RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:21-JUL-1998 08:50:19.00

SUBJECT: info on forthcoming EIA report on Kyoto

TO: Kathleen A. McGinty (CN=Kathleen A. McGinty/OU=CEQ/O=EOP @ EOP [CEQ])
READ:UNKNOWN

TO: Sally Katzen (CN=Sally Katzen/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: Alan S. Polasky (CN=Alan S. Polasky/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: William J. Antholis (CN=William J. Antholis/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TEXT:

In Todd's office Friday, I was asked for any available info regarding the forthcoming EIA study. As you probably recall, Jay Hakes (Administrator of EIA) was asked by Mr. Sensenbrenner (or volunteered) to perform an analysis of the Kyoto Protocol (I think this was at an April hearing). EIA does not have the capability to model international trading, so they are looking at effects from a range of possible numbers for the amount of reductions that have to be accomplished domestically (from having domestic emissions in 2010 be 7 percent below 1990 levels to having them be 24 percent above 1990 levels -- their take on Janet's testimony). EIA also focuses on carbon dioxide emissions (perhaps exclusively, but we are not completely sure) and not on all gases and sinks, because that is the way their models are set up. They then compute permit prices and economic effects using the DRI macro model and the National Energy Modeling System.

EIA has very preliminary results -- basically printouts -- that suggest the following (these can all change as the results get more definitive):

(1) for the "Yellen testimony" case, permit prices around $50 per ton and economic losses around 0.5 percent of GDP

(2) for stabilizing emissions at 1990 levels, a permit price of $150 per ton and annual economic losses over 1 percent of GDP

(2) for the "Kyoto Protocol done domestically case", permit prices well in excess of $200 per ton (very similar to the WEFA analysis; these numbers are higher than they would be in the SGM model -- though the difference in the assumption regarding trading makes more difference than the difference between the SGM and DRI-NEMS models).

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:22-JUL-1998 20:41:30.00

SUBJECT: posting the climate change document on the CEA webpage

TO: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Mary Fibich (CN=Mary Fibich/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Susan P. Clements (CN=Susan P. Clements/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Alan S. Polasky (CN=Alan S. Polasky/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Should we explore the possibility of posting the climate change report on the CEA webpage? This may reduce the number of hard copies we would have to send out and decrease the time spent by staff handling requests.
Apparently, Dan Chang used to handle all of our webpage work. Do we know who handles this kind of work now? Do we know who the EOP webmaster is?
Joe

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:22-JUL-1998 08:27:31.00

SUBJECT: Re: another possible validator

TO: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
What about Steven DeCanio--who was the mastermind of the Economists'
Statement and heads Redefining Progress?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:22-JUL-1998 10:14:20.00

SUBJECT:

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D13]MAIL445132901.226 to ASCII,
The following is a HEX DUMP:

Council of Economic Advisers

The Current Economic Outlook

July 22, 1998

- Recent changes in forecasts for growth in 1998
- Components of second-quarter slowdown
    - inventories
    - GM strike
    - net exports—the impact of Asia
- Forecast and risks going forward

Indicators of Current Production

Contributions to GDP Growth

(percentage points, annual rate)

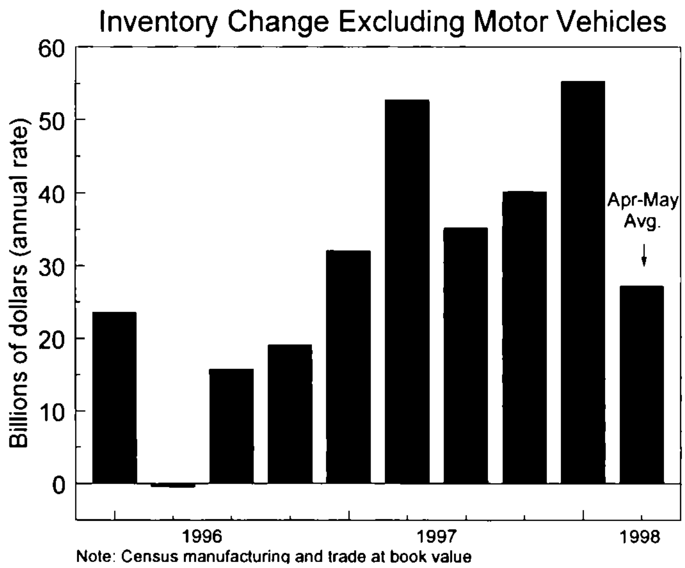
Component of GDP	1998:Q1[1]	1998:Q2[2]
Consumption (excluding motor vehicles)	4.0	2.8
Residential Investment	0.7	0.5
Business Fixed Investment (excluding motor vehicles)	1.9	1.0
Federal Government	-0.7	0.3
State and Local Government	0.1	0.3
Inventory Investment (excluding motor vehicles)	2.1	-1.6
Motor Vehicle Production	-0.4	-0.5
Net Exports (excluding motor vehicles)	-2.4	-2.9
TOTAL	5.4	-0.1
Other Indicators of Current Production		
Production-Worker Hours (percent change)	3.2	0.8
Unemployment Rate (percent)	4.7	4.4
Industrial Production (percent change)	1.2	2.5

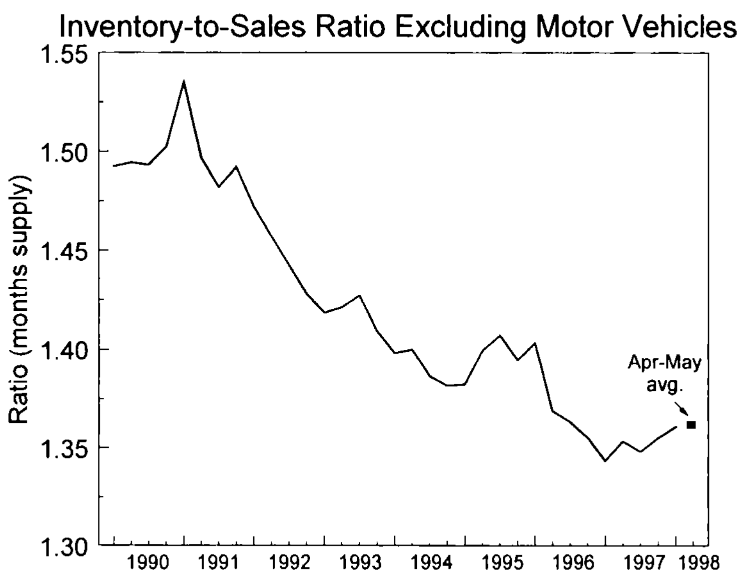
[1]Contributions excluding motor vehicles are CEA estimates
[2]Growth in GDP and its components in 1998:Q2 are estimates.

- Data released over the last week suggest that growth slowed sharply in the second quarter and may even have turned negative.
- Areas of particular weakness include:
  - inventory investment
  - motor vehicle production (GM strike)
  - net exports (Asian financial crisis)
- Other labor market and production indicators tell a slightly different story than the spending components: they suggest positive but slower growth in the second quarter.

- The advance estimate of GDP growth in the second quarter, to be released July 31, is most likely to be in the range of -1.0 to 1.0 percent.

Inventories

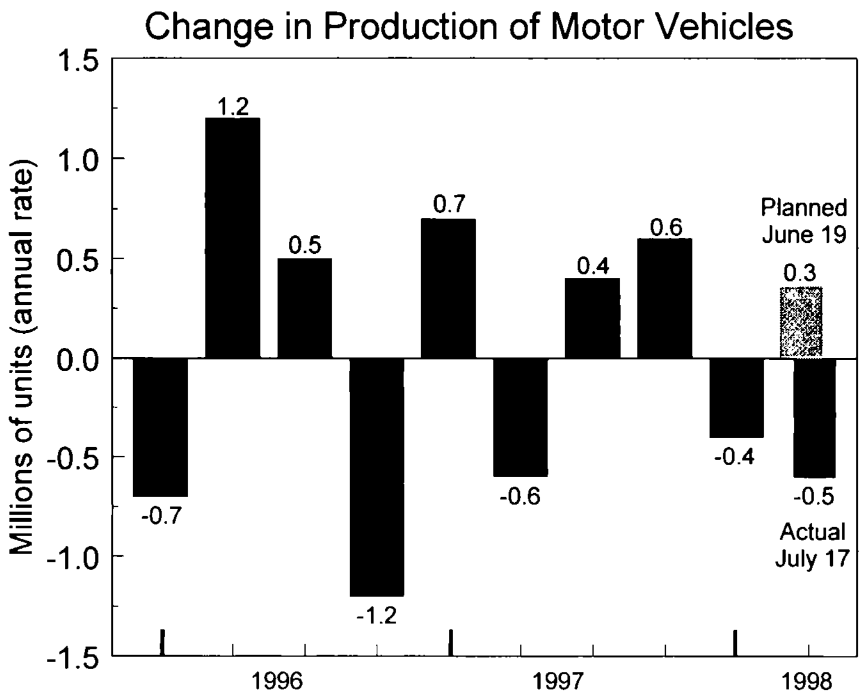




- After a rapid buildup in the first quarter, inventory investment in April and May declined toward a more normal level. A decline in the pace of inventory accumulation temporarily slows GDP growth.

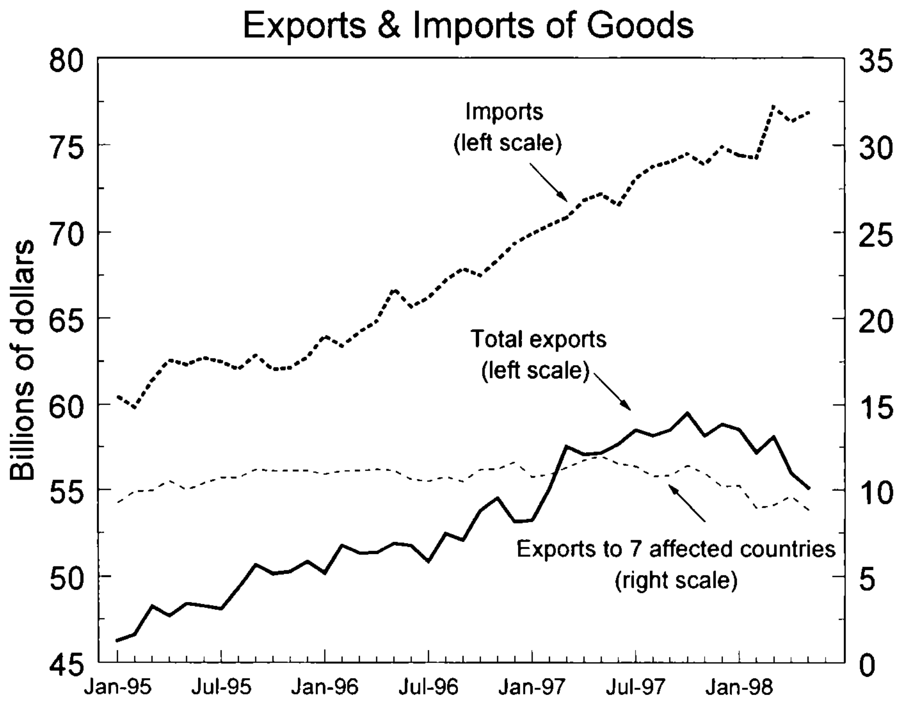
- The inventory-to-sales ratio remains quite low, with little or no evidence of an inventory overhang.

Motor Vehicle Production



- Motor vehicle production fell well short of planned schedules as a result of the GM strike, which subtracted about 0.6 percentage point from second quarter growth.

Net Exports



- Exports have fallen sharply since last year—with almost all of the decline accounted for by exports to seven troubled Asian economies.

Forecast and Risks

Forecasts of Real GDP Growth in 1998

	Q1	Q2	Q3	Q4	Yr/Yr	Q4/Q4
Current CEA Projection (7/22)	5.4	0.0	2.0	2.0	3.0	2.3
Mid-Session Review (5/26)	3.4	2.4	2.0	2.0	2.9	2.4
Consensus forecast (7/18)[1]		0.1	2.0			

[1] Panel of 18 economists polled by Macroeconomic Advisers, LLC.

- Even with zero growth in the second quarter, if the economy settles down to 2.0 percent growth in the second half of the year, growth for 1998 as a whole could be slightly greater than what was forecast in the Mid-Session Review.

- Important risks to the forecast include the following:

  - sharp drop in the stock market

  - worsening of the Asia crisis

  - prolonged GM strike

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:24-JUL-1998 14:29:25.00

SUBJECT: Global Climate Economic Analysis

TO: J (J [UNKNOWN])
READ:UNKNOWN

TO: Alan S. Polasky (CN=Alan S. Polasky/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
fyi
---------------------- Forwarded by Jeffrey A. Frankel/CEA/EOP on 07/24/98
02:26 PM ---------------------------

"Robert_Stavins/FS/KSG" @ ksg.harvard.edu
07/24/98 12:55:52 PM
Record Type: Record

To: Jeffrey A. Frankel/CEA/EOP
cc:
Subject: Global Climate Economic Analysis

Jeff,

I haven't had a chance yet to read the materials you sent the day before yesterday, but I thought I should provide you with an advance copy of a potential Op-Ed on a closely related topic that I believe has been submitted on my behalf to the Washington Post. It's in WordPerfect 6.1. If you have trouble opening it, I can fax a copy instead.

(See attached file: oped2)

Rob

Robert N. Stavins, Albert Pratt Professor of Business and Government,
and Faculty Chair, Environment and Natural Resources Program,
John F. Kennedy School of Government, Harvard University,

79 John F. Kennedy Street, Cambridge, Massachusetts 02138
Phone: 617-495-1820 Fax: 617-496-3783 E-Mail: robert_stavins@harvard.edu
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Assistant: Ms. Marelu Justus, Phone: 617-496-8054, Fax: 617-496-3783
E-Mail: marelu_justus@ksg.harvard.edu

- oped2

==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D1]MAIL45005601H.226 to ASCII,
The following is a HEX DUMP:

Unfair Analysis of Global Climate Economics

Robert N. Stavins*
July 23, 1998
[773 words]

Advocates of aggressive actions to avert potential damages from global climate change are frequently accused — sometimes reasonably — of playing "Chicken Little" by sketching doomsday scenarios of what will happen if nothing is done. But strident global warming skeptics can likewise be subject to this same criticism when they use unduly gloomy economic forecasts of the costs of taking remedial action.

Recently, Wharton Econometrics Forecasting Associates (WEFA), not affiliated with and not to be confused with the Wharton School of the University of Pennsylvania, released a study that suggests grave economic consequences for the United States from any attempt to implement the Kyoto Protocol on Climate Change. There is legitimate scientific and economic disagreement about many aspects of the climate change debate, but the WEFA study, unfortunately, does not make an honest argument. Instead, it provides a worst-case — indeed, an impossible case — analysis of the costs of U.S. compliance.

To forecast the future outcomes of public policies, economists frequently must employ complex and powerful computer models. Every such model contains mathematical assumptions to represent real-world policies or conditions. The WEFA model, as its analysts freely

*Albert Pratt Professor of Business and Government, and Faculty Chair of the Environment and Natural Resources Program, John F. Kennedy School of Government, Harvard University.

acknowledge, omits in its assumptions all of the flexibility mechanisms included in the Kyoto Protocol and in the Clinton Administration's stated policy positions.

