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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Lawrence H. Summers to POTUS re: APEC Leaders Meeting: Economic Outlook & Agenda (4 pages)	09/08/99	P5 1240
002. memo	Lawrence H. Summers to POTUS re: APEC Leaders Meeting: Economic Outlook & Agenda (5 pages)	11/09/00	P5 1241
003. memo	Karin Lissakers (IMF) to Larry Summers & Wes McGrew re: Brazil (LOI) (1 page)	11/12/98	P1/b(1) Unclass.
004. report	re: Brazil - LOI (Letter of Intent) (11 pages)	11/12/98	P1/b(1) (C)

COLLECTION:

Clinton Administration History Project

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FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [23]

Jimmie Purvis

jp3

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

September 8, 1999

MEMORANDUM FOR THE PRESIDENT

FROM: Lawrence H. Summers LHS

SUBJECT: APEC Leaders Meeting: Economic Outlook and Agenda

The economic outlook for many Asia countries has improved significantly over the past year. Korea has experienced the most dramatic turnaround, while Malaysia, the Philippines, Singapore and Thailand are also seeing a return to positive annual growth. The other non-Japan Asian economies have experienced continued growth or at least a slowing in the pace of contraction, with the stabilization in Indonesia being particularly impressive. Japan's strong growth rate in the first quarter of the year -- though in part a statistical anomaly -- has contributed to increased hopes for a sustained return to positive growth. The Russian economy appears to have stabilized, and Mexico is experiencing quite strong growth, but Chile is in recession.

While the recovery in seriously affected Asian APEC economies is very encouraging, the crisis leaves in its wake bankrupt individuals, corporations and financial institutions which will constrain full recovery of domestic demand and economic growth for several years. Many governments have initiated financial and corporate restructuring programs designed to address these weaknesses, but have a long way to go in fully implementing them. Financial markets in these countries will remain vulnerable to negative developments until reforms are completed. However, as economic growth returns, the greater danger is that governments may become complacent about the need to undertake politically difficult reforms.

Economic Objectives of Leaders Meeting

At the APEC Leaders Meeting the overall objective is to advance trade and investment liberalization as proposed by New Zealand. Key to this end is APEC's support for a new WTO Round of multilateral trade negotiations at November's WTO Ministerial in Seattle. Other themes you will want to promote include:

- Welcoming the rapid return to growth in the economies most affected by the 1997-98 crisis and noting that the cooperative growth strategy outlined at last year's meeting is working;

- Warning of the dangers of complacency and the need to continue implementing corporate and financial sector reform programs and sound macroeconomic policies designed to achieve robust domestic demand led growth;

- Highlighting the importance of Y2K contingency plans and increased preparedness to respond to potential problems in critical sectors such as telecommunications, power, distribution, and financial services;

- Encouraging governments to address long-term problems in building social safety nets for the most vulnerable members of our societies; and

- Furthering efforts to strengthen the international financial architecture.

Outlook in Key Countries

Japan: Renewal of growth of domestic demand in Japan is key to sustainable growth in the region. The economy has shown some recent signs of firming, bolstered by the improving external environment and by policy measures taken by the Japanese government to extricate the economy from its longest postwar recession. Overall, however, Japan's economy has not been performing well in the 1990s. Since early 1993, real GDP growth has averaged only 1.2% per year (vs. 3.4% in the United States), while employment fell 0.5% between January 1993 and July 1999 (vs. a 12.0% rise in the United States). A 1997 recovery was nipped in the bud by an ill-timed sharp fiscal contraction, and the economy was further weakened by the failure of some major domestic financial institutions and, later, a fall in Asian demand for Japanese exports. Reflecting these factors, Japan's current account surplus remains large: the surplus for the first half of 1999 reached an annual rate of $115 billion, down slightly from last year's $121 billion (3.2% of GDP). The United States' largest trade deficit is with Japan. It reached $64 billion last year and continues to rise.

The Japanese government has responded to the deteriorating situation with significant policy steps. Increased fiscal stimulus helped support the economy through the first half of 1999. (Annualized growth was a statistically flawed 8.1% in the first quarter, but the economy probably contracted in the second quarter -- data to be released by September 10.) The Diet appropriated $500 billion (12% of GDP) in public funds last October to stabilize the banking system; the March 1999 injection of funds to recapitalize major banks has reduced the risk of systemic crisis in the near term. The Bank of Japan's monetary policy aims at keeping short-term interest rates close to zero and maintaining liquidity in money markets.

Despite the government's efforts, the prospect for sustained recovery remains uncertain. Solid private demand growth is elusive and the banking system remains weak. Business sentiment has improved somewhat, but surveys indicate that firms still plan to cut investment spending. Consumption is likely to remain weak or worsen in light of pressures from continued corporate restructuring on income and employment. Treasury staff expect real GDP growth of only 0.4% this year, with a small decline in prospect once again for the year 2000 -- even assuming that there will be a further supplemental budget to keep government spending from falling off. Although such a supplemental budget appears likely this fall, we still fear that Japan may succumb to complacency and cut back on stimulus before the economy achieves a durable recovery.

If you have a chance to talk with Prime Minister Obuchi on the side, you should impress upon him the following points:

- Crucial to avoid complacency, especially given recent signs suggesting your policies have helped improve the outlook. It is extremely important that macroeconomic policies remain expansionary until a durable economic recovery is solidly in place. Hope you will move boldly and quickly on a substantial supplemental budget.

- In 1997, Japan's incipient recovery was stopped cold by fiscal contraction. Cannot let that happen again.

- On banking, still need to move aggressively to achieve permanent disposal of bad assets.

China: Developments in China could also have important repercussions on the region's growth. The Chinese authorities have accorded highest economic priority to sustaining GDP growth and job creation at a level sufficiently high to ward off social unrest. Weak external and domestic demand pose significant downside risks to officially projected growth of 7% this year. On the domestic side, there is increasing recognition by the authorities that attention to the twin problems of financial sector and state-owned enterprise reform is not just a long-term policy challenge, but an immediate need to ensure that investment resources are not squandered and the quality of growth is improved. Nonetheless, GOC plans for state-owned enterprise and banking sector reforms remain at an early stage. On the external side, falling exports, declining foreign investment and persistent deflation in 1999 have led to heightened expectations of a devaluation. This was further fueled by Central Bank Governor Dai's statement in July 1999 that China's exchange rate follows a "managed float" -- a theme echoed since then by many other government officials.

During 1998 we welcomed China's stable exchange rate policy, noting that it was in China's best interest and that it helped facilitate Asia's recovery. Although a Chinese devaluation would still impact negatively on exports of other Asian countries, especially textiles and low-end consumer goods, developing Asian economies are now in a better position to cope with a moderate Chinese devaluation if it is managed correctly. Consequently, we should be neutral on China's exchange rate policy, so as to avoid any ownership of their decision.

In your discussions with President Jiang, you should highlight:

- The importance that China continues to address the various challenges of economic reform and pursue policies to strengthen domestic demand-led growth.

- Our hopes that GOC leadership press forward with reforms of the state-owned enterprise and financial sectors.

Russia: The Russian economy has defied the gloomiest forecasts that followed last year's financial crisis. In fact, over the past 11 months, the Russian government has stuck to a fairly prudent macroeconomic policy course but has made limited progress on structural reforms. The real economy is showing signs of recovery with industrial production up and GDP projected to be flat in 1999 versus earlier forecasts of a 7% decline. The ruble has held reasonably steady this year, and the trade surplus and government revenues are up significantly, although this is largely due to improved competitiveness resulting from last year's devaluation and a near doubling in oil prices. Russia appears to have met the macroeconomic targets for the next tranche of its IMF loan scheduled for September.

Nevertheless, Russia's economic situation is still precarious. The current recovery is the result of transitory factors which cannot sustain growth without further reforms. The recent allegations of corruption and money laundering highlight the fact that deep-rooted structural problems that have held Russian growth back since independence continue. Continued large-scale capital flight shows that even with the recent recovery, Russia does not have the institutional framework to attract investment capital. There are also near-term risks. Additional government spending during the election campaign could re-ignite inflation or put pressure on the ruble. The banking sector does not function and efforts to restructure it have hit political roadblocks. Thus, while the current economic "bounce" is welcome, Russia still has a long way to go to implement the structural reforms necessary to lay the groundwork for long-term economic growth.

In your meeting with Prime Minister Putin you should emphasize:

- That the rebound of the Russian economy following last year's crisis is encouraging, but recovery is not sustainable without further structural reforms. Recognize the difficulty in passing legislation this fall with the Duma concentrating on the elections, but critical that the reform program be pushed forward in order to stay on track with the IMF and World Bank.

- That concerns about recent allegations of money laundering and corruption overshadow the progress Russia has made on reform and hurt our ability to support your reform program going forward. Critical that Russia address these allegations with maximum transparency.

Asian Crisis Countries: With the exception of Indonesia, the other four Asian crisis economies are expected to grow by 2% or more this year. The Korean authorities are now projecting the economy will grow by a strong 8%, and the IMF recently raised its forecast to 6.5%. Despite the improving economic outlook, these economies remain vulnerable to downside risks and need to complete their structural reform programs. For example, in July, Korea's second largest conglomerate (Daewoo Group) nearly defaulted on its debts, raising market concerns about the solvency of numerous Korean financial institutions heavily exposed to the group. The crisis was brought on due to Daewoo's excessive debt-to-equity position and its unwillingness to undertake needed reform. Emergency action by the government, including the provision of emergency liquidity assistance to financial institutions, has temporarily calmed Korean markets, but the government faces politically difficult choices in how to facilitate the restructuring of Daewoo and other large conglomerates. Similar vulnerabilities remain in the other crisis countries.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 9, 2000

MEMORANDUM FOR THE PRESIDENT

FROM: Lawrence H. Summers LHS

SUBJECT: APEC Leaders' Meeting: Economic Outlook and Agenda

Key Economic Themes

At the APEC Leaders' Meeting, you will want to emphasize four issues:

- Continued high oil prices pose a risk to the region's recovery. Urge easing of supply constraints and long-term price sustainability.
- Further progress in restructuring undercapitalized banks and over-leveraged corporations is necessary to sustain growth and reduce vulnerabilities.
- While the international community has made much progress in reforming the international financial architecture, urge APEC countries to support us in our continued efforts. To reduce the risk of financial panic countries need to continue to focus on: stronger national balance sheets (particularly a higher ratio of liquid foreign assets to short-term foreign liabilities); strong bank regulation and supervision; greater transparency; limiting government guarantees; and more sustainable exchange rate regimes.
- It is misguided to continue to blame hedge funds for Asia's problems, especially since the number and size of these institutions have been sharply reduced, probably to the detriment of the supply of global liquidity.

Asian Overview

The outlook in most of Asia remains strong, despite some recent weakening. Excluding Japan, growth during the second quarter of this year fell to a more sustainable rate of 5 percent annualized compared to 9 percent in the first quarter. Economies with well-regulated, transparent financial systems that were least subject to government directed lending (Singapore and Hong Kong) appear not only to have best withstood the downturn, but are enjoying the most robust recoveries.

However, recoveries in some countries (Thailand, Malaysia, China and Indonesia) remain dependent upon exports and accommodative monetary and fiscal policies. Some of the cyclical factors that supported growth are fading: output gaps are closing and global liquidity conditions are tightening. External financing costs have increased, with both U.S. rates and risk spreads on emerging market debt up. Asian companies, particularly high tech companies, are also finding it much more difficult to get equity financing. In several countries (Indonesia, Philippines, and Thailand) fiscal policies will need to be tightened to avoid unsustainable debt accumulation.

Looking forward, incomplete financial and corporate restructuring will be an increasingly binding constraint on potential output and will leave economies vulnerable to negative shocks. Governments need to: 1) fully re-capitalize banks, particularly through foreign investment, so they are better positioned to force corporate debtors to implement needed debt restructuring; 2) strengthen bankruptcy regimes to force debtors to negotiate; and quickly privatize government shares of intervened financial institutions.

Other key risks which could derail the recovery are: 1) higher oil prices (which could hit Korea, the Philippines and Thailand particularly hard), 2) a slowdown in demand for high tech exports (which would hurt Korea, Malaysia and Taiwan), and 3) domestic political instability (with Indonesia, the Philippines and Taiwan most vulnerable).

Outlook and Key Issues in Selected Countries

China

In your discussion with President Jiang, you should:

- Stress the need to limit subsidizing state-owned enterprises through the banking system and to permit enterprises to sink or swim on their commercial merits.
- Express concern that Chinese companies may be viewing equity as "interest free debt" whereas in the U.S. a primary use of equity is its role in strengthening corporate governance rather than raising funds.

Economic activity in China has strengthened significantly over the past year, reducing the risk of social unrest. Strong export demand, particularly from other Asian countries, and recovery in domestic consumption and investment have pushed GDP growth to over 8% (from 7% last year) and eased deflationary pressure. The prospect of WTO accession has increased the urgency of economic reform, and the government is taking advantage of the more benign macroeconomic situation to move forward on measures that were put on hold during the Asian crisis. However, we remain concerned about the dependence of growth on unsustainable fiscal stimulus which consists largely of investment in inefficient state-owned enterprises (SOEs).

China's weak financial sector, laboring under a heavy burden of non-performing loans (NPLs, estimated at 30-50% of total loans) to inefficient SOEs, remains a source of systemic risk and a major constraint on growth. China's fledgling stock markets have neither increased the efficiency of financial intermediation nor improved corporate governance. Most equity listings remain minority stakes in money-losing SOEs. Most importantly, the government remains reluctant to close non-viable firms.

Japan

In your meeting with Prime Minister Mori, you should:

- Welcome the recently announced stimulus package, which will help reduce the risk of renewed recession, and note that further structural reforms, including market-opening deregulation and financial reform, are the keys to achieving stronger growth.
- Urge Prime Minister Mori to propose a timetable for moving forward with the negotiation of the principal policy issues of the U.S.-Japan tax treaty.

Since the beginning of last year, Japan has been recovering gradually from its deep 1997-98 recession, with private forecasters projecting 2 percent GDP growth both this year and in 2001. However, a still-weak financial system is an ongoing risk. And corporate restructuring, while positive in the longer-term, may slow growth in the short-run if firms' efforts to cut excess capacity and staff constrain business investment and household consumption.

A key bilateral issue is the need to modernize the U.S.-Japan tax treaty. Our informal discussions with the Japanese have avoided basic policy issues such as withholding tax rates, which are of fundamental interest to the U.S. business community. We have reached the point where our discussions cannot move forward effectively without discussing these broader issues. Regardless of the view of the next Administration, the U.S. business community will seek to politicize the negotiation of our bilateral tax treaty unless we can tell them that there is an agreed plan in place for taking our discussions forward.

Korea

In your meeting with President Kim Dae-Jung, you should:

- Note the importance of allowing nonviable companies, even large ones -- such as Hyundai Engineering and Daewoo -- to fail.
- Encourage faster sales of intervened financial institutions, noting from our own experience during the S&L crisis, the longer the government holds on to intervened financial institutions, the higher the ultimate fiscal cost.

The economy has been buoyed by strong export growth, particularly of high tech goods. By building up its international reserves, Korea has dramatically reduced its vulnerability to a balance of payments crisis. However, growth is slowing (from 9 percent this year to an expected 6 percent in 2001) and Korea is among the most vulnerable Asian country to high oil prices. Korean corporations remain over-leveraged and the financial sector undercapitalized which will continue to lead to periodic bouts of investor concern about another domestic liquidity crisis. Creditors recently took an encouragingly tough stance that placed Daewoo Motors in court receivership after the union refused to accept job cuts. However, the union's stance was based on the belief that the government will yet bail out Daewoo.

Indonesia

In your meeting with President Wahid, you should:

- Stress the need for rapid, but also transparent and arms-length, sales of assets nationalized during the crisis in order to renew investor confidence, dispel allegations of corruption and alleviate the public debt burden.
- Note disappointment that key commitments to the IMF -- particularly bank privatization -- are slipping and that GOI ownership of the banking sector increases the risk of further rounds of costly bank re-capitalization at public expense.

Indonesia's economy has been strengthening -- real GDP growth is expected to exceed 4 percent this year, up from about zero in 1999, due partly to surging oil and non-oil exports. However, the recovery is fragile. Investor confidence remains weak, due to political uncertainty and enduring concerns about the GOI's capacity and commitment to follow through with its IMF-supported economic program. The GOI is expected to miss key end-December commitments to the IMF to sell banks nationalized during the crisis. As a result, the IMF program could go off track.

Our overarching concern is the sustainability of public finances. The cost of re-capitalizing banks pushed public debt to more than 90 percent of GDP. To alleviate this burden, the GOI needs to more rapidly sell assets it holds, which will also renew investor confidence. Unfortunately, the agency tasked with asset sales has been slowed by allegations of corruption and political resistance to privatization which in turn is undermining support for the economic program.

Russia

In your meeting with President Putin, you should:

- Emphasize that a strong program of structural reforms, including financial sector restructuring and improving the rule of law, is the best way to generate sustainable growth.
- Highlight that passing anti-money laundering legislation that meets international standards would demonstrate that Russia is committed to international norms of behavior.

The Russian economy has strengthened substantially since the 1998 financial crisis, and the IMF is now forecasting 7 percent GDP growth in 2000. The recovery is broad-based, spurred both by high energy prices and a weak ruble, which have boosted profits and investment and generated a large balance-of-payments surplus. Foreign exchange reserves have more than doubled this year to over $25 billion. The government has been running a large budget surplus in 2000 (3 percent of GDP). All federal revenues are now collected in cash and barter has fallen sharply since the 1998 crisis.

To make growth sustainable Russia needs to implement structural reforms. These include financial sector restructuring, improving the investment climate, and enhancing the rule of law. The new Russian economic plan is quite strong, although the key challenge will be implementation. Russia has enacted significant tax reform and has passed a balanced 2001 budget through the initial stages in the Duma. We are concerned about Russia's weak anti-money laundering regime and are pressing Russia to pass an anti-money laundering law that meets international standards. The IMF and Russia are negotiating a new program, although Russia is not likely to draw new funds from the IMF since Russia is unlikely to need them. The Russians are pressing Paris Club members to agree to a new rescheduling of their Soviet-era debt after they reach agreement with the IMF. Due to Russia's strong balance of payments, another rescheduling will be very difficult to justify as long as current favorable conditions continue to prevail.

Vietnam

In your discussions with the Vietnamese authorities, you should urge them to:

- Implement extensive reform of state-owned enterprises which are increasingly squandering the country's resources.
- Strengthen the financial sector by reforming state-owned commercial banks ending the government's practice of directed-lending to nonviable SOEs.

Vietnam stands at an important crossroads. In the late 1980s, the government rejected central planning to embrace the market, yielding an average growth rate of 8 percent from 1990 to 1997. But the economy deteriorated sharply starting in late 1997, reflecting the adverse impact of the Asia crisis and domestic structural weaknesses. Foreign direct investment – the engine of growth in the mid-1990s – has plunged in recent years, reflecting investors' concerns over the slow pace of economic reform and the poor business environment. In the absence of a second round of bold economic reforms, the country risks falling even further behind its more dynamic neighbors. This is particularly true in light of China's accession to the WTO.

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Ted Truman to Secretary Rubin & Deputy Secretary Summers re: Dan Zelikow in Brazil (2 pages)	02/09/1999	P1/b(1)
002. memo	Daniel Zelikow to Assistant Secretary Truman re: Reflections on Brazil Trip (4 pages)	02/09/99	P5 1242
003. notes	re: Meeting with Fund Mission Team (2 pages)	c. 1999	P5
004. notes	re: Meeting with Arminio Fraga, Ministry of Finance (3 pages)	02/04/99	P5
005. notes	re: Meeting at Finance Ministry with Finance Minister Pedro Malan, Pedro Parente, & Amaury Bier (3 pages)	02/05/99	P5
006. notes	re: Meeting with Think-tankers (1 page)	c. 1999	P5
007. notes	re: Notes from Meetings at Central Bank (3 pages)	c. 1999	P5
008. memo	Robert E. Rubin to POTUS re: Economic issues for State Visit of Jiang Zemin (2 pages)	c. 1999	P1/b(1)
009. notes	Lawrence Summers to Sandy Berger re: Read-out from Meetings in China (1 page)	01/15/98	P1/b(1)
010. notes	Lawrence Summers to Sandy Berger re: Read-out from Meetings in Hong Kong (1 page)	01/15/98	P5

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DEPARTMENT OF THE TREASURY
WASHINGTON

February 9, 1999

MEMORANDUM TO ASSISTANT SECRETARY TRUMAN

FROM: **Daniel M. Zelikow** DMZ.
Deputy Assistant Secretary
Asia, the Americas and Africa

SUBJECT: **Reflections on Brazil Trip**

From what Steve Backes and I learned on our short visit late last week, I am more skeptical than before about Brazil's ability to avoid a highly negative scenario. There are some positive developments to report: a new Central Bank President who is both savvy and quickly taking charge; the apparent strength of the banking system; improved prospects for privatizing formerly "untouchable" state enterprises; and a renewed discussion with the IMF that will produce a program that involves more adjustment, less Brazilian discretion, and better monitoring. But Brazil's fiscal constraints may be insurmountable in the short-term, given the erosion of political support for President Cardoso and a paralytic system of government, and, if so, raises the prospects of a more depreciated exchange rate and re-ignition of inflation.

The Good News...

1. Improvements at the central bank. Apart from being well received in financial markets, Arminio Fraga's appointment as President is likely to produce several changes at the central bank that will help to rebuild confidence. He has won agreement from President Cardoso to seek significant institutional reforms that will formalize the Bank's focus on price stability and help insulate it from contrary political pressures. We were told that these changes will require a year to work through Congress. He has made good progress in recruiting a new senior management team (though Paulo Leme has since dropped off). He is also intent on cleaning out some of the Bank's lower quality holdings of reserves at the earliest opportunity (he was disappointed and surprised when he saw the balance sheet for the first time the day before). Arminio thinks the Bank can and should improve its transparency further, and he was an important force behind the announcement last week that Brazil would seek to subscribe to SDDS and to comply with IMF Article VIII. He also readily agrees to submit to limitations on central bank interventions in exchange markets, though he wants to retain some inter-temporal attitude to thwart manipulations such as those that allegedly occurred on February 2nd. Monetary policy was still to be worked out along the lines announced at Pedro and Stan's press conference, but Arminio expressed a willingness to raise interest rates in the near term if needed to contain inflationary expectations and to establish his own bona fides as an inflation-fighter.

2. Banking system solidity. We went over banking system vulnerabilities in some detail, and the Brazilians seem to have a convincing story. Capital ratios are high. NPLs remain low and stress tests indicate that they could rise substantially without posing much of a risk to the banking system's financial health. In part this is because banks have had a long time to prepare for this crisis and to adjust their portfolios to reflect worsened exchange rate, interest rate and credit risks. More important, perhaps, is the fact that only 30% of system assets are bank loans, and most of the rest is holdings of government securities.

3. More privatization. The President has signed off on privatizing Banco do Brasil, Caixia Economica, and plans to speed up the privatization of Electrobras, and public water and sewer companies, which are largely owned by municipalities and require legislation to bring about. The intention is to privatize a strategic stake in Banco do Brasil by end-2000. But none of this seems imminent, and they don't seem willing to confront the Congress frontally right now on Banco do Brasil or Petrobras.

4. Progress with the IMF. The markets seemed to like Pedro's announcement at his and Stan Fischer's joint press conference that the new primary surplus target for 1999 would be 3.0-3.5% of GDP, up from 2.6%. A larger primary surplus target was seen as necessary given the much higher current estimates of the PSBR and concomitant impact on the debt dynamics (see below). The Brazilians have also identified another 1.2% in fiscal measures for which Congressional approval won't be needed. Pedro committed Brazil to reach the original targets on their debt ratios, despite the nearly 5% of GDP addition to the debt stocks attributable to the devaluation. The Fund and Brazil have agreed on a monetary policy framework, an exchange rate policy, and are close to agreement on a balance of payments scenario which would involve a realistic level of international support and a more interventionist approach towards the foreign commercial banks. I do not think they will reach agreement on the details by week's end, however, as is their current plan.

These are my biggest worries:

1. An economic scenario that lacks credibility. The organizing focus of policy seems to have shifted from primary surplus targets to stabilizing debt dynamics -- to 46.5% of GDP by year 2001, the original program target. Quite apart from the seeming arbitrariness of that number, to reach it one needs to accept an economic scenario that I don't think holds together. First, real interest rates for 1999 are assumed to average 10.5%. This may be reasonable for a Latin country with a floating exchange rate: Mexico's real rates are similar. But it does not seem easily reconciled with concurrent attempts to limit exchange rate depreciation and inflationary expectations, and to compensate investors for persistent exchange rate volatility and the significant -- though still unquantified -- credit spread implicit in current government debt yields. The path projects that real interest rates would start off low, rise, and then retreat, a scenario that assumes investors will be negatively surprised by inflation and not subsequently insist on higher

nominal rates because of on-going inflationary expectations. It also assumes that today's nominal rates are sufficient to put inflation on a trajectory to reach mid-single digits by year-end and to appreciate the *real* to attain a 1.65 yearly average (from today's 1.92). The growth projection of -3.5% in 1999 is within market expectations, but 4% and 5% in the following two years may be suspect.

2. A fiscal adjustment that will not be achievable. The Fund seeks a primary surplus of 3.5%, which would still leave the 1999 PSBR at some 10% or more (owing to the impact of devaluation, high nominal interest rates, and slower growth). The reverse Tanzi effect will help some, and the Brazilians have identified more measures which approximate 1.2% of GDP. But they have come to the conclusion that they can neither go back to Congress for more measures nor expect any further adjustment from the States. In fact, the Fund team now expects the States to achieve net fiscal balance at best, down from a 0.4% net contribution in the first LOI. This leaves administered prices of state enterprises, particularly on refined petroleum products, as a vital component of the fiscal adjustment. Raising administered prices now would also feed directly into inflation and increase pressures for a larger increase in the minimum wage, the real value of which the Government is constitutionally obliged to protect. The level of the minimum wage, in turn, affects the fiscal because social insurance payments are tied to it. It also has an impact on inflationary expectations and wage awards in the private sector.

3. Renewed ruptures in inter-governmental fiscal relations. Even if the Federal budget performs well, there are plenty of ways that State budgets could turn out much worse. The leverage of the Federal Government to do anything about State finances is not great. The constitutionally mandated Federal transfers to the poorer States can be withheld, and these are sufficiently important to force adjustment. Unfortunately, it is the richer States with the biggest budgets and debts owed to the Federal Government that are most in need of adjustment, least inclined to make them, and least susceptible to coercion from Brasilia. It is not even legally possible for the Federal Government to compel these States not to squander the revenue gains from inflation on civil service wage awards. Judging from the rhetoric over today's news wires, President Cardoso's hard line against State governors who have sought to renegotiate their Federal debts may now be shifting. If he succumbs to the demands of the most hostile or needy States, it is inevitable that even allied governors and those least deserving of assistance will seek their own fiscal concessions.

4. A balance of payments that leaves little room for error. The Brazilians and the Fund continue to refine their BOP projections. Right now, they are still close to our own estimates, which anticipate heavy outflows in the first half of the year, substantial official support, and continued reductions in international reserves before private capital inflows resume in the second half of 1999. This scenario depends on substantial roll-overs of interbank lines and arresting domestic capital flight by the second quarter of the year. My concern for the BOP is less on mandating inter-bank rollovers (which the Brazilians seemed closer to accepting) as it is on the

behavior of investors in securitized external debt. However erroneous, foreign market participants seem inclined to focus on the need to achieve certain primary surplus targets, a certain PSBR, a certain level of depreciation to avoid hyper-inflation, a certain trajectory in the debt dynamics to avoid a default, even specific fiscal measures such as the CPMF increase. Even if they can sell the markets on their economic assumptions, the Brazilians will inevitably disappoint on some or all of these policy expectations. Foreigners, who are already underweight Brazil and virtually non-existent in domestic government securities, still have the capacity to drive domestic interest rates higher because of the readiness of domestic participants to arbitrage into Brazil's external debt instruments, which foreigners could dump. The BOP does not leave much room to accommodate a policy decision to let interest rates and the exchange rate fall further for very long.

5. Protracted delays in agreeing to an IMF program that can muster support at the Board. I find it hard to imagine that the IMF team will be able to conclude a revised program by this weekend, as is currently the plan. Another round of negotiations will be needed, especially if additional fiscal measures of the magnitude the IMF foresees will be required. Adding to the problem is the tension between the BOP, which needs the money right now to bolster confidence, and the official creditors' concerns about Brazil's credibility. The Fund team believes very strongly -- an opinion buttressed by many in their Executive Board -- that the program should not go forward until the CPMF is approved, which cannot occur until March 22nd. Even a compromise to split tranches and disburse some resources after the first House vote on the CPMF would push a Board review off until March 10th. There is also the full expectation by both the Fund and the Brazilians that the BIS would disburse proportionally with the Fund. That remains to be seen, given current sentiment.

A complete set of our trip notes is attached.

cc: Tim Geithner

Attachment

Withdrawal/Redaction Sheet
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OCUMENT NO. ND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
)01. memo	Lawrence Summers to Secretary Rubin re: Conclusions of Treasury/Fed Meeting on EMU (partial) (1 page)	06/12/96	P3/b(3)
)02. memo	Robert E. Rubin to POTUS re: Visit of French President Chirac (2 pages)	01/26/96	P5 1244

COLLECTION:

Clinton Administration History Project

OA/Box Number: 24126

FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [27]

Jimmie Purvis

jp24

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
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Freedom of Information Act - [5 U.S.C. 552(b)]

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

January 26, 1996

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin RER

SUBJECT: Visit of French President Chirac

I want to make you aware of two issues that the French President is likely to press you on in your meeting on February 1:

First, President Chirac is likely to seek your support for an initiative at the Lyon Summit to improve international monetary stability. I would advise you to discourage him from putting commitments to limit exchange rate fluctuations up for discussion.

Everyone would rather not have big exchange rate swings like we saw last spring. Then, the dollar dropped more than 20 percent against the yen and 14 percent against the German mark before recovering with help from purchases of dollars by us and other major countries. But the costs of limiting swings in exchange rates can be much higher than the costs of letting the markets run until conditions are favorable for turning them around. In addition, there are times when exchange rate adjustment is needed. We were not willing to have the Fed raise interest rates and derail the domestic economy in order to keep the dollar from declining a year ago. Looking to the future, we don't want to boost the importance we attach to exchange rates further, lest we be faced with a choice between raising interst rates or not doing what we promised on exchange rates.

Buying and selling currencies cannot be counted on to do the job without interest rate adjustments. And, as European experience has shown, even large interest rate increases sometimes fail to do the job. The French have been through this, most recently in 1992, and Chirac has consequently been lukewarm about re-fixing a tight link between the French franc and the German mark. But he would love to have others on the hook in the hope that this would reduce the cost to France of maintaining fixed parity with the mark.

Exchange market developments have been reasonably favorable since last spring, and this is not the time to contemplate a change in an approach that has, on the whole, served us well.

Chirac may propose an alternative approach to improve monetary stability, where we could find more common ground. He is concerned about the role of financial derivatives as a destabilizing force in the market. I think this is way overdone by the French -- speculative players in these markets are froth on the massive global financial market. Moreover, they are not completely free of supervision. Nonetheless, there are issues here that merit close attention internationally. I am more concerned about risks of failures in these markets than in any contribution to exchange rate volatility. Supervision by both management and the regulators has not kept up with innovation. It is worth giving ample attention to supervision of these cross-border markets, as was agreed at Halifax. Another push to the regulators at the Lyon Summit would be useful, although the French would probably go too far in stifling innovation if we let them.

Second, Chirac is likely to raise IDA, the World Bank's concessional lending facility for the poorest developing countries. He will likely be extremely critical of our failure to meet our commitments to IDA and the other multilateral development banks, and our inability to commit to participating in the next IDA replenishment. He may note G-7 commitments made in Halifax to support IDA. This is a serious problem since it will take an increase from 1996 appropriated funding levels just to make up our outstanding arrears in this fiscal year. Meanwhile, the rest of the world is ready to go forward with new commitments of multilateral assistance to the poorest countries. I recommend that you stress: 1) that you are committed to participation in IDA; 2) that you have made meeting existing U.S. commitments to IDA a top priority; and 3) that we are working hard to be in a position to pledge a new U.S. contribution -- at a credible level with realistic prospects of Congressional support -- at the earliest possible date.

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Robert E. Rubin to POTUS re: Your Dinner with German Chancellor Kohl (2 pages)	06/04/97	P5 1245
002. briefing paper	re: Russian Financial Issues (2 pages)	ca. 1999	P5
003. memo	Robert E. Rubin to POTUS re: Meeting with German Chancellor Schroeder (3 pages)	02/09/99	P5 1246
004. memo	Robert E. Rubin to POTUS re: The Economic Agenda for the Lyons G-7 Summit (4 pages)	06/24/96	P5 1247

COLLECTION:

Clinton Administration History Project

OA/Box Number: 24126

FOLDER TITLE:

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Jimmie Purvis

jp25

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

June 4, 1997

MEMORANDUM FOR PRESIDENT CLINTON

FROM: Robert E. Rubin R.E.R.

SUBJECT: Your Dinner with German Chancellor Kohl

I would like to provide you with some background on the economic issues facing Germany, with EMU on the horizon, and related U.S. interests.

Germany's Economic Challenges

Chancellor Kohl's principal challenge is to generate sustained economic growth to lower Germany's high unemployment, while also bringing down the budget deficit.

- Over the past four years, Germany has grown at half of the U.S. rate. Most economists forecast growth of only 2-1/4% - 2-1/2% in 1997-98, not enough to bring down unemployment much.
- Jobs in Germany have fallen by nearly 1-1/2 million since 1993; unemployment is now over 11 percent.
- Chancellor Kohl faces enormous difficulties in getting parliamentary approval of tax reforms and structural reforms that are needed to increase investment and employment in Germany.

Prospects for EMU Growing Cloudy

Developments over the past two weeks have increased the uncertainty surrounding EMU and its implications for the rest of the world.

- Chancellor Kohl is an ardent supporter of EMU, but the German public is worried about replacing the DM with a potentially soft, inflationary euro (the chosen name of the new currency). To assuage German fears, Chancellor Kohl's government has consistently argued for a strict interpretation of the Maastricht criteria with the unstated intention of excluding inflationary, high-deficit countries like Italy. But both France and Germany, the two essential players in EMU, face difficulties in reaching the 3% budget target.
- Last month, Chancellor Kohl's government sparked a major political row with a plan to revalue gold held by the

Bundesbank and transfer the resulting profits to the government. This plan apparently provided a painless way of closing small budget gaps for 1997 and 1998. The Bundesbank denounced the plan and this week the government backed off from its proposal.

- Meanwhile, the Socialist victory in the French parliamentary elections poses a problem for Germany. The Socialists campaigned against EMU-inspired austerity. Prime Minister-elect Jospin stated after the election that he would insist on a broad EMU that includes countries such as Italy and Spain.

U.S. Interests in EMU

We have consistently supported European integration, but we have not explicitly endorsed EMU nor have we publicly commented on the specifics of how EMU is launched and which countries participate.

Our interests lie in seeing that sound and credible policies are adopted that will enable Europe to meet its economic challenges effectively. If Europe succeeds in addressing these challenges, we see no risks for the United States. However, we are concerned that in their attempt to meet the Maastricht criteria and in the transition to EMU, European governments have not and will not devote enough attention to their pressing need for labor market and competition reforms.

G-7

On a different subject, the only real leadership in international economic affairs comes from the G-7 Finance Ministers, who report to the G-7 Heads of State. It's important to keep this process intact. It works because these countries share the same perspective of developed economies. We are not asking you to raise this, but provide this in case it comes up.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

February 9, 1999

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin RER

SUBJECT: Meeting with German Chancellor Schroeder

I want to highlight some of the key economic issues on the agenda for your upcoming meeting with Chancellor Schroeder.

Russia. The Russians continue to press the U.S. (and presumably Germany) to put political pressure on the Fund to agree to a weak program for Russia. We have told the Russians explicitly that the Fund will not lend for political reasons and that it is up to Russia to engage seriously with the IMF on technical discussions for a program. We should encourage Germany to give a similar message. The Russian Duma approved the government's draft 1999 budget on February 5, but it is based on unrealistic assumptions and needs serious adjustment if it is to be the basis for an IMF program. On debt issues, Germany, as Russia's largest creditor, has taken a hard line in discussions on Russian debt so far. Chancellor Schroeder may ask about recent press reports that claimed that U.S. officials have discussed debt forgiveness with Russian officials. We have consistently told the Russians that an IMF agreement is needed before the Paris Club can consider any restructuring of Russia's foreign debt.

Key Points to Make:

- We all want to find ways to support the Russians. But, a sustainable budget and a workable IMF program are necessary or else international assistance would be wasted – again.

- G-7 needs to give consistent message to Russian government that IMF will not lend for political reasons. Russia needs to engage in serious technical discussions with IMF.

- The U.S. has consistently told the Russian government that an agreement with the IMF is needed before Russia can begin discussions with the Paris Club on debt restructuring.

- When/if the time comes for the Paris Club to consider a restructuring of Russian debt, it will be important for the U.S. and Germany to consult closely to develop a reasonable restructuring proposal.

International Financial Architecture. It is particularly important that we work closely with Germany, chair of the G-7/G-8 Summit process, to produce concrete, well-thought-out recommendations for the Summit. German Finance Minister Lafontaine has been pressing for cooperation to stabilize exchange rates as a centerpiece of changes in the international financial system, although Chancellor Schroeder does not seem to agree. We also do not support this, rather believe that improvements should be centered around: (1) incentives to convince emerging market countries to adopt good policies and build stronger financial systems; and (2) finding better ways to clarify the risks of certain types of financial activity and getting markets to pay attention to those risks. We also believe success of our efforts depends on involving key emerging markets in decision-making and are pleased Germany now agrees with us on this issue.

Key Points to Make:

- Agree on the importance of strengthening international financial architecture.
- Important for our finance ministers and central bank governors to develop concrete, well-considered proposals for sensible global financial reforms in time for the Cologne Summit.

If raised (exchange rate target zones):

- We support cooperation on better overall macro policies through the G-7 process, but we do not believe it makes sense to try to manage exchange rates.
- Floating rates allow us to aim domestic monetary policy principally at sustaining domestic growth with stable prices, an appropriate objective for our economies.
- The experience of European countries in establishing the Euro shows that tremendous political will and economic convergence is needed for a concerted monetary and exchange rate policy.
- The current situation among G-7 countries differs from the situation within Europe in this respect.

