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U.S. DEPARTMENT OF THE TREASURY

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TREASURY NEWS

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Testimony by
Secretary of the Treasury
Nicholas F. Brady
Before the
Committee on the Budget
U.S. Senate
Wednesday, March 1, 1989

Chairman Sasser, Senator Domenici and members of the Committee, I am pleased to be here today to discuss with you President Bush's proposed fiscal year 1990 budget. I know that you have already heard from the Director of the Office of Management and Budget, Richard Darman, and the Chairman of the Council of Economic Advisors, Michael Boskin, so in my testimony I will not repeat a detailed presentation of the Bush budget. However, I do wish to devote some time to discussing the financial aspects of our plan to solve the Savings and Loan crisis, which I know to be of interest to members of this Committee.

The approach to the budget I wish to take today is from the perspective of overall economic policy, thus, I will discuss the importance of deficit reduction to the continued vitality and strength of our national economy and to maintaining and improving our position in the world economy.

We are all aware that we continue to be in a period of extraordinary economic expansion, which has produced millions of jobs, while reducing inflation. We must equally be aware that to sustain this expansion we must reduce the deficit.

As you know, last week the Federal Reserve raised the discount rate one half of a percent to seven percent. I'd like to say a few words about that. First, and foremost, the Bush Administration and the Federal Reserve share absolutely a firm commitment to fighting inflation. It is possible to have somewhat differing interpretations of the same economic statistics, to think one set of statistics means more than another, and still share the same goal of fighting inflation.

The Federal Reserve is using the strongest weapon in its arsenal to fight inflation to advance the cause of the long-term strength and vitality of our national economy. The strongest weapon we in the government have to further the cause of our long-term economic strength is deficit reduction. We must do our part. Even to delay action costs us -- in terms of interest rates, jobs, the Savings and Loan crisis, the third world debt problem.

Let us be frank with one another. We are constrained between revenue levels which are the result of the 1988 election which validated President's Bush's commitment to "No new taxes" and a Gramm-Rudman-Hollings maximum deficit level of $100 billion prescribed in law. So, there are not funds to do all that we want.

Stepping back from the roar of the budget discussions for a minute, one could say, "this is where the country wants us to operate." The key is to have the American people say, "They did what we wanted with what we gave them."

ECONOMIC ASSUMPTIONS

The Bush Administration is absolutely committed to working with you to reduce the deficit. But, some have questioned our economic assumptions. First, I would like to point out that historically the executive branch's economic assumptions have not had a consistent bias toward a rosy scenario. In fact, in the last seven years, the Reagan Administration underestimated growth four times and overestimated it three.

For this year, we believe that the economy will continue to grow, but at a slightly slower pace than last year's drought adjusted rate. We are projecting that GNP will grow 3.5 percent next year. But when we exclude the impact of the rebound from the drought, our forecast is for a moderate 2.8 percent growth rate. This is slower than last year's 3.3 percent drought adjusted growth rate. Our long term forecast for a 3.2 percent sustainable growth rate is right in line with our experience over the past 40 years, during which real GNP growth averaged 3.3 percent.

As one who worked for over 30 years in financial markets, may I make a few comments on interest rate assumptions. During my first year in business, 1954, ten year government bonds carried an interest rate of 2.4 percent. They reached 14 percent in 1981. These same ten year government bonds were 12.4 percent as recently as 1984, but declined to 7.7 percent in 1986. They now carry an interest rate of 9.3 percent.

Attached as an exhibit to my testimony is a graph showing the decline in rates surrounding the passage of Gramm-Rudman-Hollings. From three and one-half months prior to the passage of this all-important fiscal legislation until three and one-half months after, interest rates declined 300 basis points. Was it the only cause of this rapid decline in interest rates? No. Was it a principal cause? Yes.

This would indicate to me that while there is plenty of room for honest disagreement about the future level of interest rates, there is some evidence that fiscal actions have an effect on interest rates, particularly long-term rates. My conclusion is that investors and savers all over the world are waiting for a sign from our government that we are committed to fiscal prudence, and are willing to do something about it. Delay in reaching a budget agreement may only maintain the current high level of interest rates and cost the U.S. and the world unnecessary pain.

In sum, do I think our economic assumptions will prove true if we don't reduce the deficit? No. Will they prove accurate if we do? I believe so.

PRESIDENT'S BUDGET

I know that you have heard a great deal about the specific proposals in our budget from Budget Director Darman. However, I would like to reiterate a few key points. Within the confines of meeting the Gramm-Rudman-Hollings target, the President has proposed budget priorities which if adopted will make a significant investment in our country's future. Among his key proposals, he has:

-- pledged $6 billion to winning the war against drugs;

-- kept his promise to emphasize education, not just through an increase in funding but through programs which encourage excellence in education: awards to successful schools, a recognition program for superior students, a national science scholars program, and a plan to foster magnet schools;

-- addressed environmental issues, particularly that of acid rain; and

-- proposed fully funding the McKinney Act and increasing overall funding to assist the homeless by nearly 30 percent over last year's levels.

Mindful of the growing need for child care, the President proposes to increase assistance to low-income families through changes in the tax code. He proposes a new, refundable tax credit of up to $1,000 for each child under four in low-income working families. This credit would be available to very low-income families, in which at least one parent works, in tax year 1990, and will be expanded to include additional families in following years. By this tax assistance the President's budget provides vital support to families while permitting families to make their own choices about child care that best fits their needs. The President further proposes to make the existing dependent care credit refundable. In its current state the existing credit is of no value to lower income families who do not pay tax.

THE SAVINGS AND LOAN SOLUTION

The President's budget also contains the funding required to resolve the Savings and Loan crisis. It has three components. The first part consists of $50 billion to resolve currently insolvent institutions which may become insolvent over the next several years. Secondly, the plan ensures adequate servicing of the $40 billion in past FSLIC obligations.

And third, and perhaps most important, the plan provides $33 billion in financial resources necessary to put S&L deposit insurance on a sound financial basis for the future.

At the heart of our plan is the creation of a Resolution Trust Corporation (RTC), for which the FDIC will be the primary manager directed to resolve all S&Ls which are now insolvent or become so over the next three years.

To provide the $50 billion to the RTC, we will create a new, separate, privately-owned corporation, the Resolution Funding Corporation (REFCORP), which will issue $50 billion in long-term bonds to raise the needed funds. To pay the principal, industry funds will be used to purchase zero-coupon, long-term Treasury securities which will grow through compound interest to a maturity value of $50 billion. This assures the repayment of the principal of the bonds issued by REFCORP. Funds to purchase these zero-coupon bonds will come exclusively from private sources:

-- The FHLBanks will contribute about $2 billion of their retained earnings -- which are currently allocated to, but not needed by, the existing Financing Corporation (FICO) -- plus approximately 20 percent of their annual earnings, or $300 million, in 1989, 1990 and 1991;

-- The S&Ls will contribute a portion of their insurance premiums; and

-- If necessary, proceeds from the sale of FSLIC receivership assets will be used.

No Treasury funds or guarantees will be used to repay any REFCORP principal.

Interest payments on the REFCORP bonds will come from a combination of private and taxpayer sources:

-- The FHLBanks, beginning in 1992, will contribute $300 million a year;

-- The RTC will contribute a portion of the proceeds generated from the sale of receivership assets, and proceeds from warrants and equity participations taken in resolutions; and

-- Treasury funds will make up any shortfall.

All Treasury funds used to service REFCORP interest will be scored for budget purposes in the year expended.

Funds for the second component of our plan -- servicing the cost of the $40 billion in resolutions already completed by FSLIC -- also will come from a combination of S&L industry and taxpayer sources:

-- FICO will issue bonds under its remaining authority and contribute the proceeds;

-- The S&Ls will contribute a portion of their insurance premiums;

-- FSLIC will contribute the proceeds realized from the sale of receivership assets taken in already completed resolutions, as well as miscellaneous income; and

-- Treasury funds will be used to make up any shortfall.

The final component of the plan is managing future S&L insolvencies and building the Savings Association Insurance Fund (SAIF), the new S&L insurance fund, during the post-RTC period. The funding will come from a portion of S&Ls' insurance premiums and Treasury funds as needed.

These sources provide about $3 billion per year to handle any insolvencies which occur in the 1992-99 period and in addition contribute at least $1 billion per year to building the new Savings Association Insurance Fund. Overall the plan contains $33 billion in post-RTC funds from 1992 to 1999 to manage future insolvencies and contribute to building a healthy new S&L insurance fund. Assuming that $24 billion is used for post-RTC resolutions, by 1999 the SAIF fund will still contain just under $9 billion at a minimum to support the healthy S&Ls.

The net impact of the entire plan -- which includes paying for completed S&L resolutions, paying for the S&L resolutions still to be completed, and providing for fully funded insurance funds for both commercial banks and thrifts -- is $1.9 billion in

FY90 and $39.9 billion over the next 10 years.

CAPITAL GAINS

The President's budget includes important revenue-related measures that fall within the jurisdiction of the Treasury Department. These measures also directly reflect the President's commitment to a budget that sustains a strong economy and builds upon it to enhance our future economic power.

We propose a major tax initiative designed to enhance America's long-term growth and competitiveness: a reduction and restructuring of the capital gains tax to encourage long-term investment. Our proposal calls for a 45 percent exclusion of long-term gains or a 15 percent tax rate cap, whichever is more advantageous to the taxpayer. As an important part of this plan, we have targeted the greatest relative benefits to those with incomes lower than $20,000, if married, and $10,000 if single. Such taxpayers would be eligible for a 100 percent exclusion--no tax at all on long-term capital gains.

The policy of a lower tax rate for capital gains was first established in the Revenue Act of 1921. This policy remained in effect for 65 years. During this time it was endorsed by Democrats and Republicans alike as an important means of stimulating investment. The Tax Reform Act of 1986 eliminated that differential in 1987. In my judgement, the benefits of a lower capital gains tax merit its reinstatement. It is important for the long-term strength of our economy that our tax laws encourage saving and investment in entrepreneurial activities. I believe the essential benefit of a reduction in the capital gains tax goes beyond simply encouraging short-term investment and growth. Over the next four years, we propose to phase in a three year holding period for capital assets sold to qualify for the lower capital gains tax rates. Thus we want to shift the focus of investors from the short-term to the long-term, because ultimately, it is long-term investment which will provide our economy with its fundamental strength. Thus we propose to restore this long-acknowledged incentive to American enterprise.

Enhancing incentives for long-term investment is not the only area in which we need to act if the United States is going to remain a leader in the world economy. It is equally important that we take steps to augment policies and programs which stimulate research and development and which foster our long-term productive capacity.

To this end, the President's budget increases investment in basic research by increasing funding for science and technology programs by 13 percent over the enacted 1989 funding levels. Furthermore, we propose to make the tax credit for research and experimentation permanent. For a number of years, we have had a temporary tax credit to encourage additional research and experimentation (R&E) by U.S. industry. The current credit expires at the end of 1989. It's time we stopped sending stop and go signals to the business community on the importance of research to our economic strength.

Accordingly, the President has proposed to make this credit a permanent feature of the landscape so that U.S. corporations can make their R&E plans with a longer horizon. With this same purpose in mind, the President has also proposed a permanent and more beneficial formula for the allocation of R&E expenses between domestic and foreign income.

INTERNATIONAL CONTEXT

Improving our competitive position in the world economy is very important to our future international economic position. Reducing the deficit will not only improve our competitive position, but is of vital importance to our overall international economic standing. I wish to take a few minutes to address the international implications of our work on the budget this year.

The new reality is that there are no more international boundaries when it comes to the flow of dollars--no border control, no customs officials and no barriers. The influence of foreign financial markets on our economy is great and deep. Most of the world's financial transactions settle daily through the New York Federal Reserve Bank. Before the advent of instantaneous transfer of information and electronic funds transfers this settling of accounts would have taken weeks, now it occurs every night. There are two "wires" through which the transactions settle. The CHIPS wire which largely handles international transactions, and the Fed wire which handles mostly, but not exclusively, domestic transactions. Last month on average about $735 billion worth of transactions were settled per day on the CHIPS wire. And the level of activity is increasing on average at a rate of 25 percent a year. If you approximate the international transactions settled via the Fed wire, then there are about $1 trillion of international transactions settled every day on these wire systems. This amounts to $5 trillion a week, in other words greater each week than our yearly GNP.

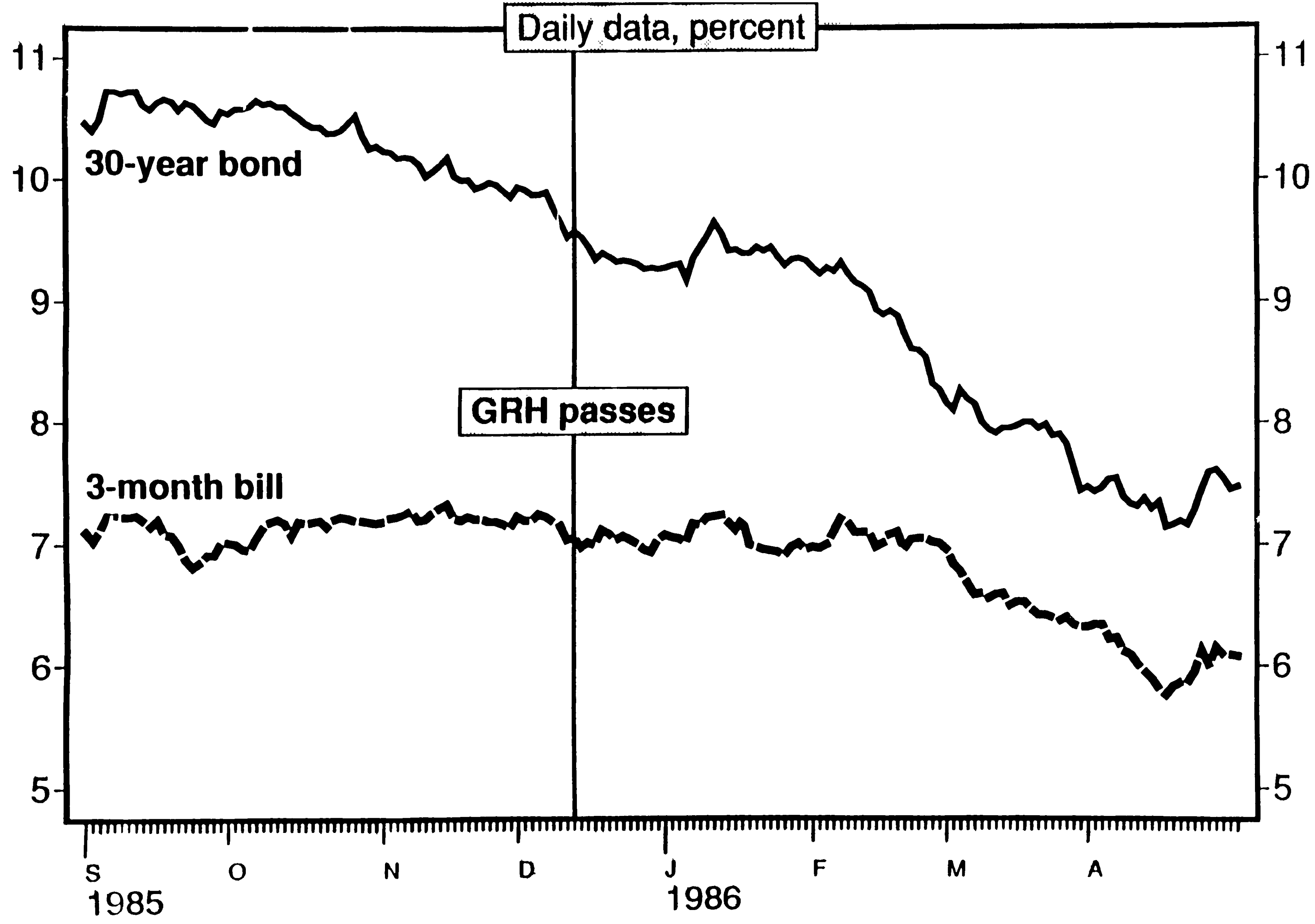
Another statistic which demonstrates the power of international finance on our economy is that at the end of 1987 the total stock of U.S. assets held by foreigners was almost $400 billion greater than the stock of foreign assets held by Americans. Ten years ago this difference was $50 billion in our favor. While one can have different views of how to interpret those numbers, one point is clear -- we cannot ignore the effect of international markets on our balance of payments when considering the need for deficit reduction.

Both the flow of financial transactions through the Fed wire and CHIPS and the amount of U.S. assets held by foreigners are in a sense a measure of foreign confidence in our ability to maintain a sound economy and reduce our budget deficit. The tally of the world's opinion of our progress is registered every day through the Federal Reserve's wire's. It is vital that we act decisively to preserve that confidence.

Lest there be any doubt about the extent of the world's interest and concern about the deficit, let me share with you some of the feelings of my G-7 colleagues -- who met here in Washington, DC the first week in February. We are engaged in a team effort, the economic policy coordination process, to provide a growing world economy. I have been pressing them to stimulate their domestic economies and open their markets to sustain world economic growth. They, in turn, are deeply concerned about our ability to reduce the deficit. They worry that we lack the strength of purpose to meet the Gramm-Rudman-Hollings target. They are knowledgeable about the details of our budget process and are watching very carefully how we handle our budget negotiations. They are concerned that our commitment to abiding by the current Gramm-Rudman targets is less than firm and unequivocal, that if meeting the $100 billion target becomes too onerous that we will move the goal line. I assured them on behalf of us all that people in this government--executive and legislative branches alike--are firmly and absolutely committed to meeting the deficit reduction target. I have told them that we will get there one way or the other.

I know you share this commitment. I am delighted to be here today to discuss with you how we can achieve this common goal.

INTEREST RATES, SEPTEMBER 1985 TO APRIL 1986



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DAVID R. MALPASS LEAVES TREASURY

MAR 3 1989

DEPARTMENT OF THE TREASURY

Secretary of the Treasury Nicholas F. Brady announced today that David R. Malpass, Deputy Assistant Secretary for Developing Nations, is leaving the Department to become the Minority Staff Director of the Joint Economic Committee of the U.S. Congress. The Committee studies domestic and international economic issues for both the Senate and House of Representatives.

Mr. Malpass has been with the Department for three years. Since April 1988, he has served as the Deputy Assistant Secretary for Developing Nations. His responsibilities included economic and financial relations with developing nations, U.S. policies within the international financial institutions, and economic development policies. He also worked closely with Congress, testifying five times on a range of international issues.

From 1986-1988, Mr. Malpass was Legislative Manager in Treasury's Office of Legislative Affairs. He worked on budget, economics and international issues, including tax reform, the trade bill, and the 1987 budget summit.

From 1984-1986, Mr. Malpass worked for the Senate Budget Committee as it's international economist and as Senior Analyst for Taxes and Trade. From 1977-1983, Mr. Malpass held financial positions in Portland, Oregon.

Mr. Malpass holds a bachelors degree in physics and a masters degree in business administration. In 1983, he was a Fellow in Georgetown University's School of Foreign Service. A native of Michigan, he now resides in the District of Columbia.

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REMARKS BY
DEPUTY SECRETARY OF THE TREASURY
M. PETER MCPHERSON
BEFORE THE
FIFTH ANNUAL SAN FRANCISCO INSTITUTE
OF THE
NATIONAL CENTER ON FINANCIAL SERVICES
UNIVERSITY OF CALIFORNIA, BERKELEY
MARCH 2, 1989

GLOBAL COMPETITION IN FINANCIAL SERVICES: A VIEW FROM WASHINGTON

I. Introduction

-- I am pleased to participate in this very timely discussion of financial services.

-- I would like to comment today on the need to look at this topic from an international point of view. I believe that policy-makers must examine the competitive position of the U.S. financial services industry within a global context.

-- We are all well aware that the U.S. slice of the global financial services pie has shrunk markedly.

-- For example, among the top 500 banks ranked by assets last July, the number of U.S. banks fell to 87 from 104 during 1987. Meanwhile the number of Japanese banks increased to 107 from 82 the previous year. Although this is only one estimate, and there may be several reasons for the U.S. decline, the trend is clear.

-- In fact, between 1972 and 1986 the Federal Reserve Board found that among the top developed countries, major U.S. banks experienced the slowest growth in total worldwide assets measured in U.S. dollars. The growth rate ran 10 percent during that time, while Japanese banks' assets grew at an average annual rate of 19 percent, followed by Swiss and German banks at 16 percent and 15 percent respectively.

-- The financial services industry is the lubricant of the world economy. Its smooth and efficient functioning is essential to economic growth worldwide. Even though its participants are private citizens, public policy plays a role.

-- The U.S. Treasury is keenly aware of the need to pursue public policies that are in tune with the problems and potential opportunities U.S. financial firms encounter in today's market, both at home and abroad.

-- On the domestic front, we are committed to a vigorous U.S. economy and a healthy financial infrastructure. Shortly after assuming office, President Bush outlined his budget program. He is committed to reducing our budget deficit -- a goal considered critical to sustaining a prosperous domestic economy.

-- Similarly, we are equally committed to ensuring a stable and sound financial infrastructure. The task of modernizing our nation's financial services industry remains an important objective. The Bush Administration is committed to Glass-Steagall reform. Moreover, we applaud the Federal Reserve's recent decision to broaden securities powers for commercial banks. Efforts to modernize, of course, must be weighed with the need, for prudential reasons, to ensure an adequate regulatory and auditing framework.

-- We have many experts here today who can offer a variety of insights into the multi-faceted subject of financial services. Other speakers will be exploring the U.S. domestic angle of financial services in great depth.

-- I would like to look at this topic from an international point of view. Specifically, I would like to focus my remarks on a critical element of global competition -- that is the treatment U.S. financial firms receive in foreign markets.

II. The View from Washington

-- The issue of how U.S. financial firms are treated in foreign markets has been of great concern to the previous Administration and remains paramount within the current one.

-- Moreover, the Omnibus Trade and Competitiveness Act of 1988 now requires the Secretary of the Treasury, in conjunction with other U.S. Government agencies, to report on the extent to which foreign countries deny national treatment to U.S. banking and securities companies. It also calls for a review of U.S. efforts to eliminate such discrimination.

-- As Congress has made clear, action is needed in instances where national treatment has been denied to U.S. firms in other countries.

-- This concern motivated the Congress to include a primary dealer provision in the Trade Act. This provision essentially prohibits the Federal Reserve from designating a foreign-owned firm a primary dealer if that foreign country denies U.S. firms equal access to its government securities market.

-- The growing trend advocating restricted entry to U.S. financial markets if U.S. firms are denied access to foreign markets, has lent a sense of urgency to the question of how the U.S. should respond to perceptions of unequal global competition.

-- The fundamental position of the Executive Branch has not changed.

-- We adamantly support open financial markets at home and abroad.

-- We firmly believe that if U.S. financial firms are able to compete on a level playing field, they can successfully compete anywhere in the global market.

-- Recent developments in financial services around the world have created numerous exciting opportunities. International capital markets have grown dramatically this decade. Despite a temporary lull in 1987, the volume of borrowing on international financial markets reached an all-time high last year of approximately $452 billion. Relatively strong economic growth worldwide combined with robust investment activity, suggests continued capital market growth.

-- Equally important, many governments have embarked on a course of domestic market deregulation and liberalization. While much work remains to be done in many of these countries, some important steps are under way, for example, in Great Britain, Japan, Canada, Denmark and Belgium. And as I mentioned, the U.S. has been engaged in an ongoing debate about banking reform. Several major emerging economies such as Korea and Taiwan have also pursued efforts to modernize and expand their domestic capital markets.

-- As these developments have unfolded, the Administration, particularly the Treasury, has campaigned relentlessly for open financial markets -- specifically for equality of competitive opportunity -- both at home and abroad.

-- Before I continue, I would like to emphasize that open markets do not benefit just U.S. financial firms. While foreign banks and securities firms clearly gain by the greater opportunities that open markets provide, the home country is the ultimate beneficiary.

-- A liberalized, deregulated and more technologically advanced domestic financial market, particularly in the developing economies, contributes to a more competitive and efficient domestic financial services industry. An efficient financial infrastructure in turn can funnel capital more effectively into the home economy. As a result, borrowing costs and spreads should be reduced, more financial instruments should become available, capital flight can be deterred and greater foreign capital inflows can be encouraged. Indeed, failure to take these steps will mean that the country concerned is left even further behind as modern technology develops elsewhere.

III. Treasury Initiatives

-- I would now like to turn to what the Treasury has been doing to achieve the goal of open financial markets.

National Treatment Study

-- Regarding the U.S. market, the Treasury wholeheartedly supported the International Banking Act of 1978 which adopted the principle of national treatment for foreign banks operating in the United States. National treatment requires that host governments provide foreign institutions the same competitive opportunities that domestic institutions receive. In fact, we define national treatment in financial services as equality of competitive opportunity.

-- At the same time, the International Banking Act mandated the Administration to report to Congress on the treatment that U.S. banks receive abroad, and on efforts to eliminate discrimination against them.

-- The original National Treatment Study, was completed in 1979 and, at the request of the Congress, was updated in 1984 and 1986. The 1986 report examined not only the treatment of U.S. banks abroad but also that of U.S. firms engaged in securities business.

-- The Omnibus Trade and Competitiveness Act of 1988 (Section 3602) has now formalized the reporting process on a four-year schedule. The Secretary of the Treasury is required to report to Congress by December 1, 1990, and every four years thereafter, on the extent to which foreign countries are denying national treatment to U.S. banking institutions and securities underwriters. The report will also describe efforts undertaken by the United States to eliminate such discrimination. In addition, it will examine the degree to which foreign financial services companies have entered into business in the U.S.

-- Perhaps as important, the Trade Act (Section 3603) instructs the President, or his designee, to conduct bilateral discussions when advantageous to ensure that U.S. financial services firms have access to foreign markets and receive national treatment, and that barriers are reduced.

-- The 1990 report to Congress will include the major traditional markets but will also give added emphasis to other areas such as financial centers in Latin America, the Asian economies, and the EC. These regions have become increasingly important to the financial services industry.

-- We have serious national treatment concerns in Latin America. Most of the nations in this region have enjoyed and benefitted from hard currency trade funds and other services supplied by foreign banks, including our own. But at same time, many of these countries have denied foreign investors the right to establish in the domestic market.

-- Given the dynamic growth of financial activity in the Pacific Basin, the 1990 report will undoubtedly also place increased emphasis on the treatment U.S. financial institutions receive in Korea, Singapore, Thailand, Taiwan and Philippines.

-- The European Community's plan to create a single financial market by 1992 also warrants special attention in the next study.

Bilateral Talks

-- In addition to monitoring the treatment U.S. financial firms receive abroad in the course of preparing our reports to the Congress, the Treasury has undertaken extensive bilateral discussions with many of our financial partners. We have achieved significant progress in many of these talks.

-- Perhaps the most notable progress has been in Treasury's financial discussions with the Japanese. The so-called Yen/Dollar group -- now known as the U.S.-Japan Working Group on Financial Markets -- has met six times since the fall of 1984. These talks have contributed to greater access for U.S. firms to Japanese financial markets -- to their stock exchanges, government securities markets, and to a lesser degree their money markets.

-- Financial talks with the Canadians resulted in a financial services section of the U.S.-Canada Free Trade Agreement which took effect January 1, 1989. This is a landmark agreement since it is the first binational agreement by either of the signatories covering the entire financial sector.

-- It is a balanced agreement that should remove many discriminatory practices U.S. financial institutions have encountered. These include restrictions on market share, asset growth and capital expansion for U.S. bank subsidiaries operating in Canada.

-- The Treasury has also been actively involved in the EC's efforts to create a single financial market.

-- While we have supported the EC goal of economic and financial liberalization, we are troubled that possible reciprocity provisions could lead to discrimination and regulatory chaos -- actions which would undoubtedly invite retaliation.

-- We have made some progress. On one important issue, the EC has finally said that reciprocity will not be applied retroactively, nor on a "mirror-image" basis. This, of course, is not enough -- but it is a start.

-- In the newly industrializing economies of East Asia, we have welcomed the Koreans' recent partial interest rate deregulation, but have urged them to broaden their liberalization measures to address a variety of U.S. banks' problems, such as greater ability to open branches and obtain access to local currency funding.

-- The Treasury has also engaged in financial services talks with Taiwan.

-- Among other measures, at a meeting last summer, the Taiwan authorities announced their intention to move toward national treatment in the revision of their banking law. Such a move could enhance U.S. firms' ability to engage more competitively in a number of new activities, such as savings and trust operations.

IV. Next Steps

Problem Areas

-- Despite the progress I have just outlined, many problems persist. I would like to enumerate some of these briefly.

- For example, in Japan, we continue to push for further financial market liberalization -- including the development of a deep liquid money market and further interest rate deregulation. Such developments would permit foreign banks to compete more effectively in the domestic market.

- Moreover, further domestic market liberalization and deregulation in Japan should contribute to a more level playing field globally, since the regulatory environment in Japan has tended to keep down the cost of capital to Japanese financial institutions. Cost of capital is one of the most important factors in the global competitive picture, particularly in our position vis-a-vis Japan.

- In South Korea, restrictions must be removed on branching, local currency funding, and ownership of real property. The lack of a genuine interbank market for won funding also affects foreign banks' ability to operate competitively.

- We would also welcome approval of additional branches for U.S. banks, as well as a more accelerated capital markets liberalization program.

- In Taiwan, we hope to see continued movement toward national treatment. Entry restrictions for foreign banks should be relaxed, foreign exchange controls need to be liberalized further, wholly-owned foreign securities branches and subsidiaries should be permitted, and onerous capital requirements for foreign banks should be revised.

- Most of our immediate concerns in Canada have been addressed in the U.S.-Canada Free Trade Agreement. The agreement establishes a consultative mechanism between the U.S. Treasury Department and the Canadian Department of Finance to address any financial services problems in each other's markets.

- While we applaud the EC's basic objectives of economic and financial liberalization, as I mentioned previously, we are troubled by its inclination to resort to reciprocity. More work clearly needs to be done in this area.

- We believe that reciprocity would undermine efforts to liberalize financial markets and mark a fundamental departure from the principles of national treatment and non-discrimination which have provided the basis for progress to date.

- One concern is that reciprocity could be used to discriminate against non-EC based firms.

- ° For example, the EC could define reciprocity in a way that forces the U.S. to permit EC financial institutions to engage in activities in the U.S. comparable to those activities American firms are able to undertake in the Community. European financial firms have expressed concern about U.S. Glass-Steagall and interstate banking restrictions.

- ° If the U.S. is unwilling to grant EC firms special treatment in the U.S. -- i.e., something better than national treatment -- or to change U.S. laws and regulations to permit all firms to conduct the same activities here as EC firms do in the EC, then access could be denied to American firms in the EC.

- ° In Latin America, we intend to pursue better treatment for U.S. firms in a broad range of financial services in the course of bilateral discussions. We would like to see a more open and hospitable climate for all investors in this region.

Where Do We Go from Here?

-- The larger question is where do we go from here in addressing problems U.S. financial firms face in meeting global competition.

-- One unknown factor in all this is the role of the Uruguay Round. Governments have considered the merits of including financial services among those areas which could be discussed in a multilateral setting. There are a number of open questions as to how financial services might be handled. In any case, national treatment should be the cornerstone of any multilateral negotiation. Regardless of the outcome of these deliberations, I believe we must continue our bilateral consultations.

-- From a public policy point of view the most we can do -- and must do -- is to ensure that a level playing field exists on which our firms can compete. We basically have two roads we can travel to achieve this objective.

-- One is to pursue a course of reciprocity and selectively close our doors to foreigners if U.S. firms encounter obstacles in foreign markets. The other is to continue to press in bilateral talks for open markets worldwide.

-- I strongly believe that no one benefits in a game of reciprocity.

-- Imagine what kind of financial system the United States would have if we were to adopt a policy of reciprocity. Both at the Federal level and in the 50 states, we would have a matrix of different rules to be applied in different ways for different institutions from all over the world. Banks from more than 60 countries are represented in the U.S. while U.S. banks are located in over 70 foreign markets. The number of different regimes which could be applied, and would have to be administered, is staggering. Reciprocity would clearly be an invitation to chaos.

-- I believe the problems I have discussed can only be dealt with by an international commitment to a modern version of national treatment -- what we call equality of competitive opportunity.

-- This means providing all domestic and foreign participants, in any given market, the right to compete on a fair and equal basis. Only if this type of commitment is made by all parties can we expect markets to remain open around the world.

V. Conclusion

-- To conclude, let me emphasize that, when looking at the state of the U.S. financial services industry, policy-makers must bear in mind the global perspective. We have an obligation not only to examine this industry within a U.S. financial market context, but also to look at it within the context of what is happening in foreign markets. We must ensure that our firms can compete in those markets -- just as foreign firms can compete in ours.

-- If markets remain open, I am convinced that U.S. firms can meet global competition.

-- Considerable progress has been made over the years in opening up foreign financial markets. We need to build on this progress through continued negotiations and other methods.

-- Absent such progress, however, we must live with the consequences.

-- Congress has shown itself to be very sensitive to denials of national treatment overseas. If foreign financial markets are perceived to be hopelessly closed to U.S. firms, then we must be prepared to succumb to a battle where reciprocity is viewed as the only weapon.

-- In the long run we would all lose. Access to markets is like sound health. It may only be missed when it is no longer available.

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DEPARTMENT OF THE TREASURY

Remarks by
The Secretary of the Treasury
Nicholas F. Brady
Before the American Bankers Association
Banking Leadership Conference

Capital Hilton Hotel
Washington, D.C.
March 2, 1989

Good morning and thank you for this opportunity to meet with the leadership of the American banking community. I have great respect for your industry, which helps form the foundation of the largest and strongest economy in the world.

The American Bankers Association Leadership Conference provides an important forum for you to establish industry positions on the major issues facing our nation.

I will concentrate most of my remarks this morning on the President's reform plan for the savings and loan industry. But before getting to that, I would like to take just a few minutes to touch on some of the other important priorities the Bush Administration will be pursuing.

PROMOTING ECONOMIC GROWTH

Our first and foremost economic priority is fostering a more competitive, innovative economy which will continue to lead the world as we move toward the 21st century. And I am pleased to say that our economic outlook is very good. Economic growth means rising living standards for working Americans and new job opportunities for those who are out of work.

We must remain vigilant against inflation so that it does not plague our economy as it did in the late seventies. It is possible to have somewhat differing interpretations of economic statistics, to think one set of statistics means more than another, but there is no difference between the Administration and the Federal Reserve Board on the importance of resisting and preventing inflation in order to help sustain the economic expansion.

CUTTING THE BUDGET DEFICIT

We must recognize as we pursue our goal of inflation-free economic growth that the greatest obstacle to success is the federal budget deficit. And the best way to fight inflation and encourage economic growth is to cut the deficit.

That is why President Bush has proposed to Congress a budget that will meet next year's Gramm-Rudman-Hollings deficit reduction target of $100 billion without raising taxes. His budget takes the more than $80 billion in new revenues resulting from economic growth and allocates them to deficit reduction and spending priorities.

The President pledged in his budget address to Congress that he and his team are ready to work with the Congress, "day and night, if that's what it takes, to meet the budget targets and to produce a budget on time." Budget Director Darman, Governor Sununu and I have begun to negotiate with the Congress to achieve the budget reduction all of us agree is necessary.

THIRD WORLD DEBT

Perhaps the most difficult of the major issues facing us at the outset of the Bush Administration is the problem of Third World debt. Unlike the federal budget deficit or even the savings and loan industry crisis, this is not a problem that we in the U.S. have the power or the resources to solve by ourselves.

Only about 30 percent of the debt is held in the U.S. and there are not sufficient resources anywhere in the world to provide an immediate solution to this seemingly intractable problem. We have now completed our review of the current debt strategy and are examining possible changes to that plan. We will have more to say on that soon.

THE S&L PLAN

Now, let me turn to what has been one of my top priorities since the day I was sworn in as Secretary of the Treasury: a sound, responsible solution to the savings and loan crisis.

President Bush is correct. No simple or painless solution to this problem exists. Only eighteen days after he was inaugurated, however, he announced the Administration's plan. In doing so, President Bush reaffirmed our commitment to fix it now, fix it right, and fix it once and for all.

The Administration's savings and loan industry reform plan meets these standards. It serves as a blueprint for comprehensive reform and sound financing. It is pro-industry--for S&Ls, for banks and for the industries they serve.

For banks, the plan has a number of positive aspects. First and foremost, it will quickly resolve the failing savings and loans and thus reduce deposit costs for banks and healthy S&Ls. Second, it proposes reforms you have advocated for some time to require S&Ls to meet safety and soundness standards more like those required of commercial banks. And finally, it pays for a very large problem without using any funds at all from the banks.

RESOLVING INSOLVENT S&Ls

Now, let me turn to a few of the most important details: On February 7, the day after the President announced his plan, the FSLIC, FDIC, OCC, and the Federal Reserve worked together to stabilize insolvent institutions. To date, 34 insolvent S&Ls have been brought under regulatory control. Within six weeks, 200 of the worst cases should be in the hands of federal authorities.

That action should begin to reduce the cost of funds -- for banks, as well as for savings and loans. Moreover, this quick action will give us a head start on implementing the resolutions, which will be executed as soon as Congress provides the necessary financing.

THE REFORM PLAN

We have also proposed fundamental reforms in the way the S&L industry is insured and regulated. To correct the systemic problem of having the regulator act both as an industry advocate and insurer, FSLIC will be separated from the Bank Board and attached administratively to the FDIC.

The combined resources of FDIC and FSLIC will create an insurer with independence and sufficient capacity to deal with this big job.

While a single agency will be created, separate insurance funds will be maintained for commercial banks and for savings and loans. Here is our ironclad pledge: The separate insurance funds will not be commingled, and premiums from each industry will be used only for its own insurance fund.

The Chairman of the FHLBS will continue to be the chartering authority and the primary federal supervisor of savings and loans. The current board will be replaced by a single chairman, who will be subject to the general direction of the Secretary of the Treasury in the same manner as the Comptroller of the Currency.

SAFETY AND SOUNDNESS

The Administration plan will increase safety and soundness standards for savings and loan institutions by requiring these institutions to meet standards equivalent to commercial bank capital and regulatory standards within a two-year period. We have learned a valuable lesson: Deposit insurance simply will not work without sufficient private capital at risk and up front.

Incentives for attracting new capital will further increase the amount of private capital protecting depositors. For example, bank holding companies will be permitted to acquire an insolvent savings and loan without the existing cross-marketing and tandem restrictions. After two years, bank holding companies will be able to acquire any savings and loan without these restrictions. (Of course, non-complying activities would have to be divested.)

The FDIC will be given enhanced authority to set insurance standards for all savings and loans, both federal and state-chartered. It will be able to restrict risky activities that have been authorized by some states in the past. The FDIC also would have a "fast whistle" to halt unsafe and unsound practices, while still protecting insured depositors.

All in all, these steps will create a system of checks and balances for savings and loans that more closely parallels that of commercial banks. And that ultimately is in the best interest of the S&Ls, the banks, their customers and all of us as taxpayers.

SOUNDNESS OF THE DEPOSIT INSURANCE FUNDS

Beyond the regulatory reforms which are designed to insure that massive insolvencies are never allowed to occur again, there is a fundamental need to put the federal deposit insurance funds on a sound financial basis. This can be accomplished by reestablishing the basic principle of industry-financed deposit insurance funds standing between any future industry problems and the taxpayer.

The cost of the S&L solution underscores the importance of requiring all federal deposit funds to be adequately capitalized. The FDIC insurance fund's reserve-to-insured deposit ratio has fallen to an estimated all-time low of 0.83 percent.

We propose increasing commercial bank premiums to bring the FDIC fund more in line with its historical reserve-to-deposit ratio to protect depositors and taxpayers. Specifically, we propose a gradual rise in the deposit insurance premiums paid by commercial banks, from eight basis points currently to 12 basis points next year and 15 basis points the following year.

As soon as the fund reaches a 1.25 percent reserve-to-insured deposit ratio, rebates will be granted on premiums.

It is important to point out that this is the first statutory increase in the FDIC's deposit insurance premium since 1935. During the intervening years, the amount of deposits insured per depositor in any one institution has increased from $2,500 in 1933 to the current level of $100,000.

Let me emphasize, however, that all of the increased premium revenue paid by commercial banks will go to the FDIC insurance fund; not one penny from commercial banks will go to any S&L resolution or to the new Savings Association Insurance Fund.

THE FINANCING PLAN

The financing portion of the Administration's plan has three components. The first $50 billion is to resolve currently insolvent institutions and any other marginally solvent institutions which may become insolvent over the next several years. Second, the plan ensures adequate servicing of the $40 billion in past FSLIC obligations. Third, the plan provides $24 billion for any insolvencies that may occur between 1992 and 1999.

At the heart of our plan is the creation of a Resolution Trust Corporation (RTC) to resolve all S&Ls which are now GAAP insolvent or become so over the next three years. The creation of this new corporation will allow the isolation and containment of all insolvent S&Ls during the three-year resolution process and will facilitate a full and precise accounting of all the funds that are used.

To provide the $50 billion to the RTC, we have asked the Congress to create a separate corporation, the Resolution Funding Corporation (REFCORP), which will issue $50 billion in long-term bonds to raise the needed funds. REFCORP will use S&L industry funds to purchase zero-coupon, long-term Treasury securities with a maturity value of $50 billion to assure the repayment of the principal of the bonds issued by REFCORP.

Interest payments on the REFCORP bonds will come from a combination of private and taxpayer sources. All Treasury funds used to service REFCORP interest will be scored for budget purposes in the year expended.

Funds for the second component of our plan -- servicing the

$40 billion in resolutions already completed by FSLIC -- also will come from a combination of S&L industry and taxpayer sources.

Funds for the third component of the plan -- managing future S&L insolvencies and building the new S&L insurance fund during the post-RTC period -- will come from a portion of the S&Ls' insurance premiums and Treasury funds as needed.

CONCLUSION

In conclusion, the Administration's activity of the past few weeks should illustrate clearly our commitment to a long-lasting resolution of the S&L crisis. We have presented a structurally sound plan. We have proposed a balanced financing package that requires contributions from the S&L industry and also lives within the government's means.

The plan will create a healthy thrift industry by removing the insolvents, reducing excess capacity, and requiring those which remain to have capital and accounting standards equivalent to banks. The results for the commercial banks will be reduced cost of funds and competitors operating on a level playing field. And by requiring that deposit insurance be fully funded and self-funded, the plan will reinforce depositor confidence in the system.

President Bush deserves a great deal of credit for stepping forward with a plan that will do the job. And that plan deserves your outright support. Thank you very much.

# # # # #

ANNUAL TRADE PROJECTION REPORT TO CONGRESS

Prepared Jointly by the Department of the Treasury
and the Office of the United States Trade Representative

March 1, 1989

Annual Trade Projection Report - 1989

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PART I: INTRODUCTION

The Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418) contains numerous reporting requirements, including, in Section 1641, a requirement for an Annual Trade Projection Report. The impetus for this report reflected widespread concern about the emergence of substantial U.S. trade and current account imbalances and the impact of foreign economic trends and policies on these imbalances.

The report is to include a review and analysis of key economic developments in countries and groups of countries that are major trading partners of the United States, projections for developments in various macroeconomic variables in the reporting year and the following year, conclusions and recommendations for policy changes to improve the outlook, and the impact on U.S. trade of market barriers and other unfair practices.

The legislation specifies that the report is to be prepared jointly by the Treasury Department and the Office of the United States Trade Representative, in consultation with the Chairman of the Board of Governors of the Federal Reserve System. The Report is to be submitted on March 1 of each year to the Senate Finance Committee and the Ways and Means Committee of the House of Representatives.

This is the initial report submitted pursuant to P.L. 100-418; Section 1641. Part II provides a review and analysis of recent macroeconomic developments in countries or groups of countries that are major trading partners of the United States, as well as a review of key recent developments in the U.S. economy. Part III presents projections for key macroeconomic developments in 1989 and 1990 in the same countries and country groups. The two main sections are organized as follows: Section 1 discusses economic growth, fiscal trends and current and trade account developments in the industrial countries; Section 2 reviews key developments elsewhere in the world economy, discussing the non-OPEC member Less Developed Countries (non-OPEC LDCs), including the Newly Industrializing Asian Economies (NIEs), as well as the OPEC countries. Part IV reviews the policy issues raised by these projections, and Part V discusses the impact on U.S. trade of market barriers and other unfair practices.

Readers are, in addition, referred to the Treasury Department's October 1988 Report to Congress on International Economic and Exchange Rate Policy, which discusses key issues, including exchange rate developments, in considerable depth and provides a more detailed review of important recent historical trends. That report was also completed under requirements in the Omnibus Trade and Competitiveness Act of 1988 (P.L.100-418).

PART II: REVIEW AND ANALYSIS OF RECENT DEVELOPMENTS

1. Developments in the Industrial Countries

Real economic growth in the industrial countries in 1988 was, for the most part, substantially stronger than had widely been expected, particularly in view of concerns raised by the financial market turbulence in the fall of 1987. In fact, average real GNP growth in the OECD group of industrialized countries strengthened to an estimated 4 percent in 1988, well above the average growth rate during the previous decade.

A. Key Developments in the United States

Because economic developments in the United States are such an important determinant of performance elsewhere in the industrial country group, a brief review of these developments will help put the subsequent discussion in context. Real GNP growth in the United States rose from 3.4 percent in 1987 to 3.8 percent in 1988 on an annual average basis, but slowed from 5.0 percent to 2.7 percent when measured on a fourth quarter over fourth quarter basis, i.e., the fourth quarter of 1988 versus the fourth quarter of 1987. (The latter measurement helps assess the trend rate of growth during the course of the year -- accelerating or slowing down -- though it is also more sensitive to developments in the starting and ending quarters.)

However, this general picture of slowing growth in the United States in 1988 is misleading given the substantial depressing effect of last year's drought. When the GNP data are adjusted for the drought a rather different picture emerges: U.S. real GNP growth improved even more strongly on an annual average basis, to 4.1 percent, and slowed less substantially on a 4th/4th basis, to 3.3 percent. The drought adjustment is particularly striking on the 4th/4th basis because of the greater negative impact of the drought on GNP during the second half of the year.

The effects of the ongoing reduction of the U.S. trade and current account deficits are clearly evident in the national accounts. (Note: There are two basic measurements of the external side of any economy. The balance of payments, i.e., the trade and current accounts, measures the nominal dollar value of international transactions in goods (trade account) and goods and services (current account). The national income and product accounts (the NIPA or GNP accounts) incorporate the external side of the economy by including exports and imports of goods and services on a real, i.e., price-adjusted, basis. Thus, by separating the domestic side of the economy (i.e., private and public consumption, and investment) from the external side (exports and imports), and by presenting both in price-adjusted terms, the NIPA measurement identifies the relative contributions of each to the overall real growth performance.)

Domestic demand growth in the United States was 3.0 percent in 1988, unchanged from its 1987 growth rate. Thus, GNP growth exceeded domestic demand growth by a substantial margin in both 1987 and 1988. As explained above, this gap illustrates the net positive contribution of the external side to overall U.S. growth since 1986. In 1988 the strong real improvement in exports of goods and services added a total of about 0.8 percentage points to real GNP growth; thus better net exports produced about 20 percent of total U.S. growth last year even though exports account for only about 13 percent of overall real GNP. So looked at from the standpoint of the NIPA, the U.S. external adjustment process continued, and indeed strengthened, in 1988.

Adjustment is also clearly evident when measured on a balance of payments basis. As noted in the summary above, the U.S. trade deficit was reduced by an estimated $35 billion in 1988, and the current account deficit by about $20 billion. Expressed as a percent of GNP, which facilitates international comparisons of countries of different size, the U.S. current account deficit narrowed from 3.4 percent in 1987 to 2.8 percent in 1988.

The bulk of the improvement in the U.S. trade deficit in 1988 occurred against the industrial countries (about $20 billion), which collectively absorb 64 percent of total U.S. exports. Within this group, the U.S. deficit vis-a-vis Western Europe (27 percent of total U.S. exports) was cut by more than half, from $27 billion to $13 billion: the U.S. deficit with Germany fell by about $3 billion due entirely to higher exports; and the U.S. trade balance with the U.K. improved by nearly $4 billion, to a small surplus. The balance of U.S. trade with the EC shifted by $12 billion, from a deficit of $21 billion to a deficit of $9 billion. The U.S. trade account improvement against Japan (which accounts for about 12 percent of U.S. exports and 20 percent of U.S. imports) was about $4 billion.

There was also a considerable decline in the U.S. trade deficit with the developing countries in 1988. Against this group, which accounts for 33 percent of U.S. exports (i.e., more than Western Europe), the U.S. deficit narrowed by $13 billion, from $59 billion in 1987 to about $46 billion last year. The U.S. trade deficit with Mexico (the third largest U.S. export market after Canada and Japan) fell by $3 billion; however this shift was partly offset by a $1 billion increase in the U.S. trade deficit with Brazil.

Roughly half of the U.S. deficit shift against the LDCs was accounted for by a $5.5 billion decline in the deficit with the Newly Industrializing Economies of Asia. (This group accounts for 11 percent of U.S. exports and 14 percent of U.S. imports.) The bulk of this improvement came against Taiwan, with which the U.S. deficit fell from $17 billion to $13 billion. Against Korea, on the other hand, the U.S. deficit was virtually unchanged.

Finally, the U.S. deficit with the OPEC countries was reduced by $4 billion due mainly, and perhaps surprisingly given the general slowdown in OPEC import growth, to higher U.S. exports; given oil price developments in 1988 U.S. imports from OPEC were reduced by about $1 billion.

B. Developments in Other Industrial Countries

The accelerated economic growth in the industrial countries in 1988 was due to a number of factors. First, consumer and business sentiment improved dramatically during the first half of 1988, rebounding from the excessive pessimism that had prevailed in the wake of the October 1987 financial market events. The effect of this shift was seen in private consumption spending, which was clearly stronger than initially expected, and, most importantly, in substantially higher real investment spending. Second, the rate of growth of world trade jumped by about 50 percent in volume terms (from nearly 6 percent in 1987 to an estimated 9 percent in 1988) both reflecting and at the same time contributing to stronger overall industrial country growth. Third, some special factors -- like a mild winter and extra work days in Europe -- gave growth rates an early boost in 1988.

As noted above, stronger investment activity in 1988 contributed importantly to the general improvement in domestic demand growth in the industrial countries outside the United States. In fact, gross investment spending increased in real terms in each of the six foreign Summit countries (Japan, Germany, France, U.K., Italy and Canada), in some cases (Germany and the U.K.) dramatically. In the 12 EC countries as a group investment growth rose from about 4.5 percent in 1987 to an estimated 7.5 percent last year, an unexpectedly good result that was generally shared by the other European countries.

Developments in another key domestic demand component, private consumption, however, were less uniform. Consumption growth rates picked up in Japan, the U.K. and the Netherlands, remained essentially unchanged in France, and generally declined in the rest of the group. For the EC as a whole, private consumption growth is estimated to have declined marginally in 1988 but, at about 3.5 percent, still remained well above average growth rates in the first half of the decade. Although it is difficult to generalize, these declines to some extent reflected the impact on real earnings of wage restraint and somewhat higher inflation.

Taken together these trends indicate that in addition to the quantitative improvement in economic growth in our major industrial trading partners in 1988, there was some further qualitative improvement as well. Specifically, the gap between domestic demand growth and overall GNP growth in the key surplus countries -- an important determinant of the speed of trade and current account adjustment -- widened, particularly in Japan.

In aggregate, average domestic demand growth in the six foreign Summit countries rose from an annual average of 4.3 percent in 1987 to an estimated 5.5 percent in 1988. Average GNP growth was 3.4 and 4.4 percent, respectively; thus the domestic demand versus overall growth gap for this country group remained at about 1 percent in real terms. The same general picture applies to the EC group as a whole, while in the smaller European economies domestic demand growth is estimated to have exceeded GNP growth by about half this amount.

Turning to country specifics, Japan was again the Summit country growth leader in 1988 with its real GNP growth rate increasing from 4.5 percent in 1987 to an estimated 6.0 percent. Domestic demand (specifically, private consumption and investment) was again clearly the driving growth force, expanding by nearly 8 percent in real terms. The picture for Germany is similar, but less impressive. Overall GNP growth picked up strongly in 1988 (to about 3.6 percent) after a disappointing 1.8 percent advance in 1987. Bolstered mainly by investment, domestic demand growth rose from 3.1 percent in 1987 to an estimated 3.9 percent in 1988. The gap between domestic demand and GNP growth in Germany thus narrowed considerably, from 1.3 percent in 1987 to 0.3 percent in 1988.

Domestic demand growth in the U.K was appreciably stronger in 1988 (perhaps 5.8 percent), driven in large part by surging investment. In Canada and Italy domestic demand growth also led GNP in 1988; in France and Belgium both advanced by about 3.5 percent, while in the Netherlands growth rates were a more modest 2.5 percent.

Thus, in the important Summit 6 group as a whole (which, due entirely to Japan and Germany, is running a substantial combined current account surplus), the external side of the economy exerted a net drag on growth in 1988; i.e., net exports of goods and services declined in real terms. For both Japan and Germany this was the third consecutive such annual adjustment. (In the United States, conversely, improving net exports have been a positive contributor to GNP growth since 1987.)

B. Fiscal Balances

The fiscal deficits of industrial country governments were, in aggregate, generally reduced in 1988 due largely to the automatic stabilizer effects of the stronger economic growth described above. Specifically, higher growth and corporate profits tended to boost tax revenues while, on the other side of the budget accounts ledger, outlays for public support programs such as unemployment insurance tended to grow more slowly or even decline. For the most part, therefore, the fiscal tightening in 1988 appears to have been mainly cyclical rather than structural.

Calculations by analysts with the Organization for Economic Cooperation and Development (OECD) indicate that underlying fiscal policies in the industrial countries were mildly contractionary in 1988 after having been mildly expansionary in 1987. The OECD estimates that the 'cyclically-adjusted' overall fiscal position of the Summit 6 moved toward surplus by about 0.2 percent of GNP in 1988 after having eased by 0.3 percent of GNP in 1987. That is, when adjusted for the effect of automatic stabilizers (fiscal drag) plus discrete policy changes, the combined general government fiscal position (i.e., including all levels of government) of the six countries swung from slight stimulus in 1987 (0.3 percent of GNP) to slight contraction in 1988. Over the two year period, therefore, underlying fiscal policy in the Summit 6 group was essentially neutral. The OECD also estimates that the same figures apply to the European economies in aggregate.

There were, however, some important differences among countries. In Japan, the effects of a large increase in public investment and a late-1988 income tax cut were countered by higher growth-related revenues, resulting in a slight increase in the small (0.4 percent of GNP) general government surplus. In Germany, income tax cuts that came on stream in January 1988 helped boost the general government deficit somewhat, to an estimated 2.1 percent of GNP in 1988. **However, after several years of contractionary policies the German deficit, expressed as a percentage of GNP, still remains well below levels recorded in the early 1980s.**

The general government fiscal position continued to improve in the U.K. in 1988, with the surplus rising to 1.4 percent of GNP; expenditures have remained within fairly restricitve targets while revenues have benefitted from strong growth and privatization receipts. Elsewhere, the general picture is one of continued efforts to restrain expenditure growth coupled with better than anticipated revenues, producing deficits in 1988 that were somewhat reduced relative to GNP.

C. External Accounts

Although developments in the external accounts of individual industrial countries in 1988 were typically divergent, it is clear that in important respects progress continued to be made toward achieving better international balance. The U.S. trade and current account deficits were reduced in both nominal terms and as a percent of GNP. The counterparts to this U.S. adjustment in 1988 are found in lower external surpluses in Japan, the EC (and Europe more broadly), and the Asian NIEs.

Japan's current account surplus declined from $87 billion in 1987 to $79.5 billion in 1988, reflecting both a decline in the trade surplus and an increase in the invisibles deficit. The key development on the trade side was a very strong surge in import volume (about 16 percent) compared with export volume growth estimated at about 4.5 percent. However, with total exports running at nearly twice the level of total imports, the trade surplus was reduced by less than $1 billion in dollar terms (to $96 billion).

Canada's 1988 merchandise trade account netted out to a surplus of about $7.2 billion, down about $1 billion from 1987, as the real growth rates of both imports and exports picked up. However, with the traditionally large invisibles deficit running below its 1987 level, the current account deficit narrowed to an estimated $7 billion.

The combined current account surplus of the European Community dropped from about $37 billion in 1987 to an estimated $15 billion in 1988. However, there were important differences in the performance of specific member countries. The most striking development was a nearly sixfold increase in the current account deficit of the U.K., from $4.4 billion in 1987 to an estimated $25 billion in 1988. Lower oil earnings were partly responsible, but the bulk of the shift was accounted for by a surge in imports of investment goods.

Germany's trade surplus, on the other hand, reached a new record in DM terms (equivalent to an estimated $73 billion) due mainly to much stronger investment goods exports to the other EC countries. As a result, the German current account surplus rose by about $4 billion to nearly $49 billion (Germany is running a large and growing invisibles deficit), though relative to GNP it declined slightly to 3.9 percent.

Current account patterns within the rest of the EC remained little changed in 1988. France's deficit rose slightly to about $4.5 billion but remained quite small as a share of GNP, as was essentially the case for Italy.

Elsewhere within the EC, as well as in Europe as a whole, there were few remarkable developments: the combined deficit of the Nordic countries remained little changed (about $9 billion); the combined Benelux surplus rose from $6 billion to approximately $9 billion; and newly admitted EC member Spain slipped into deficit.

2. Developments Outside the Industrial Countries

Growth developments in the Less Developed Economies (LDCs) as a group were broadly satisfactory in 1988, though in contrast to the industrial countries, overall real growth was somewhat slower than in 1987. Specifically, the GNP weighted average real growth rate of the 137 non-OPEC LDCs tracked by Treasury analysts slowed from about 3.7 percent in 1987 to a provisionally estimated 3.1 percent last year.

As usual, however, there were important differences among countries and country groups, with the overall average strongly affected by developments in a few of the largest economies. Average real growth slowed in Latin America but remained quite strong in the Newly Industrializing countries of Asia.

In fact, the overall LDC growth slowdown in 1988 was due almost entirely to negative developments in a few Latin American economies. Specifically, Brazil registered zero real growth in 1988 (after 2.9 percent in 1987) and Mexico's growth rate slipped from about 1.5 percent in 1987 to an estimated 0.5 percent in 1988. As a result, in Latin America as a whole aggregate GNP growth slowed from 2.5 percent in 1987 to 1.4 percent in 1988. Elsewhere, the non-OPEC LDC real growth performance was about on par with 1987 rates, i.e., just under 4 percent.

The Newly Industrializing Economies of Asia (NIEs; Taiwan, Korea, Singapore, Hong Kong) were again the clear growth leaders, recording a weighted average growth rate of about 10 percent in 1988 after a similar outturn in 1987: Korea's growth rate remained at roughly 12 percent while Taiwan's slipped to a still impressive 8 percent.

The aggregate non-OPEC LDC current account balance registered a small $1 billion deficit in 1988 after a $4 billion surplus in 1987. As with the growth figures discussed above, however, there were sharp differences among individual countries and regions.

The combined current account surplus of the Asian NIEs declined by an estimated $5 billion in 1988, to about $26 billion. This correction was due entirely to a halving of Taiwan's surplus, from about $18 billion in 1987 to an estimated $9.6 billion in 1988; however, about $4 billion of this correction was due to special, and probably one-time, gold purchases. Korea's surplus, on the other hand, rose further to approximately $14 billion.

Other key current account developments within the non-OPEC LDC group were: a dramatic deterioration in Mexico's position, which shifted from a $3.4 billion surplus in 1987 to a $3 billion estimated deficit in 1988; a substantial opposite move in Brazil's current account, which shifted from about a $1 billion deficit in 1987 to a provisional $4.4 billion surplus in 1988.

Despite the important current account shifts within individual countries, the combined current account position of Latin America as a whole has actually changed relatively little in dollar terms in recent years. A $17 billion deficit in 1986 was reduced to $11 billion in 1987, where it remained last year.

The four Asian NIEs (Korea, Taiwan, Hong Kong, and Singapore) have become particularly significant players in the international trading system. Since 1970, their share of world exports has more than tripled to 7.4 percent. Moreover, these economies have in aggregate, accumulated external surpluses that account for a significant share of current global imbalances. Taiwan and Korea have recently been running large current account surpluses -- two to four times those of Japan and Germany as a proportion of GNP. (It should be noted, however, that Korea ran a current account deficit as recently as 1986.)

The factors that are responsible for the growth of the Asian NIEs' external surpluses vary among the individual countries and generalizations are difficult. Some important elements are relative advantages in costs of production and an emphasis on export production at the expense of domestic consumption and improved living standards. The expansion of world trade, and of the U.S. economy especially, has of course benefitted the NIEs, though this applies to the rest of the world as well. Undervalued exchange rates have also been a major factor in the cases of Korea and Taiwan.

The 13 member OPEC group collectively experienced a substantial increase in its current account deficit in 1988 as earnings from oil and gas exports were reduced significantly by the roughly 20 percent decline in the average dollar price of OPEC oil. After the deficit narrowed from $26 billion in 1986 to under $11 billion in 1987, it about doubled in 1988 to $20 billion. (Although the OPEC group typically runs a substantial trade surplus, it has been highly volatile in recent years and is significantly exceeded by a large deficit on invisibles transactions.)

PART III: PROJECTED DEVELOPMENTS IN 1989 AND 1990

Before reviewing projections for this year and next, it is important to set forth several key assumptions on which the analysis is based. First, all projections for individual countries and groups of countries are based on current policies. For the United States it is assumed that the federal budget deficit is reduced along the Gramm-Rudman-Hollings path. No assumptions are made as to how fiscal or monetary policies may be altered during the forecast period. Secondly, exchange rates are assumed to remain constant in nominal terms at current levels. Finally, the Administration's forecasts for the U.S. economy contained in the budget provide the basis for the U.S. outlook -- itself an important factor in the economic performance of the major U.S. trading partners.

As a result of these various basic assumptions, the projections discussed below are not "best guesses" of what the economic situation will turn out to be in 1989 and 1990. They are, rather, "best guesses" of what the situation will be unless policies change.

Latest forecasts and economic data indicate that the current economic expansion in the industrial countries is expected to continue through 1989 and 1990, its seventh and eighth consecutive years. However it is widely expected that the pace of overall growth will be at a somewhat slower rate than in 1988. As was the case in 1988, world trade growth should continue to outstrip real GNP growth substantially, providing support for the ongoing external adjustment process as well as a firm foundation and stimulus to overall growth. Inflation in the industrial world is, on average, expected to remain moderate through 1990. It is more difficult to generalize regarding fiscal side developments: many countries will continue to pursue, with varying intensity, policies designed to reduce budget deficits and public borrowing requirements. However, it is also true that tax reform and the overall reduction of tax burdens remains a policy objective in numerous other countries.

1. Projections for the U.S. Economy

The U.S. economy is expected to continue to expand along a sustainable growth path this year and in 1990. After last year's partially drought-influenced growth slowdown, GNP growth (on the 4th/4th basis) is officially forecast to pick up to about 3-1/2 percent in 1989 and to remain at roughly this rate in 1990. (Note: This 1989 growth rate tends to overstate the underlying growth momentum of the economy due to the negative end-1988 impact of the drought discussed above.)

U.S. growth rates on an annual average basis are likely to be a bit lower, but still in the 3 to 3-1/2 percent range in both years. Domestic demand growth rates are forecast to remain in the 2-1/2 to 3 percent range. Thus the external side will remain a net positive contributor to overall growth, with real increases in exports expected to exceed import growth substantially. On the balance of payments basis, further declines in the U.S. trade and current account deficits are expected; however, given rising debt service costs there will not be a full pass-through of the trade deficit reductions to the current account.

2. Projections for the Other Industrial Countries

A. Economic Growth

Real economic growth in the industrial countries is expected to slow somewhat this year, to the 3.0-3.5 percent range, i.e., returning to the rate recorded in 1987. Largely responsible for this moderate slowdown will be an anticipated return of investment growth to a more measured rate in 1989 after its unusual strength in 1988. While 1990 is a bit beyond the normal projection horizon, preliminary work suggests a further, though more modest, growth slowdown in the major foreign industrial countries. It is anticipated that aggregate real growth in the Summit 6 countries will be just under 3 percent on average in 1990.

There is broad agreement among forecasters that German real GNP growth will fall back somewhat this year from last year's sharply higher rate, mainly reflecting the dampening effect of various tax increases on disposable income and private consumption growth. Japanese growth should also slow this year, though for different reasons and to a rate that will still be well above that of the other Summit economies. Specifically, private consumption growth in Japan should remain quite robust while investment growth -- an especially dynamic factor in 1988 -- cools considerably.

Given Germany's size and the impact of its economic policies on other EMS countries, it is not surprising that the aggregate growth performance of the four largest European economies (Germany, France, U.K., and Italy) will not diverge much from the German trend. The U.K. is unlikely to maintain the very strong investment and private consumption growth rates recorded in 1988 in the face of recent monetary policy tightening; real GNP growth in the U.K. is expected to fall back to a more sustainable rate. France did not experience similarly exceptional developments in 1988, but both consumption and investment rates nevertheless appear likely to cool this year.

Prospects for the rest of Europe, within and outside of the EC, are broadly similar: slower real GNP and domestic demand growth due in part to a return of investment to lower growth rates. Specifically, GNP growth in the non-Summit European countries is expected to slow by about one half a percentage point, to 2-3/4 percent.

Domestic demand growth in the six foreign Summit countries should, in aggregate, continue to outpace that of overall GNP growth. However, the extent to which domestic demand growth exceeds GNP growth is likely to narrow significantly this year. In addition, there are important differences among the countries. Taken together, domestic demand growth in the four major European countries (and in the smaller European countries as well) is expected to be roughly the same as GNP growth, just under 3 percent.

The disappearance of the domestic demand/GNP growth gap within the Europe Big 4 this year is expected to be shared broadly. In Germany, France and the U.K. domestic demand growth rates will drop substantially, though for the different reasons mentioned above, pulling overall GNP growth down with them. From a trade adjustment perspective the possible elimination of this gap suggests that limited further progress may be made this year toward adjusting the aggregate Europe Big 4 trade imbalance. In Japan, in contrast, domestic demand growth is forecast to continue to exceed GNP growth though here too the gap is expected to narrow relative to 1988.

At this early forecasting stage analysis suggests continued moderate overall GNP growth in the industrial countries in 1990, which is potentially the eighth consecutive expansion year. However, while the general growth picture appears reasonably satisfactory in a quantitative sense, it is less so in a qualitative one. Specifically, our projections indicate that the pattern of domestic versus overall growth is not likely to be much different from this year's.

For the foreign Summit Six, GNP growth is expected to slow moderately, to just below 3 percent. Growth rates in the two largest foreign economies, Japan and Germany, are both expected to slow somewhat further, though for different reasons. Despite the enactment of the final stage of a multi-year tax reform in Germany, tax cuts amounting to about 0.5 percent of GNP are not expected to boost private consumption significantly. Consumption growth is likely to be restrained by an increase in the savings rate, and investment growth will probably slow after two relatively strong years. If these views are borne out, German GNP growth could subside to the bottom end of growth in the foreign Summit countries.

In Japan, on the other hand, private consumption growth is likely to continue at roughly its 1989 pace, but a fairly substantial slowdown in plant and equipment investment is expected. Nevertheless, Japan's projected 1990 GNP growth rate is likely to remain well above the Summit Six average.

Growth rates are also likely to slow a bit further in Italy and France, the other two major continental European economies. In the U.K. by contrast, real GNP growth may well strengthen in 1990 as exports continue to improve and private consumption rebounds from what is expected to be weaker growth this year.

At this juncture, it is expected that the rest of Europe will be on a roughly 2-1/2 percent growth path in 1990. Spain, Portugal and Turkey are again likely to be the top growth performers, while real growth in Denmark and Sweden should remain relatively slow. The aggregate growth rate of the EC will of course be driven largely by developments in the four major economies, and thus is likely slip to about 2-1/2 percent.

B. Fiscal Balances

If budgetary policies remain as presently anticipated -- as must be assumed -- the aggregate fiscal stance of the OECD as a whole (again, cyclically adjusted) will be broadly neutral over the 1989-1990 period. Nevertheless, there will be some significant differences among the individual countries. Fiscal policy in the United States will be geared toward meeting statutory requirements for reducing the federal deficit. In Japan, the fiscal deficit is likely to rise moderately, reflecting the combination of a variety of tax changes with a modest rise in government expenditures. Germany's planned policy over the period combines an array of tax and social payment increases this year with further income tax reductions in 1990. The overall German government budget deficit (as a percent of GNP) will therefore decline in 1989 and rise in 1990; but over the 1989-90 period its average will be well below that of the 1987-88 period.

The U.K. shifted to a budgetary surplus in 1988, despite tax cuts, and, relative to GNP, is likely to show moderately rising surpluses in 1989 and 1990. France has combined higher outlays on selected domestic programs with reduced corporate and excise taxes, but little overall change is expected in its relatively small deficit. On present policies the general government deficit in Italy will remain essentially unchanged and relatively high as a percent of GNP (11.5 percent in 1988). Similarly, little change is anticipated in the Canadian budget deficit through 1990.

The smaller European countries have been steadily reducing public deficits as a percent of GNP since the early part of the decade, and this trend is expected to continue. Specifically, the average deficit is likely to be held below 2 percent this year and next, compared with a 5 percent level in 1983.

C. External Accounts

Current account projections for the industrial countries in 1989 and 1990 indicate that the external adjustment process should continue, albeit with less uniform improvement than might be desired. World trade flows will, of course, be driven importantly by the growth trends discussed above. Thus, with aggregate industrial country growth expected to slow moderately in 1989 and 1990, so too should the real expansion (i.e., volume growth) of trade. Nevertheless, trade volume growth in the OECD countries should still remain fairly robust and again outstrip GNP growth by more than a 2:1 margin. Indeed, average trade volume growth over the 1988-90 period should prove to be higher than in any three year period since the mid-1970s.

Preliminary projections indicate that the combined current account surplus of the Summit 6 countries will decline this year and again in 1990. Specifically, after an estimated surplus of $88 billion in 1988, the Summit 6 total surplus is forecast to fall to about $74 billion in 1989 and $64 billion in 1990. This implies that the group's combined surplus will have been nearly halved since its record high of $123 billion in 1986.

The largest shift should be seen in Japan, whose current account surplus is expected to drop significantly from about $80 billion last year. Roughly half of this projected decline is accounted for by a decline in the (dollar value) trade surplus, with the remainder accounted for by an increase in the Japanese services and transfers deficit.

Germany, however, presents a different picture. With export growth having rebounded from a brief slump in 1987 (due in the main to the commodity composition of German exports and the stronger foreign demand for investment goods), the German trade surplus is likely to rise moderately through 1990. Thus, despite an expected increase in its traditional invisibles deficit, Germany's current account surplus will probably remain broadly unchanged. On a regional basis, the key feature of the German trade account has been a sharp increase in its surplus with other EC countries, and this is expected to persist.

Elsewhere within the Summit 6, no dramatic changes are anticipated. Last year's ballooning of the U.K.'s trade (and current account) deficits is not likely to be reversed by 1990. France, Italy and Canada should collectively have about the same current account deficit in 1990 as they had in 1988.

The smaller OECD countries should, in aggregate, experience an increase in their relatively small combined current account deficit due largely to an expected increase in Spain's deficit. Among the others, surpluses and deficits are fairly minor in dollar terms, and no substantial shifts are anticipated. Thus, current account trends in the OECD as a whole through 1990 will essentially track developments in the largest seven economies.

2. Projections for the Non-Industrial Countries

The developing countries should post somewhat higher aggregate real growth in 1989 and remain on a fairly even keel in 1990, aided by the expected continued moderate growth in the industrial countries. Trends in Latin America will again be dominated by developments in Mexico and Brazil. In both cases, current trends suggest a modest growth rebound this year, with somewhat higher real growth in Argentina as well. Thus for the region as a whole, we anticipate a return to the 3-1/2 to 4 percent growth range through 1990.

Growth prospects for the Asian NIEs remain quite good. Although the two biggest economies, Taiwan and Korea, are likely to experience a slowdown from their recent double-digit rates, growth should remain at about 9 and 7 percent, respectively. These projections imply aggregate NIE growth rates in the 7 to 8 percent range this year and next. Contributing to this slower growth scenario will be a reduced rate of export expansion and an increase in the growth rate of imports. The NIEs traditionally pursue relatively conservative fiscal policies, which implies little direct growth stimulus from the public side and continued fiscal surpluses.

Assessing recent economic growth developments in the OPEC group, and producing credible projections for the future, is extremely difficult in view of serious data problems with two of the largest countries, Iran and Iraq, and oil price uncertainty. We do not disagree fundamentally with the latest IMF staff projections, which suggest that average growth for the group is likely to improve from about 1 percent in 1988 to about 2 percent in 1989. Obviously, the picture for this year and next will be importantly affected by oil price developments. If oil prices remain around current levels (which is but one of several alternative scenarios), and barring any exceptional developments, aggregate OPEC growth in 1990 could again be be within the 1-1/2 to 2 percent range.

The aggregate current account deficit of the non-OPEC LDCs is forecast to expand this year, from an estimated $29 billion in 1988 to about $39 billion. About half of this shift is expected it be accounted for by a decline in the combined surplus of the NIEs; the remainder reflects a projected $2 billion increase in the Latin American deficit and scattered increases throughout the rest of the non-OPEC LDC group.

Current account developments in the NIEs will, as usual, be dominated by Korea and Taiwan. Korea's large surplus is expected to narrow somewhat this year given the already emerging trends of slower export and stronger import growth. In Taiwan, the adjustment that was already underway in 1988 should continue this year, reducing the current account surplus further. This projection, however, depends importantly on greater import penetration. In both countries additional surplus reductions are anticipated in 1990, though they might not be as substantial as this year.

Given these basic projections for the two largest economies, the combined current account surplus of the NIEs as a group should show further declines in both 1989 (to $21 billion) and 1990 (to $18 billion). These current account projections however tend to obscure a somewhat stronger underlying adjustment process in the trade accounts alone. Both Korea and Taiwan are running growing surpluses on the invisibles account (services and transfers) which partially offsets reductions in merchandise trade surpluses. Thus while we expect a $8 billion reduction in the combined NIE current account surplus between 1988 and 1990, the projected reduction in the merchandise trade deficit is $11 billion. If our projections are borne out, the overall trade surplus of the NIEs in 1990 will drop below $10 billion.

Key developments shaping the combined Latin American current account deficit in 1989 and 1990 are: substantially reduced surpluses in Brazil relative to 1988; and marginally lower deficits in Mexico. In aggregate, Latin America's current account deficit is forecast to widen slightly (to $13 billion) in 1989 and then narrow slightly (to $11 billion). In light of the projected industrial country growth and trade trends outlined above, we do not anticipate any dramatic developments on the trade side. The Latin American region's combined trade surplus is expected to remain little changed, in the $27-28 billion range.

Current account developments in the OPEC countries in 1989/90 will of course turn importantly on the situation in the world oil market and the extent to which these producers are able to affect it. With industrial country growth expected to slow this year and next, and given excess worldwide production capacity, neither demand nor supply-side considerations suggest strong price pressure developing in the near-term. A marginal rise in the OPEC trade surplus would cut its combined current account deficit commensurately.

PART IV: POLICY ISSUES

The basic near-term policy objectives for the industrial countries, particularly those with large external imbalances, will remain what they have been for the past few years. Together they need to ensure that real growth continues at a steady, solid pace, that inflationary pressures are contained, and that the external adjustment process remains on track in the context of a healthy and growing international trade and financial system. These goals apply as well to the non-industrial countries.

There is no controversy about these general objectives. Indeed, they reflect a clear international consensus and have been endorsed often and in considerable detail by participants in the annual Economic Summit meetings, the regular meetings of the Summit country Finance Ministers and and Central Bank Governors, and the semi-annual meetings of the IMF's policy-making Interim Committee.

There are of course inevitable differences of view about the relative importance of the various objectives, and about the best means of achieving them. In order to discuss and help resolve these differences, the summit countries have developed and strengthened the process of coordinating their economic policies. International economic policy cooperation has been a central theme at the past three Economic Summits (Tokyo in 1986, Venice in 1987, Toronto in 1988) and will again be so at the upcoming 1989 Summit in Paris. (This process was reviewed in considerable detail in the October 1988 Treasury Department Report to Congress on International Economic and Exchange Rate Policy, and readers are referred to that report for a full discussion.)

The policy coordination process has produced a clear and solid consensus on the basic elements of achieving the shared objective of reducing external imbalances while remaining on a sustainable growth path. At the broadest level, continued adjustment requires supportive international macroeconomic developments. The industrial countries need to remain on a non-inflationary growth path to stimulate world trade and provide growing markets for their own exports and the exports of the LDCs that are striving to meet the objectives of debt management, growth and development.

The participants are committed to the basic policy course necessary to translate these objectives into real progress. The United States, for its part, is committed to substantial federal budget deficit reductions, improving its international competitiveness, and bolstering its savings rate. For the countries with large external surpluses -- particularly Japan and Germany -- this means implementing macroeconomic and structural policies to ensure open, growing domestic markets. Essentially, domestic demand growth in the surplus countries must be strong enough to compensate for the contractionary effect of declining surpluses.

There has been a growing recognition, however, that most economies suffer from structural impediments to growth and adjustment which diminish the effectiveness of fiscal, monetary and exchange rate policies. Hence the scope of the coordination process has been expanded to include, in addition to the traditional focus on macroeconomic policy, specific examination of the complementary role that structural reforms can play. At Toronto each of the participating countries agreed to specific structural reform steps including, inter alia: reducing labor market rigidities that inhibit flexibility and prolong high unemployment; cutting subsidies that impede the efficient flow of resources both domestically and across international borders; reforming tax systems that discourage risk-taking and innovation and supress demand; liberalizing financial markets; and, reducing burdensome regulations and excessive public intervention in private sector activities.

Thus the policy coordination process is an evolving one. By specifically incorporating macroeconomic and structural considerations, and by examining the broader consequences of individual policy choices, it is well suited to producing medium-term solutions to what are, after all, medium-term problems.

The need for appropriate macroeconomic and structural policies is not, however, limited to the industrial countries. The LDCs also have an essential role to play. For example, the NIEs need to permit their exchange rates to move in line with market forces and the underlying strength of their economies in order to contribute to more balanced trade flows and further global adjustment. Other policy changes in the NIEs, including structural reforms to give greater emphasis to domestic demand as a source of growth and, in the cases of Korea and Taiwan, measures to liberalize trade and capital flows are also necessary. Since mid-1986, the United States has conducted discussions with the four -- most intensively with Korea and Taiwan -- about these issues. In addition, the OECD is exploring ways to open an informal dialogue with the NIEs, focussing on mutual responsibilities to promote open markets for trade, investment and other financial transactions.

As a general matter the LDCs, and especially the heavily indebted economies, need to ensure that their policies support domestic growth and capital formation, reduce inflation, and encourage appropriate financial support from the commercial banks and the international financial institutions. Resolving the serious imbalances in these economies is a major medium-term challenge that will require sound policies in both the macroeconomic and structural areas.

Fiscal deficits and monetary creation must be brought under control, capital flight must be halted and investment policies must encourage return of overseas funds to bolster domestic investment, distortions of relative prices -- as well as interest and exchange rates -- must be reduced, excessive regulation and public sector intervention should be eliminated, and trade policies should encourage greater integration with the global trading system.

Fortunately, there is growing evidence that the LDCs recognize that market-oriented policies hold the greatest promise for growth, development and global economic integration. In addition to encouraging this emerging shift in attitudes, it is essential for the industrial economies to provide material support by maintaining open and growing markets, reducing distortions in the global trading system and providing appropriate support for the international financial institutions. The policy coordination process is an integral part of this larger effort.

PART VI: IMPACT OF TRADE BARRIERS

The Congress requires the reporting of foreign barriers to U.S. trade in the National Trade Estimate Report as revised by Section 1304 of the Omnibus Trade and Competitiveness Act of 1988. The law also requires quantification, where feasible, of the estimated effects of individual barriers to U.S. exports of good and services and on U.S. foreign direct investment. This report is due and will be sent to the Congress by April 30, 1989.

Because of the two-month interval between the mandatory submission dates for the two reports, the National Trade Estimate Report is only now in preparation as this Annual Trade Projection Report is being finalized. For a listing of foreign trade barriers and their impact on U.S. trade and foreign direct investment, the Congress is, therefore, referred to the forthcoming National Trade Estimate Report.

Care should be exercised in the interpretation of the impact of foreign barriers on U.S. trade and investment. Specific trade barriers can and do have a substantial impact on exports, imports, production and trade balances for specific products and, to a lesser extent, for specific U.S. bilateral trade relationships. However, trade barriers have relatively little impact on the aggregate imbalance in U.S. trade.

Summing the estimated trade effects of individual trade barriers would overestimate the impact on aggregate U.S. exports of eliminating foreign trade barriers. By definition, the "partial equilirium" analysis in which trade barrier effects usually are estimated precludes drawing any derivative implications of specific trade barriers for the aggregate trade balance.

Trade barriers are important because they introduce microeconomic inefficiencies (resource misallocation) at the national and international levels and impose economic welfare costs on societies. However, their effect on aggregate trade balances or the projection of aggregate balances is limited.

federal financing bank NEWS
WASHINGTON, D.C. 20220

Press 566-2041
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FOR IMMEDIATE RELEASE March 3, 1989

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of July 1988.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $149.9 billion on July 31, 1988, posting an increase of $0.1 billion from the level on June 30, 1988. This net change was the result of increases in holdings of agency debt of $102.7 million, of agency-guaranteed debt of $11.9 million, and a decrease in agency assets of $10.9 million. FFB made 39 disbursements during July.

Attached to this release are tables presenting FFB July loan activity and FFB holdings as of July 31, 1988.

