developed in Europe -- could be applied successfully today to the world as a whole.

Thus, we must concentrate on improving the present system and, as Secretary Baker suggested last week in Paris, the G-7 coordination process provides the most flexible, credible, and realistic approach for achieving meaningful reform of our international monetary arrangements. There is no reason why reform of the system cannot or should not be accomplished by the step-by-step process that is underway. The coordination process addresses present realities:

- It combines a careful balance of flexibility with commitments and obligations that takes into account the reality of national sovereignty;

- It comprehends the broad range of monetary, fiscal and exchange rate policies necessary for achieving a sound, open world economy;

- It can encourage corrective policy actions without relying on mechanisms that appear to be automatic, but prove to be excessively rigid and thus are ignored until political pressures build up to unmanageable levels;

- It provides flexibility in utilizing different adjustment policies, domestic or external, depending on circumstances;

- It is symmetrical by placing adjustment pressures on both surplus and deficit countries; and

- It represents a credible approach which, by recognizing and taking account of political and economic realities, is more likely to produce meaningful results than other grandiose, but unrealistic, proposals.

The process is not perfect and there is scope for further improvement, but it does address the critical issues for making the system work. Proposals for a drastic and more formal overhaul of our monetary arrangements may provide dramatic headlines, but result in little real forward movement. In the competition for a better international monetary system, one wonders if the turtle will not run a better race than the rabbit.

In this connection, the major industrial countries have agreed to develop a commodity price indicator as an additional analytical instrument in the coordination process. The commodity price indicator would supplement the existing national indicators in order to help in assessing and reaching judgments about economic policies and performance. It will be used as an analytical tool, rather than as an automatic trigger for policy changes or an anchor for currencies.

Discussions on the commodity indicator are proceeding. The focus is on developing a price index based on a wide range of primary commodities -- foods, fibers, and metals -- and weighted on the basis of G-7 consumption. A number of issues remain to be resolved, but it is our expectation that this work can be completed expeditiously so that the indicator can be in operation by the Toronto Summit.

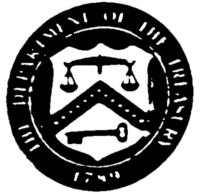
But we cannot stop there. The Summit countries are identifying priority areas where structural reforms need to be pursued. This includes tax reform, financial market liberalization, deregulation of markets and removal of barriers to labor mobility, agriculture reform, government subsidies, and trade barriers. We need to find ways to broaden the coordination process to deal with these issues as a complement to our efforts on macroeconomic policies.

We will need to consider other steps as well to refine the means of assessing whether an economy's performance is significantly deviating from an appropriate path, suggesting the need for consultation and possible action. This might involve consideration of "monitoring zones" for key variables such as growth, trade balances and so forth.

Conclusion

The economic policy coordination process is a response to the new realities arising from a global financial revolution that is pushing national boundaries outward at an accelerating pace. It represents a pragmatic and flexible means of dealing with current problems. Slow but steady progress is being made but we are not out of the woods. We must be alert to new opportunities to move ahead, recognizing that strengthening the functioning of our international monetary arrangements must be achieved in incremental steps. The continued success of this effort provides the only meaningful international monetary reform that makes sense.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

Remarks by
Secretary of the Treasury
James A. Baker, III
at the Central Bank for
West African States (BCEAO)
Monday, May 30, 1988
Dakar, Senegal

It is an honor to address such a distinguished group in such impressive surroundings. This morning I had a good meeting with President Diouf. I reiterated what I had told my colleagues in Washington: I could not come to West Africa without stopping here in Dakar. I could not miss the opportunity to let you know, and for all the world to hear, just how much we Americans admire you and how proud we are to be your friends.

There are many ties that bind Americans and Senegalese. We share many values. Our two countries have a common dedication to the principles of democracy, representative government, and the rule of law. That dedication lies at the heart of our bilateral relationship and serves to energize our cultural and educational exchanges and our development activities. Over the years, our common dedication has also facilitated the spirit of frank dialogue that President Diouf and President Reagan have cultivated.

Our two presidents also share a common dedication to economic reform. They believe in government that delivers what it promises and intrudes as little as possible on the prerogatives of the private sector. They also understand that, in the United States as in Africa, the process of economic reform is not an easy one. What I'd like to do this afternoon is talk a bit about the relationship between economic reform and democracy.

During my term as Secretary of the Treasury I've had the opportunity to discuss the economic reform process with leaders from every continent. It is a process that typically passes through several stages. At first, reforms are implemented with considerable urgency. They correct the worst economic distortions in prices and markets while reducing budget and current account deficits.

B-1430

Improved finances and higher agricultural production are among the early results of the reform process as farmers respond to higher prices and market deregulation. A country typically receives additional credits from the World Bank, the IMF, and bilateral donors to support their efforts. With these reforms official creditors and commercial banks frequently reschedule debt, and, in some cases, commercial banks provide additional, new financing.