Economic Outlook for Germany, EMU. We are concerned about slowing growth in Europe and its impact on fragile recoveries of emerging markets. After nearly 3% growth in 1998, the eleven members of the European Monetary Union (EMU) are likely to grow around 2% this year, with Germany growing slower. The erosion of confidence in the Schroeder government, suggested by the SPD/Green loss in Hesse state elections over the weekend, will not help Germany's economic outlook. Also, the accompanying loss of the SPD/Green majority in the Bundesrat will make it more difficult for the government to move its agenda forward. With Japan mired in recession and the U.S. current account deficit on the rise, it becomes even more critical that Europe support domestic demand-led growth to provide a market outside the United States for crisis country exports.

January's launch of the European Economic and Monetary Union, the culmination of years of preparation, proceeded smoothly. However, the focus on EMU preparations and its subsequent success have shifted vital attention away from structural reforms needed to improve labor market flexibility, attract new investment, and establish Europe on a higher path of sustainable domestic demand-led growth. The new government -- notably the Chancellor's less moderate Finance Minister Lafontaine -- has explicitly shifted emphasis from structural reforms toward monetary and fiscal stimulus as a means of reducing unemployment. While not requiring your engagement at this time, I expect the issue of structural reform to remain with us for some time to come.

It is possible that Chancellor Schroeder may ask about increasing European representation (to include the European Central Bank, EC and Euro-11 representation) in the G-7 Finance Ministers' process. We have resisted expanding the group size to preserve its small, informal working nature.

As Ambassador Barshefsky will convey in more detail, we have a number of outstanding trade issues with the EU, which we need to resolve effectively.

<u>Key Points to Make</u>:

- U.S. economy still strong. But very important that Europe and Japan strengthen domestic demand and hope we can continue to work together to help emerging markets recover.

- The key challenge is growth. We can't sustain this imbalance in growth and openness between the United States and the rest of the world.

- Congratulations on smooth (January) launch of the long-planned Economic and Monetary Union (EMU).

- Look forward to working with the EMU, and sincerely believe that if EMU is good for Europe it also will be good for the United States.

<u>If Raised (Euro-representation in G-7):</u>

- Important to find solution to representation issue that is sensitive to Europe's needs, yet preserves the small, informal nature of the group.

- Decisions about informal meetings at the ministerial level best left to the ministers themselves.

96-5299

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

June 24, 1996

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin RER

SUBJECT: The Economic Agenda for the Lyons G-7 Summit

This note provides a summary of key issues on the economic agenda for Lyons.

Growth and Job Creation

You go to this Summit with the strongest economic record in the G-7 -- the longest and strongest recovery, the lowest budget deficit, and the best performance creating jobs (seven times more over the past few years than all the other G-7 combined).

The outlook for the rest of the G-7 is mixed, but with signs of improvement.

- Japan is showing stronger growth, the result of an aggressive program of fiscal and monetary stimulus, which we actively encouraged. The current account surplus has fallen sharply to below two percent of GDP, almost half the level in 1993. Nevertheless, the underlying trend in private demand growth remains uncertain and we do not want to see the recovery or the reduction in the trade surplus jeopardized by an early or excessively sharp tightening of policy.

- Europe is preoccupied by the path to a common currency. With slow growth and high unemployment, it will be difficult for Germany and probably impossible for France to reach a budget deficit of three percent or less next year as called for in the Maastricht treaty. Recent political signals suggest a willingness to use the flexibility that exists in the treaty to begin the process of creating a common currency, but this will not reduce the need to deal over time with the structural rigidities and generous entitlement programs which are keeping budget deficits and unemployment high.

Financial Stability

Exchange Rates

The dollar's recovery last year and the restoration of relative calm to the exchange markets have contributed to the improved outlook in our economies and demonstrated the effectiveness of our approach to G-7 cooperation.

- It is important that you resist any attempt by President Chirac to push the dollar artificially higher or to move us to a more managed exchange rate system that would force us to raise interest rates to stabilize the dollar at the expense of U.S. growth.

Reducing Risk in the Financial Markets

We have made considerable progress on the Halifax Summit reforms to reduce the risk of future financial crises.

- The IMF has put in place strong disclosure standards as part of an improved early warning and prevention system.

- The G-10 have endorsed specific proposals for encouraging private investors to bear a greater share of the burden of responding to future crises.

- We have reached broad agreement on a $50 billion arrangement, including substantial financial commitments from a number of emerging market economies, to help the IMF avert crises that could threaten the stability of the international monetary system.

- The international regulatory community has intensified cooperation to deal with the risks presented by, among other things, financial derivatives and to coordinate supervision across national borders of large, diversified financial institutions.

- A priority for the coming year should be to strengthen financial supervision in emerging markets.

Development and Debt

Focus on Africa

President Chirac wants this to be the Development Summit. We share a common concern for the poorest countries, notably in Africa, which risk being left behind. However, we would put more emphasis on the need for targeted efforts to support political and economic reform to create an environment in which development can succeed and less emphasis on the volume of aid.

Debt Reduction

One initiative that would bring great benefit to the poorest countries that embrace reform is a U.S.-U.K. proposal to reduce their debt burden. This proposal involves a World Bank-financed trust fund, an IMF lending facility, and deeper debt reduction by official creditors through the Paris Club.

The key unresolved issue is how to finance the IMF's contribution. We have strongly advocated the sale of a small portion of the IMF's roughly $40 billion of gold and the investment of the proceeds to generate income that could be used to ease the burden on the poorest developing countries.

- We and the U.K. have brought most of the G-7 on Board. Germany is the sole strong holdout against gold sales, with Italy still expressing some support for Germany's position.

- Germany's opposition seems to be based primarily on the belief that the IMF's gold reserves should only be used in a dire emergency (even though our plan would not spend the proceeds of a gold sale, but merely invest them in an income-generating asset that could be used to reduce debt burdens). German officials also fear that agreeing to IMF gold sales could put pressure on them to sell German gold to reduce the budget deficit.

- The alternative of financing the IMF's contribution to the debt initiative through bilateral contributions is: (1) not necessary given the vast resources of the IMF; (2) not appropriate given the contributions the U.S. and other governments are making to reducing bilateral debt burdens; and (3) not something Congress would support.

We want to support Chirac in trying to use the Summit to convince Kohl to change Germany's position, or at least to accept that the gold sales will go forward over Germany's opposition.

IDA

You are also likely to be pressed on the issue of our contributions to IDA -- the low interest rate window of the World Bank for loans to the poorest countries.

- We have undertaken to clear overdue contributions of $934 million this year, but the House included only $525 million in its appropriation bill. The Senate was pointing towards a somewhat higher figure, but not more than $700 million, when the appropriations process was derailed in the Senate last month.

- You can be emphatic about your personal commitment to IDA and your other foreign assistance priorities, but being realistic, the Republican Congress will leave us short of our goal (even though the IDA commitment in question was made by President Bush).

- Exclusion of U.S. firms from bidding on projects funded from a special fund set up by others to keep resources flowing this year has sharpened Congressional opposition to IDA.

- The best course to maintain IDA is to not reopen negotiations this year, while we make best efforts to obtain funding.

cc Anthony Lake
Laura Tyson

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Robert E. Rubin to POTUS re: U.S. Exchange Stabilization Facility for Indonesia (3 pages)	10/30/97	P5 1248
002. memo	Karin Lissakers (IMF) to Deputy Secretary Summers, Under Secretary Lipton, & Assistant Secretary Giethner re: Camdessus on Indonesia (1 page)	03/16/98	~~P1/b(1)~~ Unclass
003. memo	Mark Sobel (IMF) to Steve Saeger re: Indonesia (1 page)	05/18/98	~~P1/b(1)~~ Unclass.
004. letter	POTUS to President Soeharto re: Developments in Indonesia (1 page)	05/19/98	~~P1/b(1)~~ Unclass.
005. memo	Lawrence H. Summers to POTUS re: Your Meeting with President Wahid of Indonesia (1 page)	11/10/99	P5 1249

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Jimmie Purvis

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

October 30, 1997

MEMORANDUM FOR PRESIDENT CLINTON

FROM: Robert E. Rubin RER

SUBJECT: U.S. Exchange Stabilization Facility for Indonesia

Overview

As we have discussed over the past several days, we plan to extend U.S. contingent financial support to Indonesia in the context of an IMF adjustment program to help restore financial market confidence in Indonesia and its currency. Indonesia is close to agreement with the IMF on needed policy reforms. Upon conclusion of that agreement, we intend to announce that the United States will be willing to provide up to $3 billion in contingent financial support to Indonesia to back-up its IMF program.

The Rationale for U.S. Support

Indonesia has come under sustained financial pressure over the last several months. Since July 1, the exchange rate has depreciated by 33%, the stock market has fallen by 35%, and short-term interest rates have risen as high 40%. The sources of Indonesia's financial problems lie in a number of factors, including: the contagion effects of the Thai crisis, a large overhang of short-term debt, problems in the banking sector, and concerns about political stability. Combined with the effects of the recent droughts and fires, this is likely to cause a sharp slowdown in growth and widespread financial distress. If this crisis continues unabated in Indonesia, there is the risk of a further intensification of the crisis in South East Asia with potential further contagion in North East Asia and other emerging markets around the world.

By providing a U.S. financial commitment in support of an IMF adjustment package, we believe we can help increase the prospects of the success of that program. The contingent financing we and several other nations will offer should reinforce incentives for timely and full implementation of Indonesia's IMF program. Moreover, the restoration of financial stability to Indonesia should have a positive effect on confidence regionally.

The United States' economic interest in Asia is substantial, as evidenced by the $186 billion in U.S. exports to the region last year. We also have substantial security interests in the region. Indonesia is the largest country in Southeast Asia and occupies a strategic geographical location.

We need to be able to participate in shaping cooperative financial arrangements in the region to deal with crises when they arise. A financial commitment by the United States will be an important step to ensure that we maintain our leadership role in the region. It is important that we do not cede leadership in these areas to Japan.

Multilateral and Regional Response to Indonesian Crisis

The IMF is close to announcing a strong reform program for Indonesia aimed at restoring financial stability. We expect the IMF to contribute $10 billion to this program, with the World Bank and Asian Development Bank providing $3.5 in addition to the $4.5 billion available in their pipelines. Among other things, this program will:

- tighten monetary policy to stabilize exchange markets;
- tighten fiscal policy through revenue increases and expenditure cuts to produce fiscal surplus and improve budget transparency;
- strengthen the domestic financial sector by closing insolvent banks and improving regulation and supervision; and
- improve economic efficiency and governance by ending various marketing monopolies, reducing tariffs and non-tariff barriers.

Japan, Singapore, Malaysia, and Australia have also offered contingent financial assistance to Indonesia. We expect that Singapore will contribute $5 billion in resources and for Japan to contribute about the same amount. Malaysia has offered $1 billion. Australian may extend a currency swap to Indonesia similar to the $1 billion swap offered to Thailand.

There are significant risks in going forward with a U.S. commitment to Indonesia. There may be criticism from Capitol Hill and from the public, which could make approval of some of our initiatives on Capitol Hill more difficult. Our commitment may also create an expectation that the United States will step in with direct financing to support other economies when they encounter trouble. On balance, however, we believe that U.S. interests will be best served by this action.

Mechanics of an Indonesian Program

Our financial commitment to Indonesia would be financed with the resources of the Exchange Stabilization Fund. This support would be a back-up for Indonesia's IMF program and would only be drawn on in the event that financial market pressures were greater than currently envisaged and foreign currency reserves were depleted below a specified level. Furthermore, this support would depend on Indonesia's continued eligibility to draw upon IMF resources under its program.

We are structuring our contingent commitment so as to minimize risks to the United States. Among the conditions we will insist on are:

- that Indonesia maintain a cushion of reserves;
- the right to accelerate repayment;
- a right to demand additional adjustment measures (over and above the conditions agreed and being implemented under its IMF program) in order to be eligible to draw our funds;
- short-term maturities; and
- an appropriate interest rate that will cover U.S. risk.

U.S. exposure would be limited to 60 days at one-time, but there would be an expectation that we could roll over each drawdown several times for up to one year.

The statute establishing the Exchange Stabilization Fund provides that a loan or credit may be made for more than six months in any twelve month period only if the President gives Congress a written statement that "unique or emergency" circumstances require such a loan or credit be for more than six months. You sent such a statement with respect to the February 1995 Mexico stabilization package. We will request you to provide such a statement, if necessary, for the Indonesia facility at an appropriate time.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 10, 1999

MEMORANDUM FOR THE PRESIDENT

FROM: Lawrence H. Summers LHS

SUBJECT: Your Meeting with President Wahid of Indonesia

Indonesia's new government offers hope for much needed stability, but the country's economic challenges remain formidable. *Large banking and corporate sector debt problems must be resolved and the government needs to establish credibility with its own citizens, the Chinese financial community and the international financial community to restore private investment.* The economy, which was showing signs of recovery last spring, has lost momentum in recent months due to the problems and uncertainties associated with East Timor, the political transition, the Bank Bali scandal and the associated paralysis of economic policy decisions.

The principal challenges to recovery and the core of your message to Wahid should be in the following areas:

- The government needs to build a legal and regulatory infrastructure to promote a favorable environment for private investment and substantially reduce corruption. Transparent rules and procedures that provide adequate protection for lenders and investors are essential. In this light, the government itself must be seen as honoring its international commitments, including respecting the rights of independent power producers to international arbitration in accordance with their contracts.

- The government needs to develop a credible program to restructure the private financial system and to force corporate restructuring to move forward.

- The government must articulate and implement a credible macroeconomic program that the IMF can support, including a monetary policy that will support exchange rate stability and a fiscal program that provides the stimulus necessary to support economic recovery.

You should impress upon Wahid that we will be as helpful as we can with the IMF, World Bank, ADB and the Paris Club to give the support Indonesia needs. However, you need to emphasize to Wahid the importance of restoring the credibility his predecessors lost. As is true for any new government, the impressions formed by actions and statements during the early part of an administration will have significant effect on the entire term.

You should also inform Wahid that a legislative mandate provides that the United States cannot support new IFI assistance (other than to address basic human needs) until Indonesia has in place a functioning system for reporting to civilian authorities audits of military receipts and expenditures.

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Deputy Secretary Summers to Secretary Rubin re: Appointment of Michel Camdessus for a Third Term as Managing Director of the International Monetary Fund (pages 2-3 are closed in whole b(6) (3 pages)	04/08/96	P5, b(6) 1250
002. memo	Karin Lissakers (IMF) to Tim Geithner re: G-10 Discussion on Capital Account Convertibility (2 pages)	12/03/96	~~P1/b(1)~~
003. memo	Karin Lissakers (IMF) to Larry Summers, Jeff Shafer, & David Lipton re: An IMF Agenda for the Second Clinton Administration (1 page)	01/06/97	~~P1/b(1)~~
004. memo	Karin Lissakers (IMF) to Larry Summers, Jeff Shafer, & David Lipton re: An IMF Agenda for the Second Clinton Administration (15 pages)	01/06/97	~~P1/b(1)~~

COLLECTION:

Clinton Presidential Records
Clinton Administration History Project

OA/Box Number: 24126

FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [31]

jp27

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [a)(5) of the PRA]
P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.
PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).
RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

b(1) National security classified information [(b)(1) of the FOIA]
b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
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b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

4/8/96

ACTION

MEMORANDUM FOR SECRETARY RUBIN

FROM: Deputy Secretary Summers

SUBJECT: Appointment of Michel Camdessus for a Third Term as Managing Director of the International Monetary Fund (IMF)

ACTION FORCING EVENT:

We need to make a decision whether to support the growing consensus in favor of a third five-year term for IMF Managing Director Michel Camdessus, whose current term expires in January 1997. By tradition, a European heads the Fund and a U.S. citizen heads the World Bank.

RECOMMENDATION:

That you call Camdessus to indicate our support for a third term as the MD of the IMF.

_______ Agree _______ Disagree _______ Let's Discuss

BACKGROUND:

On balance, we think that Camdessus has been a reasonably effective MD and that his activism and creativity have usually benefitted U.S. interests. We see no potential alternative candidate that would gain sufficient European support to overtake the growing consensus to reappoint Camdessus. Greenspan concurs, though not with much enthusiasm. This issue is expected to be resolved by the Spring Meetings of the IMF Interim Committee and World Bank Development Committee, April 22 and 23. We do not see any benefit in dragging out the decision-making process.

We are inclined to agree with the notion of a three-year rather than the normal five-year term. After ten years on the job, Mr. Camdessus is beginning to show signs of wear and tear. This would take Camdessus one year beyond the mandatory IMF retirement age (although the MD is not subject to this rule). Therefore, if a significant faction emerges favoring a curtailed third term, we should be supportive, but we should avoid the lead, both in appearance and deed.

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Lloyd Bentsen to POTUS re: Japan (1 page)	10/28/93	P5 1251
002. letter	POTUS to Prime Minister Hosokawa re: Upcoming Meeting in Seattle (2 pages)	circa Oct. 1993	P1/b(1) Unclass.
003. memo	Robert E. Rubin to POTUS re: Your Meeting with Prime Minister Hashimoto (2 pages)	04/1196	P5 1252
004. memo	Robert E. Rubin to POTUS re: April 25 Meeting with Japanese Prime Minister Hashimoto (2 pages)	04/23/97	P5 1253
005. talking points	re: Key Points for Call to President Kim Young Sam (2 pages)	circa Nov. 1997	P5
006. talking points	re: Key Points for Your Call to Prime Minister Hashimoto (2 pages)	circa Nov. 1997	P5
007. memo	Karin Lissakers (IMF) to Deputy Secretary Summers & Deputy Assistant Secretary Atkinson re; Mobilizing Funds for IMF Korea Disbursements (1 page)	12/02/97	P1/b(1) Unclass.
008. memo	Karin Lissakers (IMF) to Deputy Secretary Summers, Under Secretary Lipton, & Assistant Secretary Geithner re: Managing Director's Briefing on Fund Agreement with Korea (5 pages)	12/03/97	P1/b(1) Unclass.
009. memo	Lawrence H. Summers to POTUS re: Your Meeting with President Kim Dae-Jung: Key Economic Issues (1 page)	06/30/99	P5 1254

COLLECTION:

Clinton Administration History project

OA/Box Number: 24124

FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [2]

Jimmie Purvis

jp31

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
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THE SECRETARY OF THE TREASURY
WASHINGTON

October 28, 1993

MEMORANDUM FOR THE PRESIDENT

FROM: Lloyd Bentsen Lloyd Bentsen

SUBJECT: Japan

We are entering a critical stage in the economic policy debate in Japan. I propose that you write the Prime Minister over the next few days to outline our objectives on the economic front and to signal that you would like to use the Seattle meeting to move the ball forward on these issues.

First, we should send a signal about the importance of further stimulus. An official advisory committee will endorse an income tax cut on the eve of your meeting with Prime Minister Hosokawa in Seattle. But, the package now under consideration is too small and may well be neutralized by expenditure cuts and subsequent consumption tax increases after a short interval. I do not propose that you address any quantitative issues in your letter, but simply advise the Prime Minister that we are hopeful of strong fiscal steps, not weak ones.

There is a second advisory group charged by the Prime Minister with finding ways to "create a more consumer-oriented economy and reduce the large current account surplus" which is scheduled to release an interim report on November 8. I would like the letter to refer to this also.

Third, we need to push for more progress on market access issues under the Framework discussions. I am sure Mickey Kanter would agree that we have seen little progress in most of the sectoral negotiations to date. The Prime Minister should be made aware that you plan to bring this up in Seattle.

Fourth, we need to encourage the Prime Minister to take the steps necessary to help close the Uruguay Round. I would defer to Mickey on the substance of your message, but I do not think we can afford to let them continue to hide behind our disagreements with the European Community.

Attached is a draft letter.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

April 1

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin REG

SUBJECT: Your Meeting with Prime Minister Hashimoto

Your meeting with Prime Minister Hashimoto will take place against a background of a gradually improving Japanese economy, rapid U.S. export growth to Japan, a sharply declining Japanese current account surplus, and firm dollar exchange rates.

- Much of this improvement reflects an effective record of cooperation on macroeconomic and financial policies over the past year. By pressing for fiscal stimulus and interest rate reductions in Japan, we played a significant part in arresting the sharp downturn in Japan last year and laying the foundation for recovery and further reductions in Japan's surplus. Without such measures, our cooperation in exchange rates would have been ineffective. With them, U.S. and Japan efforts reversed the excessive appreciation of the yen last spring, created a much firmer tone for the dollar and boosted confidence in Japan, which is now being translated into growth.

Despite these positive developments, Japan's recovery is still young and relatively weak. The average private forecast is for two percent real growth in 1996. With public expenditures set to decline later this year and tax increases scheduled to go into effect in early 1997, there is some risk that fiscal policy in Japan will turn contractionary before a strong recovery is firmly established.

- In light of this, it would be helpful if you would encourage the Prime Minister to take action in his supplemental budget in the summer to avoid an early reduction in fiscal stimulus and to keep monetary policy accommodative.

Japan's financial system is still vulnerable and the legislative changes necessary to help fix the problem are still hostage to an ongoing political struggle over the use of public funds to help failed financial institutions and depositors.

- You should be careful to avoid appearing to endorse any specific proposal, but it would be helpful to emphasize the importance that we and the financial markets place on quick action to address the financial problems in the banking sector.

The Prime Minister may ask for some statement that the United States will continue to cooperate with Japan in the exchange markets. Japan would like to see the yen continue to decline against the dollar, or at least establish a firm ceiling to prevent any significant reversal in depreciation that has already occurred.

- If he pursues this line, you should make the point that exchange market stability is unlikely to endure without appropriate underlying economic policies. For Japan, this means further deregulation and market opening and continued support from macroeconomic policies for domestic demand growth and current account adjustment.

In your public statements, I think you want to avoid any comment on exchange rates. It is especially important to avoid any statement that could be construed as concern about a strong dollar, given the recent and still fragile return of market confidence in our currency. If asked directly, the best response is something that shifts the emphasis back to fundamental economic policies and away from exchange rates.

- We are generally pleased with developments over the past year.

- We think it is important that Japan continue to pursue policies that will support sustained growth, further reductions in the current account surplus, and more trade liberalization.

- On the U.S. side we need to continue deficit reduction as we have for three years now.

- A strong dollar is in America's economic interest.

The absence of this final statement in particular could cause an adverse market reaction.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

April 23, 1997

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin RER

SUBJECT: April 25 Meeting with Japanese Prime Minister Hashimoto

We see new economic risks on the horizon in Japan which will be important for you to address in your meeting with Prime Minister Hashimoto on April 25.

The key sources of our concern are the following:

- We face a significant risk that Japan's current account surplus will increase sharply over the next two years (from $66 billion in 1996 to a projected $88 billion in 1997 and $126 billion in 1998).

- The Prime Minister's aggressive fiscal consolidation program (a 2 percentage point reduction in the structural deficit this year) increases the risk of a slowdown in domestic demand, a further decline in the yen, and a more rapid rise in exports, all of which would tend to magnify the increase in the surplus that is already likely to occur.

- The Prime Minister believes that his deregulation initiatives will offset the short-term contractionary effects of the planned fiscal consolidation. We believe that this is extremely unlikely.

- The financial system remains weak, and vulnerable to systemic crisis, if the Government is not able to move more rapidly to resolve a problem that is substantially larger than our S&L problem was in the 1980s.

- As Ambassador Barshefsky will convey in more detail, we have a number of outstanding trade issues, which we need to resolve effectively.

The Prime Minister faces limited political options right now. Having made a strong commitment to cutting the fiscal budget deficit, he is not inclined to alter that course. He has publicly committed to an ambitious deregulation program that so far -- outside the financial arena -- looks to have uncertain yield in terms of materially benefitting U.S. firms trying to compete in the Japanese market. For us, increased heat on the trade front (Japan's surplus, fast-track, China MFN) makes this the right time to revitalize our trade agenda with Japan.

In this context, our approach has been to get the Prime Minister to reaffirm publicly the objectives ensuring strong, domestic-demand-led growth and avoiding a resurgence of Japan's current account surplus. While welcoming the Prime Minister's deregulation agenda, we have emphasized that the test of success will be the extent to which this results in greater competition in heavily regulated sectors, improved market access for foreign firms and lower prices for Japanese consumers.

In your meeting it would be helpful if you would reiterate the basic points you made in your letter of April 2 to the Prime Minister:

- Concerned that a large Japanese current account surplus will reemerge. Appreciate the need to reduce budget deficits, but an overly rapid fiscal consolidation places downward pressure on the yen and jeopardizes a domestic-demand-led recovery.

- Urge flexibility in coming months to take policy actions as needed to ensure strong, domestic-demand-led growth and avoid a resurgence of Japan's current account surplus.

- Fully support commitment to deregulation, urge continued efforts to improve market access for foreign firms, and propose a more active dialogue on these issues.

- Welcome actions so far to correct banking system problems -- quick and comprehensive resolution needed to preserve financial system stability.

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

June 30, 1999

MEMORANDUM FOR THE PRESIDENT

FROM: Lawrence H. Summers LHS

SUBJECT: Your Meeting with President Kim Dae-Jung: Key Economic Issues

Korea is recovering remarkably well from the Asian financial crisis. Following a contraction of almost 6 percent in 1998, the economy is projected to grow by 4-5 percent in 1999. External financing problems have been alleviated by the buildup to nearly $60 billion in foreign exchange reserves. Confidence has also been restored, which is reflected in the stabilization of the *won* and the recovery of the stock market to above its pre-crisis level.

The turnaround is largely due to the government's efforts to deal with the crisis. Monetary and fiscal policy helped restore confidence in early 1998, after which the government has pursued greater stimulus. Korea has also implemented financial and corporate sector reforms that address major vulnerabilities at the heart of the crisis. The government closed 27 insolvent financial institutions and allocated $53 billion of public funds to purchase bad loans and re-capitalize banks. It also developed a voluntary process for heavily leveraged companies to restructure their debt.

Still, there is more work to be done. Korean banks will almost certainly require additional government assistance. Deeper operational restructuring is also needed among Korea's conglomerates (*chaebol*) to make them economically viable. The biggest challenge is to force the largest five *chaebol* to carry through with reforms. These five alone account for nearly 10 percent of GDP, yet they are inefficient and consume a disproportionate share of domestic savings.

Several U.S. industries (e.g. semiconductors, shipbuilding, steel) are concerned that persistent overcapacity within these *chaebol* has created unfair competition, and that the Korean government has continued to provide these conglomerates with preferential treatment in the restructuring process. We have pursued these claims very seriously and have yet to find any evidence to support them. Nevertheless, you should raise the importance of following through with reform in a way that achieves real operational restructuring of the *chaebol* and precludes preferential treatment.

- In your meeting with Kim you should congratulate him for implementing the politically difficult but necessary measures that have brought Korea out of the crisis.

- You should also note that reform is not complete, and failure to follow through will undermine Korea's ability to return to high rates of sustainable growth. It is important that the government also does not engage in preferential treatment in the reform effort.

Another issue that may arise relates to Korea's desire to borrow an additional $400 million from the World Bank (on top of $7 billion already borrowed). We question the appropriateness of Korea continuing large borrowings from the Bank. If it does, we have told the Koreans it should pay the Bank's higher "emergency lending" terms. If raised, you should note that Korea is relatively wealthy, can afford to pay the higher terms, and should consider early repayment of previous loans.

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION	
001. memo	Lawrence H. Summers to POTUS re: Update on Argentina Economic Situation in Advance of President De La Rua's Visit to Washington (2 pages)	06/06/00	P5	1255
002. memo	Lawrence H. Summers to POTUS re: Update on Argentina Economic Situation in Advance of President De La Rua's Visit to Washington (2 pages)	06/06/00	P5	1256
003. memo	Secretary Bentsen to POTUS re: Your Meeting with President-elect Zedillo (2 pages)	11/23/94	P5	1257

COLLECTION:

Clinton Administration History Project

OA/Box Number: 24124

FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [3]

Jimmie Purvis

jp32

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

June 6, 2000

MEMORANDUM FOR THE PRESIDENT

FROM: Lawrence H. Summers LHS

SUBJECT: Update on Argentina Economic Situation in Advance of President De La Rua's Visit to Washington

Summary
Markets have become increasingly concerned over the past few months about Argentina. They do not fault De La Rua's economic strategy of fiscal discipline, structural reform and commitment to parity between the peso and the U.S. dollar. But many see Argentina as caught in a box where it cannot grow due to its overvalued exchange rate and fiscal restraint, even though fiscal loosening or a devaluation might unleash greater dangers. Argentina's need to roll over large amounts of external debt each year makes it especially vulnerable to shifts in investor sentiment. On the positive side, most still expect at least a weak recovery this year, Argentina has already covered two-thirds of its 2000 foreign debt issuance needs, and the new budget cuts and other reforms announced May 30 were well received. In our view the government's economic strategy is broadly appropriate and a benign outcome is still probably, but the risks of a financial crisis within the next year are non-trivial and the situation merits close attention.

We recommend that you raise the following issues:

- We support your reform program and will watch the situation closely and do what we can to be helpful.
- We are aware of the economic challenges and risks you face, including uncertainties in the global financial markets and in the strength of economic recovery in Argentina.
- Only advice we might offer is the need to send a clear and consistent message to investors on your commitment to reform. Sometimes it seems presentation is as important as substance, in the short-term, for building confidence.

Background
President De La Rua inherited a daunting set of economic challenges when he took office last December. Argentina and many other South American countries had just been through a year of recession, due in large part to global financial turbulence and low commodity prices. In Argentina's case, the fixed exchange rate under its one-peso-to-one-dollar "convertibility" system deprived it of the opportunity for export stimulus available under a floating exchange rate, and the strong dollar has exacerbated its competitiveness problem. Finally, the outgoing Menem left a fiscal deficit of close to 4% of GDP, and to reassure investors, the new government was forced to make contractionary fiscal cuts at a time when the economy needed growth.

De La Rua put forward an orthodox program of tax increases, expenditure cuts, structural reforms, and negotiation of a new IMF agreement. Argentina was initially rewarded with improved international demand for its debt and lower interest rates. But investor sentiment turned down again this spring, and its international borrowing costs widened again. In part that reflects rising interest rates across emerging markets in response to external factors such as Fed tightening and volatility in the U.S. equity market. But in part it reflects disappointing growth figures in Argentina, weak fiscal numbers that cast doubt on its ability to meet targets under its IMF program, and fear that Argentina has no way out of the low growth trap formed by the rigid exchange rate and need for fiscal austerity. Gaffes in public relations, rumors that President De La Rua was dissatisfied and would fire Economy Minister Machinea, and conflicting messages by different government officials also likely contributed to an erosion in policy credibility.

De La Rua responded in the last week of May by generally reaffirming his support for Machinea and announcing a strong program of new expenditure cuts, including wage reductions of 12% or more for civil servants, and a redoubled effort on structural reforms. The initial reaction has been favorable, but serious questions remain in many investors' minds about the country's economic prospects.

We have watched the situation closely and met regularly with the economic team, and I have met twice with President De La Rua. In our view he and his team have a good sense of what needs to be done and their strategy of fiscal restraint and structural reforms is the right one at this point. We also understand their decision to stick to the convertibility system, even though it reduces policy flexibility. The Argentine public is deeply committed to the convertibility system that brought stability after years of hyper-inflation, and there are legitimate fears that floating or devaluing the exchange rate would unleash instability and bankruptcies -- though it is noteworthy that similar fears in Brazil were not realized when it floated its currency last year.

However, we cannot rule out the risk that the situation will deteriorate further and pressure will build for a change in economic policy course, including the exchange rate system. If economic and financial pressures were to force a change in strategy, it is our sense that De La Rua would be more likely to adopt the U.S. dollar as the national currency than to devalue, though he recently flatly rejected both options. While that would not remove the rigidities of the present system, it could deepen the credibility of Argentina's monetary policy and thereby help reduce country risk and international borrowing costs.

If Argentine authorities were seriously to consider formally adopting the U.S. dollar (dollars are already widely used and the banking system is more than half dollarized), they might seek our support, including an agreement to rebate the seigniorage revenues that Argentina would lose (and the U.S. would gain) if it gave up the right to print its own money. We could be generally supportive of dollarization, and in any event Argentina and other countries are free to use our dollar if they choose, as Panama and Ecuador now do. However, we do not have any legal mechanisms for rebating seigniorage and would need legislative approval to do so. That would present complicated foreign policy, budget scoring, and other political hurdles that would probably be insurmountable, at least this year.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

MEMORANDUM FOR THE PRESIDENT

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SUBJECT: Update on Argentina Economic Situation in Advance of President De La Rua's Visit to Washington

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We have watched the situation closely and met regularly with the economic team, and I have met twice with President De La Rua. In our view he and his team have a good sense of what needs to be done and their strategy of fiscal restraint and structural reforms is the right one at this point. We also understand their decision to stick to the convertibility system, even though it reduces policy flexibility. The Argentine public is deeply committed to the convertibility system that brought stability after years of hyper-inflation, and there are legitimate fears that floating or devaluing the exchange rate would unleash instability and bankruptcies -- though it is noteworthy that similar fears in Brazil were not realized when it floated its currency last year.

However, we cannot rule out the risk that the situation will deteriorate further and pressure will build for a change in economic policy course, including the exchange rate system. If economic and financial pressures were to force a change in strategy, it is our sense that De La Rua would be more likely to adopt the U.S. dollar as the national currency than to devalue, though he recently flatly rejected both options. While that would not remove the rigidities of the present system, it could deepen the credibility of Argentina's monetary policy and thereby help reduce country risk and international borrowing costs.

If Argentine authorities were seriously to consider formally adopting the U.S. dollar (dollars are already widely used and the banking system is more than half dollarized), they might seek our support, including an agreement to rebate the seigniorage revenues that Argentina would lose (and the U.S. would gain) if it gave up the right to print its own money. We could be generally supportive of dollarization, and in any event Argentina and other countries are free to use our dollar if they choose, as Panama and Ecuador now do. However, we do not have any legal mechanisms for rebating seigniorage and would need legislative approval to do so. That would present complicated foreign policy, budget scoring, and other political hurdles that would probably be insurmountable, at least this year.

94-139443

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 23, 1994

MEMORANDUM FOR PRESIDENT CLINTON

FROM: Secretary Bentsen LMB

SUBJECT: Your Meeting with President-elect Zedillo

When you have lunch with President-elect Zedillo today he may raise the exchange rate of the peso. Mexico has had considerable difficulty with its exchange rate in recent months. There was another bout of pressure last week.

The peso's weakness reflects market concerns about both Mexico's trade deficit, which is about 7 percent of GDP compared to just over 2 percent for the U.S., and political uncertainties surrounding Chiapas and the investigation of the assassination of party leader Ruiz.

Markets have been ignoring the good news about the Mexican economy -- growth is recovering, inflation is down and the budget is balanced.

The Mexicans are determined to defend their exchange rate. This week, after reconfirmation (with much fanfare) of the existing exchange rate policy in the PACTO with Mexican business and labor, the peso has fared much better. On Monday, I also made a statement of support on Mexican television.

President-elect Zedillo is eager to have a further show of confidence in the Mexican economy come out of your meeting today. I am attaching a statement that would serve this purpose.

In your conversation with President-elect Zedillo, you should make clear our commitment in general terms to support Mexican economic stability. In this regard, you may wish to note that we have in place a $6 billion swap line. And you can point to the North American Financial Group comprised of myself and my Mexican and Canadian counterparts as a place to deal with these issues.

I want to caution you on two points:

- You should discourage Zedillo from thinking that we could get for him further exchange rate support from the Europeans. We have exhausted our leverage with Europe after going to them during the NAFTA debate and again following the Colosio assassination.

- You should also not agree to a drawing on the swap line at this time. It's not likely to help the peso more than simply having the swap arrangement in place. And a drawing would risk a backlash in our Congress -- many on the Hill wrongly see this as foreign aid.

In public commentary, it is essential that we make no comment on the Mexican exchange rate unless pressed. In that event, I recommend that you simply express your judgement that Mexican economic fundamentals are sound, and express your confidence in President-elect Zedillo. (A Q & A is attached.)

Attachments:

Statement on Mexico's Economy
Question and Answer on the Peso

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION	
001. memo	Robert E. Rubin to POTUS re: Update on Mexico's Stabilization (3 pages)	05/15/95	P5	1258
002. briefing paper	re: Why Should We Advance the US-Mexico Economic Relationship? (3 pages)	09/19/95	P5	
003. talking points	re: Talking Points for Call to Ortiz (2 pages)	10/25/95	P5	
004. memo	Lawrence H. Summers to POTUS re: An Update on Mexico's Economic Performance & Challenges in Advance of President-elect Fox's Visit to Washington (2 pages)	08/23/00	P5	1259

COLLECTION:

Clinton Presidential Records
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[History of the Department of the Treasury - Supplementary Documents] [4]

Jimmie Purvis

jp33

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

5/15/95

MEMORANDUM FOR THE PRESIDENT

FROM: **Robert E. Rubin** R.E.R.

SUBJECT: **Update on Mexico's Stabilization**

While it is too early to reach any definite judgements - and major disruption is always possible - indications these past few weeks suggest that our financial support program and Mexico's policy adjustments are working to bring about the country's financial stabilization. As Mexico's adjustment policies take hold, fears of default have receded, and the "tequila effect" on other emerging market economies seems to have abated. Perhaps our view can best be described as cautious but encouraged by the developments in recent weeks.

Mexico is taking the policy actions essential for recovery:

- a restrictive monetary policy has been maintained, with the money base declining sharply since the beginning of the year;
- fiscal policy has been tightened, and results for the first quarter exceed the government's budget targets;
- prospects for further privatization and private investment in Mexico's infrastructure have been advanced, as necessary regulatory and legislative reforms have been approved;
- the government has dispensed with the nationwide wage bargaining process (the "pacto"), promoting greater flexibility in labor markets without triggering a wage-price spiral; and
- Mexico's economic institutions have become more transparent, with much more information disclosed to the public.