First, the WEFA study assumes that no countries undertake emissions trading, even though the right of the industrialized countries to engage in such trading is stated in the Kyoto agreement. Studies by Stanford University's highly regarded Energy Modeling Forum indicate that international trading among industrialized countries could reduce U.S. costs of emission reductions by 50 percent.

Second, the WEFA study assumes that developing countries will do nothing to reduce greenhouse gas emissions. But the Kyoto Protocol establishes the Clean Development Mechanism, which could lower U.S. costs by an additional 20 percent. More important, if key developing countries participate more fully, for example by taking on emissions targets and participating in international trading, the U.S. costs could be reduced even more.

Third, the WEFA study assumes that emissions reductions would occur only through carbon dioxide reductions. But all six major greenhouse gases are covered by the Protocol. Moreover, the Kyoto agreement gives nations the flexibility to choose which greenhouse gases to reduce. Allowing for "trading" across gases could lower costs by another 10 percent.

Fourth and finally, the WEFA study assumes that no carbon sink opportunities for absorbing greenhouse gas emissions are available. But the Kyoto agreement explicitly includes forestry activities and counts them in a way that is particularly attractive for the United States. Including low-cost carbon sink options reduces U.S. compliance costs even more.

By ignoring these flexibility mechanisms, the WEFA analysis fails to assess accurately the costs of complying with the Kyoto Protocol, because the analysis is fundamentally inconsistent with the Clinton Administration's publicly stated approaches to reducing greenhouse gas emissions. As the Administration has stated over and over again, reducing greenhouse emissions can be done smart or it can be done dumb. By failing to account for these flexibility mechanisms, the WEFA analysis calculates the costs of doing it dumb.

Greenhouse gas emissions that contribute to global warming can be reduced cost-effectively by employing market mechanisms. The result is that the economic cost to the United States of complying with the Kyoto Protocol targets can be 10 percent of what WEFA estimates. That's 90 percent less than the WEFA study claims.

The President and Vice President have made it perfectly clear that the Kyoto Protocol will not be submitted to the Senate until there is meaningful participation by key developing countries. Thus, the WEFA study is not only a worst-case analysis, it is essentially an impossible-case analysis. By making a grossly unfair comparison, WEFA raises the specter of "Chicken Little," warning that the economic sky will fall, and thereby further distorting the already contentious and confusing debate over what to do about the threat of global climate change.

Most likely, the economic costs of reducing the risk of climate change will be significant. Contrary to overly optimistic claims about abundant "win-win opportunities," it could cost the U.S. economy between three-tenths of one percent and three percent of annual gross national product to meet the U.S. targets under the Kyoto Protocol, depending on the degree to which flexible, international policy mechanisms are employed. Such costs are not trivial, but neither do they represent national economic catastrophe, as some have claimed. Indeed, none of these cost estimates tell us much of value, in the absence of sound estimates of the other side of the ledger — the economic benefits of reducing the risk of damages due to climate change. The policy process is poorly served by exaggerations from either side of the debate.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:24-JUL-1998 17:57:47.00

SUBJECT: final versions of US h2 papers

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
from Treasury, for Halifax 2
---------------------- Forwarded by Jeffrey A. Frankel/CEA/EOP on 07/24/98
05:57 PM ---------------------------

Nouriel Roubini
07/24/98 11:51:10 AM
Record Type: Record

To: Jeffrey A. Frankel/CEA/EOP
cc:
Subject: final versions of US h2 papers

Jeff, I forward you the following materials I received from Brad Setser
concerning today's Halifax II meeting (in case you did not receive them).
We may want to talk together about this meeting before we go. Let me know.
Nouriel

---------------------- Forwarded by Nouriel Roubini/CEA/EOP on 07/24/98
11:52 AM ---------------------------

"SETSERB%DOM13.DOPO8" <BRAD.SETSER @ treas.sprint.com>
07/24/98 11:09:34 AM
Record Type: Record

To: Nouriel Roubini/CEA/EOP
cc:
Subject: final versions of US h2 papers

Date: 07/24/1998 10:57 am (Friday)
From: Brad Setser
To: ex.mail."nouriel.roubini@cea.eop.gov"
Subject: final versions of US h2 papers

+ draft memo reporting all we have done to Rubin.

bws

- att1.unk
- att2.unk
- att3.unk
- att4.unk
- att5.unk
- att6.unk
- att7.unk

==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D29]MAIL49805701N.226 to ASCII,
The following is a HEX DUMP:

Contributor: United States of America

Limiting government guarantees of private foreign currency obligations

Overview

Government guarantees, both explicit and implicit, are used to promote a number of objectives: forestalling self reinforcing runs on the financial system and on banks in particular; protecting troubled corporations from insolvency, with the associated economic and social costs, including, in some cases, the prospect that corporate insolvencies would result in cascading bank failures; and subsidizing preferred forms of economic activity.

Such guarantees, however, can distort the provision of credit and exacerbate moral hazard, and thus may contribute to the creation of crises. Guarantees that have to be honored impose substantial budgetary costs on the public sector. Measures to consider include:

a) limiting the extension of guarantees;
b) making the scope and coverage of guarantees, or contingent claims on the government, explicit and disclosed;
c) pricing guarantees to reflect the probability of their use.

Guarantees extended to the financial sector, particularly, guarantees of the financial system's foreign exchange liabilities

Banks occupy a special place in the financial and payments system. Banks are also uniquely vulnerable to the sudden withdrawal of credit. Consequently, governments typically guarantee, either explicitly or implicitly, much of the liabilities side of a bank's balance sheet. The proper design of this safety net and the need to strengthen prudential bank regulation are subjects being addressed in the second working group.

Guarantees of the foreign currency liabilities of the banking sector are a matter of particular concern to the international community, since such guarantees often implicitly rely on the backstop provided by the resources of the official community. The second working group's efforts to strengthen national financial systems constitute the first line of defense against the possibility that the resources of the international community will be needed to back or otherwise subsidize the guarantees made by national governments. However, this working group can usefully examine ways to limit the international safety net associated with government guarantees of the foreign currency liabilities of the banking sector.

In a crisis, the international community could refuse to provide sufficiently large quantities of liquidity to allow a country facing an acute payments difficulties to back all of the short-term external liabilities of its financial sector. This would effectively force the government either to negotiate quickly a voluntary or quasi-voluntary rollover of existing external credit lines or to impose a mandatory standstill. Alternatively, the provision of international financial assistance could be conditioned on the negotiation of a rollover agreement that "bailed in" private creditors, preventing international assistance from being used to support the short-term obligations of the banking system.

– Both mechanisms would "lock in" the banking system's external liabilities. Preventing private creditors from drawing down their claims during a crisis imposes costs on the private creditors in the form of reduced liquidity, even if they were not ultimately required to write down their loans, and reduces pressure on the government's reserves and the exchange rate.

– Standstills, however, can be disruptive, may damage a country's credit-worthiness and may affect adversely the flow of funds to emerging markets in general.

-- Such concerns have to be weighed against the moral hazard generated by effectively guaranteeing the short-term foreign currency denominated credits extended to the financial systems of emerging markets.

Guarantees to encourage restructuring and new external inflows after onset of a crisis

After the onset of a crisis, government guarantees can be used to encourage the restructuring and to guarantee the inflow of new funds in order to sustain trade credits and interbank lines. If the guaranteed new funds that flow into the banking system are used to pay for the outflow of old unguaranteed liabilities, external creditors may be trading unguaranteed for guaranteed lines of credit rather than providing new money. Guarantees to attract new inflows during a crisis are most helpful when existing credits have already been locked in, either through a informal roll over agreement or a formal standstill.

Use of exchange rate guarantees to facilitate restructuring of the debt of the private non-financial sector

In the absence of strong insolvency regimes and effective systems of enforcement, or in situations where the magnitude of private non-bank debt problems would overwhelm the existing legal, economic and social infrastructure, the government may need to provide a supplementary framework to encourage prompt restructuring of private debts. This is especially true when the absence of prompt restructuring in the context of a strong insolvency regime is precluding the provision of the new credits needed to sustain the operation of many corporations, thus reducing the value of existing claims on the corporate sector.

In this context, governments have provided exchange rate insurance that protects both debtors and creditors against the risk of additional exchange rate depreciation. In the cases of Mexico' s FICORCA program and Indonesia's incipient INDRA program, these guarantees have involved the creation of an exchange rate guarantee agency which swaps the external liabilities of the indebted corporation for a new liability, denominated in the local currency and owed to the exchange rate guarantee agency. If the company pays the guarantee agency in local currency, the guarantee agency pays external creditors in hard currency.

The prospect of an exchange rate scheme may encourage both creditors and debtors to delay restructuring in the hope of obtaining an exchange rate subsidy. Consequently, such guarantees should not be offered routinely. However, in certain circumstances, exchange rate insurance schemes may have a role in crisis resolution.

The following principles should guide the design of any such guarantees.

-- Exchange rate guarantees should be designed as insurance schemes rather than as schemes to implicitly use the government's hard currency assets and borrowing capacity to subsidize the repayment of private external debt. The insurance provided should be priced to reflect a market-based risk premium and should be designed to limit, to the greatest extent possible, the risks assumed by the government.

-- In particular, governments should only insure against exchange rate risk, not against commercial risk. If private corporations cannot pay the requisite amount of local currency to the guarantee agency, the guarantee agency should not be obligated to provide the requisite amount of foreign currency.

Tokyo Meeting
G-22 Working Group III on International Financial Crisis

Annotated Agenda

The working group will need to address the following critical and often difficult issues in the context of its final report.

Subject Area: Policies to prevent crises and to limit their scope

Topic 1: Scope of government guarantees

Overview: At the London meeting, there was broad agreement that governments need to protect the integrity of the banking system, but should not guarantee either individual banks or the corporate sector. Some participants stressed that it was possible to commit credibly to a policy of allowing individual banks to fail while protecting the stability of the financial system as a whole (Argentine experience). However, many participants noted that the government's protective umbrella tended to expand in the event of a crisis. Some noted that, in certain circumstances, the desire to protect the banking system can lead the government to try to prevent insolvent corporations from defaulting.

Issues relating to design of the national safety nets protecting banking systems are being addressed by the second working group. However, this working group usefully could examine the need to limit the use of the international safety net to finance guarantees made by national governments, and, in particular, measures that might discourage governments from issuing blanket guarantees – which are often perceived to be backed implicitly by the resources of the international community – in an effort to stem a crisis. The working group may also want to examine when guarantees should be used to facilitate a general restructuring of private debt in the event of a crisis and when they should be used to encourage the provision of new credit during crisis resolution and workouts. Some have expressed concern that new, guaranteed credits extended after a crisis may simply replace existing, unguaranteed credits; others have indicated that guarantees may be essential to prompt crisis resolution in certain circumstances.

Background Papers: United States, "Limiting government guarantees;" Australia, "Public guarantees, socialization of risks and ringfencing."

Broad issues: To what extent can governments credibly commit, ex ante, not to provide guarantees to the private sector? In the event of a crisis, how can the outward extension of the government's protective umbrella be discouraged? In what circumstances should guarantees be used to facilitate a debt restructuring? Should government guarantees be used to encourage the provision of certain types of new credits after there has been either a de facto or de jure standstill?

Discussion points: What can we learn from the experience of countries where individual banks have been allowed to fail? Given that guarantees of foreign currency liabilities represent a potential claim on the international community, can we agree that the use of government guarantees should be limited, the scope and coverage of the guarantees should be made explicit and disclosed fully, and that such guarantees should be "priced " to reflect the probability that they will be used?

Topic 2: Effective insolvency and debtor/creditor regimes

Overview: Because national insolvency and debtor-creditor regimes help limit the extent to which corporate financial difficulties contribute to economy-wide external payment problems, the effectiveness of such regimes in facilitating restructuring and exit is a matter of broader interest. Even if legal mechanisms and procedures are infrequently put to use, effective insolvency laws create incentives for negotiated resolution and provide a framework for the restructuring of troubled firms.

At the first meeting, the group indicated that the Secretariat's working paper summarizing national submissions on effective insolvency regimes provided a useful starting point for the development of set of core features or principles of effective insolvency regimes. The group may also want to consider laws governing debtor- creditor relations. These laws provide the framework for the extension of credits secured by the assets of an enterprise and are integral to the operation of an effective insolvency regime. They provide a framework for collecting debts prior to borrower insolvency and determine the rights of secured creditors within insolvency.

Background Papers: Secretariat, "Key principles and features for insolvency regimes;" United States, AKey elements of debtor-creditor regimes.@

Broad issues: Can we agree on the need for effective insolvency and debtor-creditor regimes?

Discussion points: Can we agree to endorse the principles/ features of an effective insolvency regime identified in Secretariat paper? Can we endorse the key elements of debtor-creditor regimes suggested by the United States? Should the group endorse wider adoption of the UNCITRAL Model Law on Cross-Border Insolvency as a potentially helpful means of coordination in multi-jurisdictional bankruptcies?

Subject area: Improving Creditor Coordination

Topic 3. Encouraging adoption of bond clauses

Overview: In London, there was broad agreement on the utility of the collective representation, qualified majority voting and sharing clauses identified in the Rey Report as a means to improve creditor coordination. A number of emerging markets expressed interest in issuing bonds with such clauses, provided that they could avoid the possible price penalty associated with going first. Some suggested that these clauses could carry a permanent price penalty: making default less messy would increase the probability of default. Others felt that a price penalty might not materialize: the clauses would facilitate the orderly resolution of inevitable defaults and consequently would reduce creditors' collective losses. The working group now needs to identify measures that could be taken to encourage wider use of such clauses.

Background Papers: United States, "Implementation of collective action clauses;" Mexico, "Proposed changes to bond documentation;" Hong Kong, "Sample clauses."

Discussion points: How should the international community encourage the use of the bond clauses identified in the Rey Report in sovereign bond agreements? Should the use of such clauses only be encouraged in foreign currency bonds issued by one country in another country, or could their use be encouraged in domestically-issued bonds as well?

Topic 4. Improving coordination between private creditors and the international community

Overview: Several participants have proposed that the official community should set up more formal lines of communication with the private sector and, in the case of a crisis, should coordinate the involvement of private creditors in crisis management and resolution. In particular, it has been suggested that the IMF should be able to bring the main creditors together quickly in the event of a crisis. Consequently, it has been proposed that the official community should establish ex ante rules and procedures to facilitate the creation of a creditors coordination committee in the event of a crisis. There was no consensus at the London meeting on the appropriate role for contacts between private creditors and the IMF/ official community during a crisis or on who should represent the private sector and who should represent the international community in any dialogue between the private sector and the official community. Several members expressed concern that a dialogue between the official community and a select group of private creditors risked divulging confidential, commercially valuable information.

Background Papers: Secretariat paper (forthcoming); Belgium, "Improving creditor coordination."

Broad issues: How would issues of representation (who should represent the creditors and the international community) be resolved in any dialogue between creditors and the official community? Should the official community and private creditors develop ex ante procedures to facilitate the formation of a creditors coordinating committee that would negotiate with debtor countries during a crisis? Should the IMF be able to call for the creation of a creditor coordinating committee and initiate negotiations to extend the maturities of maturing debt during an acute crisis?