FEDERAL FINANCING BANK

JULY 1988 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 #468	7/8	$ 15,330,000.00	10/12/88	6.875%	
TENNESSEE VALLEY AUTHORITY					
Advance #915	7/4	232,000,000.00	7/12/88	6.875%	
Advance #916	7/8	163,000,000.00	7/14/88	6.875%	
Advance #917	7/12	229,000,000.00	7/18/88	6.935%	
Advance #918	7/14	22,000,000.00	7/19/88	7.056%	
Advance #919	7/14	138,000,000.00	7/21/88	7.056%	
Advance #920	7/18	239,000,000.00	7/25/88	7.051%	
Advance #921	7/21	115,000,000.00	7/29/88	7.045%	
Advance #922	7/25	14,000,000.00	8/1/88	7.072%	
Advance #923	7/25	108,000,000.00	8/2/88	7.072%	
Advance #924	7/29	166,000,000.00	8/5/88	7.338%	
Advance #925	7/31	141,000,000.00	8/8/88	7.292%	
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Greece 16	7/12	3,965,092.84	9/1/13	9.170%	
Greece 17	7/12	75,589,495.78	8/25/14	9.170%	
Philippines 11	7/12	39,870.53	9/12/90	8.403%	
Greece 17	7/15	4,175,369.02	8/25/14	9.303%	
Portugal 2	7/22	490,997.76	9/11/95	9.137%	
Greece 17	7/25	83,404.00	8/25/14	9.313%	
Morocco 11	7/26	2,066,804.90	9/8/95	9.086%	
Morocco 12	7/26	788,431.84	9/21/95	9.022%	
Greece 17	7/29	220,030.50	8/25/14	9.377%	

+rollover

FEDERAL FINANCING BANK

JULY 1988 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT					
Community Development					
*Niagara Falls, NY	7/1	$ 4,223,077.00	7/1/93	8.475%	8.655% ann.
Long Beach, CA	7/20	642,100.00	8/1/88	7.025%	
San Juan, PR	7/22	1,078,415.00	10/3/88	7.118%	
Los Angeles, CA	7/26	1,000,000.00	8/1/88	7.133%	
Rochester, NY	7/29	199,000.00	8/31/04	9.254%	9.468% ann.
RURAL ELECTRIFICATION ADMINISTRATION					
*Wabash Valley Power #104	7/5	7,681,000.00	12/31/16	8.929%	8.832% qtr.
*Wabash Valley Power #206	7/5	347,000.00	12/31/16	8.929%	8.832% qtr.
*Wabash Valley Power #206	7/5	337,000.00	7/5/90	8.110%	8.029% qtr.
New Hampshire Elec. Coop. #270	7/5	718,000.00	12/31/17	8.933%	8.835% qtr.
*Wabash Valley Power #206	7/11	61,000.00	7/11/90	8.375%	8.289% qtr.
*Wolverine Power #182A	7/11	2,427,000.00	1/2/90	8.179%	8.097% qtr.
*Wolverine Power #183A	7/11	3,146,000.00	1/2/90	8.179%	8.097% qtr.
*Wabash Valley Power #104	7/14	6,642,000.00	12/31/16	9.286%	9.181% qtr.
*Wabash Valley Power #206	7/14	302,000.00	12/31/16	9.286%	9.181% qtr.
Sho-Me Power Corp. #324	7/15	650,000.00	9/30/90	8.496%	8.408% qtr.
Basin Elec. Power Coop. #232	7/18	1,255,000.00	12/31/22	9.273%	9.168% qtr.
*Cajun Electric Coop. #197A	7/18	19,000,000.00	10/1/90	8.464%	8.376% qtr.
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-88-10	7/29	683,645,362.76	10/31/88	7.367%	

*maturity extension

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	July 31, 1988	June 30, 1988	Net Change 7/1/88-7/31/88	FY '88 Net Change 10/1/87-7/31/88
Agency Debt:				
Export-Import Bank	$ 11,226.2	$ 11,226.2	$ -0-	$ -1,237.3
NCUA-Central Liquidity Facility	95.2	96.5	-1.3	-16.2
Tennessee Valley Authority	17,054.0	16,950.0	104.0	668.0
U.S. Postal Service	5,592.2	5,592.2	-0-	1,238.8
sub-total*	33,967.6	33,864.9	102.7	653.3
Agency Assets:				
Farmers Home Administration	59,674.0	59,674.0	-0-	-5,335.0
DHHS-Health Maintenance Org.	79.3	84.0	-4.7	-4.7
DHHS-Medical Facilities	96.4	102.2	-5.9	-5.9
Overseas Private Investment Corp.	-0-	-0-	-0-	-0.7
Rural Electrification Admin.-CBO	4,071.2	4,071.2	-0-	-170.0
Small Business Administration	16.1	16.4	-0.3	-3.5
sub-total*	63,936.9	63,947.8	-10.9	-5,519.7
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	18,556.5	18,539.2	17.2	-607.5
DEd.-Student Loan Marketing Assn.	4,940.0	4,940.0	-0-	-0-
DOE-Geothermal Loan Guarantees	50.0	50.0	-0-	50.0
DHUD-Community Dev. Block Grant	321.0	329.7	-8.8	-3.3
DHUD-New Communities	-0-	-0-	-0-	-30.6
DHUD-Public Housing Notes +	2,037.0	2,037.0	-0-	-37.3
General Services Administration +	387.5	387.5	-0-	-8.0
DOI-Guam Power Authority	32.6	32.6	-0-	-0.5
DOI-Virgin Islands	26.6	26.7	-0.1	-0.6
NASA-Space Communications Co. +	949.4	949.4	-0-	140.8
DON-Ship Lease Financing	1,758.9	1,758.9	-0-	-29.4
Rural Electrification Administration	19,206.0	19,204.1	1.9	-1,990.9
SBA-Small Business Investment Cos.	675.5	678.5	-3.1	-65.1
SBA-State/Local Development Cos.	879.6	884.0	-4.5	-20.2
TVA-Seven States Energy Corp.	1,986.1	1,976.9	9.2	153.2
DOT-Section 511	48.5	48.5	-0-	-6.9
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	52,032.1	52,020.2	11.9	-2,447.1
grand total*	$ 149,936.6	$ 149,832.9	$ 103.8	$ -7,313.5

*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 RELEASE AT 12:00 NOON
March 3, 1989

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 $9,000 million of 364-day Treasury bills to be dated March 16, 1989, and to mature March 15, 1990 (CUSIP No. 912794 TV 6). This issue will result in a paydown for the Treasury of about $ 200 million, as the maturing 52-week bill is outstanding in the amount of $ 9,200 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 Standard time, Thursday, March 9, 1989.

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 March 16, 1989. In addition to the maturing 52-week bills, there are $ 14,963 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 $ 2,497 million as agents for foreign and international monetary authorities, and $7,363 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 $ 330 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 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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
March 6, 1989

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,211 million of 13-week bills and for $7,216 million of 26-week bills, both to be issued on March 9. 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing June 8, 1989			:	26-week bills maturing September 7, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	8.65%	8.97%	97.813	:	8.64%	9.16%	95.632
High	8.66%	8.98%	97.811	:	8.67%	9.19%	95.617
Average	8.65%	8.97%	97.813	:	8.66%	9.18%	95.622

Tenders at the high discount rate for the 13-week bills were allotted 5%.
Tenders at the high discount rate for the 26-week bills were allotted 18%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 55,055	$ 55,055	:	$ 38,790	$ 38,790
New York	31,867,750	6,194,560	:	20,620,675	6,090,375
Philadelphia	30,455	30,455	:	22,195	22,195
Cleveland	53,980	53,505	:	41,470	41,470
Richmond	76,165	55,165	:	48,675	48,675
Atlanta	47,685	47,485	:	37,900	37,900
Chicago	1,312,140	57,140	:	973,890	96,630
St. Louis	54,120	33,620	:	39,760	32,120
Minneapolis	10,315	10,315	:	9,970	9,970
Kansas City	44,360	44,360	:	54,225	54,225
Dallas	31,785	31,785	:	24,500	24,500
San Francisco	1,800,150	118,650	:	1,713,895	216,395
Treasury	479,285	479,285	:	502,505	502,505
TOTALS	$35,863,245	$7,211,380	:	$24,128,450	$7,215,750
Type					
Competitive	$31,846,640	$3,194.775	:	$19.071,935	$2,159,235
Noncompetitive	1,423,485	1,423,485	:	1,195,205	1,195,205
Subtotal, Public	$33,270,125	$4.618,260	:	$20,267,140	$3.354,440
Federal Reserve	2,532,230	2,532,230	:	2,400,000	2,400,000
Foreign Official Institutions	60,890	60,890	:	1,461,310	1,461,310
TOTALS	$35,863,245	$7,211,380	:	$24,128,450	$7,215,750

An additional $9.510 thousand of 13-week bills and an additional $342,490 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

TREASURY NEWS

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MAR AM
DEPARTMENT

Text as Prepared
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Expected at 10:30 a.m., E.S.T.

Testimony by
Secretary of the Treasury
Nicholas F. Brady
Before the
Committee on Appropriations
U.S. Senate
Tuesday, March 7, 1989

Chairman Byrd, Senator Hatfield and members of the Committee, I am pleased to be here today to discuss with you President Bush's proposed fiscal year 1990 budget. I know that you have already heard from the Director of the Office of Management and Budget, Richard Darman, so in my testimony I will not repeat a detailed presentation of the Bush budget.

The approach to the budget I wish to take today is from the perspective of overall economic policy, thus, I will discuss the importance of deficit reduction to the continued vitality and strength of our national economy and to maintaining and improving our position in the world economy.

We are all aware that we continue to be in a period of extraordinary economic expansion, which has produced millions of jobs, while reducing inflation. We must equally be aware that to sustain this expansion we must reduce the deficit.

As you know, last week the Federal Reserve raised the discount rate one half of a percent to seven percent. I'd like to say a few words about that. First, and foremost, the Bush Administration and the Federal Reserve share absolutely a firm commitment to fighting inflation. It is possible to have somewhat differing interpretations of the same economic statistics, to think one set of statistics means more than another, and still share the same goal of fighting inflation.

The Federal Reserve is using the strongest weapon in its arsenal to fight inflation to advance the cause of the long-term strength and vitality of our national economy. The strongest weapon we in the government have to further the cause of our long-term economic strength is deficit reduction. We must do our part. Even to delay action costs us -- in terms of interest rates, jobs, the Savings and Loan crisis, the third world debt problem.

Let us be frank with one another. We are constrained between revenue levels which are the result of the 1988 election which validated President's Bush's commitment to "No new taxes" and a Gramm-Rudman-Hollings maximum deficit level of $100 billion prescribed in law. So, there are not funds to do all that we want.

Stepping back from the roar of the budget discussions for a minute, one could say, "This is where the country wants us to operate." The key is to have the American people say, "They did what we wanted with what we gave them."

ECONOMIC ASSUMPTIONS

The Bush Administration is absolutely committed to working with you to reduce the deficit. But, some have questioned our economic assumptions. First, I would like to point out that historically the executive branch's economic assumptions have not had a consistent bias toward a rosy scenario. In fact, in the last seven years, the Reagan Administration underestimated growth four times and overestimated it three.

For this year, we believe that the economy will continue to grow, but at a slightly slower pace than last year's drought adjusted rate. We are projecting that GNP will grow 3.5 percent next year. But when we exclude the impact of the rebound from the drought, our forecast is for a moderate 2.8 percent growth rate. This is slower than last year's 3.4 percent drought adjusted growth rate. Our long term forecast for a 3.2 percent sustainable growth rate is right in line with our experience over the past 40 years, during which real GNP growth averaged 3.3 percent.

As one who worked for over 30 years in financial markets, may I make a few comments on interest rate assumptions. During my first year in business, 1954, ten-year government bonds carried an interest rate of 2.4 percent. They reached 14 percent in 1981. These same ten-year government bonds were 12.4 percent as recently as 1984, but declined to 7.7 percent in 1986. They now carry an interest rate of about 9.3 percent.

Attached as an exhibit to my testimony is a graph showing the decline in rates surrounding the passage of Gramm-Rudman-Hollings. From three and one-half months prior to the passage of this all-important fiscal legislation until three and one-half months after, interest rates declined 300 basis points. Was it the only cause of this rapid decline in interest rates? No. Was it a principal cause? Yes.

This would indicate to me that while there is plenty of room for honest disagreement about the future level of interest rates, there is some evidence that fiscal actions have an effect on interest rates, particularly long-term rates. My conclusion is that investors and savers all over the world are waiting for a sign from our government that we are committed to fiscal prudence, and are willing to do something about it. Delay in reaching a budget agreement may only maintain the current high level of interest rates and cost the U.S. and the world unnecessary pain.

In sum, do I think our economic assumptions will prove true if we don't reduce the deficit? No. Will they prove accurate if we do? I believe so.

I know that you have heard a great deal about the specific proposals in our budget from Budget Director Darman. I would simply like to reiterate the fundamental point that, within the confines of meeting the Gramm-Rudman-Hollings target, the President has proposed budget priorities which if adopted will make a significant investment in our country's future.

THE SAVINGS AND LOAN SOLUTION

The President's budget contains the funding required to resolve the Savings and Loan crisis. It has three components. The first part consists of $50 billion to resolve currently solvent institutions which may become insolvent over the next several years. Secondly, the plan ensures adequate servicing of the $40 billion in past FSLIC obligations.

And third, and perhaps most important, the plan provides $33 billion in financial resources necessary to put S&L deposit insurance on a sound financial basis for the future.

At the heart of our plan is the creation of a Resolution Trust Corporation (RTC), for which the FDIC will be the primary manager directed to resolve all S&Ls which are now insolvent or become so over the next three years.

To provide the $50 billion to the RTC, we will create a new, separate, privately-owned corporation, the Resolution Funding Corporation (REFCORP), which will issue $50 billion in long-term bonds to raise the needed funds. To pay the principal, industry funds will be used to purchase zero-coupon, long-term Treasury securities which will grow through compound interest to a maturity value of $50 billion. This assures the repayment of the principal of the bonds issued by REFCORP. Funds to purchase these zero-coupon bonds will come exclusively from private sources:

-- The FHLBanks will contribute about $2 billion of their retained earnings -- which are currently allocated to, but not needed by, the existing Financing Corporation (FICO) -- plus approximately 20 percent of their annual earnings, or $300 million, in 1989, 1990 and 1991;

-- The S&Ls will contribute a portion of their insurance premiums; and

-- If necessary, proceeds from the sale of FSLIC receivership assets will be used.

No Treasury funds or guarantees will be used to repay any REFCORP principal.

Interest payments on the REFCORP bonds will come from a combination of private and taxpayer sources:

-- The FHLBanks, beginning in 1992, will contribute $300 million a year;

-- The RTC will contribute a portion of the proceeds generated from the sale of receivership assets, and proceeds from warrants and equity participations taken in resolutions; and

-- Treasury funds will make up any shortfall.

All Treasury funds used to service REFCORP interest will be scored for budget purposes in the year expended.

Funds for the second component of our plan -- servicing the cost of the $40 billion in resolutions already completed by FSLIC -- also will come from a combination of S&L industry and taxpayer sources:

-- FICO will issue bonds under its remaining authority and contribute the proceeds;

-- The S&Ls will contribute a portion of their insurance premiums;

-- FSLIC will contribute the proceeds realized from the sale of receivership assets taken in already completed resolutions, as well as miscellaneous income; and

-- Treasury funds will be used to make up any shortfall.

The final component of the plan is managing future S&L insolvencies and building the Savings Association Insurance Fund (SAIF), the new S&L insurance fund, during the post-RTC period. The funding will come from a portion of S&Ls' insurance premiums and Treasury funds as needed.

These sources provide about $3 billion per year to handle any insolvencies which occur in the 1992-99 period and in addition contribute at least $1 billion per year to building the new Savings Association Insurance Fund. Overall the plan contains $33 billion in post-RTC funds from 1992 to 1999 to manage future insolvencies and contribute to building a healthy new S&L insurance fund. Assuming that $24 billion is used for post-RTC resolutions, by 1999 the SAIF fund will still contain just under $9 billion at a minimum to support the healthy S&Ls.

The net impact of the entire plan -- which includes paying for completed S&L resolutions, paying for the S&L resolutions still to be completed, and providing for fully funded insurance funds for both commercial banks and thrifts -- is $1.9 billion in FY90 and $39.9 billion over the next 10 years.

CAPITAL GAINS

The President's budget includes important revenue-related measures that fall within the jurisdiction of the Treasury Department. These measures also directly reflect the President's commitment to a budget that sustains a strong economy and builds upon it to enhance our future economic power.

We propose a major tax initiative designed to enhance America's long-term growth and competitiveness: a reduction and restructuring of the capital gains tax to encourage long-term investment. Our proposal calls for a 45 percent exclusion of long-term gains or a 15 percent tax rate cap, whichever is more advantageous to the taxpayer. As an important part of this plan, we have targeted the greatest relative benefits to those with incomes lower than $20,000, if married, and $10,000 if single. Such taxpayers would be eligible for a 100 percent exclusion--no tax at all on long-term capital gains.

The policy of a lower tax rate for capital gains was first established in the Revenue Act of 1921. This policy remained in effect for 65 years. During this time it was endorsed by Democrats and Republicans alike as an important means of stimulating investment. The Tax Reform Act of 1986 eliminated that differential in 1987. In my judgement, the benefits of a lower capital gains tax merit its reinstatement. It is important for the long-term strength of our economy that our tax laws encourage saving and investment in entrepreneurial activities. I believe the essential benefit of a reduction in the capital gains tax goes beyond simply encouraging short-term investment and growth. Over the next four years, we propose to phase in a three-year holding period for capital assets sold to qualify for the lower capital gains tax rates. Thus we want to shift the focus of investors from the short-term to the long-term, because ultimately, it is long-term investment which will provide our economy with its fundamental strength. Thus we propose to restore this long-acknowledged incentive to American enterprise.

Enhancing incentives for long-term investment is not the only area in which we need to act if the United States is going to remain a leader in the world economy. It is equally important that we take steps to augment policies and programs which stimulate research and development and which foster our long-term productive capacity.

To this end, the President's budget increases investment in basic research by increasing funding for science and technology programs by 13 percent over the enacted 1989 funding levels. Furthermore, we propose to make the tax credit for research and experimentation permanent. For a number of years, we have had a temporary tax credit to encourage additional research and experimentation (R&E) by U.S. industry. The current credit expires at the end of 1989. It's time we stopped sending stop and go signals to the business community on the importance of research to our economic strength.

Accordingly, the President has proposed to make this credit a permanent feature of the landscape so that U.S. corporations can make their R&E plans with a longer horizon. With this same purpose in mind, the President has also proposed a permanent and more beneficial formula for the allocation of R&E expenses between domestic and foreign income.

INTERNATIONAL CONTEXT

Improving our competitive position in the world economy is very important to our future international economic position. Reducing the deficit will not only improve our competitive position, but is of vital importance to our overall international economic standing. I wish to take a few minutes to address the international implications of our work on the budget this year.

The new reality is that there are no more international boundaries when it comes to the flow of dollars--no border control, no customs officials and no barriers. The influence of foreign financial markets on our economy is great and deep. Most of the world's dollar financial transactions settle daily through New York. Before the advent of instantaneous transfer of information and electronic funds transfers this settling of accounts would have taken weeks, now it occurs every night. There are two "wires" through which the transactions settle. The CHIPS wire which largely handles international transactions, and the Fed wire which handles mostly, but not exclusively, domestic transactions. Last month on average about $735 billion worth of transactions were settled per day on the CHIPS wire. And the level of activity is increasing on average at a rate of 25 percent a year. If you approximate the international transactions settled via the Fed wire, then there are about $1 trillion of international transactions settled every day on these wire systems. This amounts to $5 trillion a week, in other words greater each week than our yearly GNP.

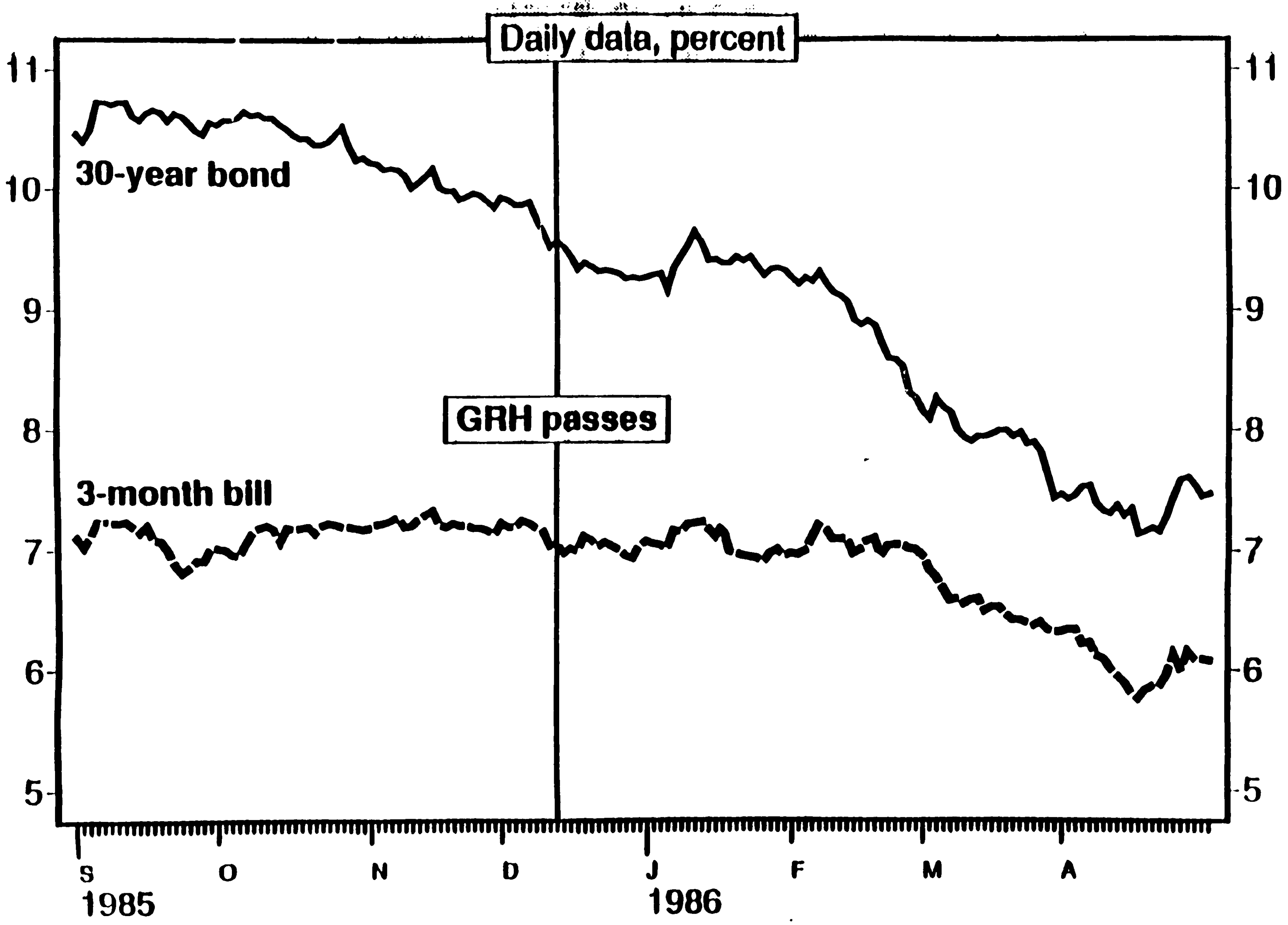
Another statistic which demonstrates the power of international finance on our economy is that at the end of 1987 the recorded stock of U.S. assets held by foreigners was almost $400 billion greater than the stock of foreign assets held by Americans. Ten years ago this difference was $50 billion in our favor. While one can have different views of how to interpret those numbers, one point is clear -- we cannot ignore the effect of international markets on our balance of payments when considering the need for deficit reduction.

Both the flow of financial transactions through the Fed wire and CHIPS and the amount of U.S. assets held by foreigners are in a sense a measure of foreign confidence in our ability to maintain a sound economy and reduce our budget deficit. The tally of the world's opinion of our progress is registered every day through the Federal Reserve's wires. It is vital that we act decisively to preserve that confidence.

Lest there be any doubt about the extent of the world's interest and concern about the deficit, let me share with you some of the feelings of my G-7 colleagues -- who met here in Washington, DC the first week in February. We are engaged in a team effort, the economic policy coordination process, to provide a growing world economy. I have been pressing them to stimulate their domestic economies and open their markets to sustain world economic growth. They, in turn, are deeply concerned about our ability to reduce the deficit. They worry that we lack the strength of purpose to meet the Gramm-Rudman-Hollings target. They are knowledgeable about the details of our budget process and are watching very carefully how we handle our budget negotiations. They are concerned that our commitment to abiding by the current Gramm-Rudman targets is less than firm and unequivocal, that if meeting the $100 billion target becomes too onerous that we will move the goal line. I assured them on behalf of us all that people in this government--executive and legislative branches alike--are firmly and absolutely committed to meeting the deficit reduction target. I have told them that we will get there one way or the other.

I know you share this commitment. I am delighted to be here today to discuss with you how we can achieve this common goal.

INTEREST RATES, SEPTEMBER 1985 TO APRIL 1986



TREASURY NEWS

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

FOR RELEASE AT 3:00 PM
March 6, 1989

Contact: Peter Hollenbach
(202) 376-4302

TREASURY ANNOUNCES ACTIVITY IN SECURITIES IN THE STRIPS PROGRAM FOR FEBRUARY 1989

The Department of the Treasury announced activity figures for the month of February, 1989 of securities within the Separate Trading of Registered Interest and Principal of Securities program, (STRIPS). The principal outstanding for eligible securities was $326,960,184,000 with $250,378,914,000 held in unstripped form and $76,581,270,000 held in stripped form. The amount reconstituted through February was $18,928,840,000. The attached table gives a breakdown of STRIPS activity by individual loan description.

These monthly figures are included in Table VI of the Monthly Statement of the Public Debt, entitled "Holdings of Treasury Securities in Stripped Form." These can also be obtained through a recorded message on (202) 447-9873.

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TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, FEBRUARY 28, 1989
(In thousands)

Loan Description	Maturity Date	Principal Amount Outstanding			Gross Amount Reconstituted to Date
		Total	Portion Held in Unstripped Form[1]	Portion Held in Stripped Form[1]	
11-5/8% Note C-1994	11/15/94	$6,658,554	$5,576,954	$1,081,600	$2,334,400
11-1/4% Note A-1995	2/15/95	6,933,861	6,234,821	699,040	948,960
11-1/4% Note B-1995	5/15/95	7,127,086	5,434,926	1,692,160	1,124,000
10-1/2% Note C-1995	8/15/95	7,955,901	7,005,101	950,800	628,000
9-1/2% Note D-1995	11/15/95	7,318,550	6,794,550	524,000	913,600
8-7/8% Note A-1996	2/15/96	8,410,929	8,113,329	297,600	88,000
7-3/8% Note C-1996	5/15/96	20,085,643	19,919,243	166,400	177,600
7-1/4% Note D-1996	11/15/96	20,258,810	19,966,810	292,000	86,400
8-1/2% Note A-1997	5/15/97	9,921,237	9,776,037	145,200	-0-
8-5/8% Note B-1997	8/15/97	9,362,836	9,362,836	-0-	-0-
8-7/8% Note C-1997	11/15/97	9,808,329	9,792,329	16,000	73,600
8-1/8% Note A-1998	2/15/98	9,159,068	9,159,068	-0-	-0-
9% Note B-1998	5/15/98	9,165,387	9,165,387	-0-	-0-
9-1/4% Note C-1998	8/15/98	11,342,646	11,342,646	-0-	-0-
8-7/8% Note D-1998	11/15/98	9,902,875	9,902,875	-0-	-0-
8-7/8% Note A-1999	2/15/99	9,719,800	9,719,800	-0-	-0-
11-5/8% Bond 2004	11/15/04	8,301,806	2,716,206	5,585,600	1,167,200
12% Bond 2005	5/15/05	4,260,758	1,725,608	2,535,150	129,400
10-3/4% Bond 2005	8/15/05	9,269,713	6,379,313	2,890,400	1,017,600
9-3/8% Bond 2006	2/15/06	4,755,916	4,755,916	-0-	-0-
11-3/4% Bond 2009-14	11/15/14	6,005,584	1,415,984	4,589,600	1,222,400
11-1/4% Bond 2015	2/15/15	12,667,799	2,729,719	9,938,080	425,440
10-5/8% Bond 2015	8/15/15	7,149,916	1,946,716	5,203,200	429,760
9-7/8% Bond 2015	11/15/15	6,899,859	3,258,259	3,641,600	345,600
9-1/4% Bond 2016	2/15/16	7,266,854	5,139,654	2,127,200	594,400
7-1/4% Bond 2016	5/15/16	18,823,551	13,369,951	5,453,600	2,756,800
7-1/2% Bond 2016	11/15/16	18,864,448	10,118,368	8,746,080	2,756,640
8-3/4% Bond 2017	5/15/17	18,194,169	8,417,209	9,776,960	1,068,640
8-7/8% Bond 2017	8/15/17	14,016,858	9,580,058	4,436,800	169,600
9-1/8% Bond 2018	5/15/18	8,708,639	5,763,839	2,944,800	410,400
9% Bond 2018	11/15/18	9,032,870	6,307,070	2,725,800	60,400
8-7/8% Bond 2019	2/15/19	9,609,932	9,488,332	121,600	-0-
Total		326,960,184	250,378,914	76,581,270	18,928,840

[1] Effective May 1, 1987, securities held in stripped form were eligible for reconstitution to their unstripped form. The amounts in this column represent the net affect of stripping and reconstituting securities.

Note: On the 4th workday of each month a recording of Table VI will be available after 3:00 pm. The telephone number is (202) 447-9873.
The balances in this table are subject to audit and subsequent adjustments.

GPO 937-948

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CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
March 7, 1989

MAR 8

TREASURY'S WEEKLY BILL OFFERING

DEPARTMENT

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $ 14,400 million, to be issued March 16, 1989. This offering will result in a paydown for the Treasury of about $ 575 million, as the maturing bills are outstanding in the amount of $14,963 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 Standard time, Monday, March 13, 1989. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 7,200 million, representing an additional amount of bills dated December 15, 1988, and to mature June 15, 1989 (CUSIP No. 912794 SE 5), currently outstanding in the amount of $ 7,804 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,200 million, to be dated March 16, 1989, and to mature September 14, 1989 (CUSIP No. 912794 SX 3).

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 March 16, 1989. In addition to the maturing 13-week and 26-week bills, there are $ 9,200 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 $1,921 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $2,251 million as agents for foreign and international monetary authorities, and $7,363 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 ɾecords 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

ARY, ROOM 5310

MAR 9 8 [illegible]

DEPARTMENT [illegible]

Text as Prepared

Remarks by Thomas J. Berger
Deputy Assistant Secretary of the U.S. Treasury
for
International Monetary Affairs
before
The Conference on the Future
of
Canadian and U.S. Financial Services
in the Global Context
The Centre for Canadian-American Studies
University of Windsor
Windsor, Ontario
March 1, 1989

In Search of Free Trade in Financial Services: Reflections on the U.S. - Canada Experience

Good afternoon. I am delighted to be here today to discuss the topic of free trade in financial services and to share with you my reflections on the Financial Services Chapter of the U.S.-Canada Free Trade Agreement (FTA). My colleagues and I at the U.S. Treasury spent over a year negotiating this bilateral financial services agreement with our counterparts in the Canadian Government. Like any endeavor in which one invests substantial time, there are certain lessons learned as a result of the process. Perhaps the key lesson I took away from the negotiations was the importance of teamwork. Although I headed the U.S. negotiating group, every member of my team brought an unique and in-depth knowledge base about a different sector of the financial markets. This "diversity of excellence" and our ability to work together and use this knowledge to our advantage was crucial to our success. That being said, I must confess that there were times when I felt indispensable and uniquely contributory to the process. Whenever this happened, however, I was quickly and politely reminded by my U.S. colleagues of the following words uttered by Charles de Gaulle:

> "The graveyards are full of indispensable men."

What I would like to do this afternoon is to share with you some of the other lessons of the U.S.-Canada talks and to comment on their implications for future negotiations in the financial services sector. Putting aside the lesson on indispensability just described, there were three general lessons learned from the U.S.-Canada financial services negotiations. The first was how to conduct a negotiation in the highly technical area of financial services. Put in another way, what are the critical elements that will allow for a successful and smooth negotiating process? Secondly, although the FTA was a bilateral agreement, there definitely were some lessons learned about what might be realistic to expect in wider, multilateral negotiations on financial services. Finally, the third lesson has to do with the financial services industry itself -- how it has changed and what this means for future bilateral or multilateral financial market negotiations. Let me deal with each of these in turn.

Lesson #1: Negotiating Financial Services Is More Art than Science.

Certain critical factors allowed the U.S. and Canada to reach a mutually satisfactory financial services agreement. Future negotiations about financial market issues will stand a greater chance of success, in my opinion, if they follow these principles:

(a) Low profile.

-- Herb Schmertz of Mobil Corporation wrote a book in 1986 entitled, Good-bye to the Low Profile. While this may be the correct recipe for trade negotiations, given the sensitivity of financial markets to changes affecting them, financial services negotiations need to be conducted with due regard to confidentiality.

-- During the U.S.-Canada process we did not hold press conferences nor did we negotiate through the press. This is how it should be done instead of more publicly as is often the case in trade negotiations.

(b) Dispute settlement mechanisms must be flexible.

-- Financial services are different from other services because of various prudential, regulatory and supervisory concerns.

-- This was implicitly recognized at the Mid-Term Review of the Uruguay Round in Montreal last December where language was inserted into the draft services framework agreement making it possible for discussions in some sectors to proceed outside the framework agreement. It was agreed that the framework might not be suitable for all sectors.

-- In the U.S.-Canada case, the Financial Services Chapter of the FTA was not covered by the formal dispute settlement mechanism of the overall Agreement. Instead, both countries agreed to a more flexible, consultative process between the Canadian Department of Finance and the U.S. Treasury should problems arise.

-- This type of mechanism should provide the confidentiality, flexibility and regulatory input necessary to arrive at fair dispute settlements. The lesson for future financial services negotiations is that heavy, mechanistic dispute settlement procedures overseen by non-experts are not appropriate and are hazardous to the health of financial markets.

(c) Don't get bogged down over definitions and semantics.

-- During the FTA talks both sides wanted to liberalize their financial markets, but despite these good intentions there were difficulties.

-- For example, even though the U.S.-Canada talks only involved two parties -- both of whom adhere to a variety of OECD codes -- we could not agree on a mutually acceptable definition of national treatment.

-- Rather than allowing ourselves to become bogged down over definitions, we "agreed to disagree." Instead of further debates, we worked around the issue to fashion an agreement fair to both sides. And, even though the agreement never defined national treatment, it respected the spirit embodied in the concept of equality of competitive opportunity.

-- Francis Bacon described this important principle of successful negotiations as follows:

> " All rising to a great place is by a winding stair."

(d) Financial not trade experts must do the negotiating.

-- Given the complexity and range of financial issues covered in the FTA, the negotiations would have been doomed if they had not been conducted by financial experts who understood the nuts and bolts involved.

-- Despite similarities in the U.S. and Canadian financial markets, the regulatory, supervisory and prudential differences between our two systems remain considerable. Financial Ministries and regulators from different countries often have honest differences in their approach to problems. This means that negotiators must respect and work within these basic differences. Experienced financial market hands understand and are sensitive to these differences as well as to discriminatory practices. Hence, they are more likely to be able to conclude a meaningful agreement that will remove barriers.

-- In addition, because the banking and financial markets play such an important role in the conduct of monetary and macroeconomic policy, it's just common sense that financial market negotiations be conducted directly by people who have responsibility for these policies.

Lesson #2: Bilateral and Multilateral Negotiations Have More Differences than Similarities.

No decisions have been reached at this point regarding which service sectors will be included in the Uruguay Round. If financial services are included, the negotiations are likely to be very different in character from those in the FTA. Some of the key differences that I see are as follows:

(a) Bilateral discussions allow for a sharper focus on specific issues.

-- In a multilateral setting it will be much more difficult to address the specific, bilateral problems such as those we dealt with in the FTA. It may be that success in negotiating financial services in a multilateral context will be defined as achieving agreement with respect to only general principles.

(b) Bilateral problems will be magnified and made more complex in multilateral talks.

-- Given U.S. and Canadian inability to reach an agreement on the definition of national treatment -- even with similar legal, supervisory and regulatory systems -- progress in a multilateral forum is likely to be even harder.

-- With the greater complexity of multilateral negotiations, two aspects of Lesson #1 become even more important: the need for financial experts to do the negotiating and the requirement for a dispute settlement mechanism that is extremely flexible.

-- However, there is a silver lining to increased complexity; it could lay to rest once and for all the emotional and simplistic appeal of the concept of reciprocity in financial services. As you are probably aware, the Commission of the European

Communities has proposed using reciprocity as a standard for granting third countries access to newly liberalized sectors in Europe in those areas not covered by the GATT.

-- If we enter into multilateral negotiations on financial services, the variety of financial environments around the world and the scale of our presence in each others' markets should make clear to all the impossibility of providing reciprocal treatment for foreign firms without creating huge regulatory bureaucracies and markets with limited flexibility.

Lesson #3: Changes That Have Taken Place in the Financial Services Industry Will Make Future Negotiations Easier.

Prior to joining the Treasury Department in 1986 I spent a number of years in New York with both Citibank and Merrill Lynch. During this time the key buzzword in financial circles was "globalization." Every self-respecting bank wanted to be a worldwide, full-service "superbank." Securities firms felt the same way. The name of the game was to be all things to all customers.

This type of talk, of course, does not facilitate financial services negotiations. Countries that may be considering liberalizing their markets view such chatter as concrete evidence that expansion-hungry financial institutions from, say, the U.S. or Japan, will come in willy-nilly and swallow the local banks and securities firms. And, I would be less than frank with you if I didn't say that there were some concerns of this type in Canada during the course of the FTA negotiations.

However, in recent years both commercial bankers and investment bankers have become more realistic and hard-headed. Most have given up the quest to have a branch in every country or to dominate every market. Many overseas operations have not been as profitable as hoped and, of course, Black Monday, October 19, 1987, brought a new sense of realism to all financial institutions. In today's environment, the new buzzphrase is "niche player." Banks and securities firms are more concerned about doing what they do best rather than expanding for the sake of expansion.

This new trend should be helpful in promoting financial liberalization. It should allay the fears of those countries who envision tidal waves of foreign investment in the financial services industry the minute a market-opening move is made.

Conclusion

In conclusion, I would like to offer two quotes by one of the world's most successful, practical and realistic negotiators, Niccolo Machiavelli (1469-1527). "Old Nick" as he was called by some issued a warning in his classic book, The Prince, to those offering advice or holding forth on the lessons of history. He put it this way:

> "Tender your advice with modesty."

I hope that my comments today on the lessons learned from the U.S.-Canada negotiations have been in harmony with Machiavelli's wise observation.

Machiavelli also counseled in The Prince that those who seek to be useful to others follow the following principle:

> "Represent things as they are in real truth rather than as they are imagined."

Again, I hope my remarks this afternoon have been faithful to this important principle.

Thank you very much for your attention.

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE

March 9, 1989

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $9,007 million of 52-week bills to be issued March 16, 1989, and to mature March 15, 1990, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	8.66%	9.40%	91.244
High -	8.68%	9.43%	91.224
Average -	8.68%	9.43%	91.224

Tenders at the high discount rate were allotted 86%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 32,430	$ 32,430
New York	22,879,325	8,116,800
Philadelphia	20,905	20,905
Cleveland	43,915	43,915
Richmond	58,645	58,645
Atlanta	39,840	37,700
Chicago	1,152,350	114,790
St. Louis	40,470	33,330
Minneapolis	21,240	21,240
Kansas City	79,660	72,160
Dallas	32,880	27,180
San Francisco	1,767,185	177,185
Treasury	250,985	250,985
TOTALS	$26,419,830	$9,007,265

Type		
Competitive	$22,332,710	$4,920,145
Noncompetitive	1,057,120	1,057,120
Subtotal, Public	$23,389,830	$5,977,265
Federal Reserve	2,800,000	2,800,000
Foreign Official Institutions	230,000	230,000
TOTALS	$26,419,830	$9,007,265

NB-168

TREASURY NEWS

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

EMBARGOED UNTIL DELIVERY
Expected at 1:45 p.m. EST
Friday, March 10, 1989

Remarks by
The Secretary of the Treasury
Nicholas F. Brady
to the
Brookings Institution and
The Bretton Woods Committee
Conference On Third World Debt

More than 40 years ago, the representatives of 44 nations met at Bretton Woods, New Hampshire to build a new international economic and financial system. The lessons learned from a devastating world depression and global conflict guided their efforts. At the concluding session, the President of the conference, Treasury Secretary Henry Morgenthau, described this lesson in the following manner:

> We have come to recognize that the wisest and most effective way to protect our national interests is through international cooperation -- this is to say, through united effort for the attainment of common goals. This has been the great lesson of contemporary life -- that the peoples of the earth are inseparably linked to one another by a deep, underlying community of purpose.

The enduring legacy provided by the Bretton Woods institutions is lasting testament to the success of their efforts. This community of purpose still resides in these institutions today. We must once again draw on this special sense of purpose as we renew our efforts to create and foster world growth.

These past seven years we have faced a major challenge in the international debt problem. This situation is, in fact, a complex accumulation of a myriad of interwoven problems. It contains economic, political and social elements. Taken together, they represent a truly international problem, for which no one set of actions or circumstances is responsible. And for which no one nation can provide the solution. Ultimately, resolution depends on a great cooperative effort by the international community. It requires the mobilization of the world's resources and the dedication of its goodwill.

Since 1982 the world community has endeavored to come to terms with international debt. In 1985 we paused and took stock of our progress in addressing the problem. As a result of that review, together we brought forth a new strategy, centered on economic growth. This still makes sense. However, it is appropriate that now, almost four years later, we again take stock. Thus in recent months we have undertaken to look afresh at the international debt situation. The purpose was to discover what progress has been made: to see where we as a community of nations have succeeded and where we have not. And, where our success has not met our expectations, to understand why we have not achieved our goals. We have studied in depth, we have consulted widely -- seeking and taking into account the views of debtor nations, multilateral institutions, commercial banks and legislatures. We have also consulted closely with Japan and other industrial countries in order to begin to lay the basis for a common approach to the debt problem by the creditor countries.

Let me share with you the results of our reassessment as part of the ongoing process of international collaboration. I would hope that the ideas and suggestions I put forth here will provide a basis for a concerted effort by the international community to reinvigorate a process that has become debt-weary. However, we must strengthen the process without stopping it. As we move ahead with these ideas in the weeks ahead, it is important to continue working on individual debt problems.

Recent Progress

Our review confirmed that we have accomplished much, but much remains to be done.

The experience of the past four years demonstrates that the fundamental principles of the current strategy remain sound:

o Growth is essential to the resolution of debt problems;

o Debtor nations will not achieve sufficient levels of growth without reform;

o Debtor nations have a continuing need for external resources;

o Solutions must be undertaken on a case-by-case basis.

In recent years, we have seen positive growth occur in many debtor nations. Last year six major debtor nations realized more than four percent positive growth. This is primarily due to the debtors' own efforts. The political leadership of many of these nations has demonstrated their commitment to implement vital macroeconomic and structural reforms. In many countries this has been reflected in the privatization of nationalized industries. In some countries there has also been a move towards opening their shores to greater foreign trade and investment. Current account deficits have been sharply reduced, and the portion of export earnings going to pay interest on external debt has declined. These are significant achievements. All the more so, since in parallel progress, a number of debtor nations have advanced towards more democratic regimes. This has required great courage and persistence. The people of these countries have made substantial sacrifices for which they've earned our admiration. We must work together to transform these sacrifices into tangible and lasting benefits.

In another positive development, we have avoided a major disruption to the global payments system. Commercial banks have strengthened their capital and built reserves, placing them in a stronger position to contribute to a more rapid resolution of debt problems. The "menu" approach of the current strategy has helped to sustain new financial support while also encouraging debt reduction efforts. The banks have provided loans in support of debtor country economic programs. The stock of debt in the major debtor countries has been reduced by some $24 billion in the past two years through various voluntary debt reduction techniques.

However, despite the accomplishments to date, we must acknowledge that serious problems and impediments to a successful resolution of the debt crisis remain. Clearly, in many of the major debtor nations, growth has not been sufficient. Nor has the level of economic policy reform been adequate. Capital flight has drained resources from debtor nations' economies. Meanwhile, neither investment nor domestic savings has shown much improvement. In many cases, inflation has not been brought under control. Commercial bank lending has not always been timely. The force of these circumstances has overshadowed the progress achieved. Despite progress, prosperity remains, but for many, out of reach.

Other pressures also exist. The multilateral institutions and the Paris Club have made up a portion of the shortfall in finance. Commercial bank exposure to the major debtors since 1985 has declined slightly, while the exposure of the international institutions has increased sharply. If this trend were to continue, it could lead to a situation in which the debt problem would be transferred largely to the international institutions, weakening their financial position.

These are realities that we cannot deny. They are problems we must address if we are to renew progress on the international debt crisis.

Let me reiterate that we believe that the fundamental principles of the current strategy remain valid. However, we believe that the time has come for all members of the international community to consider new ways that they may contribute to the common effort.

In considering next steps, a few key points should be kept in mind:

- First, obviously financial resources are scarce. Can they be used more effectively?
- Second, we must recognize that reversing capital flight offers a major opportunity, since in many cases flight capital is larger than outstanding debt.
- Third, there is no substitute for sound policies.
- Fourth, we must maintain the important role of the international financial institutions and preserve their financial integrity.
- Fifth, we should encourage debt and debt service reduction on a voluntary basis, while recognizing the importance of continued new lending. This should provide an important step back to the free markets, where funds abound and transactions are enacted in days not months.
- Finally, we must draw together these elements to provide debtor countries with greater hope for the future.

Strengthening the Current Strategy

Any new approach must continue to emphasize the importance of stronger growth in debtor nations, as well as the need for debtor reforms and adequate financial support to achieve that growth. We will have success only if our efforts are truly cooperative. And, to succeed we must have the commitment and involvement of all parties.

First and foremost, debtor nations must focus particular attention on the adoption of policies which can better encourage new investment flows, strengthen domestic savings, and promote the return of flight capital. This requires sound growth policies which foster confidence in both domestic and foreign investors. These are essential ingredients for reducing the future stock of debt and sustaining strong growth. Specific policy measures in these areas should be part of any new IMF and World Bank programs. It is worth noting that total capital flight for most major debtors is roughly comparable to their total debt.

Second, the creditor community -- the commercial banks, international financial institutions, and creditor governments -- should provide more effective and timely financial support. A number of steps are needed in this area.

Commercial banks need to work with debtor nations to provide a broader range of alternatives for financial support, including greater efforts to achieve both debt and debt service reduction and to provide new lending. The approach to this problem must be realistic. The path towards greater creditworthiness and a return to the markets for many debtor countries needs to involve debt reduction. Diversified forms of financial support need to flourish'and constraints should be relaxed. To be specific, the sharing and negative pledge clauses included in existing loan agreements are a substantial barrier to debt reduction. In addition, the banking community's interests have become more diverse in recent years. This needs to be recognized by both banks and debtors to take advantage of various preferences.

A key element of this approach, therefore, would be the negotiation of a general waiver of the sharing and negative pledge clauses for each performing debtor, to permit an orderly process whereby banks which wish to do so, negotiate debt or debt service reduction transactions. Such waivers might have a three year life, to stimulate activity within a short but measurable timeframe. We expect these waivers to accelerate sharply the pace of debt reduction and pass the benefits directly to the debtor nations. We would expect debtor nations also to maintain viable debt/equity swap programs for the duration of this endeavor, and would encourage them to permit domestic nationals to engage in such transactions.

Of course, banks will remain interested in providing new money, especially if creditworthiness improves over the three year period. They should be encouraged to do so, for new financing will still be required. In this connection, consideration could be given in some cases to ways of differentiating new from old debt.

The international financial institutions will need to continue to play central roles. The heart of their effort would be to promote sound policies in the debtor countries through advice and financial support. With steady performance under IMF and

World Bank programs, these institutions can catalyze new financing. In addition, to support and encourage debtor and commercial bank efforts to reduce debt and debt service burdens, the IMF and World Bank could provide funding, as part of their policy-based lending programs, for debt or debt service reduction purposes. This financial support would be available to countries which elect to undertake a debt reduction program. A portion of their policy based loans could be used to finance specific debt reduction plans. These funds could support collateralized debt for bond exchanges involving a significant discount on outstanding debt. They could also be used to replenish reserves following a cash buyback.

Moreover, both institutions could offer new, additional financial support to collateralize a portion of interest payments for debt or debt service reduction transactions. By offering direct financial support for debt and debt service operations, the IMF and the World Bank could provide new incentives, which would act simultaneously to strengthen prospects for greater creditworthiness and to restore voluntary private financing in the future. This could lead to considerable improvements in the cash flow positions of the debtor countries.

While the IMF and World Bank will want to set guidelines on how their funds are used, the negotiation of transactions will remain in the market place -- encouraged and supported but not managed by the international institutions.

It will be important that the Fund and the Bank both be in a strong financial position to fulfill effectively their roles in the strengthened strategy. The Bretton Woods Committee has provided an important public service in mobilizing capital resources for these institutions. The capital of the World Bank has recently been replenished with the implementation of the recent general capital increase providing approximately $75 billion in new resources to the Bank. With respect to the Fund, the implementation of these new efforts to strengthen the debt strategy could help lay the basis for an increase in IMF quotas. There are, of course, other important issues that have to be addressed in the quota review, including the IMF arrears problem and a need for clear vision of the IMF's role in the 1990's. It is our hope that a consensus can be reached on the quota question before the end of the year.

Creditor governments should continue to reschedule or restructure their own exposure through the Paris Club, and to maintain export credit cover for countries with sound reform programs. In addition, creditor countries which are in a position to provide additional financing in support of this effort may wish to consider doing so. This could contribute significantly to the overall success of this effort. We believe that creditor governments should also consider how to reduce regulatory, accounting, or tax impediments to debt reduction, where these exist.

The third key element of our thinking involves more timely and flexible financial support. The current manner in which "financial gaps" are estimated and filled is cumbersome and rigid. We should seek to change this mentality and make the process work better. At the same time, we must maintain the close association between economic performance and external financial support.

While we believe the IMF should continue to estimate debtor financing needs, we question whether the international financial institutions should delay their initial disbursements until firm, detailed commitments have been provided by all other creditors to fill the financing "gap." In many instances, this has served to provide a false sense of security rather than meaningful financial support. The banks will themselves need to provide diverse, active, and timely support in order to facilitate servicing of the commercial debt remaining after debt reduction. Debtor nations should set goals for both new investment and the repatriation of flight capital, and to adopt policy measures designed to achieve those targets. Debtor nations and commercial banks should determine through negotiations the portion of financing needs to be met via concerted or voluntary lending, and the contribution to be made by voluntary debt or debt service reduction.

Finally, sound policies and open, growing markets within the industrial nations will continue to be an essential foundation for efforts to make progress on the debt problem. We cannot reasonably expect the debtor nations to increase their exports and strengthen their economies without access to industrial country markets. The Uruguay Round of trade negotiations provides an important opportunity to advance an open trading system. We must all strive to make this a success.

Conclusion

Taken together, the ideas I have discussed today represent a basis on which we can work to revitalize the current debt strategy. We believe that through our efforts we can provide substantial benefits for debtor nations in the form of more manageable debt service obligations, smaller and more realistic financing needs, stronger economic growth, and higher standards of living for their people.

If we work together, we can make important progress towards our key objectives:

- o to assure that benefits are available to any debtor nation which demonstrates a commitment to sound policies;
- o to minimize the cost or contingent shift in risk to creditor governments and taxpayers;
- o to provide maximum opportunities for voluntary, market-based transactions rather than mandatory centralization of debt restructurings;
- o and to better tap the potential for alternative sources of private capital.

In the final analysis, our objective is to rekindle the hope of the people and leaders of debtor nations that their sacrifices will lead to greater prosperity in the present and the prospect of a future unclouded by the burden of debt.

FINANCIAL INSTITUTIONS REFORM, RECOVERY AND ENFORCEMENT ACT OF 1989

SECTION-BY-SECTION ANALYSIS

Section 101. PURPOSES. Section 101 provides that the purposes of this Act are: to promote a safe and stable system of affordable housing finance through regulatory reform; to improve supervision by strengthening capital, accounting, and other supervisory standards; to establish a relationship by the Treasury Department over the Federal Home Loan Bank System similar to that of the Office of the Comptroller of the Currency; to establish an independent insurance agency to provide deposit insurance for savers; to put the federal deposit insurance system on a sound financial basis for the future; to create a new corporation to contain, manage and resolve failed thrift institutions; to provide the necessary private and public financing to resolve failed institutions in an expeditious manner; to provide for improved supervision and enhanced enforcement powers; to increase criminal and civil money penalties for crimes of fraud against financial institutions and depositors; and for other purposes.

TITLE II - FEDERAL DEPOSIT INSURANCE CORPORATION AUTHORITIES AND RESPONSIBILITIES.

Section 201. FINANCIAL INSTITUTIONS. Section 201 generally replaces "bank" with "financial institution"--a term that includes both banks and savings associations (thrifts)--throughout the Federal Deposit Insurance Act (FDI Act). It also replaces "Federal Home Loan Bank Board" with "Chairman of the Federal Home Loan Bank System" (FHLBS).

Section 202. DUTIES OF THE FEDERAL DEPOSIT INSURANCE CORPORATION. Section 202 authorizes the FDIC to insure savings associations in addition to banks.

Section 203. FDIC BOARD MEMBERS. Section 203 increases the membership of the FDIC's Board of Directors from three members to five. The Comptroller of the Currency and the Chairman of FHLBS are *ex officio* members. The other three are appointive members, no more than two of which may be from the same political party. As under current law, the appointive members have fixed six-year terms. The President may designate one appointive member as the Chairman and one as the Vice Chairman of the FDIC. Under current law, Board members may not serve as officer or director of any insured bank or of a Federal Reserve bank, and may not hold stock in any insured bank. Section 203 provides that, in addition, Board members may not serve as directors or officers of any insured thrifts or of any Federal Home Loan bank, and may not invest in any insured thrift, or in any bank holding company or savings and loan holding company. The Board members serving on the date of enactment are to complete their terms of office, and the Chairman is to continue to serve as Chairman until his successor has been appointed and qualified.

Section 204. DEFINITIONS. Section 204 amends some of the existing definitions in Section 3 of the FDI Act, and also provides several new definitions.

The term "insured bank" is retained.

Section 3(j) of the FDI Act, which defines "receiver", is clarified to provide that "conserving assets" is one of the functions of a "receiver", and includes "savings associations" among the institutions for which a receiver may act.

Section 3(l), which defines "deposit", is amended to include obligations of savings associations, and to specify that foreign currencies and obligations expressed in foreign currencies, do not qualify as "deposits." The Chairman of the FHLBS is added to the list of bank regulators with which the FDIC Board must consult in any decision on whether to treat other obligations as deposits.

Section 3(m), which defines "insured deposit", is amended to accommodate deposits held by thrifts and makes allowance for any differences that might currently exist between an "insured deposit" under the FDI Act and an "insured account" under the National Housing Act. Section 204 specifies that any liability that was an "insured account" under the FSLIC's rules, but that would not otherwise qualify as an FDIC-insured deposit, will continue to be insured for six months after the effective date of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRRE Act), or (in the case of a fixed-maturity time deposit) until its earliest maturity date occurring after the expiration of six months from enactment of the amendments.

Section 3(q), which defines the term "appropriate Federal banking agency", adds the Chairman of the FHLBS as the appropriate Federal banking agency with respect to a savings association or a savings and loan holding company.

Section 204 adds a new definition for the term "savings association". This term includes thrifts that are insured by the FSLIC on the effective date of the FIRRE Act, any Federal savings and loan association or Federal savings bank, and any State-chartered savings and loan. "Savings association" also includes any corporation that the FDIC considers to be operating substantially in the same manner as a savings and loan association.

Section 204 also adds definitions for "default" and "danger of default", which are generally defined to be determinations by a public authority for appointment of a conservator or receiver. These concepts are taken from the National Housing Act, and are used throughout the FDI Act in lieu of current references to "closed" banks and banks in "danger of closing".

Finally, Section 204 defines various other terms--e.g., "bank," "financial institution" (which includes "banks" and "savings associations"), and "financial institution holding company" (which includes bank holding companies and savings and loan holding companies).

Section 205. INSURED SAVINGS ASSOCIATIONS. Section 205 provides that all FDIC-insured banks and all FSLIC-insured institutions continue to be insured by the FDIC without application or approval. In addition, this section states that whenever a financial institution files an application with another Federal banking agency that would result in granting insurance to the institution--e.g., an application for a national bank charter--the other agency must provide the application to the FDIC for comment (such comment to be made in a reasonable time) and the agency must take the FDIC's comments into account in deciding whether to grant the application.

Section 206. APPLICATION PROCESS; INSURANCE FEES. Section 206 requires State savings associations to apply to the FDIC for deposit insurance. Federal savings associations may apply to the FHLBS, but must also submit an application to the FDIC together with a certificate from the FHLBS. The FDIC Board must consider the first five factors specified in Section 6 of the FDI Act when evaluating the application. The FDIC Board (which may not delegate denial authority in the case of such Federal associations) may, after reviewing the application and the certificate, decline to insure the applicant and must provide specific written reasons to the Chairman of FHLBS for any such denial. Section 206 provides that any financial institution that becomes insured must pay any entrance fee prescribed by FDIC regulations. The fee is paid into the particular fund, the Bank Insurance Fund (BIF) or the Savings Association Insurance Fund (SAIF), depending upon which Fund it joins. The same rules generally apply to conversions. When a bank that is already a member of the BIF converts into a SAIF member, the bank must pay an entrance fee to the SAIF. When a savings association converts into a BIF member, the savings association must pay an entrance fee to the BIF. The fee in each case must be enough to prevent the dilution of the reserves of the Fund to be joined by the institution.

FDIC must approve any conversion transaction. There is a five-year moratorium on such conversions although the FDIC may permit a conversion during the moratorium with respect to a de minimis transaction (such as minor branch sales) or in cases where the FDIC and the Oversight Board of the Resolution Trust

Corporation agree that the conversion transaction is in the best interests of both BIF and SAIF.

In a conversion transaction, the institution must also pay an exit fee as determined by the Secretary of the Treasury to be paid to the Resolution Trust Corporation (RTC) or such agency as determined by the Secretary.

Finally, Section 206 provides for "cross-guarantees" by insured financial institutions that are commonly controlled. Each such financial institution must reimburse FDIC, as requested, for any loss the FDIC may incur in connection with the failure of, or assistance to, another commonly owned insured financial institution. However, for the first five years after the effective date of the FIRRE Act, BIF members do not have to reimburse the FDIC for losses in connection with SAIF members, and vice versa.

The cross-guarantees are subordinate in right of payment to deposits (except those owed to commonly controlled institutions), to secured obligations, and generally to other liabilities except as specified. The cross-guarantees are superior, however, to obligations owed to other commonly-controlled companies or to shareholders, to debts and obligations that are subordinated to depositors and other general creditors, and to contingent claims.

The FDIC may specify how much of the overall loss will be borne by any given institution, but must consult with the Federal supervisor of any such institution for the purpose of setting the procedures and schedules of any program of reimbursement.

The FDIC must promulgate regulations to implement an administrative review procedure, and to provide a hearing to any commonly-controlled financial institution that is required to reimburse the FDIC. When courts review the FDIC's determinations regarding the amount of the liability, and regarding procedures and schedules for reimbursement, the courts must sustain the FDIC's determinations unless they are found to be arbitrary or capricious.

The Bank Holding Company Act definitions of "control" and "company" are adopted for this purpose.

Section 207. INSURABILITY FACTORS. Section 207 adds, as a new factor for agencies to consider when evaluating applications that result in deposit insurance, the risk presented to the BIF, to the SAIF, and to the overall Deposit Insurance Fund as a whole.

Section 208. ASSESSMENTS. Section 208 provides that the FDIC, after reaching agreement with the other three Federal banking agencies, may require insured financial institutions to file additional reports for insurance purposes.

Section 208 also sets insurance assessment rates for BIF members (generally banks) on one hand and for the SAIF members (generally savings associations) on the other. BIF members must pay the current rate (1/12 of 1 percent) until the end of the current year. For the year 1990, the rate is 12/100 of 1 percent. After 1990, the rate remains at 15/100 of 1 percent. SAIF members must likewise pay their current rate (20.8/100 of 1 percent) until December 31, 1990. From January 1, 1991, through December 31, 1993, they pay 23/100 of 1 percent. Finally, on January 1, 1994, this rate becomes 18/100 of 1 percent, where it remains.

The FDIC may raise these rates for the BIF Fund or the SAIF fund if the FDIC makes any of the following findings about the Fund in question:

--That the Fund has experienced a net loss in any of the prior three years;

--That the Fund's "reserve ratio"--the ratio of its net worth to its insurance liabilities--is less than 1.20 percent; or

--That extraordinary circumstances exist that raise a reasonable risk of serious future losses to the Fund in question.

The FDIC may not raise the rates more than 50 percent over the prior year's rate, and, in any event, the maximum rate for either Fund is 35/100 of 1 percent.

The FDIC may also lower the rates below the statutory minimums. The FDIC may set a lower rate for a Fund if the FDIC determines that the ratio of the Fund's net worth to its insurance liabilities exceeds 1.25 percent, and if the FDIC believes that the ratio is not likely to decrease for the next five years.

Finally, every financial institution must pay a minimum annual assessment of $500 or such greater amount as is necessary to cover the direct costs related to assessment and processing.

Section 208 clarifies that amounts of premiums paid to the Financing Corporation (FICO) and the Resolution Funding Corporation (REFCORP) under their respective authorities to assess, are to be subtracted from the amounts assessed under this section to be paid to SAIF. This ensures that institutions are not double or triple assessed.

Section 208 also provides for assessment credits. When the reserve ratio of a Fund exceeds 1.25 percent (or such higher level as determined by the FDIC), the FDIC may rebate to the Fund's members some of the assessments they have paid in the prior year. The rebate would be the lesser of the amount necessary to reduce the Fund's reserve ratio to 1.25 percent (or to the level determined by the FDIC) or 60 percent of the net assessment income the Fund members have paid in during the prior year. This section, as all the others dealing with assessments, is Fund specific. The FDIC must deduct any amount that an institution owes the FDIC from any rebate to be credited to that institution. Furthermore, the FDIC may not rebate any amounts to SAIF members so long as the Financing Corporation is authorized to assess SAIF members for Financing Corporation interest obligations.

Finally, Section 208 extends the scope of the Change in Bank Control Act to reach savings associations as well as banks. Elsewhere the FIRRE Act repeals Title IV of the National Housing Act, which contains the provisions of the equivalent law currently applicable to savings and loan associations.

Section 209. FDIC CORPORATE POWERS. Section 209 makes technical and conforming amendments to Section 9 of the FDI Act, which generally sets forth the basic corporate powers of the FDIC. Section 209 also clarifies the FDIC's authority to define any terms used in the FDI Act that are not specifically defined, and to interpret definitions that are defined; provided that the FDIC definitions are not binding on other Federal banking agencies.

Section 210. ADMINISTRATION OF THE FDIC. Section 210 gives the FDIC the same authority to examine insured thrifts as it has now with respect to insured banks.

Section 211. INSURANCE FUNDS; FDIC POWERS AS RECEIVER. Section 211 amends Section 11 of the FDI Act to provide for two separate insurance funds, which are not to be commingled. BIF is essentially a continuation of the FDIC's existing fund, which until the passage of the FIRRE Act has been known as the Permanent Insurance Fund. All the assets, debts, obligations, contracts, and other liabilities of the existing FDIC fund are transferred to the BIF. All assessments paid by BIF members (generally banks) are to be paid into this Fund, and the assets of the Fund are to be used in connection with BIF members. The other Fund is the SAIF. All assessments paid by SAIF members (generally thrifts) (which are not otherwise committed to the Financing Corporation or Resolution Trust Corporation) are to be paid into the Fund, and the assets of the Fund are to be used in connection with SAIF members. In addition, the Treasury is to make the following contributions to the SAIF, subject to available appropriations:

Fiscal Year	Dollars (in Billions)
1991	$2.0
1992	3.4
1993	4.6
1994	3.0
1995	4.0
1996	4.0
1997	4.0
1998	4.0
1999	3.0

In the event that case resolution costs run higher than estimated over the period from 1992 through 1999, then Treasury (subject to available appropriations) will contribute additional funds to SAIF that may exceed the levels in the above table so as to cover resolution costs that do not come from other income sources and keep the fund at a minimum level. The minimum level of the fund for each of the years 1992 through 1999 is as follows:

Fiscal Year Beginning October 1,	Dollars (in Billions)
1992	$1.0
1993	2.1
1994	3.2
1995	4.3
1996	5.4
1997	6.5
1998	7.6
1999	8.8

Treasury will provide funds to keep SAIF at the above minimum levels until the earlier of 1999, or the first fiscal year that SAIF's reserve ratio is at least 1.25 per centum.

Finally, the FDIC is authorized to borrow from the Federal Home Loan Banks, with concurrence of the Chairman of the System, such funds as the FDIC deems necessary for the use of the SAIF, subject to the cap on borrowing specified in Section 216. This borrowing authority was authorized for FSLIC prior to enactment of this Act. Any borrowings under this section become a specific liability of SAIF.

Section 211 defines the FDIC's authorities and duties as receiver or conservator. The authorities essentially parallel those heretofore exercised by the FSLIC and the FDIC, and are designed to give the FDIC power to take all actions necessary to resolve the problems posed by a financial institution in default. Section 211 specifies that the authority includes the power to conduct business, including taking deposits, and performing all functions of the financial institution in its own name; to take necessary action to put the institution in sound and solvent condition; to merge the institution with another insured financial institution; to organize a Federal savings association to take over assets and liabilities from a failed thrift, or to organize a bridge bank or a new national bank to take over assets and liabilities of any insured financial institution; to transfer assets or liabilities of the financial institution, including those associated with any trust business carried on by the institution, without any further approvals; to place the financial institution in liquidation; to determine claims; and to exercise all powers and authorities granted by the Act or incidental thereto.

Section 211 of FIRRE Act establishes a claims procedure, with specific deadlines both for creditors and for the FDIC, to be followed in cases where the FDIC has been appointed receiver. Section 211 enables the FDIC, when acting as receiver, to request a stay of litigation or other similar proceeding for a period of up to 90 days after its appointment. The appointment of a receiver or conservator can often change the character of litigation. The stay gives the FDIC a chance to analyze pending matters and decide how best to proceed.

Section 211 also codifies the common-law right of a receiver or conservator to disaffirm or repudiate contracts. The need to exercise this right generally occurs when a failed institution has entered into a long-term lease or long-term service contract shortly before going into default. Without the common-law right of disaffirmance or repudiation, the lessor or contractor could reap a windfall for a service or lease that was clearly not necessary. (Section 211 provides, however, that a lessor is entitled to the contractual rent for the period the receiver occupies the premises.)

In order to repudiate or disaffirm a contract the FDIC, as receiver, must determine that the contract would be burdensome to the estate of the failed institution or that the disaffirmance would promote the orderly administration of the financial institution's affairs. If the FDIC disaffirms or repudiates the contract within ninety (90) days from the date the FDIC is appointed receiver or discovers the existence of the contract or lease, there will be no resulting damages for the disaffirmance against either the FDIC or the estate of the financial institution in default.

Conversely, Section 211 allows the FDIC as receiver to enforce contractual terms that the FDIC deems necessary for the orderly execution of its duties as receiver. Contracts often have a provision specifying that the contract is automatically in default on the appointment of a receiver or conservator, or similar event. Such provisions are generally held void and section 211 merely codifies the common-law rule.

Section 211 requires the FDIC to keep and maintain a full accounting with respect to the affairs of the financial institution in default and specifies that the accounting shall be available to the institution's shareholders and other regulatory agencies. Section 211 also provides that the FDIC may destroy records of a Federal financial institution default after five years from its appointment as receiver.

Section 211 specifies that, when a receiver or conservator is appointed for an insured Federal financial institution (or for an insured District bank or District savings and loan association) for the purpose of liquidating it or winding up its affairs, the FDIC must be appointed as such receiver or conservator. Section 211 authorizes, but does not require, the FDIC to accept appointment as receiver in other circumstances, if appointment is offered: namely, to serve as conservator for an insured Federal or District financial institution for the purpose of operating the institution, or to serve as conservator or receiver for State institutions either for operating or for liquidation purposes. When the FDIC serves as conservator or receiver for a State institution, it has all the rights, powers and privileges granted to receivers of State financial institutions under State law in addition to, and not in derogation of, the powers conferred by the FDI Act.

Section 211 provides that the FDIC as conservator or receiver shall not be subject to the direction or supervision of any other agency or Department in the exercise of its duties (except as may otherwise be provided in the FIRRE Act). The only exception to the rule is where the FDIC has been appointed conservator for a Federal financial institution by that institution's primary regulator, and the institution continues to operate in conservatorship. In such cases, the FDIC shall be subject to the supervision of that primary regulator.

In addition, Section 211 gives the FDIC the power currently available to the FSLIC to appoint itself as sole conservator or receiver of an insured State financial institution under certain conditions. The FDIC may not exercise this power unless it makes each of two findings.

First, either (1) that a conservator, receiver or other legal custodian has been appointed for an insured State financial institution, that the appointment has been outstanding for at least 15 consecutive days, and that one or more depositors is unable to obtain withdrawal of his or her deposit, in whole or in part, or (2) that a State financial institution has been closed by or under the laws of any State. Second, that any of the following grounds exist: (1) insolvency in that the assets of the institution are less than its obligations to its creditors and others, including depositors; (2) substantial dissipation of assets or earnings due to any violation or violations of law, rules, or regulations, or to any unsafe or unsound practice or practices; (3) an unsafe or unsound condition to transact business; (4) willful violation of a cease-and-desist order which has become final; or (5) concealment of books, papers, records, or assets of the institution or refusal to submit books, papers, records, or affairs of the institution for inspection to any examiner or to any lawful agent of the FDIC.

Section 211 specifies that payments made on account of a BIF member may only be made from the BIF, and that payments on account of a SAIF member may only be made from the SAIF. The FDIC may require proof of claims and may determine claims, subject to review by the Court of Appeals for the District of Columbia Circuit or for the circuit where the financial institution is located. The court must sustain the FDIC's determination unless the court finds the determination to be arbitrary or capricious.

Section 211 provides that, when the FDIC pays insurance to a depositor, the FDIC is automatically subrogated to the depositor's claim against the institution. The automatic right of subrogation now applies only to national banks; Section 211(g) extends it to all insured financial institutions.

Section 211 allows the FDIC to use its Deposit Insurance National Bank powers in the case of failed thrifts as well as in the case of failed banks, but does not otherwise change the role or powers of Deposit Insurance National Banks.

Section 211 makes technical changes in the bridge bank statute. The changes clear up some of the statute's ambiguities and streamline bridge bank operations. For example, Section 211 allows the FDIC to use bridge banks in the case of savings associations as well as banks. Section 211 also specifies that while a person who serves in any capacity with respect to a bridge bank does not thereby become an officer or employee of the United States for purposes of Title 5 of the United States Code, a Federal employee who serves in some capacity with respect to a bridge bank does not thereby lose any such status under Title 5; but Federal employees may not receive additional compensation apart from their Federal compensation. In addition, Section 211 provides that a bridge bank may be treated as a financial institution in default. Treating a bridge bank as being "in default" makes it clear that the bridge bank is eligible for the provisions applicable to failed and failing institutions (*e.g.*, acquisition by interstate holding companies). Section 211 also gives a bridge bank three one-year extensions of corporate life, not just one such extension as is the case now.

Section 211 clarifies the principle that people with claims against the estate of a failed financial institution are only entitled to their share of the institution's estate: i.e., that the value of a claim is the amount that claimant would have received had the FDIC liquidated the estate. Section 211 makes it explicit that the value of any such claim is not affected by the procedure that the FDIC may choose to adopt in dealing with a failed institution, even if the procedure results in making some creditors whole (e.g., a purchase-and-assumption transaction in which all deposits, both insured and uninsured, are transferred to an acquiring institution but other claims are not transferred). Section 211 permits the FDIC to make additional payments to, or for the benefit of, particular creditors or categories of creditors out of its own resources without becoming obligated to make similar payments to any other claimant or category of claimant. The FDIC may only use the resources of the Fund to which the failed institution belonged in making any such payments.

Under this procedure, no creditor ever receives any less than the fair value of his claim against the estate. But at the same time, the FDIC is free to take action that is to the benefit of the institution and the public without being subject to the constraint of making all creditors whole if even one creditor is made whole.

Section 211 also provides that, where the FDIC elects to operate an institution in default for a period of time before beginning to wind up its affairs, the FDIC would incur no liability to any claimant should the estate of the institution be diminished during such period of operation, absent a finding of bad faith on the part of the FDIC.

Section 211 authorizes the FDIC to make rules and regulations for the conduct of conservatorships and receiverships, and enables the FDIC to adjudicate claims. The power to adjudicate may be exercised only if the FDIC has first issued regulations governing the processing of claims. Claims determinations made by agency adjudication are subject to appellate court review, and must be upheld unless found to be arbitrary or capricious. In the absence of FDIC regulations governing claims resolution, the Federal district courts (or State or local courts) would have jurisdiction to hear such cases.

Finally, Section 211 bars courts, to the same extent as the Home Owners' Loan Act does now under existing law, from restraining or affecting the exercise of the powers or functions of the FDIC as receiver or conservator, except at the request of the Board of Directors.

Section 212. FSLIC RESOLUTION FUND. Section 212 creates the FSLIC Resolution Fund. Consistent with the provisions of Title IV of this Act, this Fund is the successor to the existing reserves and assets, debts, obligations, contracts and other liabilities of the FSLIC, and is required to be held separately and not commingled with BIF or SAIF.

The FSLIC Resolution Fund is funded from the following sources in the listed priority: (1) the income generated on the assets transferred to it; (2) the proceeds of the resolution of insolvent thrift institutions which became insolvent prior to December 31, 1988 (to the extent such funds are not required by the Resolution Funding Corporation); (3) the proceeds from borrowings by the Financing Corporation; and (4) until 1992, from the assessments levied on SAIF members and not required by the Financing Corporation or the Resolution Trust Corporation. Section 212 also provides for additional funding by the Secretary of the Treasury from appropriated funds, if needed.

Any judgment resulting from any civil action or proceeding to which the FSLIC was a party prior to its dissolution in any action or which is initiated against the FDIC based upon FSLIC actions is limited to the assets of the FSLIC Resolution Fund.

The FSLIC Resolution Fund will be dissolved when its debts and liabilities have been satisfied and all its assets have been sold, with remaining funds being covered into Treasury because of

Treasury funds having been injected into the FSLIC Resolution Fund over the years. Only minimal offices and office supplies are to be transferred to SAIF.

Section 213. AMENDMENTS TO SECTION 12. This section makes conforming technical changes to Section 12 of the FDI Act, which deals with paying insurance to depositors, the appointment of agents to assist the FDIC in conducting receiverships, and other matters.

Section 214. AMENDMENTS TO SECTION 13. Section 214 specifies that the funds held in each of the specific funds administered by the FDIC must be invested separately, and may not be commingled. Section 214 allows the FDIC to stay legal proceedings involving asset purchases for up to 90 days. Section 214 also amends the "cost test" for FDIC assistance. Under current law, the FDIC may not provide assistance in excess of that amount which the FDIC determines to be reasonably necessary to save the cost of liquidating (unless continued operation is necessary to provide essential banking services). Section 214 would additionally require FDIC to consider the immediate and long-term obligations of the FDIC with respect to the assistance, and also the Federal tax revenues foregone by the Government as a result of specific tax benefits granted to acquirers of financial institutions in default or in danger of default.

Section 214 provides that transfers of assets or liabilities associated with any trust business may be effected by FDIC in connection with any asset purchase transaction without any further State or Federal approval.

Section 214 eliminates the requirement for approval by the appropriate State authority and by a court for sales of assets or pledges of assets to secure loans by conservators, receivers or liquidators to the FDIC.

Section 214 clarifies the provision invalidating certain secret agreements against interests of the FDIC. Section 214 makes it clear that these provisions apply to assets that the FDIC acquires as receiver as well as to assets that it acquires in its corporate capacity.

Section 214 specifies that the Board of Directors of the FDIC must act by a 75 percent vote (rather than the present unanimous vote) in order to override State objection to an assisted interstate acquisition of an insured financial institution in default having $500,000,000 or more in assets.

Section 214 retains the current rules governing interstate acquisitions of banks, and keeps them separate from those that govern thrifts. It tightens the rules by providing that such acquisitions would be prohibited if they threaten the safety or soundness of the acquirer or would not result in the future viability of the resulting institution.

Section 214 transfers the parallel interstate-acquisition provisions relating to thrifts, which now appear at section 408(m) of the National Housing Act, to subsection 13(k) of the FDI Act (with technical and conforming amendments). These rules continue to apply only to savings institutions and are not extended to banks. The current law allows an override of the laws or constitution of any State, or any Federal law, that constitutes a material impediment to supervisory acquisitions and provides for consultation with State authorities. In addition, as amended, in exercising this override authority, the FDIC must obtain the prior concurrence of the Chairman of the Federal Home Loan Bank System in all respects other than section 10(e)(3) of the Home Owners' Loan Act, and the prior concurrence of the Federal Reserve Board for the override of the Bank Holding Company Act or Federal Reserve Act.

Section 215. BORROWING AUTHORITY. Section 215 increases the borrowing authority of FDIC from $3,000,000,000 to $5,000,000,000, and also specifically states that the Secretary of the Treasury must approve any use of the credit line.

Section 216. LIMITATION ON BORROWING.

Section 216 clarifies the existing provision specifying that the only kind of non-Federal tax to which the FDIC, in its corporate capacity or as receiver, is subject is a tax on real property.

Section 216 further specifies that if an insured institution fails to pay a tax, the FDIC's only obligation as receiver or conservator for the institution is to pay the pro-rata claim for the tax--the FDIC will not be subject to any special penalties or forfeitures that might otherwise apply (e.g., loss of a secured interest in the property.)

Finally, Section 216 sets a cap on the notes, debentures, bonds, and similar obligations, including estimated losses for guarantees and other liabilities of the BIF and of the SAIF, respectively. Each cap is set independently. In each case, the Fund may not incur such obligations in an amount exceeding 50 percent of the Fund's adjusted net worth, including reserves for losses and similar reserves or $10,000,000,000, whichever is less. These obligation caps apply to borrowings by the Funds, and do not affect or apply to the FDIC's power to draw upon its credit line of $5,000,000,000 from the Treasury.

Section 217. REPORTS. Section 217 requires the FDIC to report to Congress annually on its operations, activities, budget, receipts and expenditures. Current law specifies only the FDIC's operations as subject to reporting requirements. Section 217 also requires the FDIC to make quarterly reports to the Secretary of the Treasury and to the Director of the Office of Management and Budget with respect to the FDIC's financial operating plans and forecasts (including estimates of actual and future spending, and estimates of future non-cash obligations) taking into account the FDIC's financial commitments, guarantees and other contingent liabilities.

Section 218. REGULATIONS GOVERNING INSURED FINANCIAL INSTITUTIONS. Section 218 specifies that FDIC signs displayed by insured financial institutions shall represent whether an institution is a BIF member or a SAIF member. Section 218 subjects all insured financial institutions to the Bank Merger Act. The Chairman of FHLBS is the responsible agency with respect to mergers where the acquiring, assuming or resulting institution is to be a savings association. Section 218 provides that all insured State financial institutions, other than State member banks or District banks, would be subject to the requirement of prior FDIC consent to the reduction of capital.

Section 218 sets out new rules governing subsidiaries of insured savings associations. Whenever an insured savings association establishes or acquires control of a company, or elects to conduct any new activity through a company that the association controls, the savings association must notify the FDIC and the Chairman of FHLBS. The savings association must deduct its entire investment in and loans to the company from its own capital for purposes of determining capital adequacy if the company is engaged in activities not permissible for a national bank. In any event, mortgage banking activities need not be deducted.

The Chairman of FHLBS is given rule-making authority over subsidiaries' activities. The Chairman of FHLBS may order a thrift to divest itself of a subsidiary if the company constitutes a serious risk to the thrift's financial safety. Both the FDIC and the Chairman of FHLBS are given the same powers with respect to a savings association's subsidiary as they have with respect to the savings association itself pursuant to this section 218 or section 8 of the FDI Act.

Section 218 states that the FDIC may determine by regulation, with respect to all State-chartered SAIF members (after consultation with the Chairman of the FHLBS) that any specific activity (other than any activity permitted to a Federal savings and loan association) poses a serious threat to the SAIF, and may prohibit any such activity. Once the FDIC issues such a regulation, it may order that no SAIF member may engage directly in that activity. Section 218 further specifies that a SAIF member may not be held liable indirectly for any obligation arising out of the activity of the subsidiary unless the obligation is in writing, is executed by the SAIF member and the party to whom the obligation is owed, is approved by the SAIF member's board of directors or an official committee of the association, and the liability or obligation has been continuously maintained as an official document of the SAIF member.

Section 219. NONDISCRIMINATION. This section specifies that the

FDI Act is not intended to discriminate against State nonmember banks or against State-chartered thrifts. It also eliminates the provision requiring nondiscrimination on account of having capital stock less than the amount required for Federal Reserve membership.

TITLE III - SAVINGS ASSOCIATION SUPERVISION IMPROVEMENTS

Section 301. DEFINITIONS. This section revises the definitional section of the Home Owners Loan Act of 1933 ("HOLA") to incorporate the new terms used in the FIRRE Act.

Section 301(1) defines the term "Chairman" as the Chairman of the Federal Home Loan Bank System created under the FIRRE Act.

Section 301(2) defines the term "System" as the Federal Home Loan Bank System.

Section 301(3) defines the term "savings association" to include: (1) all institutions currently supervised by the Federal Savings and Loan Insurance Corporation; (2) all federally chartered savings and loan associations and savings banks; (3) all state-chartered building and loan, savings and loan, and homestead associations and cooperative banks; and (4) those state savings banks that will be members of the Savings Association Insurance Fund.

Section 301(4) defines the term "federal association" to include all federal savings and loan associations and federal savings banks chartered pursuant to section 5 of the HOLA.

Section 301(5) defines the term "federal banking agencies" as the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation.

Section 302. SUPERVISION OF SAVINGS ASSOCIATIONS. This section creates a new section 3 of the HOLA setting forth new provisions applicable to the Chairman's responsibilities as primary federal supervisor and regulator of both federally and state-chartered savings associations. It also incorporates into the HOLA certain provisions of the National Housing Act ("NHA").

Section 302(a) establishes the scope of the Chairman's overall responsibilities for the supervision and regulation of savings associations. It clarifies that the HOLA's purpose of encouraging credit for housing is coupled with the purpose of establishing a safe and sound system to provide such credit. The Chairman is given the power to examine state associations and is granted broad rulemaking authority to carry out his responsibilities to supervise and regulate savings associations in accordance with both the HOLA and all other applicable laws. The rulemaking authority includes the ability to issue rules governing safety and soundness. Uniform accounting and disclosure standards are to be prescribed for all savings associations. These standards are to be coordinated with capital standards established by the Chairman. Savings associations are to be in full compliance with these uniform accounting standards by no later than December 31, 1993. This carries forward the uniform accounting provisions adopted in the Competitive Equality Banking Act of 1987. Those rules, regulations, and policies established by the Chairman that govern the safe and sound operation of savings associations are to be no less stringent than those established by the Office of the Comptroller of the Currency. The section also transfers into new section 3(d) of the HOLA the existing authority to set geographical lending limits generally within an area one hundred miles from the location of the savings association's principal office (currently found in section 403(b) of the NHA).

Section 302(b) preserves, with minor technical changes, former Section 409 of the NHA by transferring this section to new Section 3(e) of the HOLA. As modified, this section provides that insured savings accounts and share accounts held by FDIC-insured savings associations are lawful investments and may be accepted as security for specified public funds of the United States and funds of corporations organized under United States laws notwithstanding limitations upon the investment of, or upon the acceptance of security for the investment or deposit of, such funds.

Section 302(c) transfers former Section 410 of the NHA pertaining to participation in lotteries to new section 3(f) of the HOLA with conforming amendments. This section prohibits a savings association from dealing in lottery tickets, dealing in bets used as a means of participating in a lottery, announcing, advertising, or publicizing the existence of a lottery or participant/winner of a lottery, or using its offices for such prohibited activities. Savings associations are not prohibited from accepting funds from, or performing any lawful services for, a State operating a lottery.

Section 302(d) preserves former section 413 of the NHA relating to disclosures of beneficiaries with respect to federally related mortgage loans, by transferring this section to new section 3(g) of the HOLA with conforming amendments. Under this provision, savings associations are prohibited from making a federally related mortgage loan to any agent, trustee, nominee, or other person acting in a fiduciary capacity without the prior condition that the identity of the person receiving the beneficial interest of the loan shall at all times be revealed to the association. With respect to such loans, the Chairman of the Federal Home Loan Bank system may request the identity of such person and the nature and amount of the loan.