These policy adjustments, combined with American, IMF, and World Bank support, are having the desired effects:

- Mexico's trade balance has already moved into surplus, with exports continuing last year's trend to stand 32% above a year earlier in the first quarter as imports fell back to near levels of a year ago - a tribute to the economic flexibility created by Mexico's liberalization and privatization policies these past few years;

- with U.S. and IMF financial support, the stock of dollar-indexed short-term debt (tesobonos) has been reduced from $29.5 billion at the start of the year to $12.5 billion today;

- of the $3.0 billion we advanced to Mexico in April, $2.0 billion was added to external reserves, as demand for pesos began to reappear and a few public and private sector institutions issued securities in small amounts abroad.

Financial markets have responded strongly to these positive developments:

- the peso has appreciated significantly in the past few weeks and volatility is much reduced;

- domestic interest rates have declined by some 20 percentage points, despite restraints on money growth, as expectations for inflation have been lowered;

- Mexico's stock market has risen by more than 40% in both peso and dollar terms since its late February lows;

- prices of the government's dollar-denominated bonds have also improved dramatically, and yields have declined from closing highs of over 30% to 14% now, as investors perceive a diminished risk of default.

To date, the United States has disbursed $8 billion to ease Mexico's liquidity crisis, net of repayments, $1 billion of which has been extended by the Federal Reserve Board. The IMF disbursed $7.8 billion in February, and another $10 billion in Fund resources could become available in the second half of the year depending upon Mexico's performance in the first half. I plan to authorize Mexico to draw another $2 billion medium-term swap next Friday, to be announced Thursday evening.

Caution is still essential, however. Mexico's finances are stabilizing, but its economy continues to deteriorate. The pressure on firms and the Mexican people will intensify before economic growth resumes. And the international financial markets are still skeptical, so that the flow of funds is also still limited.

- The banking system is particularly stressed. Other economic sectors have also been hard hit, and job losses are large and growing.

- The crisis has resulted in a large drop in the real incomes of those who have kept their jobs, dealing a direct blow to Mexico's middle class whose material conditions and aspirations for the future have been badly hurt.

Our financial support alleviates this drop in Mexico's standard of living, but only a resumption of economic growth will restore it over time.

Under these circumstances, President Zedillo and his government face a major challenge in sustaining public confidence and social cohesion until economic growth returns. Mexico's fragile 'stabilization is also vulnerable to other kinds of political shocks, such as a renewal of armed hostilities in Chiapas or upheaval within the PRI.

Despite these concerns, Mexico's progress so far gives cause for optimism. Three months ago, a radical change in the course of policy was needed for the stabilization program to work. Now, it would appear, steadfastness and vigilance are required.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

August 23, 2000

MEMORANDUM FOR THE PRESIDENT

FROM: Lawrence H. Summers LHS

SUBJECT: An update on Mexico's economic performance and challenges in advance of President-elect Fox's visit to Washington

Summary

Mexico appears well poised to pass through the 2000 presidential election year without an economic crisis. Over the medium term, Mexico continues to face significant challenges. The fiscal position is too dependent on oil revenues, the cost of the 1995 bank bailout has yet to be fully recognized, the energy sector is still state-owned and requires enormous investment, and income inequality and crime are serious problems. President-elect Fox has laid out a vision of a North American economic and monetary union in 20 to 30 years.

You may wish to raise the following points with President-elect Fox:

- It is important that you use the momentum associated with your election to advance quickly your agenda. However, markets must perceive your economic team as technically competent and sophisticated and your proposals to address Mexico's medium-term challenges as well thought out and feasible.

- Encourage your continued support of the Zedillo government repaying all outstanding IMF loans ahead of schedule. This would be a sign of Mexico's growing economic strength and maturity.

- Care must be taken in public discussion of greater North American economic integration to avoid creating unrealistic expectations and a potential backlash on NAFTA.

Background

Mexico has successfully differentiated itself from other Latin American countries. It was the only major Latin American economy to escape recession in 1998-99, and GDP growth has averaged five percent annually over the last four years. President-elect Fox's victory was well received by the financial markets (the peso has appreciated 6.5% since his election) and Mexico is doing well in the areas of vulnerability that led to previous election-year crises. The fiscal deficit is small, the current account deficit is modest, inflation is in the single digits, the flexible exchange rate provides a shock absorber, and public external debt amortization is miniscule. The Zedillo administration converted Mexico's IMF stand-by program to a "precautionary" arrangement in July and is discussing with the Fund early repayment of all outstanding Fund loans – reportedly with the support of Fox's team.

Mexico is vulnerable to the U.S. business cycle (the United States buys about 25 percent of Mexico's GDP), volatility in the international financial markets, swings in oil prices, and domestic political shocks. Rapid economic growth over the last year accentuates that vulnerability.

Mexico also faces important medium-term challenges. First, increased fiscal prudence will be necessary to absorb the costs of bank restructuring estimated at 19% of GDP, higher spending in education and social programs, and fiscal decentralization. Second, electricity and petroleum sectors have yet to be privatized, and they face daunting investment needs that the public sector can ill afford. Third, the Mexican government must do a better job ensuring the personal safety of Mexico's residents, the protection of private property, transparency, due process, and access to opportunity for all Mexicans.

President-elect Fox will have to convince a divided Congress and, at times, a reluctant populace of the need for difficult reforms to meet those challenges and to fulfill his campaign promises of achieving seven percent economic growth and the creation of 1.4 million jobs annually. The markets are broadly in agreement with Fox's proposed agenda, though Fox's economic team would do well to exercise more care in their public presentations of proposed reforms.

Finally, Fox envisions the creation of a North American economic and monetary union in 20 to 30 years. Fox believes closer integration with the United States and Canada – including a more open regional labor market – is the best way to reduce differences between standards of living in the three North American countries.

Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION	
001. memo	Lawrence H. Summers to POTUS re: Strategic Petroleum Reserve (2 pages)	09/13/00	P5	1260
002. memo	Lloyd Bentsen to POTUS re: Russian Economic Reform & the Washington Summit--Building Economic Partnership (5 pages)	09/26/94	P5	1261
003. memo	Lawrence H. Summers to Secretary Bentsen re: Memorandum to the President on Russian Economic Reform & the Washington Summit (1 page)	09/23/94	P5	1262
004. memo	Lloyd Bentsen to POTUS re: Ukraine: Economic Reform & the Kuchma State Visit (3 pages)	11/18/94	P5	1263
005. memo	Robert E. Rubin to Vice President Gore re: Economic Themes for Upcoming Visit of Ukrainian Prime Minister (1 page)	09/21/95	P5	1264
006. briefing paper	re: Current Economic Situation in Ukraine (2 pages)	circa Sept. 1995	~~P5~~	
007. memo	Robert E. Rubin to Vice President Gore re: Gore-Chernomyrdin Commission Meeting (1 page)	01/11/96	P5	1265
008. memo	Under Secretary Shafer to Secretary Rubin re: Proposed Meeting with Russian Prime Minister Viktor Chernomyrdin (1 page)	circa Jan. 1996	P5	1266

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Jimmie Purvis

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DEPARTMENT OF THE TREASURY
WASHINGTON D.C.

September 13, 2000

SECRETARY OF THE TREASURY

MEMORANDUM FOR THE PRESIDENT

FROM: Lawrence H. Summers LHS

SUBJECT: Strategic Petroleum Reserve

Chairman Greenspan and I believe that using the Strategic Petroleum Reserve at this time, as proposed by DOE, would be a major and substantial policy mistake. Even DOE suggests its impact on heating oil prices would be quite small. Moreover, it would set a new and ill-advised precedent, and the claim that the exchange is nothing more than a policy of technical SPR management would simply not be credible in the current environment. If you are inclined to authorize a SPR exchange, I would like to speak with you before you make your decision.

The proposed sale of 60 million barrels is 3½ times as large as the largest previous such sale, which was during the Gulf War. Even DOE estimates that the proposed sale would reduce the price of home heating oil by only 2.6 cents per gallon by January. An effect of this size would be lost in day-to-day price fluctuations. In part, the modest size of the impact reflects the fact that refineries in the U.S. have only limited capacity, no matter what the availability of crude petroleum.

Chairman Greenspan and I believe, for a number of reasons, that even this modest effect overestimates the probable impact. In particular, DOE fails to take account of (a) any offsetting effect from the repurchase segment of the swap; (b) any offsetting reduction in privately held inventories; and (c) any reduction in supply, including a possible reduction in over-quota production by OPEC members.

The downsides of a SPR exchange outweigh the limited benefits.

- The current tight world oil market and the political problems that this is raising in a number of countries creates a situation in which Iraq might attempt to disrupt markets by withholding supplies. We need to be in a position to respond immediately and forcefully should Iraq do so. Using the SPR at this time diminishes its psychological value as a potential response to Iraqi mischief. More importantly, using the SPR to replace more than 2 million barrels per day in lost Iraqi production *in addition to* the proposed 1 million barrels per day exchange would place the SPR under unprecedented operational stress.

- Using the SPR at this time would be seen as a radical departure from past practice and as an attempt to manipulate prices. The SPR was created to respond to supply disruptions and has never been used simply to respond to high prices or a tight market. Given the substantial size of the proposed sale, and its proximity to both the OPEC meeting and the November election, it will be impossible to argue credibly that the proposed exchange is simply a technical SPR management policy.

- Despite the diplomatic efforts with the Saudis, there is a substantial risk that others will adjust their supplies in response. It will be impossible to exchange 60 million barrels without attracting considerable attention. Oil producers make ongoing adjustments. We cannot predict how this change in the equation will impact their judgements on balance. When combined with the diplomatic pressure that has been placed on OPEC by a number of consuming nations, producing nations are likely to believe that they will be perceived as bowing to U.S. pressure if they fail to respond adversely to this use of the SPR. Furthermore, using the SPR would expose us to valid charges of naiveté because we would be using changes in crude supply as a very blunt tool for dealing with the prospect of high heating oil prices.

- Engaging in a large SPR exchange would increase the sense of Administration ownership of oil prices. It would set a dangerous precedent that would put pressure on all future Presidents and call into question our commitment to the free operation of these markets.

I understand the salience of the oil price issue. There are alternatives available involving the SPR that are focused and targeted on the home heating oil issue. These would be less threatening to the Saudis because they are smaller and better targeted, and they would not jeopardize our capacity to respond to Iraqi mischief and set a much less dangerous precedent.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ECRETARY OF THE TREASURY

September 26, 1994

MEMORANDUM FOR THE PRESIDENT

FROM: LLOYD BENTSEN LMBentsen

SUBJECT: Russian Economic Reform and the Washington Summit -- Building Economic Partnership

Introduction

Your Summit meeting with President Yeltsin will focus on the theme of a pragmatic partnership between Russia and the United States that pays. On the economic side, this theme will find expression in the emphasis on our two countries' desire to forge a strong trade and investment partnership between our private sectors. But we must recognize that this partnership will require time to mature. In particular, the results produced for both partners will hinge on Russia's success in continuing down the path of reform.

The Washington Summit offers a good opportunity to build this partnership. We should stress to President Yeltsin that a private sector trade and investment relationship must be built on three pillars -- stable macroeconomic conditions, a sound tax system and market institutions, and direct bilateral support for U.S. exports and investments. You should use the Summit as an opportunity to commit our partnership to strengthening these three pillars.

The Summit Message

Russia must intensify its reforms and offer its people a vision of a U.S- Russian partnership based on trade and investment between our private sectors. This message has several components.

1. **Russian reform is verging on success, but drift is setting in. Russia should seize the moment and put in place a bold economic reform program in 1995.**

Russia has come far in building a market economy. But the gains are not yet secure, depriving Russia of the true benefits of stability. With continuing high inflation, a turnaround in growth and jobs will be delayed and businessmen will protect themselves against inflation rather than make sound investments.

Russia now faces key decisions on its 1995 economic program. Will the anti-inflation policy be maintained? Will meaningful tax reform go forward? Will enterprises be subjected to market disciplines? The answers will set Russia's reform course and determine whether it will secure large-scale multilateral financial support that remains undrawn.

We need to tell Yeltsin that: there are real benefits to be gained from an intensified stabilization effort; real stabilization is attainable; and Western support can play a key role. Reports suggest Russia is aiming at a 1995 budget deficit of 5% of GDP (implying spending cuts of 3% of GDP). This gap can be covered without inflationary money printing -- Western support from the IMF and World Bank could provide financing of 3% of GDP; Russia now sells a small amount of bonds which could be increased by 2% of GDP.

2. **Tax reform is a key example of the need for institutional and structural reform.**

We would especially like to help Russia reform its tax system and offer Yeltsin concerted multilateral technical assistance for this purpose. This effort could pool G-7, World Bank and IMF experts.

Reform of the Russian tax system is essential. This year, Russia is collecting only 65% of planned revenues, jeopardizing stabilization. Collapsing state firms are unable to pay taxes. Onerous and arbitrary taxation drives the private sector toward massive tax evasion. Tax administration is weak and competition for tax revenues between federal, state and local governments is intense.

This is but one key example highlighting that Russia is not rapidly creating an institutional climate that rewards private sector activity. The lack of a body of contract law that respects private property hampers expansion of the new private sector and foreign investment.

3. **There is substantial Western support available for a genuine, intensified reform effort.**

While increased multilateral support has flowed to Russia this year, much more is available to help make reform achievable.

o The Naples Summit endorsed a U.S.-led initiative to expand IMF support to transforming countries. We expect agreement on this package by the IMF/World Bank Annual Meetings in Madrid in early October. Russia's access could increase by $5 billion, on top of large scale support already planned under a full IMF program, including: $4 billion in IMF standby support; a deep, multi-year G-7 debt rescheduling; and the $6 billion currency stabilization fund if Russia anchors the ruble.

o The West wants to work with Russia to help build a system of social protection. The World Bank has several loans in its pipeline, totalling well above $1 billion. But this funding is going untapped due to a lack of Russian interest.

4. Direct support for exports will promote trade and investment, but is no substitute for real private sector activity.

We need to remind Yeltsin that we can only go so far in supporting exports to Russia given our budget constraint and that we only see a transitional role for government in supporting exports. Russia will also be helped substantially by working more closely with the G-7 to implement the $3 billion SPRP. Our private sector is prepared to invest massively in Russia when a more attractive environment for foreign direct investment emerges. Russia can make an important start by putting the U.S.-Russian income tax treaty back on track and our banks on the same footing as European banks.

<u>The Economic Scene in Moscow</u>

The rest of this memorandum provides background for the Summit.

Intensified Macroeconomic Stabilization

Prime Minister Chernomyrdin has kept Russia moving forward in a reformist direction this year, while the major changes made in 1992-93 are beginning to produce clear, positive results. Let me cite seven points illustrating why Russia is moving along well.

- One, Russia's privatization program has been a huge success. Russian data show that nearly 70% of firms are now in private hands. Private sector activity now generates some two-thirds of retail activity.

- Two, inflation averaged 20% monthly in 1993. But it has been in single digits since February and was 5% in July and August.

- Three, fiscal policies are more disciplined. The budget deficit as a share of GDP was cut from 18% in 1992 to 8% in 1993. This year, a similar outcome is expected, and Russia is further slashing spending in the face of plummeting revenues.

- Fourth, money growth has been curbed. Russia has real positive interest rates. Falling inflation has allowed the central bank to cut nominal interest rates from 17-1/2% to 10-3/4% monthly.

- Fifth, real personal income is way up -- 30% since you met President Yeltsin in Vancouver -- boosted by the growth of the private sector and moonlighting.

- Sixth, the share of people living below subsistence has fallen from one-third last year to one-sixth this year.

- Seventh, because Russia freed prices in 1992, there is now consumer choice -- high-quality goods are widely available and long queues are a thing of the past.

Because of these positive developments, Russia's 1994 economic program earned IMF support under the $1.5 billion systemic loan negotiated earlier this year. The World Bank approved $1.5 billion in project loans ahead of the Naples Summit. The G-7 policy of intensified engagement, which you spearheaded, contributed significantly to these positive developments.

But these gains are not secure, as evidenced by the recent nose dive in the ruble and Russia's foreign exchange reserves. With reforms beginning to bite hard, there has been some relaxation of financial policies. Why? First, tax revenues are only 65 percent of the total budgeted, leading Russia to undertake extreme, discretionary sequestration to sustain its stabilization effort. Second, financial difficulties in state enterprises are giving rise to demands for bailouts and relief from inter-enterprise arrears.

This situation will once again test the vision and determination of President Yeltsin and Prime Minister Chernomyrdin. Will Russia succumb to these pressures and lose the hard-won gains of 1994? Or will Russia press on with stabilization, and force enterprises to adjust to the rigors of the marketplace? The outcome of this struggle will be perhaps the greatest single determinant of the climate for trade and investment in the coming years.

Modern market institutions

Trade and investment also require a stable institutional environment that encompasses modern tax, legal, and financial systems as well as widespread private ownership.

The most striking progress has been in privatization. Privatization completed its first highly successful phase, embracing 70% of enterprises. Phase Two, mainly cash sales of remaining state holdings in large enterprises, has started under a Yeltsin decree.

But the economic return from privatization will take time to materialize. Enterprise restructuring is off to a slow start, partly due to half-hearted government commitment to enforce financial discipline on enterprises. There is seemingly little appetite for enforcing bankruptcy. There has been little follow-through in reknitting the social safety net, either in developing a strategy, designating a counterpart, or seeking Western support.

Moreover, the institutional environment remains weak. A commercial code that respects private property rights has yet to emerge. Taxation is punitive and arbitrary, leaving private firms little choice but to evade taxes. The MMM stock scandal highlighted the lack of regulation.

Direct Support for Trade and Investment

As you know, we will announce at the Summit a $100 million increase in U.S. direct assistance for exports to Russia under OPIC and TDA. Eximbank has already extended $1 billion in guarantees to Russia. This is helping to spur U.S. exports and create jobs at home.

The $3 billion Special Privatization and Restructuring Program (SPRP) which you launched at the Tokyo Summit is moving into the implementation phase. Our $100 million Fund for Large Enterprises in Russia is up and running. The EBRD is creating ten regional funds, $50 million each, with G-7 countries. This should help provide a large infusion of equity and know-how.

But U.S. exports to Russia are small at $3 billion yearly and total foreign investment, $2-3/4 billion, is far below Russia's potential. Businesses are eager to enter Russia, but are deterred by a poor business environment, even where projects seem profitable. They are prepared to export when western governments assume their risks. Yet, this is not a solid basis for a private sector partnership.

Russian policy itself is a big part of the problem. The decision earlier this year to impose a punitive excess wage tax violated the spirit of the U.S.-Russian income tax treaty and denied our firms its benefits. The decision to allow several European banks to service Russian clients, while denying Chase Manhattan similar rights, was discriminatory. While both issues are being resolved, they have harmed U.S. firms' perception of the investment climate.

ANNEXES

Annex I

Last year at Tokyo, the G-7 endorsed a $43 billion package of multilateral support, conditioned on Russia undertaking necessary reforms. This support has flowed more quickly this year, as Russia stepped up its reform progress. The table at Annex I reviews progress under the Tokyo package, and shows that $29 billion of the support has been approved.

Annex 2

In January when you met President Yeltsin in Moscow, you highlighted five initiatives we could take to help accelerate the pace of Russian reform and Western support. We have delivered on each initiative.

Attachments

UNDER SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON

SEP 28 1994

MEMORANDUM FOR SECRETARY BENTSEN

FROM: Lawrence H. Summers LHS

SUBJECT: Memorandum to the President on Russian Economic Reform and the Washington Summit

ACTION FORCING EVENT

We have prepared the attached memorandum to the President on economic aspects of the forthcoming Washington Summit between President Clinton and President Yeltsin. You sent similar memos to the President ahead of the April 1993 Vancouver Summit and the January 1994 Summit. The White House asked that you provide such a memo to the President for the Washington Summit.

RECOMMENDATION

That you transmit the attached memo to the President.

Agree LMB Disagree _______ Let's Discuss _______

BACKGROUND AND SUMMARY

The memo notes that the trade and investment partnership between Russia and the United States will take time to mature and depends on Russian reform. It observes that this partnership has three pillars: macroeconomic reform, a sound tax system and market institutions, and direct support for U.S. exports and investments.

It recommends the President tell Yeltsin that we: 1) commend Russia for its reforms to date, but hope Russia will put in place a bold 1995 program; 2) want to offer multilateral technical assistance to reform Russia's tax system as a means of building institutional and structural reform; 3) reaffirm the West's commitment to provide large-scale multilateral support for an intensified reform effort; and 4) can provide direct support for trade and investment but this is no substitute for real private sector activity.

We also provide a background section on why we think the Russian economy is moving along positively and on the other pillars of the trade and investment partnership.

Edward S. Knight

94-13780

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

November 18, 1994

MEMORANDUM FOR THE PRESIDENT

FROM: Lloyd Bentsen LMB

SUBJECT: Ukraine: Economic Reform and the Kuchma State Visit

Summary

I am writing to offer a few key messages you might wish to convey to Ukrainian President Kuchma when you meet to discuss Ukraine's fledgling economic reform program and Western support for it during your discussions on November 22-23.

Ukraine has seen three years of deep economic decline, resulting from the collapse of communism and sustained policy mismanagement. That decline and the lack of economic leadership contributed to regional divisiveness and undermined the development of a healthy sense of national identity. Economic reform must spur recovery, but should also help strengthen the legitimacy and cohesion of the state. With the recent Ukrainian action on nuclear weapons issues, we should be freer to focus on the economic agenda.

Upon coming into office, Kuchma moved quickly to pull the country together behind a strong economic reform agenda. Instead of awaiting the emergence of a consensus among the elites, he launched a bold, if incomplete, reform program, and gained the financial backing of the IMF and World Bank. He has improved economic relations with Russia, as seen in the recent negotiations to defer Ukraine's debts. Nonetheless, Ukraine's fragile reform effort is drawing fire from parliamentary opponents, and has not received concrete backing from some of our key allies.

Key Messages

1. **Praise President Kuchma for launching a bold reform program that merits strong support from the international community.**

Kuchma's economic program -- implemented in the face of a hostile Parliament and over the Prime Minister's deep reservations -- gives reform a strong start. Kuchma has put in place a strong government economic team, underscoring his commitment to market reform.

He has worked with the West every step of the way, hoping that western support would bring both financial and political benefits. Ukraine's program earned a $370 million IMF loan under its special facility for transforming economies. The World Bank will follow with a $550 million loan to finance critical imports in December.

2. Warn that partial or unsustained reforms will not bring the clear benefits needed to produce political backing for reform.

To muster political backing for reform, the early steps must produce palpable results. Partial reform brings partial results. Deepening reform quickly is key to results people will notice in early 1995.

People must be free to run businesses unencumbered; inflation must be brought down convincingly; and international trade and the foreign exchange market must be liberalized so Ukraine can integrate quickly into the world economy.

Ukraine must carry through on its commitment to work with the IMF on a comprehensive economic program for 1995. This program should aim at price and exchange rate stability. Ukraine should also launch a major mass privatization initiative and slash the government's pervasive role in the economy in order to create jobs and growth.

3. Offer to play the lead role in mobilizing multilateral and bilateral support for Ukraine's reforms, including further pressure on our recalcitrant allies.

At the Naples Summit, you convinced a reluctant G-7 to pledge over $4 billion in international assistance to support genuine reform in Ukraine over the next two years. To follow up, I invited Ukraine's economic team to join G-7 Finance Ministers at our early October meeting in Madrid to discuss their reforms and that support. Those efforts have paid off: Ukrainian reform is underway and the IMF and World Bank loans represent the first deliveries of this assistance.

Now, the problem before the world community is to raise adequate financing to back Ukraine's reform program. As you know, we pledged a large $100 million contribution in the fourth quarter of 1994, and we have prepared a contribution for 1995. We are also providing this support in the form of a balance of payments grant, rather than our traditional support for projects.

Unfortunately, our allies have balked. The EU considered, and so far has rejected, a $100 million loan. Japan is refusing to make a contribution. We are continuing to press our G-7 allies and you can assure Kuchma we will not give up.

4. Our chances for raising funds will be helped by Ukraine and the IMF reaching agreement on a standby loan.

Most of the $4 billion will be IMF and World Bank support. The standby loan -- which represents the strongest positive signal the IMF can confer -- is the next step.

Our allies are more likely to lend once that loan is set. The EU and Japan have both explained their delay by saying they are awaiting an IMF standby loan.

Ukraine's Start on the Path of Reform

Ukraine's economic performance over the last few years has been bleak. If there is a silver lining, it is that the government's failures drove the economy underground and, with a burgeoning informal sector, the private economy now accounts for 40% of GDP. Kuchma's reform program, while it is not yet comprehensive reform, represents a bold departure from the past.

- **Its first element is liberalization.**

  -- In the past, prices for key items have been controlled. Energy prices were roughly 10-20% of world prices! Now, energy prices are being raised to equal import costs; bread price subsidies have been cut out; rents, utilities and other service prices have been hiked.

  -- Exports proceeds were confiscated by the use of an artificially low exchange rate. That depressed exports, drove traders to inefficient barter, and stimulated massive capital flight -- $2 billion per annum. Now, Kuchma has reopened the currency market and established convertibility for trade. If this policy is sustained, Ukraine should see exports jump.

- **The second element is stabilization.**

  -- The fiscal deficit was 13% of GDP in 1993 and without remedial measures, the deficit was headed toward 24% of GDP this year. Now, with the subsidy reductions and other fiscal reforms, the deficit goal is 10% of GDP.

  -- Monetary policy was so lax last year, that Ukraine had a hyperinflation reaching 90% monthly in late 1993. The central bank engineered a monetary squeeze and an inflation reduction this year, but that effort was on the verge of breaking down as Kuchma took action. Now, a credit freeze is in place and positive real interest rates have been established. The stage is set for a sustained reduction in inflation, once the transitional effects of liberalization pass through the economy and the new budget policy takes hold.

- **The third element is privatization.**

  -- Actual privatization has been minimal. In July, Parliament suspended most privatization and continues to reject governmental proposals to restart the process. Now, the Kuchma Government has issued a privatization decree to preempt the Parliament and is near agreement with the World Bank on a mass privatization program.

95-150238

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

9/21/95

MEMORANDUM FOR VICE PRESIDENT GORE

FROM: Robert E. Rubin R

SUBJECT: Economic Themes for Upcoming Visit of Ukrainian Prime Minister

Ukraine has made significant progress toward achieving macroeconomic stabilization since undertaking its reform effort last October. The Government's commitment to sustain these reforms remains fragile however, and its momentum has begun to flag. Ukraine's reforms have reached a critical juncture, and without a reinvigoration in the leadership's efforts, even the reform gains already attained are in jeopardy. Yevhen Marchuk's position as Prime Minister and his close relationship with President Kuchma make his active support for market reform critical to its success. Marchuk's visit is an important opportunity to make the following key points:

- Ukraine has made real stabilization progress, but recent policy relaxation jeopardizes hard won gains. Ukraine faces the toughest adjustment period of its reform program this year, but only continued performance will generate a genuine economic recovery. It is critical that Ukraine get back on track with its IMF program. Marchuk's involvement in ensuring consistent stabilization performance and in jumpstarting privatization is key to its success.

- The international community stands behind Ukraine, and it has already received most of the $4 billion in assistance pledged last summer in Naples. The G-7 has pledged another $2 billion in IFI assistance to support continued strong performance through the end of 1996.

- The United States is committed to supporting Ukraine's reform efforts and has pledged over $350 million in bilateral assistance over the last year. With Ukraine's cooperation, U.S. assistance will be disbursed expeditiously and we will urge our allies to do likewise.

- It is crucial that Ukraine make reform progress sustainable by strengthening its economic institutions and developing a strategic vision of its future as an emerging market economy. The United States stands ready to provide technical assistance to help in this process.

Background

Until the middle of the summer, Ukraine was on track with its stabilization program. The budget was on target, monetary policy was tight, and monthly inflation fell from 21% in January to 4.8% in June, with the exchange rate remaining steady. Despite this progress, economic recovery has not been evident in official statistics and the leadership has raised questions about its commitment to market reform. While an agreement has been reached which will allow Ukraine to access the next $350 million tranche of its IMF program, recent statements by Kuchma and Marchuk have raised doubts about their commitment to the stabilization program. It is critical Marchuk recognize that reducing inflation and accelerating privatization are the only viable steps to a genuine economic recovery and that his active support for these policies is crucial to their success.

153961

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

January 11, 1996

MEMORANDUM FOR VICE PRESIDENT GORE

FROM: Robert E. Rubin RER

SUBJECT: Gore-Chernomyrdin Commission Meeting

I understand you will be hosting Russian Prime Minister Chernomyrdin for the sixth meeting of the Gore-Chernomyrdin Commission at the end of January. I would like to recommend that you also hold a small side meeting with Mr. Chernomyrdin, which I would attend, to touch on some key macroeconomic issues that are outside the normal scope of the GCC and better handled outside the formal GCC structure. If your schedule does not permit a side meeting during Mr. Chernomyrdin's visit, I would be happy to host it instead. I understand that at past GCC meetings you and former Secretary Bentsen met with Mr. Chernomyrdin on macroeconomic issues, and that Mr. Bentsen also hosted a small breakfast meeting for Mr. Chernomyrdin at the June 1994 GCC meeting.

I would anticipate a meeting with Mr. Chernomyrdin would touch on IMF support and debt rescheduling, topics that are essential to Russia's reform course and Western support, as well as to our work here at Treasury. Late January will likely find Russia having finished its first full-IMF program and engaged in discussions with the IMF on a three-year successor program. At the same time, Russia will be in the middle of negotiations with the Paris Club of official creditors on a comprehensive rescheduling of Russia's $40 billion plus of debt to Western nations.

Against that background, Mr. Chernomyrdin's visit provides a good opportunity to reinforce our message of strong support for reform as the Russian leadership charts its economic policy course for the coming months. As a result of solid economic policies over the past year, Russian inflation is now at a post-Soviet low and still falling, the ruble is stable, and output has bottomed out and looks poised to rebound. In the run-up to the June elections, I believe we should convey the message that economic growth and low inflation are good politics as well as good economics.

My staff at Treasury will be working with other agencies to help prepare for the January GCC meetings, and I encourage you and your staff to feel free to call upon us to assist in any way in your preparations.

95-153961

ACTION

- Recommend VPOTUS and Rubin hold a side-meeting w/ Chernomyrdin on Russian macro-economic
- Similar to past meetings
- NEED TO reinforce our message of strong support for reform

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

UNDER SECRETARY

MEMORANDUM FOR SECRETARY RUBIN

THROUGH: Deputy Secretary Summers LS

FROM: Under Secretary Shafer

SUBJECT: Proposed Meeting with Russian Prime Minister Viktor Chernomyrdin

ACTION FORCING EVENT:

Prime Minister Chernomyrdin plans to visit Washington on January 29 for the sixth biannual meeting of the "Gore-Chernomyrdin Commission" (GCC). This provides an opportunity for you to meet with him to discuss macroeconomic issues.

RECOMMENDATION:

That you sign the attached memorandum to Vice President Gore. It suggests he host a small meeting to discuss macroeconomic issues with Chernomyrdin that you would attend; or if such a meeting is not feasible for the Vice President, that you host it instead.

___✓___ Agree _______ Disagree _______ Let's Discuss

BACKGROUND:

Late January will find Russia at an important point in its economic reform course. First, negotiations between Russia and the IMF on a three-year Fund program to succeed the present standby may well still be underway. Second, Russia will be negotiating a comprehensive debt rescheduling with the Paris Club. Third, the Russian leadership will be charting its economic policy course in the run-up to the June Presidential elections.

Mr. Chernomyrdin is a dominant player in Russian relations with the IMF and overall economic policy, together with Mr. Chubais. A macroeconomic discussion would help ensure we go beyond bilateral GCC issues and show support for broad economic reform. Lloyd Bentsen and the VP met with Chernomyrdin at past GCC meetings to talk macroeconomics, and at the June 1994 meeting, Mr. Bentsen hosted Mr. Chernomyrdin for a breakfast discussion.

The GCC is co-chaired by Vice President Gore and Prime Minister Chernomyrdin, with co-Vice Chairs Secretary Brown and Oleg Davydov, Minister for Foreign Economic Relations. The GCC focus is trade and investment issues, such as market access, OPIC and Exim support, oil sector legislation, and treatment of U.S. investors; health and the environment, and technical cooperation.

ATTACHMENT: Memorandum to Vice President Gore

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Robert E. Rubin to Vice President Gore re: Economic Reform Themes for Visit by PM Chernomyrdin (1 page)	01/26/96	P5 1267
002. memo	Larry Summers to Secretary Rubin re: Your Meeting with President Clinton Today to Discuss Russia (1 page)	05/20/96	P5 1268
003. memo	Robert E. Rubin to POTUS re: Meeting in Helsinki (1 page)	03/19/97	P5 1269
004. memo	Karin Lissakers (IMF) to Larry Summers & David Lipton re: Russia & IMF (5 pages)	11/03/97	P1/b(1) Unclass.
005. talking points	re: RER Points for Camdessus Call on Russia (1 page)	circa April 1999	P5

COLLECTION:

Clinton Administration History Project

OA/Box Number: 24124

FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [6]

Jimmie Purvis

jp35

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advise between the President and his advisors, or between such advisors [a)(5) of the PRA]
P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

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PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).
RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

b(1) National security classified information [(b)(1) of the FOIA]
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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

January 26, 1996

SECRETARY OF THE TREASURY

MEMORANDUM FOR VICE PRESIDENT GORE

FROM: Robert E. Rubin RER

SUBJECT: Economic Reform Themes for Visit by PM Chernomyrdin

While it is always difficult to predict Russian economic developments, I would like to offer you the following thoughts on Russian economic reform and Western support.

Prime Minister Chernomyrdin deserves to be praised for Russia's impressive economic performance last year. Mr. Chernomyrdin gets a lot of criticism at home for the hardships of reform, and I think it would do him good to hear your encouragement. Russia's gains can be seen in the numbers. Inflation started the year at 18% per month and ended at 3%. The markets responded with growing confidence. After falling three years and hitting a low in April, the ruble rebounded and finished the year 10% up from its low. For the first time, the public was willing to buy substantial volumes of government debt, giving the government a non-inflationary alternative to printing money. As economic stabilization took root, the real economy bottomed out. For the year, output was down only 4%, after 12% in 1994.

Good economics is good politics. Russian leaders will face temptations to unleash a new round of subsidies in an attempt to buy the June Presidential election. But that strategy would be self-defeating. First, the Russian budget is already squeezed tight. Any big new programs would could only be financed by printing money, which would reignite inflation and undermine real incomes of the poorest and most vulnerable. As freshly-minted money hit the markets, the ruble would slide against foreign currencies, at the expense of the average Russian who does not have large U.S. dollar bank accounts. Second, judging from past experience, new subsidies would more likely end up in the pockets of old state enterprise managers than the hands of the workers. Third, the transition experience elsewhere suggests Russia is now poised for growth, if it keeps to reform.

If the government sticks to its reform program and reaches a new IMF agreement, it could head into elections with a full year of inflation below 5% a month and ruble strength under its belt, and the beginning of real economic growth. That scenario is not just good economics, it is good politics.

We should remain steady in our message of strong support for strong reform. We cannot vacillate with every up and down of Russian politics. Nor can we put our financial resources on the line without some assurance we are supporting a solid program that will bring economic growth and allow Russia once again to stand on its own feet. Our strategy for supporting Russian reform over the next three years has two main pillars: a $9.5 billion IMF loan to support the 1996-98 reform program and a comprehensive rescheduling of official debts inherited from the old USSR. Both pillars are contingent on strong Russian performance and adherence to the path of reform.

Attached is a brief paper on Russian economic reform prepared by my staff.

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

5/20/96

MEMORANDUM FOR SECRETARY RUBIN

FROM: Larry Summers

SUBJECT: Your Meeting with President Clinton Today to Discuss Russia

Issue: The purpose of the meeting with the President is to discuss how to respond to Yeltsin's request for new financial support before the elections. I will accompany you, and we expect State and NSC will also participate.

There appears to be internal USG agreement that the U.S. cannot provide Yeltsin significant bilateral financing. But we are concerned others may want to push the IMF to accelerate its lending in the next two months, either by switching from monthly to quarterly tranches or by boosting Russia's access under its EFF program and disbursing the increment up-front. We believe that would be a bad idea that would be resisted by the IMF and by other major Fund shareholders.

Suggested Points follow. Additional background is attached.

-- We are working closely with the IMF to identify areas of flexibility in order to maximize room for expenditure while keeping Russia on track with its EFF program.

-- We believe that staying on the IMF program is the best way to ensure Russia gets maximum external financing.

-- It is highly unlikely the IMF would consider extraordinary measures to provide Russia with large-scale new support before the elections (either by moving to quarterly disbursements or raising access under the EFF above the present $10.2 billion).

-- We think Larry's role in Moscow should be to convey the risks of going off the IMF program while exploring areas of flexibility that would accommodate maximum Russian government spending consistent with the program.

  o There are serious economic and political risks of going off-program, but if Russia were to choose to do so, it has adequate financial resources to finance new spending.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

March 19, 1997

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin RER

As you leave for Helsinki, I just wanted to underscore one issue. I know how important Russia's role in the G-8 is to all that we're trying to do with Russia, nonetheless it is crucial that we maintain a G-7 mechanism to force decisions on critical economic issues such as those you raised in Halifax.

This requires that there be a separate meeting and statement (but not a press conference) of the G-7 leaders on economic issues at the Denver and subsequent summits.

I hope you have a successful trip.