Discussion points: There exists a spectrum of potential forms that an enhanced, formalized dialogue between private creditors and the international community could take, ranging in degree of formality and scope from: a) listening to the views of private creditors; b) discussing particular countries with private creditors; c) discussing possible workout packages with private creditors; to d) preparing the terms of a workout package with a select group of creditors that would then be applied to remaining creditors. At what point on this spectrum would the members of the working group feel comfortable? Would the desire for greater communication between the official sector and private creditors be better served by enhanced transparency and disclosure?

Topic 5. Contingent credit facilities

Overview: At the London meeting, there was broad agreement that private contingent credit facilities might provide an instrument to help ease contagion-induced market volatility if used prudently, but there were risks that such facilities might be used imprudently and serve to delay needed adjustment. The Mexicans and Argentines emphasized that such lines provided a cheaper source of liquidity than the holding of reserves and that the need to periodically renew access provided useful ex ante discipline.

Some have suggested that the international financial institutions (IFIs) could create new contingent credit facilities in order to increase the resources that a country might be able to access either before the onset of a full-scale crisis or after the imposition of a de facto standstill on existing payments. Some have suggested the creation of a IFI-linked facility that would provide liquidity to any country that met pre-determined access conditions. Others have suggested that IFI-enhanced credit facilities should be used in the context of an IMF sanctioned standstill as a mechanism to provide new, senior credits.

Background Papers: Mexico, "Mexican liquidity facility;" Argentina, paper expected.

Broad issues: Will such private credit facilities provide for the inflow of new money in the event of market instability? In what circumstances would the use of private contingent credit facilities be helpful and in what circumstances would the use of such facilities only delay needed adjustment?

Discussion points: In what circumstances should countries try to set up private contingent credit facilities? If there were to be new IFI-linked contingent credit facilities, how could access to such facilities be structured? Could some form of credit enhancement by the international financial institutions create a mechanism to provide senior new credits to a country that has entered into a payments standstill?

Subject area: Improving Crisis Management

Topic 6. International assistance in the event of a crisis

Overview: At the first meeting, there was extensive discussion about the appropriate level and form of international assistance in the event of a crisis. In particular, the working group discussed whether or not the international community should provide sufficient assistance to a crisis country so as to avoid the imposition of some type of payments standstill/ private sector involvement. Several participants emphasized that standstills significantly disrupt private markets and consequently should not be initiated routinely or if other options exist.

Some indicated that access to the IMF's Supplementary Reserve Facility or other forms of exceptional financing should, at the minimum, trigger a quasi-voluntary rollover and extension of existing private debt – a rollover/ debt extension that would be prompted, at least in part, by the prospect of an imminent mandatory standstill or involuntary debt exchange in absence of a voluntary agreement. Others expressed reservations about using an arbitrary measure, like a country's IMF quota, rather than economic criteria as the basis for the imposition of a standstill. Several participants suggested that the international community might finance current account adjustment, but not adjustment stemming from outflows originating in the capital account.

Background Papers: Germany, "Preconditions and timing of an involvement of private creditors;" OECD, "Time-consistency in crisis management;" United States, "Use of debt suspensions in international financial crises."

Broad issues: The IMF and official community will not always be available to provide sufficient funds to allow a country facing acute difficulties to make all payments coming due. The criteria that should guide the official community as it decides when to provide assistance, and the appropriate scale of such assistance, to a country facing an acute payments crisis need to be determined.

Discussion points: Should, for example, a distinction be made between current account adjustment/ reserve accumulation and capital account adjustment? Should assistance be based on a judgement about the prospective debt servicing needs and macroeconomic trends in the debtor country? What criteria should guide the decisions of the official community regarding the amount of official financing provided during a crisis?

Topic 7. Voluntary, negotiated payment standstills and mandatory suspensions of payments

Overview: At the first meeting, several members indicated that the international community will eventually be faced with a crisis so large that sufficient official funds will not be available. A number of emerging market countries highlighted the costs associated with suspensions, particularly mandatory suspensions imposed by the government; voluntary agreements with creditors were clearly preferred whenever possible.

The mechanics of any suspension of payments were also discussed briefly. Regling offered a matrix distinguishing between six different possible types of crises and proposed developing *ex ante* procedures for addressing each type of crisis. Some have argued that the government could not require a suspension of payments on private debt without imposing comprehensive capital controls; others have indicated that if a particular category of debt is central to the overall loss of confidence in a country (as were Korean bank liabilities, for example), the suspension of payments on that particular category of debt might stabilize the situation without the use of comprehensive controls.

Background Papers: France, "Standstills as currency/ capital account crisis resolution means;" United States, "Use of debt suspensions in international financial crises;" South Africa, "The South African debt standstill;" Korea, "Korea's experience of short-term debt rollover;" Canada, "How the exchange rate fits in."

Broad issues: What sequence of events should lead to the imposition of a standstill? What measures can be employed to encourage a voluntary debt extension/ rollover? When is a mandatory standstill preferable? When would comprehensive capital controls be needed? What implications does the choice of exchange rate regime have for crisis resolution and workout procedures? Is there a strong need to protect private debtors from legal action in the event of an internationally-sanctioned standstill?

Discussion points: Should there be a presumption that certain types of crises will typically result in a voluntary or a mandatory suspension of payments? Can we agree that the IMF should, when appropriate, informally sanction a standstill by lending into arrears? Can Article VIII.2.b be interpreted to protect private debtors from legal action?

INFORMATION

MEMORANDUM FOR **SECRETARY RUBIN**
DEPUTY SECRETARY SUMMERS

FROM: Caroline Atkinson, Deputy Assistant Secretary for International Monetary Policy

SUBJECT: Material for second meeting of the G22 Working Group on Private-Sector Burden Sharing

As you know, Under Secretary David Lipton will be co-chairing, along with Martin Werner of Mexico, the second meeting of Working Group III in Tokyo on Wednesday, July 29.

The attached annotated agenda identifies what we consider to be the most difficult issues facing the Working Group. The outcome of the discussions in Tokyo will guide the Working Group's final report. In addition, we have prepared several issues papers (attached) for the Tokyo meeting in coordination with the Federal Reserve staff. Treasury papers address the following topics: the use of standstills in international financial crises; limiting government guarantees of foreign currency liabilities; implementation options for bond clauses; principles and features of effective insolvency regimes; and key elements of debtor-creditor regimes.

Summary of key topics

Two closely related topics on the agenda, international assistance in a crisis and the use of standstills, are among the most difficult issues that we will be addressing.

- The working group will consider the circumstances when large scale official financial assistance is, and is not, warranted. We have suggested that, under normal circumstances, official assistance should be scaled to reflect the financing needed to build reserves and to sustain a reasonable current account position during the period of adjustment; not to reflect the quantity of debt coming due in a defined time period that is unlikely to be rolled over. However, exceptional financing might be extended if a debt suspension would risk generating negative systemic consequences and/or in the case when the provision of liquidity, in combination with limited adjustment, might avert a crisis.

- Consequently, a comprehensive approach to the management of future crises must allow for the possibility that a government may need to initiate negotiation of a voluntary standstill and rescheduling of either its own payments or private sector payments, or to suspend either its own payments or private-sector payments until the relevant debtors and creditors reach agreement on a more durable refinancing. In practice, these two options should be viewed as two end points in a range of possible approaches which vary in the degree of coercion employed. Many "voluntary" agreements may be prompted by the imminent prospect of a mandatory suspension of payments or mandatory debt exchange.

The working group will discuss the use of private contingent credit facilities and the possibility that the international financial institutions could create new IFI-linked contingent credit facilities in order to increase the resources that a country might be able to access either before the onset of a full-scale crisis (Hausman proposal) or after the imposition of a de facto standstill on existing payments (Stern proposal).

- We see the advantages of the Mexican and Argentine contingent credit facilities, but doubt that such facilities would provide much new money in a serious crisis and fear that an imprudent government could use such facilities to delay needed adjustment.

- We are not particularly attracted to the Hausman proposal, but are interested in further considering how the IFIs could be used to encourage the private sector to provide senior new credits during workouts/ crisis resolution.

A number of European countries have proposed enhancing coordination and communication between the official community and private creditors. We worry that an institutionalized forum could convey inside information and believe it would be difficult to determine who should represent either private creditors or the official community. The desire for greater communication between the official sector and private creditors would be better served by more regular publication of IMF views and other measures to enhance transparency.

We are concerned by the tendency for the scope of government guarantees to expand just before or during a crisis. We want to make clear that countries should not rely on unlimited use of the resources of the international community to back such guarantees. On the other hand, we recognize that guarantees may have a more productive role in crisis resolution, both by facilitating restructuring and by helping to assure the continued provision of limited quantities of new credits.

The working group has agreed on the desirability of collective actions clauses in sovereign bond contracts. We have identified two strategies to promote the implementation of bond clauses: 1) moral suasion by the official sectors of major financial centers to encourage the issuers, underwriters and fiscal agents of sovereign and quasi-sovereign bonds to use such clauses or 2) requiring that such clauses be included in sovereign and quasi-sovereign bonds registered in major financial centers. A first step would be for the working group to arrange for a respected group of practitioners to draft and endorse a set of model clauses.

Finally, the general counsel's office, in consultation with some outside practitioners and other members of the working group, has drafted a set of features and principles of insolvency and debtor-creditor regimes that we hope the working group will ultimately endorse. We are considering having these principles endorsed by a well-respected organization of bankruptcy practitioners. We hope to piggy back of the work being done in the second working group to help strengthen the incentives for a country to enhance its insolvency regimes.

Attachments:

Tab A: Annotated agenda for Tokyo meeting of Working Group III
Tab B: Treasury papers for Working Group III

– Use of standstills in international financial crises
– Limiting government guarantees
– Implementation options for bond clauses
– Key principles and features for insolvency regimes
– Key elements of debtor-creditor regimes

CC: Lewis Alexander, Federal Reserve
Timothy Geithner
Ed Knight
Michael Froman

rer_tko.wpd
brad setser/imf

[Automated Records Management System Hex-Dump Conversion]

KEY PRINCIPLES AND FEATURES FOR INSOLVENCY REGIMES

Robust national insolvency regimes can help limit the extent to which corporate financial difficulties contribute to economy-wide external payments problems and enhance the efficiency of capital markets. This is because insolvency laws minimize creditors' aggregate losses resulting from borrower non-performance by fostering cooperation among creditors when they are confronted by borrowers in financial difficulty, thereby maximizing asset value and benefitting the economy as a whole. In the absence of insolvency laws, creditors may engage in a socially wasteful race to be the first to seize collateral or to obtain judgment against a debtor. This race may lead to dismemberment of the debtor's assets, to a loss of value for all when the assets are worth more as a whole than as a number of pieces, and to a general loss of market confidence. For this reason, it is in the collective interest of creditors that the disposition of the debtor's assets be carried out in an orderly manner. This coercive aspect of insolvency arrangements enhances social welfare by ensuring that the losses incurred by all creditors are not increased by unilateral actions.

Even if an insolvency regime is infrequently put to use in a given situation, the regime creates incentives for negotiated resolution and provides a framework for negotiating a workout or restructuring outside of court-administered insolvency proceedings. As a result, insolvency regimes can play a vital role in stabilizing the commercial systems of economies in financial distress.

Among the most important basic objectives of an insolvency regime are to maximize the ex-post value of the firm (whether it is liquidated or reorganized); to provide for fair and predictable treatment of creditors when debtors cannot fully meet their obligations; and to facilitate credit in commercial transactions by providing for an orderly, predictable system of liquidation. In practice, insolvency laws are designed to balance the rights and interests of various constituencies in apportioning the burdens of insolvency in a manner consistent with a country's policies and goals.

While there may be variations in countries' approaches, there are certain key principles and features that can be identified as important to an effective insolvency regime for commercial firms.[1] Such regimes should:

1. <u>Strike a Careful Balance Between Liquidation and Reorganization</u>. An insolvency regime should carefully balance the advantages of near-term debt collection through

[1] Financial firm insolvencies, particularly bank insolvencies, entail unique risks which are absent in the bankruptcy of most commercial concerns. For this reason, the key features and principles for insolvency regimes set forth here are intended to apply only to the insolvency of commercial firms and not to financial firms.

liquidation and of maintaining the debtor as a going concern through reorganization. A regime should seek to avoid disruption through massive liquidations and should seek to maximize asset value. Increasing creditor bargaining power may lead to premature liquidations. On the other hand, increasing debtor bargaining power may incur costs and delays, and may affect the cost and availability of credit to the economy. Liquidation and reorganization scenarios alike must contain appropriate incentives for company management.

One of the principal goals of an insolvency regime is to maximize, to the extent possible, the payment of creditors' legitimate claims and the recognition of creditors' rights. An insolvency regime should provide for effective creditor participation through the provision of effective notice of key matters to creditors and for creditors to have a voice in decisions (this is often done by a creditors' committee).

2. Provide for Timely, Efficient and Impartial Resolution of Insolvencies. Insolvencies should be resolved quickly and the operations of the debtor should not be unduly disrupted while the process is underway. Within the context of insolvency, numerous disputes can arise that will require prompt resolution. Deadlines should be established in the law for resolution of specific matters and for the insolvency proceedings as a whole. Consideration should be given to expedited procedures (including "prepackaged" plans), to the establishment of specialized courts or administrative tribunals, and to allocation of considerable responsibility to the trustee to handle insolvency cases efficiently.

3. Prevent a " Race to the Courthouse" or Fire Sale of Assets by Creditors. An insolvency procedure should be orderly and prevent a "race to the courthouse" by individual creditors seeking quick judgments against the debtor or a fire sale of assets. Collection of individual debts often reduces the total value of the pool of assets available to settle all claims against an insolvent borrower and precludes reorganizations. A stay of creditor action provides "breathing space" for debtors and trustees to examine the debtor's operations without defending against creditor action and assurance to creditors that similarly-situated creditors will receive similar treatment without having to "race to the courthouse." A critical issue is whether secured creditors are subject to a stay; if not, they may be able to undermine the proceedings by selling assets they hold as collateral that are vital to the debtor's business. Some mechanism should be put in place that will assure secured creditors that their rights will not be impaired by a stay.

4. Provide for a Procedure that is Transparent and Contains Incentives for Gathering and Dispensing Information. Transparency and incentives for gathering and dispensing information enable courts, the trustee and creditors to assess reorganization and liquidation options.

5. Recognize Existing Creditor Rights/Respect Priority of Claims with a Predictable and Pre-Established Process. Outside of insolvency, creditors may not all have equal rights; for example, secured creditors may have rights to collateral that are not shared by unsecured creditors. Recognition and enforcement of these differing rights within the

context of the insolvency regime create certainty in the market, thereby facilitating the extension of credit.

As a general rule, the hierarchy of claims established outside of insolvency, or rule of absolute priority, should be maintained in insolvency. Where an insolvency regime disregards the terms of pre-existing contracts, perverse incentives can be established going forward. Senior claims should therefore be paid in full before more junior claims (including equity). An important issue in this context is that insolvency regimes should not discriminate between individual creditors that have equal standing outside insolvency. Clear rules for ranking the priority of both existing and post-petition creditor claims are important in order to provide clarity to lenders, who may be deterred if there is uncertainty as to where they stand in the event of insolvency proceedings.

