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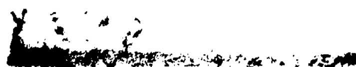

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Department of the Treasury

PRESS RELEASES

Numbers not used are JS-4329 and HP-15.

June 19, 2006
JS-4326

Statement of Deputy Treasury Secretary Robert Kimmitt on International Compact for Iraq

Last Friday, the United Nations agreed to the request of the Government of Iraq to work together on an International Compact for Iraq. We welcome and applaud the UN's active participation in this important initiative.

We commend Iraq for its commitment, as part of this Compact, to take a series of steps to achieve objectives in economic and reconstruction areas. In exchange, we expect the international community will provide sustained political and economic support to help them achieve these goals.

As President Bush pledged last week following meetings at Camp David, the United States is prepared to support this endeavor by working closely with the Government of Iraq, the UN, the International Financial Institutions, and partners in Europe, Asia and the Middle East, to help the Iraqis secure support for their new government.

June 20, 2006
js-4327

Statement of Assistant Secretary for International Affairs Clay Lowery Before the Senate Committee on Banking, Housing, and Urban Affairs On Reauthorization of the Ex-Im Bank

Chairman Shelby, Ranking Member Sarbanes, and members of the committee, thank you for the opportunity to discuss the reauthorization of the Export-Import Bank of the United States (Ex-Im Bank). I am pleased to be here with Acting Ex-Im Bank Chairman James Lambright because we are in total agreement on the importance of a strong Ex-Im Bank.

This Administration believes that, given a level playing field, U.S. exporters can compete with anyone in the world. As the lead U.S. Government agency on international economic and financial policy, Treasury leads the U.S. delegation to the OECD export credit negotiations, which are intended to establish that level playing field. Working closely with Ex-Im Bank and other U.S. Government financing agencies, we have successfully developed multilateral rules to reduce or eliminate the use of foreign export financing subsidies. These rules help to protect all U.S. exporters by ensuring that the competition for export sales is driven by price, quality, and service -- and not by unfair government financing. Equally important, these OECD rules protect U.S. taxpayers from having to pay for a subsidy program that would be necessary to counter foreign subsidy programs in the absence of these rules.

Export Financing and the Role of the OECD Arrangement

The OECD members that negotiate these multilateral financing rules are referred to as the Participants to the Arrangement for Officially Supported Export Credits (the Participants; the Arrangement). The Participants are those governments which provide the vast bulk of export financing for capital goods to developing countries. The Arrangement rules are critical to ensuring that the export financing provided by governments promotes market principles, a level playing field, and transparency. As these rules apply to all sources of official export financing, policy agencies such as finance and economics ministries represent their governments among the Participants. In addition to Treasury and Ex-Im Bank, the U.S. delegation includes the Departments of Commerce and State, USTR, USAID, the Trade and Development Agency, and any other agency whose programs or policy role might be affected by negotiations.

Export subsidies are bad economic policy and very costly to taxpayers. They close markets to competition and reduce global economic growth. By distorting trade flows, subsidies also distort the global allocation of resources and reduce international economic efficiency. Exporters who become dependent on tied aid subsidies become less efficient and unable to compete on market terms.

Moreover, using subsidies for export promotion is ultimately self-defeating because when one nation uses subsidy programs to gain a competitive advantage, others naturally follow suit to protect their interests. This inevitably leads to an export subsidy race which harms the international economic system and severely undermines or reverses the gains from trade. This is why successive Administrations have worked in the OECD to negotiate a trade finance environment driven by market forces in which all U.S. exporters can compete.

The Arrangement complements the WTO anti-subsidy rules. The WTO does not restrict the use of aid subsidies -- tied or untied -- because resource transfers from

rich to poor countries are important for the latter's development. The U.S. uses the Arrangement to ensure that aid-financed subsidies are really development aid and not export promotion in disguise.

Aid, tied or untied, is normally in the form of official development assistance (ODA) offered by a donor's development ministry and can be in the form of grants or credits. However, tied aid also is a form of export subsidy in which financing is formally linked to the purchase of goods and services from donor-country firms.

The U.S. offers tied aid through USAID, as part of the "Buy America" mandate. However, U.S. tied aid is usually in the form of grants which, dollar-for-dollar, distort trade far less than credits and provide greater assistance to developing country recipients.

Many other OECD donors use tied and untied aid credits in order to leverage more exports while reducing the budgetary cost of aid and thereby increase domestic political support for their aid programs. Before the Arrangement, competitive economic and political pressures resulted in many foreign tied aid credits being de facto export promotion. Since tied aid credit terms are more favorable to the borrower than standard export credit terms, tied aid distorts trade flows in favor of the tied aid provider's firm when the two forms of financing compete.

Under the rules, tied aid is now focused on the poorer countries - those with per capita incomes below $3,255 annually. Wealthier countries like Mexico, Korea and Malaysia are no longer eligible for tied aid. Tied aid is now virtually non-existent in major projects for power (thermal and hydro), oil and gas pipelines, telecommunications, air traffic control equipment, industry and manufacturing. This has enabled U.S. exporters to compete for contracts in these commercial sectors without the concern of confronting tied aid. Instead, tied aid now is used primarily for what are generally regarded as bona fide development projects in sectors such as health, education, water, sanitation, and roads.

Recent Negotiating Successes

During Ex-Im Bank's 2002 reauthorization, Treasury reported on the success of disciplining tied aid use and the remaining challenges associated with two other foreign financing practices that distort trade and threaten the level playing field that we seek - untied aid and market windows. Since that testimony, Treasury has continued its work to address these issues in the OECD. (Efforts were highlighted in two reports to Congress in June 2004.) I am pleased to report that significant progress has been made on all fronts, and, as Ex-Im Bank's latest Competitiveness Report shows, neither untied aid nor market windows pose the same challenge that they did in 2002.

Untied aid is aid that may not be formally linked to donor country procurement. Untied aid typically is used for non-commercial projects with a development impact. However, without formal OECD rules on what procedures, practices, and procurement results constitute untied aid for the purposes of exempting it from the tied aid disciplines, donor governments can use untied aid to circumvent the tied aid rules agreed to by the OECD members in 1992 and distort trade in favor of the donor. Examples include requiring aid recipients to use donor-country firms for design and engineering work or requiring a donor-country firm to run the bidding process, thereby creating a de facto bias toward the firms of that country.

Over the last few years, Treasury negotiated an agreement in the OECD that members would stop offering tied aid for design and engineering studies for projects that will then be financed with untied aid. We firmly believe that this practice provided an unfair technical advantage to donor country firms when bidding for untied aid projects.

In addition, in January 2005, following intensive bilateral discussions with the EC and Japan (the two largest untied aid donors) and a Treasury-led initiative in the G-7, a ground-breaking OECD agreement was reached. This agreement requires that untied aid donors notify the OECD of projects and bidding information 30 days in

advance of the start of the bidding process. We believe that this will provide valuable information to U.S. exporters to help them compete effectively for untied aid projects that have averaged $8 billion a year since 1993 and are currently rising. Moreover, donor governments agreed to maintain a minimum bidding period of 45 days to further facilitate participation by U.S. and other exporters. The U.S. makes this project and bidding information available on the Commerce Department's website at web.ita.doc.gov/sif/untied.nsf/.

Furthermore, to ensure that donor governments treat foreign bidders fairly, donors will report the outcome of untied aid bids to the OECD on an annual basis. We will review carefully the results of the transparency agreement later this year to confirm whether U.S. exporters are winning a fair share of these projects. If not, and this new transparency shows that untied aid continues to distort trade, the data will provide a credible foundation for the U.S. to request OECD negotiations for comprehensive rules for untied aid.

We also have seen some progress on disciplining market windows since the Ex-Im 2002 reauthorization. Market windows are quasi-official institutions that support national exports, but because they purport to operate as private sector actors, they are not subject to any transparency or discipline concerning the terms and conditions of their financing. Market windows have the ability to offer financing on better terms than either the private markets or export credit agencies. The two largest market windows are KfW of Germany and EDC of Canada.

Following extensive but inconclusive OECD and bilateral discussions on the issue, EDC seems to be voluntarily shifting its activities toward non-export credit support. KfW has been subjected to an EC-mandated separation of its official and commercial business. We expect this action to result in far greater transparency and market-like discipline on its export financing function. While the potential certainly remains that either institution could offer terms that undercut the OECD rules and the private market, current trends show that significant progress is being made. Nevertheless, Treasury and Ex-Im Bank will continue to monitor the situation closely.

Finally, our success in disciplining tied aid continues since our last testimony. The benefits to the U.S. of negotiating and implementing international rules on the use of tied aid continue to be dramatic. Prior to 1992 -- before the OECD tied aid rules came into effect -- donors offered $10-$12 billion of tied aid annually and the resulting U.S. export losses were estimated to be $2 billion or more per year. Since 1992, tied aid credits have averaged only $4 billion annually - a minimum reduction of 60 percent - and therefore have been cumulatively reduced by about $80 billion.

Treasury estimates that U.S. exports of capital goods are higher by at least $1 billion a year as the result of tied aid rules that reduce trade distortions. Furthermore if the U.S. had competed for these additional exports by using tied aid, the War Chest would have required roughly $300 million annually in additional appropriations - a cumulative savings of $4 billion for U.S. taxpayers since 1993.

The War Chest

Continued success in the OECD rules based approach to tied aid as well as untied aid and market windows is dependent in large part on Treasury's ability to use the War Chest as a policy tool. Removing that role would undermine U.S. credibility and deter cooperation from our OECD partners. More importantly, this would seriously weaken the U.S. position in any effort to negotiate new rules, such as those for untied aid, and to enforce the existing rules. A weakened U.S. position in the export financing disciplines arena will almost certainly raise the cost to the U.S. taxpayer of protecting U.S. exporters against unfair foreign subsidies.

Congress created the tied aid War Chest in 1986 in order to provide the Administration with leverage to negotiate economically and developmentally sound tied aid rules in the OECD. The War Chest was also intended as a means to enforce these rules and leverage additional market-opening negotiations, as necessary. As a result of Treasury-led negotiations, the comprehensive set of tied

aid rules outlined earlier took effect in 1992, providing a better balance between the development and commercial objectives of the OECD donor governments.

The selective use of War Chest funds to enforce tied aid rules has worked exceedingly well in reducing trade distortions and leveling the playing field for U.S. exporters at virtually no cost to the U.S. taxpayer. As a result of this success, foreign tied aid programs have been pushed out of most areas of commercial competition, and the demand by U.S. exporters for tied aid matching has declined dramatically. Despite this decline in demand, the War Chest remains an important tool in the U.S. policy arsenal. Treasury uses the War Chest as leverage not only to enforce existing rules on tied aid and other trade-distorting activities but also to negotiate new rules as needed -- as may be the case for untied aid.

While we refer to tied aid "rules," they are not legally binding. They are voluntary, as are all the export credit rules under the Arrangement. Other donors have voluntarily addressed U.S. concerns and agreed to stop or limit their financing for the types of capital projects that the U.S. has argued should be ineligible for tied aid credits. The tied aid projects that our OECD partners are now financing are specifically permitted under the rules and are less distorting to trade.

Given the voluntary nature of the Arrangement, the U.S. must be careful how it decides to implement its matching policy. An insufficiently judicious policy on use of our tied aid would give our OECD partners an incentive to abandon the Arrangement and expand the scope of their tied aid programs to include larger, more commercial projects. This would create a vicious cycle of increasing tied aid from all parties and generating a larger demand for the War Chest. The gains that the successive Administrations have worked to achieve over the last fifteen years would quickly unwind.

This is not to suggest that the U.S. should never match any tied aid offers. Some tied aid projects pass the OECD eligibility test but can still create longer-term advantages for foreign exporters by setting technical standards, providing brand name recognition, allowing maintenance and repair capabilities to become established, etc. Any of these elements can tilt the playing field for future commercial sales. War Chest matching is a vital tool to ensure that tied aid is not used, intentionally or unintentionally, to tilt longer-term competitive conditions against U.S. exporters. Treasury fully supports using the War Chest in such instances.

In addition, the tied aid rules have two systemic shortcomings. The first relates to small projects below $3 million and the second relates to projects in the railway and mass transit sectors. Small projects are exempt from the tied aid rules in order to minimize the administrative burden of the rules. However, some OECD members used this exemption aggressively to finance small commercial projects in violation of the spirit of the rules. In response to this, Treasury has been clear that it automatically supports using the War Chest to match small commercial projects.

Passenger railway and mass transit projects also meet the eligibility rules because they are highly capital intensive, meaning their costs are normally not recouped from their own earnings over the term of an export credit agency (ECA) loan. In addition, their revenues are limited because they are often unable to charge the full economic value of their services. Therefore, Treasury has been clear that such projects are frequently good candidates for War Chest matching, and just such a matching offer was approved earlier this year.

In conclusion, this policy-based approach to matching foreign tied aid offers allows us to protect U.S. exporters from unfair use of tied aid, while recognizing the legitimate development objectives of foreign aid programs. It is in the interest of U.S. exporters and taxpayers that the War Chest remain a tool to leverage the broader, rules-based approach. The current Treasury/Ex-Im Bank tied aid principles and procedures were put in place in close cooperation with Congress in 2002, are working well, and have not produced a single disagreement between the two agencies.

I appreciate the opportunity to appear before you today and look forward to your questions. Thank you.

-30-

June 20, 2006
2006-6-20-13-14-18-27254

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $66,086 million as of the end of that week, compared to $66,281 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	June 9, 2006			June 16, 2006		
TOTAL	66,281			66,086		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	11,805	11,136	22,941	11,797	11,015	22,812
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,731	5,420	17,151	11,725	5,363	17,088
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			6,535			6,533
3. Special Drawing Rights (SDRs) [2]			8,613			8,612
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	June 9, 2006			June 16, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						
2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets						
	June 9, 2006			June 16, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL

1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

PRESS ROOM

June 20, 2006
JS-4328

Treasury to Sponsor First Pandemic Flu Response Exercise
Focused on Financial Sector
Florida Coalition to Host Program

The Treasury Department in cooperation with the FloridaFIRST regional financial coalition will sponsor the first U.S. pandemic flu response exercise focused on the financial sector Thursday, June 22 in Miami, Fl.

Treasury Deputy Assistant Secretary for Critical Infrastructure Protection and Compliance Policy Scott Parsons and will join 70 participants from Florida financial services firms and health, police and fire officials from local, state and federal agencies to test the local industry's preparedness for such a crisis.

FloridaFIRST is a regional coalition formed by financial institutions based in Miami with the goal of enhancing the resilience of the financial sector in South Florida to handle threats from terrorism and natural disasters. FloridaFIRST is a collective effort to protect the homeland through public and private partnerships. Treasury helped to facilitate the partnership's creation in October 2005. For more information on the coalition, please visit: http://www.treas.gov/press/releases/js2970.htm.

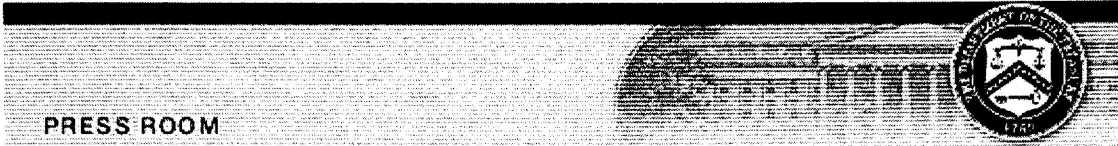
The emergency response exercise is not open to the media; however, Treasury officials are available for interviews to discuss the program. To schedule an interview, please contact Jennifer Zuccarelli at (202) 622-8657.

Who
Deputy Assistant Secretary Scott Parsons

What
FloridaFIRST pandemic flu response

Where
Miami-Dade Emergency Operations Center
9300 NW 41 Street
Miami, FL

When
Thursday, June 22



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June 20, 2006
JS-4330

US Treasurer to Visit Puerto Rico Chamber of Commerce

U.S. Treasurer Anna Escobedo Cabral will speak with the Puerto Rican Chamber of Commerce in Fajardo, Puerto Rico on Friday, June 23. The event is open to the press and the Treasurer is available for interviews on a range of topics including the U.S. economy, financial education, currency and immigration.

The U.S. Treasurer serves as an adviser to the Secretary of the Treasury on matters relating to currency production and security. The Treasurer also serves as one of the Treasury Department's principal advisors and spokespersons in the area of financial literacy and education. Before taking her office at the Treasury, she served as director of the Smithsonian Institution's Center for Latino Initiatives and as president and CEO of the Hispanic Association on Corporate Responsibility.

- Who: U.S. Treasurer Anna Escobedo Cabral
- What: Remarks before the Puerto Rico Chamber of Commerce
- When: Friday, June 23 3:00 p.m. (AST)
- Where: El Conquistador Resort, Poinsettia Room
  1000 Conquistador Ave.
  Fajardo, Puerto Rico

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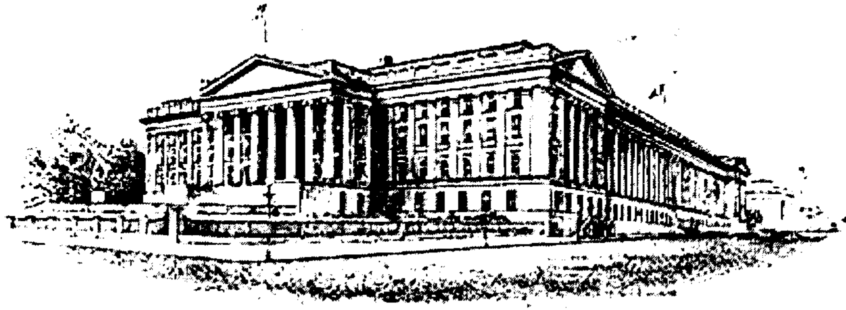
REPORTS

- Tesorera de Los Estados Unidos Visitará la Cámara de Comercio de Puerto Rico (PDF)



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

AVISO DE PRENSA: 23 DE JUNIO DEL 2006
CONTACTO (en inglés por favor): Jennifer Zuccarelli (202) 622-8657

TESORERA DE LOS ESTADOS UNIDOS VISITARÁ LA CÁMARA DE COMERCIO DE PUERTO RICO

La Tesorera de los Estados Unidos, Anna Escobedo Cabral, hablará con la Cámara de Comercio de Puerto Rico en Fajardo, Puerto Rico el viernes 23 de junio. Este evento estará abierto a los medios de prensa, los cuales podrán entrevistar a la Tesorera Cabral sobre la economía estadounidense, la educación financiera en los Estados Unidos, la moneda estadounidense y el tema de inmigración entre otros.

La Tesorera aconseja al Secretario del Departamento del Tesoro en asuntos relacionados con la producción del dinero y la seguridad del mismo. La Tesorera también sirve como una consejera principal del Departamento del Tesoro en asuntos relacionados con la educación financiera. Antes de asumir el puesto de Tesorera, también fue la directora del Centro de Iniciativas Latinas para el Instituto Smithsonian y anteriormente la presidente de una asociación sin fines de lucro llamada Hispanic Association on Corporate Responsibility.

QUIÉN: **ANNA ESCOBEDO CABRAL, TESORERA DE LOS ESTADOS UNIDOS**

QUÉ: **AUDIENCIA ANTE LA CAMARA DE COMERCIO DE PUERTO RICO**

CUÁNDO: **VIERNES 23 DE JUNIO A LAS 3:00 PM (AST)**

DÓNDE: **EL CONQUISTADOR RESORT, POINSETTIA ROOM**
1000 CONQUISTADOR AV.
FAJARDO, PUERTO RICO

June 22, 2006
JS-4331

Testimony of Pat O'Brien, Assistant Secretary
Office of Terrorist Financing and Financial Crimes
U.S. Department of the Treasury
Before the Senate Committee on Banking, Housing, and Urban Affairs
Washington, DC

Chairman Shelby, Ranking Member Sarbanes, thank you for the opportunity to address you today on a very important issue that presents us with a tremendous challenge.

Iran is a state sponsor of terrorism that has demonstrated a reckless intention to support, facilitate, and direct global terrorist activity. In addition to its blatant sponsorship of global terror, Iran intends to acquire weapons of mass destruction. Exacerbating an already worrisome pattern of dangerous behavior was the election of hardline Iranian President Ahmadinejad in June 2005. His provocative comments about wiping Israel off of the map and Iran's continued activities to destabilize the region and pursue a nuclear weapons capability have heightened the world's concern.

We have been working very closely with our interagency counterparts to consider these threats and develop an appropriate strategy to confront them. Both terrorism and WMD proliferation require vast support networks through which money and material flow. The Treasury Department -- working with its interagency partners -- has unique tools to address this potent mix of money, terror and WMD, and has been devoting considerable time and attention to addressing this Iranian threat.

We are in now in a particularly crucial moment. The United States, the United Kingdom, France, Germany, Russia, and China have presented a package of incentives and disincentives to Iran to resolve the problem posed by the Iranian nuclear weapons program. As the President and Secretary of State have said, we are dedicated to resolving this issue diplomatically and will exhaust the diplomatic channel accordingly. But if the diplomatic path is not successful, the international community has a range of options to make clear that Iran's pursuit of nuclear weapons will come at the cost of its own isolation.

I would like to provide an overview of the various threats posed by Iran and the relevant authorities we have at Treasury, both with respect to proliferation and terrorism, and with respect to Iran in general.

The Threat Posed by the Iranian Regime

The scope of Iran's perilous activity is enough to warrant significant concern. Iran's sponsorship of these activities is even more troubling because of the vast resources it has to facilitate this threatening conduct. Be it the spread of WMD, the funding of terrorist and militant groups in Lebanon, the Palestinian territories, and Iraq, Iran has the resources to invest substantially in violent projects. We are working steadily with the interagency community, to target the networks that move these funds and prevent them from abusing the integrity of the world's financial system.

Nuclear Weapons Development and Missile Technology

There is now widespread understanding that the Iranian regime is dedicated to

acquiring a nuclear weapons capability, in addition to other kinds of weapons of mass destruction capabilities and the means to deliver them.

As a complimentary measure to the international diplomatic process to press Iran to end its pursuit of nuclear weapons, the Administration will continue to protect ourselves and our financial system against companies engaged in WMD proliferation, including those facilitating Iran's pursuit of WMD technologies. In June 2005, the President issued Executive Order 13382, aimed at undercutting firms involved in proliferation of WMD and their support networks. Proliferators traffic in expensive and sophisticated technologies, and depend heavily on international trade. The President's Executive Order authorizes us to cut off proliferators and their supporters from the U.S. financial system and to encumber their international commerce.

E.O. 13382 authorizes the imposition of strong financial sanctions against not only WMD proliferators, but also against entities and individuals providing support or services to them. Designation under this Order prohibits all transactions between the designated entities and any U.S. person and freezes any assets the entities may have located under U.S. jurisdiction.

Since June 2005, the U.S. Department of the Treasury has designated six Iranian entities for their support of the proliferation of WMD and their missile delivery systems, including Iran's pursuit of nuclear weapons under the guise of a peaceful nuclear energy program:

- The **Atomic Energy Organization of Iran** (AEOI), which reports directly to the Iranian President, is the main Iranian institute for research and development activities in the field of nuclear technology, including Iran's centrifuge enrichment program and experimental laser enrichment of uranium program, and manages Iran's overall nuclear program.
- The **Aerospace Industries Organization** (AIO), a subsidiary of the Iranian Ministry of Defense and Armed Forces Logistics, is the overall manager and coordinator of Iran's missile program. AIO overseas all of Iran's missile industries.
- The **Shahid Hemmat Industrial Group** (SHIG) is responsible for Iran's ballistic missile programs, most notably the Shahab-3 medium range ballistic missile which is based on the North Korean No Dong missile. The Shahab-3 is capable of carrying chemical, nuclear, and biological warheads and has a range of at least 1500 kilometers. SHIG has received help from China and North Korea in the development of this missile.
- The **Shahid Bakeri Industrial Group** (SBIG) is an affiliate of Iran's AIO. SBIG is also involved in Iran's missile programs. Among the weapons SBIG produces are the Fateh-110 missile, with a range of 250 kilometers, and the Fajr rocket systems, a series of North Korean-designed rockets produced under license by SBIG with ranges of between 40 and 100 kilometers. Both systems are capable of being armed with chemical and possibly other types of warheads.

The **Novin Energy Company** has transferred millions of dollars on behalf the AEOI to entities associated with Iran's nuclear program. Novin operates within the AEOI, and shares the same address as the AEOI; and

- The **Mesbah Energy Company** is a state-owned company subordinate to the AEOI. Through its role as a front for the AEOI, Mesbah has been used to procure products for Iran's heavy water project. Heavy water is essential for Iran's heavy-water-moderated research reactor project, which when completed, could provide Iran the capability to produce plutonium for nuclear weapons.

Just this past week, we designated four Chinese companies and one U.S. representative office, which supplied Iran's military and Iranian proliferators with missile-related and dual-use components. No reputable company or institution should be doing business with these entities.

Support for Terrorism and Violence

Iran also actively sponsors terrorism and violence across the Middle East. The Islamic Revolutionary Guard Corps (IRGC) and Ministry of Intelligence and Security (MOIS) – both Iranian government bodies – are directly involved in the planning and support of terrorist acts by non-state actors and continue to sponsor and train a variety of violent groups that act as surrogates on Iran's behalf.[1]

The Administration is or will, as appropriate, draw on all instruments of national power to combat the very real threat posed by Iran's sponsorship of terrorism. At Treasury, we are focused on the support networks, trying to identify and sever the lines of support that fuel terrorist activities. Stopping the money flows is particularly challenging in this instance, as Iran draws upon a large network of state-owned banks and parastatal companies, which is difficult to penetrate and thwart. We are also hampered by the fact that many of our key allies have yet to recognize Hizballah as a terrorist organization. Nevertheless, there remain opportunities for disruption, and we continue to pursue them vigorously.

Broad Sanctions Against Iran

At the Treasury Department, we have also been enforcing a set of far-reaching sanctions against Iran that have been in place since 1995. Pursuant to the Iranian Transactions Regulations, 31 C.F.R. Part 560 (the "ITR"), Treasury's Office of Foreign Assets Control (OFAC) administers commercial and financial sanctions against Iran that prohibit U.S. persons from engaging in a wide variety of trade and financial transactions with Iran or the Government of Iran. The term *U.S. person* means any U.S. citizen, permanent resident alien, entity organized under the laws of the United States (including foreign branches), or any person in the United States.

The ITR prohibit most trade in goods and services between the United States and Iran or the Government of Iran. U.S. persons are also prohibited from dealing in Iranian-origin goods overseas or in goods for export to Iran from third countries. Non-U.S. persons are prohibited by the ITR from re-exporting controlled U.S. origin goods to Iran. However, the import and export of information and informational materials to and from Iran is exempt by statute. In addition, the Trade Sanctions Reform Act provides for specific licenses to be issued for the export of certain agricultural products, medicine and medical devices to Iran.

Aside from the trade-related sanctions described above, the ITR prohibit any post-May 7, 1995 investments by U.S. persons in Iran. U.S. persons are also prohibited from facilitating transactions by third-country persons that could not be engaged in by U.S. persons themselves. Finally, the ITR prohibit U.S. persons from evading or attempting to violate any of the prohibitions contained in the ITR.

OFAC also maintains in effect the Iranian Assets Control Regulations, 31 C.F.R. Part 535 (the "IACR"), which governed the freezing of Iranian assets at the time of the hostage crisis. Pursuant to the 1981 Algiers Accords, most Iranian assets in the United States were unblocked and transferred to various escrow accounts. The IACR remain in effect to facilitate the resolution of claims before the Iran-U.S. Claims Tribunal in The Hague. Certain assets related to claims before the Iran-United States Claims Tribunal remain blocked in the United States and consist mainly of diplomatic and consular property.

Private Sector Reaction

Perhaps as important as governmental action is the response that we are seeing from the international private sector to the Iranian regime's destabilizing activities. As it witnesses firsthand the disturbing direction in which the Iranian regime seems to be headed, the financial sector has begun to reassess whether it is appropriate or prudent to do business with Iran. The words and signals coming out of Iran have led observers to worry about Iran as an investment arena and have prompted reputable members of the international financial community to curtail or cut ties with

Iran altogether.

- In the international banking community, UBS ceased its activities with Iran. Credit Suisse announced that it would no longer establish new business relations with Iran. ABN Amro and HSBC have also curbed their dealings with Iran.
- Energy firms Baker Hughes, ConocoPhillips, and BP PLC have reportedly suspended dealings with Iran.
- In May, the Organization for Economic Cooperation and Development (OECD) downgraded Iran's credit rating for official credits and now assesses Iran at the same level of risk as countries with active insurgencies, such as Colombia and Sri Lanka.

These are just the decisions that have been publicly reported. Reputable institutions around the world are making quiet decisions to cut back or sever their dealings with Iran, having decided that they do not want to do business with this state sponsor of terror and proliferator. We in the government can inform this process by identifying specific threats that private firms might otherwise be unable to detect and protect against.

Conclusion

We are in a critical moment with Iran now. The Treasury Department along with all members of the U.S. Government, is lending its full support to the State Department's work to bring about a successful outcome to this recent round of multilateral efforts. In the meantime, we will continue to use our tools and leverage to dismantle networks that support terrorism and weapons proliferation, wherever they may be. We can not afford to alleviate any pressure on sponsors of terrorism and supporters of WMD proliferation, and we will continue to do everything in our power to deny these networks access to the financial system.

June 22, 2006
js-4332

Statement of Treasury Secretary John W. Snow on Disclosure of the Terrorist Finance Tracking Program

"President Bush has made it clear that ensuring the safety of the American people and citizens around the globe must be our number one priority.

"Consistent with this charge, one of the most important things we at Treasury do is to follow the flow of terrorist monies. They don't lie. Skillfully followed, they lead us to terrorists themselves, thereby protecting our citizens.

"Given our intimate knowledge of the global financial system and financial flows, along with our close working relationships with financial institutions around the world, Treasury is uniquely positioned to track these terrorist money flows both internationally and domestically. This is part of an overall governmental effort to map terrorist networks and apprehend terrorists around the world. By following the money, the U.S. has been able to locate operatives and their financiers, chart terrorist networks, help bring them to justice, and save lives.

"I am particularly proud of our Terrorist Finance Tracking Program which, based on intelligence leads, carefully targets financial transactions of suspected foreign terrorists. Let me be clear what this program is, and what it is not. It is an essential tool in the war on terror, based on appropriate legal authorities with effective oversight and safeguards. It is not "data mining", or trolling through the private financial records of Americans. It is not a "fishing expedition", but rather a sharp harpoon aimed at the heart of terrorist activity. That fact makes today's disclosure so regrettable, because the public dissemination of our sources and methods of fighting terrorists not only harms national security but also degrades the government's efforts to prevent terrorist activity in the future.

"If there are people sending money to help al Qaeda, then we need to know about it. We also need to take advantage of that knowledge to follow the money trail and thwart them.

"It's hard to overstate the value of this information. That's why, during my tenure, I've focused intently on this program. It is consistent with our democratic values and legal traditions. I know that it works to make America and the world safer. I'm proud of the fact that the 9-11 Commission gave its highest level of recognition to our work. It would have been irresponsible not to have undertaken this program. As President Bush said, we will not sit back and wait to be attacked again," said Secretary Snow.

-30-

June 23, 2006
JS-4333

Treasury Secretary John W. Snow and Under Secretary for Terrorism and Financial Intelligence Stuart Levey to hold Press Conference

Treasury Secretary John W. Snow and Under Secretary for Terrorism and Financial Intelligence Stuart Levey will hold a press conference today at 11:30 a.m. to discuss the Terrorist Finance Tracking Program.

The following event is open to credentialed media:

Who
U.S. Treasury Secretary John W. Snow and Under Secretary Stuart Levey

What
Press Conference on the Terrorist Finance Tracking Program

When
Friday, June 23, 11:30 a.m. (EDT)

Where
U.S. Department of the Treasury
Media Room – 4121
1500 Pennsylvania Ave., NW
Washington, DC

Note
Media without Treasury press credentials should contact Frances Anderson at (202) 622-2960, or frances.anderson@do.treas.gov with the following information for clearance into the building: full name, Social Security number and date of birth.

June 23, 2006
JS-4334

Statement of Under Secretary Stuart Levey on the Terrorist Finance Tracking Program

My job, as Under Secretary for the Office of Terrorism and Financial Intelligence, is to track the movement of money of terrorists and other national security threats, and do everything I can to disrupt those money flows. I take this job extremely seriously, as do the hundreds of dedicated people at Treasury and our partner agencies who focus on combating terrorist financing and protecting innocent people around the world from vicious and senseless attack.

"Following the money" is one of the most valuable methods we have to identify and find terrorists. If a terrorist operative that you're watching sends or receives money from another person, you know that there's a link between the two. Money trails don't lie. And, to wire money through a bank, a person needs to provide a name, address, and account number – exactly the kind of concrete leads that that can move an investigation forward and allow us to take action.

As a part of our efforts to track the funds of terrorists, we are confirming that we have subpoenaed records on terrorist-related transactions from SWIFT.

SWIFT is the premier messaging service used by banks around the world to issue international transfers, which makes its data exceptionally valuable. I would note that SWIFT is predominantly used for overseas transfers. It does not contain information on ordinary transactions that would be made by individuals in the United States, such as deposits, withdrawals, checks, or electronic bill payments.

The legal basis for this subpoena is routine and absolutely clear. The International Emergency Economic Powers Act, a statute passed in 1977, allows us to issue administrative subpoenas for financial records. We issue such subpoenas regularly, and our authority to do so has never been called into doubt. The SWIFT subpoena is powerful but narrow, as it allows us to access only that information that is related to terrorism investigations. We are not permitted to browse through the data, nor can we search it for any non-terrorism investigation. In practice, this means that we have accessed only a minute fraction of SWIFT's data.

Multiple layers of strict controls have been put in place to make sure that the information is not misused. Before they can run a search against this data, analysts must first explain how the target of the search is connected to a terrorism investigation. If the link cannot be established, the data cannot be searched. Pursuant to an agreement we reached with the company, SWIFT's auditors are able to monitor those searches in real time and stop any one of them if they have any concerns about the link to terrorism. In addition, a record is kept of every search that is done. These records are all reviewed either by an outside independent auditor, the company's auditors, or both.

The SWIFT data has proven to be one of the most valuable sources of information that we have on terrorist financing. It has enabled us and our colleagues to identify terrorist suspects we didn't know, and to find addresses for those that we did. It has provided key links in our investigations of al Qaida and other deadly terrorist groups.

We have briefed appropriate members of Congress and their staffs on this program.

We briefed the central bank governors of all the G-10 countries. We briefed key members of the 9/11 Commission. The reaction from experts -- across the political spectrum -- has been that this is exactly the kind of creative and vigorous approach that is needed to combat the elusive terrorist threat that we face. Indeed, our use of the SWIFT data was one of the principal reasons that the otherwise critical 9/11 Commission Public Discourse Project awarded its only "A-" to our counter-terrorist financing efforts.

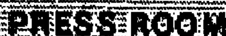
Until today, we have not discussed this program in public for an obvious reason: the value of the program came from the fact that terrorists didn't know it existed. They may have heard us talking about "following the money," but they didn't know that we were obtaining terrorist-related data from SWIFT. Many may not have even known what SWIFT was.

With today's revelations, this is unfortunately no longer true. This is a grave loss.

The terrorists we are pursuing are deadly serious and take every precaution to keep their plans and methods to themselves. We cannot expect to continue disrupting their activities if our most valuable programs are exposed on the front page of our newspapers.

I can assure you, however, that we, along with our colleagues in the U.S. Government and abroad, will continue to pursue terrorists aggressively and responsibly, to map their networks and disrupt their lines of support. I believe that this is exactly what the American people expect of us.

Thank you.



June 23, 2006
js-4335

Remarks of Anna Escobedo Cabral
U.S. Treasurer
U.S. Department of the Treasury

Before the Puerto Rico Chamber of Commerce

Fajardo, Puerto Rico - Muy buenas tardes. Es un placer estar con todos ustedes hoy día en la bella "Isla del Encanto" – Puerto Rico. Agradezco inmensamente esta invitación y oportunidad de compartir con ustedes un poco de información sobre algunas medidas que la Administración del Presidente Bush y el Departamento del Tesoro han designado como prioridades para garantizar el constante crecimiento económico que hemos visto en los Estados Unidos en los últimos años.

Estaré compartiendo estos pensamientos con todos ustedes hoy día en inglés, pero con mucho gusto trataré de responder a cualquier inquietud al concluir esta porción del programa en ambos idiomas – inglés y español.

Once again, thanks so much for your warm welcome. Thank you to the Puerto Rico Chamber of Commerce and Miriam for inviting me here today.

As I was saying, I am thrilled to be back in beautiful Puerto Rico to speak to such a distinguished group of business leaders, and particularly to all inspiring Puerto Rico business-women present in this room today.

It is also an honor to join Governor Anibal Acevedo Vila, and Representative José Aponte, President of the Puerto Rico House of Representatives, at this conference. I really appreciate the hospitality demonstrated to me and I am truly touched by the wonderful recognition given to me earlier today as an honored guest. And of course, it is also a great honor to be joined by so many other distinguished guests at this week's conference, particularly Dr. Antonia Coello Novello, who as many of you know served as the 14th Surgeon General of the U.S. What an amazing achievement!

As I look out into this room, I see an example of what is possible with a little bit of planning, faith, hard work and some responsible risk-taking. I can honestly say I feel so inspired by each and every one of you.

You know, Latina entrepreneurs and business-women really are a force to be reckoned with – and not just in the United States – but on a global scale.

- More than one-third (34.9%) of all Hispanic owned firms are owned by women. Hispanic women-owned firms employ 18.5% of the workers in all Hispanic-owned firms and generate 16.3% of the sales. (Center for Business Women's Business Research, November 2004)
- Latinas control 39% of the 1.4 million companies owned by minority women in the United States, which generate nearly $147 billion in sales. (Center for Women's Business Research, November 2004)
- Four in 10 minority women-owned firms are owned by Latinas. (U.S. Hispanic Chamber of Commerce)

I want to thank you, not only on my behalf, but also on behalf of Secretary Snow and President Bush for all you do to help build prosperity on a large scale.

In the U.S. we've seen that our economy has surged over the past few years. Although I only have a few minutes to spend with you today, I'll spend some time sharing some facts about this amazing economic growth we're experiencing, and also spend time sharing with you information about what helped get us to this point. But I will also take a few minutes to raise some issues of rather pressing importance for you to consider, and I will ask you to think about some critical areas, which still merit our attention. For instance, we need to continue spending increased time and effort on such areas as improving financial literacy and education. Treasury is engaged in many efforts right now to promote increased financial literacy of all people in the U.S. as well as abroad. I'll tell you about some resources you can pass on to your employees – useful tools and resources to help people manage their personal finances and create wealth.

For now, I'd like to begin by circling back to my first comment – businesses have really contributed greatly to the U.S. economy in the past few years.

I'd like to share some recent facts and statistics with you, so that you can really come to understand the power and influence you have on markets, and more importantly, on individual lives.

Consider this. In the first quarter of 2006, the U.S. economy grew at an impressive rate of 5.3 percent, following an already very impressive year for growth. In 2005, our economy grew at 3.5 percent. We keep outdoing ourselves – and the pie keeps growing.

The President always does a nice job of putting those figures into perspective and I want to do the same today. To put it into context for you, think of this – in 2005, our economy grew faster than Japan and more than twice as fast as France. It also grew more than three-times as fast as Germany.

In fact, the U.S. economy is the fastest growing of any major industrialized nation in the world. Productivity is growing at the highest rate in years, and much of that can be attributed to businesses much like the ones you are responsible for running.

For 33 consecutive months, our economy has created an astounding number of new jobs – 5.3 million new jobs – and many Latina business owners can take credit for that high figure. You are creating jobs and improving people's lives. Right now, the national unemployment rate has fallen to 4.6 percent – lower than the average of any decade since the 1950's.

I'm really excited about that figure – more than most. You see, I have 4 grown children and only one left in college. MIT is a good school, but let me tell you, I'll be happy when my son Christopher graduates. I'm really actually quite thrilled, because my children, your children, young professionals graduating from college will have the benefit of taking advantage of a fantastic job market. The job market for college graduates is the best it's been in five years.

Small businesses are flourishing and creating many of those jobs. We need to give small business owners a lot of credit because it takes courage to start and manage your own business. There is a great deal of new business investment out there – and that is really fantastic news, since it serves as an indication of confidence that we will continue to do well far ahead into the future. When business owners like you invest and expand your operations, it is clear that great things are ahead of us, that we foresee only more growth and success.

Did you know that the number of Hispanic-owned businesses is growing at three times the national rate? Hispanic unemployment is at the lowest rate in years at only 5 percent? Additionally, real after-tax income has grown by almost 9 percent. Now that is the power of ownership! It stands to reason why this Administration strongly advocates and promotes an ownership society.

Well, you have to stop and wonder how we achieved all this growth despite the many challenges this Administration inherited just a few years ago – a recession,

the stock market correction, corporate scandals, the 9/11 terrorist attacks, and the Gulf Coast Hurricanes devastation of last year.

The key really is to encourage growth through sound fiscal and monetary policy. Bottom line, the government cut taxes and yet generated more tax revenues this past year. Surging tax revenues are a sign of a strong economy. Tax revenues have well-exceeded forecasts for 2004 and 2005. Treasury is now reporting the highest annual tax receipts ever. To date tax receipts are up almost 13% this year, an added gain to last year's gain of 14.5%.

In fact, one of the most important explanations for this strong economy is low taxes. We find repeatedly that when you allow people to keep more of their own money, they have more money to invest, more of it to start or expand a business, or to pay for other important things like a college education or to purchase a home.

In a pro-business environment, those additional dollars may be better spent by a business in order to expand and increase the production of goods and provision of services to clients at home and abroad. We do, after all, live in a global marketplace.

We need to continue to encourage an environment in which the entrepreneurial spirit remains strong, allowing people to keep more of the money they earn. With more investment, this economy can only continue to grow. We can't expect the government to do it all for us – we can't expect it to make money for us. We've got to do it for ourselves – and we have to create our own opportunities. In order to do so successfully however, government and the private, public and nonprofit sectors need to acquire the skills to manage their money wisely, to invest it and make it grow.

I earlier mentioned the importance of improving financial education. In my role as Treasurer, I will continue working toward achieving this goal of improving financial education for all people in the U.S. and abroad.

Although our economy continues to grow and there are more jobs available for more Americans since the 1950's, somehow we continue to fall short in the area of personal finance knowledge and good personal finance habits.

This could be attributed to a complex and burgeoning economy like ours that creates more choices and sophisticated vehicles for saving and making one's money grow. (This can be an especially daunting challenge for people who are unfamiliar with this country's customs and primary language – English.)

When we talk about financial education in today's terms, what we're really talking about is improving people's quality of life. But achieving our common goals will require us to go beyond creating additional nicely manicured brochures.

As I often say, education means not just presenting information in a nice neat package – it also means delivering it through the right channels by people who are trusted in their respective communities.

This sort of education in which we're all engaged in is really about helping to create new opportunities for people – opportunities like paying for a child's college education, purchasing a home, starting a business or planning for a secure retirement.

That is why improving financial education levels for all Americans is a high priority for Treasury and President Bush's Administration.

Additionally, it is important to promote financial education because we can see what can happen to those that are disenfranchised from access to financial education or a relationship with traditional financial service providers.

We witnessed this first-hand after last year's Gulf Coast Hurricanes. Many people without bank accounts in these hard hit areas found it much more difficult to access benefits they were expecting to receive, and often times could not do so by traditional mail because they were displaced and difficult to track and reach.

At Treasury, we are engaged in several campaigns and multi-agency efforts to improve financial education in the country.

First, Treasury leads the efforts of the Financial Literacy and Education Commission created in 2003 when the President signed the Fair and Accurate Credit Transactions Act, and the twenty agencies that form it were tasked with developing a plan to improve the money management skills of people in the U.S. Commonly referred to as the FLEC, it recently released a strategy for financial education during Financial Literacy Month in April of 2006 titled – Taking Ownership of the Future: The National Strategy for Financial Literacy.

The Commission was also tasked with developing a federal financial education web site and toll-free hotline, which were launched in English and Spanish in October of 2004 – MyMoney.gov and 1-888-MyMoney. I urge you to visit and spread the word about MyMoney.gov. It has been recently updated to include an interactive quiz called the "Money Twenty" and the strategy that I mentioned earlier is also available and can be downloaded at MyMoney.gov.

The Strategy looks at a variety of important topics, such as homeownership, credit management, retirement savings, and "banking the unbanked" – an issue that my office has currently been particularly focused on and is researching extensively.

It also describes the challenges and guideposts for possible solutions.

Sometimes the solutions come from the Federal government, but often nonprofit organizations, businesses and other private sector players provide important resources for those wishing to learn more about financial matters.

It also puts forward examples of financial education programs that community leaders, business people, and volunteers can all look to as they design programs of their own to enhance financial literacy.

And at the end of each chapter in the strategy, you will notice that Calls to Action are highlighted. It is our hope that these calls to action will provide a springboard for further open and inclusive discussion on a whole myriad of issues.

I also want to tell you about another very special campaign my office has been involved in – Go Direct. About a year and half ago, the Treasury and Federal Reserve Banks launched a campaign called Go Direct, in Spanish known as Directo A Su Cuenta. Its objective is to encourage seniors to receive their Social Security benefits by direct deposit.

It not only communicates the importance of direct deposit – but provides the means by which seniors can make the switch from a paper check to direct deposit. We have a dedicated call center staffed by bilingual personnel ready to assist all beneficiaries.

The call center is only one of many ways we are helping beneficiaries sign up for direct deposit. Our Web sites: www.GoDirect.org and www.DirectoASuCuenta.org, allows beneficiaries to access a step-by-step online tool to sign up – either on their own or through their bank or credit union.

It's a known fact that direct deposit is not only the most secure way for receiving Social Security benefits; it is also the most convenient way for all beneficiaries to have immediate access to their benefits. However, despite 95 percent of Americans having heard or read about identity theft, a survey sponsored by the U.S. Department of Treasury and the Federal Reserve Banks revealed that many are unaware of the security benefits of direct deposit over paper checks.

That is why I urge you to help us spread the word about this great free service. Keep in mind that direct deposit can also provide seniors receiving SSA payments with a sense of control of their money. This is true even under the most difficult circumstances. Again, as you know Hurricane Katrina displaced tens of thousands of beneficiaries just days before their checks arrived in the mail. In uncertain times like these, enrolling in direct deposit can offer a much needed peace of mind to federal benefit recipients.

I have had a chance to share some very good economic news with you. But statistics cannot adequately capture the contributions of business leaders like yourselves, individuals who have the potential of bringing about positive change and improving people's lives. That is invaluable and that is why your work and contributions are so important.

Thank you again – this has been a great opportunity for me to share with you just a few of the efforts we're involved in here at Treasury and to highlight just some of the President's priorities to keep our economy and businesses strong.

Please enjoy the rest of the conference!

-30-

June 23, 2006
JS-4336

Treasury Assistant Secretary Fratto to Hold Weekly Press Briefing

Treasury Assistant Secretary for Public Affairs Tony Fratto will hold the weekly media briefing on Monday, June 26 in Main Treasury's Media Room. The event is open to all credentialed media.

Who
Assistant Secretary for Public Affairs Tony Fratto

What
Weekly Briefing to the Press

When
Monday, June 26, 11:15 AM (EDT)

Where
Treasury Department
Media Room (Room 4121)
1500 Pennsylvania Ave., NW
Washington, DC

Note
Media without Treasury press credentials should contact Frances Anderson at (202) 622-2960, or frances.anderson@do.treas.gov with the following information: name, Social Security number, and date of birth.

June 23, 2006
JS-4337

Treasury Asst. Secretary to Discuss GSEs with Financial Services Roundtable

U.S. Treasury Assistant Secretary for Financial Institutions Emil W. Henry, Jr. will give remarks before the Housing Policy Council of the Financial Services Roundtable on Monday, June 26 at the Financial Services Roundtable. The Assistant Secretary will discuss government sponsored enterprises (GSEs) and systemic risk.

WHO
ASSISTANT SECRETARY FOR FINANCIAL INSTITUTIONS EMIL W. HENRY, JR.

WHAT
REMARKS ON GSES AND SYSTEMIC RISK

WHEN
MONDAY, JUNE 26 9:00 A.M. (EDT)

WHERE
FINANCIAL SERVICES ROUNDTABLE
1001 PENNSYLVANIA AVE., NW
WASHINGTON, D.C.

June 26, 2006
JS-4338

Remarks of Emil W. Henry, Jr.
Assistant Secretary for Financial Institutions
U.S. Department of the Treasury

Before the Housing Policy Council of the
Financial Services Roundtable

Washington, DC- Thank you very much for that kind introduction. I am very happy to be here. The Roundtable was one of, if not the first, place that I visited after being sworn in at Treasury back in October. I still remember my pleasant conversation with Steve Bartlett. In that conversation, he asked if Treasury planned to get "more involved" in the GSE reform debate. I think it is safe to say that we have and I think it is wonderful that I am back at the Roundtable to talk more about why there needs to be strong GSE reform legislation.

There are times when certain words or phrases are used or overused to such an extent that they verge on losing their meaning. As anyone in the room today with teenage children understands, the impact of a parent's drumbeat of cautionary words, on any topic, can over time, diminish with repetition. As the public GSE reform discussion crescendos, I fear we may be at such a point with the phrase "systemic risk". If you have followed the arc of the GSE debate for the past few years then you will note that the terms "systemic risk" and "GSEs" are inextricable. However, such repetition could make the likelihood of a systemic event occurring seem more the stuff of intellectual musing than hard reality.

There also appears to be significant misunderstanding about what it means and why we need to be concerned about it. So, the purpose of my remarks today is to clarify what is meant by "systemic risk" as it relates to the GSEs, why we think it exists, what might transpire in a GSE-initiated systemic event, and why these are unnecessary risks that can and should be easily avoided.

At the outset, let me be clear on the meaning of systemic risk: it is the potential for the financial distress of a particular firm or group of firms to trigger broad spillover effects in financial markets, further triggering wrenching dislocations that affect broad economic performance. Perhaps a useful analogy is to think about systemic risk as an illness that can become highly contagious.

It is important to note that these types of concerns are not simply theoretical. Like the case of a single gunshot setting off an avalanche, there are times when even seemingly modest or localized events in particular financial markets can trigger adverse consequences of enormous proportions. One recent example of this type of event is global financial turmoil in 1998.

In August of 1998, Russia's external debt amounted to roughly $100 billion--a tiny fraction of global debt. And yet that event led to panic and volatility in financial markets that ultimately triggered the Long Term Capital Management (LTCM) implosion and a period of significant financial distress. LTCM pursued a convergence trading strategy. It established very large positions across many markets, many of which were essentially bets that liquidity, credit, and volatility spreads would return to more normal levels. Instead, spreads widened sharply in the financial turmoil following the Russian default and LTCM suffered losses greatly exceeding that predicted by conventional risk models. The LTCM crisis laid bare the dangers of excessive leverage and perhaps more importantly, put a white hot light on creditors' and counterparties' over-confidence in the "hedged" nature of that

fund's portfolio and strategy.

If the Russian default could have such wide-reaching ramifications, you can understand why this Administration is so deeply concerned about the potential market repercussions of a deterioration in the financial conditions of a GSE, which collectively have more than $2 trillion of outstanding debt.

The hard lessons from LTCM include: i) the danger of investment decisions which rely upon the presumption of liquidity, ii) the importance of transparency and disclosure, iii) the extent of the interdependencies of our global markets, financial firms, investors and businesses, iv) the fact that complexity is sometimes the enemy of stability, v) the danger of complacency and false confidence in hedging strategies which, by definition can never hedge out all risk and which can produce the opposite of the desired effect in the absence of liquidity.

So, we at the Treasury are confident we are not simply "crying wolf". Before LTCM few, if any, would have guessed that it could have imposed significant systemic consequences for the financial markets. And sadly, some are not heeding the important lessons from this experience in the GSE reform debate.

To address such a looming problem, the Administration has consistently argued for meaningful reform of the regulatory structure of the GSEs. This reform must include mechanisms to protect the broader financial markets and our financial firms and counterparties from unnecessary risks. The core basis for our policy of reform is the systemic risk presented by the size of the GSEs' mortgage investment portfolios and the corresponding concentration of risk in these two federally-chartered enterprises. Simply stated, our financial markets would be safer if these assets and associated risks were broadly redistributed. And to add insult to this potential injury, these huge investment portfolios are much larger than what is necessary to accomplish the GSEs' mission.

The risks of the mortgage investment business are complex and far more difficult to manage than the risks of the GSEs other major business – the credit guarantee business.

There are numerous levels of risk presented by the mortgage investment portfolios, but at a basic level the risk is created as follows: GSE portfolios are comprised primarily of fixed-rate mortgages, either held as whole loans, mortgage-backed securities (MBS), or other mortgage-related assets. While mortgages in the U.S. typically allow borrowers the option to prepay at will, the aggregation of fixed-rate mortgages requires that the investor develop strategies to mitigate risks presented by these uncertain cash flows – both prepayments and extensions. Unless the portfolios are hedged properly, in a period of significant interest rate movement, there is the risk to the GSEs that their assets and liabilities will be quickly become broadly mismatched which can lead to insolvency --much like the dynamics of the S&L crisis.

To properly hedge against such a dislocation, the burden rests on the GSEs to construct complex models of, among many things, borrower behavior, attempting to divine how and when borrowers will adjust behavior as interest rates change. Once models are created the GSEs must, in addition to other things, deploy highly complex derivative-based strategies and other risk transfer mechanisms. However, the risk, of course, never disappears.

We all know that there are many large companies investing in mortgages that are exposed to similar risk. So what makes the GSEs different?

There are three primary ways that the GSEs uniquely impose systemic risk on our financial system. Taken individually, each reason might not be a cause for dramatic action. However, aggregating each of these attributes under a single entity that also carries with it the broad misperception of a government backstop or guarantee creates a perfect storm scenario.

The first element is the sheer size of the GSEs' investment portfolio. Since 1990, the mortgage investment business of both of the housing GSEs has grown rapidly. From 1990 through 2003, Fannie Mae's mortgage investments increased from $114 billion to $902 billion. Freddie Mac's growth in mortgage investments was even more dramatic. From 1990 through 2003, Freddie Mac's mortgage investments increased from $22 billion to $660 billion. Today's combined GSEs' mortgage investment portfolios still total almost $1.5 trillion. By any standard, these are huge investment portfolios.

Secondly, the GSEs are not subject to the same degree of market discipline as other large mortgage investors. That lack of market discipline is reflected in preferential funding rates that result directly from the market's long-standing false belief that the US government guarantees or stands behind GSE debt. Of course, it is this funding advantage which drove the expansion of the portfolios in the first place.