Once the most glaring economic imbalances have been dealt with, the political and business leadership turns its attention to confronting the country's fundamental structural problems. They devise further reforms that transform underlying economic structures and institutions. This stage involves streamlining government operations, eliminating inefficient enterprises, removing subsidies, and improving the efficiency of individual markets. Not surprisingly, these measures can be controversial. They can even spur doubts about the reform process itself.

Four years ago your government embarked on a courageous structural adjustment program designed to improve Senegal's economic performance, to achieve greater economic self-reliance, and to provide expanded economic opportunity for future generations. You took some bold steps. You decided to forego government consumption in favor of private consumption and investment. You made both your exports and your domestic industrial production more competitive vis-a-vis world markets. And you reduced your reliance on imported food in favor of competitively priced local cereals.

Compared to many other countries -- some of which have a more favorable natural-resource base than Senegal -- you have made impressive progress in achieving these objectives:

- Your economic growth, which was negative in 1984/85, has averaged 4.3 percent over the past two years.

- Your overall budget deficit has been reduced from 4.6 percent of GDP in 1983/84 to 1.4 percent of GDP in 1986/87 and internal arrears of the government have been reduced by 62 percent during the same period.

- Your balance of payments deficit has been cut nearly in half -- to 5.5 percent of GDP in 1986/87; and

- Since 1983/84 you have increased cereals production by over 17 percent and peanut production by almost 13 percent.

These results have been widely admired. Your economic reform program is among the most successful anywhere.

You have proven that the private sector can out-perform the public sector in agriculture. Farmers preserved their seeds and made wise economic decisions on fertilizers and other inputs. Over 50 billion CFA Francs were pumped into the rural sector as a result of incentive producer prices and bumper harvests.

For the first time, farmers -- the largest and most hard-pressed segment of your population -- had the cash to buy consumer items -- a bicycle, a radio, additional fabric for clothing. There was even a surplus to replenish personal food stocks and help poor relatives in the cities.

Your economic reforms shifted incentives and benefits from urban consumption to the generally poorer but more productive agricultural sector. The policy worked. Through it Senegal has been able to achieve adjustment with growth. But the stresses and strains of this shift have had an impact on social and political life in Senegal, just as they do elsewhere.

The repercussions of reform are often felt most severely in urban areas. Senegal is no exception to this general rule. The challenge is to use the reform process to generate jobs through continued modernization, diversification of the economy, and expanded private investment, both domestic and foreign.

As appropriate macroeconomic policies continue, specific sectoral impediments to growth need to be addressed. Reform of financial and banking systems will mobilize greater domestic savings. That kind of reform provides adequate finance for small- and medium-sized businesses -- often the motors of economic growth. Eliminating barriers and special arrangements that protect domestic industries paves the way for more efficient new enterprises. Reductions in administrative regulation and governme nt intervention in the economy allow greater scope for private initiative.

I know there has been much debate here, as elsewhere in both the industrial and developing world, about the wisdom of the structural adjustment program. One thing, however, is clear: The choice facing countries across the globe is not whether to adjust, but how. The alternative to managed adjustment is forced adjustment brought on by foreign exchange shortages and fiscal insolvency.

Obviously, substantial additional support from the international community will be required. A developing country's own efforts cannot be regarded as sufficient to assure success. Economic reforms must be adequately supported by donors. That donor support, nonetheless, can only complement a country's own economic reform efforts; it cannot substitute for them.

To be successful, these economic reform efforts must also be sustained. Economic reform is a continuing process -- not one that is accomplished in 3- or 5-year segments. Sustaining the process of economic reform requires that each country regard the economic reforms as part of its own program, not imposed from the outside as an arbitrary requirement for assistance or debt rescheduling. A sustained economic reform effort internalizes the process within the country. It only succeeds when the program is broadly accepted by the whole population.

The process in turn places a burden on the national political leadership to be willing to respond to the feedback from the process. Not only do the leaders have to understand the effects of their policies, but they must listen and learn from the experience of all sectors of their population through open channels of communication. Only then can they achieve a national consensus on the direction and pace of the reform process itself. It is only through such a consensus that people feel that they have a stake in the success of economic reform.

Can developing nations achieve such a consensus? I believe they can. Furthermore, I believe that the democracies of the third world have the best chance of doing so. Some say African nations are not mature enough politically to support democracy, let alone multiparty democracy. Such critics believe that only Western countries with powerful economies can afford the luxury of democratic institutions. I would argue the opposite -- that it is through democratic institutions that countries can arrive at the consensus necessary to sustain economic reforms.

Senegal is a successful democracy. You have drawn on the best of your traditions, and you have learned from the experiences of others. Your fellow democracies have watched as your nation has opened its political life to a wide range of political parties. Despite all the turmoil of your recent elections, you have not retreated from your commitment to a multiparty democracy.