6. Provide for Equitable Treatment of Similarly-Situated Creditors, including Similarly-Situated Foreign and Domestic Creditors. Similarly-situated creditors should be treated equitably. The ability to recapture assets transferred immediately prior to the filing of an insolvency petition, when such transfers are prejudicial to creditors, also generally helps promote equitable treatment among creditors and creditor confidence.

7. Maximize Value of Assets. Insolvency law should provide for an alternative to liquidation in the form of a possibility to reorganize the debtor firm in cases where creditors would not involuntarily receive less than in a liquidation and the value of a firm to creditors and society is maximized by maintaining the debtor in operation. The maximum value for creditors can often be obtained through reorganization rather than through liquidation. Court supervision of a reorganization should be streamlined to foster efficiency since business rescues often require quick action.

   New financing is critical to the ability of the debtor to reorganize and to the maximization of the value of assets, whether in a reorganization or in a liquidation. Protections, including in the form of priority in eventual liquidation distributions, should be provided to creditors that extend financing after a proceeding has commenced so that they will be encouraged to do business with the debtor.

   When insolvency does not result in payment in full of creditors' claims, consideration should be given to providing a "fresh start" to honest debtors by discharging unpaid debts.

8. Establish a Framework for Cross-Border Insolvency. In order to coordinate among jurisdictions, an insolvency regime should provide for fair rules on cross-border insolvencies with recognition of foreign proceedings like that provided for in the UNCITRAL Model Law on Cross-Border Insolvency.

Insolvency law is meaningless unless enforced in a fair and predictable manner by competent tribunals staffed by professionals trained in commercial matters. The relevant members of the community (the legal and dispute resolution communities, and domestic debtors and creditors) must be brought into the implementation process so that they understand and will utilize the regime.

Comprehensive insolvency reform is not fully effective without parallel reform of the financial system and of other commercial laws. Sustaining or restoring a viable financial sector is key for restoring financial health to reorganized firms and to the economy as a whole. Legal impediments to effective reorganizations should also be considered in such matters as tax consequences of debt forgiveness, conversion of creditors' claims into ownership interests in the debtor, restrictions on transferring creditors' rights, and respect of property rights generally when an entity becomes involved in an insolvency proceeding.

IMPLEMENTATION OF COLLECTIVE ACTION CLAUSES IN SOVEREIGN AND QUASI-SOVEREIGN BOND CONTRACTS OUTLINE OF POLICY OPTIONS

I. In General

The problem of lack of coordination among creditors in sovereign debt contracts is acute in today's environment since a great deal of sovereign debt takes the form of bonds (rather than bank loans) held by numerous creditors, dispersed across various sectors, often having disparate interests. As noted by the Rey Report, clauses designed to improve creditor coordination could be built into international debt contracts to facilitate orderly workouts. Although the Rey Report noted the importance of these clauses, little action has been taken to promote their implementation. A critical question is whether market participants can be expected to include such clauses in their contracts voluntarily and/or whether it is necessary to require that they include these clauses in their contracts. This note suggests policy options for implementation of the collective action clauses identified in the Rey Report in sovereign and quasi-sovereign bond contracts.[1]

II. Identify Groups to Draft/Organization to Endorse Model Clauses

- While versions of collective action clauses are available, it would be helpful to have a larger group of practitioners draft model clauses in order to enhance visibility.

- Working Group could identify and ask a group to draft and an organization to endorse clauses. Drafters should include several noted practitioners representing both borrowers and lenders. Endorsement of the clauses could then be sought.

III. Two Options for Implementation

<u>Moral Suasion</u>

The following suggests several ideas for obtaining inclusion of collective action clauses in sovereign and quasi-sovereign bond contracts short of requiring their inclusion in

[1] While this note deals only with inclusion of collective action clauses in sovereign and quasi-sovereign bond contracts, there is a separate issue of whether to include such clauses in other types of bond contracts (for example, in bonds issued by private corporations) and other instruments.

publicly-registered sovereign and quasi-sovereign bond issues. The ideas under this heading could be pursued as a group, or each on its own.

- **Focus on Issuers**. Sovereign issuers could agree to include collective action clauses in their next bond issues or in the issues of their agencies or instrumentalities ("quasi-sovereign" issuers).

  Major financial center countries represented in the Working Group could also **identify frequent issuers of sovereign or quasi-sovereign bonds in their market** and ask these issuers to include the clauses in their next issues.

- **Meet with underwriters**. Major financial center countries represented in the Working Group could convene the major underwriters of sovereign and quasi-sovereign bonds in their jurisdictions and emphasize to them the importance of inclusion of these clauses in these issues.

- **Meet with major institutional investors.** Major financial center countries represented in the Working Group could meet with major institutional investors in their jurisdictions.

- **Meet with fiscal agents**. Major financial center countries represented in the Working Group could meet with the major fiscal agents in their jurisdictions in order to emphasize the importance of inclusion of these clauses in sovereign and quasi-sovereign issues. Fiscal agents have a role in making sharing and collective representation clauses work.

- **Specific approach**. (1) endorse work on technical drafting of clauses and identify organization to endorse clauses; (2) major financial center countries to engage in educational effort with identified constituencies; (3) major financial center countries to identify sovereign and quasi-sovereign issuers likely to come to their markets soon and gain agreement that such issuers will use clauses; (4) major financial center countries to consider use of clauses in their own issues.

Require inclusion of clauses in publicly-registered sovereign and quasi-sovereign bond issues

- **Major financial center countries could explore options for requiring inclusion of clauses in publicly-registered sovereign and quasi-sovereign bond issues in their countries.**

- **Need to confer with regulatory authorities.** Major financial center countries could confer with their regulatory authorities as to whether requiring clauses in publicly-registered sovereign and quasi-sovereign transactions will be possible. It is possible that in some countries, inclusion would require legislation. In cases where requiring clauses is problematic, major financial center countries could also explore if there are actions that regulatory authorities could take short of requiring such clauses, e.g., by requesting that sovereign and quasi-sovereign issuers include these clauses, but not requiring them to do so.

KEY ELEMENTS OF DEBTOR-CREDITOR REGIMES

Debtor-creditor laws provide the framework for the extension of credit secured by the assets of an enterprise -- both its movable property (framework for secured transactions) and its real estate (framework for mortgages). These laws are integral to the operation of an effective insolvency regime. They provide a framework for collecting debts prior to borrower insolvency, mitigating the overall economic impact of that insolvency. They also determine the rights of secured creditors within insolvency, lessening the effect of insolvency on such creditors and, thereby, on the financial system.

More generally, effective debtor-creditor laws can have positive and economically important effects on the strength and stability of the financial sector:

- When these laws actually permit lenders to take collateral for loans, a secured lender can make a loan to the same borrower that is larger, at lower interest rates, and for a longer term at less risk than can an unsecured lender.

- Laws that permit a wide variety of capital goods to serve as collateral and laws that permit more than one mortgage on real estate make it possible for both lenders and borrowers to diversify risk. Multiple types of collateral permit more than one lender to serve one borrower, avoiding one-to-one relations between banks and borrowers.

- Laws that permit a wide variety of instruments, creditors, and lenders foster the development of non-bank financial and non-financial credit intermediation. In some countries, for example, such alternative means of credit delivery mean that bank financing is only about one-third of total credit; in other financial markets, bank credit is closer to ninety percent of total credit. The lack of dependence on bank credit lessens the potential effect of any banking problem on the financial market and on overall macroeconomic performance.

- Finally, permitting the operation of a broad range of collateral and creditors increases the amount of available credit and broadens its distribution. This reduces the pressures for official directed lending institutions that previously attempted to fill this gap in the name of promoting access to credit.

Certain key elements of debtor-creditor laws can be identified as important to an effective debtor-creditor regime:

1. Creation of Security Interest. The laws should permit: property to serve as collateral with a legal framework for mortgages (for immovable property) and a legal framework for secured transactions (for movable property); all economically important assets to serve as collateral for a loan; and security interests in other than explicitly identified collateral (for

example, generic inventory items) to be created. All economically important agents should be able to act as lenders and as borrowers in secured transactions and all economically important secured transactions should be permitted. The creation of security interests should be inexpensive relative to the amounts lent.

2. Priority. The law should provide for a simple, inexpensive and unambiguous system of assigning priorities to lenders against the movable and immovable property that secures the loans.

3. Registration of Security Interests. Inexpensive public or publicly-sanctioned private providers of registry services should provide rapid, and totally public registration services to permit lenders to readily determine the priority of their claims against the collateral that secures the loan.

4. Enforcement. Enforcement must be rapid and cheap. If current laws and legal institutions cannot achieve this standard, the law should envision mixtures of public (e.g., courts, sheriffs) and publicly-sanctioned enforcement systems (self-help remedies, continuation of proceeds) that will permit such enforcement.

Contributor: United States of America

The Use of Debt Suspensions in International Financial Crises

Issues and Scenarios

Paper Prepared for the Working Group on International Financial Crises

The first meeting of the working group identified a number of critical issues relating to the use of debt suspensions in the management of international financial crisis. Key questions include: when to impose a standstill; who should decide to impose a standstill; whether to try to negotiate a voluntary or quasi-voluntary standstill with private creditors or to impose a mandatory suspension of payments; and what categories of obligations should be included in the voluntary standstill or the mandatory suspension of payments.

A comprehensive approach to the management of future crises must consider the full range of possible debtor-creditor relationships and debt instruments that could generate payments problems. It must allow for the possibility that a government may need either to initiate negotiation of a voluntary standstill and rescheduling of private sector payments, or to suspend private-sector payments.

This paper has two parts. The first explores some broad issues raised by the possibility that countries may be obliged to interrupt debt payments. The second presents an illustrative scenario that highlights certain issues involved in the suspensions of debt payments.

How Suspensions and Workouts Might Be Used

When a government faced with a serious balance-of-payments problem concludes that the government or the private sector may be unable to service its foreign-currency debt, the government is likely to seek assistance from the IMF. In several recent cases, however, the amounts of financing usually available from the Fund would not have allowed the countries involved to make their impending debt payments, and much larger amounts of additional official financing were provided by the Fund, by other international financial institutions, and by national governments. These cases raise two serious concerns. First, limitations on the financial resources of the Fund, present and prospective, may prevent the Fund from continuing this practice, even in comparable cases. Second, large-scale assistance from the Fund may encourage some debtors countries to act imprudently and has permitted some private foreign creditors of the countries in crisis to run down their claims without taking significant or in some cases any losses.

If it adopts and implements appropriate policies, a country that faces a serious balance-of-payments problem can be expected to qualify for assistance from the Fund, including financing from the Supplementary Reserve Facility, when its problem derives in part from the need to make large foreign-currency debt payments. But there may be cases when the Fund determines that it is unwilling to scale its assistance to the size of the country's debt payments, even when those payments become unexpectedly large because of a change in creditors' views about the country's near-term prospects.

The working group will want to consider the circumstances when large scale official financial assistance is the appropriate policy response; and equally, the circumstances when the provision of such assistance would not be warranted. Possible criteria include:

(1) IMF and other official assistance should be scaled to reflect the financing needed to build reserves to a targeted level and to sustain a reasonable current account position during the period of adjustment; IMF and other official assistance should not be scaled to reflect the quantity of debt coming due in a defined time period that is unlikely to be rolled over.

(2) Exceptional financing might be extended if a debt suspension would risk generating negative systemic consequences and/or in the case when the provision of liquidity, in combination with limited adjustment, would might avert a crisis.

If a country facing an acute balance of payments crisis does not obtain sufficient official financing to permit the government and private sector to make their scheduled debt payments, it will need to determine if it will need to suspend some or all of those payments. There are two broad ways in which debt payments can be suspended:

(1) Debtors, including the government itself, can reach informal agreements with appropriate groups of private-sector creditors, who undertake to roll over their impending claims and then negotiate a more durable refinancing or restructuring of those claims.

(2) The government can prohibit debt payments on classes of foreign-currency claims, even by private-sector debtors willing and able to make those payments, with the prohibition lasting long enough for the relevant debtors and creditors to reach agreement on a more durable refinancing or restructuring of the affected claims.

In practice, these two options should be viewed at two end points in a range of possible approaches which vary in the degree of coercion employed; many "voluntary" agreements may be inspired by the imminent prospect of a mandatory suspension or debt exchange. The government will have to choose the appropriate option based on the relevant circumstances.

The informal approach embodied in the first option may do less damage to the country's creditworthiness and that of other debtor countries. Furthermore, an informal approach may be less likely to be viewed as the harbinger of comprehensive capital or foreign-exchange controls and thus prove less likely to aggravate the debtor country's problems by provoking capital flight.

However, an informal agreement, unlike a mandatory suspension, may require that the government and private debtors offer creditors relatively attractive terms to encourage their voluntary cooperation. Such sweeteners may generate substantial costs at later stages, particularly if the large premiums required to encourage a voluntary rollover ultimately undermine the foreign exchange position of the debtor country.

The likelihood of reaching an informal agreement may be enhanced if the debtor government can obtain the assistance of creditor governments to encourage their banks and other creditors to enter into negotiations to produce an informal agreement. The credible threat of a mandatory suspension of payments may also be helpful in convincing private creditors to roll over their claims, though there is a risk that such a threat will provoke a destructive race for the door as creditors scramble to exit prior to the imposition of a formal suspension of payments.

Mechanisms to facilitate the coordination of bondholders would enhance the probability of reaching a voluntary agreement to restructure a distressed debtor's bonded debt. However, in the absence of mechanisms for collective action, it may be difficult to persuade large numbers of bondholders that they should roll over their claims temporarily in a reasonable time frame given the difficulties associated with identifying dispersed bond holders, selecting representatives to negotiate on behalf of the bond holders, and the possibility that rogue bond holders would refuse any agreement. As a practical matter, then, an informal approach, although advantageous, may be most feasible if most of the debt is owed to a relatively homogenous group of creditors.

The scope of any outright suspension on payments should be limited to those forms of debt that involve large foreign-currency payments or may start to do so soon. The announcement of the suspension should be linked to the creation of a framework to facilitate the negotiated restructuring and rescheduling of outstanding claims. This framework will be based on macroeconomic adjustment contained in an IMF program and should clearly indicate what the government is willing, and not willing, to do in order to facilitate restructuring. The framework may need to encourage certain categories of private debtors to negotiate collectively and to identify and eliminate regulatory impediments to debt restructuring.

An effective suspension of debt payments would also need to address several additional issues: Should interest payments as well as repayments of principal be prohibited? Should the suspension cover foreign-currency debt held by the residents of the debtor country? Should it cover debt denominated in the debtor country's currency? What about debt owed to--or by--foreign affiliates of domestic entities? What about derivatives and other off-balance-sheet liabilities? Answers to these questions will depend on the circumstances of the debtor country.

In both an informal suspension based on the consent of the relevant creditors and a mandatory suspension, the debtor country's government will play a major role in initiating either negotiations or the interruption of debt payments. If the circumstances require a suspension of private payments, the government will need to coordinate the behavior of its private-sector debtors – by persuasion in the case of an informal suspension and by coercion in the case of an outright prohibition.

Debt Suspension Scenario

This section presents a debt-suspension scenario which may be useful in highlighting the issues that a debt suspension would raise. The scenario assumes that there will be case when the international community will not provide large-scale financial assistance to a country facing an acute balance of payments crisis, and the country must therefore refinance or reschedule some or all of its foreign-currency debt. The scenario is illustrative, not prescriptive.