To underscore this lack of discipline, imagine for just a moment if some of our most prominent complex financial institutions announced major accounting improprieties, significant restatements and serial failings and shortcomings in risk management and internal controls, and then further announced the cessation of annual reports and other standard disclosure materials. Does anyone in this room doubt the ferocity of "market discipline" that would sweep down upon these institutions in the form of higher borrowing costs for market-based funding and heightened counterparty scrutiny?

Further complicating the external discipline picture is that the GSEs operate with less capital, meaning they are more leveraged than other financial institutions. A non-GSE firm would have to have considerably more capital to access capital markets at anything close to the rates the GSEs are granted. Greater leverage provides less of a capital cushion to absorb losses and it enhances the ability of the GSEs to grow.

None of these obvious market-based checks have reined in the GSEs' growth. Simply put, traditional market discipline has not applied for the GSEs.

The third element is the level of interconnectivity between the GSEs' mortgage investment activities and the other key players in our Nation's financial system. By way of example, as of December 31, 2005, commercial banks held $264 billion in GSE debt obligations (while not specifically broken out on call reports, given the relative size of the GSEs, the bulk of these obligations are likely those of Fannie Mae, Freddie Mac, and the FHLBanks). In comparison to bank tier-1 capital, GSE debt obligations exceeded 50 percent of capital for 54 percent of these commercial banks, and GSE debt obligations exceeded 100 percent of capital for 34 percent of these commercial banks. In addition, the GSEs' interest rate positions are highly concentrated and pose significant risks to a number of large financial institutions.

What I just laid out forms the basic framework around how the GSEs pose systemic risk: large size; lack of market discipline; high degree of connections throughout our financial system. While the U.S. financial markets are highly efficient and resilient, they are not infallible. Now let's look at this issue even more closely.

Systemic events can unfold by direct and/or indirect spillovers. Direct spillovers arise when the failure of a particular firm creates substantial losses for those who carry direct exposure with such firm, such as its creditors. Indirect spillovers typically develop, not from direct exposures to the firm at the epicenter of the crisis, but when this firm causes a lack of confidence leading to a sense of panic and turbulence that results in action that generates substantial losses for firms that were not directly exposed to the impaired firm. Such spillovers – not the initial event -- typically take the greatest toll on economic activity and, in the case of the GSEs, the potential for both direct and indirect spillover effects is nothing short of breathtaking.

How could such a systemic event begin? They are many possible sparks but an unexpected sharp or volatile swing in interest rates, or in the parlance of risk managers, an interest rate "shock" would certainly be a distinct possibility. Of

course the GSEs claim to attempt to hedge their exposure for these types of events, though I note the following:

- the OFHEO report suggests that the GSEs' focus on hedging such events have been, at best, lacking--at worst dangerously irresponsible;
- hedging is not an exact science and models are only as good as the judgments and expectations reflected in their inputs -- they are often wrong.
- the LTCM episode provides a case study for the elements of a financial crisis; a number of these elements are present here:
- highly leveraged entities
- presumptions of liquidity
- enormously complex derivatives portfolios
- abundant publicly-stated confidence in being properly hedged fostering a fundamental misperception as to the risks in the business
- heavy reliance on risk-sensitivity models which, in the case of LTCM were, of course, wrong.

If such an interest rate shock occurred in a way that was not captured by the models, the results could be without precedent. The immediate implication would be actual and mark-to-market losses.

The resulting actual or perceived inability of a GSE to meet its debt or MBS obligations or a significant decline in the market value of the GSEs debt obligations could be transmitted throughout the financial sector and the broader economy through a couple of channels.

An obvious transmission mechanism is through direct losses to the commercial banking system, derivative counterparties, or other creditors. If these key financial intermediaries suffered losses related to their GSE exposures, this could lead to a broader contraction of credit availability – for example fewer loans being made or more restrictive loan terms - that could have adverse implications f or overall credit availability and U.S. economic performance.

In addition to the direct impact on the GSEs' creditors, consider, for example just a few of the other consequences. A sharp deterioration in a GSE's financial condition would almost certainly increase risk premiums and boost yields on GSE debt and MBS relative to swap and Treasury yields. Even if the rise in GSE yields might not fully reflect the true financial condition of the GSEs, institutions that are particularly exposed to GSE spreads to swaps and Treasuries in their ordinary course of business would be at risk in this scenario. In particular, institutions such as large banks, hedge funds, and securities broker dealers that might hedge the interest rate risk in their MBS positions by establishing short positions in swaps and Treasuries could suffer substantial losses.

To give you a sense of the potential scope of this one aspect of transmitting a GSE's financial problems, consider the group of primary dealers. The Federal Reserve's primary dealer report indicates that the 22 primary dealers--a group that includes many of the dealer subsidiaries of the most important banks and investment banks in the United States--in aggregate typically maintain net long positions in GSE straight debt and MBS of about $130 billion and $30 billion, respectively. These long positions are hedged in part by short positions in Treasuries on the order of about $130 billion. Therefore any widening in GSE debt and MBS spreads over Treasuries would likely result in dealer losses that could be very substantial, especially relative to their capital. Such losses might cause dealers to rein in their positions and market-making activities in the GSE debt and MBS markets and in many other markets as well. Losses sustained by some primary dealers could well be large enough to reduce capital below regulatory minimums. Risk spreads for many private firms would likely widen substantially and banks could choose to tighten credit availability. Financial markets across the board would likely become very illiquid and volatile as firms with significant losses attempted to unwind their positions.

Unfortunately, that might not be the end of the story. The GSEs make use of a considerable amount of short-term funding, that is then hedged to some degree to replicate long-term funding. For example, short-term instruments account for more

than 20 percent of all outstanding debt for both Fannie Mae and Freddie Mac. In a financial crisis, the GSEs might face difficulty in accessing debt markets. This difficultly might force the GSEs liquidate some MBS holdings, putting excessive downward pressure on prices in a market that the GSEs are supposed to be stabilizing.

Those asset sales, in turn, would likely undermine confidence and exacerbate the sense of panic in the market and add to the losses of the GSEs and other entities that are major holders of GSE obligations.

I could elaborate further with various scenarios of how such a meltdown might play out in various corners of our world's capital markets. I have not mentioned, for example, the potential volatility and unraveling of emerging markets that might ensue as they tend to do when a crisis results in a "flight to quality" mentality.

And of course, there are scenarios that could play out with foreign investors, a group that might not appreciate fully the GSEs' relationship with the U.S. Government and who own nearly $1 trillion of GSE debt and MBS. Indeed, GSE obligations held on behalf of foreign official institutions at the Federal Reserve Bank of New York have been increasingly rapidly over the last 18 months and now exceed $500 billion.

So there are virtually limitless scenarios. But you get the point. We already know the lessons here. There is no need to endure the test.

I assume that some might contend that, despite the GSEs' current accounting, corporate governance, and risk management problems, what I have just laid out in terms of GSE getting into serious financial trouble is unlikely. Past history reminds us that serious financial problems in the GSEs are not only a possibility, but an unfortunate reality. And, I feel compelled to remind you that the federal government has taken steps to assist a troubled GSE in the past.

Do we really want to be faced with unwarranted and irresponsible calls for bailing out another failed GSE?

In fact, has it been so long that we have forgotten Fannie Mae's significant financial troubles in the late 1970s and early 1980s? During this time period, Fannie Mae's balance sheet looked a lot like a savings & loan. As interest rates rose, Fannie Mae's cost of funds rose above the interest rate it was earning on its long-term, fixed-rate mortgages. Like many S&Ls, Fannie Mae became insolvent on a mark-to-market basis. It lost hundreds of millions of dollars. Only a combination of legislative tax relief, regulatory forbearance, and a decline in interest rates allowed Fannie Mae to grow out of its problem.

In the mid-1980s, the Farm Credit System (FCS) fell victim to a sharp drop in land prices, deterioration of agriculture market conditions, and increased interest rate volatility. These economic factors coupled with poor interest rate risk management resulted in $2.7 billion in losses in 1985 followed by a $1.9 billion loss in 1986. In the end, the federal government provided $1.26 billion to the FCS in financial aide.

While I suppose those expectations were correct in the 1980s, as I noted recently, past government bailouts or assistance should not be viewed as a good predictor of future government actions.

What I hope you ask yourself after hearing this is "Why?" and "What can we do about it?"

The answer to the first question is unsatisfying. Ignoring all the rhetoric and spin, the simple truth is that there is no need for our financial markets to be exposed to this risk. Passionate statements made by the GSEs to the contrary, the GSE investment portfolios are not necessary for them to stay true to their mission.

The answer to the second question is much more satisfying – we can address this

risk rather easily. As long as the portfolios of the GSEs are reduced gradually and responsibly, the overall impact to the housing market should be trivial.

I would be pleased to answer any questions you might have on this important topic. Thank you very much.

June 26, 2006
4339

Letter to the Editors of *The New York Times*
by Treasury Secretary Snow

Mr. Bill Keller, Managing Editor
The New York Times
229 West 43rd Street
New York, NY 10036

Dear Mr. Keller:

The *New York Times'* decision to disclose the Terrorist Finance Tracking Program, a robust and classified effort to map terrorist networks through the use of financial data, was irresponsible and harmful to the security of Americans and freedom-loving people worldwide. In choosing to expose this program, despite repeated pleas from high-level officials on both sides of the aisle, including myself, the Times undermined a highly successful counter-terrorism program and alerted terrorists to the methods and sources used to track their money trails.

Your charge that our efforts to convince The *New York Times* not to publish were "half-hearted" is incorrect and offensive. Nothing could be further from the truth. Over the past two months, Treasury has engaged in a vigorous dialogue with the Times - from the reporters writing the story to the D.C. Bureau Chief and all the way up to you. It should also be noted that the co-chairmen of the bipartisan 9-11 Commission, Governor Tom Kean and Congressman Lee Hamilton, met in person or placed calls to the very highest levels of the Times urging the paper not to publish the story. Members of Congress, senior U.S. Government officials and well-respected legal authorities from both sides of the aisle also asked the paper not to publish or supported the legality and validity of the program.

Indeed, I invited you to my office for the explicit purpose of talking you out of publishing this story. And there was nothing "half-hearted" about that effort. I told you about the true value of the program in defeating terrorism and sought to impress upon you the harm that would occur from its disclosure. I stressed that the program is grounded on solid legal footing, had many built-in safeguards, and has been extremely valuable in the war against terror. Additionally, Treasury Under Secretary Stuart Levey met with the reporters and your senior editors to answer countless questions, laying out the legal framework and diligently outlining the multiple safeguards and protections that are in place.

You have defended your decision to compromise this program by asserting that "terror financiers know" our methods for tracking their funds and have already moved to other methods to send money. The fact that your editors believe themselves to be qualified to assess how terrorists are moving money betrays a breathtaking arrogance and a deep misunderstanding of this program and how it works. While terrorists are relying more heavily than before on cumbersome methods to move money, such as cash couriers, we have continued to see them using the formal financial system, which has made this particular program incredibly valuable.

Lastly, justifying this disclosure by citing the "public interest" in knowing information about this program means the paper has given itself free license to expose any covert activity that it happens to learn of - even those that are legally grounded, responsibly administered, independently overseen, and highly effective. Indeed, you have done so here.

What you've seemed to overlook is that it is also a matter of public interest that we use all means available - lawfully and responsibly - to help protect the American people from the deadly threats of terrorists. I am deeply disappointed in the *New York Times*.

Sincerely,

[signed]

John W. Snow, Secretary
U.S. Department of the Treasury

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June 23, 2006
JS-4340

Terrorist Finance Tracking Program
Fact Sheet

- After the September 11th terrorist attacks, President Bush declared that we would use all elements of national power to fight a different kind of war against terror. On September 23, 2001, the President launched a new campaign against terrorist financing when he issued Executive Order 13224. This EO authorized the Treasury Department – in conjunction with other Cabinet agencies -- to use all appropriate measures to identify, track, and pursue not only those persons who commit terrorist acts here and abroad, but also those who provide financial or other support for terrorist activity.
- Treasury developed the Terrorist Finance Tracking Program to identify, track, and pursue suspected foreign terrorists, like al Qaida, Hamas, and Hezbollah -- and their financial supporters. The Treasury Department is uniquely positioned to track terrorist money flows and assist in broader US Government efforts to uncover terrorist cells and map terrorist networks here at home and around the world. These efforts have not only disrupted terrorist networks, they have saved lives.
- As part of its vital mission, Treasury issues subpoenas to SWIFT – a Belgium-based company with U.S. offices that operates a worldwide messaging system used to transmit bank transaction information – seeking information on suspected international terrorists. Under the terms of the subpoenas, the U.S. government may only review information as part of specific terrorism investigations.
- Based on intelligence that identifies an individual or entity, the US Government is able to conduct targeted searches of the limited subset of records provided by SWIFT in order to trace financial transactions of suspected terrorist activity.
- SWIFT information greatly enhances our ability to map out terrorist networks, often filling in missing links in an investigative chain. The US Government acts on this information to target and disrupt the activities of terrorists and their supporters.
- By following the money, the U.S. has been able to identify and locate operatives and their financiers, chart terrorist networks, and help keep money out of their hands.
- The TFTP is firmly rooted in sound legal authority, based on statutory mandates and Executive Orders -- including the International Emergency Economic Powers Act of 1977 (IEEPA), and the United Nations Participation Act (UNPA).
- In no way does the TFTP involve data mining or trolling through the financial records of Americans. In fact, most Americans would never have information that would be included in the SWIFT data. We work to ensure the appropriate and limited use of the information while maintaining respect for individual privacy.
- SWIFT is overseen by a committee drawn from major central banks – including the U.S. Federal Reserve, the Bank of England, the European Central Bank, the Bank of Japan, and the lead overseer, the National Bank of Belgium. The overseers have been informed about SWIFT's participation with the Treasury and the safeguards and assurances put in place.
- The program has rigorous safeguards and protocols to protect privacy. Searches of records must identify the terrorism-related basis, which is systematically logged and auditable. Regular, independent audits of the program have confirmed that the U.S. Government has consistently

observed the established safeguards and protocols.

- Furthermore, appropriate Members of Congress, including the members of the House and Senate intelligence committees, have been briefed on this program.
- The TFTP is separate and complementary to other US Government efforts focused on terrorist financing. For example, the Treasury Department, as mandated by Congress in the Bank Secrecy Act, requires financial institutions to make available a range of similar information for law enforcement and counterterrorism purposes. The Government relies on financial data every day in pursuing criminal and terrorist activity.
- This is exactly the kind of program that Americans want and expect from their government to prevent further terrorist attacks. The 9/11 Commission was critical of the government for its failure to have this kind of program – one that uses all available information to connect the dots -- in place prior to the September 11th attacks. In fact, in its final report card the 9/11 Commission's Public Discourse Project awarded the government-wide effort to combat terrorist financing the highest grade, citing the government's "significant strides in using terrorism finance as an intelligence tool."
- Furthermore, noting the value of this kind of activity, Congress has directed Treasury to explore the implementation of systems to review all cross-border financial transactions. Treasury's Financial Crimes Enforcement Network (FinCEN) is studying the feasibility of developing such a program in response to Congress.
- There is no doubt that America and our allies in the war on terror are safer today because of this program.
- It is important to note that the Treasury Department is open and transparent about its efforts to identify and track the financial transactions of foreign terrorist suspects and their supporters. Whether in congressional testimony, in public speeches, or communications with the news media, Treasury officials have always highlighted the Department's efforts to track suspected terrorist financing activity.
- However, as with any national security program, the Administration is appropriately protective of the methods and sources it employs to execute its mission. The public dissemination of sources and methods degrades national security and the government's efforts to prevent terrorist activity.

REPORTS

- Legal Authorities Underlying the Terrorist Finance Tracking Program

Legal Authorities Underlying the Terrorist Finance Tracking Program

- The SWIFT data is provided pursuant to subpoenas based on statutory mandates and related Executive orders for combating terrorism.
- The International Emergency Economic Powers Act of 1977 authorizes the President, during a national emergency, to investigate bank transfers and other transactions in which a foreign person has any interest. 50 U.S.C. § 1702. Similarly, the United Nations Participation Act authorizes the President, when implementing United Nations Security Council Resolutions, to investigate economic relations or means of communication between any foreign person and the United States. *See* 22 U.S.C. § 287c; UNSCR 1333 (2000) and 1373 (2001).
- In Executive Order 13224, relying in part on IEEPA and the UNPA, the President declared a national emergency to deal with the 9/11 terrorist attacks and the continuing and immediate threat of further attacks, and blocked the property of, and prohibited transactions with, persons who commit, threaten to commit, or support terrorism. 66 Fed. Reg. 49079 (Sept. 25, 2001). The President delegated his authorities under the Executive Order to the Secretary of the Treasury. Treasury issued the subpoenas to SWIFT pursuant to Executive Order 13224 and its implementing regulations. *See* 31 C.F.R. Part 594; 31 C.F.R. § 501.602.

For background:

- The subpoenas fully comport with applicable Fourth Amendment standards (*i.e.*, the investigation of terrorism is properly authorized by the Congress; the data requested are "reasonably relevant" to that investigation; and the subpoenas are not unduly burdensome).
- The Foreign Intelligence Surveillance Act, 50 U.S.C. §§ 1801-1863, is not applicable to the Program. The SWIFT data is produced pursuant to a subpoena for financial records. Treasury is not engaged in "electronic surveillance" – it is not acquiring any radio or wire communication (*see* 50 U.S.C. § 1801(f)(1), (2), (3)) and there does not exist a legitimate expectation of privacy with respect to financial records (*see* 50 U.S.C. § 1801(f)(4); *United States v. Miller*, 425 U.S. 435, at 442-43).
- The Right to Financial Privacy Act of 1978 (RFPA), 12 U.S.C. §§ 3401-3422, is not applicable to the Program. RFPA delineates procedural requirements for a government agency to obtain from a bank financial records of its individual customers, such as by administrative subpoena. RFPA does not apply, however, to a company such as SWIFT that does not have individual persons as customers, but rather acts as an intermediary for financial institutions.
- Under the Bank Secrecy Act, Treasury mandates that financial institutions maintain and provide transaction records for law enforcement purposes, including for counter-terrorism investigations. *See, e.g.,* 31 U.S.C. § 5318; and 12 U.S.C. § 1829b.

June 27, 2006
JS-4341

Opening Statement of Henry M. Paulson, Jr.
before the Senate Finance Committee

Chairman Grassley, Ranking Member Baucus, and members of the Finance Committee, thank you for inviting me to testify here today. I am honored that President Bush has nominated me to serve as the 74th Secretary of the Treasury, following the distinguished leadership of Secretary John Snow. And I appreciate the time members of this Committee have taken to meet with me and consider my nomination. Frequent communication between the Treasury Department and this committee is of vital importance, and if confirmed I look forward to building on the important dialogue that we have already begun.

I am also grateful to my family for supporting my decision to pursue this opportunity.

The Treasury Department has a critical role to play in helping to set the direction of the U.S. and global economy – a role that reaches back to America's founding. If confirmed, I will strive to carry forward the Treasury Department's rich legacy.

I have admired the work of the Treasury Department throughout my 32-year career in finance – and particularly during the last eight years, when I have led a global financial institution. As the steward of the U.S. economic and financial systems, the Treasury has helped lay the groundwork for the American economy to become a model of strength, flexibility, dynamism and resiliency.

This is a system that generates growth, creates jobs and wealth, rewards initiative, and fosters innovation. It is also a system that offers considerable social and economic mobility. We must never take this for granted, and we cannot allow Americans to lose faith in the benefits our system offers. America is the land of opportunity. We need to be vigilant in ensuring that each and every American has the opportunity to acquire the skills to compete, and to see those skills rewarded in the marketplace.

One way we can do this is to maintain a macroeconomic climate that enables workers, families, businesses – both small and large – to thrive. That calls for spending discipline and predictable taxation, combined with prudent regulation.

If confirmed, I will focus intensely on how the United States can maintain and strengthen our competitive position. As a product of a mid-sized town in Illinois, I will of course always remember Chairman Grassley's succinct description of the Treasury secretary's role: "to understand how tax policy, capital markets, international trade, and currency policy affect Main Street USA."

As we work to promote greater economic opportunity for the American people, we must always remember that the American economy is deeply integrated with the global economy. That brings challenges, but even greater opportunities. While maintaining confidence in our ability to compete throughout the world, we must be prepared to embrace the change that will contribute to our long-term prosperity. Open markets help to boost productivity and drive America's economic growth, which in turn creates new and better jobs for American families. It's also true that the global integration of economies and markets holds the promise of a more prosperous and secure world. In my extensive travels throughout the world, I've seen countless examples of the benefits of economic reform.

If confirmed, I will be active in affirming America's leadership role in the global economy, where we must continue to be a constructive and stabilizing force. I also look forward to working alongside other colleagues in the Cabinet to advocate policies and actions which provide open and level markets for U.S. investment and for U.S. products.

To close, I will briefly outline some of the steps that could be taken to achieve a stronger and more competitive U.S. economy:

- Addressing the long-term unfunded obligations of Social Security and Medicare that threaten to unfairly burden future generations.
- Keeping taxes low and collecting them in a simpler and fairer manner that does not distort economic decision-making.
- Expanding opportunities for American workers, farmers, and businesses – big and small – to compete on a level playing field with the rest of the world.
- Maintaining and enhancing the flexibility of our capital and labor markets, and preventing creeping regulatory expansion from driving jobs and capital overseas.
- Finally, the U.S. economy will be stronger if we can continue to foster an entrepreneurial spirit and culture which generates innovation, risk-taking, and productivity growth that raises living standards to keep America the economic envy of the world.

If confirmed, I look forward to frequent consultation with members of this Committee to advance these important ideas. And if confirmed, I also look forward to working with the Treasury Department's select corps of professionals, who play a critical role in the stability and vitality of the U.S. economy.

Thank you Mr. Chairman.

June 27, 2006
2006-6-27-13-0-2-21646

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $65,624 million as of the end of that week, compared to $66,086 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	June16, 2006			June 23, 2006		
TOTAL	66,086			65,624		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	11,797	11,015	22,812	11,684	10,894	22,578
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,725	5,363	17,088	11,637	5,318	16,955
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			6,533			6,493
3. Special Drawing Rights (SDRs) [2]			8,612			8,558
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	June 16, 2006			June 23, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						
2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets						
	June 16, 2006			June 23, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL

1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

June 29, 2006
JS-4342

Testimony of D. Scott Parsons, Deputy Assistant Secretary for Critical Infrastructure Protection and Compliance Policy U.S. Department of the Treasury

Before the U.S. House of Representatives Committee on Financial Services Subcommittee on Oversight and Investigations

Thank you Chairwoman Kelly, Ranking Member Gutierrez, and Members of the Subcommittee. I appreciate the opportunity to speak to you about the Treasury Department's contribution to pandemic planning within the financial services sector. Though the Treasury's efforts are just a small part of the enormous Federal effort, we have been very active. President Bush stated, "Together we will confront this emerging threat and together, as Americans, we will be prepared to protect our families, our communities, this great Nation, and our world."

I would like to begin my remarks by telling you about the sector's general state of preparedness and then tell you about the Treasury's leadership on pandemic planning within the financial services sector.

Financial Services Sector Preparedness

I am pleased to report that the financial services sector has undertaken significant steps toward ensuring its resilience to withstand both man-made and natural disasters. President Bush has led the overall development and implementation of an effective program to defend our country's critical infrastructure. The financial services sector plays an indispensable role in the Nation's economic system, providing individuals, businesses, and the government with credit and liquidity, short and long-term investments, risk-transfer products, various payment systems, and depository services. It enables people to save for their education and retirement, to purchase their homes, and to invest in their dreams. The financial services system is essential to America's overall economic well being.

I note that we have experienced a number of events in recent years that have tested our resilience. The attacks of September 11, 2001, the power outage of August 2003, and the elevation of the threat level for the financial sector in August 2004 all tested the preparedness and resolve of the sector. Most recently, Hurricane Katrina caused unprecedented devastation in multiple States. Yet the American financial system survived each of these events, and through hard work and investment, became stronger and better able to contend with such disruptions.

On December 17, 2003, the President issued Homeland Security Presidential Directive – Seven (HSPD-7), which established a national policy for Federal departments and agencies to identify and prioritize United States critical infrastructure and key resources and to protect them from terrorist attacks. HSPD-7 recognizes that various Departments and agencies have specific knowledge, expertise, and experience in working with certain sectors. Therefore, this directive provides for Sector Specific Agencies, or lead agencies, for given sectors. The Department of the Treasury is designated as the Sector Specific Agency for the banking and finance sector.

Under this designation, the Treasury collaborates with Federal, State, and local governments and the appropriate private sector entities to encourage the development of information sharing and analysis processes, and to support sector-

coordinating mechanisms to: (1) identify, prioritize, and coordinate the protection of critical infrastructure and key resources; and (2) facilitate sharing of information about physical and cyber threats, vulnerabilities, incidents, potential protective measures, and best practices.

We have developed a two-pillared structure within both the public and the private sectors to support the Treasury's efforts to safeguard the financial services sector. The first pillar is the Financial and Banking Information Infrastructure Committee (FBIIC), which is chaired by the Treasury's Assistant Secretary for Financial Institutions and is comprised of the Federal and State financial regulators. The second pillar is the Financial Services Sector Coordinating Council (FSSCC) which is comprised of the leading financial services institutions and trade organizations. We also rely on the Financial Services Information Sharing and Analysis Center (FS-ISAC) to communicate with the sector during a crisis.

The Treasury has a strong commitment to ensuring the financial system continues to serve all Americans. The Secretary has tasked the Treasury Department's Office of Critical Infrastructure Protection and Compliance Policy with the responsibility for developing and executing policies affecting the resilience of the United States financial system. The majority of these efforts require close cooperation and partnership with the public and private sector. In carrying out these efforts, the Treasury continues to:

- Work with government agencies, private sector firms, and national and regional organizations to establish a single point of contact for critical financial infrastructure issues;
- Promote strong relationships between financial institutions and the State and local governments where financial sector operations are located;
- Inform the private and public sectors about the available resources that protect the financial infrastructure; and
- Support the availability of accurate and timely information about potential threats on a national and regional level.

Treasury's Contribution to Pandemic Planning in the Financial Services Sector

Let me now turn specifically to today's topic. Pandemic influenza is a serious threat. Moreover, although the narrow specifics of an influenza pandemic threat are unique, elements contained within the planning for pandemic countermeasures are relevant to preparedness for radiological, nuclear, biological and chemical threats. The United States experienced three major pandemics in the twentieth century. The influenza pandemic of 1918 killed tens of millions of people worldwide, and estimates are that between 500,000 and 800,000 people in the United States lost their lives. Milder outbreaks of influenza in 1957 and 1968 killed tens of thousands of Americans, and perhaps millions more across the world.

Most disasters are confined to a limited geographic area, usually measured by the number of cities and States that are impacted. Pandemic influenza is unique in that it has the potential to affect our entire country very quickly, from Wall Street securities firms to Midwestern credit unions, to back-office operations centers in the Arizona desert that serve them both and many others.

This type of potential disruption forces us to think differently about how we prepare for something as widespread as a pandemic. For example, we must change the way businesses within the financial services sector think about business continuity. A firm cannot simply move to out of region back-up facilities and restore operations because it is likely those facilities are also experiencing challenges associated with the pandemic. Without proper planning, a pandemic could disrupt the ability of a financial institution to operate.

For example, contingency planning, in both the public and private sector, must now take into consideration efforts to mitigate the spread of influenza within the firm or a department. Among the key issues for consideration are the stockpiling of masks, gloves and anti-viral agents, additional hand washing stations for employees, and identifying and isolating employees who may be sick.

There are many possible impacts of a pandemic on firms' abilities to operate. One of the most likely is a sharp increase in employee absenteeism. It is important that we begin to consider now how best to cope with high absenteeism rates. Here, too, there are many considerations, including making provisions to provide parking for employees who may not want to take public transportation, childcare for workers if schools are closed, cross training so that workers can do multiple jobs, and identifying work streams that can be performed at home, and ensuring that internal information technology is prepared to support that work from home.

Finally, as we consider all of these issues, we must also recall that for unbanked Americans, the ability to access financial services is generally based on person-to-person interactions, such as cashing a check or purchasing a money order, and we must take into consideration the unbanked and consider whether there are unique or specific concerns that affect them and the financial services firms that serve them.

The financial sector uses many independent third parties to provide services that range from cleaning, to the repair of computer systems, to security. Many financial firms are now requiring their service providers and, at times, even their business partners, to have business continuity plans in place as a condition of doing business. We view this as beneficial as this produces a positive cascading effect in the financial services supply chain which increases the overall preparedness for a pandemic.

Interdependencies with other sectors must also be taken into consideration. Financial sector regulators and institutions have been considering their interdependencies with other sectors of the economy. For example, we are considering whether the telecommunications infrastructure would be adequate to support the internet traffic generated by a large number of people working at home, especially the residential portion that connects an employee's residence to major trunks of the internet, and the need for any additional data security measures should employees be required to work from their homes. Similarly, the financial sector is dependent upon transportation, especially public transportation for its employees, and therefore it is vital to understand public transport planning for coping with a pandemic. We have engaged with each of these sectors, as we have during other threats, and we remain committed to working together with these sectors to ensure the needs of the financial community are met.

The President is leading a massive Federal effort that respects and appreciates the role of States and localities, as well as the private sector, in such an event. The Homeland Security Council's *Implementation Plan for the National Strategy for Pandemic Influenza* contains over 300 critical actions to address the threat of a pandemic. At the end of last year, as part of this effort, the Congress appropriated $3.8 billion dollars for pandemic planning. In addition, there was $2.3 billion appropriated recently for pandemic flu, as part of the emergency supplemental appropriations.

The Treasury has been very active within the financial services sector to provide and share the most current thinking about what a 21st century pandemic could look like, so that sector participants can use the latest information to build and improve plans and scenarios to mitigate the potential risks. The principles that guide our leadership role in the financial services sector are that our planning efforts will be based on medical science, which is provided to us by experts outside of the Treasury, and that planning efforts will emphasize the protection of the life and safety of our fellow Americans, whether they be employees or customers of financial firms, or others, the importance of business continuity within financial firms, and the significant number of interdependencies needed to sustain operations during an outbreak of a pandemic. Please allow me to spend a few minutes describing key elements of our plan, which focuses on coordination, education, outreach, and an effort to exercise and test the plans and procedures that have been developed.

Last year, the FBIIC created a working group to focus on pandemic influenza. The purpose of the group is to identify areas of concern and to identify and share best practices as it relates to business continuity for the financial community. This group

has been meeting regularly, and has also been in close communication with the FSSCC.

One concern that we have been often asked about is banknotes and coinage. In the immediate aftermath of any disaster, there may be some movement toward a greater use of currency. This may be no different in the immediate aftermath of a pandemic. In this vein, the Treasury's United States Mint and the Bureau of Engraving and Printing are working with the Federal Reserve Banks to ensure that banknote and coin inventories are adequate should financial institutions need additional supplies. The Treasury and the relevant financial services sector regulators are committed to working with sector participants to address these types of issues before a pandemic, or any crisis, arrives.

An important mission for the FBIIC is to be in a position to centrally coordinate policymaking and decision-making in the event of a situation that requires emergency actions. The FBIIC has in place well-tested emergency protocols, that were employed during Hurricanes Katrina, Rita and Wilma, and during the elevation of the threat level in New York and Washington, DC. These protocols have explicit provisions for reaching out to the private sector. In the event of any pandemic, these collaboration, communication and coordination tools would be used to ensure that those within financial regulatory agencies as well as the entities within the financial services sector are in touch with the most up-to-date information and instructions.

The FSSCC has recently formed an infectious disease working group. I know that you will be hearing from a private sector panel next, but I would like to say that these two working groups, the FBIIC group and the FSSCC group, are working well together and representing public and private interests.

I mentioned previously that our strategies to protect the sector are grounded in sound medical science. To that point, the Treasury has hosted two presentations with leading Federal officials from the health and medical community. On December 16, 2005 we invited a leading medical expert in the area of vaccine science to speak to members of the FBIIC and the FSSCC. This physician discussed several pertinent topics such as: the history and spread of pandemics in the US; the composition of the H5N1 avian flu strain and the spread of the virus; and a forecast of the possible infection rates should the disease mutate into a form that is transmittable between humans. Meeting participants also discussed vaccines and prophylaxis against the virus, including issues involving anti-viral agents. This session helped the regulatory agencies and private sector representatives share a common understanding of many aspects of the virus.

On June 6, 2006, the Treasury hosted a joint meeting of the FBIIC and FSSCC to get an update on the H5N1 virus and an update on the latest thinking in the medical community. At this meeting we invited a leading physician and health care administrator to give an update on the *President's National Strategy for Pandemic Influenza*. This physician spoke about community shielding strategies and also gave an update on the H5N1 virus. His presentation was particularly relevant, given the effect that community shielding strategies (such as school closures and "snow days") would have on the financial services sector. The sector is particularly interested in any actions the Federal government might take so that it can modify its contingency planning to take into consideration those actions. Our plan is to continue to hold joint medical briefings every six months, or as needed, to ensure we are collectively aware of the latest medical science in this area.

We also believe it is vital to reach beyond Washington, DC and conduct an outreach campaign to carry the message for pandemic preparedness to all parts of the country. The Treasury's outreach initiative, sponsored by the FBIIC and the FSSCC, will take us to twenty-one cities across the country by the end of the year. The objective of these meetings is educational – to promote financial services sector preparedness to deal with man-made or natural disruptions, including terrorism, hurricanes, and pandemics and encourage the formation of regional financial coalitions, such as the very first one created in Chicago, and the others that have been created or are under development. These events bring together Federal, State, and local officials with financial institutions and provide a great

opportunity to encourage financial services pandemic preparation at the community level.

I now turn to one of our most important strategies, which is the use of exercises. We learn many lessons from thinking through what actions will be taken during a potential crisis. Last week the Treasury sponsored a pandemic flu tabletop exercise with FloridaFIRST, a newly formed regional financial coalition based on the highly successful ChicagoFIRST model. FloridaFIRST represents the second in a Treasury Department supported private sector initiative to establish regional financial coalitions around the country. The exercise brought together financial services, public health, and law enforcement officials from local, State, and Federal levels. Participants took home a long list of lessons learned, of which the key insights include:

- Development of contingency plans specific to a pandemic influenza is vital;
- Private sector institutions will look to Federal, State and local health officials for trigger points to enact certain parts of pandemic plans and for other information related to the pandemic;
- Development of an all-inclusive plan for the safety of employees, their families, and clients is important, and the plan must be communicated and understood by employees before a pandemic hits; and
- Implementation of good personal hygiene plans, such as hand washing, should begin now, not during a pandemic; and
- Infrastructure to support work at home programs must be strengthened before a pandemic occurs.

The Treasury, together with its FBIIC partners, will be working with financial institutions to assist them in working towards the development of measures to implement or enhance their efforts in these areas.

Robert Otero, FloridaFIRST Chairman, said that the "exercise will be a catalyst for a paradigm shift in the way institutions prepare for future disasters." We look forward to continuing to work with the Florida financial institutions we met with last week, and their appropriate regulators, to ensure that we all continue along the path of preparedness.

The exercise was so successful that we are going to schedule a joint FBIIC and FSSCC exercise on pandemic planning this summer. We would like to host similar exercises with other regional financial coalitions established, with the Treasury's support, based on the ChicagoFIRST model. Coalitions have been established in Southern California and the San Francisco Bay Area and there is interest in Las Vegas, Houston, Seattle, and Philadelphia as well as other cities

The Treasury Department has been actively involved with our counterparts abroad. We have had enlightening conversations with financial regulators in Hong Kong. They have a unique perspective, not only because recent cases of H5N1 in humans are in their backyard, but because of the outbreak of the Severe Acute Respiratory Syndrome virus a few years ago. We have also met with representatives from the UK's Tripartite Standing Committee about how they interact with their own UK financial services sector. We hope to take the any lessons learned from our counterparts and apply them here in the United States.

In addition to these presentations, working groups, exercises, and meetings, the Treasury represents the financial sector across Federal government, from the Department of Homeland Security to the Department of Labor and to the Small Business Administration. My staff and I spend countless hours promoting education and preparedness for pandemic influenza.

One of the questions we are considering is what the economic impact of a pandemic would be. This is a very difficult question to answer. We know the direct effects are disease and mortality. Indirect effects include the reaction citizens have to a pandemic: -- would people continue to show up at work, and would they isolate themselves physically so as to avoid contagion? Some have suggested there would be little or no economic impact, while others have forecast declines in GDP

of 5% or more. Certainly economic impacts depend on the severity of the influenza, and it is likely that an outbreak as severe as that of 1918 could have some measurable effect on the economy.

It is important to remember that we have a strong economy that is highly resilient. There is an effort currently underway across the government to build new economic models to try and understand economics based on previous pandemics, but also taking into account structural changes in our economy, which is much different than that of the last major influenza outbreak in 1968. We anticipate that this work will continue to develop through the rest of this year.

Pandemic Planning within the Sector

Pandemic preparedness requires the collective efforts of Federal, State, and local authorities in close partnership with the private sector. The financial services sector is active in its preparedness efforts and it is taking the threat of pandemic influenza very seriously. We still have a lot of work to do -- it is often said that preparedness is a race with no end – but working together we have made great strides. While it is difficult to quantify or measure progress on pandemic preparedness, I can state definitively that awareness about the threat of a pandemic has increased dramatically in the financial services sector, and a significant number of firms are now planning to deal with a pandemic as part of their business continuity strategies

I don't want to spend too much time talking about what I know you will hear from my private sector colleagues but I do want to spend a few minutes talking about the serious and productive work the sector is undertaking to prepare itself. The sector is currently building robust plans to continue to operate during a pandemic and, though some nonessential services may be temporarily halted, critical functions will continue to operate.

The sector's professionals have concerns and they are actively working with health professionals to address their unanswered questions. Overall, I believe that you will hear that the number one priority from the financial services sector is the safety of their fellow Americans – employees, their families, and customers.

Conclusion

Again, thank you for allowing me the opportunity to testify before you today. As I said before, we are working very hard to prepare the financial services sector for a pandemic outbreak, but the Treasury's efforts are only a single part of the overall Federal response. We are committed to ensuring that payment systems, settlement and clearing, retail banking networks, credit and debt, liquidity, insurance, and derivative instruments remain available during a crisis, either man-made or natural, including a pandemic. These are the operations that enable an efficient and orderly financial system on which investors, businesses, and our global trading partners rely. These financial functions are vital to providing our citizens the financial services all Americans depend on every day. And, while I believe we have made great progress toward preparedness for the financial services sector, it is clear that all levels of the public and private sectors must work together to have an effective plan to handle a pandemic.

Thank you for your attention to this important topic.

June 29, 2006
JS-4343

Treasury Names Three Deputy Assistant Secretaries

Treasury has named Robert Dohner Deputy Assistant Secretary for Asia, International Affairs; Nova Daly Deputy Assistant Secretary for Investment Security, International Affairs; and Mark Warren Deputy Assistant Secretary for Tax and Budget, Legislative Affairs.

In his position Dohner is responsible for helping shape Treasury policy on regional and country-specific economic issues in Asia. He was formerly the Director of the East Asia Office, responsible for China, Japan, and other economies of East and Southeast Asia. Prior Treasury positions include Tokyo Financial Attaché and Director of the Office of Central and Eastern Europe. Before joining Treasury, Dohner was a Senior Economist at the President's Council of Economic Advisers, a Principal Economist at the OECD, and Senior Economic Adviser to Under Secretary of State for Economic and Agricultural Affairs Robert Zoellick during the first Bush Administration. He also taught economics at the Fletcher School of Law and Diplomacy at Tufts University, and he has worked at the GATT and the Monetary Authority of Singapore. Dohner has a Ph.D. in economics from M.I.T.

As the Deputy Assistant Secretary for Investment Security, Daly will oversee the staff office responsible for managing the Department's work as the chair of the Committee on Foreign Investment in the United States. Most recently, Daly served under the National Security Council as the Director for International Trade where he handled multiple trade and investment policy issues – including investment security and CFIUS matters. Prior to the NSC, Daly was the Senior Advisor for Trade Policy for Commerce Secretary Donald Evans and had worked for the Senate Finance Committee on trade and investment issues. He holds an undergraduate degree in political science from the University of California, Irvine and a graduate degree in international law and organizations from American University.

Warren is responsible for coordinating with Congress on tax, pension, Social Security and budget issues. Warren started his career on Capitol Hill in 1995 with the House Committee on Small Business and moved to the Senate in 1997 where he served as the Senate Small Business Committee's Chief Tax and Finance Counsel and later as the Staff Director and Chief Counsel. Most recently, he served as the Chief Counsel of the Senate Republican Policy Committee from February 2004 through June 2006. He holds an undergraduate degree in finance and a law degree from Georgetown University, and a Masters Degree in tax law from New York University. Warren has also spent time in private practice working in New York and Washington, DC.

June 29, 2006
JS-4344

**Statement of Treasury Secretary John W. Snow
On GDP the Tax Cut Package Reconciliation**

"Today's final revision for first quarter 2006 real GDP reveals the U.S. economy grew at a remarkable 5.6 percent rate – once again demonstrating that the President's tax relief helped spawn strong economic growth over the last three years, with 12 straight quarters of increased capital investment, more that 5.3 million jobs and higher standards of living for all Americans.

"With this my final official statement on economic growth as Treasury Secretary, I would like to take this opportunity to convey my confidence in the President's economic policies. There can be no doubt that the U.S. economy is in a better place because of the President's leadership. I am particularly pleased by the clear progress on the deficit –with strong federal receipts, it's clear we are ahead of schedule to meet the President's goal. What's more, with an agenda focused on improving the future of America's energy outlook and competitiveness, U.S. economic strength will be sustained for future generations.

"I was also pleased to see the Senate's quick confirmation of my successor, Hank Paulson. The President, the U.S. Treasury and America will be well-served by Mr. Paulson's knowledge, ability and leadership."

June 30, 2006
js-4345

Remarks of Anna Escobedo Cabral
U.S. Treasurer
U.S. Department of the Treasury

Before the League of United Latin American Citizens
(LULAC)

Milwaukee, Wisc.- Brent, thanks for your kind words and introduction. It is great to be in Milwaukee, Wisconsin today for your 77th Annual League of United Latin American Citizens' Convention and Expo. You and your staff have done a phenomenal job in putting this event together – so congratulations.

I sincerely appreciate LULAC's invitation to participate in this year's Women's Luncheon and this opportunity to speak to such a dynamic group of women – and really – such a fantastic group of individuals and leaders. Many of you may know that I had the great privilege to be with you a year ago, and I can't begin to tell you how honored I am to have been invited to return to this conference this year.

There is so much good news I want to share with you on many fronts today – good news about the economy, about government efforts to improve education, particularly financial education in the U.S., and most importantly about current policy reform issues, including immigration reform. The Administration is absolutely concerned and working very diligently on all of this.

But first, I would like to take a few moments to recognize Hector Flores. As you all know, Hector has served LULAC and its members for many years with honor and distinction – almost three decades. His commitment is long-standing. Even before becoming president of this organization in 2002, Hector served LULAC and this community in a variety of positions. I truly consider Hector Flores a friend and a dear colleague; he has truly advocated for the needs and concerns of the Latino community. So Hector, again, on my part and on behalf of President Bush and Secretary Snow, I want to thank you for your years of service to this community.

You know, this organization has a very rich history as one of the oldest and largest civil rights organizations in the U.S. – and it should be commended for the significant work it is invovled in, day-in and day-out. I would say that the work of organizations like this one are of great importance, and often, also of great consequence to the decisions our policymakers in Washington ultimately make on a variety of topics.

Organizations like this serve as a bridge for individuals who not only want to better understand issues of the day, but are also interested and quite frankly very motivated about letting decisionmakers know where they stand on a various issues. Remember that Washington is a very long way from where most of us come, so we need people in key positions who are advocating for minority communities in the U.S.

However, you should know that organizations like this also really do provide the decisionmakers and policy advisors – those with a vested interest in presenting their perspective on many public policy issues – an opportunity to do so directly with the community.

LULAC is an important bridge to a number of Latinos who currently serve in high-

ranking government positions. Many government officials who have great interest in reaching out to this community also comprise a number of highly-qualified women who currently serve on President Bush's team – such as Secretary of State, Dr. Condoleezza Rice, Secretary of Labor, Elaine Chao, Chair of the U.S. Equal Employment Opportunity Commission, Cari Dominguez and the Department of Energy's Director of the Office of Minority Economic Impact and Diversity, Theresa Alvillar-Speake – just to name a few. Many more have been appointed to be judges by President Bush.

It is a fact that women today play an increasingly important role in how public policy decisions are shaped. We continue to move forward as professionals and contribute to our society mainly because of the important work and often self-sacrifice of women who have come before us. Women in the U.S. have shaped this country's history, and they have helped make it stronger and better. They have used their talents and abilities to bring about profound improvements in their communities across this great country. And they have played a vital role in helping achieve justice and equal rights for all U.S. citizens.

The contributions of women in this country are many. Unfortunately, we do not have enough time to mention them all, but just consider for a moment many of those who have helped shape American history. Since its beginnings, our country has been blessed by noteworthy women who played defining roles in our Nation.

Sakajawea, who today appears on the Golden Dollar coin, was a Native American woman who befriended the explorers Meriwether Lewis and William Clark 150 years ago as they crossed the great Northwest. She helped Lewis and Clark's expedition complete the first successful overland transcontinental journey. Other significant female figures include Lucretia Mott, who courageously wrote and spoke against slavery and the lack of equal rights for women, and Rosa Parks, who in 1955 refused to give up her seat on a city bus in Montgomery, Alabama, helping to inspire a nationwide movement for equal justice under the law.

Additionally, many women have blazed a trail for those of us following in their steps in the medical and legal professions. For instance, Elizabeth Blackwell was the first woman in America awarded a medical degree, and she dedicated her pioneering efforts as a physician to helping others. And Sandra Day O'Connor served as the first female Associate Justice of the Supreme Court of the United States from 1981 to 2006 and became known for her case-by-case approach to jurisprudence.

Of course Dr. Antonia Novello, appointed to be the Surgeon General of the United States in 1990, comes to mind as well. She was both the first woman and the first Latin American to be appointed to this post. I have to mention that just last week, I had the privilege of joining Dr. Novello at a Puerto Rico Chamber of Commerce event where I spoke before another fantastic group of businesswomen and entrepreneurs in Fajardo, Puerto Rico. Dr. Novello's accomplishments and those of the many Latinas like the ones present in this room today really inspire me – I'm sure they inspire all of us.

However, they also should keep us mindful that as today's businesswomen, professionals, community leaders and political figures, we really do have a huge responsibility to future generations of women – a responsibility to continue opening paths to increased opportunity.

Today, there are about 149 million women in the U.S., according to recent findings from the U.S. Census Bureau in 2004. We are indeed a force to be reckoned with as consumers, but also as drivers of the market. More than one-third (34.9 %) of all Hispanic owned firms are owned by women. Hispanic women-owned firms employ 18.5% of the workers in all Hispanic-owned firms and generate 16.3% of the sales according to the Center for Women's Business Research. *(November 2004)* Additionally, this same group has reported that Latinas control 39% of the 1.4 million companies owned by minority women in the United States, which generate nearly $147 billion in sales. *(Center for Women's Business Research, November 2004)* And, four in 10 minority women-owned firms are owned by Latinas. *(U.S. Hispanic Chamber of Commerce)*

I think it is safe to credit many of those women-owned businesses for the significant growth and amazing job creation we have seen in this country in the past few years. And when we stop to consider this significant economic growth, we have to acknowledge that there is much to be grateful for in this country, and a lot to be optimistic about thanks to this Administration's sound monetary and fiscal public policy approach over the past years.

Our economy is strong and it continues to grow. And we are seeing that opportunity for the Latino community is increasing as well.

We've seen that just in the first quarter of 2006, our economy grew at an impressive annual rate of 5.6 percent, and since August of 2003, the U.S. economy has added more than 5.3 million new jobs – more than all 25 nations of the European Union combined. In fact, the latest figures show that the national unemployment rate has fallen to 4.6 percent – lower than the average of any decade since the 1950's. The Latino community in particular has seen more job growth too. At 5 percent, Hispanic unemployment is currently at the lowest rate in years!

Productivity is growing too, and we're seeing that wages are also rising. And because taxes are low, workers and investors are keeping more of the money they earn – giving many individuals the opportunity to make their hard-earned money grow more and in some instances accomplish many life-long goals – such as paying for a child's college education, purchasing a home, starting a business or expanding an existing one.

In fact, many small businesses are expanding and creating many of those new jobs. Currently, the number of Hispanic-owned businesses is growing at three times the national rate. It's great to know that the Latino community forms a significant part of the recent U.S. economic success story!

This recent economic growth we've experienced is truly astounding, especially when you stop and consider the challenges we have faced as a nation in recent years – the recession this Administration inherited, the stock market correction, corporate scandals, terrorist attacks on our soil, and the 2005 Gulf Coast Hurricane devastation.

Despite these significant challenges, our economy is surging, businesses have had the ability and opportunity to expand, and new job opportunities are cropping up – including for recent college graduates. The job market for college graduates is the best it's been in five years!

However, one significant challenge remains before for us. Many of those who seek opportunities in our country are still currently living in the shadows because they do not currently have legalized status to remain and work in the country. This brings me to another significant policy issue that President Bush and his Administration are facing head on, and quite frankly, working very hard to address in the most balanced and responsible way possible.

Immigration reform of course, is an issue that is most on our minds today. I can tell you, it is a priority issue for the President as well. As you know ensuring that we put into action a comprehensive plan on immigration reform will have a great significance on the safety and economic stability of the country, and for individuals.

We can't say with full certainty what the number is, but we do know that about 11 million undocumented workers remain in the country illegally and are living in the shadows. Many of those are Latinas who remain in the shadows of this economy and lack basic protections. We need to bring those women and their families out of the shadows.

The President understands the importance of creating reasonable and creative approaches to ensure that we deal with the problem of people who have been in this country for a long period of time and are only trying to make an honest living.

The President is on the record as saying that it doesn't make any sense to approach the problem by forcing these people to leave the United States. I agree. You just can't just throw millions of people out of the country.

On the other hand, we cannot just give these individuals straight out amnesty. Giving automatic citizenship doesn't make any sense either because it will likely encourage others to come to the United States through illegal channels.

The President's comprehensive approach instead acknowledes that we ought to consider alternative approaches to legalizing the status for people who have been in the country for years, people who have passed an extensive criminal background check, and who can prove they have worked by means of an honest living in this country for quite a while. At the same time, those individuals would be required to pay a penalty, but also be given the opportunity to apply for citizenship. Of course, they would have to wait behind those who have applied for entry and citizenship before them.

One thing is for sure, many good people certainly disagree on some particulars of this controversial issue, and they all have very strong views on this matter of immigration reform. These views are often shaped and fueled by concerns over safety, family, national security, economics and even politics.

The good news however, is that there is some consensus among most people on signficant fronts. All Americans want to be safe from terrorists, drug traffickers and others who seek to harm all people living in this country. We also all want to continue to see ongoing prosperity and economic growth for our country. I would venture to say that most Americans want an immigration policy that protects our national security interests and economic interests, but also encompasses our attributes of being a generous and welcoming nation.

The President's comprehenisive plan could achieve all that. Additionally, the President has been very clear that it is also very important to enforce our immigration laws, and he plans to help on that front by enhancing resources to do so effectively and safely.

By 2008, this Administration will have doubled the number of Border Patrol officers, and the National Guard will serve a temporary supporting role as. State and local authorities will be trained to better assist Federal officers. And there are plans to end the futile catch-and-release program on the Southern border.

Additionally, new technologies will help monitor acitivity at the border. The Administration has increased funding for interior immigration enforcement by 42 percent, and the President has signed legislation doubling federal resurces for worksite enforcement. These are necessary steps in order to secure our borders and protect all people currently living within our borders.

But we need to be realistic about confronting this problem head-on. Hungry and needy people – people who desire to work at an honest job will inevitably continue to find any way to feed their families. Economic disparity still exists between the U.S. and its southern neighbors.

Again, a temporary work program which meets the needs of our growing economy is necessary. Such a program would help establish realistic rules, which would no longer be ignored. As U.S. Attorney General Alberto Gonzalez recently stated: "The rising tide of immigration would be channeled and controlled, so that it continues to energize our Nation in a constructive way. Lawful taxpayers and safe workplaces would replace illegal workers and unsafe conditions. We would introduce a culture of law and fairness into an area where the rules have long been flouted."

With comprehensive reform, both employees and employers know that there are rules that must be followed. Moreover, both legal and economic incentives would exist to follow the rules. Immigrants who have broken the law would have to face

the consequences of not complying with the law. However, employers would also be subject to fines for breaking the law. Employers must be held accountable for the legality of the workers they hire.

At the end of the day the President's plan is about protecting people and drawing illegal immigrants out of the shadows of society, which benefits everyone, except perhaps the "coyotes", human traffickers and others that take advantage of this population.

Once we bring this population out of the shadows, we need to ensure that we encourage this community to learn how to navigate the system in which they will be operating. Not only will we need to work together with community groups to teach people the English language, but we will also need to encourage their training and education.

One of the areas I work on of great importance to the Department of the Treasury is financial education. We will also need to help this community acquire the necessary skills to manage their finances and build a reserve of cash for emergencies or to plan out for future goals and a secure retirement. In fact, this is a skill that all women need to master.

I know I don't have much time left, but I want to tell you a little bit about some of the resources that the federal government has already made available in both English and Spanish – we've made the Spanish-language material because we know it takes some time to learn the English-language well.

A federal commission – the Financial Literacy and Education Commission – along with the Department of the Treasury developed a national financial education web site and toll-free hotline launched in October 2004 – MyMoney.gov and 1-888-MyMoney. I urge you to visit and spread the work about MyMoney.gov. It has been recently updated to include an interactive quiz called the "Money Twenty." You can find a whole world of information on budgeting, buying a home, paying for an education, investing, planning for retirement and more. I hope LULAC will share this with its members.

On that note, and in closing, I also want to note that LULAC has partnered with the Treasury Department on the Go Direct Campaign. ***Go Direct*** focuses on motivating federal benefit recipients to sign up for direct deposit.

Go Direct provides the means by which seniors and all federal benefit recipients can make the switch from a paper check to direct deposit. We have a dedicated call center staffed by bilingual personnel ready to assist all beneficiaries. The call center is only one of many ways we are helping beneficiaries sign up for direct deposit. Our Web sites: www.GoDirect.org and www.DirectoASuCuenta.org, allows beneficiaries to access a step-by-step online tool to sign up – either on their own or through their bank or credit union. Again, thank you Brent and for your and LULAC's support on this campaign.

And I truly want to thank you all for your time and attention. I really appreciate this opportunity to visit with you and share some highlights about so many of the priorities this Administration and the Treasury Department is working on. Enjoy the rest of the week.