Your friends in the United States and throughout the world are heartened by the spirit of reconciliation which has become the focus of your national political agenda. Such a spirit offers the opportunity to address the issues still confronting the Senegalese people. It will allow you to build the consensus needed to sustain your impressive record.

I know that President Diouf and other leaders are dedicated to serious economic reform, and I would not presume to speak to you so frankly if I were not equally persuaded that the Senegalese people will set their grievances aside and gather in a national consensus around the central issues that confront the nation.

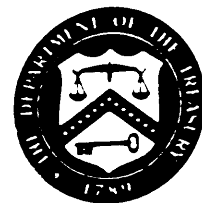
As you remain dedicated to serious economic reform, America will do its best to help Senegal help itself. As you mobilize your own resources, your friends will also channel their assistance resources, mobilize private investment, and open access to world markets to facilitate your efforts. You are well on your way toward achieving your economic goal of real development with social justice.

You are also well on your way to achieving your political goal of a more equitable, more open, and more effective democracy. President Diouf has made it clear that he will not retreat from the multiparty model, and I understand that there is currently much debate, within the majority party, among the opposition, and in your free press about electoral code reforms, better access to the government media by the opposition, improved voting techniques, and better voter education. We are enormously heartened by this evidence of a rededication to the democratic ideal.

Much is at stake here in Senegal. I know that Senegal is not trying to be a model for anyone else -- but rather you are trying to live up to your own high ideals. That is a worthy goal. But I hope you do realize that your ideals are shared and admired. Yo ur success inspires other successes. You are truly a model for the re st of the developing world.

Thank you. Wa Salaam.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE May 26, 1988

RESULTS OF AUCTION OF 5-YEAR 2-MONTH NOTES

The Department of the Treasury has accepted $7,001 million of $24,499 million of tenders received from the public for the 5-year 2-month notes, Series L-1993, auctioned today. The notes will be issued June 1, 1988, and mature August 15, 1993.

The interest rate on the notes will be 8-3/4%. The range of accepted competitive bids, and the corresponding prices at the 8-3/4% rate are as follows:

	Yield	Price
Low	8.75%*	99.926
High	8.77%	99.843
Average	8.77%	99.843

* Excepting 1 tender of $3,000.

Tenders at the high yield were allotted 65%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 17,623	$ 17,623
New York	22,153,033	6,555,271
Philadelphia	12,784	12,784
Cleveland	22,956	22,956
Richmond	41,487	14,487
Atlanta	17,478	17,477
Chicago	1,275,216	207,466
St. Louis	38,006	19,005
Minneapolis	14,162	14,162
Kansas City	39,051	36,551
Dallas	7,617	7,617
San Francisco	856,339	71,939
Treasury	3,271	3,271
Totals	$24,499,023	$7,000,609

The $7,001 million of accepted tenders includes $522 million of noncompetitive tenders and $6,479 million of competitive tenders from the public.

In addition to the $7,001 million of tenders accepted in the auction process, $335 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities.

B-1431

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 12:00 NOON May 27, 1988

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $8,750 million of 364-day Treasury bills to be dated June 9, 1988, and to mature June 8, 1989 (CUSIP No. 912794 SC 9). This issue will result in a paydown for the Treasury of about $1,050 million, as the maturing 52-week bill is outstanding in the amount of $9,812 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Thursday, June 2, 1988.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. This series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing June 9, 1988. In addition to the maturing 52-week bills, there are $13,357 million of maturing bills which were originally issued as 13-week and 26-week bills. The disposition of this latter amount will be announced next week. Federal Reserve Banks currently hold $2,269 million as agents for foreign and international monetary authorities, and $7,858 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rate of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $80 million of the original 52-week issue. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-3.

B-1432

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

10/87

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 12:00 NOON May 27, 1988

TREASURY OFFERS $4,000 MILLION OF 9-DAY CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for approximately $4,000 million of 9-day Treasury bills to be issued June 7, 1988, representing an additional amount of bills dated December 17, 1987, maturing June 16, 1988 (CUSIP No. 912794 PU 2).

Competitive tenders will be received at all Federal Reserve Banks and Branches prior to 1:00 p.m., Eastern Daylight Saving time, Wednesday, June 1, 1988. Each tender for the issue must be for a minimum amount of $1,000,000. Tenders over $1,000,000 must be in multiples of $1,000,000. Tenders must show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions must not be used.

Noncompetitive tenders from the public will not be accepted. Tenders will not be received at the Department of the Treasury, Washington.

The bills will be issued on a discount basis under competitive bidding, and at maturity their par amount will be payable without interest. The bills will be issued entirely in book-entry form in a minimum denomination of $10,000 and in any higher $5,000 multiple, on the records of the Federal Reserve Banks and Branches. Additional amounts of the bills may be issued to Federal Reserve Banks as agents for foreign and international monetary authorities at the average price of accepted competitive tenders.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m., Eastern time, on the day of the auction. Such positions would include bills acquired through "when issued" trading, futures,

and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

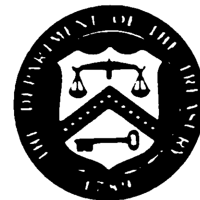
No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Those submitting tenders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch in cash or other immediately-available funds on Tuesday, June 7, 1988. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars may be obtained from any Federal Reserve Bank or Branch.