This scenario envisions that the government facing an acute crisis will first informally approach foreign creditors and ask them to roll over their claims on both the government and its private-sector debtors. If an agreement is reached for a roll over, it will then seek an agreement on the refinancing or restructuring of the debt at issue. If an informal approach does not yield results, however, the government will impose an outright prohibition of payments on both sovereign and certain categories of private debt and initiate negotiations to permanently reschedule the debt at issue. While the scenario envisions a sequential approach, with the credible threat of a formal suspension employed to prompt an informal agreement, in practice, the government may need to choose between the two possibilities at an earlier stage in the process.

The scenario assumes that the international community will implicitly sanction the suspension through IMF lending into arrears.

Scenario: Effort to negotiate informal restructuring of private and sovereign debt; followed by suspension of payments if no informal agreement is reached.

Notification and Consultation

As soon as there are indications of a serious payments problem, reflected in a depreciation of the currency or falling foreign-exchange reserves, and the government of the country experiencing serious payment problems concludes that it will be difficult for the government or private sector to service or refinance its foreign-currency debt, the government enters into consultations with the IMF to achieve an agreed assessment of the country's situation and the scale of its prospective liquidity problem and to obtain the Fund's advice concerning the policy adjustments that the government should make, including, where appropriate, exchange-rate adjustments, in order to resolve the prospective problem.

If serious debt difficulties begin to materialize despite those policy adjustments, the government of the country experiencing payments problems applies formally for access to Fund credit and begins discussions with the Fund, under expedited procedures, on the design of an adequate policy program.

International Response

If the country's problem is deemed to threaten serious systemic consequences , the IMF and other institutions may decide to provide large-scale financial assistance, subject to strict conditionality, and the country may not be obliged to interrupt its debt payments. However, in general, IMF and other official assistance should be scaled:

(1) to reflect the financing needed to build reserves to a targeted level; and
(2) to sustain a reasonable current account deficit during the period of adjustment;

IMF and other official assistance should not be scaled to reflect the quantity of debt coming due in a defined time period that is unlikely to be rolled over.

If it is decided that large-scale assistance will not be provided, the Fund should indicate

(1) its willingness to advise and cooperate with the government in devising appropriate ways to limit the country's debt payments; and
(2) how much the country will be able to draw from the Fund when agreement is reached on a policy program;

Informal Suspension of Payments

If the government of the country experiencing payments problems determines that the amount of official financing available will not permit the country to make all its debt payments on schedule and the government determines that it does not want to proceed immediately to a mandatory suspension, the government will be obligated to take the following steps, as applicable, given its debt profile:

(1) propose the onset of negotiations with its creditors, with the purpose of first extending the maturity of its obligations coming due in the near term and ultimately refinancing or restructuring its outstanding sovereign obligations,

(2) propose that private-sector debtors enter promptly into discussions with their foreign creditors, with the purpose of first extending the maturity of obligations coming due in the near term and ultimately refinancing or restructuring some or all of these obligations:

(a) foreign-currency debt owed by domestic banks to foreign banks
(b) foreign-currency debt owed by domestic corporations to foreign banks
(c) foreign-currency bonds issued by domestic corporations

(3) put no restrictions on secondary trading in any of instruments listed above;

(4) seek the assistance of creditor-country governments to coordinate the response of their banks and, where appropriate, other creditors and to encourage these creditors, when appropriate, to enter promptly into negotiations;

(5) the terms of arrangements for a rollover/ refinancing will reflect degree of coercion involved in the rollover/ refinancing arrangement; truly voluntary schemes will reflect market conditions – and market conditions will be influenced by, among other factors, the scale of IMF assistance;

(6) governments may seek to employ guarantees and other sweeteners to encourage truly voluntarily roll over agreement; tension exists between desire to rely on voluntarism and desire to minimize use of guarantees;

(7) if foreign currency bonds issued by either the government or domestic corporations need to be restructured, mechanisms to encourage the coordination of private bond holders would enhance the prospect of a voluntary agreement.

Mandatory Suspension of Payments

If no voluntary agreement is reached to extend to the maturity of critical categories of obligations or the government decides that a voluntary agreement is impractical or undesirable, the government will need to take the following steps:

(1) announce the suspension of payments on some or all its own foreign-currency debt instruments, but puts no restrictions on secondary trading in those instruments or the other instruments listed at (3), below;

(2) announce a date by which it will be ready to begin discussions with holders of its own debt instruments (i.e., its private creditors), aimed at reaching an early agreement regarding a resumption of debt payments;

NB: If the government does not have large debt payments coming due, steps (1) and (2) are omitted.

(3) prohibit the making of debt-service payments on some or all of these private-sector obligations:

(a) foreign-currency debt owed by domestic banks to foreign banks
(b) foreign-currency debt owed by domestic corporations to foreign banks
(c) foreign-currency bonds issued by domestic corporations

(4) recommend that domestic banks, if covered by the prohibition, begin consultations among themselves to prepare for discussions with their creditors, aimed at reaching early agreement regarding a refinancing or restructuring of their debt payments,

(5) recommends that domestic corporations, if covered by the prohibition, begin to prepare individually for discussions with their creditors;

(6) announce that it will impose no other restrictions on capital outflows;

(7) in the absence of effective insolvency regimes, or in circumstances when the scale of the prospective problem would overwhelm the existing legal infrastructure, the government may need to propose or assist in developing a framework for out-of-court negotiations between debtors and creditors.

International Response (Continued)

The IMF formally approves the debtor-country's policy program, sets the amount of IMF funding, and indicates explicitly that the debtor country is expected to accumulate arrears pending agreement with its private creditors on resuming the debt payments of the debtor-country government and those of private-sector debtors covered by the prohibition. To facilitate the provision of new credit after the imposition of a suspension on payments, the IMF may indicate that it will lend into arrears on the debt covered by the standstill but will not lend into arrears on credits extended after the imposition of the standstill.

Crisis Resolution

The IMF monitors compliance by the debtor-country government with its IMF program, including the efforts of the government and of private-sector debtors to reach agreements with their private-sector creditors.

The debtor-country government and banks reach agreements with their private creditors.

A refinancing or restructuring of interbank debt is apt to involve more or less uniform terms for all of the debtor and creditor banks, and the negotiation of those terms should thus be conducted by representatives of the two sides. Individual corporate debtors reach agreements with their private creditors or resolve their debt problems by recourse to existing insolvency procedures or special out-of-court procedures established by the government. A refinancing or restructuring of corporate debt is less likely than restructuring of bank debt to result in uniform terms for all debtors. Hence, each debtor should normally be expected to negotiate with its own creditors–banks, bondholders, and others. Where well-functioning insolvency regimes exist, debtors that fail to come to terms with their foreign creditors before the prohibition of debt payments is rescinded risk liquidation. However, in the absence of effective insolvency regimes, there will be a need for the government to propose or assist in developing a framework for out-of-court negotiations between debtors and creditors.

The prohibition on debt payments is ended; it may be necessary, however, to extend the intended duration of the prohibition for certain groups of private-sector debtors.

Economic adjustments resulting from its IMF program–and its agreements with its private creditors–permit the debtor country to resume debt payments on a sustainable basis, and the country regains access to international capital markets, although it may face higher borrowing costs than before the liquidity crisis.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:27-JUL-1998 11:39:41.00

SUBJECT: Press statement on 2nd Quarter GDP (?)

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: Sandra F. Daigle (CN=Sandra F. Daigle/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
I expect that Janet will want to issue a Press Statement on Friday's 2nd quarter release of GDP. Here are some paragraphs that I wrote for the trade release ten days ago (but which were excised from the final statement because Gene thought it was too early to discuss GDP). I feel that these paragraphs would be a good starting point for Friday's statement. =================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D38]MAIL410120218.226 to ASCII,
The following is a HEX DUMP:

FOR IMMEDIATE RELEASE
FRIDAY, JULY 31, 1998

CONTACT: MICHELE JOLIN
CHIEF OF STAFF
(202) 395-5084

Statement by Janet L. Yellen
Chair, Council of Economic Advisers

Quarterly GDP growth is almost always more erratic than projections. Today, the Commerce Department estimated that economic growth slowed to __ percent in the second quarter after an extraordinary 5.4(?) percent annual pace in the first quarter. Three factors took a bite out of second-quarter output: the effect of the Asian crisis on net exports, a drop in the pace of stockbuilding after an extraordinary first-quarter pace, and the strike at GM which cut second-quarter growth by about 0.6 percentage point at an annual rate.

Two of these three factors are temporary: the slowing of inventory investment and the strike at GM. Inventory accumulation has now slowed to a sustainable pace, and so this part of the adjustment to slower growth is behind us. Inventories remain lean with respect to sales, and the May liquidation of retail stocks was most likely a surprise rather than an intended one--given the sharp (1.2 percent) increase in retail sales during that month. Similarly the GM strike is a temporary factor, and the return to work will boost GDP growth by at least as much as it has subtracted thus far.

The erosion of net exports underline the importance of a resumption of economic growth in the Asian region. This requires two elements: the rapid adoption of economic reforms in Japan and the continued implementation of structural economic reforms in the crisis countries. In this regard, a rapid approval in Congress of the IMF refunding is essential to prevent the worsening of economic conditions in the Asian region and which risks denting economic growth in the United States.

American households remain in sound condition. Real disposable personal income grew at a solid 3.6(?) percent annual rate in the first half of the year, and consumer spending was very strong in both the first and second quarters. The Administration continues to project moderate economic growth, with continued job creation and low unemployment in 1998 and beyond. In fact, it remains very likely that economic growth for the year as a whole will be higher than our last official projection--the 2.9 percent growth projected in the Mid-Session Review.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:27-JUL-1998 13:00:54.00

SUBJECT: China and GCC

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
In case you missed it, there is a paragraph in Todd's weekly report to the POTUS on climate change on a Chinese officials' positive statements regarding climate change.
I think Janet and Joe should get FULL credit!

---------------------- Forwarded by Michele Jolin/CEA/EOP on 07/27/98 12:59 PM ---------------------------

Jonathan H. Adashek
07/27/98 08:41:01 AM
Record Type: Record

To: See the distribution list at the bottom of this message
cc: Todd Stern/WHO/EOP
Subject: Weekly Report

Here it is.

Message Sent
To:

Dirk Forrister/WHCCTF/EOP
Shelley N. Fidler/WHCCTF/EOP
Beth A. Viola/CEQ/EOP
Elliot J. Diringer/CEQ/EOP
Roger S. Ballentine/WHO/EOP
William J. Antholis/OPD/EOP
Martha L. Wofford/WHCCTF/EOP

Rosina M. Bierbaum/OSTP/EOP
Julie M. Anderson/WHCCTF/EOP
James W. Rubin/WHCCTF/EOP
peterson_t @ btgcinema.com @ inet
Andrew D. Kauders/WHCCTF/EOP
Michele Jolin/CEA/EOP
Lisa M. Kountoupes/WHO/EOP
Elizabeth A. Arner/WHCCTF/EOP
Irwin P. Raij/OVP @ OVP
David B Sandalow/CEQ/EOP

=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D53]MAIL44081121J.226 to ASCII,
The following is a HEX DUMP:

July 26, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: TODD STERN

SUBJECT: Climate Change Weekly Report (weeks of July 13 and 20)

Congressional

Appropriations. A little good news in the House this week. First, we worked with Rep. Obey on an amendment to override the Knollenberg gag order in the report to the VA-HUD bill. The amendment passed 226-198, with 175 Ds and 51 Rs voting for it. Rep. Greenwood had planned to offer an amendment to neutralize the Knollenberg bill language, but at the last minute, Greenwood, decided to not offer it. We were working this hard, as were the enviros. It would surely have lost, but probably with a respectable vote. Greenwood, along with Reps. Boelhert and Waxman, criticized the bill language during floor debate. Because the Senate bill does not contain any such language on this issue, we are hopeful that we can work with the Senate and these House members to modify the language in conference.

Second, after an initial 213-212 defeat, the House accepted a Skaggs/Fox amendment to the Interior Approps bill to add back $45 million to DOE's energy efficiency budget; $34 million of this was part of our climate change initiative. This still leaves us far below your requested increase of $193 million, but it was an important step in the right direction.

Domestic policy

Economic analysis. CEA's economic analysis, which provides the underpinning to Janet Yellen's February economic testimony on the Hill, is ready for release. There is one open issue that I will address through a separate memo that should be ready for your review Monday or Tuesday.

Federal energy. As you know, we used this week's radio address to roll out the first four elements of your federal energy plan, all related to significantly reducing the use of energy in federal buildings. A good AP story ran in the Sunday *Washington Post.* Your announcement included: (1) a directive to all agencies urging them to maximize their use of energy saving performance contracts, accompanied by specific OMB guidance; (2) a new campaign to replace 300,000 light bulbs/fixtures in federal buildings with fluorescents in the next three years; (3) a directive to agencies to maximize efforts to earn EPA's Energy Star label for their buildings; (4) DOD's and six other agencies' agreement to build all new buildings, starting in the year 2000, according to sustainable design principles (e.g., 50% more energy efficient). We are pressing ahead on the other elements of your federal energy plan. *Auto tax credit.* I met separately with GM and Chrysler this week to see if the logjam could be broken in discussions on an auto tax credit. The discussions to date, led by NEC, CEQ and OVP, have foundered on the companies' opposition to a performance based credit (i.e., a credit for cars that achieve two/three times ordinary mileage for their class). What they would support is a credit for use of specific technologies -- such as hybrid engines. Our side has resisted until now out of concern that unless the credit is performance based, you can't be certain that greenhouse gas emissions will decline; the technology could be put into larger cars so that net emissions, compared to a conventional engine in a smaller car, were the same. GM argues that these technologies will always save emissions because even if the hybrid goes into a bigger car, it'll emit less than a conventional engine in the bigger car. My feeling is that to have an auto tax credit which Detroit would actively support on the Hill would be a huge boost for us -- and would give us a transportation initiative with some zip -- so I want to rapidly explore whether we can't bend enough to make a deal. Adequate acceptance by the environmental community (which likes our performance based proposal) would be essential to make this work.

Industry consultations. We met recently with CEOs from the steel, cement and forest products industries. The meetings were cordial, but there is a good deal of wariness on the part of many of these leaders. They are uncertain about the level of reductions that would be expected of them under a ratified treaty, uncertain about how mechanisms like trading would work, and concerned about the lack of developing country participation. The Asian financial crisis has made this last concern a good deal more acute, especially for industries like steel and forest products facing stiff competition from those countries. The idea that our Kyoto obligations would give these countries *another* price advantage (beyond cheap labor and a devalued currency), riles many of these CEOs. We, of course, stress the value of working in partnership with us, but with many industries, this is going to be tough sledding.

<u>Diplomatic</u>

A senior Chinese official has offered one of the most positive statements from her government to date on the topic of emissions trading. Deng Nan, Vice Minister of Science and Technology (and daughter of Deng Xiaoping), said that China is willing to work with other countries to develop rules for emissions trading and would welcome further discussions with the U.S. on this topic. The remarks came during a ceremony attended by Ambassador Sasser, launching a program to build a demonstration energy efficient building in Beijing.