June 30, 2006
js-4346

Treasury Announces Private Sector Initiative with Latin American Counterparts

Initiative Will Focus on Strengthening Defenses Against Money Laundering, Terrorist Financing

The U.S. Department of the Treasury Thursday helped launch a U.S.-Latin America Private Sector Dialogue (US-LA PSD) focused on strengthening defenses against money laundering and terrorist financing.

Fifty key U.S. and Latin American private and public sector representatives held a roundtable at the Treasury where they began discussing ways to facilitate and improve private sector information and best practices sharing on the implementation of core anti-money laundering/counter-terrorist financing (AML/CFT) controls. Through their discussion, roundtable participants agreed to commence a long term private sector dialogue on AML/CFT through a series of conferences, seminars and workshops that join U.S. and Latin America banks in a direct exchange.

"The Treasury Department recognizes the importance of the longstanding ties between the U.S. and Latin American financial sectors," said Pat O'Brien, Treasury Assistant Secretary for Terrorist Financing. "With this in mind, the Treasury is eager to help launch and facilitate this dialogue to help bolster our defenses against the dual threats of terrorist financing and money laundering, and foster greater understanding and cooperation between our regions."

Based on the recent success of a March 2006 conference in Cairo to launch the US-Middle East/North Africa Private Sector Dialogue on AML/CFT (US-MENA PSD), Treasury officials are confident that a similarly successful initiative with Latin American counterparts can work.

"The most important role in this process is for banks to work with the government - not only to assist to government in efforts to combat money laundering and terrorist financing, but also to encourage the government to continue to improve its systems," said Gustavo Rodrigues, President of GAFISUD (Financial Action Task Force Style Regional Body for South America) and President of the Brazilian Financial Intelligence Unit (FIU).

"This Roundtable was a special opportunity to facilitate the beginning of a productive dialogue between US and Latin American banks about AML/CFT implementation, with the support and participation of the regulatory authorities. The Central Bank of Argentina is a true supporter of this initiative," said Zenon Biagosch, Director and Vice Superintendent of the Central Bank of Argentina.

"With the strong support of the U.S. and Latin American banking communities, leadership from key parties such as GAFISUD, and financial policy and supervisory authorities from both regions, we look forward to seeing successes and taking key strides with Latin America," O'Brien said.

The Treasury Department is dedicated to promoting prosperity and stability in the U.S. and global financial systems. As part of this overarching objective, the Treasury Department seeks to promote awareness and implementation of core AML/CFT standards internationally to safeguard the financial system against rogue

nations, terrorist facilitators, money launderers, drug kingpins, and other international security threats. In addition to its bilateral and multilateral efforts, the Treasury Department is working with committed partners worldwide to help promote private sector AML/CFT implementation.

Today's Roundtable consisted of representatives from the Treasury, including its Office of Foreign Assets Control (OFAC), the Financial Crimes Enforcement Network (FinCEN), and the Office of the Comptroller of the Currency, the Federal Reserve, and the U.S. Department of State. Zenon Biagosch and Gustavo Rodrigues played leadership roles, and were joined by members of the Latin American Bankers Association (FELABAN), the Florida International Bankers Association (FIBA), the American Bankers Association (ABA), as well as representatives of major U.S. banks and others.

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June 30, 2006
js-4347

Report On Foreign Holdings of U.S. Securities At End-June 2005

The final results from the annual survey of foreign portfolio holdings of U.S. securities at end-June 2005 are released today and posted on the U.S. Treasury web site at (http://www.treas.gov/tic/fpis.html).

The survey was undertaken jointly by the U.S. Treasury, the Federal Reserve Bank of New York, and the Board of Governors of the Federal Reserve System. The most recent report covered the survey for end-June 2005. Surveys are carried out annually, and the next survey will be for end-June 2006.

Complementary surveys measuring U.S. portfolio holdings of foreign securities are also carried out annually. Data from the most recent survey, which reports on foreign securities held by U.S. residents at year-end 2005, are currently being processed. Preliminary results are expected to be reported by September 30, 2006.

Overall Results

The survey measured foreign holdings as of June 30, 2005, of $6,864 billion; with $2,144 billion held in U.S. equities, $4,118 billion in U.S. long-term debt securities (of which $717 billion were
holdings of asset-backed securities (ABS)), and $602 billion in U.S. short-term debt securities. The previous such survey, conducted as of June 30, 2004, measured foreign holdings of $6,019 billion; with $1,930 billion in U.S. equities, $3,501 billion in U.S. long-term debt securities, and $588 billion in U.S. short-term debt securities.

REPORTS

- Foreign Holdings of U.S. Securities Tables

Table 1. Foreign holdings of U.S. securities, by type of security, as of recent survey dates

(Billions of dollars)

Type of Security	June 30, 2004	June 30, 2005
Long-term Securities	5,431 [r]	6,262
Equity	1,930 [r]	2,144
Long-term debt	3,501 [r]	4,118
Asset-backed	453 [r]	717
Other	3,048 [r]	3,401
Short-term debt securities	588	602
Total	6,019 [r]	6,864
Of which: Official	1,663 [r]	1,938

[r] revised.

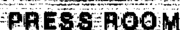
Table 2. Foreign holdings of U.S. securities, by country and type of security, for the major investing countries into the U.S., as of June 30, 2005

(Billions of dollars)

	Country or category	Total	Equities	Long-term debt	Short-term debt
1	Japan	1,091	178	814	100
2	United Kingdom	560	260	283	16
3	China, Mainland	527	3	485	40
4	Luxembourg	460	151	273	37
5	Cayman Islands	430	152	252	26
6	Belgium	335	18	312	5
7	Canada	308	221	74	13
8	Netherlands	262	161	93	8
9	Switzerland	238	129	94	15
10	Bermuda	202	59	123	20
11	Germany	200	83	110	8
12	Ireland	191	58	80	53
13	Middle East Oil-Exporters[1]	161	82	54	24
14	Singapore	144	89	51	4
15	Taiwan	126	7	117	2
16	France	122	71	41	10
17	Korea, South	118	1	106	11
18	Hong Kong	96	23	47	26
19	Australia	92	57	26	10
20	Sweden	84	49	33	1
21	Mexico	80	13	51	16
22	Russia	76	*	14	62
23	British Virgin Islands	75	47	24	4
24	Norway	68	37	29	2
25	Italy	50	31	15	4
	Country Unknown	196	2	193	1
	Rest of world	569	162	323	84
	Total	6,864	2,144	4,118	602
	Of which: Official	1,938	177	1,438	322

1. Includes Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates (Trucial States)

* Greater than zero and less than $500 million.



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July 5, 2006
js-4348

Treasury Calls for Large Position Reports

The Treasury is calling for Large Position Reports from those entities whose reportable position in the 4-7/8% Treasury Notes of May 2008 equals or exceeds $2 billion as of close of business **Wednesday, June 28, 2006**. This call for Large Position Reports is a test. Entities with reportable positions in this note equal to or exceeding this $2 billion threshold must report these positions to the Federal Reserve Bank of New York. Entities with positions in this note below $2 billion are not required to file Large Position Reports. Reports must be received by the Government Securities Dealer Statistical Unit of the Federal Reserve Bank of New York before noon Eastern Time on **Wednesday, July 12, 2006,** and must include the required position and administrative information. Large Position Reports may be faxed to (212) 720-5030 or delivered to the Bank at 33 Liberty Street, 4th floor.

Details on Call for Large Position Reports

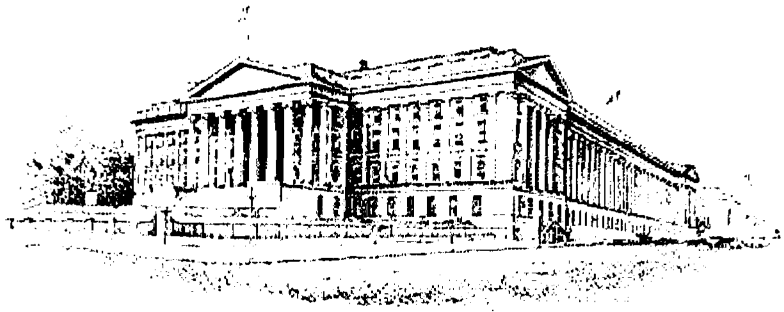
Security Description	4-7/8% Treasury Notes of May 2008, Series V-2008
CUSIP Number	912828 FG 0
CUSIP Number of STRIPS Principal Component	912820 ND 5
Maturity Date	May 31, 2008
Date for Which Information Must Be Reported	June 28, 2006 as of COB
Large Position Reporting Threshold	$2 Billion (Par Value)
Date Report Is Due	July 12, 2006, before noon Eastern time

This call for large position information is made under Treasury's large position reporting rules (17 CFR Part 420). The notice calling for Large Position Reports is also being published in the *Federal Register*. This press release and a copy of a sample Large Position Report, which appears in Appendix B of the rules at 17 CFR Part 420, are available at the Bureau of the Public Debt's Internet site at www.publicdebt.treas.gov.

Questions about Treasury's large position reporting rules should be directed to Treasury's Government Securities Regulations Staff at Public Debt on (202) 504-3632. Questions regarding the method of submission of Large Position Reports should be directed to the Government Securities Dealer Statistical Unit of the Federal Reserve Bank of New York at (212) 720-7993.

- Background on Calls for Large Positions Reports

-30-



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 11:30 A.M. July 5, 2006
CONTACT Jennifer Zuccarelli, (202) 622-8657

BACKGROUND ON CALL FOR LARGE POSITION REPORTS

Treasury's large position reporting rules (17 CFR Part 420), which were issued in final form on September 12, 1996 (61 FR 48338), established recordkeeping and reporting requirements for entities that control large positions in certain Treasury securities. An amendment to the rules was issued on December 18, 2002, and was effective January 17, 2003. The rules put in place an on-demand reporting system which, in response to a notice by Treasury requesting large position information, requires large position reports to be filed by entities that control a position in a particular Treasury security or securities equaling or exceeding the specified large position threshold. Holders will have three and one-half days in which to respond to the request, unless otherwise noted on the press release.

The rules were first effective March 31, 1997. When the rules were announced, Treasury said that it would issue a test call annually. Treasury has issued seven previous test calls, and one non-test call.

The purpose of the rules is to give Treasury the means to acquire information quickly on concentrations of a security's holdings in the event of a market dislocation affecting that security. The rules are intended to improve the information available to Treasury and other regulators regarding concentrations of control and to ensure that regulators have the tools necessary to monitor the Treasury securities market. Large positions, in and of themselves, are not inherently harmful, and there is no presumption of manipulative or illegal intent on the part of a controlling entity merely because it is required to submit a large position report in response to these rules. The Treasury does not expect to have to use such authority for such purposes frequently, but it wants holders' reporting systems to be fully functional in the event it needs to require large position information.

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PRESS ROOM

June 29, 2006
js-4349

Treasury Secretary Snow Announces Resignation

Treasury Secretary John W. Snow has formally resigned as the 73rd Secretary of the Treasury effective today. Treasury Deputy Secretary Robert M. Kimmitt will serve as Acting Secretary until Henry M. Paulson is sworn in.

-30-

July 6, 2006
2006-7-6-12-37-21-28776

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $67,831 million as of the end of that week, compared to $65,624 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	June 23, 2006			June 30, 2006		
TOTAL	65,624			67,831		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	11,684	10,894	22,578	11,927	11,058	22,985
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,637	5,318	16,955	11,882	5,399	17,281
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			6,493			7,906
3. Special Drawing Rights (SDRs) [2]			8,558			8,618
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	June 23, 2006			June 30, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						
2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets						
	June 23, 2006			June 30, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL

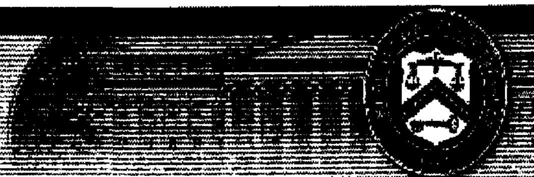
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.



PRESS ROOM

July 6, 2006
JS-4350

**Quarles to Discuss
U.S. Corporate Governance Rules,
American Competitiveness**

Under Secretary for Domestic Finance Randal K. Quarles will participate in a roundtable discussion with Members of Congress at the Financial Services Forum on Monday. The panel, which will be hosted by former Secretary of Commerce Donald L. Evans, will discuss the effects of U.S. corporate governance rules on the competitiveness of American businesses and financial markets.

Who
Under Secretary for Domestic Finance Randal K. Quarles

What
Remarks on U.S. Corporate Governance Rules

When
Monday, July 10 2:00 pm (EST)

Where
The Mandarin Oriental Hotel
Room Oriental C
1330 Maryland Ave, SW
Washington, DC

PRESS ROOM

July 6, 2006
js-4351

Media Advisory:
Treasury Assistant Secretary Warshawsky to Hold Economic Briefing

U.S. Treasury Assistant Secretary for Economic Policy Mark Warshawsky will hold a media briefing to discuss the state of the U.S. Economy. The event is open to credentialed media.

Who U. S. Treasury Assistant Secretary Mark Warshawsky

What Economic Media Briefing

When Friday, July 7, 10:30 a.m. (EDT)

Where Media Room – Main Treasury
1500 Pennsylvania Ave, NW
Washington, DC

Note: Media without Treasury press credentials should contact Frances Anderson at (202) 622-2960, or frances.anderson@do.treas.gov **with the following information: name, Social Security number and date of birth.**

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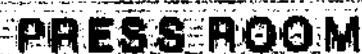
July 7, 2006
JS-4352

Statement of Acting Treasury Secretary Robert M. Kimmitt on June Employment Report

"The employment report for this month showing 121,000 jobs being created in June provides further evidence of the strength of the U.S. economy. Since the President's tax relief program took effect in mid-2003, we have seen twelve straight quarters of increased business investment, leading to more than 5.4 million jobs being created and a remarkable 4.6 percent unemployment rate – lower than the average rate in each of last four decades.

"Higher tax revenues are also an indication of a strong economy, and in fact, year-to-date tax receipts are now running 12.9 percent over the 14.6 percent increase of last year. This is a clear indication that, with continued attention to spending discipline, we are on the right path to meeting the President's deficit reduction goal early.

"The President has laid the pro-growth foundation for sustained U.S. economic strength, and his proposals like the American Competitiveness and Advanced Energy initiatives will build upon that strength and will create even higher standards of living for future generations of Americans."



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July 7, 2006
JS-4353

The Evolution of the G-7 and Economic Policy Coordination

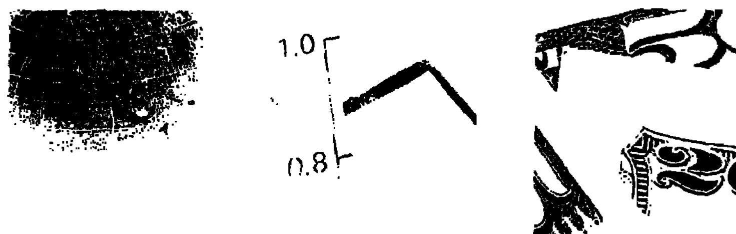
The growth of global economic imbalances has generated much talk about how the situation can possibly be unwound gradually or in an orderly manner. Perceived currency misalignments appear to be increasing protectionist pressures. In the face of these challenges, some look back wistfully to the time of the Plaza Agreement. Some analysts are even calling for a Plaza-like "coordination" agreement to promote an orderly reduction in global imbalances.3 At the same time, the G-7 major economies that have traditionally participated in macroeconomic policy coordination and thereby took on such challenges for the global system no longer carry as much economic weight in the global economy as they once did. Indeed, as key emerging market economies play a larger and growing role on the global economic scene, they are now a more critical part of the global imbalance equation.

REPORTS

- Occasional Paper No 3 July 2006

THE EVOLUTION OF THE G-7 AND ECONOMIC POLICY COORDINATION

OCCASIONAL PAPER NO. 3
JULY 2006



BY MARK SOBEL AND LOUELLEN STEDMAN

DEPARTMENT OF THE TREASURY • OFFICE OF INTERNATIONAL AFFAIRS

Department of the Treasury
Office of International Affairs
Occasional Paper No. 3
July 2006

The Evolution of the G-7 and Economic Policy Coordination

By Mark Sobel and Louellen Stedman[1]

DISCLAIMER

This is the third in a series of Occasional Papers from the Treasury Department's Office of International Affairs. These papers examine international economic issues of current relevance in an effort to identify underlying trends and issues for policymakers. These papers are not statements of U.S. Government, Department of the Treasury, or Administration policy and reflect solely the views of the authors.[2]

The growth of global economic imbalances has generated much talk about how the situation can possibly be unwound gradually or in an orderly manner. Perceived currency misalignments appear to be increasing protectionist pressures. In the face of these challenges, some look back wistfully to the time of the Plaza Agreement. Some analysts are even calling for a Plaza-like "coordination" agreement to promote an orderly reduction in global imbalances.[3]

At the same time, the G-7 major economies that have traditionally participated in macroeconomic policy coordination and thereby took on such challenges for the global system no longer carry as much economic weight in the global economy as they once did. Indeed, as key emerging market economies play a larger and growing role on the global economic scene, they are now a more critical part of the global imbalance equation.

These debates have put vexing questions on the table. Can officials from G-7 and other key economies "coordinate" their policies effectively to strengthen global stability and growth? Is the G-7 still relevant, given that global economic weight – and more importantly relative contributions to recent global growth – is increasingly shifting to other countries?

Clearly, the potential for coordination has shifted over time. The Keynesian revolution and more recent moves toward independent central banks reinforced policy-makers' belief that they could manage their own economic objectives and destinies on their own to a greater degree than in the past. Policy-makers continue to debate who should adjust and by how much. Larger countries in particular are less inclined to subordinate domestic economic objectives to an external discipline or to allow domestic objectives to bear a disproportionate burden of external adjustment. Much research has been undertaken by econo-

[1] Mark Sobel has served as Deputy Assistant Secretary for International Monetary and Financial Policy since 2000 and worked on international monetary policy issues at Treasury from 1985-1992 and for much of the second half of the 1990s. Louellen Stedman worked in Treasury's Office of International Monetary Policy as Deputy Director and Director from 1998-2002 and served as a Senior Policy Advisor on international monetary policy issues through 2005.

[2] The authors thank Ted Truman, Karen Johnson, Joe Gagnon, James Lister, Robert Kaproth, Michael Kaplan, Marvin Barth, John Weeks, and Jon Burks, among others, for their helpful and thoughtful comments.

[3] See, for instance, William R. Cline, "The Case for a New Plaza Agreement," *Policy Brief in International Economics (No. B05-4)*, Institute for International Economics, December 2005.

mists to analyze the results of coordination, with varying conclusions about the value of the exercise.[4]

Yet countries do not have the luxury of operating independently. The exponential growth in global financial markets clearly has spillover effects, which affect the conduct of macroeconomic policy. On balance, the interactions among key economies are increasing, and globalization has raised a wide range of common and new economic and financial challenges for policy-makers. Thus, the international community needs processes to bring officials together to make them aware of developments in each other's economies and their effects on others – and to consider if and how they should act together in this light. It is in this context that new mechanisms for economic policy management among the major economies emerged after the demise of Bretton Woods and continue to evolve today.

This paper briefly examines macroeconomic policy coordination in the post-Bretton Woods era and assesses the potential for a Plaza-like agreement in the current climate. It also reviews the evolution of the G-7 over the last two decades in order to engage on the debate about the G-7's relevance. To be sure, there are many more detailed analyses of this history and scholarly assessments of the success of coordination. This paper aims to offer a brief historical review and to explore these questions from a perspective inside one government in the G-7 process.

Managing global economic adjustment and the interactions among countries is not a new question. In principle, the gold standard provided clear rules for adjustment. But it had important weaknesses: it subjected countries to wide variations in output/inflation, and countries jumped ship from time to time (for instance, the United Kingdom following the first World War). Similarly, the Bretton Woods System provided for a high degree of policy automaticity in principle, but it too allowed the build up of huge systemic asymmetries and stress. Policy-makers could not agree on who should adjust and by how much, and the system met its demise.

Without an automatic policy adjustment mechanism in place, the need emerged for other means to address economic policy interactions across borders. All countries would benefit from a system that balanced the needs and interests of countries, constrained policies that undermined the economic objectives of others, and achieved a better outcome for all than could have been reached by single countries acting independently. In principle, economic policy coordination could entail individual countries formulating and implementing policies jointly with others, including trading off policies if need be, in order to secure a higher level of global economic welfare. On the other hand, no system can objectively balance the at times divergent self-interests and needs of countries.

It was after the first oil price shock in December 1973 that the five major industrial countries (G-5) made their first post-Bretton Woods attempt to coordinate policies. But they failed on this occasion to agree on specific macroeconomic policies. They tried again at the London Summit in 1977 when Leaders established growth targets, which were not achieved.[5]

The next effort came at the Bonn Summit in 1978, when Leaders agreed on a set of policies intend-

[4] See, for instance, Laurence H. Meyer, Brian M. Doyle, Joseph E. Gagnon and Dale W. Henderson, "International Coordination of Macroeconomic Policies: Still Alive in the New Millennium?" *International Finance Discussion Paper Number 723*, Board of Governors of the Federal Reserve System, April 2002, and Edwin M. Truman, "A Critical Review of Coordination Efforts in the Past," *Macroeconomic Policies in the World Economy*, ed. Horst Siebert. Heidelberg: Springer.

[5] Meyer, Doyle, Gagnon and Henderson, p. 18.

ed to fuel stronger global growth. Specific policy commitments were made by each Leader, including fiscal expansion in Japan and Germany and deregulation of oil prices in the United States, and together all committed to bring the Tokyo Round of trade negotiations to a successful conclusion.[6] Many see this as the pinnacle of economic policy coordination. But these policies were just beginning to take effect when the second oil price shock hit in 1979, and many blamed the Bonn Summit for inflationary pressures that emerged thereafter. Following the Bonn Summit, meaningful coordination of economic policies languished for some years.[7] Indeed, there was considerable discord in major countries in this period about how and to what extent to align their policies. The United States believed that countries should set policy independently and allow markets to determine exchange rates without any official guidance.[8] Others saw more promise in coordination, with France advocating throughout the period a new international monetary conference to agree on a common approach.[9]

Despite differences in outlook among the major economies in the early 1980s, newly challenging economic circumstances in these countries and their consequences helped create the context for a new coordination push in the middle of the decade. The resulting period represents the most sustained effort among Finance Ministers to coordinate policy in the post-Bretton Woods era.

In the United States, the early 1980s featured an expansive fiscal policy (notably tax cuts and increased defense spending), and tight monetary policy to wring out inflation. Real interest rates rose. The dollar appreciated. The U.S. current account deficit expanded to a then-whopping 3-1/2 percent of GDP. Unemployment was high, peaking around 10 percent, the Midwest suffered, shifting from manufacturing to "rust belt". Global competitive pressure built up on U.S. farmers and producers – and economic policymakers felt the heat.

By 1985, the new Secretary of the Treasury, James A. Baker, faced tremendous protectionist pressure. The dollar had already peaked and started to fall in February, but the political crescendo had built sufficiently to motivate a major effort to "coordinate" policy – announced in September 1985 at the Plaza Hotel in New York City. The communiqué detailed specific policy intentions to lay the basis for continuing strong growth and addresing imbalances, including tax cuts in Germany and fiscal expansion in Japan to help promote growth. The official document further asserted that exchange rates should more fully reflect fundamentals, calling for appreciation of non-dollar major currencies and indicating a willingness by Ministers to cooperate to achieve this end – which they did through extensive, coordinated intervention thereafter. The imperative of addressing global imbalances was further underscored by the Baker-Miyazawa agreement in October 1986, which made clear the commitment to further policy measures, rather than merely relying on exchange rates.[11]

Whether the Plaza Agreement was a success is

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[6] C. Fred Bergsten, "Should G7 Policy Coordination Be Revived?" *The International Economy*, Fall 2003.
[7] Silvia Ostry, "Canada, Europe and the Economic Summits," paper presented at All-European Canadian Studies Conference, The Hague, Netherlands, 24-27 October 1990.
[8] Jeffrey A. Frankel, "International Nominal Targeting: A Proposal for Coordination in the 1990s," expanded April 1990 version of a paper published in the *Kinyu Journal*, March 1990.
[9] See discussion in *International Monetary Cooperation Since Bretton Woods*, Harold James, (Washington, D.C.: International Monetary Fund, 1996), pp. 409-435, highlighting the passion among some (particularly France) for a new international monetary conference and the skepticism and resistance by others (notably U.S. Treasury Secretary Donald Regan).
[10] The role accorded macroeconomic discussions in the annual Economic Summits has varied substantially over time, but in general has lessened over time, especially in contrast with the 1970s. This paper focuses on macroeconomic discussions among Finance Ministers and Central Bank Governors and only references Summitry in several instances.
[11] Sam Y. Cross, "Notes for FOMC Meeting," December 16, 1986.

still a matter of debate among analysts; the dollar had already started to fall, and it is not clear to what extent the Plaza Agreement furthered this trend.[12] In any case, the dollar remained in decline until February 1987. At that time, the major countries sought to halt the trend and announced a new more comprehensive agreement at the Louvre, based on an assessment of fundamentals. Privately, understandings were reached about appropriate ranges for exchange rates. Despite the Louvre Accord, the dollar continued to decline. Truman attributes this at least in part to the specification of clear policy actions that were not implemented,[13] though it is not certain that even full implementation of commitments would have captured the attention of market participants and convinced them that the U.S. government truly wished to stop the dollar's slide. The stock market crash in October 1987 followed, and many analysts point to public debate between the United States and Germany about monetary policy as one contributing factor.

The G-7 tried once more to shore up market sentiment in December by issuing a communiqué based on telephone consultations (the"telephone communiqué"). Ministers reaffirmed their Louvre commitments, underscored the importance of fundamentals and announced new measures to help bring their economies into balance – in particular through additional fiscal measures in the United States and tax cuts in Germany. This was accompanied by a coordinated intervention that did indeed mark an upturn in the dollar,[14] though not a lasting one.

After 1987, current account deficits of the major industrial countries "gradually but surely fell to more sustainable levels."[15] Indeed, the U.S. current account reached balance in 1991. A number of factors contributed to this adjustment, including the effects of dollar decline over time (as the dollar lost 30 percent of its value in real trade-weighted terms between mid 1985 and mid 1991) and the slowdown in U.S. growth at the decade's end.[16] Importantly for external adjustment, growth in Germany and Japan was particularly strong in the latter part of the 1980s and early 1990s, influenced by the initial impact of German reunification and expansive Japanese monetary policy, and outpaced U.S. growth for several years.

During this period, policy-makers' ability to deliver fundamental reforms and sound policies, which are the ultimate determinants of exchange rate relationships, was uneven. To be sure, policy-makers reached informal understandings about exchange rate levels and were prepared to take a public view as to when exchange rate changes were in line, or not, with fundamentals and to act on that view. Japan and Germany did look at budgetary priorities in light of international economic interactions. Interest rates were adjusted at concurrent times by major central banks on occasion. But many commitments were not new. Interest rate adjustments reflected economic needs and self-interest in the individual countries, and monetary policy was not geared solely to maintaining understandings about exchange rate ranges. Despite its commitments to the G-7 and the Gramm-Rudman-Hollings legislation aimed at controlling spending, the United States did not deliver in good time on the promise to reduce its deficit. Despite commitments to the G-7 about reducing interest rates, the German government could not deliver the Bundesbank, which slightly increased a key interest rate in September 1987 just before the G-7 meeting.[17]

Apart from the results of multilateral surveillance, the process of economic policy coordination it-

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[12] Truman.
[13] Ibid.
[14] James, p. 457.
[15] Ibid.
[16] Sebastian Edwards,"The End of Large Current Account Deficits, 1970-2005: Are there Lessons for the Untied States?" *National Bureau of Economic Research Working Paper 11669* September 2005.
[17] James, p. 453.

self evolved substantially during this period. The Group of Five (G-5) continued secretive discussions that had begun in the mid-1970s, culminating in the announcement of the Plaza Agreement in 1985. Indeed, whereas the G-5 had been a secret group that did not issue communiques, with the exception of the January 1985 meeting, the process set off by the Plaza Agreement then led to an expansion of the group into the G-7 and a pattern of public statements that has since become relatively consistent, with the exception of a brief period. The IMF developed a process for examining "objective indicators" and providing papers to the G-7, which offered a common set of data for the G-7's multilateral surveillance discussions.[18]

The entire process was appealing and created a sense of order in other ways. The sequencing of communiqués, lists of policy commitments, and aura of cooperation created a sense of progress. In fact, however, commitments on the surveillance front were naturally limited, given the preeminence of domestic politics, such that agreement and action on concrete new policy actions was not the rule. Thus, communiqués often repeated policy objectives already achieved, announced domestically and/or not within direct control of Finance Ministers. And, as noted above, the actual results lagged behind the commitment to adjusting policies.

Also, during this period, senior G-7 officials often tasked their technical experts to work together on common problems in areas not related to multilateral surveillance, for example on IMF operational and policy issues. The international debt crisis provoked extensive discussion about the nature of the problem and potential solutions, eventually leading to the Brady Plan in 1989. These taskings promoted increased cohesion and deepened contacts at many levels among G-7 finance ministries and central banks.

In sum, the Plaza Agreement and its aftermath demonstrated both the usefulness and limitations of multilateral engagement on economic policies. Policy-makers recognized the growing interactions among their economies and the reality that these inter-linkages must factor into their thinking about and formulation of domestic economic policy choices, although they were not willing to make the sacrifices necessary to maintain the discipline of a fixed exchange rate and more rules-based system. They all shared a strong interest in preserving stability, and were mindful of maintaining a sense of order in the system and working to resist protectionism. As creditors and key players in the system, they represented a like-minded grouping for setting forth perspectives on global economic issues beyond the G-7. Some good results were obtained. Thus, they clearly did not want to throw international economic policy to the wind. Yet the conviction behind macroeconomic policy "coordination" was less clear and the ensuing results at times fell short of the mark. In some cases, officials did not agree on announced coordinated actions or did not have a shared understanding of what they would mean. Further, the scope for changing domestic policies as a result of international considerations was often limited.

In the 1990s, two major dynamics shaped interactions within the G-7. First, on the macroeconomic policy front, policy-makers tended to be more inwardly focused as domestic policy challenges and political dynamics consumed much of their attention. Shaping concerted macroeconomic policies was not as prominent a theme as in the 1980s. Expectations about the ability to achieve macroeconomic results through multilateral surveillance were more tempered, and policy-makers emphasized that keeping one's own house in order was perhaps the main contribution that could be made to a healthy global environment.

[18] James M. Boughton, Silent Revolution - The International Monetary Fund 1979-1989, (Washington, D.C.: International Monetary Fund, 2001), pp. 214-15.

Second, shared interests in broader global policy issues, such as the break-up of the Soviet Bloc, the Asian financial crisis and the operation of the international financial institutions, drew the attention of policymakers and consumed more of their discussions as they mapped out common approaches in these areas.

National economic developments posed considerable challenges for policymakers. In the United States, the imperative of restoring fiscal balance dominated the economic policy agenda in the 1990s. The U.S. fiscal deficit began to decline in the early 1990s and swung to surplus by the end of the decade, underpinned by good growth and a stream of "revenue surprises" as the stock market surged. For its part, the Federal Reserve "opportunistically" continued to bring inflation down and under control, building on the experience of the 1980s in the wake of the challenges of the late 1970s.[19] Overall, after slowdown in the early 1990s, the U.S. economy gradually gained steam through the decade.

While the United States was building momentum, Japan was experiencing the aftermath of the bursting of the 1980s bubble economy. Despite serious signs of trouble and recession, banking sector reform was delayed. After substantially easing fiscal policy to spur growth, premature fiscal consolidation in 1997 stalled recovery, contributing to a contraction in the economy that year and the following. Monetary policy eventually became increasingly and highly accommodative. The challenges faced in Japan over this period were entrenched, and opinions differed internally and abroad about how to promote recovery.

In Europe, attention was heavily influenced by domestic agendas and intra-European affairs. German reunification in 1990 imposed high costs on the German economy, which contracted in 1992 and achieved only moderate growth in subsequent years, weighed down also by deep structural rigidities. The crisis in the Exchange Rate Mechanism of the European Monetary System in 1992-1993 also consumed the attention of financial officials.[20] Later on in the decade, the advent of European Monetary Union dominated the financial agenda, and European officials heavily focused on establishing the framework for the euro through the Maastricht Treaty and building the European Central Bank (ECB). Performance in some of the periphery countries of Europe improved markedly, as the lure of using the euro from the start facilitated improved policies and convergence of interest rates to German levels. But despite this progress, persistent unemployment and structural rigidities took a heavy toll, especially in the key continental countries. Overall, while the EU experienced some recovery in the mid to late 1990s, performance lagged significantly behind the United States.

Further, a shift in attitudes left policymakers even more doubtful about the feasibility and potential contribution of coordinating macroeconomic policy across borders.

- As monetary policy was able to bring inflation down, many central banks increasingly built up their credibility and felt increasingly accountable to get inflation down and keep it low. With monetary aggregates offering a less reliable policy anchor, inflation targeting regimes began to develop – in New Zealand, Sweden, Canada, Australia, and the United Kingdom. Obviously, exchange rates remained part of central banks' monetary equation, but the emphasis was more squarely placed on keeping low inflation. In the United States, senior Fed officials maintained that external developments would be taken into account to the extent that they

[19] Athanasios Orphanides and David Wilcox, "The Opportunistic Approach to Disinflation"; Federal Reserve Board Finance and Economics Discussion Series; May 1996.
[20] Edwin M. Truman, "Economic Policy and Exchange Rate Regimes: What Have We Learned in the Ten Years Since Black Wednesday?"; speech at the European Monetary Symposium, London School of Economics, September 16, 2002.

had feedback effects on the U.S. economy and that monetary policy responses should be aimed at the optimal performance of the U.S. economy.[21]

- Questions about fiscal policy as a flexible tool for macroeconomic management remained as acute as ever. As always, the conduct of fiscal policies required extensive compromises with legislatures and delved into fundamental domestic political choices. Lags between the announcement of fiscal intentions and implementation remained long. Policy-makers increasingly felt fiscal policy should follow a medium–term course and was not an appropriate instrument for macroeconomic fine-tuning.

- Attitudes toward foreign exchange market intervention grew increasingly skeptical in major countries. After frequent coordinated intervention during the Plaza and Louvre period and through the end of the 1980s and early 1990s, with the United States an active participant, officials—particularly in the United States—increasingly doubted the efficacy of intervention. In short, this growing skepticism reflected a return to that of the early 1980s, but it also took into account the realities of the modern global economy and markets.

Authorities increasingly felt that the amounts they could mobilize for intervention paled in comparison with huge and growing daily foreign exchange market turnover. They recognized that intervention operations would be sterilized, neutralizing the monetary policy impact of such operations. The exchange rate was increasingly thought of by most as an outcome of policies and not an object of policy. Current account targeting was eschewed, especially as current account positions were inextricably linked to global capital flows and the world of financial market participants. There was also concern that official actions and statements to the market could themselves create volatility, distracting markets from intermediating forces of supply and demand.

In the United States in particular, the prevailing view became that intervention should be used very sparingly and for signaling purposes when exchange rates were markedly out of line with perceived underlying fundamentals. That said, the G-7 cooperated closely to intervene on exchange rates when such action was perceived as warranted, for instance to address yen strength in 1995, yen weakness in 1998, and euro weakness in September 2000. These concerted operations demonstrated anew the ability of G-7 officials to work closely together, even against the background of greater constraints and limitations on their ability to"coordinate"policies. They also showed that even if officials were skeptical about foreign exchange market intervention, policymakers did not preclude that serious misalignments might arise and that when it came to intervention, they had"never said never".

While the limits of macroeconomic policy"coordination"increasingly became evident during the 1990s, the decade witnessed new and intense G-7 cooperation on other fronts.The first half of the 1990s saw the collapse of the Soviet Union, the emergence of many newly independent states, and the Mexican crisis of 1994, which was a harbinger of capital account crises to come.

The second half of the 1990s was also dominated by the Asian financial crisis, and crises in Brazil and Russia. The G-7 extensively discussed the challenges posed by these crises and their views on the appropriate international response. Intensive efforts were made to improve the "architecture" (some would say"plumbing") of the international monetary system, particularly modernization of the IMF. Transparency and data dissemination were introduced into the Fund's lexicon; the Fund delved into the world of strengthening financial sectors and supervision and regulation;

[21] Alan Greenspan, The Federal Reserve's Semi-Annual Monetary Policy Report; July 21, 1998.

standards and codes of good policy practice were promoted; national balance sheet analysis took root; and IMF facilities were revised, with some streamlined and the Supplemental Reserve Facility and the Contingent Credit Line added.

As they confronted the events of the 1990s, G-7 governments deepened their dialogue and cooperation, with more frequent interactions facilitated by improved communication technology. The emerging market crises of the mid and late 1990s led to extensive conference calls, consultations and actions together to help restore stability – further reinforcing the tight dynamics of the G-7 Finance Deputies in particular. Interestingly, the efforts to achieve shared goals in the international financial institutions (IFIs), where as major creditors they could carry sway, underscored the importance of the G-7 process even as the perceived utility of heavy engagement on multilateral surveillance waned.

On the whole, discussions within the G-7 involved good give and take on an increasing range of issues in the face of globalization. Multilateral surveillance exercises continued, but more as a means of keeping abreast of others' situation than an exercise in exerting peer pressure. To be sure, though, the United States often heavily engaged and exerted peer pressure, especially with Japan, in a bilateral context.

The G-7 process also evolved in other ways. With the advent of the euro, the question of participation in G-7 discussions needed reexamination. To adapt, the G-7 put in place new procedures, whereby the European Central Bank President and the Finance Minister from the country holding the EU Presidency (and a member of the Euro group) replaced national central banks during surveillance and exchange rate discussions, while Euro-area national central banks remained the interlocutors on broader policy issues. Driven by Summitry in the early 1990s, the G-7 also invited Russian officials to meet with the G-7 on Russian reform.

When emerging market country policies became critical to broader stability, the United States sought to bring the G-7 together with key Asian and other emerging market countries to share information and discuss ways to change policy approaches. The "Group of 22" sprang from a discussion between President Clinton and Singaporean Prime Minister Goh in the height of the Asia crisis and produced three reports on issues central to the crisis reflecting the input and views of major industrial and emerging market countries alike. Thereafter, the G-7 launched the Group of Twenty (G-20) as a permanent forum. These groups helped change the dynamics of the international dialogue and began the more recent wave of modernization that continues today.

Also in the wake of the Asia crisis, the G-7 created the Financial Stability Forum (FSF), bringing together regulators, central bank and finance ministry officials from their countries, along with standard setters and officials from other key financial centers and institutions. Creating the FSF was a critical effort to make sure that financial officials stayed vigilant in working together on the promotion of financial stability in the face of ever-rapid changes in global financial markets.

Since the new millennium, G-7 engagement has been characterized by both continuity and change.

- Continuity in the sense that multilateral surveillance exercises remain a key part of G-7 deliberations – though with modest expectations regarding "coordination" given constraints on domestic macroeconomic policy formulation and skepticism among most about foreign exchange market intervention —and that engagement has focused on a wide range of issues.

- Change in the sense that the forces of globalization and the power of private financial markets have accelerated, global imbalances far larger than those in the 1980s have

emerged, there is a rising imperative to reach beyond the G-7 countries to tackle challenges in the world economy, and cooperation continues to expand into new policy areas.

On the multilateral surveillance front, discussions were initially influenced by the U.S. downturn in the wake of the perfect storm of the bursting of the tech bubble, the 9/11 terrorist attacks, and the aftermath of corporate scandals. Japan began to clean up its financial sector, put itself on a recovery track and end deflation. Europe most recently shows signs of somewhat stronger growth, though there has been only limited progress on structural reforms and unemployment remains high.

Subsequently, as conditions strengthened, two dominant issues have taken center stage in G-7 surveillance discussions.

First, the emergence of large global imbalances appropriately features prominently on the agenda. The G-7 relatively quickly came to a consensus that that adjustment of global imbalances was a shared responsibility and that a three-part strategy for orderly adjustment was needed in the context of sustained and strong global growth. The three components widely agreed were: fiscal consolidation and raising private saving in the United States, structural reforms to raise potential growth in Europe and Japan, and greater flexibility in exchange rates, especially where such flexibility is lacking – with a particular focus on emerging Asia and China.

The G-7 effort to tackle the challenges of global imbalances also yielded the Agenda for Growth, launched by Ministers and Governors in September 2003 and aimed to address supply-side issues to increase flexibility and raise productivity growth. Each country committed to pursue additional pro-growth policies, and together they agreed to engage in regular "supply-side surveillance," which would include assessing (or "benchmarking") proposed reforms and reviewing their results. The ability of G-7 members to deliver on promises was limited, however, and many of the needed structural reforms were outside the control of Finance Ministers and Central Bank Governors.

Despite agreement on the three-part strategy and the launch of the Agenda for Growth, basic questions about who should adjust, how, and by how much have remained.

- U.S. fiscal consolidation is clearly in the U.S. national interest. Some foreign voices seemingly suggest, though, that if only the United States would rein in its fiscal deficit, U.S. external deficits would be quickly reduced with the global economy benignly more balanced. At the very same time, many foreign officials—and often the same officials—also stress how important solid U.S. growth and demand for imports are to their economies. Criticisms of the U.S. "twin deficits" continue, notwithstanding the lack of a good correlation between U.S. fiscal and current account deficits in past decades.

- The Euro-area's current account position is near balance. Thus, some European officials argue that the Euro-zone is not really part of the global adjustment equation, though it surely needs to improve economic performance for its own good. Others, including U.S. officials, do not support this view. They believe there are important gains to be made in the European non-tradeable services sector and investment climate, which could boost European potential growth, stimulate demand for imports, attract greater flows of global capital, and lead to a sustainable current account deficit. From this perspective, Europe is part of the global adjustment picture and part of the solution.[22]

- Japan has clearly felt that external demand

[22] Treasury Department, "Report to Congress on International Economic and Exchange Rate Policies"; May 2006; pp. 6-7.

is an important support for Japanese growth in overcoming deflation and getting back on a solid recovery track in the wake of its doldrums. Some Japanese officials psychologically may be less inclined than their U.S. or European counterparts to view the exchange rate as a simple by-product of other policies. Others outside of Japan emphasize that it is critical for Japan to wean itself from export-led growth.

- The G-7 has called for countries beyond its confines to increase currency flexibility, particularly China, to assist in the global adjustment process; in turn, greater currency flexibility in China is seen as a means of facilitating greater flexibility throughout Asia, given other Asian countries' concerns about maintaining competitiveness vis-à-vis China. Asian officials recognize the need for greater currency flexibility. But they have also pointed to underlying saving-investment relationships in their countries as key to understanding their current account positions and argued that currency flexibility will not contribute significantly to solving global imbalances.

On balance, then, while there is agreement about the broad strategy, beneath the surface there are some key, nuanced differences about relative contributions to global adjustment.

The IMF's latest proposals on a process for multilateral consultations may represent an important effort to reinforce the role of shared responsibility, understanding, and peer pressure in the international monetary system. These proposals underscore the multilateral dimension of global imbalances and the need for a broader discussion of imbalances than can be afforded within the confines of the G-7. The process should also help promote exchange rate policies that are consistent not only with domestic policies, but global adjstment with the international monetary system.

A second key issue framing G-7 surveillance discussions this decade has been the declining collective weight of G-7 economies in the world economy – and the resulting limits on their ability to influence the world economy through their own policy actions. The world economy is now in its fourth consecutive year of growth exceeding four percent annually (on a purchasing power parity basis). This is a phenomenal and welcome development. But growth performance is quite disparate. The United States continues to outpace other G-7 countries and has been the main engine of global growth for some time. Meanwhile, fast-growing emerging market countries, particularly in emerging Asia, are imparting a source of dynamism to the global economy. In 1985, the G-7 countries accounted for 48.9 percent of global GDP (using PPP weights); in 2005, they only constituted 41.9 percent.[23] As G-7 growth is lagging behind that in emerging markets, the weight of the G-7 in the global economy is declining, and the G-7 is no longer providing the same degree of marginal impetus to global growth.

The challenges posed by global imbalances, world financial markets, and shifting weight in the global economy have affected the G-7 process itself.

The constraints on macroeconomic policy coordination that prevailed in the 1990s – notably the simple realities of the domestic political conduct of fiscal policy, the increasing focus of central banks on inflation and to a lesser degree exchange rates, skepticism about the wisdom of current account targeting, and doubts regarding the efficacy of intervention – remain well-entrenched. The role of peer pressure has further softened. In addition, the United States in particular has in general fur-

[23] International Monetary Fund, World Economic Outlook Database, September 2005. The changes in PPP weights for developing countries and emerging markets reflect both countries gaining and losing weight. Fast-growing emerging markets have seen their PPP weight in the world economy increase far more than the decline in G-7 weight. China, India, and South Korea saw their combined PPP share of the global economy rise over 13 percentage points in this period.

ther stepped back from efforts to promote specific policy change in G-7 partner countries, preferring a more collegial approach.

As stated by then-Assistant Secretary for International Affairs Randal Quarles: "A continual process of informal discussion and contact provides the best means for understanding the interaction of national policies around the globe and greater sensitivity to each country's concerns....I think our current informal processes are working as well as they can in a world of diverse perspectives. The most important contribution any country can make is to improve its own economy's performance. The better an economy functions individually, the more positive a contribution it can make to the global economy."[24]

Thus, while G-7 policy-makers have valued interactions with each other, G-7 multilateral surveillance discussions have focused more on reviewing developments than a back and forth examination of prospects and policy changes.

At the same time, G-7 cooperation on issues beyond the macroeconomic realm has continued and deepened. There was close and continuing engagement in addressing country cases such as Brazil, Argentina, Uruguay and Turkey. The initial HIPC debt reduction initiative and the more recent Multilateral Debt Relief Initiative were clear products of G-7 cooperation. The G-7 as always has continued its work on IFI reform, for instance achieving greater harmony on the balance between flexibility and limits on exceptional access to IMF financing. And G-7 cooperation also helped achieve incorporation of Collective Action Clauses in sovereign external bond contracts.

Cooperation also entered new terrain – the G-7's unity in tackling the challenge of combating terrorist financing was a new and resolute chapter in cooperation, symbolized so strikingly by the joint press conference of G-7 Finance Ministers at their special meeting in early October 2001. That cooperation launched strenuous day-to-day G-7 efforts at collectively designating terrorists, freezing their assets, incorporating FATF standards into the daily activities of the Fund and Bank, and cleaning up unsafe financial practices. These efforts built on and were facilitated by earlier work within the G-7 and other international groupings on offshore financial centers and the abuse of the international financial system.

Further, while G-7 debates on IMF reform could be seen as a hardy perennial, the Medium Term Strategic Review – against the background of the recent decline in IMF credit outstanding and the desire to tackle the governance structure of the Fund – in some respects is a qualitatively different and more sweeping exercise than witnessed in the past few years.

Just as the substantive discussions have changed, the process of G-7 engagement has also evolved. G-7 Finance Deputies remain at the heart of the process, meeting often, holding conference calls, and frequently speaking or emailing daily. They organize Ministerial sessions and engage intensively if an emerging market begins to face problems. The members of this group get to know each other well, and the group is sufficiently small to get business done.

G-7 Ministers and Governors continue to meet three times a year, and the Finance Ministers meet alone with their Russian counterpart (as the G-8) to discuss finance issues ahead of the Leaders' annual summits. The "choreography" of the G-7 meetings has grown complicated, and debates swirl about who has domain for a given issue and who should be at the table. In recent meetings, the ECB President and the President of the European Economic and Finance Council have attended the G-7's multilateral surveillance session; European national central bankers then join the discussions; then Russian and

[24] Randal Quarles, remarks in *The Euro at Five: Ready for a Global Role*, (Washington, D.C., Institute for International Economics, Adam Posen, editor; April 2005), p. 42.

European Commission officials attend a portion of the meeting. The heads of the IMF and World Bank also attend parts of the meeting. As a result, many people are in the room, which tends to lead to more scripting and less candor among top officials. European efforts to coordinate positions in the G-7 with other EU states can further complicate informal exchanges.

More pronounced and likely significant for the long term are the shifts in G-7 interactions with those outside its membership and an existential soul-searching now underway about how the G-7 fits into today's global architecture. This dynamic is linked to the changing pattern of global economic weight discussed above and is also mirrored in the current intense debates about changing IFI governance, particularly at the IMF.

The issue of who should be included in exclusive, heavyweight discussions on the world economy and international financial system is a thorny one.

- The G-7 still accounts for over 40% of global GDP on a PPP basis and far more than half using market prices, plus nearly half the voting power of the IFIs. The G-7 countries tend to be like-minded creditors of the system. But many others are becoming creditors too.

- The G-20 has taken root as a key forum for broader dialogue on key international economic and financial policy issues. It has usefully brought emerging market officials together with those of the G-7, providing an opportunity for mutual education and increasing buy-in from emerging markets for many of the initiatives pursued in the IFIs and elsewhere such as the broader adoption and implementation of standards and codes. The G-20 has helped G-7 officials deepen contacts with emerging market colleagues and this has facilitated interaction, particularly at urgent times. The G-20 is a highly valuable and new piece of the global architecture. Yet, the G-20 is large, and some participate far more actively than others.

- And then there are the changing dynamics and evolving roles of countries within the system ("variable geometry"). China's impact on the global economic system is huge, undeniable, and must be taken into account. India and Brazil as well, large countries in their own right, are beginning to show the fruits of reforms as liberalization and sound policies take hold, growth is quickening, and their impact on the world economy is evident. Amid sustained high petroleum prices, oil producers are accumulating sizeable reserves and petro-dollar recycling is back on the international agenda. Even if the G-7 accounts for a large part of global GDP, outside the G-7, and the United States in particular, other key emerging markets are providing significant impulse to global growth and are having a pronounced and growing impact on the global economy. Addressing global imbalances requires engaging heavily with new actors outside the G-7.

Against this background, the G-7 countries have been conducting "outreach" – often inviting others to meet with the group on the sidelines of meetings. For instance, G-7 Deputies met with their Chinese counterparts in 2003 and have repeated this practice several times since. Ministers and Governors first invited the Chinese in September 2004 to discuss China's current economic situation and outlook and its importance for the global economy. More broadly, China, India, Brazil, and South Africa have joined G-7 meetings on an ad hoc basis, as have others, to discuss global economic developments. At their most recent meeting, G-7 Ministers heard a presentation from the Chairman of the G20 Deputies and held an informal dinner with officials from China, Russia, Saudi Arabia, and UAE to discuss issues concerning petrodollars and their recycling.

Through these sessions, a table that is already quite large is potentially becoming even bigger. This raises the question about how big the table should be and who should be there in order to fa-

cilitate useful discussions and to allow the group to achieve something meaningful. Outreach to important economies beyond the G-7 is here to stay and one can easily foresee a future in which outreach moves beyond ad hoc arrangements toward greater institutionalization. How that is done is another question, one that increasingly and more urgently needs to shape the agenda of G-7 and other policy-makers.

Large global imbalances and the growing weight of emerging market economies have spawned debates – why not a Plaza 2? Why not declare the G-7 dead?

The Plaza Agreement and Louvre Accord demonstrated the strong level of cooperation and political will among financial officials in the major countries at the time. Still, the limits and constraints on sovereign actors in coordinating policies were evident in the 1980s, and the extent of "coordination" that prevailed even then is at times overstated. Economic policy thinking in the 1990s reinforced these limits and constraints. Fiscal fine-tuning was increasingly eschewed. Monetary policy focussed more forcefully on achieving low inflation and promoting central bank independence and credibility. Exchange rates played less of a role as a policy target in most major countries, and there was far less conviction about the efficacy of foreign exchange market intervention, except in limited circumstances. These trends from the 1990s have generally been reinforced since 2000, especially as the power of private markets has grown.

Against this background, economic policy discussions in the G-7 have evolved over time to focus to a greater extent on informal exchanges of views. The role of peer pressure has softened. Policy-makers focus for all intents and purposes on keeping their own economic houses in order. But even if the potential for explicit macroeconomic coordination has diminished, policy-makers are acutely aware of the interactions among their economies. Multilateral surveillance remains a useful process, and policy-makers benefit from discussing economic performance and sharing and debating policy approaches. Further, one should not underestimate the strong ties that exist among participants in the G-7 process, nor discount their ability to muster a collective political will to take action to address challenges, macroeconomic, exchange market, or otherwise, especially in response to a clear common threat.

In addition, cooperation has been extended to other critical areas. The G-7 process built up in the 1980s, 1990s and this decade, and the fluid interactions facilitated thereby have allowed the G-7 to tackle international economic and financial challenges of key geo-strategic significance – the transformation of the ex-Soviet states, the Asian financial crisis and its wake, and debt relief for the poorest. The world economy has strongly benefited as a result. And the creation of the G-20 and other mechanisms for broader consultation, policy debate, and mutual education have helped deepen discussions, build consensus, and enhance policy-making well beyond the G-7.

The ongoing value of extensive informal consultations among key policymakers points not to preservation of the status quo, but to the need for evolution in this process in order to increase the potential for cooperation to strengthen the global economy going forward. The changes achieved thus far to extend consultations to those playing a greater role in the world economy are critical and beginning steps forward. But the world is changing faster than the existing process for consultation and cooperation. Evolution thus needs to accelerate in order to reflect shifting global economic weight, impetus, and financial power, as well as globalization and the dominance of private capital markets. Change simply must be faced soon by the G-7 and IFI Boards in particular, for the international community to retain tools for cooperation that remain central and relevant in the modern global economy.

PRESS ROOM

July 7, 2006
JS-4354

**Quarles to Discuss
U.S. Corporate Governance Rules,
American Competitiveness**

Under Secretary for Domestic Finance Randal K. Quarles will participate in a roundtable discussion with Members of Congress at the Financial Services Forum on Monday. The panel, which will be hosted by former Secretary of Commerce Donald L. Evans, will discuss the effects of U.S. corporate governance rules on the competitiveness of American businesses and financial markets.

Who
Under Secretary for Domestic Finance Randal K. Quarles

What
Remarks on U.S. Corporate Governance Rules

When
Monday, July 10 4:00 pm (EDT)

Where
The Mandarin Oriental Hotel
Room Oriental C
1330 Maryland Ave. SW
Washington, DC

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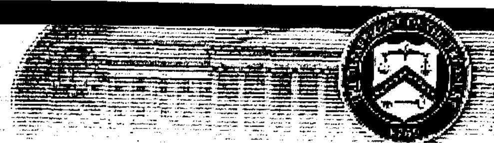

July 10, 2006
HP-01

REMARKS PREPARED FOR DELIVERY BY
U.S. TREASURY SECRETARY HENRY M. PAULSON
AT SWEARING-IN CEREMONY

Mr. President, thank you for those kind remarks and for giving me this opportunity to serve as America's 74th Treasury secretary. I appreciate the trust you have placed in me to lead the Treasury Department at a time when we must ensure that our economy remains strong, our markets remain competitive, and our workers have the opportunity to realize their full economic potential.