Section 302(e) preserves former section 414 of the NHA by transferring this section to new section 3(h) of the HOLA and makes conforming amendments. This section provides that a savings association may take, receive, reserve, or charge on any loan, note, bill of exchange, or other evidence of debt, interest at the greater of (1) a rate not more than one per centum in excess of the discount rate on ninety-day commercial paper in the specified Federal Reserve Bank where the institution is located, or (2) the rate allowed by the laws of the state where such institution is located. If the former rate exceeds the rate that would be permitted in the absence of this section, such rate may be employed notwithstanding any state constitution or statute, which is thus preempted. This section also prescribes penalties for knowingly charging a rate in excess of the "greater" rate permitted in subsection (a) of the provision.

Section 302(f) provides that no savings association may issue securities which guarantee a definite maturity except with the specific approval of the Chairman, nor issue any securities the form of which has not been approved by the Chairman. This section is intended to preserve, as section (3)(i) of the HOLA, a similar provision of former section 403(b) of the NHA.

Section 303. APPLICABILITY. This section applies to all savings associations those provisions of the HOLA that either authorize examination by the Chairman of the Federal Home Loan Bank System or proscribe or limit certain association activities, where such prohibitions or limitations are equally appropriate for federally chartered and state-chartered institutions. Specifically, those provisions deal with the HOLA territorial application (section

7); the Bank System's general supervisory authority (section 3) and enforcement authority (section 5(d))--including the authority to recoup the cost of its examinations (section 9); set capital standards for associations (sections 5(s) and (t)); restrict transactions with affiliates, loans to insiders (section 11), tying arrangements (section 5(q)), and certain advertising practices (section 12); supervision of savings association holding companies (section 10); rules requiring membership by all savings associations in a Federal Home Loan Bank (section 5(f)); and rules covering conversions from a state to a Federal charter (section 5(i)), from a state savings bank to a Federal savings bank (section 5(o))and from a mutual savings association to a stock savings association (section 5(p)).

This section would apply to Federal savings associations only those provisions of the HOLA that are relevant to the holders of Federal charters, such as rules authorizing various types of accounts (HOLA section 5(b); investment authority (section 5(c)); qualifications for individuals seeking a Federal charter (section 5(e)); subscriptions of preferred stock and full-paid income shares by the United States (sections 5(g) and (j)); exemption from state taxation (section 5(h)); trust powers (sections 5(l) and (n)); out of state branches (section 5(r)) and District of Columbia savings associations (sections 5(m) and 8). These Federal-charter only delineations are intended to maintain the distinctions between Federal and state-chartered associations that exist under current law.

Section 304. CONFORMING NAME CHANGES. This section makes terminology changes to existing law to conform to the treatment used in this legislation.

Section 304(1) would replace the terms "association," "Federal association," or "Federal savings and loan association" in the HOLA where they refer only to federally chartered associations with the term "Federal savings association." By doing so, this subsection would be merely adopting terminology consistent with the overall treatment of such associations in this legislation.

Section 304(2) would replace references to "association" in the HOLA with "savings association" where the term refers to state-chartered institutions under the supervision of the Federal Home Loan Bank System. Thus, this subsection will ensure that these relevant provisions of the HOLA apply to the latter body of associations, consistent with the overall treatment of such associations in this legislation.

Section 304(3) would exempt certain sections of the HOLA from the name change of section 304(1) and (2). These exceptions generally deal with situations where the original HOLA language was somewhat different from language found in other HOLA provisions or where, as in the conversion statutes, the distinction is still relevant. Moreover, references to the government-sponsored associations in HOLA sections 5(c)(1)(D) and (F) and "domestic building and loan associations" in HOLA section 5(r)(1) would remain unchanged because those terms have meaning independent of their inclusion in the HOLA.

Section 305. SAFETY AND SOUNDNESS. This section amends section 1464(a) of the HOLA, which sets forth the purpose of that statute, by adding language emphasizing the importance of the safe and sound operations of the nation's savings associations to the statute's purpose of providing credit for home financing.

Section 306. DEPOSITS. This section would amend current subsection 5(c)(1)(G) of the HOLA to clarify that federal savings associations may invest in deposits of any type in any financial institution whose deposits are insured by the Federal Deposit Insurance Corporation.

Section 307. SUPERVISORY REVISIONS. Section 307(a) would delete the majority of the enforcement provisions currently in the HOLA with regard to federally chartered savings associations. These provisions are subsumed in the enforcement provisions of section 8 of the Federal Deposit Insurance Act, as amended, with regard to all institutions for which the Chairman of the Federal Home Loan Bank System is the appropriate federal banking agency.

Section 307(b) would preserve without change the existing general enforcement and related authorities currently contained in section 5(d)(1) of the HOLA and would redesignate 5(d)(1) as

5(d)(1)(A).

Section 307(c) would transfer the provisions of section 407(m) of the NHA, with conforming amendments, into section 5(d)(1)(B) of the HOLA. Section 407(m) of the NHA provides for routine examination of institutions supervised by the Chairman of the Federal Home Loan Bank System and their affiliates. In addition, this section preserves the powers of the Chairman in formal examination procedures including subpoena power and the ability to take and preserve testimony under oath. Finally, it authorizes an administrative law judge to conduct hearings in enforcement actions.

Section 308. RECEIVERSHIPS. This section amends the current provisions of the HOLA on the appointment of conservators and receivers (Section 5(d)(6) redesignated as (d)(2)) to provide for the Chairman's appointment of the Federal Deposit Insurance Corporation rather than the Federal Savings and Loan Insurance Corporation as conservator or receiver for both federally and state-chartered savings associations. It incorporates provisions currently located in section 406 of the NHA setting forth the procedures to be followed in the case of state savings associations, without substantive change except with regard to the time for approval of state officials. In that regard, it would cut back from 90 to 30 days the amount of time that must elapse before the Chairman could act in the event that notice of grounds for the appointment of a conservator or receiver for a state savings association has been provided to the appropriate state official and no response has been received.

Sections 309. TECHNICAL AMENDMENT. This section would renumber section 5(d)(11) of the HOLA, dealing with the Chairman of the Federal Home Loan Bank System's ability to issue rules and regulations on conservatorships and receiverships, as section 5(d)(3). This renumbering would be necessary because of the deletion of preceding paragraphs. The renumbered section would also be amended by section 304 of the FIRRE Act to apply to all savings associations.

Sections 310. TECHNICAL AMENDMENT. This section would preserve and renumber sections 5(d)(12) (B) and (C) of the HOLA, dealing with penalties that would attach to criminal conduct by employees or agents of savings associations and failure to comply with demands of conservators and receivers, as section 5(d)(4). This renumbering would be necessary because of the deletion of preceding paragraphs. The renumbered section would also be amended by section 304 of the FIRRE Act to apply to all savings associations.

Section 311. AMENDMENT TO SECTION 5. This section is a technical amendment that would renumber section 5(d)(14) of the HOLA, which provides definitions dealing with the ability of the Chairman of the Federal Home Loan Bank System to enforce compliance with applicable law and regulations, as section

5(d)(5). This renumbering is necessary because of the deletion of preceding subparts. This section would also amend that HOLA provision to state that the enforcement powers of the Chairman of the Federal Home Loan Bank System would remain in effect against a savings association even when that association had its insured status terminated by the Federal Deposit Insurance Corporation, so long as the association retained deposits insured by the FDIC.

Section 312. TECHNICAL AMENDMENT. This section would renumber section 5(d)(16) of the HOLA, dealing with compliance with monetary transaction recordkeeping and report requirements by savings associations, as section 5(d)(6). This renumbering would be necessary because of the deletion of preceding paragraphs. The renumbered section would also be amended by section 304 of the FIRREA to apply to all savings associations.

Section 313. CONVERSIONS. This section would expand the existing provisions of section 5(i) of the HOLA regarding the authority of the Chairman of FHLBS to oversee and approve mutual-to-stock conversions to include state-chartered savings associations. This amendment is required due to the proposed repeal of the NHA and the resulting need to incorporate this authority with respect to mutual to stock conversions of state-chartered savings associations into the HOLA. In addition it incorporates the grievance procedures for the NHA with regard to conversion decisions.

Section 314. CAPITAL STANDARDS. This section requires the Chairman of the FHLBS to establish for all savings associations capital standards that are no less stringent than those applied to national banks. Such standards are to be promulgated within 90 days of the enactment of the Act and are to be fully implemented by June 1, 1991. The section establishes certain differences from standards currently applicable to national banks in the areas of goodwill and the treatment of certain subsidiaries and provides that the Chairman's standards may have minor differences from those currently applicable to national banks so long as the Chairman's standards would not result in materially lower capital standards. With respect to goodwill, capital may include such goodwill existing on the date of enactment of FIRRE Act, but it must be amortized over a ten-year period (or such shorter period as determined by the Chairman of FHLBS with the concurrence of the Secretary of Treasury). With respect to investments in subsidiaries engaged in activities not permissible for national banks, such investment and loans to the subsidiary must be deducted from capital (in any event, the investment in and loan to a subsidiary engaged solely in mortgage banking activities are not to be deducted). The Chairman is also permitted to take into account differences in powers and in asset and liability composition between savings associations and national banks, so long as the resulting capital standards are not materially lower than the capital standards applicable to national banks. The section further provides that the Chairman may, until June 1, 1991, restrict the asset growth of savings associations not in compliance with these capital standards. After that date, asset growth by such associations would be prohibited. The Chairman could restrict the asset growth of any savings association, regardless of its capital level, that he determined was taking excessive risks or paying excessive rates for deposits.

Section 315. TECHNICAL AMENDMENT. This section would replace all references to "association" in section 8 of the HOLA, which deals with District of Columbia savings associations, with "savings association" and all references to "Federal savings and loan association" with "Federal savings association." By so doing, this section would be merely adopting terminology consistent with the overall treatment of such associations in this legislation.

Section 316. REPEAL. This section would repeal section 9 of the HOLA, which deals with accounting principles and other standards and requirements. These requirements would be covered elsewhere in the HOLA as amended by this legislation.

Section 317. RECOVERY REGULATIONS REPEALED. This section repeals section 10 of the HOLA and section 416 of the NHA. Those sections permitted the Federal Home Loan Bank Board to provide capital forbearance to certain federal associations and insured institutions. Section 317 provides that associations and institutions operating under capital plans previously approved pursuant to those sections may continue to operate under such plans so long as they remain in compliance with the terms of such plans and continue to supply to the Chairman of the System regular and complete reports on their progress in meeting goals under the plans.

Section 318. COST OF EXAMINATION AND REPORTS. Section 318 adds a new section to the HOLA preserving authority from the NHA to assess the costs of examining savings associations (or affiliates) upon the savings associations (or affiliates) in proportion to their assets or resources. This section also addresses remedies available to the Chairman when an affiliate refuses to pay examination costs or refuses to permit examination or provide required information. This section addresses the deposit of funds derived from assessments, the Chairman's authority to issue regulations governing the computation and assessment of examination expenses, the authority to assess for the examination of an associations fiduciary activities, and the obligation of savings associations and affiliates to provide the Chairman with access to information and reports regarding examinations by other public regulatory authorities. These provisions are intended to be comparable to those governing the Office of the Comptroller of the Currency.

Section 319. SAVINGS AND LOAN HOLDING COMPANIES. This section transfers the provisions of the Savings and Loan Holding Company Act from the NHA to the HOLA. In addition, this section deletes current NHA sections 408(d), (p) and (t), which pertain to transactions with affiliates, and replaces those provisions with a new subsection 10(d) in the Home Owners' Loan Act, which refers to new section 11 of the HOLA (Section 320 below), which establishes a uniform approach to regulation of transactions with affiliates based on sections 23A and 23B and section 22(h) of the Federal Reserve Act. This section also deletes current section 408(g) of the NHA, which imposed debt approval requirements on certain types of savings and loan holding companies. The debt control provisions of the Savings and Loan Holding Company Act have generally been viewed as an obstacle to acquisitions, overly burdensome to administer, and producing limited supervisory benefits not commensurate with the burden associated with the approval requirements involved. This section also removes current section 408(m) of the NHA, which is moved to Section 13(k) of the Federal Deposit Insurance Act.

This section also makes changes to the qualified thrift lender test, currently contained at section 408(o) of the NHA, to provide new sanctions for failure to satisfy the qualified thrift lender requirements. Under the new qualified thrift lender rule, a thrift that fails to maintain its status as a qualified thrift lender, must, within 3 years of the date it loses such status, convert its charter to a bank charter unless it requalifies as a qualified thrift lender within the one-year period after losing such status and maintains its status as a qualified thrift lender thereafter. Also under the new rule, three years after losing qualified thrift lender status, a thrift will be prohibited from obtaining advances from its Federal Home Loan Bank and engaging in any activities not permitted either for a national bank or a bank chartered in the state in which the thrift resides. Effective immediately upon losing its status as a qualified thrift lender, the thrift would also be prohibited from expanding its activities, or opening any additional branch offices. Any company that controls a thrift that loses its qualified thrift lender status shall, beginning three years after the thrift has lost its status as a qualified thrift lender, be, subject to restrictions on its activities, regulated as if it were a bank holding company. Any bank chartered as a result of these requirements for failure to maintain qualified thrift lender status will continue to pay savings association assessments until December 31, 1993 (or such later date if it loses its status after that date), and would also be assessed the exit fees and entrance fees applicable to conversion.

Section 320. TRANSACTIONS WITH AFFILIATES. This section adds new section 11 to the HOLA, which establishes a uniform approach to regulation of transactions with affiliates based on Sections 23A, 23B and 22(h) of the Federal Reserve Act. The Chairman of the Federal Home Loan Bank System would also retain the right to determine for reasons of safety and soundness to impose additional restrictions on transactions with affiliates and insiders of savings associations.

Section 321. ADVERTISING. This section provides that no savings association shall carry on any sale, plan, or practices, or any advertising, in violation of regulations promulgated by the Chairman. This section would preserve a similar provision found in former Section 403(b) of the NHA.

TITLE IV. DISSOLUTION AND TRANSFER OF FUNCTIONS, PERSONNEL, AND PROPERTY OF FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION.

Section 401. DISSOLUTION. This section provides for the dissolution of FSLIC within 60 days of enactment of this legislation. It also provides for all insurance and receivership functions of FSLIC to be performed by the FDIC or the RTC after enactment.

Section 402. CONTINUATION OF RULES. This section provides that all rules and regulations of the FSLIC or the Board in effect on the date of enactment which relate to insurance of accounts, administration of the insurance fund or conduct of conservatorships or receiverships shall remain in effect and be enforced by the FDIC or the RTC. All other rules and regulations of the FSLIC shall remain effective and enforceable by the FHLBS. The Chairman of FDIC and the Chairman of FHLBS are required to identify the rules and regulations referred to in this section within 60 days of enactment and to publish notice thereof in the Federal Register. The FDIC is vested with authority to promulgate and enforce rules to prevent actions by savings associations which could pose a serious threat to the Savings Association Insurance Fund or the Bank Insurance Fund.

Section 403. PERSONNEL. Subsection (a) requires the Chairman of the FHLBS and the Chairman of the FDIC to identify employees of FSLIC and the Board whose functions will be transferred to FDIC under the Act.

Paragraph (a)(1) provides certain rights for employees who elect to transfer to FDIC. All employees so identified shall be offered a position with FDIC. Employees are to be transferred to FDIC within 60 days of enactment. This transfer is deemed a transfer of function under applicable RIF regulations. All employees transferred will be placed in a competitive area separate from those already in existence at FDIC. In placing transferred employees under RIF procedures, FDIC may assign excepted service employees to competitive service positions and may convert transferred positions from the excepted service to the competitive service. Any transferred employee placed by FDIC in a competitive service position shall be given career or career-conditional status. Transferred employees shall be given their RIF notices within 90 days after transfer. Such employees will be accorded pay and grade retention under the principles reflected in applicable OPM regulations.

Paragraph (a)(2) provides certain rights to employees who decline to transfer. Such employees will be given severance pay under applicable regulations. FHLBS will pay for severance pay. Such employees will also be granted placement assistance by OPM for 120 days.

Paragraph (a)(3) also provides certain rights for employees who transfer to FDIC but then decline an offer of employment. Such employees are provided severance pay like that provided to employees who decline to transfer. Such employees are also eligible for early out retirement as long as they do not decline a reasonable offer of employment. This paragraph also permits FDIC to offer early out retirement to employees if it has a reorganization of the combined workforces within one year after completion of the transfer.

Paragraph (a)(4) permits all transferred employees to retain any benefit or membership which the employee had at the date of enrollment provided the FHLBS continues the benefit or program for its employees. The FHLBS will pay any difference between the cost of such benefits and the cost to FDIC of providing such benefits.

Section 404. DIVISION OF PROPERTY AND PERSONNEL. This section provides that the Chairman of FHLBS with the Chairman of FDIC shall divide all personnel and property of FSLIC between their organizations within 60 days of enactment. Any dispute will be settled by the Office of Management and Budget.

Section 405. REPEALS. This section repeals sections 401, 402, 403, 404, 405, 406, 407, 411, 415, and 416 of the National Housing Act. The foregoing does not effect provisions of such sections that have been transferred to other surviving statutory provisions.

Section 406. REPORT. This section requires FSLIC, prior to its dissolution, to provide a written report to Treasury, the Office of Management and Budget and Congress.

TITLE V - FINANCING FOR THRIFT RESOLUTIONS.

Subtitle A -- Resolution Trust Corporation

Sec. 501. RESOLUTION TRUST CORPORATION ESTABLISHED. Section 501 provides for the establishment of the Resolution Trust Corporation (the "Corporation") and describes its powers and authorities. The Oversight Board of the Corporation and the Corporation itself are stated to not be "agencies" or "executive agencies" under Title 5 of the United States Code.

Section 501 provides that the purpose of the Corporation is to carry out a program, under the direction of the Oversight Board, to manage and resolve all cases involving institutions, the accounts of which were insured by the Federal Savings and Loan Insurance Corporation, prior to enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, for which a receiver or liquidating conservator had been appointed since January 1, 1989, or is appointed within the three-year period following the date of the enactment of that Act; to manage the assets of the Federal Asset Disposition Association; and to perform other authorized functions. In its resolution activities, the Resolution Trust Corporation is authorized to take warrants, voting and nonvoting equity, or other participation interests in resolved institutions or assets or properties acquired in connection with resolution. In carrying out its obligations, the Corporation is provided with all of the case resolution and financial assistance rights and powers provided to the Federal Deposit Insurance Corporation, provided that in resolving an institution, the Corporation must not provide assistance in excess of the amount determined to be reasonably necessary to save the cost of liquidating.

Section 501 further provides that the membership of the Oversight Board of the Resolution Trust Corporation shall consist of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Attorney General of the United States, or their respective designees, with the Chairman being the Secretary of the Treasury. The term of each member of the Oversight Board will expire when the Corporation is terminated and vacancies on the Oversight Board will be filled in the same manner as the vacant position was previously filled. Members of the Oversight Board are permitted to receive reasonable allowance for necessary expenses of travel, lodging, and subsistence incurred in attending meetings and other activities of the Oversight Board, consistent with maximum travel expense limitations provided in Title 5 of the United States Code. The duty of the Oversight Board is to review and have overall responsibility over the work, progress, management and activities of the Corporation and may disapprove, in its discretion, any and all regulations, policies, procedures, guidelines, statements, contracts, and other actions of the Corporation. It is further required to approve or disapprove, in its discretion, any and all agreements for the purchase of assets and assumption of liabilities, any and all agreements for the acquisition, consolidation or merger, or any other transaction proposed by the Corporation. All decisions of the Board require an affirmative vote of at least a majority of the members voting. The Oversight Board is authorized to employ necessary staff, which shall be subject to the terms and conditions of employment applicable to the Corporation, provided that the Oversight Board should utilize to the extent practicable the personnel of the agencies of the three members of the Oversight Board, without additional compensation to carry out the Oversight Board's staff functions. Finally, the Oversight Board should adopt necessary rules and keep permanent and accurate records of its acts and proceedings.

Section 501 also provides that a chief executive officer of the Corporation must be selected by the Oversight Board to serve at the pleasure of the Board.

Section 501 provides the corporate powers of the Corporation under the direction of the Oversight Board to be as follows: to have a corporate seal; to issue capital certificates; to provide for officers, employees and agents; subject to the approval of the Oversight Board, to hire, promote, compensate, and discharge officers and employees of the Corporation, without regard to title 5, United States Code, provided that compensation and benefits of such employees shall be consistent with those of the Federal Deposit Insurance Corporation; to prescribe by the Oversight Board its bylaws; with the consent of any executive department or agency, to use the information, services, staff, and facilities of such in carrying out this title; to enter into contracts and make advances, progress, or other payments with respect to such contracts; to acquire, hold, lease, mortgage, or dispose of, at public or private sale, real and personal property, and otherwise exercise all the usual incidents of ownership of property necessary and convenient to its operations; to obtain insurance against loss; to modify or consent to the modification of any contract or agreement to which it is a party or in which it has an interest under this title; to deposit its securities an its current funds under the terms and conditions applicable to the Federal Deposit Insurance Corporation under Section 13(b) of the Federal Deposit Insurance Act and pay fees therefor and receive interest thereon as may be agreed; and to exercise such other powers as set forth in this title, and such incidental powers as are necessary to carry out its powers, duties and functions in accordance with this title.

In addition, Section 501 provides that the Resolution Trust Corporation has special powers as follows:

1. To enter into contracts with the Federal Deposit Insurance Corporation (which is required to be the primary manager that will manage assets and institutions unless otherwise specifically provided by the Oversight Board) and with such other persons or entities, public and private, as it deems advisable and necessary in order to manage the institutions for which it is responsible and their assets. All contracts with persons or entities other than the Federal Deposit Insurance Corporation are required to be subject to a competitive bid process.

2. To set the policy on credit standards to be used by an institution for which it is responsible.

3. To require a merger or consolidation of an institution for which it is responsible.

4. To organize one or more Federal mutual savings associations, which must be chartered by the Federal Home Loan Bank System and insured by the Federal Deposit Insurance Corporation through the Savings Association Insurance Fund.

5. To review and analyze all insolvent institution cases resolved by the Federal Savings and Loan Insurance Corporation since January 1, 1988, through the date of enactment of this Act,

and to actively review all means by which it can reduce costs under existing Federal Savings and Loan Insurance Corporation agreements, including through the exercise of rights to restructure such agreements, subject only to the monitoring of the Oversight Board. The Corporation is required to report to the Oversight Board the results and conclusions of its examination, and thereafter the Corporation, as permitted by the terms of any resolution agreement and upon the express concurrence of the Oversight Board, may restructure such agreements where savings would be realized therefrom, the costs of which restructuring shall be a liability of the Corporation.

6. To exercise all resolution powers and activities authorized to be exercised by the Federal Deposit Insurance Corporation and the former Federal Savings and Loan Insurance Corporation, including but not limited to the powers and authorities with respect to receiverships or conservatorships, to engage in assistance transactions, to collect indebtedness, to enforce liabilities and obligations, and to exercise relevant incidental powers.

7. To exercise such other incidental powers that the Corporation determines to be necessary to carry out its purposes.

With respect to institutions managed by the Corporation (those organized as federal mutuals by the Corporation) Section 501 provides that they are subject to conditions and limitations imposed by the Corporation on the following: growth of assets; lending activities; asset acquisitions (except as necessary to serve its existing customer base with residential mortgages or consumer loans); use of brokered deposits; and payment of deposit rates. It is further provided that all such savings associations are subject to all laws, rules, and regulations otherwise applicable to them as insured savings associations, and to their appropriate regulators.

Section 501 requires the Corporation to convert the Federal Asset Disposition Association ("FADA") to a corporation or other business entity and sell it, wind it down, or dissolve it, no late than 180 days after enactment of this law. If FADA is sold, no contract rights to manage savings association resolutions would be transferred.

Section 501 authorizes the Corporation to issue nonvoting capital certificates to the Resolution Funding Corporation in an amount equal to the aggregate amount of funds provided to it by the Resolution Funding Corporation. The Corporation may not pay dividends on is capital certificates. The Corporation, the capital, reserves, and surplus thereof, and the income derived therefrom, are exempt from Federal, State, municipal, and local taxation except taxes on real estate held by the Corporation, according to its value as other similar property held by other persons is taxed. Finally, the Corporation is required to terminate five years after this law is enacted. Simultaneously with the termination of the Corporation, all its assets and liabilities must be transferred to the FSLIC Resolution Fund to be managed by the Federal Deposit Insurance Corporation with the proceeds of the net assets being provided to the Resolution Funding Corporation to pay interest costs.

Section 501 provides for jurisdiction of law suits in which the Corporation is a party.

Section 501 further provides that guarantees issued by the Federal Savings and Loan Insurance Corporation after January 1, 1989, and before the date of enactment of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, made in connection with liquidity advances made to savings associations by the Federal Reserve Banks and Federal Home Loan Banks (the "Lenders") and guaranteed by the Federal Savings and Loan Insurance Corporation during such period, become by operation of law obligations of the Corporation. These obligations under the guarantees to the Lenders are required to be paid by the Corporation one year after the date of enactment of this law (to the extent that the loans have not previously been paid) using any funds or other assets available to the Corporation, including resources available to it through borrowing by the Resolution Funding Corporation.

Section 501 authorizes the Corporation to issue such regulations, policies, procedures, guidelines, or statements as that

Corporation considers necessary or appropriate to carry out its functions.

Finally, Section 501 provides the Corporation with an emergency line of credit from the Treasury, and authorizes and directs the Secretary of the Treasury to loan to the Corporation on such terms as may be fixed by the Secretary of the Treasury amounts not exceeding in the aggregate $5,000,000,000 outstanding at any one time.

Subtitle B -- Resolution Funding Corporation

Section 502. RESOLUTION FUNDING CORPORATION ESTABLISHED. Section 502 amends the Federal Home Loan Bank Act to add a new section 21b that establishes a corporation to be known as the Resolution Funding Corporation (hereinafter referred to as the "Funding Corporation") to provide funds to the Resolution Trust Corporation ("RTC") through the issuance of debt obligations to the public. New section 21b requires the Federal Home Loan Banks ("FHLBanks" or "Banks") to invest in the newly created Funding Corporation, which, in turn, will be required to invest in the RTC. Under subsection (b) of new section 21b, the Chairman of the Federal Home Loan Bank System ("Chairman") is required to charter the Funding Corporation no later than five days after the enactment of this title V of the Financial Institutions Reform, Recovery and Enforcement Act of 1989.

Subsection (c) of new section 21b provides for a Directorate that will manage the Funding Corporation. The Directorate will be composed of three members, one of whom will be the Director of the Office of Finance of the FHLBanks or his successor, and two of whom will be selected by the Oversight Board of the Resolution Trust Corporation ("Oversight Board") from among the presidents of the FHLBanks. Each of the two FHLBank presidents will serve for a term of three years. With respect to the initial terms of the two presidents, one such president will be appointed for a term of two years and one will be appointed for a term of three years, and thereafter, each member will be appointed for a term of three years. No president of a FHLBank will be selected to serve an additional term on the Directorate unless each of the FHLBank presidents had already served at least as many terms as the president being selected to serve the additional term. The Oversight Board will select a chairperson of the Directorate from among the three members. Paragraph (9) of subsection (c) provides that members of the Directorate will not receive any compensation from the Funding Corporation for their service on the Directorate.

Paragraph (6) of subsection (c) of new section 21b provides that the Funding Corporation will have no paid employees, and that the Directorate, with the approval of the Chairman, can authorize the officers, employees, or agents of the FHLBanks to act for and on behalf of the Funding Corporation to carry out the functions of the Funding Corporation.

Paragraph (7) of subsection (c) provides that all administrative expenses, issuance costs and custodian fees will be paid by the FHLBanks. The amount each FHLBank will pay will be determined by the Oversight Board with each Bank paying a pro rata amount based upon its required capital stock investment in the Funding Corporation. Administrative expenses of the Funding Corporation do not include the interest on its obligations. The terms "issuance costs" and "custodian fees" are defined under subsection (k) of this new section 21b.

Subsection (d) of new section 21b provides for the corporate powers of the Funding Corporation. The Funding Corporation, subject to the other provisions of this section and to the regulations, orders and directions as may be prescribed by the Oversight Board, will have the corporate powers necessary and appropriate for its operations as a specialized corporate entity. Such corporate powers include the power to issue nonvoting capital stock to the FHLBanks; to purchase capital certificates issued by the RTC; to borrow from the capital markets by issuing debt, the proceeds of which will be invested in the RTC, or used to refund obligations whose proceeds were so invested, under terms and conditions approved by the Oversight Board; and other powers which are customary and usual for corporations generally.

The Funding Corporation will be owned by the FHLBanks and will be used as a means of purchasing capital certificates issued by the RTC. Paragraph (1) of subsection (e) of new section 21b requires each FHLBank to invest in the nonvoting capital stock of the Funding Corporation at such time and in such amounts as prescribed by the Oversight Board. The stock issued by the Funding Corporation to the FHLBanks will have a par value determined by the Oversight Board and will be transferable only among the FHLBanks as prescribed by the Oversight Board at not less than par. The Banks' investment will be lawful, notwithstanding limitations found elsewhere in the Federal Home Loan Bank Act.

Paragraph (3) of subsection (e) of new section 21b limits the cumulative investment for capitalization of the Funding Corporation by each FHLBank to the aggregate of its legal reserves plus "undivided profits" minus amounts the Banks will have used to invest in the capital stock of the Financing Corporation. This limitation will be calculated by adding each Bank's legal reserves on December 31, 1988, plus "undivided profits" on such date, minus amounts invested in the Financing Corporation as of such date, and by adding, for the period December 31, 1988 through December 31, 1991, or such later date as necessary to fund the Funding Corporation Principal Fund, legal reserves plus "undivided profits" minus amounts required to be used to invest in the Financing Corporation. For purposes of the Banks' investment in the Funding Corporation, the language referring to "legal reserves" and "undivided profits" will include all retained earnings of the FHLBanks except for those amounts held in the "dividend stabilization reserve" as of

December 31, 1985, and amounts required to be used by the FHLBanks to purchase capital stock in the Financing Corporation.

The "dividend stabilization reserve" will be excluded from investment in the Funding Corporation because it includes funds, above the legal reserves, that had been determined not to be paid as dividends in the year earned, so as to create a possible supplement to future years' dividends. To ensure that only amounts held in the "dividend stabilization reserve" as of December 31, 1985, are excluded from the amounts that may be invested in the Funding Corporation, the legislation cross-references the table set forth in section 21(a)(7) of the Federal Home Loan Bank Act, which table specifically lists the amounts held by each FHLBank in its "dividend stabilization reserve" as of December 31, 1985. For purposes of this section, "undivided profits" includes retained earnings other than legal reserves and amounts held in the "dividend stabilization reserve" as of December 31, 1985. "Legal reserves" refers to the amount each FHLBank has and is required to carry to a reserve account pursuant to the first two sentences of Section 16(a) of the Federal Home Loan Bank Act.

Under paragraph (4) of subsection (e) of new section 21b, each FHLBank is required to purchase a specified percentage of the first $1 billion of stock in the Funding Corporation. The percentage of the first $1 billion that each Bank is required to invest in nonvoting capital stock of the Funding Corporation is derived from a formula taking into account each Bank's individual share of total FHLBank System retained earnings (minus their "dividend stabilization reserves" and amounts used to invest in the capital stock of the Financing Corporation") and the share of deposits insured by the Federal Savings and Loan Insurance Corporation ("FSLIC") immediately prior to the enactment of this Act held by each Bank's member savings associations. By taking into account the shares of such FSLIC-insured deposits held by a Banks' member savings associations, the formula accommodates Banks' member savings associations that were insured by the Federal Deposit Insurance Corporation ("FDIC") immediately prior to the enactment of this Act.

Under paragraph (5) of subsection (e), allocation of the remaining stock purchases is based on the percentage of total assets of members insured by FSLIC immediately prior to the enactment of this Act represented at each Bank; however, no Bank is required to exceed the limitation set forth in paragraph (3) of subsection (e). The aggregate amount of Funding Corporation stock that must be purchased by all of the FHLBanks is not reduced because of the limitation in that paragraph. Therefore, paragraph (6) of subsection (e), described below, provides for a reallocation of stock purchases among Banks that have not reached their limits.

Paragraph (6) of subsection (e) of new section 21b provides that if a FHLBank cannot purchase the full amount of stock in the

Funding Corporation because that amount exceeded its legal reserves plus undivided profits minus the amount the Bank used to invest in the Financing Corporation, the amount that the Bank cannot purchase will be prorated for investment among the remaining FHLBanks based on their stock holdings in the Funding Corporation, as long as the cumulative amount of funds required to be invested by the remaining Banks did not exceed their legal reserves plus undivided profits minus the amounts used to invest in the Financing Corporation.

Any FHLBank that did not purchase the full amount of Funding Corporation capital stock as required under the formula in paragraph (5) will be required to purchase, annually at the issuance price, from those Banks to which such stock was reallocated, the stock originally allocated to it under such paragraph. The amount of such stock repurchases will be determined by the Oversight Board by prorating among the FHLBanks, based upon the amount reallocated to and purchased and held by such Banks, the amount available for such purchases. The "amount available" includes all retained earnings of the Bank on whose behalf an investment has been made under subparagraph (A)(i), less certain amounts. The "amount available" does not include the Bank's special dividend stabilization reserve (as of December 31, 1985), nor an amount of retained earnings equal to the amount of Funding Corporation and Financing Corporation capital stock already purchased by the Bank. Until the restricted Bank has fulfilled this repurchase obligation, it is prohibited from paying dividends in excess of one-quarter of its net earnings available for dividends. Such funds not paid out in dividends are to be placed in a reserve account required by the Oversight Board and will not be available for dividends.

Paragraph (7) of subsection (e) of new section 21b provides for additional sources of funds for the Funding Corporation Principal Fund in the event that each FHLBank has exhausted the investment amount applicable with respect to such Bank under paragraph (3) (and paragraph (9), described below), as calculated under paragraphs (4), (5) and (6) of subsection (e). Subparagraph (A) of paragraph (7) provides that, first, the Funding Corporation, with the approval of the Board of Directors of the FDIC, will assess each Savings Association Insurance Fund member an assessment as if such assessment was assessed by the FDIC with respect to Savings Association Insurance Fund members pursuant to section 7 of the Federal Deposit Insurance Act, as amended. The maximum amount of the aggregate amount assessed, however, will be the amount of additional funds necessary to fund the Funding Corporation Principal Fund; provided that the amount assessed under this subparagraph (A) and the amount assessed by the Financing Corporation under section 21 of the Federal Home Loan Bank Act will not exceed the amount authorized to be assessed pursuant to section 7 noted above. The Financing Corporation will have first priority to make such assessments. All such amounts assessed under this subparagraph (A) will be subtracted from the amounts authorized to be assessed by the FDIC pursuant to section 7 noted above.

To the extent funds available pursuant to subparagraph (A) are insufficient to capitalize the Funding Corporation so as to provide funds for the Funding Corporation Principal Fund, then the FDIC will transfer to the Funding Corporation from the receivership proceeds of the FSLIC Resolution Fund the remaining amount of funds necessary for such purpose.

Paragraph (9) of subsection (e) of new section 21b provides that notwithstanding any other limiting provisions in sections 21, 21a and 21b of the Federal Home Loan Bank Act, the aggregate annual amount that will be contributed by the FHLBanks from their annual earnings under subsections (e)(3)(B) and (f)(2)(B) of this section (for the period from the date of enactment of this Act, until such time as the Funding Corporation has no more liabilities) for Funding Corporation principal and interest payments and Financing Corporation principal payments under section 21 of the Federal Home Loan Bank Act, for any given year, will be $300,000,000; provided, however, that such aggregate annual amount will be such lesser number equal to all the amounts needed for the purposes of subsection (e), as determined by the Oversight Board, if such total amounts will be less than $300,000,000. This amount will be in addition to the approximately $2,000,000,000 by the FHLBanks to be contributed from their retained earnings as of December 31, 1988, which are not needed by the existing Financing Corporation.

Paragraph (1) of subsection (f) of new section 21b authorizes the Funding Corporation, subject to the direction of the RTC, to issue up to $50,000,000,000 in debt obligations. Paragraph (2) of subsection (f) provides for the payment of interest on such obligations. The Funding Corporation will pay the interest due on (and any redemption premium with respect to) Funding Corporation obligations from funds obtained for such interest payments from certain specified sources described below.

Subparagraph (A) requires the RTC to pay to the Funding Corporation the net proceeds received by the RTC from the liquidation of institutions under its management, pursuant to new section 21a of the Federal Home Loan Bank Act, to the extent they are determined by the Oversight Board to be in excess of funds necessary for resolution costs in the near future, and any proceeds from warrants and participations of the RTC.

Subparagraph (B) provides that to the extent the funds available from the RTC pursuant to subparagraph (A) are insufficient to cover the amount of interest payments on the obligations, then the FHLBanks will pay to the Funding Corporation the aggregate annual amount of $300,000,000, minus the amounts needed by the Financing Corporation pursuant to section 21 of the Federal Home Loan Bank Act and for the purchase of Funding Corporation capital certificates, with each Bank's individual share to be determined pursuant to the formulation and limitations of paragraphs (3) through (6) of subsection (e).

Subparagraph (C) provides that the proceeds of all net assets of the RTC, upon its dissolution, will be transferred to the Funding Corporation to be used for interest payments before any Treasury funds are used.

Finally, subparagraph (D) provides that, to the extent that the Directorate determines after consultation with and approval of the Secretary of the Treasury that the Funding Corporation is unable to pay the interest on any obligation issued under this subsection from the sources of funds under (A), (B), and (C), the Secretary of the Treasury will pay to the Funding Corporation the additional amount due which will be used by the Funding Corporation to pay such interest. In each case where the Secretary of the Treasury is required to make a payment under this paragraph to the Funding Corporation, the amount of the payment will become a liability of the Funding Corporation that will be repaid to the Secretary of the Treasury upon dissolution of the Funding Corporation to the extent that the Funding Corporation may have any remaining assets. There is authorized to be appropriated to the Secretary of the Treasury, for fiscal year 1989 and each fiscal year thereafter, such sums as may be necessary to carry out this paragraph.

Paragraph (3) of subsection (f) provides that on maturity of an obligation issued by the Funding Corporation under this subsection, the obligation will be repaid by the Funding Corporation from the liquidation of noninterest bearing instruments held in the Funding Corporation Principal Fund. The Funding Corporation will obtain funds for such Principal Fund from the sources of funds obtained pursuant to subsection (e). All of such funds will be invested in noninterest bearing instruments which are described in paragraph (1) of subsection (g) of this new section 21b.

Paragraph (4) of subsection (f) provides that, subject to the terms and conditions as approved by the Oversight Board, the gross proceeds of any obligation issued by the Funding Corporation will be used to purchase capital certificates issued by the RTC or to refund any previously issued obligation the proceeds of which were invested in the capital certificates of the RTC.

Under paragraph (5) of subsection (f) of new section 21b, obligations of the Funding Corporation with the approval of the Oversight Board, like FHLBank obligations, will be lawful investments and may be accepted as security for all fiduciary, trust, and public funds, the investment or deposit of which will be under the authority or control of the United States or any officer thereof.

Under paragraph (6) of subsection (f) of new section 21b, obligations of the Funding Corporation will be treated in the same manner as FHLBank obligations for purposes of investment, sale, underwriting, purchase, use as collateral, and dealing by financial institutions such as banks, thrifts, and credit unions.

Under paragraph (7) of subsection (f) of new section 21b, obligations issued by the Funding Corporation will have the same tax status as obligations of the FHLBanks. Thus, interest earned on those obligations will be taxable as income at the Federal, but not the State level.

Under paragraph (8) of subsection (f) of new section 21b, obligations issued by the Funding Corporation will be exempt securities under the provisions of the Federal securities laws administered by the Securities and Exchange Commission.

Paragraph (9) of subsection (f) of new section 21b, requires the Oversight Board and the Directorate to ensure that minority owned or controlled commercial banks, investment banking firms, underwriters, and bond counsels throughout the United States have an opportunity to participate to a significant degree in any public offering of obligations issued by the Funding Corporation under this section.

Under paragraph (10) of subsection (f) of new section 21b, the Funding Corporation's obligations will not be obligations of or guaranteed as to principal by the Chairman of the Federal Home Loan Bank System, the FHLBanks, the United States, or the RTC. The Secretary of the Treasury will pay interest on such obligations as required by subsection (f) of this section.

Subsection (g) of new section 21b sets forth the use and disposition of assets of the Funding Corporation not required to be invested in the RTC, not required for current interest payments, and not required for the Funding Corporation Principal Fund. Paragraph (1) provides that, subject to the regulations, restrictions, an limitations prescribed by the Oversight Board, such assets will be invested in the instruments described in subparagraphs (A), (B), (C) and (D), which are the same instruments FHLBanks are permitted to invest their resources under section 16 of the Federal Home Loan Bank Act.

Paragraph (2) of subsection (g) requires the Funding Corporation to invest in and hold in a segregated account, zero coupon instruments, Treasury STRIPS or other noninterest bearing instruments, as described in paragraph (1) of that subsection, of which the total principal payable at maturity will approximately be equal to the aggregate amount of principal on the Funding Corporation's obligations. The purpose of this segregated account is to assure the repayment of principal on the Funding Corporation's obligations.

Under paragraph (1) of subsection (h) of new section 21b, the Funding Corporation will have the same tax status as the FHLBanks. In addition under paragraph (1), the Secretary of the Treasury is authorized to prepare the necessary forms of stock, debentures, and bonds, as approved by the Oversight Board, pursuant to section 23 of the Federal Home Loan Bank Act, for obligations of the Funding Corporation, as the Secretary of the Treasury is also so authorized for obligations of the FHLBanks.

Paragraph (2) of subsection (h) of new section 21b provides that the Federal Reserve banks are authorized to act as depositaries for or fiscal agents or custodians of the Funding Corporation.

Paragraph (3) of subsection (h) of new section 21b accords the Funding Corporation, although the Corporation will have no Government capital invested in it, the same coverage under the Government Corporations Control Act as the FHLBanks are accorded under that Act pursuant to section 11(j) of the Federal Home Loan Bank Act (12 U.S.C. 1431(j). Thus, audits of the Funding Corporation will be conducted by the General Accounting Office. In addition, the Secretary of the Treasury, a Federal Reserve Bank, or a bank designated as a depository or fiscal agent of the United States Government has the authority to keep funding Corporation accounts (although the Secretary of the Treasury can waive the provision regarding accounts). Furthermore, before the Funding Corporation can issue obligations and offer them to the public, the Secretary of the Treasury will prescribe the various conditions to which the obligations will be subject (including the form, denomination, maturity, and interest rate), the way and time the obligations will be issued, and the price for which the obligations will be sold. This procedure is currently in place for the issuers who are subject to Section 9108(a) of title 31, United States Code (part of the Government Corporations Control

Act) and in practice the Treasury generally approves terms and conditions on obligations as proposed by these issuers. Finally, before the Funding Corporation could buy or sell a direct obligation of the United States Government, or an obligation on which the principal, interest, or both, is guaranteed, of more than $100,000, the Secretary of Treasury will have to approve the purchase or sale, although the Secretary can waive this requirement. All of these authorities also pertain to the FHLBanks' issuance of debt.

Paragraph (4) of subsection (h) of new section 21b provides that any civil action, suit or proceeding to which the Funding Corporation is a party, will be deemed to arise under the laws of the United States, and the U.S. District Court for the District of Columbia will have original jurisdiction over any such action, suit or proceeding. The Funding Corporation is authorized, without bond or security, to remove any such action, suit or proceeding from a State court to the U.S. District Court for the District of Columbia.

Subsection (i) of new section 21b provides for the termination of the Funding Corporation. The Funding Corporation will be dissolved, as soon as practicable, after the date by which all the RTC capital certificates purchased by the Funding Corporation have been retired. On the effective date of the Funding Corporation's dissolution, the Oversight Board will be authorized to exercise any power of the Funding Corporation in order to conclude its affairs. Upon termination, the remaining funds will be transferred to the Treasury to the extent of funds provided to the Funding Corporation over the years and interest thereon, with any remainder to the FHLBanks in retiring the capital stock.

Subsection (j) of new section 21b provides that the Oversight Board will be authorized to prescribe such regulations as may be necessary to carry out the provisions of new section 21b including issuing regulations to define the terms used in the section.

Subsection (k) of new section 21b defines certain terms that are used in the section. Paragraph (1) defines "insured savings association" to mean a savings association as such term is defined by section 3(u) of the Federal Deposit Insurance Act and which was insured by FSLIC immediately prior to the date of enactment of this Act. Paragraph (2) defines the "Oversight Board" to mean the Oversight Board of the RTC, and after termination of the RTC to mean the Secretary of the Treasury, the Chairman of the Federal Reserve Board and the Attorney General of the United States. Paragraph (4) defines "issuance costs" to mean issuance fees and commissions incurred by the Funding Corporation in connection with the issuance or servicing of any of the Funding Corporation's obligations, and includes legal and accounting expenses, trustee and fiscal paying agent charges, costs incurred in connection with preparing and printing offering materials, and advertising expenses to the extent these costs is incurred in connection with issuing any obligation. Paragraph (5) defines "custodian fees" to mean any fee incurred by the Funding Corporation in connection with the transfer of or maintenance of any security in the segregated account established under subsection (g), and any other expense incurred in connection with the establishment and maintenance of the segregated account.

Section 503. FINANCING CORPORATION. This section amends section 21 of the Federal Home Loan Bank Act which established the Financing Corporation. Subsections (1), (2), (3) and (4) of this section 503 provide for technical amendments to section 21. These amendments essentially provide that after the enactment of this Act the Financing Corporation, if necessary, will purchase capital certificates or capital stock issued by the FSLIC Resolution Fund, which will be the successor to the Federal Savings and Loan Insurance Corporation ("FSLIC"). These certificates and stock will not pay dividends, and any payment on them to the Financing Corporation upon termination of the FSLIC Resolution Fund will be subordinate to any liability to Treasury for the monies it has provided to that Fund.

Section 503 also replaces, with a new provision, the existing subsection (f) of section 21 which authorized the Financing Corporation to assess FSLIC insured institutions for amounts necessary to obtain interest payments for Financing Corporation obligations. The new provisions identify the sources of funds for interest payments to be as follows:

Paragraph (1) includes the Financing Corporation assessments which were assessed on insured institutions pursuant to subsection (f) of this section prior to the enactment of this Act.

Paragraph (2) provides that the Financing Corporation, with the approval of the Board of Directors of the Federal Deposit Insurance Corporation, will assess on each insured Savings Association Insurance Fund member an assessment as if such assessment was assessed by the Federal Deposit Insurance Corporation with respect to Savings Association Insurance Fund members pursuant to section 7 of the Federal Deposit Insurance Act. The amount assessed hereunder, however, and the amount assessed by the Funding Corporation under section 21b of the Federal Home Loan Bank Act will not exceed the amount authorized to be assessed under section 7 of the Federal Deposit Insurance Act, and that the Financing Corporation will have first priority to make such assessments. In addition, all assessments made by the Financing Corporation under section (2) and the Funding Corporation under section 21b of the Federal Home Loan Bank Act will be subtracted from the amounts authorized to be assessed by the Federal Deposit Insurance Corporation under section 7 of the Federal Deposit Insurance Act.

Paragraph (3) provides that to the extent the funds available pursuant to paragraphs (1) and (2) are insufficient to cover the amount of interest payments on the obligations, then the Federal Deposit Insurance Corporation will transfer to the Financing Corporation from the proceeds of the FSLIC Resolution Fund the remaining amount of funds necessary for the Financing Corporation to make interest payments only to the extent the funds are not required by the Resolution Funding Corporation for the Funding Corporation Principal Fund under section 21b of the Federal Home Loan Bank Act.

Section 503 also defines "insured savings association" to mean a savings association as such term is defined by section 3(U) of the Federal Deposit Insurance Act and which was insured by the Federal Savings and Loan Insurance Corporation immediately prior to the date of enactment of this Act.

Section 504. Section 504 is a technical amendment to add the Funding Corporation to the list of "mixed ownership" government corporations under the Government Corporations Control Act. Although there will be no government capital invested in the Funding Corporation, this category of "mixed ownership" has been accorded to the Funding Corporation to provide it with parallel legal status to that of the FHLBanks.

TITLE VI - THRIFT ACQUISITION ENHANCEMENT PROVISIONS

Section 601. ACQUISITION OF THRIFTS BY BANK HOLDING COMPANIES. Section 601 amends the Bank Holding Company Act effective two years after the date of enactment, to specifically permit the Federal Reserve Board to allow bank holding companies to acquire any savings association, not only failed or failing ones as the Board currently permits. The section also specifies that effective immediately the Board shall not impose restrictions on transactions between the savings association and its holding company affiliates other than those imposed generally by the affiliate transactions statutes at sections 23A and 23B of the Federal Reserve Act or other applicable statutes. This section is intended to direct the Board not to impose its so-called "tandem operations" restrictions on bank holding companies that acquire thrift institutions.

Section 602. INVESTMENTS BY SAVINGS AND LOAN HOLDING COMPANIES IN UNAFFILIATED THRIFT INSTITUTIONS. Section 602 amends the provisions governing savings and loan holding companies (section 408 of the National Housing Act, 12 U.S.C. 1730a, in current law; to be transferred into the Home Owners' Loan Act) to allow a savings and loan holding company to hold up to 5 percent of the voting shares of an unaffiliated savings association or savings and loan holding company. This provision also permits multiple savings and loan holding companies to acquire up to 5 percent of the voting shares of any company. Current law prohibits any such ownership in savings associations other than a controlling ownership. This revised treatment is intended to mirror the ability of bank holding companies to acquire up to 5 percent of the voting shares of unaffiliated banks.

Section 603. TECHNICAL AMENDMENT TO THE BANK HOLDING COMPANY ACT. Section 603 amends the Bank Holding Company Act (12 U.S.C. 1841) to define the terms "insured institution" and "savings association." The definition used incorporates the definition in the Home Owners' Loan Act, as amended.

TITLE VII - FEDERAL HOME LOAN BANK SYSTEM REFORMS

Subtitle A. --Federal Home Loan Bank Act Amendments

Section 701. DEFINITIONS. Section 701(a) would add a definition for "savings association" to the Federal Home Loan Bank Act. The definition conforms to the definition of that term in the amendments of the Home Owner's Loan Act found in Title III of this Act.

Section 701(b) creates a new paragraph (11) to Section 2 of the Federal Home Loan Bank Act (12 U.S.C. 1422) to state that the term "Chairman" used in the Federal Home Loan Bank Act, as amended, refers to the Chairman of the Federal Home Loan Bank System.

Section 701(c) is a technical amendment to the Federal Home Loan

Bank Act, the Home Owner's Loan Act, as well as any other Federal law in which a term thereof names the Federal Home Loan Bank Board. This section makes clear that the Chairman of the Federal Home Loan Bank System succeeds to all Federal statutory provisions affecting the Federal Home Loan Bank Board, including all prerogatives granted it by such laws except those expressly repealed or amended by this Act. Although this Act expressly amends selected references in several Federal statutes to the Federal Home Loan Bank Board to read, Chairman of the Federal Home Loan Bank System, this section is intended to amend all other existing references to the Federal Home Loan Bank Board to read Chairman of the Federal Home Loan Bank System.

SECTION 702. FEDERAL HOME LOAN BANK SYSTEM CHAIRMAN. This section amends Section 17 of the Federal Home Loan Bank Act (12 U.S.C. 1437) as follows:

Subsection (a) is amended by abolishing the Federal Home Loan Bank Board and vesting the powers and duties of the Federal Home Loan Bank Board and of its Chairman in the Chairman of the Federal Home Loan Bank System, who will continue to supervise and regulate the Federal Home Loan Banks. The Chairman of the Federal Home Loan Bank System will be subject to the general directions of the Secretary of the Treasury. This latter provision is similar to one for the Comptroller of the Currency and is intended to provide the Secretary with the same oversight authority over the Chairman of FHLBS as he currently has with respect to the Comptroller. The Chairman of the System will implement the Federal Home Loan Bank Act, the Home Owners Loan Act and other laws. The Chairman of the System will have rulemaking authority to implement those laws.

Subsection (b) is amended to provide that the Chairman of the System must be a citizen of the United States. He would be appointed by the President for a five year term with the consent of the Senate. The President would be able to remove the Chairman. The President would be required to communicate the reasons for removal to the appropriate committee of the Senate. The Chairman would continue to serve until a successor is appointed.

Subsection (c), provides that subject to the approval of the Secretary of the Treasury, the Chairman of the System is empowered to employ and fix the salaries of such employees, attorneys, and agents. The Chairman would have the authority to appoint agents as necessary to carry out his duties. The Chairman would be authorized to designate who will act in the Chairman's absence. The Chairman would have the authority to continue or establish collective offices or administrative units of the Federal Home Loan Banks and to appoint the heads of such entities after consulting the Federal Home Loan Banks. The Chairman would be authorized to delegate to an agent any power (except rulemaking).

Subsection (d) provides that the Chairman of the System has the authority to suspend or remove any director, officer, employee, or agent of any Federal Home Loan Bank or any joint office or administrative unit of such bank, and is revised only to require that the fact of suspension or removal be communicated to that person.

Subsection (e) provides that the salaries of the Chairman and other agents and employees will be paid from assessments levied on the Federal Home Loan Banks and that such assessments, like those imposed by the Comptroller of the Currency on national banks under 12 U.S.C. 481, shall not be construed as Government funds or appropriated monies. Compensation, other than that of the Chairman would be paid (as in the Comptroller's Office) without regard to other laws applicable to officers or employees of the United States.

Subsection (f) provides that the Chairman shall not have a financial interest in a member of a Federal Home Loan Bank.

Subsection (g) restates existing provisions of Section 17 to preserve authority exercised by the Board when it was a constituent agency of the Housing and Home Finance Agency.

Subsection (h) is amended to provide that the Chairman will make an annual report to Congress.

Section 703. ELECTION OF BANK DIRECTORS. This section would change the law by changing the manner of the selection of the directors of the Federal Home Loan Banks. It would establish three classes of directors, with three directors chosen for each class. The Class A directors would represent the stockholding members of the bank and be chosen by the stockholding members. Class C directors would represent the public and would be chosen by the Chairman of the Federal Home Loan Bank System. The Class B directors would be chosen by the Class A directors and the Class C directors to represent the housing industry and the financial services industry. The Chairman of the Federal Home Loan Bank System would appoint one of the Class C directors as the chairman of the board of directors of each Federal Home Loan Bank and one Class C Director as deputy chairman, who would serve in the absence of the chairman. The third Class C director would serve in the absence of the chairman and deputy chairman.

The provisions regarding the election of directors are, in large part, based on similar provisions governing the directors of Federal Reserve banks.

Section 704. FEDERAL HOME LOAN BANK LENDING. Section 704 authorizes the Federal Home Loan Banks to make loans to the Federal Deposit Insurance Corporation, subject to the concurrence of the Chairman of the Federal Home Loan Bank System, for the use of the Savings Association Insurance Fund and provides that such loans to the Corporation shall be a direct liability on that insurance fund. This provision is substituted for the current law provision, under which the Federal Home Loan Banks are authorized to make such loans to the Federal Savings and Loan Insurance Corporation.

Section 705. CHIEF SUPERVISORY OFFICER. Section 705(a) requires the senior supervisory employee of each Federal Home Loan Bank to report to the chief supervisory official of the Chairman of the Federal Home Loan Bank System. This section authorizes the Chairman of the Federal Home Loan Bank System to remove the senior supervisory employee of each Bank for cause. This section retains the title, established by the Federal Home Loan Bank Board through regulation, of Principal Supervisory Agent for the senior supervisory employee of each Bank. It is the intent of this section that the President of the district bank will no longer be responsible for the supervisory role of the district bank.

Section 705(b) amends the heading of section 19 of the Federal Home Loan Bank Act to reflect the substantive changes made in that section.

Section 706. THRIFT ADVISORY COUNCIL. Section 706 (1) amends section 8a of the Federal Home Loan Bank Act to change the name of the Federal Savings and Loan Advisory Council to the Thrift Advisory Council.

Section 706 (2) and (3) amend section 8a of the Federal Home Loan Bank Act to delete obsolete references to the Board of Trustees of the Federal Savings and Loan Insurance Corporation and to the Corporation itself.

Section 707. FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION INDUSTRY ADVISORY COMMITTEE. This section abolishes the Federal Savings and Loan Insurance Corporation Industry Advisory Committee.

Section 708. RATE OF INTEREST. This section repeals section 5b of the Federal Home Loan sank Act as that provision is obsolete.

Section 709. LIQUIDITY REQUIREMENTS. Section 709 (1) makes a technical change to section 5A of the Federal Home Loan Bank Act.

Section 709 (2) amends Section 5A by substituting at subsection (d) the Federal Deposit Insurance Corporation for the Federal Savings and Loan Insurance Corporation which would allow a penalty assessment for deficiency in compliance with the section's liquidity requirements made against a savings association to be paid to the Federal Deposit Insurance Corporation if the offending savings association is not a member of a Federal Home Loan Bank. It is intended that any penalty paid to the Federal Deposit Insurance Corporation under authority of section 5A of the Federal Home Loan Bank Act, as amended, will be for the use of the Savings Association Insurance Fund.

Section 709(3) makes a technical amendment to subsection (f) of section 5A of the Federal Home Loan Bank Act.

Section 709(4) would allow the Chairman of the Federal Home Loan Bank System to classify, by regulation, as a liquid asset such other assets as the Chairman of the System may determine comports with the purposes of subsection (a) of Section 5a, as amended.

Section 710. ADVANCES. Section 710(a) substitutes "savings association" for "insured institution" at subsection (e) of section 10 of the Federal Home Loan Bank Act.

Section 710(b) substitutes "Section 1467a" for "Section 1730a(a)(1)(A)" at paragraph (3)(A) of subsection (e) of section 10 of the Federal Home Loan Bank Act.

Section 710(c) substitutes "Section 1467a" for "Section 1730a (o) in paragraph (3)(B) of subsection (e) of section 10 of the Federal Home Loan Bank Act.

Section 710(d) substitutes "Section 1467a" for "Section 1730a(o)(5)(A) in paragraph (3)(C) of subsection (e) of section 10 or the Federal Home Loan Bank Act.

Section 711. CONFORMING FEDERAL HOME LOAN BANK ACT AMENDMENTS. Section 711(a) deletes a portion of section 1438(c)(5) of Title 12, United States Code, regarding the receipts from the sale of the Board's old building and receipts from a special assessment to build the current Board building.

Section 711(b) deletes a portion of section 1438(c)(6) of Title 12, United States Code, regarding the submission of a budget for the current Board building.

Section 711(c) repeals section 1438a of Title 12, United States Code as obsolete. It will no longer be necessary to differentiate between administrative and nonadministrative expenses of the Chairman of the Federal Home Loan Bank System.

Section 711(d) deletes the last sentence of section 1439 of Title 12, United States Code which refers to obsolete reference to nonadministrative expenses.

Section 711(e) deletes a portion of section 101 of Title I of the Act of June 16, 1943 (12 U.S.C. 1439a) which refers to a provision repealed by section 713 of this Act to conform with section 713 of this Act.

Section 711(f) amends section 111 of Title I of Public Law No. 93-495 to delete the term "the Federal Home Loan Bank Board."

Subtitle B. -- Conforming Amendments

Section 712. FEDERAL HOME LOAN MORTGAGE CORPORATION ACT

AMENDMENTS. Section 712 (1) changes the composition of the three member board of directors of the Federal Home Loan Mortgage Corporation to include, ex officio, the Chairman of the Federal Home Loan Bank System, who shall be chairman of the board of directors, the Secretary of the Treasury (or his designee), and the Secretary of Housing and Urban Development (or his designee), and provides that the board of directors may elect a Vice-Chairman.

Section 712 (2) substitutes the Resolution Trust Corporation for the Federal Savings and Loan Insurance Corporation in section 305 of the Federal Home Loan Mortgage Corporation Act, and also substitutes the term "Chairman" for the term "Board" in the last sentence of subsection (a)(2) of said section 305.

Section 713. REPEAL OF LIMITATION OF OBLIGATION FOR ADMINISTRATIVE EXPENSES. This section amends subsection (b) of section 7 of the First Deficiency Appropriation Act of 1936 to delete the terms "Federal Home Loan Bank Board", "Home Owner's Loan Corporation", and "Federal Savings and Loan Insurance Corporation."

The reference to the Home Owner's Loan Corporation is deleted because that instrumentality, once a component of the Federal Home Loan Bank Board, was dissolved in 1951.

Section 714. AMENDMENT OF ADDITIONAL POWERS OF CHAIRMAN.

Section 714(A) makes a technical amendment to subsection (c) of section 502 of the Housing Act of 1948, as amended, to strike out obsolete terms and substitute therefor the term, "Chairman of the Federal Home Loan Bank System."

Section 714(B) amends subsection (1) of subsection (c) of said section 502 by inserting the term "Federal" between the terms "of any" and "State or". This amendment will authorize the Chairman of the Federal Home Loan Bank System to accept or contract for services with another Federal agency.

Section 715. AMENDMENT OF TITLE 5, UNITED STATES CODE.
Section 715(A) makes a technical amendment to Section 5314 of Title 5, United States Code regarding the salary of the Chairman of the Federal Home Loan Bank System.

Section 715(B) adds a reference to sections 17a of the Federal Home Loan Bank Act (12 U.S.C. 1437) and section 19 of the Federal Home Loan Bank Act (12 U.S.C. 1439) to section 5373 of Title 5, United States Code in order to make that provision consistent with the mandate of section 702 of this Act that decisions regarding the salaries and administration of staff personnel employed by the Chairman of the Federal Home Loan Bank System are made by the Chairman, subject to approval by the Secretary of Treasury, without regard to any other laws regarding employees of the Federal Government.

Section 716. AMENDMENTS OF TITLE 31, UNITED STATES CODE. Section 716(A) creates a new section 307a of Title 31, United States Code to reflect the fact that the Chairman of the Federal Home Loan Bank System is subject to the general direction of the Secretary of the Treasury.

Section 716(B) adds a new paragraph (3) to subsection (c) of Section 321, Title 31, United States Code in order to clarify the relationship between the Chairman of the Federal Home Loan Bank System and the Secretary of the Treasury.

Section 716(C) adds the term "Office of the Chairman of the Federal Home Loan Bank System" to subsection (a) of section 714, Title 31, United States Code, in order to authorize audits by the Comptroller General.

Section 716(D) deletes a reference to the Federal Savings and Loan Insurance Corporation.

Section 717. AMENDMENT OF BALANCED BUDGET AND EMERGENCY DEFICIT CONTROL ACT PROVISIONS. Section 717(A) makes technical changes to subsection (1)(A) of subsection (g) of section 255 of the Balanced Budget and Emergency Deficit Control Act of 1985 to substitute the Chairman of the Federal Home Loan Bank System and Resolution Trust Corporation for the Federal Home Loan Bank Board and Federal Savings and Loan Insurance Corporation.

Section 717(B)(1) makes technical changes to subsection (4) of subsection (b) of said section 256 to substitute the Chairman of the Federal Home Loan Bank System and Resolution Trust Corporation for the Federal Home Loan Bank Board.

Section 717(B)(2) deletes a reference to the Federal Savings and Loan Insurance Corporation in said provision.

Section 718. AMENDMENT OF TITLE 18, UNITED STATE CODE.
Section 718(A) repeals sections 1008 and 1009 of Title 5, United States Code as obsolete.

Section 718(B)(1) strikes a reference in said section to the Federal Home Loan Bank Board and Home Owner's Loan Corporation and adds a reference to a Federal savings bank.

Section 718(B)(2)&(3) make technical changes in said section to reflect amendments made by this Act.

Section 718(B)(4) strikes a reference to the Federal Savings and Loan Insurance Corporation.

TITLE VIII - BANK CONSERVATION ACT AMENDMENTS

Section 801. DEFINITIONS. Section 801 amends section 202 of the Act of March 9, 1933, title II of which is the Bank Conservation

Act ("Act"). The amendment defines the term "bank" to include federally-chartered financial institutions, other than national banks, that are supervised by the Comptroller (hereinafter referred to as "bank"). This added provision would permit the Comptroller to place into conservatorship institutions such as federal branches of foreign banks.

Section 802. APPOINTMENT OF CONSERVATOR. Section 802 amends section 203 of the Act to give the Comptroller exclusive authority to appoint either the FDIC or another person as conservator for a bank and sets out a number of conditions under which the Comptroller may make such an appointment. These conditions are similar to the grounds for appointment of a conservator or receiver for federal savings and loan associations under current law. See 12 U.S.C. 1464(d)(6)(A). These circumstances generally exist in foundering banks, i.e., banks that are in an unstable condition as a result of mismanagement, insider abuse, or a downturn in the segment of the economy in which the bank is most involved. Existing section 203 does not establish explicit standards for appointing a conservator. To provide a measure of the flexibility that exists currently, the amendment would authorize the Comptroller to identify other circumstances in which the appointment of a conservator is justified. The Comptroller could use a conservator to return an unstable bank to stability or, at a minimum, maintain the status quo to provide a more saleable bank.

The current provisions regarding the appointment of a conservator do not address judicial review. The proposed bill, in accord with other statutes authorizing the appointment of a conservator by federal financial regulatory agencies, would permit an affected bank to bring an action within 10 days of the appointment. The action would be in the nature of an injunction to terminate the Comptroller's decision to appoint a conservator. This process would permit an expeditious resolution of the Comptroller's decision to appoint a conservator. Any other judicial action pending against the bank would be stayed until the conservatorship matter is resolved. Judicial review would not be available in cases where the bank has consented to the imposition of a conservator or where its insurance has been terminated (an action that already provides adequate administrative and judicial review).

Section 803. EXAMINATIONS. Section 803 amends section 204 of the Act by deleting the existing provision authorizing the Comptroller to conduct such examinations as are necessary to inform him of the condition of the bank. This provision is no longer necessary. Because a bank under conservatorship remains a national bank, the Comptroller may continue to conduct such examinations pursuant to the general examination authority. See 12 U.S.C. 481. New section 803 requires the Comptroller to consult with the FDIC when examining and supervising an ongoing bank for which the FDIC has been appointed conservator.

Section 804. TERMINATION OF CONSERVATORSHIP. Section 804 amends section 205 of the Act regarding the termination of the conservatorship. Under the proposed amendment, the conservatorship may be terminated as the result of a sale, merger or consolidation of the bank, or by the bank being placed in receivership by a declaration of insolvency, or by the bank being permitted to resume its business in the same form as previously, although most likely under new management or directorate. When the FDIC has been appointed conservator, the Comptroller must seek the approval of the FDIC to terminate the conservatorship. The FDIC would wind up the affairs of such a conservatorship. If the bank is sold, provision is made for an interpleader action whereby shareholders and nondepositor claimants may request that the district court equitably distribute the net proceeds of such sale. This provision is included as a protection for the shareholders and nondepositor claimants because they are otherwise precluded from suing the conservator for actions taken (except where gross negligence can be shown). See proposed 12 U.S.C. 203(b)(3) and 209.

Section 805. CONSERVATOR; POWERS AND DUTIES. Section 805 replaces the existing provisions of section 206 of the Act with provisions that specify, in general terms, the powers and responsibilities of the conservator. The current Act does not establish with sufficient clarity that the conservator has the full range of powers possessed by bank management. Proposed section 206 resolves this situation by stating that the conservator will be given the authority and responsibility of the shareholders, officers and board of directors. It is anticipated that regulations will be written regarding the specific powers and duties of the conservator. Proposed section 206 also provides that the conservator, except to the extent waived or modified by the Comptroller, shall be subject to the laws applicable to officers, directors and employees of a national bank. The provisions of this section are intended to establish that the conservator has sufficient flexibility and authority to operate the bank in an attempt to restore it to a stable and/or profitable operation and to give the conservator the authority to sell the bank.

In addition, proposed section 206 authorizes the Comptroller to pay the conservator at rates in excess of rates paid to federal employees performing similar work in certain situations. This provision will enable the Comptroller to recruit competent personnel from outside the agency to act as conservators as the need arises by allowing the Comptroller to compensate such individuals in a manner commensurate with similar positions in private industry.

Section 806. LIABILITY PROTECTION. Section 806 replaces the existing provisions of section 209 of the Act with new language. The current section makes the conservator subject to the provision of, and to the penalties prescribed by, specific criminal and banking statutes. A specific listing is no longer required since proposed section 206 subjects the conservator to all the laws, including those enumerated in current section 209, applicable to national bank officers, directors and employees.

Under proposed section 209, the conservator would be protected from personal liability for actions taken by him as a conservator except for those actions which are grossly negligent. Because the conservator would be making difficult decisions regarding a troubled bank, proof of "gross negligence" would require that the conservators' decision was an extreme and obvious departure from prudent banking practices resulting in significant damage to the bank.

In addition, section 209(b) adds a provision that will allow the Comptroller to indemnify the conservator out of available funds, other than those specified in 31 U.S.C. 1304.

Section 807. RULES AND REGULATIONS. Section 807 amends section 211 of the Act. Section 211 currently provides that the Comptroller may promulgate rules and regulations to carry out the conservatorship statutes. Proposed section 211 would maintain the Comptrollers' rulemaking authority.

Section 808. REPEALS. Section 808 repeals section 207 (reorganization; consent of depositors and creditors) and section 208 (provisions as to segregation of deposits inapplicable after termination of conservatorship, notice of termination) of the

Act. These provisions are no longer necessary under the proposed conservatorship legislation. In addition, the existing provisions of sections 206 and 208 that require segregated deposits are considered a major impediment in the current conservatorship statute.

Section 809. CONFORMING AMENDMENT. Section 809 would add conservators appointed under 12 U.S.C. 203 to the list of persons that may be appointed by the Comptroller of the Currency without regard to the otherwise applicable limitation contained in 5 U.S.C. 5373 (which generally prohibits an agency head from fixing the compensation of a position or employee at no more than the maximum rate for GS-18).

TITLE IX - ENFORCEMENT POWERS IMPROVEMENT ACT OF 1989

OVERVIEW

Title IX approaches the concept of enforcement both from a civil and criminal perspective. The goal of this title is to assure that both regulators and prosecutors have a full arsenal of weapons available to take swift corrective measures and to facilitate both punishment and restitution, wherever appropriate. The provisions recognize that unsafe or unsound practices and fraud and other financial crimes have both victims and societal costs and must be dealt with accordingly.

SUBTITLE A - REGULATION OF FINANCIAL INSTITUTIONS

This subtitle improves the enforcement powers of the financial institution regulatory agencies such as by adding additional civil penalty provisions and by greatly augmenting the existing penalty provisions to a maximum of $1,000,000 a day, in some cases. Variations of many of the provisions in Subtitle A are contained in H.R.32 and were passed by the Senate during the last session of Congress as part of S.1886.

Section 902. SECTION 8 OF THE FEDERAL DEPOSIT INSURANCE ACT. Section 902(a) makes amendments to section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818). These enforcement powers will now apply equally with respect to savings associations and to the Chairman of the Federal Home Loan Bank System (FHLBS) by operation of the definitional change from "insured bank" to "insured financial institution" throughout this Act. Accordingly, many of these authorities that previously were set forth for the Federal Home Loan Bank Board in section 5(d) of the Home Owners' Loan Act (12 U.S.C. 1464(d)) are repealed in section 307, as discussed above.

Section 902(a)(1) replaces terms such as "director, officer, employee, agent, or other person participating in the conduct of the affairs" of financial institutions throughout section 8 of the Federal Deposit Insurance Act with the new term "institution-related" party. This change must be read in conjunction with the new definitions of "institution-related party" and "controlling shareholder" in section (a)(17). Institution-related party includes not only directors, officers, employees and agents of a financial institution, but also controlling shareholders, independent contractors, and other persons participating in the conduct of the affairs of an insured financial institution or a subsidiary thereof (e.g., a service corporation subsidiary of a savings association) or a person required to file a change-in-control notice. Under appropriate circumstances, an attorney, accountant or appraiser could be an independent contractor or person participating in the affairs of an institution.

Section 902(a)(2) amends the insurance termination procedures in section 8(a) of the Federal Deposit Insurance Act (12 U.S.C. 1818(a)) in three respects: First, in section (a)(2)(A), the current maximum statutory notice the FDIC gives to primary regulators of intention to terminate insurance is reduced from not more than 120 to not more than 60 days. Second, in section (a)(2)(B) the Federal Deposit Insurance Corporation (FDIC) is given the discretion to shorten the current two-year period that all deposits are insured after termination of insurance to a minimum period of six months.

Third, in section 902(a)(2)(C), a new temporary order of termination of insurance authority is introduced for extreme situations where an institution is found to be virtually without capital. This procedure could be invoked by the FDIC after consultation with the primary regulator for the institution. The termination would go into effect ten days after issuance unless enjoined by the financial institution through an action in Federal district court. After the effective date of the order, deposits will continue to be insured for not less than six months or more than two years, at the discretion of the FDIC, and the institution can proceed with the regular administrative hearing process on the termination issue provided in the normal termination process.

Decisions by the Board of Directors to issue a notice of intention to terminate insurance or to issue temporary or final orders terminating insurance under section 8(a) may not be delegated, as discussed with reference to section.(a)(18), below.

Section (a)(3) clarifies that cease and desist authority to order affirmative action to correct violations or practices in section 8(b) of the Federal Deposit Insurance Act (12 U.S.C. 1818(b)) includes the authority to order "reimbursement, restitution, indemnification, recision, the disposal of loans or assets, prohibitions or restrictions on growth, guarantees against loss, or other appropriate action". The authority to order restitution was put in question by the decision in the case of Larimore v. Conover, 789 F.2d 1244 (7th Cir. 1986). In that case, the court held that the cease and desist authority of section 8 did not authorize the Comptroller of the Currency to order a director of a national bank to make restitution for losses resulting from violating lending limit provisions of the National Bank Act. The court held that the Comptroller would have to seek reimbursement in a district court action under 12 U.S.C. 93. Under the proposal in this bill, restitution could be ordered without respect to whether the practice or violation giving rise to the restitution involved unjust enrichment or reckless disregard for the law.

This amendment also specifies that the cease and desist authority extends to placement of limitations on the activities or functions of not only the financial institution, but any institution-related party necessary to correct conditions that exist because of an unsafe or unsound practice or violation of law.

The amendments in section (a)(4) and (5) are necessary to reflect that the Chairman of the Federal Home Loan Bank System may exercise cease and desist authority with respect to savings and loan holding companies, all service corporations and all subsidiaries of service corporations under section 8(b) (12 U.S.C. 1818(b)).

Current law does not permit Federal Home Loan Bank Board (FHLBB) enforcement actions against other than "affiliate" service corporations which has the result that service corporations owned by many savings associations can escape enforcement actions. A recent example was the FHLBB's inability to issue enforcement orders against SISCORP, a state-wide service corporation in Oklahoma that is now insolvent. This service corporation made bad real estate loans that produced serious losses to its parent savings associations.

Section (a)(4) is necessary to specify that the Chairman of the FHLBS may take action with respect to a savings and loan holding company even if it is also a bank holding company.

Sections 902(a)(6) and (7) amend the temporary cease and desist authority of section 8(c) of the Federal Deposit Insurance Act (12 U.S.C. 1818(c)). Sections (a)(6) and (7) would eliminate the need for the appropriate banking agency to determine as a condition to issuance of a temporary cease and desist order that a violation or unsafe or unsound practice would be likely to cause "substantial" dissipation of assets or will "seriously" weaken the condition of the financial institution. It will be enough to determine that there would be a likely dissipation or weakening. In addition section (a)(6) will allow a temporary cease and desist order to place limitations on the activities or functions of the financial institution or restrictions on its growth.

Section (a)(3)(7) provides that the temporary cease and desist order authority may be used when a financial institution's records are so "incomplete or inaccurate" that the appropriate banking agency cannot determine the financial condition of the institution or can only determine the condition with great difficulty. The temporary cease and desist order may include a direction to take affirmative action to restore the records to a complete and accurate state.

In recent years, the need for this authority has been demonstrated to be acute. Although somewhat extreme, examples of the need for this power that the FDIC has recently encountered include the following situations: (1) an FDIC-insured institution maintaining all its books and records in plastic garbage bags, and (2) an FDIC-insured institution operating without an employee capable of making postings on the banks' ledgers, thereby making it impossible for the institution to determine its own financial condition. Another example of the need for this authority is the case of Empire Savings and Loan Association, Mesquite, Texas.

Sections 902(a)(8), (9), and (10) set forth amendments to the provisions dealing with the grounds and procedures for removal or prohibition from participation in the affairs of a financial institution by institution-related parties. At present, the statute provides for a three-part test, the second part of which requires either a showing of "substantial" financial loss or that the interests of depositors are "seriously" jeopardized. The appropriate banking agency will no longer have to reach the conclusion prior to removal that the institution has or will suffer substantial financial loss or the interest of the depositors could be seriously jeopardized by the continued actions of the party. It will be enough to determine there will be probable loss or jeopardy to the interests of depositors.

Section 902(a)(10) for the first time establishes that a person removed, suspended or prohibited from participating in the affairs of an insured financial institution will be under an industry-wide bar. This means unless the person has received prior written approval from the appropriate regulatory agency, he will not be able to participate in the conduct of the affairs of any other insured financial institution, Edge corporation, bank or savings and loan holding company, any service corporation or other savings association subsidiary, any federally insured credit union or institution chartered under the Farm Credit Act.

Participation would include acting as an officer, director, employee, agent, controlling shareholder (other than a holding company), independent contractor or, under appropriate circumstances, acting as an attorney, accountant or appraiser.

Section (a)(16), discussed below, addresses the separate, but related, criminal penalty for participation in an insured institution following certain criminal convictions.

Section 902(a)(11) is a technical amendment to section 8(f) (12 U.S.C. 1818(f)), the provision dealing with judicial stays of suspension and removal orders. This amendment is necessary because of the changes to section 8(e), described above.

Section 902(a)(12) clarifies that all enforcement actions under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), including industry-wide removal orders, may be brought against former institution-related parties after termination, resignation or other separation. An institution-related party cannot frustrate an administrative action against him and take up employment with another financial institution by merely resigning before an action is taken, nor will the closing of an institution affect the agency's jurisdiction. The need for this amendment was highlighted by the recent decision of the Court of Appeals for the District of Columbia in the case of Stoddard v. Board of Governors of the Federal Reserve System (No. 88-1148, March 3, 1989).

Sections 902(a)(13) and (14) amend the civil penalty authority provisions of section (8)(i) (12 U.S.C. 1818(i)). In section (a)(13), the current maximum $1,000 per day penalty for violations of cease and desist orders or orders relating to Bank Secrecy Act compliance procedures is raised to a maximum of $25,000 per day for each day during which violations continue. In addition, if an order is violated with reckless disregard for the safety and soundness of a financial institution, a maximum penalty of $1,000,000 per day may be applied.

Section (a)(14) makes a significant enforcement authority improvement. New section 8(i)(4) (12 U.S.C. 1818(i)(4)) provides the appropriate federal banking agency with general civil penalty authority against any institution or institution-related party who has violated any law or regulation relating to financial institutions or any condition imposed in writing by a regulatory agency. It also allows a civil money penalty to be issued against an institution-related party who has breached a fiduciary duty or engaged in an unsafe or unsound practice resulting in loss to the institution or gain to the individual. This authority would be available where no other civil penalty authority currently exists and even, under certain circumstances, where it does. For instance, if there was a criminal conviction for a crime such as misapplication (18 U.S.C. 656 or 657) and for whatever reason the Justice Department did not impose a civil penalty under the new authority set forth in section 915 of this bill, the appropriate federal banking agency could proceed to assess a penalty under section 8(i)(4). However, pursuant to section 8(i)(4)(c), a civil money penalty could not be assessed twice against the same party for the same violation. For instance, the appropriate federal banking agency could not assess an additional penalty under this section after the Department of Treasury assessed a civil penalty under the Bank Secrecy Act (31 U.S.C. 5321) based on the same violations.

It is anticipated generally that use of this authority by a federal banking agency would not be appropriate if there was a civil penalty authority under a more specific civil penalty statute such as 31 U.S.C. 5321.

Again, civil penalty amounts are set at a maximum of $25,000 for day for each day the violation continues or a maximum of $1,000,000 for violations made with reckless disregard.

Section (a)(15) merely clarifies that banking agencies have the authority to define by regulation terms not otherwise defined in section 8 (12 U.S.C. 1818).

Section 902(a)(16) raises the criminal penalty in section 8(j) (12 U.S.C. 1818(j)) for institution-related parties who participate in the conduct of the affairs of any insured financial institution despite a removal, suspension or non-participation order by an appropriate federal regulatory agency. The criminal fine is raised from a maximum of $5,000 to a maximum of $1,000,000 and the violation is raised from a misdemeanor to a felony, carrying a maximum sentence of five years.

Section (a)(17) revises the definitions section, section 8(k) (12 U.S.C. 1818(k)). The main change is the addition of a definition of "institution-related party" and "controlling shareholder" as that term is used in the definition of institution-related party. This change is discussed above with reference to section (a)(1) of this Act.

Section 902(a)(18) adds five new subsections to section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818). First, new subsection 8(t) (12 U.S.C. 1818(t)) gives appropriate federal banking agencies the authority to pay informants awards to financial institution employees and other persons who provide original information that leads to recovery of a criminal fine or victim restitution, or forfeiture relating to enumerated criminal offenses, or of a civil penalty under section 8. This is similar to the authority of the Internal Revenue Service and other law enforcement agencies, such as the United States Customs Service. This authority only would apply to recoveries over $50,000 and would be limited to 25% of the recovery or $100,000, whichever is less.

Payment of awards would be totally discretionary. A decision to pay or not to pay a reward would not be reviewable by any court or be subject to any administrative review other than any that may be afforded to claimants by the appropriate federal banking agency.

An appropriate federal banking agency would notify and seek the concurrence of the Attorney General before paying or promising to pay a reward under this section to assure against adversely affecting ongoing investigations or prosecutions.

Second, new subsection 8(u) (12 U.S.C. 1818(u)) provides protection to an employee of an insured financial institution who gives information to a regulatory agency regarding a possible violation of law or regulation or to the Department of Justice relating to a possible violation of a criminal law. The employee would have a civil cause of action in Federal district court if he is discharged or discriminated against because of his assistance to the government. Similar to other employee protection statutes covering reporting of information on to health and safety violations, such as 42 U.S.C. 5851 (relating to nuclear safety), recovery would be limited to reinstatement with compensatory damages, such as back pay and lost employment benefits.

Third, a new subsection 8(v) (12 U.S.C. 1818(v)) allows the Board of Directors of the Federal Deposit Insurance Corporation to request the Chairman of the Federal Home Loan Bank System to take any enforcement action authorized by section 8 with respect to a savings association. If the FHLBS does not take the recommended action within 60 days of receipt of the formal recommendation from the FDIC, the Board of Directors may order the FDIC to take the action itself. In "exigent circumstances" the sixty-day period may be waived by the FDIC. The definition of exigent circumstances will be the subject of a memorandum of understanding between the Chairman of the FHLBS and the Board of Directors of the FDIC.

Fourth, a new subsection (8)(w) (12 U.S.C. 1818(w)) makes clear that the enforcement authority granted in section 8 of the

Federal Deposit Insurance Act is in addition to, and not limited by, any other statutory grant of authority, as provided by either Federal or State law. Thus, it modifies, in part, the Larimore decision with respect to the use of district court proceedings in lieu of administrative action under section 8.