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE May 31, 1988

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,401 million of 13-week bills and for $6,410 million of 26-week bills, both to be issued on June 2, 1988, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing September 1, 1988			26-week bills maturing December 1, 1988		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	6.50%	6.70%	98.357	6.82%	7.16%	96.552
High	6.53%	6.73%	98.349	6.84%	7.18%	96.542
Average	6.53%	6.73%	98.349	6.83%	7.17%	96.547

Tenders at the high discount rate for the 13-week bills were allotted 72%.
Tenders at the high discount rate for the 26-week bills were allotted 38%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

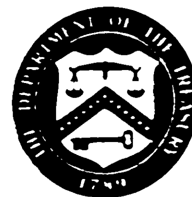
Location	Received	Accepted	Received	Accepted
Boston	$ 37,005	$ 37,005	$ 27,840	$ 27,840
New York	23,607,295	5,562,560	20,713,555	5,325,585
Philadelphia	25,975	24,760	14,315	14,315
Cleveland	38,155	37,700	33,315	33,315
Richmond	50,620	40,620	40,320	40,320
Atlanta	31,015	31,015	25,150	25,150
Chicago	1,928,435	127,710	1,616,965	120,645
St. Louis	38,240	33,000	22,655	20,035
Minneapolis	17,560	11,160	12,285	9,185
Kansas City	63,740	49,740	38,220	38,220
Dallas	31,230	21,230	24,460	16,360
San Francisco	1,082,950	89,950	1,383,070	407,670
Treasury	334,505	334,505	330,980	330,980
TOTALS	$27,286,725	$6,400,955	$24,283,130	$6,409,620
Type				
Competitive	$23,789,785	$2,904,015	$20,136,150	$2,262,640
Noncompetitive	993,370	993,370	767,800	767,800
Subtotal, Public	$24,783,155	$3,897,385	$20,903,950	$3,030,440
Federal Reserve	2,315,500	2,315,500	2,000,000	2,000,000
Foreign Official Institutions	188,070	188,070	1,379,180	1,379,180
TOTALS	$27,286,725	$6,400,955	$24,283,130	$6,409,620

An additional $106,930 thousand of 13-week bills and an additional $830,520 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-1434

TREASURY NEWS



Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. May 31, 1988

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $12,800 million, to be issued June 9, 1988. This offering will result in a paydown for the Treasury of about $550 million, as the maturing bills are outstanding in the amount of $13,357 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, June 6, 1988. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,400 million, representing an additional amount of bills dated March 10, 1988, and to mature September 8, 1988 (CUSIP No. 912794 QL 1), currently outstanding in the amount of $7,244 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,400 million, to be dated June 9, 1988, and to mature December 8, 1988 (CUSIP No. 912794 QW 7).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing June 9, 1988. In addition to the maturing 13-week and 26-week bills, there are $9,812 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $1,806 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $1,886 million as agents for foreign and international monetary authorities, and $7,858 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

B-1435

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of one-half hour prior to the closing time for receipt of tenders on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

10/87

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

TEXT AS PREPARED
For Release Upon Delivery
Expected at 2:00 pm DST

Remarks by Thomas J. Berger
Deputy Assistant Secretary of the U.S. Treasury
for
International Monetary Affairs
before
The York University Conference
on
The Future of the International Monetary System
Toronto, Ontario
Canada
June 2, 1988

Banks, Governments and International Debt:

Where Do We Go from Here?

I welcome this opportunity to review recent developments and current prospects for addressing international debt problems. The debt crisis which emerged six years ago posed potentially serious risks to the debtor nations and the global economy. Through mutual effort and cooperation, we have reduced these risks and improved the debtors' prospects for a return to steady growth and creditworthiness.

In my remarks this afternoon I would like to:

- o Summarize the basic principles underlying the current debt strategy;
- o Review recent progress;
- o Touch on the role of creditor governments and commercial banks; and
- o Consider with you the key issues we now have to address.

B-1436

The International Debt Strategy

The strategy we embarked upon in the fall of 1985 has helped move us a considerable distance toward our goals. It also has provided a basis for meeting the changing circumstances of individual countries while maintaining a steady focus on the following four key principles:

- First, is the central importance of economic growth in easing the debt burden over time.

- Second, in order to promote growth, market-oriented policy reforms within the debtor nations are crucial.

- Third, to support these reforms, additional capital is needed in the form of equity, debt and the return of flight capital.

- And fourth, each case should be dealt with on its own merits, recognizing the inescapable fact that the particular circumstances of each country are different.