To my family, and especially Wendy, my wife and best friend of 37 years – thank you for your support as I return to public service, after 32 years in the private sector. Wendy and I are very pleased to have on stage with us today – my mother, Marianna, our son Merritt, and our daughter Amanda. Also here are a number of close friends and family members, including my brother Dick and my sister Kay. We all fondly remember our late father, Merritt, who was an amateur historian and an Alexander Hamilton fan.

Thank you Chief Justice Roberts for administering the oath of office.

And thank you to all of my Cabinet colleagues, my friends and colleagues from Goldman Sachs, members of Congress, and other distinguished guests, for attending this ceremony.

As I begin my first day at the Treasury Department, I remember those who have preceded me in this post. Throughout our nation's history, my predecessors here have helped to build an economy and a financial system that are the envy of the modern world.

Mr. President, I am 100 percent committed to building on these past achievements and to doing my best to ensure that our economy remains a model of strength, flexibility, and openness. I look forward to working with you in collaboration with your other economic advisers, my Cabinet colleagues, members of both parties of Congress, and the great professionals at Treasury. One of my first priorities will be forging a close working relationship with Treasury's career professionals.

Under your leadership, Mr. President, our economy has achieved steady growth and has created millions of jobs. This growth has been achieved despite the stiff challenges of terrorist attacks, an economic downturn, corporate scandals, and devastating natural disasters. And as you have pointed out, there are still a number of challenges ahead of us and important goals to be met.

The American economic system and our workers have always been winners and they will continue to win. Our job is to help them do just that. We need to pursue economic and regulatory policies that are responsive to today's world and to the challenges and goals you have set forward.

And, of course, as we pursue these goals, we must always remember that the strength of the U.S. economy is linked to the strength of the global economy. It is critical for the United States to remain actively engaged with our economic partners. And it's in our interest to advance those policies that will help to build a more prosperous world. Doing so contributes to our economic progress, as well as our national security.

If we retreat from the global stage, the void is likely to be filled by those who do not share our commitment to economic reform. Instead, we must work to expand trade and investment, work to reform and modernize international financial markets and be vigilant in identifying and managing potential financial vulnerability.

Mr. President, thank you again for the nomination, and thank you for coming today. I look forward to getting to work.

July 10, 2006
2006-7-10-13-36-31-5083

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $68,026 million as of the end of that week, compared to $67,831 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	June 30, 2006			July 7, 2006		
TOTAL	67,831			68,026		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	11,927	11,058	22,985	11,972	11,103	23,075
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,882	5,399	17,281	11,928	5,425	17,353
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			7,906			7,922
3. Special Drawing Rights (SDRs) [2]			8,618			8,635
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	June 30, 2006			July 7, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						
2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets						
	June 30, 2006			July 7, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL

1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

PRESS ROOM

July 10, 2006
HP-02

Treasury Secretary Paulson Places Calls to Capitol Hill, Others

WASHINGTON - Newly sworn-in Secretary of the U.S. Treasury, Henry M. Paulson, spent the morning and afternoon placing calls to Capitol Hill, fellow Cabinet members, and his global counterparts.

High resolution photo available at www.treas.gov. Secretary Paulson's bio available at http://www.treas.gov/organization/bios/paulson-e.html

All media queries should be directed to
The Press Office at (202) 622-2960.
Only call this number if you are a member of the media.

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PRESS ROOM

July 10, 2006
HP-03

Treasury Secretary Paulson Meets with Department Staff

WASHINGTON - Newly sworn-in Secretary of the U.S. Treasury, Henry M. Paulson, today met with Treasury staff to discuss his vision for the Department.

High resolution photo available at www.treas.gov Secretary Paulson's bio is available at http://treas.gov/organization/bios/paulson-e.html.

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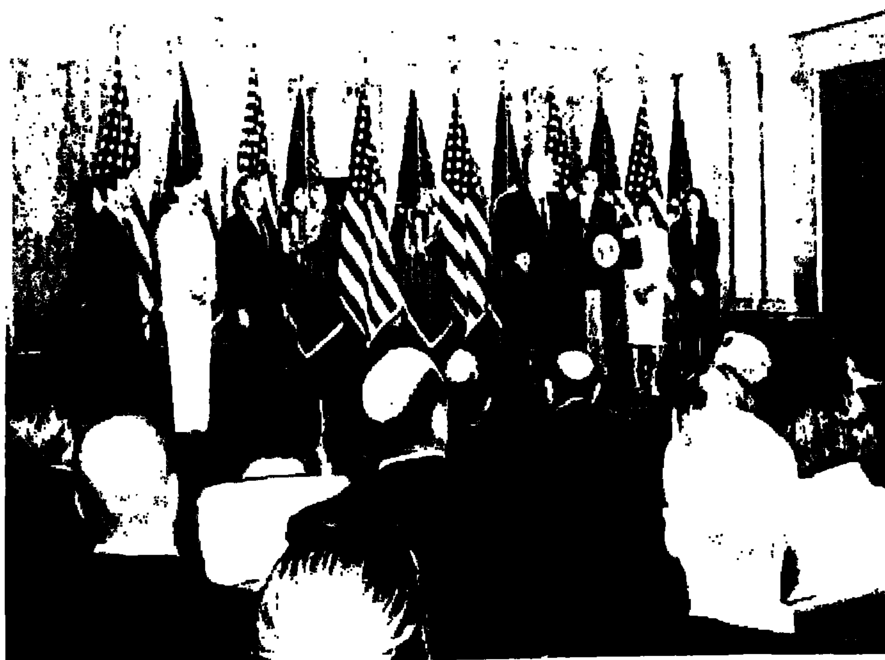
High Resolution Image

PRESS ROOM

July 10, 2006
hp-04

Paulson Sworn into Office as the 74th Secretary of the Treasury



WASHINGTON - Henry M. Paulson was sworn into office today as the 74th

Secretary of the United States Treasury. President George W. Bush joined Paulson for the ceremony in the Treasury Department's historic Cash Room. Chief Justice John Roberts administered the oath of office.

High resolution photo available at www.treas.gov. Secretary Paulson's bio available at http: treas.gov organization bios paulson-e.html.

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The Press Office at (202) 622-2960.
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-30-

July 11, 2006
HP-05

Testimony of Stuart Levey, Under Secretary
Terrorism and Financial Intelligence
U.S. Department of the Treasury
Before the House Financial Services Subcommittee on Oversight and Investigations

Chairwoman Kelly, Ranking Member Gutierrez, and distinguished Committee members. This is my fifth time appearing before your Committee in the past two years in what has been an ongoing and fruitful discussion of our government's efforts to track and combat terrorist financing. These sessions have advanced our shared mission to undermine terrorist networks and disrupt their vicious objectives. It is always a privilege to be here.

As this Committee knows well, tracking and combating terrorist financing are critical facets of our overall efforts to protect our citizens and other innocents around the world from terrorist attacks. This is true for two main reasons. First, when we block the assets of a terrorist front company, arrest a donor, or shut down a corrupt charity, we deter other donors, restrict the flow of funds to terrorist groups and shift their focus from planning attacks to worrying about their own needs. While any single terrorist attack may be relatively inexpensive to carry out, terrorist groups continue to need real money. They depend on a regular cash flow to pay operatives and their families, arrange for travel, train new members, forge documents, pay bribes, acquire weapons, and stage attacks. Disrupting money flows stresses terrorist networks and undermines their operations. In recent months, we have seen at least one instance of what we look for most - a terrorist organization indicating that it cannot pursue sophisticated attacks because it lacks adequate funding.

Second, "following the money" is one of the most valuable sources of information that we have to identify and locate the networks of terrorists and their supporters. If a terrorist associate whom we are watching sends or receives money from another person, we know that there's a link between the two individuals. And, while terrorist supporters may use code names on the phone, when they send or receive money through the banking system, they often provide information that yields the kind of concrete leads that can advance an investigation. For these reasons, counter-terrorism officials place a heavy premium on financial intelligence. As the 9/11 Commission staff pointed out - and as Chairman Hamilton testified before this Committee - "following the money to identify terrorist operatives and sympathizers provides a particularly powerful tool in the fight against terrorist groups. Use of this tool almost always remains invisible to the general public, but it is a critical part of the overall campaign against al Qaeda." The Terrorist Finance Tracking Program was just such an invisible tool. Its exposure represents a grave loss to our overall efforts to combat al Qaida and other terrorist groups.

We are facing a clever and adaptive enemy that takes extensive precautions to cover its tracks. If we are to exploit the vulnerability that financial transactions represent, we need to marshal all of our resources and ingenuity. We need to cooperate seamlessly within our government, drawing on our different strengths and talents and appropriately sharing our information without hesitation. We need to work closely with the private sector, which is sometimes best positioned to detect suspicious behavior. And we need to proceed hand-in-hand with our foreign partners, both in sharing information and taking action to identify terrorist financiers, disrupt their operations, and hold them accountable.

My colleagues in the Treasury Department and across the U.S. government have been working with dedication and ingenuity to meet this demanding challenge. Our

theater of engagement literally spans the world, from the money changing tables of Kabul to the jungles of South America's Tri-Border Area, from finance ministries to the compliance offices of the world's most sophisticated banks. Thanks to their tireless efforts, we have achieved real successes. The 9/11 Commission's Public Discourse Project awarded its highest grade, an A-, to the U.S. Government's efforts to combat terrorist financing. I would be happy to discuss these efforts in greater detail in a subsequent hearing, and reference some recent highlights in the margin.

The Terrorist Finance Tracking Program has been a key part of these overall efforts. I had no hand in initiating this program, so I can say without any conceit that Secretary Snow was right in saying that the Terrorist Finance Tracking Program exemplifies government at its best. The Society for Worldwide Interbank Financial Telecommunication (SWIFT) is the premier messaging service used by banks around the world to issue international transfers, which makes its data exceptionally valuable. I would note that SWIFT is predominantly used for overseas transfers. It does not contain information on most ordinary domestic transactions made by individuals in the United States, such as deposits, withdrawals, ATM use, checks, or electronic bill payments. The SWIFT data consists of records of completed financial transactions; it does not provide access to individual bank account information. This program is consistent with privacy laws as well as Treasury's longstanding commitment to protect sensitive financial data.

In response to a subpoena, SWIFT makes available to us a subset of its records that it maintains in the United States in the normal course of its business. The legal basis for this subpoena is the International Emergency Economic Powers Act (IEEPA), a statute passed in 1977, which allows the government to compel the production of information pursuant to Presidential declarations of national emergency. We issue such administrative subpoenas regularly, and our authority to do so is clear. In this case, our subpoena is issued pursuant to President Bush's declaration of an emergency with respect to terrorism after September 11th in Executive Order 13224. That declaration has been renewed yearly in light of the continuing threat posed by al Qaida and other deadly terrorist groups.

The SWIFT subpoena is powerful but narrow. We cannot simply browse through the records that SWIFT turns over - we are only able to see that information which is responsive to targeted searches in the context of a specific terrorism investigation. The data cannot be searched unless the analyst first articulates the specific link between the target of the search and a terrorism investigation. I want to emphasize that we cannot search this data for evidence of non-terrorist-related crime, such as tax evasion, economic espionage, money laundering, or other criminal activity. As a result, we have accessed only a minute fraction of the data that SWIFT has provided.

The program contains multiple, overlapping layers of governmental and independent controls to assure that the data is only searched for terrorism purposes and that all data is properly handled. Pursuant to an agreement that we reached with the company, SWIFT representatives are able to monitor these searches in real time and stop any one of them if they have any concerns about the link to terrorism. In addition, a record is kept of every search that is done. These records are reviewed both by SWIFT's representatives and an outside independent auditor.

Members of the Congressional intelligence committees were briefed about this program, and our colleagues in the central banks of the G-10 countries were likewise informed.

The benefits of the Terrorist Finance Tracking Program have been incalculable. This program provides a unique and powerful tool that has enhanced our efforts to track terrorist networks and disrupt them. That is the opinion of experts familiar with this program, both in and out of the government, irrespective of political orientation. It is also the view of those closest to the data, who are in the best position to know. I have on my staff a group of intelligence analysts who spend their days in a secure room poring over information to unmask the key funders and facilitators of terrorist groups. If you spoke with them, they would point to this program as one of the most important and powerful tools they have to follow the money.

They value this program because it leads to results. The details remain classified, but the program has been instrumental in identifying and capturing terrorists and financiers and in rolling up a terrorist-supporting charity. The program played an important role in the investigation that eventually culminated in the capture of Hambali, Jemaah Islamiyya's Operations Chief, who masterminded the 2002 Bali bombings. The program supplied a key piece of evidence that confirmed the identity of a major Iraqi terrorist facilitator and financier. Because we were able to make this data available to an ally, this facilitator remains in custody. But the program has also proven its worth in many less dramatic, but equally significant ways. Anyone who has tried to piece together a complex terrorism investigation over months or years of sweat and dead-ends knows how important it can be to uncover a previously unknown link or fact. This program generates just such connections and leads nearly every day, which are then disseminated to counter-terrorism experts in intelligence and law enforcement agencies.

In short, the Terrorist Finance Tracking Program has been powerful and successful, grounded in law and bounded by safeguards. It represents exactly what I believe our citizens expect and hope we are doing to prosecute the war on terror.

Much has been said and written about the newspapers' decision to publish information about this program. As a government official, I must first point out that the newspapers almost certainly would not have known about this program if someone had not violated his or her duty to protect this secret.

At the same time, I do very much regret the newspapers' decision to publish what they knew. Secretary Snow and I, as well as others both inside and outside the government, made repeated, painstaking efforts to convince them otherwise. We urged that the story be held for one reason only: revealing it would undermine one of our most valuable tools for tracking terrorists' money trails. We were authorized to set these arguments out for the relevant reporters and editors in an effort to convince them not to publish. In a series of sober and detailed meetings over several weeks, we carefully explained the program's importance as well as its legal basis and controls. We strongly urged them not to reveal the source of our information and explained that disclosure would unavoidably compromise this vital program.

These were not attempts to keep an embarrassing secret from emerging. As should be clear from my testimony above, I am extremely proud of this program. I am proud of the officials and lawyers in our government whose labors ensured that the program was constructed and maintained in the most careful way possible. And I am proud of the intelligence analysts across our government who have used this information responsibly to advance investigations of terrorist groups and to make our country safer. I asked the press to withhold the story because I believed - and continue to believe - that the public interest would have been best served had this program remained secret and therefore effective.

Some observers have argued that the disclosure of the program did little damage because terrorist facilitators are smart and already knew to avoid the banking system. They correctly point out that there has been an overall trend among terrorists towards cash couriers and other informal mechanisms of money transfer - a trend that I have testified about. They also hold up as public warnings the repeated assertions by government officials that we are actively following the terrorists' money.

What we had not spoken about publicly, however, is this particular source. And, unfortunately, this revelation is very damaging. Since being asked to oversee this program by then-Secretary Snow and then-Deputy Secretary Bodman almost two years ago, I have received the written output from this program as part of my daily intelligence briefing. For two years, I have been reviewing that output every morning. I cannot remember a day when that briefing did not include at least one terrorism lead from this program. Despite attempts at secrecy, terrorist facilitators have continued to use the international banking system to send money to one another, even after September 11th. This disclosure compromised one of our most valuable programs and will only make our efforts to track terrorist financing - and to prevent terrorist attacks - harder. Tracking terrorist money trails is difficult enough

without having our sources and methods reported on the front page of newspapers.

I can assure you, however, that our efforts will not wane. With our interagency colleagues and our partners abroad, we will continue to draw on every resource at our disposal to uncover and disrupt these terrorist networks.

Thank you.

A few selected examples of our interagency work on terrorist financing follow:

* We have made dramatic progress in combating terrorist abuse of charities through a combination of law enforcement and regulatory actions against corrupt NGOs, both at home and abroad. In tandem with these enforcement efforts, active engagement with the legitimate charitable sector has succeeded in raising transparency and accountability across the board.

* Thanks to our work in cooperation with the private sector to enhance anti-money laundering/counter-terrorist financing procedures in the financial system, many terrorists have been forced to resort to alternative means of moving money - such as cash couriers - that are more cumbersome or risky. Couriers offer concealment, but some get caught and some get greedy, and a terrorist is likely to think twice before entrusting a large sum to any one courier. We are working bilaterally and through international organizations like the Financial Action Task Force to ensure that countries around the world both pass and implement laws to regulate the movement of cash across their borders. Our law enforcement colleagues, notably those in DHS's Immigration and Customs Enforcement, are training border agents around the world to make sure these programs work.

We have encouraged countries around the world to make increased use of the U.N. Security Council to seek the designation of terrorist supporters. This global designation program, overseen by the U.N.'s 1267 Committee, might be the most powerful tool for global action against supporters of al Qaida. It envisions 192 U.N. Member States acting as one to isolate al Qaida's supporters, both physically and financially. Increasingly, countries have begun to look to this committee, and administrative measures in general, as an effective complement to law enforcement action. In 2005, 18 Member States submitted names for the Committee's consideration, many for the first time.

PRESS ROOM

July 11, 2006
HP-06

Under Secretary Randal K. Quarles
Statement On Mid-Session Budget Review

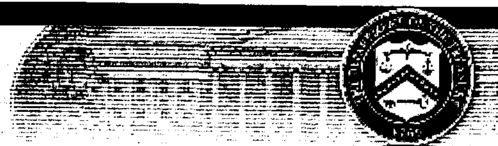
Treasury Under Secretary for Domestic Finance Randal K. Quarles issued the following statement today regarding the Office of Management and Budget's mid-year review of the FY06 budget projections:

"The results of the mid-session review of the federal budget released this morning, which show a dramatic reduction in the deficit forecast, demonstrate the strength of the U.S. economy and the benefits of the Administration's economic and tax policies. Those policies have promoted strong U.S. growth, and as the economy grew, so did our tax revenues.

"Every month this fiscal year, Treasury has seen some of the highest levels of tax revenue in history, with year-to-date receipts now running 13 percent higher than last year's. This is particularly notable given that last year's receipts were themselves 14.6 percent higher than the year before. This revenue growth has accounted for 90 percent of the improvement in the deficit forecast, and with this improvement it is clear we are on a path to meet the President's deficit reduction goal early.

"While our strong revenue growth is encouraging, it is also important to emphasize that spending restraint makes a difference, as lower than expected outlays have also contributed to the reduction in the budget deficit. There is no doubt that a line item veto for the President can help further restrain spending, and exercising fiscal responsibility is essential if we are to maintain the encouraging trend demonstrated today."

PRESS ROOM



July 12, 2006
HP-07

Statement of Edmund C. Moy
Director-Designate
U.S. Mint, U.S. Department of the Treasury
Before the Senate Banking, Housing
and Urban Affairs Committee

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee on Banking, Housing and Urban Affairs, thank you for this honor and opportunity to appear before you today to discuss my nomination to become the 38th Director of the United States Mint.

Joining me today is my wife, Karen.

To many Americans and me, the United States Mint represents the best of America. I respect its place in our history. I appreciate the beauty and artistry of its coins. I value its role in facilitating commerce, and I have learned about our collective culture through its designs on the Nation's coinage. I am pleased and honored by the trust President Bush has placed in me by asking me to serve in this important position, joining the ranks of those privileged to serve as Directors since President Washington asked David Rittenhouse to serve as the first Director of the Mint in 1792. If confirmed, I look forward to working closely with this Committee and Congress on all the policy and legislative issues that will determine the course for American coinage now and in the future.

The United States Mint applies world-class business practices in making, selling, and protecting our Nation's coinage and assets.

I am committed to this Mission Statement and the 1900 men and women of the United States Mint who work to implement the practices that fulfill the requirements of Congress and the country to produce approximately 15 billion coins annually. These coins are distributed to the Federal Reserve banks and branches for commerce and trade; The United States Mint also maintains the physical custody and security of the Nation's more than $100 billion in gold and silver assets. And finally, it produces numismatic coins, medals, gold, silver and platinum bullion coins for the general public to collect.

I value public service and, if confirmed, I will bring to bear all the experience I have earned through my career in management, marketing and human resources both in the private sector and government. These are essential areas for the United States Mint which also shares characteristics of both a business and governmental organization, operated for the benefit of the public, with revenues approaching $2 billion.

I have spent 10 years as a sales and marketing executive, 8 years working with venture capital firms and entrepreneurs, and 4 years overseeing $7 billion in annual Federal Government expenditures for managed health care programs with the Department of Health and Human Services. I am familiar with the demands of being an officer and director, having served in those capacities at several companies and nonprofits.

Most recently, I have been honored to serve the President of the United States in a human resources capacity as a member of the Office of Presidential Personnel. I have worked closely with many members of the cabinet and independent agencies

to understand the results they desire, recruiting the nation's best and brightest to attain those results, and then making recommendations to the President for those who may serve as appointees. I understand the responsibility appointees have to the President, and their accountability to Congress and the American people to be good stewards of the public's trust and resources.

I am confident that my experience and qualifications will contribute to the continuing success of the United States Mint.

If confirmed, I see some immediate responsibilities and challenges before me. Implementing the "Presidential $1 Dollar Coin Act of 2005," which this Committee approved, is a major operational focus for the United States Mint that is well under way. As directed by that legislation, the United States Mint has, and will continue, to work with those who can influence and encourage the greater use and acceptance of dollar coins in American commerce.

The rising cost of metals used in coin production is prompting some needed analysis and consideration of the impact of that trend on all denominations of coins, especially the penny and nickel. Public preferences and priorities on this subject will loom large, and the United States Mint will need to provide technical and manufacturing considerations to Congress, the Administration and others who are evaluating the future course of coinage.

Reviewing, refining if necessary, and implementing the United States Mint's business, management, operational and strategic plans, executing the President's Management Agenda, and providing effective leadership, are priorities for me should I be confirmed.

Thank you for the honor and privilege to appear before you today.

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July 12, 2006
HP-08

Treasury Identifies Money Laundering Cell of the Arellano Felix Organization

The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) today identified 34 companies and individuals associated with two Mexican drug cartels, the Arellano Felix Organization and the Arriola Marquez Organization, pursuant to the Foreign Narcotics Kingpin Designation Act (Kingpin Act). Both the Arellano Felix Organization (AFO) and Arriola Marquez Organization (AMO) were previously named by the President as Mexican drug kingpins under the Kingpin Act.

"Our action designates a key financial cell of Mexico's notorious Arellano Felix Organization," said Barbara Hammerle, Acting Director of OFAC. "This financial network, headed by Mexican national Lorenzo Arce Flores, utilizes money service businesses and other front companies in Mexico to launder the AFO's monies. Our designation process exposes the financial nerve center of Mexican drug cartels, thereby encumbering efforts to bankroll illicit proceeds."

"Taking down multinational drug organizations such as the AFO and AMO requires a two-pronged approach – arresting the traffickers and seizing their financial assets. DEA and its OFAC partners are committed to bringing traffickers from the kingpin to the runner to justice while at the same time stripping them of the money and assets they need to carry on their illicit operations," said Donald Semesky, Chief of Financial Operations for the Drug Enforcement Administration (DEA).

The first OFAC action targets an Arellano Felix Organization money laundering cell, run by key individual Lorenzo Arce Flores, comprised of 14 companies and 15 individuals located in Tijuana, Baja California, Mexico. The second OFAC action identifies five individuals who are financial operatives of the Arriola Marquez Organization in the state of Chihuahua, Mexico.

"Whenever money and drugs intertwine for illicit profit, our financial expertise will be utilized to unravel the most complex and sophisticated money laundering schemes", said Special Agent in Charge Kenneth Hines, IRS Criminal Investigation, San Diego Field Office

Lorenzo Arce Flores is a key AFO money launderer who is also tied to AFO lieutenant, Jesus Abraham Labra Aviles. The AFO was designated as a drug kingpin by the President in June 2004 and Jesus Abraham Labra Aviles was designated by OFAC in November 2004. Lorenzo Arce Flores directs an extensive and diversified operation which facilitates money laundering and bulk smuggling of cash across the border. OFAC has identified several Mexican money service businesses that are part of the Arce Flores network, including CAJA AMIGO EXPRESS S.A. DE C.V., OPERADORA DE CAJA Y SERVICIOS S.A. DE C.V., MULTICAJA DE TIJUANA S.A. DE C.V. and PROFINSA, all located in Tijuana, Baja California, Mexico. In addition, a Mexican armored car company, STRONG LINK DE MEXICO S.A. DE C.V., is named as part of this money laundering operation.

Lorenzo Arce Flores' principal money laundering method is the smuggling of U.S. currency into Mexico. It is then converted into Mexican Pesos through a number of money service businesses (commonly referred to as "casas de cambio" or "centros cambiarios") that he or AFO lieutenant Jesus Abraham Labra Aviles own or control. Two key Arce Flores operatives, Frederico Carlos Torres Ramirez and Nancy

Karina Rocha Lopez, were also designated today. The 29 companies and individuals designated by OFAC are all key components in this money laundering cell's operations.

Today's OFAC action also targets 5 individuals, previously blocked pending investigation, that are part of the Arriola Marquez Organization's financial network. These individuals include key family members of Mexican drug kingpin Oscar Arturo Arriola Marquez and other key individuals who control CORRALES SAN IGNACIO S.P.R. DE R.L. DE C.V., a large cattle breeding company in Chihuahua, Mexico previously named by OFAC in August 2005.

Oscar Arturo Arriola Marquez, Miguel Angel Arriola Marquez and the Arriola Marquez Organization were all identified by President Bush as drug kingpins on June 1, 2005. Oscar and Miguel Arriola Marquez were indicted in the District of Colorado for federal drug trafficking and money laundering violations. Both are currently incarcerated in Mexico awaiting extradition to the U.S.

OFAC attributes close coordination with the Drug Enforcement Administration (DEA) as a key factor in today's enforcement action. Notably, the San Diego and El Paso/Juarez Field Divisions, as well as Immigration and Customs Enforcement in San Diego, the IRS-CI San Diego and the Imperial County Narcotics Information Network (NIN) in San Diego.

The entities and individuals designated today are subject to the economic sanctions imposed against narcotics traffickers under the Kingpin Act. Today's action by OFAC freezes any assets found in the United States and prohibits all financial and commercial transactions between the designees and any U.S. person.

The action taken today brings the total number designated under the Kingpin Act to 270: 62 drug kingpins worldwide and 79 companies and 129 other individuals in Mexico, Colombia, Jamaica, Peru, Thailand and St. Kitts.

A complete list of the individuals and entities designated today may be accessed here: http://www.treasury.gov/offices/enforcement/ofac/actions/index.shtml

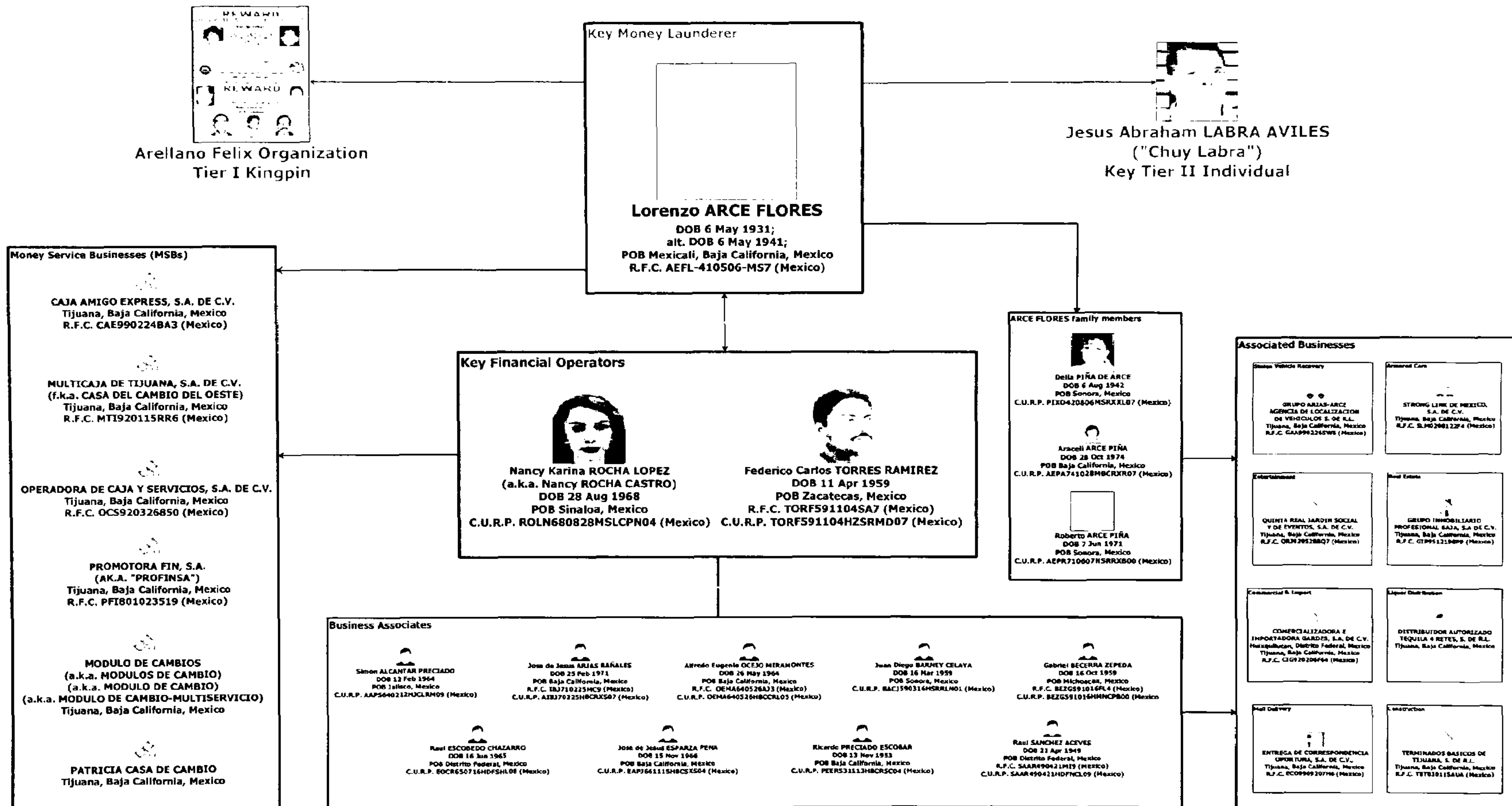
REPORTS

- Chart of Today's Designation.

Foreign Narcotics Kingpin Designation Act
Arellano Felix Organization (AFO)
July 2006

U.S. Department of the Treasury
Office of Foreign Assets Control
All individuals and businesses displayed on this chart are Mexican.

Lorenzo Arce Flores Money Laundering Cell



PRESS ROOM

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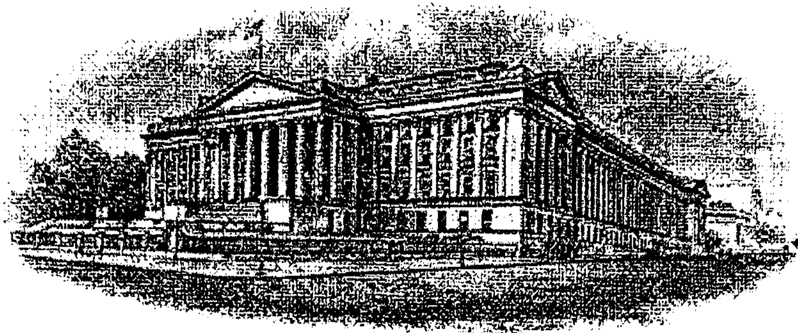
July 12, 2006
HP-09

Testimony of Assistant Secretary Clay Lowery before the Senate Foreign Relations Committee on Promoting Infrastructure Through the Multilateral Development Banks

International Affairs Assistant Secretary Clay Lowery testified before the Senate Foreign Relations Committee on promoting infrastructure through multilateral development banks.

REPORTS

- Lowery Testifies before Senate Foreign Relations on MDBs



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 9:30 A.M. (EDT) JULY 12, 2006
CONTACT Brookly McLaughlin (202) 622-2920

TESTIMONY OF ASSISTANT SECRETARY CLAY LOWERY BEFORE THE SENATE FOREIGN RELATIONS COMMITTEE ON PROMOTING INFRASTRUCTURE THROUGH THE MULTILATERAL DEVELOPMENT BANKS

Chairman Lugar, Ranking Member Biden, Members of the Committee, I am pleased to have the opportunity to discuss the importance of infrastructure to achieving our shared goal of promoting economic development and reducing poverty. The multilateral development banks (MDBs) have an important role to play in helping developing countries meet this vital need. Theirs is a broad engagement that encompasses direct funding to catalyze other financial flows; creating the enabling environment to stimulate private investment flows, both domestic and foreign; supporting innovative approaches that can be scaled up if successful; putting in place safeguards to address and mitigate adverse social and environmental impacts; and taking steps to reduce corruption.

Importance of Infrastructure

Infrastructure is essential to economic growth and productivity – it is the fundamental investment backbone for the private sector, essential for delivery of social services, improves regional integration, and is a fundamental jump-start for countries coming out of conflict. As many studies have shown, the economic returns to infrastructure are high. The returns depend on the region and the quality of the infrastructure, but research by the World Bank suggests, for example, that a 10 percent increase in Latin America's infrastructure assets could result in an extra 1.5 percentage points of growth per year. Another World Bank model indicates that if the growth of investment in Africa's infrastructure had equaled that of East Asia during the 1980s and 1990s, the average African would be roughly 30% wealthier today. This is a conservative estimate as one specific small scale example demonstrates – an ADB study showed how the establishment of a new road in a Vietnamese village raised the per capita income of the local households by 30 percent between 1993 and 1998.

Infrastructure – whether related to transportation, water supply and sanitation, energy, or communication – is a vital input into private sector development, including small and medium enterprises. This is not unique to the developing world; the dynamism of the U.S. economy is due in large measure to the foresight of investments in such infrastructure basics as the interstate highway system – which is now celebrating its 50th anniversary – and efficient local and regional electric power grids. We often take these for granted, but they are not taken for granted by the poor in countries where clean water and reliable energy are luxuries, if they exist at all.

Infrastructure also is essential to the delivery of social services and human capital development, such as by providing power to health care clinics or to light and heat rural classrooms. Improving access to clean water and sanitation services also affects economic growth and poverty reduction directly by improving health and labor productivity through reductions in water-borne diseases and reducing the amount of time people spend fetching water. According to the World Health Organization, each year roughly 1.7 million lives are lost to unsafe water and inadequate sanitation.

Infrastructure can play an important role in promoting regional integration and entry into the global economy, which is a particularly important development challenge in countries with small labor markets and limited natural resources. Singapore is one example of an economy that has flourished because it put in place the infrastructure needed to become an international trading center, which helped it graduate, long ago, from official development assistance.

Countries emerging from conflict or natural disasters need fast responses to rebuild infrastructure facilities as a starting point for reconstruction of the economy and restoration of basic services. The current government of Afghanistan, for example, recognized that civil war and a legacy of neglect had left the country facing a serious infrastructure shortfall. The MDBs have helped the government to prioritize, design, finance, and implement projects and regulatory systems to overcome this legacy. Despite the substantial challenges, we are already seeing results. Financing from the Asian Development Bank (AsDB) for a private sector cellular phone provider, for example, has led to rapid distribution of telecommunications services that are so reliable that even the U.S. officials based in Afghanistan use them. Reconstruction of the country's highway network is proceeding steadily, with the AsDB completing a vital road between Kandahar and Spin Boldak, at the Pakistani border, and the World Bank completing roads that are helping to connect Kabul to Tajikistan. Moreover, travel time to go end-to-end on the Kabul-to-Kandahar Highway, which was also financed by USAID, has fallen significantly from 16 hours down to 5 or 6 due to recent improvements in road conditions. These roads are help get goods to market and provide the basic infrastructure that will allow Afghanistan to achieve its vision of becoming a land bridge connecting Central and South Asia.

Infrastructure Needs

Infrastructure needs in both low-income and emerging market economies are vast. While calculations vary, even the lower-end estimates by the World Bank suggest that developing countries need to devote around 5.5 percent of GDP to infrastructure investment, which is well above the average level of investment in the sector, currently around 3.5 percent of GDP. The under-investment reflects not only declining official assistance flows (recently reversed by most of the MDBs), but more importantly investment climates considered inhospitable by many private sector investors.

The U.S. has encouraged increased attention to infrastructure by the multilateral development banks (MDBs) recognizing that developing countries' needs were not being met and that investment flows from the private sector were declining, particularly in the wake of the Asian financial crisis. In 2003, the World Bank adopted an Infrastructure Action Plan that has scaled up infrastructure investments, expanded the range of instruments and funding sources, and catalyzed private resources. Other MDBs, with U.S. urging, are creating special funding facilities, such as the Infrastructure Facility of the Americas at the Inter-American Development Bank and the Infrastructure Consortium for Africa established at the African Development Bank. The Asian Development Bank has expanded its infrastructure lending in the last few years, primarily in energy, water supply and management, rural transport, and telecommunications. The EBRD has important initiatives in power and energy, municipal and environmental infrastructure, transport and telecoms.

In addition to providing direct financing (loans, grants, equity and guarantees to mitigate risk), the MDBs support infrastructure development by strengthening the policy and regulatory framework, giving analytical and diagnostic support – such as investment climate assessments and country infrastructure

studies – and building institutional capacity to manage infrastructure investments. It is also critical that the MDBs do more – directly and indirectly – to attract both foreign and domestic private-sector investment in critical infrastructure.

Successful Projects and Innovative Approaches

Much is known about the controversial projects which the MDBs have helped finance and which have commanded a great deal of U.S. officials' time and resources. However, to focus exclusively on these operations is to overlook a substantially greater portion of projects that are likewise having a positive impact on economic activity and social well being. Let me use this opportunity to highlight examples where MDBs have supported innovative infrastructure proposals and projects that meet pressing public needs.

- The AfDB is helping the countries of Senegal and Mali to complete the missing road links between Bamako and Dakar and thereby reduce transport costs and promote further economic integration between the two countries and their neighbors. The project aims, by 2010, to reduce the amount of time for goods removal at the Dakar port from seven to two days; to reduce the border crossing time from one day to two hours; and to reduce the distance to fetch water from 5 km to less than 1 km. The project will also be partially financed by private transport sector operators in Senegal and Mali.

- The World Bank has helped to complete a network of water and sanitation services in Ahmedabad, India, that has increased the daily profits from vegetable farming by women living and working in local slums and has sharply reduced the incidence of disease. A World Bank water supply and sanitation project in Uttar Pradesh empowers local communities to make design choices and procure goods and services.

- The IFC has made a number of investments in locally owned firms, such as Celtel, a cellular telephone company operating in Africa that subsequently witnessed remarkable success. Within seven years of starting up operations, Celtel grew to operating in 14 countries and serving around nine million subscribers.

- In the Kyrgyz Republic, the EBRD is working with a state-owned joint-stock power company to improve the efficiency and reliability of electric power transmission and distribution in the Talas region, as well as to support private involvement in power and improve collection and reduce commercial losses. It is an important step towards private management of power distribution for the first time in the Central Asian region.

This is just a sampling; there are many other infrastructure projects that I could cite.

The way forward

I will not sit here and tell you that everything has gone well in this sector. I am well aware that many infrastructure projects – those funded by the MDBs as well as by other sources – have been affected by mismanagement, cost overruns, and outright corruption. The World Bank recently produced a lessons learned paper in which it identified a number of common issues that prevented it from achieving better results on its infrastructure engagements. The main culprits included inappropriate project design, delays in addressing access for the poor, insufficient management of expectations of private sector participation, late recognition of the importance of environmental and social sustainability, a lag in addressing corruption issues, and weaknesses in communications with stakeholders. When these things happen, infrastructure investments become enduring reminders of these inefficiencies, and send a negative signal to both donors and the private sector. These are important lessons and as the largest

shareholder in the MDBs, we will continue to work to see that these lessons are reflected in the Bank's operations going forward.

First, we will work to enhance the application of proper safeguards, to offset or reverse the problems through regular scrutiny and oversight of MDB projects and policies – including, where we can afford it, to conduct site specific scrutiny.

Second, we strive to set the highest standards across the MDBs, in terms of fiduciary controls, procurement practices and environmental and social safeguards. As I said in my remarks on anti-corruption to this Committee in March of this year, Treasury is advancing a comprehensive reform agenda at the MDBs to attack corruption around the world and to root out corruption within the MDBs. Particularly germane to the infrastructure sector is sound revenue management. Through our interventions, we have secured key policy and project-related reforms, such as the transparent accounting and reporting of project related revenue flows to make sure that these projects are accountable. For example, following strong U.S. leadership, the International Development Association (IDA) agreed to require that financial assistance for any project with a significant impact on revenues should be predicated upon the government having in place a functioning system for accounting for revenues and expenditures. We will continue to work to ensure that public disclosure by MDBs is the norm.

Third, we must continue to raise the bar on securing results-oriented approaches that build in monitorable targets and benchmarks to measure and track results in MDB-financed projects. We have seen progress in this regard: now all of the MDBs are producing results measurement frameworks for their on-the-ground investments. We will closely monitor a new pilot project by the World Bank to strengthen the risk profile of infrastructure projects during the design phase and develop benchmarks and indicators that will trigger needed remedial action during project implementation.

Fourth, one of the lessons from experience is that access for the poor raises a distinct set of issues for project preparation and implementation. This requires dialogue with shareholders that goes beyond the local elites and government to include the poor. Access for the poor also requires new approaches for structuring projects. One potential approach that is being used is output-based aid. This model uses targeted subsidies for reducing service costs for the poor while allowing private infrastructure providers to pursue cost recovery. In Cambodia, for example, private service providers were selected on a competitive basis to roll out water and sanitation services to villages. To make sure that this did not exclude the poorest inhabitants, who otherwise might not have enough money to pay the up-front costs of getting hooked up to the system, an incentive payment was provided directly to the service provider for each eligible poor family that was connected to the network.

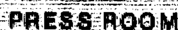
Finally but no less importantly, the MDBs will need to do a better job in engaging private capital and promoting the market's role in delivering services. Because official development assistance provides only around five to ten percent of current spending on infrastructure, the MDBs' engagement will need to demonstrate both selectivity and "additionality." By "additionality," I mean that the MDBs have to bring something to the table that the host country or private sources cannot or will not. And where the Banks do engage, they should demonstrate that they are picking high-impact projects. Until 1997, there was a steadily increasing appetite by the private sector for investing in developing country infrastructure sectors. The Asian financial crisis and several high-profile project failures have cut those private flows in half, but this trend can be reversed with the right policy and regulatory framework and with assistance to help countries develop bankable projects.

Given the vast infrastructure needs and the shortage of public and official finance, the international financial institutions need to find effective ways of unlocking private investment flows by addressing specific market failures. We firmly believe that innovative proposals can employ small amounts of official finance to catalyze orders of magnitude more in private investment. That's the kind of

leveraging of public money we like to see. As one example, we know that private investors often have a hard time obtaining information on which infrastructure proposals make economic sense and which are largely driven by politics. We have developed an innovative initiative in the IDB, targeting official money to reduce investors' search costs for good projects that gets at precisely this problem.

If the MDBs are to catalyze increased volumes of private capital, they will need to: (1) address the regulatory regime obstacles so that investors have a degree of certainty and a clear path for cost-recovery; (2) promote realistic expectations about the benefits of private capital; and (3) seek new mechanisms such as output-based aid and public-private partnerships that address the sustainability of private infrastructure services. We are committed to working with the banks to help countries put in place this framework.

In closing, I welcome your interest in this very important aspect of the work of the multilateral development banks and I look forward to your questions.



July 13, 2006
HP-10

Prepared Statement of Eric Solomon
Nominee for Treasury Assistant Secretary for Tax Policy
July 13, 2006

Mr. Chairman, Senator Baucus, and Members of the Senate Finance Committee, I am honored to appear before the Committee as President Bush's nominee to serve as Assistant Secretary of the Treasury for Tax Policy. It is truly an honor for me to have the opportunity to serve our country in this role.

The collegial and cooperative manner in which the Chairman, Senator Baucus, and the other Members of the Committee work is well known. If confirmed, I hope to work with the Committee and your staff in the same way on the important and difficult issues that face our tax system.

I am pleased to come before this Committee at a time of sustained economic growth. The President's tax relief, including lower tax rates on individual income and lower tax rates on capital gains and dividends, among other provisions, has contributed to the strong performance of our Nation's economy.

Nevertheless, as we all know, there are great challenges before us. The foremost challenge is our tax code itself. It is complex, hard to understand and difficult to administer. It imposes enormous compliance costs on taxpayers and on the government. Its numerous intricate provisions often distort economic decisions. The tax code contains many provisions that were enacted decades ago and have not been updated to reflect changes in our dynamic and increasingly global economy. Its complexity breeds perceptions of unfairness and creates opportunities for avoidance.

A primary example of the difficulties caused by our tax code is the alternative minimum tax (AMT). The AMT is a parallel tax system that, for many taxpayers, requires a second computation of tax liability. It was enacted in 1969 to ensure that a small group of high-income individuals who paid no income tax would pay at least some tax. The reach of the AMT has expanded far beyond its original purpose.

We need a tax system that is simple, fair, and promotes economic growth. The Report of the President's Advisory Panel on Federal Tax Reform has provided a strong foundation for consideration of ways to ensure that our tax system better meets the needs of our society and economy. If confirmed, I look forward to working together with Secretary Paulson, the Administration, this Committee and the Congress to address the challenging issue of tax reform.

Another critical challenge before us is tax compliance. We are fortunate that the vast majority of Americans fulfill their tax obligations. However, some do not, either because they do not understand their obligations or because they choose to disregard their obligations. A critical role of the Office of Tax Policy at the Treasury Department is to work together with the IRS to provide timely and appropriate guidance so that taxpayers trying to satisfy their tax obligations know how to do so. For these taxpayers, published guidance reduces uncertainty and prevents the burden on taxpayers and the IRS caused by audits and litigation.

In the years that I have served at the Treasury Department, I have spent an enormous amount of time participating in the effort to combat tax shelters. In my view, we have made significant progress. The combination of IRS enforcement

efforts against taxpayers and promoters, listing notices, disclosure regulations, enactment of the Sarbanes-Oxley Act, press disclosures, and other events have contributed to the decline in improper mass-marketed tax products. In this regard, I particularly want to express my appreciation for the actions of Chairman Grassley, Senator Baucus and other members of this Committee, both in your public statements and in the leadership you have provided in Congress to give the Treasury Department and the IRS additional tools needed to address this problem

An area in which we need to make more progress is the tax gap. The tax gap undermines confidence in the fairness of our tax system and fosters noncompliance. The tax gap also results in a de facto tax increase for compliant taxpayers who pay more because others fail to pay their share.

The IRS has made headway in its efforts to improve compliance. However, we need to do more to increase the level of compliance. At the same time, we need to maintain the proper balance between enforcement efforts, on the one hand, and compliance burdens and protection of taxpayer rights on the other hand.

The President's 2007 Budget includes several proposals to reduce the tax gap. These proposals are an important first step in the right direction. If confirmed, I look forward to working with the Secretary Paulson, the IRS, this Committee and the Congress to consider regulatory, administrative and legislative methods to reduce the tax gap.

In closing, I would like to thank a number of people. First, I want to recognize all the economists and lawyers on the staff of the Office of Tax Policy. I have never worked with such a talented group of people who give so much as part of a team dedicated to public service. I would also like to recognize Bob Carroll, our Deputy Assistant Secretary for Tax Analysis, with whom I have worked as a partner in heading the Office of Tax Policy for the last year and a half.

Finally, I want to recognize my parents, Bob and Elaine Solomon, and my brothers, Neal and Mark, to whom I owe so much. Most importantly, I want to thank my wife Amy and my daughter Sarah, for their support, patience and love during all these years that I have committed myself to public service.

Thank you again for the opportunity to appear before the Committee this morning. I would be pleased to answer any questions.

PRESS ROOM

July 14, 2006
HP-11

Treasury Under Secretary to Speak on GSE Panel in NY

Treasury Under Secretary for Domestic Finance Randal K. Quarles will participate in a panel discussion regarding government sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac in New York City, NY on Wednesday. Office of Federal Housing Enterprise Oversight (OFHEO) Director James Lockhart will also speak on the panel.

The event is open to the media. Members of the press wishing to attend must RSVP with Jennifer Zuccarelli at the Treasury Department.

Who
Under Secretary for Domestic Finance Randal K. Quarles

What
Panel Discussion on GSEs

When
Wednesday, July 19 6:00 pm (EDT)

Where
The New York Yacht Club
37 W. 44th Street
New York City, NY

PRESS ROOM

July 14, 2006
HP-12

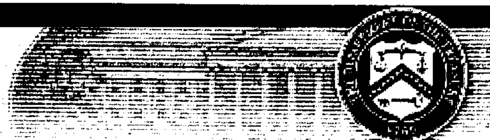
Secretary Henry Paulson Provides his Signature for use on U.S. Paper Currency

Newly sworn-in Secretary of the Treasury, Henry M. Paulson, Jr., provides his signature to the Bureau of Engraving and Printing Director Larry Felix for use on U.S. paper currency.

All media queries should be directed to
The Press Office at (202) 622-2960.
Only call this number if you are a member of the media.

High Resolution Image

PRESS ROOM



July 14, 2006
hp-13

U.S.-Brazil Group for Growth Meets

Washington, D.C. - The United States and Brazil held the fifth meeting of the Group for Growth today in Washington, D.C. President Bush and President Lula launched the Group in June 2003 with the aim of advancing the shared goals of strong economic growth, job creation and poverty reduction. The last meeting of the Group was held in August 2005 in Rio de Janeiro, Brazil.

Today's meeting was co-chaired by Timothy D. Adams, Under Secretary for International Affairs at the U.S. Department of Treasury, and Luiz A. Pereira da Silva, Secretary for International Affairs at Brazil's Ministry of Finance. U.S. Treasury Assistant Secretary for International Affairs Clay Lowery also participated.

The Brazilian and U.S. delegations discussed the need for fundamental reform of the IMF's governance structure to better reflect global economic weight. The Group supported a two-step process. The first step, at the Singapore Annual Meetings, would be a limited quota increase for a small number of unequivocally underrepresented countries. The second step, to be completed by 2008, would deliver far-reaching reforms including a revised quota formula with GDP as the predominant variable, a broader recipient list for emerging market quota increases, and an increase in basic votes. The Brazilian and U.S. delegations agreed to work together to advance these reforms ahead of the Annual Meetings. The Group also discussed options for debt relief and reform at the Inter-American Development Bank.

The other focus of the discussion today was the urgent challenge of reducing poverty and inequality in this hemisphere. Participants agreed on the critical need to provide the poor with the opportunities and tools they need to benefit from growth: access to capital, education, infrastructure and markets at home and abroad. Under Secretary Adams and Secretary Pereira reiterated their support for an ambitious outcome from the WTO Doha Round negotiations and agreed on the benefits of trade for growth and poverty reduction.

Secretary Pereira described Brazil's successful efforts to increase formal job creation and reduce poverty and inequality while fostering macroeconomic stability and sustainable economic growth: "The Brazilian poor have been the main beneficiary of low inflation and increased efficiency of the economy." Under Secretary Adams stressed: "Spreading opportunity to those left out and left behind is the highest U.S. economic priority in the hemisphere. I am impressed by how much we and our Brazilian colleagues agree on what needs to be done."

The Group agreed to reconvene in Brazil in the first quarter of 2007.

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PRESS ROOM

July 17, 2006
HP-14

US Treasury to Help Alabama Teachers Bring Financial Education to Schools

U.S. Treasury Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr. will speak with approximately 400 teachers in Mobile, Ala. on Tuesday, July 18 to help bring financial literacy into Alabama classrooms.

America's high school seniors are not making the grade on personal money matters, scoring an average of 52 percent on a nationwide financial literacy test administered by the Jump$tart Coalition. Iannicola will help teachers integrate financial education into their curricula as part of a one-day conference hosted by the coalition's Alabama chapter.

The Treasury Department and other agencies and departments in the Financial Literacy and Education Commission released a strategy to improve financial literacy in America earlier this year. The plan, titled Taking Ownership of the Future: The National Strategy for Financial Literacy, is available in English and Spanish at MyMoney.gov.

Who: Deputy Assistant Secretary for Financial Education, Dan Iannicola, Jr.

What: Remarks to 400 Ala. Teachers on Financial Education in the Classroom

When: Tuesday, July 18, 12:30 p.m. (CDT)

Where: Arthur R. Outlaw Convention Center
One South Water Street - Second Floor
Mobile, Alabama

-30-

July 17, 2006
2006-7-17-16-28-27-5302

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $67,330 million as of the end of that week, compared to $68,026 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	July 7, 2006			July 14, 2006		
TOTAL	68,026			67,330		
1. Foreign Currency Reserves [1]	**Euro**	**Yen**	**TOTAL**	**Euro**	**Yen**	**TOTAL**
a. Securities	11,972	11,103	23,075	11,827	10,890	22,717
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,928	5,425	17,353	11,766	5,315	17,081
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			7,922			7,891
3. Special Drawing Rights (SDRs) [2]			8,635			8,601
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	July 7, 2006			July 14, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						
2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets						
	July 7, 2006			July 14, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL

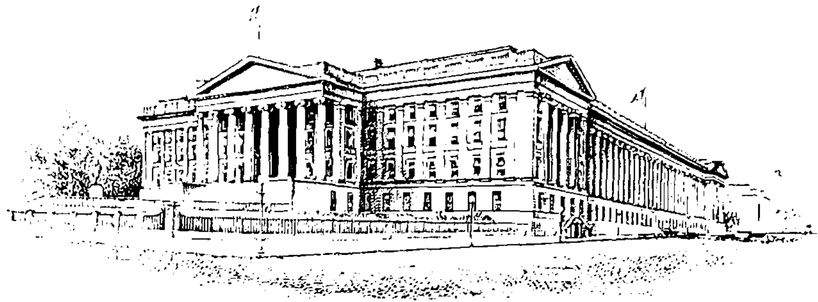
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.



DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 9 A.M. (EDT) JULY 18, 2006
CONTACT Brookly McLaughlin (202) 622-2920

TREASURY INTERNATIONAL CAPITAL DATA FOR MAY

Treasury International Capital (TIC) data for May are released today and posted on the U.S. Treasury web site (www.treas.gov/tic). The next release date, which will report on data for June, is scheduled for August 15, 2006.

Net foreign purchases of long-term securities were $69.6 billion.

- Net foreign purchases of long-term domestic securities were $88.8 billion. Of this, net purchases by foreign official institutions were minus $1.4 billion and net purchases by private foreign investors were 90.2 billion.
- U.S. residents purchased a net $19.2 billion in foreign issued securities.