Finally, a subsection 8(x) (12 U.S.C. 1818(x)) is added to set forth the only four actions under section 8 that cannot be delegated by the Board of Directors of the FDIC. Three relate to termination of insurance under section 8(a), and the fourth to the authority in new subsection 8(v) to initiate an enforcement action against a savings association.

Section 902(b) raises the criminal penalty of section 19 of the Federal Deposit Insurance Act (12 U.S.C. 1829) for financial institutions that allow participation in the conduct of the affairs of a financial institution or service as an institution-related party by a person who has been convicted of a criminal offense involving dishonesty or breach of trust, without prior approval from the FDIC. The penalty also applies to the person who acts as an institution-related party or participates in the affairs of a financial institution after such a conviction, without prior approval.

In the same section, the standard is changed from "willful" to "knowing." The penalty is raised from a maximum $100 a day for each day the prohibition is violated, to a maximum of $1,000,000 for each day the prohibition is violated. The penalty is also raised from a misdemeanor to a felony, carrying a maximum prison term of five years. Currently, the FDIC may recover penalties collected under this provision "for its own use." Because of the great increase in the dollar amount of the penalty, the FDIC only will be able to recover the costs of penalty assessment and collection.

Section 903. PARALLEL INCREASES IN CIVIL PENALTY PROVISIONS. This section amends several other civil penalty provisions in all cases to increase the current maximum daily penalty amounts to $25,000 for each day a violation continues, and in cases of violations made with reckless disregard for the safety or soundness of an institution, to a maximum of $1,000,000 for each day a violation continues.

Section 903(a) similarly raises the civil penalty in section 29(a) of the Federal Reserve Act (12 U.S.C. 504(a)) for a number of violations of the Federal Reserve Act. The current maximum penalty is $1,000 per day.

Section 903(b)(1) raises the criminal penalty in section 8 of the Bank Holding Company Act of 1956 (12 U.S.C. 1847(a)) for violations of the Bank Holding Company Act. The criminal fine for willful violations is raised from a maximum of $10,000 per day to a maximum of $1,000,000 per day and the violation is raised from a misdemeanor to a felony, with a maximum term of imprisonment of five years.

The current criminal penalty in section 1847(a) (for false entries in the books of a holding company) has been eliminated from that section and incorporated into 18 U.S.C. 1005. See section 915(e) below.

Section 903(b)(2) raises the civil penalty for violations under section 8 of the Bank Holding Company Act (12 U.S.C. 1847(b)(1)) from the current maximum of $1,000 per day. It also is clarified that civil and criminal penalties for violations of the Bank Holding Company Act are cumulative.

Section 903(c) raises the civil penalty for violations of the prohibition against tying arrangements in section 106(b)(2)(F)(i) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972(2)(F)(i)). The current penalty is a maximum of $1000 per day for each day the violation continues.

Section 903(d) raises the general civil penalty authority of the Comptroller of the Currency in section 5239 of the Revised Statutes (12 U.S.C. 93) and section 902(e) raises the civil penalty in section 5240 of the Revised Statutes (12 U.S.C. 481) for refusal to permit examination of a national bank or affiliate. The current maximum penalties under those provisions are $1,000 per day.

Section 904. PENALTY FOR VIOLATION OF "CHANGE IN BANK CONTROL ACT." Section 904 makes several improvements to the penalty provision of the Change in Bank Control Act, section 7(j)(16) of the Federal Deposit Insurance Act (12 U.S.C. 1817(j)(16)). First, the current scienter standard of "willful" is eliminated and the penalty amount for violations is raised from a maximum $10,000 per day to a maximum of $25,000 for each day during which the violation continues. For violations made with reckless disregard for the safety or soundness of a financial institution, the penalty is raised to a maximum of $1,000,000 for each day during which the violation continues.

Also, the penalty procedures for assessment and collections are made comparable to those for other federal banking agencies civil penalties, with penalty assessments reviewed through administrative hearings and appeal to the Court of Appeals. Currently, Change in Bank Control Act penalties are subject to a trial de novo in Federal district court.

The deletion of the "willful" standard will afford the regulatory agencies the opportunity to move more easily against individuals who take control of a financial institution, without ever having filed a change in bank control application, and force the institution to buy worthless or near-worthless assets from them.

These amendments will apply equally to changes in savings association control pursuant to section 7 of this Act.

Section 905. REPORTS. Section 905(a) eliminates a provision in the Bank Protection Act requiring insured financial institutions to submit reports with respect to security devices and procedures. Section (b) eliminates an obsolete requirement relating to reports to the Comptroller of the Currency.

Sections (c),(d),(e) and (f) make parallel improvements to four civil penalty provisions relating to call report violations for national banks, State nonmember banks, and federal reserve member banks, and bank to reporting violations for holding companies, respectively. The provisions make clear that not only failure to submit and late submissions are subject to penalty, but also false, misleading and incomplete submissions or publications. The maximum penalty is raised to $25,000 for each day a report is not submitted or a false, misleading or incomplete report is not corrected. In the case of violations made with reckless disregard for the safety and soundness of an institution, the maximum penalty is raised to $1,000,000 per day. The current penalty under all four penalty provisions is a maximum daily penalty of $1,000.

One of the first and foremost indicators of the financial condition of an institution is the call report, the report on condition and income that must be regularly filed with appropriate federal banking agencies. If, in its call report, an institution deliberately has failed to charge off loans classified loss, or failed to provide for a loan loss reserve, it has inflated its overall condition, thereby lulling the depositors and shareholders into a false sense of security by implying that the institution is in a stronger financial condition than it actually is. The increased civil money penalty for submission of false or misleading call reports provided in the bill will provide a much needed incentive to encourage financial institution to file accurate call reports, and prevent distortion of an institution's financial condition.

Experience has shown that the current penalties are inadequate to encourage compliance. For instance, on March 21, 1988, the FDIC issued a bank letter requesting that all FDIC-insured banks submit their call reports on time. Despite this Bank Letter, which was by no means the first request for timely submissions, thousands of banks failed to submit their reports on time. The increased civil money penalty proposed in this bill will encourage compliance. The higher penalties are meant to be directed at chronic late-filers or those who deliberately delay in order to postpone the release of adverse financial information.

SUBTITLE B -- REGULATION BY THE CHAIRMAN OF THE FEDERAL HOME LOAN BANK SYSTEM

Section 906. EXAMINATION AUTHORITY. This section is being eliminated in technical corrections to this Act, as these provisions are repeated in sections 307 and 311, above.

Section 907. REPORTS OF CONDITION AND PENALTIES. This section adds a new subsection (u) to the Home Owners' Loan Act of 1933 (12 U.S.C. 1464(u)) providing for submission of call reports by savings associations and a new penalty for failure to report or for submitting or publishing false, misleading or incomplete information. This is comparable to the existing requirement for such reports for federally insured banks. The penalty provisions also are parallel to those discussed above in section 905 for banks and holding companies.

Section 908. SAVINGS AND LOAN HOLDING COMPANIES. Section 908(a) increases the civil and criminal penalties for violations of the Savings and Loan Holding Company Act to conform with the penalty for Bank Holding Company Act violations in section 903(b). Criminal and civil penalties are cumulative.

Section (b) adds a new civil penalty for reporting violations by savings and loan holding companies parallel to the reporting provision and penalty for bank holding companies. See section 905(f).

Section 909. CONTINUITY OF AUTHORITY FOR ONGOING LITIGATION. Section 909 affirms that ongoing litigation in the name of the FHLBB or the FSLIC will be continued, as appropriate, under this Act.

Section 910. TEMPORARY EXTENSION OF AUTHORITY. Section 910 states that any action initiated or taken by the FHLBB or FSLIC under one of the enforcement authorities in section 5 of the Home Owners' Loan Act or under section 407 of the National Housing Act, repealed by this Act, may be carried on by the Chairman of the FHLBS as if those provisions were still in effect.

SUBTITLE C -- CREDIT UNIONS

Sections 911, 912, and 913. AMENDMENTS TO 206, 205 AND 202. The amendments made in this section to the enforcement powers in the Federal Credit Union Act (12 U.S.C. 1782, 1785, 1786) conform to the improved enforcement authorities and increased penalties of other federal financial institution regulatory agencies under this Act. Parallel amendments are found in Subtitle A for almost every provision in Subtitle C. The explanation for the comparable provisions in Subtitle A should be consulted.

SUBTITLE D -- RIGHT TO FINANCIAL PRIVACY ACT

Section 914. AMENDMENTS TO THE RIGHT TO FINANCIAL PRIVACY ACT. There are a number of exceptions to the general requirement of the Right to Financial Privacy Act of 1978 ("RFPA"), (Title XI of Pub. L. 95-630, 12 U.S.C. 3401 et seq.) that there be notice to a financial institution customer prior to disclosure of his records to a federal authority. One exception made to facilitate smooth functioning of the examination process is the exception in section 1113(b) (12 U.S.C. 3913(b)) which provides that the RFPA does not apply to supervisory agencies in the exercise of their supervisory, regulatory or monetary functions.

The amendment in section 914(a) and (b)(1) merely makes explicit that this exception from the RFPA for supervisory agencies with respect to financial institutions, extends to both bank and savings and loan holding companies and subsidiaries of financial institutions or holding companies, as well as to officers, directors, employees, agents and other persons participating in the affairs of a financial institution, holding company or subsidiary. The amendment in (b)(1) also specifies that this exemption applies to a supervisory agency in the exercise of its conservatorship or receivership functions.

Section 914(b)(2) adds two new exceptions to section 1113(b) of the RFPA (12 U.S.C. 3413(b)). First, a new subsection 1113(m) makes explicit that the RFPA does not apply to examination or disclosures by the Federal Reserve System in the exercise of its authority to extend credit to depository institutions and others.

Second, a new subsection 1113(n) is added to cover disclosures to the Resolution Trust Corporation.

In section (c) a new provision is added to section 1120 of the RFPA (12 U.S.C. 3420) to prohibit financial institutions from notifying customers or other persons of the existence of a grand jury subpoena relating to violations of certain enumerated major crimes in title 18, United State Code, against financial institutions or regulatory agencies -- section 215 (financial institution bribery), sections 656 and 657 (financial institution misapplication and embezzlement), sections 1005 and 1006 (false entries), sections 1007 and 1008, (fraud against deposit insurer), section 1014 (false statement or overvaluation), and section 1344 (financial institution fraud).

With respect to restricting notice of grand jury subpoenas involving grand jury investigations of other crimes, the Department of Justice still would have to seek an ex parte court order pursuant to section 1109 (12 U.S.C. 3409), as provided in section 1113(i) (12 U.S.C. 3413(i)).

In criminal investigations involving serious financial institution crimes, there is a compelling need that financial institution insiders and those acting in concert with them are not advised prematurely of the existence of criminal investigations or the parameters of the investigations. Notification could cause serious damage to investigations and could lead to possible flight, destruction of evidence, and removal of assets. This prohibition should be automatic and not depend on the existing delayed notice procedures.

Congress recently recognized the need for special treatment under the RFPA for those involved in crimes against financial institutions and supervisory agencies. In section 6186(c) of the

Anti-Drug Abuse Act of 1988, Pub. L. 100-690 (Nov. 18, 1988), a new exception from the customer notice provisions was added to allow a financial institution to provide records of a financial institution insider if there is reason to believe the records are relevant to a possible crime against the institution or supervisory agency by an insider. This amendment prohibiting notification of grand jury subpoenas enhances the effectiveness of section 6186(c) by assuring that its purpose is not frustrated.

A related change is made in section 916(h), below, to provide a new criminal obstruction of justice penalty against a financial institution officer, director, or employee who notifies a customer or other party despite this RFPA prohibition.

SUBTITLE E -- CRIMINAL ENHANCEMENTS

Section 915. INCREASED CRIMINAL PENALTIES AND CIVIL PENALTIES FOR CERTAIN FINANCIAL INSTITUTION OFFENSES. Section 915 increases the criminal sanctions for several major financial institution crimes in title 18, United States Code, under which those who jeopardize the safety or soundness of insured financial institutions, either from the inside or from without, are prosecuted. The crimes covered are: section 215 (financial institution bribery), sections 656 and 657 (financial institution misapplication and embezzlement), sections 1005 and 1006 (false entries on the books of financial institutions), sections 1007 and 1008, now consolidated as section 1007, (fraud on deposit insurer), section 1014 (false statement or overvaluation), and section 1344 (financial institution fraud). The penalties proposed are purposely the most stringent for any white collar crime. The severity of the penalty can be compared to the penalties for money laundering under 18 U.S.C. 1956 and 1957.

The criminal sanctions are raised generally to a maximum criminal fine of $1,000,000 for each day the violation continues or $5,000,000, or twice the amount authorized by section 3571(d) of title 18, whichever is greater. This means that, depending on which is greater, a maximum daily fine of $1,000,000 can be imposed, or if a violation does not lend itself to a daily penalty or occurs on only a few days, the $5,000,000 maximum would be available. As a third alternative, if the result would be an even higher fine, a court could use the measure of twice the fine set forth in section 3571(d). Twice the amount of the criminal fine in section 3571(d) would be four times the amount of pecuniary gain to the defendant or loss to the affected financial institution, whichever is greater.

In addition, in section 915, for the first time, the Civil Division of the Justice Department and the U.S. Attorney's Offices are given civil penalty authority for violations of these sections. All criminal and civil sanctions are cumulative. This means that Justice may elect whether to proceed civilly or criminally upon a referral from a bank regulatory agency or may develop cases civilly or criminally without a referral, for instance on the basis of an informant's information. It may also proceed with a civil penalty at the conclusion of a criminal case or impose a civil penalty in conjunction with a criminal plea arrangement. Nevertheless, it is intended that the Department of Justice continue to work closely with the regulatory agencies on these matters. This authority is intended to provide an additional means of assessing penalties and is not intended to limit or restrict those penalties that may otherwise be assessed by the regulatory agencies pursuant to their authority.

The major difference between the civil and criminal violation will be the lower standard of proof in civil cases and the method of developing the basis for the violation. If, following assessment of a civil penalty, payment is not made, the Attorney General may recover the penalty through an action in Federal district court. The standard of proof for a civil penalty case will be a preponderance of the evidence. The civil case will be developed through a new civil summons authority comparable to the civil summons authority of numerous other agencies with civil penalty authority. See, e.g., 31 U.S.C. 5318(a) (summons authority of the Secretary of the Treasury under the Bank Secrecy Act). Standard summons enforcement provisions, including contempt authority, is included.

The civil penalties, like the criminal penalties, will be the largest civil money penalties available under any civil penalty authority. Generally, the maximum penalty is $1,000,000 for each day the violation continues, the amount of the pecuniary gain to the individual attributable to the violation, or $5,000,000, whichever is greater.

In addition to increased penalties and civil penalty authority in section 915, the following changes are made in sections (a) through (i):

In section (a)(2), the references to "bank" insured by the FDIC are changed to "an institution" and the reference to institutions insured by the FSLIC is deleted.

The amendment in (d)(1) sets forth that section 1005 (false entries) applies to officers, directors, agents and employees of bank and savings and loan holding companies. The current mirror image criminal provisions in the Bank Holding Company and Savings and Loan Holding Company Acts are eliminated. This is discussed in reference to section 903(b), above.

In section (d)(2), a "participation" offense is added to section 1005 (false entry on the books of a bank) which is comparable to the participation offense currently in section 1006 (credit union and savings and loan false entries).

The amendments in sections (f) and (g) consolidate current sections 1007 (fraud on the FDIC) and section 1008 (fraud on

FSLIC) into a new section 1007.

Section (j) adds a new statute of limitations provision, section 3293 of title 18, United States Code, which extends the statute of limitations for the crimes discussed in section 915 (sections 215, 656, 657, 1003, 1006, 1007, 1008, 1014, and 1344 of title 18) to ten years. Currently, the general five-year statute of limitations for all crimes listed in 18 U.S.C. 3282 applies. This extension to ten years recognizes both the complexity of many of the investigations under these provisions and the volume of such investigations pending and anticipated in the near future. The limitations period is comparable to that for certain national security violations under 18 U.S.C. 792.

The increased period shall apply to any offense committed before the effective date of this Act as long as the five year statute has not run as of this date. It is well established that the application of a new statute of limitations to violations for which the old statute has not run does not violate the constitutional prohibition on *ex post facto* laws. *See*, *e.g.*, *United States v. Richardson*, 512 F.2d 105 (3rd Cir. 1975).

Since October 1987, in accordance with sentencing reform provisions of the Comprehensive Crime Authority Control Act of 1984, federal judges must sentence in accordance with guidelines promulgated by the United States Sentencing Commission. A statutory increase in a maximum imprisonment terms such as those made in section (a) through (i) of this section will probably, but not necessarily, cause the Sentencing Commission to readjust upward the recommended penalty for such a violation when it next submits guideline amendments to Congress. Section (k) is a direction to the Commission to increase the sentencing guideline for violations of the financial institution crimes treated in section 915 where the violation "substantially" jeopardizes the safety and soundness of a financial institution.

This section directs an increase in the guideline level to at least level "24" in such situations. This will mean, in effect, that there will be a mandatory minimum sentence for such violations by first offenders of at least fifty-one months of imprisonment. It is anticipated that courts will rely on the judgment of federal financial institution regulatory agencies in determining whether there has been substantial jeopardy to the safety and soundness of an institution.

Section 916. MISCELLANEOUS REVISIONS TO TITLE 18. This section 916(a) merely replaces the term "Federal Home Loan Bank Board" with the term "Federal Home Loan Bank System" in title 18, consistent with this Act.

Section 915(b) and (c) amends sections 212 and 213 of title 18 (relating to gratuities and loans to bank examiners) to specify that these provisions apply to examiners of the FHLBS and changes the reference to "banks" insured by the FDIC to "institutions," consistent with this Act.

Section (d) repeals 18 U.S.C. 1009, an obsolete and unused provision making it a crime to circulate rumors about the FSLIC.

Sections 915(e), (f), (g) and (i) merely make technical revisions to four criminal provisions to make changes necessitated by the Act, such as removing references to FSLIC.

Section (h) adds a new provision in the obstruction of justice statute, 18 U.S.C. 1510, making it a crime for a financial institution, officer, director, partner, or employee to notify a customer or any other party, including another financial institution insider, of the existence or contents of a grand jury subpoena relating to one of the financial institution crimes discussed in section 915, (sections 215, 656, 657, 1007, 1008, 1014, or 1344 of title 18). A related RFPA amendment is discussed in section 914(c), above.

Section (j) adds sections 656 and 657, financial institution misapplication and embezzlement, and 1344, financial institution fraud, to the predicates for violations of the RICO (Racketeer Influenced and Corrupt Organizations) statute, 18 U.S.C. 1961-1968. This will, in effect, provide prosecutors with another tool against those who steal from financial institutions from within and without and seek to profit further from their crimes through investment in other businesses.

Section 917. CIVIL AND CRIMINAL FORFEITURE SECTION. Again in section 917, weapons have been borrowed from the Administration's war against drugs and money laundering by adding civil (new section 983) and criminal (new section 984) forfeiture authority in connection with violations of the financial provisions discussed in section 915. Similar forfeiture authority was added for money laundering and domestic Bank Secrecy Act violations in 1986, as sections 981 and 982 of title 18.

Civil forfeiture will allow the Department of Justice to move immediately against the property which is the proceeds of the violation or against property traceable to that property as soon as it has probable cause for the violation. As in money laundering cases, time will often be of the essence because perpetrators of these offenses attempt to move and conceal their assets as investigations develop.

Because of the nature of the crimes and the victims, forfeited amounts will be applied, after deduction for the costs of forfeiture, differently than amounts forfeited under other provisions of law. Under section 983(e)(3), in the case of insolvent institutions, proceeds will be applied to the Treasury General Fund, and, in the case of ongoing institutions to the General Fund, or at the option of the appropriate federal financial institution regulatory agency, may be made available as restitution to the institution.

As with other victim restitution, under 18 U.S.C. 3523, the amount received from the forfeiture would be deducted from other amounts received as restitution in other civil actions or through cease and desist orders.

Criminal forfeiture would apply following a conviction. The court would be required to order forfeiture, unlike orders for victim restitution, which are discretionary. The proceeds of a criminal forfeiture would be applied in the same way as civil forfeiture proceeds.

Section 918. GRAND JURY AMENDMENT.

SECTION 918: GRAND JURY AMENDMENTS: Section 918(a) amends Rule 6(e) of the Federal Rules of Criminal Procedure to overcome impediments to the government's civil enforcement efforts caused by two decisions of the United States Supreme Court. On June 30, 1983, the Court ruled in United States v. Sells Engineering, Inc., 463 U.S. 418 (1983), that Department of Justice attorneys handling civil cases are not "attorneys for the government" for the purposes of Rule 6(e). Therefore they may not obtain grand jury materials that pertain to their civil cases without a court order, and such an order may be granted only upon a showing of "particularized need." The Court stated that the "particularized need" standard of Rule 6(e) was not satisfied only by a showing that non-disclosure would cause lengthy delays in litigation or would require substantial duplication of effort.

In a companion case, United States v. Baggot, 463 U.S. 476 (1983), the Court further limited federal law enforcement abilities by narrowly defining the purpose for which disclosures may be made. It held that agency proceedings such as civil tax audits are not "preliminary to a judicial proceeding," and thus, no court order may be secured in such cases, no matter how compelling the need.

Civil enforcement initiatives have been frustrated by the inability to share grand jury materials with Department of Justice (DOJ) civil attorneys or with agencies, such as federal financial institution regulatory agencies, that contemplate using those materials in administrative or regulatory proceedings such as cease or desist or removal proceedings or civil penalty assessments. The prosecutor is limited in his ability to advise civil attorneys or agency authorities of activities that may also violate civil laws which should be investigated, sometimes preventing timely pursuit of meritorious civil cases. Then, if the civil attorneys or agencies do learn of the grand jury investigation, they must duplicate virtually the entire criminal investigation -- an effort which may not be feasible or, at best, will cause substantial delays and require needless expenditure of effort, time and money.

The amendments will (1) permit prosecutors to make automatic disclosure of grand jury materials to Department of Justice civil attorneys for civil purposes without a court order; (2) expand the types of proceedings for which other executive departments and agencies may gain court-authorized disclosure to include not only "judicial proceedings," but also other matters within their jurisdiction, such as adjudicative and administrative proceedings; and (3) reduce the "particularized need" standard for court-authorized disclosure to a lesser standard of "substantial need" in certain circumstances. The amendments also codify a legal issue unanswered by Sells, but recently resolved affirmatively by the Supreme Court in United States v. John Doe, Inc. I, 481 U.S. 102 (1987): whether the same criminal prosecutor who conducted the grand jury investigation is authorized to present the companion civil case.

In 6(e)(3)(A)(i), disclosure may be made to any government attorney, i.e., Department of Justice attorney, "to enforce federal civil law." This term is to be read broadly; it includes civil enforcement in all non-criminal actions in which the United States is a party, such as admiralty, immigration, customs and damage suits. In the terms of this Act, it would include disclosure to Department of Justice civil attorneys for the purpose of assessment of new civil penalties discussed in section 915. Disclosure is not limited by the term "judicial proceeding," but can be made for the sole purpose of an initial review of potential civil liability or to facilitate global dispositions of cases, thus eliminating the barrier to settlements caused by the inability to provide sufficient information for the DOJ civil attorney to evaluate the merits of proposed settlements.

This amendment covers disclosure only to attorneys and their support staff such as secretaries and paralegals. If further disclosures to non-attorney personnel such as examiners, auditors or agents are necessary to assist in the civil case, a court order must be sought.

The addition of the words "civil law" in (6)(e)(3)(B) will permit personnel to whom disclosure has been made for criminal purposes pursuant to subparagraph (A)(ii), to utilize that material to assist any attorney for the government in enforcing civil law. It will allow DOJ civil attorneys to discuss the evidence not only with the criminal prosecutor, but also with the agents, auditors or examiners who worked on the grand jury investigation without court order.

The proposal recognizes that the primary purpose of a grand jury is, and must remain, to enforce federal criminal laws and in no way alters that well-founded policy. It is therefore the intent of the Department of Justice to issue policy guidelines that restate existing practices and the current case law that a grand jury may not be improperly used to gather evidence for civil purposes. To make the criminal priority explicit, the guidelines will state that the criminal prosecutor has the discretion to decide whether and when to disclose materials to civil attorneys, and further, to decide what materials should be disclosed.

Disclosures will be limited to only those materials relevant to the civil case.

Section 6(e)(3)(i) is amended by the addition of the words "particularized need" to reflect the existing standard for court-authorized disclosures made preliminary to or in connection with a judicial proceeding. While not changing current law, the addition of the term "particularized need" is intended to demonstrate the contrast between this higher standard and the lesser standard of "substantial need" that is required in new section (C)(v), applicable when government agencies seek disclosure with the concurrence of the Department of Justice. This provision will provide the only available method of disclosure for private parties. It can also be used by government agencies with independent litigating authority when the Justice Department exercises its discretion and declines to request disclosure under new section (C)(v).

Section 6(e)(3)(C)(v) is the entirely new section authorizing prosecutors to seek court approval to release grand jury information to government agencies for use in matters within that jurisdiction. This is intended to cure the Baggot problem by eliminating the requirement that court-authorized disclosure must be for use in a "judicial proceeding," and also to overrule Sells by reducing the "particularized need" standard to a "substantial need" standard.

Under the substantial need standard, a court could consider a number of factors, including but not limited to, any of the following: (1) the public interest -- particularly the protection of the public health or safety or the safety or soundness of a federally insured financial institution -- served by disclosure; (2) the burden or cost of duplicating the grand jury investigation; (3) the potential unavailability of witnesses; (4) the fact that the department or agency already has a legitimate independent right to the materials; (5) the avoidance of unnecessary inefficiency or waste of resources; (6) the need to prevent ongoing violations of law; and (7) the expiration of an applicable statute of limitations. In weighing these considerations, consistent with the Supreme Court's decision in John Doe, Inc. I, a court would not be able to deny disclosure merely because the agency for whom disclosure is sought may have alternative discovery tools available to it.

On the other hand, the "substantial need" test does not contemplate that a court would become simply a "rubber stamp" for the government's request for disclosure. Review under this standard should require a Justice Department attorney to make more than a showing of mere convenience or simple relevance to matters within the jurisdiction of the agency.

The words "for use in a matter within the jurisdiction of an agency" makes clear that an agency's administrative, enforcement and other non-judicial proceedings are included. Since the phrase "matters within the jurisdiction of an agency" has already been broadly interpreted in cases involving 18 U.S.C. §1001, it was selected to avoid listing every conceivable agency proceeding. In the context of financial institution administrative and enforcement actions, it could include use in licensing, examination, corporate application involving change in control or ownership, removal actions, cease and desist orders, termination of insurance, receivership actions, or penalty assessments.

Effective control would be exercised by the court in permitting disclosure only when the agency had a substantial need, and by delineating in its order the specific purposes for which disclosure is authorized. Disclosures will not be sought by Department of Justice attorneys without careful consideration of all factors and a determination that there is a strong public interest for each disclosure. Agency personnel who receive court-authorized disclosures of grand jury materials under this subparagraph will be authorized to use the material only for the purpose for which the court order was granted.

Section 918(b) amends the Fair Credit Reporting Act to permit access to consumer credit report records pursuant to a subpoena issued by a grand jury. Presently, 15 U.S.C. 1681b forbids a credit reporting agency from furnishing such records except in a few restricted instances. One of these is "in response to the order of a court." Although some district courts have held that a Federal grand jury subpoena is such an order, the predominant judicial view is that a grand jury subpoena does not qualify. See, e.g., Matter of Application to Quash Grand Jury Subpoena, 526 F. Supp. 1253 (D. Md. 1981).

Consumer credit report records are useful in pursuing many kinds of fraud, including fraud involving financial institutions. The current requirement for a court order poses a burdensome hurdle to the effective investigation of fraud by Federal grand juries. Although the privacy interests sought to be protected under the Act warrant placing restrictions on access, a Federal grand jury subpoena carries with it significant safeguards under Rule 6(e) of the Federal Rules of Criminal Procedure. In a comparable context, disclosure of customer records of financial institutions themselves are protected by the Right to Financial Privacy Act ("RFPA") (12 U.S.C. 3401 et seq.). Nevertheless, section 1113(i) of the RFPA (12 U.S.C. 3413(i)) contains an express exception for any subpoena issued in connection with proceedings before a grand jury." This leads to the anomalous result that records in the possession of a financial institution may be disclosed pursuant to a grand jury subpoena, but the very same records in the possession of a consumer reporting agency may not be able to be disclosed.

Section 919. LITIGATION AUTHORITY. This section merely affirms that the changes made to this Act to the responsibilities of financial institution regulatory and insurance agencies may not be construed as impairing or diminishing the authority of the Attorney General under section 18 U.S.C. 516, to conduct and coordinate litigation on behalf of the United States Government.

Section 920. DEPARTMENT OF JUSTICE APPROPRIATION. This section provides authorization of appropriations of $50 million annually, for fiscal years 1989 through 1991, to investigate and prosecute financial institution crimes. It is critical that additional resources be made available to identify, investigate and bring to justice those who undermine the safety and soundness of financial institutions.

This independent authorization is intended to supplement that included in the annual Department of Justice appropriations authorizations for this purpose. Beginning with fiscal year 1992, the need for authorization of continuing appropriations for this purpose will be addressed within the context of the annual appropriations authorizations request.

This additional funding is authorized to be appropriated to the Attorney General. It is intended that these funds may supplement any appropriations under the control of the Attorney General. The Attorney General would have the flexibility to adjust the funding among the organizations involved in investigating and prosecuting financial institution fraud, such as the Federal Bureau of Investigation, the U.S. Attorneys, and the Criminal and Tax Divisions, to achieve the objectives of this authorization.

TITLE X

STUDY OF FEDERAL DEPOSIT INSURANCE AND BANKING REGULATION

Section 1001. STUDY. Section 1001 requires the Secretary of the Treasury, in consultation with the bank and thrift Federal regulators and the Director of the Office of Management and Budget to conduct a study of the Federal deposit insurance, system, including an appropriate structure for the offering of competitive products and services to consumers consistent with standards of safety and soundness.

Section 1002. TOPICS. Section 1002 lists the topics to be included in the above study as follows:

> Risk and rate structure for deposit insurance; incentives for market discipline; the scope of deposit insurance coverage and its impact on the liability of the insurance fund; the feasibility of market value accounting, assessments on foreign deposits, limitations on brokered deposits, the addition of collateralized borrowings to the deposit insurance base, and multiple insured accounts; policies to be followed with respect to the recapitalization or closure of insured depositories whose capital is depleted to or near the point of, insolvency; and the efficiency of housing subsidies through the Federal Home Loan Bank System.

Section 1003. FINAL REPORT. Section 1003 requires the Secretary to submit to Congress within eighteen months from the date of enactment of this Act, a final report which shall contain a detailed statement of findings and conclusions, including recommendations for advisable administrative and legislative action.

Title XI - MISCELLANEOUS PROVISIONS

Section 1101. AMENDMENTS TO SECTION 202 OF THE FEDERAL CREDIT UNION ACT. Section 202 of the Federal Credit Union Act (FCU Act) establishes the method by which federally-insured credit unions provide funding to the National Credit Union Share Insurance Fund. Currently, each federally-insured credit union maintains a capitalization deposit of 1 percent of its insured shares. This amendment would phase out the capitalization deposit over eight years and revert to a premium method of funding.

The NCUA Board would be authorized to issue regulations necessary to implement this change, including the authority to assess insurance premiums during the phase out period if necessary to maintain the equity level of the insurance fund.

Section 1102. AMENDMENT TO SECTION 203 OF THE FEDERAL CREDIT UNION ACT. This is a conforming amendment to Section 203 of the FCU Act, removing a reference to the capitalization deposit.

Section 1103. AMENDMENT TO SECTION 5240 OF THE REVISED STATUTES. Section 1103 amends Section 5240 of the Revised Statutes. As amended, the section authorizes the Comptroller of the Currency, subject to the approval of the Secretary of the Treasury, to fix the compensation of employees of the OCC and to make a report thereof to Congress. In setting and adjusting compensation, the Comptroller is directed to seek to maintain comparability with compensation paid by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and the Chairman of the Federal Home Loan Bank System. The amendment provides that such compensation shall be determined by the Comptroller without regard to the provisions of any other law, including any provision of Title 5 of the United States Code.

TREASURY NEWS

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March 13, 1989
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(202) 566-2041

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Bridge Loan to Venezuela

The U. S. Treasury Depaertment welcomes Venezuela's intention to address its economic and financial situation in a courageous and decisive manner.

We believe that President Perez' economic program can provide a basis for sustained economic growth, fiscal consolidation and effective debt management.

At the request of the Venezuelan authorities, and in recognition of the quality of their economic and financial adjustment efforts, the U. S. Treasury has agreed to provide a short-term bridge loan of $450 million.

NB-170

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March 13, 9189

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,216 million of 13-week bills and for $7,203 million of 26-week bills, both to be issued on March 16, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing June 15, 1989			:	26-week bills maturing September 14, 1989		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	8.65%a/	8.97%	97.813	:	8.75%b/	9.28%	95.576
High	8.70%	9.02%	97.801	:	8.76%	9.29%	95.571
Average	8.69%	9.01%	97.803	:	8.76%	9.29%	95.571

a/ Excepting 1 tender of $10,000.
b/ Excepting 2 tenders totaling $20,000.

Tenders at the high discount rate for the 13-week bills were allotted 36%.
Tenders at the high discount rate for the 26-week bills were allotted 77%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 41,155	$ 41,155	:	$ 29,970	$ 29,970
New York	19,113,465	5,531,425	:	23,863,515	6,283,535
Philadelphia	28,725	28,725	:	25,155	24,695
Cleveland	49,450	49,450	:	42,585	42,185
Richmond	68,365	68,365	:	62,790	62,790
Atlanta	43,795	43,595	:	46,535	43,260
Chicago	1,279,900	467,900	:	1,037,400	58,400
St. Louis	48,885	35,685	:	35,975	27,975
Minneapolis	12,010	12,010	:	10,590	10,590
Kansas City	56,515	56,515	:	54,260	54,260
Dallas	45,685	37,485	:	38,465	28,465
San Francisco	1,603,385	371,135	:	1,511,140	86,005
Treasury	472,715	472,715	:	451,095	451,095
TOTALS	$22,864,050	$7,216,160	:	$27,209,475	$7,203,225
Type					
Competitive	$18,808,340	$3,160,450	:	$22,236,895	$2,230,645
Noncompetitive	1,436,560	1,436,560	:	1,201,275	1,201,275
Subtotal, Public	$20,244,900	$4,597,010	:	$23,438,170	$3,431,920
Federal Reserve	2,363,355	2,363,355	:	2,200,000	2,200,000
Foreign Official Institutions	255,795	255,795	:	1,571,305	1,571,305
TOTALS	$22,864,050	$7,216,160	:	$27,209,475	$7,203,225

An additional $71,905 thousand of 13-week bills and an additional $473,795 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

TREASURY NEWS

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

For Release Upon Delivery
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STATEMENT OF DENNIS E. ROSS
ACTING ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I appreciate this opportunity to speak with you today about the Administration's proposal to reduce the rate of tax on long term capital gains. The President's Budget for fiscal year 1990 includes a number of proposals that affect revenues, but none that is more important to the continued health of the economy and our future competitiveness. In my testimony today I will explain the tax and economic policy objectives that support the Administration's proposal and how the proposal relates to and is consistent with the objectives of tax reform.

I will also explain the basis for our estimate of the proposal's revenue effects. We recognize that this aspect of the debate over the proper tax treatment of capital gains is highly controversial. We accept, moreover, that reasonable minds can differ over the revenue effects of a cut in the capital gain rate. At the same time, we believe a careful review of the available evidence supports Treasury's estimate that the proposal raises revenue in the budget period and in the long run. Accordingly, we have supplied an unprecedented amount of information concerning the basis for our estimate. If these hearings produce no more than a careful examination of the issues involved in estimating a reduction in capital gain rates, we will have advanced debate over an important issue of tax policy and I believe also increased the chances that a capital gain preference will be restored.

The Administration's Proposal

In general, the Administration's proposal would allow individuals to exclude 45 percent of the gain realized upon the disposition of qualified capital assets. The maximum tax rate applicable to any gains on qualified assets would be 15 percent. A qualified asset would generally be defined as any asset that qualifies as a capital asset under current law and satisfies the phased-in holding periods. For example, assuming the holding period is satisfied, an individual's residence would be a qualified asset and gain on its disposition would be eligible for the lower capital gains rate as well as the continued rollover of gain and the $125,000 one-time exclusion provided under current law.

Disposition of a qualified asset by a RIC, REIT, partnership, or other passthrough entity would continue to be treated as capital gain under the proposal and would be eligible for the exclusion in the hands of individual investors.

Holding Period and Effective Date. To be treated as qualified assets eligible for the lower capital gains rate, assets will need to satisfy the following holding periods: more than 12 months for assets sold in 1989, 1990, 1991, and 1992; more than 24 months for assets sold in 1993 and 1994; and more than 36 months for assets sold in 1995 and thereafter.

The proposal would be effective generally for dispositions of qualified assets after June 30, 1989. Dispositions of qualified assets after that date would be fully protected by the exclusion or maximum rate. That is, there would be no blended rate for gains realized in 1989 after June 30. Conversely, gains realized on or before June 30, 1989, would not be eligible for the exclusion, maximum rate, or any of the other provisions of the proposal and would be taxable under current law.

Installment sales, including sales preceding the effective date, would be eligible for the preference to the extent installments were realized after the effective date.

15 Percent Maximum Rate. A 15 percent maximum tax rate would apply to capital gains on qualified assets. Thus, while a taxpayer's ordinary income may be subject to a 33 percent marginal rate (due to phase-out of the 15 percent rate or personal exemptions), capital gains would not be subject to a marginal rate exceeding 15 percent. In some cases, the application of a 45 percent exclusion would result in an effective tax rate lower than 15 percent; for example, if the taxpayer's marginal rate is 15 percent, a 45 percent exclusion would result in an effective tax rate of 8.25 percent.

100 Percent Exclusion for Low Income Taxpayers. A taxpayer would be eligible for a 100 percent exclusion on sales of qualified assets if the taxpayer's adjusted gross income is less than $20,000 and the taxpayer is not subject to the alternative minimum tax. The $20,000 amount would be calculated taking the 45 percent capital gains exclusion into account. Thus, if a taxpayer's adjusted gross income is $22,000 (including the full amount of gains realized on capital assets), and a 45 percent exclusion on capital gains would reduce the taxpayer's taxable income to less than $20,000, the taxpayer would be eligible for the 100 percent exclusion.

The $20,000 figure applies to married taxpayers filing jointly and to heads of households. Single taxpayers and married taxpayers filing separately would be eligible for the 100 percent exclusion if their adjusted gross incomes are less than $10,000.

Relationship to the AMT. Taxpayers who are subject to the alternative minimum tax would not be eligible for the 100 percent exclusion. In making this determination, a taxpayer's tentative minimum tax would be compared with his regular tax computed using a 45 percent exclusion. If the tentative minimum tax exceeds the regular tax, the taxpayer has liability under the alternative minimum tax and would not be eligible for the 100 percent exclusion. The ineligibility for the 100 percent rate would have no other effect on the taxpayer.

Collectibles Not Treated as Qualified Assets. The proposal would deny capital gain treatment for gains realized upon the disposition of collectibles, as defined under the individual retirement account (IRA) rules. These rules prohibit investments by IRAs in collectibles, which are defined to include works of art, rugs, antiques, precious metals, gems, stamps, alcoholic beverages, and most coins. The Secretary of the Treasury is also given authority to specify other tangible personal property to be treated as collectibles. Proposed regulations define collectibles to include musical instruments and historical objects.

Depreciable Assets. The Administration's proposal would not alter the definition of a capital asset; however, gain from the sale, exchange, or other disposition of depreciable or depletable property used in a trade or business would not be treated as gain eligible for the lower capital gains rates. For this purpose, depreciable property refers to any property which is of a character subject to an allowance for depreciation under Code sections 167 or 168. Thus, gains realized on the disposition of intangible property, the cost of which may be recovered through amortization deductions (see Treasury Regulation Section 1.167(a)-3), such as sports player contracts, would be treated as ordinary income if the intangible property is used in the taxpayer's trade or business. The fact that cost recovery of an intangible asset may be referred to as "amortization" would not prevent its being treated as depreciable property under this provision. Depletable property refers to any property of a character that is subject to an allowance for depletion, whether cost or percentage depletion.

Under current law, gains on dispositions of special section 1231 assets, which include certain interests in timber, coal, iron ore, livestock, and unharvested crops, are eligible for capital gain treatment while losses on such property are ordinary losses. Under the Administration's proposal, no assets would be afforded such asymmetrical treatment.

Gains on nondepreciable property that is used in a trade or business and is not held for sale in the ordinary course of business would be eligible for the lower capital gains rates. Losses on such property would also be treated as capital losses. Thus, for example, gain or loss realized on the disposition of land that is used in a trade or business and is not held for sale to customers would be treated as capital gain or loss.

Capital Losses. Capital losses would be defined as under current law; however, each dollar of long-term capital loss that does not offset long-term capital gain could offset only 50 cents of noncapital gains income, as was the case prior to 1987. The $3,000 capital loss limitation would remain. Unused capital losses could be carried over indefinitely.

Preventing Abuses. Special rules will be included in the legislation to prevent abusive shifting of capital gains from high income taxpayers to related low income taxpayers in order to qualify for the 100 percent exclusion, designed for true low and moderate-income taxpayers. For example, the 100 percent exclusion might be denied to individuals recently claimed as a dependent on the return of another taxpayer.

Because the proposal provides favorable tax treatment to sales of corporate stock, without regard to whether the assets held by the corporation are qualified assets, it may also be necessary to adopt rules preventing the use of a corporation as a vehicle to convert ordinary income to capital gain. For example, it could be appropriate to restrict or deny altogether capital gain treatment on sales of S corporation stock, leaving shareholders to recognize any capital gains through sales of the S corporation's assets.

Reasons for The Proposal

Encourage Long-Term Investment. A capital gain preference has long been accepted as an important incentive for capital investment. In our own country, the first tax rate differential for capital gains was introduced by the Revenue Act of 1921. For each of the next 65 years there was always some tax differential for capital gains. At times there was an exclusion of some portion of the nominal gains. At times there was a series of exclusions that depended upon the length of time a taxpayer held an asset before selling. At times there was an alternate tax rate cap. But at no time subsequent to 1921 and prior to 1987 were capital gains ever taxed the same as ordinary income.

Our major trading partners have similarly recognized the importance of the capital gain preference. Canada, Japan, Germany and the United Kingdom all provide some level of preferential treatment for capital gains.

The Administration's proposal further adds to the incentive effects of the capital gain preference by targeting it to long-term investment. Currently, investors receive the same tax treatment whether they hold an asset for 10 years or 10 minutes. If this country is to maintain its leadership role in the world economy, we need to encourage investment, and, in particular, investment that is oriented to long-term growth rather than short-swing, speculation. By orienting investors more towards the long term, we will also enable and encourage corporate managers to take the long view of their companies' businesses, and to make the investment in research and development needed for success in future markets.

Lock-In Effect. Under a system in which capital gains are not taxed until "realized" by the taxpayer, a substantial tax on capital gains tends to lock taxpayers into their existing investments. Thus, taxpayers who, independent of tax considerations, would convert their existing assets to new investments may instead hold on to their investments to avoid paying tax on any accrued gains.

This so-called lock-in effect of capital gains taxation has at least two adverse effects. First, it produces a misallocation of capital in the economy since it alters the investment decisions that would be made in a genuinely free market. Second, the lock-in effect, depending on its strength, may deprive the government of revenue. To the extent taxpayers defer sales of existing investments, or hold onto such investments until their death, taxes that might otherwise have been paid are deferred or avoided altogether. The combination of these two effects produces a situation in which both the taxpayer and the government lose. The taxpayer is discouraged from pursuing what he believes is a more attractive investment and the government loses revenue.

Although some lock-in effect exists at any positive rate of tax on capital gains income, a preference for long term capital gains diminishes its adverse effects. The 45 percent exclusion proposed by the Administration would both improve the allocation of investment capital and trigger enough additional realizations to produce a net revenue gain to the Treasury.

Inflation. Although inflation has been kept low under policies of the past 8 years, even low rates of inflation mean that every nominal capital gain includes a "fictional" element of profit attributable to inflation. High rates of inflation, such as those that existed in the mid and late 1970s, exacerbate the problem.

Ideally, an income tax would consider only "real" changes in the value of capital assets; the element of nominal gain attributable to inflation would be disregarded. Current law taxation of nominal capital gains in full has the perverse result that real gains are overstated (and taxed too highly) and real losses are understated and, in some cases, actually converted by inflation from losses to gains. The Administration's proposed 45 percent exclusion for long-term capital gains would provide a rough adjustment for the inflationary element of capital gains. Although not a conceptually perfect response to the problem of inflation, this rough adjustment avoids the complexities and additional record-keeping that a precise inflation adjustment would require.

Low and Moderate Income Taxpayers. Low and moderate income individuals typically do not realize capital gains of the same size or with the same frequency as higher income taxpayers. It is not true, however, that only high income taxpayers would benefit from a capital gains tax rate differential. Although a large percentage of capital gains is realized by high income taxpayers, most taxpayers who would benefit from the Administration's proposal have low and moderate incomes. In 1985, the latest year for which detailed tax return data have been analyzed, one-third of all tax returns with long-term capital gains reported other (noncapital gain) income of less than $20,000. Nearly three-fourths of all tax returns with capital gains had other income of less than $50,000. And less than 2 percent had other income of $200,000 or more. (See Table 1.)

Economic studies of the behavioral reactions of individuals to changes in the taxation of capital gains suggest that lower income individuals are less responsive than higher income taxpayers to capital gains tax rate changes. The Administration's proposal for a 100 percent exclusion for lower income taxpayers provides such taxpayers with an extra measure of incentive to make direct capital investment.

Collectibles. Investment in so-called collectibles, which include works of art, stamp and coin collections, antiques, valuable rugs, and similar items does relatively little to enhance the nation's economic growth or productivity. For this reason collectibles do not warrant the preferential treatment accorded other capital investments.

Treatment of Gain on Depreciable Property. Depreciable property sales are not particularly sensitive to changes in the tax rate. The timing of such sales is more likely to be determined by the condition of the particular asset or by routine business cycles of replacement than would be true of capital assets held by investors. Thus, unlike a preferential rate for investor held capital assets, a preferential rate for sales of depreciable assets could not be justified as offsetting a strong lock-in effect and would lose rather than gain revenue. Correspondingly, the case for extending a capital gain preference to depreciable assets would have to rest substantially on the incentive effects of the preference.

The tax system has historically provided incentives for investment in depreciable and depletable property through the cost recovery system. For example, current law allows investment in plant and equipment to be recovered on an accelerated basis, permits percentage depletion for a broad range of natural resources, provides special treatment for the costs of raising timber, and has a variety of special rules under which the cost of certain intangibles may be amortized. An additional incentive in the form of a capital gain preference is at this time neither necessary nor appropriate.

Moreover, the availability of accelerated cost recovery coupled with capital gain treatment on sales of depreciable or depletable property has been a major factor behind tax shelter activity. Although the passive loss rules adopted in the 1986 Act limit tax shelter activity, restoration of a capital gain preference could make tax shelters more attractive.

Finally, gains and losses from sales or other dispositions of depreciable and depletable property should be treated in the same manner as other business income or loss and gains or losses from sales of other business property (e.g., inventory). The asymmetrical treatment of gains and losses from such depreciable or depletable property provided by pre-1987 law, i.e., the availability of capital gain treatment for gains and ordinary loss treatment for losses, is without justification as a matter of tax policy.

Effects of Proposal on Revenues

As I stated earlier, the effect on Federal tax revenues of changes in capital gains tax rates is highly controversial. Studies using different data, different explanatory variables, and different statistical methodologies have reached different conclusions. Our estimate was made after a careful review of empirical studies by experts in government and the academic community. Our estimate of induced realizations attempts to approximate a consensus from an admittedly wide range of results.

Before analyzing our estimate in detail, allow me to make one point about its source. The revenue estimates reported in the budget were produced by Treasury's Office of Tax Analysis, the same Treasury office that provides revenue estimates for all other legislative and budget proposals. You may have seen press reports that other offices in Treasury determined the estimates or that the Office of Tax Analysis produced them with the proverbial gun to its head. Whether the product of misinformation or fevered imagination, such reports are simply wrong. Although there has been a debate for some time at Treasury as to the proper basis for estimating changes in the capital gain rate, the simple fact is that these estimates reflect the same basic assumptions the Office of Tax Analysis has used for a number of years in analyzing capital gains proposals.[1]

Consistency with Prior Estimates. Perhaps the best place to start in analyzing the current estimate is with Treasury's estimate of the 1986 Act changes in capital gain taxation. Many have asked how Treasury could score restoration of a capital gain preference as raising revenue when it scored the elimination of the preference in the 1986 Act as raising revenue. The short answer to that question is that the current proposal does not simply reverse the changes made in the 1986 Act. When fully phased-in, the budget proposal limits the preference to nondepreciable assets with a 3-year holding period. This effectively targets assets that are more likely to be sold in response to a lower tax rate, and turns the budget proposal from a revenue loser in the long run to a long run revenue gainer.

One factor that masks the consistency in Treasury's estimates is that our published estimate of the 1986 Act capital gain change includes revenue not actually attributable to the elimination of the capital gain preference. Prior to the 1986 Act, there was a 30 percentage point differential in the rates of tax applicable to capital gains and other income (i.e., a 50 percent maximum rate on ordinary income and a 20 percent maximum rate on capital gains). That differential created a large incentive for taxpayers to convert ordinary income to capital gains. Elimination of the differential eliminated incentives for income shifting and consequently raised substantial revenue.

[1] The general realization response estimated for both the 1986 Act and this proposal is midway between the time-series and panel cross-section estimates published in the 1985 Treasury study of capital gains.

Although our published estimates attributed all of the revenue gain from reduced income shifting to the capital gain proposal, the greater part of it was in fact a result of the reduction in ordinary rates from 50 to 28 percent. Thus, even if the 1986 Act had left capital gain rates at 20 percent, the reduction in the ordinary rates would have substantially reduced the capital gain differential and resulted in a revenue pick-up from diminished income shifting. By including that revenue pick-up in the line estimate of the capital gain change, the positive revenue effects of that proposal were substantially overstated. If that estimate were restated, backing out the effect of the reduction in ordinary income rates, the capital gain rate increase raised only modest revenue in the long run.

Revenue Effects of Proposal's Separate Elements. Table 3 shows the separate revenue effects of the various elements of the capital gains proposal. In addition, it shows the "static" and behavioral effects incorporated in the estimate. Additional revenues resulting from positive macroeconomic effects, i.e., revenue effects from an increase in economic growth and productivity, are not included in the revenue estimate. I will address the macroeconomic revenue impact later.

1. Effect of Tax Rate Reduction on the Level of Current Law Realizations. Row 1 of Table 3 states the revenue loss that results from reducing tax rates on capital gains that would be realized at current law tax rates; i.e., realizations that would have occurred regardless of a reduction in tax rates. This loss is what a truly "static" revenue estimate would show. This "static" revenue loss results from applying the proposal to all assets held 1 year or longer and is estimated to be $ -11.9 billion in fiscal year 1990 and to be about $ -20 billion a year and growing gradually thereafter.

The basis for these calculations is reflected in Table 4, which shows that about $150 billion of net long term capital gains will be realized in 1989 and that this amount will grow to about $200 billion by 1994 with no change in law. Because the Treasury had estimated a greater behavioral response to the 1986 Act change than did the staff of the Joint Committee on Taxation, it is our understanding that the Joint Committee on Taxation staff assumes a somewhat higher path of realized gains under current law and hence a somewhat larger "static" revenue loss.

2. Effect of Increased Realizations. The second row of Table 3 shows the revenue collected from realizations that would not occur absent the lower tax rate. These induced gains are accelerated from realizations in future years, are due to portfolio shifting to capital gain assets from fully taxable income sources, or are taxable realizations that would otherwise have been tax-exempt because they would have been held until death, donated to charities, or realized but not reported.

As indicated by a comparison of Rows 1 and 2, we estimate that revenues from induced realization gains more than offset the revenue loss from lower rates on current gains. This conclusion is based on the assumed responsiveness of taxpayers to changes in the capital gain rate, which is in turn the central and most controversial aspect of the debate over capital gains and revenue.

The level of taxpayer responsiveness is generally termed "elasticity," which in this context is shorthand for the expression "percentage increase in induced capital gains divided by the percentage decrease in the overall capital gains tax rate." Thus, a tax cut will tend to generate a revenue increase if the elasticity is estimated to be greater than 1, no change in revenue if the elasticity is exactly 1, and a revenue loss if the elasticity is less than 1. 2/

Our assumption about capital gain elasticities is based on a review of government and academic studies examining the question. A cursory evaluation of these studies, which are listed in Table 5, reveals that those carried out with so-called cross section data or panel data (examining individual taxpayers in a given year or for several years) tend to yield higher estimates of taxpayer responsiveness than those carried out with time-series data (examining taxpayers in the aggregate for a number of years). Giving consideration to studies of both types, we believe that the elasticity estimates used by Treasury are comfortably in the middle of the range reported in the studies. We estimate an elasticity of 1.2 in the short run, dropping to about 1.0 in the long run, and to about 0.9 after considering the impact of converting ordinary income but before targeting the proposal for certain kinds of assets. It is our understanding that estimates made by the staff of the Joint Committee on Taxation employ a much lower long-run estimate -- perhaps as low as 0.7 -- which is within the range of the studies, but in our view clearly at the lower end. This difference in elasticities, which may seem relatively small, accounts for the great bulk of the difference between the Treasury and the Joint Committee on Taxation estimates.

2/ Even this general statement will not always be accurate. An elasticity for reduced capital gains realizations that is slightly less than 1 generally will still generate a revenue increase because taxpayers paying the highest tax rates are the most responsive. Induced realizations are disproportionately distributed with more being taxed at above-average tax rates and fewer being taxed at below-average tax rates. In addition, the general statement will not be accurate for studies using "last dollar" or maximum statutory rates.

Table 4 shows that for the Administration's basic proposal (i.e., before targeting assets, extending the holding period to 3 years, and providing additional low income tax relief) the estimated amount of induced realizations is large: $167 billion in 1991, nearly doubling the amount of gains that would have been realized with no change in law. By 1995, induced realizations would be expected to level off at about 87 percent of the level of current law capital gains realizations.

This near doubling of realizations, from an estimated $183 billion to about $349 billion at 1989 levels, may seem remarkably optimistic until it is placed in the following perspective.

- The total accumulation of unrealized qualifying gains at the end of 1987 was an estimated $4 trillion. That's trillion, not billion.

- If we exclude from this figure gains on personal residences, which largely escape tax because of the rollover and one-time $125,000 exclusion, the total pool of gains that could be realized is still $2 trillion.

- The year-over-year increase in this accumulation -- a good guide to the potential long-run realizations -- has been running about $350 billion per year, even with personal residences excluded, and is expected to grow.

3. Effect of Deferring Gains Until After Effective Date. Row 3 of Table 3 shows that the proposal will induce some taxpayers to defer realizations in the first half of 1989 until after the effective date of the proposal. With the announcement of the proposal in February and the assumed enactment and effective date of July 1, 1989, some realizations that otherwise would occur between the announcement date and the effective date will be delayed in order to benefit from the lower tax rate. The estimate predicts that about $1.4 billion of revenue will be lost only over the fiscal year 1989-1990 period due to realizations deferred until the effective date.

4. Effect of Conversion of Ordinary Income to Capital Gain Income. The proposal will induce taxpayers to realize additional capital gains currently and will encourage taxpayers to earn income in the form of lower taxed capital gains. Since the advent of preferential tax rates on capital gains in 1922, taxpayers have found various ways to convert ordinary taxable income into capital gains. Many of the most obvious conversion techniques have been stopped, but a capital gains tax rate differential will encourage taxpayers to shift to sources of income with lower tax rates.

Methods of converting ordinary income to capital gain income include shifting away from wages and salaries to deferred compensation, such as incentive stock options; shifting out of fully taxable assets, such as certificates of deposit, to assets yielding capital gains; and shifting away from current yield assets to growth assets, including corporations reducing their dividend payout ratios. It is assumed that the conversion of ordinary income to capital gain income will occur gradually, increasing from a negligible amount in 1991 to about $2.5 billion by the fifth year.

5. Effect of Excluding Depreciable Assets and Collectibles. The revenue estimate of the proposal is significantly affected by the exclusion of depreciable assets and collectibles from the lower rate. The 1985 Treasury study of capital gains found the responsiveness of capital gain realizations from assets other than corporate shares to be relatively low.[3/] That is, for some classes of assets the additional tax from induced realizations will not offset the tax loss from lower tax rates on gains that would occur under current law. By restricting the lower rates to more responsive assets, the proposal raises an incremental amount of additional net revenue, $1.2 billion in 1990, rising to $2.1 billion by 1994.

6. Effect of Phasing In the 3-Year Holding Period Requirement. The 3-year holding period requirement is phased in gradually beginning in 1993. Any holding period encourages taxpayers to defer realizations until they are eligible for the lower rate. During the transition to the 3-year holding period, a one-time revenue loss will occur as realizations are deferred. After the transition is completed, the 3-year holding period raises revenue because it, like the depreciable asset exclusion, tends to limit the lower rate to assets more responsive to changes in capital gains tax rates. Assets sold after only 1 or 2 years for consumption or other purposes, rather than deferred to 3 years, would generally be less responsive to lower tax rates.

The phase-in of the 3-year holding period will encourage many taxpayers to defer realizations that would otherwise occur after 1 or 2 years until they become eligible for the lower tax rates. In addition, the phase-in will provide an incentive during the transition for some taxpayers to accelerate the realization of some gains. For instance, taxpayers who might realize gains held for 18 months in early 1993 might choose to accelerate those gains into calendar year 1992 to be eligible for the lower rate as 1-year assets. Thus, the phase-in will

[3/] The estimated elasticity from panel cross-section data was 2.07 for corporate shares, 0.71 for residential rental real estate, and 0.43 for all other assets.

increase realizations in 1992 and revenues in fiscal years 1992 and 1993. Due to the two-step phase-in (the jump to 2 years in 1993 and to 3 years in 1995), the revenue pattern creates temporary incremental revenue losses in fiscal years 1994 and 1996. By 1998, the long-run effect of imposing a 3-year holding period is a revenue increase of $1.5 billion.

7. Effect of 100 Percent Exclusion for Low-Income Taxpayers. The additional provision to exclude all qualified capital gain realizations from tax for taxpayers with low incomes will lose approximately $0.3 billion annually. In 1985, taxpayers with adjusted gross incomes of less than $20,000 accounted for 30.2 percent of returns with capital gains and 11.4 percent of net long-term capital gain realizations. Some of these taxpayers, however, were taxpayers with low adjusted gross income due to large tax preferences. The potential cost of this feature is reduced by limiting the zero tax rate to individuals who are not subject to the alternative minimum tax rate. The provision is considered after the initial 45 percent exclusion so the revenue loss is due only to the rate reduction from 8.25 percent (55 percent times 15 percent) to zero, not the full reduction from 15 percent to zero.

Total Effect of the Proposal. The Administration's proposal is estimated to increase Federal revenues in fiscal years 1989 through 1993 due to the large induced realizations in the initial years from the unlocking of previously accrued gains. During fiscal years 1994 through 1996, a one-time revenue loss will occur as the 3-year holding period requirement is phased in, causing taxpayers to defer short-term realizations. After fiscal year 1997, the proposal will increase Federal receipts between $1 and $2 billion annually.

Comparison of Treasury and Joint Committee on Taxation Estimates

Table 6 summarizes the principal differences between the Treasury estimate of the revenue impact and the Joint Committee on Taxation staff estimate. In order to isolate the various effects in a comparable way, it is necessary to combine four rows of the more detailed Treasury revenue table and two rows of the Joint Committee table.

As discussed above, the main difference between the Treasury revenue estimate and the revenue estimate made by the staff of the Joint Committee on Taxation is that the latter estimate assumes a lower level of responsiveness by taxpayers. This difference shows up in the first bank of numbers on Table 6. A second and related difference appears in the third bank of numbers, dealing with the phase-in of a 3-year holding period. The Treasury estimate assumes a good deal of shifting on the part of taxpayers delaying and accelerating certain sales as the holding period is stretched out, while the Joint Committee on Taxation staff estimate assumes less responsiveness to shifting realizations around effective dates.

Macroeconomic Impact of the Proposal

Our revenue estimates of the Administration's proposal do not include potential increases in the rate of macroeconomic growth expected from a lower capital gains tax rate. This conforms to the general budget practice of including macroeconomic effects of revenue and spending proposals in the underlying economic forecast and hence the budget revenue and outlay totals, but excluding such effects from budget lines showing revenue impacts of any particular proposal. In the case of the proposed lower capital gains tax rate, the investment, savings, and national income growth will be most significant over the longer term.

There are two ways the Administration's capital gains proposal would affect growth. First, a lower tax rate on capital gains that qualify under the Administration's proposal would mean a lower cost of capital, primarily on corporate sector investment. Since these investments incur higher than average taxes under current law, the proposed change helps promote a more efficient playing field. By itself, this more efficient allocation of capital among sectors would improve economic welfare and lead to higher growth.

Second, by lowering the cost of capital generally, the proposal would encourage more savings and investment, leading directly to greater capital formation and eventually to a higher rate of growth in the economy.

One possible approach to quantifying the long-run macroeconomic effects would be to employ the kind of models and techniques that were used by Treasury to evaluate long-run macroeconomic consequences of tax reform. As an illustration, if we assume a 4 percent constant long-run rate of inflation and a 4 percent after-tax real rate of return required by investors, these models suggest that the Administration's proposal could increase real national income by between 0.2 percent and 0.4 percent after the economy fully adjusts. This, in turn, would translate into a permanent annual increase in long-run tax revenues of about $3 billion to $5 billion in real 1989 terms. This revenue increase would be in addition to that reflected in the budget estimate which I have discussed above.

Consistency with Tax Reform

Many appear to oppose a reduction in the capital gains rate for fear that it would reopen tax reform. They argue that the elimination of the capital gains preference was a basic trade-off in exchange for lower tax rates on other income. On this view, restoring the capital gain preference would either leave the system biased in favor of wealthy taxpayers or lead inevitably to an increase in the rate of tax on other income.

The low marginal tax rates established in tax reform were an achievement of historical significance, and plainly should not be jeopardized. Although we should thus be appropriately cautious in reexamining decisions made in tax reform, the ultimate test must be whether, consistent with the principles underlying tax reform, a proposed change in the tax law improves the efficiency and fairness of the tax system. Most accept that a capital gain preference has positive effects on economic efficiency, but we believe it is also consistent with distributional fairness.

In the first place, our estimates show that the lower capital gain rate will generate more tax revenue from wealthy taxpayers. It is difficult to argue that a proposal that increases the tax liabilities of the wealthy biases the system in their favor.

Nor do we think this conclusion is inconsistent with the premises of the 1986 Act. As I stated earlier, the Administration's proposal raises revenue precisely because it is not a simple reversal of the changes made in 1986. The capital gain preference would be restricted to a smaller pool of assets, with the preference denied to the assets historically used in tax shelters. In addition, taxpayers will be required to hold their investments for a substantial period, with the preference denied to short-swing, speculative activity.

Finally, as this Committee well knows, the 1986 Act was more complex than a simple trade of lower rates of tax on ordinary income for an elimination of the capital gain preference. Tax reform also involved substantial base broadening, the impact of which landed disproportionately on affluent taxpayers. Even more fundamentally, tax reform involved a substantial transfer of tax burden from the individual to the corporate sector, none of which was factored into the analysis of the legislation's distributional effects. In that context, the addition of a capital gains tax rate, limited primarily to holders of corporate stock, cannot fairly be seen as undermining the progressivity of the tax income system.[4]

[4] If tax changes resulting from induced realizations are taken into account along with static changes in tax, the restoration of a capital gains tax rate differential results in a slightly progressive redistribution of taxes. For example, as shown in Table 2, before making adjustments for conversion and targeting, under our basic proposal there would be a 9.2 percent increase in tax for all taxpayers with over $50,000 of adjusted gross income and a 3.1 percent reduction in capital gains tax for taxpayers with less than $50,000 of income.

Conclusion

In sum, we believe the case for the Administration's capital gain proposal is compelling. The proposal will provide an important incentive for long-term savings and investment, which over time will boost productivity and economic growth. Importantly, this incentive comes without cost in revenues, and indeed in our view significantly increases revenues in the budget period and in the long run.

We recognize that for some the possibility that a cut in the capital gain rate could increase revenue is "too good to be true." They dismiss the argument as a fanciful elaboration of supply-side economics. Although such reactions are understandable, they miss the critical point that the capital gains tax rate under current law is elective with taxpayers. Until a taxpayer sells his asset, the rate of tax is zero. Capping the statutory tax rate at 15 percent will cause many taxpayers, who would otherwise elect a zero tax rate by retaining their investments, to realize their gains and pay some tax.

Finally, let me emphasize Treasury's willingness to provide whatever assistance we can as the Committee examines the Administration's proposal and the tax and economic policy issues it raises. We have attempted in our testimony to lay out in detail the policy basis for the proposal and for our estimate of its revenue effects. We stand ready to supply such additional information as Committee members would find relevant.

That concludes my prepared remarks. I would be pleased to respond to any questions.

Attached Tables and Exhibits

-- Table 1 showing the distribution of capital gains tax changes by income class for the basic proposal with induced realizations included.

-- Table 2 showing the distribution of returns with capital gains by non-gains income class.

-- Table 3 showing the Treasury estimates in detail.

-- Table 4 showing the distribution of realizations under current law and under the basic 45%-15% proposal.

-- Table 5 showing the range of elasticities appearing in various studies by academic and government economists.

-- Table 6 showing a line-by-line comparison of the Joint Committee on Taxation and the Office of Tax Analysis revenue estimates.

Table 6

Treasury and Joint Committee Revenue Estimates For the President's Capital Gains Proposal

Item	Fiscal Years, $ Billions					
	1989	1990	1991	1992	1993	1994
1. General Proposal 1/						
Treasury	0.6	3.9	3.6	1.4	-0.6	-1.2
Joint Committee on Taxation	0.6	2.4	-6.2	-8.9	-9.8	-11.6
Difference	0.0	-1.5	-9.8	-10.3	-9.2	-10.4
2. Exclusion of Certain Asset Types						
Treasury	0.2	1.2	1.7	1.9	2.1	2.1
Joint Committee on Taxation	0.2	1.3	2.7	2.9	3.1	3.2
Difference	0.0	0.1	1.0	1.0	1.0	1.1
3. 3-Year Holding Period						
Treasury	0.0	0.0	0.0	0.4	1.0	-7.4
Joint Committee on Taxation	0.0	0.0	0.0	0.1	0.3	-1.9
Difference	0.0	0.0	0.0	-0.3	-0.7	5.5
4. Exclusion for Certain Taxpayers						
Treasury	0.0	-0.3	-0.3	-0.3	-0.3	-0.3
Joint Committee on Taxation	-0.1	-0.4	-0.4	-0.4	-0.5	-0.5
Difference	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2
Total Revenue Effect						
Treasury	0.7	4.8	4.9	3.5	2.2	-6.8
Joint Committee on Taxation	0.7	3.3	-4.0	-6.4	-6.9	-10.9
Difference	-0.1	-1.5	-8.9	-9.7	-9.1	-4.0

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Office of Tax Analysis

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1/ Includes the JCT's 45% exclusion and effective date lines, and Treasury's static estimate, increased realizations, delayed realizations around effective date and conversion of income lines.

Table 5

Long-Term Capital Gains Realization Elasticities Derived From Academic and Government Studies

Studies	Data Type	Capital Gains Type	Derived Realization Elasticity	Elasticity Derived by Simulation
Individual Tax-Return Studies:				
Feldstein, Slemrod, and Yitzhaki (1980)	Cross-Section, High-Income Sample, 1973	Corporate Stocks	-3.75	No
Minarik (1981)	Cross-Section, High-Income Sample, 1973	Corporate Stocks	Range from -.44 to -.79	No
Auten and Clotfelter (1982)	Panel Data, Middle-Income Sample, 1967 to 1973	All Capital Assets	Short-Run Range: -.91 to -3.46, Long-Run Range: -.36 to -1.45	No
U.S. Treasury (1985)	Panel Data, 1971 to 1975	All Capital Assets	Long-Run Range: -1.16 to -2.20	Yes
U.S. Treasury (1985)	Panel Data, 1971 to 1975	Corporate Stocks Real Estate Other Assets	Long Run: -2.07 Long Run: - .71 Long Run: - .43	Yes
Aggregate Time-Series Studies:				
U.S. Treasury (1985)	Time Series, 1954-1985, All Taxpayers	All Capital Assets	Short Run: -1.3 Long Run: -0.8	No
Lindsey (1987)	Pooled Cross-Section and Time Series, 1965-1982	All Capital Assets	*Short Run: -2.14 *Long Run: -1.37	No
Darby, Gillingham, and Greenlees (1988)	Time Series 1954 to 1985, All Taxpayers	All Capital Assets	*Long-Run Range: -.62 to -1.55	No
Congressional Budget Office (1988)	Time Series 1954 to 1985, All Taxpayers	All Capital Assets	*Range from -.79 to -.99	No
Auerbach (1988)	Time Series 1954 to 1986, All Taxpayers	All Capital Assets	*Long-Run Range -.06 to -1.08	No

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* Not reported by author(s). Derived at 25.4 percent average tax projected for 1988 by CBO Report (1988), Table 8

Table 4

Realizations of Net Long Term Capital Gains Under Current Law and an Across the Board Rate Cut 1/

($ Billions)

Tax Year		Realizations Under Current Law	Realizations Under Rate Cut 1/	Change in Realizations Rate Cut 1/
1980		71	--	--
1981		78	--	--
1982		87	--	--
1983		117	--	--
1984		136	--	--
1985		166	--	--
1986		319	--	--
1987	P	140	--	--
1988	E	135	--	--
1989	E	151	288	137
1990	E	168	333	165
1991	E	183	349	167
1992	E	193	357	164
1993	E	201	367	166
1994	E	206	384	178
1995	E	210	393	183
1996	E	215	402	187
1997	E	220	412	192
1998	E	225	421	196
1999	E	230	431	201

Department of the Treasury
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1/ The estimate assumes a 45% exclusion, 15% maximum rate on capital gains. This does not include the effect of a limitation to non-depreciable assets, a three year holding period, or a 100% exclusion for low income families.

'P', Data are preliminary and include short term capital gains.
'E', Estimate.

Table 3

Revenue Effects of The President's Capital Gains Proposal
Fiscal Years 1989-1999

Effects of Proposal	Fiscal Years ($billions)										
	Budget Period						Longer Run*				
	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Effect of Tax Rate Reduction on Existing Gains Projected For Current Law Realizations	-1.6	-11.9	-17.6	-19.1	-20.2	-21.0	-21.5	-22.0	-22.5	-23.0	-23.5
Effect of Increased Realizations	2.4	17.1	21.8	21.8	21.5	22.3	22.3	22.9	23.4	23.9	24.5
Effect of Delaying Gains Until the Effective Date	-0.2	-1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Effect of Conversion of Ordinary Income to Capital Gain Income	0.0	-0.1	-0.6	-1.3	-1.9	-2.5	-2.5	-2.6	-2.6	-2.7	-2.8
Effect of Excluding Depreciable Assets and Collectibles	0.2	1.2	1.7	1.9	2.1	2.1	2.3	2.4	2.4	2.5	2.5
Effect of Phased in Three Year Holding Period	0.0	0.0	0.0	0.4	1.0	-7.4	-2.3	-11.7	-0.1	1.5	1.5
Effect of 100% Exclusion for Certain Low Income Taxpayers	-0.0	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
TOTAL REVENUE EFFECT OF PROPOSAL	0.7	4.8	4.9	3.5	2.2	-6.8	-2.0	-11.3	0.2	1.8	1.8

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Notes:

These estimates include changes in taxpayer behavior but do not include potential increases in the level of macroeconomic growth.
Details may not add due to rounding.
Disaggregated effects are stacked in sequence.
** Longer run estimates assume 1994 growth extends past the budget forecast period.*

Table 2

Distribution of Net Capital Gains, and Tax Liability
Under Current Law and an Across the Board Rate Cut 1/

(Calendar Year 1991, $Billions)

Adjusted Gross Income Class Under Current Law	Capital Gain Realizations		Tax on Capital Gains	
	Current Law	Rate Cut 1/	Current Law	Rate Cut 1/
Less Than $10,000	19	22	0.9	0.7
$10,000 to $19,999	7	10	0.9	0.7
$20,000 to $29,999	8	12	1.3	1.2
$30,000 to $49,999	15	29	3.3	3.6
$50,000 to $99,999	24	54	6.3	7.5
$100,000 to $199,999	23	50	6.4	6.9
$200,000 or more	86	172	22.2	23.7
TOTAL	182	349	41.3	44.3

Department of the Treasury
Office of Tax Analysis

March 14, 1989

1/ The estimate assumes a 45% exclusion, 15% maximum rate on capital gains. This does not include the effect of a limitation to non-depreciable assets, a three year holding period, or a 100% exclusion for low income families.

Table 1

Distribution of Net Long Term Capital Gains For Returns With Long Term Capital Gains in 1985

(In Percent)

Adjusted Gross Income Class Without Capital Gains	Distribution of Returns With Long Term Gains	Distribution of Long Term Gains	Percentage of Total Returns With Long Term Gains
Less than $10,000	16.9%	19.7%	5.1%
$10,000 to $19,999	16.5	5.9	6.5
$20,000 to $29,999	15.9	6.1	9.8
$30,000 to $49,999	24.7	12.0	13.6
$50,000 to $99,999	19.7	17.5	24.6
$100,000 to $199,999	4.5	12.6	56.2
$200,000 or more	1.8	26.2	76.1
TOTAL	100.0%	100.0%	9.9%

Department of the Treasury
Office of Tax Analysis

March 14, 1989

Source: 1985 IRS Statistics of Income

TREASURY NEWS

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

FOR IMMEDIATE RELEASE March 13, 1989

GERALD L. HILSHER
LEAVES TREASURY TO RETURN TO PRIVATE LEGAL PRACTICE

Secretary of the Treasury Nicholas F. Brady announced today that Deputy Assistant Secretary for Law Enforcement Gerald L. Hilsher is leaving the Department to return to private legal practice in Tulsa, Oklahoma, where he will become "Of Counsel" to the firm of Huffman, Arrington, Kihle, Gaberino & Dunn.

As Deputy Assistant Secretary for Law Enforcement, Mr. Hilsher has responsibility for oversight of Treasury's law enforcement bureaus, including the Secret Service, the Customs Service, the Bureau of Alcohol, Tobacco & Firearms, and the Federal Law Enforcement Training Center. He is also responsible for the promulgation and enforcement of regulations under the Bank Secrecy Act. During his tenure, he has been involved in such diverse matters as Presidential candidate protection, federal firearms policy, drug interdiction, anti-money laundering initiatives, white collar crime, and was deeply involved in the development of the 1988 Anti-Drug Abuse Act.

Mr. Hilsher left private practice in Tulsa, to join the Reagan/Bush Administration as Deputy Assistant Secretary for Law Enforcement in February, 1987. He was an Assistant United States Attorney in charge of the Organized Crime Drug Enforcement Task Force in Tulsa from 1982-1985.

Mr. Hilsher graduated from Northeastern Oklahoma State University in Tahlequah, Oklahoma and received his law degree from the University of Texas School of Law in Austin, Texas. As long-time Tulsa residents, he and his wife Vickie are looking forward to their return to the Sooner State.

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TEXT AS PREPARED

REMARKS BY
THE SECRETARY OF THE TREASURY
NICHOLAS F. BRADY
BEFORE THE NATIONAL ASSOCIATION OF HOME BUILDERS

WASHINGTON, D.C.
MARCH 13, 1989

Good afternoon and thank you for this opportunity to meet with a group that represents the Nation's residential and commercial building industry. We believe strongly that the President's S&L reform package is pro-housing and good for your business. Hopefully, in the days ahead we can continue the dialogue we have started with you to ensure the swift enactment of the President's reform program to resolve the S&L problem.

I will concentrate most of my remarks this morning on the President's reform plan for the savings and loan industry. But before getting to that, I would like to take just a few minutes to touch on some of the other important priorities the Bush Administration will be pursuing.

PROMOTING ECONOMIC GROWTH

Our first and foremost economic priority is fostering a more competitive, economy which will continue to lead the world as we move toward the 21st century. We are in our 76th consecutive month of economic expansion and we will do everything we can to make sure economic growth continues. Economic growth means rising living standards for working Americans and new job opportunities for those who are out of work.

We must remain vigilant against inflation so that it does not plague our economy as it did in the late seventies. It is possible to have somewhat differiug interpretations of economic statistics, to think one set of statistics means more than another, but there is no difference between the Administration and the Federal Reserve Board on the importance of resisting and preventing inflation in order to help sustain the economic expansion.

CUTTING THE BUDGET DEFICIT

We must recognize as we pursue our goal of inflation-free economic growth that the greatest obstacle to success is the federal budget deficit. And the best way to fight inflation and encourage economic growth is to cut the deficit.

That is why President Bush has proposed to Congress a budget that will meet next year's Gramm-Rudman-Hollings deficit reduction target of $100 billion without raising taxes. His budget takes the more than $80 billion in new revenues resulting from economic growth and allocates them to deficit reduction and spending priorities.

The President pledged in his budget address to Congress that he and his team are ready to work with the Congress, "day and night, if that's what it takes, to meet the budget targets and to produce a budget on time." Budget Director Darman, Governor Sununu and I have begun to negotiate with the Congress to achieve the budget reduction all of us agree is necessary.

THE S&L PLAN

Now, let me turn to what has been one of our top priorities from the very first days of this Administration: a sound, responsible solution to the savings and loan crisis.

President Bush is correct. No simple or painless solution to this problem exists -- a point your testimony noted last week. Only eighteen days after he was inaugurated however, he announced the Administration's plan. In doing so, President Bush reaffirmed our commitment to fix it now, fix it right, and fix it once and for all.

The Administration's savings and loan industry reform plan meets these standards. It serves as a blueprint for comprehensive reform and sound financing. It is pro-consumer -- putting deposit insurance on a sound basis for the future to protect depositors and taxpayers -- and it is pro-industry -- for S&Ls and the industries they serve.

RESOLVING INSOLVENT S&Ls

Now, let me turn to a few of the most important details: On February 7, the day after the President announced his plan, the FSLIC, FDIC, OCC, and the Federal Reserve worked together to stabilize insolvent institutions. To date, 118 insolvent S&Ls have been brought under regulatory control. Within six weeks, 200 of the worst cases should be in the hands of federal authorities.

That action should begin to reduce the cost of funds for your industry. Moreover, this quick action will give us a head start on implementing the necessary resolutions of insolvent thrifts, which will be initiated as soon as Congress provides the necessary financing.

THE REFORM PLAN

We have also proposed fundamental reforms in the way the S&L industry is insured and regulated. To correct the systemic problem of having the regulator act both as an industry advocate and insurer, FSLIC will be separated from the Bank Board and attached administratively to the FDIC.

The combined administrative resources of FDIC and FSLIC will create an insurer with independence and sufficient capacity to tackle this job. While a single agency will be created, separate insurance funds will be maintained for commercial insured banks and for savings and loans.

The Chairman of the Federal Home Loan Bank System (FHLBS) will continue to be the chartering authority and the primary federal supervisor of savings and loans. The current board will be replaced by a single chairman, who will be subject to the same general direction by the Secretary of the Treasury as the Comptroller of the Currency. Let me stress a critical point here. It is not the intent of the legislation to have the Treasury Department micro-manage the day-to-day affairs of S&Ls or the new Federal Home Loan Bank System or advances by the system to S&Ls. That's the job we expect the Chairman and his supervisory personnel to do.

SAFETY AND SOUNDNESS

The Administration plan will increase safety and soundness standards for savings and loan institutions by requiring these institutions to meet standards equivalent to commercial bank capital standards by June 1, 1991. The Chairman of the Federal Home Loan Bank System will administer these capital requirements, with fairness and flexibility where it is required. For example, contrary to some comments that have been made, S&Ls that don't meet the deadline won't be liquidated -- they simply will not be able to grow after 1991 without providing adequate private capital. Much of the problem we see today is related to excessive growth in the past without sufficient capital. We have learned a valuable lesson: Deposit insurance simply will not work without sufficient private capital at risk and up front. While we can be flexible in the administration of these capital standards, we cannot afford to weaken them or delay the date they become effective.

Incentives for attracting new capital will further increase the amount of private capital protecting depositors. For example, bank holding companies will be permitted to acquire an insolvent savings and loan without the existing cross-marketing and tandem restrictions. After two years, bank holding companies will be able to acquire any savings and loan without these restrictions.

The FDIC will be given enhanced authority to set insurance standards for all S&Ls, both federal and state-chartered. It will be able to deny insurance for risky activities that have been authorized by some states in the past. The FDIC would also have a "fast whistle" to halt unsafe and unsound practices, while still protecting insured depositors.

All in all, these steps will create a system of checks and balances for S&Ls that more closely parallels that of commercial banks. And that ultimately is in the best interest of S&Ls, their customers and all of us as taxpayers. As their customers, you should benefit directly from enacting the President's plan quickly to ensure a stable business environment in the future.

SOUNDNESS OF THE DEPOSIT INSURANCE FUNDS

Beyond the regulatory reforms which are designed to insure that massive insolvencies are never allowed to occur again, there is a fundamental need to put the federal deposit insurance funds on a sound financial basis. This can be accomplished by reestablishing the basic principle of industry-financed deposit insurance funds standing between any future industry problems and the taxpayer.

The cost of the S&L solution underscores the importance of requiring all federal deposit funds to be adequately capitalized. The FDIC insurance fund's reserve-to-insured deposit ratio has fallen to an estimated all-time low of 0.83 percent. The Plan we put forward proposes increasing commercial bank premiums to bring the FDIC fund more in line with its historical reserve-to-deposit ratio to protect depositors and taxpayers.

THE FINANCING PLAN

The financing portion of the Administration's plan has three parts. The first $50 billion is to resolve currently insolvent institutions and any other marginally solvent institutions which may become insolvent over the next several years. Second, the plan ensures adequate servicing of the $40 billion in past FSLIC obligations. Third, the plan provides $24 billion for any insolvencies that may occur between 1992 and 1999.

At the heart of our plan is the creation of a Resolution Trust Corporation (RTC) to resolve all S&Ls which are now GAAP insolvent or may become so over the next three years. The creation of this new corporation will allow the isolation and containment of all insolvent S&Ls during the three-year resolution process and will facilitate a full and precise accounting of all the funds that are used. The Secretary of the Treasury will serve as Chairman of the RTC, together with the Chairman of the Federal Reserve Board of Governors and the Attorney General as the additional oversight members. Our goal will be the orderly disposition of assets inherited by the RTC, without dumping assets on depressed markets.

To provide the $50 billion to the RTC, we have asked the Congress to create a separate corporation, the Resolution Funding Corporation (REFCORP), which will issue $50 billion in long-term bonds to raise the needed funds. REFCORP will use S&L industry funds -- including what is left of the $3 billion Congress authorized from the FHLBank System in the 1987 legislation creating the Financing Corporation (FICO) -- to purchase zero-coupon, long-term Treasury securities with a maturity value of $50 billion to assure the repayment of the principal of the bonds issued by REFCORP.