Bennetta
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Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Mark Sobel (IMF) to David Lipton, Tim Geithner, N. Lee, A. Baukol, and B. Cox re: Update on Russia-IMF (2 pages)	07/08/98	P1/b(1) Unclass.
002. memo	From Mark Sobel (IMF) re: IMF Debrief to G-7 Directors on Russia (2 pages)	08/13/98	P1/b(1) Unclass.
003. note	Karin Lissakers (IMF) to Deputy Secretary Summers, Under Secretary Lipton, & Assistant Secretary Geithner re: Russia (1 page)	08/13/98	P1/b(1) Unclass.
004. briefing paper	re: Mandatory Conversion of GKOs: Russia: Preliminary Considerations (IMF document) (5 pages)	circa Aug. 1998	P1/b(1) Unclass.
005. briefing paper	re: Russia: Scope for Intensification of Exchange Controls (IMF document) (2 pages)	circa Aug. 1998	P1/b(1) Unclass
006. memo	To the Vice President re: Policy Priorities for Russia (4 pages)	circa Oct. 1998	P5 1270
007. briefing paper	re: Russia Strategy (5 pages)	circa Oct. 1998	P5
008. memo	To the Vice President re: Responding to Russia's Economic Crisis (6 pages)	circa Oct. 1998	P5 1271
009. memo	Senior Deputy Assistant Secretary Truman to Rubin, Summers, & Geithner re: Principals Meeting on Russia (3 pages)	11/12/98	P5 1272
010. memo	To the Vice President re: Russia's Economic Crisis (5 pages)	circa Oct. 1998	P5 1273
011. memo	From Mark Sobel (IMF); For the Files re: Russia - IMF Staff Briefing to Board on Latest Mission (3 pages)	11/02/98	P1/b(1) Unclass

COLLECTION:

Clinton Administration History Project

OA/Box Number: 241124

FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [7]

Jimmie Purvis

jp36

RESTRICTION CODES

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MEMORANDUM FOR THE VICE PRESIDENT

DRAFT

SUBJECT: **Policy Priorities for Russia**

The current situation: Russia's financial crisis is exacting an enormous toll. The destruction of ruble stability has reversed what many view as Russia's principle financial achievement of the last six years. High inflation is re-emerging, especially hurting the most vulnerable parts of Russia's population. Economic activity is slumping, and large parts of the payments system are inoperative. Unemployment is rising sharply in the service and consumer goods sectors. Domestic government debt is being restructured, inflicting serious costs on domestic and foreign investors alike. Russia's external debt obligations loom very large, especially in ruble terms; arrears are already mounting on obligations to the Paris Club, which Russia only recently joined.

The Russian government and monetary authorities have no good or easy stabilization policy choices. The government can no longer borrow either domestically or from non-residents, so deficit cutting is imperative. But the breakdown in the payments system and the drop in output and imports caused by the crisis itself have pushed tax and tariff revenues to perhaps half usual inadequate levels. Further expenditure cuts, though essential, will be strongly resisted. The pressure for money creation -- to finance the current deficit, clear wage and pension arrears, and bail out banks -- will be intense.

All this comes at a time of uncertainty in Russia's political arena, a profound lack of consensus about the right economic policy strategy, and an extremely tough global environment. Prime Minister Primakov and his government are faced with the enormously difficult but inescapable challenge of charting an economic course and building the support necessary to implement it.

Our vital stake in Russia's future and its transformation success is undiminished. We must engage steadily and closely with Russia during this troubled period. Part of that engagement has to be an intensive effort, perhaps drawing on our experience and that of other countries, to help Russia identify what has gone wrong and how the Russian economy and financial system can be fixed. Our engagement must also include fulfillment of President Clinton's firm promise in Moscow to support the right kinds of Russian reforms and policies.

Lessons from the transformation effort so far: The crisis has dramatized what has been clear for some time: Russia lacks essential underpinnings of a market economy: confidence in the currency as a store of value (or even as a medium of exchange for large transactions); a banking system which lends to unaffiliated private firms; a legal system which protects property and investor rights; a regulatory and tax system which ensures a fair, predictable, competitive, transparent business environment, adequately funds the government, and does not serve as a vehicle for state corruption.

There are at least two schools of thought as to why these have not developed in Russia. One is that it has taken a long time for them to develop anywhere, and the West had unrealistic expectations about how long it would take to develop market institutions and practices which had never existed in Russia. The other is that the United States and Western and Central Europe do not provide the right models for Russia. Asian development paths, more dependent on relationships than on law and on public-private cooperation, may be more relevant.

Perhaps both are partly right. But another consideration is central for Russia. It relates to the role of the state. The irony in the aftermath of the Soviet period is that the experience of communism has heavily damaged, perhaps even destroyed, Russian people's trust in the state, their willingness to cede power to the state, and their faith in the state's ability to provide an effective social safety net. The overriding objective of business people, legislators, local officials, and individuals is to ensure protection, or at least distance, from what is perceived as the state's arbitrary, predatory, and corrupt authority.

For this reason, a lot of the West's reform agenda aimed at bringing the shadow, barter economy into the formal, taxed and regulated sector ran directly counter to Russian peoples' perceived interests. From this perspective, it is not hard to see why it failed. It also makes it easier to understand why Russians are willing to put up with the enormous inefficiencies of a barter system as a means to avoid the greater perceived risks and costs associated with being part of the state regulated sector. The sobering lesson is that Russia faces a protracted struggle, not only to build the right kinds of state institutions but also to overcome deep-rooted resistance to the basic objective of strengthening the state. We should be mindful that, as in our country, part of the ultimate resolution of this legitimacy issue will probably come from a redistribution of power from the center to the regions and localities.

The other lesson concerns the relative emphasis in economic policy on stabilization vs. structural reform. With hindsight it seems clear that the Russians got stuck in the stabilization phase of reform, mostly because of a failure to do the things which would have made stabilization sustainable, like fix the tax system. Successive Russian governments struggled ineffectually with this issue, leaving little reform energy left for other challenges. The failure to do structural reform killed prospects for growth which in turn repeatedly threatened and ultimately destroyed stability. Russia and we should be careful to avoid this vicious cycle in the months ahead. Support for organic reforms should proceed with the same urgency as support for stabilization and through all means possible -- financing from international financial institutions, technical assistance, training and educational exchanges, public-private partnerships.

The reform/growth agenda and the West's engagement: The following considerations should govern our message to Russia on reform and help from the West:

(1) Stabilization/exchange rate policy: Stabilization will have to rely primarily on deficit cutting through a combination of revenue increases from the energy sector (which has benefitted from the devaluation), expenditure cuts and reallocation, and rapid implementation of measures to extend the reach of the tax system to the barter economy, such as tax collection on an accrual basis (taxes are due when the transaction occurs not when cash payment is received). While some monetization of the deficit and arrears clearance is probably unavoidable, it should be strictly limited and done in consultation with the IMF. Money creation must not expand to finance indiscriminate bank bailouts. The high inflation emerging now and ahead has clear implications for exchange rate policy. Our sense is that Russian authorities are moving toward attempts to

stabilize the ruble through restrictions on exchange market operations and other steps toward inconvertibility, trade controls, and limits on access to dollar holdings and use. This is exactly the wrong direction for Russia; it will drive people deeper into barter and revive administrative controls that provide additional opportunities for corruption. A ruble float is a better policy choice during this period with the possibility of a renewed peg in the future under the right macroeconomic policy conditions.

(2) Tax reform: To date, successive Russian governments have been unable to build a viable coalition in support of tax reform. A reasonable basis for doing so is to cut rates but apply them more broadly, predictably, and fairly. Moreover, the goal of reducing disincentives for new businesses to move from the informal to formal sector should be overriding. We should urge fixes to the tax system which balance three objectives: (1) raising revenues; (2) simplicity, predictability, ease of administration, and business-friendliness; and (3) broad appeal to potential constituents for tax reform. Reconciling these three objectives may well mean lower than desirable federal revenues. The ultimate solution may have to come from changes in Russia's fiscal federalism. More expenditures and more tax authority may have to be shifted from the center to the regions/municipalities.

(3) Bank restructuring: The collapse of the banking sector provides an opportunity to rebuild a well-managed, well-regulated sector which actually promotes growth through lending to private businesses, including small- and medium-sized businesses. But bank restructuring has been an enormously sensitive and politically-charged issue in many countries. It is extremely hard to avoid pressures to bail out undeserving, even corrupt, banks and to allow them to retain their old managers. But there are no Russian sources of financing for these bailouts and real concern in responsible quarters of the Russian government and central bank about the inflationary consequences of doing so through central bank credits. In addition, the task of fully auditing and examining existing banks in order to make informed decisions about which (few) banks should be supported is very difficult, especially in the Russian context where information on bank balance sheets is inadequate and unreliable. Technical assistance is critical, as is World Bank and EBRD financing. But financing has to be strictly conditioned on saving only those banks which are well-run and solvent or potentially solvent, which provide full and accurate information, and which are truly systemically important (i.e., which hold substantial deposits from individuals).

(4) Creation of a sustainable and effectively targeted social safety net and clearance of wage and pension arrears: This is an essential objective if the Russian government is to build its citizenry's stake in a stronger state. World Bank technical assistance and financing can be instrumental in this context, but they have to support real reform and new, viable systems, not just payment of pension arrears or financing the current gap in the pension system.

(5) Restructuring industry and spurring new business creation and growth: The experience of many countries suggests that the right approach is a combination of: (1) fixing the policy/regulatory environment and (2) government action to do the things that markets and the private sector can not or will not do. Subsidies and directed credits are not the right approach; they waste scarce resources and create inflation. There are no short cuts on the first challenge. It involves a long list of improvements to the legal and institutional framework: enforcement of

sound property, contract, and bankruptcy law; winning the fight against corruption; strengthening the legal basis for land and housing markets; increasing labor market flexibility; elimination of burdensome firm licensing and registration requirements; and strengthening shareholder rights and enforcement, including the right to accurate and reliable disclosure of firm financial information. With regard to the second, while acknowledging the fiscal constraints on Russian government action, we should engage in a constructive discussion with Russian authorities to identify opportunities where government can usefully intervene, such as financing product-related R&D; facilitating lending to those with no access the formal financial sector; human capital formation; building infrastructure; strengthening nuclear security. Financing these efforts could come from a combination of reallocation of GOR spending, the international financial institutions (IFIs), bilateral financing, and public/private partnerships.

(6) Increasing foreign direct investment (FDI): In the near term, as a second best policy which would help bring in much needed foreign investment and generate positive demonstration effects for the rest of the economy, the Russian government could create special, stable tax and regulatory regimes for foreign investments (e.g., PSAs). Over time, coverage of these special regimes could be extended to new sectors and to domestic investments. FDI could also be attracted by making privatization procedures more competitive and transparent.

(7) Russia's external debt obligations (Paris Club, IFIs, eurobonds, bank-to-bank external debt): Recent indications suggest that the Russian government is moving toward a more cooperative strategy with respect to foreign creditors. If this proves correct, we should respond with a constructive approach to Russia's Paris Club arrears/obligations, urging Russia to adopt a responsible payments strategy and to move toward agreement with the IMF on a new program.

(8) Relations with the IMF and World Bank: Russia and the Fund should use this period to explore new, permanent solutions to Russia's fiscal problem that have some chance of mobilizing political consensus and being implemented. The Fund should help Russia chart a path back to stability that is sustainable but realistic. Once this path is agreed and launched, the World Bank should move quickly to take the lead in financing the key structural reforms outlined here.

(9) Humanitarian assistance: The West can and should help Russia meet basic human needs. Given the very poor Russian harvest, the sharp ruble devaluation, and greatly diminished trade finance, there will likely be food shortages and/or dramatic food prices increases in particular regions this winter, putting the most vulnerable in real jeopardy. We should work hard to reach rapid agreement with the GOR on food aid which is designed and implemented in a manner that ensures that the food goes to the right people.

(10) Technical assistance: In the wake of the crisis, we should undertake a thorough review of USG technical assistance to ensure that it is directed at the right problems, effective, and fully utilized. Pending the outcome of this review, a focus on bank restructuring, the rule of law and anti-corruption efforts, and fiscal federalism and tax administration would seem to be warranted.

MEMORANDUM FOR THE VICE PRESIDENT

SUBJECT: **Responding to Russia's Economic Crisis**

The current situation: Russia's financial crisis is exacting an enormous toll. Market confidence in Russia's medium term prospects is all but destroyed. The dramatic loss of ruble stability has reversed what many view as Russia's principal financial achievement of the last six years. High inflation is re-emerging, especially hurting the most vulnerable parts of Russia's population. The payments system is largely inoperative, economic activity is slumping, and imports have fallen sharply in many sectors including food. Unemployment is rising in the service and consumer goods sectors. Domestic government debt is being restructured, inflicting serious costs on domestic and foreign investors alike. Russia's external debt obligations loom very large, especially in ruble terms; arrears are already mounting on obligations to the Paris Club, which Russia recently joined as a creditor.

The Russian government and monetary authorities have no good or easy stabilization policy choices. The government can no longer borrow either domestically or externally, so deficit cutting is imperative. But the breakdown in the payments system and the drop in output and imports caused by the crisis have reduced tax and tariff revenues to perhaps half their usual inadequate levels. Further expenditure cuts, though essential, will be strongly resisted. The pressure for money creation -- to finance the current deficit, clear wage and pension arrears, and bail out banks -- will be intense.

All this comes at a time of uncertainty in Russia's political arena, a profound lack of consensus about the most sensible economic strategy, seriously mixed signals on policy contributing to a perception of drift, and an extremely tough global environment. Prime Minister Primakov and his government are faced with the enormously difficult but inescapable challenge of charting a new economic course. The crisis may in fact be an opportunity to build political support for fundamental reforms that would lead to real benefits for the majority of Russian, and not just a select few.

Some Russian officials have already developed a number of reasonable proposals along these lines. The Chairman of the Federal Commission for Securities Markets, for example, has made proposals that would significantly improve the business climate. Likewise, the Central Bank has developed a bank restructuring plan that could be highly effective, if implemented properly. These plans must be refined, coordinated and implemented. Of course, without political support, the best plans are futile.

Our vital stake in Russia's future and its transformation success is undiminished. We must engage steadily and closely with Russia during this troubled period. Part of that engagement has to be an intensive effort, perhaps drawing on our experience and that of other countries, to help Russia identify what has gone wrong and how the Russian economy and financial system can be fixed. Our engagement must also include fulfillment of President Clinton's firm promise in Moscow to support the right kinds of Russian reforms and policies.

Lessons from the transformation effort so far: The crisis has dramatized what has been clear for some time: Russia lacks essential underpinnings of a healthy market economy: confidence in the currency as a store of value (or even as a medium of exchange for large transactions); a banking system which lends to unaffiliated private firms; a legal system which adequately protects property and investor rights; a fair regulatory and tax system which ensures a predictable, competitive, transparent business environment, effectively funds the government, and does not serve as a vehicle for state corruption.

There are at least two schools of thought as to why these have not developed in Russia. One is that it has taken a long time for them to develop anywhere, and the West, as well as Russian reformers, had unrealistic expectations about how long it would take to develop market institutions, laws, and practices which had never existed in Russia. The other is that the United States and Western and Central Europe do not provide the right models for Russia. Asian development paths, more dependent on public-private cooperation and relationships than on law and transparency, may be more relevant.

Perhaps both are partly right. But another consideration is central for Russia. It relates to the role of the state. The irony in the aftermath of the Soviet period is that the experience of communism has heavily damaged, perhaps even destroyed, Russian people's trust in the state, their willingness to cede power to the state, and their faith in the state's ability to provide an effective social safety net. The overriding objective of business people, legislators, local officials, and individuals is to ensure protection, or at least distance, from what is perceived as the state's arbitrary, unreliable, and corrupt authority.

For this reason, it could be argued that the reform agenda aimed at bringing the unofficial barter economy into the formal, taxed and regulated sector ran directly counter to Russian peoples' perceived interests. From this perspective, it is not hard to see why it failed. It also makes it easier to understand why Russians are willing to put up with the enormous inefficiencies of a barter system as a means to avoid the greater perceived risks and costs associated with being part of the state regulated sector. The sobering lesson is that Russia faces a protracted struggle, not only to build effective state institutions but also to overcome deep-rooted resistance to the basic objective of strengthening the law-based state. We should be mindful that, as in our country's history, part of the ultimate resolution of this legitimacy issue will probably come from some redistribution of power from the center to the regions and localities.

The other lesson concerns the relative emphasis in economic policy on stabilization vs. structural reform. With hindsight it seems clear that the Russians got stuck in the stabilization phase of reform, mostly because of a failure to do the things which would have made stabilization sustainable, like fixing the tax system. Successive Russian governments struggled ineffectually with this issue, leaving little reform energy left for other challenges. The failure to do structural reform killed prospects for growth which in turn repeatedly threatened and ultimately destroyed stability. Russia and we should be careful to avoid this vicious cycle in the months ahead. Support for organic reforms should proceed with the same urgency as support for stabilization and through all means possible -- financing from international financial institutions, technical assistance, training and educational exchanges, public-private partnerships.

Policy message to Russia: It will be critical not to draw the wrong lessons from this crisis. The failure of Russia's economy to grow was not the result of monetary policy. Printing a lot of additional money will not induce people and businesses to invest in the real economy or even to hold more rubles (as inflation accelerates). We also conclude that the market democracy model remains the right one for Russia, but it has to be underpinned by a state which provides a competitive, orderly, predictable, and transparent environment. There is nothing cultural or uniquely Russian about the country's failure to invest and grow during the last six years. Russian economic performance can instead be attributed to a rational response on the part of Russian people and businesses to very real policy, regulatory, and legal failures. The focus of Russia's authorities should be on correcting those failures as well as on stabilization. The U.S. and the West should strongly support these reforms with policy dialogue, financing, and technical assistance. Moreover, if Russia moves forward resolutely to strengthen policies and the investment climate, the West should also consider ways of helping Russia tackle challenges which the market and the private sector are not suited to address.

Economic policies and the West's engagement: further discussion

(1) Stabilization/exchange rate policy: Stabilization will have to rely primarily on deficit cutting through a combination of revenue increases from the energy sector (which has benefitted from the devaluation), expenditure cuts and reallocation, and rapid implementation of measures to extend the reach of the tax system to the barter economy, such as tax collection on an accrual basis (taxes are due when the transaction occurs not when cash payment is received). While some monetization of the deficit and arrears clearance may be unavoidable, it should be strictly limited, offset by some exchange reserve drawdowns, and preferably done in consultation with the IMF. Money creation must not expand to finance indiscriminate bank bailouts.

The high inflation emerging now and ahead has clear implications for exchange rate policy. It appears that Russian authorities are attempting to stabilize the ruble through restrictions on exchange market operations and other steps toward inconvertibility, trade controls, and limits on access to dollar holdings and use. This is exactly the wrong direction; it will drive people deeper into barter and revive administrative controls that provide additional opportunities for corruption. A ruble float is a better policy choice during this period, with the possibility of a renewed peg in the future under the right macroeconomic policy conditions.

Key policy measures:

- Restrict monetary emissions.
- Restore currency convertibility allowing market forces to determine a sustainable exchange rate.

(2) Tax reform: To date, successive Russian governments have been unable to build a viable coalition in support of tax reform. A reasonable basis for doing so is to cut rates but apply them more broadly, predictably, and fairly. Moreover, the goal of reducing disincentives for new businesses to move from the informal to formal sector should be overriding. We should urge fixes to the tax system which balance three objectives: (1) raising revenues; (2) simplicity, predictability, ease of administration, and business-friendliness; and (3) broad appeal to potential constituents for tax reform. Reconciling these three objectives may well mean lower than desirable federal revenues. The ultimate solution may have to come from changes in Russia's fiscal federalism to better balance revenues and responsibilities. More expenditures and more tax authority may have to be shifted from the center to the regions/municipalities.

Key policy measures:

- Simplify VAT administration and reduce evasion by putting the tax on an accrual basis.
- Give large taxpayer units (LTUs) jurisdiction over relevant taxpayers and subject both large enterprises and the LTUs to audits by reputable international firms.
- Implement a single presumptive tax on small business to simplify tax compliance.
- Amend tax code to give State Tax Service authority to seize assets and perform audits.

(3) Bank restructuring: The collapse of the banking sector provides an opportunity to build a well-managed, well-regulated banking system which actually promotes growth through lending to private businesses, including small- and medium-sized businesses. But bank restructuring has been an enormously sensitive and politically-charged issue in many countries. It is extremely hard to avoid pressures to bail out undeserving, even corrupt, banks and to allow them to retain their old managers. But there are no Russian sources of financing for these bailouts and real concern in responsible quarters of the Russian government and central bank about the inflationary consequences of doing so through central bank credits. In addition, the task of fully auditing and examining existing banks in order to make informed decisions about which (few) banks should be supported is very difficult, especially in the Russian context where information on bank balance sheets is inadequate and unreliable. Technical assistance is critical, as is World Bank and EBRD financing. But financing has to be strictly conditioned on saving only those banks which are well-run and solvent or potentially solvent, which provide full and accurate information, and which are truly systemically important (i.e., which hold substantial deposits from individuals).

Key policy measures:

- Conduct full and accurate audits of banks to identify a few to preserve as the basis for a re-built payments system, as the Central Bank has proposed.
- Refrain from providing liquidity to remaining banks and instead restructure and/or liquidate them through a mechanism like the U.S. Resolution Trust Corporation.
- Replace the current owners and managers of insolvent banks.
- Separate banks from large financial-industrial groups and ensure loans are made only on commercial criteria.
- Allow greater participation by foreign banks to help construct a healthy, well-managed banking system that lends to the real sector of the economy.

(4) Creation of a sustainable and effectively targeted social safety net and clearance of wage and pension arrears: This is an essential objective if the Russian government is to build its citizenry's stake in a stronger state and is critical to long-term fiscal and social stability. World Bank technical assistance and financing can be instrumental in this context, but they have to support real reform and new, viable systems, not just payment of pension arrears or financing the current gap in the pension system.

Key policy measures:

- Bring the pension system into balance for the long-term through higher retirement ages, means-testing, and/or payroll tax changes.
- Focus social/health insurance on reducing non-essential benefits thereby reducing the payroll tax burden, and freeing up funds for the most needy.
- Target unemployment insurance to sectors/regions where unemployment is most acute.

(5) Restructuring industry and spurring new business creation and growth: The experience of many countries suggests that the right approach is a combination of: (1) fixing the policy/regulatory environment and (2) government action to do the things that markets and the private sector can not or will not do. Subsidies and directed credits are not the right approach; they waste scarce resources and create inflation. There are no short cuts on the first challenge which is at the heart of an "organic" approach to economic reform. It involves a long list of improvements to the legal and institutional framework, some of which are highlighted below. With regard to the second, while acknowledging the fiscal constraints on Russian government action, we should engage in a constructive discussion with Russian authorities to identify opportunities where government can usefully intervene, such as financing product-related R&D; facilitating lending to those with no access the formal financial sector; human capital formation; building some kinds of infrastructure; strengthening nuclear security. Financing these efforts could come from a combination of reallocation of GOR spending, the international financial institutions (IFIs), bilateral financing, and public/private partnerships.

Key policy measures:
- Eliminate the 'propiska' system of residency permits.
- Improve bankruptcy laws and support the bankruptcy of major insolvent enterprises.
- Increase regulation of natural monopolies, ensure fair access to transport and energy distribution systems.
- Strengthen housing and real estate markets by bolstering property rights and rules for sale and lease of land, particularly urban land.
- Ban certain abusive practices by majority shareholders and strengthen the authority of the Federal Commission for Securities Markets to punish offenders.
- Combat crime and corruption in police units which administer the anti-corruption laws.

(6) Increasing foreign direct investment (FDI): In the near term, as a second best policy which would help bring in much needed foreign investment and generate positive demonstration effects for the rest of the economy, the Russian government could create special, stable tax and regulatory regimes for foreign investments. Over time, coverage of these special regimes could be extended to new sectors and to domestic investments. FDI could also be attracted by making privatization procedures more competitive and transparent.

Key policy measures:
- Pass and implement legislation on production sharing agreements (PSA) to unlock billions of dollars of FDI into Russia's energy sector.
- Adopt international accounting standards as planned in 1999.

(7) Russia's external debt obligations (Paris Club, IFIs, eurobonds, bank-to-bank external debt): Recent indications suggest that the Russian government is moving toward a more cooperative strategy with respect to foreign holders of frozen government bonds. If Russia also adopts a responsible payments strategy in the Paris Club and moves toward agreement with the IMF on a new program, we should respond as cooperatively and constructively as possible.

(8) Relations with the IMF and World Bank: Russia and the Fund should use this period to explore new, permanent solutions to Russia's fiscal problem that have some chance of

mobilizing political consensus and being implemented. The Fund should help Russia chart a path back to stability that is sustainable but realistic. Once this path is agreed and launched, the World Bank should move quickly to take the lead in financing the key structural reforms outlined here.

(9) Humanitarian assistance: The West can and should help Russia meet basic human needs. Given the very poor Russian harvest, the sharp ruble devaluation, and greatly diminished trade finance, there will likely be food shortages and/or dramatic food prices increases in particular regions this winter, putting the most vulnerable in real jeopardy. We should work hard to reach rapid agreement with the GOR on food aid which is designed and implemented in a manner that ensures that the food goes to the right people.

(10) Technical assistance: In the wake of the crisis, we should undertake a thorough review of USG technical assistance to ensure that it is directed at the right problems, effective, and fully utilized. Pending the outcome of this review, a focus on bank restructuring, the rule of law and anti-corruption efforts, and fiscal federalism and tax administration would seem to be warranted.

log & file

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

November 12, 1998

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS
ASSISTANT SECRETARY GEITHNER

FROM: Acting Principal ~~SENIOR~~ DEPUTY ASSISTANT SECRETARY TRUMAN EMT

SUBJECT: Principals meeting on Russia: Recommended POTUS response to expected Primakov request for large financing package for Russia (Addendum to briefing)

We understand from the IMF resident rep in Moscow that Prime Minister Primakov will ask President Clinton for a large multilateral/bilateral financing package for Russia when the two meet in Kuala Lumpur. (Mr. Livshits visited IMF res rep Gilman in Moscow to convey the Russian intention to make this request. In addition, Russian Finance Ministry officials have told Gilman that preparation of the 1999 deficit is on hold until Mr. Primakov talks to the President and clarifies the question of how much external official financing will be available.) Serious Russian deficit cutting and other reform will not be offered as the Russian quid pro quo. Instead, Mr. Primakov will offer ratification of START II. Mr. Primakov is expected to argue the political impossibility of cutting spending and raising taxes during Russia's current deep economic and financial crisis. **The question of what the President should say to Mr. Primakov in response is expected to dominate the discussion at today's Principals' meeting on Russia.**

We suggest that you offer the points below for use by the President in his response. The points provide the rationale for why IFI financing for a large 1999 budget deficit is not a good idea, and they outline alternative forms of engagement to provide near- and medium-term help for Russia.

Suggested POTUS points to PM Primakov:

- o Keenly aware of the enormous difficulty you face in building support for a responsible economic policy path that will lead Russia out of economic and financial crisis.

- o Especially commend signals from you and your government that you are trying to avoid irresponsible money creation and high inflation.

- o As you know, I have led the effort to mobilize financing for Russia to support reform and I want to continue to do so.

- o But we both have to be very clear about the objective of this extraordinary external financing. It is to help Russia bear the near-term costs of reform, not to avoid reform.

- In the wake of the experience of the last seven years, we also have to be clear about what policies will work in Russia and what policies have not worked.

- What will not work is more borrowing to finance an unsustainably large budget deficit. From what I understand, one of the few points on which there is consensus, both within Russia and outside it, is that Russia already has borrowed too much to finance excessive budget deficits and private capital flight.

- I also understand, from personal experience, that there is a great distance between reaching consensus that the deficit is too large and reaching consensus on what to do to reduce it.

- I think it would be a mistake for the international community to provide financing once again which relieves the pressure on Russia to implement a domestically-financeable budget, principally because it would not help solve Russia's fundamental problems.

- Have to stress that we faced intense criticism at home for the disbursement of nearly $5 billion in IMF funds this summer.

  - At a time when the IMF was heavily criticized and when its resources were short, we were accused of wasting a lot of money to support an unsustainable economic program in Russia.

  - If we proposed financing now in the absence of credible fiscal adjustment in Russia, we would be rightly accused of going down exactly the same road again.

- But we can agree on one point, Russia has focused too exclusively on fiscal adjustment and not sufficiently on building the underpinnings of a market economy, especially creating a policy/regulatory/legal climate in which people are willing to invest their capital in job-creating new businesses.

- For these reasons, we have thought very carefully about how we can be helpful during this difficult period. Our approach has the following elements.

  - The **large food aid package** recently agreed is a clear demonstration of our willingness to help Russia mitigate the impact of the crisis on the most vulnerable of Russia's people.

  - We are strongly encouraging the international financial institutions to be as active as possible to **support bank restructuring and a restoration of the payments system** in Russia.

  - As you continue to work with the IMF on a viable macroeconomic program, we support lending from the World Bank and the EBRD to **finance growth-promoting structural reform and productive projects.**

We are taking a **low-key approach in the Paris Club** despite your arrears to us and others. We have avoided a formal declaration of default which would trigger nullification of the Paris Club rescheduling agreement itself.

-- In our policy dialogue with your government, we want to embark on an intensive exploration of what can be done to **promote foreign direct investment** in Russia, stable investment to foster jobs, exports, and growth.

-- We are working on a plan to increase sharply **increase security assistance** in the areas of nuclear security and non-nuclear weapons of mass destruction, cooperation with your scientists, and military downsizing and relocation.

MEMORANDUM FOR THE VICE PRESIDENT

SUBJECT: **Russia's Economic Crisis**

The current situation: Russia's financial crisis is exacting an enormous toll. Market confidence in Russia's medium term prospects has fallen sharply. The dramatic loss of ruble stability has reversed what many view as Russia's principal financial achievement of the last six years. High inflation is re-emerging, especially hurting the most vulnerable parts of Russia's population. Domestic government debt is being restructured, inflicting serious costs on domestic and foreign investors alike. Russia's external debt obligations loom very large, especially in ruble terms; arrears are already mounting on obligations to the Paris Club, which Russia recently joined as a creditor.

The Russian government and monetary authorities have no good or easy stabilization policy choices. The government can no longer borrow either domestically or externally, so deficit cutting is imperative. But the crisis itself is intensifying resistance to revenue increases and further expenditure cuts. The pressure for money creation -- to finance the current deficit, clear wage and pension arrears, and bail out banks -- is intense.

All this comes at a time of uncertainty in Russia's political arena, a lack of domestic consensus about the right economic strategy for Russia, and an extremely tough global environment. Prime Minister Primakov and his government are faced with the enormously difficult but inescapable challenge of charting a new economic course. The crisis may in fact be an opportunity to build political support for fundamental reforms that would lead to real benefits for the majority of Russians, not just a select few.

Some Russian officials have already developed a number of reasonable proposals along these lines. The Chairman of the Federal Commission for Securities Markets, for example, has made proposals that would significantly improve the business climate. Likewise, the Central Bank has developed a bank restructuring plan that could be highly effective, if implemented properly. These plans must be refined, coordinated and implemented. Of course, without political support, the best plans are futile.

Lessons from the transformation effort so far: The crisis has dramatized what has been clear for some time: Russia lacks essential underpinnings of a healthy market economy: confidence in the currency as a store of value (or even as a medium of exchange for large transactions); a banking system which lends to unaffiliated private firms; a legal system which adequately protects property and investor rights; a fair regulatory and tax system which ensures a predictable, competitive, transparent business environment, effectively funds the government, and does not serve as a vehicle for state corruption.

There are at least two schools of thought as to why these have not developed in Russia. One is that it has taken a long time for them to develop anywhere, and the West, as well as Russian reformers, had unrealistic expectations about how long it would take to develop market institutions, laws, and practices which had never existed in Russia. The other is that the United States and Western and Central Europe do not provide the right models for Russia. Asian development paths, more dependent on public-private cooperation and relationships, may be more relevant.

Perhaps both are partly right. But another consideration is central for Russia. It relates to the role of the state. The irony in the aftermath of the Soviet period is that the experience of communism has heavily damaged, perhaps even destroyed, Russian people's trust in the state, their willingness to cede power to the state, and their faith in the state's ability to provide an effective social safety net. The overriding objective of business people, legislators, local officials, and individuals is to ensure protection, or at least distance, from what is perceived as the state's arbitrary, unreliable, and corrupt authority.

For this reason, it could be argued that the reform agenda aimed at bringing the unofficial barter economy into the formal, taxed and regulated sector ran directly counter to Russian peoples' perceived interests. From this perspective, it is not hard to see why it failed. It also makes it easier to understand why Russians are willing to put up with the enormous inefficiencies of a barter system as a means to avoid the greater perceived risks and costs associated with being part of the state regulated sector. The sobering lesson is that Russia faces a protracted struggle, not only to build effective state institutions but also to overcome deep-rooted resistance to the basic objective of strengthening the law-based state. We should be mindful that, as in our country's history, part of the ultimate resolution of this legitimacy issue will probably come from some redistribution of power from the center to the regions and localities.

The other lesson concerns the relative emphasis in economic policy on stabilization vs. structural reform. With hindsight it seems clear that Russia got stuck in the stabilization phase of reform, mostly because of a failure to do the things which would have made stabilization sustainable, like fixing the tax system. Successive Russian governments struggled ineffectually with this issue, leaving little reform energy left for other challenges. The failure to do structural reform killed prospects for growth which in turn repeatedly threatened and ultimately destroyed stability.

Policy message to Russia: It will be critical not to draw the wrong lessons from this crisis. The failure of Russia's economy to grow was not the result of a shortage of money. Printing a lot of additional money will not induce people and businesses to invest in the real economy or even to hold more rubles (as inflation accelerates). We also conclude that the market democracy model remains the right one for Russia, but it has to be underpinned by a state which provides a competitive, orderly, predictable, and transparent environment. There is nothing cultural or uniquely Russian about the country's failure to invest and grow during the last six years. Russian economic performance can instead be attributed to rational response on the part of Russian people and businesses to very real policy, regulatory, and legal failures. The focus of Russia's authorities should be on correcting those failures as well as on stabilization.

Policy priorities for Russia

(1) <u>Stabilization/exchange rate policy:</u> Stabilization will have to rely primarily on deficit cutting through a combination of revenue increases from the energy sector (which has benefitted from the devaluation), expenditure cuts and reallocation, and rapid implementation of measures to extend the reach of the tax system to the barter economy, such as tax collection on an accrual

basis (taxes are due when the transaction occurs not when cash payment is received). While some monetization of the deficit and arrears clearance may be unavoidable, it should be strictly limited, offset by some exchange reserve drawdowns, and preferably done in consultation with the IMF. Money creation must not expand to finance indiscriminate bank bailouts.

High inflation ahead has clear implications for exchange rate policy. It appears that Russian authorities are attempting to stabilize the ruble through restrictions on exchange market operations and other steps toward inconvertibility and trade controls. This is exactly the wrong direction; it will drive people deeper into barter and revive administrative controls that provide additional opportunities for corruption. A ruble float is a better policy choice during this period, with the possibility of a renewed peg in the future under the right macroeconomic policy conditions.

Key measures:

- Restrict monetary emissions.
- Restore currency convertibility allowing market forces to determine a sustainable exchange rate.

(2) Tax reform: To date, successive Russian governments have been unable to build a viable coalition in support of tax reform. A reasonable basis for doing so is to cut rates but apply them more broadly, predictably, and fairly. Moreover, the goal of reducing disincentives for new businesses to move from the informal to formal sector should be overriding. Fixes to the tax system should balance three objectives: (1) raising revenues; (2) simplicity, predictability, ease of administration, and business-friendliness; and (3) broad appeal to potential constituents for tax reform. Reconciling these three objectives may well mean lower than desirable federal revenues. The ultimate solution may have to come from changes in Russia's fiscal federalism to better balance revenues and responsibilities. More expenditures and more tax authority may have to be shifted from the center to the regions/municipalities.

Key measures:

- Simplify VAT administration and reduce evasion by putting the tax on an accrual basis.
- Give large taxpayer units (LTUs) jurisdiction over relevant taxpayers and subject both large enterprises and the LTUs to audits by reputable international firms.
- Implement a single presumptive tax on small business to simplify tax compliance.
- Amend tax code to give State Tax Service authority to seize assets and perform audits.

(3) Bank restructuring: The collapse of the banking sector provides an opportunity to build a well-managed, well-regulated banking system which actually promotes growth through lending to private businesses, including small- and medium-sized businesses. But bank restructuring has been an enormously sensitive and politically-charged issue in many countries. It is extremely hard to avoid pressures to bail out undeserving, even corrupt, banks and to allow them to retain their old managers. But there are no Russian sources of financing for these bailouts and real concern about the inflationary consequences of doing so through central bank credits. In addition, the task of fully auditing and examining existing banks in order to make informed decisions about which (few) banks should be supported is very difficult, especially in the Russian

context where information on bank balance sheets is inadequate and unreliable. Financing for restructuring should be strictly conditioned on saving only those banks which are well-run and solvent or potentially solvent, which provide full and accurate information, and which are truly systemically important (i.e., which hold substantial deposits from individuals).

Key measures:

- Audit banks to identify a few to preserve as the basis for a re-built payments system, as the Central Bank has proposed.
- Refrain from providing liquidity to remaining banks and instead restructure and/or liquidate them through a mechanism like the U.S. Resolution Trust Corporation.
- Replace the current owners and managers of insolvent banks.
- Separate banks from large financial-industrial groups and ensure loans are made only on commercial criteria.
- Allow greater participation by foreign banks to help construct a healthy, well-managed banking system that lends to the real sector of the economy.

(4) <u>Creation of a sustainable and effectively targeted social safety net and clearance of wage and pension arrears:</u> This is an essential objective if the Russian government is to build its citizenry's stake in a stronger state, and it is critical to long-term fiscal and social stability.

Key measures:

- Bring the pension system into balance for the long-term through higher retirement ages, means-testing, and/or payroll tax changes.
- Focus social/health insurance on reducing non-essential benefits thereby reducing the payroll tax burden, and freeing up funds for the most needy.
- Target unemployment insurance to sectors/regions where unemployment is most acute.

(5) <u>Restructuring industry and spurring new business creation and growth:</u> The experience of many countries suggests that the right approach is a combination of: (1) fixing the policy/regulatory environment and (2) government action to do the things that markets and the private sector can not or will not do. Subsidies and directed credits are not the right approach; they waste scarce resources and create inflation. There are no short cuts on the first challenge which is at the heart of an "organic" approach to economic reform. It involves a long list of improvements to the legal and institutional framework, some of which are highlighted below. In Russia's continuing effort to integrate into the global economic and trading system, the early legislative implementation of WTO provisions can contribute to achieving this goal, as well as move Russia towards WTO membership. With regard to the second challenge, Russia should carefully evaluate where government can usefully intervene, such as assisting commercially relevant R&D; facilitating lending to those with no access to the formal financial sector; human capital formation; building some kinds of infrastructure; strengthening nuclear security. The composition of government expenditure could be shifted to allocate appropriate levels of spending into these areas.

Key measures:

- Eliminate the 'propiska' system of residency permits.
- Improve bankruptcy laws and support the bankruptcy of major insolvent enterprises.