Foreigners' Transactions in Long-Term Securities with U.S. Residents
(Billions of dollars, not seasonally adjusted)

		2004	2005	12 Months Through May-05	12 Months Through May-06	Feb-06	Mar-06	Apr-06	May-06
1	Gross Purchases of Domestic Securities	15178.9	17175.0	15880.8	18085.5	1497.2	1688.6	1380.8	1941.5
2	Gross Sales of Domestic Securities	14262.4	16164.3	15005.9	17002.8	1394.6	1602.2	1319.6	1852.7
3	**Domestic Securities Purchased, net** (line 1 less line 2) /1	**916.5**	**1010.7**	**874.9**	**1082.7**	**102.6**	**86.4**	**61.3**	**88.8**
4	**Private, net /2**	**680.9**	**889.5**	**718.4**	**945.6**	**85.0**	**84.1**	**39.2**	**90.2**
5	Treasury Bonds & Notes, net	150.9	270.0	173.7	186.8	8.3	9.1	-7.9	27.5
6	Gov't Agency Bonds, net	205.7	187.8	187.1	225.1	28.4	15.1	9.6	27.1
7	Corporate Bonds, net	298.0	353.1	306.4	417.7	31.1	42.5	34.3	34.1
8	Equities, net	26.2	78.7	51.3	116.0	17.2	17.5	3.2	1.5
9	**Official, net**	**235.6**	**121.1**	**156.5**	**137.2**	**17.6**	**2.3**	**22.1**	**-1.4**
10	Treasury Bonds & Notes, net	201.1	69.2	119.0	54.4	12.5	-5.9	11.3	-14.3
11	Gov't Agency Bonds, net	20.8	32.0	24.1	47.7	2.4	3.9	5.7	9.3
12	Corporate Bonds, net	11.5	19.0	13.3	26.5	3.4	2.6	1.7	2.4
13	Equities, net	2.2	1.0	0.0	8.6	-0.7	1.6	3.4	1.2
14	Gross Purchases of Foreign Securities	3123.1	3681.4	3152.1	4446.0	408.6	455.1	398.7	536.9
15	Gross Sales of Foreign Securities	3276.0	3854.0	3337.7	4623.0	420.6	474.2	408.8	556.1
16	**Foreign Securities Purchased, net** (line 14 less line 15) /3	**-152.8**	**-172.6**	**-185.6**	**-177.0**	**-12.0**	**-19.1**	**-10.1**	**-19.2**
17	Foreign Bonds Purchased, net	-67.9	-45.1	-88.0	-45.1	-0.2	-7.1	-2.0	-14.3
18	Foreign Equities Purchased, net	-85.0	-127.5	-97.6	-131.9	-11.9	-12.0	-8.1	-4.9
19	**Net Long-Term Flows** (line 3 plus line 16)	**763.6**	**838.1**	**689.3**	**905.8**	**90.6**	**67.3**	**51.1**	**69.6**

/1 Net foreign purchases of U.S. securities (+)
/2 Includes International and Regional Organizations
/3 Net U.S. acquisitions of foreign securities (-)

HP-16

July 18, 2006
HP-17

Treasury Adds Two Entities to the List of Iranian Weapons Proliferators

The Department of the Treasury today designated two additional Iranian companies, Sanam Industrial Group and Ya Mahdi Industries Group, for their ties to missile proliferation.

"As long as Iran's nuclear ambitions continue to threaten the international community, the United States will use its authorities to target Iran's efforts to sell and acquire items used to develop weapons of mass destruction and the missiles capable of carrying them," said Stuart Levey, Treasury's Under Secretary for Terrorism and Financial Intelligence (TFI). "We have now taken steps to financially isolate thirteen entities tied to Iranian proliferation, and will continue to act aggressively against this grave threat."

This action was taken pursuant to Executive Order 13382, an authority aimed at financially isolating proliferators of weapons of mass destruction, their supporters, and those contributing to the development of missiles capable of delivering WMD. Designations under E.O. 13382, which is administered and enforced by the Treasury's Office of Foreign Assets Control (OFAC), prohibits all transactions between the designees and any U.S. person and freezes any assets the designees may have under U.S. jurisdiction.

Sanam Industrial Group and Ya Mahdi Industries Group are being designated by OFAC because they are owned or controlled by, or act or purport to act for or on behalf of, directly or indirectly, the Aerospace Industries Organization (AIO), which the United States Government designated in the annex to E.O. Order 13382. AIO is a subsidiary of the Iranian Ministry of Defense and Armed Forces Logistics, and manages and coordinates Iran's missile program and oversees all of Iran's missile industries.

The Sanam Industrial Group, a subordinate to the AIO, has purchased millions of dollars worth of equipment on behalf of the AIO from entities associated with missile proliferation.

Ya Mahdi Industries Group is also subordinate to the AIO and has been involved in international purchases of missile-related technology and goods on behalf of the AIO.

Background on E.O. 13382

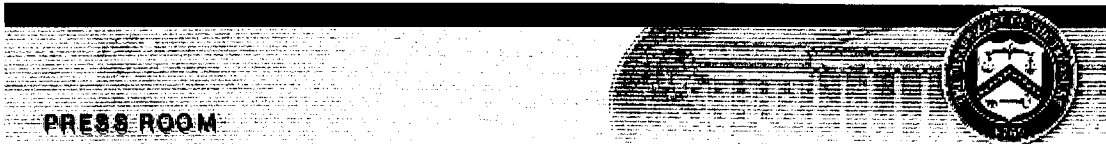
Today's action builds on President Bush's issuance of E.O. 13382 on June 29, 2005. Recognizing the need for additional tools to combat the proliferation of WMD, the President signed the E.O. authorizing the imposition of strong financial sanctions against not only WMD proliferators, but also entities and individuals providing support or services to them.

In the annex to E.O. 13382, the President identified eight entities operating in North Korea, Iran, and Syria for their support of WMD proliferation. E.O. 13382 authorizes the Secretary of the Treasury, in consultation with the Secretary of State, the Attorney General, and other relevant agencies, to designate additional entities and individuals providing support or services to the entities identified in the annex to the Order.

In addition to the eight entities named in the annex of E.O. 13382 and the two named today, the Treasury Department has designated sixteen entities and one individual as proliferators of WMD, specifically:

- Eight North Korean entities on October 21, 2005;
- Two Iranian entities on January 4, 2006;
- One Swiss individual and one Swiss entity tied to North Korean proliferation activity on March 30, 2006; and
- Four Chinese entities and one U.S. entity tied to Iranian proliferation activity on June 13, 2006.

The designations announced today are part of the ongoing interagency effort by the United States Government to combat WMD trafficking by blocking the property of entities and individuals that engage in proliferation activities and their support networks.



July 18, 2006
HP-18

Statement by Treasury Under Secretary Levey Upon Departure from Seoul

SEOUL, KOREA – Stuart Levey, the U.S. Treasury Department's Under Secretary for Terrorism and Financial Intelligence (TFI), made the following statement today upon his departure from Seoul:

"Today, I concluded the first leg of a long-planned trip to Asia to meet with my counterparts to discuss ongoing issues of concern to the region and the greater international community. While in Seoul, I met with officials at the Ministry of Foreign Affairs and Trade, the Ministry of Finance and Economy, the Korean Financial Intelligence Unit, and the National Security Council to discuss issues of common interest, including the new United Nations Security Council Resolution that requires all member states to prevent the transfer of any financial resources in relation to DPRK's missile or WMD programs.

"My colleagues and I shared views on ways to safeguard the global financial sector from illicit conduct, including the proliferation of weapons of mass destruction, money laundering, and terrorist financing. Our discussions were productive and educational, and I look forward to continuing the dialogue between the United States and our partners in the Republic of Korea.

"As the week progresses, I look forward to meeting with my counterparts in Vietnam, Japan, and Singapore to also discuss ways to strengthen the international financial system from abuse by proliferators, terrorists, narcotics traffickers, and other illicit actors," said Levey.

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July 18, 2006
hp-19

**Testimony of Randal K. Quarles,
Under Secretary for Domestic Finance
U.S. Department of the Treasury**

Before the Senate Banking, Housing and Urban Affairs

Good afternoon Chairman Shelby, Ranking Member Sarbanes and Members of the Committee. Thank you for the opportunity to appear before you today to discuss the role of insurance in our economy and the need to modernize the regulation of insurance. This is an important topic, one that affects not only the efficiency and competitiveness of a significant U.S. industry and a central function of the U.S. financial system, but one that has broad consequences as well for the ability of our economy as a whole to innovate and to grow.

INTRODUCTION

In the first instance, the issues surrounding insurance regulation are significant because the U.S. financial services industry is one of our country's most important areas of economic activity, and the insurance industry is a large part of the U.S. financial sector. According to the Federal Reserve, at the end of 2005, total assets held by U.S. insurance companies totaled $5.6 trillion, as compared with $11.82 trillion for the banking sector, and $10.5 trillion for the securities sector.

In addition to the size and importance of the insurance industry considered solely in itself, however, insurance – like other financial services – has substantial ripple effects through the economy as a whole. Insurance performs an essential function in our overall economy by providing a mechanism for businesses and the general population to safeguard their assets from a wide variety of risks. The ability of businesses to insure against risk adds a degree of certainty to their planning and thus contributes to greater economic activity and enhanced economic growth. The general population also benefits from being able to purchase protection for various types of losses that would be difficult for individuals to absorb on their own. Insurance companies are in the business of managing these risks. They specialize in evaluating the potential for losses and perform an important function by spreading that risk widely across various segments of our economy and population.

Insurance is also like other financial services in that its cost, safety and ability to innovate and compete are heavily affected by both the substance and the structure of its system of regulation. As a result, then, both of the industry's importance considered simply as a separate line of economic activity as well as its consequences for commerce and economic growth more broadly, we should seek to ensure that the regulatory system for the insurance industry is consistent with the efficient and cost-effective provision of its services and with continuing evolution and innovation in the design and distribution of its products.

In that regard, there appears to be virtually no disagreement that the current state-based insurance regulatory system could benefit from further modernization. There have been a variety of approaches that have been considered: state driven efforts at reform, total federal preemption of the state-based system, the setting of federal standards for states to administer, and the creation of a dual chartering structure that would allow insurers to opt for either state or federal regulation.

Unlike the banking and securities sectors, insurance is solely regulated at the state-

level, and while this multiplicity of regulators can provide certain benefits in the form of local expertise and control, it does raise a number of issues that deserve further consideration. In our view, those issues fall into three main categories:

- Potential inefficiency, resulting both from the substance of regulation (especially price and form control) but also from its structure (the inevitable duplication and cost associated with multiple non-uniform regulatory regimes);
- International impediments, both questions of comity (facilitating international firms' operations in the U.S., which benefits U.S. consumers) and competitiveness (facilitating U.S. firms' operations abroad, which provides growth opportunities for U.S. industry and helps diversify their risk exposures);
- Systemic "blind spots", the inability of the official sector to understand and respond to the insurance sector's evolving contribution to risks affecting the financial system as a whole.

At the most fundamental level, the question posed in each of these areas is whether the our current system of insurance regulation is up to the task of meeting the challenges of insurance regulation in today's evolving and increasingly global insurance market. More broadly, we should evaluate whether the benefits of regulatory competition (which are fostered by our existing structure or other multiple-regulator structures) are outweighed by the costs of regulatory fragmentation (which are significant in a 50-state system).

BACKGROUND

The current structure of insurance regulation in the United States is the result of a long history. In 1868, the U.S. Supreme Court concluded that the issuance of an insurance policy was not interstate commerce, and therefore outside the constitutionally permitted scope of federal government's legislative and regulatory authority. (*Paul v. Virginia*) In 1944, some 76 years later, the Court reversed itself holding that insurance was indeed subject to federal regulation and federal antitrust law (*United States v. South-Eastern Underwriters Association*). In 1945, before any assumption of federal regulatory authority over insurance, Congress passed the McCarran-Ferguson Act, which "returned" the regulatory jurisdiction over the business of insurance back to the states, and generally exempted the business of insurance from most federal laws provided such activities were regulated by state law.

Under the current state-based regulatory system, each state has a chief insurance regulator, generally referred to as "commissioner," who is charged with administering state insurance laws, promulgating regulations, and other duties pertaining to the supervision of the business of insurance. In most states the insurance commissioner is appointed by the governor. In 11 states, including California, the commissioner is elected. Each state commissioner is a member of the National Association of Insurance Commissioners (NAIC) that was founded in 1871. The NAIC is the primary vehicle through which state insurance regulators exchange information and coordinate activities to enhance the effectiveness of insurance regulation.

State insurance regulation can be divided into two broad categories:

- solvency or financial regulation aimed at preventing insurer insolvencies and mitigating consumer losses should insolvencies occur; and
- consumer protection and market regulation focused on potential anti-consumer practices.

Each state enacts state-specific insurance laws. The NAIC has developed model laws and regulations covering various aspects of the insurance business in an effort to achieve greater uniformity. In the solvency and financial regulation area these

range from accounting and investments to solvency/market examinations, holding companies, insider trading and proxies, and reinsurance. In the consumer protection area these model rules cover matters ranging from privacy protection, deceptive advertising, unfair policy terms, and discriminatory or unfair treatment of policyholders. Many model laws must be approved by state legislatures before they can be implemented, while some states may have the authority to adopt model regulations in certain areas without legislative action. The adoption of model laws and regulations has been spotty at best. It is a cumbersome process that, in many cases, can take a number of years. It also allows for variation in implementation across states.

The state-based insurance regulatory system was subject to significant criticism in the 1980's after several major insurance companies became financially impaired. At that time, there were calls for regulatory reform, including a proposal for a preemptive federal regulator. State insurance regulators, sensing that the state-based system was in jeopardy, made some impressive strides in undertaking initiatives to reform state solvency regulation. They established an NAIC Accreditation Program requiring the adoption of designated model laws and regulations, and a review of the insurance regulatory agency of each state by an independent review team to assess compliance with the required standards. As a result, today there is a relatively uniform solvency regime that has been implemented across the states. However, in other areas of regulation, the states appear to be much more reluctant to adopt uniform standards.

Another important aspect of the state-based insurance regulatory system is its system of guaranty funds. Unlike the system that is in place for federally-insured depository institutions, there is not a federal guarantee ensuring that policyholder claims are paid. Each state operates its own guaranty fund, and typically separate funds are maintained for property/casualty insurance (mostly personal lines) and life/health insurance. If an insurer becomes insolvent, the state insurance regulator typically is appointed as the liquidator. As liquidator, the regulator appoints a receiver to manage the liquidation. The guaranty fund then works with the receiver and assumes responsibility for the payment of a specified portion of the claims that would otherwise have been paid by the insurer. The state-based guarantee system is funded primarily on a post-assessment basis, with all insurers that write particular types of business being subject to an assessment to fund losses.

KEY ISSUES IN CONSIDERING INSURANCE REGULATORY MODERNIZATION

An important part of this debate is what should be the role, if any, of the federal government in insurance regulation. While the state-based system has a number of potential merits – such as local knowledge of insurance market conditions and preserving local decision making over key aspects of activity within a particular state – it does raise a number of issues that need to be considered as financial markets evolve in this country and abroad. The key issues I will focus on today are: potential inefficiencies associated with the state-based system – most prominently undue regulatory burden and price controls; international implications for free markets and competitiveness; and fully understanding the impact of the insurance sector on financial sector soundness.

Potential Inefficiencies of the State-based System

As I indicated, there is virtually no dispute over the fact that there is a general need for modernization of the current state-based system. One aspect of modernization has been a focus on the lack of uniformity in state regulation. Even though the NAIC has achieved some success over the past 135 years in fostering more uniformity among the states, many of its model laws and regulations have not been enacted by the states. States interpret these model laws differently, and craft individualized exceptions to them. This should not be a surprise given that the general nature of state legislatures and regulators to preserve authority in areas where it is perceived to be warranted.

Nonetheless, differing state insurance regulatory treatment can lead to inefficiencies and undue regulatory burden. This can directly limit the ability of insurers to compete across state boundaries. Reduced competition can diminish

the quality of services, consumer choice, and ultimately lead to higher prices.

At the most basic level, states have individual requirements that insurers and producers (i.e., agents and brokers) must meet to operate in each state. For example, all insurers must receive a license from each state in which they plan to do business. While the NAIC has tried to simplify this procedure, the filing requirements for licenses can vary significantly from state to state and companies must still ascertain and comply with those requirements.

All states also require a license from those who wish to sell insurance, and the licensing process also varies from state to state. The multi-state licensing of insurance producers has been somewhat streamlined in recent years thanks to the provisions of the Gramm Leach Bliley Act, which provided for a federal preemptive producer licensing system (the National Association of Registered Agents and Brokers) that served as a threat to the states to develop a more unified system. The states responded and established a system that established the required reciprocity arrangements. Reciprocity arrangements have somewhat streamlined the process; however, agents must still obtain a license in each state in which they do business.

Another area of potential inefficiency is form approval regulation. Form approval is the system or process by which state insurance regulators review and approve (or disapprove) policy forms insurers wish to use in a state. There are at least seven categories of state policy form approval systems, including the use of state required forms, strict prior approval of forms, "file and use," "use and file" - to no form filing required. State form approvals can be based on any number of factors. For example, some states require certain disclosures and descriptions of coverage, some even specify the proper typeface sizes and the color of ink, as well as specifying that the disclosure has to be on the first page of the policy – a requirement that can make an insurer have to have state specific cover pages for their policies. Some states also require special disclosures for particular products such as small face amount life insurance policies, or special "buyer's guides" or policy endorsements for certain products. Requirements for descriptions of coverage can also vary from state to state, with some states requiring the language text itself to be based on specific readability standards, such as a minimum score of 40 on the Flesch reading ease test or compliance with some other test approved by the commissioner.

The NAIC made efforts to achieve a higher degree of uniformity in product approvals by launching such programs as CARFRA (Coordinated Advertising, Rate and Form Review Authority) and SERFF (System for Electronic Rate and Form Filing). In addition, just last month some 27 states entered into an Interstate Insurance Product Regulation Compact that would provide for uniform national product standards for the products sold by life insurers (life insurance, annuities, disability income insurance, and long-term care insurance). While these efforts may lead to some degree of greater uniformity, it is still up to each state to interpret and enforce such standards.

States justify form approval as a necessary tool for consumer protection. However, there should be a careful analysis of the cost and benefits of these requirements at the individual state level. In addition, having multiple technical state requirements makes it very difficult, and very costly, for an insurer to roll-out a new product on a nation-wide basis.

Perhaps the greatest potential for inefficiency in the current state-based system is with price controls. Insurance is perhaps the last major market in the United States with direct price controls. The term "price controls" is frequently used to describe state regulation of rates used by property/casualty insurers licensed or admitted in a state (referred to as the "licensed/admitted market"). This market includes such personal lines of insurance as automobile and homeowners, as well as a substantial portion of the commercial lines of insurance such as fire, burglary, theft, workers compensation, and commercial automobile. The basic legal standard for rates in all states is that they not be "inadequate, excessive, or unfairly discriminatory." In the early years of state insurance regulation, the emphasis was more on whether rates were adequate, and thus would prevent solvency problems.

However, more recently it seems as though most of the controversy over price controls has concerned efforts of state regulators to hold down prices for their constituents by denying rate increases on grounds that they are excessive.

States address rate regulation in a number of different ways. For example, as to rates on most lines of commercial property/casualty insurance; 5 states have no filing requirements (No File); 2 require informational rate filings only (Information Only); 9 allow rates to be used without pre-filing, but they must be subsequently filed (Use and File); 13 require filing before they are used (File and Use); 19 require rates to be filed and approved before they are used (Prior Approval). Of the 43 states with some degree of rate control, many also provide for the exemption of rate approval requirements on certain large commercial property/casualty policies based on the amount of the premium charge or size of the policyholder.

One of the fundamental principles of economics is that price controls result in inefficient outcomes. If the mandated price is set above the market clearing price, the result will be surpluses; if the mandated price is set below the market clearing price, the result will be shortages. The latter outcome is what we generally observe in insurance markets with strict price controls. When insurers are unable to charge what they feel is an adequate rate for their product, they generally tighten their underwriting standards in order to limit their writings to "preferred" risks that are less likely to suffer an insured loss. Not being able to charge an adequate rate also limits insurers' abilities to price on the basis of measurable differences. To the extent that prices do not accurately reflect differences in risk, low-risk consumers are effectively forced to subsidize high-risk consumers. This obviously leads to shortages in the voluntary market, or a "tightening market," and increases demand on what is referred to as the residual markets. Residual markets, known also as "shared" or "involuntary" markets or "markets of last resort," are state-sponsored mechanisms that provide consumers with another way to obtain automobile, property, or workers compensation insurance coverage .

For example, where a driver with a history of multiple accidents applies for insurance, an insurer might be willing to write the coverage if it could charge a rate commensurate with the risk. However, if that rate was more than the state regulator allowed it to charge, then the insurer would likely refuse to write the policy. If no other insurer in the voluntary market were willing to issue coverage at an approved rate, then the driver could apply to the state's residual market (sometimes referred to as the "assigned risk pool.")

All licensed insurers in a state are generally required to participate in that state's residual markets, typically by assuming a fair share of the residual market's operating results. Residual market programs are rarely self-sufficient, and where the premiums received are insufficient to support the program's operation, insurers are generally assessed to cover the resulting deficits.

The residual market mechanism is the way that states address the shortages that are caused by price controls. While it is theoretically possible for the price control/residual market mechanism structure to duplicate the result that would occur in the absence of price controls, that outcome seems highly unlikely. At the most basic level, given that the residual market mechanism structure requires all insurers to share in the fortunes of the residual market mechanism, as the size of the residual market grows, it would be likely that fewer and fewer insurers would be willing to do business in that line of insurance. As insurers pull back from that line of insurance, further pressure is placed upon the residual market mechanism. So in a broad sense, one potential outcome of the price control/residual market mechanism structure is that it artificially restricts the number of insurance suppliers in a particular market. States typically respond to this outcome by adjusting prices to preserve the viability of that particular market.

Most evidence indicates that there is a strong correlation between the size of residual markets and price controls: the larger the residual market you find in a state, you will also generally find a tighter market and a higher degree of rate inadequacy - often the result of price controls. In other words, price controls generally result in elevated residual market populations when the permitted rates are lower than indicated by market forces.

Automobile insurance is often cited as an example of problems with state price controls. In 2004, the average nationwide percentage of private passenger cars insured through residual market mechanisms was 1.5 percent. However, in states with more restrictive price controls, such as North Carolina and Massachusetts, the percentage of private passenger cars insured through the residual market was, respectively, 24.2 percent and 6.5 percent. In general, states with a less restrictive regulatory environment (e.g., Illinois and South Carolina) are generally characterized by lower and less volatile loss ratios, smaller residual markets, and insurance expenditures below the national average.

Another example is workers' compensation insurance, which is often pointed to as the line of insurance with the greatest degree of rate regulation. In the last few years, the percentage of workers' compensation premiums in residual markets has been on the increase. Among those states that report through the National Council on Compensation Insurance (25) the residual markets' share has increased from 3.2 percent in 1999 to 11.5 percent in 2005, and was even as high as 12.7 percent in 2004. There is also wide variation among individual states, with 2005 market shares ranging from 1.1 percent in Idaho to highs of 22.7 percent in New Jersey and 20.5 percent in Massachusetts.

International Issues

U.S. firms and firms from abroad in insurance, banking, and securities compete across the globe and around the clock. Clearly foreign sources of insurance capital are important for a robust U.S. insurance market.

As noted above, the lack of uniformity in our state-based insurance system has the potential to lead to inefficiency and undue regulatory burden. While all insurance companies that are licensed to operate in the U.S. are subject to same regulatory standards, foreign firms likely find adapting to such standards more difficult. From the international perspective, issues that have been raised in bilateral financial regulatory discussions with foreign officials are that our insurance market has at least 50 different regulators, and they or their insurance companies have no single regulator to coordinate with on insurance matters. Navigating the state-based insurance regulatory structure is likely a challenge for a new foreign company seeking to do business in the U.S, and has likely impeded the flow of capital into the U.S. to some degree. Issues that have been brought to our attention include: rate and form approvals; capital adequacy standards; and guarantee fund membership.

The U.S. insurance market, in particular the global nature of insurance, is vastly different than it was six decades ago when McCarran-Ferguson was enacted. To give an example of the sort of efforts underway internationally, the European Union (EU) is continuing its work on its Solvency II project focused on insolvency risk for insurers in preparation for its scheduled introduction on an EU-wide basis in 2010. Solvency II is an important undertaking for it encompasses quantitative capital requirements, a supervisory review process expected to harmonize the procedure in Europe, and it will conform to disclosure requirements with those of the international accounting standard-setters. This is all part of the effort to forge one insurance market for the twenty-five member states in the EU.

Reflecting the growing international nature of the markets, the NAIC is working closely with international regulators on a number of projects, such as Solvency II in the EU, on international accounting standards, and others. The NAIC itself is not a regulator but facilitates communications among the states on international regulatory issues. To that the end, it engages in regulatory cooperation with international insurance regulators and through Memoranda of Understanding (MOUs), and supports individual members by providing technical assistance to regulatory agencies. The NAIC also coordinates closely with Office of the U.S. Trade Representative in international financial services negotiations, and it participates in Treasury's financial markets regulatory dialogues with various countries, including China, Japan, and the EU.

To sum up, there is significant work underway in international insurance regulation to reflect the changes taking place in the US and global insurance markets. In

evaluating proposals to modernize our system of insurance regulation, we, too, need to consider what will best serve us in maintaining an insurance marketplace that attracts capital and does not set up artificial and costly barriers. A number of countries are pushing forward with regulatory systems seeking more uniform, efficient and stronger insurance sectors, in order to underpin more and better products for their consumers with less risk to the financial system.

Lack of Federal Understanding of Risk in the Insurance Market

As previously noted, the insurance sector is a critical part of the broader U.S. economy and in terms of size alone a key participant in U.S. financial sector. In comparison to other financial institutions, it could be argued that financial problems at an insurer or reinsurer pose less potential to generate broad economic problems or pose systemic risk in the financial system. The immediate financial problems from the failure of a large insurer or reinsurer could be limited given the nature of insurance contracts (e.g., delayed payments, dispersed risks, and timing of in force coverage) and the general funding strategies of many insurers (e.g., a focus on meeting potential near term liquidity needs to pay claims). Nonetheless, there remains some potential for disruptions in the insurance market to impact economic activity and financial markets. And importantly, these potential risks may not be well understood at either the state or federal level.

At the most basic level, the failure of a large insurer or reinsurer could place stress on state guarantee funds and to policyholders that do not have guarantee fund protection (mostly large commercial organizations). This could in turn have a negative impact on the broader economy, which could also impact other financial institutions. While market participants should perform their own due diligence when they enter into insurance contracts, given the magnitude of potential consequences of a large insurer insolvency the federal government should have a better understanding of the nature and potential for such an event.

Given that the insurance sector is also a direct participant in a number of financial markets, either through direct credit exposures or through derivative counterparty relationships, financial problems at insurers could be transmitted throughout the broader economy. For example, there has been a considerable amount of attention paid to the expanding credit derivatives market. While there are a number of issues that might warrant attention, as with many other derivative contracts, a credit derivative is very similar to an insurance policy that pays off when certain credit events occur. Given the close correlation to insurance, insurance companies appear to be taking a more active role in this market. From an overall perspective of market stability, do we fully understand what risks insurance companies are undertaking, or how their activity could impact the credit derivatives and other financial markets?

In addition to broad areas of financial sector stability, there has been a convergence across some product lines that are offered by banking, securities, and insurance firms. This is particularly true in regard to wealth management products. Many wealth management products serve a similar purpose (e.g., variable rate annuities and mutual funds), but are offered by firms with different charters and underlying regulatory structures. Any underlying economic reason for treating like products differently for regulatory purposes has blurred over time. Much like the state-based insurance system, differing regulatory treatment for like products adds complexity and creates potential problems for the free flow of capital. Given the general efficiency of capital markets, differences in regulation (whether through capital standards, product approval standards, or otherwise) and differences in tax treatment can direct capital flows away from their most efficient uses. These are all areas where the federal government should have a better understanding of potential implications.

What should be apparent is that the insurance industry is extremely complex. While the state-based system has made improvements in solvency and holding company regulation, under a structure with over 50 different regulators it may even be somewhat difficult for individual state regulators to get a firm handle on the risks that large complex insurance companies pose to our Nation's insurance system. Add into that mix that the federal government has little to no role in the state-based

insurance regulatory system, and we are left with what could be a large blind spot in evaluating risks that are posed to the general economy and financial markets.

CONCLUSION

To sum up, it is clear to us – as we think it is to most observers – that our current system of insurance regulation requires modernization to meet the challenges facing the insurance industry, and financial services generally, in the 21st century. Our existing system of regulation has the potential to lead to inefficient economic outcomes (raising the cost and reducing the supply of many insurance products), deters international participation in our domestic markets (again raising costs and limiting consumer choice), creates obstacles to our own insurance firms' international expansion, and limits the ability of any one regulator to have an overview of risk in the insurance sector and its contribution to risk in the financial system more broadly. These are issues of importance not just to the insurance industry, or even the larger financial services industry, but to the economy as a whole, because of the essential role that the mitigation of risk through insurance has in promoting commercial activity and enhancing economic growth.

Treasury has been closely monitoring the developments of the various approaches to modernizing insurance regulation – ranging from the self-initiated approaches of the state regulators, and establishing federal standards for the harmonization of state insurance rules, to the concept of an optional federal charter now being considered by this Committee. While we are still evaluating what approach we believe to be the most appropriate, what is clear is that each of them should be evaluated in light of the fundamental issues we have discussed today. Again, thank you for addressing the issue of insurance regulatory modernization and for giving me the opportunity to express the Treasury's views. We look forward to continuing this dialogue.

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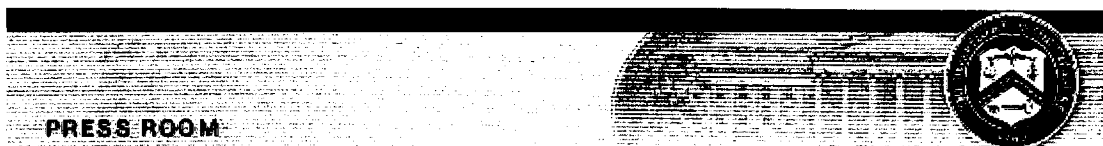

July 19, 2006
hp-20

Assistant Secretary Warshawsky to Leave Treasury for Private Sector

WASHINGTON, DC – On July 6, 2006 Assistant Secretary for Economic Policy Mark Warshawsky submitted his letter of resignation to the President. Warshawsky made the decision to leave Treasury for the private sector over the last several weeks. His resignation will be effective July 28, after which he will begin working with Watson Wyatt Worldwide, a global human capital consulting firm. The content of Warshawsky's letter of resignation is included herein.

July 6, 2006

The Honorable George W. Bush
The President of the United States
White House
Washington, D.C. 20500

Dear Mr. President:

It has been an honor and a privilege to serve in your Administration at the Treasury Department for four and a half years, including the last two years as Assistant Secretary for Economic Policy. At this time of transition for the Department, and after achieving many accomplishments for your program of government, I feel it is now an appropriate time for me to leave to return to the private sector. I therefore resign from the office of Assistant Secretary of the Treasury for Economic Policy, effective after July 28, 2006.

Working under your leadership and the leadership of Secretary Snow, often in partnership with others in the Department and your Administration, I am proud of the many successes that I and my office have had in the last years. In particular, the Trustees' Reports were enhanced and all assumptions were reviewed carefully and updated so that precise, transparent and comprehensive measurement would serve as the basis for the essential discussions that citizens and policymakers have had, and in which they still need to fruitfully engage, to reform the Social Security and Medicare programs. Our office put forward a fair and complete assessment of the Terror Risk Insurance Program that served as the basis for the Secretary's recommendation to Congress that this program, appropriate in its time, be successively scaled back to allow the private sector to resume a steadily growing role. We played a major part in the design of the Administration's legislative proposal to put the private defined benefit pension system and its government-sponsored insurer on a stable and sustainable basis and to encourage future growth, so that current and future workers can look forward to getting a secure source of retirement income. I encourage the Congress to complete this important legislation soon. We provided accurate evaluations and forecasts of the performance of the economy, as the basis for the preparation of your annual budgets and as a testament to the need for, and the success of, your tax and regulatory policies.

In these efforts, as well as in the many other analyses and pieces of policy advice in various macroeconomic and microeconomic areas including Social Security,

FEHBP and flood insurance reform that I provided to the Secretary and other senior officials in the Department and the Administration, I was fortunate to work with the extraordinarily dedicated and creative career and political staffs of the Office of Economic Policy. As Henry Paulson embarks on his term of office, I know that he will want to call upon this remarkably talented group of professionals for insightful, unbiased and reasoned information, analysis, and suggestions.

I wish Mr. Paulson well in his stewardship of the Department and the economy and I wish you well in your continued strong leadership of the Federal Government and our great Nation.

Sincerely yours,

Mark J. Warshawsky
Assistant Secretary for Economic Policy

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July 19, 2006
HP-21

Remarks of Randal K. Quarles
Under Secretary for Domestic Finance
U.S. Department of the Treasury

At the Reuters Panel Discussion on Government Sponsored Enterprises

New York City, NY- Thank you for inviting me here today to discuss issues related to government sponsored enterprises and GSE reform.

As many of you know we appear to be at a critical point in the GSE reform debate. We at the Treasury are on record supporting legislative efforts to improve the regulation of the housing GSEs and, importantly, legislation that provides a clear statutory instruction to the new GSE regulator regarding the size of the GSE's retained investment portfolios.

We have spoken many times on why it is important to limit the size of the GSEs' retained portfolios. While the mortgage securitization activity conducted by Fannie Mae and Freddie Mac does in fact provide a public benefit by increasing the amount of capital available to support mortgage credit – thus decreasing its cost and increasing its supply – their retention of large investment portfolios does not further this purpose. These retained portfolios do, however, concentrate rather than distribute the prepayment and interest rate risks associated with mortgages and mortgage-backed instruments held by them, and concentrate them in entities that – as a result of the lower levels of capital they are required to hold – are substantially more leveraged than other financial institutions. Because of the funding advantage enjoyed by the GSEs, they are able to grow these portfolios to a much greater degree than a purely private sector entity could, and as they continue to grow in size it becomes increasingly risky for counterparties to hedge them, particularly given the complicated hedging strategies run by the GSEs.

That has led us to the conclusion, which remains our position today, that it is critical that both of these points – both a strengthened regulator and a mandate to address portfolio size – be included in any final legislation from Congress.

I think what appears to have gotten lost in the debate is actually what is meant by a mandate to address portfolio size or what has often been phrased as "portfolio limits." To address this, let me start with what is not implied by portfolio limits in the legislative context.

First, neither Treasury, nor anyone else for that matter, is suggesting that a hard portfolio cap be put in place. By "hard" cap I mean a fixed dollar amount for the size of the GSEs' retained portfolio that is specified in legislation. There is wide agreement--an agreement shared by Treasury and the Administration--that a "hard" cap would not provide the needed flexibility for the GSEs to accomplish their housing mission.

Second, a portfolio cap does not imply that there would have to be an immediate sell-off of the GSEs' existing retained mortgage portfolios. As Treasury has maintained all along, any portfolio cap would have to have an appropriate transition period to avoid the potential for market disruption.

Finally, a portfolio cap should not limit the ability of the GSEs' to conduct their guarantee business or react to emergency situations. Again, as we have

consistently noted, the GSEs' credit guarantee business should not be affected by a portfolio cap, and the new regulator should have the ability to lift these requirements to address material disruptions in the mortgage market.

So what would be accomplished with a portfolio cap?

A properly constructed portfolio cap would address the Administration's fundamental concerns regarding systemic risk. And a key element of such a cap would be clear direction to the new regulator on what should be included in the GSEs' retained mortgage portfolios. There are two reasons this statutory direction is important. First, without that direction, it would be very difficult for the new regulator, given its focus on only the GSEs, to evaluate fully the potential for systemic risk. Similarly, without direction, even a stronger regulator with the full range of necessary authorities can find it difficult to make the tough decisions that are necessary.

A properly constructed portfolio cap would also tie the GSEs' activities more closely to their mission. I remain somewhat puzzled as to why there is not more support for this concept. The GSEs were provided a set of public benefits to accomplish a particular public mission. We should continually evaluate whether or not the GSEs are using their public benefits to accomplish that mission. The portfolio cap supported by the Administration does exactly that: it does not expressly reduce the size of the retained portfolios; it simply directs that the retained investments be tied to the specific missions of the enterprises. It is instructive in itself that all sides agree this focus on mission could result in a substantial reduction of those portfolios.

As you all know, the Administration has strongly supported provisions in the GSE reform bill passed by the Senate Banking Committee S. 190 that address the GSEs' retained portfolios by providing the new regulator clear direction on what assets are permissible for the GSEs to hold. Even though clear direction is provided to the new regulator, it is important to note that whatever specific limitations the new regulator imposes would be done through regulation. Thus, any limits would be reviewed and evaluated in an open and transparent process, and all interested parties would have the ability to comment.

The specific list of permissible assets in S. 190 is directly linked to the GSEs' mission and to reducing systemic risk by focusing the GSEs on their securitization activities. For example, the GSEs would be permitted to hold mortgages and mortgage-backed securities for the purposes of securitization, and mortgages acquired to meet the affordable housing goals if such assets are not readily securitized. Other categories of assets in S.190 relate to the GSEs' basic business operations, including the need to maintain liquidity, which is covered by holding Treasury securities. S.190 recognizes the fact that holding hundreds of billions of mortgages and MBS does not, however, help maintain mortgage market liquidity. If the GSEs needed to act as a liquidity provider in a particular situation, they would not be selling assets from their portfolios to purchase new mortgages or MBS, as these actions would have a destabilizing rather than stabilizing impact. Furthermore, as I noted previously, we fully support providing authority for the regulator to lift the cap to address temporary disruptions in the market.

S. 190 also has another important provision that is often overlooked. The new regulator has the ability, by order, to make temporary adjustments to the regulations regarding the permissible asset holdings for the GSEs. This would seem to give the new regulator clear authority to respond to temporary disruptions in the mortgage market. We would certainly be open to greater clarification of this flexibility if this remains a sticking point.

Let me close by saying that we still believe that a legislative solution is achievable and is the best way to address our concerns. Given the importance of the issue, however, we have to consider all the tools at our disposal. As we have noted recently, Treasury is in the process of evaluating our GSE debt approval process. We are undertaking this evaluation to ensure that our process is more standardized, and so that our process can meet any potential eventuality that might be necessary, including limiting the GSEs' debt issuance.

Secretary Paulson has made it clear to me that he believes there is systemic risk associated with the GSE's retained portfolios. While he shares the view that a legislative outcome is preferable, he has instructed us to ensure that the mechanics of our debt approval process are robust enough to give Treasury the practical option of limiting the GSEs' debt issuance in accordance with our statutory authority should that become necessary. If a legislation solution is not achieved, Treasury will have no choice but to consider additional action.

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July 20, 2006
HP-22

Treasury Designates Canadian and Sudanese National for Support to al Qaida

The U.S. Department of the Treasury today designated Abu Sufian Al-Salamabi Muhammed Ahmed `Abd Al-Razziq, a Canadian and Sudanese citizen, for his high-level ties to and support for the al Qaida network. Today's action was taken pursuant to Executive Order 13224, which is aimed at prohibiting transactions with terrorists and their supporters and freezing their assets.

"Treasury continues to take action against al Qaida and its support network," said Deputy Assistant Secretary of the Treasury Daniel Glaser. "Abd al-Razziq has been closely tied to senior al Qaida leadership. We are taking steps to inhibit his ability to harm the United States and our allies."

`Abd Al-Razziq has provided administrative and logistical support to al Qaida, and has been identified as being close to Abu Zubayda, a former lieutenant of Usama bin Ladin, involved in al Qaida recruitment and training.

Today's designation of `Abd Al-Razziq, carried out by the Treasury's Office of Foreign Assets Control (OFAC), was executed under Executive Order 13224, an authority that targets the assets of terrorists and their financiers. Al Qaida was designated a Specially Designated Global Terrorist (SDGT) pursuant to Executive Order 13224 on September 23, 2001.

IDENTIFIER INFORMATION

Abu Sufian Al-Salamabi Muhammed Ahmed `Abd Al-Razziq

AKA:	Abousofian Abdelrazik
AKA:	Abousofian Abdelrazek
AKA:	Sofian Abdelrazik
AKA:	Abousofiane Abdelrazik
AKA:	Abousfian Salman Abdelrazik
AKA:	Abu Sufian Abd Al Razeq
AKA:	Abu Sufian
AKA:	Abu Juiriah
AKA:	Abou El Layth
AKA:	Aboulail
AKA:	Abulail

AKA:	Jolaiba
AKA:	Djolaiba the Sudanese
AKA:	Ould El Sayeigh
DOB:	6 August 1962
POB:	Al-Bawgah, Sudan
ALT POB:	Albaouga, Sudan
Nationality 1:	Sudanese
Nationality 2:	Canadian
Passport:	Canada BC166787

According to information available to the United States Government, 'Abd Al-Razziq has provided administrative and logistical support to al Qaida. He has been identified as being close to Abu Zubayda, a former high-ranking member of the al Qaida network, involved in recruitment and training. 'Abd Al-Razziq is known to have been a member of an extremist cell in Montreal, Canada. He was also closely associated with Ahmed Ressam, who attempted to attack the Los Angeles International Airport in conjunction with the Millennium celebrations in January 2000.

PRESS ROOM

July 25, 2006
HP-23

Treasury Assistant Secretary Fratto to Hold Weekly Press Briefing

Treasury Assistant Secretary for Public Affairs Tony Fratto will hold the weekly media briefing today in Main Treasury's Media Room. The event is open to all credentialed media.

Who
Assistant Secretary for Public Affairs Tony Fratto

What
Weekly Briefing to the Press

When
Tuesday, July 25, 11:15 AM (EDT)

Where
Treasury Department
Media Room (Room 4121)
1500 Pennsylvania Ave., NW
Washington, DC

Note
Media without Treasury press credentials should contact Frances Anderson at (202) 622-2960, or frances.anderson@do.treas.gov with the following information: name, Social Security number, and date of birth.

July 25, 2006
HP-24

Testimony of Randal K. Quarles, Under Secretary for Domestic Finance U.S. Department of the Treasury

Before the Senate Committee on Banking, Housing and Urban Affairs

Chairman Shelby, Ranking Member Sarbanes, Members of the Committee, good morning, it is a pleasure to be here today. I would like to thank you for holding this hearing and allowing the Treasury Department to present its views. I am pleased to be here today to contribute to a discussion of a topic that is of critical importance to our financial markets, namely the regulation of hedge funds.

In May, before a subcommittee of this panel, I presented testimony regarding the role that hedge funds play; that is, what hedge funds do for and in our financial markets. As I said then, if government addresses the question of regulation of any financial institution or activity without a clear understanding of the place it plays in our financial system, we run the risk of imposing unnecessary, excessive, or inappropriate legislation.

As we consider the regulation of hedge funds, we should keep in mind that the role they fulfill in our financial markets is continuously evolving; and in recent years it has been evolving rapidly. Therefore, before I turn to the subject of today's hearing, I would like to reiterate some of the key points from the testimony I gave in May 2006, in which I discussed some of the characteristics of hedge funds and some of the potential benefits and risks that they can present.

Background

Despite the fact that hedge funds are today the subject of everyday discussion in the financial press and among policymakers, there is no universally accepted definition of a hedge fund. A recent report by the International Organization of Securities Commissions (IOSCO) on the results of a survey of the regulatory approaches toward hedge funds of 20 IOSCO members revealed that none of the survey respondents had a formal definition of "hedge fund." In the late '90s, the President's Working Group on Financial Markets (PWG) defined a hedge fund as "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public." Though this was a useful working definition for the PWG's purposes, it is limited in how widely it can be applied, in large part because it does not distinguish hedge funds from other forms of unregistered capital pools that are generally recognized to have distinctive features, such as private equity funds and venture capital funds. In my May testimony I suggested that there are a number of features that can help to distinguish hedge funds from other capital pools, including: legal structure; investment objective and strategy; compensation scheme; investor base and capital commitment; and disclosure.

As I testified in May, hedge funds have experienced dramatic growth, especially in recent years. They have grown from an estimated $50 billion in assets in 1988 to about $300 billion in 1998 to over $1 trillion in assets today. Current estimates suggest that there are about 9,000 hedge funds.

Hedge funds employ a variety of investment strategies that vary considerably depending on the goals and needs of the investors and the types of instruments in

which the fund invests. Much, if not all, of this growth has been market driven, and, as a consequence, it has been subject to a significant amount of market discipline. As hedge funds have grown, their investor base has evolved, bringing increasing levels of professional analysis to the investor side of the relationship. Each new group of investors has imposed certain forms of discipline on hedge funds, resulting in the hedge fund market becoming much more "institutionalized" as it has developed. In addition, since the failure of Long Term Capital Management (LTCM) in 1998 hedge fund investors – and creditors – have recognized the need for more discipline regarding the use of leverage and collateral, and hedge fund investors now demand more transparency of their fund managers. Therefore, while the hedge fund market has grown dramatically in the past twenty years, there is at least some reason to believe this growth has been subject to reasonable private sector discipline.

Hedge funds clearly provide certain benefits to the financial markets. At the same time, they can also put stresses on it that need attention. In my May testimony, I discussed at length many of the benefits and potential risks that can arise from the activities of hedge funds. Hedge funds impart potential benefits both to the financial marketplace, in general, as well as to investors.

In the financial marketplace, hedge funds provide liquidity, price efficiency, and risk distribution, and contribute to the further global integration of markets. Because of the varying strategies employed by hedge funds, they are often the willing buyers or sellers that provide additional liquidity to financial markets. Hedge funds contribute even more significantly to marketplace liquidity in less traditional markets. Many hedge funds seek to create returns by targeting price inefficiencies, including wide bid/ask spreads. While this activity certainly benefits the hedge funds that are profiting from the trades, it has the salutary effect of creating narrower spreads and more efficient markets. Hedge funds can help mitigate market-wide concentrations of risk by transferring and distributing market risk through their willingness to be counterparties in derivatives trades. Today, there is no question that hedge funds are among the dominant participants in the re-distribution of market risk. In their search for the next profit opportunity, hedge funds often lead the way to identifying new and emerging markets. These markets often provide opportunities that no longer exist in more mature marketplaces. This, in turn, leads to further globalization of our marketplace which provides more choice for investors and greater efficiency of markets globally.

Hedge funds can have a direct positive impact on the investing community. Speaking broadly, hedge funds can provide investors with opportunities for diversification, "alpha" or excess returns, and capital protection in down markets. Hedge funds provide investors with more choices of both instruments and investment strategies. More choices allow investors the ability to diversify their investment portfolios, which is a common goal of many investors. In contrast to conventional investment vehicles employing traditional "go-long" strategies, the flexibility in the hedge fund structure enables strategies that attempt to produce positive returns in both bull and bear markets; that is, providing opportunities for generating "alpha" or excess returns, even in thriving years, and for capital protection (or better) in declining markets. It is worth noting that as the hedge fund industry grows and becomes more mature and institutionalized, excess returns have become harder to find. In addition, a common technique employed by many hedge funds attempting to generate excess returns is employing leverage, which, of course, presents its own specific set of concerns.

While hedge funds can provide benefits to investors and the overall marketplace, they present some risk as well. There are risks that hedge funds' aggregate employment of large amounts of leverage or over-concentration of certain positions could have negative consequences for the marketplace. Certain valuation risks also are present in the hedge fund industry. Other risks involve operational challenges associated with the over-the-counter (OTC) clearance and settlement systems. Many of these risks, however, are not unique to hedge funds.

Leverage refers to the use of repurchase agreements, short positions, derivative contracts, loans, margin, and other forms of credit extension to amplify returns. With increased leverage, of course, comes increased risk. As discussed by the

PWG in its report after the LTCM failure, excessive leverage can greatly magnify negative effects of market conditions. Linked closely with the issue of leverage and the potential for impaired liquidity in a period of market stress is the issue of concentration of market positions or "crowded trades." Sometimes referred to as "herding," crowded trades can arise to the extent that hedge fund managers are inclined to pursue the same or similar investment strategies. If numerous market participants establish large positions on the same side of a trade, especially in combination with a high degree of leverage, this concentration can contribute to a liquidity crisis if market conditions compel traders simultaneously to seek to unwind their positions. The risk, of course, is market disruption and illiquidity, possibly exacerbating the risk of a systemic financial market crisis.

As hedge funds become larger, their valuation policies and procedures become more important to the marketplace as a whole. Valuation is often dependent on complex proprietary models, but because of their proprietary nature, these models have not been subject to broad-based scrutiny and there is a concern that there could be unanticipated changes that might only present themselves in certain market conditions. Moreover, valuation concerns are exacerbated in the hedge fund industry because hedge fund adviser compensation is tied to period returns which, of course, requires periodic asset valuations. With respect to OTC settlement and clearance systems, hedge funds as a group do not pose a greater operational risk than any other group of market participants. However, operational risks can be posed by certain market conditions and certain technological conditions in certain *products*, particularly *new* products, where technological and legal infrastructures tend to lag product development and volume growth. These acute "growing pains" have developed most recently in the credit derivatives market across a wide spectrum of participants.

Thus, hedge funds, or any other group of participants, potentially could have a disruptive impact if there were concentrations of positions or attempted mass liquidation in illiquid markets. However, many of these issues and concerns have been or are actively being addressed – outside of a formal scheme of direct regulation of hedge funds – both by policymakers and by private sector groups.

In its report on LTCM, the PWG cautioned that problems can arise when financial institutions do not employ sufficient discipline in their credit practices with customers and counterparties. To this end, the PWG made several recommendations designed to help buttress the market-discipline approach to constraining leverage. Numerous public and private sector groups, such as Counterparty Risk Management Group II (also known as the Corrigan Group), also took up the cause of enhancing counterparty credit risk management, and many have continued to focus on emerging developments such as the growth of products containing embedded leverage. These efforts and others have had the positive effects that I alluded to earlier.

Valuations and correlations also can change rapidly in unexpected ways and these changes can have a ripple effect in the marketplace, especially if the instruments are concentrated and illiquid. In July 2005, the Corrigan Group issued a number of "guiding principles" and recommendations for all types of participants. It recommended that: 1) investment in risk management systems should continue, with full model testing and validation and independent verification; and 2) analytics should include stress testing, scenario analysis, and expert judgment, with special attention to the inputs and assumptions.

The Federal Reserve Bank of New York, Counterparty Risk Management Group II, Bank for International Settlements, International Swap and Derivatives Association, The Bond Market Association, and Depository Trust & Clearing Corporation all have made recommendations or undertaken efforts to strengthen the technological and legal aspects of the settlement and clearance systems for all market participants. The International Monetary Fund has also raised issues generally related to market concentrations and illiquidity and the potential for systemic risk in its recent "Global Financial Stability Report," and member countries and regulators continue to develop and coordinate policies and approaches to deal with these issues globally.

Treasury and the PWG can contribute significantly to these policy debates in the

first instance by facilitating communication in the official sector and with industry participants and academics regarding credit risk management, concentration of risks, valuation techniques and models, and clearance and settlement systems. While the PWG continues to discuss these issues and formulate and coordinate actions and plans, we are encouraged by these positive developments noted above.

Regulation of Hedge Funds

The PWG's position on direct regulation of hedge funds

In its 1999 report on LTCM, the PWG was mainly concerned about the systemic risks posed by hedge funds and other highly leveraged institutions. Specifically, the PWG was concerned that excessive and unconstrained leverage could, in an episode of unusual market stress, lead to a general breakdown in the functioning of the financial markets. Accordingly, the PWG made a series of recommendations designed to encourage hedge funds, hedge funds' counterparties, and regulators to focus on enhancing market-wide practices for counterparty risk management. A number of the private sector initiatives I have already mentioned were initiated in direct response to the PWG's recommendations.

One recommendation the PWG did not make, however, was for the direct regulation of hedge funds. The PWG stated that, "if further evidence emerges that indirect regulation of currently unregulated market participants is not working effectively to constrain leverage," then direct regulation of hedge funds, among other measures, "could be given further consideration to address concerns about leverage." Even with that caveat, the PWG took care to emphasize that it believed its recommendations "would best address concerns related to systemic risk without the potential attendant costs of direct regulation of hedge funds." To date, the PWG has not observed evidence that "indirect" methods of constraining leverage are not working effectively.

SEC Hedge Fund Adviser Registration Rule

In late 2004, the Securities and Exchange Commission (SEC) issued a final rule that required hedge fund advisers to register with the Commission, mainly out of a perceived need to address increasing instances of hedge fund fraud and a concern that less sophisticated investors were becoming increasingly exposed to hedge fund investments, either directly or indirectly through their pension plans. The rule went into effect on February 1, 2006, prompting more than 1,100 previously unregistered hedge fund advisers to register with the SEC.

Neither Treasury nor the PWG ever took a formal position on the rule. We did work with the SEC, however, both bilaterally and through the PWG, to make sure we understood the SEC's rationale for their rule, and what their goals and expectations were regarding its implementation. Although we did not formally comment on the SEC's proposed rule, we did ask the SEC to work with the Commodity Futures Trading Commission (CFTC) to avoid potential duplicative registration requirements for CFTC-registered commodity pool operators and commodity trading advisers.

This past June, the U.S. Court of Appeals for the D.C. Circuit ruled that the SEC's hedge fund adviser registration rule was arbitrary in the way it redefined the term "client" so as to bring hedge fund advisers under the registration requirements of the Investment Advisers Act, and the court therefore vacated the rule. SEC Chairman Cox, in his statement on the Court's decision, expressed a very pragmatic approach to dealing with this decision. He noted that the SEC will continue to work with the PWG as it reevaluates its approach to hedge fund activity and as the SEC considers alternative courses of action. We look forward to working with Chairman Cox and the SEC staff on these issues.

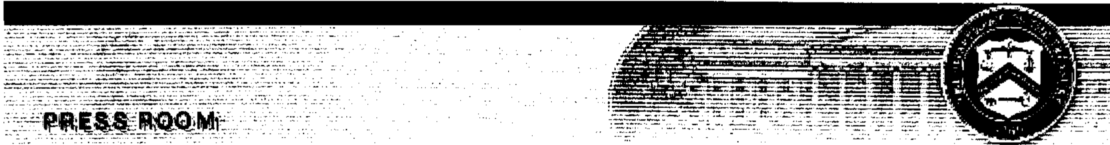
Conclusion

Thank you again for allowing the Treasury Department to participate this afternoon.

As I have mentioned, the question of the regulation of hedge funds must be carefully considered in light of the important role they play in our financial markets.