Interest payments on the REFCORP bonds will come from a combination of private and taxpayer sources. The $300 million in FHLBank retained earnings is from funds not available for dividends and therefore will not directly reduce the earnings of thrifts. All Treasury funds used to service REFCORP interest will be scored for budget purposes in the year expended.

Funds for the second component of our plan -- servicing the $40 billion in resolutions already completed by FSLIC -- also will come from a combination of S&L industry and taxpayer sources.

Funds for the third component of the plan -- managing future S&L insolvencies and building the new Savings Association Insurance Fund (SAIF) during the post-RTC period -- will come from a portion of the S&Ls' insurance premiums and taxpayer funds as needed.

A REVITALIZED HOUSING FINANCE SYSTEM

Today, as in the past, the S&L industry plays an important role in housing finance. The S&L industry's problems do not stem fundamentally from their traditional business of mortgage financing. Nonetheless, problems in the S&L industry are a threat to the viability of our housing finance system and they must be fixed.

The Administration's plan is designed explicitly to promote housing finance by revitalizing the S&L industry and by maintaining, the FHLBS and its facility for managing advances to thrifts. The regulatory reforms outlined earlier as well as oversight by Treasury of the FHLBS help insure a financially viable S&L industry to serve housing finance. We believe that the best thing for housing finance in this country is a strong and sound S&L industry.

Moreover, the plan provides for explicit representation for the housing industry on the boards of directors of the regional Federal Home Loan Banks. The objective is to ensure that the concerns of the housing industry play a direct role in the policies and practices of these government sponsored enterprises.

Finally, the plan provides funding not just to resolve insolvent S&Ls, but also includes funding to establish a new S&L insurance fund for the future. The majority of future S&L insurance premiums are allocated to this insurance fund; none pay for REFCORP interest. And taxpayer funds are allocated to the insurance fund as well, giving tangible proof of our commitment to the future of the S&L industry as a provider of housing finance.

CONCLUSION

In conclusion, the Administration's activity of the past few weeks should illustrate clearly our commitment to a long-lasting resolution of the S&L crisis and a commitment to a strong, vibrant housing finance industry. We have presented a structurally sound plan. We have proposed a balanced financing package that requires contributions from the S&L industry and also lives within the government's means.

The plan will create a healthy thrift industry by removing the insolvents and requiring those which remain to have capital and accounting standards equivalent to other financial institutions. And by requiring that deposit insurance be fully funded, the plan will reinforce depositor confidence in the system. In short, we have developed a plan that is good for the housing industry.

President Bush deserves a great deal of credit for stepping forward with a plan that will do the job. And that plan deserves your forthright support. Where we differ on details, let us continue to talk with one another for the good of the public.

Let me leave you with one final thought and ask for your firm commitment. We have moved swiftly to present a credible plan to get the S&L problem off the front pages of the daily newspapers and create a more stable environment for residential finance. We now need Congress to act just as swiftly. Delay costs you and it costs the taxpayers money.

We have encouraging signals from the new leadership of both the House and Senate Banking Committees, starting with the House Financial Institutions Subcommittee markup on April 4, followed by the Senate Banking Committee the next week. We need your support and help to stay on a fast track. The American people deserve no less. With your cooperation, we can move ahead and get this problem behind us once and for all. Thank you very much.

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TREASURY NEWS

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CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
March 14, 1989

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,400 million, to be issued March 23, 1989. This offering will provide about $ 125 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $14,270 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 Standard time, Monday, March 20, 1989. The two series offered are as follows:

91-day bills (to maturity date) for approximately $ 7,200 million, representing an additional amount of bills dated December 22, 1988, and to mature June 22, 1989 (CUSIP No. 912794 SF 2), currently outstanding in the amount of $ 7,254 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 7,200 million, to be dated March 23, 1989, and to mature September 21, 1989 (CUSIP No. 912794 SY 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 March 23, 1989. 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 $1,756 million as agents for foreign and international monetary authorities, and $3,717 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.

TREASURY NEWS

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DEPARTMENT OF THE TREASURY

**Testimony by
Secretary of the Treasury
Nicholas F. Brady
Before the
Committee on Ways and Means
U.S. House of Representatives
Wednesday, March 15, 1989**

Chairman Rostenkowski, Mr. Archer and members of the Committee, I am pleased to be here today to discuss with you President Bush's proposed fiscal year 1990 budget. I know that you have already heard from the Director of the Office of Management and Budget, Richard Darman, so in my testimony I will not repeat a detailed presentation of the Bush budget.

The approach to the budget I wish to take today is from the perspective of overall economic policy, thus, I will discuss the importance of deficit reduction to the continued vitality and strength of our national economy and to maintaining and improving our position in the world economy.

We are all aware that we continue to be in a period of extraordinary economic expansion, which has produced millions of jobs, while reducing inflation. We must equally be aware that to sustain this expansion we must reduce the deficit.

As you know, the Federal Reserve recently raised the discount rate one half of a percent to seven percent. I'd like to say a few words about that. First, and foremost, the Bush Administration and the Federal Reserve share absolutely a firm commitment to fighting inflation. It is possible to have somewhat differing interpretations of the same economic statistics, to think one set of statistics means more than another, and still share the same goal of fighting inflation.

The Federal Reserve is using the strongest weapon in its arsenal to fight inflation to advance the cause of the long-term strength and vitality of our national economy. The strongest weapon we in the government have to further the cause of our long-term economic strength is deficit reduction. We must do our part. Even to delay action costs us -- in terms of interest rates, jobs, the Savings and Loan crisis, the third world debt problem.

Let us be frank with one another. We are constrained between revenue levels that are the result of the 1988 election which validated President Bush's commitment to "No new taxes" and a Gramm-Rudman-Hollings maximum deficit level of $100 billion prescribed in law. So, there are not funds to do all that we want.

Stepping back from the roar of the budget discussions for a minute, one could say, "This is where the country wants us to operate." The key is to have the American people say, "They did what we wanted with what we gave them."

ECONOMIC ASSUMPTIONS

The Bush Administration is absolutely committed to working with you to reduce the deficit. Some have questioned our economic assumptions. But, I would like to point out that historically the executive branch's economic assumptions have not had a consistent bias toward a rosy scenario. In fact, in the last seven years, the Reagan Administration underestimated growth four times and overestimated it three.

For this year, we believe that the economy will continue to grow, but at a slightly slower pace than last year's drought adjusted rate. We are projecting that GNP will grow 3.5 percent next year. But when we exclude the impact of the rebound from the drought, our forecast is for a moderate 2.8 percent growth rate. This is slower than last year's 3.4 percent drought adjusted growth rate. Our long term forecast for a 3.2 percent sustainable growth rate is right in line with our experience over the past 40 years, during which real GNP growth averaged 3.3 percent.

As one who worked for over 30 years in financial markets, I would like to make a few comments on interest rate assumptions. During my first year in business, 1954, ten-year government bonds carried an interest rate of 2.4 percent. They reached 14 percent in 1981. These same ten-year government bonds were 12.4 percent as recently as 1984, but declined to 7.7 percent in 1986. They now carry an interest rate of about 9.3 percent.

Attached as an exhibit to my testimony is a graph showing the decline in rates surrounding the passage of Gramm-Rudman-Hollings. From three and one-half months prior to the passage of this all-important fiscal legislation until three and one-half months after, interest rates declined 300 basis points. Was it the only cause of this rapid decline in interest rates? No. Was it a principal cause? Yes.

This would indicate to me that while there is plenty of room for honest disagreement about the future level of interest rates, there is some evidence that fiscal actions have an effect on interest rates, particularly long-term rates. My conclusion is that investors and savers all over the world are waiting for a sign from our government that we are committed to fiscal prudence, and are willing to do something about it. Delay in reaching a budget agreement may only maintain the current high level of interest rates and cost the U.S. and the world unnecessary pain.

In sum, do I think our economic assumptions will prove true if we don't reduce the deficit? No. Will they prove accurate if we do? I believe so.

I know that you have heard a great deal about the specific proposals in our budget from Budget Director Darman. I would simply like to reiterate the fundamental point that, within the confines of meeting the Gramm-Rudman-Hollings target, the President has proposed budget priorities which if adopted will make a significant investment in our country's future.

THE SAVINGS AND LOAN SOLUTION

The President's budget contains the funding required to resolve the Savings and Loan crisis. It has three components. The first part consists of $50 billion to resolve currently insolvent institutions and those which may become insolvent over the next several years. Secondly, the plan ensures adequate servicing of the $40 billion in past FSLIC obligations.

And third, and perhaps most important, the plan provides $33 billion in financial resources necessary to put S&L deposit insurance on a sound financial basis for the future.

At the heart of our plan is the creation of a Resolution Trust Corporation (RTC), for which the FDIC will be the primary manager, directed to resolve all S&Ls which are now insolvent or become so over the next three years.

To provide the $50 billion to the RTC, we will create a new, separate, privately-owned corporation, the Resolution Funding Corporation (REFCORP), which will issue $50 billion in long-term bonds to raise the needed funds. To pay the principal, industry funds will be used to purchase zero-coupon, long-term Treasury securities which will grow through compound interest to a maturity value of $50 billion. This assures the repayment of the principal of the bonds issued by REFCORP. Funds to purchase these zero-coupon bonds will come exclusively from private sources:

-- The FHLBanks will contribute about $2 billion of their retained earnings -- which are currently allocated to, but not needed by, the existing Financing Corporation (FICO) -- plus approximately 20 percent of their annual earnings, or $300 million, in 1989, 1990 and 1991;

-- The S&Ls will contribute a portion of their insurance premiums; and

-- If necessary, proceeds from the sale of FSLIC receivership assets will be used.

No Treasury funds or guarantees will be used to repay any REFCORP principal.

Interest payments on the REFCORP bonds will come from a combination of private and taxpayer sources:

-- The FHLBanks, beginning in 1992, will contribute $300 million a year;

-- The RTC will contribute a portion of the proceeds generated from the sale of receivership assets, and proceeds from warrants and equity participations taken in resolutions; and

-- Treasury funds will make up any shortfall.

All Treasury funds used to service REFCORP interest will be scored for budget purposes in the year expended.

Funds for the second component of our plan -- servicing the cost of the $40 billion in resolutions already completed by FSLIC -- also will come from a combination of S&L industry and taxpayer sources:

-- FICO will issue bonds under its remaining authority and contribute the proceeds;

-- The S&Ls will contribute a portion of their insurance premiums;

-- FSLIC will contribute the proceeds realized from the sale of receivership assets taken in already completed resolutions, as well as miscellaneous income; and

-- Treasury funds will be used to make up any shortfall.

The final component of the plan is managing future S&L insolvencies and building the Savings Association Insurance Fund (SAIF), the new S&L insurance fund, during the post-RTC period. The funding will come from a portion of S&Ls' insurance premiums and Treasury funds as needed.

These sources provide about $3 billion per year to handle any insolvencies which occur in the 1992-99 period and in addition contribute at least $1 billion per year to building the new Savings Association Insurance Fund. Overall the plan contains $33 billion in post-RTC funds from 1992 to 1999 to manage future insolvencies and contribute to building a healthy new S&L insurance fund. Assuming that $24 billion is used for post-RTC resolutions, by 1999 the SAIF fund will still contain just under $9 billion at a minimum to support the healthy S&Ls.

The net impact of the entire plan -- which includes paying for completed S&L resolutions, paying for the S&L resolutions still to be completed, and providing for fully funded insurance funds for both commercial banks and thrifts -- is $1.9 billion in FY90 and $39.9 billion over the next 10 years.

REVENUE PROVISIONS

The President's budget includes important revenue-related measures that fall within the jurisdiction of the Treasury Department. These measures also directly reflect the President's commitment to a budget that sustains a strong economy and builds upon it to enhance our future economic power.

CAPITAL GAINS

We propose a major tax initiative designed to enhance America's long-term growth and competitiveness: a reduction and restructuring of the capital gains tax to encourage long-term investment. Our proposal calls for a 45 percent exclusion of long-term gains or a 15 percent tax rate cap, whichever is more advantageous to the taxpayer. As an important part of this plan, we have targeted the greatest relative benefits to those with incomes lower than $20,000, if married, and $10,000 if single. Such taxpayers would be eligible for a 100 percent exclusion--no tax at all on long-term capital gains.

The policy of a lower tax rate for capital gains was first established in the Revenue Act of 1921. This policy remained in effect for 65 years. During this time it was endorsed by Democrats and Republicans alike as an important means of stimulating investment. The Tax Reform Act of 1986 eliminated that differential in 1987 while generally reducing taxes. In our view, the reinstatement of some type of capital gains differential is totally consistent with one of the major goals of the 1986 Act. That was, and is, to reduce tax rates to stimulate entrepreneurial activity.

Our proposal does that by targetting the benefits of those activities which will expand economic productivity and expand investment. I believe the essential benefit of a reduction in the capital gains tax goes beyond simply encouraging short-term investment and growth. Over the next four years, we propose to phase in a three-year holding period for capital assets sold to qualify for the lower capital gains tax rates. Thus we want to shift the focus of investors from the short-term to the long-term, because ultimately, it is long-term investment which will provide our economy with its fundamental strength. Thus we propose to restore this long-acknowledged incentive to American enterprise.

RESEARCH AND EXPERIMENTATION

Enhancing incentives for long-term investment is not the only area in which we need to act if the United States is going to remain a leader in the world economy. It is equally important that we take steps to augment policies and programs which stimulate research and development and which foster our long-term productive capacity.

To this end, the President's budget increases investment in basic research by increasing funding for science and technology programs by 13 percent over the enacted 1989 funding levels. Furthermore, we propose to make the tax credit for research and experimentation permanent. For a number of years, we have had a temporary tax credit to encourage additional research and experimentation (R&E) by U.S. industry. The current credit expires at the end of 1989. It's time we stopped sending stop and go signals to the business community on the importance of research to our economic strength.

Accordingly, the President has proposed to make this credit a permanent feature of the landscape so that U.S. corporations can make their R&E plans with a longer horizon. With this same purpose in mind, the President has also proposed a permanent and more beneficial formula for the allocation of R&E expenses between domestic and foreign income.

ENTERPRISE ZONES

In order to stimulate local government and private sector revitalization of economically distressed areas, the President has proposed an enterprise zone initiative. This initiative includes selected federal employment and investment tax credits to be offered in conjunction with federal, state, and local regulatory relief. Up to 70 zones may be selected between 1990 and 1993.

CHILD CARE

Mindful of the growing need for child care, the President proposes to increase assistance to low-income families through changes in the tax code. He proposes a new, refundable tax credit of up to $1,000 for each child under four in low-income working families. This credit would be available to very low-income families, in which at least one parent works, in tax year 1990, and will be expanded to include additional families in following years. By this tax assistance the President's budget provides vital support to families while permitting them to make their own choices about child care that best fits their needs. The President further proposes to make the existing dependent care credit refundable. In its current state the existing credit is of no value to lower income families who do not pay tax.

SPECIAL NEEDS ADOPTION

The President proposes to permit the deduction from income of expenses incurred associated with the adoption of special needs children up to a maximum of $3,000 per child.

MEDICARE HOSPITAL INSURANCE

Currently, State and local employees hired prior to April 1, 1986, are not covered by Medicare Hospital Insurance, nor are they subject to the tax. The President's budget proposes that as of October 1, 1989, all state and local government employees would be covered by Medicare Hospital Insurance.

These are the major revenue-related proposals in the President's budget. Let me reiterate that the intent behind these proposals is to sustain a strong economy while fostering an equitable distribution of benefits and responsibilities to our citizens.

INTERNATIONAL CONTEXT

Improving our competitive position in the world economy is very important to our future international economic position. Reducing the deficit will not only improve our competitive position, but is of vital importance to our overall international economic standing. I wish to take a few minutes to address the international implications of our work on the budget this year.

The new reality is that there are no more international boundaries when it comes to the flow of dollars--no border control, no customs officials and no barriers. The influence of foreign financial markets on our economy is great and deep. Most of the world's dollar financial transactions settle daily through New York. Before the advent of instantaneous transfer of information and electronic funds transfers this settling of accounts would have taken weeks, now it occurs every night. There are two "wires" through which the transactions settle. The CHIPS wire which largely handles international transactions, and the Fed wire which handles mostly, but not exclusively, domestic transactions. Last month on average about $735 billion worth of transactions were settled per day on the CHIPS wire. And the level of activity is increasing on average at a rate of 25 percent a year. If you approximate the international transactions settled via the Fed wire, then about $1 trillion of international transactions are settled every day on these wire systems. This amounts to $5 trillion a week, in other words greater each week than our yearly GNP.

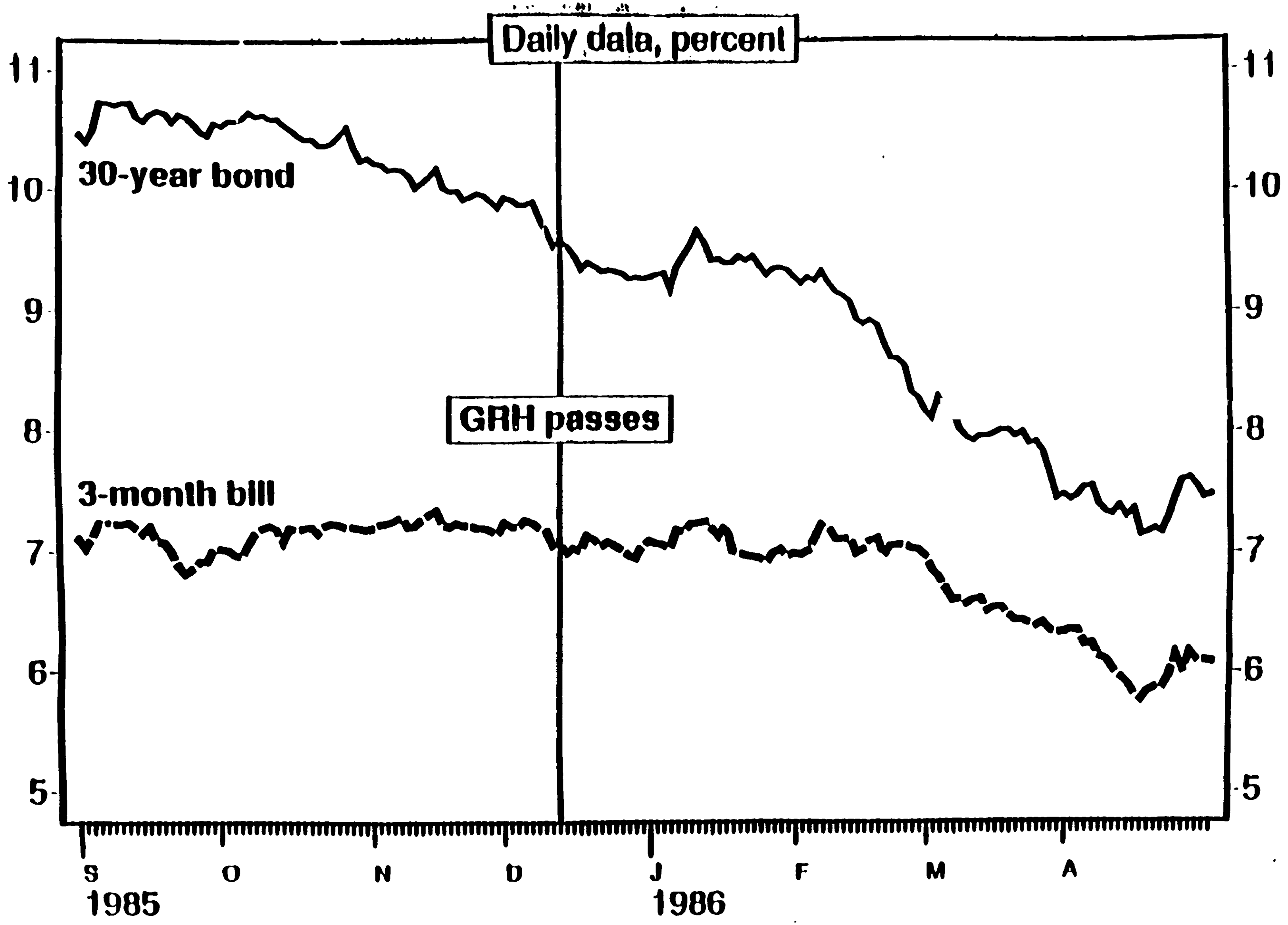
Another statistic which demonstrates the power of international finance on our economy is that at the end of 1987 the recorded stock of U.S. assets held by foreigners was almost $400 billion greater than the stock of foreign assets held by Americans. Ten years ago this difference was $50 billion in our favor. While one can have different views of how to interpret those numbers, one point is clear -- we cannot ignore the effect of international markets on our balance of payments when considering the need for deficit reduction.

Both the flow of financial transactions through the Fed wire and CHIPS and the amount of U.S. assets held by foreigners are in a sense a measure of foreign confidence in our ability to maintain a sound economy and reduce our budget 'deficit. The tally of the world's opinion of our progress is registered every day through CHIPS and the Fed wire. It is vital that we act decisively to preserve that confidence.

Lest there be any doubt about the extent of the world's interest and concern about the deficit, let me share with you some of the feelings of my G-7 colleagues -- who met here in Washington, DC the first week in February. We are engaged in a team effort, the economic policy coordination process, to provide a growing world economy. I have been pressing them to stimulate their domestic economies and open their markets to sustain world economic growth. They, in turn, are deeply concerned about our ability to reduce the deficit. They worry that we lack the strength of purpose to meet the Gramm-Rudman-Hollings target. They are knowledgeable about the details of our budget process and are watching very carefully how we handle our budget negotiations. They are concerned that our commitment to abiding by the current Gramm-Rudman targets is less than firm and unequivocal, that if meeting the $100 billion target becomes too onerous, we will move the goal line. I assured them on behalf of us all that people in this government--executive and legislative branches alike--are firmly and absolutely committed to meeting the deficit reduction target. I have told them that we will get there one way or the other.

I know you share this commitment. I am delighted to be here today to discuss with you how we can achieve this common goal.

INTEREST RATES, SEPTEMBER 1985 TO APRIL 1986



TREASURY NEWS

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For Release Upon Delivery
Expected at 10:00 a.m., EST
March 15, 1989

**STATEMENT OF
DANA L. TRIER
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE**

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to testify concerning the Administration's budget. I would like to begin by reviewing and discussing the specific tax proposals contained in the budget, except for the capital gains proposal, which was the subject of separate testimony before your committee yesterday by Acting Assistant Secretary for Tax Policy Dennis E. Ross. Then I will discuss expiring tax provisions which have not been proposed for extension by the budget.

The budget contains the following proposals affecting receipts: (1) reduction of capital gains rate for individuals; (2) modification and making permanent the research and experimentation credit; (3) modification of research and experimentation expense allocation rules; (4) provision of energy tax incentives; (5) provision of enterprise zone initiatives; (6) provision of child tax credit and making refundable child and dependent care tax credits; (7) permitting deduction for special needs adoption; (8) extension of Medicare insurance coverage to state and local employees; (9) repeal of the airport and airway trust fund tax trigger; (10) extension of the communications excise tax; and (11) certain miscellaneous proposals affecting receipts.

The following provisions will expire in 1989 and are not proposed for extension by the budget: (1) the tax credits for investments in solar, geothermal, and ocean thermal property; (2) the targeted jobs tax credit; (3) authority to issue qualified mortgage bonds and mortgage credit certificates; (4) authority to issue qualified small issue bonds; (5) deduction for health insurance of self-employed; (6) exception to early plan distribution rules for employee stock ownership plans; (7)

low-income housing credit; and (8) certain provisions relating to financially troubled thrift institutions. The following provisions expired in 1988 and, we understand, are the subject of sufficient interest to your committee to warrant our comment at this time: (1) exclusion for employer-provided group prepaid legal services; and (2) exclusion for employer-provided education assistance.

SUMMARY OF THE PRESIDENT'S BUDGET PROPOSALS AFFECTING RECEIPTS

Modification and Making Permanent the Credit for Research and Experimentation

Current Law

Present law allows a 20 percent tax credit for the increase in a taxpayer's qualified research expenses over a base amount. The base amount is the taxpayer's average annual qualified research expenditures over the prior 3 years. This base, however, is defined so that it can never be less than 50 percent of current qualified expenditures. The credit is available only for research expenditures paid or incurred in carrying on the trade or business of the taxpayer. As a result, new firms and firms entering a new line of business cannot claim the credit for qualified R&E until the expenses relate to an ongoing trade or business.

The amount of any deduction for research expenditures is reduced by 50 percent of the amount of credit taken for that year. The current research credit expires at the end of 1989.

Budget Proposal

The proposed R&E credit would retain the incremental feature of the present credit and its 20 percent rate, but would make the credit permanent and modify the calculation of the base amount. The new base would be a fixed historical base equal to the average of the firm's qualified R&E expenditures for 1983 through 1987 and would be indexed for inflation. Firms also would have the option of a separate 7 percent credit for expenditures which exceed 75 percent of the base amount. As with current law, all firms would be subject to a base equal to at least 50 percent of R&E expenditures. The proposal also would liberalize the "trade or business" test so that new firms and firms entering new lines of business could claim the credit. Finally, the proposal would reduce the amount of the taxpayer's deduction for research expenses by the amount of the credit.

Discussion

The Administration is committed to encouraging continued growth of private, domestic research activities by establishing a permanent tax credit for research and experimentation (R&E). The tax credit for research is intended to create an incentive for technological innovation. R&E activity, by its nature, is long term and taxpayers should be able to plan their research activity knowing whether the credit will be available. If the credit is to have the intended incentive effect, it should be made permanent.

The proposal also would modify the structure of the current credit to increase its incentive effect and its availability for firms undertaking research. The proposal would increase the credit's incentive effect by replacing the current credit's moving base with a fixed-base structure. The critical feature of this fixed base is that a firm's current spending will have no effect on future credits. Thus, unlike the current credit, a dollar of credit earned in the current year does not reduce credits in future years.

The proposal also would increase the percentage of R&E-performing firms eligible for the credit. This increase is achieved in two ways: (1) through the design of the primary and alternative bases, which results in a larger number of firms with R&E expenditures above the base; and (2) by liberalizing the trade or business test to allow expenditures of new firms and firms entering new lines of business to claim the credit.

Since the proposal would index the credit base, the amount of the credit allowable to any firm and the cost of the credit to the Government would no longer depend on the rate of inflation. Finally, by disallowing a deduction for R&E expenses to the extent of R&E credits taken, the proposal would provide similar tax treatment for all sources of Federal support for research.

Revenue Estimate

Fiscal Years			
1990	1991	1992	1993
	($ billions)		
-0.4	-0.7	-1.0	-1.2

Modification and Making Permanent R&E Expense Allocation Rules

Current Law

Temporary rules for allocating research and experimentation (R&E) expenses generally expired on May 1, 1988. Under those rules, U.S. firms were allowed to allocate 64 percent of their expenses for R&E performed in the United States to U.S. source income. The remaining 36 percent of expenses were allocated between U.S. and foreign source income on the basis of either gross sales or gross income. The amount allocated to foreign source income on the basis of gross income had to be at least 30 percent of the amount allocated to foreign source income on the basis of gross sales.

Since expiration of the R&E allocation rules, R&E expenses have been allocated between U.S. and foreign source income under detailed 1977 Treasury regulations, which were designed to match R&E expenses with the foreign and domestic source income related to the expenses.

Budget Proposal

The proposal would permit 67 percent of R&E expenses to be allocated to U.S. source income. The remaining 33 percent would be allocated on the basis of either gross sales or gross income. No limitation would be placed on the allocation to U.S. source income under the gross income method.

The proposal would apply retroactively to the expiration of the earlier rules, generally May 1, 1988.

Discussion

The proposal would increase tax incentives for U.S. firms to engage in U.S. based research activity. Current law allocates more R&E expenses to foreign source income and less to U.S. source income than the proposal. The higher allocation to foreign source income under current law reduces the amount of foreign tax credits that firms can use to offset their U.S. tax liability. Because many firms have excess foreign tax credits, the existing allocation regulations can reduce firms' U.S.-based R&E expenditures. Making the rules permanent would provide U.S. firms with the certainty necessary to assess long-term tax ramifications of their R&E expenses.

Revenue Estimate

Fiscal Years

1990	1991	1992	1993
	($ billions)		
-1.7*	-0.7	-0.8	-0.9

*The FY 1990 revenue loss includes the retroactive application of this proposal.

Energy Tax Incentives

Current Law

Current law provides incentives for domestic oil and gas exploration and production by allowing the expensing of certain intangible drilling and development costs ("IDCs") and the use of percentage depletion. Current law does not provide any further incentive for exploratory drilling or tertiary enhanced recovery techniques.

In general, IDCs include expenditures incurred or paid by an operating or working interest owner in the development of oil or gas properties which are neither for the purchase of tangible property or part of the acquisition price of the oil or gas property. IDCs include amounts paid for labor, fuel, repairs, and site preparation. IDCs do not include geological and geophysical costs, nor do IDCs include surface casing costs. IDC deductions on successful oil and gas wells are a tax preference item for purposes of the alternative minimum tax (the "AMT"). Therefore, this tax preference item increases a taxpayer's alternative minimum taxable income, which may subject such taxpayer to liability for the AMT. The IDC preference item for purposes of the AMT is the amount by which a taxpayer's "excess IDCs" claimed with respect to successful wells exceed 65 percent of the taxpayer's net income from oil, gas, or geothermal properties. "Excess IDCs" are the amount by which the IDC deduction for the year (attributable to successful wells) exceeds the deduction that would have been claimed had the IDCs been capitalized and either amortized over a 10-year period or recovered through depletion.

Independent producers and royalty owners (but not integrated oil companies) recover capital expenditures with respect to oil and gas properties using the higher of cost or percentage depletion. Under cost depletion, the amount of the depletion deduction is equal to the portion of the taxpayer's basis equal to the percentage of total reserves produced during the year. Under percentage depletion, the amount of the depletion deduction is equal to a statutory percentage of gross income from the property (15 percent in the case of oil and gas production not in excess of 1,000 barrels). The percentage depletion deduction, however, may not exceed 50 percent of the taxable income from the property for the taxable year, computed without regard to the depletion deduction. Unlike cost depletion, percentage depletion may result in deductions over the life of a property in excess of the taxpayer's basis in the property. The percentage depletion deduction may not exceed 65 percent of the taxpayer's net taxable income for the year. The "transfer rule" prohibits percentage depletion with respect to an oil or gas property that is transferred after it has been "proven" (i.e., shown to have oil and gas reserves).

Budget Proposal

The budget contains four provisions intended to strengthen our domestic oil and gas industry. Two proposals would provide temporary tax credits that would be phased out if the average daily U.S. well head price of oil is at or above $21 per barrel for a calendar year. First, a temporary tax credit would be allowed for exploratory intangible drilling costs in the amount of 10 percent of such costs for the first $10 million in expenditures (per year per company) and 5 percent of such costs in excess of $10 million. Second, a temporary 10 percent tax credit would be allowed for all capital expenditures on new tertiary enhanced recovery projects (i.e. projects that represent the initial application of tertiary enhanced recovery to a property). These credits could be applied against both the regular and alternative minimum tax. However, the credits, in conjunction with all other credits and net operating loss carryovers, could not eliminate more than 80 percent of the tentative minimum tax for any year. Unused credits could be carried forward. These credits would be effective for expenditures after December 31, 1989.

The third proposal is to eliminate the so-called "transfer rule" and raise the percentage depletion deduction limitation to 100 percent of the net income from each property. This proposal would be effective for taxable years beginning after December 31, 1989. Finally, the budget proposal would eliminate 80 percent of current AMT preference items generated by exploratory IDCs incurred by independent producers. This proposal would be effective for expenditures after December 31, 1989.

Discussion

The Administration is committed to an energy policy that is designed to strengthen our domestic oil and gas industry and improve the level of domestic energy reserves. The sharp reduction in world oil prices and the increasing levels of oil imports may raise both energy security and national security concerns. The prolonged period of low oil prices has caused a substantial decline in our domestic energy reserves resulting from a 70-percent decrease in domestic exploratory drilling, a 20 percent increase in development drilling, and the abandonment of a large number of marginal wells. The decline in domestic reserves and our increased dependence on foreign oil may leave our nation vulnerable to potential supply disruptions. In addition, our ability to respond to supply disruptions has been impaired to the extent that the prolonged period of low oil prices has damaged our domestic oil industry. The special tax incentives proposed by the budget are appropriate to encourage higher levels of exploratory drilling and the continued operation of our marginal wells. This may lead to increased domestic reserves and a stronger domestic energy industry that would be better able to respond to supply disruptions.

The level of proven domestic reserves is closely related to the level of domestic exploratory drilling. Historically, independent producers have drilled a majority of our exploratory wells even though they are generally much smaller than the integrated producers. The tax incentives on which independent producers have traditionally depended are percentage depletion and the expensing of intangible drilling costs (IDCs). The budget proposals would increase the benefit of these tax incentives and provide additional incentives to encourage exploratory drilling by independent producers.

The budget proposal would also encourage production from marginal properties. The transfer rule discourages the transfer of producing wells from an owner in whose hands the property may be uneconomic to an owner who may be more efficient. The 50 percent of net income limitation may encourage the abandonment of marginal or high-cost properties which produce a relatively small amount of net income. By eliminating the transfer rule and raising the net income from the property limitation to 100 percent, the budget proposal would reduce the likelihood that tax factors will cause the abandonment of producing properties. Finally, by providing a tax credit for tertiary enhanced recovery projects, the budget proposal would encourage the use of such techniques to squeeze additional production from known fields.

Revenue Estimate

	Fiscal Years			
	1990	1991	1992	1993
		($ billions)		
10 percent credit for exploratory drilling	-0.2	-0.3	-0.3	-0.4
10 percent credit for tertiary enhanced recovery	*	*	*	*
Eliminate the transfer rule and increase the net income allowance to 100 percent for percentage depletion by independent producers and royalty owners	*	*	*	*
Eliminate 80 percent of exploratory IDC tax preferences from minimum tax for independent producers	-0.1	-0.1	-0.1	-0.1

* $50 million or less.

Provision of Enterprise Zone Incentives

Current Law

Existing Federal tax incentives generally are not targeted to benefit specific geographic areas. Although the Federal tax law contains incentives that may encourage economic development in economically distressed areas, they are not limited to use with respect to such areas.

Budget Proposal

The proposed enterprise zone initiative would include selected Federal employment and investment tax credits to be offered in conjunction with Federal, state, and local regulatory relief. Up to 70 zones would be selected between 1990 and 1993.

There would be both capital-based and employment-based tax credits, although the details of the tax credits have not been specified. The extent of the tax subsidies would vary, with larger subsidies in the early years that decline over time. Total Federal revenue losses would gradually rise, however, as more zones are designated.

The willingness of states and localities to "match" Federal incentives would be considered in selecting the special enterprise zones to receive these additional Federal incentives.

Discussion

Despite sustained national prosperity and growth, certain areas have not kept pace. The enterprise zones initiative would stimulate local government and private sector revitalization of economically distressed areas. Enterprise zones would encourage private industry investment and job creation in economically distressed areas by removing regulatory and other barriers inhibiting growth. They would also promote growth through selected tax incentives to reduce the risks and costs of expanding in severely depressed areas.

Revenue Estimates

Fiscal Years

1990	1991	1992	1993
	($millions)		
-150	-200	-300	-400

Provision of New Child Care Tax Credit and Making Current Child and Dependent Care Tax Credit Refundable

Current Law

The Internal Revenue Code of 1986 (the "Code") provides assistance to low-income working families through both the earned income tax credit (EITC) and the child and dependent care tax credit.

Earned Income Tax Credit. Low-income families with minor dependents may be eligible for a refundable income tax credit of up to 14 percent of the first $6,500 in earned income. The maximum amount of the credit is $910. The credit is reduced by an amount equal to 10 percent of the excess of adjusted gross income (AGI) or earned income (whichever is greater) over $10,240. The credit is not available to taxpayers with AGI or earned income over $19,340. Both the maximum amount of earnings on which the credit may be taken and the income level at which the phase-out region begins are adjusted for inflation (1989 levels are shown). Families have the option of receiving the refund in advance through a payment added to their paychecks.

Child and Dependent Care Credit. Taxpayers may also be eligible for a nonrefundable income tax credit if they incur expenses for the care of certain dependents in order to work. To be eligible for the credit, taxpayers must be married and file a joint return or be a head of household. Two-parent households with only one earner generally do not qualify for the credit.

Employment-related expenses eligible for the credit are limited to $2,400 for one qualifying individual and $4,800 for two or more qualifying individuals. Further, employment-related expenses cannot exceed the earned income of the taxpayer, if single, or, for married couples, the earned income of the spouse with the lower earnings.

Taxpayers with AGI of $10,000 or less are allowed a credit equal to 30 percent of eligible employment-related expenses. For taxpayers with AGI of $10,000 to $28,000, the credit is reduced by 1 percentage point for each $2,000, or fraction thereof, above $10,000. The credit is limited to 20 percent of employment-related dependent care expenses for taxpayers with AGI above $28,000.

Dependent Care Assistance Programs. If the employer has a dependent care assistance program, employees are allowed to exclude from income amounts paid or incurred by the employer for dependent care assistance provided to the employee. The amount excluded from income may not exceed $5,000 per year ($2,500 in the case of a separate return filed by a married individual). An employee generally may not take advantage of both the child and dependent care credit and this income exclusion.

Budget Proposals

Effective January 1, 1990, low-income families containing at least one worker would be entitled to a new refundable tax credit of up to $1,000 for each dependent child under age four. The credit would be equal to 14 percent of earned income, with a maximum credit equal to $1,000 per child. Initially, the credit would be reduced by an amount equal to 20 percent of the excess of AGI or earned income (whichever is greater) over $8,000. In subsequent years, both the starting and end-points of the phase-out range would be increased by $1,000 increments. In 1994, the credit would phase-out between $15,000 and $20,000. Families would have the option of receiving the refund in advance through a payment added to their paychecks.

The existing child and dependent care tax credit would be made refundable. Families could claim either the new child credit or the child and dependent care credit, whichever would be greater.

Discussion

The proposals would increase the resources available to low-income families, better enabling them to choose the child-care arrangements which best suit their needs and correspond to their personal values.

Revenue Estimate

	Fiscal Years			
	1990	1991	1992	1993
		($ billions)		
Revenue loss	*	*	*	.1
Outlays[1]	.2	1.8	2.2	2.4

* $50 million or less.

[1] Increased outlays attributable to refunds payable to eligible individuals with no tax liability.

Permitting Deduction for Special Needs Adoptions

Current Law

Expenses associated with the adoption of children are not deductible under current law. However, expenses associated with the adoption of special needs children are reimbursable under the Federal-State Adoption Assistance Program (Title IV-E of the Social Security Act) under which the Federal Government shares 50 percent of these costs up to a maximum Federal share of $1,000 per child. Special needs children are those who by virtue of special conditions such as age, physical or mental handicap, or combination of circumstances, are difficult to place for adoption. Reimbursable expenses include those associated directly with the adoption process such as legal costs, social service review, and transportation costs.

Budget Proposal

The proposal would permit the deduction from income of expenses incurred associated with the adoption of special needs children up to a maximum of $3,000 per child. Eligible expenses would be limited to those directly associated with the adoption process that are eligible for reimbursement under the Adoption Assistance Program. Expenses which were deducted and reimbursed would be included in income in the year in which the reimbursement occurred.

Discussion

The proposal, when combined with the current outlay program, would assure that reasonable expenses associated with the process of adopting a special needs child do not cause financial hardship for the adoptive parents. In addition, the proposal is responsive to the Administration's concern that adoption of these children be specially encouraged and may call to the attention of families interested in adoption the various programs which help families adopting children with special needs.

Revenue Estimate

Fiscal Years			
1990	1991	1992	1993
	($millions)		
*	-3	-3	-3

* Less than $500,000

Extension of Medicare Hospital Insurance (HI) to State and Local Employees

Current Law

State and local government employees hired on or after April 1, 1986, are covered by Medicare Hospital Insurance and their wages are subject to the Medicare tax (1.45 percent on both employers and employees). Employees hired prior to April 1, 1986, are not covered by Medicare Hospital Insurance nor are they subject to the tax.

Budget Proposal

As of October 1, 1989, all State and local government employees would be covered by Medicare Hospital Insurance.

Discussion

State and local government employees are the only major group of employees not assured Medicare coverage. A quarter of State and local government employees are not covered by voluntary agreements nor by law. However, 85 percent of these employees receive full Medicare benefits through their spouse or because of prior work in covered employment. Extending coverage would assure that the remaining 15 percent have access to Medicare and would eliminate the inequity and the drain on the Medicare trust fund caused by those who receive Medicare without fully contributing.

Under the proposal, an additional 2 million State and local government employees would be contributing to Medicare. Of these, roughly 300,000 employees would become newly eligible to receive Medicare benefits, assuming an employee has satisfied the minimum 40 quarters of covered employment.

Revenue Estimate[1]

Fiscal Years			
1990	1991	1992	1993
	($ billions)		
1.8	1.9	1.9	1.9

[1] Net of income tax offset.

Repeal of the Airport and Airway Trust Fund Tax Trigger

Current Law

The Airport and Airway Safety and Capacity Expansion Act of 1987 established a trigger that would reduce by 50 percent several of the airport and airway trust fund taxes. The trigger will take effect in calendar year 1990 because the 1988 and 1989 appropriations for the capital programs funded by these taxes were less than 85 percent of authorizations. The trigger will reduce by 50 percent the 8 percent air passenger tax, the 5 percent air freight tax, and the 14 cents per gallon non-commercial aviation fuels tax. It will also substantially reduce the aviation gasoline tax.

Budget Proposal

The proposal would repeal the tax reduction trigger, resulting in increased airport and airway trust fund receipts of $1.2 billion in FY 1990 and increased governmental receipts (net of income and employment tax offsets) of $0.9 billion.

Discussion

Repeal of the trigger is required for the accumulation of funds for the modernization of airport and airway facilities in the United States in the early 1990s.

Revenue Estimate[1]

Fiscal Years			
1990	1991	1992	1993
($ billions)			
0.9	1.6	1.7	1.8

[1] Net of income tax offsets. The estimates shown are relative to current services receipts which assume continuation of trigger rates through 1994.

Extension of the Communications (Telephone) Excise Tax

Current Law

The Omnibus Budget Reconciliation Act of 1987 (the "1987 Act") extended the communications excise tax until the end of 1990. The tax is imposed at a rate of 3 percent on local and toll (long-distance) telephone service and on teletypewriter exchange service. Allowing the tax to expire would reduce Federal tax receipts by approximately $2.5 billion annually.

Budget Proposal

The proposal would permanently extend the 3 percent Federal communications excise tax. The tax rate is substantially less than the 10 percent rate that was in effect between 1954 and 1972, and as low or lower than the rate in effect for any year since 1932 (except for 1980-82). The base of the tax would not be broadened.

Discussion

Extension of the communications excise tax would maintain a revenue source that has been in existence continuously since 1932, and would avoid the disruption that would occur if the tax were allowed to expire and then were reenacted.

Revenue Estimate[1]

Fiscal Years			
1990	1991	1992	1993
($ billions)			
0	1.6	2.6	2.8

[1] Net of income tax offset.

Miscellaneous Proposals Affecting Receipts

IRS Enforcement Initiative. The proposal would increase IRS funding for tax law enforcement to improve compliance and collection of past due taxes.

Increase NRC User Fees. The proposal would increase user fees to cover 100 percent of the cost to the Nuclear Regulatory Commission ("NRC") of regulating nuclear power plants costs, effective October 1, 1989.

Initiate FEMA User Fees. The proposal would recover 100 percent of costs of regulating the evacuation plans of the nuclear power industry through user fees, effective October 1, 1989.

Increase D.C. Employer Contribution to CSRS. Under the proposal, the D.C. government would pay retirement cost-of-living adjustments (COLAs) to its retirees and their survivors. The initial annual payment would begin in 1991 because of a proposed budget COLA freeze for government annuitants in 1990.

Extend Reimbursable Status to Amtrak. The proposal would exempt Amtrak from the railroad unemployment tax rate, but would require Amtrak to reimburse the unemployment fund for actual costs of their employees. The proposal would ensure that public subsidies Amtrak receives are used for purposes other than paying for the high unemployment costs of private freight railroads.

Eliminate Superfund Petroleum Tax Differential. The proposal would equalize the superfund petroleum excise tax rates applicable to domestic crude oil and imported products through a slight increase in the tax rate on domestic crude oil and a slight decrease in the rate on imported petroleum products. This would achieve a system of petroleum excise taxes that is consistent with GATT.

Other Proposals. Additional changes affecting receipts include the Administration's pay raise proposals; extension of the customs processing fee, which is scheduled to expire September 30, 1990, at current rates; and the establishment of a fee for the U.S. Travel and Tourism Administration (USTTA). A user fee on taxpayer telephone information services is proposed for 1991; a design evaluation will be conducted in 1989 and 1990 that will include an actual demonstration of the technologies and systems capabilities.

Revenue Estimates

	Fiscal Years			
	1990	1991	1992	1993
		($ billions)		
IRS Enforcement Initiative	0.3	0.6	0.7	0.7
Increase NRC User Fees	0.3	0.3	0.3	0.3
Initiate FEMA User Fees	*	*	*	*
Increase DC Government CSRS Contributions	0.0	*	*	*
Extend Reimbursable Status to Amtrak	*	*	*	*
Eliminate Superfund Petroleum Differential	0.0	0.0	0.0	0.0
Other Proposals	-0.1	0.1	0.1	0.2

*$50 million or less.

PROVISIONS THAT WILL EXPIRE IN 1989 AND ARE NOT PROPOSED FOR EXTENSION BY THE BUDGET

Business Energy Tax Credits

Background

A tax credit is allowed under section 46 of the Code for investments in certain "energy property." For "solar energy property," the tax credit was 15 percent in 1986, 12 percent in 1987, 10 percent in 1988 and is 10 percent in 1989. For "geothermal property," the tax credit was 15 percent in 1986, 10 percent in 1987 and 1988, and is 10 percent in 1989. For "ocean thermal property," the tax credit was 15 percent in 1986, 1987 and 1988. These credits expire at the end of 1989.

Solar property consists of equipment that uses solar energy to generate electricity or steam or to provide heating, cooling, or hot water in a structure. Geothermal property consists of equipment, such as turbines and generators, that converts the internal heat of the earth into electrical energy or another form of useful energy. Ocean thermal property consists of equipment, such as turbines and generators, that converts ocean thermal energy into electrical energy or another form of useful energy.

The tax credits for solar, geothermal, and ocean thermal property were originally scheduled to expire at the end of 1985, but were extended for three years by the Tax Reform Act of 1986 (the "1986 Act").

Discussion

The tax credits for solar, geothermal, and ocean thermal property were enacted to stimulate the development and business application of these energy sources as alternatives to nonrenewable fossil fuels, such as petroleum, natural gas, and coal. The methods for producing these alternative energy sources were generally well known, but they were not being fully exploited because of price and other advantages of fossil fuel systems. The energy tax credits were intended to increase demand for property producing or using energy from these alternative sources, thereby stimulating technological advances in the design, production, and operation of such equipment.

We do not believe that the tax credits for solar, geothermal, and ocean thermal property should be extended. These investment incentives apply only to certain targeted activities. Thus, they produce a tax differential among investments that is inconsistent with the fundamental concepts underlying the 1986 Act. This tax differential distorts the allocation of resources by encouraging businesses to make investments that, without the tax credit, would be uneconomical at current and expected future market prices. We do not believe that this allocative inefficiency can be justified in this case.

Although we oppose extension of the energy tax credits, we recognize the importance of preparing for increased future use of alternative energy sources in light of the Nation's limited reserves of fossil fuels. For this reason, the Federal government provides substantial support for the development of alternative energy sources through energy research and development programs.

The President's fiscal year 1990 budget requests spending authority of $114 million for solar and renewable energy research and development. This research covers a broad range of technologies, with emphasis on the generation of electricity from solar, biomass, geothermal, and wind energy. We believe that these research and development expenditures represent the most appropriate way to promote technological advances with respect to alternative energy sources.

Revenue Estimate

One year extension of business energy credits

Fiscal Years

1990	1991	1992	1993
	($ millions)		
-56	-35	4	2

Targeted Jobs Tax Credit

Background

Section 51 of the Code allows employers a tax credit for the employment of individuals belonging to one of nine targeted groups. The amount of the allowable targeted jobs tax credit ("TJTC") is generally equal to 40 percent of the first $6,000 of wages paid to a member of a targeted group in the first year of employment. The employer's deduction for wages is reduced by the amount of the credit. A targeted group member must be employed at least 90 days (14 days in the case of summer youth employees) or perform a minimum of 120 hours of work (20 hours in the case of summer youth employees) before an employer qualifies to claim the TJTC. The credit is unavailable for wages paid to an individual who begins work after December 31, 1989.

The nine targeted groups of employees are the following: economically disadvantaged youths (ages 18-22); economically disadvantaged summer youths (ages 16-17); economically disadvantaged youths participating in cooperative education programs; economically disadvantaged Vietnam-era veterans; economically disadvantaged ex-convicts; certain handicapped workers; certain work incentive employees (AFDC recipients and

WIN program registrants); Supplemental Security Income recipients; and general assistance recipients.

For purposes of the TJTC, a worker is economically disadvantaged if the worker's family income is below 70 percent of the Bureau of Labor Statistics lower living standard income levels during the prior six months. To claim the credit for an employee, an employer must receive a written certification that the employee is a targeted group member. Certifications of eligibility for employees are generally provided by State employment security agencies. The employer must have received, or filed a written request for, a certification on or before the date a targeted worker begins employment.[1]

Discussion

The TJTC was intended to increase employment of targeted workers who are considered to be low-skilled and difficult to employ and train by reducing the wage costs of employing these workers. The credit achieves its desired effect only when it results in the hiring of targeted employees who would not otherwise have been hired. Where an employer claims the credit with respect to workers who would have been hired without regard to the credit, the credit does not serve its intended incentive effect, and is merely a windfall for the employer.

The evidence that the credit has not had the intended incentive effect is quite strong. The Labor Department estimated, for example, that in 1981 2.4 million to 3.0 million disadvantaged youths found employment in the private sector of the economy, whereas only 176,000 economically disadvantaged youths received certification for the TJTC. Thus, in that year over 92 percent of economically disadvantaged youths who found employment did so without benefit of the credit.

A net increase in targeted employment may not result even when the TJTC is directly responsible for the employment of a targeted worker. That is, if newly hired certified targeted employees replace previously employed targeted employees who are no longer eligible for the credit or are hired in place of uncertified targeted workers, targeted employment will not increase on a net basis. A recent study of the TJTC by the National Commission for Employment Policy found that many companies retroactively claim the credit, thus receiving a tax windfall for workers hired without regard to their qualification

[1] If the employer has received a written preliminary determination that the employee is a member of a targeted group, the employer may file a written request for a final certification within five calendar days after the targeted worker begins employment.

under the TJTC program.[2] Moreover, we believe it is likely that any increase in hiring of targeted workers as a result of the credit is achieved at the expense of other low-skilled workers who have not qualified for the credit but have job skills similar to those of the targeted groups. Finally, increases in targeted employment by firms claiming the credit are partially offset by the loss of employment in other sectors of the private economy.

Other Federal programs currently provide assistance to many of those eligible for the TJTC. Under the Job Training Partnership Act, grants are made to the states to prepare low-income and unskilled youths and adults for entry into the labor force, and contracts are also provided for specialized job training to handicapped persons. The Job-Corps provides remedial training and job skills training for disadvantaged youth. Other training programs are targeted to veterans, native Americans, and migrant and seasonal farm workers.

Revenue Estimate

	Fiscal Years			
	1990	1991	1992 ($ millions)	1993
One Year Extension of the TJTC	-74	-141	-149	-55
Two Year Extension of the TJTC	-74	-196	-295	-210

Qualified Mortgage Bonds and Mortgage Credit Certificates

Background

In the 1970s, State and local governments discovered that they could issue tax-exempt mortgage revenue bonds to provide below-market rate mortgage loans to their residents at no cost to themselves. By 1980, the issuance of tax-exempt bonds for owner-occupied housing had grown to 20 percent of total tax-exempt financing. Prior to the Mortgage Subsidy Bond Tax Act of 1980 (the "1980 Act"), there were no federal restrictions on who could benefit from the subsidized mortgages financed with these tax-exempt bonds. Beginning with the 1980 Act, a series of legislative changes were enacted to target the subsidy to first-time homebuyers, to improve the efficiency of the subsidy,

[2] The Targeted Jobs Tax Credit in Maryland and Missouri: 1982-1987, National Commission for Employment Policy Research Report No. 88-18 (November, 1988).

and to curtail the mounting federal revenue losses from the issuance of these bonds.

First, in order to target the subsidy to those individuals with a greater need, the 1980 Act imposed eligibility requirements on mortgages financed with proceeds of qualified mortgage bonds. The 1980 Act required that (a) the mortgages finance only principal residences; (b) the mortgagor not have owned a principal residence during the immediately preceding three years; and (c) the acquisition cost of the residence not exceed 90 percent of the average area purchase price for single family residences. In certain targeted low-income areas, the first-time homebuyer requirement was waived, and the purchase price limitation was increased to 110 percent of the average area purchase price. These requirements were liberalized by the Tax Equity and Fiscal Responsibility Act of 1982 (the "1982 Act"). Under the 1982 Act, up to 10 percent of the mortgages in non-targeted areas could be for existing homeowners, and the purchase price limits were increased to 110 percent (120 percent in targeted areas) of the average area purchase price.

The 1986 Act tightened the mortgage eligibility requirements. The 1986 Act reduced to 5 percent the mortgages in non-targeted areas that could be for existing homeowners and reinstated the lower purchase price limits that applied before the 1982 Act. The 1986 Act also imposed a household income limit of 115 percent of the higher of the area or Statewide median income. In targeted areas, the income limit was increased to 140 percent of the median and was waived for one-third of the mortgage financing. These income limits were revised by the Technical and Miscellaneous Revenue Act of 1988 (the "1988 Act"). Under the 1988 Act, the income limits are determined by reference to area median income (rather than by reference to the higher of the area or Statewide median), the limits are reduced to 100 percent (120 percent in targeted areas) for families with fewer than three persons, and the limits are increased (to no more than 140 percent) in areas where housing costs are high in relation to area median income. The 1988 Act also provides that, in the case of mortgages originated after December 31, 1990, all or a portion of the federal tax subsidy from the mortgage during the first 5 years is to be recaptured through an increase in the mortgagor's individual income tax liability if the assisted home is disposed of within 10 years. The maximum recapture amount (1.25 percent of the mortgage principal amount for each of the first 5 years) is ratably phased out during the second 5 years. The amount recaptured is reduced or eliminated if the mortgagor's income does not increase above a prescribed level and is capped at 50 percent of the gain realized on disposition of the home.

Second, in order to curtail the mounting federal revenue losses from the issuance of mortgage revenue bonds, the 1980 Act imposed a volume cap on the aggregate amount of qualified mortgage bonds that could be issued within a State during a calendar year. The annual volume cap for each State was the greater of $200 million or 9 percent of the average annual amount of mortgages for owner-occupied residences originated in the State during the preceding three years. The 1986 Act repealed the separate volume cap for qualified mortgage bonds and subjected these bonds to the unified volume cap that applies to private activity bonds generally.

Third, in order to ensure that a greater portion of the federal subsidy accrued to the homebuyers, the 1980 Act limited the arbitrage profits that the issuer could earn and retain. The spread between the interest rate on the mortgages and the yield on the bonds was limited to one percentage point. (The allowable spread were increased to one and one-eighth percentage points by the 1982 Act). In addition, any arbitrage profits earned from investing the bond proceeds in non-mortgage investments was required to be paid or credited to the mortgagors (or, if the issuer elected, to the Treasury). The 1988 Act requires the arbitrage profits to be rebated to the Treasury and requires bonds proceeds not used to originate mortgages within 3 years (and mortgage prepayments) to be used to redeem bonds within 6 months.

Finally, in order to provide an opportunity to review the effects of the new requirements, the 1980 Act provided that the qualified mortgage bond program would terminate at the end of 1983. The authority to issue qualified mortgage bonds was extended through 1987 by the 1984 Act, through 1988 by the 1986 Act, and through 1989 by the 1988 Act.

In the Deficit Reduction Act of 1984 (the "1984 Act"), Congress tried to improve the efficiency of the mortgage subsidy by allowing State and local governments to elect to trade some or all of their qualified mortgage bond authority for authority to issue mortgage credit certificates ("MCCs"). The trade-in rate was set at 20 percent of the nonissued bond amount. MCCs entitle a homebuyer to a nonrefundable income tax credit in the amount of 10 percent to 50 percent (as determined by the issuing authority) of interest paid on a mortgage incurred to finance the mortgagor's principal residence. The maximum annual credit per recipient is $2,000. Eligibility for the credit is based on the same criteria as for qualified mortgage bonds. The 1986 Act increased the MCC trade-in rate from 20 percent to 25 percent. The authority to issue MCCs is scheduled to terminate at the end of 1989, along with the authority to issue qualified mortgage bonds.

Discussion

The Administration opposes any further extension of the authority to issue qualified mortgage bonds. Other federal support for owner-occupied housing for low- and moderate-income families exists. Moreover, tax-exempt qualified mortgage bonds are very costly and an extremely inefficient means of providing assistance to low- and moderate-income homebuyers.

The federal income tax rules provide substantial assistance to homeowners through the allowance of a deduction for interest on mortgages of up to $1 million incurred to purchase a principal (or second) residence, allowance of a deduction for real estate taxes, rollover of capital gains on sales of a principal residence, and allowance of a one-time exclusion of capital gains of up to $125,000 on the sale of a principal residence by a taxpayer aged 55 or older. As a result, the income from owner-occupied housing investments is exempt from tax over the entire lifetime of most taxpayers. The mortgage interest and real estate tax deductions allow taxpayers to reduce their withholding taxes and have more take-home pay with which to make monthly mortgage payments. We estimate that these special tax provisions provided over $50 billion in assistance to owner-occupied housing in fiscal year 1988.

In addition to preferential tax treatment, other federal programs aid homebuyers. For example, the Federal Housing Administration and Veterans' Administration provide mortgage insurance that allows many first-time homebuyers to purchase a home with a low downpayment.

Tax-exempt financing is an extremely inefficient means of providing assistance to low- and moderate-income homebuyers. The subsidy is possible because high-income individuals and other persons subject to a high marginal rate of tax are willing to accept lower interest rates on tax-exempt bonds. The portion of the benefits captured by the purchasers of the bonds is large, due to the large outstanding volume of tax-exempt bonds, including mortgage revenue bonds. A GAO study estimates that because of the inherent inefficiency, as well as the significant overhead costs of administering the subsidy, less than half of the tax benefits were passed along to homebuyers.3/ Because of these inefficiencies, the program provides a low rate of subsidy to prospective homebuyers. The program, therefore, is unlikely to encourage home ownership for persons who would not otherwise be purchasing homes. This fact is suggested by the GAO study, which found that two-thirds of assisted households could have afforded the homes they purchased without assistance and that most of the rest could have purchased homes in the near future without assistance.

Finally, the costs of the qualified mortgage bond program are very high. Revenue estimates that focus on the short-term revenue loss resulting from a new tax-exempt bond issue vastly understate the long-term revenue loss. The long-term revenue loss reflects up to 30 years of tax subsidies. For example, we estimate that the revenue loss from all outstanding qualified mortgage bonds in fiscal year 1988 is $1.8 billion, almost all of which is attributable to bonds issued before 1988. In addition, the increased supply of tax-exempt bonds resulting

3/ U.S. General Accounting Office, Home Ownership: Mortgage Bonds Are Costly and Provide Little Assistance to Those in Need, 1988.

from the qualified mortgage bond program raises interest costs for State and local governments for financing traditional public projects such as schools, roads, sewers, and public buildings.

In summary, extension of the qualified mortgage bond program is unnecessary, inefficient, and very expensive. The qualified mortgage bond program is the least cost-effective means of providing federal assistance to owner-occupied housing and does not provide sufficient assistance to those who may need it to justify its large cost. If Congress deems that additional assistance for first-time homebuyers is necessary, it should consider providing all such assistance in the form of mortgage credit certificates to improve the efficiency of the program.

Revenue Estimate

	Fiscal Years			
	1990	1991	1992	1993
		($ millions)		
One-year extension	-37	-44	-41	-35

Qualified Small Issue Bonds

Background

In the 1960s, State and local governments discovered that they could issue tax-exempt industrial development bonds (IDBs) to provide below-market rate loans to private businesses at no cost to themselves. Prior to the Revenue and Expenditure Control Act of 1968 (the "1968 Act"), there were no federal restrictions on the types of business activities that could benefit from the subsidized loans provided with these tax-exempt bonds. Beginning with the 1968 Act, a series of legislative changes were enacted to restrict the purposes for which tax-exempt IDBs could be issued and to curtail the mounting federal revenue losses from the issuance of these bonds.

The 1968 Act primarily restricted tax-exempt IDB financing to certain exempt activities. The exempt activities for which such financing continued to be available were those that traditionally had been carried on by State and local governments and that furthered some public purpose (e.g., multifamily rental housing, transportation facilities, and sewage and solid waste disposal facilities). The 1968 Act, however, also permitted tax-exempt IDBs to be issued to finance land and depreciable property of any type for any private business as long as the bonds qualified under a special exemption for small IDB issues.

Under the 1968 Act, an IDB qualified as an exempt small issue if the aggregate face amount of the issue did not exceed $1 million. In determining whether the $1 million limit was exceeded, the aggregate face amount of other exempt small issues issued primarily with respect to facilities located in the same locality was taken into account if the principal user of both facilities was the same. The small issue exemption was amended by the Renegotiation Amendments Act of 1968 to permit issuers to elect to apply a $5 million limit in lieu of the $1 million limit. The $5 million limit was applied by also taking into account any capital expenditures incurred during a 6-year period with respect to other facilities in the same locality if the principal user of the bond-financed facilities and the other facilities was the same. The 6-year period began 3 years before and ended 3 years after the date of issue. The $5 million limit was increased to $10 million by the Revenue Act of 1978.

Between 1976 and 1981, tax-exempt IDB financing grew from 33 percent of total tax-exempt financing to 56 percent of total tax-exempt financing. During the same period, annual volume of tax-exempt small issue IDB financing grew from $1.5 billion to $13.3 billion. Based on this growth, annual volume in 1987 was estimated by the Joint Tax Committee to reach $31.3 billion. The proliferation of tax-exempt IDBs was contributing to a significant narrowing of the spread between tax-exempt and taxable interest rates, increased interest costs for State and local governments for financing traditional public projects, distortions in the allocation of scarce capital resources, and mounting federal revenue losses. For these reasons, the 1982 Act eliminated the tax-exemption for small issue IDBs issued after December 31, 1986. The 1982 Act also prohibited use of more than 25 percent of the proceeds of these bonds for certain retail and recreational facilities. Despite the restrictions imposed by the 1982 Act, the volume of tax-exempt IDB financing continued to grow. By 1983, tax-exempt IDB financing amounted to 61 percent of total tax-exempt financing.

The 1984 Act imposed additional restrictions on tax-exempt IDBs. In an effort to curb the continually rising federal revenue losses from the issuance of these bonds, the 1984 Act imposed a cap on the volume of tax-exempt IDBs that could be issued within a State during a calendar year. The annual volume cap for each State was the greater of $200 million or $150 for each State resident. Bonds issued for multifamily rental housing and governmentally-owned transportation facilities were exempt from the volume cap. The 1984 Act also restricted the portion of the proceeds of a tax-exempt IDB issue that could be used to acquire land and generally prohibited the acquisition of existing property unless a prescribed level of expenditures was incurred for rehabilitation of the property. Additional restrictions on tax-exempt small issue IDBs were imposed. To eliminate the practice of issuing these bonds to finance each store in a large shopping mall, the $10 million capital expenditure limitation was clarified to apply to an entire project. The 1984 Act also restricted the availability of tax-exempt small issue financing to businesses that benefited from no more than $40 million of outstanding tax-exempt IDBs. The 1984 Act, however, permitted tax-exempt small issue IDBs to be issued to finance manufacturing facilities for two additional years, through December 31, 1988.

The 1986 Act included a comprehensive set of provisions designed to meaningfully constrain the volume of tax-exempt bonds issued by State and local governments to subsidize nongovernmental activities. Between 1975 and 1985, the volume of tax-exempt private activity bonds (including tax-exempt IDBs, student loan bonds, mortgage revenue bonds, and bonds for section 501(c)(3) charitable organizations) increased from $8.9 billion to $124.2 billion. As a share of total State and local borrowing, financing for these private activities increased from 29 percent to 55 percent. The 1986 Act consolidated the two separate State volume caps that applied to IDBs and qualified mortgage bonds into a single unified State volume cap on private activity bonds. The annual volume cap for each State is the greater of $150 million or $50 for each State resident. Bonds exempt from the volume cap are those for airports, docks and wharves, governmentally-owned solid waste disposal facilities, and section 501(c)(3) charitable organizations. The 1986 Act repealed authority to issue tax-exempt private activity bonds for several exempt activities that were not traditionally carried on by State and local governments and that primarily furthered private business interests (e.g., bonds for sports facilities, air and water pollution control facilities, and convention and trade show facilities). The 1986 Act also placed restrictions on the exempt activities for which tax-exempt financing continued to be available to target the subsidy to activities that actually served a public purpose (e.g., the low- and moderate-income occupancy requirement for multifamily rental housing projects was significantly tightened). The 1986 Act, however, also extended the authority to issue tax-exempt small issue IDBs to finance manufacturing facilities for one additional year, through December 31, 1989. These bonds are now referred to as qualified small issue bonds.

Discussion

The Administration opposes any further extension of the authority to issue qualified small issue bonds for manufacturing facilities. As discussed above, tax-exempt financing is not an efficient or appropriate means of providing a subsidy to private business, and tax-exempt financing should generally be restricted primarily to those activities that traditionally have been carried on by State and local governments and that further public rather than purely private interests.

Moreover, the use of tax-exempt financing to subsidize private manufacturing businesses has anti-competitive and distortive effects on the economy. Manufacturing businesses that receive tax-exempt financing have significant advantages over their competitors, which must raise capital with higher-cost taxable financing. Yet, the availability of qualified small issue financing depends on the size of a particular facility, on the amount of capital expenditures incurred in a particular locality by principal users of the facility, on which localities have the necessary programs in place and the available private activity bond authority to issue the bonds, and on the ability of persons to negotiate through obstacles of State and local law and procedure. It is unrealistic to assume that qualified small issue bond authority will necessarily be allocated to financing of private manufacturing businesses for which any subsidy might actually be necessary or desirable. Furthermore, the use of private activity bond authority to finance these purely private business activities reduces the amount of the subsidy available for the exempt activities that specifically have been targeted and approved for tax-exempt financing.

Revenue Estimate

	Fiscal Years			
	1990	1991	1992	1993
		($ millions)		
One-year extension	-10	-12	-13	-12

Deduction for Self-Employed Individuals of 25% of Health Insurance Costs

Section 162(l) of the Code provides that self-employed individuals may deduct 25 percent of the amount paid for health insurance for the individual and the individual's spouse and dependents. In the case of a self-employed individual who has employees, the deduction is available only if the health insurance is provided under a plan that meets the nondiscrimination requirements of section 89. The deduction does not apply to amounts paid in years beginning after 1989.

This provision was added to the Code by the 1986 Act to make more consistent the tax treatment of health insurance benefits provided to self-employed individuals and employees (whose employer-provided health insurance is generally excluded from income), and also to encourage a narrowing of the gap in health coverage among small businesses.

The Administration supports efforts to better coordinate the tax treatment of health insurance expenditures among employees and self-employed individuals and to narrow the gaps in health insurance coverage. However, we believe that an extension of the self-employed health insurance deduction rule does not significantly address the inconsistencies in the tax treatment of health care expenditures and would not result in significant increases in health care coverage. Accordingly, in light of the significant revenue loss that would result from extension, the Administration opposes extension of this provision.

Providing a deduction to self-employed individuals will provide more consistent tax treatment to only small segment of the population. It does not address the more significant inequity between employees whose employer provides health insurance and those whose employer does not. Moreover, the provision will not significantly address the gaps in health insurance coverage. In many cases, the deduction is being utilized by self-employed individuals who would purchase health insurance in any event. In the case of a self-employed individual who has employees, the value of the deduction will in many cases not be sufficient to induce the individual to provide health insurance to the employees. Similarly, the provision provides no benefit to employees who must purchase health insurance on their own.

Revenue Estimate

Permanent extension of the section 162(l) deduction

Fiscal Years

1990	1991	1992	1993
	($ millions)		
-147	-268	-319	-368

Exception to the Early Withdrawal Tax for Distributions from Employee Stock Ownership Plans

Section 72(t) of the Code imposes a 10-percent additional income tax on distributions received by an individual from tax-qualified qualified retirement plans prior to age 59-1/2. Section 72(t)(2)(C) provides an exception from the additional income tax for certain distributions received from Employee Stock Ownership Plans ("ESOPs") prior to 1990.

The Administration opposes extension of the exception from the additional income tax for distributions from ESOPs. The additional income tax on early distributions is designed to discourage individuals from withdrawing their retirement savings prior to age 59-1/2 and to recapture some portion of the tax savings provided to tax-qualified plans providing retirement income. ESOPs receive the same advantage of tax deferral and are subject to the same general distribution rules as other tax-qualified retirement plans, including eligibility for five-year forward income averaging and rollover treatment. The Administration believes that the additional income tax should apply to ESOPs in the same manner that it applies to other tax-qualified plans to discourage employees from diverting their ESOP savings for nonretirement uses.

Low-Income Housing Credit

Background

A tax credit is allowed under section 42 of the Code for qualified expenditures with respect to low-income residential rental housing. The credit was enacted as part of the 1986 Act, and was intended to provide tax incentives more efficient than those under prior law for encouraging the production of affordable low-income rental housing.

The credit for any low-income building is limited to the amount allocated to the building by a designated State agency, which allocation generally must be made in the year in which the building is placed in service. States may allocate credits each year subject to annual credit authority limitations for each State, may not carry unused credit authority from one year to the next, and may make allocations only through 1989. However, the 1988 Act permits a building to be placed in service within the two years succeeding the year in which the credit allocation is received, provided that (1) the building is part of a project in which the taxpayer's basis at the end of the allocation year is more than ten percent of the reasonably expected basis for the project, and (2) the building involves either new construction or substantial rehabilitation. Consequently, while the credit generally is scheduled to expire for property placed in service after December 31, 1989, certain property placed in service by 1991 may qualify for the credit.

The credit is claimed with respect to a qualified building in annual installments during a ten-year period generally beginning with the year in which the building is placed in service. After 1987, the annual tax credit percentage for non-federally subsidized new buildings is determined by the Secretary of the Treasury to yield a discounted present value over the ten-year credit period (based upon federal borrowing rates) equal to 70 percent of the expenditures eligible for the credit. A lesser tax credit percentage, similarly determined by the Secretary of the Treasury to yield a discounted present value equal to 30 percent of eligible expenditures over the ten-year credit period, is available for certain acquisition costs of existing buildings and for federally subsidized new buildings. For these purposes, rehabilitation expenditures are treated as a "separate new building," and "federal subsidies" are defined to include tax-exempt financing and below-market federal loans.

The credit generally is available only for qualifying expenditures with respect to units rented to households satisfying one of two minimum income criteria: (1) at least 40 percent of the units in a project must be rent restricted and occupied by households having no more than 60 percent of area median gross income; or (2) at least 20 percent of the units in a project must be rent restricted and occupied by households having no more than 50 percent of area median gross income.

Gross rents on qualifying low-income units must not exceed 30 percent of the foregoing income limitations.

While the credit is claimed over a ten-year period, buildings must comply with the low-income housing requirements for a period of fifteen years. If, during this compliance period, a building fails to comply with the applicable requirements, or the taxpayer disposes of the building, the taxpayer may have to recapture the credit. Non-compliance or disposition within the first eleven years could result in recapture of one-third of the credit amount, while recapture thereafter would be less.

Discussion

The Administration strongly supports the ultimate objective of the low income housing credit to improve housing for low-income families and individuals. The Administration has not proposed an extension of the low income housing credit as currently structured because the credit does not appear to provide an efficient subsidy for low income housing.

The relative efficiency of the current credit should be fully analyzed before any decision is made to extend the credit. This is especially important as a budget matter because the revenue cost of the low-income housing credit continues for ten years with every year that the credit is extended. Based upon preliminary information for 1987-88, we anticipate that the revenue cost of the low-income housing credit will be approximately $295 million in fiscal year 1989. Moreover, we expect this cost to grow to approximately $715 million in fiscal year 1993 as a result of increased usage of the credit since 1987, placement in service of qualifying buildings through 1991, and continuing claims for credits over the ten-year period following placement in service of a qualifying building.

The motivation for enactment of the low-income housing credit was the inefficiency of the low-income housing tax provisions under prior law. Congress was concerned that the tax preferences under prior law were not effective in providing affordable housing for low-income individuals. The preferences under prior law were uncoordinated and not directly related to the number of low-income households being served. In addition, there was no incentive for recipients of tax subsidies to provide more low-income units than the minimum amount required, nor was there any direct incentive to limit rents.

While the low-income housing credit is a clear improvement over prior tax incentives and although the structure of the credit has been significantly improved by recent legislation; we continue to have significant concerns about the efficiency and equity of the credit. Some subsidized units simply may replace units that would have been available in the absence of federal assistance, and the credit may not result in significant long-run housing supply increases. The percentage of the cost of the credit that accrues to the benefit of low-income families is unclear. The additional administrative costs borne by the IRS, HUD, and State agencies as a consequence of the credit have not been determined. The credit includes no requirements for maintenance, and the incentive of landlords renting at below-market rates to prevent deterioration is unclear where there may be no corresponding loss of tenants. Without additional subsidies, project owners may have no economic incentive to continue to rent to low-income tenants after the 15-year compliance period has elapsed. Finally, the credit may not make housing available or affordable to households substantially below the poverty level.

Revenue Estimate

	Fiscal Years				
	1990	1991	1992	1993	1990-1993
		($ millions)			
One Year Extension of Low-Income Housing Credit	-55	-200	-295	-325	-875
Two Year Extension of Low-Income Housing Credit	-55	-260	-505	-635	-1455

Special Tax Rules Applicable to Reorganizations of Financially Troubled Thrifts

Prior Law

In the Economic Recovery Tax Act of 1981 (the "1981 Act"), in order to resolve some of the uncertainties of prior law and to permit the relevant supervisory authority to arrange mergers of financially troubled thrift institutions with healthy institutions at a lower cost to the supervisory authority, Congress enacted special tax rules for transactions involving financially troubled thrift institutions.

First, as enacted in 1981, Section 597 provided a special exclusion from income for amounts received by a domestic building and loan association from the FSLIC under its financial assistance program. Section 597 also provides that no reduction in the basis of the recipient's assets is required on account of such a payment. Although Section 597 appears to contemplate that such assistance might be regarded as either a nonshareholder contribution to capital (which would necessitate a basis reduction under Section 362(c)) or gross income, the Treasury Department believes that. in the absence of Section 597, such amounts are generally properly viewed as gross income.

Second, Section 368(a)(3)(D), as enacted in 1981, permitted certain acquisitions of financially troubled thrift institutions to qualify as tax-free reorganizations under Section

368(a)(1)(G), without regard to the continuity of interest or distribution requirements ordinarily applicable in the case of (G) reorganizations. Until December 31, 1988, this rule applied only if (1) the acquired institution was a thrift institution (i.e., a domestic building and loan association, a non-stock cooperative bank organized and operated for mutual purposes and without profit, or a mutual savings bank); (2) the relevant supervisory authority certified that the acquired thrift was insolvent, could not meet its obligations currently, or would be unable to meet its obligations in the immediate future in the absence of action by the supervisory authority; and (3) the acquiring corporation acquired substantially all of the assets and assumed substantially all of the liabilities (including the deposits) of the acquired thrift.

Third, in the case of transactions that qualified under the relaxed rules as a (G) reorganization, section 382(1)(5), as enacted in 1981, permitted the acquiring corporation to succeed to the net operating loss carryovers, built in losses, and excess credit of the acquired thrift, without limitation under Section 382, provided that the shareholders, creditors, and depositors of the acquired institution acquire a 20 percent interest in the acquiring corporation as a result of the acquisition. For this purpose, depositor interests are considered interests in the acquired institution.

In the 1986 Act, Congress repealed these provisions effective December 31, 1988.

Current Law

In the 1988 Act, Congress extended these provisions for one additional year, though December 31, 1989, but modified them by requiring that certain tax attributes be reduced by an amount equal to 50 percent of the agency assistance received and by making these provisions applicable to FDIC assisted reorganizations of troubled banks.

Thus, under current law, the provisions of section 368(a)(3)(D) and 382 (1)(5) as described above are retained, and extended to banks in the case of transactions that meet certification requirements similar to those required for thrifts. Section 597 as currently in effect excludes both FDIC and FSLIC assistance payments from income, but requires that an amount equal to 50 percent of the amount excludable be applied to reduce tax attributes in the following order: (1) pre-assistance net operating losses; (2) allowable interest deductions; and (3) recognized limit-in losses on certain portfolio assets.

Discussion

The Administration's plan for the S&L industry, as embodied in the proposed "Financial Institutions Reform, Recovery and Enforcement Act of 1989," contemplates permitting these special tax provisions to expire at the end of this year. Although these provisions have played a role in facilitating the resolution of insolvent savings and loan institutions, such indirect subsidies are inherently inefficient and do not permit the kind of full and precise accounting for costs envisioned by the Administration's Plan.

The 1986 Act repeal of these special provisions, after a two year transition period, comported with one of the basic themes of the 1986 Act, that the tax laws should not provide beneficial treatment to some industries, or segments of an industry, and not others. The Treasury Department generally supported this decision as sound tax policy.

The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity in May 1985 specifically recommended that these provisions be repealed. That recommendation, however, included a longer transition period, to January 1, 1991. In March 1988, we testified that the Treasury Department remained concerned that the two year transition period provided in the 1986 Act was insufficient, and that we would not object to a one year delay of the repeal of the special provisions. The Treasury Department thus did not oppose the provisions in the 1988 Act that modified and extended these special rules. We are strongly opposed, however, to any further extension of these provisions.

In general, we believe that the subsidization of specific industries through the Federal tax laws is inefficient. In the case of the special provisions applicable to reorganizations of financially troubled thrifts, the subsidy is not only inefficient, but also more costly than Congress believed when it acted upon these provisions in 1986 and 1988. As discussed below, the nature of the activity to which these provisions apply makes estimation of the revenue costs extremely difficult.

It is difficult to predict the use and value of the tax benefits provided through the special thrift merger rules. Because these transactions are seldom, if ever, negotiated on the premise that the agency should receive 100 percent of the predicted value of the tax benefits, the use of these rules to provide Federal assistance to FSLIC is inherently inefficient. The acquiring firm may receive a sizable portion of the tax benefits, which means that the cost to the Treasury of providing indirect assistance to FSLIC through the tax code is greater than the cost of providing direct assistance. Even if the deals were arranged so that FSLIC received 100 percent of the tax benefits, there would be no reason to believe that the acquiring firm would not attempt to "trade" the loss of these benefits and negotiate more advantageous provisions elsewhere in the acquisition contract. For example, an acquiring firm may agree that FSLIC will receive all of the tax benefits, but the firm may demand a lower capital infusion requirement or a higher guaranteed yield on covered assets.

In the revenue estimating process, the uncertainties of predicting the use and value of tax benefits available in an individual transaction are compounded by the lack of knowledge of the tax position of the acquiring firm and the heavy reliance on outlay estimates provided by FSLIC. This is true because the ability of the acquiring firm to use the tax benefits available from a FSLIC assisted merger depends both upon the expected income of the acquiring firm and on the application of the tax rules that restrict the use of the tax benefits, including section 382, section 384, and the separate return limitation year rules of the consolidate return rules to the particular circumstances of that transaction. However, this information is generally not known.

PROVISIONS WHICH EXPIRED IN 1988

Employer-Provided Group Prepaid Legal Services

Background

Prior to 1989, the value of employer contributions to, and employee benefits provided under, a "qualified group legal services plan" was excluded from an employee's income under section 120 of the Code. Amounts excluded from income were also excluded from an employee's social security tax wage base. A qualified group legal services plan was defined as a separate written plan of an employer for the exclusive benefit of its employees or their spouses or dependents. The plan was required to provide specified personal (i.e., non-business) legal services to employees through prepayment of, or provision in advance for, all or part of an employee's legal fees for such services. Benefits under the plan were required to be provided in a manner that did not discriminate in favor of officers, owners, or highly compensated employees. In addition, no more than 25 percent of the amounts paid to the qualified plan could be for the benefit of persons holding a more than five percent ownership interest in the employer.

Prior to 1988, section 501(c)(20) of the Code exempted from tax organizations or trusts the exclusive function of which was to form part of a qualified group legal services plan under section 120. These organizations were permitted to provide other legal services or indemnification against legal costs without jeopardizing their tax-exempt status.

With the expiration of section 120, the benefit to an employee of coverage under an employer-provided legal services plan generally is included in the employee's gross income and social security tax wage base. An offsetting income tax deduction would be allowable to the employee only in very limited circumstances.

Discussion

The Administration would oppose the permanent reinstatement of section 120. This section created inequitable distinctions among taxpayers that, in our view, cannot be justified.

The exclusion for group legal services permitted a limited group of employees to achieve the effect of a deduction for their personal legal costs (and an exclusion of such amounts from the social security wage base), simply because their employers operated qualified group legal services plans. According to a Labor Department study, only 3 percent of all employees had access to such plans in 1985. Thus, although the intent of section 120 was to increase access to legal services for middle income taxpayers, only a small percentage of taxpayers actually benefited. Moreover, section 120 produced an inequitable tax advantage for participants in group legal services plans as compared to the vast majority of other individuals, who, because they could not deduct their personal legal expenses, paid such expenses with after-tax dollars. Even among participants in a qualified group legal services plan, the tax exclusion provided the greatest benefits to higher-income participants who were subject to higher marginal rates of income tax.

Employer-Provided Education Assistance

Background

Under section 127 of the Code, up to $5,250 of the value of educational assistance provided by an employer under a qualified educational assistance program could be excluded from an employee's income. In 1988, such educational assistance did not include expenditures for graduate level courses. Specifically, the exclusion did not apply to any benefits with respect to any course taken by an employee who had a bachelor's degree or was receiving credit toward a more advanced degree, if the particular course could be taken for credit by any individual in a program leading to a law, business, medical, or any other advanced academic or professional degree.

In order to qualify for the exclusion, the educational assistance program was required to meet several conditions, including that the assistance be provided in a manner that did not discriminate in favor of officers, owners, or highly compensated employees. In addition, no more than five percent of the amounts paid under a qualified educational assistance program could be for the benefit of persons holding a more than five percent ownership interest in the employer. Section 127, which was first enacted in 1978, expired on December 31, 1988.

Section 117(d)(2) excludes from taxable income amounts of "qualified tuition reduction," i.e., reduced tuition provided on a nondiscriminatory basis to an employee of an educational organization for the education (below the graduate level) of the employee or the employee's spouse or dependent children. This exclusion is subject to the limitation of section 117(c), which makes the exclusion inapplicable to any amount that represents payment for teaching, research, or other services by the student if the performance of such services is required as a condition for receiving the tuition reduction. Prior to the expiration of section 127, section 127(c)(8) provided that, in the case of a graduate student engaged in teaching or research activities, section 117(d) was applied without regard to the requirement that the education be below the graduate level. The 1988 Act made this provision permanent by adding it to section 117(d). Accordingly, even though section 127 has expired, section 117 serves to exclude from income the portion, if any, of a graduate student tuition reduction that is in excess of reasonable compensation for teaching or research services performed.