I firmly believe that this strategic framework remains the the only viable long-run approach. The logic is irrefutable. The problems of debt and development can only be solved through the growth of debtor countries. Growth necessitates capital and continuing access to the credit markets. Growth also requires durable, market-oriented economic reforms. These adjustments will make debtor nations more attractive for future investment -- both domestic and foreign. Together with that investment, the reforms promise stronger growth, higher standards of living, and more productive and flexible economies.

The debt strategy's key principles are constant, but its execution is dynamic. Indeed, one of the greatest strengths of this approach is its adaptability. Early last year we suggested a "menu" of financing options -- which I will discuss in greater detail later -- to make sure that investment opportunities evolve with this long-term problem. The problems of debt and development did not arise overnight. They unfolded over a period of years, and it will take years to solve them.

I recognize, of course, that some critics urge another path -- the development of large-scale, generalized, mandatory debt forgiveness schemes. We strongly oppose such "quick-fix" approaches -- including the creation of an international debt facility -- for a number of reasons.

First, this approach will preclude debtors from gaining access to credit markets for years to come -- including vital trade finance. And it would likely even exacerbate existing problems with the flight of local capital.

Second, this approach would forgo the benefits of case-by-case actions, taken over time, to secure economic adjustments to make investments more productive. It ignores that a big part of the solution is to improve the productivity of investments, enabling them to pay their own way. The debt burden, is one constraint -- like those posed by politics, history, culture, sociology, and local economic structures -- and it should not be our sole preoccupation.

Third, these debt forgiveness schemes, which generally rely on a consolidating mechanism, would irreparably politicize the problem, distracting creditors and debtors alike from the difficult but fundamental economic adjustment tasks.

Fourth, this method actually would encourage counterproductive debt repudiations to depreciate the value of the debt so as to maximize the so-called "benefits" of forgiveness.

Fifth, in addition to all these costs, this approach does not even score well according to its supposed rationale of delivering significant debt service savings. An across-the-board thirty percent forgiveness of all the bank debt of all top 15 debtors would lower annual debt service by about $7 billion. To put that figure in perspective, the drop in LIBOR interest rates since 1981 saves the major debtors almost four times as much.

Last, but perhaps most important, proposals to have the public sector purchase private sector debt would necessitate a large, not-to-be returned infusion of public funds, with the continuing risk on these loans also shifted to the taxpayer. Not only is it inappropriate for governments unilaterally to force private financial institutions to sustain losses, but those governments would then end up paying for debtor wards around the globe.

<u>Progress to Date</u>

Admittedly there is fatigue among both debtor countries and commercial banks, but contrary to those who would argue that wholesale debt relief is the only solution, I believe the present strategy <u>is</u> producing results and moving us toward resolution of this difficult problem. Allow me to draw your attention to the following facts:

- According to World Bank data, 8 of the 15 major debtor countries grew at 4-5 percent or better last year, compared with only three countries in 1985. We should bear in mind that growth for the 15 countries was a negative 3% in 1983.

- o Debt service ratios for the group have fallen by one-fourth and interest service ratios by one-third in the past few years. This is largely due to the substantial decline in interest rates since 1982.
- o Aggregate current account deficits have been sharply reduced from a peak of $50 billion in 1982 to $15 billion in 1986, and $8 billion in 1987.
- o Export earnings rose by 13 percent to near record highs last year, while imports this year should be the highest since 1982.
- o The adoption of debt/equity swap mechanisms in some countries, as well as broader policy reforms, has encouraged the return of flight capital, while also helping to reduce debt and debt service burdens.

On a more general basis, the concentration of resources on the debt problem has been impressive. Since October 1985, the World Bank has agreed to provide nearly $14 billion in new loans to support reform efforts in the major debtor nations, while the IMF has provided $5 billion in temporary balance of payments assistance to these nations. Official creditors have rescheduled some $18 billion in outstanding debt, including interest payments. Commercial banks have committed some $17 billion in new finance. Banks have also rescheduled over $211 billion in outstanding debt, reduced spreads, and provided longer grace periods and maturities.

The Role of Creditor Governments

Let me now touch upon the part being played by creditor governments in the debt strategy. In my view, it is not the role of governments to take the banks out of their LDC exposures, nor to assume for their taxpayers part of the risk on commercial bank LDC loans, nor to put up massive amounts of funds from their budgets through a new international debt facility to purchase existing commercial bank debt at a discount. Furthermore, it is not the role of the international financial institutions to offer credit enhancements more routinely; specifically, World Bank guarantees of commercial bank debt are exceptional and their use should remain limited.

Commercial bank numbers in terms of reschedulings may look impressive, but we must remember that commercial banks lent more to begin with and, therefore, have much more debt to reschedule. Commercial banks have been rescheduling principal, while creditor governments, through the Paris Club, have rescheduled interest as well as principal.