It is for that reason that Treasury is examining in detail the issues I have discussed this morning, with a view to evaluating whether the growth of hedge funds – as well as other phenomena such as derivatives and additional alternative investments and investment pools – hold the potential to change the overall level or nature of risk in our markets and financial institutions. This examination will involve bringing key government officials together to review their approaches to these financial market issues. The first such meeting was held last week, chaired by Assistant Secretary of the Treasury Emil Henry, and will be followed by further discussions in the future. We are also beginning a broad outreach to the financial community to help us examine these questions. As part of this comprehensive review chaired by the Treasury, we will be working with the SEC – both bilaterally and through the PWG – as Chairman Cox and the Commission consider alternative courses of action following the D.C. Circuit Court's recent decision.

Looking forward, we will be focused on seeking to understand in the most comprehensive way possible whether and how changes in the structure of the financial services industry – of which the rapid growth of new forms of capital accumulation, such as hedge funds, is just one example – have materially affected the efficiency with which markets intermediate risk, whether risk is pooled in different ways or in different places than it has been in the past – and if so, what appropriate policy responses might be. We will seek to be forward looking and to think about these changes not in a fragmented fashion, but in a comprehensive way. At the moment it is too soon to say what initiatives will result from this focus, but this is the lens through which we will filter the various ideas and efforts with which we will all be grappling over the next few years.



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July 25, 2006
HP-25

A Dynamic Analysis of Permanent Extension of the President's Tax Relief

Executive Summary

This Report presents a detailed description of Treasury's dynamic analysis of the President's proposal to permanently extend the tax relief provisions enacted in 2001 and 2003 that are currently set to expire at the end of 2010. These enacted provisions include:

- Lower tax rates on ordinary income;
- Lower tax rates on dividends and capital gains;
- A ten-percent individual income tax rate bracket;
- Doubling of the child tax credit; and
- Reducing marriage tax penalties.

The purpose of the report is to provide a more in-depth, transparent understanding of dynamic analysis, while also illustrating the positive contributions the tax relief, together with spending reductions, can be expected to continue to make to the U.S. economy. In addition, the analysis shows the importance of making the tax provisions permanent for the U.S. economy's long-term economic growth.

Dynamic Analysis

Dynamic analysis goes beyond traditional analysis of tax policy by focusing on the broad

economic effects in both the short and long term. Simply, dynamic analysis provides a more comprehensive and complete approach to analyzing tax policy by including its effects on the overall size of the economy and other major macroeconomic variables. The President's FY 2007 Budget proposes to create a division of dynamic analysis within the Department of Treasury's Office of Tax Analysis.

The Economic Benefits of Tax Relief

As evidenced by key economic indicators such as increased capital investment and Gross

Domestic Product (GDP), and strong job growth, the President's tax relief played an important role in strengthening the U.S. economy as it was coming out of the recent recession, and in the longer-term by increasing the after-tax rewards to work and saving. Lower tax rates enable workers to keep more of their earnings, which increases work effort and labor force participation. The lower tax rates also enable innovative and risk-taking entrepreneurs to keep more of what they earn, which further encourages their entrepreneurial activity. The lower tax rates on dividends and capital gains lower the cost of equity capital and reduce the tax biases against dividend payment, equity finance, and investment in the corporate sector. All of these policies increase incentives to work, save, and invest by reducing the distorting effects of taxes. Capital investment and labor productivity will thus be

higher, which means higher output and living standards in the long run.

Treasury has conducted its dynamic analysis using a model that accounts for the effects of this greater work effort, increase in savings and investment, and improved allocation of resources on the size of the economy. While this model captures many aspects of a modern economy and economic behavior, others are not reflected in the model. For example, the model assumes that resources are fully employed in the economy and that capital is only somewhat mobile internationally. These are areas for future development.

REPORTS

- Treasury Report on Dynamic Analysis of Permanent Tax Relief

Office of Tax Analysis
U.S. Department of the Treasury

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July 25, 2006

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Different Components of Tax Relief Have Different Effects on the Economy

Treasury's dynamic analysis of the President's tax relief indicates that making the tax relief permanent can be expected to increase the level of annual output (i.e., national income) ultimately by about 0.7 percent. The analysis also shows separately the effects of the President's tax relief in three parts reflecting: 1) the lower tax rates on dividends and capital gains; 2) the lower tax rates on ordinary income (i.e., the top four rate brackets); and 3) the 10-percent tax rate bracket, higher child tax credit, and marriage penalty relief. This decomposition reveals that these tax relief components are likely to have very different effects on future economic activity. For example, extending just the lower tax rates on dividends and capital gains increases output in the long run by 0.4 percent, but when the lower tax rates for the four top income tax brackets are extended as well, output increases by a total of 1.1 percent in the long run.

Financing Tax Relief – Government Spending Reductions over Increased Tax Rates

The analysis reveals that the long-run effects of these policies depend crucially on whether they are financed by lower spending or higher taxes in the future and are sensitive to assumptions on underlying parameters. The issue of how, or even if, these policies need to be financed remains a source of discussion among economists. The analysis presented here suggests these policies will result in substantially more economic activity if they are financed by a future reduction in government spending than if they are financed by future tax increases. If the tax relief is financed by future tax increases – that is, if the aggregate amount of tax relief is temporary – then it may result in lower output in the long run. For that reason, the Administration has emphasized permanence for the tax relief *and* spending restraint in its Budgets.

A Dynamic Analysis of Permanent Extension of the President's Tax Relief

1. Introduction

This Report presents a detailed description of Treasury's dynamic analysis of the President's proposal to permanently extend the tax relief provisions enacted in 2001 and 2003 that are currently set to expire at the end of 2010. These provisions include the lower tax rates on ordinary income, the lower tax rates on dividends and capital gains, the 10-percent individual income tax rate bracket, a doubling of the child tax credit, and a reduction in marriage tax penalties.

Tax relief can be important when the economy is performing below its full potential, and can increase its potential in the longer term. In 2003, real GDP was below its potential level and the unemployment rate was elevated. The tax relief enacted in 2001 and 2003, together with reductions in short-term interest rates by the Federal Reserve, helped stimulate economic growth and move the economy out of the 2001 recession more quickly. Previous Treasury analysis using the Macroeconomic Advisers macro-econometric model estimated that without the tax relief passed in 2001, 2002, and 2003, as many as 3 million fewer jobs would have been created by the end of 2004 and real GDP would have been as much as 3.5 to 4.0 percent lower.

Beyond this short-term economic stimulus, the President's tax relief also helps encourage economic growth in the longer term by increasing the after-tax reward from work, saving, and investment. The lower tax rates enable workers to keep more of their earnings, which increases work effort and labor force participation. The lower tax rates also enable innovative and risk-taking entrepreneurs to keep more of what they earn, which further encourages their entrepreneurial activity. The lower tax rates on dividends and capital gains lower the cost of equity capital and reduce the tax biases against dividend payment, equity finance, and investment in the corporate sector. All of these policies improve incentives for work, saving, and investment by reducing the distorting effects of taxes. Capital investment and labor productivity will thus be higher, which means higher output and living standards in the long run.

The Treasury Department's dynamic analysis relies on a model that takes into account the effects of work effort, increase in savings and investment, and improved allocation of resources on the size of the economy. The overlapping generations (OLG) general equilibrium model used for this analysis (described in detail in the appendix to this report) is structured to account for the effects of changes in the effective tax rate on capital and labor income and the consequent effects on economic growth. Representative consumers and firms incorporate future prices into their current period decisions of how much to save, work, and produce. Output is generated by four production sectors, and individual level decisions of representative consumers determine the aggregate level of labor supply and savings in each year.

While this model captures many aspects of the economy and economic behavior, other aspects are not reflected in the model. For example, the model ignores cyclical disruptions in the employment of capital and labor, assuming instead that all resources in the economy are always fully employed. The model includes a relatively simple representation of international capital flows in which capital is only somewhat mobile internationally. There is no uncertainty in the

model and households and firms exhibit perfect foresight regarding future prices and tax rates. These are areas for future development.

This analysis shows the likely economic effects of making the tax relief permanent. The results indicate that the level of annual output (i.e., national income) may ultimately be higher by 0.7 percent because of the combined effects of the President's tax relief.

The analysis also shows separately the effects of the President's tax relief in three parts reflecting: 1) the lower tax rates on dividends and capital gains; 2) the lower tax rates on ordinary income (i.e., the top four rate brackets); and 3) the 10-percent tax rate bracket, higher child tax credit, and marriage penalty relief. This decomposition reveals that the tax relief components are likely to have very different effects on future economic activity. For example, extending just the lower tax rates on dividends and capital gains increases output in the long run by 0.4 percent, but when the lower tax rates for the four top income tax brackets are extended as well, output increases by a total of 1.1 percent in the long run. Extending the remainder of the tax relief – the 10 percent rate, the expansion of the child tax credit, and the reduction in marriage penalties – stimulated economic activity during and immediately after the recession and served other purposes, such as making the tax code more progressive. However, these elements of the tax relief do not have positive growth effects in the longer term in ways that this type of model can measure.

The analysis reveals that the long-run effects of these policies depend crucially on how they are eventually financed and are sensitive to assumptions on underlying parameters. The issue of how, or even if, these policies need to be financed remains a source of discussion among economists. The analysis presented here suggests these policies will result in substantially more economic activity if they are financed by a future reduction in government spending than if they are financed by future tax increases. If the tax relief is financed by future tax increases – that is, if the tax relief is temporary – it may well result in lower output in the long run. In effect, the temporary tax relief must be paid back with interest through future tax increases, which implies that future tax rates increase compared to current law. For that reason, the Administration has emphasized permanence for the tax relief *and* spending restraint in its Budgets. The sensitivity of the results to financing and parameter assumptions is described in detail below.

The remainder of this report is organized as follows. The next section describes previous work done by Treasury that estimated the short-run economic effects of the President's tax relief. Section 3 describes the model used in the permanence analysis in greater detail. Section 4 outlines the methodology employed in simulating the economic effects of extending the 2001 and 2003 tax relief and discusses some of the limitations of the model. Section 5 describes and explains the results and the last section concludes.

2. Effect of the President's Tax Relief in the Near Term

The focus of this Report is on the future economic effects of permanently extending the President's tax relief. As described in the introduction, the model used for this analysis assumes that the economy is always performing at its potential. This assumption simplifies the model and allows for a more detailed representation of household labor supply and savings behavior in both

the near term and the long run. Yet this simplification implies the model used for this report is not able to capture the short-run stimulus that tax relief may provide when the economy is operating below potential. Such a situation existed when the President's tax relief was passed in 2001 and 2003; real GDP was below its potential level and the unemployment rate was elevated.

The Treasury Department previously compared how the economy would have performed if there had been no tax relief using a different type of model that is designed to capture the interactions of economic sectors as the economy fluctuates around its potential growth path. These models attempt to account for changes in the level and growth of GDP, employment, inflation, and interest rates. Short-run changes in monetary and fiscal policies are important determinants of accelerations and deceleration of employment and output in these models. In this earlier analysis, the Treasury Department used the Macroeconomic Advisers macroeconometric model to estimate how the economy would have performed had there been no legislated fiscal stimulus from 2001 through 2004. This analysis found that the tax relief increased employment and output substantially above what would have occurred otherwise.

Specifically, Treasury found that, without enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, the Job Creation and Worker Assistance Act of 2002, and the Jobs and Growth Tax Relief Reconciliation Act of 2003: (1) by the second quarter of 2003, the economy would have created as many as 1.5 million fewer jobs and GDP would have been as much as 2 percent lower, and (2) by the end of 2004, the economy would have created as many as 3 million fewer jobs and real GDP would be as much as 3.5 to 4.0 percent lower.

Note that the analysis described in this section estimates the economic effects that the President's tax relief has already had on the economy, assuming that interest rates followed the same path as they did historically from 2001 forward. The remainder of the paper discusses the likely future economic effects of making the President's tax relief permanent.

3. Model description

For the remainder of the analysis in this Report, the Treasury Department used a conventional neoclassical growth model with overlapping generations of taxpayers developed by Tax Policy Advisers, LLC.[1] In this life-cycle model, tax policy affects the incentives to work, to save and invest, and to allocate capital among competing uses. Representative consumers and firms incorporate future prices into their current period decisions of how much to save, work, and produce. Output is generated by four production sectors, and individual level decisions of representative consumers determine the aggregate level of labor supply and savings in each year. An overview of the model follows, with important equations and further explanation provided in the appendix.

Firm Behavior

Firm behavior is modeled for each of the four production sectors – corporate, noncorporate, owner-occupied housing, and rental housing. In the owner-occupied housing sector, home owners are treated as "firms" who produce housing and rent it to themselves, taking into account

[1] See http://www.taxpolicyadvisers.com.

the tax advantages of home ownership. Each production function takes the standard Cobb-Douglas form.

Firm managers choose the optimal levels of labor demand and investment to maximize the value of the firm, or profits, in each period. Investment in each sector is determined according to the "*q*" theory of investment modified to include adjustment costs. This implies that firms will continue to invest as long as the increase in the value of the firm is greater than the after-tax cost of investment. Firm managers explicitly calculate the time path of investment in response to a change in the tax structure as a function of the tax-induced change in "*q*", which denotes the ratio of the market value of capital assets to their replacement costs, taking into account convex costs of adjusting the level of investment from its steady state level. Differences in the level of depreciation allowances for tax purposes and economic depreciation are modeled explicitly, as is the value of the existing tax basis at any point in time. The debt-to-capital ratio is assumed to be fixed in each industry, and dividends in the corporate sector are assumed to be a fixed fraction of after-tax corporate earnings. The model assumes the traditional view of dividend taxes, which implies dividend taxes increase the cost of capital to firms.

Individual Behavior

The model has a conventional overlapping generations structure. All individuals in a given cohort are identical, with each living for 55 years, the last 10 of which are spent in retirement.[2] Each individual has perfect foresight and chooses consumption (and thus saving) to maximize lifetime utility – an aggregation of utility in each of the 55 periods of the lifecycle, discounted at a fixed rate of time preference that is common to all individuals – subject to a lifetime budget constraint that takes into account a hump-shaped age-wage profile, inheritances and a target bequest. Utility in each period is a CES function of leisure and an aggregate consumption good which is in turn an aggregation of four goods – a composite good produced by the corporate sector, a composite good produced by the non-corporate sector, owner-occupied housing, and rental housing. The intertemporal elasticity of substitution is assumed to be 0.35 and the intratemporal substitution elasticity between goods and leisure is assumed to be 0.8.[3] Sensitivity to these and other parameters is considered in more detail below.

Government Behavior

The model includes a simple characterization of the Social Security program. Government services are separable in the individual utility function and government debt is a constant fraction of Gross National Product (GNP) in the initial steady state.

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[2] This formulation, in effect, excludes an individual's life prior to joining the labor force, but does include both individuals' working years plus their retirement. An alternative approach to modeling the retirement decision would be to allow the retirement age to be endogenous so that individuals could come out of retirement and rejoin the work force in response to reform-induced changes in the after-tax wage. This potential labor supply response is precluded by assuming a fixed retirement age.

[3] See Elmendorf (1996), Engen, Gravelle, and Smetters (1997) and Altig *et al.* (2001) for discussion on the plausible range of values for these parameters. These parameter values yield a Frisch elasticity of labor supply, which measures the labor supply elasticity holding the marginal utility constant, equal to 0.4. This value is consistent with the range of estimates reported in Browning, Hansen, and Heckman (1999).

The government finances government expenditures by collecting taxes, and issuing government debt. The tax instruments available to the government in the initial equilibrium include the following: (1) a corporate income tax; (2) an individual income tax with a progressive wage income tax structure and a tax base that is adjusted for various exclusions, exemptions, deductions and credits; and (3) constant rate capital income taxes applied at different average rates to non-corporate business income, interest income, dividends and capital gains.

An important feature of this type of model is that a permanent reduction in taxes, as compared to the baseline, would lead to an unsustainable accumulation of government debt relative to GNP and the model will not converge without an offsetting change to stabilize the debt-to-GNP ratio. In this type of model, the tax relief is typically financed by an offsetting change in taxes or spending, that can occur in the future or contemporaneously with the initial policy change and can take a multitude of forms. In this analysis it is assumed that the government's financing requirement is satisfied by either cutting future government spending or raising future taxes, in part to illustrate the sensitivity of the results to the financing assumption.

International Capital Flows

Although the focus of the model is on the U.S. domestic economy, it includes a simple representation of international capital flows, which are assumed to respond to differences in after-tax rates of return in the U.S. and the "rest of the world" through a constant elasticity expression.[4] This approach represents a compromise between the standard closed economy approach and the alternative of a completely open economy in which capital is perfectly mobile and the international return to capital is fixed. A more sophisticated modeling of the international flows of goods and capital would be a marked improvement over the current version of the model.

4. Methodology

In the steady state, per-capita growth in the model is equal to a constant rate of technological change. In the initial steady state, the model's tax parameters are calibrated to match current law average marginal effective tax rates by income source over the budget window. Simplifying assumptions were made in order to meld the data into the stylized model. First, given the requirement of constant tax rates in the steady state, the initial tax rates were set equal to the average of current law rates over the period 2011-2016, when statutory rates are unchanging. Second, the initial steady state assumes that current law polices are fiscally sustainable. That is, tax revenues in each period are just large enough to pay for government spending and transfer payments, including interest on the government debt, so that the government debt-to-GNP ratio is constant.[5] The initial share of tax revenues as a percentage of GNP is set to match current law averaged over the years 2011-2016.

[4] This elasticity is set equal to 0.2 in the base case, which implies that international capital flows are not very sensitive to differences in the after-tax rate of return in the U.S. compared to the rest of the world.

[5] Note that this approach ignores the structural fiscal imbalance of the Social Security and Medicare systems, but this assumption seems appropriate in generating the likely independent effect of a tax change and is commonly used in this type of analysis. For example, see Auerbach (2002).

The tax relief is decomposed into three parts to show the economic effects of each:

1. Extend the lower rates on dividends and capital gains. (Dividends and capital gains are taxed at a top rate of 15 percent, as compared to a top rate on dividends of 39.6 percent and for long-term gains of 20 percent in the absence of tax relief);
2. Extend the reduction in the top four ordinary individual rates. (These rates are maintained at 25, 28, 33 and 35 percent, as compared to the rates of 28, 31, 36 and 39.6 percent that would apply beginning in 2011 under current law. The repeal of the phase-out of personal exemptions and itemized deductions [PEP and Pease provisions] is also extended); and,
3. Extend the higher child tax credit ($1,000 per child), reduction in marriage tax penalties (by increasing the standard deduction and increasing the size of the 15 percent bracket for joint filers), and the 10-percent tax rate bracket.[6]

The percentage decline in average marginal tax rates by income source compared to current law for the years 2011-2016 is shown in Table 1.[7] Extending the lower tax rates on dividends leads to more than a 50 percent decline in the average marginal dividend tax rate compared to current law for the years 2011 through 2016. Extending the relief on capital gains leads to more than a 20 percent decline in the average marginal tax rate on capital gains for the same period. Lowering ordinary rates leads to a decline in the average marginal tax rate on labor income of 5.6 percent, while the average marginal rate on small business income (income from sole proprietorships, partnerships, and S-corporations) falls by 11.4 percent. Extending the reminder of the tax relief has only small effects on the change in marginal tax rates.[8]

Financing the Tax Relief

As discussed above, an important feature of this type of model is that tax relief must be financed by an offsetting change in government revenues or spending to stabilize the ratio of government debt to GNP. There are numerous possibilities for satisfying the government's intertemporal budget constraint and two are examined in this analysis: (1) the tax relief is permanent and future government spending is reduced, and (2) future taxes are increased. Specifically, in this analysis, the tax relief is assumed to remain in place through the end of the 10-year budget window (i.e., 2016), holding government spending equal to the baseline amount during this period, and issuing additional government debt relative to the baseline to account for the decline in tax revenues over the budget window. The tax relief is then financed by either: (1) adjusting government consumption spending in each year after the 10-year budget window to hold the ratio of government debt-to-GNP at the ratio that exists in the first year after the budget window (2017), or (2) adjusting all income tax rates proportionally in each period after the budget window to hold the government debt-to-GNP ratio equal to the value it takes in the first year

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[6] The economic effects of the repeal of the estate tax are not included in this analysis. There is considerable uncertainty regarding the likely behavioral responses to repealing the estate tax, and the target bequest motive used in this model is not very flexible in capturing the range of likely responses.

[7] The average marginal rates are weighted by income from that source.

[8] The decline in the marginal tax rate on wages actually becomes smaller (5.1 percent decrease) when the full tax relief is extended. This appears to be the result of more taxpayers being affected by the AMT and the longer phase-out of the child tax credit.

after the 10-year budget window (2017).[9] The first financing option is consistent with the Administration's policy of spending restraint. The second financing option, in effect, models the tax relief as temporary, which requires that future taxes increase enough to pay for the temporary decline in taxes with interest.

Sensitivity to Underlying Parameter Assumptions

The results also depend on how responsive households and firms are to changes in after-tax prices, such as the wage rate and the interest rate. The behavioral parameters used for the base case simulations are shown in Table 2. There are three primary parameters that affect the responsiveness of household labor supply and savings to tax changes: the intertemporal elasticity of substitution, the intratemporal elasticity of substitution between the composite consumption good and leisure, and the initial share of leisure in the time endowment. The base case simulations use values for these parameters that approximate "central tendency" estimates. However, there is uncertainty about the exact value of these parameters and results are also presented that consider "low" and "high" values for these parameters.[10] In addition, the degree to which housing and non-housing goods are substitutable is adjusted. The approach taken for this Report is to adjust the parameters as a group, rather than individually, mostly to facilitate ease in presentation.[11] This approach provides only limited information on the importance that any given parameter would have on the results, but it provides an overall sense of the robustness of the results and highlights the uncertainty that remains in the economics literature on the likely responsiveness of taxpayers to changes in tax rates.

Limitations of the Model

The model used for this analysis captures many of the likely economic effects that would result from extending the President's tax relief, including incentive effects on household labor supply and savings, the intersectoral reallocation of capital that would result from reducing the double taxation of corporate profits, and the crowding out of private investment that would occur by financing the tax relief through issuing government debt. Like all economic models, this model employs important simplifying assumptions, and other economic models, which employ different simplifying assumptions, could yield different economic results from extending the President's tax relief. The model used in this analysis departs from economic reality in the following ways.

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[9] Auerbach (2002) and Auerbach and Kotlikoff (1987) employ a similar approach when examining the effects of a temporary tax decrease financed with future tax increases. The Congressional Budget Office (2004, 2006) also makes similar financing assumptions, but the reduction in government spending (or the increase in income taxes) is phased in over a 10-year period after the end of the 10-year budget window which allows the debt-to-GNP ratio to rise somewhat more in the long-run.

[10] The Frisch labor supply elasticity equals 0.18 under the low response parameters and 0.75 under the high response parameters. This is consistent with the results surveyed by Browning, Hansen and Heckman (1999), and recent papers by Ziliak and Kniesner (1999, 2005) and Lee (2001), which estimate the Frisch labor supply elasticity for men ranges between 0.0 and 0.5. The econometric literature has generally found larger labor supply responses for women compared to men, but there are few studies that measure the Frisch labor supply elasticity for women. Aaronson and French (2002) suggest this value is believed to be around 1. This Report assumes the Frisch labor supply elasticity for women ranges between 0.55 and 1.25, and that women account for one-third of labor earnings.

[11] A similar approach is taken by Rogers (1997). For each simulation, this Report also adjusts the rate of time preference in order to maintain the initial capital-output ratio.

First, this model does not account for short-term deviations in output from potential GNP. This implies that the model does not capture some of the short-run benefits of tax relief when it occurs at a time when the economy is below its potential, which occurred with the 2001 and 2003 tax relief. Section 2 of this Report describes a separate Treasury analysis of the effect of the President's tax relief that includes these cyclical effects.

Second, the treatment of international capital flows is quite simple. A broader model would employ a more sophisticated representation of these flows and would also include international trade in goods. The limited role of international capital flows allowed in this model has only a minor impact on the economic results in this analysis. It is unclear whether a broader model of international trade and capital flows would lead to results that are smaller or larger in magnitude than the results presented in this paper.

Third, as mentioned above, the model assumes that the "traditional" view of dividend taxation holds, which implies that taxes on dividends increase the cost of investing in the corporate sector. An alternative approach that is termed the "new" view of dividend taxation suggests that dividend taxes are capitalized into the value of the firm, but do not affect marginal investment decisions.[12] The degree to which each view represents an accurate portrayal of the economy remains an unsettled issue. Recent research suggests a segmented market, with some firms behaving in a manner consistent with the traditional view and other firms behaving in a manner consistent with the new view.[13]

To the extent that the new view holds, the output gains resulting from extending the lower tax rates on dividends found in this analysis are likely to be overstated. However, this model also does not include a measure of other efficiency gains that would likely result from lowering the tax rate on dividends due to reducing the distortions between debt and equity financing. Moreover, the model assumes that the level of dividends and corporate payout decisions are held fixed.[14] It is not clear whether a fuller model that accounts for both new view firms and these other financial distortions would show larger or smaller effects overall.

Fourth, this model assumes perfect certainty and perfect competition. Of course, as suggested by empirical research, some individuals save as a precaution against unforeseen events and at least a portion of savings is not very sensitive to changes in the interest rate. Thus, the implied elasticity of savings with respect to the after-tax interest rate in the certainty model is likely to be higher than in a model that incorporates risk. To partially offset the lack of risk in the model, households have a simple target bequest motive that tends to mitigate the savings response.[15] On the other hand, some models with imperfect competition find that the distortionary effects of capital income taxation are larger than models that assume perfect competition.[16]

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[12] For an excellent overview of these issues, see Zodrow (1991).
[13] For example, see Auerbach and Hasset (2003).
[14] The importance of these distortions is also diminished to the extent the new view holds.
[15] It is worth noting, however, that Hurst, *et al.*, (2005) recently estimated that precautionary savings account for less than 10 percent of total wealth.
[16] For example, see Judd (2002).

Fifth, this model likely overstates the economic cost of deficit finance of temporary tax relief as the rate of return to government bonds in the model is greater than the rate of growth in GNP.[17] Historically, the average return on government debt is below the average growth rate of the economy, which implies it might not be necessary to increase taxes in the future in order to stabilize the government debt ratio. Some research suggests that the need to raise future tax rates to pay for temporary tax relief only occurs with a small probability.[18]

Finally, the financing assumptions used in this model are conventional for this type of analysis and are not meant to be predictions of what policies actually would be set by this Administration or by a future Administration or Congress. Numerous other policy prescriptions also could be employed. If the revenue cost of the tax relief is financed through reductions in government spending, then the sooner those reductions begin, the smaller would be the crowding out effect on private investment and the larger would be the increase in long-run output. If the revenue cost of the tax relief is financed through future tax increases, then the way future taxes are increased would greatly affect the long-run results; the more the future tax increases affect marginal rates, the more future economic output will suffer as a consequence.

5. Description of results

As described above, results are presented assuming that the tax relief is financed either through a future decrease in government spending or a future increase in taxes. The first year in the model is set to be 2007. Households and firms in the tax relief simulations anticipate the future continuation of lower tax rates after 2010 and the offsetting fiscal policy of reducing government consumption or increasing tax rates beyond the budget window. However, the macroeconomic effects for the first four years of the budget window (2007-2010) are generally small as tax rates do not change between the different simulations for those years. Results are presented in Tables 3 and 4, and discussed below for only the last six years of the budget window (2011-2016) and for the long run.

<u>Tax Relief Financed with Future Decrease in Government Spending</u>

For this set of results, the model assumes that government consumption purchases (i.e., government spending) adjust after 10 years to stabilize the government debt-to-GNP ratio. In the model, government consumption purchases do not enter household utility functions and only indirectly affect household decisions through market prices.[19] Prior to 2017, the debt-to-GNP ratio is allowed to rise, but, beginning in 2017, government purchases decline in each year to hold the government debt ratio fixed.

Most of the economic effects of the tax relief can be explained by examining households' budgets and prices. The tax relief leads to offsetting substitution and income effects for both

[17] The model assumes that the after-tax rates of return to government bonds, private bonds and corporate equity are equal.
[18] See Ball, Elmendorf, and Mankiw (1998).
[19] That is, government spending is not valued by households. An alternative assumption is that valued government spending decreases, such as government transfer payments to individuals. This would mostly eliminate the income effects of the tax relief and lead to larger output effects. A more detailed modeling of the government sector would also be an improvement in the model.

household leisure and consumption choices. The reduction in the marginal tax rates on labor and capital income increases the price of current leisure and consumption, and households respond by supplying more labor and savings through the substitution effect.[20] The reduction in tax liabilities increases household after-tax wealth, and households' desire to consume more leisure and consumption through an income effect. There is an additional income effect (termed the human wealth effect) which supports an initial increase in labor supply and savings. This effect arises from the increase in the after-tax interest rate that results from the lower tax on capital, but this effect becomes less important over time as the interest rate declines as capital accumulates.

However, other effects also are at work. The lower tax rate on dividends lowers the effective tax rate on investment in the corporate sector relative to the other sectors. The reduction in the double tax on corporate profits results in a more even taxation of investments across production sectors, a more efficient allocation of capital, and an increase in output.

In addition, when lower taxes on capital income are financed initially by issuing government debt, private investment is crowded out by an increase in government borrowing. Private saving may increase as a result of the tax relief (and may be augmented by capital inflows from abroad), but private investment will generally not increase by the same amount because a portion of the increase in private saving funds the increase in government debt. When the majority of the tax relief is on labor income, the crowding-out effect is even larger and private investment could even decline in the short run. When government purchases decline after the budget window to stabilize the government debt ratio, more private saving is released to fund private investment, although some crowding out of private investment does persist in the long run.

The short-run and long-run effects for all three steps of the permanence proposals under the base case parameters are shown in Table 3 for the two financing assumptions. The results from lowering the dividends and capital gains rates are shown in column (1). Substitution effects dominate when capital gains and dividends rates fall in 2011, and private savings and investment increase in both the short run and long run. The capital stock increases by an average of 0.2 percent from 2011-2016 compared to the baseline and GNP increases by 0.1 percent.[21] The increase in output is helped by a more efficient allocation of capital that comes from reducing the double taxation of corporate investment. In the long run, the capital stock increases by 1.2 percent, and output increases by 0.4 percent, with a small decline in labor supply of 0.1 percent.

When reductions to the top four ordinary income tax rates are extended as well, crowding out during the budget window is more pronounced and the average increase in the capital stock is just 0.1 percent for the years 2011 through 2016. Domestically funded investment actually declines during this period, but capital inflows from abroad lead to an overall increase in the

[20] The reduction in the wage tax rate leads to a shifting from leisure towards labor within a period, while the reduction in the effective capital tax rate leads households to shift leisure and consumption into the future.
[21] Real gross national product (GNP) is used as the measure of national output. Investment in the domestic economy financed by foreigners would lead to an increase in gross domestic product (GDP), but some of this increase must be returned to the foreign owners of the capital. GNP, which nets out the return to foreign-owned capital more accurately reflects the resources available to U.S. citizens.

capital stock.[22] Column (2) of Table 3 also indicates that labor supply increases by 0.7 percent on average from 2011-16 leading to an increase in output of 0.7 percent during the same time period. Domestically funded private investment increases after the budget window as the government debt ratio is stabilized over time by reducing government spending, and in the long run the capital stock increases by 2.3 percent, labor supply increases by 0.2 percent, and output increases by 1.1 percent.[23]

In contrast, column (3) shows that when adding the remaining tax relief that increases the deficit with only a small variation in marginal tax rates, then financing government debt more than offsets for the increase in private savings and capital inflows from abroad so that the capital stock declines on average by 0.3 percent from 2011-2016 compared to the initial steady-state, and GNP is only 0.5 percent larger (due to the increase in labor supply of 0.5 percent). Once government spending is reduced to stabilize the government debt ratio, private investment increases so that in the long-run, the capital stock increases by 2.3 percent and output increases by 0.7 percent.

Extending the increase in the child tax credit, the 10-percent marginal tax bracket, and the reduction in marriage tax penalties primarily increase individual after-tax income, but result in very little change in marginal tax rates. Households respond to this rise in income by increasing their consumption of goods and services. Households also consume more leisure, which leads to a long-run decline in labor supply of 0.3 percent through the income effect.[24] This decline in labor supply is the primary reason why the long-run increase in GNP is smaller than in the previous simulation. To a lesser extent, the greater crowding out of private investment that results from a higher government debt burden also contributes to this relative decline, as indicated by the decline in domestically financed investment from 2.6 to 2.3 percent. The overall capital stock shows no change between the two simulations due to an offsetting increase in foreign capital flows.

Tax Relief Financed with Future Increase in Taxes

Under this financing assumption, all average and marginal tax rates on labor and capital income are changed by the same proportion in each year after the 10-year budget window in order to maintain the baseline amount of government services and to maintain the government debt-to-GNP ratio at the value it takes at the end of the budget window. In effect, the tax relief is modeled as temporary, as it is more than reversed in the future by across-the-board, proportional tax increases.

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[22] The rows labeled "Investment" in Table 3 and Table 4 reflect domestically funded gross investment, while the rows labeled "Capital Stock" in Table 3 and Table 4 represent changes in the domestic capital stock regardless of whether the new investment is funded by domestic savings or foreigners.

[23] The long-run change in labor supply for the simulations in this section is small as the substitution effect resulting from higher after-tax wages is offset by an income effect from the household's increase in lifetime wealth due to the decline in tax payments.

[24] As indicated in Table 1, the decline in the average marginal tax rate on labor income is also slightly smaller under the full extension of the tax cuts, compared to when just the top four ordinary rates are decreased. This also contributes to the relative decline in labor supply through the substitution effect.

Again, much of the results can be explained in terms of income and substitution effects. But in this case, as tax rates increase after the budget window, the substitution and income effects discussed above work in opposite directions. Households are forward looking and many of the transitional generations make choices that are influenced by both the tax decreases and the following tax increases. This implies that income effects are less important determinants of behavior during the budget window, and households respond by supplying more labor and savings during this period relative to the simulations discussed above in which future government consumption decreases.

The second set of results reported under column (1) in Table 3 shows the effects of financing the lower dividends and capital gains tax rates with future increases in all income taxes. On net, in the long run this combination of tax relief and tax increases reduces the burden of taxation on corporate investment in favor of greater taxation of labor income and, to a lesser extent, capital income in other sectors. This implies some increase in output resulting from a more efficient allocation of capital across production sectors. These gains are offset to a certain extent in the long run by the crowding out of investment due to a higher government debt ratio and the higher tax rates needed to pay for higher interest payments on the government debt. In the long run, the capital stock increases by 0.7 percent and GNP increases by 0.3 percent (compared to increases of 1.2 percent and 0.4 percent, respectively, when government consumption declines).

The results in column (2) show a similar pattern. Over the budget window, households work more and save more compared to the same tax relief with a government spending offset. Labor supply increases on average by 0.9 percent during 2011-16, rather than 0.7 percent; the capital stock increases by 0.6 percent, rather than 0.1 percent; and GNP increases by 0.9 percent, rather than 0.7 percent. In the long run, the increase in tax rates needed to stabilize the government debt ratio leads to no change in labor supply compared to an increase of 0.2 percent when government spending declines, and the capital stock increases by 0.3 percent compared to 2.3 percent when government spending declines. GNP increases in the long-run by only 0.3 percent, compared to the 1.1 percent increase described above.

Extending all of the tax relief and then financing with an increase in taxes after the budget window leads to short-run effects that are again slightly larger than if a reduction in government consumption is used to finance the revenue cost of the tax decrease. The capital stock increases by 0.6 percent during 2011-16 and GNP increases by 0.8 percent. However, in the long run, the combined effects of increasing marginal tax rates and crowding out lead to a decline in labor supply (0.8 percent), capital (1.8 percent) and GNP (0.9 percent).

Sensitivity Analysis

This section reports the macroeconomic results of the same tax changes and financing assumptions described above with different values for certain parameters that represent "low" and "high" levels of responsiveness.

Lowering the intertemporal elasticity of substitution reduces the degree to which households are willing to substitute consumption and leisure across time, which leads to a lower savings supply response to a decrease in capital taxes. If only dividends and capital gains tax rates are lowered

and financed by future reductions in government spending, the capital stock increases by 0.9 percent in the long-run using the lower parameter values, compared to a 1.2 percent increase using the base case parameters. In the long run, if lower tax rates on dividends and capital gains are extended and financed by reductions in future government spending, GNP increases by 0.3 percent using low parameter values, and by 0.5 percent using the high parameter values.

The choice of parameter values has little influence on the long-run increase in GNP when using future income tax increases to finance extensions of the lower rates on dividends and capital gains. For the low parameter values, GNP increases by 0.2 percent in the long run and for the high parameter values, GNP increases by 0.3 percent, as seen in column (1) of Table 4. The small difference is primarily the result of the parameters having offsetting effects. Lowering the intertemporal elasticity of substitution lowers the savings response, but lowering the intratemporal elasticity of substitution and the initial leisure share of the time endowment dampens the labor supply response and labor supply does not decline as much when future tax rates are increased.

The choice of parameter values has a greater influence when extensions of the lower ordinary tax rates for the top four individual brackets are added to the lower tax rates on dividends and capital gains. The long-run increase in GNP when the tax relief is financed by reducing future government spending ranges from 0.4 percent using the low responsiveness parameters to 1.6 percent using the high responsiveness parameters. When the tax relief is financed by increases in future tax rates, then GNP in the long-run falls by 0.1 percent under the low response parameters and increases by 0.6 percent under the high response parameters.

Similarly, when all of the tax relief is extended and financed by the reduction in future government spending, then long-run GNP increases by only 0.1 percent in the low response case and by 1.2 percent in the high response case. However, when using future income tax increases to pay for the tax relief, then, in both the low response and the high response case, GNP falls by 0.9 percent in the long run. Again, this is the result of lower behavioral response parameters working in offsetting ways when income taxes are raised. Lower intertemporal and intratemporal elasticity of substitutions imply a smaller labor supply response during the budget window and a higher debt-to-GNP ratio at the end of the window which results in larger crowding out effects. This leads to a large decrease in the capital stock (3.6 percent) in the long run. However, the lower labor supply response results in a reduction in labor supply of only 0.4 percent in the long run as future income taxes are increased. In contrast, under the higher response parameter values, the capital stock falls by only 1.3 percent, but labor supply falls by 1.1 percent as labor supply is more sensitive to the long-run increase in marginal tax rates on labor.

6. Conclusion

The analysis presented in the paper suggests that permanently extending the President's tax relief enacted in 2001 and 2003 likely would lead to a long-run increase in the capital stock and an increase in national output in both the short run and the long run. If the revenue cost of that tax relief is offset by reducing future government spending, the increase in output is likely be about 0.7 percent under plausible assumptions. If, instead, the tax relief is extended only through the

end of the budget window (i.e., it is temporary), the tax relief would increase national output in the short run, but long-run output would decline as future tax rates increase.

The analysis also suggests that if only the portions of the President's tax relief that primarily reduce marginal tax rates are extended (i.e., the lower rates on dividends, capital gains and the top four ordinary income brackets), it is likely that output would increase regardless of whether the revenue cost of the relief is financed through a future reduction in government spending or a future increase in tax rates, although the increase would be considerably larger if government consumption is reduced.

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Table 1

Average Percentage Change in Average Marginal Tax Rates by Income Source Compared to Current Law for Years 2011-2016

	(1) Lower Dividends and Capital Gains Tax Rates	(2) (1) Plus Lower Top 4 Ordinary Rates	(3) (2) Plus Remaining Tax Cut Extensions
Wages	0.0%	-5.6%	-5.1%
Dividends	-52.8%	-52.9%	-54.1%
Capital Gains	-21.0%	-23.3%	-23.7%
Interest	0.0%	-7.1%	-8.2%
Business Income*	0.0%	-11.4%	-12.1%

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* Includes income from IRS Form 1040 Schedules C, E and F

Table 2

Model Parameters

	Baseline	Low	High
Intertemporal substitution elasticity	0.35	0.20	0.50
Intratemporal substitution elasticity (between leisure and goods)	0.80	0.50	1.00
Leisure share of time endowment	0.40	0.30	0.50
Rate of time preference*	0.001	-0.055	0.024
Elasticity of substitution between housing and non-housing good	1.00	0.50	1.50
International capital flow elasticity	0.20	0.20	0.20
Population growth rate	0.01	0.01	0.01
Technological growth rate	0.01	0.01	0.01
Adjustment cost parameter	5.00	5.00	5.00
Capital income share	0.34	0.34	0.34
Capital/output ratio	2.29	2.29	2.29

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*The rate of time preference was adjusted to maintain the initial capital-output ratio

Table 3

Macroeconomic Effects of Extending The 2001 and 2003 Tax Cuts with Base Case Parameter Values: Percentage Change from Initial Steady-State Values

	(1) Lower Dividends and Capital Gains Tax Rates		(2) (1) Plus Lower Top 4 Ordinary Rates		(3) (2) Plus Remaining Tax Cut Extensions	
	2011-2016	Long-run	2011-2016	Long-run	2011-2016	Long-run
Base Simulation*						
Financed by Decreasing Future Government Consumption						
Real GNP	0.1%	0.4%	0.7%	1.1%	0.5%	0.7%
Capital Stock	0.2%	1.2%	0.1%	2.3%	-0.3%	2.3%
Labor Supply	0.0%	-0.1%	0.7%	0.2%	0.5%	-0.3%
Consumption	0.1%	0.6%	1.1%	2.5%	1.3%	3.5%
Investment	0.5%	1.6%	-0.5%	2.6%	-3.0%	2.3%
Financed by Increasing Future Income Taxes						
Real GNP	0.2%	0.3%	0.9%	0.3%	0.8%	-0.9%
Capital Stock	0.3%	0.7%	0.6%	0.3%	0.6%	-1.8%
Labor Supply	0.1%	-0.1%	0.9%	0.0%	0.7%	-0.8%
Consumption	0.0%	0.1%	0.7%	0.4%	0.5%	-0.7%
Investment	1.1%	1.1%	2.1%	0.5%	1.8%	-2.0%

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* Assumes the U.S. is a large open economy with a simple representation of limited international capital flows

Table 4

Macroeconomic Effects of Extending The 2001 and 2003 Tax Cuts with Low and High Degree of Responsiveness: Percentage Change from Initial Steady-State Values*

	(1) Lower Dividends and Capital Gains Tax Rates		(2) (1) Plus Lower Top 4 Ordinary Rates		(3) (2) Plus Remaining Tax Cut Extensions	
	2011-2016	Long-run	2011-2016	Long-run	2011-2016	Long-run
Low Responsiveness						
Financed by Decreasing Future Government Consumption						
Real GNP	0.1%	0.3%	0.3%	0.4%	0.1%	0.1%
Capital Stock	0.0%	0.9%	-0.4%	0.8%	-1.1%	0.6%
Labor Supply	0.0%	-0.1%	0.1%	-0.3%	-0.1%	-0.7%
Consumption	0.3%	0.7%	1.5%	2.9%	1.9%	4.0%
Investment	-0.3%	1.1%	-4.4%	0.2%	-7.8%	-0.5%
Financed by Increasing Future Income Taxes						
Real GNP	0.1%	0.2%	0.5%	-0.1%	0.4%	-0.9%
Capital Stock	0.2%	0.4%	0.3%	-1.6%	0.3%	-3.6%
Labor Supply	0.0%	-0.1%	0.4%	-0.1%	0.2%	-0.4%
Consumption	0.0%	0.2%	0.6%	0.5%	0.5%	0.0%
Investment	0.7%	0.6%	0.4%	-2.4%	0.0%	-5.3%
High Responsiveness						
Financed by Decreasing Future Government Consumption						
Real GNP	0.2%	0.5%	1.1%	1.6%	0.9%	1.2%
Capital Stock	0.2%	1.3%	0.5%	3.1%	0.2%	3.1%
Labor Supply	0.1%	0.0%	1.3%	0.7%	1.1%	0.1%
Consumption	0.0%	0.6%	1.2%	2.7%	1.3%	3.4%
Investment	1.0%	1.8%	1.4%	3.6%	-0.2%	3.4%
Financed by Increasing Future Income Taxes						
Real GNP	0.2%	0.3%	1.3%	0.6%	1.1%	-0.9%
Capital Stock	0.3%	0.8%	0.8%	0.9%	0.8%	-1.3%
Labor Supply	0.1%	-0.1%	1.4%	0.2%	1.1%	-1.1%
Consumption	0.0%	0.1%	0.9%	0.5%	0.7%	-1.1%
Investment	1.3%	1.3%	3.1%	1.4%	2.9%	-1.1%

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* Assumes the U.S. is a large open economy with a simple representation of limited international capital flows

Appendix: Description of the Tax Policy Advisers OLG Model

The model has four production sectors – owner-occupied housing, rental housing, non-corporate non-housing goods and services, and a corporate non-housing goods and services sector. The time path of investment demands in all three sectors is modeled explicitly, taking into account capital stock adjustment costs. On the consumption side, the current tax advantage of owner-occupied housing relative to other assets is taken into account in modeling the demands for the four goods. This section outlines the basic structure of the model, which combines various features from similar and well-known models constructed by Auerbach and Kotlikoff (1987), Goulder and Summers (1989), Goulder (1989), Keuschnigg (1990) and Fullerton and Rogers (1993), with the time path of investment in each production sector calculated to maximize firm value in the presence of convex (quadratic) adjustment costs, following Hayashi (1982). The full details of the model are provided in Diamond and Zodrow (2005).

The Corporate and Non-Corporate Non-Housing Production Sector

In each period s, firms in the corporate and non-corporate production sectors produce output (X_s), which includes all non-housing goods and services, using capital K_s^X and labor L_s^X using a CES production function with an elasticity of substitution in production σ_X and a capital share parameter a_X. Firms are assumed to choose the time path of investment to maximize the present value of firm profits or, equivalently, maximize firm value V_X, net of all taxes. Total taxes in the corporate and non-corporate production sectors in period s, are

$$T_s^X = \tau_{bs}^X \left[p_s^X X_s - w_s L_s^X - f_{FT} I_s^X - \Phi_s^X I_s^X - f_{IT} i_s B_s^X - f_{IT} \delta_\tau^X K_{\tau s}^X \right] + (1 - \tau_{bs}^X) \tau_{ps}^X K_s^X ,$$

where τ_{bs}^X is the tax rate on business income in sector X, p_s^X is the price of the good in sector X, w_s is the wage rate, I_s^X is gross investment, Φ_s^X are (deductible) adjustment costs per unit of investment, i_s is the before-tax interest rate, B_s^X is total indebtedness, $\delta_{\tau s}^X$ is depreciation for tax purposes, $K_{\tau s}^X$ is the remaining tax basis of the capital stock, τ_{ps}^X is the property tax rate in sector X, with property taxes assumed to be fully deductible against the business income tax, and f_{IT} (f_{FT}) is one under the income tax (consumption tax) and zero otherwise.[25] Following Goulder and Summers (1989) and Cummins, Hassett and Hubbard (1994), the adjustment cost function per unit of investment is assumed to be a quadratic function of gross investment per unit of capital

$$\Phi_s \left(\frac{I_s^X}{K_s^X} \right) = \frac{p_s^X (\beta^X / 2)(I_s^X / K_s^X - \mu^X)^2}{I_s^X / K_s^X}$$

[25] That is, depreciation and interest expense are deductible under an income tax, while expensing is allowed under a consumption tax with no interest deductions. The property tax on businesses is treated as a tax on capital rather than a benefit tax (Muthitacharoen and Zodrow, forthcoming).

where β^X is the parameter that determines the level of adjustment costs and μ^X is set so that adjustment costs are zero in the steady state.

Assuming firms do not make any financial investments, total net cash receipts, including net new bonds issued, BN_s^X, and net new shares issued (new equity investment in the non-corporate sector) VN_s^X, must either be used to finance new investments (including adjustment costs) or distributed to shareholders

$$[p_s^X X_s - w_s L_s^X - i_s B_s^X] - T_s^X + BN_s^X + VN_s^X = I_s^X \left(1 + \Phi_s^X\right) + DIV_s^X,$$

where DIV_s^X is the dividend payout in sector X. Each firm is assumed to maintain a fixed debt/asset ratio b^X and pay out a constant fraction of earnings after taxes and depreciation (the non-corporate firm distributes all net income) in each period. This implies that new investments in the corporate sector are financed with debt and new share issues if retained earnings do not supply enough equity to finance the desired level of investment. New investments in the non-corporate sector are financed with debt and new equity investments since there are no retained earnings in this sector.

The model assumes individual level arbitrage, which implies that the after-tax return to bonds must equal the after-tax return received by the owners of the firm, or

$$\left(1 - \tau_{bs}^X\right) i_s = \frac{\left(1 - \tau_{ds}\right) DIV_s^X + \left(1 - \tau_{gs}\right)\left(V_{s+1}^X - V_s^X - VN_s^X\right)}{V_s^X},$$

where τ_{is} is the average marginal personal income tax rate on interest income, τ_{ds} is the average marginal tax rate on dividends, τ_{gs} is the average effective annual accrual tax rate on capital gains $\left(V_{s+1}^X - V_s^X - VN_s^X\right)$. Solving this expression for V_s^X, subject to the transversality condition requiring a finite value of the firm, yields

$$V_s^X = \sum_{u=s}^{\infty} \frac{\left[\left(1 - \tau_{du}\right)/\left(1 - \tau_{gu}\right)\right] DIV_u^X - VN_u^X}{\prod_{v=s}^{u} \left[1 + (1 - \tau_{iu}) i_u / (1 - \tau_{gu})\right]},$$

That is, the value of the firm in the composite good sector equals the present value of all future net distributions to the owners of the firm. The time path of investment that maximizes this expression in the presence of adjustment costs is

$$\frac{I_s^X}{K_s^X} = \frac{q_{s+1}^X - 1 + b^X + f_{FT} \Omega_s^X \tau_{bs} + f_{IT} Z_{s+1}^X}{\mathrm{p}_s \beta^X \left(1 - \tau_{bs} \Omega_s^X\right)},$$

where q_{s+1}^X is shadow price of additional capital (commonly referred to as 'marginal q' which equals the ratio of the market value of a marginal unit of capital to its replacement cost), Ω_s^X is a weighted average of the dividend and capital gains tax rates divided by one minus the capital gains tax rate, and Z_{s+1}^X is the tax savings from accelerated depreciation allowances on future investments.

The relationship between 'marginal q' and 'average q' (denoted as Q_s^X) is

$$q_s^X = \frac{V_s^X - X_s^X}{K_s^X} = Q_s^X - \frac{X_s^X}{K_s^X}$$

where X_s^X is the value of future depreciation deductions on the existing stock of capital used in the production of thee good in sector X.

The Owner-Occupied and Rental Housing Production Sectors

Housing is produced in the owner-occupied and rental housing production sectors where, following Goulder and Summers (1989) and Goulder (1989), rental housing is produced by non-corporate landlords and owner-occupied housing is produced by the owners. The technology used in the production of rental housing (R_s) and owner-occupied housing (O_s) is assumed to be identical – capital and labor combined in a CES production function with an elasticity of substitution in production of σ_H and a capital share parameter of a_H .[26] Landlords and owner-occupiers are also are assumed to choose time paths of investment to maximize the equivalent of firm value, net of total taxes.

In the case of the rental housing sector, the firm is modeled as a non-corporate firm. This implies that landlords are taxed at the individual level, so total taxes paid are

$$T_s^R = \tau_{hs}^R \left[p_s^R R_s - w_s L_s^R - f_{FT} I_s^R - \Phi_s^R I_s^R - f_{IT} i_s B_s^R - mK_s^R - f_{IT} \delta_\tau^R K_{\tau s}^R \right] + (1 - \tau_{hs}^R) \tau_{ps}^R K_s^R ,$$

where τ_{hs}^R is the average marginal tax rate applied to rental housing income,[27] m is annual maintenance expenditures per unit of rental housing capital, and the definitions of all other variables are analogous to those in the composite good production sector. Solving the cash flow equation in the rental housing sector for after-tax rents received by landlords S_s^R yields

[26] Thus, the producer prices of rental and owner-occupied housing services are identical. However, rental and owner-occupied housing services are not perfect substitutes, so that the mix of rental and owner-occupied housing services changes along the transition path to a new equilibrium.
[27] The tax rate on rental housing income is a weighted average of the non-corporate tax rate on landlord profits and the corporate tax rate. The weight is determined by the share of rental housing produced in the corporate sector, which is equal to 10 percent.

$$S_s^R = p_s^R F_s^R(\cdot) - w_s L_s^R - i_s B_s^R - mK_s^R - T_s^R + BN_s^R + E_s^R - I_s^R(1+\Phi_s^R),$$

where E_s^R is net new equity invested by landlords in the rental housing sector. Individual arbitrage in this case implies

$$(1-\tau_{is})i_s = \frac{S_s^R + (1-\tau_{gs})(V_{s+1}^R - V_s^R - E_s^R)}{V_s^R}$$

which can be solved for the value of the rental housing firm

$$V_s^R = \sum_{u=s}^{\infty} \frac{[1/(1-\tau_{gu})]S_s^R - E_s^R}{\prod_{v=s}^{u}[1+(1-\tau_{iu})i_s/(1-\tau_{gu})]}.$$

The time path of investment that maximizes this expression in the presence of adjustment costs is

$$\frac{I_s^R}{K_s^R} = \frac{q_{s+1}^R - \Omega_s^R + b^R\Omega_s^R + f_{FT}\Omega_s^R\tau_{bs}^R + f_{IT}Z_{s+1}^R}{\mathrm{p}_s\Omega_s^R\beta^R(1-\tau_{bs}^R)}.$$

The expression for relationship between 'marginal q' and 'average q' in the rental housing sector is analogous to that in the composite good sector.

By comparison, in the owner-occupied housing sector, since imputed rents are untaxed and maintenance expenditures are not deductible while mortgage interest and property taxes are deductible, total taxes are

$$T_s^O = -z_s\tau_{is}i_s B_s^O + (1-z_s\tau_{is})\tau_{ps}^O K_s^O,$$

where z_s is the fraction of individuals who are itemizers. The flow of (untaxed) imputed rents to owner-occupiers is

$$S_s^O = p_s^O F_s^O - w_s L_s^O - i_s B_s^O - T_s^O - mK_s^O + BN_s^O + E_s^O - I_s^O(1+\Phi_s^O)$$

The expressions for individual level arbitrage and firm value are analogous to those in the rental housing sector, and investment in the owner-occupied sector is

$$\frac{I_s^O}{K_s^O} = \frac{q_{s+1}^O - \Omega_s^O + b^O\Omega_s^O}{\mathrm{p}_s\Omega_s^O\beta^O}.$$

The expression for relationship between 'marginal q' and 'average q' in the owner-occupied housing sector is analogous to that in the composite good sector.