- Increase regulation of natural monopolies, ensure fair access to transport and energy distribution systems.
- Strengthen housing and real estate markets by bolstering property rights and rules for sale and lease of land, particularly urban land.
- Ban certain abusive practices by majority shareholders and strengthen the authority of the Federal Commission for Securities Markets to punish offenders.
- Combat crime and corruption in police units which administer the anti-corruption laws.
- Strengthen/guarantee protection of intellectual property rights.

(6) Increasing foreign direct investment (FDI): In the near term, as a second best policy which would help bring in much needed foreign investment and generate positive demonstration effects for the rest of the economy, the Russian government could create special, stable tax and regulatory regimes for foreign investments, such as in the energy sector. Over time, with comprehensive tax and regulatory reform, the need for special regimes will diminish. FDI could also be attracted by making privatization procedures more competitive and transparent.

Key measures:
- Pass and implement legislation on production sharing agreements (PSA) to unlock billions of dollars of FDI into Russia's energy sector.
- Adopt international accounting standards as planned in 1999.

(7) Russia's external debt obligations (Paris Club, IFIs, eurobonds, bank-to-bank external debt): Russia should engage cooperatively with creditors, adopt a responsible payments strategy in the Paris Club, and move toward agreement with the IMF on a new program.

(8) Relations with the IMF and World Bank: Russia and the Fund should use this period to explore new, permanent solutions to Russia's fiscal problem that have some chance of mobilizing political consensus and being implemented. Russia should work with the IMF on a path back to stability that is sustainable and realistic and that is fully implemented. Russia should also redouble efforts to move forward on the key structural reforms outlined here which can be supported by World Bank financing.

(9) Humanitarian assistance: The West can and should help Russia meet basic human needs. The recently agreed food package should help address the effects of the very poor Russian harvest, the sharp ruble devaluation, and greatly diminished trade finance on the most vulnerable groups in Russia's population.

(10) Technical assistance: In the wake of the crisis, we should undertake a thorough review of USG technical assistance to ensure that it is directed at the right problems, effective, and fully utilized. Pending the outcome of this review, a focus on bank restructuring, the rule of law and anti-corruption efforts, and fiscal federalism and tax administration would seem to be warranted.

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Robert E. Rubin to POTUS re: Your Meeting with Thailand's Prime Minister Chuan Leekpai (1 page)	03/12/98	P5 1274
002. memo	Acting Secretary (IMF) to Members of Executive Board re: Republic of Korea - Second Quarterly Review Under Stand-By Arrangement - Letter of Intent (1 page)	05/04/98	P1/b(1) (C)
003. letter	Chol-Hwan Chon & Kyu-sung Lee to Michel Camdessus re: Letter of Intent - South Korea (2 pages)	05/02/98	P1/b(1) (C)
004. memo	re: Updated Memorandum on Economic Program for Second Quarterly Review, 1998 (19 pages)	circa May 1998	P1/b(1) (C)
005. memo	Todd Scneider (IMF) to Jason Singer re: Korea - Round II (1 page)	05/27/98	P1/b(1) Unclass.
006. report	re: Republic of Korea - 1998 Article IV Consultation & Second Quarterly Review Under Stand-By Arrangement (IMF document) (5 pages)	05/27/98	P1/b(1) Unclass.

COLLECTION:

Clinton Administration History Project

OA/Box Number: 24124

FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [8]

Jimmie Purvis

jp37

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advise between the President and his advisors, or between such advisors [a)(5) of the PRA]
P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.
PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).
RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

b(1) National security classified information [(b)(1) of the FOIA]
b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

March 12, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: Robert E. Rubin R.E.R.

SUBJECT: Your Meeting with Thailand's Prime Minister Chuan Leekpai, March 13, 1998

Thailand has made substantial progress in recent months regaining credibility with the markets, based on improved implementation of economic reform. To help consolidate these gains, we announced on March 4 that the U.S. would be prepared to support Thailand's access to the IMF Supplemental Reserve Facility (SRF), if needed. (SRF loans have shorter maturities and higher interest rates than normal IMF loans to encourage a country to return to private sector borrowing as soon as possible.) I spoke with Finance Minister Tarrin on Tuesday, March 2, to let him know we intended to do this. He was very pleased. Minister Tarrin was also highly interested in the US-led G-7 export financing initiative which includes U.S. Exim-Bank willingness, under certain conditions, to provide up to $1 billion in short-term trade finance insurance. We do not expect that the Prime Minister will ask for additional support from the Treasury ESF account.

Despite recent progress, however, Thailand is by no means out of the woods. It remains vulnerable to negative developments of other problem countries in the region and the government has many politically difficult economic decisions to make this year.

In your meeting with Prime Minister Chuan, I recommend that you:

-- Compliment him on the difficult, but necessary, measures his government has taken in the last three months and those outlined in Thailand's revised IMF Letter of Intent. Emphasize the importance of sustained commitment to reform and the dangers of premature easing.

-- Underscore our recent support for Thailand's access to the IMF SRF and additional U.S. and G-7 trade financing initiatives.

-- Inform him that we will continue to encourage the World Bank and Asian Development Bank to help Thailand develop social safety net programs to address problems caused by the ongoing recession and economic restructuring.

I will meet separately with Prime Minister Chuan prior to your meeting. I will review in more detail financial sector developments, problems that Thai companies are experiencing in accessing trade credits, and new bankruptcy laws that are being developed to facilitate corporate workouts.

Attachment: Economic Developments and Key Commitments in Thailand's IMF Letter of Intent

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Edward S. Knight to Secretary Rubin; re: Preliminary Legal Assessment (3 pages)	05/01/95	P5 1275
002. memo	Edward S. Knight to Secretary Rubin; re: Legal Memorandum (19 pages)	05/12/95	P5 1276

COLLECTION:

Clinton Administration History Project

OA/Box Number: 24125

FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [14]

Jimmie Purvis

jp41

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
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95-1456 22

DEPARTMENT OF THE TREASURY
WASHINGTON

GENERAL COUNSEL

May 1, 1995

MEMORANDUM FOR SECRETARY RUBIN

FROM: EDWARD S. KNIGHT ESK

SUBJECT: Preliminary legal assessment of closing off Pennsylvania Avenue in front of the White House

Based on preliminary research, there are at least four options pursuant to which the portion of Pennsylvania Avenue in front of the White House could be closed off to vehicular traffic. I raise these options as a preliminary matter, and specifically, do not opine that any of the options provide definitive legal support or represent the universe of possible approaches to accomplish this action. On the other hand, I believe that they merit your attention at this time as you continue to consider and evaluate proposals concerning Pennsylvania Avenue.

1. <u>Protective Authority of the United States Secret Service (USSS)</u>

** The USSS has closed Pennsylvania Avenue, after consultation with the D.C. Metropolitan Police Department, for very short periods of time relying on its statutorily mandated protective responsibilities under 18 U.S.C. 3056.[1]

** The Secretary of the Treasury is authorized to prescribe regulations governing access to buildings and grounds which constitute areas where the President is <u>temporarily</u> residing or visiting. (This may be a difficult argument since the White House is, of course, the President's <u>permanent</u> residence.)

2. <u>Authority vested by Congress in District of Columbia (D.C.) Government</u>

** "The Street and Alley Closing Procedures Act of 1982" (1982 Act) requires that the D.C. City Council may be petitioned to pass legislation closing D.C. streets and transferring title.

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[1]18 U.S.C. 3056(a) provides in relevant part that "[u]nder the direction of the Secretary of the Treasury, the United States Secret Service is authorized to protect...the President, the Vice President (or other officer next in the order of succession to the Order of the President)...."

** D.C. City Council may pass emergency legislation which has provisional effect for 90 days, subject to congressional approval and veto.

** Other "Home Rule" laws enacted by Congress, including the 1982 Act, impose many procedural (and time consuming) hurdles, including: applications filed with Surveyor of the District; comments solicited from many city agencies; recommendations forwarded to D.C. City Council; National Capital Planning Commission, a federal agency, also reviews application; D.C. mayor signs into law and forwards to both House of Congress or 30 day layover period.

** The Supreme Court has indicated that authority over the streets of a city is a "peculiarly municipal function." There is no evidence that Congress has altered this presumption with respect to D.C.

3. General Presidential Authority

** Because we know of no circumstances where the general executive powers of the President have been relied on to support the closing of a city street or other comparable objective, any conjecture as to whether the President possesses such authority is merely speculative at this point. It is an area which my office and the Office of Legal Counsel are exploring further at this time.

4. Congressional Authority

** Congress has viewed the power to close D.C. streets as a municipal power, and it has chosen to delegate that municipal power to the D.C. government that it created (e.g., "Home Rule" laws). Accordingly, Congress could take the view that Pennsylvania Avenue is an important exception to this principle and pass emergency legislation allowing the Executive Branch to determine whether Pennsylvania Avenue or a portion thereof should remain open to vehicular traffic.

TREASURY CLEARANCE SHEET

NO. 95-145622

Date

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

FROM: Edward S. Knight

THROUGH:

SUBJECT: Legal Assessment of closing off PA Ave.

REVIEW OFFICES (Check when office clears)

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

☐ Under Secretary for International Affairs
☐ International Affairs

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

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

☐ Other

NAME (Please Type)	INITIAL	DATE	OFFICE	TEL. NO.
INITIATOR(S)				
Knighte	ESK	5/1/95	General Counsel	2-0027
REVIEWERS				

SPECIAL INSTRUCTIONS

☐ Review Officer Date ☐ Executive Secretary Date

DO F 80-02.1 (04/89)

DEPARTMENT OF THE TREASURY
WASHINGTON

GENERAL COUNSEL

May 12, 1995

MEMORANDUM FOR SECRETARY RUBIN

FROM: EDWARD S. KNIGHT Edward S. Knight

Subject: Legal Memorandum of the Secretary's Authority to Close Pennsylvania Avenue and other Streets Around the White House Perimeter

Summary

This memorandum discusses your legal authority, under 18 U.S.C. Section 3056 ("Section 3056"), to close Pennsylvania Avenue and other streets adjacent to the White House.

We conclude that Section 3056 provides you with broad legal authority to close these streets provided that you determine, as a factual matter, that such closure is necessary in order to protect the President.

Facts

In response to the September 12, 1994 plane crash on the South Grounds of the White House, then Secretary Bentsen established the White House Security Review ("Review") to examine White House security issues in light of this incident. The Review's scope was expanded to include a study of additional security issues raised by the subsequent incidents, including the shooting at the White House by Francisco Duran.

Among the recommendations made by the Review is to close to vehicular traffic Pennsylvania Avenue between Madison Place and 17th Street, State Place, and the segment of South Executive Avenue that connects into State Place. These streets are contained within the National Capital Service Area, a federal enclave consisting of the White House and other federal buildings and property.[1] Specifically, the Review concluded that there is no alternative to prohibiting vehicular traffic on those streets that would ensure the protection of the President and others in

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[1] 40 U.S.C. 136 establishes a federal area within the District of Columbia to include "the principal Federal monuments, the White House, the Capitol Building, the United States Supreme Court Building, and Federal executive, legislative and judicial office buildings located adjacent to the Mall and the Capitol Building..." and authorizes federal control over police protection and the maintenance of streets and highways in this area.

the White House complex from explosive devices carried by vehicles near the perimeter.

Analysis

The authority to protect the most significant Constitutional officer of the Federal government should be construed broadly. Indeed, courts have long recognized the paramount importance of protecting the President.[2] Even when Constitutional rights are implicated, such as First Amendment rights, courts have recognized the "substantiality" and "significance of America's interest in presidential security."[3] The "uniqueness and importance" of protecting the President has also persuaded courts to sanction "greater limitation than would be applicable generally" with respect to the use of public streets.[4]

Section 3056(a) provides in relevant part that

> "Under the direction of the Secretary of the Treasury, the United States Secret Service is authorized to protect the following persons: (1) the President, the Vice President...(2) the immediate families of those individuals listed in paragraph (1)...." 18 U.S.C. 3056(a)[5]

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[2]"The Nation undoubtedly has a valid, even overwhelming interest in protecting the safety of its Chief Executive...." Watts v. United States, 394 U.S. 705, 707 (April 22, 1969).

[3]White House Vigil for the ERA Committee v. Clark, 746 F.2d. 1518, 1528 (D.C. Cir. 1983). "At stake is not merely the safety of one man, but also the ability of the executive branch to function in an orderly fashion and the capacity of the United States to respond to threats and crises affecting the entire free world." Id. We note that closing streets to vehicular traffic would not violate any Constitutional rights.

[4]A Quaker Action Group v. Morton, 516 F.2d 717, 729 (D.C. Cir. 1975).

[5]A separate statutory section, 18 U.S.C. 1752(d), authorizes you to take certain actions necessary to protect the President while he is visiting or temporarily working or residing in a particular locale away from his permanent residence at the White House. The legislative history makes clear that the purpose of the statute is to clarify the Secret Service's authority to provide zones of protection for persons that it is authorized to protect under Section 3056.

The plain language of Section 3056 provides you with broad authority to do that which is necessary to protect the President and the other protectees listed in the statute. We have found nothing in the legislative history of Section 3056 that imposes limitations on your authority to protect the President. Nor have we found any case law restricting this authority.[6]

Although Section 3056 specifically lists certain law enforcement authorities of the Secret Service[7], the statute does not specifically mention closing streets to protect the President. Nonetheless, we believe that the provision provides you with broad legal authority to close the streets mentioned above should you determine that it is necessary to do so in order to protect the President. Moreover, we believe that you will continue to have authority to close these streets under Section 3056 so long as you continue to determine that, as a factual matter, doing so is necessary to protect the President. The Department of Justice concurs in these conclusions. (See Legal Opinion of Office of Legal Counsel, Department of Justice attached at Tab A.)

In 1865, the Secret Service was created as a bureau under the Department of the Treasury to combat counterfeiting. In 1901, as result of the assassination of President William McKinley, Congress directed the Secret Service to protect the new President, Theodore Roosevelt. In 1906, Congress finally enacted legislation making presidential protection a permanent Secret Service responsibility, that authority which is now embodied in Section 3056. Protective responsibilities have expanded greatly since that time to include additional protectees under Section 3056, as well as a number of temporary protective duties, such as providing security for the Declaration of Independence and the U.S. Constitution.

Historically, the Secret Service has been involved in a wide range of actions to assure the safety of the President. These

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[6]My office, the Office of the Chief Counsel to the Secret Service, and the Office of Legal Counsel at the Justice Department have conducted exhaustive research with respect to Section 3056, its legislative history and any case law interpreting its provisions. Very little responsive material was discovered. The particular language in Section 3056 providing for the protection of the President was authorized by P.L. 82-79 enacted in 1951. Prior to 1951, the Secret Service's authority to protect the President was provided for in annual appropriations bills. With respect to each of these sources, there is no reference to any limitations imposed on the Secretary with respect to such authority.

[7]E.g., the authority to execute warrants, carry firearms, make arrests. See 18 U.S.C. 3056(c).

actions have included closing streets and portions of highways to protect the President while on travel, closing parking garages to safeguard against bomb threats, restricting airspace over the President and cordoning off areas in hotels in which the President is present.[8] On numerous occasions, certain streets around the perimeter of the White House, including Pennsylvania Avenue, have been closed on a temporary basis because the Secret Service viewed such temporary closures as necessary in connection with its protective mission. Although we are unaware of any such closure lasting beyond five days, we believe that you have authority to close the streets as long as you believe it necessary to do so to protect the President.

As discussed above, the Review concluded that "there is no alternative to prohibiting vehicular traffic on Pennsylvania Avenue and the other streets listed above, that would ensure the safety of the President and others in the White House complex from explosive devices carried by vehicles near its boundaries." We conclude that this finding provides sufficient factual support for you to exercise your authority to close these streets.

We believe that the most effective way to execute your authority pursuant to Section 3056 is to direct to the Director of the Secret Service to take this action and to delegate to him the authority necessary to effect the street closures contemplated by this memorandum.

Exercising your authority to close these streets under Section 3056, however, is not entirely free of litigation risk.[9] We believe, however, that we would likely defeat any challenges to your authority in this matter.

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[8]The Secret Service acts pursuant to its collective authority under Section 3056, 18 U.S.C. 1752 and 3 U.S.C. 202. The Secret Service also has typically taken such actions with the assistance of state and local law enforcement officials, and, in certain actions, such as restricting airspace, through federal authorities.

[9]A number of related legal issues are worth mentioning. Due to the likelihood that closing the streets will be viewed as a "major federal action significantly affecting the quality of the human environment" under the National Environmental Policy Act of 1969 ("NEPA"), the Department, at a minimum, is required to consult with the Council on Environmental Quality in connection with any street closure. Once the streets are actually closed, the Department will be required to undertake other actions under NEPA. Under the Administrative Procedures Act, notice to the public of the streets closures should be posted on site and subsequently in the Federal Register.

Finally, you may wish to seek permanent legislation as a prudential matter to manifest congressional support for your action.

ATTACHMENTS

Tab A OLC Legal Opinion

cc: Under Secretary Noble

U. S. Department of Justice

Office of Legal Counsel

Office of the
Deputy Assistant Attorney General

Washington, D.C. 20530

May 12, 1995

MEMORANDUM FOR EDWARD S. KNIGHT
GENERAL COUNSEL
DEPARTMENT OF THE TREASURY

From: Richard Shiffrin RS
Teresa Wynn Roseborough TWR
Deputy Assistant Attorneys General

Re: The Secretary of the Treasury's Authority to Order the Closing of Certain Streets Located Along the Perimeter of the White House Under 18 U.S.C. § 3056

This is in response to your request for a legal opinion from the Office of Legal Counsel ("OLC") on whether the Secretary of the Treasury ("Secretary") has the authority to order the closing to vehicular traffic of (1) Pennsylvania Avenue between 17th Street and Madison Avenue, (2) State Place, (3) and the segment of South Executive Avenue that connects into State Place in furtherance of his responsibility to protect the President under 18 U.S.C. § 3056. Based on a review of section 3056 and related statutes, their legislative histories, and relevant court and OLC opinions, we conclude that section 3056 grants the Secretary broad authority to take actions that are necessary and proper to protect the President. In light of the recommendations of the White House Security Review and the United States Secret Service's unique expertise and special responsibility in this matter, we agree with your conclusion that section 3056 authorizes the actions contemplated by the Secretary.

I. <u>Background</u>

The White House Security Review, which was recently established by former Treasury Secretary Bentsen to examine White House security issues, has determined that "there is <u>no</u> alternative to prohibiting vehicular traffic on Pennsylvania Avenue that would ensure the safety of the President and others in the White House complex from explosive devices carried by vehicles near its boundaries." Request for Legal Opinion from Edward S. Knight, General Counsel, U.S. Department of Treasury, to Walter E. Dellinger, III, Assistant Attorney General, Office of Legal Counsel, U.S. Department of Justice 1 (May 10, 1995). You have informed this Office that in light of the Secretary's responsibilities to protect the President under section 3056, he is considering ordering the closing to vehicular traffic of portions of three streets that bound the grounds of the White House: (1) Pennsylvania Avenue between 17th Street and Madison Avenue, (2) State Place, and (3) the segment of South Executive Avenue that connects into State Place. Id. You have also informed this Office of your view that the conclusion of the White House Security Review provides sufficient factual support for the Secretary to exercise his authority to close the streets mentioned above. Id.

We have been informally advised that in the past, the Secret Service has taken, on a temporary basis, actions similar to those contemplated. These actions have included closing streets and portions of highways to protect the President while traveling, closing parking garages to safeguard him against bomb threats, restricting airspace over the President, and cordoning off areas in hotels in which the President was present.[1] The Secret Service has also, on occasion, temporarily closed certain streets around the perimeter of the White House, including Pennsylvania Avenue.[2]

II. Legal Analysis

A. Statutory Authority

1. Section 3056

Section 3056 provides, in pertinent part, that "[u]nder the direction of the Secretary of the Treasury, the United States Secret Service is authorized to protect . . .:"

> (1) The President, the Vice President (or other officer next in the order of succession to the Office of President), the President-elect, and the Vice President-elect [and]
> (2) The immediate families of those individuals listed in paragraph (1).

18 U.S.C. § 3056(a)(1)-(2).

In addition to that broadly-stated authority, officers and agents of the Secret Service are authorized, under the direction of the Secretary, to perform certain enumerated

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[1] We have been advised by the Department of the Treasury that the Secret Service has historically taken these steps pursuant to its authority under 18 U.S.C. §§ 3056 and 1752, and 3 U.S.C. § 202. We have also been informed that the Secret Service generally takes such actions with the assistance of state and local law enforcement officials.

[2] The Department of the Treasury has informed us that East Executive Drive was permanently closed to vehicular traffic by the National Park Service in 1985. According to the Department of the Treasury, when the Park Service closed East Executive Drive it consulted with the District of Columbia's Department of Transportation but did not file an application for street closing under the District of Columbia's street closing procedures.

functions,[3] and to "perform such other functions and duties as are authorized by law." 18 U.S.C. § 3056(c)(1)(F). Aside from expressly granting certain powers generally afforded federal law enforcement personnel, the statute does not attempt to enumerate the specific actions the Secret Service may take in fulfilling its responsibility to protect the President.

The legislative history of section 3056 also does not include any enumeration of the specific actions the Secretary may take to protect the President. Although the Secret Service has routinely protected the President since the assassination of President McKinley in 1901, see S. Rep. No. 467, 82d Cong., 1st Sess. 2-3 (1951), Congress did not provide explicit formal authority for this role until 1951. See Pub. L. No. 82-79, 65 Stat. 121, 122 (1951). Neither the congressional report language nor the floor debates concerning the authorizing legislation elaborate upon the activities and functions Secret Service officials may undertake in protecting the President. Moreover, subsequent amendments to section 3056 pertaining to the Service's protection duties merely expanded the group of officials over which the Secret Service has protective responsibilities, without delineating how the protection is to be accomplished.

Although both the language of section 3056 and its legislative history are silent as to specific protective acts, the language and legislative history of 18 U.S.C. § 1752, which authorizes the Secretary to designate and regulate temporary residences of the President, provide some insight into the scope of the Secret Services' authority under section 3056 with respect to the environs of the White House. Section 1752 was apparently intended to provide the Secret Service with authority to provide the same degree of protection for the President outside the vicinity of the White House as Congress believed the Secret Service could exercise, under section 3056, within the vicinity of the White House. Section 1752 grants the Secretary the authority to "designate by regulations the buildings and grounds which constitute the temporary residences of the President." 18 U.S.C. § 1752(d)(1). It also allows the Secretary "to prescribe regulations governing ingress or egress to such buildings

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[3] Such functions include the ability to:

> (A) execute warrants issued under the laws of the United States;
> (B) carry firearms;
> (C) make arrests without warrant for any offense against the United States committed in their presence, or for any felony cognizable under the laws of the United States if they have reasonable grounds to believe that the person to be arrested has committed or is committing such felony;
> (D) offer and pay rewards for services and information leading to the apprehension of persons involved in the violation or potential violation of those provisions of law which the Secret Service is authorized to enforce;
> (E) pay expenses for unforeseen emergencies of a confidential nature under the direction of the Secretary of the Treasury and accounted for solely on the Secretary's certificate.

18 U.S.C. § 3056(c)(1).

and grounds and to post, cordon off, or otherwise restrict areas where the President . . . is or will be temporarily visiting." 18 U.S.C. § 1752(d)(2).

The legislative history of the statute suggests that, when enacting section 1752, Congress believed the Secret Service already had similar or greater authority to control access to the environs of the White House. In 1969, Senator Hruska introduced S. 2896, stating that its purpose was "to provide more effective control over unauthorized entry into the temporary residence of the President, and any buildings which are being temporarily used as executive office buildings." 115 Cong. Rec. 25436 (1969) (statement of Sen. Hruska). The Senate Judiciary Committee report accompanying S. 2896 stated that the bill would "extend Federal protection to temporary residences and offices of the President." S. Rep. No. 1252, 91st Cong., 2d Sess. 6 (1970)(emphasis added). The report also mentioned that the bill was "designed to provide a uniform minimum of Federal jurisdiction for Presidential security when the President is on temporary visits," id., noting the testimony of the Director of the Secret Service that "[f]rom a security standpoint, the President is most vulnerable when he is outside the White House complex traveling or residing temporarily in some other section of the country" and "the enactment of . . . [the] legislation is necessary in order to guarantee the safety of the President when he is temporarily absent from the Executive residence." Id. at 6-7. Finally, reflecting the belief that federal law already was adequate to ensure protection of the President within the vicinity of the White House, the report opined that "[a]lthough the Secret Service is charged with protecting the person of the President . . . there is, at the present time, no Federal statute which specifically authorizes them to restrict entry to areas where the President maintains temporary residences or offices." Id. at 7.

Similar themes were expressed during floor debate on the bill. In describing the problems confronting the Secret Service when protecting the President outside of Washington, Senator McClellan stated:

> Protecting the President . . . is a formidable task for the Secret Service, which is charged with safeguarding the personal life of the President. As difficult as this task is, however, it is rendered even more difficult because the Secret Service's present powers are somewhat limited. Title 18, section 3056 of the United States Code authorizes the Secret Service to protect the life of the President, but does little more. Consequently, the Service must rely upon a patchwork of State laws and local ordinances and local officers to clear areas for security perimeters, to provide for free ingress and egress when the President is visiting, and to protect the President's private homes from trespassers.

116 Cong. Rec. 35651 (1970)(statement of Sen. McClellan).

Moreover, Senator Hruska, speaking in support of the legislation, declared:

> It would be unconscionable not to recognize the obvious fact that the President's vulnerability is maximized when he is traveling or residing temporarily in another section of the country. It would be unconscionable not to recognize the obvious fact that the Secret Service does not presently possess adequate Federal authority during these most vulnerable occasions. This body cannot ignore the obvious responsibility and duty it has at this moment to create the needed protection and authority.

116 Cong. Rec. 35653 (1970) (statement of Sen. Hruska).[4]

It is clear that Congress did not perceive that it was giving the Secretary greater power to protect the President when he was away from the White House than when he was within it. Rather, the language and legislative history of section 1752 reflect a belief that the authority afforded by section 1752 with respect to temporary residences already was available with respect to the President's permanent residence, the White House.

Section 1752 plainly grants the Secretary authority to "cordon off" and limit ingress and egress to an area where the President will be visiting to create a security perimeter, even when creating such a perimeter will require the closing of a public street to vehicular traffic. Since congressional action did not reflect any intent to give the Secretary greater authority under section 1752 than exists under section 3056, it would be incongruous for us to conclude that the Secretary has such authority with respect to temporary presidential residences but lacks the authority to cordon off or limit ingress and egress to an area to create an appropriate security perimeter around the White House.

Turning back to the language of section 3056, we note again that Congress painted the Secret Service's Presidential protection authority with a broad brush. That treatment seems reasonable, given the nature of Presidential protection services. Protecting the President requires a certain amount of flexibility to respond quickly to changing and often potentially dangerous situations. Too tight a rein on the authority of the Secret Service would compromise Presidential security. As we have stated in affirming the authority of the Secret Service, under section 3056, to cordon off the area in the vicinity of the White House as a protective measure in anticipation of large-scale demonstrations, "the Secret Service may not have unlimited powers in protecting the President but its powers are broader than routine public safety measures. The test to be applied, it seems, is whether, given the overwhelming interest in protecting the President and his performance of his duties, the measures taken are reasonable under the circumstances." Memorandum from William H. Rehnquist, Assistant Attorney General, Office of Legal Counsel, to Honorable Robert E. Jordan, III, General Counsel, Department of the Army 11 (Nov. 12, 1969).

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[4] S. 2896 was passed by the Senate on October 8, 1970, see 116 Cong. Rec. 35654 (1970), and incorporated into the Omnibus Crime Control Act of 1970, Pub. L. No. 91-644, tit. V, § 18, 84 Stat. 1880, 1891 (1971).

Relevant case law confirms this broad view. The Supreme Court has recognized that "[t]he Nation undoubtedly has a valid, even an overwhelming, interest in protecting the safety of its Chief Executive and in allowing him to perform his duties without interference from threats of physical violence." Watts v. United States, 394 U.S. 705, 707 (1969). See also White House Vigil for the ERA Committee v. Clark, 746 F.2d 1518, 1528 (D.C. Cir. 1984) ("At stake is not merely the safety of one man, but also the ability of the executive branch to function in an orderly fashion and the capacity of the United States to respond to threats and crises affecting the entire free world"). Accordingly, courts have construed the Secretary's authority under Section 3056 broadly, even in the face of constitutional challenges. In fact, the only limitation the courts have recognized on the Secretary's authority has been the Constitution. Where, for example, first amendment rights have been implicated, courts have balanced the Secret Service's interest in protecting the President against the first amendment rights of those burdened by such actions.[5]

Even in the first amendment context, however, courts have been careful to allow the Secret Service latitude in acting to protect the President. In a decision concerning the Secret Service's denial of a White House press pass to a journalist, the D.C. Circuit required the Secret Service to publish the standards it uses to determine White House press pass eligibility. In delineating the requirements imposed on the Secret Service, however, it agreed with the Secret Service that the first amendment did not require "detailed articulation of narrow and specific standards or precise identification of all the factors which may be taken into account in applying [the] standard." Sherrill v. Knight, 569 F.2d 124, 130 (D.C. Cir. 1977). The court stated that "[i]t is enough that the Secret Service be guided solely by the principle of whether the applicant presents a potential source of danger to the President and/or his immediate family so serious as to justify his exclusion." Id. Arguing that this more flexible approach was appropriate given the mission of the Secret Service, the court declared that "[t]his standard is sufficiently circumspect so as to allow the Secret Service, exercising expert judgment which frequently must be subjective in nature, considerable leeway in denying press passes for security reasons." Id. The court also indicated its belief that courts should be "appropriately deferential to the Secret Service's determination of what justifies the inference that an individual constitutes a potential risk to the physical security of the President or his family." Id.

Courts have allowed the Secret Service even more latitude outside of the first amendment context. In Scherer v. Brennan, 379 F.2d 609 (7th Cir.), cert. denied, 389 U.S. 1021 (1967), the court found within the scope of the Secret Service's duties to protect the President the barring of a federally-licensed firearms dealer from his own home and his

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[5] See A Quaker Action Group v. Hickel, 421 F.2d 1111, 1117-18 (D.C. Cir. 1969). See also Sherrill v. Knight, 569 F.2d 124, 128 n.14 (D.C. Cir. 1977), citing A Quaker Action Group, 421 F.2d at 1117 ("[t]he congressional grants of authority to the Secret Service to protect the President . . . and to control access to temporary presidential residences . . . cannot be said to authorize procedures or actions violative of the Constitution . . . . [W]e cannot agree with the Government's argument that mere mention of the President's safety must be allowed to trump any First Amendment issue").

constant surveillance even though he had voiced no direct threat to the President. The appellant argued that this invasion of privacy was illegal under the Supreme Court's analysis in Camara v. San Francisco, 387 U.S. 523 (1967) (holding that the fourth amendment requires a warrant for inspection of private premises by health inspectors unless the occupant consents thereto). In rejecting appellant's argument, the court stated, "Here, the need to protect the President of the United States from possible physical harm would justify measures that might not be considered appropriate in routine health inspections." Scherer, 379 F.2d at 612.

2. Section 202

In addition to the broad authority to protect the President granted in section 3056, 3 U.S.C. § 202 grants the "United States Secret Service Uniformed Division" authority to perform duties prescribed by the Secretary to protect the "White House in the District of Columbia" and "any building in which Presidential offices are located." This provision makes clear that the Secretary has authority to direct not only such action as is necessary to protect the person of the President but also the White House itself and the Old Executive Office Building, which is also bounded by the designated streets.

The language and legislative history of sections 3056 and 1752, the authority granted in section 202, the court decisions, and former opinions of this Office suggest that while the Secretary's authority to protect the President may not be unlimited, the Secretary may take such actions as are consistent with the Constitution, not prohibited by statute, and reasonable under the circumstances for the protection of the President in the performance of his duties. We perceive no constitutional impediment to the closing of the designated streets. Consequently, given the conclusions of the White House Security Review with respect to the vulnerability of the White House, the Secretary would appear to have the authority to expand the security perimeter of the White House by closing the designated streets if the Secretary concludes that such action is reasonably necessary to protect the President. We now turn to consideration of whether any other statutes prohibit or limit such action.

B. Other Relevant Statutes

Other congressional grants of authority that could arguably apply to the streets at issue do not diminish the Secretary's authority to close them to vehicular traffic. We will discuss each such congressional grant of authority in turn.

1. District of Columbia Street Closing Authority

The District of Columbia government has exercised the power to close streets and transfer title within the District of Columbia since 1932, when Congress, pursuant to its plenary powers over the District of Columbia,[6] granted it such authority. See Techworld Dev. Corp. v. D.C. Preservation League, 648 F. Supp. 106, 111 (1986), citing S. Rep. No. 688, 72d Cong., 1st Sess. 3 (1932). When Congress passed the District of Columbia Self-Government and Governmental Reorganization Act, Pub. L. No. 93-198, 87 Stat. 774 (1973) (codified at D.C. Code Ann. §§ 1-211 -- 1-299) ("Home Rule Act"), it delegated to the present District of Columbia government all powers that had been granted to the previous government, see D.C. Code Ann. § 1-227(a), including the power to close streets.

D.C. Code §§ 7-421 -- 7-428 authorize the District of Columbia City Council ("Council") to close streets within the District of Columbia. The street closing process established by the Council requires referral of street closing applications to the National Capital Planning Commission for review and recommendation, to the Advisory Neighborhood Commissions affected, and to abutting property owners. See D.C. Code Ann. at § 7-422.

We do not believe D.C. Code §§ 7-421 -- 7-428 or the Home Rule Act prevent the Secretary from closing the streets at issue. First, in passing the Home Rule Act, Congress provided that the Council shall have no authority to "[e]nact any act, or enact any act to amend or repeal any Act of Congress, which concerns the functions or property of the United States or which is not restricted in its application exclusively in or to the District." Id. at § 1-233(a)(3). Rejecting the United States' assertion that the Council's act of closing a government-owned street in Northwest Washington violated this provision, the court in Techworld stated:

> [T]he limitation of § 1-233 is included to ensure that the local government does not encroach on matters of national concern. It withholds authority over property used by the United States in connection with federal governmental functions, and over property of national significance. The Council may not concern itself with the Lincoln Memorial, or the White House, or with the United States Courthouse. The closing of a small street in Northwest Washington, however, is precisely the sort of local matter Congress wishes the D.C. Council to manage.

Techworld, 648 F. Supp. at 115. See also District of Columbia v. Greater Washington Cent. Labor Council, AFL-CIO, 442 A.2d 110, 116 (D.C. 1982), cert. denied, 460 U.S. 1016 (1983) (quoting legislative history of the Home Rule Act: "The functions reserved to the federal level would be those related to federal operations in the District, and to property held and used by the Federal Government for conduct of its administrative, judicial, and legislative operations; and for the monuments pertaining to the nation's past"). See also id. at 116 n.1, quoting Hearings on Self-Determination for the District of Columbia, Part 2, 93d Cong., 1st Sess. 52 (1973) (statement of John Nevius, former Chairman of the Council) ("For the purposes of identifying these Federal functions, we are speaking basically of three

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[6] See U.S. Const. art. I, § 8, cl. 17.

things: First, the function regarding Federal buildings and properties; second, the conduct of Federal business . . . and third, the function of international relations and matters concerning the diplomatic corps").

Here, unlike the situation in Techworld, Congress has delegated by statute to the Secret Service the indisputably federal function of protecting the President. In this context, we believe that D.C. Code § 1-233(a)(3) establishes that the Council may not assert its authority where doing so would interfere with the Secret Service's ability to carry out its congressionally-mandated function of protecting the President.

Second, the streets slated for closing are located within the National Capital Service Area, a geographic area comprising many of our national governmental buildings and monuments, the White House, the National Mall and other areas, over which Congress in the Home Rule Act reserved some federal administrative authority. Section 739 of the Home Rule Act, Pub. L. No. 93-198, tit. VII, § 739 (codified at 40 U.S.C. § 136), established the National Capital Service Area. It also established the position of a presidentially-appointed National Capital Service Director within the Executive Office of the President and charged that office with assuring "that there is provided . . . adequate police protection and maintenance of streets and highways" within the National Capital Service Area. 40 U.S.C. § 136(b).

The National Capital Service Area provision was added to the Home Rule Act as a floor amendment. Suggesting that the National Capital Service Area was an area of heightened federal interest within the District of Columbia, the chief sponsor of the amendment, Representative Green, stated that the National Capital Service Director "would have jurisdiction [within the area] over the police department, fire protection, over sanitation, the streets, the roads and accesses to them." 119 Cong. Rec. 33611 (1973) (statement of Representative Green). See also id. at 33645 (". . . the President would appoint a Director of Federal Area Services who would be responsible for police protection, fire protection, sanitation, the streets, and access to roads"). While the language and legislative history of the provision do not suggest that the District of Columbia has no jurisdiction over the National Capital Service Area, they do suggest that Congress considered the federal government's interest in areas within the National Capital Service Area to be greater and more important than its interest in areas outside the National Capital Service Area. We believe this reservation of federal governmental interest further supports the Secret Service's authority to take unilateral action in closing streets within the National Capital Service Area in an effort to protect the President.[7]

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[7] We are aware of only one District of Columbia court decision discussing the National Capital Service Area. The limited analysis presented in that opinion supports our view that the federal government exercises greater administrative authority over areas within the National Capital Service Area than it exercises with respect to other areas within the District of Columbia. In rejecting a claim that Congress had not delegated to the District of Columbia the authority to tax personal property within the National Capital Service Area, the court in Itel Corp. v. District of Columbia, 448 A.2d 261, 267 n.10 (D.C.) cert. denied, 459 U.S. 1087 (1982),

2. Administrative Procedure Act

You have also raised the issue of whether the Secretary's action would constitute a "rule" as defined by the Administrative Procedure Act ("APA"), 5 U.S.C. §§ 551-559, at § 551(4), thereby triggering the requirement to provide "interested persons" with notice and opportunity to comment as a part of the rulemaking process. We believe that the Secretary could successfully argue that the notice and comment requirements of the APA do not apply because his action in closing the streets at issue to provide protection for the President is not a "rule" within the meaning of section 551(4). Moreover, if the federal government owns the streets in question, any action to close them would be exempt from the APA pursuant to the "public property" exception in 5 U.S.C. § 553(a)(2).