Creditor governments have also been contributing in many other ways. First, the major industrial nations have maintained a sound international economic environment with sustained growth, low inflation, and open markets. This is especially true for the United States, which took over 50 percent of the increase in non-oil LDC exports between 1982 and 1986.

Second, the industrial countries have provided leadership in international efforts to address the problems of various debtor countries, often providing bridge financing at key moments. This has involved helping a number of countries to resume normal relations with financial institutions and reestablish fruitful negotiations with the IMF and World Bank. Third, we in the U.S. and a number of other industrial nations have helped to remove regulatory obstacles to new loans and innovative financing techniques.

Fourth, creditor governments have provided sustained support for the international financial institutions. In 1983 these governments provided the major share of a quota increase for the International Monetary Fund of $33 billion and recently have agreed to support a $75 billion general capital increase for the World Bank. Finally, the industrial nations have secured the implementation of important innovations to strengthen the debt strategy generally.

For example, at the IMF Interim Committee on April 14th, it was agreed in principle to establish a combined Compensatory and Contingency Financing Facility. This new facility will help cushion the effect on IMF standby programs of unforeseen external developments such as weaker commodity prices, natural disasters, or sustained higher interest rates that might force a performing country off its economic course. We expect the new facility to expand potential access for the 15 major debtors by more than 25 percent -- potentially more than $12 billion, depending of course upon external developments.

Creditor governments have also taken a number of significant measures to assist low-income developing nations. The IMF's new Enhanced Structural Adjustment Facility will provide concessional resources totalling six billion SDRs to low-income countries facing protracted balance of payments problems. In addition, donor governments have pledged $6.4 billion of bilateral financing to be used in cooperation with the World Bank for low-income African countries with severe debt problems that have undertaken adjustment programs.

The Role of Commercial Banks

What is the role of the commercial banks at this point in the long-term workout of the debt problem? To facilitate commercial

bank financing packages, Treasury Secretary Baker proposed last year the development of a "menu" of financing options.

Such menus can help meet the diverse interests of both debtor nations and the banking community, and can include both new money and debt conversion options. Some of the menu items that might be included in future financing packages are:

- Trade and project loans to support private sector production and growth.
- New money bonds which have some of the characteristics of senior debt.
- Bonds or notes that are convertible into local equity.
- Exit bonds for banks wanting to exit from future new money obligations.
- On-lending rights permitting loans to be targetted to specific enterprises.
- Debt/equity swaps to help reduce both debt and debt service burdens.
- Debt/charity swaps to advance health, education and conservation programs.
- And traditional balance of payments loans.

This menu approach has gained broad acceptance as the basis for new financing packages. The newest "option" is reflected in the recent Mexican debt exchange offer. Through this transaction, Mexico was able to exchange $3.7 billion in outstanding commercial bank debt for $2.6 billion in new Mexican bonds collateralized by a special U.S. Treasury 20-year security, for a net $1.1 billion in debt retired and $1.6 billion in interest saved over 20 years.

We expect additional debt conversions techniques to be developed in the period ahead. In order to be successful, such efforts must be voluntary, privately financed, and developed within the market to benefit commercial banks and debtor nations alike.

In sum, the menu approach emphasizes a negotiated, market-oriented way of resolving debt problems. Both commercial banks and debtors should actively pursue efforts to further develop the menu approach, while creditor governments can help assure that regulatory impediments do not stand in their way.

Unfortunately, however, it has generally been the debtor governments rather than the commercial banks that have taken the

lead in developing menus and orchestrating new transactions. This was true in the case of the Mexican debt exchange offer, the Philippine Investment Notes and the Argentine exit bonds.

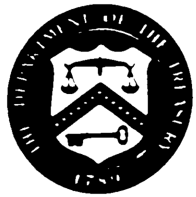
Commercial banks should not wait for innovative financing options to be offered by debtor governments; nor should they call on creditor governments and the international financial institutions to "enhance" new bank credits through guarantees or other support mechanisms. Rather, banks should challenge the most creative minds among their executive ranks to develop financing options that can advance common interests in dealing with the debt problem. In addition, the banks should discuss with the international financial institutions and debtor governments those areas where policy reforms can best assist debtors' return to creditworthiness.

Banks must also work to improve communication within the banking community and to further streamline the new lending process to help assure that new financing is made available in a more timely fashion. In short, banks must lead rather than react; work cooperatively rather than individually; and support innovation in order to advance the process.

Conclusion

In conclusion, let me summarize the tasks before us: Indebted countries must be steadfast in their pursuit of sound policies. Commercial banks and the international financial institutions must be willing to support these adjustment efforts with increased capital flows. And finally, the industrial countries must sustain their rate of demand growth and improve the access of debtor nations to their markets. Such a cooperative solution to the debt problem is the only real answer.

Thank you very much.