With the expiration of section 127, an employer's payment or reimbursement of an employee's educational expenses generally must be included in the employee's income unless the cost of the assistance qualifies under section 117(d) as a tuition reduction, under section 132 as a fringe benefit, or under section 162 as a deductible job-related expense of the employee. In general, educational expenses are treated as job-related only if the education maintains or improves skills required in an employee's retention of his job, job status, or rate of compensation. Education that qualifies the employee for a new job (with the same or a different employer) is not considered job-related.

Discussion

The Administration opposes the reinstatement of section 127 chiefly because this provision accorded tax benefits to only a small proportion of similarly situated taxpayers and did not principally benefit those most in need of educational assistance. This view is supported by a study of section 127 conducted by the Treasury Department, as required by Public Law 98-611. That study was issued in June, 1988.

The tax-favored treatment of educational expenses under section 127 applied to only a small percentage of persons taking courses to train for a new job or occupation, thus creating inequitable distinctions among taxpayers. Obviously, the tax benefit was not available to unemployed persons or to workers whose employers did not offer such programs. Moreover, self-employed individuals and many small business owners were, as a practical matter, unable to benefit effectively from section 127 plans.4/ As Table 1 indicates, 84 percent of all adult education courses taken in 1984 to qualify for a new job

4/ Although section 127 provided that self-employed individuals and sole proprietors could technically qualify for the benefits of the section, effectively these benefits were primarily available only to employees of larger businesses. Closely held businesses were unable to benefit from section 127 because of the requirement that no more than five percent of the amounts paid under the educational assistance program be for the benefit of persons holding a more than five percent ownership interest in the employer.

or occupation were paid for by the student himself. Thus, only 16 percent of such training could have benefited from section 127.

Moreover, the Treasury Department study and various other studies suggest that the section 127 educational assistance plans failed to achieve the primary objective offered for their tax subsidy, namely increasing opportunities among lower paid, lower skilled workers for training for new, better paying jobs and occupations. Instead, the effect of this tax subsidy may have been to contribute to the sharp increase since 1978 in adult education that is related to the current job and is concentrated among higher paid and better educated workers.5/ Thus, for example, a Labor Department survey found that higher-paid professional and administrative employees were more likely than production workers to have employer educational assistance plans offered to them, and were more likely to be offered full, rather than partial, reimbursement.6/ In addition, as Table 2 indicates, less educated workers in lower-paying jobs represented a smaller fraction of participants in adult education courses in 1984 than in 1969, before the enactment of section 127.

In summary, although the Administration strongly supports the objective of promoting education, we believe that section 127 unfairly provided, at a substantial revenue cost, preferential treatment to a relatively small group of individuals, a disproportionately high percentage of whom were higher paid professional and administrative personnel. For these reasons, the Administration opposes the reenactment of section 127.

Revenue Estimates

	Fiscal Years				
	1989	1990	1991	1992	1993
			($ millions)		
Three year extension	-70	-430	-319	-97	-
One year extension	-70	-215	-	-	-

5/ Department of the Treasury, Report to the Congress on Certain Employee Benefits Not Subject to Federal Income Tax, 2 (1988).

6/ U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in Medium and Large Firms In 1985, Washington: U.S. Government Printing Office (1986).

This concludes my prepared remarks. I would be pleased to respond to your questions.

EMPLOYER-PROVIDED EDUCATION ASSISTANCE

Table 1

Adult Education in 1984
Reason for Taking Course and Source of Payment
(in thousands)

	Total Courses	Job-Related Courses				Non-Job-Related Courses	Unknown
		Improve in Current Job	New Job in Same Occupation	New Job in New Occupation	Other		
Total Courses	40,751	19,703	984	3,818	1,654	14,448	145
Employer Paid	14,800	12,328	242	549	797	857	28
Row Percentages							
Total Courses	100.0	48.0	2.4	9.4	4.0	35.5	0.3
Job-Related	-	75.3	3.8	14.6	6.3	-	-
Employer Paid	100.0	83.0	1.6	3.7	5.3	5.8	0.1
Job-Related	-	88.6	1.7	3.9	5.7	-	-
Column Percentages Employer Paid	36.3	62.6	24.6	14.4	48.2	5.9	19.3

Source: Tabulated from: U.S. Department of Education, Center for Educational Statistics, Trends in Adult Education 1969-1984, Tables G-H, pp. 33-36.

Table 2

Distribution of Adult Education Participants and the Adult Population 17 Years and Older, by Selected Characteristics May 1969 and 1984

Characteristic	Adult Participants		Population 17 Years Old and Over	
	1969	1984	1969	1984
Total number (in thousands)	13,041	23,303	130,251	172,583
Total percent	100%	100%	100%	100%
Sex:				
Men	52	45	47	47
Women	48	55	53	53
Race:				
White	92	92	89	86
Black	7	6	10	11
Other	1	2	1	3
Ethnicity:				
Hispanic	-	3	-	6
Age group:				
17-34	53	50	37	42
35-54	36	38	35	30
55 and over	11	12	28	28
Education level:				
Less than 12th grade	16	8	44	27
High school graduates	38	30	34	38
Some college (1 to 3 years)	20	26	12	18
Bachelor's degree or higher	26	36	10	17
Regions:				
Northeast	23	17	25	22
North Central	30	26	28	25
South	24	31	31	34
West	23	24	16	20
Income group:				
Above median family income	68	65	50	50
Below median family income	32	35	50	50
Labor force status:				
Employed	78	81	57	61
Unemployed	2	4	3	5
Keeping house, going to school	18	12	27	22
Other (retired, etc.)	3	3	13	13
Occupational groups:*				
Executive/managerial	11	15	9	11
Professional/technical	33	31	13	15
Administrative support	17	17	15	16
Sales and service	16	20	27	26
Other	23	17	36	32

Source: U.S. Department of Education, Center for Educational Statistics, Trends in Adult Education 1969-1984, Table 1, page 3, 1987.

* The basis of these percentages are employed adult education participants and the employed population 17 years and older.

- Not available.

Note: Details may not add to totals because of rounding.

TREASURY NEWS

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DEPARTMENT

Richard W. Porter
Appointed Deputy Assistant Secretary
(Policy Review and Analysis)

Secretary of the Treasury Nicholas F. Brady today announced the appointment of Richard W. Porter to serve as Deputy Assistant Secretary of the Treasury for Policy Review and Analysis in the Office of Policy Development, effective Monday, February 27, 1989. Mr. Porter will be responsible for providing the Assistant Secretary for Policy Development with analysis and briefings on the full range of the Department's policies.

Mr. Porter served as the Transition Office Contact for the Department of Labor and was an analyst and the chief writer of the Domestic Policy group in the Bush/Quayle campaign. Prior to that, he worked as a lawyer-economist for Lexecon, Inc. in Chicago. He also served as a law clerk for Judge Richard A. Posner of the U.S. Court of Appeals for the Seventh Circuit.

Mr. Porter received his J.D. with honors from the University of Chicago Law School in 1989. He was awarded the John D. Olin Prize for the outstanding graduate in law and economics and was a member of Order of the Coif. He received his B.A. with high honors from Middlebury College in 1981 and was elected to Phi Beta Kappa.

Mr. Porter was born on November 20, 1959 in Mt. Kisco, New York to William P. and Barbara W. Porter.

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FOR IMMEDIATE RELEASE March 15, 1989

Emily Landis Walker
Appointed Executive Secretary
Office of the Assistant Secretary
(Policy Develoment)

Secretary of the Treasury Nicholas F. Brady today announced the appointment of Emily Landis Walker to serve as Executive Secretary to the Secretary of the Treasury effective February 27, 1989. In this position, Mrs. Walker will be responsible for the Department's Executive Secretariat which processes and coordinates all written and policy materials for the Secretary and Deputy Secretary.

Since 1988, Mrs. Walker has served as Deputy Assistant Secretary of the Treasury for Policy Review and Analysis. From 1984-1988 she served as Assistant to the U.S. Executive Director of the International Monetary Fund (IMF) while he was serving concurrently as Senior Deputy Assistant Secretary of the Treasury for International Economic Policy. Prior to that she worked in the Exchange and Trade Relations Department of the IMF.

Mrs. Walker received her M.A. in 1981 from Johns Hopkins School of Advanced International Studies, attending the Bologna Center in Italy, and a B.A. in International Affairs and French from the University of North Carolina at Chapel Hill in 1978. She also attended the Vanderbilt-in-France program.

Mrs. Walker was born on July 2, 1956 in Clarendon Hills, Illinois to George H. and the late Jane M. Landis. She resides in Alexandria, Virginia with her husband, William J. Walker and daughter, Sarah Jane.

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TREASURY NEWS

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REMARKS BY
THE SECRETARY OF THE TREASURY
NICHOLAS F. BRADY
BEFORE THE NATIONAL COUNCIL OF SAVINGS INSTITUTION'S
1989 GOVERNMENT AFFAIRS ROUNDTABLE

WESTIN HOTEL
WASHINGTON, D.C.
MARCH 14, 1989

Good morning. Thank you for this opportunity to meet with a group that represents the leaders of the savings and loan industry. President Bush has asked me to tell you how much we appreciate your support of the Administration's reform plan. It is, as you know, a solid foundation for the solution to the problems caused by the large number of insolvent S&Ls. We salute your leadership in urging swift passage of the reform plan. We also recognize that you have raised some concerns about particular aspects of the proposal. We are optimistic that in the days ahead we can continue the dialogue we have started with you to resolve our remaining differences.

My remarks this morning will center on the President's reform plan for the savings and loan industry. But before getting to that, I would like to take just a moments to touch on some of the other economic priorities the Bush Administration is pursuing.

PROMOTING ECONOMIC GROWTH

Our first and foremost economic priority is fostering a more competitive, innovative economy that will continue to lead the world as we move toward the 21st century. I am pleased to say that our economic outlook is good. Broad-based economic growth means rising living standards for working Americans and new job opportunities for those who are out of work.

We remain vigilant against inflation. The Bush Administration will not allow inflation to plague our economy as it did in the late seventies. Now, as all of us know, it is possible to have somewhat differing interpretations of economic statistics, to think one set of statistics means more than another. But there is no difference between the Administration and the Federal Reserve Board on the importance of resisting and preventing inflation in order to help sustain the current economic expansion.

CUTTING THE BUDGET DEFICIT

As we pursue our goal of inflation-free economic growth, the greatest obstacle to success is the federal budget deficit. And the best way to fight inflation and encourage economic growth is to cut the deficit.

That is why President Bush has proposed to Congress a budget that will meet next year's Gramm-Rudman-Hollings deficit reduction target of $100 billion without raising taxes. His budget takes the more than $80 billion in new revenues resulting from economic growth and allocates them to deficit reduction and spending priorities.

The President pledged in his budget address to Congress that he and his team are ready to work with the Congress, "day and night, if that's what it takes, to meet the budget targets and to produce a budget on time." Budget Director Darman, Governor Sununu and I have begun to negotiate with the Congress and we're making real progress.

THE S&L PLAN

Now, let me turn to what has been one of my other top priorities since the day I was sworn in as Secretary of the Treasury: a sound, responsible solution to the savings and loan crisis.

President Bush is correct. No simple or painless solution to this problem exists -- a point your testimony noted last week. Only eighteen days after he was inaugurated, however, President Bush announced our plan. In doing so, he reaffirmed our commitment to fix it now, fix it right, and fix it once and for all.

The reform plan meets these standards. It serves as a blueprint for comprehensive reform and sound financing. It is pro-consumer -- putting deposit insurance on a sound basis for the future to protect depositors and taxpayers as well -- and it is pro-industry -- benefitting S&Ls and the housing industry.

RESOLVING INSOLVENT S&Ls

Now, let me turn to a few of the most important details: On February 7, the day after the President announced his plan, the FSLIC, FDIC, OCC, and the Federal Reserve acted together to place insolvent institutions under supervisory control. To date, 118 insolvent S&Ls have been brought under regulatory control. In short order, 200 of the worst cases should be in the hands of federal authorities.

That action should begin to reduce your cost of funds. Moreover, this quick action will give us a head start on implementing the necessary resolutions of insolvent thrifts. We can begin as soon as Congress provides the necessary financing.

THE REFORM PLAN

We have also proposed fundamental reforms in the way the S&L industry is insured and regulated. To correct the systemic problem of having the regulator act both as an industry advocate and insurer, FSLIC will be separated from the Bank Board and attached administratively to the FDIC.

The combined administrative resources of FDIC and FSLIC will create an insurer with independence and sufficient capacity to tackle this big job. While a single agency will be created, separate insurance funds will be maintained for commercial insured banks and for savings and loans.

The Chairman of the Federal Home Loan Bank System (FHLBS) will continue to be the chartering authority and the primary federal supervisor of savings and loans. The current board will be replaced by a single chairman, who will be subject to the general direction of the Secretary of the Treasury in the same manner as is the Comptroller of the Currency. Let me stress a critical point here. It is not the intent of the legislation to have the Treasury Department take a heavy-handed approach and micro-manage the day-to-day affairs of S&Ls or the new Federal Home Loan Bank System. We expect the Chairman and his supervisory personnel to maintain regulatory independence within the general oversight of the Treasury.

SAFETY AND SOUNDNESS

The Administration plan will increase safety and soundness standards for savings and loan institutions by requiring standards equivalent to commercial bank capital standards by June 1, 1991. The Chairman of the Federal Home Loan Bank System will administer these capital requirements, with fairness and with flexibility. For example, contrary to some comments that have been made, S&Ls that don't meet the deadline won't be liquidated -- they simply will not be able to grow after 1991 without adequate private capital at risk.

Much of the problem we see today is related to excessive growth in the past without sufficient capital. We understand that these standards in the legislation impose burdens on some institutions which have engaged in mergers under the oversight of regulators, and we are willing to discuss appropriate modifications.

But we have learned a valuable lesson: Deposit insurance simply will not work without sufficient private capital at risk and up front. While we can be flexible in the administration of these capital standards, we cannot afford to weaken them or delay the date they become effective.

Incentives for attracting new capital will further increase the amount of private capital protecting depositors. For example, bank holding companies will be permitted to acquire an insolvent savings and loan without the existing cross-marketing and tandem restrictions. After two years, bank holding companies will be able to acquire any savings and loan without these restrictions.

The FDIC will be given enhanced authority to set insurance standards for all savings and loans, both federal and state-chartered. It will be able to deny insurance for risky activities that have been authorized by some states in the past. The FDIC also would have a "fast whistle" to halt unsafe and unsound practices, while still protecting insured depositors.

All in all, these steps will create a system of checks and balances for savings and loans that more closely parallels that of commercial banks. There will be no more unfair competition from insolvent institutions. And that even-handed approach ultimately is in the best interest of S&Ls, your customers and all of us as taxpayers.

SOUNDNESS OF THE DEPOSIT INSURANCE FUNDS

Beyond the regulatory reforms that are designed to insure that massive insolvencies are never allowed to occur again, there is a fundamental need to put the federal deposit insurance funds on a sound financial basis. This goal can be accomplished by reestablishing the basic principle of industry-financed deposit insurance funds standing between any future industry problems and the taxpayer.

The cost of the S&L solution underscores the importance of requiring all federal deposit funds to be adequately capitalized. The FDIC insurance fund's reserve-to-insured deposit ratio has fallen to an estimated all-time low of 0.83 percent. We also propose increasing commercial bank premiums to bring the FDIC fund more in line with its historical reserve-to-deposit ratio also to protect depositors and taxpayers.

You obviously have a number of concerns: first, increasing your current premium by 2 basis points in 1990 (it drops from 23 to 18 basis points in 5 years); second, the increased requirements for private capital at risk to stand ahead of the deposit insurance fund; and third, using a portion of future funds of the Federal Home Loan Bank System to put the S&L system on a sound footing.

We understand your concerns and we pledge to continue to work with you, as we have in the past, to address those concerns where it's possible.

THE FINANCING PLAN

The financing portion of the Administration's plan has three components. The first $50 billion is to resolve currently insolvent institutions and any other marginally solvent institutions that become insolvent over the next several years. Second, the plan ensures adequate servicing of the $40 billion in past FSLIC obligations. Third, the plan provides $24 billion for any insolvencies that may occur between 1992 and 1999.

At the heart of our plan is the creation of a Resolution Trust Corporation (RTC) to resolve all S&Ls which are now GAAP insolvent or become so over the next three years. The creation of this new corporation will allow the isolation and containment of all insolvent S&Ls during the three-year resolution process. It will also facilitate a full and precise accounting of all the funds that are used.

To provide the $50 billion to the RTC, we have asked the Congress to create a separate corporation, the Resolution Funding Corporation (REFCORP), which will issue $50 billion in long-term bonds to raise the needed funds. REFCORP will use S&L industry funds to purchase zero-coupon, long-term Treasury securities with a maturity value of $50 billion to assure the repayment of the principal of the bonds issued by REFCORP.

Interest payments on the REFCORP bonds will come from a combination of private and taxpayer sources. All Treasury funds used to service REFCORP interest will be scored for budget purposes in the year expended. No S&L insurance premiums will be used to pay interest on REFCORP borrowings.

Funds for the second component of our plan -- servicing the $40 billion in resolutions already completed by FSLIC -- also will come from a combination of S&L industry and taxpayer sources.

Funds for the third component of the plan -- managing future S&L insolvencies and building the new Savings Association Insurance Fund (SAIF) during the post-RTC period -- will come from a portion of the S&Ls' insurance premiums and Treasury funds as needed. Approximately $33 billion will go to SAIF (with $24 billion for possible future case resolution), demonstrating a fast funding-up of your new insurance fund and our tangible commitment to the future of this all-important industry.

CONCLUSION

In conclusion, the Administration's activity of the past few weeks should illustrate clearly our commitment to a long-lasting resolution of the S&L crisis and a commitment to your industry. In our opinion, we have presented a structurally sound plan. We have proposed a balanced financing package that requires contributions from the S&L industry in meaningful amounts and also lives within the government's means.

For too long we have allowed undercapitalized thrifts to remain in business, providing government subsidized competition to healthy financial institutions. The result has been higher deposit costs, reduced operating margins and declining public confidence in the thrift system.

The Administration's plan will change this. It will create a healthy thrift industry by removing the insolvents, reducing over capacity, reducing deposit costs, and requiring those that remain to have capital and accounting standards equivalent to your commercial bank competition. And by requiring that deposit insurance be fully funded, the plan will reinforce depositor confidence in the system.

President Bush deserves a great deal of credit for stepping forward with a plan that will do the job. We appreciate your support for the plan so far. We believe it deserves your continued and forthright support. Where we differ on details, let us continue to work together for the good of the public and for the S&L industry.

Now is clearly time for action. I'm here today to ask for your help. We have moved swiftly to present a credible plan that will put the S&L crisis behind us and at the same time create a more stable environment for your business. Congress needs to act decisively and swiftly. Delay costs you and the American taxpayers money.

At this moment, we have encouraging signals from the new leadership of both the House and Senate Banking Committees. The House Financial Institutions Subcommittee is going to markup the bill on April 4. The Senate Banking Committee follows the next week. We must stay on course and maintain a fast track. The American people deserve nothing less than our best efforts. With your cooperation, we can move ahead to get this problem behind us once and for all. Thank you very much.

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REPORT ON THE TAXATION OF SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS IN CALENDAR YEAR 1986

Office of Tax Analysis
U.S. Department of the Treasury

January 1989

THE SECRETARY OF THE TREASURY
WASHINGTON

February 27, 1989

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Section 121 of Public Law 98-21, the Social Security Amendments of 1983, provides that "the Secretary of the Treasury shall submit annual reports to the Congress and to the Secretary of Health and Human Services and the Railroad Retirement Board on:

(A) the transfers made....during the year, and the methodology used in determining the amount of such transfers and the funds or account to which made, and

(B) the anticipated operation of this....during the next five years."

Pursuant to that section, I hereby submit the "Report on the Taxation of Social Security and Railroad Retirement Benefits in Calendar Year 1986."

Copies of the report are being sent to Representative Dan Rostenkowski, Chairman of the Committee on Ways and Means, Acting Secretary Donald Newman of Health and Human Services, and Chairman Robert Gielow of the Railroad Retirement Board, Chicago, Illinois.

Sincerely,

Nicholas F. Brady

Enclosure

THE SECRETARY OF THE TREASURY
WASHINGTON

February 27, 1989

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

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Sincerely,

Nicholas F. Brady

Enclosure

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I. INTRODUCTION AND SUMMARY

The Treasury Department annually transfers to the Social Security and Railroad Retirement trust funds income tax collections derived from the taxation of Social Security and Railroad Retirement benefits as required by the Social Security Amendments of 1983 (P.L. 98-21). The Act required that beginning in January 1984 Social Security and Tier I Railroad Retirement benefits be partially taxable for high income taxpayers. The Act further specified that the Treasury Department estimate the tax liability attributable to these benefits and transfer these amounts to the Federal Old Age and Survivors Insurance (FOASI). Federal Disability Insurance (FDI). and Railroad Retirement trust funds. In addition. the Act required adjustments in the amounts transferred to the trust funds in the event that the estimates of the tax liability attributable to the benefits. made before the year's tax returns become available. are subsequently shown to be incorrect. This report meets the requirement for the transfers of 1986 calendar year tax liabilities.[1] The 1986 tax return data for the required adjustments were obtained in 1988 from the Internal Revenue Service (IRS).[2] This report also meets a requirement in the Act that an annual report be made to the Congress on the methodology and forecasted transfers over the five subsequent years.

The amounts transferred to the Social Security trust funds are calculated as the difference between tax liabilities with and without the inclusion of benefits in taxable income for returns with taxable Social Security and Tier I Railroad Retirement benefits. A taxpayer adds taxable wages. interest. dividends. and other taxable income to one-half of Social Security and Tier I Railroad Retirement benefits plus tax-exempt interest on state and local obligations to obtain a sum which is compared to certain thresholds. The threshold for single taxpayers is $25.000 and for joint returns it is $32.000. A maximum of 50 percent of the Social Security and Tier I Railroad Retirement benefits are includable in Adjusted Gross Income (AGI) if a taxpayer's income exceeds the threshold. For taxpayers with incomes slightly above the threshold amounts or with relatively large Social Security and Tier I Railroad Retirement benefits. the percentage of such benefits includable in AGI is often lower than the 50 percent maximum.

The initial calendar year 1986 transfers of $3.656 million to the trust funds were $126 million higher than the amount of tax liability calculated from actual 1986 tax return data. Transfers to the FDI and Railroad Retirement accounts were initially overstated by $116 million and $39 million. respectively. These overpayments were partially offset by an underpayment to the FOASI account of $29 million. Correcting adjustments were made in the July 1988 trust fund transfers. Transfers to the trust funds for calendar years 1987 through 1991. including the adjustment for 1986 and an anticipated adjustment for 1987. are estimated to be $20.085 million.

This report also contains a section which presents the distribution of beneficiaries who include FOASI. FDI. and Tier I Railroad Retirement benefits in taxable income. When returns are classified according to AGI. nearly half of the tax liability attributed to the inclusion of benefits is paid by filers with AGI less than $50.000. However. the proportion of benefits includable in AGI varies among taxpayers. with beneficiaries including an average of 39 percent of benefits in AGI. When the income classifier is expanded to include the non-taxable portion of benefits. about one-third of the tax liability resulting from the taxation of benefits is paid by filers with AGI plus non-taxable benefits of less than $50.000.

II. METHODOLOGY AND ESTIMATES OF BENEFIT TAXATION FOR THE INITIAL CALENDAR YEAR 1986 TRUST FUND TRANSFERS

The Treasury Department's Office of Tax Analysis (OTA) has the responsibility for estimating the tax liability attributable to the Social Security and Tier I Railroad Retirement benefits received by high-income beneficiaries.[3] The OTA provides the information to the Treasury Department's Office of Finance and Planning. which has the authority to transfer funds from general revenues to the Social Security and Railroad Retirement trust funds.

The OTA estimated the 1986 tax liability effects of the benefit taxation provision of the Act using the Office's Individual Income Tax Model.[4] The Individual Income Tax Model contains information from a stratified random sample of seventy-five thousand tax returns selected from the IRS's Statistics of Income file, various imputations of data not available from tax returns. and a tax calculator which computes changes in tax liabilities attributable to changes in the tax code. Computations based on this model are weighted to produce results that are representative of the population that filed returns in the year the sample was selected. The imputations and the tax calculator are described below, after which the initial 1986 transfers are discussed.

Imputation of data items not available from tax returns was necessary to make initial revenue estimates of the additional tax liability attributable to the taxation of Social Security and Tier I Railroad Retirement benefits. First. the Individual Income Tax Model was modified to include data on taxable pension benefits. For example, total payable benefits. as provided by the Social Security Administration and the Railroad Retirement Board, was distributed among appropriate taxpayers. This distribution was based on the most recent Current Population Survey data from the Census Bureau. Second, an imputation was made for tax-exempt interest on state and local obligations because it is included in the benefit inclusion formula but is not reported in IRS statistics.[5]

Calculation of the tax liability effect of the new legislation required forecasts of 1986 revenue when 1984 tax data were the latest available. Forecasts of tax effects beyond 1984 required that the data items on the Individual Income Tax Model be adjusted for three types of growth. First. an adjustment was made for the forecasted growth in Social Security and Tier I Railroad Retirement pension benefits provided by the Social Security Administration and the Railroad Retirement Board.[6]

Second. an adjustment was made to capture the maturing of the beneficiary population. The current structure of the Social Security system ensures that for the near future new beneficiaries subject to tax have both greater benefits and higher incomes than prior entrants. Finally. the thresholds were adjusted to reflect the effect of inflation on their real value. The thresholds which trigger taxation of Social Security and Tier I Railroad Retirement benefits are not adjusted for inflation. so the real value of the thresholds erode with some beneficiaries becoming taxable as inflation raises their incomes over the thresholds.

These imputations and forecasts are inputs to the tax calculator which utilizes information from each potential filing unit to calculate each unit's Federal income tax liability. For purposes of making the initial 1986 transfers. the Individual Income Tax Model was used to estimate 1986 tax liabilities with and without Social Security and Tier I Railroad Retirement benefits included in AGI. The Tax Model takes account of changes in itemized deductions which are affected by AGI (e.g.. as AGI increases. it becomes more difficult to meet the criteria for deducting medical and casualty expenses). the individual minimum tax. and the usage of tax credits (the increased liability resulting from inclusion of Social Security benefits in AGI enables some taxpayers to use credits which otherwise might not be usable in that year).[7] The Tax Model calculates the percentage of total benefits included in AGI as a result of the special benefit inclusion formula. and the associated marginal tax rates.

Estimates of the additional tax liability from the partial taxation of Social Security benefits for calendar year 1986 were made in late 1985 and were adjusted as new information was obtained. Transfers to the trust funds on a quarterly basis are authorized by Treasury Department regulations. The amount transferred each quarter equals one-fourth of the estimated change in calendar year tax liability as a result of the Act (plus adjustments for prior transfers). The transfers required by the Act are allocated to the following accounts:

- Federal Old Age and Survivors Insurance (FOASI)

- Federal Disability Insurance (FDI)

- Railroad Retirement (Tier 1):
  - Social Security Equivalent Benefit Account (SSEBA)
  - Railroad Retirement Account (RRA)

Since October 1984, the tax attributable to receipt of Tier 1 Railroad Retirement benefits has been transferred into two trust funds maintained by the Railroad Retirement Board. The Social Security equivalent benefit account (SSEBA) was established in October 1984 by the Railroad Retirement Solvency Act of 1983. From the SSEBA, the Railroad Retirement Board pays retired rail workers the amount of Tier 1 Railroad Retirement benefits which is equivalent to the Social Security benefits they would have received had their service been covered under the Social Security system rather than the Railroad Retirement system. The tax liability attributable to the Social Security equivalent benefits is transferred into the SSEBA. The remaining portion of Tier 1 benefits is paid from the Railroad Retirement Account (RRA), and consequently, the tax liability attributable to this portion is transferred into the RRA.

The Consolidated Budget Reconciliation Act of 1986 (COBRA) modified the taxation of Tier 1 Railroad Retirement benefits. Social Security equivalent benefits will continue to be taxed in the same manner as Social Security benefits, with the tax liability transferable to the SSEBA. However, under COBRA, the remaining portion of Tier 1 benefits was made taxable in the same manner as private pension benefits beginning with tax year 1986. (Tier 2 Railroad Retirement benefits have been treated for tax purposes as private pension benefits since 1984.) The tax collections from the Tier 1 non-SSEBA benefits, along with the liabilities attributable to Tier 2 benefits, will continue to be transferred to the RRA until September 30, 1989. Since COBRA was not enacted until April 1986, two transfers had already been made to the RRA based on the prior law treatment of non-SSEBA Tier 1 benefits. With the passage of COBRA, an adjustment was made to the account to correct for the resulting change in 1986 liability.[8] For purposes of this report, Tier 1 benefits will henceforth refer only to the SSEBA portion of the Railroad Retirement benefits.

Table 1 compares the assumptions used to estimate the initial transfers for calendar year 1986 with the actual results. The top section of the table indicates that for FOASI, it was initially assumed that 5.8 percent of the $177,350 million of benefits paid out in 1986 would be included in AGI at a marginal tax rate of 32.4 percent, yielding an initial transfer of $3,353 million. Similar assumptions were used to obtain the initial estimates of the tax liability associated with Tier 1 Railroad Retirement benefits: 5.6 percent of the $3,781 million paid out in Tier 1 Railroad Retirement

TABLE I

COMPARISON OF ASSUMPTIONS USED TO ESTIMATE INITIAL TRANSFERS FOR CALENDAR YEAR 1986 WITH ACTUAL RESULTS[1]

Initial Transfer Assumptions[2]

Trust Funds	Total Benefits Paid ($millions)	Benefits Includable in AGI (%)	Tax Rate on Benefits Includable in AGI (%)	Initial Transfers ($ millions)
Federal Old Age & Survivors Insurance	177,350	5.8	32.4	3.353
Federal Disability Insurance	19.714	3.7	31.6	234
Railroad Retirement Tier I	3,781	5.6	32.4	69
Total	200,845	5.6	32.3	3.656

Actual Results[3]

Trust Funds	Total Benefits Paid ($millions)	Benefits Includable in AGI (%)	Tax Rate on Benefits Includable in AGI (%)	Initial Transfers ($ millions)
Federal Old Age & Survivors Insurance	176,738	6.1	31.2	3.382
Federal Disability Insurance	19,849	2.6	22.6	118
Railroad Retirement Tier I	3.781	2.9	27.5	30
Total	200.368	5.7	30.8	3.530

Department of the Treasury
Office of Tax Analysis

January 10. 1989

[1] Different assumptions were used for each quarterly transfer. This table presents a weighted average of these quarterly transfer assumptions. Rounding of results may prevent exact matching of totals.

[2] Source: The total benefits paid data were estimates provided by the Social Security Administration and the Railroad Retirement Board; the other data came from the Individual Income Tax Model of the Office of Tax Analysis.

[3] Source: The total benefits paid data are from the Annual Statistical Supplement for 1987 of the Social Security Bulletin. the Social Security Administration and the Railroad Retirement Board: the other data come from the Internal Revenue Service's Individual Master File data.

benefits were included in AGI at a 32.4 percent marginal tax rate, yielding a $69 million transfer. Relative to retirees, recipients of Social Security disability benefits have lower incomes. As a result, smaller tax parameters were used in the estimation of the initial transfer of disability benefits: 3.7 percent of the $19.714 million in FDI benefits were included at a 31.6 percent marginal tax rate resulting in a transfer of $234 million. The actual results are discussed in the following section.

III. ADJUSTMENTS TO TRANSFERS FOR ACTUAL 1986 TAX RETURN INFORMATION

The Social Security Amendments of 1983 require that transfers made on the basis of estimates be subsequently adjusted when actual tax return data become available. To calculate the additional tax liability for calendar year 1986 resulting from partial taxation of Social Security and Railroad Retirement benefits, the IRS created a data file based on Form 1040 records. All filers who report taxable Social Security or Tier I Railroad Retirement benefits on their Form 1040 are included in this data file. While the Form 1040 provides information on the total amount of benefits includable in taxable income, it does not indicate whether the filer received FOASI, FDI or Tier I Railroad Retirement benefits. Such information is necessary for the appropriate allocation of revenues among the trust funds. To obtain this information, the Form 1040 records belonging to those beneficiaries who report taxable benefits were matched to the Form 1099 records provided by the Social Security Administration and the Railroad Retirement Board. (While the actual Forms 1099-SSA do not distinguish between retirement and disability benefits, the records provided by the Social Security Administration to the IRS do include the source of benefits.)

The IRS then calculated the number of tax returns with benefits which might be includable in AGI, the gross dollar amount of benefits ultimately paid to beneficiaries who filed tax returns, the amount of benefits included in AGI, and the additional taxes resulting from inclusion. Next, total taxable benefits were subtracted from taxable income, and the tax liability was recalculated. The difference between the filers' true tax liabilities and the reestimated liabilities, when benefits are not included in taxable income, equals the amount of revenues attributable to the taxation of benefits.

The lower section of Table I shows the additional tax liability attributable to partial inclusion of Social Security and Railroad Retirement benefits calculated from actual 1986 tax returns. In 1986, the Social Security Administration and the Railroad Retirement Board paid out $200.368 million in FOASI, FDI, and Tier I Railroad Retirement benefits. As a result of the Social Security Amendments of 1983, $11.471 million in benefits were added to AGI for calendar year 1986. On average, these benefits were taxed at a marginal rate of 30.8 percent, yielding $3,530 million in additional revenues. For all trust funds, initial transfers exceeded actual receipts by $126 million.

During the previous year, the trust funds returned a total of $12 million back to general revenues, as a consequence of IRS data on actual 1985 tax liabilities. However, in 1985, the transfer to the FOASI account was corrected by an amount nearly equal - but opposite in sign - to the combined transfers to the FDI, SSEBA, and RRA funds. The 1986 correcting adjustment to the FOASI account is substantially smaller than the 1985 correction, while the adjustments for FDI and Tier I Railroad Retirement have not changed significantly from the previous year.

The 1986 IRS tax return data show that $29 million should be transferred from general revenues to the FOASI account. Initial estimates of total benefits paid out in 1986 were in excess of actual benefit expenditures by $612 million. In addition, the initial estimate of the marginal tax rate erred on the positive side, by 1.2 percentage points. But, the proportion of benefits includable in taxable income was initially understated by three-tenths of a percentage point, and the total amount of tax liabilities transferred consequently fell short by $29 million.

As in 1985, the initial assumptions regarding the proportion of FDI and Railroad Retirement Tier I benefits included in AGI and the applicable marginal tax rates were too high. In the FDI account, the initial estimates assumed that 3.7 percent of benefits would be taxable at a marginal tax rate of 31.6 percent. Instead, 2.6 percent of benefits were taxable at a marginal tax rate of 22.6 percent. Similarly, the initial estimates for the Tier I Railroad Retirement benefit accounts overstated the amount of benefits includable in AGI and the applicable tax rate by 2.7 and 4.9 percentage points, respectively.

As a result of the reconciliation of estimated and actual 1986 tax liability, the July 1, 1988 transfer included an upward adjustment in the FOASI account and downward adjustments in the FDI and Railroad Retirement accounts. These adjustments reflect the changes from the initial transfers and are presented in Table 2.

IV. FORECAST OF TRANSFERS TO TRUST FUNDS FOR 1987-1991

The Social Security Amendments of 1983 required that the annual report include a forecast of transfers to the trust funds for the next five years.

TABLE 2

ADJUSTMENTS TO TRUST FUNDS FOR CALENDAR YEAR 1986 BASED ON COMPARISON OF THE INITIAL TRANSFERS WITH ACTUAL RESULTS

($ millions)

Trust Funds	Initial Transfers for Calendar Year	Actual Results	Change from Initial Transfer
Federal Old Age & Survivors Insurance	3.353	3.382	+29
Federal Disability Insurance	234	118	-116
Railroad Retirement Tier I	69	30	-39
Total	3.656	3.530	-126

Department of the Treasury
Office of Tax Analysis

January 25. 1989

The forecast is produced by the OTA using the methodology described in Section II. Social Security and Railroad Retirement benefit forecasts are obtained from the respective agencies, and the percent of aggregate retirement benefits includable in AGI and marginal tax rates are obtained by extrapolating the Individual Income Tax Model in accordance with the Administration's budget forecasts. In addition, the estimates of future transfers reflect the information obtained from the IRS computation of marginal tax rates and benefits includable in AGI reported on tax returns for calendar year 1986. Downward adjustments have been made in the percentages of FDI and Tier I Railroad Retirement benefits includable in AGI for 1988 through 1991 as a result of the information from 1986 and prior year tax returns.

The estimated transfers for calendar years 1987-1991, including the 1986 adjustments and anticipated adjustments for 1987, are presented in Table 3. It is expected that the Act will result in $20.085 million being transferred to the Social Security and Railroad Retirement trust funds in calendar years 1987-1991. The Tax Reform Act of 1986 lowers the tax liability effect of the Social Security Amendments of 1983, causing approximately a $3 billion decline over the 1987-1991 period due to decreases in marginal tax rates.

V. DISTRIBUTION OF TAXABLE BENEFITS AND TAX LIABILITY ATTRIBUTABLE TO TAXATION OF BENEFITS

This section contains an analysis of the distributions of returns with taxable Social Security and Tier I Railroad Retirement benefits by AGI class. The analysis is based on the preliminary 1986 Statistics of Income (SOI): a stratified random sample of approximately 89,000 individual income tax returns. Weights are applied to individual returns in order to create a representative sample of taxpayers. Because of sampling error, the SOI provides a less precise measure of taxable benefits than the special IRS data base containing the universe of recipients with taxable benefits, used in the calculation of the 1986 tax liability.[9] However, the SOI includes more data from the Forms 1040, 1040A, and supporting forms and schedules, permitting a more extensive distributional analysis.

As shown in Table 4, approximately 3.2 million filing units report taxable benefits. Since each filing unit may contain more than one beneficiary, the number of beneficiaries paying income tax on their benefits cannot be inferred without making some assumption regarding the number of beneficiaries per filing unit. Since married couples, filing joint returns, constitute about two-thirds of this total, it is reasonable to assume that no more than 5.3 million beneficiaries report taxable benefits. In 1986, 38 million persons received retirement or disability benefits, suggesting that approximately 8 to 14 percent of beneficiaries paid taxes on their benefits.

TABLE 3

FORECAST OF THE NET TRANSFERS FOR CALENDAR YEARS 1987-1991 DUE TO THE SOCIAL SECURITY AMENDMENTS OF 1983[1]

($ millions)

Calendar Year Transfers

	Initial Transfers Already Made		Estimated Transfers			Total Transfer
Trust Funds	1987	1988	1989	1990	1991	1987 -1991
Federal Old Age and Survivors Insurance: Net Transfer...........	3,190	3,314	3,823	4,259	4,679	19,265
Federal Disability Insurance: Net Transfer...........	-39	57	194	235	269	716
Railroad Retirement Tier 1: Net Transfer...........	-28	2	36	45	49	104
TOTAL	3,123	3,373	4,053	4,539	4,997	20,085

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[1] Transfers for 1987 and 1988 have already been made and include adjustments for prior-year actuals. The estimates for 1989-1991 include the impact of the Tax Reform Act of 1986 and expected adjustments.

TABLE 4

DISTRIBUTION OF TAXABLE SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS AND RESULTING TAX LIABILITY FOR TAX RETURNS WITH TAXABLE BENEFITS. BY ADJUSTED GROSS INCOME CLASS

Adjusted Gross Income	Returns With Taxable Benefits (000)	Adjusted Gross Income ($ millions)	Amount of of Total Benefits ($ millions)	Amount of Taxable Benefits ($ million)	Inclusion Rate (percent)	Amount of Additional Tax Liability ($ million)	Tax Rate on Taxable Benefits (percent)
Less than $30.000	594	15,409	5,392	843	16	200	24
$30,000 to $50,000	1,584	61,467	12,348	4,966	40	1.402	28
$50,000 to $100,000	769	50,918	7,024	3,512	50	1,270	36
$100,000 to $200,000	167	22,286	1,921	963	50	412	43
Greater than $200,000	61	31,262	729	365	50	156	43
Total	3,175	181,342	27,414	10.649	39	3,441	32

Department of the Treasury
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January 26. 1989

Source: Preliminary 1986 Statistics of Income and Treasury Individual Tax Model runs.

Table 4 shows that nearly 600.000 filers with taxable benefits or 18 percent of all recipients with taxable benefits have AGI between $20.000 and $30.000. An additional 1.6 million filers with taxable benefits report AGI between $30.000 and $50.000. Since the income test for the taxation of benefits includes tax-exempt interest. it is possible for some taxpayers to be liable for tax on benefits with AGI significantly below the income thresholds. However. this number is probably small. with only one percent of beneficiaries reporting AGI below $20.000. With over half of recipients with taxable benefits reporting AGI below $50.000. a sizable number of recipients appear to be close to the income thresholds which determine the amount of taxable benefits.

Other data in Table 4 confirm this hypothesis. Taxable benefits are compared to the total benefits received by the filers in order to derive inclusion rates. On average. beneficiaries in the taxable range include 39 percent of benefits in AGI. One-third of beneficiaries with taxable benefits are in the phase-in region for the taxation of benefits. Among these beneficiaries. the rate of inclusion of benefits is about 25 percent. The other two-thirds of beneficiaries with taxable benefits include the statutory maximum 50 percent of benefits in AGI.

In general. taxable Social Security and Railroad Retirement benefits represent a relatively small proportion of AGI regardless of the proximity of the beneficiary to the income thresholds. Taxable benefits constitute about six percent of AGI. with the greater share of taxable income derived from interest. dividends. capital gains. earnings and pensions. For recipients with taxable benefits. about half of AGI consists of interest. dividends and capital gains. The importance of labor income in AGI varies according to marital status. ranging from 7 percent among single filers to 25 percent among married filers.

The distribution of returns reporting taxable benefits is classified according to AGI plus non-taxable benefits in Table 5. As would be expected. the inclusion of all benefits in the income classifier shifts the distribution upwards. With AGI only as the classifier. filers in the under $50.000 range bear 47 percent of the tax liability attributable to the inclusion of benefits in AGI. With the expanded AGI classifier. this proportion falls to 35 percent. Note that this expanded AGI classifier still excludes certain income items. such as tax-exempt interest income. which may affect the relative well-being of the high-income elderly.

TABLE 5

DISTRIBUTION OF TAXABLE SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS AND RESULTING TAX LIABILITY FOR TAX RETURNS WITH TAXABLE BENEFITS. BY ADJUSTED GROSS INCOME PLUS THE UNTAXED PORTION OF BENEFITS

Adjusted Gross Income Plus The Untaxed Portion of Benefits	Returns With Taxable Benefits (000)	Adjusted Gross Income ($ millions)	Amount of of Total Benefits ($ millions)	Amount of Taxable Benefits ($ million)	Inclusion Rate (percent)	Amount of Additional Tax Liability ($ million)	Tax Rate on Taxable Benefits (percent)
Less than $30,000	151	3,282	809	193	24	45	23
$30,000 to $50,000	1,755	61,126	13.741	4.253	31	1.148	27
$50.000 to $100,000	1,018	61,170	9.904	4,721	48	1,615	34
$100,000 to $200,000	180	22,682	1.980	992	50	424	43
Greater than $200,000	70	33,082	980	490	50	209	43
Total	3.175	181,342	27.414	10.649	39	3,441	32

Department of the Treasury
Office of Tax Analysis

January 26, 1989

* Less than $1 million.

Source: Preliminary 1986 Statistics of Income and Treasury Individual Tax Model runs.

FOOTNOTES

[1] The "Report on the Taxation of Social Security and Railroad Retirement Benefits in Calendar Year 1985," released in July 1987 by the Office of Tax Analysis, contains a description of the methodology used to estimate and adjust transfers of the 1985 tax liability attributable to receipt of Social Security and Tier I Railroad Retirement benefits.

[2] The IRS data are not available until approximately one and one-half years after the close of the applicable calendar year due to the normal lags in tax return filing, processing, transcription, and analysis.

[3] The OTA does not estimate the liability attributable to the receipt of Social Security benefits by non-resident aliens. One-half of any Social Security benefit received by a non-resident alien is subject to a 30 percent tax rate, and this amount is automatically withheld by the Social Security Administration (SSA). Each month, SSA sends a certification of the amount withheld to the Office of Finance and Planning, and the transfer of the withheld amount from the trust fund to general revenues and back again to the trust fund is effected. (In practice, the monies never leave the trust fund.) Since SSA has information on the actual amounts withheld, the Office of Tax Analysis does not estimate these withheld amounts.

[4] A detailed description of the Individual Income Tax Model can be found in a paper by James C. Cilke and Roy A. Wyscarver entitled "The Individual Income Tax Simulation Model" in the Compendium of Tax Research 1987, Washington, D.C.: Government Printing Office, 1987.

[5] While Form 1040 has a place where taxpayers are asked to list how much state and local government interest is included in the benefit inclusion calculation, these numbers were not tabulated by the IRS for tax year 1986. The IRS will tabulate this item beginning in tax year 1987.

[6] These projections do not include benefits received by non-resident aliens.

[7] No allowance was made for the option to income average. This effect was judged to be minor and the Committee Report on the Social Security Amendments of 1983 specifically noted that this effect could be omitted from consideration if it was thought to be of little consequence; see p. 29 of Senate Report 98-23, Social Security Amendments of 1983, March 11, 1983.

[8] During the first half of 1986. $4 million were transferred to the RRA based on the pre-COBRA treatment of non-SSEBA Tier I benefits. After the passage of COBRA. this amount was transferred back to general revenues in July 1986. But this negative adjustment was more than offset by a positive correcting adjustment of $34 million back to the account to reflect the greater liability resulting from the treatment of non-SSEBA benefits as private pensions. This positive correction also occurred in July 1986.

[9] A comparison of Tables 1 and 4 show that the SOI underestimates the amount of taxable benefits by $824 million. The 1986 SOI data file used in the preparation of Tables 4 and 5 is preliminary. and subsequent revisions to the file may reduce this discrepancy. Remaining differences between the SOI and the special IRS data base reflect sampling error in the former. The marginal tax rates as estimated by the Individual Tax Model are slightly larger than those from the special IRS data base. thus reducing the differences in the computation of the 1986 tax liability.

This study was prepared by Janet Holtzblatt of the Office of Tax Analysis' Revenue Estimating staff. under the direction of Howard Nester.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
March 15 , 1989

CONTACT: Lawrence Batdorf
202/566-2041

President's Child Tax Credit Proposals

Under President Bush's Child Care Tax Credit Proposal sent to Congress today (the "Working Family Child Care Assistance Act of 1989"), low income families containing at least one worker would be entitled to take a new tax credit of up to $1,000 for each child under the age of four. For each such child, families could receive a credit equal to 14 percent of earned income with a maximum credit equal to $1,000 per child.

Initially, the credit would be reduced by an amount equal to 20 percent of the excess of adjusted gross income or earned income (which ever is greater) over $8,000. As a result the credit would not be available to families with adjusted gross income or earned income greater that $13,000 (13,000-8,000 = 5,000 X .20 = 1,000).

-- Children under the age of four are unlikely to be in either pre-school or school and their families incur greater cost for their care than they do for older children.

-- The credit would be refundable and be effective for tax years beginning January 1, 1990.

-- After 1990, both the starting and end-point of the phase-out range would be increased by $1,000 increments. In 1994 the credit would phase-out between $15,000 and $20,000.

-- Families would have the option of receiving the refund in advance through a payment added to their paycheck.

-- An estimated 3.5 million families would be eligible for the credit when it is fully implemented.

A second proposal (also sent to Congress today) would make the current child and dependent care credit refundable providing a benefit to about one million additional families with children under the age of thirteen.

-- Taxpayers would continue to claim this credit on their tax returns in the same manner as they do now. Taxpayers eligible for both the new child tax credit and the existing child and dependent care credit would have the option to claim either credit for each child under the age of four.

-- The proposals reflect the President's commitment to emphasize parental choice in child care and to the special obligation to first provide additional assistance to families most in need.

* -- The Treasury Department estimates the cost of the proposals to be $187 million for fiscal 1990, increasing to $2.5 billion by fiscal 1993. These amounts are included in the President's fiscal 1990 budget.

TREASURY NEWS

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

For Release Upon Delivery
Expected at 9:00 A.M.
Thursday, March 16, 1989

Statement by the Honorable David C. Mulford
Assistant Secretary of the U.S. Treasury
for International Affairs
before the
Subcommittee on International Finance and Monetary Policy
United States Senate

Mr. Chairman and members of the Subcommittee:

I welcome this opportunity to discuss the two reports that have been transmitted to your full Committee, the Administration's review of the international debt strategy, and our suggestions for strengthening international efforts to alleviate the debt burden in developing countries.

In mid-December, then President-elect Bush called for a thorough reassessment of current public policy on this issue. At that time, the Treasury Department was in the midst of preparing reports, as required by law, that have had a direct bearing on the policy recommendations that we have developed. Therefore, I will open my remarks with a summary and conclusions of the reports.

International Discussions on an International Debt Management Authority

Turning to the report on the negotiation of an International Debt Management Authority, the Treasury Department has reviewed many international debt facility proposals. Most of these proposals have several common elements, including a significant, up-front injection of capital and the assumption of full risk on principal and interest.

As required by the legislation, the report assesses the use of IMF gold stock and World Bank uncommitted liquid assets to establish an Authority. With regard to use of IMF gold stock, the report notes that mobilization of gold for the Authority could only be accomplished through the sale of gold, with proceeds made available to the authority. Such sales would reduce the IMF's basic reserves, which serve as backing for creditor claims on the IMF. They could have an adverse impact on gold prices and international gold reserves of the U.S. and other countries. Since only a small segment of IMF membership would benefit directly from this use of gold stocks, it would be extremely difficult to obtain the 85 percent majority vote necessary to authorize IMF gold sales for the authority.

The use of World Bank resources to establish such an authority would also be constrained by financial and legal obstacles. The Bank's liquid assets are earmarked to fund contractual lending commitments. These assets afford the Bank a margin of flexibility in raising funds in the international capital markets. Pledging Bank assets to a debt authority could affect the Bank's creditworthiness and increase its cost of funding. On the legal side, the Bank's Articles of Agreement do not cover the pledging of liquid assets. Moreover, pledging of the Bank's assets could raise questions concerning negative pledge clauses in agreements under which the Bank is the borrower. Each such clause typically provides that the Bank cannot pledge its assets to secure its obligations unless the benefits of the pledge are shared equally by the lenders which are parties to the agreement.

Our assessment concluded that negotiation of an Authority could materially increase the likelihood of payment interruptions and a further decline in secondary market prices. We believe that the suggested, market-oriented approach outlined by Secretary Brady on March 10 addresses Congressional concerns with less risk to taxpayers.

Voluntary debt reduction techniques have been developed by the commercial banks and debtor countries in response to both the banks' strategies and goals, and debtor nations' appetite for capturing the discount on their debt. All of the 15 heavily indebted middle income countries, with the exception of Colombia, Ivory Coast and Morocco, have participated in voluntary, market-driven debt reduction operations totaling $28 billion since 1985.

We have concluded after months of study that debt reduction and debt service reduction can be successfully accomplished in the market place.

We have reviewed numerous debt facility proposals in preparing the report at hand and, I would stress, not with jaundiced eyes but with a fresh view. In the final analysis, however, we have reaffirmed a market-oriented approach that would encompass both voluntary reduction in debt and access to private capital, while minimizing the expense and risk to the public sector.

The Report on Special Purpose Allocation of SDRs

Pursuant to the 1988 Trade Act, we have studied the feasibility of a special purpose allocation by the IMF of Special Drawing Rights (SDRs) to the poorest countries for use in repaying their debt to foreign governments and international financial institutions. The report concludes that the use of SDRs would undermine adjustment incentives, contribute to inflationary pressures, weaken the liquidity of the SDR and its usefulness as a monetary asset, and undermine the ability of the United States to mobilize its SDR holdings.

The report determined that the IMF's Enhanced Structural Adjustment Facility (ESAF) is a preferred alternative for helping the poorest countries. It suggests that the Administration's request for a $150 million contribution to the ESAF represents a more effective means of providing U.S. support for efforts to deal with the balance of payments and debt problems of the poorest countries.

The Report on the World Bank's Strategy in Debtor Countries

I would like to take a moment to review the conclusions of the report transmitted yesterday to your colleagues in the House of Representatives. As required by H.R. 4645, we have carefully reviewed the World Bank's role in debtor countries. In our judgment, one of the World Bank's most vital functions in these countries is to promote sound economic reform programs through its adjustment programs and to catalyze additional financial support.

In short, after careful study, we have come to conclusions somewhat parallel to the intent of legislators as expressed in H.R. 4645. Additional financial resources and an easing of debt service burdens can strengthen and sustain debtor nations' commitment to economic adjustment programs. The report summarizes our ideas on possible initiatives for voluntary, market-based debt reduction through use of Bank resources. I would underscore, at this juncture, that such funds would be available only for those countries undertaking adjustment programs, and individual transactions would be negotiated between debtors and commercial creditors.

Strengthening the Debt Strategy

The debt difficulties of developing countries remain a serious global problem which requires cooperative efforts on the part of all parties. Following a thorough review of the current approach by the Administration, Secretary Brady has recently outlined suggestions for strengthening the international debt strategy. Our suggested approach builds upon the basic principles that have guided international efforts in recent years. It recognizes the continued vital importance of stronger growth, debtor reforms, external financial support, and a case-by-case approach to individual nations' problems.

Our suggestions would maintain a central role for the IMF and World Bank within the debt strategy in encouraging debtor policy reforms and catalyzing financial support, and recognize the continuing need for new lending from commercial banks. However, we would also place stronger emphasis on new investment flows and the repatriation of flight capital as alternative sources of private capital. To this end, we would encourage the IMF and World Bank to work with debtor nations to focus on specific measures to improve the investment climate and encourage the return of flight capital as part of their policy-based loan programs, in addition to vital macroeconomic and structural reforms.

In addition, we would focus international efforts on achieving more rapid and broadly based, voluntary debt reduction during the next three years in order to ease debt burdens and improve prospects for stronger growth. One of the key factors at play in determining the extent of voluntary debt reduction activity is the legal constraints within existing commercial bank agreements, which must be waived by most or all commercial bank participants for each individual debt reduction transaction. Debt/equity swaps and sales in the secondary market are exceptions, but there is a strong interest within debtor nations in obtaining more direct benefits from commercial banks' willingness to reduce their own exposure -- as can be obtained through debt/bond exchanges or cash buybacks.

A waiver of such provisions as sharing and negative pledge clauses in existing commercial bank loan agreements could go far to free up market activity in this area, and to accelerate the pace of debt and debt service reduction with direct benefits to debtor nations. Such waivers might have a limited life of perhaps three years, to stimulate activity within a short but measurable time frame.

In addition, an integral part of the approach would be for debtor nations engaged in debt reduction to maintain viable debt/equity swap programs, which have helped to substantially reduce the stock of debt in several countries. Provisions which permit domestic nationals to engage in such transactions can also contribute to the repatriation of flight capital, as we have seen in the case of Chile.

As debtor nations negotiate policy-based loan programs with the IMF and the World Bank, a portion of these loans would be set aside to finance debt reduction transactions negotiated between the debtor and the banks. Such "set-aside" amounts would be used to collateralize discounted debt/bond exchange transactions or to replenish debtor reserves following cash buybacks.

For debtor nations which have negotiated agreements to reduce the stock of debt, the IMF and World Bank could also make available support for interest payments on a rolling basis for a limited period. Such support could be available for transactions which involve either a substantial discount of principal or a major reduction in interest rates.

While the IMF and World Bank would set guidelines on how their funds are used, the negotiation of transactions would remain in the market place -- encouraged and supported but not managed by the international institutions.

Such transactions could lead to considerable improvements in the cash flow positions of the debtor countries, reducing their need for external financial support to more manageable levels. Nevertheless, new lending would still be needed -- in addition to efforts to repatriate flight capital and attract new investment. Such new financing could include a range of special purpose loans such as trade credits and project loans, as well as club loans by a group of banks or continued concerted lending in individual cases.

As part of this approach, creditor governments should also continue to reschedule or restructure their own exposure through the Paris Club, and to maintain export credit cover for countries with sound reform programs. In addition, creditor countries which are in a position to provide additional financing in support of this effort may wish to consider doing so. This could contribute significantly to the overall success of this effort. We believe that creditor governments should also review their regulatory, accounting, and tax regimes with a view to removing impediments to debt reduction, where these exist.

Broad international support is critical to strengthening the current strategy. It will require cooperative efforts by creditor and debtor governments, the commercial banking community, and the international financial institutions. We have consulted closely with these groups and have sought suggestions from Members of Congress prior to developing the ideas introduced last week by Secretary Brady. The Japanese have expressed their strong support, including a willingness to provide supportive financing, and a number of other creditor and debtor nations have made favorable responses to the general approach we have outlined.

Conclusion

Taken together, the ideas I have discussed today represent a basis on which we can work together to revitalize the current debt strategy. We must address key problems -- the restoration of private financial flows, the return flight capital, the need for sustained economic reforms in many countries, and preservation of the financial soundness of the multilateral institutions -- if we are to renew progress in addressing international debt problems.

We believe that through the suggestions we have outlined, including efforts to stimulate broader voluntary debt and debt service reduction, substantial benefits can be provided for debtor nations in the form of more manageable debt service obligations, smaller and more realistic financing needs, stronger economic growth, and higher standards of living for their people.

I look forward to consultations with members of Congress in the weeks and months ahead, and ask you for your support as we develop within the international community a more specific agenda for further action. Thank you.

TREASURY NEWS

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ROOM 5310
MAR 2
DEPARTM

For Release Upon Delivery
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Statement by the Honorable David C. Mulford
Assistant Secretary of the U.S. Treasury
for International Affairs
before the
Subcommittee on International Development Finance,
Trade and Monetary Policy
U.S. House of Representatives

Mr. Chairman and members of the Subcommittee:

I welcome this opportunity to discuss the three reports that were transmitted to your full Committee, the Administration's review of the international debt strategy, and our suggestions for strengthening international efforts to alleviate the debt burden in developing countries.

In mid-December, then President-elect Bush called for a thorough reassessment of current public policy on this issue. At that time, the Treasury Department was in the midst of preparing reports, as required by law, that have had a direct bearing on the policy recommendations that we have developed. Therefore, I will open my remarks with a summary and conclusions of the reports.

The Report on the World Bank's Strategy in Debtor Countries

As required by H.R. 4645, we have carefully reviewed the World Bank's role in debtor countries. In our judgment, one of the World Bank's most vital functions in these countries is to promote sound economic reform programs through its adjustment programs and to catalyze additional financial support. Various Bank programs designed to achieve these twin goals are outlined in the report.

While we call upon the Bank to increase its efforts to return borrowers to the growth path, we recognize that sustained growth in many countries has been elusive; aggregate data for 17 heavily indebted nations are included in the report which support these findings. This is not to say that the "Baker Plan" has been a failure -- far from it. The review of the debt strategy has reaffirmed the effectiveness of a case-by-case approach which emphasizes growth and debtor country reform. Highlighted in the report are achievements of the past four years, including improved export performance; sustained adjustment efforts of several major debtors, including Chile, Colombia, Mexico, Morocco and the Philippines; and declines in the stock of debt through voluntary, market-based techniques.

However, further progress on adjustment programs will require the release of additional financial resources as well as an easing of debt service burdens in order bring about sustained growth. It is recognized that the debt strategy needs to be strengthened especially in this area. In addition to new lending, negotiated reductions in debt and debt service burdens can provide important external financial support. Other non-debt creating methods, which we continue to strongly advocate, are direct and portfolio investment, debt/equity swaps, and, importantly, the return of flight capital.

We strongly believe that the international financial institutions should retain central roles in the debt work-out process. This will help win the confidence of the creditor community, and nurture a market-place where both debt reduction and new money can be negotiated in parallel. But we must also preserve the financial integrity of these institutions, and minimize risk to creditor governments and taxpayers.

By discussing several of our new ideas for facilitating debt reduction, the report directly addresses Congressional interest in expanding the World Bank's role in debt reduction. The report summarizes our ideas on possible initiatives in this area. I would underscore, at this juncture, that such funds would be available only for those countries undertaking adjustment programs, and individual transactions would be negotiated between debtors and commercial creditors.

In short, after careful analysis and review, we have come to conclusions somewhat parallel to the intent of legislators as expressed in H.R. 4645. Additional financial resources and an easing of debt service burdens can strengthen and sustain debtor nations' commitment to economic adjustment programs.

The Report on Special Purpose Allocation of SDRs

Pursuant to the 1988 Trade Act, we have studied the feasibility of a special purpose allocation by the IMF of Special Drawing Rights (SDRs) to the poorest countries for use in repaying their debt to foreign governments and international financial institutions. The report concludes that the use of SDRs would undermine adjustment incentives, contribute to inflationary pressures, weaken the liquidity of the SDR and its usefulness as a monetary asset, and undermine the ability of the United States to mobilize its SDR holdings.

The report determined that the IMF's Enhanced Structural Adjustment Facility (ESAF) is a preferred alternative for helping the poorest countries. It suggests that the Administration's request for a $150 million contribution to the ESAF represents a more effective means of providing U.S. support for efforts to deal with the balance of payments and debt problems of the poorest countries.

International Discussions on an International Debt Management Authority

Turning to the report on the negotiation of an International Debt Management Authority as required by the 1988 trade legislation, the Treasury Department has reviewed many international debt facility proposals. Most of these proposals have several common elements, including a significant, up-front injection of capital and the assumption of full risk on principal and interest.

As required by law, we fully examined possible use of IMF gold stocks or World Bank liquid assets, but determined that such measures would face significant obstacles. I refer you to the detailed analysis at the end of the report.

Our assessment concluded that negotiation of an Authority at this point could materially increase the likelihood of payment interruptions and a further decline in secondary market prices. We believe that the suggested, market-oriented approach outlined by Secretary Brady on March 10 addresses Congressional concerns with less risk to taxpayers.

Voluntary debt reduction techniques have already been developed by the commercial banks and debtor countries in response to both the banks' strategies and goals, and debtor nations' appetite for capturing the discount on their debt. Voluntary, market-driven debt reduction operations since 1985 now add up to an estimated $28 billion.

Strengthening the Debt Strategy

The debt difficulties of developing countries remain a serious global problem which requires cooperative efforts on the part of all parties. Following a thorough review of the current approach by the Administration, Secretary Brady has recently outlined suggestions for strengthening the international debt strategy. Our suggested approach builds upon the basic principles that have guided international efforts in recent years. It recognizes the continued vital importance of stronger growth, debtor reforms, external financial support, and a case-by-case approach to individual nations' problems.

Our suggestions would maintain a central role for the IMF and World Bank within the debt strategy in encouraging debtor policy reforms and catalyzing financial support, and recognize the continuing need for new lending from commercial banks. However, we would also place stronger emphasis on new investment flows and the repatriation of flight capital as alternative sources of private capital. To this end, we would encourage the IMF and World Bank to work with debtor nations to focus on specific measures to improve the investment climate and encourage the return of flight capital as part of their policy-based loan programs, in addition to vital macroeconomic and structural reforms.

In addition, we would focus international efforts on achieving more rapid and broadly based, voluntary debt reduction during the next three years in order to ease debt burdens and improve prospects for stronger growth. One of the key factors at play in determining the extent of voluntary debt reduction activity is the legal constraints within existing commercial bank agreements, which must be waived by most or all commercial bank participants for each individual debt reduction transaction. Debt/equity swaps and sales in the secondary market are exceptions, but there is a strong interest within debtor nations in obtaining more direct benefits from commercial banks' willingness to reduce their own exposure -- as can be obtained through debt/bond exchanges or cash buybacks.

A waiver of such provisions as sharing and negative pledge clauses in existing commercial bank loan agreements could go far to free up market activity in this area, and to accelerate the pace of debt and debt service reduction with direct benefits to debtor nations. Such waivers might have a limited life of perhaps three years, to stimulate activity within a short but measurable time frame.

In addition, an integral part of the approach would be for debtor nations engaged in debt reduction to maintain viable debt/equity swap programs, which have helped to substantially reduce the stock of debt in several countries. Provisions which permit domestic nationals to engage in such transactions can also contribute to the repatriation of flight capital, as we have seen in the case of Chile.

As debtor nations negotiate policy-based loan programs with the IMF and the World Bank, a portion of these loans would be set aside to finance debt reduction transactions negotiated between the debtor and the banks. Such "set-aside" amounts would be used to collateralize discounted debt/bond exchange transactions or to replenish debtor reserves following cash buybacks.

For debtor nations which have negotiated agreements to reduce the stock of debt, the IMF and World Bank could also make available support for interest payments on a rolling basis for a limited period. Such support could be available for transactions which involve either a substantial discount of principal or a major reduction in interest rates.

While the IMF and World Bank would set guidelines on how their funds are used, the negotiation of transactions would remain in the market place -- encouraged and supported but not managed by the international institutions.

Such transactions could lead to considerable improvements in the cash flow positions of the debtor countries, reducing their need for external financial support to more manageable levels. Nevertheless, new lending would still be needed -- in addition to efforts to repatriate flight capital and attract new investment. Such new financing could include a range of special purpose loans such as trade credits and project loans, as well as club loans by a group of banks or continued concerted lending in individual cases.

As part of this approach, creditor governments should also continue to reschedule or restructure their own exposure through the Paris Club, and to maintain export credit cover for countries with sound reform programs. In addition, creditor countries which are in a position to provide additional financing in support of this effort may wish to consider doing so. This could contribute significantly to the overall success of this effort. We believe that creditor governments should also review their regulatory, accounting, and tax regimes with a view to removing impediments to debt reduction, where these exist.

Broad international support is critical to strengthening the current strategy. It will require cooperative efforts by creditor and debtor governments, the commercial banking community, and the international financial institutions. We have consulted closely with these groups and have sought suggestions from Members of Congress prior to developing the ideas introduced last week by Secretary Brady. The Japanese have expressed their strong support, including a willingness to provide supportive financing, and a number of other creditor and debtor nations have made favorable responses to the general approach we have outlined.

Conclusion

Taken together, the ideas I have discussed today represent a basis on which we can work together to revitalize the current debt strategy. We must address key problems -- the restoration of private financial flows, the return flight capital, the need for sustained economic reforms in many countries, and preservation of the financial soundness of the multilateral institutions -- if we are to renew progress in addressing international debt problems.

We believe that through the suggestions we have outlined, including efforts to stimulate broader voluntary debt and debt service reduction, substantial benefits can be provided for debtor nations in the form of more manageable debt service obligations, smaller and more realistic financing needs, stronger economic growth, and higher standards of living for their people.

I look forward to consultations with members of Congress in the weeks and months ahead, and ask you for your support as we develop within the international community a more specific agenda for further action. Thank you.

DEPARTMENT OF THE TREASURY

Interim Report to the Congress
Concerning
International Discussions on an
International Debt Management Authority

March 1989

Interim Report to the Congress Concerning International Discussions on an International Debt Management Authority

Legislative Requirements

Section 3111 of the Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418) (the Act) requires the Secretary of the Treasury to study the feasibility and advisability of establishing an International Debt Management Authority (the Authority) to purchase and restructure the sovereign debt of less developed countries. According to the provisions of the Act, in studying the feasibility and advisability of establishing the Authority, the Secretary may determine that the initiation of international discussions on the establishment of the Authority would:

-- cause a material increase in the discount on sovereign debt,

-- materially increase the probability of default on such debt, or

-- materially enhance the likelihood of debt service disruption.

If such determination is not made, the Secretary must initiate discussions with those countries he determines to be appropriate for the purpose of establishing the Authority. The Secretary must include in interim reports to the Congress an explanation in detail of the reasons for the determination.

Section 3112 of the Act requires the Secretary of the Treasury to review all potential resources available to the International Monetary Fund (IMF) and the World Bank which could be used to support the creation of the Authority and to direct the U.S. Executive Directors of the International Monetary Fund and World Bank to determine the amount of, and alternative methods by which, the IMF gold stock and World Bank uncommitted liquid assets could be pledged as collateral to obtain financing for the Authority.

The Act requires two interim reports on the progress being made on the study or in international discussions on establishing an Authority, as well as a final report on the study or discussions and recommendations. This is the first of the two interim reports. The second is due on August 23, 1989. The first report must also include the findings of the U.S. Executive Directors on the potential use of IMF and World Bank resources to support such a facility. This report responds to these legislative requirements.

Debt Strategy Review

The Administration has undertaken a major review of the international debt strategy. As a part of this review, we have had discussions on debt problems with the G-7 industrial countries as well as with a number of developing countries. Both our internal review and the international discussions are designed to consider possible measures to strengthen the current debt strategy. Our focus has of necessity extended beyond the narrow parameters of Sections 3111-3113 of the Trade Act. Consequently, as a part of this review and pursuant to Section 3113 of the Act, we have approached the IMF and the World Bank to study alternative ways to deal with international debt problems.

As one element of the broader review, we have looked at a variety of proposals for an international debt facility, including the specific proposal included in this legislation. In this context, we have considered whether an international debt facility which assumes substantial risk on outstanding commercial bank debt is necessary or desirable, or whether alternative measures are available which can encourage greater voluntary debt reduction without a broad shift in risk to the public sector.

Virtually all debt facility proposals have several elements in common. Generally, they provide for the new facility to purchase commercial bank debt paper outright or to swap new securities issued by the facility for such debt, both at a discount. Some portion of this discount would be passed on to the debtor nations. Creditor governments and perhaps the IMF or the World Bank would back these transactions and assume the risk on the debt transferred to the Authority. Significant up-front costs to the participating creditor governments and international financial institutions would be involved. These would require additional budgetary expenses for creditor nations, where budgets are already constrained. Use of IMF and World Bank resources to collateralize funding for the Authority will be discussed later in this report. In addition to bearing the risk on the claims assumed by the Authority, the creditor governments (and the international financial institutions) would become contingently liable for the payment of interest due until the debt is repaid. If the facility were to issue consols (perpetual debt) to commercial banks in exchange for their claims, as in some proposals, the contingent liability for payment of interest to banks could be permanent.

The potential cost to U.S. and other industrial country taxpayers could be substantial - there is some $275 billion of commercial bank debt to the 15 heavily indebted middle income debtors[1] alone.

These proposals inherently shift the risk on developing country loans from commercial banks to the international financial institutions or creditor governments as the principal means of solving international debt problems. Several of the key industrial countries, moreover, have strongly opposed the concept of an

[1] Includes Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

international debt facility and such a broad shift in risk to the public sector.

On the other hand, voluntary debt reduction measures are already occurring without the need for centralized facilities that control, manage, and possibly mandate prices for the debt reduction process. Various voluntary debt reduction techniques have reduced the external debt of 15 major debtor countries owed to commercial banks by more than $26 billion during the past four years. As shown in Table 1, nearly half of this reduction was from debt/equity swaps ($12.5 billion), to which we could add $2 billion in repatriation of flight capital by Chilean nationals for domestic investment purposes. In addition, commercial banks have undertaken some $7 billion in private debt restructurings (primarily in Mexico) and nearly $7 billion in other types of swaps, including informal debt conversions (primarily Brazilian and Argentine) and the 1988 Mexican debt/bond exchange. The vast bulk of these agreements ($26 billion) have been reached in the past two years with more than $18 billion in 1988 alone. With further encouragement from the debtor countries, the industrial countries, and the international financial institutions, the commercial banks would probably increase their participation in debt sales and debt conversions, as well as in other voluntary debt reduction techniques. There are a number of factors encouraging commercial banks to move in this direction. These factors are discussed in more detail below.

Table 1

Debt Reduction by Category
1985 - 1988

Debt/Equity Swaps	$12.5 bn
Private Debt Restructuring	7.0 bn
Repatriation of Flight Capital via Swaps (Chile)	2.1 bn
Informal Debt Conversions	5.0 bn
Debt/Bond Swap (Mexico)	1.1 bn
Cash Buybacks (Bolivia and Chile)	0.6 bn
TOTAL	$28.3 bn

Treasury Estimates.

Secretary of the Treasury Nicholas F. Brady recently suggested a new approach to revitalize the current international debt strategy, which if pursued could provide substantial benefits for the debtor nations through lower levels of debt, more manageable debt service obligations, smaller and more realistic financing needs, stronger economic growth, and higher standards of living in debtor nations. It is envisioned that this new approach would catalyze new opportunities for voluntary, market-based transactions and would better tap the potential for alternative sources of private capital. Several of these potential benefits have also been put forth as justification for the establishment of an international debt facility. However, unlike in the case of a debt facility, this suggested approach would (1) minimize the cost or contingent shift in risk to creditor governments, (2) avoid mandatory prices for debt exchanges (with prices pre-set by the facility), and (3) maintain a market-oriented approach to debt restructurings.

This new approach: (1) builds upon the fundamental principles of the current debt strategy; (2) focuses international efforts on achieving more rapid and broadly based, voluntary debt reduction to ease debt burdens and improve prospects for strong growth; (3) recognizes the continuing need for new lending from the commercial banks in conjunction with voluntary debt reduction, while placing stronger emphasis on new investment flows and the repatriation of flight capital; (4) maintains a central role for the IMF and the World Bank within the debt strategy in encouraging debtor policy reforms and catalyzing financial support; and (5) redirects and increases available IMF and World Bank resources -- from their current capital stock -- to support debt and debt service reduction transactions agreed upon by the commercial banks and debtor nations as an additional spur to growth in the debtor nations.

Consequently, in the light of ongoing discussions and these ideas recently put forward by Treasury Secretary Brady on measures to strengthen the current international debt strategy, we do not believe that it is appropriate to begin formal negotiations concerning the Authority at this point. Our suggestions can produce substantial results in terms of debt and debt service reduction with less shift in risk to the public sector. Furthermore, it is the determination of the Secretary of the Treasury that such negotiations in the current atmosphere could materially depress secondary market prices and materially enhance the likelihood of debt service disruption. Indeed, past discussions of such facility proposals have contributed to domestic pressures to restrict debt/equity swap programs, which, in turn, have had a negative impact on secondary market prices. Considerations underlying this determination are discussed in detail below.

Secondary Market Prices

Prices in the secondary market are influenced by market-wide demand and supply conditions, country-specific developments, and general expectations regarding future developments. Short-term factors are clearly more dominant in determining secondary market prices than the prospects over time for individual nations to return to voluntary access to markets. This is due in major part to the lack of long-term demand for these claims. Moreover, there is a tendency for transaction prices for all of these countries to be affected by significant developments in one or more individual countries, with insufficient market differentiation among individual countries. Chilean debt prices, therefore, can be adversely affected by Brazilian or Venezuelan actions which depress prices for external debt owed by these countries.

Estimates of the size of the secondary market in 1988 range from $15 to $40 billion, depending upon the nature of transactions being measured. Because of the nature of the market (a series of individual transactions undertaken by a variety of players with no central "market"), data on specific and aggregate transactions are not readily available. Transactions in some countries' debt paper can be rather infrequent, and as in the case of any "thin" market, the quoted price is not generally an appropriate indicator of the underlying value of the paper or even the price at which it will be sold. Quoted prices for a country's debt are for the debt paper most frequently traded, and this varies from country to country. Since the debt paper of a single debtor country is heterogeneous -- different spreads, interest rate basis, and so forth -- multiple prices for a country's debt may prevail. The average discount of 30 percent at which Mexican debt was voluntarily exchanged for new 20-year bonds last spring was substantially lower than the 50 percent discount prevailing in the secondary market for Mexican paper at that time.

Demand for debt in this market arises predominantly from debt-for-debt swaps, cash sales, and direct debt conversions into alternative instruments. Debt-for-debt swaps usually involve banks exchanging claims on one country for claims on another, although they may also involve exchanges of debt owed by different parties within the same country. These transactions may account for as much as 75 percent of secondary market activity, according to some analysts. Generally these exchanges are undertaken for portfolio or strategic reasons specific to a given bank or banks' situations: These may include a desire to concentrate holdings in countries where the bank has strategic business interests, or to diversify holdings to spread risk.

Cash sales by banks, on the other hand, are primarily designed to reduce or exit from LDC exposure as a means of boosting stock values and the ability to raise capital. Such sales may be made: (1) to financial institutions accumulating paper for package swaps; (2) to corporations for direct investment through debt/equity swaps; or (3) to charitable or academic institutions for environment, education or development swaps. None of these produce a direct benefit to the debtor nations, unless they end up as debt/equity swaps.

On the other hand, sales of debt to a debtor nation through direct cash buybacks reduce directly its outstanding indebtedness and debt service obligations. In spite of these advantages and their having been successfully used recently, for example, by both Bolivia and Chile, their adoption is generally hampered by the need to get waivers from the commercial banks of the sharing clauses existing in most bank loan agreements, and this can be time consuming.

Banks also engage in direct debt/equity swaps for their own account, as well as other debt conversions such as the 1988 Mexican debt/bond exchange and Brazilian exit bonds. These instruments all convert commercial bank claims into alternative financial instruments and may involve a reduction in principal amount, a reduction in interest rates, and/or a more marketable claim. Banks may or may not continue to include these new instruments in the calculation of their LDC loan exposure.

Secondary markets for cash sales remain fairly thin, although the volume of transactions has been growing. Prices quoted reflect the most recent transactions rather than a homogeneous, highly liquid market. The final demand for debt paper, other than by commercial banks, however, appears to be primarily debt/equity swaps, underscoring the importance of debt/equity programs as a key factor in determining secondary market prices. The debtor countries themselves would be the most natural purchasers of the debt held by the commercial banks, but again, as mentioned above, they are restricted in implementing such buyback schemes by the obligation to get a waiver of the sharing clause in the bank loan agreements. Speculative demand appears to be quite narrow, perhaps in part because banks prefer to "sell" debt paper to (1) other financial institutions willing to assume any new money obligations coincident to the loans, or (2) entities anticipating specific conversions (into equity, environmental use) which may have been agreed in advance of the transaction.

Over the last two years, secondary market prices have fallen sharply. As illustrated in the accompanying chart, the weighted average price for commercial bank debt of the 15 major debtors was 68 cents per dollar of face amount in January 1987, while in January 1989, it was only 36 cents: a decline of 47 percent. As of the first of February 1989, the average price for individual country debt varied from 4 cents for Peru, the lowest price among the 15 major debtors, to 60 cents for Chile, the highest. Of the largest debtors, Mexican paper was trading at 37 cents on the dollar, during the first week in February; Brazilian paper, at 33 cents; and Argentine paper at 18 cents on the dollar. Secondary market prices for the 15 major debtors over the last two years are given in Table 2.

Table 2

Secondary Market Prices for the 15

Major Debtors' Bank Debt

(Selected Dates and in Cents per Dollar)

	1987		1988		1989	
Country	Feb	Dec	Mar	Aug	Jan	Feb
Argentina	65.0	33.5	28.0	21.8	19.5	18.3
Bolivia	9.0	11.0	11.0	10.0	10.0	9.0
Brazil	69.0	46.0	47.0	46.3	34.0	29.3
Chile	68.0	61.0	57.0	59.5	60.0	58.5
Colombia	86.0	65.0	65.0	66.5	56.0	51.0
Ecuador	64.0	36.5	31.5	21.0	12.5	12.5
Ivory Coast	77.0	40.0	30.0	26.5	19.0	15.0
Mexico	57.0	50.0	48.5	46.8	38.3	35.8
Morocco	69.0	52.0	50.0	50.0	47.0	46.5
Nigeria	36.0	29.0	28.5	27.0	19.0	21.0
Peru	18.0	7.0	5.0	5.0	5.0	4.0
Philippines	70.5	50.0	50.5	52.5	46.3	41.8
Uruguay	71.0	59.0	59.5	60.0	59.5	59.5
Venezuela	75.0	57.0	53.3	50.0	37.8	34.3
Yugoslavia	78.0	49.0	46.5	47.0	44.0	44.0
Weighted Average	64.5	46.6	45.0	43.4	35.2	32.3

Source: Salomon Brothers.

As indicated in the chart, there were two major declines in secondary market prices. The first decline of 32 percentage points largely reflected the impact of the Brazilian moratorium and substantial reserving by U.S. money center banks in early to mid-1987.

Provisioning has been instrumental in determining the banks' willingness to supply claims to the secondary market, in addition to other factors such as portfolio considerations and long-term business interests. The market discount, tax treatment, regulatory requirements, capital adequacy concerns, and accounting practices are also important. Citibank began this first wave of provisioning on May 19, 1987 when it announced that it was transferring $3 billion to its reserves for possible credit losses. This action raised its reserves to 25 percent of its exposure to heavily indebted developing countries. The remaining money center banks and some regional banks chose to follow Citibank's lead and soon built reserves up to an average of 25 percent of LDC exposure.

Smaller banks in Europe and the Middle East, according to IMF estimates, were the major suppliers of debt to the market prior to the mid-1987 increase in provisioning by major U.S. money center banks, followed by additional provisioning by Canadian, British, and Japanese banks, as well. British authorities released guidance in August 1987 on reserving against LDC claims. On December 17, 1987, the Bank of Boston signaled a second wave of provisioning by the regional banks by increasing its loan loss reserves by 54 percent. In the third quarter of 1988 the Canadian authorities issued requirements that Canadian banks should increase their provisioning against LDC claims from 15 percent to a range of 30 - 40 percent.

The second major decline in secondary market prices occurred from mid- to late 1988. Declines of over 20 percent were registered in the prices of debt of Brazil, Venezuela, Ecuador, the Ivory Coast and Nigeria. Declines of 10-20 percent were registered in the prices of debts of Argentina, Colombia, Mexico and the Philippines. Market participants have suggested that this decline was generated by adverse market psychology fueled, in part, by the impression that investment opportunities in the debtor countries were narrowing and, in part, by the regional banks selling off claims to clear their books of LDC debt by the end of the year. Canadian provisioning requirements may also have increased the supply of Canadian paper for sale. Moreover, a number of country-specific developments reflected either worsening domestic economic situations or increased rhetorical stridency within some of the key debtors which appear to have had a dramatic impact on secondary market prices. In particular, news of possible debt service suspensions, as well as heightened publicity on establishing debt facilities in the latter part of 1988, also contributed to the downward pressures on prices.

Given the importance of debt/equity swaps (and less significant so far, other debt conversions), any disruptions in the operation of debt/equity programs can have a major impact on the demand for debt in the secondary market, and hence on secondary market prices. Mexico's temporary suspension of its debt/equity swap program in early November 1987 caused the prices of its debt to drop only slightly, because demand for Mexican debt for purposes other than conversion into equity remained strong according to some market traders. However, Brazil's suspension of its debt/equity program in January 1989 may have contributed to a drop of more than 5 cents in its secondary market price.

Debt Service Disruptions

Interest or principal arrears by debtor countries can also disrupt the market, since non-payment of debt service on outstanding claims could increase the risk of holding them. Holders of these claims have the choice of either selling them immediately for whatever price possible or taking a further reduction in earnings.

The last few years offer numerous examples of debt service disruptions and associated accumulations in arrears.

Peru began limiting public external debt service payments to 10 percent of export revenues in July 1985. Since this ceiling was imposed, Peru's external payments arrears have accumulated to almost $10 billion, equivalent to over half of its current debt. More recently, Ecuador imposed a moratorium on interest payments to the commercial banks in January 1987. As a result, arrears began to accumulate and have grown to approximately $1 billion in two years.