The APA defines "rulemaking" as "agency process for formulating, amending, or repealing a rule." 5 U.S.C. § 551(5). In defining a "rule", the APA identifies several components: a rule may be "of general or particular applicability"; it must be of "future effect"; and must be "designed to implement, interpret, or prescribe law or policy" or must "describe[] the organization, procedure, or practice requirements of an agency." Id. at § 551(4).

We do not believe that closing the affected streets in order to protect the President is the sort of action that Congress intended to be subject to the APA's notice and comment process. A decision to close the streets would not be designed to "implement, interpret, or prescribe law or policy" so as to provide guidelines or procedures for parties to follow in the future. To the contrary, the Secretary's action in closing the streets would be an isolated agency action that does not affect or govern subsequent agency acts or decisions. Daingerfield Island Protective Society v. Babbitt, 823 F. Supp. 950, 957 (D.D.C. 1993) (National Park Service approval of design for interchange connecting George Washington Memorial Parkway and island in Potomac River was not a "rule" under 5 U.S.C. § 551(4)). The Secretary would be acting in a particular situation based on a unique set of facts, pursuant to a statute authorizing his agency personnel, the Secret Service, to protect the President. We do not believe that this unilateral action executing such a decision is the sort of government action that Congress contemplated in defining a "rule" for purposes of the APA.[8]

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stated, "this part of the, Home Rule Act serves to add some federal bureaucracy to the existing D.C. bureaucracy in order to ensure adequate services, not to authorize the provision of services by the District."

[8] Even if a court were to find that the Secretary's action constituted a rule under 5 U.S.C. § 551(4), the Secretary could invoke the "good cause" exception provided under 5 U.S.C. § 553(b)(B). Under that section, the requirements of notice and opportunity for comment do not apply when the agency for good cause finds that the procedures are "impracticable, unnecessary, or contrary to the public interest." Id. We believe that in the instant case the Secretary's basis for invoking the good cause exemption would be upheld, as there is a clear public interest in providing the President thorough and prompt protection when necessary to meet security

Moreover, even if the Secretary's contemplated action did constitute a "rule" under the APA, the APA provides an exception to its requirements for "[any] matter relating to agency management or personnel or to public property, loans, grants, benefits, or contracts." 5 U.S.C. § 553(a)(2) (emphasis added). The "public property" exception has been interpreted to exempt from APA coverage rules issued by any agency with respect to real or personal property owned by the United States or by any agency of the United States, including rules relating to the sale or management of such property. Story v. Marsh, 732 F.2d 1375, 1384 (8th Cir. 1984); Wilderness Public Rights Fund v. Kleppe, 608 F.2d 1250, 1253 (9th Cir. 1979), cert. denied, 446 U.S. 982 (1980); City of Santa Clara v. Andrus, 572 F.2d 660, 673-74 (9th Cir.), cert. denied, 439 U.S. 859 (1978). See also United States Dept. of Justice, Attorney General's Manual on the Administrative Procedure Act 27 (1947). Accordingly, if the streets sought to be closed to vehicular traffic are owned by the federal government, we believe that any action taken to close those streets would be exempt from the APA under section 553(a)(2).

3. National Historic Preservation Act

We do not believe that the National Historic Preservation Act ("NHPA"), 16 U.S.C. §§ 470-470w-6, and the regulations promulgated pursuant to it, 36 C.F.R. §§ 800.1-800.15, prohibit the Secretary from taking prompt action with respect to closing to vehicular traffic the contemplated streets. Section 106 of the NHPA provides that "prior to the approval of the expenditure of any Federal funds" on an "undertaking," the head of a federal agency must "take into account the effect of the undertaking on any district, site, building, structure, or object that is included in or eligible for inclusion in the National Register." 16 U.S.C. § 470f. It further provides that the agency head shall afford the Advisory Council on Historic Preservation ("Council") a "reasonable opportunity" to comment on the effect that such undertaking will have on a historic site. Id. Although consultation with the Council must be had "prior to approval of the undertaking," 36 C.F.R. § 800.1(a), the agency head is not bound by the Council's comments or recommendations. See 36 C.F.R. § 800.6.

The vast majority of the areas that the Secretary contemplates closing, including Pennsylvania Avenue between 17th Street and Madison Avenue, and State Place, appear to be part of the "Lafayette Square Historic District," which is included in the National Register of Historic Places and is therefore one of the sites covered by section 106. National Register of Historic Places Inventory: Nomination Form for Lafayette Square Historic District.

Whether the NHPA's consultation process for certain historic sites (section 106 process), 36 C.F.R. §§ 800.3-800.5, is triggered depends on whether the agency's action is an "undertaking" under the NHPA. By regulation, the Council has defined the term

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requirements.

"undertaking" as "any project, activity, or program that can result in changes in the character or use of historic properties, if any such historic properties are located in the area of potential effects." 36 C.F.R. § 800.2(o).[9] (emphasis added). Courts have tended to construe the definition broadly. Historic Green Springs, Inc. v. Bergland, 497 F. Supp. 839, 853 (E.D. Va. 1980); National Indian Youth Council v. Andrus, 501 F. Supp. 649, 676 (D.N.M. 1980), aff'd, National Indian Youth Council v. Watt, 664 F.2d 220 (10th Cir. 1981). And we cannot deny that the Secretary's contemplated action appears to fit within the definition in section 800.2(o) in that the street closing would make a direct change in the use of the historic area because it will prohibit a significant use currently allowed, that is, vehicular traffic.

Even if the contemplated street closing were considered an "undertaking" pursuant to 16 U.S.C. § 470f, however, it is our conclusion that the consultation requirements of the Council's regulatory scheme do not prohibit the Secretary from taking the necessary and immediate action to protect the President of closing to vehicular traffic the aforementioned streets. The statutory and regulatory framework of the NHPA cannot reasonably be read to require strict compliance with the consultation requirements in the case of an emergency. For example, if a water main breaks in an urban historic area, maintenance crews must be able to promptly remedy the situation even if that entails physical destruction of roads and sidewalks in the historic area and closure to all traffic for an extended period of time; surely Congress would not expect consultation before the maintenance work commenced. Similarly, if a crime is committed in an historic area or in an historic building, law enforcement officials would be able to secure the area if necessary to apprehend the perpetrators, preserve evidence, and take necessary and reasonable steps to ensure the safety of members of the public, even if such measures change the use of the historic site by re-routing traffic, setting up roadblocks, or denying access to buildings and areas. Again, those law enforcement actions could be handled promptly without compliance with the NHPA consultation requirements.

We do not construe the section 106 process to preclude the Secretary, after having "tak[en] into account the effect of the undertaking," from authorizing the undertaking to go forward initially on a provisional basis, with no irreversible effects, and thereafter giving the Council a reasonable opportunity to comment on it before deciding to put the undertaking on a final and permanent footing. In other words, as we construe the statute and regulation, the "undertaking" that requires prior consultation with the Council must be one that would effect a permanent change in the character and use of the site.

Common sense dictates that the NHPA could not require the Secretary to comply with the consultation and review procedures of the section 106 process in a manner which would

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[9] In addition, "the project, activity, or program must be under the direct or indirect jurisdiction of a Federal agency or licensed or assisted by a Federal agency. Undertakings include new and continuing projects, activities, or programs and any of their elements not previously considered under section 106." 36 C.F.R. § 800.2(o).

compromise the Service's ability and mission to ensure the safety of the President and others in the White House complex. A contrary result would render the Service's broad authority under 18 U.S.C. § 3056 ineffective; it cannot be that Congress intended that the NHPA could mandate adherence to its procedural requirements when such adherence would directly interfere with the Secret Service's statutory duty to protect the President of the United States.

We believe that if the Secretary, as the exigencies permit, provides the Council with notice of the Service's protective actions and requests the Council's comments on the actions, the Secretary will be deemed to have complied with the NHPA's requirement that the agency head afford the Council a "reasonable opportunity" to comment. Of course, whether any given opportunity is reasonable depends on the particular circumstances at issue.

4. National Environmental Policy Act

You have also expressed concern about the possible impact of the National Environmental Policy Act of 1969 Pub. L. No. 91-190, 83 Stat. 852 (1970), as amended (codified at 42 U.S.C. §§ 4321-4370) ("NEPA"), and its related regulations concerning federal agency action, on the Secretary's ability to immediately close the identified streets. Without expressing a view as to whether or to what extent NEPA might apply to the street closings, we note that NEPA's emergency exception is broad enough to permit the Secretary to proceed after brief consultation with the Council on Environmental Quality. Section 1506.11 of title 40, Code of Federal Regulations, provides:

> Where emergency circumstances make it necessary to take an action with significant environmental impact without observing the [NEPA regulations,] . . . the Federal agency taking the action should consult with the [Council on Environmental Quality] about alternative arrangements. Agencies and the Council will limit such arrangements to actions necessary to control the immediate impacts of the emergency. Other actions remain subject to NEPA review.

We believe that the necessity revealed by the White House Security Review of enhancing the security perimeter around the White House is an "emergency" within the meaning of this regulation. Accordingly, we believe that the Secretary may close the designated streets without running afoul of NEPA. If possible, the Secretary should consult with the Council on Environmental Quality concerning alternative arrangements prior to closing the streets at issue.

III. Conclusion

For the foregoing reasons, we conclude that the Secretary has authority under section 3056 to close the streets mentioned above to vehicular traffic. In addition, we conclude that the other congressional grants of authority discussed above do not diminish that authority.

TREASURY CLEARANCE SHEET

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

FROM: Edward S. Knight

THROUGH:

SUBJECT: Legal memo of the Secretary's authority to close PA Ave., and other streets around the WH perimeter

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b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

DEPARTMENT OF THE TREASURY
WASHINGTON

GENERAL COUNSEL

May 6, 1997

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS

FROM: **Edward S. Knight** ESK

SUBJECT: **Potential Legislative Routes for IRS Reform Measures**

Introduction

The Chief of Staff has raised a number of questions regarding the Congressional implications of possible IRS governance restructuring legislation. One possible outcome of such legislation is that a board of undetermined structure would govern some or all IRS activities; another scenario would have the IRS completely removed from the Department of the Treasury. This memorandum addresses these scenarios and outlines some likely routes legislation would take.

The memorandum also notes some of the other potential IRS reforms that would require legislation. Although these measures could be included as part of governance restructuring legislation, they also could be enacted without changes to IRS governance. To emphasize this point, these other potential initiatives are discussed separately from governance restructuring.

Discussion

Assumptions. This memorandum makes the following assumptions:

- that the traditional committee structure and jurisdiction in the House and Senate would be followed for this legislation;
- that the IRS Restructuring Commission's report, currently scheduled to be released publicly on June 30, will include recommendations for legislative action; and
- that the report will be referred by the House and Senate leadership to appropriate Congressional committees with instructions to hold hearings and report out legislation designed to implement reform.

After the pieces of legislation are reported out from the different committees, they either could be sent to the floor separately, combined into one bill, or attached either separately or together to other legislation, such as appropriations bills. Therefore, accurately predicting a legislative path for IRS reform legislation is problematic.

IRS Statutory Authorization. Under **26 U.S.C. § 7801(a)**, the "administration and enforcement of this title [26] shall be performed by and under the supervision of the Secretary of the

Treasury." This gives the Secretary very broad authority for implementing the Internal Revenue Code.

26 U.S.C. § 7802(a) states that there shall be in the Treasury a Commissioner of Internal Revenue appointed by the President with the advice and consent of the Senate and that the Commissioner "shall have such duties and powers as may be prescribed by the Secretary . . . ."

Under **26 U.S.C. § 7803(a)**:

> The Secretary is authorized to employ such number of persons as the Secretary deems proper for the administration and enforcement of the internal revenue laws, and the Secretary shall issue all necessary directions, instructions, orders, and rules applicable to such persons.

Again, this authority is very broad. Historically, the Secretary has exercised his authority over the organization of the IRS through the issuance of Treasury Orders, such as TO 150-02 (1/11/94), "Establishment of Certain Offices in the National Office of the Internal Revenue Service." That Order sets out the organization and the titles of the top officials of the IRS and discusses the subject matter responsibilities of those officials.

Scenario 1 - Creation of a Governing Board for Some or all IRS Activities

(1) Would creation of a governing board require a change in title 26?

The Secretary currently has sole authority for administration and enforcement of title 26. Any legislation that took that power away from the Secretary by, for example, giving final decision making power to a board, would require revision of title 26. The type of board that seems to be contemplated by some members of the Restructuring Commission—one that assumed some or all of the Secretary's authority over the IRS—would require changes to title 26. The Commission also is considering giving the board the power to appoint and/or remove the IRS Commissioner, which could raise constitutional concerns.

However, under section 7803 the Secretary could create a board and delegate his statutory powers to it without any changes to title 26. In this case, the Secretary would retain ultimate control over the board through a veto power over board decisions. Nonetheless, the Secretary could not delegate to the board powers he does not have. So, for example, he could not delegate the power to hire or fire the Commissioner, who is a Presidential appointee. Board members could include individuals who also hold positions outside of the government. To recruit and retain certain individuals with the background and expertise to make a significant contribution to the board, it may be necessary to obtain a statutory waiver from the conflict of interest provisions of title 18 for these board members.

(2) What committees would have jurisdiction over the legislation?

Subject	House	Senate
For amendments to title 26, including the creation of a governing board	•Ways and Means Committee •Ways and Means Subcommittee on Oversight	• Finance Committee • Finance Subcommittee on Taxation and IRS Oversight
For amendments to the conflict of interest provisions of title 18	•Judiciary Committee •Government Reform and Oversight (GRO) Committee	•Judiciary Committee •Governmental Affairs Committee

(3) Is this legislation that could be included on an appropriations bill?

Yes.

(4) Could it be part of a reconciliation bill?

Yes. In fact, some knowledgeable Congress watchers believe Republican leaders might try to make it part of a reconciliation bill.

In the Senate, however, the Byrd Rule may prevent some or all of these measures from being attached to reconciliation bills. The Byrd rule (codified in 1990 as Section 313 of the Budget Act) authorizes senators to raise a point of order against a reconciliation bill, amendment or conference report that includes "extraneous" material. Extraneous is hard to define precisely, but the definition includes provisions that would increase the deficit or make changes that are fundamentally nonbudgetary. To overcome the point of order and waive the Byrd Rule, supporters of a provision must obtain 60 votes. The Byrd Rule has been very effective in preventing controversial, nonbudgetary items from being included in reconciliation bills.

(5) Are there any other possible implications of such legislation?

There are many other implications, such as constitutional questions, some of which are discussed in the other memoranda on IRS reform.

(6) If the IRS was subject to a governing board, what committee would have jurisdiction over the agency?

Most likely the House Ways and Means and Senate Finance Committees would continue their preeminent roles in exercising jurisdiction over the IRS and any governing board. However, absent a change in current Congressional committee jurisdiction, the Government Reform and Oversight and Government Affairs Committees, as well as the other committees listed in the final section of this memorandum, also would continue to have a role in the oversight of the IRS.

Scenario 2 - Removal of the IRS from the Treasury Department

(7) Would creation of an IRS independent of the Treasury Department require a change in title 26?

Yes. In addition to the changes to the sections under which the Secretary exercises authority (noted in the answer to question (1) above), other changes would be required throughout the Internal Revenue Code. For example, under 26 U.S.C. § 7805, the Secretary is given authority to "prescribe all needful rules and regulations for the enforcement of" title 26. That is one of many sections of title 26 that would need to be changed if the IRS were no longer part of Treasury.

(8) What committees would have jurisdiction over the legislation?

The House Ways and Means Committee and the Senate Finance Committee likely would have primary jurisdiction over this legislation.

(9) Is this legislation that could be included on an appropriations bill?

Yes.

(10) Could it be part of a reconciliation bill?

Yes, but see the discussion of the Byrd Rule under question (4) above.

(11) Are there any other possible implications of such legislation?

There are many other implications, such as constitutional questions, some of which are discussed in the other memoranda on IRS reform. For example, the notion of creating an independent IRS raises even more grave constitutional concerns than the notion of giving a board the power to appoint and remove the IRS Commissioner.

(12) If the IRS were independent of the Treasury Department, what committees would have jurisdiction over the newly independent agency?

The House Ways and Means and Senate Finance Committees likely would continue in their preeminent roles regarding IRS oversight. Other committees also would continue to have a role in IRS oversight, absent a change in Congressional committee jurisdiction. See the next section of this memorandum.

Other Potential IRS Reform Measures

As noted in the Introduction, other potential IRS reform measures also would require legislative changes. Such measures either could be part of legislation that would restructure IRS governance or could be enacted without changes in governance. The potential reforms discussed below are those that have received attention from the IRS Restructuring Commission and others, but not the entire universe of potential changes. It also should be noted that some additional flexibility in personnel matters for the IRS currently exists and would not require new legislation.

(13) What committees would have jurisdiction over reform legislation?

Subject	House	Senate
For flexibility in personnel and procurement	•Government Reform and Oversight (GRO) Committee •GRO Subcommittee on Civil Service •GRO Subcommittee on Human Resources •Small Business Committee •Small Business Subcommittee on Government Programs and Oversight	•Governmental Affairs Committee •Governmental Affairs Subcommittee on Post Office and Civil Service •Small Business Committee
For two-year or capital budget issues	•Budget Committee	•Budget Committee
For changes in appropriations matters	•Appropriations Committee •Appropriations Subcommittee on Treasury, Postal Service and General Government	•Appropriations Committee •Appropriations Subcommittee on Treasury, Postal Service and General Government
For possible amendments to the Federal Advisory Committee Act	•Government Reform and Oversight (GRO) Committee •GRO Subcommittee on Government Management, Information and Technology	•Governmental Affairs Committee •Governmental Affairs Subcommittee on Oversight of Government Management and the District of Columbia

(14) Is this legislation that could be included on an appropriations bill?

Yes.

(15) Could it be part of a reconciliation bill?

Yes, but note the discussion of the Byrd Rule under question (4) above.

cc: Michael Froman
Linda Robertson
Sheryl Sandberg

Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Ted Truman to Secretary Rubin & Deputy Secretary Summers re: Dan Zelikow in Brazil (2 pages)	02/09/1999	P1/b(1)
002. memo	Daniel Zelikow to Assistant Secretary Truman re: Reflections on Brazil Trip (4 pages)	02/09/99	P5
003. notes	re: Meeting with Fund Mission Team (2 pages)	c. 1999	P5
004. notes	re: Meeting with Arminio Fraga, Ministry of Finance (3 pages)	02/04/99	P5
005. notes	re: Meeting at Finance Ministry with Finance Minister Pedro Malan, Pedro Parente, & Amaury Bier (3 pages)	02/05/99	P5
006. notes	re: Meeting with Think-tankers (1 page)	c. 1999	P5
007. notes	re: Notes from Meetings at Central Bank (3 pages)	c. 1999	P5
008. memo	Robert E. Rubin to POTUS re: Economic issues for State Visit of Jiang Zemin (2 pages)	c. 1999	P1/b(1)
009. notes	Lawrence Summers to Sandy Berger re: Read-out from Meetings in China (1 page)	01/15/98	P1/b(1)
010. notes	Lawrence Summers to Sandy Berger re: Read-out from Meetings in Hong Kong (1 page)	01/15/98	P5

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Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [a)(5) of the PRA]
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b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

Meeting with the Fund Mission Team

1. BOP: IMF staff revised their BOP calculations slightly, with the current account worsening by around $2 billion, the capital account improving by less than $1 billion, and the external financing gap widening from $10 billion tp $11.3 billion. A quarterly breakdown retains the previous path, wh large external financing requirements in the first half ($14.2 billion) with financing surpluses in the second half ($2.9). Once we are back in Washington, a more detailed comparison with our numbers and the Fed's will be provided.

2. FISCAL: Teresa indicated that the Brazilian authorities are using overly-optimistic assumptions both on the primary balance calculation (3.0-3.5 percent of GDP surplus) and on the real interest rates (10.5% yearly avg) and that the IMF team was still in the process of reconciling these numbers for the program. Specifically:

   A. Fund staff estimates show a primary surplus of 2.2% (based on identified additional measures such as oil price increase, postponing the first installment of the 28% court-mandated back-pay to civil servants, cutting rebates that had been given to exporters to compensate them for cascading taxes. (These were measures already mentioned to us by Malan.) As such, to reach 3.0% (a minimum, according to Teresa, who would prefer 3.5%) there would need to be 0.8% undertaken by the states and the public enterprises. This is highly doubtful to occur.

   B. Any increase in the real interest rate assumption would deteriorate the overall balance by raising interest payments. Along with Teresa, we have serious doubts as to whether the interest rate assumption is consistent with the exchange rate assumption. Teresa suggested that if the central bank does not raise interest rates soon and substantially, the exchange rate will depreciate and the program will need to be re-estimated based on an average exchange rate lower than the currently assumed R$165/$.

   C. Fund staff seemed to support the idea of setting the minimum wage increase now, before the price increases from oil and from the devaluation really take place. They acknowledged that it would only postpone the effect for one year, at which time a large increase would have to take place. But at least it might buy us some time.

   D. On the state level, there is very little room for improvement. Although they indicated that the states were not confronting balloon payments as we had been told by the private sector last night, many of the states do have seriously deficient fiscal positions.

E. The central bank should have a new privatization calendar this coming week which will shed some more light on what is in the pipeline. Teresa said that she had not heard anything from the authorities on an accelerated and deeper privatization effort with respect to Electobras. In either case, privatization is a below-the-line item and will not effect the overall balance (itwill, however, be a reduction in the debt load which, Teresa had told us earlier, was where the fund staff were focusing and where the private sector seemed to be placing their concerns).

3. INTEREST RATES. The Fund (Teresa and Stan) had been told that interest rates would be increased in the very-short run; this is consistent with Teresa's belief that interest rates need to be raised to shore up outflows. This is at odds with our discussion with Arminio, however, where he said that interest rates would remain at current levels unless there were signs of excessive inflation. Teresa indicated that the TBAN system needs to be eliminated, where the rate is hooked to the overnight rate with a penalty; if they want to have a floating exchange rate, they have to have freely moving interest rates.

4. BANKING DATA QUESTIONS: IMF staff has been working with the central bank during the course of the current mission to revise their data collection and dissemination process on banking data. They have deepened the coverage to look not only at more banks but also nonbanks. They examine 35 tops banks interbank lines ($22 billion outstanding), MLT non-bank registered ($22 billion), and public sector MLT ($4 billion). This yields $48 billion out of total bank lending of $60 billion—or 80% identified. A difficulty is that short-term debt is not registered and is therefore not tracked. Data on these bank claims will be available on a weekly basis (on Tuesdays). In general, the agreed with what the central bank had told us yesterday—that the corporates were very small and could essentially be ignored. We suggested that they generate a 1-2 page explanation of the monitoring system for the G-7 Board members to alleviate current fears.

Meeting With Arminio Fraga
Ministry of Finance
Thursday, February 4, 1999

The meeting with Arminio was productive and yielded a much more coherent understanding as to where the authorities hope to take Brazil in the short- and medium-term.

1. Monetary: Fraga informed us that the central bank would be targeting inflation, using interest rates and reserve requirements as tools to respond to unexpected increases in prices.

   -- The goal is to have annual inflation in the mid-teens with annualized fourth quarter inflation running at 5%. Only the fourth quarter target is going to be announced anytime soon.
   -- The assumptions underlying the inflation rates are: real growth of -3.5% (followed by positive growth in the two following years of +4% and +5%, respectively); an exchange rate of R$1.65/$ (or, equivalently, 40% depreciation with about a 40% pass-through). In the past, pass-throughs have been roughly 60%. With little indexation left, recession, benign inflation environment globally, and primary surpluses, Fraga felt that 40% pass-through was plausible.
   -- Monetary policy would remain tight during the initial months, with nominal interest rates at roughly 40%–higher should inflation accelerate. After the initial turbulence has eased, Fraga feels that much lower nominal rates are possible with average real rates for the year around 10.5% [this strikes us as very low and depend on inflation in HI significantly higher than mid-teens].
   -- At least initially, they will also set quarterly NDA targets to use as a nonbinding benchmark.

2. Central Bank Independence: The released this pm a communique that would greatly enhance central bank independence, including a bundesbank-like mandate for preserving the purchasing power of the real, an accountability to congress (including a regular Humphrey-Hawkins testimony), fixed terms for President and directors, and a cooling off period (or quarantine as they called it) of 6 months for top central bank officials from working in the financial sector upon leaving the central bank. The last is seen as the political price for getting Congress on board for the constitutional changes that will be needed to secure CB independence).

   -- Fraga was unclear if this would need an amendment to article 192 but he thought it would (he is checking).
   -- The goal is to have this in place by year's end.

3. Fiscal: Fraga recognized the importance of showing a declining and therefore sustainable debt stock path.

- Target a primary surplus of 3-3.5% of GDP. Inflation will help through a reverse Tanzi effect–we will try to get specific numbers from them and the Fund on this tomorrow.
- He indicated that the impact on devaluation would be 4% of GDP added to the debt stock, that the losses on the futures position would be stuck in the budget right away (the amounts weren't specified, though he did say that the PSBR could be as much as 10% of GDP this year.
- Fiscal measures: He sell excess shares in listed state companies, including Electrobras (need to verify which were already included in the original program).
- He seemed extremely pleased with President Cardoso's agreement to take action on Banco do Brasil and Caixia Economica, a pet project of Fraga's. The first step, which will be announced within the next two weeks, will be an announcement of a commission to analyze the role of the two with a view toward making them more efficient and rationalized, including selling a strategic equity stake in Banco de Brazil. The analysis is to be done by September, and the sale will be done within 2 years). Fraga admitted that it would be a difficult sell in Congress, but he did not think it would derail outstanding fiscal steps such as the CPMF, which Cardoso insists is in the bag.
- He also said that new measures to achieve the primary surplus additions would be "real", and focused within the Federal Government on the expenditure side..

4. <u>Program to Boost National Savings</u>: In an effort to increase private savings in the longer term, they are considering:

- 2nd generation social security reforms
- pension fund reform (he sees Mexico and Chile as models)
- insurance sector reform: the sector is overly- and poorly-regulated, particularly the life insurance sector.
- SEC reform
- change current methods of taxation on investment
- other undisclosed measures

5. <u>Exchange Rate Policy:</u>

- Based on a BOP analysis, the central bank intends to sell foreign exchange each month
- Fraga indicated that, when the markets are thin and subject to manipulation, the central bank will intervene. This would be done with limits (say $100m per intervention, with a monthly cap, and subject to volatility triggers). We expressed our concern about the discretion involved and the clouding of their free-float with an amount of discretion that probably wouldn't make much of a difference if there were a severe attack. Fraga was insistent that he needed at least some discretion to avoid manipulation so as not to leave himself defenseless, as the bank was last Friday.

-- The central bank will be entirely out of the futures market after the expiration of their $5 billion for next month. He wasn't so sure about Banco do Brasil's independent activities and wanted me to raise it with Malan.

-- Fraga intends to analyze the composition of their reserves to get a better indication of the level of junk reserves. He expressed dismay upon learning yesterday the amount of junk held, and said that when he took over the job of Vice President a few years ago, he inherited $5b in junk of a total of $16b. He left the Bank with no junk. That is a major objective of his this time too.

-- He noted that Bank's short position in FX market was now about $1b in reais. He thinks that will have to be raised to make market work better.

6. Enhancements; Fraga expressed caution on any enhancements that would take the form of a guarantee because it could pollute their other debt. He wanted to discuss this more fully when we meet together with Pedro tomorrow.

7. Investment Advisor: Fraga had been quite convinced about hiring an adviser but now wasn't so sure. He was concerned about the credibility of the adviser's role, given the Korea experience, and was worried that there'd be some bad-mouthing by firms not selected. He noted that they were already getting lots of proposals to raise money, even on his first day on the job.

8. Foreign Financing: the external financing gap was still an open question and would require further analysis. He said he thought BOP numbers pretty good, but that we'd address this tomorrow together.

9. Bank rollovers: He took point that there is very inadequate data on foreign bank credits to non-banks, and on the nature of the Bank-to-bank pass-throughs to the enterprise sector. He thinks the reduction of roughly $10b in interbank lines so far essentially has run its course. He referred to a mapping exercise on the interbank /trade lines which was underway. This discussion was vague and not very satisfactory. Will pursue tomorrow.

10. Transparency: Contrasting his view with Marcus, who was also at the meeting, he thinks the central bank has far to go to improve transparency. He will be focusing on this.

11. Personnel: Referred to progress being made in building his new team. Paulo Leme agreed to join today, and will take Demosthenes job and will be leading the international financing effort and the roadshow presentations (can't think of a better person to do it). He's also got lined up a new research director and director of reserve/fx management, but hasn't got their sign-off yet to announce.

12. Overall, he struck us as in command of his thoughts, if not yet all the details. He wants to make sure we're comfortable with the program because he needs our vocal support and support with the g7.

Will be meeting with Teresa first thing tomorrow morning, followed by a day of meetings being set up by Marcus.

Meeting at the Finance Ministry
With Finance Minister Pedro Malan, Pedro Parente, and Amaury Bier
February 5, 1999

***Fiscal*:**

The authorites recognized that their significant lack of credibility is weighing on the markets and will need to be repaired for a reversal in capital inflows. As such, they expressed a strong recognition that they are unwilling to make false promises or unrealistic assumptions. That said, and of reaching a net debt to GDP target of 46.5% by 2001 (two year later than originally envisaged).

1) Primary Surplus Effects in 1999: they explained to us the constraints on further fiscal consolidation and the challenge of reaching a primary surplus of 3.0-3.5 percent in 1999.

A. There is little room for revenue enhancement, implying that new fiscal measures will most certainly need to come from the expenditure side. Measures being considered will not involve going to congress. These are:

a. oil price increase;
b. postponing the first installment of the 28% court-mandated back-pay to civil servants.
c. cutting rebates that had been given to exporters to compensate them for cascading taxes. (this should make our congress happy).

B. They agreed with the Fund that there would only be marginal benefit from a reverse

Tanzi effect for several reasons:

a. Social security benefits will increase with the minimum wage increase; the minimum wage is expected to be increased in May.
b. The increased price of oil due to the devaluation will either erode the Petrobras surplus if wholesale domestic oil prices are not raised accordingly or will contribute to inflation and to pressures on the minimum wage hike. Although delaying a domestic price adjustment would push off the inflationary pressures, the authorities did not find this an attractive alternative (Stan Fischer also said to them that it was important to get the price hike in effect immediately to feed into the tradables).
c. There will be tax evasion.

A. On the benefit side, the authorities have agreed to another year of zero wage increases in the public sector. BNDES also reports somewhat higher expectations in real terms for privatization receipts given the devaluation and foreign source of much of the sales proceeds. This would only help below the line, of course. They also expect something more from electrobras acceleration, but don't have numbers yet.

2) Debt Stock: They are targeting a net debt-to-GDP ratio of 46.5% by 2001, two years later than originally envisaged by the IMF program. The devaluation is estimated to have increased the debt burden by 4-5 percent of GDP, including central banks futures losses.

   A. The feasibility of the target is highly sensitive to assumptions on growth (-3.5 in 1999, +4 in 2000, and +5 in 2001) and on the real interest rate (10.5% average for 1999, single digist in 2000 and 2001). We are skeptical about these assumptions, particularly the real interest rate assumptions.

   B. Increased privatization may occur in 2000-01 (relative to baseline) with Banco do Brazil and possibly Caixia and with Petrobras—all of which will need significant public debate to win political support. Banco do Brasil is anticipated to be completed by end-2000. Petrobras will not even be placed on the calendar in 1999 because of the political ramifications. They would begin with efforts to consolidate operations of Caixia and Banco do Brasil, but don't expect any cost savings in 1999.

   C. Water and sewers are also being actively considered (will help state budgets, not federal); this requires a change in existing law, but they don't expect that to be difficult.

Monetary:

The Finance Ministry authorities reiterated what Fraga had told us the previous day, that the central bank would be targeting inflation with the use of interest rates as a tool and NDA targets as rough guidelines.

1) Real interest rates will initially be high, increase further as inflation begins to decline but before credibility has changed inflation expectations significantly, and then fall substantially—yielding an average real interest rate of 10.5%. They do not anticipate a need for an initial increase above current levels.

2) Although the authorities agreed that intervention should not be used to go against trends in the exchange rate, they tried to impress upon us the importance of have the flexibility to smooth thin markets; as justification, they cited two concerns:

   A. "Black Friday," when the real fell to R$2.15 per dollar, was viewed as market manipulation during periods of extreme thinness on the markets.
   B. Evidence in other crisis countries illustrates the dangers of multiple equilibria
   C. Would feed market a certain amount of reserves based on analysis of BOP gap.

3) M0 shows is relatively inelastic to changes in the interest rate; reaction to interest rate changes could be slow. Need some sort of moving average.

Bank Data Issues:

1) Bank-on-bank data should be available in detailed form from the central bank. Bank-on-corporate data was being prepared, although the exposure was extremely limited in this category. (We spoke to the central bank about this and informed us that detail data was available and had been sent to the IMF for some time now).

Enhancements:

The Ministry of Finance indicated that there were differing views on MDB enhancements. Fraga, in particular, was apparently opposed to the idea while Amaury was much more willing to accept the idea that enhancements would not damage future debt placement.

Meeting with Think-tankers

1. Big vulnerability on ability to contain inflation is the decision on setting the minimum wage, which is normally done on May 1st. The issue is the rule used rather than the level, as the rule is typically replicated extensively by the private sector. The direct impact is fiscal in that social insurance payments are keyed off the minimum. They have the legal/technical latitude to set a minimum with no increase, despite the constitutional mandate to preserve the real value of the minimum wage. However, given Cardoso's uneven support, especially among the poor, and the fact that Cardoso himself must set the minimum wage, not clear if he will be able to withstand the political pressure for raising it.

2. Another vulnerability on fiscal stems from intergovtal fiscal relations. The ability to withhold constitutionally mandated transfers is a powerful weapon but may not be sufficient. First, there are several law suits, sanctioned by state supreme courts, that prohibit the Feds from withholding transfers. Not clear what the Fed Supreme Court will decide, and a decision is expected very soon. Second, legal challenges will continue and will be affected more by the political context than by the law. Third, the mandated transfers are actually a relatively small proportion of the biggest states' budgets, which is where the main problems lie. The smaller states, which could be bludgeoned into compliance, are doing so anyway. Fourth, it is a fact that some of the big states are not financially viable under the terms of the debt deals they worked out with the Feds in 1995. They agreed to baloon payments which can't be met without politically infeasible reductions in state services. Yet it will be extremely difficult to restructure the debts of these states without opening the pandora's box of the others' debt deals. Fifth, there is the political context of local elections coming up in October 2000, which will start to weigh on governors' decisions.

3. Another bit of bad news coming down the pike are the decisions by the governors of Minas and Rio Grande do Sul to rescind the very rich tax incentives proferred foreign investors in carm manufacturing to locate in those states. In one case, Mercedez has already built a big plant. Expects this to become public in 10 days and a very adverse reaction from foreign investors who will question durability of their incentives too.

4. Skepticism about IMF program's assumptions. Informed people don't believe the nominal deficit targets or inflation projections. There is also concern that IMF is more focused on making Brazil work in its narrow definition to restore its reputation than the economic health of the real sector.

5. Appreciation for Treasury's role in assembling package. Thinks we should become more active, but behind the scenes. Noted that our visit was carried on national television yesterday. We appeared to be checking up on IMF, however, not Brazil, given the imminent joint press conference with Stan., which itself was considered highly unusual. Wants us to continue urging full implementation.

Notes from Meetings at Central Bank

Meetings attended by Gustavo Bussinger (DepHd of Economics), Maria do Socorro (Hd of International Reserves), Head of Trade Finance Dept, Alvir Hoffmann (DepHd of Supervion Dept), and chaired by Demosthenes Madureira, Acting President.

1. On monetary and xrate policy: As you might expect, Demosthenes and Bussinger wouldn't be drawn, deferred to my earlier meeting with Arminio, and said that Arminio and economic team would decide. D. did proffer a somewhat sympathetic view to a non-discretionary intervention rule, suggesting that the instrument of intervention, if tightly regulated, may not be worth the loss of purity. On the other hand, he drew the distinction with Mexico's non-intervention rule as citing the absence of reserves in the latter situation which made intervention not practicable from the get-go. In general, they demonstrated a high degree of familiarity with the Mexican put scheme and auctions, for example, by noting that Mexico put in place the put scheme only in August 1996 and the auctions in January of 1998. They evidenced a real sense of trauma (as did the finance ministry) about the events of last Friday when the real saw no floor.

2. On the BOP. Noted that the BOP was currently being revised, so didn't have updated estimates. On a preliminary basis, projected a shift in the trade account of +$10b, assuming an xrate of 1.60-1.70. At 1.80, estimated an additional shift of $1.2b-1.8b. Expected the CA deficit at the more appreciated rate to come in at $20-22b in 1999, representing 2.6-2.8% of GDP. Expected very short lags on the trade accounts (3 months or so for the adjustment to occur), but much longer lags with interest and services. The whole CA would also be subject to strong seasonal patterns, with a widening impact in QIV.

3. On financial vulnerability of the private sector. Cited absence of any vulnerability to devaluation of banking sector because system only $1b short now, and was long $s at time of greatest depreciation. Because the crisis had been "pre-announced", banks had cut back their exposure to vulnerable borrowers in advance. More on this below. In the real sector, the picture isn't as clear. They believe that the private sector as a whole is well hedged and well-capitalized. And most of the largest firms have a natural hedge with exports. They infer these conclusions from the sharp drop off in utilization of the futures market (implying lower demand rather than supply), and ready availability of dollar-indexed govt securities, though others noted the longer tenor of these bonds rendering them less suitable for hedging purposes, which makes me think they're not so sure.

4. On domestic debt restructuring. Left me with the impression that this would be last resort (after inflation). Noted near-total ownership by domestic participants, and 50+% ownership by domestic banking sector. Because 70% of banking system assets are govt securities, this would achieve little fiscally and destroy the domestic banking system in process. Cited bank runs last Friday as attributable to fears of debt restructuring, precipitated by Menem statement and front-page editorial (an unusual event) of a major Sao Paulo daily calling for restructuring. People still singed by experience of bank asset confiscations under Collor, so this was really a domestic capital flight into real cash, not a flight into dollars.