TREASURY NEWS 

Department of the Treasury • Washington, D.C. • Telephone 566-2041

Remarks of the Honorable M. Peter McPherson
Deputy Secretary of the Treasury
Before the
Debt for Development Conference
Department of State
Washington, D.C.
May 23, 1988

Thank you. It is a pleasure to be here today to discuss the role the United States government can play in helping to support and facilitate debt-for-development transactions. But first, I must commend my colleagues at A.I.D. for organizing this conference. By bringing together the active players in the development process, the Agency helps to foster cooperation, information sharing and open dialogues so critical to advancing our work.

The Strengthened Debt Strategy

To put the role of the government into perspective, I believe it useful to review the guiding principles of the "Program for Sustained Growth," launched by Secretary Baker in October 1985 at the IMF/World Bank annual meetings in Seoul, Korea. These key tenets are directly related to "debt-for-development" conversions:

° First, the central importance of economic growth and capital formation in easing the debt burden over time.

° Second, the need for market-oriented reforms in debtor nations to achieve such growth.

° Third, new debt and equity financing, and the return of flight capital, to help support such reforms.

° And fourth, a case-by-case approach to address the individual needs of each debtor country.

I firmly believe that these basic principles should continue to guide our approach in the period ahead. Developing nations need financial resources to grow, and require sustained, market-oriented reform of their economic structures. These adjustments will, in turn, promise stronger growth, higher standards of living and more productive and resilient economies, with greater resources for health, social, cultural, and educational programs.

The need for economic reform in developing countries should continue to be stressed; only with reform will these countries be able to attract investment and mobilize domestic financial resources. I would note that developing countries have a greater appreciation for market-based policies to increase economic efficiency. We have seen in a number of major debtor countries efforts to privatize public enterprises, liberalize import regimes, increase the market-orientation of their economies, reform their tax systems, and establish meaningful debt/equity and debt/charity conversion programs.

Despite these developments, additional efforts are still needed to reduce fiscal and external deficits, control inflation, encourage new investment and savings, and unleash the creative potential of the private sector within debtor nations to help catalyze new loans, equity flows, and the return of flight capital. These are essential to improving and sustaining growth.

<u>The Menu Approach</u>

The debt strategy has proved itself to be both evolutionary and innovative. For example, we have encouraged the development of a "menu" of financing techniques to meet the diverse interests of both debtor nations and the banking community. This approach emphazises a negotiated, market-oriented way of resolving debt problems, and the Treasury Department has encouraged commercial banks and debtors alike to pursue efforts to develop the "menu" further. This approach can help facilitate new financial flows, while also providing a way to convert outstanding debt obligations into alternative financing instruments.

Debt conversions, such as the Mexican debt/bond exchange that retired $3.7 billion in commercial bank debt for $2.6 billion in new, collateralized Mexican bonds, as well as "exit" bonds, debt-equity swaps, and debt-charity or debt-development swaps, also have their place in the debt strategy.

Treasury has been a strong advocate of debt-equity conversions. Greater resort to equity financing can help strengthen the corporate sectors of many developing countries, while also enabling both domestic and foreign investors to provide risk capital to generate needed growth and development. This alternative to debt financing has, of course, the added sweetener of reducing debt service burdens and the stock of debt. All told, it is a win-win situation that helps to get countries onto the growth path. Some $7.5 billion in debt/equity swaps have taken place in five countries since 1985.

Efforts by commercial banks, debtor governments and private voluntary organizations to convert voluntarily existing loan obligations into local currency or local currency securities at mutually satisfactory prices in an effort to reduce overall debt burdens can play a useful role within the basic debt strategy, and in advancing development projects in debtor countries.

Treasury's support for these debt conversion efforts, however, should not be taken as support for general debt forgiveness schemes. Such schemes would shift the risk of private sector loans to the public sector and require major expenditures of taxpayer money. We continue to firmly oppose them.

The Role of the U.S. Government in Supporting Debt Conversions

The role of the United States and other creditor governments is, rather, to help reduce tax and regulatory obstacles to these transactions, while preserving the soundness of the financial system and encouraging sound economic management in developing countries.

a. IRS Ruling

In support of debt conversions, the Internal Revenue Service issued Revenue Ruling 87-124 in November of 1987 to provide guidance to U.S. banks, corporations, and other institutions in assessing the U.S. income tax consequences of entering into debt-equity and debt-charity swaps. Gene Steuerle, Deputy Assistant Secretary of the U.S. Treasury for Tax Analysis will help steer us through the tax implications later in the morning.

b. Coordination with the World Bank

Further, as many of you are aware, Treasury staff are currently working closely with World Bank staff regarding recommendations, as outlined in the Treasury Department's recent report to Congress, on how the Bank might help facilitate "debt-for-nature swaps." The Bank will continue to work with developing countries to establish priorities for conservation and environmental projects. Staff is also exploring ways that environmental and conservation groups can "piggyback" debt swaps onto World Bank loans and programs. The Bank might also act as an "information broker" to help assist the start-up and development of these initiatives. We expect to see concrete results soon, including a pilot program to establish debt-for-nature swap programs that would draw on the expertise of the Bank in structuring and implementing a swap program.