In February 1987, Brazilian authorities announced a moratorium on interest payments for medium-term bank claims. This moratorium generated some $4 billion in interest arrears during 1988, but was formally terminated in December 1988 with the conclusion of a new financing package with commercial banks. The new package included commitments for a broader debt/equity program (cited above) and had a positive impact on secondary market prices.

In January 1989 Venezuela decided to halt principal repayments to commercial banks to conserve reserves, pending negotiations to reopen the 1987 commercial bank rescheduling. Because of the size of their debt, both the Brazilian and Venezuelan actions further reduced secondary market values for their debt and depressed the market for Latin American debt in general.

On the positive side, Chile has maintained an open, flexible debt conversion program, implemented far reaching economic reforms and reduced inflation to nearly 10% per year, one of the lowest inflation rates in Latin America. Consequently, the secondary market for its debt remains comparatively active at prices that are the highest of the major debtors.

In addition to these countries' specific activities, broader consideration and pressures for an international debt facility have also contributed to expectations of across-the-board debt relief and debtor actions to restrict debt/equity programs in the hope of obtaining larger scale relief without such conversions. Discussion of a series of proposals during mid to late 1988 has fed these expectations. These include, in particular, congressional discussions of debt facility proposals as part of deliberations on the Omnibus Trade and Competitiveness Act of 1988.

It has been one of the proposals actively considered by the Latin American Group of Eight[2] (G-8) which met in Punta del Este in October 1988, in part, to consider alternatives for resolving the region's debt problems. In subsequent meetings, the G-8 nations specified that a multilateral debt facility was one possible mechanism through which their objectives could be achieved.

Such discussions of the potential for an international debt facility were not the only factor affecting secondary market prices during the summer of 1988. However, when combined with the strong rhetoric warning of possible suspension of debt service in the absence of generalized debt relief and actual

[2] Members are Argentina, Brazil, Colombia, Mexico, Peru, Uruguay, and Venezuela. Panama was originally part of the group but has been excluded due to domestic political circumstances.

suspensions of Venezuelan debt service and Brazilian debt/equity and relending programs, they clearly had a depressing effect on secondary market prices.

In sum, it is our view that the best way to respond to the concerns of Congress as reflected in this legislation and to accomplish the objectives of reducing debt and debt service burdens is through the approach recently suggested by the Secretary of the Treasury to revitalize the current debt strategy.

Potential Resources to Support an Authority

Section 3112 of the Act provides that no "funds, appropriations, contributions, callable capital, financial guarantee, or any other financial support, or obligation, or contingent support of the United State Government may be used for the creation, operation, or support of the International Debt Management Authority" without the express approval of Congress through subsequent law. The Section directs·the Secretary of the Treasury to review all potential resources available to the multilateral financial institutions, particularly the IMF and World Bank, which could be used to support the creation of such a facility. As required by legislation, the U.S. Executive Directors of the IMF and the World Bank have reviewed the amounts of, and alternative methods by which, the IMF gold stock and World Bank uncommitted liquid assets could be used to support the creation of the Authority, and alternative methods for their use. Their findings are summarized below.

Use of IMF Gold

Section 3112(a)(1) of the Act provides for a determination of the amount of, and alternative methods by which, the gold stock of the (IMF) could be pledged as collateral to obtain financing for the Authority. Such use of IMF gold raises a number of important legal, financial and policy issues which require careful consideration in making such a determination.

The IMF owns 103 million ounces of gold with a book value of SDR 3.6 billion (about $4.8 billion at end February 1989 exchange rates) and a current market value of roughly $40 billion. The gold represents the IMF's basic reserve and, together with other IMF assets, is available to satisfy creditors' claims on the Fund. In addition, the IMF can mobilize its gold assets to help achieve the purposes of the IMF as specified in its Articles of Agreement.

In this connection, the IMF may sell gold either at market prices, to members or the private market, or at book value (SDR 35 per fine troy ounce) to countries that were members on August 31, 1975, in proportion to their IMF quotas on that date. The proceeds from such sales can be used for regular IMF operations (and thus is an alternative to an increase in quota subscriptions or borrowing) or to provide balance of payments assistance on special terms to developing countries in difficult circumstances.

The IMF Articles of Agreement do not permit the use of the Fund's gold as collateral for financing by a debt management authority that would be a separate legal entity independent from the IMF. Moreover, the IMF could not borrow from members or the private market using gold as collateral and provide the resources to the Authority. However, the IMF could sell gold at market related prices, with the profits made available to a debt management authority whose purposes were determined to be consistent with and supportive of those of the Fund.

A decision to sell or otherwise mobilize IMF gold requires an 85-percent majority vote of the IMF's Executive Board. Subsequent decisions on use of the proceeds require a 70-percent majority vote for regular IMF operations and an 85-percent majority for all other purposes. Moreover, under Section 5 of the Bretton Woods Agreements Act (22 U.S.C. 286c), congressional authorization would be required for the United States to support a decision to use IMF resources, including gold, for the special benefit of a segment of the IMF membership.

The provisions on mobilization of IMF gold became effective in 1978 as part of the amendment of the IMF's Articles of

Agreement. These provisions reflected an agreement which carefully balanced diverse and strongly-held views about the proper role of gold in the international monetary system, the desirability of retaining gold as a sort of ultimate IMF reserve, and the distribution of the proceeds of any IMF gold sales. The increase in the voting majority on key gold-related decisions from 70 to 85 percent was designed to assure a broad consensus and, in particular, to provide the United States, the largest member with about 20 percent of the total voting power, a veto over such decisions.

The IMF sold 50 million ounces of gold during 1976-1980 as part of the agreement on the amendments to the Articles of Agreement. However, no action has been taken to mobilize the Fund's gold since the late 1970s despite several proposals to use the gold to back a dollar substitution account and as an alternative to the 1983 increase in IMF quotas. This situation reflects the continued wide divergence of view on the appropriate use of IMF gold among IMF members and the difficulty of obtaining the 85-percent majority vote for gold-related decisions.

A decision to sell IMF gold and use the profits to support a debt management authority would reduce the resources potentially available for the IMF traditional balance of payment financing responsibilities and could accelerate the need for a quota increase and/or new IMF borrowing. At present, the IMF's financial position is relatively strong with some $45 billion in liquid assets available for lending. However, this situation can change rapidly as occurred in the late 1970s and early 1980s. The ability of the IMF to sell gold to replenish its currency holdings provides a necessary safety net to deal with unforseen contingencies. The use of the gold for a debt management authority could necessitate earlier and larger resource additions.

A contingency that is of particular concern to the United States and other creditors relates to the role of the Fund's gold as backing for creditors' claims on the IMF. These claims arise from use of members' quota subscriptions and from loans by members to the Fund. They are considered liquid reserve assets by the member and may be used automatically, and on short notice, to acquire currencies from the IMF to meet a balance of payments need.

In the event creditors sought to encash their claims to meet balance of payments financing needs, and the IMF's available usable currency resources proved inadequate, the Fund would be able as a last resort to mobilize the gold to acquire the necessary currencies. Moreover, the creditors would have first claim on the gold should other resources be insufficient. A decision to sell IMF gold to support a debt management authority would compromise the ultimate security of creditor claims and thus the liquidity and monetary character of IMF related reserve assets. Therefore, creditors have strongly opposed use of IMF gold to expand IMF financing and are likely to resist use of the Fund's gold for a debt management authority. Indeed, some creditors have indicated that they would consider seeking early repayment of loans to the IMF in the event that the IMF's gold reserves were reduced.

Creditor claims on the IMF currently total about SDR 28 billion (at end-1988). The United States is the IMF's single largest creditor with reserve claims of roughly SDR 7.2 billion, approximately 25 percent of the total. The U.S. reserve position in the IMF also accounts for more than one-quarter of total U.S. foreign exchange reserves.

Similarly, the use of IMF gold for a debt management authority would benefit a minority of the Fund membership (for example, 39 of the 151 IMF members have restructured commercial bank debt). Other members, particularly the poorest countries, can be expected to oppose use of IMF gold for this purpose. At a minimum, these countries can be expected to press for concessions, either in terms of use of gold for them or measures to expand and ease the conditions on IMF financing to deal with their problems. This could result in actions that would hasten the need for a quota increase and/or measures that would weaken the monetary character of the institution.

As noted above, IMF support for the Authority would probably require the sale of the Fund's gold and use of the proceeds in excess of book value for the authority. Sale of the entire 103 million ounces at current market prices (about $400 per ounce) would result in profits of about $36 billion, or 15 percent of the total commercial bank debt of the middle-income debtors.

However, it is unlikely that profits of this magnitude could be realized. The gold markets are thin and volatile, and the IMF would not be able to sell 103 million ounces without depressing the gold price, perhaps drastically. In recent years, for example, the annual supply of gold from mine production reaching the market has amounted to about 50 million ounces, less than 45 percent of the total IMF gold stock. The previous IMF market sales of 25 million ounces of gold were stretched over 4 years, 1976-1980, in an attempt to avoid market disruption. Nevertheless, the price dropped by about one-third during the year following the decision to sell gold as the market positioned itself to absorb the new supplies. The United States is a major gold holder, with about 260 million ounces ($104 billion at current market prices), and a drop in gold prices would reduce the value of these holdings as well as impact adversely on domestic gold producers.

In conclusion, while use of IMF gold to support the purposes of the Authority is possible under the Fund's Articles of

Agreement, such action could pose serious risks to the IMF's financial integrity and is likely to be strongly opposed by many members. It is therefore extremely unlikely that the necessary 85-percent majority vote could be obtained for this purpose.

World Bank Liquid Resources

Section 3112(a)(2) of the Act provides for a determination of the amount of, and alternative methods by which, liquid assets controlled by the World Bank, and not currently committed to any loan program could be pledged for obtaining financing for an international debt management authority. It is our determination that there are significant financial and legal obstacles to such use of the Bank's liquid assets.

As of end December, 1988 the Bank's liquid assets (cash and short-term investments) amounted to $19.4 billion equivalent. The principal reason why the Bank holds these investments is to fund contractual lending commitments. Unlike commercial banks, the Bank typically disburses its loans over several years, so that at any point in time there is a substantial overhang of loan commitments which have been legally contracted but not yet disbursed. This overhang, the Bank's undisbursed loan balance, amounted to $43.1 billion at end December, 1988. Other contractual obligations -- for borrowers to repay the Bank and for the Bank to repay its own borrowings -- roughly balance each other. Thus the Bank's $19.4 billion in investments are in effect already committed to contracted but undisbursed loans of over $43 billion, of which approximately $12 to $13 billion is projected to be disbursed annually over the next few years. Consequently, the Bank's liquid assets represent no more than a partial advance funding of these contracted loan commitments.

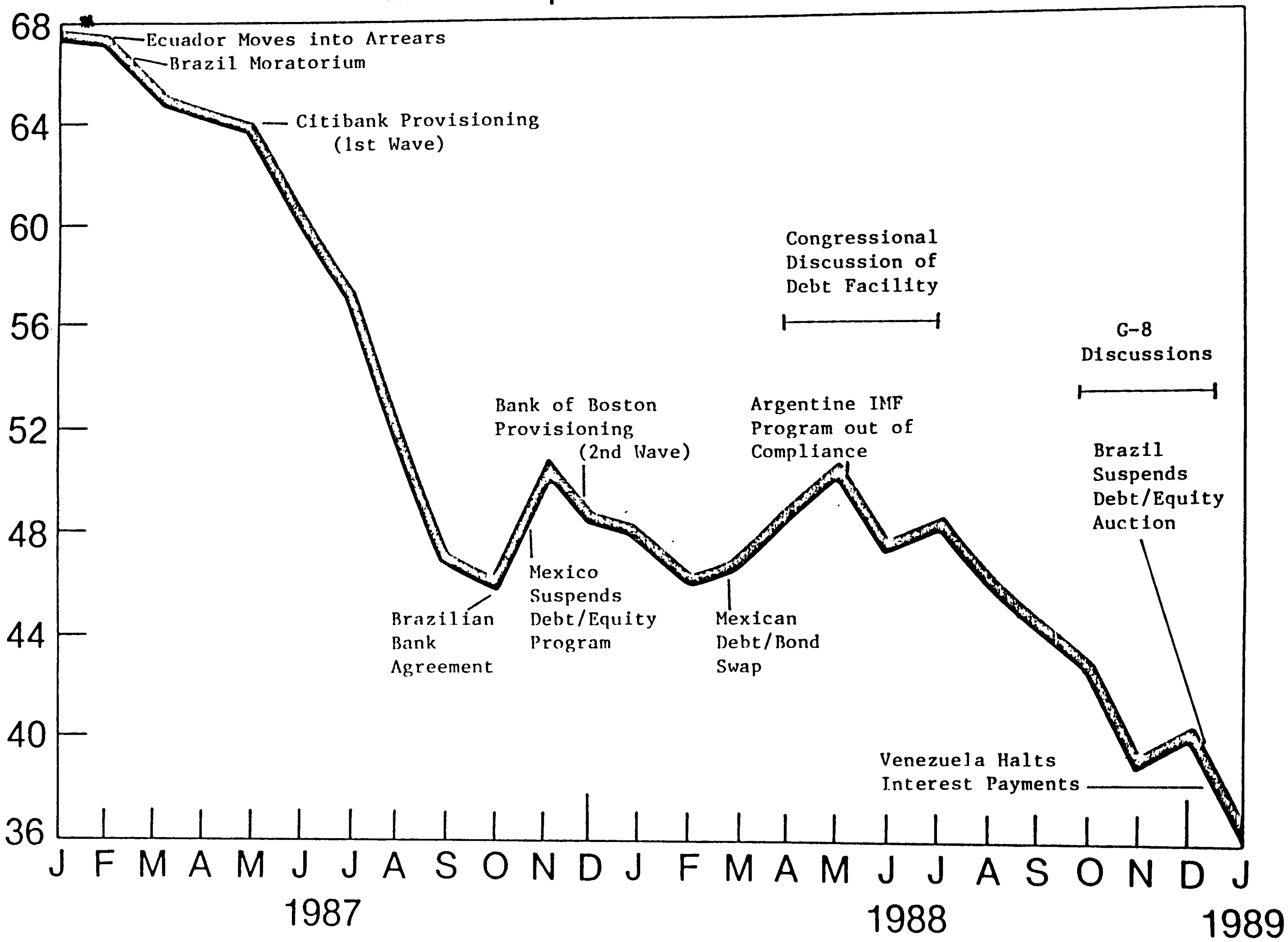
A related aspect of the Bank's level of investments is the flexibility it affords to the Bank in its funding strategy, which is heavily dependent upon borrowings in the international capital markets. That the Bank has this margin of flexibility in its need to borrow is perceived as an important element of strength by the financial markets and has been explicitly noted as such by the bond rating agencies. If a portion of those liquid assets were pledged to some other purpose, in connection with the credit enhancement of commercial bank loans, the financial markets and rating agencies would take note of the pledge and reassess the Bank's financial standing accordingly. Since the debt facility would certainly be viewed by the markets as a risky undertaking, the perceived value of the pledged assets and the Bank's creditworthiness would suffer.

Finally, the Articles of Agreement of the Bank specifically authorize the Bank to extend loans and guarantees but do not mention the pledging of the Bank's liquid assets. There are thus legal questions about the Bank's authority to enter into such a pledge transaction.

Pledges of the Bank's liquid assets could also raise questions concerning the Bank's negative pledge made in connection with its market borrowings. The Bank invariably undertakes, in support of its bond issues and other funding transactions, that it will not cause or permit to be created on its assets any mortgage, pledge, or other lien as security for bonds, notes, or other evidences of indebtedness which have been issued or guaranteed by the Bank unless the transactions containing this undertaking receives similar security. In other words, the Bank cannot pledge its assets (liquid or otherwise) to secure specific Bank obligations unless the benefits of the pledges are shared equally by the holders of all Bank debt containing a negative pledge clause.

SECONDARY MARKET PRICES

In Cents per $1 Face Value



Weighted Average for 15 major debtors
Source: Salomon Brothers

DEPARTMENT OF THE TREASURY

First Report to the Congress
Concerning
World Bank Strategy and Lending Programs
in Debtor Countries

March 1989

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First Report to the Congress Concerning World Bank Strategy in Debtor Countries

SECTION ONE: Legislative Requirements

This report responds to the legislative requirement in H.R. 4645, Section 3(d)[1] that the Secretary of the Treasury prepare a report addressing World Bank strategy and lending programs in debtor countries. The legislation reflects Congressional interest in developing a stronger role for the World Bank in supporting debt reduction -- particularly through the use of policy-based lending to facilitate debt service reduction and through World Bank partial guarantees on debt service payments in financing packages involving significant debt reduction.

Section II of this report examines the current role of the World Bank in the international debt strategy. It describes the World Bank's strategy and lending programs in the "Highly Indebted Countries"[2], as well as in the seriously indebted countries of Sub-Saharan Africa. It spells out the Bank's focus on promoting structural reforms in developing countries to facilitate long-term growth and to ease the burden of debt on these economies.

[1] As enacted into law by Section 555 of the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1989 (P.L. 100-461).

[2] The World Bank identifies the following as "Highly Indebted Countries:" Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cote d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

Section III surveys progress made by debtor countries and recent developments in the market vis-a-vis debt reduction. The experiences of debtor countries in implementing adjustment programs and pursuing long-term growth are examined in aggregate and as individual country examples. Further, the report discusses countries' efforts to reduce their debt through market mechanisms and highlights the World Bank's role in facilitating these and other negotiations between debtors and their commercial bank creditors.

The final section of the report summarizes U.S. suggestions for strengthening the current strategy. The new ideas discussed include a greater role for the World Bank in facilitating debt reduction.

SECTION II: The World Bank's Role under the Current Strategy

The debt problems encountered by developing countries in the 1980s have to some extent disrupted the World Bank's efforts to promote development and alleviate poverty in these countries. The international strategy for addressing debt problems has assigned the World Bank an important role in assisting developing countries to undertake programs that will facilitate growth and ease the burden of their debt. The Bank cooperates extensively with the International Monetary Fund to advise countries on policies aimed at both macroeconomic stability and structural reform. Both these institutions are crucial actors in the debt workout process. However, this report will focus exclusively on the World Bank's role.

The Bank's Strategy in the Highly Indebted Countries

The strengthened debt strategy set out in 1985 focused on the need for debtor countries to achieve stronger, sustained growth through comprehensive macroeconomic and structural reforms. The World Bank's long-term strategy for helping the Highly Indebted Countries manage and reduce their debt burden is based on such growth-led recovery.

The Bank's lending programs in each of these countries are designed to facilitate -- through a variety of economic forces -- renewed growth that will gradually reduce debt ratios and lead over time to restored access to financing from private markets. The success of such efforts by the Bank rests in large measure on individual debtor countries' own ability and willingness to implement adjustment programs, as well as the availability of additional financial resources or other financial support for adjustment.

The Bank promotes economic reforms in debtor countries through advice in both the design and execution of adjustment programs. Adjustment lending was introduced in 1980 to help developing countries restore their trade and balance of payments deficits to sustainable levels. Since 1982 and particularly since 1985, adjustment lending has taken on greater importance due to ongoing economic and financial difficulties in many of the borrowing countries. Accordingly, the scope of adjustment lending has been expanded to provide more comprehensive support for reforms which help countries overcome structural weaknesses and regain sustained growth.

The objectives of adjustment programs are multiple and vary for each country, which is primarily responsible for the design and implementation of its own program. Bank adjustment lending complements investment lending by promoting the appropriate macroeconomic and sectoral policies vital to the success of individual projects. Adjustment programs have been particularly oriented toward:

- market-opening measures to encourage foreign direct investment and capital inflows;
- liberalization of trade, including the reduction of export subsidies;
- reform of tax systems and labor markets;
- development of financial markets to mobilize domestic savings and facilitate efficient investment; and
- increased reliance on the private sector to help increase employment and efficiency.

The Bank's tools for promoting structural adjustment include both Structural Adjustment Loans (SALs) and Sectoral Adjustment Loans (SECALs), which vary mainly in the breadth of the policy and institutional reforms they involve. SALs generally support economy-wide programs to increase domestic resource mobilization and to improve efficiency through reform of trade policies, pricing regulations, government revenue collection and government expenditures. SECALs focus on reforms in specific sectors such as finance, trade, agriculture, industry and energy and target mechanisms including sectoral pricing and the elimination of subsidies for a particular sectoral product or input, for example. The Bank has recently increased its emphasis on SECALs over SALs because their implementation seems to be more manageable for governments.

The Bank has recently evaluated adjustment lending as a mechanism for economic reform and growth inducement. While some shortcomings of methods and implementation were identified, the general conclusion has been that realistic programs are useful instruments for assisting governments in the reform and restructuring of their economies that can help them achieve sustained growth.

The other primary component of Bank strategy in its efforts to promote sustained growth and recovery in developing nations is mobilization of financial resources. Bank programs attempt to tap available resources within an economy that can spur growth; they also facilitate financing from other sources.

Investment financing is the most direct mechanism available to the Bank to stimulate expansion of an economy, and project loans still make up approximately 75% of total Bank lending.

The need for capital, foreign exchange, and technical expertise are essential elements of any program aimed at sustainable economic growth. Direct project financing in the production, social, and infrastructure sectors is a proven mechanism for supplying those elements. Moreover, this type of capital transfer permits the Bank to pinpoint the bulk of its assistance in those sectors it sees as impeding economic growth. Project loans can rehabilitate or restructure existing enterprises; they also work to expand productive capacity. These loans have financed country projects in transportation, education, industry, agricultural and rural development, energy, health and nutrition, water supply and sewerage, urban development, and telecommunications.

The World Bank's role in the reform of individual economies has also enabled it to catalyze additional financial support for adjustment programs. As discussed above, the success of the Bank's efforts in helping a country undertake growth-oriented reforms depends not only on that country's willingness and ability but also on financial support from other sources. The World Bank has taken a more active role in helping countries secure financing in recent years as a means of assuring that adequate resources were available to support reform programs.

The Bank's role in assisting debtor countries to adopt effective reform programs has been the most effective means to mobilize external financial resources required for growth.

Official creditors and commercial banks see the World Bank (and IMF) as credible institutions whose involvement with countries' economic programs serves as certification of these countries' determination to implement effective policies. Such validation has often been the basis for facilitating restructurings and new money packages for the major debtor countries.

Part of the Bank's role in catalyzing external finance has been informational: the Bank attempts to keep creditor groups -- including bilateral lenders, credit insurers, and commercial banks -- up to date on the adjustment programs, prospects, and financing needs of individual countries. The Bank has also provided ongoing technical advice to the countries regarding the design of economic policies as well as the calculation of financing needs.

In addition to this role of technical advisor, the Bank has used other mechanisms to stimulate lending to countries that have adopted appropriate reform programs. Parallel financing has been used by the Bank to encourage commercial banks to provide additional new money for major debtor countries implementing reform programs. Under a parallel financing program, commercial bank disbursements are generally linked to disbursements under World Bank loans.

In exceptional circumstances, the World Bank has also used credit enhancement techniques, such as guarantees, to provide some financial support under the debt strategy. In each of these instances, it was determined that the enhancements were necessary to help complete new financing packages which catalyzed significant additional financial flows from other sources. These techniques have been used with caution by the Bank -- and only in a limited number of cases -- in order to preserve the leverage they have on private financing, as well as the Bank's own financial standing.

We believe that the major focus of the Bank on helping countries pursue structural adjustment and achieve growth in order to ease their debt burdens has been appropriate. However, we also believe that further measures should be taken to release resources for growth in reforming countries through reducing their debt and debt service burdens. In this context, we discuss below U.S. ideas about the use of World Bank and IMF resources from current capital to support debt reduction.

A number of other economic and resource concerns have played an increasing role in the Bank's efforts to promote long-term growth in the Highly Indebted Countries, as well as in other countries. The Bank monitors carefully the impact of adjustment programs on the poor. Deliberate efforts are being made to mitigate the costs reforms impose on such vulnerable groups. Furthermore, such groups are now being recognized as economic actors who can potentially contribute to growth. The role of women in developing economies is also receiving greater attention. In many countries, various factors constrain the ability of women to participate in the economy. Better training and access to economic opportunities can help these groups increase their productivity.

The Bank is also taking greater care to consider the impact of its projects on the environment. The future economic potential of developing countries depends in part on the well-being of their natural environment, and the Bank now recognizes the need for countries to pursue conservation and environmental planning. The United States has been encouraging the Bank to integrate environmental concerns more thoroughly into the project cycle, particularly at the earlier stages, and to develop better procedures to assess the environmental impact of the projects they fund. We are working with other member countries of the Bank to improve policies in a number of areas such as access to information, outreach to non-governmental organizations in borrowing countries, and greater sensitivity to the need to protect fragile eco-systems such as tropical forests and wetlands.

By addressing these special concerns and helping countries undertake effective structural reforms, the World Bank seeks to facilitate and nurture long-term, sustained growth in developing countries, thereby easing the burden of their debt.

The Bank's Strategy in Other Seriously Indebted Countries

The need for realistic, comprehensive, and well-implemented adjustment programs to ensure recovery and sustained growth also guides the Bank's work in other seriously indebted countries. This is particularly true in the case of the low-income countries of Sub-Saharan Africa. The major difference in Bank strategy for this group of countries is that less emphasis can be placed on the mobilization of resources from private financial markets. Rather, Bank efforts center on official financial support for such countries, since the bulk of exposure in these countries comes from official creditors.

As mentioned above, investment lending remains the primary activity of the Bank. The role investment projects play in building infrastructure and enhancing the physical and human resource base is particularly important for long-term growth and development in the least developed countries. However, macroeconomic and structural adjustments are also critical to restoration of growth in these economies.

Financing adjustment programs and other resource needs in the least developed countries has presented a challenge to the Bank and the international community. Special mechanisms to mobilize and coordinate financing efforts have thus been created. These rely on the adoption of internationally accepted adjustment programs as criteria for eligibility. The World

Bank, through its International Development Agency (IDA), plays a major role in providing financing from its own resources and in serving as a catalyst for financial support from other sources for economic adjustment programs in the poorest countries.

In this regard, the World Bank has taken the lead in developing a Special Program of Assistance to increase disbursements for low-income Sub-Saharan African countries implementing economic reforms. World Bank support is provided through IDA, and the Bank encourages donors to increase concessional resource flows through cofinancing arrangements with the Bank. Country eligibility is defined in terms of commitment to and implementation of economic reform programs. In particular, Policy Framework Papers -- designed to describe borrower objectives over a three-year period and drawn up with the assistance of the IMF and World Bank -- play an important role by providing consistent guidelines for growth-oriented adjustment and resource mobilization through the programs described above and the IMF's Enhanced Structural Adjustment Facility.

SECTION III: Progress and Recent Developments

The Highly Indebted Countries have progressed at various rates in their pursuit of recovery and sustained economic growth. Even in the best conditions, correcting the serious macroeconomic imbalances that had accumulated in these countries must be recognized as a long-term process. Success in achieving balanced macroeconomic conditions and a healthy economy depends heavily on the ability of individual countries to sustain adjustment efforts. In reality, individual countries have shown different degrees of dedication: while adjustment efforts have remained strong in some countries, they have faltered in others. This variable commitment to reforms has affected growth as well as access to external finance.

The attached (Table 1) highlights the aggregate performance of the fifteen major debtors since 1981.[3] Aggregate GDP growth for this group has improved from -0.5 and -2.7 in 1982 and 1983 to 3.8% in 1986, 2.5% in 1987, and 1.5% in 1988. It should be noted that data for GDP growth in 1987-88 are heavily influenced by a sharp reduction in Brazilian and Argentine growth. Excluding Brazil, growth for the group increased from 1.6% in 1986 to an estimated 2.6% in 1988.

[3] As published in the IMF World Economic Outlook, October 1988. The fifteen major debtors include Argentina, Bolivia, Brazil, Chile, Colombia, Cote d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia; the World Bank adds Costa Rica and Jamaica to complete the list of Highly Indebted Countries.

Trade statistics provide another indication of the economic recovery and growth potential in debtor countries. The value of exports sold by the major debtors rose by 12% in 1988 and is expected to continue to rise (by 8%) in 1989. The value of imports for the group increased by 10% in 1988, and projections show that it will continue to rise at that rate in 1989.

Some progress has been made in recent years in easing the external debt burden of the major debtors. The major debtors' aggregate ratio of debt to Gross Domestic Product fell in 1988 and is expected to continue its decline in 1989. The group's debt/exports ratio has dropped by 11% since reaching its peak in 1986.

Furthermore, the ratio of debt service to exports in 1988 stood 18% below its 1982 level, and the IMF projects that this indication of the ability of debtors to service their debt will continue to show improvement in 1989. Debtor countries have been able to make this progress in reducing their debt service burden through continued improvement in export performance -- despite rising interest rates, which have tended to cause an increase in debt servicing obligations. The aggregate interest/export ratio for the fifteen shows similar improvement, although the 1987 and 1988 figures are heavily influenced by Brazilian interest arrears and repayment of those arrears.

The experiences of several countries that have in general adopted and implemented strong reform programs is illustrative of the progress achieved in promoting long-term growth and reduced debt burdens in the major debtors.

Chile, for example, has undertaken intensive policy reforms. These reforms reach across the Chilean economy, promoting greater efficiency and competitiveness. Chile has the most open investment regime in Latin America. Reforms in other areas have yielded particular progress in rehabilitating the financial and corporate sectors and liberalizing the trade regime. Because of these and other adjustments in its economic management, Chile has benefitted from real growth exceeding 5 percent for the past three years. Inflation has also been reduced to a very low level. The country's debt/equity swap programs have also reduced its existing external obligations by almost $6.5 billion.

Colombia is one of the most successful adjusters in Latin America and has avoided any formal debt rescheduling during the region's debt crisis. Colombia carried out far-reaching structural reforms in 1985 and 1986 under IMF "enhanced surveillance," while simultaneously undertaking reforms in its trade and agricultural sectors. The country has subsequently: reduced its fiscal deficit to less than 3 percent of GDP in 1988; reformed its tax system to increase equity, efficiency, and collections; and increased its international competitiveness through a more liberal foreign trade and exchange rate system. The reward has been GDP growth averaging over 5% in the 1986-88 period.

Since 1982, Mexico has been pursuing a reform program that emphasizes trade liberalization and includes public enterprise reforms, reductions in and better targeting of food and credit subsidies, greater receptivity to foreign investment, and tax reform. In further efforts to stabilize the economy, Mexico adopted in December 1987 an Economic Solidarity Pact, followed by the Pact for Stabilization and Economic Growth in 1988. These programs have significantly reduced inflation from its recent high levels. Mexico has also engaged in extensive privatization, reducing the number of state-owned enterprises by over 50%, although much remains to be done to improve the efficiency of remaining parastatals. Earnings from non-traditional exports, moreover, have increased substantially in response to efforts to diversify exports. However, declining oil prices have impeded the benefits in terms of growth that Mexico should be experiencing as a result of its sweeping reform program.

Adjustment efforts have also helped Morocco to increase exports, eliminate its current account deficit in 1988, and limit inflation to a moderate level. Structural reforms underway include measures to liberalize Morocco's foreign trade and price regimes, rehabilitate the financial sector, and improve public enterprise management. Although Morocco suffered a slowdown in GDP growth in 1987, the economy achieved a healthy level of growth in 1988, and its future prospects are quite positive.

The Philippines has also taken on a serious reform program. The tax system has been restructured; trade liberalization has significantly opened the economy; the financial sector has undergone restructuring; and a program to privatize government-owned assets has begun. The Philippines has subsequently experienced GDP growth well above the average for the major indebted countries. In order to sustain growth, current reforms need to be continued, and further efforts need to be made in areas such as exchange rate policy.

However, despite accomplishments to date, we must acknowledge that serious problems and impediments to a successful resolution of the debt crisis remain. Clearly, in many of the major debtor nations, growth has not been sufficient. Nor has the level of economic policy reform been adequate. Capital flight has drained resources from debtor nations' economies. Meanwhile, neither investment nor domestic savings has shown much improvement. In many cases, inflation has not been brought under control. Commercial bank lending has not always been timely. The force of these circumstances has overshadowed the progress achieved. Despite progress, prosperity remains out of reach for many.

The growth of per capita gross national product (Table 2) provides one indicator of the impact of economic growth on national populations. However, equity[4] might be better measured by looking at how an economy distributes the benefits of economic growth. Because distribution of economic benefits and income within a country is determined by domestic policies (and politics), economic equity is not an issue easily addressed by adjustment programs. Nonetheless, by attempting to disassemble distortions in economies, such as subsidies that disproportionately benefit the middle classes, adjustment programs do tackle some distribution issues. For instance, the removal of price ceilings on agricultural goods affords farmers a better opportunity to profit from their goods and provides more realistic incentives to production. Some strides can also be made by the Bank through poverty alleviation and other development initiatives. However, the responsibility for equitable growth rests with each country.

The overall sustainability and equity of growth achieved by individual debtor countries is difficult to determine. As reforming economies experience sequential years of significantly positive growth, they become more likely to succeed in sustaining a healthy level of growth over the long term. Much depends, however, on the continuation of good economic policies.

[4] H.R. 4645 directs the Secretary to describe debtor countries' success in achieving sustainable and equitable growth as measured by criteria such as per capita income.

In attempting to draw overall conclusions about the drain of debt servicing on debtor economies, some analysts have used **net financial transfer** figures to assess the amount of capital developing countries are exporting to the industrial world. However, calculation of these variables has been a source of controversy in the field of international economics and finance. Some sources confine these terms to the parameters of international financial markets. They define net flows (i.e., net lending or net disbursements) as actual disbursements less principal repayments, while describing net transfers as net disbursements less interest payments -- which will, of course, reflect a substantial negative outflow. One such calculation estimated net transfers on long-term debt to the 17 Highly Indebted Countries at approximately $-11 billion in 1987.

Other analysts (the Organization for Economic Cooperation and Development (OECD), for example) look more carefully at the economic significance of these terms. Such analysis reveals that net financial transfers are intended to identify the resources available to a national economy to expand domestic consumption and investment beyond the level of national output.[5] As a result, data prepared by the OECD and others include official development assistance (ODA) and private investment in a developing economy as contributors to the concept.

[5] Organization for Economic Cooperation and Development, Development Cooperation, 1988, pp. 52-55.

Table 3 illustrates the method used by the OECD for calculating net resource flows, which serve as a guideline for deriving net financial transfer estimates. These figures represent flows to all developing countries. It should be noted that Sub-Saharan African countries tend to receive more ODA than do major debtor nations and that some of the Asian countries make more substantial negative transfers abroad without overburdening their economies. Nevertheless, the OECD calculation of net resource flows offers some indication of the discrepancies involved with differing definitions. While total resource flows to developing countries have declined in the 1980s, they remain positive: approximately $89.1 billion in resources flowed to the developing world in 1988, according to the OECD. Drawing from these figures, the OECD has calculated net financial transfers (Table 4). The OECD estimate of net financial transfers to Latin America in 1987 is negative $4 billion, compared to the negative $11 billion figure cited above.

The remaining point to be made about the flow of financial resources is that neither net inflow nor net outflow can be definitively labelled beneficial for developing countries. While the inflow of financial resources to a developing country can allow it to expand consumption and experience greater investment, the existence of inflows is not necessarily a positive indicator for the country's economy and its potential for sustained growth. Large positive inflows in the late 1970s and early 1980s, for instance, portended financial and economic trauma for many developing countries in the following years because of their inability to service fully the large debt component of these flows. On the other hand, the flow of financial resources out of a developing country -- like that South Korea is now experiencing -- can indicate that the economy is highly productive and reflects a normal process in which a country moves from a net debtor to a net creditor position.

Debt Reduction

Debt reduction offers a potentially powerful tool for debtor nations to redress negative capital flow problems. A number of Highly Indebted Countries have pursued debt reduction with their commercial bank creditors via market mechanisms. These options include debt/equity swaps and other debt conversions, exit bonds, cash buybacks, and debt exchanges. Such voluntary debt reduction measures have already achieved substantial success in reducing both debt and debt service burdens.

During the past four years, various voluntary debt reduction techniques have reduced by more than $26 billion the external debt that the 15 major debtor countries owed to commercial banks. As shown in Table 5, nearly half this reduction was from debt/equity swaps ($12.5 billion). In addition, commercial banks have undertaken some $7 billion in private debt restructurings (primarily in Mexico) and over $6 billion in other types of swaps, including informal conversions and the 1988 Mexican debt/bond exchange. The vast bulk of these arrangements ($26 billion) have been made in the past two years, with more than $18 billion in 1988 alone.

The most recent example of negotiated debt reduction is found in the financial package agreed by Brazil and its commercial bank creditors. This package was the first to combine substantial new money with significant debt reduction, illustrating that these two financial techniques are not mutually exclusive. The package includes $5.2 billion in new money to support Brazil's economic program, including structural reforms, to mid-1989. The debt reduction component of the program allows larger banks to improve, through exit bonds, the risk profile of their portfolios while eliminating future commitments to new money or restructuring arrangements. In the Brazilian package, each bank was allowed to acquire up to $15 million in exit bonds, bearing interest of six percent per year.

The maximum amount of exit bonds provided for in this program was $5 billion. Initially, bank analysts estimated that these exit bonds, along with other debt reduction provisions and existing conversion programs, had the potential to reduce Brazil's external debt by more than $18 billion (net) between 1988 and 1993. If it were to take full advantage of this opportunity, Brazil could save $5 billion on future interest payments.

However, in recent months Brazil has suspended its relending program for one year and its debt-equity swap program on a more temporary basis. If these suspensions continue, they could delay debt reduction under this program. Nevertheless, the program clearly underscores the ability of debtors and commercial banks to work out agreements with diversified new money and debt reduction components. Linkages to the World Bank and IMF continue to offer important mechanisms for facilitating such agreements.

SECTION IV: Suggestions for Strengthening the Current Approach

The Administration has undertaken a major review of the international debt situation in order to assess progress and shortcomings of the current strategy. Our review reaffirmed the viability of the key principles of that strategy:

- Growth is essential to easing debt problems;
- Economic reforms are necessary to achieve such growth;
- Debtor nations have an ongoing need for external financial resources; and
- Solutions to debt problems must be pursued on a case-by-case basis.

On the other hand, the review confirmed that serious problems and impediments to a successful resolution of the debt crisis remain. In many debtor nations, growth has not been sufficient, nor has economic policy reform been adequate. Capital flight continues to drain resources from debtor countries' economies, and neither investment nor domestic savings have shown much improvement. Furthermore, while some progress has been made in reducing countries' debt through market mechanisms, the pace of debt reduction has been constrained by the sharing and negative pledge clauses in commercial bank agreements.

As a result of these ongoing problems and shortcomings of the current approach, we have concluded that additional measures are needed to address international debt problems.

In developing new ideas to confront this situation, several objectives have framed our thinking. Experience has shown us that financial resources are scarce, and we feel that they need to be used more effectively. In addition, we strongly believe that the international financial institutions should retain central roles in the debt strategy. Measures must also be taken to preserve their financial integrity and to minimize the cost or contingent shift in risk to creditor governments and taxpayers. At the same time, our review has convinced us that the international community must encourage debt and debt service reduction, while continuing to recognize the importance of new lending.

As a result of our review of debt problems, we have made specific suggestions about how debt problems might be better addressed.[6] First and foremost, the international financial institutions should continue to promote -- through advice and financial support -- economic policy reforms. Revitalized new investment, strengthened domestic savings, and the return of flight capital should receive particular emphasis, since progress in these areas can help countries to finance their own growth. We hope that the Bank will use available tools, specifically SALs and SECALs, to promote policies that encourage direct investment and bring flight capital home. Such adjustment and revitalization of debtor economies through World Bank and IMF

[6] These ideas were presented by Secretary Brady in a speech before the Brookings Institution and Bretton Woods Committee, March 10, 1989.

programs should also continue to serve as a catalyst to new financing.

Further steps need to be taken, however, to mobilize more effective and timely financial support from the creditor community. In brief, commercial banks need to work with debtor nations to agree on a broader range of alternatives for financial support, including both debt and debt service reduction and new lending mechanisms. To facilitate the debt reduction process, constraints on diversified forms of financial support need to be relaxed. In particular, the negotiation of a general waiver of the sharing and negative pledge clauses for each performing debtor could permit debt reduction negotiations between debtors and banks which choose to pursue this alternative to go forward. Such waivers might have a three-year life, to stimulate debt reduction within a relatively short time period. We expect these waivers to accelerate the pace of debt reduction, passing the benefits directly to the debtor nation.

Other steps will also be necessary to address debtor countries' financing needs. New lending will be encouraged as creditworthiness improves and differentiations are made between new money and old. Efforts will also be made to provide more timely and flexible financial support, while maintaining the close association between economic performance and external financial support.

The World Bank and IMF can support and encourage the debt reduction process by redirecting a portion of the funds which they currently have available. Negotiation of debt or debt service reductions should remain in the marketplace, rather than under the management of the international financial institutions. However, specific measures can be taken to promote debt reduction arrangements. For instance, the World Bank and IMF could redirect a portion of their policy-based loans for use to support specific transactions. These could include financing to collateralize debt-for-bond exchanges with a significant discount on outstanding debt, or to replenish foreign exchange reserves following a cash buyback.

The World Bank and IMF could also provide additional financial support to back a portion of interest on transactions involving a significant reduction of principal or a major reduction in interest rates.

These suggestions for a greater World Bank role in facilitating debt reduction are fully consistent with the intent of Congress as expressed in H.R. 4645. Discussions of these ideas are underway with other creditor governments and have been initiated with other World Bank Executive Directors. The details of our suggestions for strengthening the current debt strategy will have to be worked out through further consultations in the IMF and World Bank with other creditor and debtor governments, and with commercial banks.

It is our hope that these ideas for revitalizing the debt strategy will receive the support and attention of the international community and that all parties will move forward to facilitate progress in addressing debt problems.

TABLE 1

AGGREGATE PERFORMANCE IN THE FIFTEEN MAJOR DEBTORS

	1981	1982	1983	1984	1985	1986	1987	1988	1989
GDP Growth (%)	0.1	-0.5	-2.7	2.3	3.8	3.8	2.5	1.5	3.4
Export Values ($ billion)	127.0	112.2	111.1	123.4	118.8	99.4	112.5	126.2	136.3
Import Values ($ billion)	133.6	108.2	82.8	80.4	78.2	78.7	86.1	94.7	105.2
RATIOS, in percent:									
Debt/exports	202.4	267.8	290.8	271.7	289.6	347.9	336.7	308.3	293.7
Debt/GDP	37.8	42.3	46.5	46.0	46.0	47.4	49.7	47.2	44.9
Debt service/ exports	38.9	49.8	39.5	39.9	38.8	43.3	34.6	41.0	38.8
Interest service/ exports	22.7	30.9	29.2	29.3	28.5	27.9	21.5	26.1	25.2

** Entries for 1988 are estimated; entries for 1989 are projected.

SOURCE: International Monetary Fund, World Economic Outlook, October 1988

TABLE 2

GNP PER CAPITA

	In U.S. Dollars		Real growth rate (percent)	
	1986	1987	1980-87	1986-87
Argentina	2360	2370	-1.9	0.2
Bolivia	510	570	-5.4	0.3
Brazil	1830	2020	1.0	1.5
Chile	1310	1310	-1.8	3.6
Colombia	1260	1220	0.6	3.4
Costa Rica	1510	1590	-0.9	0.5
Cote d'Ivoire	700	750	-3.0	-5.9
Ecuador	1130	1040	-1.9	-7.9
Jamaica	870	960	-2.5	4.5
Mexico	1900	1820	-1.6	3.0
Morocco	580	620	0.5	-1.3
Nigeria	700	370	-5.0	-7.7
Peru	1150	1430	-1.1	5.9
Philippines	560	590	-3.3	3.1
Uruguay	1920	2180	-2.3	4.4
Venezuela	3850	3230	-2.3	0.0
Yugoslavia	2300	2480	0.0	-2.1

Source: The World Bank Atlas 1988

TABLE 3

TOTAL NET RESOURCE FLOWS TO DEVELOPING COUNTRIES

Current $ billion

	1979	1980	1981	1982	1983	1984	1985	1986	1987
I. OFFICIAL DEVELOPMENT FINANCE (ODF)	36.9	45.1	46.6	44.0	41.8	47.1	48.5	56.2	59.3
Official Development Assistance (ODA)	31.1	37.3	37.9	33.7	33.3	34.4	36.9	44.4	48.1
Other ODF	5.8	7.8	8.7	10.3	8.5	12.7	11.6	11.8	11.2
II. TOTAL EXPORT CREDITS	13.5	17.0	17.2	13.6	7.4	7.1	4.6	-0.3	-0.7
III. PRIVATE FLOWS	54.0	66.1	74.5	58.4	48.0	33.5	30.9	26.1	30.5
Direct Investment	13.4	11.2	17.2	12.8	9.9	11.4	6.7	12.2	20.0
Int'l Bank Lending	35.9	49.0	52.0	37.6	34.1	17.4	13.6	5.2	5.0
Total Bond Lending	x	1.5	1.5	5.0	1.1	1.0	4.8	1.6	0.5
Other Private	2.7	2.0	1.8	0.7	0.6	1.1	2.9	3.8	1.5
Grants by Non-governmental Organizations	2.0	2.4	2.0	2.3	2.3	2.6	2.9	3.3	3.5
TOTAL NET RESOURCE FLOWS (I+II+III)	104.4	128.2	138.3	116.0	97.2	87.7	84.0	82.0	89.1
Related data:									
Use of IMF credit, net	x	2.6	6.1	6.2	12.5	5.4	0.8	-1.4	-4.7

Note: 1987 data are provisional

SOURCE: Organization for Economic Cooperation and Development, Development Issues, 1988, p. 47.

TABLE 4

NET FINANCIAL TRANSFERS

Current $ billion

	1979	Average 1980-82	1983	1984	1985	1986	1987
Sub-Saharan Africa	12	12	10	8	10	13	16
North Africa and Middle East	16	9	5	7	8	6	4
Asian LICs	10	12	12	14	17	17	22
Other Asia	5	6	9	1	-3	-2	-2
Western Hemisphere	28	30	-8	-8	-15	-10	-4
Other and adjustments*	7	8	-2	5	3	3	-2
TOTAL DEVELOPING COUNTRIES	78	77	27	27	20	27	34

* Europe, Oceania, unallocated and other adjustments

SOURCE: OECD, Development Cooperation, 1988, p. 53.

TABLE 5

DEBT REDUCTION BY CATEGORY, 1985-88

Debt/Equity Swaps	$12.5 bn
Private Debt Restructuring	7.0 bn
Repatriation of Flight Capital via Swaps (Chile)	2.1 bn
Informal Debt Conversions	5.0 bn
Debt/Bond Swap (Mexico)	1.1 bn
Cash Buybacks (Bolivia and Chile)	0.6 bn
TOTAL	**$28.3 bn**

SOURCE: Treasury estimates

DEPARTMENT OF THE TREASURY

Report to the Congress

on

A Limited Purpose Allocation of Special Drawing Rights for the Poorest Heavily Indebted Countries

March 1989

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A LIMITED PURPOSE ALLOCATION OF SPECIAL DRAWING RIGHTS FOR THE POOREST HEAVILY INDEBTED COUNTRIES

PART ONE: INTRODUCTION

Section 3123 of the Omnibus Trade and Competitiveness Act of 1988 (Pub. L. 100-418, 102 Stat. 1107) requires the Secretary of the Treasury, in consultation with the directors and staff of the International Monetary Fund and such other interested parties as the Secretary may determine to be appropriate, to conduct a study of the feasibility and efficacy of reducing the international debt of the poorest of the heavily indebted countries through a one-time allocation by the International Monetary Fund of limited purpose Special Drawing Rights. The legislation also requires the Secretary to submit a report containing the findings and conclusions of the study, together with recommendations, to the Banking Committees of the House and Senate and the Senate Foreign Relations Committee. This report is being submitted in fulfillment of the requirements of Section 3123.

Part Two of the report provides relevant background on the origins, purposes, and characteristics of the Special Drawing Right (SDR). Part Three examines the proposal for a limited purpose SDR allocation for the poorest countries. Other SDR related proposals to address the problems of developing countries are reviewed in Part Four, while alternative measures to respond to the special situation of the poorest countries are considered in Part Five. Summary conclusions and recommendations are contained in the final Part.

PART TWO: THE ROLE AND USE OF THE SDR

Origin and Procedures

The SDR was created in 1969, by an amendment of the IMF Articles of Agreement to supplement then existing international reserve assets, primarily dollars and gold, as a means of assuring adequate global liquidity and a supply of official reserve assets unrelated to the balance of payments position of any one country or the vagaries in the supply of gold for official use due to production in a limited number of countries and competing private demand for gold. A subsequent amendment of the Articles of Agreement in 1978, broadened the role for the SDR by requiring Fund members to collaborate among themselves and with the Fund to make the SDR the "principal reserve asset in the international monetary system."

The Articles provide that SDRs may be allocated only to member countries that agree to participate in the arrangement (at present all IMF members are participants). The IMF and other designated official entities are permitted to hold and use SDRs in operations and transactions but may not obtain SDRs through allocation. In addition, there is no provision in the Articles for private entities to receive or hold SDRs.

The IMF Articles specify that decisions to allocate or cancel SDRs must satisfy the following criteria:

> In all its decisions with respect to the allocation or cancellation of Special Drawing Rights the Fund shall seek to meet the long-term global need, as and when it arises, to supplement existing reserve assets in such a manner as will promote the attainment of its purposes and avoid economic stagnation and deflation as well as excess demand and inflation in the world.

Decisions to allocate SDRs are made by the IMF Board of Governors, based on a recommendation by the IMF Managing Director and concurred in by the Executive Board, and require an 85-percent special majority vote of the total voting power. Thus, the United States, with over 19 percent of the IMF's voting power, can veto decisions with respect to an allocation of SDRs. Since 1969, the IMF has allocated a total of 21.4 billion SDRs, including SDR 9.4 billion in the period 1970-72 and SDR 12 billion between 1979-81.

Allocations are made to participants in proportion to their shares in IMF quotas. A member has a right to use its SDRs to acquire currencies to meet a balance of payments financing or reserve need but may not do so solely for the purpose of changing the composition of its reserves. In addition, the IMF has authorized certain voluntary SDR transactions among members and designated holders, including the IMF, without the requirement of a balance of payments financing need.

The IMF has developed special procedures to ensure that members will be able to use their SDRs to acquire currencies. Thus, members with strong balance of payments and reserve positions are designated to acquire SDRs in exchange for "freely usable currencies" (U.S. dollars, German marks, British pound sterling, Japanese yen, and French francs) from countries needing to use their SDRs. In designating countries to receive SDRs, the IMF seeks to promote a balance of holdings among participants. In any event, no country is required to accept SDRs beyond the point where its holdings exceed three times the amount of net cumulative SDR allocations that have been made to it. The country may, however, agree voluntarily to hold SDRs in excess of its acceptance limit. The Articles also provide that a member using SDRs may be required to reconstitute its SDR holdings so that the average daily balance of its holdings over a specified period exceeds a specific proportion of its allocations. At present, however, the IMF, under existing authority, has reduced the reconstitution requirement to zero although this may be changed by a 70-percent majority vote.

SDRs are valued on the basis of the market exchange rates for a basket of five currencies (the same freely usable currencies noted above) weighted broadly to reflect their relative importance in international trade and finance. The weights for the currencies in the basket are as follows: the U.S. dollar is 42 percent; the German Deutsche mark 19 percent; the Japanese yen 15 percent; and the French franc and British pound sterling 12 percent. The value of one SDR was approximately $1.32 at the end of February 1989. Since 1972, the SDR has served as the IMF's official unit of account.

Countries participating in the IMF's SDR Department are obligated to pay charges (interest) to the Fund on the cumulative allocations made to them and simultaneously receive interest on their holdings of SDRs. Thus, members holding SDRs in excess of their cumulative allocation receive net interest payments from the IMF, while members with SDR holdings below their cumulative allocation must pay net charges to the Fund. Such charges and interest are payable quarterly in SDRs at an interest rate equal to the weighted average of short-term interest rates in the five countries whose currencies comprise the SDR exchange rate basket. This interest rate, at the end of February 1989, was 8.25 percent per annum.

U.S. Legislative Authority and Restrictions

The Special Drawing Rights Act of 1968 (Pub. L. 90-349, 82 Stat. 188) authorizes U.S. participation in the SDR arrangement and provides that SDRs allocated by the IMF or otherwise acquired by the United States are resources of the Treasury Department's Exchange Stabilization Fund (ESF). The legislation also authorizes the Secretary of the Treasury to issue Special Drawing Right certificates, in such form and in such denominations as he may determine, to the Federal Reserve against SDRs held by the ESF in exchange for dollars. Such certificates may be issued only for the purpose of financing ESF purchases of SDRs or other exchange stabilization operations. The amount of certificates issued and outstanding shall at no time exceed the value of SDRs held against the SDR certificates. At the end of February 1989, SDR certificates totaling $5.0 billion were outstanding. Legislation approving U.S. participation in the 1983 increase in IMF quotas (Pub. L. 98-181) requires the Secretary of the Treasury to consult with the Congress at least 90 days prior to a U.S. vote in support of an SDR allocation.

The United States has used its SDRs for various purposes over the years, including: to pay a portion of its IMF quota increases in 1980 and 1983; to acquire foreign exchange in 1978 and in 1987 for use in foreign exchange market operations; and to make payments of net SDR charges to the IMF. At the end of February 1989, the United States held SDR 7.2 billion, equivalent in value to $9.5 billion, or about SDR 2.3 billion in excess of the total amount allocated to the United States. The U.S. SDR holdings represent roughly 25 percent of U.S. non-gold international reserve assets.

U.S. Budgetary and Financial Effects

Allocations, purchases, and sales of SDRs do not have a direct budget impact although they may affect Treasury's financing requirements. Thus, allocations to the United States involve an increase in ESF assets and liabilities by an equal amount. Purchases of SDRs for dollars reduce the ESF's cash balances and can increase the Treasury's public borrowing requirements, although the ESF may also finance such purchases through the issuance of SDR certificates to the Federal Reserve. Sales of SDRs have normally been for the purpose of acquiring foreign currencies; such sales do not immediately affect the Treasury's domestic borrowing requirements, although subsequent sales of the foreign currencies (for dollars) result in an inflow of cash to the Treasury which reduces the Treasury's borrowing requirements.

The U.S. transactions in SDRs affect the Federal budget through their impact on the financial position of the ESF. The net cash profit or loss of the ESF is recorded as a positive or negative net outlay, respectively, in the Federal budget. Interest earned on SDR holdings, and charges paid on U.S. allocations of SDRs all affect the financial position of the ESF, as does the movement in the value of the SDR against the dollar.

PART THREE: A LIMITED PURPOSE SDR ALLOCATION FOR THE POOREST COUNTRIES

The proposal in Section 3123 for a one-time allocation of SDRs to reduce the international debt of the poorest countries provides that:

- The allocation be made without regard to the quota established for the poorest countries under the Articles of Agreement of the Fund;

- Limited purpose SDRs be used only to repay official debt of the poorest countries to official creditors (i.e., governments and multilateral financial institutions).

- The allocation of limited purpose SDRs to the poorest countries not be treated as an allocation on which such countries must pay interest to the Fund; and

- The use of limited purpose SDRs by the poorest countries to repay official debt be treated as an allocation of regular Special Drawing Rights to the creditor.

The proposal is designed to facilitate debt reduction on a generalized basis for the poorest countries. Such debt reduction would be financed through unconditional money creation rather than by direct budgetary means. As such, it raises fundamental issues relating to the balance between financing and economic adjustment in dealing with debt problems, the use of a monetary reserve asset rather than budgetary resources for debt reduction, legal and procedural issues related to the SDR, and the direct benefits and costs to the United States.

Financing/Adjustment Balance

A basic principle of the international debt strategy is that debt problems must be considered on a case-by-case basis and that lasting solutions can only be achieved through the adoption of comprehensive growth-oriented economic policies, supported by appropriate external finance. In this context, the IMF plays a central role by promoting sound economic policies in individual countries, catalyzing international finance on behalf of these efforts, and providing its own limited conditional resources. The proposal for a limited purpose SDR allocation would represent a major departure from this approach by treating the poorest developing countries as a group and providing financing regardless of economic performance.

As noted earlier, the present SDR represents a form of unconditional financing which may be used without regard to the countries' economic policies and performance. While the additional resources would ease debt service pressures on countries seeking to put their economic house in order, it would have a similar effect on those countries pursuing unsound policies. By failing to differentiate between good and bad performers, the proposal could reduce incentives for the poorest countries to adopt the economic reforms which represent the only lasting solution to the debt problem.

It would be extremely difficult to limit such a proposal to the poorest countries. For example, middle income debtors have substantially larger amount of debt outstanding and face difficult economic adjustment needs. They would undoubtedly seek similar treatment, resulting in a much larger SDR allocation.

Monetary Character of the SDR

SDRs have become an accepted international monetary reserve asset in large measure because participants are assured of being able to use them to meet their balance of payments financing needs. Moreover, countries have been willing to accept and hold SDRs because of the financial characteristics of the instrument. The proposal for a limited purpose SDR would affect both the liquidity and financial characteristics of the SDR and thus the monetary character of the instrument.

Under the proposal, the debtors world repay official debt with SDRs but incur no interest cost in the use of the SDRs. At the same time, creditors which acquired the SDRs would treat them as allocated SDRs on which they must pay interest. In effect, creditors would be paying interest to themselves on the SDRs which they receive as debt repayments. Thus, creditors receiving limited purpose SDRs would earn no net interest whereas they would earn net interest on SDRs acquired from a regular allocation. Moreover, to the extent that creditors received limited purpose SDRs, their need for and willingness to acquire SDRs through other transactions could diminish. This could reduce the liquidity of outstanding SDRs and possible support for future allocations to meet a global need to supplement reserve assets.

Legal Aspects

A limited purpose allocation of SDRs to repay official debt would require amendment of the IMF Articles of Agreement, a process that in the past has taken several years to achieve. As noted previously, under the IMF's Articles, SDRs are to be allocated in proportion to IMF quotas; the limited purpose SDR allocation proposal specifies that the allocation be made without regard to the IMF's quota structure. Amendment of the Articles of Agreement would require an 85-percent special majority vote -- the same majority required for decisions on an SDR allocation -- of the Fund's membership. While there is widespread sympathy for the plight of the poorest countries, it is not clear that the necessary majority could be mobilized. Indeed, discussions in the IMF Executive Board of similar proposals for use of the SDR indicate a wide divergence of views.

As noted above, many middle and upper-income developing countries with large outstanding stocks of official and private debt would have a vested interest in seeking SDR allocations as a form of debt relief. They might be expected to oppose such treatment for the low-income developing countries unless they were treated similarly. Several industrial countries, particularly those with large net SDR holdings, have also objected strongly to the use of a monetary reserve asset for debt relief since this, as already discussed, could impair the liquidity of their SDR holdings and raise fundamental questions about the monetary character of the SDR.

Furthermore, it is unlikely that the process of amending the IMF Articles of Agreement could be limited to the SDR issue. Over the years, a wide range of proposals have been advanced that would alter fundamentally the role and functioning of the IMF. The negotiating process would be long and difficult, possibly requiring several years. The end result might well be an IMF that is no longer able to serve its key role in the international monetary system and as a cornerstone of U.S. foreign economic policy.

Impact on the United States

A limited purpose SDR allocation to repay official debt of the poorest countries would have a number of budgetary and financial effects on the United States.

-- The poorest developing countries owe about $100 billion to official creditors, of which about $10 billion is to the U.S. government. The repayment of debt owed the U.S. government in advance of maturity would increase current revenues relative to future income. This would reduce Treasury's borrowing requirements and interest costs. However, exchanging an interest bearing asset (LDC debt) for a non-interest bearing asset (limited purpose SDRs) would reduce revenue. The overall impact on the budget would depend on the interest rates involved.

-- As noted earlier, SDRs account for about 25 percent of U.S. international reserve assets (excluding gold). Any reduction in the liquidity of the SDR could adversely affect the ability of the U.S. to mobilize its reserve assets to meet a balance of payments financing need and/or for foreign exchange market operations.

-- The United States is the largest member of the IMF and has the highest SDR acceptance limit. Over time, the U.S. would be expected to acquire the largest share of the SDRs allocated for use in retiring official debt.

PART FOUR: OTHER SDR PROPOSALS

Proposals to use the SDR for purposes other than supplementing existing reserve asset have been a subject of continuing discussion in the IMF for more than 20 years. More recently, they have been an integral part of the consultations and negotiations regarding a possible SDR allocation where proposals similar to those described in the preceding section have been advanced. This section of the report focuses on the general question of an SDR allocation and other proposals for special purpose SDRs.

The Current Debate over an SDR Allocation

The IMF Articles of Agreement require the Fund to review periodically the possible need for an SDR allocation. Before making a proposal, the Managing Director is required to consult with members to ascertain whether there is broad support among participants for the proposals. In recent years, the necessary consensus on an allocation has not emerged due to fundamental differences on whether the criteria for an allocation specified in the Articles of Agreement have been met (i.e., a long-term global need to supplement existing reserve assets).

Those supporting an allocation have made several points. They contend that under present international monetary arrangements, countries must often rely on borrowings from private financial markets to satisfy their liquidity needs. In their view, these markets are an inherently unstable source of international liquidity. An allocation of SDRs could provide countries with a source of international liquidity not subject to the uncertainties of the private markets. An allocation would reduce the cost of acquiring reserves through current account adjustments by providing reserves that might otherwise only be acquired through a reduction of imports. According to proponents, an allocation would also be in keeping with the aim of making the SDR the "principal reserve asset in the international monetary system."

Opponents of an SDR allocation respond with the following considerations. In their view, the international financial markets have proved capable of meeting the liquidity needs of creditworthy countries. Indeed, the only countries that have experienced difficulties in satisfying their reserve needs, according to traditional statistical measures, have been the capital-importing countries with recent debt-servicing problems. This suggests that the criteria specified in the Articles for an allocation -- in particular the long-term global need to supplement existing reserve assets -- are not now being met. Furthermore, problems relating to a lack of access to private markets should be addressed through the use of conditional sources of liquidity associated with economic, financial, and structural policy reforms by debtor countries, rather than through the creation of unconditional liquidity such as an SDR allocation.

SDR Allocations to Promote Development Objectives

During the negotiations leading to the creation of the SDR, and subsequent discussions in the 1970s on reform of the international monetary system, a number of proposals were advanced for an "SDR aid-link" which would facilitate resource transfers to developing countries through non-budgetary means by allocating SDRs to them in excess of their shares in IMF quotas. More recently, the Group of 24 -- a body of Finance Ministers and Central Bank Governors representing the developing nations -- has renewed these calls.

The proposals for an SDR "aid-link" have not received wide support among creditor governments for several reasons. These countries believed that the use of the SDR in this manner would be inconsistent with the criteria for an allocation specified in the Articles of Agreement and incompatible with the objective of preserving the status of the SDR as a reserve asset. While recognizing the need to increase resource transfers to developing countries, creating SDRs, an international money, for this purpose was considered potentially inflationary and an undesirable precedent.

Furthermore, such "back door" means of financing foreign assistance that circumvented legislative prerogatives and normal budgetary processes were considered inappropriate and undesirable. In this connection, an SDR allocation for developmental purposes might not result in a net increase in resource flows if, as was likely, other foreign assistance financing was curtailed. Finally, there was concern that use of the SDR for resource transfers would politicize decisions on allocation and use, thereby diminishing the flexibility necessary to preserve the monetary function of the SDR.

"Conditional" SDR Allocations

In recent years, there have been a number of proposals to allocate SDRs for use in connection with formal IMF adjustment programs as a means of responding to concerns that unconditional SDR financing could undermine incentives to implement needed economic reforms. In some proposals, the allocated SDRs would augment regular IMF resources, while in others the SDRs would be used for specific purposes such as facilitating the securitization and reduction of LDC debt to private commercial banks.

The proponents of proposals to allocate SDRs to augment IMF financing of economic adjustment programs argue that it would provide an alternative to financing an IMF quota increase, which would not involve use of budgetary resources or lengthy legislative approval, as well as a means of fostering the role of the SDR in the system. Concerns have been expressed, however, that decisions to augment IMF resources should be reached on their own merits, independent of considerations relating to the SDR. (Discussions are currently underway on a possible increase in IMF quotas but no decisions have been reached.) Moreover, it was feared that allocating SDRs for this purpose would erode the role of the IMF as a quota-based institution and create a precedent that could upset the careful checks and balances between debtors and creditors built into current IMF arrangements (e.g., voting power, weighted majorities on key issues). Furthermore, since many creditor governments, including the United States, would require legislative approval to provide a grant or loan of SDRs to the IMF, the purported benefits in expediting decisions on IMF resource increases would be illusory. Finally, the real resource commitments which the United States and other creditor countries would be undertaking could increase substantially, since their obligation to accept SDRs would rise by a multiple of the amounts allocated and could exceed significantly the commitments arising from a comparable increase in quota subscriptions.

More recently, proposals have been made to use SDR allocations to guarantee interest payments on new bonds issued by LDC debtors, which would be exchanged for discounted commercial bank claims. According to such proposals, a fund would be created in the IMF and financed through an SDR allocation in which developed countries would set aside their share of an SDR allocation for use by developing countries. Heavily indebted middle-income countries would be eligible to use this facility, provided that they were implementing IMF approved adjustment programs.

Since the SDR cannot be used or held by private entities, such proposals would require that the developed countries provide currencies in exchange for SDRs to the LDC debtor or to the IMF to make required payments to commercial banks. In effect, creditor governments would be providing the same currency resources to facilitate debt reduction that would have been provided if IMF quota resources were used. In such circumstances, the real issue is whether the IMF should be used to assist in debt reduction and whether its quota resources are adequate for this purpose.

PART FIVE: IMF AND OTHER ACTIONS TO ADDRESS THE NEEDS OF THE POOREST COUNTRIES

The international community, including the IMF, has recognized increasingly the severe economic problems facing the poorest countries and their special financial needs. In recent years, the IMF has taken a number of steps to address this problem. In addition, creditor governments have initiated new programs to provide debt relief on highly favorable terms for the poorest countries.

In 1986, the IMF established the Structural Adjustment Facility (SAF) to provide balance of payments assistance on concessional terms to the poorest countries. Under the SAF, an eligible member could draw up to 63.5 percent of its quota over a 3-year period. SAF loans are extended at an interest rate of 0.5 percent per annum with repayments taking place in ten equal semiannual installments, beginning 5-1/2 years and ending 10 years from the date of disbursement.

The creation of the SAF represented a milestone in the IMF's approach to dealing with the economic and balance of payments problems of the low-income countries. Its establishment reflected the growing recognition that the longer-term structural economic problems facing the low-income countries could not readily be resolved through traditional IMF programs, which rely on short-term financing at market-related rates of interest. Instead, comprehensive growth-oriented measures needed to be developed to tackle structural impediments to growth and correct protracted balance of payments disequilibria.

This approach also recognized that a coordinated effort by the IMF, World Bank, and bilateral donors was essential to catalyze concessional resources for and to promote comprehensive growth-oriented reforms in these countries. To this end, the IMF and World Bank intensified their collaboration through the establishment of the Policy Framework process. Under this process, members eligible to use the SAF would develop a medium-term Policy Framework Paper (PFP), outlining a 3-year structural adjustment program. The PFP is developed jointly by the staffs of the IMF and World Bank and contains an assessment of the social impact of the proposed policy measures as well as the country's financing needs and possible sources of financing, including those from the SAF and World Bank.

In connection with the 1987 Venice Summit, IMF Managing Director Michael Camdessus proposed a significant expansion in the resources of the SAF. In response to this proposal, the Enhanced Structural Adjustment Facility (ESAF) was established in December 1987. The resources for the ESAF are being provided by a group of industrial and developing countries which have agreed to lend about SDR 6 billion to a special IMF trust and provide contributions to an interest subsidy account to enable the trust to extend financing with a concessional interest rate.

Access under the ESAF will be determined for individual countries on a case-by-case basis with respect to their balance of payments need and the strength of their adjustment effort. Total access on average is intended to be around 150 percent of quota over the 3-year period of the ESAF program, and maximum access is 250 percent of quota. This ceiling may be extended in exceptional circumstances up to a maximum of 350 percent of quota.

At the end of February 1989, 30 SAF and ESAF arrangements were in place with commitments totaling SDR 2.3 billion. Of these 30 arrangements, 23 represented programs with Sub-Saharan African nations. A number of new ESAF arrangements are expected to be put in place in the coming months.

The PFP process is having the desired catalytic effect in support of growth-oriented reforms. In addition to the amounts committed by the Fund, the World Bank, for its part, agreed to earmark $3 to 3 1/2 billion of the $12.4 billion of the Eighth Replenishment of the International Development Association (IDA) for adjustment programs related to PFPs. Furthermore, the Bank has extended over the 1986-88 period, $3.9 billion in adjustment lending to the 30 countries with PFPs. Substantial donor support is also being catalyzed through co-financing, in particular for Sub-Saharan Africa under the Special Program of Assistance. Donor co-financing for IBRD Fiscal Years 1988-90 in Sub-Saharan Africa is projected to total $12.5 billion under IDA and IBRD operations.

Furthermore, at the 1988 Toronto Summit, the Heads of State or Government of the seven Summit countries agreed to ease the debt servicing burdens of the poorest countries undertaking internationally supported adjustment programs. The Paris Club has recently completed work in implementing the Toronto Summit Declaration. It has established a framework of comparability, under which concessional debt will be rescheduled at concessional interest rates over 25 years, including 14 years' grace. On non-concessional debt, creditors may choose from several options to reduce the debt service burden: 1) write-off one-third of debt service due, with the remainder rescheduled over 14 years with 8 years' grace; 2) reduce interest rates by 3.5 percentage points, or by half if the original rate is less than 7 percent, with repayment taking place over 14 years with 8 years' grace; and 3) reschedule at market-based rates over 25 years with 14 years grace.

To support these international efforts on behalf of the low-income countries, especially Sub-Saharan Africa, the Administration is submitting a request, as part of the FY 1990 budget, for authorization and appropriation of a $150 million contribution by the United States to the ESAF Interest Subsidy Account. A modest U.S. contribution to the ESAF represents a very cost effective means of promoting economic reforms and political stability in many countries of key importance to the United States. The resources which the ESAF can bring to bear in these countries is many times the amount being provided by the United States to the facility or through U.S. bilateral assistance programs.

PART SIX: CONCLUSION

Major changes in international monetary arrangements since the SDR was created in 1969 -- particularly the movement towards a generally floating multiple currency system and the evolution of large globally integrated private capital markets -- have affected the basic rationale for the SDR. Nevertheless, the SDR continues to play an important role in the international monetary system as a liquid international reserve asset. In an effort to expand the role of the SDR under present international monetary arrangements and to deal with LDC debt problems, a number of proposals have been advanced to use the SDR to promote development objectives, facilitate debt relief, and/or facilitate adoption of growth-oriented adjustment programs.

The economic and financial problems facing the developing nations, particularly the poorest, are a serious concern of the United States and the international community. A number of steps have been taken, and there is scope for additional action. In this connection, however, the use of a monetary reserve asset such as the SDR has a number of drawbacks.

- o The provision of unconditional financing through a generalized use of the SDR could undermine adjustment incentives and contribute to an increase in inflationary pressures.
- o Use of the SDR to provide aid to the poorest countries could weaken the liquidity of the instrument and its usefulness as a monetary reserve asset.
- o A reduction in the usefulness of the SDR as a monetary reserve instrument could adversely affect the liquidity of U.S. reserve assets.

Consequently, it is unlikely that the 85-percent majority necessary to amend the IMF Articles of Agreement to provide for a special purpose SDR allocation could be obtained.

The international community, including the IMF, has taken a number of steps to address the pressing economic needs of the low-income countries. These measures seek to promote on a case-by-case basis economic reforms, supported by external financing or terms that reflect the specific needs of the poorest countries. The creation of the IMF's Enhanced Structural Adjustment Facility (ESAF) represents an important new initiative for this purpose.

A U.S. contribution to the ESAF represents a highly cost effective means of assisting the poorest countries while avoiding the potential problems of SDR-related proposals. For this purpose, the fiscal 1990 budget request provides for a U.S. contribution to the ESAF Interest Subsidy Account of $150 million.

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FOR IMMEDIATE RELEASE

March 16, 1989

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of August 1988.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $149.8 billion on August 31, 1988, posting a decrease of $0.1 billion from the level on July 31, 1988. This net change was the result of an increase in holdings of agency debt of $83.0 million, and a decrease in holdings of agency-guaranteed debt of $210.3 million. There was no significant change in holdings of agency assets. FFB made 59 disbursements during August.

Attached to this release are tables presenting FFB August loan activity and FFB holdings as of August 31, 1988.

NB-183

FEDERAL FINANCING BANK

AUGUST 1988 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 #469	8/4	$ 32,900,000.00	11/08/88	7.267%	
+Note #470	8/18	9,245,000.00	11/17/88	7.382%	
Note #471	8/30	60,000,000.00	11/29/88	7.696%	
Note #472	8/30	673,000.00	12/01/88	7.704%	
TENNESSEE VALLEY AUTHORITY					
Advance #926	8/2	156,000,000.00	8/08/88	7.249%	
Advance #927	8/5	173,000,000.00	8/11/88	7.181%	
Advance #928	8/8	310,000,000.00	8/15/88	7.260%	
Advance #929	8/11	27,000,000.00	8/17/88	7.340%	
Advance #930	8/11	10,000,000.00	8/18/88	7.340%	
Advance #931	8/11	124,000,000.00	8/19/88	7.340%	
Advance #932	8/15	230,000,000.00	8/22/88	7.355%	
Advance #933	8/15	75,000,000.00	8/19/88	7.355%	
Advance #934	8/19	220,000,000.00	8/26/88	7.370%	
Advance #935	8/22	38,000,000.00	8/25/88	7.407%	
Advance #936	8/22	162,000,000.00	8/29/88	7.407%	
Advance #937	8/26	219,000,000.00	8/31/88	7.613%	
Advance #938	8/29	82,000,000.00	9/01/88	7.692%	
Advance #939	8/29	132,000,000.00	9/06/88	7.692%	
Advance #940	8/31	115,000,000.00	9/06/88	7.666%	
Advance #941	8/31	260,000,000.00	9/12/88	7.666%	
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Greece 17	8/1	6,142,189.20	8/25/14	9.331%	
Greece 16	8/3	2,624,775.34	9/01/13	9.182%	
Greece 16	8/8	11,225,000.00	9/01/13	9.260%	
Morocco 10	8/10	10,885,287.16	11/30/94	8.215%	
Greece 17	8/11	1,673,432.00	8/25/14	9.471%	
Greece 16	8/22	3,175,197.34	9/01/13	9.523%	
Greece 17	8/22	3,575,250.00	8/25/14	9.525%	
Greece 16	8/29	714,210.25	9/01/13	9.549%	

+rollover

FEDERAL FINANCING BANK

AUGUST 1988 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE	INTEREST RATE
				(semi-annual)	(other than semi-annual)
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT					
Community Development					
Mayaguez, PR	8/1	$ 1,985,985.09	8/02/93	8.649%	8.836% ann.
*Long Beach, CA	8/1	5,000,000.00	8/03/92	8.723%	8.913% ann.
*Rochester, NY	8/4	1,615,000.00	8/16/93	8.981%	9.183% ann.
San Juan, PR	8/9	126,421.08	10/03/88	7.175%	
*Alhambra, CA	8/15	1,370,285.00	8/15/94	9.079%	9.285% ann.
Montgomery County, PA	8/15	199,619.99	1/15/89	7.860%	
Detroit, MI	8/17	9,000,000.00	9/01/89	8.430%	8.608% ann.
Newport News, VA	8/29	207,000.00	2/15/89	7.976%	
RURAL ELECTRIFICATION ADMINISTRATION					
*Tex-La Electric #208A	8/1	513,000.00	1/03/17	9.313%	9.207% qtr.
*Tex-La Electric #208A	8/1	196,000.00	1/03/17	9.313%	9.207% qtr.
Kamo Electric #209	8/5	3,686,000.00	10/01/90	8.472%	8.384% qtr.
*Tex-La Electric #208A	8/8	769,000.00	1/03/17	9.250%	9.145% qtr.
*Allegheny Electric #175A	8/10	3,810,000.00	10/01/90	8.731%	8.638% qtr.
*Wolverine Power #101A	8/10	350,000.00	10/01/90	8.725%	8.632% qtr.
New Hampshire Electric #270	8/10	101,000.00	1/02/18	9.322%	9.216% qtr.
*Wolverine Power #182A	8/10	2,004,000.00	1/02/90	8.489%	8.401% qtr.
*Wolverine Power #183A	8/10	2,533,000.00	1/02/90	8.489%	8.401% qtr.
*Wabash Valley Power #104	8/11	5,591,000.00	1/03/17	9.456%	9.347% qtr.
*Wabash Valley Power #206	8/11	386,000.00	1/03/17	9.456%	9.347% qtr.
*Wabash Valley Power #206	8/11	20,000.00	8/11/90	8.771%	8.677% qtr.
Contel of Kentucky #254	8/12	2,500,000.00	1/03/23	9.517%	9.406% qtr.
Associated Electric #328	8/24	7,920,000.00	10/01/90	8.847%	8.751% qtr.
Brazos Electric #144	8/24	64,000.00	1/03/22	9.500%	9.390% qtr.
*Wolverine Power #191	8/26	149,000.00	12/31/15	9.559%	9.447% qtr.
Tel. Util. of E. Oregon #256	8/29	825,000.00	1/03/23	9.551%	9.440% qtr.
*Wabash Valley Power #206	8/29	477,000.00	1/03/17	9.535%	9.424% qtr.
Tri-State Electric #250	8/30	5,000,000.00	10/01/90	8.884%	8.787% qtr.
SMALL BUSINESS ADMINISTRATION					
State and Local Development Company Debentures					
Dev. Corp. of Middle Georgia	8/10	265,000.00	8/01/03	9.177%	
N.E. Louisiana Industries Inc.	8/10	172,000.00	8/01/08	9.215%	
Pioneer Country Dev. Inc.	8/10	42,000.00	8/01/08	9.215%	
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
+Note A-88-11	8/30	671,038,262.21	11/30/88	7.700%	

*maturity extension

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	August 31, 1988	July 31, 1988	Net Change 8/1/88-8/31/88	FY '88 Net Change 10/1/87-8/31/88
Agency Debt:				
Export-Import Bank	$ 11,226.2	$ 11,226.2	$ -0-	$ -1,237.3
NCUA-Central Liquidity Facility	118.1	95.2	23.0	6.8
Tennessee Valley Authority	17,114.0	17,054.0	60.0	728.0
U.S. Postal Service	5,592.2	5,592.2	-0-	1,238.8
sub-total*	34,050.6	33,967.6	83.0	736.3
Agency Assets:				
Farmers Home Administration	59,464.0	59,674.0	-210.0	-5,545.0
DHHS-Health Maintenance Org.	79.3	79.3	0.0	-4.7
DHHS-Medical Facilities	96.4	96.4	0.0	-5.9
Overseas Private Investment Corp.	-0-	-0-	-0-	-0.7
Rural Electrification Admin.-CBO	4,071.2	4,071.2	-0-	-170.0
Small Business Administration	15.8	16.1	-0.3	-3.8
sub-total*	63,726.7	63,936.9	-210.3	-5,730.0
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	18,584.2	18,556.5	27.7	-579.8
DEd.-Student Loan Marketing Assn.	4,940.0	4,940.0	-0-	-0-
DOE-Geothermal Loan Guarantees	50.0	50.0	-0-	50.0
DHUD-Community Dev. Block Grant	321.8	321.0	0.9	-2.4
DHUD-New Communities	-0-	-0-	-0-	-30.6
DHUD-Public Housing Notes +	2,037.0	2,037.0	-0-	-37.3
General Services Administration +	387.5	387.5	-0-	-8.0
DOI-Guam Power Authority	32.6	32.6	-0-	-0.5
DOI-Virgin Islands	26.6	26.6	0.0	-0.6
NASA-Space Communications Co. +	898.8	949.4	-50.6	90.2
DON-Ship Lease Financing	1,758.9	1,758.9	-0-	-29.4
Rural Electrification Administration	19,224.8	19,206.0	18.8	-1,972.1
SBA-Small Business Investment Cos.	670.7	675.5	-4.8	-69.9
SBA-State/Local Development Cos.	874.3	879.6	-5.3	-25.5
TVA-Seven States Energy Corp.	1,999.7	1,986.1	13.6	176.0
DOT-Section 511	48.3	48.5	-0.2	-7.1
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	52,032.1	52,032.1	0.0	-2,447.1
grand total*	$ 149,809.3	$ 149,936.6	$ -127.3	$ -7,440.8

*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
March 20, 1989

LIBRARY, ROOM 5310

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,228 million of 13-week bills and for $7,200 million of 26-week bills, both to be issued on March 23, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing June 22, 1989			26-week bills maturing September 21, 1989		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	8.98% a/	9.32%	97.730	9.00% b/	9.56%	95.450
High	9.01%	9.35%	97.722	9.05%	9.62%	95.425
Average	9.00%	9.34%	97.725	9.04%	9.60%	95.430

a/ Excepting 2 tenders totaling $220,000.
b/ Excepting 2 tenders totaling $195,000.
Tenders at the high discount rate for the 13-week bills were allotted 13%.
Tenders at the high discount rate for the 26-week bills were allotted 53%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 30,325	$ 30,325	$ 27,040	$ 27,040
New York	23,588,070	6,355,770	18,768,725	6,404,475
Philadelphia	23,635	23,635	18,520	18,520
Cleveland	36,975	36,975	27,500	27,500
Richmond	150,150	63,150	40,085	40,085
Atlanta	29,710	29,710	33,850	33,850
Chicago	2,303,850	200,740	1,762,375	88,875
St. Louis	41,125	22,425	28,065	21,125
Minneapolis	8,600	8,600	8,240	8,240
Kansas City	44,030	44,030	40,915	40,915
Dallas	41,315	31,315	28,390	18,390
San Francisco	884,395	131,395	927,655	300,685
Treasury	250,255	250,255	170,600	170,600
TOTALS	$27,432,435	$7,228,325	$21,881,960	$7,200,300
Type				
Competitive	$24,452,770	$4,248,660	$17,672,160	$2,990,500
Noncompetitive	1,010,285	1,010,285	725,200	725,200
Subtotal, Public	$25,463,055	$5,258,945	$18,397,360	$3,715.700
Federal Reserve	1,917,280	1,917,280	1,800,000	1,800,000
Foreign Official Institutions	52,100	52,100	1,684,600	1,684,600
TOTALS	$27,432,435	$7,228,325	$21,881,960	$7,200,300

An additional $1,600 thousand of 13-week bills and an additional $314,800 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

NB-184

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
March 21, 1989

CONTACT: Bob Levine
202/566-2041

Y, ROOM 5310
MAR 24 8 55 AM '89
DEPARTMENT OF THE TREASURY

ADDRESS BY DR. DAVID C. MULFORD
TEMPORARY ALTERNATE GOVERNOR FOR THE UNITED STATES OF AMERICA
AT THE THIRD PLENARY SESSION
INTER-AMERICAN DEVELOPMENT BANK
IN AMSTERDAM

I want to thank the Government of the Netherlands and the people of Amsterdam for the very warm welcome we have received in this beautiful and historic city. I also want to offer my congratulations to Governor Ruding on his election as Chairman of the Board of Governors of our Bank.

Ladies and gentlemen, there is a wave of change sweeping across Latin America. Its results may be difficult to discern as we continue to wrestle with the debt problem. But, it is clear that the men and women of Latin America who are now in responsible policy positions are introducing new policies and those policies are changing their countries.