5. On bank monitoring. Here was the big surprise, that doesn't reconcile with what we heard in Min Fin and from IMF. Elaborated on the monitoring system in a way that suggested that they know the external liabilities in huge detail of on-shore and off-shore Brazilian banks, by type of credit and terms. Say they've refined system considerably since program began and that the nature of the system is well known by IMF staff (though apparently not by TERESA). Also said that virtually all trade finance is done through the banking system, and that virtually all external credits to the real sector are capital market transactions (for which they also have the data) or suppliers credits or intra-company loans. I told them that this was at great variance to what we have been told by others and that there is a big data inconsistency between BIS data, monitoring system data, and BCB web site data. They seemed to acknowledge this but said IMF has the reasons why. Mentioned a fellow named Alberto from the IMF team who has been working closely with them. I told them they should write a paper explaining the system qualitatively to the IMF Board to illuminate these issues, to which they agreed. I also suggested that creditor country ignorance of the data could be better dispelled by inviting G7 central bank reps to work in the BCB on the system with them, to which Demosthenes readily agreed (easy for him to do so, of course). Expressed some concern that IMF wouldn't agree. TERESA, however, told me she thought it was a good idea. YOU MIGHT WANT TO RAISE THIS ON THE G7 DEPS CALL. D also noted the very encouraging rollover numbers of 25th-29th Jan (93.5%) and said that the export finance component of the lines seems to be recovering, following a very erratic January.

6. Banking system. Seems very solid, from what I was told. In general, said the system has well adjusted from loss of huge income ($9b) that resulted from their use of the float in inflationary days. Also cited restructuring that has occurred in past few years, improved legislation that gives them significant powers of persuasion, and a sophisticated credit risk bureau at the BCB that is in place for all credits above R50,000. Since the Asia crisis, system has been much more selective on credit extension, and the proportion of banking system assets represented by loans is now only 30%. System is well hedged on interest rates, duration and fx. By regulation, capital asset ratios must be 11%. In fact, the system is at 19%, and the top 50 banks at 15.3%. Domestic private banks are at 25.6%; foreign banks are at 20.2%; and JVs are at 17.9%. The big banks that drag down the averages are the public sector banks, both State and Federal. Provisioning for bad loans as of Nov 98 are also very high, representing 10.78% of total credits, v. 2.22% of overdue loans and 7.4 % of loans rated as impaired. The loan performance reporting period is 60, rather than 90 days, and the entire loan is counted as impaired, not just the component in arrears, as is the case with several other Latin countries. They're not very worried about deteriorating portfolio quality on systemic health of banking system. Noted recent IMF stress tests indicating that if NPLs rose by 50%, just 7 banks would fall below statutory net worth. If NPLs rose by 100% and system had 0 profits, just 9 would fall below net worth minimum, and most of these are state-owned. [He didn't indicate what proportion of banking system these represent]. He doubted that NPLs would rise by all that much,, as interest rates have been high for a long time in a slow-growth environment, and most borrowing is done by blue-chips and very profitable businesses. Banks are well hedged to fx risk. Of system assets, R109b are dollar-linked. The system has R103b in dollar-linked liabilities. Moreover, the banks have $10b in net worth in foreign assets overseas. He's also not worried by a withdrawal of foreign bank credits. Thinks foreign banks are doing quite a lot of intra-firm credit extension, and the rest care a lot about protecting their market share

in Brazil. Said much of the roll-off of lines so far attributable to exchange rate uncertainties that are much diminished [this strikes me as way too optimistic]. Consumer credit businesses are relatively small share of lending portfolios. Moreover, the bankers' association operates an effective credit information bureau that forces consumers to pay back before they can hop to another institution. The main risks in the financial system are to be found in the leasing business. This represents, however, only $12b in banking system assets (of a total portfolio of $200b+), and the rest of the leasing businesses ($14b) are mostly foreign-owned, especially the captives of the car companies, which all have strong foreign parents.

7. US EXIM Trade Finance. At Jim Harmon's request, I raised issue of restrictions on short term trade finance that Brazil has operated since march 1997 to curtail interest rate arbitrage that was occurring by blue chips under guise of trade finance. These restrictions (which forced settlement up front) effectively preclude exim from doing short-term private sector business in Brazil and the activation of the $1b program Jim announced last week. They were aware of the problem and are working out the mechanics of changing the regs so that they can gain access to the trade finance insurance which they genuinely want. Maria warned however that the solution, though relatively easy, involves some complex issues which they will need to bring Arminio up to speed on. She said that the process of finding the solution and educating arminio should require about 3 weeks to fix the problem. PLEASE PASS THIS MESSAGE ON TO MEG AND STEVE TVARDEK.

8. Process and data sharing. Gustavo Bussinger insisted that he was now faxing the daily monetary numbers to Wes, and was surprised to hear that wes wasn't yet receiving. He also said that he would now be DHLing the Indicadores weekly to Wes, and he agreed to share more disaggregated bank-line data too. He asked that all of this be regarded as confidential. Maria apologized that she hasn't been in touch with Wes. She explained that for the sake of bureaucratic convenience and harmonizing the central bank message to us, they have designated Gustavo as the sole interlocutor with us for data sharing issues. I said that this was in itself not a problem, but that gustavo should designate an english-speaker on hiis staff who could be readily reached should he not be. He was concerned that that person wouldn't have the breadth of knowledge that he has so might not be effective. I said it would still be preferable to the delays associated with trying to reach a very busy person. He said he'd find someone. He also noted the very cordial relationship he has developed with wes, which i confirmed from the other side.

January 15, 1998
Seoul

Fax from: Lawrence H. Summers
Deputy Secretary to the Treasury

To: Sandy Berger
National Security Council

cc: Erskine Bowles
Secretary Rubin
Secretary Albright

Re: **Read-out from meetings in Hong Kong**

Met with C H Tung, the Chief Secretary and the Head of the Hong Kong Monetary Authority. There was a sense of apprehension but not imminent panic around the Asian financial crisis. Great amount of anxiety about US Congress, Fast Track, IMF etc. Surprising amount of conflict between Monetary Authority and government, as illustrated by government's great desire to find ways to defend the peg without increasing interest rates.

Policy position is to accept dollarization in extremis rather than abandon the peg. Serenity about Peregrine. Convincing denial about Chinese interference with the peg. Not totally convincing in optimism that Chinese peg will hold, and recognition that fall of the peg would be calamitous. Bothered but not conspiratorial about Taiwan devaluation. Full of complicated but not compelling schemes, first raised in Manila, to marshall new sources of international official finance and develop domestic bond markets in Asia.

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Robert E. Rubin to POTUS re: Your Dinner with German Chancellor Kohl (2 pages)	06/04/97	P5
002. briefing paper	re: Russian Financial Issues (2 pages)	ca. 1999	P5
003. memo	Robert E. Rubin to POTUS re: Meeting with German Chancellor Schroeder (3 pages)	02/09/99	P5
004. memo	Robert E. Rubin to POTUS re: The Economic Agenda for the Lyons G-7 Summit (4 pages)	06/24/96	P5

COLLECTION:

Clinton Administration History Project

OA/Box Number: 24126

FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [28]

Jimmie Purvis

jp25

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advise between the President and his advisors, or between such advisors [a)(5) of the PRA]
P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.
PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).
RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

b(1) National security classified information [(b)(1) of the FOIA]
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Russian Financial Issues

Prime Minister Primakov's government continues to move slowly on economic issues to not jeopardize the current political stability. Given Yeltsin's poor health, Primakov appears focused on building bridges to the Duma and Federation Council. So far, Primakov has enjoyed some success. His more accommodating relations with the Duma and its continued opposition to key economic reforms reflects a fundamental lack of consensus among competing political groups. This has led to ongoing political maneuvering, which is likely to continue before legislative elections in December and a presidential election scheduled for June 2000.

Since the Russian government's decision on August 17 to devalue the ruble and default on government debt, the Russian economy has slumped badly:

- -- inflation has jumped--prices rose by over 11% in December and 8% in January,
- -- output has fallen--GDP was down about 5% last year overall,
- -- the ruble has dropped by about 75% to 23 R/$,
- -- imports have plummeted by 40-50% while exports are down slightly due to low oil prices,
- -- the banking system has fallen largely into insolvency, and
- -- Russia has missed payments on domestic debt and foreign debts to the Paris and London clubs.

Budget: Russia's budgetary failings lie at the heart of the financial crisis and still remain to be addressed. The Duma passed the government's draft 1999 budget in the final reading on February 5 after making only minor changes. The budget calls for a deficit of only 2.5% of GDP, but it is based on unrealistic assumptions about inflation, the exchange rate, and revenue collection. The budget also contains few funds for bank restructuring or the clearance of wage and pension arrears. The budget will now be reviewed by the Federation Council, which may object to provisions regarding the distribution of revenue between the center and regions.

IMF: The IMF has consistently told the Russian government that the draft budget needs serious adjustment. An IMF team was in Moscow from January 22-February 5, but made only limited progress in discussions with Russian officials. The Russian government plans to provide additional proposals to the IMF this week and it has invited the IMF to return to Moscow in mid-February. It is unclear how long this process will drag and whether the Russian government will develop the appropriate sense of urgency.

If the IMF and Russia can reach an agreement on a new program, it would open up the doors for additional support. The World Bank will not consider new adjustment lending to Russia until a macroeconomic program backed by the IMF is in place. Japan's Ex-Im bank is prepared to release a loan to Russia that is tied to World Bank support. In addition, Russia's Paris Club creditors will consider restructuring Russia's debt only after Russia has an agreement with the Fund.

Debt: Russia is in arrears to Paris Club creditors on roughly $1B in debt, largely owed to Germany. Russia has also not paid $362M to London Club creditors, who declared Russia to be in default. Russia also defaulted on large amounts of domestic ruble debt (GKOs). Russia has recently issued new bonds to exchange for the defaulted ruble debt. Most foreign investors, however, have refused to exchange their ruble debt because they are holding out for more favorable terms. Russia continues to make payments on its debt to the international financial institutions, on Eurobond interest, and on official debt to Paris Club countries contracted since the breakup of the USSR. Altogether, Russia plans to pay $9.5B of the $17B in foreign debt that it owes this year.

Reserves: Russia had $11.6B in foreign reserves, including gold, at end-January. The Central Bank (CBR) has required Russian exporters to sell 75% of the export revenues in markets controlled by the CBR. Many exporters, however, are evading this requirement. The ruble has stabilized in recent weeks at about 23 R/$, but traders expect a continued slide throughout the year.

Banking: The Central Bank has developed a reasonable plan for the restructuring of the banking system, but it has failed to make much progress in implementing the plan. While the CBR has provided credits to only a limited number of Russian banks, these decisions appear to be made for political reasons. In addition, the CBR lacks the legal authority to take over insolvent banks. Lack of government action on bank restructuring has allowed owners of failed banks to strip their banks' remaining valuable assets. This will significantly increase the ultimate costs of the banking crisis to the government, depositors and creditors.

Suggested Points

- G-7 needs to pursue consistent theme with Russian government. Our message remains the same: it is in Russia's long-term interest to stay on the path of reform and integration, not isolation and state control. Secretary Albright and VP Gore each gave this message to Primakov in recent meetings.

- We all want to find ways to support the Russians. But, a sustainable budget and a workable IMF program are necessary or else international assistance would be wasted – again.

- G-7 needs to give consistent message to Russian government that IMF will not lend for political reasons. Russia needs to engage in serious discussions with IMF. So far, the Russian government has not shown sufficient willingness to work with the Fund on technical issues.

- The U.S. has consistently told the Russian government that an agreement with the IMF is needed before Russia can begin discussions with the Paris Club on debt restructuring. Until then, the G-7's joint approach of not declaring in default in the Paris Club is appropriate.

- When/if the time comes for the Paris Club to consider a restructuring of Russian debt, it will be important for the U.S. and Germany to consult closely to develop a reasonable restructuring proposal.

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Robert E. Rubin to POTUS re: Update on Mexico's Stabilization (3 pages)	05/15/95	P5
002. briefing paper	re: Why Should We Advance the US-Mexico Economic Relationship? (3 pages)	09/19/95	P5
003. talking points	re: Talking Points for Call to Ortiz (2 pages)	10/25/95	P5
004. memo	Lawrence H. Summers to POTUS re: An Update on Mexico's Economic Performance & Challenges in Advance of President-elect Fox's Visit to Washington (2 pages)	08/23/00	P5

COLLECTION:
Clinton Presidential Records
Clinton Administration History Project

OA/Box Number: 24124

FOLDER TITLE:
[History of the Department of the Treasury - Supplementary Documents] [4]

Jimmie Purvis

jp33

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
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1.0 Van — This is getting there. Why can't we have the 1912 [illegible] stuff from the Rubin testimony attributable to NAFTA and fin. support? Why can't we have any immigration, Mexican collapse stuff. Have we no forecasts of export growth to Mexi 9/1

Why Should We Advance the US-Mexico Economic Relationship?

Are we in the gray early on this? Lets move. L.

Larry 95 15015

BRIEF: Viewing the events of 1995, critics claim that Mexico's financial difficulties prove NAFTA was a mistake and that we should build walls -- not bridges -- to Mexico. The facts prove the exact opposite. Mexico's financial difficulties and their threat to American exports and jobs would have been far greater without the protection that NAFTA and U.S. financial support affords us. Both preserved economic reforms that have kept Mexican markets open to our goods. Both have bolstered investor confidence, preventing the threat to other important U.S. export markets while maintainng exports to Mexico at levels higher than otherwise might have been. Even with Mexico's present difficulties, United States exports to Mexico, and the U.S. share of all of Mexico's imports, are still **higher** -- not lower -- today than they were before NAFTA in 1993. Most important, Mexico's economic fundamentals and the opportunities Mexican economic growth presents to the United States are far better than ever before -- because of the closer economic relationship our two countries have forged.

- **Mexico's financial crisis and the current recession it created had nothing to do with NAFTA. Rather, it resulted from Mexico's pursuit of unsustainable macroeconomic policies.**

  -- Mexico's economy is in better -- not worse -- shape than it would have been without NAFTA and our financial support. NAFTA locked in trade and investment liberalizing measures that are essential for Mexico's continued economic progress. Our 1995 agreements preserved these reforms and extended them.

  -- Our economic ties help to ensure that temporary difficulties will not lead Mexico to retreat from continued pursuit of fundamental economic reforms, including market-opening measures and privatization. In 1982, Mexico reacted to its financial crisis by retreating to protectionism, stalling growth for a decade. By contrast, in 1995, Mexico pushed reforms forward with even greater vigor.

  -- Reforms undertaken already and accelerated in 1995 have left Mexico's economy with better fundamentals to sustain growth than ever before.

- **The best test of an agreement is how it works in bad times. We now see that the U.S.-Mexico economic relationship has protected American jobs and exports to Mexico from the effects of Mexico's financial crisis, because it committed Mexico to keeping its market open to our goods. We would have been in far worse shape had a crisis erupted without the insurance that NAFTA provides and the cushioning effect of our financial support in 1995.**

  -- Mexico's commitments to the United States under NAFTA have protected the United States from tariff hikes and other trade restrictions that the Mexicans have imposed on others.

-- Since NAFTA, Mexico has lowered its tariffs on U.S. products by 4.4 percent. And while in the face of crisis, Mexico raised tariffs on non-NAFTA partners by 15 percentage points on some goods. On January 1, 1995, in accordance with NAFTA provisions, Mexico cut its tariffs on U.S. imports.

-- In fact, in response to our financial agreements, Mexico has gone beyond its NAFTA obligations in its liberalization of financial services and in its extension of privatizations -- thus, creating new opportunities for American firms and workers.

-- That is why, in spite of Mexico's difficulties, our exports to Mexico over the first half of the year were 2.5 percent greater than they were in the first half of 1993, before NAFTA was adopted.

-- And, while all Mexican imports have fallen temporarily due to the financial crisis, the U.S. share of Mexican imports increased from 69.8 to 71.6 percent over the first four months of 1995, compared to the same period in 1994.

-- Our experience this year stands in sharp contrast to 1982, when the Mexicans slapped 100 percent duties aimed at American products and workers, a move that sliced our exports to Mexico by 50 percent and took more than six years to recover.

-- Most analysts expect Mexico to resume economic growth next year, and to continue as the fastest growing major export market.

- **The U.S.-Mexico economic relationship has bolstered investor confidence in Mexico. That has helped contain the effects of Mexico's crisis and avert serious threats to U.S. prosperity and jobs.**

-- With NAFTA in place and President Clinton's bold action to help Mexico face down its crisis, investor confidence has returned quickly. This stands in stark contrast to 1982, when Mexico retreated into protectionism and struggled for years to attract the foreign investment it needed to grow.

-- Our strategy has prevented Mexico's difficulties from spreading to other emerging economies. These emerging markets are our fastest growing export markets -- supporting some 4 million U.S. jobs, preventing another "lost decade" of economic opportunities in the Hemisphere.

-- These exports will make an important contribution to building a fully employed, high-wage, and even more prosperous America. For example, American workers that are employed in export-producing jobs have wages that are 13-17% higher than the U.S. national average.

- **Most broadly, Mexico's own strong reform efforts and our commitment to support them has placed Mexico on the path toward becoming the most dynamic of America's largest trading partners. If Mexico had remained a closed market, it would always be a cheap-labor competitor, and a source of poverty and tension along our 2,000- mile border for the foreseeable future.**

  -- Despite the crisis, Mexico is continuing to lower trade barriers, as required under NAFTA, and should eliminate all tariffs on U.S. goods by the year 2009.

  -- Despite the crisis, Mexico is embarking on a new and deeper round of privatizations, generating further growth and opening up opportunities for American companies to expand.

  -- In the long run, a strong, stable, and prosperous Mexico is critically important for both our countries. That is the only way for both our nations to reap the benefits that trade, commerce, and stability across our borders can afford.

97-15 / 861

October 25, 1995

TALKING POINTS FOR CALL TO ORTIZ

o I am troubled by Hacienda's press statement today for reasons of substance and process.

Substance:

o We are taking heavy political hits for the rollovers of the short-term swaps, including a "Sense of the Senate" (non-binding) resolution calling for your immediate repayment, and public attacks by D'Amato that allege misrepresentation of your progress.

o We've carefully crafted a strategy to deal with our critics, and, to be effective, this involves judicious and appropriately timed communications to the Congress and the press.

o Hacienda's statement today complicates matters and is actually incorrect: Bob had not yet taken the formal decision to roll over the swaps [though he since has], and it is certainly not Mexico's place to announce a decision by our Secretary that we have yet to do.

Process:

o Perhaps more troubling, my staff, at several levels, had explicitly advised yours of these facts and told them not to make the statement you did, explaining the reasons why.

o In fact, Zelikow had worked out with Martin Werner a statement that you could release, in Spanish, that Martin had agreed would work for your purposes (to calm the markets about the D'Amato problem). By the time Zelikow got off the phone, however, your erroneous release had come out.

-- either Zelikow was being humored by Werner or there is inadequate coordination within your ministry with your spokesman.

-- it would not be for the first time, whichever the case.

o Jeff Shafer called Werner back to complain and said to issue a correction, along the lines that Zelikow and Werner agreed. We still haven't seen it on the wires.

Conclusion:

- o I appreciate why you may have wanted to issue a statement, but, when it comes to our program, I must insist that you contact us first and respect our views.

- o If this was an error by your spokesman, it is just the latest in a long line that we have brought to your attention. His performance undermines yours and damages our mutual efforts. The problem should be corrected once and for all.

- o If this error was caused by a lack of respect for the objections of my staff, let me assure you that, pending a reversal by me, they speak on my behalf.

- o I hope that we can agree that an episode like this will not be repeated: it damages the excellent working relationship that our two ministries have enjoyed, as well as the trust that is essential for our joint efforts to succeed.

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Lawrence H. Summers to POTUS re: Strategic Petroleum Reserve (2 pages)	09/13/00	P5
002. memo	Lloyd Bentsen to POTUS re: Russian Economic Reform & the Washington Summit--Building Economic Partnership (5 pages)	09/26/94	P5
003. memo	Lawrence H. Summers to Secretary Bentsen re: Memorandum to the President on Russian Economic Reform & the Washington Summit (1 page)	09/23/94	P5
004. memo	Lloyd Bentsen to POTUS re: Ukraine: Economic Reform & the Kuchma State Visit (3 pages)	11/18/94	P5
005. memo	Robert E. Rubin to Vice President Gore re: Economic Themes for Upcoming Visit of Ukrainian Prime Minister (1 page)	09/21/95	P5
006. briefing paper	re: Current Economic Situation in Ukraine (2 pages)	circa Sept. 1995	P5
007. memo	Robert E. Rubin to Vice President Gore re: Gore-Chernomyrdin Commission Meeting (1 page)	01/11/96	P5
008. memo	Under Secretary Shafer to Secretary Rubin re: Proposed Meeting with Russian Prime Minister Viktor Chernomyrdin (1 page)	circa Jan. 1996	P5

COLLECTION:

Clinton Administration History Project

OA/Box Number: 24124

FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [5]

Jimmie Purvis

jp34

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
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CURRENT ECONOMIC SITUATION IN UKRAINE

Until the middle of the summer, Ukraine was on track with its stabilization program and had made real progress reducing inflation. The budget was on target (deficit = 3.3% of GDP) and monetary policy remained relatively tight, despite large capital inflows. Monthly inflation fell from 21% in January to 4.8% in June, and the exchange rate remained steady for most of the first half of 1995.

Despite stabilization progress and evidence that the large informal economy (~40% GDP) was growing, a recovery in output and trade was not immediately evident in official statistics, and the leadership has been showing signs of "reform fatigue". Questions about Ukraine's reform commitment arose in July due to three major developments. First, President Kuchma gave a controversial speech at the end of June in which he decried the ongoing slump in production and suggested that the reform program's inflation targets be scrapped in favor of spurring an immediate recovery in output.

A second factor was Kuchma's cabinet shakeup, which promoted Roman Shpek to Deputy Prime Minister for the Economy, but demoted reform's chief architect, Viktor Pinzenik. The President also threatened to fire Central Bank Governor Yushchenko, who has implemented a tough credit policy. Kuchma missed a unique opportunity to strengthen the cabinet's commitment to reform.

Finally and most importantly, performance slipped, with money supply growing by 14% in July. Moreover, the Rada passed a third quarter budget which increased expenditures by 2% of GDP, without compensating taxes. Results were not encouraging, with monthly inflation climbing past 5% in July and the exchange rate falling by 10% during two chaotic days in the middle of August.

The Treasury Department and the IMF actively engaged Ukraine's leadership to get their economic performance back on track. The Government and IMF agreed to a revised program in August and Kuchma and his government recommitted themselves publicly to the program's stabilization goals. The Government agreed to make expenditure cuts and tax increases to put the budget back on track. Monetary targets were revised, and the Government agreed to abandon grain export quotas. The IMF Board is scheduled to approve Ukraine's standby review and allow it to access the next $350 million tranche of its program on September 29.

Questions still remain about the Government's reform commitment and its understanding of stabilization policies. Kuchma recently restated his skepticism that the standby's inflation targets were achievable and noted his desire for the state to take a very direct and active role in boosting output. Similarly, Marchuk was even more specific in calling for new credits for industry, increased protectionism and for the state to manage trade and maintain large ownership shares in major firms. At the same time, Kuchma has implemented new tax measures and submitted a revised budget which were key preconditions for successfully concluding Ukraine's standby review, originally scheduled for mid-September. Either the leadership does not comprehend the implications of the IMF program's tight fiscal and monetary policies, which rule out new support for agriculture and industry, or it is playing domestic politics. In either case, its statements are counterproductive and erode international and domestic confidence in its economic policies.

There are concerns also about the slow pace of mass privatization. While the privatization auction apparatus is now in place, only a fraction of the privatization vouchers have been collected and minimum valuation issues at the auction often prevent firms from being successfully sold. The incentives for management and labor to privatize their firms is very low and procedures for preparing firms for the auctions remain cumbersome and expensive. Finally, the Rada has declared many agro-industry firms ineligible for privatization. Without efforts to streamline the process and a strong political push from President Kuchma and Prime Minister Marchuk, Ukraine will not even come close to reaching its goal of 8000 large and medium firms and most small firms sold by the end of the year.

Conclusion

Ukraine faces the toughest period of its transition this year, but experience in other countries shows that continued performance will generate a sustainable recovery in the near term. It is crucial that the Government get back on track with its IMF program and regain some reform momentum. Fall and winter performance will be closely watched, as this has historically been a period of high inflation. Further progress on reducing inflation, removing remaining state controls on trade and prices and accelerating privatization are necessary for securing a critical level of stability and supporting a genuine take-off in trade and output. Recent statements supporting new state support and increased regulation in the economy only threaten important stabilization gains already achieved and will not result in increased output. Moreover, the Government needs to develop a strategic vision for its future, including steps to strengthen its economic policy institutions and to take a more active hand to accelerate and shape structural reform. The United States stands ready to offer technical assistance to support all aspects of Ukraine's reform program.

Yevhen Marchuk has a key role to play in this process. As the country's new Prime Minister with a close relationship to President Kuchma, he is uniquely positioned to push forward the actual implementation of reform policies. His own recent statements favoring slower stabilization and new state involvement in the economy are dangerous and counterproductive. His active involvement in pushing stabilization and privatization forward is crucial to reform's success.

Withdrawal/Redaction Sheet
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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Robert E. Rubin to Vice President Gore re: Economic Reform Themes for Visit by PM Chernomyrdin (1 page)	01/26/96	P5
002. memo	Larry Summers to Secretary Rubin re: Your Meeting with President Clinton Today to Discuss Russia (1 page)	05/20/96	P5
003. memo	Robert E. Rubin to POTUS re: Meeting in Helsinki (1 page)	03/19/97	P5
004. memo	Karin Lissakers (IMF) to Larry Summers & David Lipton re: Russia & IMF (5 pages)	11/03/97	P1/b(1) Unclass.
005. talking points	re: RER Points for Camdessus Call on Russia (1 page)	circa April 1999	P5

COLLECTION:

Clinton Administration History Project

OA/Box Number: 24124

FOLDER TITLE:

[History of the Department of the Treasury - Supplementary Documents] [6]

Jimmie Purvis

jp35

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advise between the President and his advisors, or between such advisors [a)(5) of the PRA]
P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

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Freedom of Information Act - [5 U.S.C. 552(b)]

b(1) National security classified information [(b)(1) of the FOIA]
b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
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b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

RER points for Camdessus call on Russia

1) Russia's situation in the current international political environment is very sensitive. It is important that you understand that from the U.S. perspective it is crucial that there be no additional surprises regarding further progress toward a Russia program with the IMF.

2) So far we have not heard that the Fund has definitively ruled out providing funds to Russia in excess of the amounts that Russia owes the Fund during the program period.
   - Want to make clear that total disbursements under the program should not exceed Russian repayments – i.e. there should be no net transfer.
   - Also critical that the SDR mechanism for safeguarding disbursed funds be airtight.

3) We remain unconvinced that Russia has either the willingness or capacity to implement much in the way of real economic, financial or structural reforms under a program.
   - We view this program as primarily providing a capacity to do debt rescheduling while maintaining some level of economic stability.
   - For this reason we think that the Fund should not try to be too ambitious. Another failed program would be bad both for the IMF and its major creditors.

4) We are profoundly skeptical that Russia will be able to achieve the targeted 2% primary surplus. Of course, the Fund is in the best position to make this judgement, but we will have difficulty supporting a program that is not credible on its face.

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. memo	Mark Sobel (IMF) to David Lipton, Tim Geithner, N. Lee, A. Baukol, and B. Cox re: Update on Russia-IMF (2 pages)	07/08/98	P1/b(1) Unclass.
002. memo	From Mark Sobel (IMF) re: IMF Debrief to G-7 Directors on Russia (2 pages)	08/13/98	P1/b(1) Unclass.
003. note	Karin Lissakers (IMF) to Deputy Secretary Summers, Under Secretary Lipton, & Assistant Secretary Geithner re: Russia (1 page)	08/13/98	P1/b(1) Unclass.
004. briefing paper	re: Mandatory Conversion of GKOs: Russia: Preliminary Considerations (IMF document) (5 pages)	circa Aug. 1998	P1/b(1) Unclass.
005. briefing paper	re: Russia: Scope for Intensification of Exchange Controls (IMF document) (2 pages)	circa Aug. 1998	P1/b(1) Unclass.
006. memo	To the Vice President re: Policy Priorities for Russia (4 pages)	circa Oct. 1998	P5
007. briefing paper	re: Russia Strategy (5 pages)	circa Oct. 1998	P5
008. memo	To the Vice President re: Responding to Russia's Economic Crisis (6 pages)	circa Oct. 1998	P5
009. memo	Senior Deputy Assistant Secretary Truman to Rubin, Summers, & Geithner re: Principals Meeting on Russia (3 pages)	11/12/98	P5
010. memo	To the Vice President re: Russia's Economic Crisis (5 pages)	circa Oct. 1998	P5
011. memo	From Mark Sobel (IMF); For the Files re: Russia - IMF Staff Briefing to Board on Latest Mission (3 pages)	11/02/98	P1/b(1) Unclass.

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Clinton Administration History Project

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[History of the Department of the Treasury - Supplementary Documents] [7]

Jimmie Purvis

jp36

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
012. talking points	re: Russia - Economic Message (6 pages)	circa Dec. 1998	P5
013. memo	From Mark Sobel (IMF); For the Files re: Managing Director's Board Briefing on Russia (2 pages)	03/08/99	P1/b(1) Unclass.

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Russia strategy

The current situation: Four factors are now converging to reduce the likelihood of a sensible, resolute economic policy course in Russia:

(1) There are no good stabilization policy choices. The Russian government can no longer borrow either domestically or from non-residents, so deficit cutting is imperative. But the breakdown in the payments system and the drop in output and imports caused by the crisis itself have pushed tax and tariff revenues to perhaps half the usual inadequate levels. Opposition to further expenditure cuts and support for subsidies have intensified. The pressure for monetary emissions, to finance the current deficit, clear wage and pension arrears, and bail out the banks, is probably irresistible.

(2) The new Prime Minister Primakov has a narrow, caretaker-government mandate: to maintain political stability in Russia until the presidential elections.

(3) The increasingly urgent and widely held view is that President Yeltsin should resign (elections would then have to be held within 3 months). He is no longer an effective torch bearer for reform. Attention will increasingly be focused not on economic policy but on early presidential elections, perhaps by this spring.

(4) There is no consensus on a growth strategy and no effective political mechanism for forging one. The crisis is driving a search for a strong leader, not a convergence of views on new policies. Neither new ideas nor leaders have emerged. Russians appear to be faced with a choice between reformers who are discredited, fairly or not, and equally discredited retreads from the Gorbachev era.

As a result, we can probably expect a kind of "squeaky wheel" sequential economic policy from the Primakov government, if left to its own devices, in which it will respond more or less effectively to successive urgent problems, e.g., the collapse of the banking/payments system, food shortages, wage and pension arrears, problems in servicing external debt.

Lessons from the transformation effort so far: The crisis has dramatized what has been clear for some time: Russia lacks essential underpinnings of a healthy market economy: confidence in the currency as a store of value (or even as a medium of exchange for large transactions); a banking system which lends to unaffiliated private firms; a legal system which adequately protects property and investor rights; a fair regulatory and tax system which ensures a predictable, competitive, transparent business environment, effectively funds the government, and does not serve as a vehicle for state corruption.

There are at least two schools of thought as to why these have not developed in Russia. One is that it has taken a long time for them to develop anywhere, and the West, as well as Russian reformers, had unrealistic expectations about how long it would take to develop market institutions, laws, and practices which had never existed in Russia. The other is that the United States and Western and Central Europe do not provide the right models for Russia. Asian development paths, more dependent on public-private cooperation and relationships than on law and transparency, may be more relevant.

Perhaps both are partly right. But another consideration is central for Russia. It relates to the role of the state. The irony in the aftermath of the Soviet period is that the experience of communism has heavily damaged, perhaps even destroyed, Russian people's trust in the state, their willingness to cede power to the state, and their faith in the state's ability to provide an effective social safety net. The overriding objective of business people, legislators, local officials, and individuals is to ensure protection, or at least distance, from what is perceived as the state's arbitrary, unreliable, and corrupt authority.

For this reason, it could be argued that the reform agenda aimed at bringing the unofficial barter economy into the formal, taxed and regulated sector ran directly counter to Russian peoples' perceived interests. From this perspective, it is not hard to see why it failed. It also makes it easier to understand why Russians are willing to put up with the enormous inefficiencies of a barter system as a means to avoid the greater perceived risks and costs associated with being part of the state regulated sector. The sobering lesson is that Russia faces a protracted struggle, not only to build effective state institutions but also to overcome deep-rooted resistance to the basic objective of strengthening the law-based state. We should be mindful that, as in our country's history, part of the ultimate resolution of this legitimacy issue will probably come from some redistribution of power from the center to the regions and localities.

The other lesson concerns the relative emphasis in economic policy on stabilization vs. structural reform. With hindsight it seems clear that the Russians got stuck in the stabilization phase of reform, mostly because of a failure to do the things which would have made stabilization sustainable, like fixing the tax system. Successive Russian governments struggled ineffectually with this issue, leaving little reform energy left for other challenges. The failure to do structural reform killed prospects for growth which in turn repeatedly threatened and ultimately destroyed stability. Russia and we should be careful to avoid this vicious cycle in the months ahead. Support for organic reforms should proceed with the same urgency as support for stabilization and through all means possible -- financing from international financial institutions, technical assistance, training and educational exchanges, public-private partnerships.

Policy message to Russia: It will be critical not to draw the wrong lessons from this crisis. The failure of Russia's economy to grow was not the result of monetary policy. Printing a lot of additional money will not induce people and businesses to invest in the real economy or even to hold more rubles (as inflation accelerates). We also conclude that the market democracy model remains the right one for Russia, but it has to be underpinned by a state which provides a competitive, orderly, predictable, and transparent environment. There is nothing cultural or uniquely Russian about the country's failure to invest and grow during the last six years. Russian economic performance can instead be attributed to a rational response on the part of Russian people and businesses to very real policy, regulatory, and legal failures. The focus of Russia's authorities should be on correcting those failures as well as on stabilization. The U.S. and the West should strongly support these reforms with policy dialogue, financing, and technical assistancc. Moreover, if Russia moves forward resolutely to strengthen policies and the investment climate, the West should also consider ways of helping Russia tackle challenges which the market and the private sector are not suited to address.

The reform/growth agenda and our engagement: I would propose that the following considerations govern our message to Russia on reform and help from the West:

(1) Stabilization/exchange rate policy: The impossible fiscal bind at the moment means that stabilization will take a while. Some monetization of the deficit and of arrears clearance is inevitable. We have to be realistic about this and focus our efforts on moderating it and trying to ensure that it does not go to finance the wrong things like indiscriminate bank bailouts. The high inflation ahead has clear implications for exchange rate policy. Russian authorities seem to be moving toward trying to stabilize the ruble through restrictions on exchange market operations, trade controls and steps toward inconvertibility, and limits on access to dollar holdings and use. This is exactly the wrong direction for Russia; it will drive people deeper into barter and revive administrative controls that provide additional opportunities for corruption. We should urge a ruble float with the possibility of a renewed peg in the future as macroeconomic policy strengthens.

(2) Tax reform: The Russian government has thus far been unable to build any kind of viable coalition in support of tax reform. The only conceivable basis for doing so is to cut rates but apply them more broadly, predictably, and fairly. Moreover, the goal of reducing disincentives for new businesses to move from the informal to formal sector should be overriding. We should urge fixes to the tax system which balance three objectives: (1) raising revenues; (2) simplicity, predictability, ease of administration, and business-friendliness; and (3) broad appeal to potential constituents for tax reform. Reconciling these three objectives will likely mean lower than desirable federal revenues. The solution will probably have to come from more fiscal federalism in Russia. Some expenditures and tax authority will have to be shifted from thc center to the regions/municipalities.

(3) Bank restructuring: In theory, the collapse of the banking sector provides an opportunity to rebuild a well-managed, well-regulated sector which actually lends to the real sector. Despite the weakened political position of the oligarchs (Primakov is not beholden to them), our sense is that the central bank does not have the capacity, information, or political will to avoid bailing out undeserving, even corrupt banks and allowing them to retain their old managers. But there are no Russian sources of financing for these bailouts and real concern in responsible quarters of the Russian government and central bank about the inflationary consequences of doing so through central bank credits. We should use the leverage of World Bank/EBRD financing as directly and effectively as possible here. And we should pour in as much technical assistance as can be effectively mobilized and used.

(4) Creation of a sustainable and effectively targeted social safety net and clearance of wagc and pension arrears: This is probably the single most important tool for raising the Russian peoples' stake in a stronger state. Here too, we should use the tool of World Bank financing as effectively and rapidly as possible.

(5) Restructuring industry, spurring new business creation, and Marshall plan proposals: Our message should be that the right approach is a combination of fixing the policy/regulatory environment and government action to do the things that markets and the private sector can not or will not do. Subsidies and directed credits are not the right approach; they waste resources and generate inflation. There are no short cuts on the first challenge. It involves a long list of improvements to the legal and institutional framework: enforcement of sound property, contract, and bankruptcy law; the fight against corruption; strengthening the legal basis for land and housing markets; increasing labor market flexibility; elimination of burdensome firm licensing and registration requirements; and strengthening shareholder rights and enforcement, including the right to accurate and reliable disclosure of firm financial information. With regard to the second, while acknowledging the fiscal constraints on Russian government action, we should offer to engage in a constructive discussion to identify opportunities where government can usefully intervene, such as financing R&D; facilitating lending to those with no access the formal financial sector; human capital formation; building some types of infrastructure; strengthening nuclear security. Financing these efforts could come from a combination of reallocation of GOR spending, the IFIs, bilateral financing, and public/private partnerships. For those seized with the notion of a Marshall Plan for Russia, this is probably where to put the money.

(6) Increasing FDI: In the near term, as a second best policy which would have demonstration effects for the rest of the economy, the Russian government could create special, stable tax and regulatory regimes for foreign investors. Over time, these special regimes could serve as the basis for a broad-based reform of the investment regime. FDI could also be attracted by making privatization procedures more competitive and transparent.

(7) Russia's external debt obligations (Paris Club, IFIs, eurobonds, bank-to-bank external debt): Primakov appears inclined toward a non-confrontational strategy with the IFIs and foreign creditors. We should respond with a low-key, constructive strategy on Russia's Paris Club arrears/obligations, urging Russia to develop a realistic schedule of payments with rational burden-sharing among non-IFI creditors.