In negotiating the terms of the World Bank's General Capital Increase (GCI), the Adminstration has sought to strengthen Bank policies and programs on a broad range of environmental issues. In reporting on the recent conclusion of negotiations on a GCI, the Bank's Board of Directors has called for additional emphasis on the need for better management of human and natural resources so that countries can achieve fully sustainable development, with increased emphasis on environmental work.

I would note at this juncture that World Bank and other governmental resources must continue to be used judiciously, and that they are not intended to supplant the resources of private voluntary institutions. In a similar vein, there

are no plans for the United States government or World Bank to engage directly in debt-for-development swaps. Rescheduling IMF and/or World Bank credits would interfere with the Fund's monetary role, as well as the World Bank's AAA credit rating and, thus, its ability to raise funds in the market.

c. A Role for A.I.D.

As Ambassador Wood noted a few minutes ago, A.I.D.'s role in debt-for-development is primarily catalytic. I believe that involvement of this type by AID will help create synergy and pull together the key parties.

For example, AID already has staff working in several of the heavily indebted countries, including Mexico, Brazil, Bolivia, Ecuador and Peru. AID can help target areas where swaps will be fruitful and where host government programs could be augmented by such swaps. I strongly encourage private voluntary organizations (PVOs) to use these government resources. AID has a significant track record in the development field, and can offer both an infrastructure and guidance to charitable institutions that do not have the history, experience, staff and resources to maximize their funds abroad. As we all are well aware, such resources are too sparse to squander on ill-conceived programs. It is also the function of the PVO to preserve the value of, and exercise control over, all charitable donations from commercial banks.

A Possible Role for Commercial Banks

Treasury has, in many public statements, urged commercial banks to be creative and flexible in their approach to international debt issues. We have witnessed a number of laudable innovations in the past few years, including so called "exit vehicles" that allow banks with smaller exposures to exit from the new money commitments that are part and parcel of concerted lending packages. I would encourage the banks to consider exit vehicles which also advance development, academic, or environmental objectives.

I would also note that appropriate development support will help debtor countries get onto a growth path which will, in turn, provide new markets for U.S. goods and financial services.

While I acknowledge that contributions of developing country debt paper by commercial banks are likely to be limited, they may fit well within the charitable interests of individual banks, while also providing an exit vehicle for banks with smaller exposure, as I noted earlier. In lieu of donations, some PVOs may want to purchase debt paper with dollar donations for such conversions.

The Role of the PVOs

While the amounts at stake vis-a-vis the external debt of developing countries is relatively small, debt-for-development swaps can have a significant positive effect on conservation, health, educational and other programs, where even small amounts of money can achieve substantial results. Several of the PVOs present today have done a remarkable job in formulating and marketing the debt-for-development swap concept. Their work is proof of the wealth of ongoing ideas arising from such initiatives.

Today, we will be hearing from representatives of Conservation International regarding the debt swap that was consumated last year whereby $650,000 in debt obligations were converted into local currency and used for expanding the Beni Biosphere Reserve, home to 13 species of endangered plants and animals. We will also be learning about developments in Equador from the World Wildlife Fund. The country's central bank has authorized a debt-for-nature swap program totaling $10 million.

We understand that other countries, including Jamaica, the Philippines, Mexico, Brazil, Peru, Colombia, and the Dominican Republic are considering starting-up conservation programs. This is encouraging, and I believe that once the procedures for such transactions become more standardized, prospective host governments will become more receptive.

I would like to turn now to some of the more nettlesome issues facing private voluntary organizations -- topics that will arise in our panel discussions today. One topic is dealing effectively with host governments. Many developing countries are reluctant to enter into conversions that would allow foreigners to direct land use. On the other side of the issue, conservationists want to ensure the long-term success of projects that they are funding. Conservation International was able to bridge diverse viewpoints in Bolivia. The same is true for the World Wildlife Fund in Costa Rica and Ecuador, and we are optimistic that these swaps can be replicated in the future in other countries.

On another point, we have been told several times that developing countries will not open local currency accounts to foreigners. This strikes us as an obstacle that can be overcome.

Conclusion

In conclusion, I have observed in my years in the development arena a progressive melding of viewpoints. An April 25th article in U.S. News and World Report entitled "The Preservation Paradox" notes that "the way to get around the apparent conflict between conservation and economic development ... is to mix the two."

And the political leadership in the developing world is increasingly responsive to the underlying reality that there is a direct correlation between wise use of natural resources and economic growth. Similarly, concerted efforts by commercial banks, policy-makers, and private voluntary organizations can help advance the goal of assisting the developing world achieve economic growth and a better life for all its citizens.

Thank you very much.

JUN 1989

U.S. TREASURY LIBRARY
1 0031657