Individual Behavior

On the individual side, the model has a dynamic overlapping generations framework with fifty-five generations alive at each point in time. There is a representative individual for each generation, who has an economic life span (which begins upon entry into the work force) of fifty-five years, with the first forty-five of those years spent working, and the last ten spent in retirement. Individual tastes are identical so that differences in behavior across generations are due solely to differences in lifetime budget constraints. An individual accumulates assets from the time of "economic birth" that are used to finance both consumption over the life cycle, especially during the retirement period, and the making of bequests. The model follows Fullerton and Rogers (1993) in including a relatively primitive "target model" of bequests, with the real values of bequests assumed to be fixed and thus unaffected by changes in economic conditions, including changes in income.

At any point in time s, the consumer maximizes rest-of-life utility LU_s subject to a lifetime budget constraint that requires the present value of lifetime wealth including inheritances to equal the present value of lifetime consumption including bequests. In particular, an individual of age a at time $s = t$ chooses the time path of consumption of an aggregate consumption good and leisure in each period s to maximize rest-of-life utility

$$LU_s = \frac{\sigma}{\sigma - 1} \sum_{s=t}^{t+54-a} \frac{U_s(a)^{\left(1-\frac{1}{\sigma}\right)}}{(1+\rho)^{s-t}},$$

where σ is the intertemporal elasticity of substitution, ρ is the pure rate of time preference, and $U_s(a)$ is assumed to be a CES function of consumption of the aggregate consumption good and leisure in period s with an intratemporal elasticity of ε and a leisure share parameter of a_E. The aggregate consumption good is modeled as a CES function of the composite good and aggregate housing services (including a minimum purchase requirement for both goods), with aggregate housing services in turn modeled as CES function of owner-occupied and rental housing services. In addition, as described in detail in Diamond and Zodrow (2005), the model includes a simple social security system, government purchases of the composite good, transfer payments, a hump-backed wage profile over the life cycle, a progressive tax on wage income, and constant average marginal tax rates applied to interest income, dividends, and capital gains. The progressive labor tax uses a quadratic approximation to average and marginal tax rates similar to the method used by Auerbach and Kotlikoff (1987).

International capital flows

Although the focus of the model is on the U.S. domestic economy, it includes a simple representation of international capital flows, which are assumed to respond to differences in after-tax rates of return in the US and the "rest of the world." This approach represents a compromise between the standard closed economy approach and the alternative of a completely open economy in which international capital is perfectly mobile and the international return to

capital is fixed. Following Goulder, Shoven and Whalley (1983), capital imports (or exports) in period s are governed by the constant elasticity expression

$$\frac{K^W - K_s^F}{K^W} = \left(\frac{r_s^{US}}{r^W}\right)^{\varepsilon K},$$

where K^W is the fixed rest-of-the-world capital stock,[28] r^W is the fixed rest-of-the-world return to capital, r_s^{US} is the return after taxes to capital in the US (given the fixed debt-asset ratio of b), K_s^F is foreign exports of capital to the US in period s, and εK is a constant (positive) elasticity that determines the extent of international capital flows in the model. Thus, foreign exports of capital to the US are

$$K_s^F = K^W\left[1 - \left(\frac{r^W}{r_s^{US}}\right)^{\varepsilon K}\right].$$

For example, if $r_s^{US} > r^W$ as a result of the reform, then the US has positive capital imports in period s $(K_s^F > 0)$.

Capital imports are treated as perfect substitutes for domestic capital. Given the level of capital imports in each period, the model is closed simply by assuming that the returns, after US taxes, to foreign capital are included in the aggregate demand for the corporate good and non-corporate goods, in fixed proportions equal to the rate of these two goods in the initial equilibrium. This approach effectively implies that the US is renting capital services from abroad in each period, with foreign capital owners spending an amount equal to their after-tax rents on the two US composite goods so that aggregate demand for the goods equal aggregate supplies for those goods. There is no additional international trade in goods or services in the current version of the model.

Market Equilibrium

All markets are assumed to be perfectly competitive. Market equilibrium in the model requires that total consumer demand, obtained by aggregating the demands of each of the 55 generations alive at any point in time, must equal aggregate supply in each of the four production sectors. In addition, factor demands must equal factor supplies in the labor and capital markets, the total amounts of debt and equity held as individual wealth must equal firm stocks of debt and equity, the government is allowed to finance government spending with tax revenues and government bonds as long as the debt to GNP ratio is constant in the long run, and both individual and firm expectations regarding the time paths of future prices must be satisfied in equilibrium.

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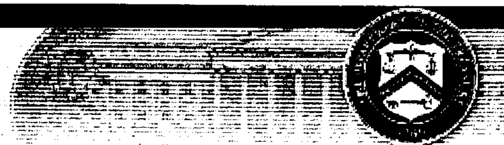
[28] Note that K^W is fixed within a period, but must increase between each period at a rate equal to the growth rate of the US economy so that a long run equilibrium can be attained.

PRESS ROOM



July 25, 2006
HP-26

Treasury, HUD Hold Conference to Advance Homeownership

U.S. Treasury Deputy Assistant Secretary for Financial Education Dan Iannicola, Jr. will give remarks on increasing homeownership tomorrow at a roundtable discussion hosted by the Department of Housing and Urban Development. This is the first of a series of meetings highlighting successful partnerships which encourage financial education to advance homeownership, as described in the Financial Literacy and Education Commission's national strategy.

The Treasury Department and twenty other agencies and departments in the Financial Literacy and Education Commission released a strategy to improve financial literacy in America earlier this year. The plan, titled Taking Ownership of the Future: The National Strategy for Financial Literacy, is available in English and Spanish at MyMoney.gov.

Who
Deputy Assistant Secretary for Financial Education
Dan Iannicola, Jr.

What
Remarks on the Financial Literacy and Education Commission's Role in Advancing Homeownership

When
Wednesday, July 26, 10:00 a.m. (EDT)

Where
U.S. Department of Housing and Urban Development
Departmental Conference Room
451 Seventh Street, SW
Washington, DC

PRESS ROOM

July 25, 2006
2006-7-25-17-32-56-8655

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $67,451 million as of the end of that week, compared to $67,330 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	July 14, 2006			July 21, 2006		
TOTAL	67,330			67,451		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	11,827	10,890	22,717	11,877	10,894	22,771
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,766	5,315	17,081	11,813	5,316	17,129
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			7,891			7,900
3. Special Drawing Rights (SDRs) [2]			8,601			8,611
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	July 14, 2006			July 21, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						
2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets						
	July 14, 2006			July 21, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL

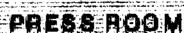
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.



July 26, 2006
HP-27

Treasury Secretary Paulson to Deliver First Speech in NYC

Washington, D.C. --Treasury Secretary Henry M. Paulson will deliver his first speech as Secretary in New York next week, on Tuesday, August 1, at the Columbia Business School. The speech will focus on the outlook and challenges for the U.S. and global economies.

While in New York, the Secretary will also visit the New York Stock Exchange and NASDAQ's Stock Market. He'll meet with business leaders at both stops to discuss current economic conditions.

What
NYSE Floor Tour
When
Tuesday, August 1, 10 a.m. (EDT)
Where
11 Wall Street, New York, NY
Contact
Allison Circle, 212-656-5717 or 646-938-6533, acircle@nyse.com

What
Remarks at the Columbia Business School
When
Tuesday, August 1, 11:30 a.m. (EDT)
Where
116th and Broadway, New York, NY(Building and room number TBA.)
Contact
Jane Trombley or Keshia Mark at (212) 854-2747
Note
Space is limited - media should RSVP by July 28.

What
NASDAQ Closing Bell Ceremony
When
Tuesday, August 1, 4 p.m. (EDT)
Where
43rd Street and Broadway, Times Square, New York, NY
Contact
Silvia Davi, 646-441-5014, silvia.davi@nasdaq.com
Note
Media should RSVP.

July 27, 2006
HP-28

**US Treasurer to Visit
TX Mexican-American Chambers of Commerce**

U.S. Treasurer Anna Escobedo Cabral will speak before the Texas Association of Mexican-American Chambers of Commerce on Friday at the organization's 31st annual Convention and Business Expo in El Paso, Texas. The Treasurer will discuss issues facing the Hispanic community including economic growth, financial education and immigration reform.

Who
U.S. Treasurer Anna Escobedo Cabral

What
Remarks on the Economy, Financial Literacy and Immigration Reform

When
Friday, July 28 12:00 p.m. (CDT)

Where
101 South El Paso Street
El Paso, TX

July 27, 2006
HP-29

Remarks by Robert Carroll,
Deputy Assistant Secretary for Tax Analysis
U.S. Department of the Treasury
Before the National Economists Club

Thank you for the opportunity to discuss with you the Treasury Department's efforts on dynamic analysis.

Before I begin, let me first acknowledge several individuals who have contributed to the work on dynamic analysis at the Treasury Department. Two individuals within the Office of Tax Analysis have contributed significantly to this effort. Jay Mackie has made contributions over many years and Craig Johnson has been at the heart of this work over the past year. We have also benefited enormously from a collaborative effort with John Diamond and George Zodrow, both with Rice University and affiliated with the James Baker III Institute on Public Policy. Many will remember John from his time with the Joint Committee on Taxation. This work could not have proceeded without the significant contributions of all of these individuals.

Earlier this week the Treasury Department released a report that details its dynamic analysis of permanent extension of the President's tax relief. This analysis was summarized in a box included in the Administration's Mid-Session Review released earlier this month.

This report represents a continuation of our work on dynamic analysis. As you may know, the Treasury Department also released a report on May 25th that summarized the dynamic analysis of the tax reform options prepared on behalf of the President's Advisory Panel on Federal Tax Reform last fall.

In many presentations on dynamic modeling, the presenter provides a detailed description of the model, focusing on the specific characteristics or embellishments that differentiate the model from previous work. For this audience, I think a more productive approach is to provide you with a brief overview of our approach, then focus on the key results - the main lessons, if you will - from our analysis, and then discuss what our next steps are at Treasury.

Modeling Approach

Back in February when describing our initiative to create a new dynamic analysis division at Treasury, we indicated that dynamic analysis would have the benefit of focusing attention on the broad economic effects of changes in tax policy. We also indicated that the effort would focus on the long-run effects of tax policy and acknowledged the results were dependent on financing and underlying assumptions. In this report, we have attempted to focus on these aspects of dynamic analysis.

It is also important to point out at the outset what our analysis does not do: It does not provide a dynamic score or estimates of the revenue feedback associated with the President's tax relief. This would involve translating the estimated changes in output into the associated change in revenues. We envision that dynamic analysis at the Treasury Department may ultimately evolve in that direction, just as it has to varying degrees at the Joint Committee on Taxation and the Congressional Budget Office, but we are still very much at the beginning of this effort.

The model we used is a conventional neoclassical growth model with overlapping generations of taxpayers - an OLG model. In this life-cycle model, tax policy affects the incentives to work, to save and invest, and to allocate capital among competing uses. It captures the intersectoral reallocation of capital that results from reducing the double tax on corporate profits, and the crowding out of private investment from financing the tax relief through issuing government debt. Representative consumers and firms incorporate future prices into their current period decisions of how much to save, work, and produce. Output is generated by four production sectors, and individual level decisions of representative consumers determine the aggregate level of labor supply and savings in each year. We included a simple representation of international capital flows. We also considered different assumptions for financing the tax cuts and considered how the results change with different values for underlying parameters.

While we used three different models to analyze the broad tax reform proposals put forward by the tax panel last fall, in the dynamic analysis of the President's tax relief we chose to use just one model, the overlapping generations model. This choice was made in large part because the version of the model we are working with is more detailed than the versions of the other models we used in the analysis conducted on behalf of the tax panel, and thus better suited for analyzing the specific features of the President's tax relief.

Five Lessons

The report provides five basic lessons:

1. Many claim that tax relief can increase economic growth, and this report supports this claim.

According to this analysis, the President's tax relief would increase real GNP by 0.7 percent in the long-run. In a $13 trillion economy, this amounts to an additional $90 billion, in today's dollars, each year, forever.

2. All tax changes are not created equal.

Some tax changes, such as the lower tax rates on capital gains and dividends, reduce the tax rates on capital, increasing the incentive to invest, and increasing incomes and living standards in the long run by making labor more productive.

Other tax changes, such as the lower tax rates on ordinary income, reduce tax rates on labor, which increase the after-tax reward to work, labor supply, and real GNP.

Yet other tax changes, such as the expanded child tax credit, marriage penalty relief and new 10 percent rate bracket, can provide other types of benefits. They may not encourage long-run growth by lowering tax rates on capital or labor, but they can provide important and timely stimulus to the economy in the near-term. This can be particularly important during a period of economic weakness, such as the U.S. economy faced several years ago. And, this is especially important when the monetary policy has already been used aggressively, as it was in 2001 and 2002.

Of course, tax changes can also be used to maintain or increase the progressivity of the income tax, and help families with their own economic challenges.

The Treasury analysis decomposed and separately considered the effects of three different portions of the President's proposal to permanently extend the tax relief:

1. Lower tax rates on dividends and capital gains;

2. Reduction in the top four ordinary tax rates; and

3. Expansion of the child tax credit, the marriage penalty relief, and the new 10 percent rate bracket.

The Treasury analysis finds that more than half of the 0.7 percent increase in long-run GNP is associated with the lower tax rates on dividends and capital gains, even though this policy change accounted for less than 20 percent of the static revenue loss. The increase in long-run GNP rises to 1.1 percent when the lower tax rates are added.

The rise in GNP is smaller when the remaining tax changes - the child tax credit, marriage penalty and new 10 percent rate bracket - are included. This result, at first glance, may seem counter-intuitive, but in this model these policies have - what economists call - income effects. Because these policies - the child tax credit, marriage penalty relief, and the new 10 percent tax rate - increase after-tax incomes, and have little effect on incentives, some taxpayers may respond by increasing their leisure and working less, which is the primary reason GNP is not as high in the long-run - 0.7 percent rather than 1.1 percent.

But again, in looking back at the 2001 and 2003 tax relief, it is crucial to remember that the broad policy objectives were two-fold: 1) to shore up and strengthen an economy that faced significant risks - a double dip recession, disinflation; and, 2) to promote long-run growth.

The package of policies accomplished those twin goals by accelerating the rate at which the economy returned to full capacity and, as this report suggests, promoting long-term growth.

3. In doing this work, it is very much our goal to be as transparent as possible in the underlying assumption and results. One key assumption in analyzing the long-run effects of the tax relief is how it is ultimately financed.

A key feature of the model used for this analysis is the recognition that the government faces what economists call an intertermporal budget constraint. This means that the present value of taxes is tied to the present value of government spending. In simpler terms, when taxes are reduced, other offsetting changes are needed.

In this report, we considered two financing options: 1) lower future government spending; and 2) higher future taxes. Under the first financing assumption - lower future government spending - we report the base results - an increase in long-run GNP of 0.7 percent. But under the alternative financing assumption - higher future taxes, long-run GNP would actually be lower by 0.9 percent.

What is the intuition behind this result? It is really quite simple. In a model where consumers are forward looking, higher future taxes discourage economic growth. But these results are suggestive of another basic point: Permanent extension of the tax relief, financed by spending restraint, will encourage economic growth. Alternatively, if the tax relief is, in effect, temporary and, in the aggregate, offset with higher future taxes, real long-term GNP can be expected to fall.

4. Also, in the interest of being as transparent as possible we also considered the sensitivity of the results to underlying assumption.

The parameters of the Treasury model are taken from the consensus of the professional literature, but they are not pinned down with certainty. The GNP estimate of 0.7 percent is the result from our base case simulation, but the report also shows that this estimate can range from 0.1 to 1.2 percent by changing the model's parameters within plausible ranges.

5. Finally, in contrasting the different policies, it is worth noting that the lower tax rates on dividends and capital gains increase GNP in the long-run, even when financed by higher future taxes. This policy change lowers some of the highest marginal tax rates that taxpayers face through the double tax on corporate profits.

The future tax increases under this financing assumption are broad-based and, essentially, marginal tax rates decline on average, which lowers the efficiency cost of raising tax revenue. Or, put slightly differently, the higher future tax revenue needed to finance the temporary tax relief actually results in an overall lower tax burden as compared to current law because the high taxes on corporate profits are, in effect, replaced with broad-based taxes.

Future Improvements

While we view this report as a significant step forward, future work will continue to improve and refine the modeling. There are many aspects of the economy that are not captured in this analysis. Like all economic models, this model employs important simplifying assumptions, and other economic models, which make different assumptions, could yield different results. The model used in this analysis departs from economic reality in a number of important ways.

First, this model does not account for short-term deviations in output from potential GNP. This implies that the model does not capture some of the short-run benefits of tax relief when the economy is below its potential, such as with the 2001 and 2003 tax relief. As discussed in the report, a different model was previously used by Treasury to analyze the demand-side or stimulative effects of the tax relief in the near term.

Second, the treatment of international capital flows is quite simple. A broader model would employ a more sophisticated representation of these flows and would also include international trade in goods. To the extent the economy is more open to international capital flows, the effects of crowding out associated with higher government debt could be dampened.

Third, this model assumes perfect certainty and perfect competition. Of course, we live in a world with uncertainty. Also, some models with imperfect competition find that capital income taxes have larger distortion effects because they are, in effect, layered on top of the preexisting distortion associated with imperfect competition.

Finally, the financing assumptions used in the simulations are conventional for this type of analysis and are not meant to be predictions of what policies might actually occur. Numerous other policy prescriptions could also occur. For example, if the tax relief is financed through reductions in government spending that occur sooner than assumed in the simulations in the Treasury analysis, government borrowing would be less, the crowding of private investment would be smaller, and the increase in long-run output would be larger.

Nevertheless, we think it is a very good start.

Next Steps

What are the next steps? As I mentioned above, the Treasury Department is working to expand its capability for dynamic analysis by standing up a new Division of Dynamic Analysis within the Office of Tax Analysis. The additional resources associated with creating this new division will help us enhance and expand our existing capabilities to address some of the limitations listed above. The additional resources are also important to conduct this analysis on a more systematic and regular basis for broad policy changes. This is of immediate relevance to the Department's current effort to evaluate different approaches for reforming the tax system.

Since this initiative was announced in early February, I have grown to better appreciate the different perspectives brought to this issue. There are some who have a long-standing interest in this subject, but who are very concerned that we at Treasury may not do this the right way. Then there are others who are concerned that dynamic analysis may politicize the work we do at Treasury. To be clear, we at Treasury are well aware of the sensitivities that arise in discussions of dynamic analysis and we take these concerns very seriously.

Again, being as transparent as possible is very important to this endeavor. It allows the professional and policy community to understand and evaluate key assumptions and results. So we need to continue to clearly divulge those assumptions and release enough information regarding the models and the results so that those outside of Treasury can understand and evaluate the work we are doing. Reports, such as the one released earlier this week, help provide this transparency.

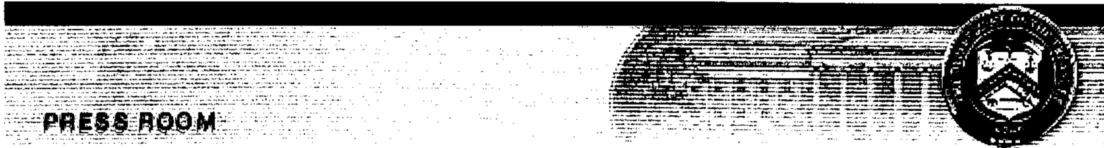
Sensitivity analysis is also critically important and will continue to be a central part of our work. As is clear from this report and the work in this area by CBO and the JCT, this type of analysis is sensitive to key assumptions, especially how a tax change is financed, so we need to continue to carefully consider those assumptions and report how the results vary with different sets of assumptions.

Continuing an open and continuing public dialogue on our work is also important. It would be clearly too much to expect that all will agree with every choice or assumption we have made. [The number of phone calls and emails I have gotten in the last day and a half can attest to this.] But the opportunity to discuss the work in forums like this and elsewhere is very helpful.

This work should be viewed very much as building on the continuing evolution of the manner in which we have integrated the behavioral aspects of taxation on economic decision making in all our work at Treasury. And, it should be remembered that we already exercise considerable judgment, and I would say good judgment, in the work we do on conventional revenue estimates and a variety of other analyses.

Finally, I think it is important to reflect that this type of analysis clearly places attention on the economic effects of tax policy, both in the long-run and over the transition path to this long-run. It helps frame the discourse on tax policy around these economic benefits, rather than the five or ten year budgetary effects of proposals. It also helps inform the discussion of tax policy by focusing attention on the key decisions that drive the results produced by this model. To what extent does a policy affect the incentives to invest or supply more labor, or work primarily through changes in the after-tax incomes of consumers? Over the longer-term, the success of dynamic analysis will largely be determined by how well it is communicated to the policy community, how open the process remains, and to what extent this type of analysis complements more conventional analysis of tax policy.

Again, I thank you very much for the opportunity to share some of these thoughts with you. I am happy to take your questions.



July 27, 2006
HP-30

Statement of Deputy Treasury Secretary Robert Kimmitt on International Compact for Iraq

I welcome the announcement today by the Iraqi government and U.N. on the International Compact for Iraq. We strongly support this important initiative, and look forward to working with Iraqi leadership, the United Nations and other members of the preparatory group to help Iraq realize its vision of a united, stable and prosperous nation underpinned by a self-sustaining economy. We endorse the priorities that have been identified to achieve these goals, and especially welcome the attention to good governance, the rule of law, a solid budgetary framework, the development of a transparent and efficient oil sector and strong, credible institutions.

At President Bush's request, I recently traveled to Europe, Iraq and the Gulf with State Department Counselor Philip Zelikow in order to discuss the Compact. In Baghdad, I had the opportunity to meet with the Prime Minister and other senior Iraqi officials. They are already undertaking the hard work necessary to bring this initiative to a successful conclusion by the end of this year. We look forward to reviewing their progress at the UN General Assembly and World Bank and IMF meetings in September.

PRESS ROOM

July 28, 2006
HP-31

Treasury Assistant Secretary Fratto to Hold Weekly Press Briefing

Treasury Assistant Secretary for Public Affairs Tony Fratto will hold the weekly media briefing on Monday, July 31 in Main Treasury's Media Room. The event is open to all credentialed media.

- **Who:** Assistant Secretary for Public Affairs Tony Fratto
- **What:** Weekly Briefing to the Press
- **When:** Monday, July 31, 11:15 AM (EDT)
- **Where:** Treasury Department
  Media Room (Room 4121)
  1500 Pennsylvania Ave., NW
  Washington, DC

Note: Media without Treasury press credentials should contact Frances Anderson at (202) 622-2960, or frances.anderson@do.treas.gov with the following information: name, Social Security number, and date of birth.

-30-

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July 28, 2006
HP-32

Treasury and IRS Issue Final Regulations on Employer HSA Contributions

Treasury and the IRS today issued final regulations concerning Health Savings Account (HSA) comparability rules. Comparability rules provide that an employer contributing to one employee's HSA must contribute comparable amounts to all employees who have HSAs.

The final regulations expand the flexibility of the proposed rules issued in August 2005. In particular, the final regulations include the following features:

- An exception from the comparability requirement for groups of collectively bargained employees;
- The ability to make different comparable contributions based on different variations of family coverage;
- Further clarification of the exclusion from the comparability requirement for employer contributions made through a cafeteria plan. Generally, under the final rules if employees are allowed to contribute to an HSA by salary reduction through a cafeteria plan, all employer contributions to the employee's HSA will be treated as being made through a cafeteria plan (and thus excluded from the comparability rules).

These provisions are designed to accommodate the needs of employers for additional flexibility in designing plans to provide health benefits for employees while preserving the protections of the comparability rules. HSAs and HSA-compatible health insurance have enabled many employers – especially smaller employers – to provide meaningful, affordable health coverage to their employees.

REPORTS

- Final Regulations -- Employer Comparable Contributions to Health Savings Accounts under Section 4980G

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 54

[TD ________]

RIN 1545-BE30

Employer Comparable Contributions to Health Savings Accounts under Section 4980G

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance regarding employer comparable contributions to Health Savings Accounts (HSAs) under section 4980G. In general, these final regulations affect employers that contribute to employees' HSAs.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability Date: These regulations apply to employer contributions to HSAs made on or after January 1, 2007.

FOR FURTHER INFORMATION CONTACT: Mireille T. Khoury (202) 622-6080 (not a toll-free number).

SUPPLEMENTARY INFORMATION

Background

This document contains final Pension Excise Tax Regulations (26 CFR part 54) under section 4980G of the Internal Revenue Code (Code). Under

section 4980G of the Code, an excise tax is imposed on an employer that fails to make comparable contributions to the HSAs of its employees.

Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Act), Public Law 108-173, (117 Stat. 2066, 2003) added section 223 to the Code to permit eligible individuals to establish HSAs for taxable years beginning after December 31, 2003. Section 4980G was also added to the Code by the Act. Section 4980G(a) imposes an excise tax on the failure of an employer to make comparable contributions to the HSAs of its employees for a calendar year. Section 4980G(b) provides that rules and requirements similar to section 4980E (the comparability rules for Archer Medical Savings Accounts (Archer MSAs)) apply for purposes of section 4980G. Section 4980E(b) imposes an excise tax equal to 35% of the aggregate amount contributed by the employer to the Archer MSAs of employees during the calendar year if an employer fails to make comparable contributions to the Archer MSAs of its employees in a calendar year. Therefore, if an employer fails to make comparable contributions to the HSAs of its employees during a calendar year, an excise tax equal to 35% of the aggregate amount contributed by the employer to the HSAs of its employees during that calendar year is imposed on the employer. See Sections 4980G(a) and (b) and 4980E(b). See also Notice 2004-2 (2004-2 IRB 269), Q & A-32. See §601.601(d)(2).

On August 26, 2005, proposed regulations (REG-138647-04) were published in the **Federal Register** (70 FR 50233). The proposed regulations clarified and expanded upon the guidance regarding the comparability rules

published in Notice 2004-2 and in Notice 2004-50 (2004-33 IRB 196), Q & A-46 through Q & A-54. See §601.601(d)(2) of this chapter. Written public comments on the proposed regulations were received and a public hearing was requested. The hearing was held on February 23, 2006. After consideration of all the comments, these final regulations adopt the provisions of the proposed regulations with certain modifications, the most significant of which are highlighted in this preamble.

Explanation of Provisions and Summary of Comments

Several commentators requested that the effective date should be at least one year from the date the regulations are finalized to give employers sufficient time to implement changes required to comply with the final regulations. The final regulations will apply to employer contributions to HSAs made on or after January 1, 2007.

An employer is not required to contribute to the HSAs of its employees. In general, however, if an employer makes contributions to any employee's HSA, the employer must make comparable contributions to the HSAs of all comparable participating employees. Comparable participating employees are eligible individuals (as defined in section 223(c)(1)) who are in the same category of employees and who have the same category of high deductible health plan (HDHP) coverage. Under the proposed regulations, the categories of coverage were self-only HDHP coverage and family HDHP coverage. Several commentators recommended that the final regulations should recognize additional categories of coverage other than self-only and family HDHP. The

final regulations adopt this recommendation and allow family HDHP coverage to be subdivided into the following additional categories of HDHP coverage: self plus one, self plus two and self plus three or more. In addition, the final regulations provide that an employer's contribution with respect to the self plus two category may not be less than the employer's contribution with respect to the self plus one category and the employer's contribution with respect to the self plus three or more category may not be less than the employer's contribution with respect to the self plus two category.

In addition, several commentators requested separate treatment for groups of collectively bargained employees, such that employers' HSA contributions to collectively bargained employees would not be subject to the comparability rules. In response to these comments, the final regulations provide that employees who are included in a unit of employees covered by a bona fide collective bargaining agreement between employee representatives and one or more employers are not comparable participating employees, if health benefits were the subject of good faith bargaining between such employee representatives and such employer or employers. Collectively bargained employees are, therefore, disregarded for purposes of section 4980G.

Numerous commentators requested guidance on the exception to the comparability rules for employer contributions made through a section 125 cafeteria plan. In response to these comments, the final regulations provide additional guidance on how employer HSA contributions are made through a cafeteria plan. Specifically, the final regulations provide that employer

contributions to employees' HSAs are made through the cafeteria plan if under the written cafeteria plan, the employees have the right to elect to receive cash or other taxable benefits in lieu of all or a portion of an HSA contribution (i.e., all or a portion of the HSA contributions are available as pre-tax salary reduction amounts), regardless of whether an employee actually elects to contribute any amount to the HSA by salary reduction. The final regulations also provide several examples that illustrate the application of the cafeteria plan exception to the comparability rules.

One commentator requested guidance on what actions an employer must take to locate any missing comparable participating former employees for purposes of contributions to eligible former employees. The final regulations provide guidance on this issue and explain that an employer making comparable contributions to former employees must take reasonable actions to locate any missing comparable participating former employees. In general, such reasonable actions include the use of certified mail, the Internal Revenue Service Letter Forwarding Program, see Rev. Proc. 94-22 (1994-1 CB 608), or the Social Security Administration's Letter Forwarding Service. See §601.601(d)(2).

Several commentators requested that testing for comparability purposes be permitted on a plan year, rather than calendar year, basis. Section 4980G mandates the use of a calendar year for testing purposes. Accordingly, the final regulations do not adopt the suggestion for plan year testing. Also, the final regulations have removed and reserved the provision dealing with instances where an employee has not established an HSA by the end of the calendar year.

Finally, one commentator requested clarification on what would constitute "reasonable interest" for purposes of section 4980G. In response to this comment, the final regulations provide that the determination of whether a rate of interest used by an employer is reasonable will be based on all of the facts and circumstances. However, if an employer calculates interest using the Federal short-term rate as determined by the Secretary in accordance with Code section 1274(d), the employer is deemed to use a reasonable interest rate.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. These regulations do not impose a collection of information on small entities, thus the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Barbara E. Pie and Mireille T. Khoury, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities).

List of Subjects in 26 CFR Part 54

Excise taxes, Pensions, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 54 is amended as follows:

PART 54--PENSION EXCISE TAXES

Paragraph 1. The authority citation for part 54 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 54.4980G-0 also issued under 26 U.S.C. 4980G, Section 54.4980G-1 also issued under 26 U.S.C. 4980G, Section 54.4980G-2 also issued under 26 U.S.C. 4980G, Section 54.4980G-3 also issued under 26 U.S.C. 4980G, Section 54.4980G-4 also issued under 26 U.S.C. 4980G, and Section 54.4980G-5 also issued under 26 U.S.C. 4980G. * * *

Par. 2. Sections 54.4980G-0, 54.4980G-1, 54.4980G-2, 54.4980G-3, 54.4980G-4, and 54.4980G-5 are added to read as follows:

' 54.4980G-0 Table of contents.

This section contains the questions for §§ 54.4980G-1, 54.4980G-2, 54.4980G-3, 54.4980G-4, and 54.4980G-5.

' 54.4980G-1 Failure of employer to make comparable health savings account contributions.

Q-1: What are the comparability rules that apply to employer contributions to Health Savings Accounts (HSAs)?
Q-2: What are the categories of HDHP coverage for purposes of applying the comparability rules?
Q-3: What is the testing period for making comparable contributions to employees' HSAs?
Q-4: How is the excise tax computed if employer contributions do not satisfy the comparability rules for a calendar year?

'54.4980G-2 Employer contribution defined.

Q-1: Do the comparability rules apply to amounts rolled over from an employee's HSA or Archer Medical Savings Account (Archer MSA)?
Q-2: If an employee requests that his or her employer deduct after-tax amounts from the employee's compensation and forward these amounts as employee contributions to the employee's HSA, do the comparability rules apply to these amounts?

'54.4980G-3 Employee for comparability testing.

Q-1: Do the comparability rules apply to contributions that an employer makes to the HSAs of independent contractors or self-employed individuals?
Q-2: May a sole proprietor who is an eligible individual contribute to his or her own HSA without contributing to the HSAs of his or her employees who are eligible individuals?
Q-3: Do the comparability rules apply to contributions by a partnership to a partner's HSA?
Q-4: How are members of controlled groups treated when applying the comparability rules?
Q-5: What are the categories of employees for comparability testing?
Q-6: Are employees who are included in a unit of employees covered by a collective bargaining agreement comparable participating employees?
Q-7: Is an employer permitted to make comparable contributions only to the HSAs of comparable participating employees who have coverage under the employer's HDHP?
Q-8: If an employee and his or her spouse are eligible individuals who work for the same employer and one employee-spouse has family coverage for both employees under the employer's HDHP, must the employer make comparable contributions to the HSAs of both employees?
Q-9: Does an employer that makes HSA contributions only for one class of non-collectively bargained employees who are eligible individuals, but not for another class of non-collectively bargained employees who are eligible individuals (for example, management v. non-management) satisfy the requirement that the employer make comparable contributions?
Q-10: If an employer contributes to the HSAs of former employees who are eligible individuals, do the comparability rules apply to these contributions?
Q-11: Is an employer permitted to make comparable contributions only to the HSAs of comparable participating former employees who have coverage under the employer's HDHP?
Q-12: If an employer contributes only to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP, must the employer make comparable contributions to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP because of an election under a COBRA continuation provision (as defined in section 9832(d)(1))?

Q-13: How do the comparability rules apply if some employees have HSAs and other employees have Archer MSAs?

' 54.4980G-4 Calculating comparable contributions.

Q-1: What are comparable contributions?
Q-2: How does an employer comply with the comparability rules when some non-collectively bargained employees who are eligible individuals do not work for the employer during the entire calendar year?
Q-3: How do the comparability rules apply to employer contributions to employees' HSAs if some non-collectively bargained employees work full-time during the entire calendar year, and other non-collectively bargained employees work full-time for less than the entire calendar year?
Q-4: May an employer make contributions for the entire year to the HSAs of its employees who are eligible individuals at the beginning of the calendar year (i.e., on a pre-funded basis) instead of contributing on a pay-as-you-go or on a look-back basis?
Q-5: Must an employer use the same contribution method as described in Q & A-3 and Q & A-4 of this section for all employees who were comparable participating employees for any month during the calendar year?
Q-6: How does an employer comply with the comparability rules if an employee has not established an HSA at the time the employer contributes to its employees' HSAs?
Q-7: If an employer bases its contributions on a percentage of the HDHP deductible, how is the correct percentage or dollar amount computed?
Q-8: Does an employer that contributes to the HSA of each comparable participating employee in an amount equal to the employee's HSA contribution or a percentage of the employee's HSA contribution (matching contributions) satisfy the rule that all comparable participating employees receive comparable contributions?
Q-9: If an employer conditions contributions by the employer to an employee's HSA on an employee's participation in health assessments, disease management programs or wellness programs and makes the same contributions available to all employees who participate in the programs, do the contributions satisfy the comparability rules?
Q-10: If an employer makes additional contributions to the HSAs of all comparable participating employees who have attained a specified age or who have worked for the employer for a specified number of years, do the contributions satisfy the comparability rules?
Q-11: If an employer makes additional contributions to the HSAs of all comparable participating employees are eligible to make the additional contributions (HSA catch-up contributions) under section 223(b)(3), do the contributions satisfy the comparability rules?
Q-12: If an employer's contributions to an employee's HSA result in non-comparable contributions, may the employer recoup the excess amount from the employee's HSA?

Q-13: What constitutes a reasonable interest rate for purposes of making comparable contributions?

'54.4980G-5 HSA comparability rules and cafeteria plans and waiver of excise tax.

Q-1: If an employer makes contributions through a section 125 cafeteria plan to the HSA of each employee who is an eligible individual, are the contributions subject to the comparability rules?
Q-2: If an employer makes contributions through a cafeteria plan to the HSA of each employee who is an eligible individual in an amount equal to the amount of the employee's HSA contribution or a percentage of the amount of the employee's HSA contribution (i.e., matching contributions), are the contributions subject to the section 4980G comparability rules?
Q-3: If under the employer's cafeteria plan, employees who are eligible individuals and who participate in health assessments, disease management programs or wellness programs receive an employer contribution to an HSA, unless the employees elect cash, are the contributions subject to the comparability rules?
Q-4: May all or part of the excise tax imposed under section 4980G be waived?

'54.4980G-1 Failure of employer to make comparable health savings account contributions.

Q-1: What are the comparability rules that apply to employer contributions to Health Savings Accounts (HSAs)?

A-1: If an employer makes contributions to any employee's HSA, the employer must make comparable contributions to the HSAs of all comparable participating employees. See Q & A-1 in '54.4980G-4 for the definition of comparable contributions. Comparable participating employees are eligible individuals (as defined in section 223(c)(1)) who are in the same category of employees and who have the same category of high deductible health plan (HDHP) coverage. See sections 4980G(b) and 4980E(d)(3). See section 223(c)(2) and (g) for the definition of an HDHP. See also Q & A-5 in '54.4980G-

3 for the categories of employees and Q & A-2 of this section for the categories of HDHP coverage. But see Q & A-6 in §54.4980G-3 for treatment of collectively bargained employees.

Q-2: What are the categories of HDHP coverage for purposes of applying the comparability rules?

A-2: (a) In general. Generally, the categories of coverage are self-only HDHP coverage and family HDHP coverage. Family HDHP coverage means any coverage other than self-only HDHP coverage. The comparability rules apply separately to self-only HDHP coverage and family HDHP coverage. In addition, if an HDHP has family coverage options meeting the descriptions listed in paragraph (b) of this Q &A-2, each such coverage option may be treated as a separate category of coverage and the comparability rules may be applied separately to each category. However, if the HDHP has more than one category that provides coverage for the same number of individuals, all such categories are treated as a single category for purposes of the comparability rules. Thus, the categories of "employee plus spouse" and "employee plus dependent," each providing coverage for two individuals, are treated as the single category "self plus one" for comparability purposes. See, however, the final sentence of paragraph (a) of Q & A-1 of '54.4980G-4 for a special rule that applies if different amounts are contributed for different categories of family coverage.

(b) HDHP Family coverage categories. The coverage categories are - -

(1) Self plus one;

(2) Self plus two; and

(3) Self plus three or more.

(c) Examples. The rules of this Q & A-2 are illustrated by the following examples:

Example 1. Employer A maintains an HDHP and contributes to the HSAs of eligible employees who elect coverage under the HDHP. The HDHP has self-only coverage and family coverage. Thus, the categories of coverage are self-only and family coverage. Employer A contributes $750 to the HSA of each eligible employee with self-only HDHP coverage and $1,000 to the HSA of each eligible employee with family HDHP coverage. Employer A's contributions satisfy the comparability rules.

Example 2. (i) Employer B maintains an HDHP and contributes to the HSAs of eligible employees who elect coverage under the HDHP. The HDHP has the following coverage options:

(A) Self-only;

(B) Self plus spouse;

(C) Self plus dependent;

(D) Self plus spouse plus one dependent;

(E) Self plus two dependents; and

(F) Self plus spouse and two or more dependents.

(ii) The self plus spouse category and the self plus dependent category constitute the same category of HDHP coverage (self plus one) and Employer B must make the same comparable contributions to the HSAs of all eligible individuals who are in either the self plus spouse category of HDHP coverage or the self plus dependent category of HDHP coverage. Likewise, the self plus spouse plus one dependent category and the self plus two dependents category constitute the same category of HDHP coverage (self plus two) and Employer B must make the same comparable contributions to the HSAs of all eligible individuals who are in either the self plus spouse plus one dependent category of HDHP coverage or the self plus two dependents category of HDHP coverage.

Example 3. (i) Employer C maintains an HDHP and contributes to the HSAs of eligible employees who elect coverage under the HDHP. The HDHP has the following coverage options:

(1) Self-only;

(2) Self plus one;

(3) Self plus two; and

(4) Self plus three or more.

(ii) Employer C contributes $500 to the HSA of each eligible employee with self-only HDHP coverage, $750 to the HSA of each eligible employee with self plus one HDHP coverage, $900 to the HSA of each eligible employee with self plus two HDHP coverage and $1,000 to the HSA of each eligible employee with self plus three or more HDHP coverage. Employer C's contributions satisfy the comparability rules.

Q-3: What is the testing period for making comparable contributions to employees' HSAs?

A-3: To satisfy the comparability rules, an employer must make comparable contributions for the calendar year to the HSAs of employees who are comparable participating employees. See section 4980G(a). See Q & A-3 and Q & A-4 in ' 54.4980G-4 for a discussion of HSA contribution methods.

Q-4: How is the excise tax computed if employer contributions do not satisfy the comparability rules for a calendar year?

A-4: (a) Computation of tax. If employer contributions do not satisfy the comparability rules for a calendar year, the employer is subject to an excise tax equal to 35% of the aggregate amount contributed by the employer to HSAs for that period.

(b) Example. The following example illustrates the rules in paragraph (a) of this Q & A-4:

Example. During the 2007 calendar year, Employer D has 8 employees who are eligible individuals with self-only coverage under an HDHP provided by Employer D. The deductible for the HDHP is $2,000. For the 2007 calendar year, Employer D contributes $2,000 each to the HSAs of two employees and

$1,000 each to the HSAs of the other six employees, for total HSA contributions of $10,000. Employer D's contributions do not satisfy the comparability rules. Therefore, Employer D is subject to an excise tax of $3,500 (35% of $10,000) for its failure to make comparable contributions to its employees' HSAs.

' 54.4980G-2 Employer contribution defined.

Q-1: Do the comparability rules apply to amounts rolled over from an employee's HSA or Archer Medical Savings Account (Archer MSA)?

A-1: No. The comparability rules do not apply to amounts rolled over from an employee's HSA or Archer MSA.

Q-2: If an employee requests that his or her employer deduct after-tax amounts from the employee's compensation and forward these amounts as employee contributions to the employee's HSA, do the comparability rules apply to these amounts?

A-2: No. Section 106(d) provides that amounts contributed by an employer to an eligible employee's HSA shall be treated as employer-provided coverage for medical expenses and are excludible from the employee's gross income up to the limit in section 223(b). After-tax employee contributions to an HSA are not subject to the comparability rules because they are not employer contributions under section 106(d).

' 54.4980G-3 Employee for comparability testing.

Q-1: Do the comparability rules apply to contributions that an employer makes to the HSAs of independent contractors or self-employed individuals?

A-1: No. The comparability rules apply only to contributions that an employer makes to the HSAs of employees.

Q-2: May a sole proprietor who is an eligible individual contribute to his or her own HSA without contributing to the HSAs of his or her employees who are eligible individuals?

A-2: (a) Sole proprietor not an employee. Yes. The comparability rules apply only to contributions made by an employer to the HSAs of employees. Because a sole proprietor is not an employee, the comparability rules do not apply to contributions the sole proprietor makes to his or her own HSA. However, if a sole proprietor contributes to any employee's HSA, the sole proprietor must make comparable contributions to the HSAs of all comparable participating employees. In determining whether the comparability rules are satisfied, contributions that a sole proprietor makes to his or her own HSA are not taken into account.

(b) Example. The following example illustrates the rules in paragraph (a) of this Q & A-2:

Example. In a calendar year, B, a sole proprietor is an eligible individual and contributes $1,000 to B's own HSA. B also contributes $500 for the same calendar year to the HSA of each employee who is an eligible individual. The comparability rules are not violated by B's $1,000 contribution to B's own HSA.

Q-3: Do the comparability rules apply to contributions by a partnership to a partner's HSA?

A-3: (a) Partner not an employee. No. Contributions by a partnership to a bona fide partner's HSA are not subject to the comparability rules because the contributions are not contributions by an employer to the HSA of an employee. The contributions are treated as either guaranteed payments under section 707(c) or distributions under section 731. However, if a partnership contributes

to the HSAs of any employee who is not a partner, the partnership must make comparable contributions to the HSAs of all comparable participating employees.

(b) Example. The following example illustrates the rules in paragraph (a) of this Q & A-3:

Example. (i) Partnership X is a limited partnership with three equal individual partners, A (a general partner), B (a limited partner), and C (a limited partner). C is to be paid $300 annually for services rendered to Partnership X in her capacity as a partner without regard to partnership income (a section 707(c) guaranteed payment). D and E are the only employees of Partnership X and are not partners in Partnership X. A, B, C, D, and E are eligible individuals and each has an HSA. During Partnership X's Year 1 taxable year, which is also a calendar year, Partnership X makes the following contributions--

(A) A $300 contribution to each of A's and B's HSAs which are treated as section 731 distributions to A and B;

(B) A $300 contribution to C's HSA in lieu of paying C the guaranteed payment directly; and

(C) A $200 contribution to each of D's and E's HSAs, who are comparable participating employees.

(ii) Partnership X's contributions to A's and B's HSAs are section 731 distributions, which are treated as cash distributions. Partnership X's contribution to C's HSA is treated as a guaranteed payment under section 707(c). The contribution is not excludible from C's gross income under section 106(d) because the contribution is treated as a distributive share of partnership income for purposes of all Code sections other than sections 61(a) and 162(a), and a guaranteed payment to a partner is not treated as compensation to an employee. Thus, Partnership X's contributions to the HSAs of A, B, and C are not subject to the comparability rules. Partnership X's contributions to D's and E's HSAs are subject to the comparability rules because D and E are employees of Partnership X and are not partners in Partnership X. Partnership X's contributions satisfy the comparability rules.

Q-4: How are members of controlled groups treated when applying the comparability rules?

A-4: All persons or entities treated as a single employer under section 414 (b), (c), (m), or (o) are treated as one employer. See sections 4980G(b) and 4980E(e).

Q-5: What are the categories of employees for comparability testing?

A-5: (a) Categories. The categories of employees for comparability testing are as follows (but see Q & A-6 of this section for the treatment of collectively bargained employees)--

(1) Current full-time employees;

(2) Current part-time employees; and

(3) Former employees (except for former employees with coverage under the employer's HDHP because of an election under a COBRA continuation provision (as defined in section 9832(d)(1)).

(b) Part-time and full-time employees. For purposes of section 4980G, part-time employees are customarily employed for fewer than 30 hours per week and full-time employees are customarily employed for 30 or more hours per week. See sections 4980G(b) and 4980E(d)(4)(A) and (B).

(c) In general. Except as provided in Q & A-6 of this section, the categories of employees in paragraph (a) of this Q & A-5 are the exclusive categories of employees for comparability testing. An employer must make comparable contributions to the HSAs of all comparable participating employees (eligible individuals who are in the same category of employees with the same category of HDHP coverage) during the calendar year without regard to any classification other than these categories. For example, full-time eligible

employees with self-only HDHP coverage and part-time eligible employees with self-only HDHP coverage are separate categories of employees and different amounts can be contributed to the HSAs for each of these categories.

Q-6: Are employees who are included in a unit of employees covered by a collective bargaining agreement comparable participating employees?

A-6: (a) In general. No. Collectively bargained employees who are covered by a bona fide collective bargaining agreement between employee representatives and one or more employers are not comparable participating employees, if health benefits were the subject of good faith bargaining between such employee representatives and such employer or employers. Former employees covered by a collective bargaining agreement also are not comparable participating employees.

(b) Examples. The following examples illustrate the rules in paragraph (a) of this Q & A-6.

Example 1. Employer A offers its employees an HDHP with a $1,500 deductible for self-only coverage. Employer A has collectively bargained and non-collectively bargained employees. The collectively bargained employees are covered by a collective bargaining agreement under which health benefits were bargained in good faith. In the 2007 calendar year, Employer A contributes $500 to the HSAs of all eligible non-collectively bargained employees with self-only coverage under Employer A's HDHP. Employer A does not contribute to the HSAs of the collectively bargained employees. Employer A's contributions to the HSAs of non-collectively bargained employees satisfy the comparability rules. The comparability rules do not apply to collectively bargained employees.

Example 2. Employer B offers its employees an HDHP with a $1,500 deductible for self-only coverage. Employer B has collectively bargained and non-collectively bargained employees. The collectively bargained employees are covered by a collective bargaining agreement under which health benefits were bargained in good faith. In the 2007 calendar year and in accordance with the terms of the collective bargaining agreement, Employer B contributes to the HSAs of all eligible collectively bargained employees. Employer B does not

contribute to the HSAs of the non-collectively bargained employees. Employer B's contributions to the HSAs of collectively bargained employees are not subject to the comparability rules because the comparability rules do not apply to collectively bargained employees. Accordingly, Employer B's failure to contribute to the HSAs of the non-collectively bargained employees does not violate the comparability rules.

Example 3. Employer C has two units of collectively bargained employees – unit Q and unit R – each covered by a collective bargaining agreement under which health benefits were bargained in good faith. In the 2007 calendar year and in accordance with the terms of the collective bargaining agreement, Employer C contributes to the HSAs of all eligible collectively bargained employees in unit Q. In accordance with the terms of the collective bargaining agreement, Employer C makes no HSA contributions for collectively bargained employees in unit R. Employer C's contributions to the HSAs of collectively bargained employees are not subject to the comparability rules because the comparability rules do not apply to collectively bargained employees.

Example 4. Employer D has a unit of collectively bargained employees that are covered by a collective bargaining agreement under which health benefits were bargained in good faith. In accordance with the terms of the collective bargaining agreement, Employer D contributes an amount equal to a specified number of cents per hour for each hour worked to the HSAs of all eligible collectively bargained employees. Employer D's contributions to the HSAs of collectively bargained employees are not subject to the comparability rules because the comparability rules do not apply to collectively bargained employees.

Q-7: Is an employer permitted to make comparable contributions only to the HSAs of comparable participating employees who have coverage under the employer's HDHP?

A-7: (a) Employer-provided HDHP coverage. If during a calendar year, an employer contributes to the HSA of any employee who is an eligible individual covered under an HDHP provided by the employer, the employer is required to make comparable contributions to the HSAs of all comparable participating employees with coverage under any HDHP provided by the employer. An employer that contributes only to the HSAs of employees who are eligible

individuals with coverage under the employer's HDHP is not required to make comparable contributions to HSAs of employees who are eligible individuals but are not covered under the employer's HDHP.

(b) Non-employer provided HDHP coverage. An employer that contributes to the HSA of any employee who is an eligible individual with coverage under any HDHP that is not an HDHP provided by the employer, must make comparable contributions to the HSAs of all comparable participating employees whether or not covered under the employer's HDHP. An employer that makes a reasonable good faith effort to identify all comparable participating employees with non-employer provided HDHP coverage and makes comparable contributions to the HSAs of such employees satisfies the requirements in paragraph (b) of this Q & A-7.

(c) Examples. The following examples illustrate the rules in this Q & A-7. None of the employees in the following examples are covered by a collective bargaining agreement.

Example 1. In a calendar year, Employer E offers an HDHP to its full-time employees. Most full-time employees are covered under Employer E's HDHP and Employer E makes comparable contributions only to these employees' HSAs. Employee W, a full-time employee of Employer E and an eligible individual, is covered under an HDHP provided by the employer of W's spouse and not under Employer E's HDHP. Employer E is not required to make comparable contributions to W's HSA.

Example 2. In a calendar year, Employer F does not offer an HDHP. Several full-time employees of Employer F, who are eligible individuals, have HSAs. Employer F contributes to these employees' HSAs. Employer F must make comparable contributions to the HSAs of all full-time employees who are eligible individuals.

Example 3. In a calendar year, Employer G offers an HDHP to its full-time employees. Most full-time employees are covered under Employer G's HDHP

and Employer G makes comparable contributions to these employees' HSAs and also to the HSAs of full-time employees who are eligible individuals and who are not covered under Employer G's HDHP. Employee S, a full-time employee of Employer G and a comparable participating employee, is covered under an HDHP provided by the employer of S's spouse and not under Employer G's HDHP. Employer G must make comparable contributions to S's HSA.

Q-8: If an employee and his or her spouse are eligible individuals who work for the same employer and one employee-spouse has family coverage for both employees under the employer's HDHP, must the employer make comparable contributions to the HSAs of both employees?

A-8: (a) In general. If the employer makes contributions only to the HSAs of employees who are eligible individuals covered under its HDHP where only one employee-spouse has family coverage for both employees under the employer's HDHP, the employer is not required to contribute to the HSAs of both employee-spouses. The employer is required to contribute to the HSA of the employee-spouse with coverage under the employer's HDHP, but is not required to contribute to the HSA of the employee-spouse covered under the employer's HDHP by virtue of his or her spouse's coverage. However, if the employer contributes to the HSA of any employee who is an eligible individual with coverage under an HDHP that is not an HDHP provided by the employer, the employer must make comparable contributions to the HSAs of both employee-spouses if they are both eligible individuals. If an employer is required to contribute to the HSAs of both employee-spouses, the employer is not required to contribute amounts in excess of the annual contribution limits in section 223(b).

(b) Examples. The following examples illustrate the rules in paragraph (a) of this Q & A-8. None of the employees in the following examples are covered by a collective bargaining agreement

Example 1. In a calendar year, Employer H offers an HDHP to its full-time employees. Most full-time employees are covered under Employer H's HDHP and Employer H makes comparable contributions only to these employees' HSAs. T and U are a married couple. Employee T, who is a full-time employee of Employer H and an eligible individual, has family coverage under Employer H's HDHP for T and T's spouse. Employee U, who is also a full-time employee of Employer H and an eligible individual, does not have coverage under Employer H's HDHP except as the spouse of Employee T. Employer H is required to make comparable contributions to T's HSA, but is not required to make comparable contributions to U's HSA.

Example 2. In a calendar year, Employer J offers an HDHP to its full-time employees. Most full-time employees are covered under Employer J's HDHP and Employer J makes comparable contributions to these employees' HSAs and to the HSAs of full-time employees who are eligible individuals but are not covered under Employer J's HDHP. R and S are a married couple. Employee S, who is a full-time employee of Employer J and an eligible individual, has family coverage under Employer J's HDHP for S and S's spouse. Employee R, who is also a full-time employee of Employer J and an eligible individual, does not have coverage under Employer J's HDHP except as the spouse of Employee S. Employer J must make comparable contributions to S's HSA and to R's HSA.

Q-9: Does an employer that makes HSA contributions only for one class of non-collectively bargained employees who are eligible individuals, but not for another class of non-collectively bargained employees who are eligible individuals (for example, management v. non-management) satisfy the requirement that the employer make comparable contributions?

A-9: (a) Different classes of employees. No. If the two classes of employees are comparable participating employees, the comparability rules are not satisfied. The only categories of employees for comparability purposes are current full-time employees, current part-time employees, and former employees.

Collectively bargained employees are not comparable participating employees. But see Q & A-1 in '54.4980G-5 on contributions made through a cafeteria plan.

(b) Examples. The following examples illustrate the rules in paragraph (a) of this Q & A-9. None of the employees in the following examples are covered by a collective bargaining agreement.

Example 1. In a calendar year, Employer K maintains an HDHP covering all management and non-management employees. Employer K contributes to the HSAs of non-management employees who are eligible individuals covered under its HDHP. Employer K does not contribute to the HSAs of its management employees who are eligible individuals covered under its HDHP. The comparability rules are not satisfied.

Example 2. All of Employer L's employees are located in city X and city Y. In a calendar year, Employer L maintains an HDHP for all employees working in city X only. Employer L does not maintain an HDHP for its employees working in city Y. Employer L contributes $500 to the HSAs of city X employees who are eligible individuals with coverage under its HDHP. Employer L does not contribute to the HSAs of any of its city Y employees. The comparability rules are satisfied because none of the employees in city Y are covered under an HDHP of Employer L. (However, if any employees in city Y were covered by an HDHP of Employer L, Employer L could not fail to contribute to their HSAs merely because they work in a different city.)