(8) IFI engagement: A pause in Russia's Fund program has been made unavoidable not only by Russia's policy direction but also because the Fund, fairly or not, shares the blame in Russia (not to mention Capitol Hill) for the crisis. We should urge the Fund to use this period to contemplate new, even radical, solutions to Russia's fiscal problem that have some chance of mobilizing a political consensus and being implemented. The Fund should chart a path back to stability that is gradual but sustainable. Once this path is agreed, we will have to press the World Bank to move quickly to take the lead in financing the key structural reforms outlined here. We have spoken often in the Russian context about passing the baton across 19th Street. This time it has to happen, and it has to be supported by G-7 bilateral assistance and by the EBRD.

(9) Humanitarian assistance: Whatever the reform path, the West can and should help Russia meet basic human needs. Given the very poor Russian harvest, the sharp ruble devaluation, and dried up trade finance, there will likely be food shortages and/or dramatic food prices increases in remote regions this winter putting the most vulnerable in real jeopardy. We should try hard to reach agreement with the GOR on food aid, while making a maximal effort to try to ensure that the food goes to the right people.

(10) Technical assistance: At this stage we should undertake thorough reviews of USG technical assistance effort. Effectiveness in some areas like tax reform is in doubt. I would suggest a technical assistance focus on bank restructuring, the rule of law and anti-corruption efforts, and fiscal federalism and tax administration.

DRAFT

Economic Message

- o Russia and the international financial community have a common objective -- creation of a viable functioning, growing Russian economy.

  - -- And that objective ought to be pursued in a pragmatic, non-ideological way.

- o Our discussions have revealed a broadly shared perception of much of what has gone wrong:

  - -- corruption and its destruction of the social contract and the investment climate;
  - -- arrears buildups, the culture of non-payment, and the rise of the barter economy;
  - -- the squandering of Russia's savings through capital flight;
  - -- excessive government borrowing, especially from abroad, which left Russia vulnerable to global financial turmoil and crowded out investment in the private sector; and
  - -- deindustrialization.

- o This common view of the challenges ought to provide the basis for Russia and the international community to come together on a program as quickly as possible.

- o But the reality is there is distrust on both sides.

  - -- Russia has legitimate concerns about its policies being micromanaged or being asked to adopt alien solutions.

  - -- The international financial community led by the IMF has legitimate concerns that Russia has a record of not living up to commitments. None of us can afford another failure, and no distinction will be made between this government and previous governments.

- o The solution is that Russia's program has to be Russian owned.

  - -- No IMF-supported program, even with generous levels of financing, can restore confidence if the international financial community (markets, international institutions, and governments) perceive a lack of political will to implement it.

  - -- This is the lesson of the Fund's experience in Indonesia earlier this year -- another case of repeated failures to implement promised reforms.

  - -- It is the lesson of Russia's experience this summer.

  - -- In Korea, the program supported by the IMF was a failure until people committed to its implementation took over. The insistence since then by Korea's President and Finance Minister that the program is Korea's, not the IMF's, has contributed enormously to its credibility.

-- In the case of Brazil, the government came to the Fund, not vice versa, and worked out a coherent economic strategy over a period of several months.

o Russia has to make choices among policy options to achieve a given set of objectives. The Fund's obligation is to give Russia accurate advice about what will work and what won't work. And the Fund at this point can only provide financial support for actual policy implementation and results, not for promises and commitments.

o This realistic approach implies real limits on how much money can flow and how quickly it can flow.

Taking Russia's economy forward:

o Growth is the central Russian problem and without it nothing else can work -- job creation and rising living standards, the fiscal balance, the financial system, elimination of arrears and non-payments, and establishment of a monetized economy.

o The Russian economy suffered large blows in the last year from the halving of oil prices and Asian contagion. These would have made things very hard even in absence of other problems. But the reality is that neither Russians nor foreigners were investing much in Russia's real economy even before these blows.

o Capital flight over the last 3 years has totaled perhaps $10-15 billion/yr. And this does not include mattress money held as dollars by Russian citizens which has been estimated in the range of $20-40 billion. (FYI: mattress money is separate from dollar deposits held in the banking system.) Until capital flight stops and productive investment starts, growth will not happen.

o The second general point is that the world has changed in terms of what types of economic activities are most valued.

-- Microsoft, which didn't exist 25 years ago, is worth more than the American automobile, steel, or aerospace industries. And the information technology sector accounts for more than 1/3 of American economic growth.

-- The option of growing through resuscitating traditional heavy industry is no more available to Russia than it is to any other economy. This is even apart from the question of where the resources to subsidize these industries would come from.

-- Increases in living standards come not from production alone but from production of goods and services people want to consume.

-- In countries as diverse as China, the United States, Brazil, India, and Poland, growth and job creation have largely come from new business creation. Russia's principal need is to restructure its economy for the 21st century, not to emphasize the industries of the 19th century.

- o Russia's experience and history are unique, but it is by no means the first country to confront entrenched problems of capital flight, corruption, a weak banking system, inadequate legal protections and market institutions, and excessive government borrowing.

- o In a purely economic sense, Russia's problems have similarities with those observed in Latin America during the 1980s.

- o Latin American experience suggests that real progress, growth, and lasting benefits for ordinary people can be achieved with a coherent program that is implemented consistently. Stopping capital flight, reducing corruption, and spurring productive investment requires actions in four areas:

(1) Rationalizing government:

Tax reform in Russia has to achieve 2 objectives: (a) levels of cash tax collection by the center and the regions in line with their respective spending obligations, and (b) reasonable tax rates, predictably and uniformly applied to a broader base.

But cutting, reallocating, and controlling spending also has to remain a fundamental part of the fiscal solution. We are told that the Russian federal bureaucracy has grown by 1.2 million people in the last 6 years. Untargeted housing subsidies waste a huge share of budgetary resources. The result is not only unsustainable spending and failure to meet obligations to pensioners, teachers, and soldiers; it is also the rise of destructive, rent-seeking bureaucratic power that discourages private investment.

There is no near-term, responsible alternative to a substantial primary (non-interest) budgetary surplus. The size is a central topic in Russia's discussions with the Fund. We would simply urge that the discussion be grounded in real, achievable numbers on both the tax and spending sides. The purpose is not to reduce the deficit for its own sake but to limit excessive government borrowing that leads to monetization and accelerating inflation. The objective is stability.

(2) Fixing the banking system:

A singular feature of the development of Russia's banking system is that relatively few banks played a major role in taking deposits, in making the payments system work, and in lending to unaffiliated companies. That has not been good for the Russian economy, but it makes the job of restructuring the banking system easier because most banks were not active in the intermediation process. Few banks have a legitimate claim to be saved. This weakens the case for numerous inflationary bailouts that clearly place the interests of a few owners above the interests of the many citizens.

Your government and the central bank have so far confounded predictions of uncontrolled credit flows to banks. Urge that you remain resolute. The attention of the global financial community is focused on the hard decisions just ahead of you that appear to us to require closing banks, changing the ownership and management of those which are saved, and permitting foreign banks to help you build a vibrant banking system. These decisions will be viewed as critical indicators of who runs Russia's financial policy.

We also recognize that the challenge is not just to make the right decisions but to build the tools to implement them -- the right laws, an effective bank restructuring agency, strong regulatory and supervisory capacity. Know that the World Bank, EBRD,US, EU and others are already giving you a lot of advice and technical assistance. We pledge firmly to continue to match assistance to your will and progress on bank restructuring.

Want to emphasize as well that our objective is not just to help you close banks but also to help make remaining banks effective agents for channeling Russian and foreign savings to the Russian private sector. We have consistently and strongly supported the model EBRD small and micro lending program in Russia. Its remarkable success and repayment record has been achieved through intensive efforts to combine financing with training -- training of loan officers and credit managers so that they are willing to take risks because they know how to assess risk.

(3) Investment climate -- the rule of law, property rights, bankruptcy, anticorruption efforts:

It is no mystery that new business are not created in Russia, especially in the formal sector, when contracts aren't enforced, debts aren't paid, bureaucrats and others extort payments, tax authorities are arbitrary and capricious, and banks can't or won't provide financing.

There is simply no substitute for dealing with the basic legal, tax, and regulatory environment. That is the reason that Western businesses, such as those in the energy sector, have absolutely insisted on remedies such as the PSA legislation.

Want to stress that the issue is not tax holidays and preferential treatment of foreign investors. It is the establishment of a requisite degree of certainty with respect to the environment in the "formal sector" that Western businesses need in order to make investment decisions.

(4) Industrial restructuring:

Industrial restructuring requires 2 basic catalysts: (a) motivation in the form of profit-seeking or at least avoidance of bankruptcy, and (b) financing. The current Russian environment supplies neither.

In Russia's "virtual economy", managers who fail to pay taxes, wages, and other debts do not fear bankruptcy and have little incentive to seek profits, especially recorded profits. It follows that strengthened corporate governance and shareholder rights and effective bankruptcy laws and enforcement are critical.

Schemes which encourage the merging of companies under renewed state ownership without changing the incentives facing the new, larger enterprise will simply shift the burden of absorbing losses back to the state. And, as I said earlier, the objective is not just production, but production of items people want to buy.

Foreign investment, as well as restructured sound banks, can play a critical role in financing well-managed enterprises. Some have suggested that regions might compete for foreign investment, not through tax holidays, but through strengthened tax and regulatory regimes. Such investments could be facilitated by guarantees, lending, or equity stakes from international financial institutions.

The investment climate and industrial restructuring are both areas where we and others, such as the World Bank and EBRD, stand willing to offer assistance.

o Russian progress in these 4 areas would be the basis for resumption of support from the international financial institutions. But results are crucial -- macroeconomic policy has to be firmly aimed at stability, taxes have to be collected, banks closed, anticorruption measures enforced, foreign investment attracted.

o Want to stress our hope that you will not neglect your engagement with the World Bank on urgent growth-promoting reforms as you consult with the Fund. We very much support the goal that programs with both institutions move together in concert.

o The largest pools of money are in private hands. Russia's eventual return to private markets is first and foremost dependent on the implementation of an economic program which assures investors that Russia's economic performance will improve and that Russia will be able to meet its debt obligations. Russia would be foolish to float more "junk bonds" now, even if it could.

o We fully recognize that Russia's near-term external obligations greatly exceed available foreign exchange. You now face hard choices about which obligations to meet. I would add that it is our perception that a strong underlying Russian desire to honor its external debts makes these choices particularly hard.

o As you make these choices, I would urge that three considerations guide your course.

(1) Progress toward agreement with the IMF is critical. The scope of what official creditors can do for Russia is fundamentally and critically determined by this criterion because creditors must have some confidence that Russia can meet its obligations.

(2) Serious and ongoing consultations with creditors, both public and private, are also crucial. Any perception that Russia is acting unilaterally, without listening and attempting to respond to the interests of creditors, is particularly harmful, and the damage will be hard to undo later. Cooperation is the name of the game.

(3) Your decisions will be judged against the test of whether creditors, other than the international financial institutions, are treated on a comparable basis, as noted in Mr. Mayer's letter to Mr. Zadornov. The test of comparability applies both to payment and to non-payment. In this regard, your apparent intention to single out pre-1992 Soviet debt for non-payment is consequential and of considerable concern to Paris Club members

Want to stress in particular that it is impossible for the US or any other Paris Club member to defend an arrangement that treats obligations to private creditors as somehow more worthy of payment than obligations to US or other member taxpayers.

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. outline	re: Japan, Asia, & the Yen (2 pages)	06/13/98	P5

COLLECTION:

Clinton Administration History Project

OA/Box Number: 24124

FOLDER TITLE:

[History of the Department of the Treasury - Supplmentary Documents] [9]

Jimmie Purvis

jp38

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advise between the President and his advisors, or between such advisors [a)(5) of the PRA]
P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

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PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).
RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

b(1) National security classified information [(b)(1) of the FOIA]
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b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

6/13/98

1. POTUS call to PM Hashimoto.

- Emphasizes gravity of situation, importance of early statement outlining general commitment to take additional policy actions -- to support strong and stable yen, to strengthen domestic demand, and to fix the financial system, to be followed by concrete steps post election.

- In support of a credible commitment along these lines, the President would offer to explore ways to cooperate in the exchange market to support the yen.

2. Exchange market intervention.

- U.S. initiates in New York, followed closely by Japan. (No other countries to join, at this stage.)

- Modest amount. Say U.S. $1 billion, Japan $2-3 billion.

- U.S. statement emphasizing seriousness of our concern for implication of a weak yen, our support for further efforts by Japan to strengthen the economy and financial system. [See attached.]

3. PM Hashimoto's statement.

- As close to current draft as possible, with following three main messages. [See attached.]

  - Strong and stable yen critical to Japan.

  - More fiscal action if necessary.

  - Clear shift in strategy in financial sector, to be implemented quickly.

  This statement would be general by design, recognizing constraints imposed by election and the reality that they do not yet have a fully developed plan for the financial sector, or the consensus yet for more dramatic fiscal action.

- To follow within 12 to 24 hours of intervention.

4. Reinforcing calls to political establishment in Japan.

- Miyazawa, Takeshita, Kato, Kajiyama and Foreign Minister.

- Emphasizing importance of follow-up, post election.

5. Possible G-7 Statement

- Echoing our statement, expressing support for Japan's effort to strengthen domestic demand and the financial system, and emphasizing a commitment to cooperate in exchange markets to support the yen, as appropriate.

6. Calls to Chinese leadership, and other key Asian finance officials.

- To emphasize the depth of our concern with yen, outline our approach.

7. LHS travels to Japan, China, and then Chairs meeting of Manilla Framework Group.

- In Japan, accompanied by appropriate Fed/OCC officials, meets with range of officials and political leaders, to explore details of post election policy steps, particularly in the financial sector.

- In China, outline Japan strategy, reinforce importance of China maintaining current exchange rate stance, explore nature, degree of pressure they face to devalue.

8. Manilla Framework Meeting

- Highlight generalized concern with Japan and the yen. General statement along the lines of the G-7.

- Review state of play in rest of Asia.

- Explore new initiative to augment IFI support for social safety net, and possibly other steps.

Withdrawal/Redaction Sheet
Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. letter	From Kenneth Kizer, Under Secretary for Health; re: Claims Involving Disabilities or Death Based on Tobacco Use During Active Service (2 pages)	02/14/97	P5

COLLECTION:

Clinton Administration History Project

OA/Box Number: 40511

FOLDER TITLE:

VBA History Project - Compensation & Pension - Claims Involving Tobacco Use During Active Service]

Jimmie Purvis

jp15

RESTRICTION CODES

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DEPARTMENT OF VETERANS AFFAIRS
Veterans Health Administration
Washington, DC 20420

IL 10-97-008
In reply refer to: 112

February 14, 1997

UNDER SECRETARY FOR HEALTH'S INFORMATION LETTER

CLAIMS INVOLVING DISABILITIES OR DEATH BASED ON TOBACCO USE DURING ACTIVE SERVICE

1. This Information Letter provides new guidance for compensation and pension (C&P) examiners on claims involving the use of tobacco products while on active duty. On January 28, 1997, Veterans Benefits Administration (VBA) sent their regional offices guidance on the adjudication of claims on this subject.

2. In Department of Veterans Affairs Opinion of General Counsel Precedent (VAOPGCPREC) 2-93 dated January 13, 1993, the General Counsel (GC) addressed the issue of service connection for disabilities or death resulting from the use of tobacco products in service. The essential holdings of that lengthy opinion, for purposes of this discussion, were that tobacco use does not constitute drug abuse, for purposes of statutes barring service connection of disability or death resulting from drug abuse, and that direct service connection of disability or death may be established if the evidence shows that injury or disease resulted from tobacco use in line of duty during military, naval, or air service. During the March 4, 1993, Judicial Review Conference Call, VBA regional offices were advised to defer action on claims involving the use of tobacco products during active service and to maintain a log for control of the cases. Effective immediately, VBA regional offices have been told to pull and adjudicate all cases on that log. The Veterans Health Administration (VHA) C&P examiners should be aware that they will be receiving an increase in their workload for this reason.

2. Medical research has identified many diseases that may be potentially caused by the use of tobacco products such as cigarettes, cigars, pipe tobacco, snuff, and chewing tobacco. Disabilities that may be caused by cigarette smoking include, but are not limited to, cancer of the lung, larynx and esophagus, coronary artery disease, atherosclerotic peripheral vascular disease, emphysema, chronic bronchitis, and chronic obstructive pulmonary disease (COPD). Cancers of the cheek and gum have been potentially linked with snuff and chewing tobacco. Medical literature has also indicated a possible link between cigar and pipe smoking and cancers of the lip, tongue, larynx, and esophagus. There may be other disabilities related to the use of tobacco products.

3. **VHA C&P examiners need to be aware that they will be requested to express an opinion on the relationship of tobacco use in service and current disability**. Review of the claims folder will be necessary. Such an opinion must be supported by factual information about, and assessment of, all pertinent issues, including the following: the relationship of tobacco use to the

specific disability claimed; the extent of tobacco use during service, as well as before and after service; the presence of other risk factors for the claimed disability and their relative importance as causal factors; the time of onset of the claimed disability; and, if applicable, the effect of cessation of smoking.

4. It is hoped that this information will be helpful to VA medical center staff, especially C&P examiners and their administrative staff, since the claims for these disabilities are now being processed. This information needs to be shared with all C&P examiners in order to make them aware of this new guidance and to prepare them to handle the influx of new claims.

/s/
Kenneth W. Kizer, M.D., M.P.H.
Under Secretary for Health

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. transcript	re: Jack Thompson's Transcript (8 pages)	ca. 1997	P5

COLLECTION:

Clinton Administration History Project

OA/Box Number: 40511

FOLDER TITLE:

VBA History Project - Compensation & Pension - Training Transcript for Class on Tobacco Claims

Jimmie Purvis

jp16

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

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5-5-4.

Jack Thompson's Transcript

Jack Thompson: I thought I'd begin this morning by talking a little bit about how the Department stumbled into this issue and contrary from some points of view it is not an issue that was necessarily the General Counsel's creation. In 1991, when the Court of Veterans Appeals in the *Sawyer* case, 1 Vet. App. 130, Judge Steinberg, in a concurring opinion, said that it was possible that the claimant could on remand establish service connection for his disability based on the
14- year history of smoking in service.

Not to long after that in 1992, a case came up to the Board of Veterans Appeals. The case involved a veteran who served from 1938 and 1945, strayed from service, and went back in 1949 and served until 1967 and then retired from the Air Force. He died of lung cancer which is why the death claim was probably based on the Jet fumes and other chemicals to which he had been exposed in service. When the case got to the Board, they got an independent medical expert opinion. Based on that expert's review of the file, he came back to the Board and said it is more likely that the veteran's 40 year history of smoking was the cause of the veteran's lung cancer. That prompted the Board to say: "Do we service connect on the basis of smoking?"

The BVA wrote out a list of questions and sent them over to General Counsel and we answered them. Really pretty simple questions when you look back at them. They asked first of all is Nicotine Dependence a disease? I am not sure why they asked the General Counsel that, but that was the first question they posed. Then they asked is smoking in service willful misconduct. They asked is it abuse of a drug. Back in 1990, Congress had precluded service connection for disabilities due to abuse of alcohol or drugs. Finally, they asked does the law permit direct service connection on the basis of smoking in service.

Well, I think they were just sort of looking for a hook because exposure to smoke versus other toxic substances in service certainly can lead to direct service connection. We told them to so in the 1993 opinion. I think it reconfirmed what they already currently do. We said whether Nicotine Dependence is a disease is really a factual question. It's not a legal question. We told them what the legal ______ since then constitutes the disease? We really want them as fact finders to make that determination.

We wrote back to them and told them what the VA regulation on willful misconduct is. We said again, we can't give you a legal opinion. We can tell you what the law says. You have to apply that law to the facts. You are the fact finder. You have to decide whether it is willful misconduct.

And then we have the history of the 1990 Act and talked about what Congress meant when it ruled off limits disabilities due to abuse of alcohol and drugs. For such drugs it is clear they meant: "A" illegal drug that you weren't even authorized under the law to use. And, number 2, legal drugs used in a way that are not intended. In other words, "abuse." Clearly, the use of a legal product such as tobacco used in its intended way is not the abuse of tobacco.

Now as we all know, if you have read the papers the last year or so, the FDA has said that nicotine is a drug and therefore, the FDA can regulate tobacco production. But, even if its a drug which it has become to be, using it is not abuse of drugs. This 1993 opinion set certain things in motion. The first discussions I had with Secretary Brown when he came on board were just a month or two after the January 1993 opinion came out. He said, "what were you thinking when you wrote that opinion." We had a long discussion about it and he said, "That is the dumbest damn thing I ever heard of." It wasn't so much he disagreed with the opinion as with the state of the law. Veterans Benefits laws especially service connection is an extremely liberal concept. So he said, "let's write up legislation that will preclude service connecting things on the basis of their relationship to tobacco use." We worked that up and submitted it initially in 1995 to the Office of Management and Budget, it didn't clear OMB. However, in the fall of 1996 it was included as a legislative proposal when the President's budget was prepared. The President's budget request for VA was prepared and it was in the budget documents that were sent to Congress in January of this year. The formal proposal went up in a letter in May. We are on record as saying that the law as it currently exists is kind of silly. It makes the government responsible for the veteran's smoking in service and, as we discussed, in some cases even for smoking post service. This really exceeds the government's responsibility to veterans. Veterans are no more or less able to make decisions about smoking whether they should engage in it or not.

We had a House Veterans' Affairs Committee hearing earlier this year that included that Bill along with several others. There is going to be a Senate Veterans' Affairs hearing next week where it is also on the agenda. It does not appear at this point that Congress is going to act on the legislation this year. I think they're going to become more interested if the new administration testament of the potential costs and savings is prepared in the next very few weeks. I am optimistic that by next year Congress is going to get serious about this and probably in the second session of the current conference beginning in January will take a real serious look at this.

The bill as it went up would preclude service connection for post service diseases whose only relationship to service is the theoretical link to smoking in service. It makes no distinction between whether you smoke prior to 1965 when the first Surgeon General's warnings were on the packs. Congress might do something about that, they might break out into classes the eligibility of people depending upon when they did their smoking. I think certainly by next year we'll have an idea as to whether there is going to be any sort of legislative relief.

I'd like to mention though that our bill would not preclude service connection for such claims filed up until the date of enactment of the law. That really is necessary from a public policy stand point because the department, especially given the history of the difficulty that we've had dealing with this, you couldn't very well say that all the cases we've been sitting on for these many months should be denied. It would look almost as if we did delay them as being in anticipation of getting legislation. So it would be prospective only and I don't anticipate Congress would do anything else.

There was a Court of Veterans Appeals decision in 1995 that predated our recent opinions on Nicotine Dependence and I want to mention that also before I put this thing in historical prospective. We talked about the Board's decision in that case. This is a World War II veteran who served only from only 1944 to 1946. Thirty-five years later, in 1981, he was diagnosed with emphysema. The Board of Veterans' Appeals service connected that emphysema based on findings that of Nicotine Dependence from service. That dependence evidence included the letter he had written to mom back home saying he was up to a pack and a half a day smoking and said, "I know I need to cut down, but it is certainly hard, Mom." He continued to smoke and thirty-five years later chronic obstructive pulmonary disease. The Board service connected, on the secondary basis classic of the secondary service connection we're talking about today.

That led Compensation and Pension Service to request some additional guidance from General Counsel. Is this really what the law provides for? Is this what we anticipated? Is this what we are expected to do? And, we came back and stated: "Pretty much, yes." If you establish that Nicotine Dependence is a disease, which Dr. Keiser has pretty much put to rest, that is what the fact is. If you establish that Nicotine Dependence in service was acquired in service, and it gets back in the resulting smoking led to a full service disease, then you service connect it on the secondary basis.

We wrote that opinion knowing how difficult all these questions of proof are. We realize we have the easy job. What the law says is what the law says. In most cases it is already spelled out right in the regulations, but you folks are the ones that have to deal with it. We can help in my office only to the point of saying what the law says. We don't tell you how to do it or how you are supposed to make these ridiculous _____. But that is what the law says and you have to apply the law. Frankly, until we start applying the law and awarding benefits, we are not going to get the attention of Congress to start with our legislation. To date, every question we get from them about this. Is this really a problem? Is this really going to cost a lot of money? Is there really cost avoidance to be gained from enacting such legislation because its not. Its not necessarily popular legislation that the veteran service organizations, national offices of the veteran service organizations are on record as opposing our legislation on the basis that it is just unfair. These veterans' habits were actually facilitated by the military and so VSOs are opposed to it. Congress needs a reason to enact.

There is a team working it up as best as they can an estimate of the cost of this but that is only a "swak" Until there is some actual proof of the cost, and that's the reason Compensation and Pension Service is asking you to keep good records on the statistics on the number of claims and the number of claims allowed. This is going to be kind of a hard sell. From where I sit, the legislative council as well as the legal council on this issue, I've got pretty mixed feelings. I do think public policy as affected in the law doesn't make a lot of sense. In fact, I think the more it is known to the public at large that we compensate for things such as that, the less support there is going to the program and at some point the bubble is going to burst. I agree very much with Secretary Brown that the law should be changed. Congress needs to address it. At the same token, until that happens, you need to apply the law in the same even handed and even liberal fashion as we do with respect to all other claims. That is the end of the remarks I have prepared and I am more than happy to discuss any of this among any other questions.

Question: I think it was significant the fact that you said in the lead case that this man from World War II got a lot of letters to his mother where he pointed out that he is addicted to nicotine. Now, I would assume in the vast majority of cases this won't be the case. Could that be for the lack of better word an "out" for establishing Nicotine Dependence? Do you agree that it would be rare that we would get in writing a statement that "I fear that my smoking is getting out of hand or something"?

Jack Thompson: I think probably it is rare. But, I think all that needs to be done is follow the drill that you're being given as to what well-grounds the claim and at that point we have to develop. I think it's a easier case once we've got hard documentary evidence of tobacco-use.

Question: I'd like to ask a question concerning the fact that we take two legal drugs, alcohol and nicotine, and we look at them entirely at 180 degrees apart. I just wandered if part of the actual willful misconduct as it affects Nicotine Dependence may be more of a medical question than anything else. Does anybody determine whether or not you can suffice to compensate for the dependence here on 5 or 6 cigarettes a day and then for the guy who has 2 ½ packs is that willful misconduct? I mean technically speaking numerous days seven days a week for your entire life classifies as an alcoholic by some, you are probably not going be functionally deficient or you are going to wind up to an alcoholic disease. But if you belong to a six pack or two a day, then you wind up with a willful misconduct. Has anybody ever tried to find out medically whether or not you could smoke a sufficiently low number of cigarettes, probably never came up with a disability and you shouldn't have that as willful misconduct?

Jack Thompson: Just think at some point the consumption reaches a point where its abuse.

Question: Yes. Which is what alcohol is. Exactly the way we deal with alcohol.

Jack Thompson: Willful misconduct, given way the current the regulation is written, I think there is some real difficult obstacles in light of the misconduct application to smoking . What the regulation said again is that conscience wrong doing, deliberate or intentional wrong doing with knowledge of or wanton and reckless disregard for the probable consequence. Probable as opposed to possible. We have some old opinions of the Solicitor in the Veterans Bureau that say it is not enough that the well-informed person would know that the conduct he is engaging in possibly could hurt him. That particular individual had to know that it was probable and more than likely than not that he was going to be harmed.

Most smokers today don't get lung cancer. Most lung cancer victims are smokers but I don't think the odd bar for most smokers is better than 50/50 that you're going to get lung cancer. We said in the 1993 opinion only what misconduct, at least under the law and regulations that we are working under today, would be very difficult and I continue to believe that. That is an issue, however, that I think the Department is going to continue to look at. Maybe more General Counsel considerations of that. More of a look as to whether the regulation is tighter than it needs to be with respect to misconduct. Is there a difference between somebody who smoked in 1964 before the Surgeon General's warning as opposed to someone who began smoking in 1966? The first warning were pretty mild. The Surgeon General said it may be hazardous to your health. By 1970, 1971 Congress stiffened up the warnings. The Surgeon General had determined that it is hazardous to your health. All of this stuff has to be rethought, but for now it is a really tough case to make.

Question: It seems to me that there would be a little more emphasis on that in your discussion, and the original opinion dealing with 1965, the labeling be that it may be hazardous and then it changed in 1969 to it is hazardous. Then, I heard you say that the veterans awareness of potential health consequences at the time the veteran engaged in cigarette smoking in relevant to this inquiry as to willful misconduct. It seems as if we are not really going to go there.

Jack Thompson: Well again, we have the easy job. We say here is what the law is, here's the things that are relevant you guys have to make the call. So, I go a little beyond what I should even say giving my opinion would be a harder case to make.

Question: I think probably we must have evidence that shows that it was willful intent somehow for the cause of the smoking. I think otherwise we may not be dealing with the issue of willful misconduct.

Jack Thompson: This is a slippery slope. I know many situations that we don't look twice at a claim where a veteran was playing flag football in service. You don't think twice about that game for willful misconduct so think about it. When I played touch football in service, I knew there was a good chance of getting my ankle stepped on or to step in a hole. Was it probable? It's really kind of the same situation. I see it as a legal activity, yet I knew there was some risk. I mean how different is it. Can they put a little warning on the football.

Question: How we deal with words, should they have known, could they have found out. Warning labels on alcohol have only recently been done. It takes one abuse that for 25-30 years we actually recognized and printed a warning on and we take another one which we never printed a warning on. On the one we never printed a warning and it becomes willful misconduct. Kind of interesting.

Jack Thompson: The question is that maybe smoking is not quite the same as abusing drugs. But we are saying for sort of the same public policy reasons, VA should not be in that business.

Question: It is kind of a cultural thing here, we've known forever that alcohol turns you into a loser and can kill you. This thing has just came along recently that smoking causes problems. Yet, culturally we are living with the abuses.

Jack Thompson: There are still a lot of parallels for alcohol. On the face of it, there was the Officer's Club and rations in the field that included cigarettes. [tape is garbled and rest of comments can not be heard]

Question: The GC opinion is going to be published in the Federal Register. Is there going to be a public comment period?

Jack Thompson: No. The reason it will be published in the Federal Register is that it puts the public on notice that it is the GC's interpretation of the law. If a GC opinion would be harmful to someone and would restrict benefits, you can't use the opinion against somebody until it has been published in the Federal Register. Technically, the public is on notice that that is the way VA views the law. This is an interpretative rule as to this is what the law is.

Question: There must surely be a term proximate from a legal stand point that is clear as to what proximate cause is. Could you embellish on that for us?

Jack Thompson: I was trying to think of an example on the train coming up here. Take it this way. Nicotine Dependence in service causes emphysema five years later. Because of my emphysema and my difficulty breathing, I want to move to Arizona. The plane I am taking to Arizona, due to the negligence of the airline, crashes. Nicotine Dependence is no longer the proximate cause. Its to remote and not proximate to my death. In other words, there is a supervening intervening cause.

Question: If you get an opinion from a medical examiner about the Nicotine Dependence and its associated with smoking, cause of lung cancer, that is proximate enough for your purpose?

Jack Thompson: I really don't think you can worry to much about proximate, just think in terms of cause. Did it cause and don't get to hung up over proximate. It is enough that a doctor says that tobacco use is a cause of the disease.

Question: So, when they say possible or that Nicotine Dependence is related to that, that's really not proximate. If it is possible Nicotine Dependence is related to that, we really don't gather cause for it.

Jack Thompson: Proximate cause has to be an indispensable part of the chain of causation. Without it, the injury was not an occurrence. So, if somebody says, it is only possible that it caused, than you have a possible proximate cause you don't have a real proximate cause.

Question: Than how would you argue that the death was not the proximate cause in your example of the airplane crash. That is he would of not had been on that plane if it had not been for that disability. How would you argue that that was not the proximate cause?

Jack Thompson: Well, what you argue is that Nicotine Dependence did cause my emphysema. Clearly, it is the proximate cause of my emphysema. However, I could have lived a ripe old age with that emphysema with good medical care. It was not an indispensable part of the plane crash. The plane crash would have occurred whether I had gone to Arizona to visit grandma.

Question: I have a Doctor's statement that said he went to Arizona, for alleviation of his illness.

Jack Thompson: Even that, if it had not been for the negligence of the airlines, I would have landed safely.

Question: I am looking at paragraph 17 that you add to the opinion as they were stating that in order for the tobacco smoking to constitute willful misconduct in a particular case, the evidence must establish that the smoking involved deliberate or intentional wrong doing and that either the veteran knew or did intend the health consequences of smoking or that the veteran's smoking was wanton and reckless disregard of the probable consequences. If the evidence shows otherwise, I guess we go by the concept that we don't judge the law, we just apply it. You know if the evidence doesn't show that willful misconduct was shown in the veteran involved in his smoking and that it involved deliberate or intended wrong doing, than we won't even consider willful misconduct.

Jack Thompson: The key phrase again, is with "disregard or probable consequences." That's a tough verdict.

Question: You mentioned proximate cause is an indispensable part. Can we be still be talking about lung cancer as a beginning at this point, I think, in terms of proximate cause. But, we're going to have far more cases of arteriosclerotic heart disease in which there are 6 to 8 major risk factors depending on whose books you read of which smoking is always one of them. There is a problem with horror factor or something about hardening of the arteries 25 or 30 years ago. Lots of people who don't smoke get arteriosclerotic heart There are very few people who don't smoke get lung cancer. That's part of the medical nexus that has to be established by the doctor.

Jack Thompson: If the doctor tells you that but for the smoking this heart disease would not of occurred, than you've got proximate cause clearly and the standard is "likely as not." That is kind of a double negative but I think that is the best way of putting it.

Question: In other words, there still has to be a nexus?

Question: Is it more than likely that our medical opinion would say something to the effect of the combination of the hereditary, the smoking and eating habits all contributed and its impossible to weigh?

Jack Thompson: Unless they are saying that take away the lung disease and it wouldn't have happened. I don't know whether you could get you refined now how this question should be posed to the examiner.

Question: I take it you've got a private medical opinion offered to well ground a claim that the connection is there and you've got the VA examiner who says he doesn't know whether it is there or not than you still would be in favor in granting.

Question: The most important thing, I have heard so far, is that nothing is going to change in the law until Congress realizes the impact. The only way they are going to realize that, is by granting. The other thing is, obviously, we are working here consistently. We've got the Board of Veterans Appeals and we've got COVA superimposed on top of Board of Veterans Appeals. If unwarranted denials find their way up to that Court than we need to get some clearer rules on what constitutes acceptable proof, and, it may not be ones the Department is going to like.

Jack Thompson: I think, unless these claims are decided in the same even handed way, with the same objective way that you decide other claims, we could get our heads handed to us because the Court knows that we are on record with Congress as wanting the law changed. So, they are going to be looking for signs that we are resistant to applying current law in an even handed way. So, from where I am standing, if we go out to deny cases it will be seen as trying to evade the dictates of the law. We're going to be in trouble. We'll get case law on this, and likely it will not be what we expect or want.

Question: Given that same analysis though, and the lack of legislation and case law to be pending, don't you see that as a slippery slope with just Nicotine Dependence in and of itself. It seems to me that's the vehicle to get the secondary service connection. But, with the trend in society right now which is virtually a smoke free environment that's becoming in turn, in more and more places, and the inability to smoke may have adverse consequences on people. They say I have Nicotine Dependence that was caused in service. Can't you see that giving use to other disabilities both psychological and physical. It seems that you want to deal with quick and of course its going to get worse, and worse, and worse.

Jack Thompson: I guess I don't disagree. When I first came in a while ago, I heard talking about when you service connect Nicotine Dependence by itself. Suppose the person doesn't have lung cancer or anything else attributed to it. He wants to be on record as having Nicotine Dependence. You should listen to the advice you're getting from Compensation and Pension Service. I would just say that historically, General Counsel has a been of the view that if there is no disability. Disability is different than a disease. You can have a disease that causes mental disability. If you have only a disease incurred in service that is not in anyway disabling, in my view, you don't service connect it. We service connect just the disabilities but that is not to say that its not important to first determine that it is not a secondary service connection case. At issue as to whether that Nicotine Dependence caused emphysema. The regulation (3.310) says if a disability is proximate, and leads to a permanent connected disease. Notice, it doesn't say the term "disability." Now, by that it means a disease incurred or aggravated in service. I think you find, and I am no expert on this, that if you find that the person is Nicotine Dependent by itself, is disabling to a degree. Like you said, the guy can't keep a job because they won't let him go outside every 20 minutes. If it is disabling then you should service connect it. For my money's worth if you do have a claim for service connection for Nicotine Dependence and that's it, I might be inclined to say, depending on the facts, that there is no current disability.

Question: We have been told that Congress isn't really to interested until they really know the impact. Would you elaborate. Are there other reactions from Congress or they feel pressured from veterans groups or the politics of it as to why they don't want to pass it?

Jack Thompson: Let just tell you why they passed so far this year. Primarily it is part of the budget process. The Committee have already been allocated how much money they can devote to the VA's budget for the following fiscal year. Back in the end of May they reported to their budget or appropriation's committee, legislation that would keep them under what their allocated amount is. So, they've met their budgetary goal for this year. They don't really need to find savings for the rest of this session. Now, that's totally apart from whether its good public policy for them to act now and reap the savings later and they have more available to spend on something than they might have to fork over.

Question: Don't they have some idea of how much this will cost? Are they taking it to consideration?

Jack Thompson: It's one thing to say the government is responsible for your smoking in service, it's another thing to say yes by god we're responsible for your post-service smoking too. That is a big jump. If you would like to know when we sent the bill up this year, one of the reasons, OMB scored it because it wasn't determined whether it is cost or savings. They scored it basically as net "0" because they thought that most of the people would compensate based on direct service connection would be military retirees. They were in service long enough so that smoking was probably so much bigger than post-service we would probably be service connecting a lot of those cases. So in the absence of any other intelligence as to what kind of cases, we would be primarily service connecting the military retiree. Well, think about it. A military retiree can retire today and there would be an offset. They would waive their retired pay to get our compensation. It would be sort of a wash. That was the way they initially viewed this, so when we sent our package up there in May with all its flourish and press releases, and everything else, and said, "By the way, we can't promise you any savings." Well, that was pre May 1997 when the Nicotine Dependence opinion was issued. We now need attention with respect to that. We realize now that we're talking about potentially, when you start talking about heart disease in an aging veterans population, we're talking real money. Congress is going to act, I don't see how they can ignore it once that becomes evident. Okay, thank you.