The G-8 climate change working group held its first meeting last week in London. Talks were constructive, but underscored the wide gaps between ourselves and the EU on the difficult issue of emissions trading. EU officials continue to insist on a percentage cap on the amount of reductions that any country may purchase from abroad.

Communications

Tuesday and Wednesday, *CNN* aired a strong two-minute segment on climate change that included footage of the heat wave in the Southwest, the Vice President's event last week and your speech to the AFT. Anti-climate remarks by Rep. Knollenberg were countered by a litany of recent weather data. On Thursday, *The Los Angeles Times* ran a story detailing your and the Vice President's recent activity on climate change. There was also significant press coverage of the House vote to drop the "gag order." In next week's issue, *Newsweek* is expected to run a piece on the heat wave, its connection to climate change and its agricultural implications.

Editorials. Our editorial mailing of a couple weeks ago continued to pay dividends. The *Washington Post, Detroit Free Press,* and *Los Angeles Times* all editorialized against the gag order provision in the VA, HUD bill. The *Free Press* also criticized the funding cuts. On Sunday, July 12, the *New York Times,* ran an editorial attacking the Knollenberg and other anti-environmental riders. On Friday, July 17, the *Times* editorialized on the heat wave in the South and Southwest and its possible link to global warming.

The Vice President's weather event on Tuesday, July 14, was covered by NBC and ABC in long pieces on the Texas drought, and also received a good deal of print coverage.

United Technologies Corporation pledged to reduce energy use 25% by the year 2007 in over 240 facilities worldwide. A congratulatory letter from you was sent to the CEO, George David.

cc: Vice President
Erskine Bowles
John Podesta
Ron Klain
Jack Lew
Katie McGinty

Mike McCurry
Gene Sperling
Jim Steinberg
Janet Yellen

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:27-JUL-1998 15:29:47.00

SUBJECT: FY deficit: $56 billion over last 12 months

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
The 12-month (trailing) moving-average of the Federal surplus is $56.2 billion. (This seems as good as any other way of projecting the FY surplus or deficit.) The CBO projected $63 billion in their July update.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:28-JUL-1998 11:17:08.00

SUBJECT: Todd Stern's weekly report

TO: Alan S. Polasky (CN=Alan S. Polasky/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D9]MAIL48806441G.226 to ASCII,
The following is a HEX DUMP:

July 26, 1998

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SUBJECT: Climate Change Weekly Report (weeks of July 13 and 20)

Congressional

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next three years; (3) a directive to agencies to maximize efforts to earn EPA's Energy Star label for their buildings; (4) DOD's and six other agencies' agreement to build all new buildings, starting in the year 2000, according to sustainable design principles (e.g., 50% more energy efficient). We are pressing ahead on the other elements of your federal energy plan.
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cc: Vice President
Erskine Bowles
John Podesta
Ron Klain
Jack Lew
Katie McGinty

Mike McCurry
Gene Sperling
Jim Steinberg
Janet Yellen

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:28-JUL-1998 18:49:14.00

SUBJECT: first (partial) draft of Qs and As

TO: Todd Stern (CN=Todd Stern/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: William J. Antholis (CN=William J. Antholis/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TO: Alan S. Polasky (CN=Alan S. Polasky/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Please find attached a WP file with Qs and As (more Qs than As right now). I would like comments on the As as well as other Qs you might have. Thanks,

Joe

=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D30]MAIL410428419.226 to ASCII,
The following is a HEX DUMP:

What portion of reductions does your analysis anticipate will be made in the U.S.?

This report does not present an assessment of the location of emissions reductions. As a part of the Adminsitration's assessment that the costs of reducing greenhouse gas emissions could be modest, we used a model that provides an illustration of the potential costs given effective implementation. This model, SGM, like other large energy-economy models of the world, can only adequately account for some kinds of policies. For example, a system of domestic and international emissions trading can be modeled well with SGM. However, other domestic initiatives, such as funding for R&D and voluntary industry commitments, cannot be modeled with SGM. All models require simplifying assumptions, so while SGM is very well designed to assess international emissions trading, it is not equipped to handle these kinds of domestic policies. Moreover, SGM does not have a land use module, so it cannot assess carbon sinks. While the permit prices we have provided reflect an output of the model where emissions reductions are allocated across regions through the tradable permit scheme, this output should not be considered the Administration's estimate of its efforts to abate emissions domestically. As the unaccounted for domestic initiatives reduce emissions, the permit price and cost associated with the tradable permit system that would be implemented for the first commitment period would fall. The reported permit prices illustrate what we mean by modest costs, and given the equivalent environmental effect of a ton of emissions regardless of its location, the modeling analysis reflects a cost-effective tradable emissions regime that attempts to achieve the goal of Kyoto at least cost.

How much money would be sent abroad? Isn't this a tax on American business and government transfers to Russia?

There will be no taxes on Americans or government trasnfers to Russia. However, U.S. firms -- not the U.S. government --- may choose to purchase international emissions permits if they so desire to meet their emissions obligations -- from Russia or other countires or through the CDM. As with any market transaction, purchases of these pemrits will have to comply with all U.S. legal and regulatory requirements. U.S. firms interested in international investmnent and emissions credits will have an incentive to ensure that other countries meet the international stanbdards for adequately monitoring and reporting their emissions of greenhouse gases. Russia will have a significant incentive to use the revenues to invest in mdern, climate-friendly plants and equipments so that as its economy recovers, it continues to produce emissions reductions for sale on international markets.

If your model does not account for key factors like domestic initiatives, carbon sinks, or electricity restructuring, why did you use that model?

No one model can handle all characteristics of the Kyoto Protocol and the President's policies to reduce greenhouse gas emissions. Indeed, as we have said previously, no one model is capable of providing definitive answers on climate change. However, models can aid our understanding of some of the key policy parameters. As we have seen, both with SGM, and through our review of the literature, including modeling exercises through the Energy Modeling Forum, flexible, market-based mechanisms for reducing emissions are critical to lowering the cost of meeting our target. Because of this insight, we employed a model to illustrate the cost-savings opportunities to trade across space and to trade across types of greenhouse gases. However, while SGM provides a solid understanding of the benefits of trading and the potential permit price under an international trading system, it does not assess other kinds of policies, like our domestic initiatives. This is another reason why we have portrayed our modeling results in the economic analysis as illustrative.

Why didn't you devise some way to factor those elements into your analysis, rather than putting them aside?

The Administration has not included quantitative estimates of emissions reductions associated with electricity restructuring, the CCTI, industry consultations, or the Federal energy program in the illustrative modeling analysis. First, the model can not assess these programs directly. Second, there is uncertainty in calculating the payoffs from funding research and development. Third, the industry consultations are still at an early stage, so it would be premature and difficult to quantify and incorporate emissions reductions from consultations into the illustrative modeling analysis. Fourth, we have attempted to err on the conservative side when accounting for technology diffusion in our analysis. This is somewhat analgous to the Administration's rationale for employing mainstream economic assumptions in our budget forecasts: in the presence of uncertainty, we are conservative in our estimates of the speed with which the economy will grow, tax receipts will rise, and the budget will improve. That way, any revisions or surprises that occur are likely to be in the pleasant direction. In this instance, we prudently and conservatively assume that there will be substantial delays between investments in new technology or the diffusion of existing technology, and the returns to such investments.

Is this CEA's analysis or the Administration's analysis? If it's the Administration's analysis, why does it not reflect any of the bottom-up perspective that DOE has used in the past?

This is the Administration's analysis. It reflects the work by many Administration agencies to evaluate the costs and benefits of mitigating climate change. The report provides the results from one model as an illustration that the costs could be modest. This conclusion that the costs could be modest is not based solely on this one model, but on a much larger review of the available climate change literature. Thus, the conclusion reflects the results from many different modeling efforts, including both economic work by the Energy Modeling Forum as well as the engineering-based approach reflected in the DOE Laboratories work.

Why is there only one scenario? Didn't you think it appropriate at least to represent other views?

The Administration's analysis presents the economic implications of the scenarios that best reflect the U.S. government's position on international trading and global participation.

Why are you so optimistic about international traidng but conservative about technology?

Our conservative approach is to avoid rosy scenarios as in budgeting. I am optimistic about trading because it is in our control to get it and make it work. We know that there are big differences in mitigation costs across countries that can lower overall costs and we will work to insure effective trading arrangements. Technology is out of our control. We can work to promote it, but there is an element of unpredictability.

Why don't you present a view that does not include the optimistic assumption that China, India, and other developing countries assume emissions targets?

That is a hypothetical scenario that is not consistent with our policies. This report illustrates, among other things, how developing countries can maintain sustainable growth while participating in an international system of emissions reductions and trading. By participating in international trading, developing countries could attract investment for cleaner energy and technologies while generating cost-effective abate opportunities for firms in industrialized countries.

You have essentially assumed an international trading system that operates as seamlessly as the New York Stock Exchange. Have you found a single outside validator to support an assumption that is this extraordinarily optimistic?

Because we are still engaged internationally on trading rules, we have the opportunity to develop a system that would promote active private sector participation with minimal transaction costs. Given the interest in climate change by such major actors like the World Bank, the Chicago Board of Trade, and the International Petroleum Exchange in London, and the efforts we have undertaken to learn from traders in other markets, we believe the potential exists to transform the concept of international trading into a practical, workable system.

Has this been peer-reviewed? Why not?

This has not been peer-reviewed. As a document that serves as a technical appendix to the testimony of the Chair of the Council of Economic Advisers, the document fell under the peer review policy of CEA. Simply put, CEA does not submit its reports for peer review. It never has, and it never will.

How did you model "meaningful participation by key developing countries"?

As the Administration has noted on numerous occasions, meaningful participation varies according to the circumstances of each developing country. (Insert standard response)

In this analysis, the $14 to $23/ton scenarios reflect an assumption that some developing countries take on emissions targets and participate in trading. While emissions targets in the first commitment period would surely constitute meaningful participation, that is not a necessary prerequisite for meaningful participation.

Your analysis includes "key developing countries" with emissions targets. Are China, India, Mexico, and Korea the only key developing countries?

These countries should not be considered the only key developing countries. In fact, the Administration does not have an official list of key developing countries. In the illustrative analysis, we used these countries as examples of the effects developing countries could have on an international trading system. In the Second Generation Model, these 4 developing countries are distinct regions from the "Rest of the World" region which encompasses all other Non-Annex I countries. The use of the model with these as "key developing countries" reflects the disaggregation of developing countries in the model rather than explicit policy decisions.

Your analysis assumes that "key developing countries" take on targets at their 2010 BAU emissions level -- this implies that they do not have to undertake any emissions reductions to comply with their targets. Is this consistent with Byrd-Hagel? Is this "meaningful participation"?

As we have said previously, there is no one-size-fits-all for meaningful participation. We have used targets set at 2010 BAU simply for illustrative purposes. It should not be construed as a statement on either Byrd-Hagel or meaningful participation, but simply as an illustration.

How much will it cost if you don't get "key developing countries" to take on targets?

That is a hypothetical that does not reflect our policy. We believe that the costs will be modest with developing countries taking on targets. Further, we believe with some kinds of emissions targets, developing countries could even benefit from adopting targets and participating in trading. Moreover, reducing emissions in these developing countries could generate substantial ancillary public health benefits, such as those related to reduced particulate matter and sulfur dioxide emissions. In these cases, it could be in the economic interest of these developing countries to take on targets.

How much will it cost if their are restrictions on international trading?

The U.S. position is to secure effective trading rules to promote low-cost emissions reductions. We have stated repeatedly our opposition to trading restrictions as both inefficient and infeasible. Since a ton of CO2 emitted in New York has the same environmental effect as a ton emitted in Moscow, we see no environmental justification for placing restrictions on trading. Since we will not accept trading restrictions, it is unnecessary to discuss this hypothetical scenario.

Costs in other studies are more than 10 times yours. Why should we believe your estimates?

Many of the other studies that have been conducted with much higher costs do not appropriately reflect the achievements our negotiators secured in the Kyoto Protocol nor the Administration's policies for future action. For example, these studies, some which even claim to be analyses of Kyoto, do not include many of the important flexibility mechanisms in the Kyoto Protocol, such as international emissions trading, the Clean Development Mechanism, as well as the potential to trade across greenhouse gases. Further, these analyses do not not account for the Administration's position on developing country participation. The flexibility measures were included in the Administration's analysis. As I have said before, we can do it dumb, or we can do it smart. Doing it dumb means that we would ignore many of the cost-effective opportunities to reduce emissions. Doing it smart implies that we would take advantage of cost-effective options, and that is why the Administration was a strong advocate in Kyoto for flexibility measures, and we will continue to serve as an advocate in subsequent negotiations.

You have provided direct costs. The economic literature indicates that total costs of a policy like this should be 2 - 4 times the direct costs. What are the total costs of your policy?

What are the benefits of Kyoto?

Would a less stringent alternative capture most of the benefits of this approach? Why didn't you assess any such alternatives?

In your analysis, you modeled a tradable permit scheme. Isn't such a scheme modeled the same way as a carbon tax? Doesn't this mean that a tradable permit scheme is just a euphemism for higher energy taxes?

In the model, aren't permits auctioned? Does the Administration intend to auction permits?

The Protocol includes a provision on banking. Did you assess the effect of banking on costs in the first commitment period? Why not?

Why can't you estimate sinks? You agreed to something in Kyoto, and you don't understand its implications 6 months later?

Battelle has recently released a draft paper of its assessment of Kyoto. It indicates that the permit price with full global trading would be $25/ton. Why is their estimate higher than yours with the same model?

You used only 1 model. With all the same assumptions, what would the likely permit prices be using other models?

Last summer, you said that relying on 3 models would be futile. Yet, now you deliver an economic analysis relying on just 1 of the 3. What has happened since then that allows you to more comfortably rely on SGM?

The report indicates that electricity restructuring will lower carbon emissions by up to 40 MMTCE. How can making electricity cheaper result in lower emissions? Won't people consume more electricity if the price falls?

These additional provisions in the Administration's proposal on electricity restructuring result in some emissions reductions. Do you have an estimate of their costs? If so, do you know what the cost per ton (average and marginal) is for those emissions reductions?

The report indicates a range of ancillary benefits. Why the large range?

Isn't the upper bound of the ancillary benefits estimate derived from EPA's 812 report methodology? Isn't it true that the Administration's economic agencies do not accept that methodology as legitimate? Why then is it in the report?

The testimony presented on March 4 before House Commerce and at several hearings since indicated that, in addition to improved air quality, the ancillary benefits include reduced congestion and traffic fatalities. However, there is no mention of these benefits in the report. Why not? Further, why would congestion and traffic fatalities decrease with a tradable permit system?