Example 3. Employer M has two divisions – division N and division O. In a calendar year, Employer M maintains an HDHP for employees working in division N and division O. Employer M contributes to the HSAs of division N employees who are eligible individuals with coverage under its HDHP. Employer M does not contribute to the HSAs of division O employees who are eligible individuals covered under its HDHP. The comparability rules are not satisfied.

Q-10: If an employer contributes to the HSAs of former employees who are eligible individuals, do the comparability rules apply to these contributions?

A-10: (a) Former employees. Yes. The comparability rules apply to contributions an employer makes to former employees' HSAs. Therefore, if an employer contributes to any former employee's HSA, it must make comparable contributions to the HSAs of all comparable participating former employees

(former employees who are eligible individuals with the same category of HDHP coverage). However, an employer is not required to make comparable contributions to the HSAs of former employees with coverage under the employer's HDHP because of an election under a COBRA continuation provision (as defined in section 9832(d)(1)). See Q & A-5 and Q & A-12 of this section. The comparability rules apply separately to former employees because they are a separate category of covered employee. See Q & A-5 of this section. Also, former employees who were covered by a collective bargaining agreement immediately before termination of employment are not comparable participating employees. See Q & A-6 of this section.

(b) Locating former employees. An employer making comparable contributions to former employees must take reasonable actions to locate any missing comparable participating former employees. In general, such actions include the use of certified mail, the Internal Revenue Service Letter Forwarding Program or the Social Security Administration's Letter Forwarding Service.

(c) Examples. The following examples illustrate the rules in paragraph (a) of this Q & A-10. None of the employees in the following examples are covered by a collective bargaining agreement.

Example 1. In a calendar year, Employer N contributes $1,000 for the calendar year to the HSA of each current employee who is an eligible individual with coverage under any HDHP. Employer N does not contribute to the HSA of any former employee who is an eligible individual. Employer N's contributions satisfy the comparability rules.

Example 2. In a calendar year, Employer O contributes to the HSAs of current employees and former employees who are eligible individuals covered under any HDHP. Employer O contributes $750 to the HSA of each current employee with self-only HDHP coverage and $1,000 to the HSA of each current

employee with family HDHP coverage. Employer O also contributes $300 to the HSA of each former employee with self-only HDHP coverage and $400 to the HSA of each former employee with family HDHP coverage. Employer O's contributions satisfy the comparability rules.

Q-11: Is an employer permitted to make comparable contributions only to the HSAs of comparable participating former employees who have coverage under the employer's HDHP?

A-11: If during a calendar year, an employer contributes to the HSA of any former employee who is an eligible individual covered under an HDHP provided by the employer, the employer is required to make comparable contributions to the HSAs of all former employees who are comparable participating former employees with coverage under any HDHP provided by the employer. An employer that contributes only to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP is not required to make comparable contributions to the HSAs of former employees who are eligible individuals and who are not covered under the employer's HDHP. However, an employer that contributes to the HSA of any former employee who is an eligible individual with coverage under an HDHP that is not an HDHP of the employer, must make comparable contributions to the HSAs of all former employees who are eligible individuals whether or not covered under an HDHP of the employer.

Q-12: If an employer contributes only to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP, must the employer make comparable contributions to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP because of an

election under a COBRA continuation provision (as defined in section 9832(d)(1))?

A-12: No. An employer that contributes only to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP is not required to make comparable contributions to the HSAs of former employees who are eligible individuals with coverage under the employer's HDHP because of an election under a COBRA continuation provision (as defined in section 9832(d)(1)).

Q-13: How do the comparability rules apply if some employees have HSAs and other employees have Archer MSAs?

A-13: (a) HSAs and Archer MSAs. The comparability rules apply separately to employees who have HSAs and employees who have Archer MSAs. However, if an employee has both an HSA and an Archer MSA, the employer may contribute to either the HSA or the Archer MSA, but not to both.

(b) Example. The following example illustrates the rules in paragraph (a) of this Q & A-13:

Example. In a calendar year, Employer P contributes $600 to the Archer MSA of each employee who is an eligible individual and who has an Archer MSA. Employer P contributes $500 for the calendar year to the HSA of each employee who is an eligible individual and who has an HSA. If an employee has both an Archer MSA and an HSA, Employer P contributes to the employee's Archer MSA and not to the employee's HSA. Employee X has an Archer MSA and an HSA. Employer P contributes $600 for the calendar year to X's Archer MSA but does not contribute to X's HSA. Employer P's contributions satisfy the comparability rules.

' 54.4980G-4 Calculating comparable contributions.

Q-1: What are comparable contributions?

A-1: (a) Definition. Contributions are comparable if, for each month in a calendar year, the contributions are either the same amount or the same percentage of the deductible under the HDHP for employees who are eligible individuals with the same category of coverage on the first day of that month. Employees with self-only HDHP coverage are tested separately from employees with family HDHP coverage. Similarly, employees with different categories of family HDHP coverage may be tested separately. See Q & A-2 in '54.4980G-1. An employer is not required to contribute the same amount or the same percentage of the deductible for employees who are eligible individuals with one category of HDHP coverage that it contributes for employees who are eligible individuals with a different category of HDHP coverage. For example, an employer that satisfies the comparability rules by contributing the same amount to the HSAs of all employees who are eligible individuals with family HDHP coverage is not required to contribute any amount to the HSAs of employees who are eligible individuals with self-only HDHP coverage, or to contribute the same percentage of the self-only HDHP deductible as the amount contributed with respect to family HDHP coverage. However, the contribution with respect to the self plus two category may not be less than the contribution with respect to the self plus one category and the contribution with respect to the self plus three or more category may not be less than the contribution with respect to the self plus two category.

(b) Examples. The following examples illustrate the rules in paragraph (a) of this Q & A-1. None of the employees in the following examples are covered by a collective bargaining agreement.

Example 1. In the 2007 calendar year, Employer A offers its full-time employees three health plans, including an HDHP with self-only coverage and a $2,000 deductible. Employer A contributes $1,000 for the calendar year to the HSA of each employee who is an eligible individual electing the self-only HDHP coverage. Employer A makes no HSA contributions for employees with family HDHP coverage or for employees who do not elect the employer's self-only HDHP. Employer A's HSA contributions satisfy the comparability rules.

Example 2. In the 2007 calendar year, Employer B offers its employees an HDHP with a $3,000 deductible for self-only coverage and a $4,000 deductible for family coverage. Employer B contributes $1,000 for the calendar year to the HSA of each employee who is an eligible individual electing the self-only HDHP coverage. Employer B contributes $2,000 for the calendar year to the HSA of each employee who is an eligible individual electing the family HDHP coverage. Employer B's HSA contributions satisfy the comparability rules.

Example 3. In the 2007 calendar year, Employer C offers its employees an HDHP with a $1,500 deductible for self-only coverage and a $3,000 deductible for family coverage. Employer C contributes $1,000 for the calendar year to the HSA of each employee who is an eligible individual electing the self-only HDHP coverage. Employer C contributes $1,000 for the calendar year to the HSA of each employee who is an eligible individual electing the family HDHP coverage. Employer C's HSA contributions satisfy the comparability rules.

Example 4. In the 2007 calendar year, Employer D offers its employees an HDHP with a $1,500 deductible for self-only coverage and a $3,000 deductible for family coverage. Employer D contributes $1,500 for the calendar year to the HSA of each employee who is an eligible individual electing the self-only HDHP coverage. Employer D contributes $1,000 for the calendar year to the HSA of each employee who is an eligible individual electing the family HDHP coverage. Employer D's HSA contributions satisfy the comparability rules.

Example 5. (i) In the 2007 calendar year, Employer E maintains two HDHPs. Plan A has a $2,000 deductible for self-only coverage and a $4,000 deductible for family coverage. Plan B has a $2,500 deductible for self-only coverage and a $4,500 deductible for family coverage. For the calendar year, Employer E makes contributions to the HSA of each full-time employee who is an eligible individual covered under Plan A of $600 for self-only coverage and $1,000 for family coverage. Employer E satisfies the comparability rules, if it

makes either of the following contributions for the 2007 calendar year to the HSA of each full-time employee who is an eligible individual covered under Plan B--

(A) $600 for each full-time employee with self-only coverage and $1,000 for each full-time employee with family coverage; or

(B) $750 for each employee with self-only coverage and $1,125 for each employee with family coverage (the same percentage of the deductible Employer E contributes for full-time employees covered under Plan A, 30% of the deductible for self-only coverage and 25% of the deductible for family coverage).

(ii) Employer E also makes contributions to the HSA of each part-time employee who is an eligible individual covered under Plan A of $300 for self-only coverage and $500 for family coverage. Employer E satisfies the comparability rules, if it makes either of the following contributions for the 2007 calendar year to the HSA of each part-time employee who is an eligible individual covered under Plan B--

(A) $300 for each part-time employee with self-only coverage and $500 for each part-time employee with family coverage; or

(B) $375 for each part-time employee with self-only coverage and $563 for each part-time employee with family coverage (the same percentage of the deductible Employer E contributes for part-time employees covered under Plan A, 15% of the deductible for self-only coverage and 12.5% of the deductible for family coverage).

Example 6. (i) In the 2007 calendar year, Employer F maintains an HDHP. The HDHP has the following coverage options--

(A) A $2,500 deductible for self-only coverage;

(B) A $3,500 deductible for self plus one dependent (self plus one);

(C) A $3,500 deductible for self plus spouse (self plus one);

(D) A $3,500 deductible for self plus spouse and one dependent (self plus two); and

(E) A $3,500 deductible for self plus spouse and two or more dependents (self plus three or more).

(ii) Employer F makes the following contributions for the calendar year to the HSA of each full-time employee who is an eligible individual covered under the HDHP--

(A) $750 for self-only coverage;

(B) $1,000 for self plus one dependent;

(C) $1,000 for self plus spouse;

(D) $1,500 for self plus spouse and one dependent; and

(E) $2,000 for self plus spouse and two or more dependents.

(iii) Employer F's HSA contributions satisfy the comparability rules.

Example 7. (i) In a calendar year, Employer G offers its employees an HDHP and a health flexible spending arrangement (health FSA). The health FSA reimburses employees for medical expenses as defined in section 213(d). Some of Employer G's employees have coverage under the HDHP and the health FSA, some have coverage under the HDHP and their spouse's FSA, and some have coverage under the HDHP and are enrolled in Medicare. For the calendar year, Employer G contributes $500 to the HSA of each employee who is an eligible individual. No contributions are made to the HSAs of employees who have coverage under Employer G's health FSA or under a spouse's health FSA or who are enrolled in Medicare.

(ii) The employees who have coverage under a health FSA (whether Employer H's or their spouse's FSA) or who are covered under Medicare are not eligible individuals. Specifically, the employees who have coverage under the health FSA or under a spouse's health FSA are not comparable participating employees because they are not eligible individuals under section 223(c)(1). Similarly, the employees who are enrolled in Medicare are not comparable participating employees because they are not eligible individuals under section 223(b)(7) and (c)(1). Therefore, employees who have coverage under the health FSA or under a spouse's health FSA and employees who are enrolled in Medicare are excluded from comparability testing. See sections 4980G(b) and 4980E. Employer G's contributions satisfy the comparability rules.

Q-2: How does an employer comply with the comparability rules when some non-collectively bargained employees who are eligible individuals do not work for the employer during the entire calendar year?

A-2: (a) In general. In determining whether the comparability rules are satisfied, an employer must take into account all full-time and part-time employees who were employees and eligible individuals for any month during the

calendar year. (Full-time and part-time employees are tested separately. See Q & A-5 in '54.4980G-3.) There are two methods to comply with the comparability rules when some employees who are eligible individuals do not work for the employer during the entire calendar year; contributions may be made on a pay-as-you-go basis or on a look-back basis. See Q & A-9 through Q & A-11 in '54.4980G-3 for the rules regarding comparable contributions to the HSAs of former employees.

(b) Contributions on a pay-as-you-go basis. An employer may comply with the comparability rules by contributing amounts at one or more dates during the calendar year to the HSAs of employees who are eligible individuals as of the first day of the month, if contributions are the same amount or the same percentage of the HDHP deductible for employees who are eligible individuals as of the first day of the month with the same category of coverage and are made at the same time. Contributions made at the employer's usual payroll interval for different groups of employees are considered to be made at the same time. For example, if salaried employees are paid monthly and hourly employees are paid bi-weekly, an employer may contribute to the HSAs of hourly employees on a bi-weekly basis and to the HSAs of salaried employees on a monthly basis. An employer may change the amount that it contributes to the HSAs of employees at any point. However, the changed contribution amounts must satisfy the comparability rules.

(c) Examples. The following examples illustrate the rules in paragraph (b) of this Q & A-2:

Example 1. (i) Beginning on January 1st, Employer H contributes $50 per month on the first day of each month to the HSA of each employee who is an eligible individual on that date. Employer H does not contribute to the HSAs of former employees. In mid-March of the same year, Employee X, an eligible individual, terminates employment after Employer H has contributed $150 to X's HSA. After X terminates employment, Employer H does not contribute additional amounts to X's HSA. In mid-April of the same year, Employer H hires Employee Y, an eligible individual, and contributes $50 to Y's HSA in May and $50 in June. Effective in July of the same year, Employer H stops contributing to the HSAs of all employees and makes no contributions to the HSA of any employee for the months of July through December. In August, Employer H hires Employee Z, an eligible individual. Employer H does not contribute to Z's HSA. After Z is hired, Employer H does not hire additional employees. As of the end of the calendar year, Employer H has made the following HSA contributions to its employees' HSAs--

(A) Employer H contributed $150 to X's HSA;

(B) Employer H contributed $100 to Y's HSA;

(C) Employer H did not contribute to Z's HSA; and

(D) Employer H contributed $300 to the HSA of each employee who was an eligible individual and employed by Employer J from January through June.

(ii) Employer H's contributions satisfy the comparability rules.

Example 2. In a calendar year, Employer J offers its employees an HDHP and contributes on a monthly pay-as-you-go basis to the HSAs of employees who are eligible individuals with coverage under Employer J's HDHP. In the calendar year, Employer J contributes $50 per month to the HSA of each of employee with self-only HDHP coverage and $100 per month to the HSA of each employee with family HDHP coverage. From January 1st through March 31th of the calendar year, Employee X is an eligible individual with self-only HDHP coverage. From April 1st through December 31th of the calendar year, X is an eligible individual with family HDHP coverage. For the months of January, February and March of the calendar year, Employer J contributes $50 per month to X's HSA. For the remaining months of the calendar year, Employer J contributes $100 per month to X's HSA. Employer J's contributions to X's HSA satisfy the comparability rules.

(d) Contributions on a look-back basis. An employer may also satisfy the comparability rules by determining comparable contributions for the calendar year at the end of the calendar year, taking into account all employees who were

eligible individuals for any month during the calendar year and contributing the same percentage of the HDHP deductible or the same dollar amount to the HSAs of all employees with the same category of coverage for that month.

(e) Examples. The following examples illustrate the rules in paragraph (d) of this Q & A-2:

Example 1. In a calendar year, Employer K offers its employees an HDHP and contributes on a look-back basis to the HSAs of employees who are eligible individuals with coverage under Employer K's HDHP. Employer K contributes $600 ($50 per month) for the calendar year to the HSA of each of employee with self-only HDHP coverage and $1,200 ($100 per month) for the calendar year to the HSA of each employee with family HDHP coverage. From January 1st through June 30th of the calendar year, Employee Y is an eligible individual with family HDHP coverage. From July 1st through December 31, Y is an eligible individual with self-only HDHP coverage. Employer K contributes $900 on a look- back basis for the calendar year to Y's HSA ($100 per month for the months of January through June and $50 per month for the months of July through December). Employer K's contributions to Y's HSA satisfy the comparability rules.

Example 2. On December 31st, Employer L contributes $50 per month on a look-back basis to each employee's HSA for each month in the calendar year that the employee was an eligible individual. In mid-March of the same year, Employee T, an eligible individual, terminated employment. In mid-April of the same year, Employer L hired Employee U, who becomes an eligible individual as of May 1st and works for Employer L through December 31st. On December 31st, Employer L contributes $150 to Employee T's HSA and $400 to Employee U's HSA. Employer L's contributions satisfy the comparability rules.

(f) Periods and dates for making contributions. With both the pay-as-you go method and the look-back method, an employer may establish, on a reasonable and consistent basis, periods for which contributions will be made (for example, a quarterly period covering three consecutive months in a calendar year) and the dates on which such contributions will be made for that designated period (for example, the first day of the quarter or the last day of the quarter in the case of an employer who has established a quarterly period for making

contributions). An employer that makes contributions on a pay-as-you-go basis for a period covering more than one month will not fail to satisfy the comparability rules because an employee who terminates employment prior to the end of the period for which contributions were made has received more contributions on a monthly basis than employees who have worked the entire period. In addition, an employer that makes contributions on a pay-as-you-go basis for a period covering more than one month must make HSA contributions for any comparable participating employees hired after the date of initial funding for that period.

(g) Example. The following example illustrates the rules in paragraph (f) of this Q & A-2:

Example. Employer M has established, on a reasonable and consistent basis, a quarterly period for making contributions to the HSAs of eligible employees on a pay-as-you-go basis. Beginning on January 1st, Employer M contributes $150 for the first three months of the calendar year to the HSA of each employee who is an eligible individual on that date. On January 15th, Employee V, an eligible individual, terminated employment after Employer M has contributed $150 to V's HSA. On January 15th, Employer M hired Employee W, who becomes an eligible individual as of February 1st. On April 1st, Employer M has contributed $100 to W's HSA for the two months (February and March) in the quarter period that Employee W was an eligible employee. Employer M's contributions satisfy the comparability rules.

Q-3: How do the comparability rules apply to employer contributions to employees' HSAs if some non-collectively bargained employees work full-time during the entire calendar year, and other non-collectively bargained employees work full-time for less than the entire calendar year?

A-3: Employer contributions to the HSAs of employees who work full-time for less than twelve months satisfy the comparability rules if the contribution amount is comparable when determined on a month-to-month basis. For

example, if the employer contributes $240 to the HSA of each full-time employee who works the entire calendar year, the employer must contribute $60 to the HSA of each full-time employee who works on the first day of each three months of the calendar year. The rules set forth in this Q & A-2 apply to employer contributions made on a pay-as-you-go basis or on a look-back basis as described in Q & A-3 of this section. See sections 4980G(b) and 4980E(d)(2)(B).

Q-4: May an employer make contributions for the entire year to the HSAs of its employees who are eligible individuals at the beginning of the calendar year (on a pre-funded basis) instead of contributing on a pay-as-you-go or on a look-back basis?

A-4: (a) Contributions on a pre-funded basis. Yes. An employer may make contributions for the entire year to the HSAs of its employees who are eligible individuals at the beginning of the calendar year. An employer that pre-funds the HSAs of its employees will not fail to satisfy the comparability rules because an employee who terminates employment prior to the end of the calendar year has received more contributions on a monthly basis than employees who work the entire calendar year. See Q & A-12 of this section. Under section 223(d)(1)(E), an account beneficiary's interest in an HSA is nonforfeitable. An employer must make comparable contributions for all employees who are comparable participating employees for any month during the calendar year, including employees who are eligible individuals hired after the date of initial funding. An employer that makes HSA contributions on a pre-funded basis may also contribute on a pre-funded basis to the HSAs of

employees who are eligible individuals hired after the date of initial funding. Alternatively, an employer that has pre-funded the HSAs of comparable participating employees may contribute to the HSAs of employees who are eligible individuals hired after the date of initial funding on a pay-as-you-go basis or on a look-back basis. An employer that makes HSA contributions on a pre-funded basis must use the same contribution method for all employees who are eligible individuals hired after the date of initial funding.

(b) Example. The following example illustrates the rules in paragraph (a) of this Q & A-4:

Example. (i) On January 1, Employer N contributes $1,200 for the calendar year on a pre-funded basis to the HSA of each employee who is an eligible individual. In mid-May, Employer N hires Employee B, who becomes an eligible individual as of June 1st. Therefore, Employer N is required to make comparable contributions to B's HSA beginning in June. Employer N satisfies the comparability rules with respect to contributions to B's HSA if it makes HSA contributions in any one of the following ways--

(A) Pre-funding B's HSA by contributing $700 to B's HSA;

(B) Contributing $100 per month on a pay-as-you-go basis to B's HSA; or

(C) Contributing to B's HSA at the end of the calendar year taking into account each month that B was an eligible individual and employed by Employer M.

(ii) If Employer M hires additional employees who are eligible individuals after initial funding, it must use the same contribution method for these employees that it used to contribute to B's HSA.

Q-5: Must an employer use the same contribution method as described in Q & A-2 and Q & A-4 of this section for all employees who were comparable participating employees for any month during the calendar year?

A-5: Yes. If an employer makes comparable HSA contributions on a pay-as-you-go basis, it must do so for each employee who is a comparable participating employee as of the first day of the month. If an employer makes comparable contributions on a look-back basis, it must do so for each employee who was a comparable participating employee for any month during the calendar year. If an employer makes HSA contributions on a pre-funded basis, it must do so for all employees who are comparable participating employees at the beginning of the calendar year and must make comparable HSA contributions for all employees who are comparable participating employees for any month during the calendar year, including employees who are eligible individuals hired after the date of initial funding. See Q & A-4 of this section for rules regarding contributions for employees hired after initial funding.

Q-6: How does an employer comply with the comparability rules if an employee has not established an HSA at the time the employer contributes to its employees' HSAs?

A-6: (a) Employee has not established an HSA at the time the employer funds its employees' HSAs. If an employee has not established an HSA at the time the employer funds its employees' HSAs, the employer complies with the comparability rules by contributing comparable amounts plus reasonable interest to the employee's HSA when the employee establishes the HSA, taking into account each month that the employee was a comparable participating employee. See Q & A-13 of this section for rules regarding reasonable interest.

(b) Employee has not established an HSA by the end of the calendar year. [Reserved]

(c) Example. The following example illustrates the rules in paragraph (a) of this Q & A-6:

Example. Beginning on January 1st, Employer O contributes $500 per calendar year on a pay-as-you-go basis to the HSA of each employee who is an eligible individual. Employee C is an eligible individual during the entire calendar year but does not establish an HSA until March. Notwithstanding C's delay in establishing an HSA, Employer O must make up the missed HSA contributions plus reasonable interest for January and February by April 15th of the following calendar year.

Q-7: If an employer bases its contributions on a percentage of the HDHP deductible, how is the correct percentage or dollar amount computed?

A-7: (a) Computing HSA contributions. The correct percentage is determined by rounding to the nearest 1/100th of a percentage point and the dollar amount is determined by rounding to the nearest whole dollar.

(b) Example. The following example illustrates the rules in paragraph (a) of this Q & A-7:

Example. In this Example, assume that each HDHP provided by Employer P satisfies the definition of an HDHP for the 2007 calendar year. In the 2007 calendar year, Employer P maintains two HDHPs. Plan A has a deductible of $3,000 for self-only coverage. Employer P contributes $1,000 for the calendar year to the HSA of each employee covered under Plan A. Plan B has a deductible of $3,500 for self-only coverage. Employer P satisfies the comparability rules if it makes either of the following contributions for the 2007 calendar year to the HSA of each employee who is an eligible individual with self-only coverage under Plan B--

(i) $1,000; or

(ii) $1,167 (33.33% of the deductible rounded to the nearest whole dollar amount).

Q-8: Does an employer that contributes to the HSA of each comparable participating employee in an amount equal to the employee's HSA contribution or a percentage of the employee's HSA contribution (matching contributions) satisfy the rule that all comparable participating employees receive comparable contributions?

A-8: No. If all comparable participating employees do not contribute the same amount to their HSAs and, consequently, do not receive comparable contributions to their HSAs, the comparability rules are not satisfied, notwithstanding that the employer offers to make available the same contribution amount to each comparable participating employee. But see Q & A-1 in ' 54.4980G-5 on contributions to HSAs made through a cafeteria plan.

Q-9: If an employer conditions contributions by the employer to an employee's HSA on an employee's participation in health assessments, disease management programs or wellness programs and makes the same contributions available to all employees who participate in the programs, do the contributions satisfy the comparability rules?

A-9: No. If all comparable participating employees do not elect to participate in all the programs and consequently, all comparable participating employees do not receive comparable contributions to their HSAs, the employer contributions fail to satisfy the comparability rules. But see Q & A-1 in ' 54.4980G-5 on contributions made to HSAs through a cafeteria plan.

Q-10: If an employer makes additional contributions to the HSAs of all comparable participating employees who have attained a specified age or who

have worked for the employer for a specified number of years, do the contributions satisfy the comparability rules?

A-10: No. If all comparable participating employees do not meet the age or length of service requirement, all comparable participating employees do not receive comparable contributions to their HSAs and the employer contributions fail to satisfy the comparability rules.

Q-11: If an employer makes additional contributions to the HSAs of all comparable participating employees who are eligible to make the additional contributions (HSA catch-up contributions) under section 223(b)(3), do the contributions satisfy the comparability rules?

A-11: No. If all comparable participating employees are not eligible to make the additional HSA contributions under section 223(b)(3), all comparable participating employees do not receive comparable contributions to their HSAs, and the employer contributions fail to satisfy the comparability rules.

Q-12: If an employer's contributions to an employee's HSA result in non-comparable contributions, may the employer recoup the excess amount from the employee's HSA?

A-12: No. An employer may not recoup from an employee's HSA any portion of the employer's contribution to the employee's HSA. Under section 223(d)(1)(E), an account beneficiary's interest in an HSA is nonforfeitable. However, an employer may make additional HSA contributions to satisfy the comparability rules. An employer may contribute up until April 15th following the calendar year in which the non-comparable contributions were made. An

employer that makes additional HSA contributions to correct non-comparable contributions must also contribute reasonable interest. However, an employer is not required to contribute amounts in excess of the annual contribution limits in section 223(b). See Q & A-13 of this section for rules regarding reasonable interest.

Q-13: What constitutes a reasonable interest rate for purposes of making comparable contributions?

A-13: The determination of whether a rate of interest used by an employer is reasonable will be based on all of the facts and circumstances. If an employer calculates interest using the Federal short-term rate as determined by the Secretary in accordance with section 1274(d), the employer is deemed to use a reasonable interest rate.

' 54.4980G-5 HSA comparability rules and cafeteria plans and waiver of excise tax.

Q-1: If an employer makes contributions through a section 125 cafeteria plan to the HSA of each employee who is an eligible individual, are the contributions subject to the comparability rules?

A-1: (a) In general. No. The comparability rules do not apply to HSA contributions that an employer makes through a section 125 cafeteria plan. However, contributions to an HSA made through a cafeteria plan are subject to the section 125 nondiscrimination rules (eligibility rules, contributions and benefits tests and key employee concentration tests). See section 125(b), (c) and (g) and the regulations.

(b) Contributions made through a section 125 cafeteria plan. Employer contributions to employees' HSAs are made through a section 125 cafeteria plan and are subject to the section 125 cafeteria plan nondiscrimination rules and not the comparability rules if under the written cafeteria plan, the employees have the right to elect to receive cash or other taxable benefits in lieu of all or a portion of an HSA contribution (meaning that all or a portion of the HSA contributions are available as pre-tax salary reduction amounts), regardless of whether an employee actually elects to contribute any amount to the HSA by salary reduction.

Q-2: If an employer makes contributions through a cafeteria plan to the HSA of each employee who is an eligible individual in an amount equal to the amount of the employee's HSA contribution or a percentage of the amount of the employee's HSA contribution (matching contributions), are the contributions subject to the section 4980G comparability rules?

A-2: No. The comparability rules do not apply to HSA contributions that an employer makes through a section 125 cafeteria plan. Thus, where matching contributions are made by an employer through a cafeteria plan, the contributions are not subject to the comparability rules of section 4980G. However, contributions, including matching contributions, to an HSA made under a cafeteria plan are subject to the section 125 nondiscrimination rules (eligibility rules, contributions and benefits tests and key employee concentration tests). See Q & A-1 of this section.

Q-3: If under the employer's cafeteria plan, employees who are eligible individuals and who participate in health assessments, disease management programs or wellness programs receive an employer contribution to an HSA and the employees have the right to elect to make pre-tax salary reduction contributions to their HSAs, are the contributions subject to the comparability rules?

A-3: (a) In general. No. The comparability rules do not apply to employer contributions to an HSA made through a cafeteria plan. See Q & A-1 of this section.

(b) Examples. The following examples illustrate the rules in this § 54.4980G-5:

Example 1. Employer A's written cafeteria plan permits employees to elect to make pre-tax salary reduction contributions to their HSAs. Employees making this election have the right to receive cash or other taxable benefits in lieu of their HSA pre-tax contribution. The section 125 cafeteria plan nondiscrimination rules and not the comparability rules apply because the HSA contributions are made through the cafeteria plan.

Example 2. Employer B's written cafeteria plan permits employees to elect to make pre-tax salary reduction contributions to their HSAs. Employees making this election have the right to receive cash or other taxable benefits in lieu of their HSA pre-tax contribution. Employer B automatically contributes a non-elective matching contribution or "seed money" to the HSA of each employee who makes a pre-tax HSA contribution. The section 125 cafeteria plan nondiscrimination rules and not the comparability rules apply to Employer B's HSA contributions because the HSA contributions are made through the cafeteria plan.

Example 3. Employer C's written cafeteria plan permits employees to elect to make pre-tax salary reduction contributions to their HSAs. Employees making this election have the right to receive cash or other taxable benefits in lieu of their HSA pre-tax contribution. Employer C makes a non-elective contribution to the HSAs of all employees who complete a health risk assessment and participate in Employer C's wellness program. Employees do not have the right to receive cash or other taxable benefits in lieu of Employer C's

non-elective contribution. The section 125 cafeteria plan nondiscrimination rules and not the comparability rules apply to Employer C's HSA contributions because the HSA contributions are made through the cafeteria plan.

Example 4. Employer D's written cafeteria plan permits employees to elect to make pre-tax salary reduction contributions to their HSAs. Employees making this election have the right to receive cash or other taxable benefits in lieu of their HSA pre-tax contribution. Employees participating in the plan who are eligible individuals receive automatic employer contributions to their HSAs. Employees make no election with respect to Employer D's contribution and do not have the right to receive cash or other taxable benefits in lieu of Employer D's contribution, but are permitted to make their own pre-tax salary reduction contributions to fund their HSAs. The section 125 cafeteria plan nondiscrimination rules and not the comparability rules apply to Employer D's HSA contributions because the HSA contributions are made through the cafeteria plan.

Q-4: May all or part of the excise tax imposed under section 4980G be waived?

A-4: In the case of a failure which is due to reasonable cause and not to willful neglect, all or a portion of the excise tax imposed under section 4980G may be waived to the extent that the payment of the tax would be excessive relative to the failure involved. See sections 4980G(b) and 4980E(c).

Deputy Commissioner for Services and Enforcement.

Approved:

Acting Deputy Assistant Secretary (Tax Policy).

PRESS ROOM

July 28, 2006
hp-33

Remarks of Anna Escobedo Cabral
U.S. Treasurer

Before the Texas Association of Mexican-American Chambers of Commerce

Good afternoon – buenos dias a todos.

It is truly a great pleasure to join you today at TAMACC's 31st Annual Convention and Expo Women's Luncheon. It's a real thrill to be in the Lone Star State, particularly in El Paso, Texas. Thanks again for inviting me.

They say that everything in Texas is bigger, and from the looks of today's fantastic turnout at this event, I guess what they say is true. I really appreciate you being here and I appreciate your energy and enthusiasm.

Before we move on, I think we should all give a hand to today's event organizers, TAMACC and particularly the El Paso business community and chambers of commerce. Thanks again to all the staff, but also to the business-women and entrepreneurs present in this room today. Many thanks for your courage, determination and contributions. They are essential to improving our economy and improving our communities.

More importantly, I really want to express my profound appreciation to all of you for being such an inspiration to the Hispanic community and to the many professional Latinas who you inspire. You may be unaware of what a true role model each and every one of you is for perhaps a young professional hoping to start her own business one day. And on behalf of Secretary Paulson and President Bush, I want to express their gratitude for all of your hard work to keep our economy going.

Quite frankly, I'm really excited about this opportunity to share with you much about the work this Administration is focused on to ensure the continued vitality of our economy. But it is also important to make you aware of some of the President's current policy priorities, particularly in the area of immigration reform, which most of you here I'm sure are somewhat familiar with – perhaps from reading or listening to recent news reports.

I also think you'll find of significant value some information I'll share with you today about the day-to-day work we're engaged in at the Treasury Department to help promote the economic conditions which can truly help individuals grow and prosper – a prosperity which often translates to improved opportunities for individuals and improved lives for whole families and whole communities. For instance, the Department's work in the area of improving financial education is particularly noteworthy. I hope you'll consider tapping into many of the tools and resources we've made available for you, your employees and your customers.

But I'm sincerely not here to tell you, "I'm from the federal government and I'm here to help." On the contrary! I'm here as a representative of the federal government to ask for *your* help. As trusted leaders in your community, you really are the best conduit to help us get the word out about many useful tools and resources the government has developed to assist your customers, employees, and business partners make the best financial decisions. All kidding aside – we really do need your help and your leadership to disseminate crucial information throughout our

communities – communities that are contributing significantly to our economy, and that unfortunately have been traditionally underserved.

That is still a real challenge today, but we're seeing some positive changes in people's level of awareness, and that includes a heightened awareness in the Washington and also in the financial services community.

A significant number of government leaders in Washington and corporate leaders are acutely aware that minority markets in the U.S. represent an important area of growth for the American economy. They also have a sincere interest in optimizing opportunities in these communities. More and more, the financial services community is looking to minority markets as areas for demonstrable growth – and that includes the Hispanic market. Just take into consideration projections from 2004 to 2009, which indicate a Hispanic buying power gain of 45 percent!

However, despite these significant contributions to the national economy, many minorities, particularly immigrants are less likely to participate in mainstream financial services. There are a variety of reasons for this. And while we've seen improvements in some areas, such as increased homeownership, there is still much room for improvement. Consider that while the rate for homeownership among minority households is higher than it has been, minority populations still are not purchasing homes at rates similar to other groups. In the past decade, the Caucasian homeownership rate has increased from 71 percent to 76 percent; while the Hispanic homeownership rate has increased from 42 percent to 50 percent between 1995 through the first quarter of 2005.

The President is aware of the challenges and opportunities that lie ahead and that is why he is truly committed to ensuring that we remain focused on promoting those policies that have placed the U.S. on the path to tremendous economic growth.

In the U.S. we've seen that our economy has surged over the past few years.

The U.S. economy continues getting stronger. Much of the economic momentum we've experienced in recent years can be explained by the President's firm commitment to promoting a pro-growth economic agenda. The resilience and strength of the U.S. economy is a fact – and this is true despite many of the recent and significant unforeseen challenges our country faced since the President first came into office – the effects of the tech stock market bubble burst, the monstrous 9/11 terrorist attacks on our soil and the devastating impact experienced of the Gulf Coast hurricanes in 2005.

The President's economic team nonetheless is focused on furthering policies which encourage enhanced opportunities for businesses to expand, as well as hire more workers to meet increased customer demands.

It is evident that these pro-growth policies are working and generating even better than expected results. Just consider the positive business investment and solid economic growth we've seen. We've had 36 straight months of capital investment growth averaging 9%, and more than 5.4 million jobs have been created since the President's tax relief took effect in mid-2003. We also now boast a 4.6% unemployment rate – a rate lower than the average rate in each of the last four decades. Thanks also in great part to businesses that understand their customers and continue to respond to the growing purchasing power of minorities, the economy has added an additional 121,000 additional jobs in just June of 2006 alone. Businesses, particularly small business like many of yours, are a significant driving force for our U.S. economy. They are really the backbone of the U.S. economy.

Additionally, although since mid-2003 people are keeping more of the money they make, pro-growth policies have nonetheless helped the federal government increase its tax revenue. In June, Treasury's monthly statement shows continued strong economic results. Receipts were up 13 percent so far this year over last year's 14.6% increase.

To put it into perspective, it may be useful to draw some comparisons. The U.S. economy is the fastest growing of any major industrialized nation in the world. Productivity is growing at the highest rate in years. In 2005, our economy grew faster than Japan and more than twice as fast as France. It also grew more than three-times as fast as Germany.

Again, we really must also credit small business owners for much of this growth. As I mentioned earlier, there is a significant amount of new business investment out there – and that is really fantastic news. It serves as an indication of the confidence we have in our economy and confidence that we will continue to do well for ourselves far into the future.

Much of this new business investment is lead by the Hispanic business community. I find it truly encouraging that the number of Hispanic-owned businesses is growing at three times the national rate. I also find very encouraging that the most recent economic indicators show that Hispanic unemployment is at the lowest rate in years – at only 5 percent.

One important explanation for this resilient and growing economy, again, is that we left more to businesses to invest by lowering their tax burden. It's about simple economics – when you allow people to keep more of their own money, they have more money to invest, and more of it to start or expand a business, or to pay for other important things like a college education or a purchase of a first home.

I can assure you that the President and his economic team will remain focused on furthering those proven and time-tested policies which encourage the innovator, the entrepreneur and the investor to dare believe in what's possible, in their own abilities and pursue dreams for a more fruitful future.

Nonetheless, increased opportunity necessitates increased preparation and education. As I mentioned earlier we can't expect the government to make money for us. We've got to do it for ourselves and we have to create our own opportunities. Doing so will require ensuring that individuals, particularly those in our respective communities, acquire the necessary skills necessary to manage their money wisely and invest it intelligently.

I mentioned earlier the importance of improving personal finance knowledge for all people across the country. Although our economy continues to grow, we still have much work ahead of us to improve financial education, particularly in minority communities, and including among Hispanics.

This challenge could be attributed to a complex and burgeoning economy like ours, which creates more choices and sophisticated vehicles for saving and making one's money grow. But often, it can also be attributed to lack of knowledge about available opportunities and resources.

When we talk about financial education in today's terms, what we're really talking about is improving people's quality of life. But achieving our common goals will require us to go beyond creating additional nicely manicured brochures.

Education requires more than just presenting information in a nice neat package. We find that we can have a greater impact when this information is delivered through trusted channels. The business community can play an instrumental role in this important task. And this sort of education in which we're all engaged is really about helping to create new opportunities for people – opportunities like paying for a child's college education, purchasing a home, starting a business or planning for a secure retirement.

Alternatively, we've also seen what can happen to those with little or no access to personal finance information and services. We realized the urgency of this task after witnessing first-hand the added difficulties many "unbanked" individuals faced as a result of last year's Gulf Coast Hurricanes. Many people without bank accounts in these hard-hit areas found it exceedingly difficult to access their

government benefits. Many of those displaced from their homes were not easily tracked. Because they had no account relationship with a bank or credit union, and therefore no debit card many had to wait to receive a replacement check via traditional mail.

Because of this experience, Treasury has strengthened its commitment to helping people understand the value of establishing a relationship with a traditional financial institution; and we are engaged in several campaigns and multi-agency efforts to improve financial education in the country. I'll give you just a snap-shot of the efforts we're helping lead in the federal government, particularly at Treasury.

First and foremost, Treasury leads the efforts of a federal commission – the Financial Literacy and Education Commission – created in 2003 after President Bush signed the Fair and Accurate Credit Transactions Act, and the 20 agencies that form it were tasked with developing a plan to improve the money management skills of people in the U.S. Commonly referred to as the FLEC, it recently released a strategy for financial education during Financial Literacy Month in April of 2006 titled – Taking Ownership of the Future: The National Strategy for Financial Literacy.

The Commission was also tasked with developing a federal financial education web site and toll-free hotline, which were launched in English and Spanish in October of 2004 – MyMoney.gov and 1-888-MyMoney. I urge you to visit and spread the word about MyMoney.gov. It has been recently updated to include an interactive quiz called the "Money Twenty" and the strategy that I mentioned earlier is also available and can be downloaded at MyMoney.gov.

The Strategy looks at a variety of important topics, such as homeownership, credit management, retirement savings, and "banking the unbanked" – all topics of concern as we've seen for the Hispanic community.

It also describes the challenges and some possible solutions. The solutions may come from the Federal government, but often nonprofit organizations, businesses like yours and other private sector players provide important resources for those wishing to learn more about personal finance issues.

It also puts forward examples of financial education programs that community leaders, business people, and volunteers can all look to as they design programs of their own to enhance financial literacy.

And at the end of each chapter in the strategy, you will notice that Calls to Action are highlighted. It is our hope that these calls to action will provide a springboard for further open and inclusive discussion on a whole myriad of personal finance issues.

Another very important campaign my office has been involved in is the Go Direct campaign. About a year and half ago, the Treasury and Federal Reserve Banks launched a campaign called Go Direct – in Spanish it is known as Directo A Su Cuenta. The campaign's objective is to encourage seniors to receive their Social Security benefits by direct deposit.

It not only communicates the importance of direct deposit – but provides the means by which seniors can make the switch from a paper check to direct deposit. We have a dedicated call center staffed by bilingual personnel ready to assist all beneficiaries.

The call center is only one of many ways we are helping beneficiaries sign up for direct deposit. Our Web sites: www.GoDirect.org and www.DirectoASuCuenta.org, allow beneficiaries to access a step-by-step online tool to sign up – either on their own or through their bank or credit union.

Direct deposit is not only the most secure way for receiving Social Security benefits; it is also the most convenient way for all beneficiaries to have immediate access to

their benefits. However, despite 95 percent of Americans having heard or read about identity theft, a survey sponsored by the U.S. Department of Treasury and the Federal Reserve Banks revealed that many are unaware of the security benefits of direct deposit over paper checks.

I urge you to help us spread the word about this fantastic resource too. Keep in mind that direct deposit can also provide seniors receiving SSA payments with a sense of control of their money. This is true even under the most difficult circumstances. Again, as you know Hurricane Katrina displaced tens of thousands of beneficiaries just days before their checks arrived in the mail. In uncertain times like these, enrolling in direct deposit can offer a much needed peace of mind to federal benefit recipients.

I have had a chance to share some very good economic news with you today. But the reality is that statistics cannot adequately capture the contributions of business leaders like you, individuals who have the potential of bringing about positive change and improving people's lives.

Unfortunately, it is also true that this data may not adequately capture the contributions of some immigrants, particularly for some who remain in the U.S. illegally – a significant amount of those individuals are Hispanic, coming from Mexico and other countries in Latin America.

They remain in the shadows and are often easy prey for those that would take advantage of the precarious situation in which they live. The President understands that while it is important to control our borders and protect our citizens, it is also imperative that we provide legal *alternatives* for those who which to gain entry into the U.S. in a safe and legal manner.

As the President says, it is rather telling when people from other countries make a conscious decision to leave their homes and families, risking everything to come to this country in search of a brighter and better future. We are a caring people, and we can not let their talent and desire to work go to waste. In fact, this country can surely benefit from it. That is why the President has outlined a comprehensive plan to reform our immigration laws.

The President believes the U.S. can be a lawful society and a welcoming society at the same time. He's said that he is committed to enforcing our immigration laws, but it will also be important to honor this country's proud immigrant heritage.

The President's comprehensive immigration reform approach aims to accomplish some very clear objectives. First, it is imperative that we protect our citizens and secure our borders. Second, it will be important to develop a temporary worker program – a program which will provide foreign workers a legal mechanism to come into the country, and in many instances do the jobs that Americans aren't doing. However, under the President's proposal, employers will also be held accountable for hiring undocumented workers.

But the reality is that there are millions of illegal immigrants who are already here in the country. While these individuals will obviously not be granted automatic citizenship, it is not a viable alternative to simply kick all these people out of the country. We'll have to deal with this challenge in a rational way – the President's plan also offers the possibility of doing so.

As Congress continues considering legislation on immigration reform, I hope that the business and nonprofit community will work together and help government provide these individuals with the tools to succeed – everything from learning English, pursuing an education and becoming financially literate- particularly as they move toward the path of legalization. This is particularly important in a society like ours filled with opportunity, but also replete with a variety of financial services options – options which many recent immigrants will not have likely yet been exposed to, particularly in their own native countries.

Ultimately, as the President has said, when it comes to devising a comprehensive approach to immigration reform, all elements of the problem must be addressed together, or none of them will be solved at all.

Thank you again for your time and attention – this has been a tremendous opportunity to make new friends and connections with the business community here in El Paso and I look forward to future opportunities to work together as we take positives steps toward many of our shared goals. It has been a real pleasure for me to share with you just a few of the efforts we're involved in here at Treasury and to highlight the President's priorities to keep our economy and businesses going strong. With your help and contributions, I know we will together continue to enhance opportunities for those who seek them.

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PRESS ROOM

July 28, 2006
hp-34

-UPDATED-
Treasury Secretary Paulson to Deliver First Speech in NYC

Washington, D.C.--Treasury Secretary Henry M. Paulson will deliver his first speech as Secretary in New York next week, on Tuesday, August 1, at the Columbia Business School. The speech will focus on the outlook and challenges for the U.S. and global economies.

While in New York, the Secretary will also visit the New York Stock Exchange and NASDAQ's Stock Market. He will meet with business leaders at both stops to discuss current economic conditions.

What NYSE Floor Tour
When 9:30 a.m. (EDT)
Where 11 Wall Street, New York, NY
Contact Allison Circle, 212-656-5717 or 646-938-6533, acircle@nyse.com

What Remarks at the Columbia Business School
When 11:30 a.m. (EDT)
Where 535 W 116th Street, 101 Low Library, The Library Rotunda, New York, NY
Contact Jane Trombley or Keshia Mark at (212) 854-2747
Note Space is limited - media should RSVP by July 28.

What NASDAQ Closing Bell
When 4 p.m. (EDT)
Where 43rd Street and Broadway, Times Square, New York, NY
Contact Silvia Davi, 646-441-5014, silvia.davi@nasdaq.com
Note Media should RSVP.

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July 31, 2006
2006-7-31-13-57-44-26128

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $67,814 million as of the end of that week, compared to $67,451 million as of the end of the prior week.

I. Official U.S. Reserve Assets *(in US millions)*						
	July 21, 2006			July 28, 2006		
TOTAL	67,451			67,814		
1. Foreign Currency Reserves [1]	Euro	Yen	TOTAL	Euro	Yen	TOTAL
a. Securities	11,877	10,894	22,771	11,949	11,043	22,992
Of which, issuer headquartered in the U.S.			0			0
b. Total deposits with:						
b.i. Other central banks and BIS	11,813	5,316	17,129	11,879	5,390	17,269
b.ii. Banks headquartered in the U.S.			0			0
b.ii. Of which, banks located abroad			0			0
b.iii. Banks headquartered outside the U.S.			0			0
b.iii. Of which, banks located in the U.S.			0			0
2. IMF Reserve Position [2]			7,900			7,901
3. Special Drawing Rights (SDRs) [2]			8,611			8,611
4. Gold Stock [3]			11,041			11,041
5. Other Reserve Assets			0			0

II. Predetermined Short-Term Drains on Foreign Currency Assets						
	July 21, 2006			July 28, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL
1. Foreign currency loans and securities			0			0
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the U.S. dollar:						
2.a. Short positions			0			0
2.b. Long positions			0			0
3. Other			0			0

III. Contingent Short-Term Net Drains on Foreign Currency Assets						
	July 21, 2006			July 28, 2006		
	Euro	Yen	TOTAL	Euro	Yen	TOTAL

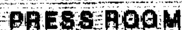
1. Contingent liabilities in foreign currency			0			0
1.a. Collateral guarantees on debt due within 1 year						
1.b. Other contingent liabilities						
2. Foreign currency securities with embedded options			0			0
3. Undrawn, unconditional credit lines			0			0
3.a. With other central banks						
3.b. With banks and other financial institutions						
Headquartered in the U.S.						
3.c. With banks and other financial institutions						
Headquartered outside the U.S.						
4. Aggregate short and long positions of options in foreign						
Currencies vis-à-vis the U.S. dollar			0			0
4.a. Short positions						
4.a.1. Bought puts						
4.a.2. Written calls						
4.b. Long positions						
4.b.1. Bought calls						
4.b.2. Written puts						

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values. Foreign Currency Reserves for the latest week may be subject to revision. Foreign Currency Reserves for the prior week are final.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.



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July 31, 2006
HP-35

Treasury Announces Market Financing Estimates

Treasury announced its current estimates of net marketable financing for the July - September 2006 and October – December 2006 quarters:

- Over the July – September 2006 quarter, the Treasury expects to borrow $30 billion of net marketable debt, assuming an end-of-September cash balance of $35 billion. The current estimate is $59 billion lower than announced in May 2006. Cash outlays are expected to exceed cash receipts by $23 billion this quarter, resulting in a financing need which is $55 billion lower than our previous estimate and is the primary contributor to the decrease in borrowing of net marketable debt this quarter.
- Over the October – December 2006 quarter, the Treasury expects to borrow $104 billion of net marketable debt to meet a projected financing need of $106 billion, assuming an end-of-December cash balance of $25 billion.

During the April – June 2006 quarter, Treasury paid down $92 billion of net marketable debt, ending with a cash balance of $46 billion on June 30. In May 2006, Treasury announced an estimated pay down in net marketable borrowing of $51 billion, assuming an end-of-June cash balance of $25 billion. Cash receipts exceeded cash outlays by $137 billion, contributing to a financing need that was $61 billion less than previously assumed. The pay down in net marketable borrowing over the quarter was $41 billion larger than previously estimated.

Since 1997, the average absolute forecast error in net borrowing of marketable debt for the current quarter is $10 billion and the average absolute forecast error for the end-of-quarter cash balance is $9 billion. Similarly, the average absolute forecast error for the following quarter is $33 billion and the average absolute forecast error for the end-of-quarter cash balance is $11 billion.

Additional financing details relating to Treasury's Quarterly Refunding will be released at 9:00 A.M. on Wednesday, August 2.

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REPORTS

- Sources and Uses Table

Sources and Uses Reconciliation Table								
			Financing					*Memo*
		Financing Need	Marketable Borrowing	All Other Sources	Total	Change in Cash Balance		*End-Of-Quarter Cash Balance*
Quarter	*Announcement Date*	(1)	(2)	(3)	(4) = (2) + (3)	(5) = (4) - (1)		(6)
Oct - Dec 2005		---	---	---	---	---		---
	Actual	**97**	**93**	**6**	**98**	**1**		**37**
	Memo: Forecast Revision	---	---	---	---	---		---
Jan - Mar 2006								
	Actual	**173**	**158**	**(14)**	**144**	**(28)**		**8**
	Memo: Forecast Revision	---	---	---	---	---		---
Apr - Jun 2006	May 1, 2006	(76)	(51)	(8)	(59)	17		25
	Actual	**(137)**	**(92)**	**(7)**	**(99)**	**38**		**46**
	Memo: Forecast Revision	(61)	(41)	1	(40)	21		21
Jul - Sep 2006	May 1, 2006	78	89	(6)	83	5		30
	July 31, 2006	**23**	**30**	**(17)**	**13**	**(11)**		**35**
	Memo: Forecast Revision	(55)	(59)	(12)	(71)	(16)		5
Oct - Dec 2006								
	July 31, 2006	**106**	**104**	**(9)**	**96**	**(10)**		**25**
	Memo: Forecast Revision	---	---	---	---	---		---

Notes: All data reported on a cash basis ($ billions)

July 31, 2006
HP-36

**Deputy Assistant Secretary for Macroeconomics
Of The Office of Economic Policy
Robert Stein
Statement for The Treasury Borrowing Advisory Committee
of The Bond Market Association**

In the three months since the Committee last met, the economy has moderated somewhat, as expected. Following a surge in overall activity in the first quarter – supported by strong consumer spending – declining residential construction and slowing business spending on equipment and software softened the overall growth pace. Still, the labor market remains healthy and core inflation remains under control.

According to the advance figures from the Bureau of Economic Analysis (BEA), real GDP grew at a 2.5 percent annual rate in the second quarter. This followed a 5.6 percent pace of growth in the first quarter and a 1.8 percent pace in the fourth quarter of 2005. The see-saw pattern of GDP growth has resulted largely from losses and recovery related to last fall's hurricanes and erratic patterns in motor vehicle sales and federal purchases. Looking over the four quarters ending in the second quarter to smooth out the temporary accelerations and decelerations, real GDP grew 3.5 percent, a very solid showing.

The composition of the four-quarter growth is favorable to continued expansion. Over the last four quarters, while real consumer spending has risen 3.0 percent, business spending on plant, equipment, and software rose 6.8 percent and exports rose 7.4 percent. Faster growth in these latter two categories suggests continued support for productivity growth ahead – as businesses use the new capital purchased – and a more competitive stance abroad.

Along with second-quarter figures, BEA also released revised estimates of real GDP since 2003. The revisions were not unusually large and left the quarterly pattern of real GDP growth largely unchanged. On average, annual real GDP growth from 2002:Q4 to 2005:Q4 was marked down by 0.3 percentage point to 3.4 percent from 3.7 percent previously. Because national accounts data are used to calculate labor productivity measures, estimates of labor productivity from 2003-2005 will also be revised.

The outlook for future business spending to expand capacity and continue the recent strong productivity performance is relatively positive. Corporate profits grew strongly in the first quarter (latest available) and as a share of GDP are at their highest level since 1966. These profits represent not only the potential for future capacity expansion, but also the potential for future hiring and increases in worker compensation.

The unemployment rate during the second quarter averaged 4.6 percent, the lowest quarterly unemployment rate since the second quarter of 2001. The rate has fallen about half a percentage point in the last year. Payroll job gains averaged about 108,000 in the second quarter, down somewhat from the first quarter average of 176,000. Over the last year the economy has added more than 1.8 million jobs. Job gains will help to keep incomes up, which will continue to support expansion.

Inflation increased in the second quarter, largely due to energy price increases. Consumer prices were up 4.3 percent from year-earlier levels in June, while consumer energy prices were up more than 23 percent and gasoline prices were up

more than 33 percent. In late March, the price of a barrel of West Texas Intermediate crude was about $66 per barrel, while in late July it has averaged about $74 per barrel. Consumers are once again facing gasoline prices in excess of $3 per gallon. Strong demand for petroleum-based fuels and geo-political considerations are probably boosting oil prices.

Outside of food and energy prices, core inflation was much more contained. Core inflation was 2.6 percent in the year ending in June, the biggest twelve-month increase since late 2001. Some statistical quirks may be partly responsible: a firming home rental market may be raising rents, which are used in constructing the owner-equivalent rent measure for housing costs. Looking back, the weakness in the home rental market as buyers took advantage of low interest rates to acquire a home may have lowered rents in 2003 and 2004, perhaps making inflation appear too low in those years.

In sum, despite recent ups and downs, the overall economy appears to be in a good position to continue growing at a moderate pace – around 3 percent – for the remaining quarters of the year.

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