Debt remains a dominant issue in Latin America today. It preoccupies Heads of State, Finance Ministers, Central Bank Governors, businessmen, bankers, the media, and the population in general. The debt problem is also a great challenge to the United States because we are your friend, as well as your largest trading partner. Latin America's standard of living, your commitment to democracy, and your ultimate resolution of the debt problem are all high priorities for the United States. We share a deep common interest. And therefore it is highly desirable that the Inter-American Development Bank -- our Bank -- make its particular contribution to resolving Latin America's debt problems.

This same wave of change has now reached the Inter-American Development Bank itself. A year ago, at our meeting in Caracas, I encouraged President Iglesias to begin building a new consensus that could support an expanded IDB, enabling it to become a more important player in promoting sustainable growth in Latin America. Today, in Amsterdam, I offer him my congratulations and appreciation.

After years of discussion and some difficult negotiations, we are now close to agreement with other major shareholders on the essential elements of a replenishment which would transform the IDB. If important remaining issues can be resolved, the Bank's resources would increase by over $26 billion. Its four year lending program would reach $22.5 billion, and policy-based lending would become a reality. The replenishment, once settled, would be significant not only for the Latin American and the Caribbean borrowers of the Bank but also for the United States. Our participation in this single replenishment would amount to nearly $9 billion, raising the total financial contribution of the United States to the Bank to over $25 billion. This is a measure of the importance that the new Administration attaches to the Bank and to its mission.

We are all now looking forward with considerable hope and expectation to the Bank taking up the challenge. The replenishment, coupled with institutional and operating reforms will position the IDB to assume broader responsibilities. It will have the opportunity to make a more significant contribution to the inhabitants of our hemisphere. It will be doing so in a world economic environment marked by many positive features.

Global Economic Developments and Prospects

Maintaining a supportive macroeconomic environment in the industrial countries has been a cornerstone of our collective efforts.

A balanced assessment of the performance of the industrial nations would conclude that our macroeconomic performance in recent years has been impressive. While one could perhaps argue that this or that element of the picture has not been fully satisfactory, the positive aspects are clear: economic expansion in the industrial countries is now into its seventh consecutive year; inflationary pressures have been kept in check; and world trade flows have expanded robustly.

We should not ignore the tremendous resilience that our economies showed in the wake of the financial market turbulence in late 1987. Contrary to widespread expectations at the time, industrial country growth picked up strongly last year, pulling world trade growth up about 9 percent.

Our task now is to continue to build on the firm foundation we have laid. The next few years will surely be challenging, as the past few years have been. Sustaining growth, resisting inflation, and bolstering trade must remain the principal objectives for the industrial countries and the LDCs as well. I am confident that we will meet these challenges.

The United States has played a central role in constructing this foundation and will continue to play an important part in further efforts. Our tasks are several. First, we need to sustain growth. We anticipate real growth in the 3.0 percent range through 1990, which would be the eighth consecutive year of expansion. Second, we need to keep the lid on inflation. Some recent statistics in the U.S. point to some price firming, but the general economic data are mixed with no clear and compelling evidence that inflationary forces are rising.

12. The third key task for the United States is to continue to make progress in reducing our Federal budget deficit. The Administration has

made a clear commitment to meet the deficit targets laid out by the Gramm-Rudman process and negotiations are in progress at this time. Finally, we need to continue reducing U.S. trade and current account imbalances. Last year, 1988, we made substantial progress and we look for more progress this year.

Strengthening the Debt Strategy

In the world environment, as seen from Latin America, the debt problem casts its long shadow over the landscape. Sunday I spoke of Secretary Brady's recent proposals for strengthening the international debt strategy. Although important progress has been made in recent years, the Bush Administration recognizes that the debt difficulties facing developing nations of the Western Hemisphere remain a serious global problem.

Our suggested approach builds upon the basic principles that have guided international efforts in recent years. It recognizes the central importance of stronger growth, economic policy reforms, external financial support, and a case-by-case approach to individual nations' problems.

Our proposals would maintain a central role for the IMF and World Bank within the debt strategy in encouraging debtor policy reforms and catalyzing financial support. This is because the heart of the problem is still the reform of economic policies to produce key structural changes and sustained economic performance. While we recognize the continuing need for new lending from commercial banks, we need to place stronger emphasis on new investment flows and the repatriation of flight capital as alternatives to over-reliance in recent years on private bank loans. To this end, we would encourage the IMF and World Bank to work with debtor nations to focus on specific measures to improve the investment climate and to encourage the return of flight capital in addition to promoting vital macroeconomic and structural reforms.

The initiative for structural reform and a sound investment climate must come from within each debtor nation. This is a difficult issue for many nations in Latin America as elsewhere. But experience shows that where reforms are made, economic results help resolve non-economic problems. In any case, the problems that must be faced in order to accomplish reform are not so difficult as those that result from stagnation and decline.

In developing our new proposals we have borne in mind particularly those countries which have made important reforms, as well as those that are willing to commit their policies and energy to major reform efforts. In short, there needs to be light at the end of the tunnel.

We believe it is necessary to place greater emphasis on international efforts to achieve more rapid and broadly based voluntary debt reduction and debt service reduction. This will improve prospects for stronger growth especially where countries have already made important reforms in their economies and stand poised to benefit from their past sacrifices.

The U.S. proposals visualize redirecting and increasing available IMF and World Bank resources -- from their current capital stock -- to support debt and debt service reduction transactions agreed in the market by debtor nations and commercial banks. This concept involves an important shift in focus away from the present practice of using official resources in ways that, in effect, increase a debtor nations' stock of debt and ultimately its debt service burden.

Debtor nations which wish to engage in a debt reduction program should develop policy reform programs with the IMF and World Bank, as a condition for access to financial support for debt reduction. At the same time, commercial banks and debtors should negotiate general waivers covering such areas as the sharing and negative pledge provisions in existing commercial bank agreements. These waivers, which we have suggested might have a life of three years, could come into effect when IMF and World Bank disbursements become available, thus making it possible for multiple transactions between a debtor and the banks to reduce debt and debt service.

Once a general waiver has been agreed upon, a portion of IMF financing and World Bank policy-based loans could be made available to support debt reduction operations. The set-aside amounts could operate as standby credits to collateralize discounted debt/bond agreements or to replenish debtor reserves following cash buybacks during the period of the waiver.

For debtor nations which have negotiated agreements to reduce the stock of debt, the IMF and World Bank could also make available support for interest payments on a rolling basis for a limited period. Such support could be available for debt restructurings or exchanges which involve either a substantial discount of principal or a major reduction in interest rates.

In addition to the measures to facilitate reduction of commercial bank debt, the Paris Club should continue providing support through rescheduling based on debtor performance, with agreement contingent upon an IMF standby program or extended financing program (EFF). Key creditor countries might also seek to assure continued access to official export credit support for debtor nations adopting Fund and World Bank programs.

We would encourage creditor nations to review regulatory, accounting, and tax provisions with a view to reducing or eliminating impediments to debt reduction, where those exist, while of course maintaining the safety and soundness of the financial system. Creditor countries that are in a position to do so should provide financial support to this effort.

We are not proposing these ideas as immediate alternatives to the current process of direct negotiations between debtors and creditors. Rather, we are suggesting that new approaches and emphasis should be phased into ongoing discussions between these parties in order to avoid any interruptions in their orderly relations.

The process might work in the following way. Each debtor nation would work out with its commercial bank creditors a range of debt and debt service reduction instruments as a central element of meeting the debtor's financing needs.

Debtors and their creditors could choose any number of debt reduction mechanisms. Debt reduction transactions, for example, might include: the offer of specific instruments (such as debt/bond exchanges) to all commercial banks; cash buybacks up to a maximum amount; and/or the negotiation of specific debt/equity or non-collateralized interest reduction instruments with individual banks.

An integral part of the approach would be for debtor nations engaged in debt reduction to maintain viable debt/equity swap programs, which can make a substantial contribution to debt reduction and already has done so in several important countries. Provisions which permit domestic nationals to engage in such transactions could also contribute to the repatriation of flight capital, as we have seen already in the case of Chile.

Debt reduction transactions are not expected to cover all the financing needs of debtor countries. Additional new financing commitments will also be needed -- in the form of concerted lending, club loans by a group of banks, or a range of trade, investment, or other credits from individual banks. In some cases, this might involve a differentiation of new loans from old debt. Repatriation of flight capital and new investment are other potential sources of finance. It is hoped that the combination of these resources will enable debtor nations to finance their needs and to meet their obligations on a timely basis. The IMF should continue to monitor progress, and each country should report on a regular basis to the IMF and the World Bank on progress in its negotiations with commercial banks.

Taken together, these proposals represent a basis on which we can work together to revitalize the current debt strategy. This will require broad international support and cooperation between creditor and debtor governments, the commercial banking community, and the international financial institutions. Japan has already expressed their strong support, including a willingness to provide supportive financing, and a number of other creditor and debtor nations have responded favorably to the general approach which we have outlined.

We look forward to discussing these proposals in the coming weeks and especially at the spring meetings of the IMF and World Bank. We believe the proposals we have outlined, including efforts to stimulate broader voluntary debt and debt service reduction, provide substantial benefits for debtor nations in the form of more manageable debt service obligations, smaller and more realistic financing needs, stronger economic growth, and higher standards of living for their people.

The Inter-American Development Bank

Turning once again to the IDB, President Iglesias has already begun to create a stronger institution which can address the very serious problems of our Latin American and Caribbean member countries. His efforts to chart a course for the Bank have been impressive and he well deserves our praise for the leadership he has displayed and for his perseverance. He also needs the support of our governments and this includes more than the provision of capital.

We must help define the Bank's mission and sharpen its focus. The recent task force reports, prepared at the President's initiative, address key organizational and operational issues. We strongly encourage all members to work cooperatively and enthusiastically with the President and with Management to implement the changes that will be necessary to transform the Bank. This may be a difficult process because there are some differences between member countries. However, I am certain that we will find constructive ways to deal with our various points of view. Indeed, we must do so ... if we want to help Latin America and the Caribbean ... and we must do so, if we want a strong IDB.

The Bank needs to be in a position to encourage its borrowers to adopt policies that improve economic performance, stimulate new foreign investment, increase domestic savings, and encourage the repatriation of flight capital. Private sector initiatives and the development of market based economies should be emphasized. Specific policy measures designed to help achieve these objectives should be an integral part of the Bank's lending operations.

Environment

The IDB's treatment of environmental issues must improve. This is an area of global importance of concern to us all. The Bank's assessment of the environmental impact of projects and programs that it helps to finance is critical. Over the past year, the Bank has made continued progress in providing training to its permanent staff on the importance of environmental issues. Seminars have been held on issues such as reservoir silting, shoreline conservation, and biodiversity issues in Latin America. The Bank is emphasizing environmentally-beneficial projects and providing technical assistance aimed at improvements in watershed management and riverine systems in Ecuador and Colombia. We applaud these and other initiatives the Bank has taken to promote environmental issues.

More needs to be accomplished, however, on organizational and staffing changes to produce effective environmental assessment procedures. The Bank needs a senior environmental line unit with a clear mandate, and with the strong, consistent support from President Iglesias to participate fully in project identification, preparation and appraisal. I strongly recommend that the President's Committee on the Environment take the lead in evaluating and distributing information on the environmental assessment of the Bank's projects and programs.

Conclusion

And finally, Mr. Chairman, a closing note. The extensive and protracted negotiations to replenish the Bank's resources continue to be near completion. We need to settle the last remaining issues as soon as possible. The Bank needs to recover its momentum and to adjust its priorities. The first priority surely must be to move ahead with an expanded Bank that can address Latin America's most urgent challenges.

Thank you very much.

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
March 21, 1989

TREASURY'S WEEKLY BILL OFFERING

23 8 55

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,400 **million, to be issued** March 30, 1989. **This offering will provide about $**125 **million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $**14,285 **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** Standard time, Monday, March 27, 1989. **The two series offered are as follows:**

91**-day bills (to maturity date) for approximately $**7,200 **million, representing an additional amount of bills dated** December 29, 1988, **and to mature** June 29, 1989 **(CUSIP No. 912794** SG 0), **currently outstanding in the amount of $**7,357 **million, the additional and original bills to be freely interchangeable.**

182**-day bills (to maturity date) for approximately $**7,200 **million, representing an additional amount of bills dated** September 29, 1988, **and to mature** September 28, 1989 **(CUSIP No. 912794** SL 9), **currently outstanding in the amount of $**9,419 **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 March 30, 1989. **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 $**1,578 **million as agents for foreign and international monetary authorities, and $**3,405 **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.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE March 22, 1989

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TREAS

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of February 1989.

As indicated in this table, U.S. reserve assets amounted to $49,373 million at the end of February, up from $48,190 million in January.

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/
1989					
Jan.	48,190	11,056	9,388	18,324	9,422
Feb.	49,373	11,061	9,653	19,306	9,353

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.

TREASURY NEWS

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MAR 23 8

Steven W. Broadbent
Appointed Deputy Assistant Secretary
for Information Systems

Secretary of the Treasury Nicholas F. Brady today announced the appointment of Steven W. Broadbent to serve as Deputy Assistant Secretary for Information Systems, effective March 13, 1989. In that capacity, Mr. Broadbent will serve as the principal advisor to the Assistant Secretary for Management on Information Systems issues.

Previously, Mr. Broadbent was associated with AT&T in a variety of sales, sales management, and network operations positions from 1982 to 1989.

Mr. Broadbent received his undergraduate education at the University of Virginia on a Navy ROTC Scholarship. He received a B.S. degree in Nuclear Engineering in 1976. Commissioned as an Ensign in May 1976, he served in the Navy both at sea and on Washington-based duty until 1980. He was then awarded a John Motley Morehead Fellowship to attend the School of Business Administration at the University of North Carolina at Chapel Hill, where he earned a M.B.A. in 1982. In 1987 Mr. Broadbent received a Masters degree in Public Policy from the George Washington University.

A native of New Jersey, Mr. Broadbent now lives in Washington, D.C. where he is active in the United States Naval Reserve.

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DEPART

FOR IMMEDIATE RELEASE
March 22, 1989

CONTACT: LARRY BATDORF
(202) 566-2041

U.S.-SPAIN INITIAL DRAFT INCOME TAX TREATY

The Treasury Department today announced that a proposed Convention for the Avoidance of Double Taxation of Income and the Prevention of Fiscal Evasion between the United States and Spain was initialled in Washington on March 16, 1989. The draft Convention and an accompanying Protocol will be transmitted to the appropriate authorities for approval and signature. Details of the texts will remain confidential until signed and submitted for ratification.

The proposed Convention provides rules for the taxation at source of business profits, employment income, and investment income, including reduced rates of tax at source on dividends, interest, and royalties. It takes into account changes in U.S. tax law introduced by the 1986 Tax Reform Act, such as the branch tax; and it provides for administrative cooperation and the limitation of treaty benefits to prevent "treaty shopping".

Once signed, the proposed Convention and Protocol will be submitted to the Senate for its advice and consent to ratification. The Convention and Protocol will enter into force on ratification and will apply prospectively. It is hoped that the new treaty will be ratified before the end of 1989.

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TREASURY NEWS

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FOR RELEASE AT 4:00 P.M.
March 22, 1989

CONTACT: Office of Financing
202/376-4350

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DEPARTMENT

TREASURY TO AUCTION 2-YEAR AND 4-YEAR NOTES TOTALING $16,750 MILLION

The Treasury will auction $9,250 million of 2-year notes and $7,500 million of 4-year notes to refund $16,527 million of securities maturing March 31, 1989, and to raise about $225 million new cash. The $16,527 million of maturing securities are those held by the public, including $2,151 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $16,750 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 prices of accepted competitive tenders.

In addition to the public holdings, Federal Reserve Banks, for their own accounts, hold $2,322 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.

Details about each of the new securities are given in the attached highlights of the offerings and in the official offering circulars.

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Attachment

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
OF 2-YEAR AND 4-YEAR NOTES TO BE ISSUED MARCH 31, 1989

March 22, 1989

Amount Offered to the Public	$9,250 million	$7,500 million
Description of Security:		
Term and type of security	2-year notes	4-year notes
Series and CUSIP designation	Series X-1991 (CUSIP No. 912827 XH 0)	Series N-1993 (CUSIP No. 912827 XJ 6)
Maturity date	March 31, 1991	March 31, 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	September 30 and March 31	September 30 and March 31
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	Tuesday, March 28, 1989, prior to 1:00 p.m., EST	Wednesday, March 29, 1989, prior to 1:00 p.m., EST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury	Friday, March 31, 1989	Friday, March 31, 1989
b) readily-collectible check	Wednesday, March 29, 1989	Wednesday, March 29, 1989

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TREASURY NEWS
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Embargoed For Release Until Delivery
Expected at 1:00 p.m. EST

TESTIMONY BY JAMES H. FALL, III
ACTING DEPUTY ASSISTANT SECRETARY
FOR DEVELOPING NATIONS
DEPARTMENT OF THE TREASURY
BEFORE THE
HOUSE FOREIGN AFFAIRS SUBCOMMITTEE ON
ASIAN AND PACIFIC AFFAIRS
(March 7, 1989)

Introduction

Mr. Chairman:

I am pleased to have the opportunity to testify before this Subcommittee today on the Philippines. Since you have expressed particular interest in the Philippines debt situation, I would like to comment in some detail on the magnitude and composition of the Philippines debt and on its debt servicing burden.

I would also like to provide the Treasury Department's views on the proposed Multilateral Assistance Initiative (MAI). Let me state that the Treasury Department supports the MAI's key objectives of preserving and strengthening democracy in the Philippines, reinforcing the government's economic restructuring efforts, and assuring a firm basis for sustained, non-inflationary growth. We are fully committed to working with the Congress and the rest of the Executive Branch in an effort to ensure its success.

The Philippines Debt Situation

External Debt - At the end of 1988, the Philippines external debt totalled an estimated $28.2 billion, equivalent to 74% of its Gross National Product (GNP). The Philippines scheduled debt service (i.e., before deferrals of principal and interest payments through rescheduling) was equal to an estimated 49% of its exports of goods and services. Later on in this testimony, I will compare these percentages with those of other major middle-income debtors.

The Philippines has benefited from a substantial rescheduling of amortization and interest payments. The International Monetary Fund (IMF) estimates that, since 1985, the Philippines has deferred $4.8 billion in amortization payments due to commercial banks and about $2 billion of principal and interest payments to official bilateral creditors through the Paris Club. Total deferrals in 1985-1988 amounted to $6.8 billion, or 38% of payments of principal and interest scheduled in that period.

In 1988 alone, the Philippines deferred $832 million in payments due to its commercial bank creditors and another $376 million to Paris Club creditors. Thus, the Philippines actual debt service payments in 1988 (after debt rescheduling) accounted for an estimated 35% of its exports of goods and services. This represents a deferral of debt service equal to about 14% of its exports of goods and services in that one year.

Composition of External Debt - According to the latest available data (for September 1987), about 85% of the Philippines total external debt was medium- and long-term (including debt to the IMF) and 15% was short-term. (See Table 1.)

- About $15 billion, or 54%, was owed to commercial banks, including $11.5 billion in medium- and long-term debt.

- Suppliers credits accounted for an additional $2.2 billion, or 8%. The bulk of this ($1.6 billion) had maturities of more than one year.

- Nearly $5 billion, or 18%, was medium- and long-term debt to multilateral institutions. More than half of this was owed to the World Bank, with the balance split fairly evenly between the IMF and Asian Development Bank.

- About $4.4 billion, or 16%, was medium- and long-term debt to or guaranteed by official bilateral creditors, such as the U.S. Government.

Debt to the United States - As of June 1988, the Philippines debt to the U.S. Government totalled somewhat more than

$1.1 billion. The Export-Import Bank was the largest U.S. government creditor, with $479 million outstanding, followed by AID, with $311 million outstanding. (See Table 2.)

The U.S. Government had also guaranteed an additional $1 billion in loans and insurance on behalf of Philippine debtors as of June 1988. The Export-Import Bank was the largest U.S. Government guarantor, with $652 million in contingent liabilities, followed by OPIC, with $325 million in guarantees and insurance.

The Philippines debt to U.S. commercial banks was estimated at about $4.2 billion as of September 1988.

Domestic Debt - At the end of 1987, Philippine national government bonds outstanding (excluding those held by the monetary authorities) were estimated at $8 billion, or about 23% of GNP. Information on the maturity structure and yields of these bonds is not available.

The national government's total interest payments, however, on both domestic and foreign debt rose sharply from 9% of its current outlays and net lending in 1983 to 27% in 1987. As a percentage of GNP, such interest payments increased from 1.3% in 1981 to 5.2% in 1987. Most of this increase resulted from the government's growing reliance on domestic, rather than foreign, financing for the fiscal deficit and from the high interest rates that prevailed during that time. The government's assumption of the domestic and foreign debt service obligations of the government non-financial institutions also played an important part in this increase.

The Philippines Debt Burden: An Assessment

Given the debt and debt service indicators that I have described, the question arises as to whether the Philippines can afford to incur additional debt, particularly additional external debt. In other words, will the Philippines be able to continue to service the debt that it already has, let alone additional debt?

In general terms, the answer to both of these questions is, "It depends." Barring unforeseen, adverse external events such as a sharp increase in international interest rates or in the price of petroleum, a sudden drop in international commodity prices, or a rise in trade barriers in the Philippines principal export markets, the Philippines ability to take on and service additional debt depends largely on the government's continued commitment to, and success in, implementing economic reform and restructuring and on President Aquino's enlightened leadership in this regard.

We are confident that President Aquino's leadership and the government's strong commitment to economic reform and restructuring will continue to contribute to diversification and growth of the Philippines exports, to significant real growth of the Philippines economy, and to an easing of the Philippines debt burden.

Thanks in large part to the Philippines renewed commitment to sound economic management, its economic progress in the past three years has been impressive, compared particularly with performance in the early 1980s. As I shall describe later, this has already contributed to an easing of the Philippines debt burden.

Cumulative real GNP growth since the beginning of 1986 exceeds 15%, compared with a cumulative decline of 6% in 1981-1985. Inflation, which reached 26% and 51% in 1983 and 1984, respectively, was reduced to an average of 5.2% annually in 1986-1988. Export volume grew 36% in 1986-1988, compared with a 28% cumulative decline in 1981-1985. Imports also grew substantially in volume terms, but the current account deficits shrank significantly nonetheless.

The one major area where performance has been less positive is the fiscal deficit. Although the consolidated public sector deficit dropped to an average of 4.5% of GNP in 1986-1988, compared with 7.1% in 1981-1985, the fiscal deficit of the national government worsened. The latter increased from an average of 2.8% of GNP in 1981-1985 to 3.7% in 1986-1988. The 6% real effective appreciation of the peso in 1988 is another disturbing factor.

As the Philippine authorities focus on their economic policy reform priorities for the future, particular attention should be devoted to:

- avoiding an overvalued exchange rate that discourages exports and encourages excessive import consumption;

- adopting additional fiscal and monetary reforms that encourage savings and investment;

- furthering trade liberalization efforts that increase the economy's efficiency;

- continuing to liberalize laws and administrative procedures to give added impetus to foreign investment; and

- restoring momentum to the government's privatization program.

In assessing the weight of the Philippines debt burden, however, and its ability to service new debt, it is helpful to consider issues other than the Philippines macroeconomic and structural policy. For example, it is useful to consider: 1) the Philippines debt burden ratios, particularly compared with those of other countries; 2) its 1989 debt service needs; 3) the Philippines prospects for additional debt relief; 4) net capital flows and reflows to the Philippines; 5) the Philippines debt-equity swap program; and 6) other programs that could help reduce its debt service burden.

The Philippines Debt Ratios - We have already reviewed some basic debt ratios for the Philippines, namely external debt as a percentage of GNP and debt service as a percentage of exports of goods and services. There is no doubt that these ratios indicate a heavy debt burden. It should be noted, however, that other major developing country debtors have even heavier debt burdens by some measures.

Table 3 illustrates how the Philippines external debt compares with that of five other countries. For example, in 1988:

- In terms of external debt as a percentage of GNP, the Philippines ranked third with a ratio of 74%, compared with 88% for Chile and 91% for Venezuela.

- The Philippines ranked fifth in terms of outstanding external debt as a percentage of annual exports with a ratio of 270%, compared with more than 500% for Argentina, about 325% for Brazil and Mexico, and 288% for Venezuela.

- In terms of debt service payments of principal and interest (before rescheduling) as a percentage of exports of goods and services, the Philippines ranked third with a ratio of 49%, compared with 93% for Argentina and 55% for Chile.

- Finally, the Philippines ranked fifth in terms of interest payments as a percentage of exports with a ratio of 23%, compared with 42% for Argentina, 30% for Brazil, and 28% for Mexico.

It should also be noted that the Philippines key debt ratios have begun to ease, in part because it has been able to restore real GNP growth and expand exports without new commercial bank borrowing since 1987. After having risen to 93% of GNP in 1986, the Philippines external debt as a percentage of GNP has declined once again to roughly its 1983 level. The ratio of debt service to exports of goods and services has also improved slightly.

These debt ratios should continue to improve. By 1992, midway through the proposed Multilateral Assistance Initiative, it is expected that the Philippines debt will have dropped by another 11 percentage points to 63% of GNP. It is also expected that the debt service ratio will have dropped significantly -- by 14 percentage points before rescheduling and by 5 percentage points after rescheduling.

1989 Debt Service Requirements - The Philippines 1989 scheduled debt service requirements are projected at $5.3 billion, including $2.6 billion in interest payments, of which approximately 60% are due to commercial banks, and $2.7 billion in principal payments. Offsetting capital inflows from bilateral creditors and multilateral institutions should total $2 billion, to which should be added some $750 million in grants from bilateral donors, including the United States. At this time, it is difficult to predict what new capital flows from commercial banks might occur in 1989 to offset the Philippines interest payments to them.

Prospects for Additional Debt Relief - The Philippines 1987 restructuring agreement with the commercial banks provides for the deferral of an additional $4.6 billion in maturities falling due in 1989-1994. Additional debt relief from official bilateral creditors via the Paris Club is also likely if the Philippines obtains and adheres to an IMF Extended Financing Facility arrangement.

In 1989, the additional deferrals of principal and interest resulting from such private and official arrangements could total well over $1 billion.

Net Capital Flows - Given the Philippines projected debt service requirements, offsetting new official grants and other capital flows, and possible additional debt relief, the Philippines is currently projected to have a negative capital flow of $1.1 billion on debt-related transactions in 1989.

It should be noted, however, that this does not reflect a negative "aid" flow. The amount of this negative capital flow is somewhat less than the Philippines projected interest payments to the commercial banks. Thus, the negative flow in debt-related transactions that is currently projected reflects the fact that we have not made an explicit assumption about the amount of new commercial bank lending in 1989. This negative flow does not result from an imbalance in official bilateral and multilateral assistance. Such official assistance has, in fact, increased substantially since the restoration of Philippine democracy.

In any event, this particular measure of capital flows is not very meaningful. It overlooks other sources of finance, such as foreign investment inflows, suppliers credits, short-term capital flows, and private remittances that are available and that can be stimulated through appropriate policies.

Indeed, the question of whether net debt-related capital flows are positive or negative tends to divert attention from the more important issue of whether such inflows are being used to pay for consumption or to finance productive investments within a sound policy framework. As the case of Korea demonstrates, negative net capital flows are not necessarily incompatible with sustained economic growth.

Debt-Equity Swaps - Debt-for-equity swaps have proven to be an effective way of reducing a country's stock of debt and debt service burden, while increasing the amount of new productive investments.

The Philippines swap program generally works in the following fashion:

- An investor, foreign or domestic, purchases a debt obligation in the secondary market at a discount determined by the market.

- The investor then trades the debt instrument with the public or private debtor through the Central Bank, receiving in return its full face value in local currency, minus any fees or other charges.

- The investor uses the local currency to make an equity investment in an existing business concern or to finance a new investment in the country.

The investor benefits from a favorable effective exchange rate, due to having received the full local currency value of a debt purchased at a discount, minus fees and other charges. The debtor, whether public or private, benefits from being relieved of an obligation denominated in foreign exchange. Finally, the country benefits from investment that maintains or generates additional employment, production, and possibly exports.

The Philippines introduced its debt-equity swap program in August 1986. As of September 1988, approved swaps totalled $485 million, only 28% of the $1.7 billion in applications received. This relatively modest amount results from certain limitations imposed on the program by the Philippine government:

- First, in late 1987 the Central Bank increased fees and other requirements that have the effect of capturing part of the secondary market discount and obliging the investor to import foreign exchange over and above the amount required to purchase the debt obligation in the secondary market. These fees and requirements substantially reduce the benefits of the debt-equity swap program for the investor.

- Second, in early 1988, the Central Bank established a cap of $180 million in annual conversions of Central Bank debt in order to control the associated Central Bank credit expansion and dampen what were seen to be the resulting inflationary pressures. I will take issue with this concern later in this testimony.

  There is no corresponding limit on conversions of private sector debt, which do not result in credit expansion. Few private sector debtors, however, are able to obtain the necessary peso counterpart. Thus, little private sector debt is being converted.

- Third, in early 1988, the Central Bank also published criteria that guide its approval or disapproval of applications for debt conversions. Preference is given to: a) new investments, as opposed to equity investments in existing facilities; b) investments that are labor-intensive, generate employment, and located in regions not yet heavily industrialized; c) activities where at least 80% of production is for export; and d) export products that are new and not subject to foreign quotas.

  Although it is not necessary to satisfy all of these criteria, they limit the program's flexibility and attractiveness unnecessarily. Restrictions on the investor's ability to repatriate profits also diminish the program's attractiveness.

In our judgment, there is ample scope for expanding the Philippines debt-equity swap program. The primary obstacle to such expansion is probably the Central Bank's cap on conversions of its debt. While I acknowledge the Central Bank's concern about the inflationary impact of such conversions, I would point out that the annual cap of $180 million under the debt-equity swap program is equal to about only 3% of the Philippines broad money supply.

Furthermore, concerns about the inflationary impact of debt-equity conversions can be addressed in other ways, as they have been in other countries. For example, more active open market sales of public sector securities could help mop up the liquidity created by the debt conversions. Greater restraint on the government's current expenditures to reduce the fiscal deficit could also help offset the credit expansion resulting from debt conversions.

Finally, I would note that conversions resulting from the privatization of public sector entities have no impact on the money supply, yet boost government revenues. A Business International report puts the equity book value of these enterprises at $31.6 billion in the Philippines.

There is potential for a more active Philippines debt-equity swap program in terms of aiding the Philippines to reduce its debt service burden, sustain an investment-led economic recovery, and generate additional employment and exports. This is all the more the case, given the entrepreneurial bent and diligence of the Philippine people.

The success of Chile's debt conversion program hints at the magnitude of the potential of debt conversion in the Philippines. Chile's programs have resulted in swap agreements totalling $6 billion since their inception in 1985, while inflation rates have declined substantially. The resulting annual debt service savings could reach $600 million.

Debt Reduction - The Philippines is interested in developing additional debt reduction instruments to supplement its debt-equity swap program. It has broached this subject with its commercial banks creditors as part of its preliminary discussions about a 1989-1990 financing package. At this stage, however, it is difficult to speculate on what form a debt reduction program might take or on the savings that might result.

This said, I should like to add that the Treasury Department would support a voluntary, market-oriented debt reduction program for the Philippines if it wishes to pursue one. Indeed, we stand ready to consult with the Government of the Philippines, if it so desires, when it is ready to explore such a program in cooperation with its commercial bank creditors.

The Multilateral Assistance Initiative

I would now like to turn to the proposed Multilateral Assistance Initiative for the Philippines (MAI). The Treasury Department shares the views expressed by others here today as to the importance of nurturing and strengthening the rebirth of democracy of the Philippines. We concur that achieving sustained, non-inflationary growth is essential to attaining this vital objective. We recognize that the Philippines will need additional capital inflows over the next few years to support its economic restructuring and lay an enduring foundation for continued growth. We are also in complete agreement that bilateral donors, multilateral institutions, and private creditors and investors alike all have an important role to play in responding to a strengthened Philippine economic reform effort with increased levels of financing.

The MAI is intended to facilitate cooperation among bilateral donors, multilateral institutions, and private lenders and investors. It will seek to stimulate additional capital flows in a way that fosters further economic reform in the Philippines. Thus, the MAI can make an important contribution to the task of achieving sustained non-inflationary growth.

The Treasury Department has played an integral role in the Executive Branch's deliberations and in consultations with other donors and the multilateral institutions to help refine the MAI's objectives and the implementing procedures.

Measuring the Success of the MAI - Economic growth and development, the improvement of living standards, and the preservation of democracy are tasks that will continue in the Philippines beyond the expected duration of the extraordinary effort that the MAI represents. Thus, the success of this international initiative cannot be measured solely by whether the Philippines has achieved a certain level of per capita income or eliminated the communist insurgency. Although these objectives are vital, the best measure of the MAI's success will be whether the Philippines is able to sustain economic development and continue to improve living standards without further need for concerted, extraordinary official assistance.

Achieving Success - The key to achieving success, therefore, is implementation of the Philippines own economic reform and restructuring program. Developed by the Government of the Philippines with the endorsement and support of the bilateral donors and multilateral institutions, this program must create the economic policy framework and conditions needed to stimulate the Philippine private sector, repatriate flight capital, attract foreign investors, diversify and expand exports, and restore the Philippines creditworthiness and access to international capital markets.

Economic Reform and Restructuring Needs - The Philippines economic reform and restructuring effort is already well under way. Trade liberalization, tariff reform, privatization, the elimination of monopolies, tax return and liberalization of the investment regime have already been initiated to open the economy to foreign competition, attract foreign capital and technology, stimulate the Philippine private sector to play a greater role in a more market-oriented economy, and generate additional fiscal revenues.

We hope that the Philippines policy priorities in the future will focus on the following seven areas:

- In fiscal policy, the major challenge is to reduce the fiscal deficit while also increasing investment expenditures. Although MAI financing will help support a higher level of investment, wage restraint and structural reforms, including further tax reform to eliminate non-economic exemptions and improve compliance, will be required to sustain higher investment over the long-term.

- Monetary policy has been constrained by the need to fight inflation and has resulted in high exchange and interest rates that inhibit private investment, exports, and production from reaching higher levels of growth. Successful fiscal adjustment and a major expansion of productive capacity, supported by the MAI, will of themselves lessen inflationary pressures and allow monetary policy to become more responsive to the needs of investment, export production, and growth.

- Faster privatization or market-reorientation of remaining public sector firms would assist the process of fiscal adjustment, increase the scope for private sector initiative, and improve economic efficiency.

- The benefits of the debt-equity swap program to the Philippines economy are currently limited by an unnecessarily restrictive quota on annual swap operations, fees, and performance and capital requirements. Removing these restrictions would stimulate greater swap activity and help reduce the burden of interest payments on the fiscal budget and stimulate greater investments and employment generation.

- Despite considerable liberalization to date, Philippine investment policy still retains features of an outmoded import-substitution model. Licensing and registration requirements for establishment of foreign investments and for importation of necessary capital and equipment need to be further simplified. De facto prohibitions that exist on foreign investment in many manufacturing sectors need to be abolished, along with performance and local content requirements.

- Progress in trade policy to date has been particularly commendable, notably in the reduction of coverage of quantitative restrictions to only 10% of total imports and in the leadership that President Aquino has shown in refusing to increase maximum tariff rates above 50%. Further import liberalization and efforts to avoid overvaluation of the peso are indispensable to improve economic efficiency, dampen inflationary pressures, encourage investment in the labor-intensive tradable goods sector that is the most likely solution to the underemployment problem, and improve the Philippines international creditworthiness.

- o Financial sector policy has been directed at the important tasks of disposing of non-performing assets, restructuring the major government development banks, and privatizing smaller government-owned banks. In the period ahead, plans being developed with the World Bank to reform the commercial banking system need to be implemented and additional steps taken to privatize the larger government-owned banks and develop the Philippines equities market.

Supporting Economic Reform and Restructuring - The recovery of the Philippine economy in the past two years attests to the competence and dedication of the Philippines economic policy-makers and to the effectiveness of reforms implemented to date. The Philippines cooperative relations with the IMF and World Bank have contributed greatly to the success of its reforms and to the process that has begun to restore international creditworthiness.

We expect that the same constructive spirit will prevail in the Philippines relations with the multilateral institutions as it continues to develop and implement its economic reform program. Discussions between the Government of the Philippines and the IMF are proceeding on an Extended Financing Facility credit. This three-year arrangement will help provide the underlying macroeconomic and structural framework for the Philippines economic program. The Philippines discussions with the World Bank -- and with AID -- on structural and sectoral policies are also expected to contribute to the formulation of the Philippines economic program.

At this critical juncture, the United States and other bilateral donors can strengthen the hand of reform-oriented policy-makers in the Philippines by linking use of their MAI assistance to implementation of economic, structural, and administrative reforms. Towards this end, the Philippines commitment to continued reform and its visible achievement of specific reform objectives should be a primary factor in determining the Administration's future budget requests for the MAI and the subsequent use of appropriated funds.

Our future budget requests should also be guided by an annual reassessment of the Philippines financing requirements and capital flows likely to be available from other sources. Too little financing could restrict the Philippines ability to sustain adequate real GNP growth and achieve the objectives of the MAI. Excessive financing from official sources, however, could reignite inflationary pressures. Moreover, it would influence the commitment to, and limit the scope for, action by Philippine policy-makers to expand the debt-equity swap program, maintain an appropriate exchange rate, and adopt needed fiscal, tax, and trade policy reforms. As a result, the prospects for stimulating the private capital flows that are essential to the success of the MAI would be greatly reduced.

Role of Debt Reduction in the MAI - A voluntary, market-oriented debt reduction program could further the objectives of the MAI, for example, by aiding the process of fiscal adjustment and freeing resources for investment.

The MAI's emphasis on supporting economic restructuring in the Philippines should facilitate the Philippines ability to work out a voluntary, market-oriented debt reduction program with its commercial bank creditors. As the restructuring process unfolds, it is expected that the Philippines export earnings will increase, along with investment, remittances, and other capital inflows. These resources would enhance the Philippines ability to pursue a variety of debt reduction arrangements with its commercial bank creditors.

I should like to reiterate that the Treasury Department is ready to consult as desired with the Government of the Philippines on possible approaches to debt reduction.

Conclusion

The MAI represents an historic opportunity in international cooperation. At stake is the strengthening of an important, strategic ally whose efforts to restore democracy, renew economic growth, and improve living standards are an inspiration the world around. The Treasury Department welcomes the opportunity to continue working with the Congress, our Executive Branch colleagues, our international partners, and the Government of the Philippines to ensure the success of this important initiative.

Attachments

Table 1 - Composition of Philippine Debt
Table 2 - Composition of Philippine Debt to the United States Government
Table 3 - Indicators of Comparative External Debt Burden

Table 1

THE PHILIPPINES

Composition of External Debt 1/

(U.S. $ Millions)

	Medium- and Long-Term	Short-Term	Total
Commercial Banks	11,541	3,570	15,111
Other Financial Institutions	345	21	366
Suppliers 2/	1,581	576	2,157
Multilateral Institutions	4,951		4,951
World Bank	2,609		2,609
Asian Development Bank	1,096		1,096
IMF	1,246		1,246
Official Export Credit Agencies 3/	1,443		1,443
Other Bilateral 4/	2,920		2,920
Japan	2,070		2,070
United States	568		568
Other	850		850
TOTAL	23,631	4,167	27,798

1/ Data as of September 1987; source = IMF
2/ Not guaranteed by official export credit agencies
3/ Guarantees/insurance on non-concessional credits
4/ Concessional terms

Memoranda

o Debt to commercial banks (as reported to the Bank for International Settlements) stood at $12.3 billion as of September 1988.

o Debt to U.S. banks (as reported to the Federal Reserve Board) totalled $4.2 billion as of September 1988.

March 6, 1989

Table 2

THE PHILIPPINES

Debt to U.S. Government 1/

(U.S. $ Millions)

Direct Credits	1,141.7
Under Foreign Assistance and Related Acts	311.7
Loans	310.5
OPIC-Investment Support	1.2
Arms Export Control Act	154.3
Agricultural Trade Development And Assistance	157.5
Currency Loans	0.5
Long-term Dollar Sales	157.0
Export Import Bank	479.2
Commodity Credit Corporation	39.0
Guarantees and Insurance	981.3
Under Foreign Assistance and Related Acts (OPIC-Investment Support)	325.4
Commodity Credit Corporation	3.7
Export Import Bank	652.2

1/ Data as of June 30, 1988

March 6, 1989

Table 3

SIX MAJOR DEBTORS

Trends in Key Economic Indicators

	GDP Growth (%)				Inflation (%)			
Country	Average 1982-85	1986	1987	1988	Average 1982-85	1986	1987	1988
Argentina	-1.2	5.5	1.6	1.5	452	90	131	300
Brazil	3.1	8.0	2.9	0.0	187	145	228	581
Chile	-1.6	5.7	5.4	6.3	22	17	22	11
Mexico	0.1	-4.0	1.4	0.5	71	86	132	128
Philippines	-1.7	1.1	5.7	6.0	23	1	4	8
Venezuela	-1.2	6.8	3.0	2.5	10	13	40	25

	Exports ($ billions)				Interest Payments Ratio 1/			
Country	Average 1982-85	1986	1987	1988	Average 1982-85	1986	1987	1988
Argentina	8.0	6.9	6.2	8.7	51	47	51	42
Brazil	23.7	22.4	26.2	33.0	43	40	32	30
Chile	3.8	4.2	5.2	7.1	42	38	27	22
Mexico	23.4	17.3	22.2	23.0	37	35	27	28
Philippines	5.0	4.8	5.7	6.8	26	24	24	23
Venezuela	15.4	8.6	10.0	10.5	23	32	22	24

	Debt/GDP Ratio (%)				Debt/Exports Ratio (%) 2			
Country	Average 1982-85	1986	1987	1988	Average 1982-85	1986	1987	1988
Argentina	72	74	78	70	453	568	670	512
Brazil	42	39	37	33	357	439	423	321
Chile	93	115	103	88	369	379	305	214
Mexico	57	78	75	58	317	426	361	328
Philippines	73	92	85	75	309	330	303	271
Venezuela	109	75	90	91	198	313	287	288

	Debt Service Ratio (%) 1/			
Country	Average 1982-85	1986	1987	1988
Argentina	101	106	146	93
Brazil	74	94	88	39
Chile	77	97	59	55
Mexico	63	65	42	44
Philippines	45	50	51	49
Venezuela	74	56	36	38

p Projection

1/ Ratio to exports of goods and services prior to debt relief
2/ Ratio to exports of goods and services.

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TREASURY NEWS

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

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FOR IMMEDIATE RELEASE
March 27, 1989

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DEPARTMENT OF THE TREASURY

CONTACT: Office of Financing
202/376-4350

TREASURY OFFERS $15,000 MILLION OF 17-DAY CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for approximately $15,000 million of 17-day Treasury bills to be issued April 3, 1989, representing an additional amount of bills dated October 20, 1988, maturing April 20, 1989 (CUSIP No. 912794 RU 0).

Competitive tenders will be received at all Federal Reserve Banks and Branches prior to 1:00 p.m., Eastern Standard time, Thursday, March 30, 1989. 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 Monday, April 3, 1989. 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

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FOR IMMEDIATE RELEASE
March 27, 1989

CONTACT: Office of Financing
202/376-4350

MAR [illegible]
DEPARTM

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,221 million of 13-week bills and for $ 7,204 million of 26-week bills, both to be issued on March 30, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing June 29, 1989			26-week bills maturing September 28, 1989		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	9.05% a/	9.39%	97.712	9.10% b/	9.67%	95.399
High	9.11%	9.46%	97.697	9.15%	9.73%	95.374
Average	9.10%	9.44%	97.700	9.12%	9.69%	95.389

a/ Excepting 3 tenders totaling $80,000.
b/ Excepting 5 tenders totaling $6,615,000.
Tenders at the high discount rate for the 13-week bills were allotted 68%.
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	$ 32,985	$ 32,985	$ 37,245	$ 37,245
New York	22,253,705	6,347,010	16,799,440	5,300,440
Philadelphia	23,630	23,630	24,725	24,725
Cleveland	74,410	60,410	40,455	40,455
Richmond	61,365	44,765	42,410	42,395
Atlanta	46,770	46,130	40,630	40,630
Chicago	1,046,690	46,690	993,150	373,650
St. Louis	53,215	28,315	43,905	36,125
Minneapolis	9,655	9,655	13,685	13,685
Kansas City	48,655	48,655	63,945	63,945
Dallas	42,510	32,510	43,105	38,655
San Francisco	939,910	86,910	1,126,850	677,460
Treasury	413,275	413,275	514,380	514,380
TOTALS	$25,046,775	$7,220,940	$19,783,925	$7,203,790
Type				
Competitive	$21,968,230	$4,142,395	$15,825,775	$3,245,640
Noncompetitive	1,219,435	1,219,435	1,171,750	1,171,750
Subtotal, Public	$23,187,665	$5,361,830	$16,997,525	$4,417,390
Federal Reserve	1,705,210	1,705,210	1,700,000	1,700,000
Foreign Official Institutions	153,900	153,900	1,086,400	1,086,400
TOTALS	$25,046,775	$7,220,940	$19,783,925	$7,203,790

1/ Equivalent coupon-issue yield.

TREASURY NEWS
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DEPARTMENT OF THE TREASURY

Text as Prepared
Embargoed for Release Upon Delivery
Expected at 8:15 a.m. CST

Remarks by
The Secretary of the Treasury
Nicholas F. Brady
Dallas Chamber of Commerce
Sheraton Park Central Hotel
Dallas, Texas
Tuesday, March 28, 1989

It is a pleasure to be here today to talk to you about an issue of great mutual concern--the crisis in the Savings and Loan industry. I am here today to report to you that the Bush Administration has acted swiftly and forcefully to resolve the crisis. Just eighteen days after his Inauguration President Bush announced a comprehensive plan to resolve the current problems in the Savings and Loan industry and to assure that the industry will be a strong, viable part of our nation's banking system in the future.

As the Treasury Department formulated the solution, we were guided by the President's directive to fix it now, fix it right and fix it for good. Our plan meets these requirements. Our plan addresses the current and long-term financial needs of the Savings and Loan industry. But it does not stop there. It also confronts the equally great need for substantial statutory and administrative reforms that will ensure that the industry can never again be driven into this kind of crisis. These reforms are absolutely essential to the future success of the S&L industry.

Let me stress, our plan is not a bailout. It is the fulfillment of the Federal Government's commitment to depositors. The plan relies on a combination of industry and taxpayer funds. We require that the industry provide as much financial support as is possible and still emerge a healthy competitive industry, once the insolvent S&Ls are taken care of.

The President has sent to the Congress legislation that will provide the necessary financing and enact the required reforms.

It is a truly comprehensive package--the draft legislation is 330 pages long. The analysis that backs it up is just as comprehensive and contains more numbers than the Dallas phone book. We are working with Congress for rapid passage of the legislation.

Part of our plan--the administrative action--is already underway. Since the President made his announcement in February, the FDIC has taken charge of over 100 insolvent S&Ls. This is a very important step. The damage that insolvent S&Ls cause extends far beyond their clients and their local communities. Insolvent institutions pay unrealistic interest rates to attract depositors, forcing solvent institutions to meet these rates to attract customers. Consequently, the cost of deposits is pushed to economically unsound levels for all institutions. We cannot permit this to continue. FDIC stewardship of insolvent S&Ls is a critical step, but the process can not be completed until Congress has passed and sent to the President the funding package that will enable the FDIC to complete the resolutions.

Let me assure you, during this interim period insured depositors remain fully protected, basic customer services have not changed, and each institution's employees continue to conduct the normal day to day operations of the institution. These thrifts are open, with deposits backed by the federal government, and ready to do business with their customers.

Despite the FDIC's swift action we continue to witness record withdrawal of funds from the S&L industry. And we will continue to see withdrawals as long as our plan is not enacted into law. The consequence of inaction affects us all. As deposits fall, revenues from insurance premiums--required to reduce the taxpayers burden--also fall. For every day of delay in enacting the President's legislation, the cost to the taxpayers increases. Currently, the cost of the solution is $20 million per day. Clearly it is in everybody's interest to have the Bush plan become law.

This is how we calculate the financing. The cost of the resolutions of insolvent S&Ls undertaken in previous years by FSLIC totals $40 billion. The cost of resolving currently insolvent S&Ls, as well as ones which may become insolvent during the next three years, is $50 billion. This $90 billion is to be provided by an equitable, and somewhat complex system of government funding and industry contributions.

Some have suggested that the resolution of the crisis would be expedited by a one-time, lump-sum appropriation of the necessary funds by the government. I strongly disagree. The taxpayers did not create this problem--there is no reason why they should have to shoulder the full burden of solving it. In addition to government funds, our plan requires the commitment of

S&L industry funds, which will finance the principal and pay a substantial portion of the interest on the $50 billion to be raised in the financial markets.

There is another reason not to try to force the taxpayer to absorb the full brunt of the financing: the intent and integrity of the Gramm-Rudman process--a process whose existence is owed in great part to the wisdom and courage of a Senator from this state. Gramm-Rudmam dictates that if the government does not meet voluntarily the mandated spending targets by a specified date, automatic, across-the-board spending cuts will be invoked. Concentrating this financial burden solely in this year's budget would mean that we would far exceed the Gramm-Rudman deficit reduction target. If we were to concentrate the financing for the S&L solution solely in this year's budget, we would sidestep this process. This would completely, and unnecessarily, render a sham the essential budgetary discipline of Gramm-Rudman. And it is important that we do not make a mockery of Gramm-Rudman. It is not only the law of the land, it is the wheelhorse of the fiscal discipline that will drive our deficit down. Meeting its deficit reduction targets is very important to the continued vitality of our economy.

Furthermore, it is important to our international economic standing that we meet and maintain the Gramm-Rudman deficit reduction procedure. Our foreign trading partners are very concerned about our ability to bring down the federal deficit, they are knowledgeable about our legislative system, and they are watching carefully to see if we keep our commitments. If we fail to honor Gramm-Rudman the effect on the financial markets could be to raise government borrowing rates. And if these rates increase by as little as ten basis points, the effect would be to overwhelm any cost savings achieved from having the U. S. Treasury directly borrow the funds to pay the cost of the S&L solution. Finally, if we open up the issue of exemptions to Gramm-Rudman, the one sure consequence will be delay in the passage of this legislation. We can not afford delay. If the debate over alternate financial plans takes even three weeks, the cost to the taxpayer goes up by $500 million. For all these reasons, the Bush financing plan is the best realistic approach to solving the S&L issue.

In addition to the financing required to solve current problems, our plan calls for an additional $33 billion over the next ten years to handle any future insolvencies and to put S&L deposit insurance on a sound footing. We will create a new Savings Association Insurance Fund whose funding will come from a combination of industry deposit insurance premiums and taxpayer funds. While most public and press commentary has centered on the $90 billion figure for insolvent S&Ls, we feel that the $33 billion is just as important, because it will help ensure that the S&Ls industry continues to be a prominent and robust player in our financial system. We are absolutely committed to the future of the S&L industry. And we've put money behind that commitment.

However, this goal cannot be attained by a strengthened insurance fund alone. Our reform package will play an indispensable role in achieving our goal.

In the past the Savings and Loan industry was treated like an undisciplined junior partner in our financial system; we demanded less and tolerated more. It had less regulation, lower capital requirements and less rigorous accounting rules. Frankly, many of them abused the freedom given to them. This must no longer be the case--the S&L industry has come of age. It is time for it to meet the standards demanded of a mature, sophisticated industry, standards that will ensure that it never again finds itself in the situation it currently faces. The events of the 1980's demonstrate that the goals of the regulator as an industry advocate and insurer inherently conflict. Our plan removes this conflict of interest by separating the FSLIC from the Federal Loan Home Bank Board and attaching it to the FDIC. This will create a strong, independent insurer with the over-arching mission to protect depositors and to maintain the integrity of the deposit insurance fund.

Our plan also requires that thrifts operate under the same accounting standards as commercial banks. And the plan gives regulators the tools to move quickly against any type of investment or other operating practices which they view as unsafe or unsound.

Some have suggested that the higher capital requirements will force out of business otherwise healthy S&Ls. This is highly unlikely. The industry is in better capital shape than many believe. First, fifty percent of all solvent S&Ls today meet the six percent capital standard. Second, while the solvent S&Ls would need $64 billion of capital to meet the six percent standard, today they already have $55 billion, or eighty-five percent of what they need. Third, the capital standard is not a make it or be liquidated standard. If a thrift has a realistic business plan and shows real progress toward reaching the standard, federal regulators have the authority to extend the time period for reaching the standard. Finally, agreements already reached between thrifts and their federal regulator to provide a longer period of time to reach the capital objective will be honored under the new system.

Our plan also requires that the thrift industry be subject to stricter regulations concerning the type of investments an S&L can make. It also increases the safety and soundness standards for the industry.

We are also going to clean out the fraud in the industry. We want the S&L industry restored to and worthy of the esteem it enjoyed from the public in the days when Jimmy Stewart was an American hero for operating a Savings and Loan. Our plan adds new enforcement authorities, and increases dramatically funding for law enforcement staff and prosecutions. Approximately $50 million per year will be authorized for three years for the Justice Department to fund a new national program to search out financial institution fraud. Maximum civil penalties will be raised to $1,000,000 per day, and maximum criminal penalties to 20 years in prison, with mandatory minimum sentencing.

Most owners and operators of Savings and Loan banks are honest, hard-working people. We owe it to them to remove the taint placed on the industry. And with your help and support, we will.

We in Washington are aware that people in Texas are concerned that federal officials will "dump" real estate held by insolvent S&L's on the local market. Congressman Steve Bartlett and Senator Phil Gramm have raised these concerns with us. They have forcefully represented your views. We understand the potential destructive effects on the local economies of wholesale dumping. Let me assure you that we intend to proceed very carefully with real estate sales. The government also has a vested interest in avoiding dumping and receiving the best possible price for the real estate. Every possible consideration will be given to the local circumstances; decisions will be evaluated and made with the best interests of everyone involved taken into consideration.

Without a doubt, the Savings and Loan crisis is a large and very difficult problem to solve. The Bush Administration has wasted no time in acting decisively to construct a far-reaching, long-lasting solution to the crisis. We did not act alone, we consulted widely--with industry experts, business leaders and members of Congress, in particular, with Chairman Henry Gonzalez of the House Banking Committee and Senator Don Riegle, Chairman of the Senate Banking Committee. We have no pride of authorship, we took good ideas wherever we found them and we believe this plan is the best result of our collective wisdom. Our proof lies in the fact that no one else has come forth with an alternative plan. However, the favorite Washington pastime of criticizing the President's plan without constructive alternatives has begun. These critiques call to mind the words of Teddy Roosevelt, who said:

> it is not the critic who counts--not the man who point out how the strong man stumbled or where the doer of deeds could have done better. The credit belongs to the man who is actually in the arena...who strives violently...and spends himself in a worthy cause---so that his place shall never be with those cold and timid souls who know neither victory nor defeat. (Pause.)

Or, as General George S. Patton said:

> A good plan, violently executed now, is better than a perfect plan next week.

Our plan has the support of the federal regulators--the Federal Reserve, the FDIC, the Federal Home Loan Bank Board and the Comptroller of the Currency. Many in Congress also support it. Now we need your support. I ask you to join with me and President Bush in calling on Congress to pass our legislation now, so that we can return the S&L industry to its previous vitality and stature. America needs a strong S&L industry, and we need your help to make it strong--working together we can achieve our goal.

TREASURY NEWS

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

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DEPARTMENT

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
March 28, 1989

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,400 million, to be issued April 6, 1989. This offering will result in a paydown for the Treasury of about $ 650 million, as the maturing bills are outstanding in the amount of $ 15,054 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 3, 1989. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated July 7, 1988, and to mature July 6, 1989 (CUSIP No. 912794 SH 8), currently outstanding in the amount of $16,747 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $ 7,200 million, to be dated April 6, 1989, and to mature October 5, 1989 (CUSIP No. 912794 SZ 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 6, 1989. 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 $ 1,976 million as agents for foreign and international monetary authorities, and $ 4,497 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.

TREASURY NEWS

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

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FOR IMMEDIATE RELEASE
March 28, 1989

CONTACT: Office of Financing
202/376-4350

MAR 30 8 55 AM '89

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $9,269 million of $27,183 million of tenders received from the public for the 2-year notes, Series X-1991, auctioned today. The notes will be issued March 31, 1989, and mature March 31, 1991.

The interest rate on the notes will be 9-3/4%. The range of accepted competitive bids, and the corresponding prices at the 9-3/4% rate are as follows:

	Yield	Price
Low	9.84%*	99.840
High	9.88%	99.769
Average	9.87%	99.787

*Excepting 5 tenders totaling $75,000.

Tenders at the high yield were allotted 50%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 78,030	$ 78,030
New York	23,535,180	7,525,170
Philadelphia	56,580	56,580
Cleveland	129,585	114,585
Richmond	127,340	111,840
Atlanta	87,965	82,315
Chicago	1,549,855	643,010
St. Louis	149,895	109,370
Minneapolis	55,300	55,300
Kansas City	174,310	171,560
Dallas	56,045	48,545
San Francisco	1,078,555	168,055
Treasury	104,395	104,395
Totals	$27,183,035	$9,268,755

The $9,269 million of accepted tenders includes $1,800 million of noncompetitive tenders and $7,469 million of competitive tenders from the public.

In addition to the $9,269 million of tenders accepted in the auction process, $1,230 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,500 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
March 29, 1989

CONTACT: Office of Financing
202/376-4350

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RESULTS OF AUCTION OF 4-YEAR NOTES

DEPARTMENT OF THE TREASURY

The Department of the Treasury has accepted $7,510 million of $26,086 million of tenders received from the public for the 4-year notes, Series N-1993, auctioned today. The notes will be issued March 31, 1989, and mature March 31, 1993.

The interest rate on the notes will be 9-5/8%. The range of accepted competitive bids, and the corresponding prices at the 9-5/8% rate are as follows:

	Yield	Price
Low	9.69%	99.789
High	9.70%	99.756
Average	9.70%	99.756

Tenders at the high yield were allotted 48%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 66,159	$ 64,159
New York	22,828,070	6,292,103
Philadelphia	43,215	43,215
Cleveland	91,676	91,676
Richmond	84,017	63,872
Atlanta	73,985	70,385
Chicago	1,296,707	266,538
St. Louis	104,142	78,965
Minneapolis	52,388	52,387
Kansas City	132,351	132,336
Dallas	42,792	37,687
San Francisco	1,233,020	279,300
Treasury	37,142	37,142
Totals	$26,085,664	$7,509,765

The $7,510 million of accepted tenders includes $1,419 million of noncompetitive tenders and $6,091 million of competitive tenders from the public.

In addition to the $7,510 million of tenders accepted in the auction process, $710 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $822 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

TREASURY NEWS

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ROOM 5310

MAR 31 8 55 '89

DEPARTMENT

FOR IMMEDIATE RELEASE March 30, 1989

Desiree Tucker Sorini
Appointed Deputy Assistant Secretary
for Public Affairs

Secretary of the Treasury Nicholas F. Brady today announced the appointment of Desiree Tucker Sorini to serve as Deputy Assistant Secretary for Public Affairs. Ms. Sorini will serve as the principal advisor to the Assistant Secretary for Public Affairs and Public Liaison on communicating Treasury policies and programs to the American public through the print and electronic media.

Prior to joining Treasury, Ms. Sorini had been Director of Public Affairs at the International Trade Administration in the Department of Commerce since 1986. From 1984 to 1986 she served as Press Secretary to Ambassador Clayton Yeutter during his tenure as United States Trade Representative. Previously, Ms. Sorini had been Special Assistant to the Director of the Women in Development Conference; Director of Fundraising for Tucker and Associates; and a marketing representative with the Xerox Corporation.

Ms. Sorini graduated in 1980 from Colorado State University with a bachelor of arts degree in Communications. She and her husband, Ronald Sorini, reside in Washington, D.C.

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MAR 31 8 55 AM '89

DEPARTMENT

FOR IMMEDIATE RELEASE March 30, 1989

Sarah M. Hildebrand Appointed Deputy Assistant Secretary for Public Liaison

Secretary of the Treasury Nicholas F. Brady today announced the appointment of Sarah McCray Hildebrand to serve as Deputy Assistant Secretary for Public Liaison, effective March 20, 1989. Ms. Hildebrand will serve as the principal advisor to the Assistant Secretary for Public Affairs and Public Liaison on communicating Treasury policies and programs to American businesses, consumers, and to state and local governments.

Before joining Treasury, Ms. Hildebrand had been Director of Congressional Affairs at the International Trade Administration in the Department of Commerce since 1987. Previously, she had served as a Congressional Liaison Officer at the Commerce Department and in managerial and organizational capacities in The White House and campaign politics. She came to Washington in the late 70's as a Legislative Assistant to Representative Dan Lungren of California.

She received a bachelor of arts degree from The College of William and Mary in Economics and Government in 1978 and was named to Outstanding Young Women of America the same year.

Ms. Hildebrand, a native of Evansville, Indiana, now resides in Alexandria, Virginia, with her husband, Bruce Hildebrand.

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DEPARTMENT OF THE TREASURY

Text as Prepared
Embargoed for Release Upon Delivery
Expected at 1 p.m. EST

Remarks by
The Secretary of the Treasury
Nicholas F. Brady
Greater New York Savings Bonds Committee
Plaza Hotel
New York, New York
March 30, 1989

Good afternoon and thank you for the opportunity to be with you today for the annual kickoff of the Savings Bond campaign. Thanks also to John B. Carter, President and Chief Executive Officer, The Equitable Financial Companies, for serving as 1989 Chairman for Greater New York. This is one of the most important geographic area campaigns in the nation. It has the greatest concentration of companies offering their employees the payroll savings plan.

Thanks to each of you for being here and joining the ranks of volunteers in the 1989 Savings Bonds campaign effort. Particular gratitude is due to the men and women on the dias, who - year in and year out - have given the Savings Bonds program the tremendous support of their time and talents. These volunteers have been instrumental in the success of the Savings Bonds program not only in New York but, to a great extent, throughout the rest of corporate America as well.

U.S. Savings Bonds make a significant contribution to financing the national debt. Because they are held on average about twice as long as marketable securities (approximately 7 years vs. 3.5 years), they provide a stable, reliable source of income to the government.

U.S. Savings Bonds are a more cost effective way for the Treasury to finance debt than are marketable securities. For every billion dollars sold, it is estimated that the Treasury (and thus U.S. taxpayers) saves $70 million. By selling over 7 1/4 billion dollars in bonds last year alone, this program saved the taxpayers over one-half billion dollars in financing costs.

Savings Bonds are also a major positive factor in encouraging saving and increasing the savings rate of Americans. They are easy to buy and widely available through the payroll savings plan offered by tens of thousands of companies and financial institutions.

In a time when increasing the nation's savings rate is among the Administration's highest priorities, the Savings Bonds program provides an important avenue for saving, particularly for the small saver. The payroll savings plan, which we are here to support, is the vehicle to those savings.

The reason for the bond program's continuing and growing success is that Savings Bonds are a good deal for everyone.

They are exempt from state or local income taxes, a particular advantage here in New York, and federal tax on the interest can be deferred until the bonds are cashed or mature.

Savings Bonds are safe -- backed by the full faith and credit of the United States. And because they are registered securities, they can be replaced if lost, stolen or destroyed.

Next year the program gains another benefit, the "College Savings Bonds," that will enhance the effectiveness of Savings Bonds as a means for parents to save for the education of their children by exempting the earned interest from federal income tax when the bonds are used to pay for the costs of a higher education.

I urge all of you to support the payroll savings bonds in your companies. It is an opportunity for your company to offer a quality benefit to your employees. Savings Bonds are both good for your employees and for our country.

Now I would like to turn to some other issues that are important to our country -- ones that President Bush is determined to face forthrightly. The President has told each of us in the Cabinet that he wants us to face the issues squarely and to solve the problems facing our country.

For us at the Treasury, this has meant tackling some of the biggest financial problems ever to face our nation.

First of all, the President has come forward with a budget that will meet the Gramm-Rudman deficit reduction targets without increasing taxes. Some predicted his budget would be called "dead on arrival", but no one is saying that now. The

President's budget is forming the basis for serious negotiations with the Congress.

We also have succeeded in changing the way Washington looks at the word "cut". In the past, budget discussions have been predicated on a baseline that is last year's budget adjusted upward for inflation and new entrants to programs. Any decline from that level, even though the resulting spending would still be higher than last year's, was termed a "cut".

Now, in doing your family budget, it would be nice if you could automatically increase spending to cover inflation and a new child, but you can't, and neither can the federal government. So we're conducting this year's budget negotiations with last year's spending level as the baseline.

It is still too early to know exactly how the budget negotiations will come out, but I do know this: We will meet the Gramm-Rudman target of a deficit below $100 billion next year, one way or another. We will do so because we must. Our hopes for continued, non-inflationary growth depend on it. And our developed and developing country partners in the world economy are depending on us to do it.

The second big issue we have tackled is Third World debt. This is perhaps the most difficult of all the economic problems, because it is so large and because a "made in America" solution just isn't possible. Too many countries are involved for that.

Nevertheless, we have put forward some important new ideas for revitalizing our international debt strategy. We believe that progress can be made in addressing and reducing the problem by shifting the focus of our efforts in the direction of debt reduction. We will continue the fundamental principles of the current approach -- advising economic reforms and encouraging growth in debtor nations. But this new emphasis will help reduce the overall debt burden, rather than adding to it, as we have been doing year after year.

Finally, I want to turn to a topic of immediate concern to all of us: the crisis facing the savings and loan industry.

The Bush Administration has acted swiftly and forcefully to resolve the crisis. Just eighteen days after his Inauguration President Bush announced a comprehensive plan to resolve the current problems in the Savings and Loan industry and to assure that the industry will be a strong, viable part of our nation's banking system in the future.

As the Treasury Department formulated the solution, we were guided by the President's directive to fix it now, fix it right and fix it for good. Our plan meets these requirements. Our plan addresses the current and long-term financial needs of the Savings and Loan industry. But it does not stop there. It also confronts the equally great need for substantial statutory and administrative reforms that will ensure that the industry can never again be driven into this kind of crisis. These reforms are absolutely essential to the future success of the S&L industry.

The President has sent to the Congress legislation that will provide the necessary financing and enact the required reforms. It is a truly comprehensive package--the draft legislation is 330 pages long. The analysis that backs it up is just as comprehensive and contains more numbers than the Manhattan phone book. We are working with Congress for rapid passage of the legislation.

Part of our plan--the administrative action--is already underway. Since the President made his announcement in February, the FDIC has taken charge of over 100 insolvent S&Ls. This is a very important step. Insolvent institutions pay unrealistic interest rates to attract depositors, forcing solvent institutions to meet these rates to attract customers. Consequently, the cost of deposits is pushed to economically unsound levels for all institutions. FDIC stewardship of insolvent S&Ls is a critical step, but the process can not be completed until Congress has passed and sent to the President the funding package that will enable the FDIC to complete the resolutions.

Let me assure you that during this interim period insured depositors remain fully protected. The thrifts remain open, ready to do business with their customers, wit deposits fully backed by the federal government.

Despite the FDIC's swift action we continue to witness record withdrawal of funds from the S&L industry. And we will continue to see withdrawals as long as our plan is not enacted into law. For every day of delay in enacting the President's legislation, the costs to the taxpayers increase. Currently, the cost of the solution is $20 million per day. Clearly it is in everybody's interest to have the Bush plan become law and become law soon.

This is how we calculate the financing. The cost of the resolutions of insolvent S&Ls undertaken in previous years by FSLIC totals $40 billion. The cost of resolving currently insolvent S&Ls, as well as ones which may become insolvent during the next three years, is an additional $50 billion. This $90 billion is to be provided by an equitable, and somewhat complex system of government funding and industry contributions.

Some have suggested that the resolution of the crisis would be expedited by a one-time, lump-sum appropriation of the necessary funds by the government. I strongly disagree. The taxpayers did not create this problem--there is no reason why they should have to shoulder the full burden of solving it. In addition to government funds, our plan requires the commitment of S&L industry funds, which will finance the principal and pay a substantial portion of the interest on the $50 billion to be raised in the financial markets to solve the problem.

There is another reason not to try to force the taxpayer to absorb the full brunt of the financing: the intent and integrity of the Gramm-Rudman process. Concentrating this financial burden solely in this year's budget would mean that we would far exceed the Gramm-Rudman deficit reduction target. This would completely, and unnecessarily, render a sham the essential budgetary discipline of Gramm-Rudman.

And it is important that we do not make a mockery of Gramm-Rudman. It is not only the law of the land, it is the wheelhorse of the fiscal discipline that will drive our deficit down. Meeting its deficit reduction targets is very important to the continued vitality of our economy and to our international economic standing. Our foreign trading partners are very concerned about our ability to bring down the federal deficit; they are knowledgeable about our legislative system, and they are watching carefully to see if we keep our commitments.

If we fail to honor Gramm-Rudman the effect on the financial markets could be to raise government borrowing rates. And if these rates increase by as little as ten basis points, the effect would be to overwhelm any cost savings achieved from having the U. S. Treasury directly borrow the funds to pay the cost of the S&L solution.

Finally, if we open up the issue of exemptions to Gramm-Rudman, the one sure consequence will be delay in the passage of this legislation. We can not tolerate delay. If the debate over alternate financial plans takes even three weeks, the cost to the taxpayer goes up by $500 million. For all these reasons, the Bush financing plan is the best realistic approach to solving the S&L issue.

In addition to the financing required to solve current problems, our plan calls for an additional $33 billion over the next ten years to handle any future insolvencies and to put the S&L deposit insurance fund on a sound basis. We will create a new Savings Association Insurance Fund whose funding will come from a combination of industry deposit insurance premiums and taxpayer funds. We are absolutely committed to the future of the S&L industry. And we've put money behind that commitment.

However, this goal cannot be attained by a strengthened insurance fund alone. Our reform package will play an indispensable role in achieving our goal.

In the past the Savings and Loan industry was treated like an undisciplined junior partner in our financial system; we demanded less and tolerated more. It had less regulation, lower capital requirements and less rigorous accounting rules. This must no longer be the case--the S&L industry has come of age. It is time for it to meet the standards demanded of a mature, sophisticated industry, standards that will ensure that it never again finds itself in the situation it currently faces.

The events of the 1980's demonstrate that the goals of the regulator as an industry advocate and insurer inherently conflict. Our plan removes this conflict of interest by separating the FSLIC from the Federal Loan Home Bank Board and attaching it to the FDIC. This will create a strong, independent insurer with the over-arching mission to protect depositors and to maintain the integrity of the deposit insurance fund.

Our plan also requires that thrifts operate under the same accounting standards as commercial banks. And the plan gives regulators the tools to move quickly against any type of investment or other operating practices which they view as unsafe or unsound.

Some have suggested that the higher capital requirements will force out of business otherwise healthy S&Ls. This is highly unlikely. The industry is in better capital shape than many would have you believe. First, fifty percent of all solvent S&Ls today meet the six percent capital standard. Second, while the solvent S&Ls would need $64 billion of capital to meet the six percent standard, today they already have $55 billion, or eighty-five percent of what they will need. Third, the capital standard is not a "make it or be liquidated" standard. If a thrift has a realistic business plan and shows real progress toward reaching the standard, federal regulators have the authority to extend the time period for reaching the standard.

Without a doubt, the Savings and Loan crisis is a large and very difficult problem to solve. The Bush Administration has wasted no time in acting decisively to construct a far-reaching, long-lasting solution to the crisis. We did not act alone; we consulted widely -- with industry experts, business leaders and members of Congress. We took good ideas wherever we found them and we believe this plan is the best result of our collective wisdom. Our proof lies in the fact that no one else has come forth with an alternative plan. However, the favorite Washington pastime of criticizing the President's plan without constructive alternatives has begun. These critiques call to mind the words of Teddy Roosevelt, who said:

> It is not the critic who counts -- not the man who points out how the strong man stumbled or where the doer of deeds could have done better. The credit belongs to the man who is actually in the arena ... who strives ... and spends himself in a worthy cause -- so that his place shall never be with those cold and timid souls who know neither victory nor defeat.

Or, as General George S. Patton said:

> A good plan, violently executed now, is better than a perfect plan next week.

Our plan has the support of the federal regulators--the Federal Reserve, the FDIC, the Federal Home Loan Bank Board and the Comptroller of the Currency. Many in Congress also support it. Now we need your support. I ask you to join with me and President Bush in calling on Congress to pass our legislation now, so that we can return the S&L industry to its previous vitality and stature. America needs a strong S&L industry, and we need your help to make it strong -- working together we can achieve our goal.

TREASURY NEWS

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March 30, 1989

CONTACT: Office of Financing
202/376-4350

MAR 31 8 55 AM '89

DEPARTMENT OF THE

RESULTS OF TREASURY'S AUCTION OF 17-DAY CASH MANAGEMENT BILLS

Tenders for $ 15,106 million of 17-day Treasury bills to be issued on April 3, 1989, and to mature April 20, 1989, were accepted at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low	9.63%	9.81%	99.545
High	9.65%	9.84%	99.544
Average	9.64%	9.81%	99.545

Tenders at the high discount rate were allotted 6%.

TOTAL TENDERS RECEIVED AND ACCEPTED BY FEDERAL RESERVE DISTRICTS (In Thousands)

Location	Received	Accepted
Boston	$ --	$ --
New York	72,878,000	15,003,000
Philadelphia	--	--
Cleveland	--	--
Richmond	1,000	--
Atlanta	--	--
Chicago	6,605,000	91,200
St. Louis	--	--
Minneapolis	--	--
Kansas City	--	--
Dallas	--	--
San Francisco	1,490,000	12,000
TOTALS	$80,974,000	$15,106,200

An additional $400,000 thousand of the bills will be issued to foreign official institutions for new cash.

federal financing bank NEWS
WASHINGTON, D.C. 20220

Press 566-2041
FFB 566-2468

NH 5310

FOR IMMEDIATE RELEASE March 31, 1989

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FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of September 1988.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $146.2 billion on September 30, 1988, posting a decrease of $3.7 billion from the level on August 31, 1988. This net change was the result of decreases in holdings of agency debt of $251.6 million, in agency assets of $900.2 million, and in agency-guaranteed debt of $2,507 million. FFB made 43 disbursements during September.

During fiscal year 1988, FFB holdings of obligations issued, sold or guaranteed by other Federal agencies posted a net decrease of $11,099 million from the level on September 30, 1987. This change was the result of decreases in agency assets of $6,630.2 million and in agency guaranteed debt of $4,954.1 million. Holdings of agency debt increased by $484.7 million.

The Omnibus Budget Reconciliation Act of 1987 authorized rural electric borrowers to prepay up to $2.0 billion of their Rural Electrification Administration-guaranteed loans from the FFB, without premium or penalty, using REA-guaranteed private market financings. Pursuant to this Act, FFB received prepayments of $2.0 billion in FY 1988. FFB suffered an associated loss of $473 million.

The Continuing Appropriations Resolution for 1988 allowed FFB borrowers under foreign military sales (FMS) guarantees to prepay at par their debt with interest rates of 10 percent or higher. Pursuant to this Resolution, FFB received FMS prepayments of $2.5 billion in FY 1988. FFB suffered an associated loss of $814 million.

Attached to this release are tables presenting FFB September loan activity and FFB holdings as of September 30, 1988.

FEDERAL FINANCING BANK

SEPTEMBER 1988 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
AGENCY DEBT					
EXPORT-IMPORT BANK					
Note #74	9/1	$ 19,000,000.00	9/01/98	9.180%	9.077% qtr.
TENNESSEE VALLEY AUTHORITY					
Advance #942	9/6	260,000,000.00	9/16/88	7.574%	
Advance #943	9/12	274,000,000.00	9/19/88	7.638%	
Advance #944	9/16	249,000,000.00	9/23/88	7.527%	
Advance #945	9/19	224,000,000.00	9/26/88	7.502%	
Advance #946	9/23	233,000,000.00	10/01/88	7.559%	
Advance #947	9/26	230,000,000.00	10/01/88	7.586%	
Advance #948	9/28	19,000,000.00	10/03/88	7.697%	
Advance #949	9/30	124,000,000.00	10/03/88	7.653%	
AGENCY ASSETS					
Rural Electrification Administration - Certificates of Beneficial Ownership					
Certificate #28	9/30	68,000,000.00	12/31/88	7.664%	
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT					
Community Development					
*Brownsville, TX	9/1	326,450.25	9/01/89	8.410%	8.587% ann.
RURAL ELECTRIFICATION ADMINISTRATION					
New Hampshire Elec. #270	9/7	386,000.00	10/01/90	8.607%	8.516% qtr.
*Wolverine Power #182A	9/9	2,170,000.00	1/02/90	8.355%	8.270% qtr.
*Wolverine Power #183A	9/9	2,686,000.00	1/02/90	8.355%	8.270% qtr.
*Wabash Valley Power #206	9/12	1,805,000.00	1/03/17	9.085%	8.984% qtr.
*Wabash Valley Power #104	9/12	5,055,000.00	1/03/17	9.085%	8.984% qtr.
Old Dominion Elec. #267	9/15	2,408,000.00	10/01/90	8.484%	8.396% qtr.
Alabama Electric Coop. #287	9/19	4,380,000.00	12/31/15	9.099%	8.998% qtr.

*maturity extension

FEDERAL FINANCING BANK

SEPTEMBER 1988 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
RURAL ELECTRIFICATION ADMINISTRATION (continued)					
Brazos Electric #230	9/29	$ 1,000,000.00	1/03/23	9.259%	9.154% qtr.
Brazos Electric #332	9/29	2,359,000.00	12/31/19	9.248%	9.143% qtr.
Tex-La Electric Coop. #329	9/30	2,037,000.00	10/01/90	8.660%	8.568% qtr.
Kamo Electric Coop. #209	9/30	6,145,000.00	10/01/90	8.660%	8.568% qtr.
*Wolverine Power Supply #182A	9/30	4,003,000.00	1/02/90	8.410%	8.323% qtr.
*Wolverine Power Supply #183A	9/30	4,905,000.00	1/02/90	8.410%	8.323% qtr.
*Colorado Ute-Electric #8A	9/30	7,750,568.80	10/01/90	8.649%	8.557% qtr.
*Colorado Ute-Electric #78A	9/30	2,385,329.68	10/01/90	8.654%	8.562% qtr.
*Colorado Ute-Electric #78A	9/30	1,031,398.38	10/01/90	8.650%	8.558% qtr.
*Colorado Ute-Electric #78A	9/30	3,194,017.12	10/01/90	8.650%	8.558% qtr.
*Colorado Ute-Electric #203A	9/30	7,537,000.00	10/01/90	8.655%	8.563% qtr.
*Colorado Ute-Electric #96A	9/30	3,066,000.00	10/01/90	8.654%	8.562% qtr.
*Colorado Ute-Electric #297	9/30	6,345,673.20	10/01/90	8.655%	8.563% qtr.
*Colorado Ute-Electric #276	9/30	1,668,848.48	10/01/90	8.655%	8.563% qtr.
*Colorado Ute-Electric #297	9/30	4,079,985.36	10/01/90	8.655%	8.563% qtr.
*Colorado Ute-Electric #297	9/30	1,276,512.22	10/01/90	8.655%	8.563% qtr.
*Allegheny Elec. Coop. #304	9/30	247,000.00	10/01/90	8.655%	8.563% qtr.
*United Power Assoc. #86A	9/30	1,239,545.43	10/01/90	8.650%	8.558% qtr.
*Basin Electric #87A	9/30	19,085,714.32	10/01/90	8.654%	8.562% qtr.
*Wabash Valley Power #206	9/30	295,000.00	10/01/90	8.660%	8.568% qtr.
*Chugach Electric #257	9/30	585,000.00	12/31/18	9.176%	9.073% qtr.
SMALL BUSINESS ADMINISTRATION					
State and Local Development Company Debentures					
Mahoning Valley Econ. Dev. Corp.	9/7	108,000.00	9/01/03	9.073%	
Quaker State CDC Inc.	9/7	231,000.00	9/01/08	9.116%	
Metropolitan Growth & Dev. Corp.	9/7	271,000.00	9/01/08	9.116%	
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-88-12	9/30	807,705,721.13	12/30/88	7.713%	

*maturity extension

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	September 30, 1988	August 31, 1988	Net Change 9/1/88-9/30/88	FY '88 Net Change 10/1/87-9/30/88
Agency Debt:				
Export-Import Bank	$ 10,957.6	$ 11,226.2	$ -268.6	$ -1,505.8
NCUA-Central Liquidity Facility	118.1	118.1	-0-	6.8
Tennessee Valley Authority	17,131.0	17,114.0	17.0	745.0
U.S. Postal Service	5,592.2	5,592.2	-0-	1,238.8
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sub-total*	33,799.0	34,050.6	-251.6	484.7
Agency Assets:				
Farmers Home Administration	58,496.0	59,464.0	-968.0	-6,513.0
DHHS-Health Maintenance Org.	79.5	79.3	0.3	-4.4
DHHS-Medical Facilities	96.4	96.4	-0-	-5.9
Overseas Private Investment Corp.	-0-	-0-	-0-	-0.7
Rural Electrification Admin.-CBO	4,139.2	4,071.2	68.0	-102.0
Small Business Administration	15.4	15.8	-0.5	-4.2
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sub-total*	62,826.5	63,726.7	-900.2	-6,630.2
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	16,011.7	18,584.2	-2,572.5	-3,152.3
DEd.-Student Loan Marketing Assn.	4,910.0	4,940.0	-30.0	-30.0
DOE-Geothermal Loan Guarantees	50.0	50.0	-0-	50.0
DHUD-Community Dev. Block Grant	318.1	321.8	-3.8	-6.2
DHUD-New Communities	-0-	-0-	-0-	-30.6
DHUD-Public Housing Notes +	2,037.0	2,037.0	-0-	-37.3
General Services Administration +	387.5	387.5	-0-	-8.0
DOI-Guam Power Authority	32.1	32.6	-0.5	-1.1
DOI-Virgin Islands	26.6	26.6	-0-	-0.6
NASA-Space Communications Co. +	898.8	898.8	-0-	90.2
DON-Ship Lease Financing	1,758.9	1,758.9	-0-	-29.4
Rural Electrification Administration	19,205.3	19,224.8	-19.5	-1,991.6
SBA-Small Business Investment Cos.	632.7	670.7	-38.0	-107.9
SBA-State/Local Development Cos.	870.9	874.3	-3.4	-28.9
TVA-Seven States Energy Corp.	2,162.4	1,999.7	162.7	338.7
DOT-Section 511	46.2	48.3	-2.1	-9.2
DOT-WMATA	177.0	177.0	-0-	-0-
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sub-total*	49,525.1	52,032.1	-2,507.0	-4,954.1
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grand total*	$ 146,150.5	$ 149,809.3	$ -3,658.8	$ -11,099.6

*figures may not total due to rounding
+does not include capitalized interest

TREASURY NEWS

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

ROOM 5310

FOR RELEASE AT 12:00 NOON
March 31, 1989

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 $ 9,000 million of 364-day Treasury bills to be dated April 13, 1989, and to mature April 12, 1990 (CUSIP No. 912794 TZ 7). This issue will result in a paydown for the Treasury of about $ 50 million, as the maturing 52-week bill is outstanding in the amount of $ 9,062 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 6, 1989.

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 13, 1989. In addition to the maturing 52-week bills, there are $ 14,724 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 $ 1,959 million as agents for foreign and international monetary authorities, and $ 6,433 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 $ 360 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 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.

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