Isn't it true that the permit price without trading would be $193/ton? Wouldn't this be about $0.50 per gallon in higher gasoline taxes?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:28-JUL-1998 15:11:24.00

SUBJECT: Re: title of econ. analysis

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: Alan S. Polasky (CN=Alan S. Polasky/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Todd's proposed title makes it sound like we are doing an economic analysis of climate change itself, as opposed to the policies, which we are not really doing. On the other hand, I suppose we could live with it, if we were indeed to reprint.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:28-JUL-1998 16:44:47.00

SUBJECT: Japan Watch: July 24, 1998 by Treausury sent by Lael for the Japan Deputies meeting

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Here's some background on Japan.
There is more too, for the Deputies meeting, which I will give you.
JF
---------------------- Forwarded by Jeffrey A. Frankel/CEA/EOP on 07/28/98
04:43 PM ---------------------------

Nouriel Roubini
07/27/98 01:52:15 PM
Record Type: Record

To: Jeffrey A. Frankel/CEA/EOP
cc:
Subject: Japan Watch: July 24, 1998 by Treausury sent to me by Lael for the Japan Deputies meeting

---------------------- Forwarded by Nouriel Roubini/CEA/EOP on 07/27/98
01:56 PM ---------------------------

Lael Brainard
07/27/98 12:28:48 PM
Record Type: Record

To: Nouriel Roubini/CEA/EOP
cc:
Subject: Japan Watch: July 24, 1998

bACKGROUND FOR MEETING ON JAPAN
---------------------- Forwarded by Lael Brainard/CEA/EOP on 07/27/98
12:29 PM ---------------------------

Malcolm R. Lee
07/24/98 10:07:33 PM
Record Type: Record

To: Lael Brainard/CEA/EOP, Melissa G. Green/OPD/EOP
cc:
Subject: Japan Watch: July 24, 1998

---------------------- Forwarded by Malcolm R. Lee/OPD/EOP on 07/24/98 10:12 PM ---------------------------

BILL.MURDEN @ treas.sprint.com
07/24/98 09:38:00 PM
Record Type: Record

To: Malcolm R. Lee
cc:
Subject: Japan Watch: July 24, 1998

Date: 07/24/1998 09:30 pm (Friday)
From: Bill Murden
To: Japan Daily Send
CC: DURHAMP, HENNESEYM
Subject: Japan Watch: July 24, 1998

Attached please find the semi-weekly Japan Watch.

Matt Hennesey, please pass to David Lipton

=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D91]MAIL45044741T.226 to ASCII,
The following is a HEX DUMP:

Sensitive, Close Hold
Internal USG only

July 24, 1998

MEMORANDUM FOR SECRETARY RUBIN
DEPUTY SECRETARY SUMMERS
UNDER SECRETARY LIPTON
ASSISTANT SECRETARY GEITHNER
DEPUTY ASSISTANT SECRETARY ATKINSON

FROM: William Murden
Director
Office of International Banking and Securities Markets

SUBJECT: **Japan Watch: Summary of Developments**

Highlights:

- Keizo Obuchi becomes president of the LDP - pledges tax cuts, stimulus spending, a freeze on the Fiscal Reform Law and quick implementation of the "Total Plan" for dealing with banking sector problems.

- Treasury Assistant Secretary Geithner sent a letter to MOF banking Director General Fushiya outlining US concerns with Japan's approach to, and pace of, banking reforms.

- Finance Minister Matsunaga said a bill to implement the government's bridge bank concept will be submitted to an extraordinary Diet session, to be convened next Thursday, and will be approved without difficulties.

- Yen strengthened against dollar to ¥140.54 (Tokyo close), while the Nikkei gained 1.1% (see *International Financial Markets Report, July 24, 1998* for details of subsequent New York trading).

Attachments: Annex I: Notes from July 24 Supervisor's Meeting on the Japan Banking Crisis
Annex II: Text of Moody's Announcement of possible Japan downgrade

Draft: IMI & IMB: Ritterhoff/Buckley/Krulak/FINATT Tokyo/Byrne

cc: T. Truman; J. Abbott, C. Sciacca, T. Curran, Malcolm Lee, M. Sobel; S. Backes, B. Boorstin, R. Carnell, N. Comstock, T. Crawford, R. Dohner, T. DuLaney, E. Kaplan, S. Flanders, J. Gagnon, G. Gensler, M. Grewe, N. Lee, J. Lister, C. Lowery, B. Murden, S. Rzemien, A. Salladin, S. Sandberg, S. Shah, K. Tong

Market Developments

Japan: Markets (Tokyo Close)

	12/31/96	12/31/97	3/31	6/16 [1]	6/30	7/23	7/24
Tokyo Nikkei 225	19,361	15,259	16,527	14,720	15,830	16,188	16,362
% change to date	-15.5%	7.2%	-1.0%	11.2%	3.4%	1.1%	---
TOPIX Banks index *% change to date*	-39.8%	-6.3%	-11.6%	6.2%	-3.6%	1.3%	---
Yen/Dollar	115.95	130.64	133.01	144.25	140.00	141.68	140.54
% change to date	21.2%	7.6%	5.7%	-2.6%	0.4%	-0.8%	---
Benchmark Bond[2]	2.56%	1.66%	1.58%	1.20%	1.32%	1.34%	1.37%
Tokyo interbank call rate (uncollateralized, overnight)	0.38%	0.44%	0.80%	0.46%	0.34%	0.42%	0.39%
JP Morgan real exchange rate (1990=100, monthly avg.)	108.7	103.3	105.3	95.3	95.3	---	---
Japan Premium: BTM[3]	9	69	20	19	38	31	31
Japan Premium: Sumitomo[3]	13	84	20	22	47	41	41

[1] day before the intervention in the foreign exchange markets
[2] No. 182 bond with seven years to maturity
[3] difference between the Bank of Tokyo-Mitsubishi or Sumitomo Bank 3-month Eurodollar rate and comparable LIBOR (in basis points)

As widely expected, Foreign Minister Keizo Obuchi was elected LDP President today (*see below*). Analysts say that Obuchi's victory had already been factored in over the past few days of decline in the various markets. After an initial drop immediately following the election news, the yen eventually closed at 140.53, strengthening 0.8%. The election results were announced after the close of the stock market. The Nikkei 225 index closed up 1.1% to 16,361.89, following a week-long slump on news of Moody's downgrade review and a tumble in banking shares. The benchmark bond yield climbed back from Thursday's 1.34% to close today at 1.37%.

Political Developments:

Obuchi elected LDP President on first ballot - Garnering 225 votes, 18 more than the majority number, Obuchi easily defeated Kajiyama (102) and Koizumi (84); there was one invalid vote. Obuchi is expected to be elected Prime Minister by lower house vote when the Diet reconvenes on July 30. Following the election, Obuchi reiterated his campaign pledges to cut individual and corporate income taxes by ¥6 trillion, and to implement "more than" ¥10 trillion (2% of GDP) in additional government stimulus spending. He also pledged to freeze the Fiscal Reform Law, which restrains expansionary fiscal policy, for an indefinite period, and to implement the "Total Plan" for dealing with banking sector problems as soon as possible.

Implications of the Election Results
In spite of Obuchi's clear victory, the selection process has left scars within the party, and Obuchi faces the difficult challenge of balancing the requirements of party unity against the need for a "new LDP image" as he assembles his Cabinet and the party executive lineup. Obuchi's personnel decisions will be hammered out over the next week, with party executives beginning to take shape within a few days and a Cabinet announcement likely to be made soon after he is elected Prime Minister on July 30.

Obuchi's rivals in the race, Kajiyama and Koizumi, maintained their composure throughout the campaign, avoiding negative and/or combative rhetoric and nominally leaving the door open for cooperation with Obuchi after his election. Whether either would be willing to serve in the Cabinet or party leadership under Obuchi is uncertain, but in light of the favorable public image of both (as opposed to Obuchi's low public appeal), there is much speculation they will be courted.

Unlike the public composure of the unsuccessful candidates themselves, some of their supporters worked so fiercely to oppose Obuchi that party unity has been scarred somewhat. A group of Koizumi supporters from urban districts where the LDP is in a particularly weak electoral position have threatened to form a new "urban party" to avoid fighting an election under an LDP banner with Obuchi at the helm.

Cabinet choices: Mending fences begins with balancing the distribution of key party and Cabinets positions among various intra-party forces. At his press conference following the election, Obuchi promised to appoint "a competent and reliable" person as finance minister if elected. Kajiyama and Miyazawa are rumored to be candidates. Obuchi will find his personnel decisions complicated for a number of reasons:

-- Obuchi is under intense public scrutiny and has publicly promised to rise above factional politics and "go outside the party" in assembling a strong Cabinet; it could prove difficult to meet the public's expectations;

-- Kajiyama, a public and business favorite for Finance Minister and/or Deputy Prime Minister, may choose not to join an Obuchi administration, particularly if he feels it will have a truncated tenure due to extremely low public approval;

-- anti-mainstream elements of the party have gone somewhat beyond the traditional tactics of LDP in-fighting, even threatening to form a new party, in a divisive campaign; and

-- an "Obuchi allergy" and fear of losing their own seats next election will make junior members hard to appease.
Extraordinary Diet session set for July 30 - Wednesday, the government and the LDP agreed to convene the Diet session July 30 based on the need to demonstrate the commitment to quickly tackle the nation's economic and financial sector

problems. The opposition parties have agreed to the proposed schedule; Obuchi had accepted the Diet schedule as a candidate. A new PM will likely be selected and a new cabinet formed at the session's outset after the incumbent cabinet resigns *en masse*. Originally, the LDP had planned to convene the extra Diet session no earlier than July 31 for five days, adjourn the session after picking the new PM for the *o-bon* holidays and reopen it later in August. LDP officials were quoted on July 23 as saying the decision to opt for the early opening and longer Diet session was based on the need to demonstrate the administration's commitment to quickly tackle the nation's economic and financial sector problems.

LDP approval rating hits record low - According to a *Yomiuri Shimbun* poll reported Thursday, the LDP registered a record low approval of 20.7%, down 8 percentage points from 28.7% in June.

Candidate Obuchi opposes interest rate rise - During a TV appearance Obuchi expressed opposition to raising the nation's record low interest rates, saying it would be "very, very difficult" to raise rates in the current environment. But he said without elaborating that he thought banks had "room to devise" a way to provide customers with better returns.

Economic Developments:

Japan's trade surplus rises - For the first half of CY1998, Japan's merchandise trade surplus rose 66.0% (yoy) to ¥6.57 trillion attributed to a decline in imports and yen depreciation. Exports rose 2.2% to ¥25.27 trillion due to more sales of autos, VCRs and other AV-related equipment; imports fell 9.9% to ¥18.70 trillion, attributed mainly to lower crude oil prices and sluggish domestic demand. The trade surplus with the United States increased 37.7% to ¥3.07 trillion; the trade surplus with EU countries surged 89.7% to ¥2.01 trillion. The trade surplus with other Asian countries fell 26.8% to ¥2.07 trillion as exports declined 15.0% and imports fell 10.6%.

For June, Japan's trade surplus grew 27.0% (yoy) ¥1,218.1 billion for the 15th straight monthly expansion, following a 66.6% rise the previous month. Exports rose 5.2% to ¥4,334.8 billion, while imports fell 1.4% to ¥3,116.7 billion. In trade with the U.S., the surplus grew 48.6% to ¥555.58 billion; the surplus with the EU climbed 68.6% to ¥358.29 billion.

Moody's to review Japan's rating - Moody's Investors Service announced Thursday that it has placed Japan's triple-A sovereign ceiling ratings for foreign currency-denominated debt and yen-denominated debt on review for possible downgrade. While it noted Japan's strengths, Moody's initiated the review because of "deep, structural problems in Japan's economy that have defied conventional policy remedies and an apparent lack of consensus among policy makers on a medium-term strategy for implementing structural reform and for managing the economy." See annex II for complete text.

ROE at 1,544 listed companies falls 1.3 points in FY1997 to 2.7% - Total net profit at non-financial companies plunged 32% to just over ¥3 trillion, stemming primarily from a 50% increase in extraordinary losses due to the write-off of nonperforming assets. ROE at Japanese manufacturers fell 0.9 points to 3.5%, while that at non-manufacturers dropped 2.3 points to

0.7%. ROE at retailers fell 3.4 points to 1.5%. Construction companies posted an aggregate net loss of ¥270 billion due to the liquidation of nonperforming assets.

Toyota, Honda revise forecasts - Toyota Motor Corp. has revised its domestic production forecast for FY1998 downward to 3.20 million vehicles from an initial forecast of 3.44 million. Similarly, Honda Motor Co Ltd said it had cut its domestic sales target for CY1998 to 764,000 vehicles from the previous target of 810,000 units. Both companies have also lowered estimates of overall domestic demand for vehicles in 1998.

Banking Developments:

Assistant Secretary Geithner sends letter to MOF banking DG Fushiya outlining US concerns with Japan's approach to and pace of banking reforms. Geithner's letter stressed the need for a more "aggressive, activist approach" in order to forestall further declines in confidence that "may have systemic consequences."

DAS Atkinson reconvened the informal banking regulators' group on Friday to discuss recent developments in Japan's financial sector policy. (Annex I)

Assistant Secretary Geithner and DAS Atkinson met with former FDIC chairman Seidman Thursday to discuss his recent advice to the Japanese authorities. He offered them a five point program:

- Get the facts;
- Set up bridge bank legislation;
- Put all the insolvent banks into the bridge bank;
- Create the sales organization and run it like the private sector; and
- Centralize decision-making authority.

Seidman said that the positive outcome of his visit was the acceptance by the Japanese authorities that banks will need to fail. Otherwise, he criticized the Japanese reformulation of his bridge bank idea on several grounds: shareholders would not be immediately wiped out; bad assets would not be cleaned out; and a two year delay (Stage 1) to look for a good bank to merge with the bridge bank was misguided and would result in a bigger bad bank. He also suggested to the authorities that a board consisting of representatives from the FSA, DIC, and MOF be established to make all decisions for closing banks on a case-by-case basis. He also told them that it was necessary to "chum the waters" with bad assets to create a secondary market. He concluded that Diet politicians, and BOJ and DIC officials were receptive to many of his ideas, but not the MOF bureaucracy.

Finance Minister Matsunaga said a bill for the government's bridge bank concept will be submitted to an extraordinary Diet session, to be convened next Thursday, and will be approved without difficulties. "The Ministry of Finance has already finished drawing up the bill, and the bill is not basically different from the ideas (of the) opposition parties, which also insist that failed financial institutions be put under the government's control," he said Friday.

Sumitomo Trust's board unanimously approved a plan to proceed with merger negotiations with Long-Term Credit Bank of Japan. A June 26 meeting of management had approved the merger proposal, but the board of directors avoided making a final decision, placing further pressure on Sumitomo Trust stock price as market players remained uncertain over whether the alliance would actually be realized. The two banks hope to set terms by September and to effect the merger by the start of fiscal 1999.

About half of the 100 trillion yen now in postal system time deposits may be withdrawn when the instruments mature in 2000 and 2001, says a source at the Posts and Telecommunications Ministry. Such a huge drain of postal savings, a key source for government loan and investment programs funds, could disrupt the bond market, analysts say, by forcing the Finance Ministry Trust Fund Bureau to sell some of its government bond holdings. Depositors may shift assets from maturing postal time deposits to private sector financial products because the ministry has not raised its ceiling on individual deposits, the source explained. Previously, whenever a large volume of time deposits approached maturity, the ministry raised the ceiling to enable depositors to roll over the instruments. In the face of growing criticism from financial institutions that the postal savings system steals business from the private sector, however, the ministry decided to maintain the current ceiling of 10 million yen next fiscal year and thereafter.

Time deposits account for 86% of total postal savings. Because many depositors opt for the longest term of 10 years - to earn the highest return - there is typically a large bubble of maturing deposits early each decade. Most instruments expiring in 2000 and 2001 were made between September 1990 and July 1991 at a rate of 6.33%. At the last bubble in 1990, about 20% of the money flowed out to private sector financial instruments even though the ministry raised its ceiling sufficiently to allow rollover of all maturing deposits. The total principal deposited at that time was 65 trillion yen. Depositors who put in the then-limit 7 million yen will see about 11.8 million yen at maturity running into the 10 trillion yen ceiling.

The Financial Supervisory Agency will ask North Pacific Bank and Hokkaido Bank to take over some borderline (Category II) lending by Hokkaido Takushoku Bank, sources at the agency told the press Thursday. The watchdog hopes to avert a bankruptcy domino effect due to the failure of Hokkaido Takushoku. The FSA wants the two to accept category 2 loans made by Hokkaido Takushoku, even if they are reclassified as category 3 after an agency inspection. In that event, the FSA will order Hokkaido Takushoku to set aside more reserves for such loans, though that will mean additional injection of public funds.

Hokkaido Takushoku assesses its loan portfolio as carrying 650 billion yen in category 2 debt. The FSA wants North Pacific banks to take over 380 billion yen of that total. North Pacific has so far agreed to take on only 106 billion yen worth, and has rejected loans amounting to 68 billion yen. Disposition of the rest may depend on reserve requirements. The FSA believes the loans rejected by North Pacific are very likely to be reclassified category 3. In that case, it will request Hokkaido Takushoku increase reserves for them, which may then enable a takeover by North Pacific. The FSA also plans to ask other banks that have trading relationships with Hokkaido Takushoku to take over the loans North Pacific has rejected.

Comment: The attempt by the FSA to convince the rescue banks to take on non-performing loans from Hokkaido Takushoku, together with the performing loans, contradicts the supposed goal of the bank restructuring strategy -- to get the bad loans out of the banking system -- not to keep them clogging up the books of private banks, and not to set up perverse incentives for the rescue bank to try to keep the loans alive.

In a meeting with Finatt/Tokyo Friday, MOF reps at the Financial System Planning Bureau criticized the resolution plan for Hokkaido Takushoku (an FSA responsibility) because:

- it appears that Hokuyo Bank will receive public funds (indirectly) without any restructuring being required;

- there is a lack of clarity in how much subsidy/reserves are to be provided to Hokuyo Bank together with the Category II loans. If these Category II loans are really Category III loans, unsustainable borrowers are being excessively supported; and

- most important, this pattern of resolution is doing nothing to help with the disposal of bad assets. In fact, the opposite.

Daiwa Securities shares fall on S&P rating cut: Daiwa Securities Co.'s shares fell as much as 5.8 percent after the brokerage's bond ratings were cut by Standard & Poor's to one notch above "junk" status. Daiwa is Japan's second-largest brokerage by sales, third- largest by market value. Standard & Poor's said it cut Daiwa Securities ratings because of the ``deterioration in the company's financial performance as a result of the rapidly changing operating environment" in Japan's brokerage industry.

The Financial Supervisory Agency is preparing to release its guidelines on reserve requirements for the four categories banks are to use in listing their loans, agency sources said Wednesday. Although the guidelines are not compulsory, they will function as a standard for the agency's financial inspections. The FSA will specify a loan-loss reserve percentage for each risk category after analyzing results of an inspection of 19 major banks. These percentages will be listed in an inspection manual the agency is expected to disclose within this year. Typically, for category 4 (irrecoverable) loans, an institution must meet a 100% reserve requirement; category 3 (likely to go bad) lending carries a 50-75% reserve requirement. The agency is likely to keep to these figures as its guidelines for lending in these two categories.

Most controversial are likely guidelines for category 2 loans - which carry some risk of default. For category 2 loans, many banks add to their general loan-loss reserves based on calculations of past default ratios. Even highly risk conscious banks usually estimated the add-on at 5%. Yet a survey of 18 institutions by the Bank of Japan has found that 16.7% of loans classified in category 2 in 1993-94 went bad within three years. The agency has been requiring major banks to sub-classify their category 2 lending into four risk groups, and will set different reserve guidelines for each of these sub-groups, the sources said.

Annex I
Supervisors' Meeting on Japan Banking Crisis
July 24, 1998

Participants:
Treasury: Atkinson, Murden, Buckley
Federal Reserve Board: Davis
OCC: Abbott, McMahon
FDIC: Sciacca

Agencies agreed with the OCC's characterization that the Japanese banking supervisors recognized the breadth but not the depth of their problems.

There was a discussion of the weakness of the FSA: new agency, staff all on detail from MOF, unclear if the FSA could pursue an independent course. FSA's international counselor, Sakura Shiga, called on several agencies during the week, to explain the FSA. Everyone was surprised to learn that the policy functions of MOF's Financial System Planning Bureau (the old Banking and Securities bureaus) will be transferred to the FSA January 2001, and that the FSA head will become a cabinet position. (An email note from Finatt/Tokyo clarifies several of the numbers provided by the FSA:

1. By the Nikkei's count, there are about 571 people in the bank examination divisions at FSA and the local finance bureaus. These people cover 19 major banks, 128 regional banks, 351 credit cooperatives, and 401shinkin banks, although prefectural governments also share the responsibility for monitoring/examining the last two categories.

2. The FSA will change to the Financial Agency in January 2001, and will (in theory) assume all financial policy-making matters except the treatment of failed institutions and "financial crisis management," which will stay with the MOF. The MOF, incidentally, will try to improve itself by changing its name to the "Treasury Ministry.")

The OCC said that it was sending two examiners to the FSA sometime in October-November to "train the trainers" on the issue of asset classification, with a possible exchange in return. (Note: there may be scope for recasting FDIC's offer of TA, which MOF politely declined, into this format and fora.)

FDIC noted that Japan needed a contingency plan to deal with the worst case scenario – run on banks and commensurate funding needs. The Japanese need to decide who is too big to liquidate and need to explicitly define the outstanding government guarantee – does it extend to the banks themselves (i.e., a guarantee against failure) or to the liabilities of the banks and, if the latter, which liabilities. OCC noted that in other Asian countries the governments' guarantee did not stop the banking crisis but did result in a large financial burden on the governments.

In a discussion of Japanese banks operating in the U.S., the regulators noted no particular problems aside from possible high Asian exposures.

In a discussion of trying to quantify tiering between different Japanese banks, the Fed noted that BTM's role as a conduit supplying dollars to many other Japanese banks made it difficult to quantify tiering among banks because many did not directly borrow in the markets.

OCC noted that Japanese banks' importance as financial intermediaries was lessening. There was some question as to whether BIS data would show this and a discussion of BIS data in general on the reporting of off-balance sheet liabilities such as derivatives.

Discussion of Japanese bank exposure numbers – bank reported NPLs versus "classified" assets/exposure. Classified assets (i.e., Categories I-IV) exceeded direct lending implying that guarantees or undisbursed credits where included in the Category I-IV classifications.

Agencies agreed to produce notes on Resolutions in the US (FDIC), rules/criteria for surviving assets (FDIC) Form 009 Country Exposure data (Fed), exposure to Japanese banks (FED), and Japanese definition of Category I-IV classifications and NPLs/recent results (Treasury).

Annex II: The following is the full text of the Moody's Investors Service news release on placing Japan's debt on review for possible downgrade:

MOODY'S WILL REVIEW FOR POSSIBLE DOWNGRADE JAPAN'S COUNTRY CEILINGS FOR FOREIGN CURRENCY AND THE DOMESTIC CURRENCY RATING OF THE GOVERNMENT OF JAPAN

Tokyo, July 23 1998 - Moody's Investors Service has placed on review for possible downgrade Japan's Aaa country ceilings for foreign currency-denominated debt and bank deposits as well as the Aaa-rated yen-denominated securities issued or guaranteed by the government of Japan. The rating agency said the review is prompted by deep, structural problems in Japan's economy that have defied conventional policy remedies; an apparent lack of consensus among policy makers on a medium-term strategy for implementing structural reform and for managing the economy; a public sector fiscal problem that, unlike most other highly-rated countries, will continue to worsen over the medium term; and signs of weakening in Japan's external position.

Of particular concern is the potential for volatile portfolio shifts into foreign currency assets by Japanese resident in the post-Big Bang environment.

At the same time, Moody's recognizes that Japan has considerable strengths, including very high income and savings, the capacity of the economy to absorb shocks, and a formidable manufacturing sector which has retained its international competitiveness despite the large exchange rate appreciation in the past decade. The country's strong external payments positions is reflected in the considerable net foreign asset position of the Bank of Japan and the commercial banking system.

Moody's review will focus on the implications of possible policy responses for the long-term strength of japan's fiscal and external payments position, and how such developments could affect the baking sector, the intrinsic strength of which Moody's considers to be much weaker than other countries rated Aaa.

As a result of this review, the Aaa-rated foreign currency securities issued by the following institutions are also on review for possible downgrade:

-- Japan Development Bank*
-- Japan Finance Corporation for Municipal Enterprises*
-- Export Import Bank of Japan*
-- Metropolis of Tokyo*
-- Chubu Electric Power Company
-- Kansai Electric
-- Nippon Telegraph and
-- Tokyo Electric Power Company Inc

*guaranteed by the Japanese Government

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:29-JUL-1998 10:53:48.00

SUBJECT: Re:

TO: Jonathan Orszag (CN=Jonathan Orszag/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TEXT:
The memo does a good job of laying out the pros and cons. One suggestion: In the fourth bullet under cons, I would take the last sentence, expand it and turn it into a separate bullet that could read as follows: The United States is a net importer of oil. This means that any oil price increase will raise the costs of American consumers by more than it benefits domestic producers. Oil exporting countries will gain from any price increase and the cost of U.S. oil imports will rise, increasing our trade deficit.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:29-JUL-1998 08:58:05.00

SUBJECT: DRAFT Memo to the President on Strategic Petroleum Reserve

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Jon said he needs comments on this ASAP.
---------------------- Forwarded by Michele Jolin/CEA/EOP on 07/29/98
08:56 AM ---------------------------

Jonathan Orszag
07/29/98 12:34:43 AM
Record Type: Record

To: See the distribution list at the bottom of this message
cc:
Subject: DRAFT Memo to the President on Strategic Petroleum Reserve

Here's a draft of the memo to the President on Bingaman's SPR proposal.
We need to get sign off on this ASAP in the morning.

Forbes: Call me and I'll explain -- I'm also leaving a note to Gene to
tell him to talk with Larry in the morning.

Steve B.: I have a question about some numbers in here. I will call you
in the morning to discuss.

Message Sent
To:____
T J. Glauthier/OMB/EOP
Melissa G. Green/OPD/EOP
DAVID.WILCOX @ MS01.DO.treas.sprint.com@INET@LNGTWY
Jeffrey A. Forbes/WHO/EOP
Michele Jolin/CEA/EOP
Steven N. Braun/CEA/EOP

==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D63]MAIL47275251I.226 to ASCII,
The following is a HEX DUMP:

DRAFT #1 July 29, 1998

MEMORANDUM FOR

FROM:

SUBJECT: Bingaman Proposal to Purchase Oil for Strategic Petroleum Reserve

Although oil prices have risen in recent weeks, they remain near a nine-year low. These low prices are adversely affecting some independent oil producers. In response, Senator Bingaman has proposed to replenish the Strategic Petroleum Reserve (SPR) to its Gulf War level by purchasing 24 million barrels of oil at a cost of $400 million. The purpose of this memorandum is to inform your decision on whether or not to support Senator Bingaman's proposal.

Our analysis of Senator Bingaman's proposal suggests that it would have an ambiguous effect on oil prices in the short run and little or no effect in the long run (six months or more). Whether this proposal affects oil prices in the short run depends in large part on whether producers liquidate some of their current oil inventories -- which are relatively high -- in response to the Federal government's purchase for the SPR. If producers reduce inventories to sell to the SPR, the transaction would merely shift inventories from producers to the Federal government with little or no effect on oil prices.

If, on the other hand, oil producers do not draw down their existing inventories or boost their production rates, Senator Bingaman's proposal could substantially drive up the price of oil and gas. We estimate that purchasing 24 million barrels of oil over one month would raise oil prices by about 10 percent or $1.40 per barrel. This would translate into a 3.4 cent increase in gas prices for all American drivers. We would expect, though, that any such increase would dissipate over a matter of a few months.

Pros:

- If we want to replenish the SPR, now is a good time because oil prices are cheap. Indeed, it is possible that the government will profit from a purchase today (if oil prices subsequently rebound). However, past experience suggests that it is generally dangerous for the government to try to game the market.

- If the SPR purchase increases the price of oil, it would help oil producers.

- This proposal could help smooth oil prices by raising them in the short term. The future markets suggest that the price of oil will rise from $14 per barrel today to about $14.75 per barrel in three months and $15.75 per barrel in six months. However, others could argue that the fact that oil prices are expected to rise is a reason not to intervene -- this could be viewed as the "market will correct itself."

Cons:

- To the extent the proposal benefits producers at all, it comes at the expense of either America's working families or other government programs.

- OMB thinks it is unlikely that it could receive an "emergency determination" for the SPR purchase. Therefore, the $400 million cost would have to be offset by cuts in other government programs. Your Administration has reserved the emergency determination for natural disasters (e.g., floods, earthquakes, droughts, etc.) and foreign conflicts.

- If the purchase has no effect on oil prices, some could argue we wasted $400 million and did not help oil producers.

- If the purchase has an effect on prices, gas prices could increase by up to 3.4 cents per gallon. Thus, some may argue that this proposal is a "tax increase" on working families. And if prices increase, industries such as airlines, railroads, and utilities would complain because their input costs would rise significantly. To the extent these industries pass through the increase in energy prices to consumers, American families will have to pay more for air travel, train travel, and their utility bills. Put simply, because we are a net importer of oil, any oil price increase costs American consumers more than it benefits American producers.

- Any increase in oil prices will tend to raise inflation and lower economic growth in the short run. A rough estimate suggests that a 10-percent increase in oil prices could lower economic growth by 0.X percent and raise the inflation rate by 0.X percent. [CHECK WITH STEVE BRAUN]

- The SPR currently exceeds the minimum amount recommended by experts.

- Some may argue that by providing insurance to this industry, we will attract additional claimants for government help whenever an industry experiences a temporary downturn.

Alternative Energy Department Proposal [CHECK]:

The Department of Energy has recently issued proposed guidelines that would invite oil companies to store oil in the SPR and pay for the storage space in oil. Oil producers do not have excess storage space and with oil prices so low, could benefit by building reserves now so that they can sell the oil later at higher prices. The SPR is currently 80 million barrels below capacity. Energy has proposed leasing 20 million barrels of space. This proposal could help

build our oil reserves back toward their previous levels and have a similar, but smaller, effect on the price of oil; by providing an incentive for businesses to build reserves, we would increase global demand today, raising the price.
[ADD MORE]

We could potentially offer this proposal as an alternative to Senator Bingaman. Since the end result may be the same -- higher oil prices in the short run -- he may be willing to sign onto this approach.

Recommendations:

NEC?
Treasury?
CEA?
OMB?
Energy?
White House Leg Affairs?
COS?

__________ Support Bingaman Proposal to Purchase Oil for Strategic Oil Reserves.

__________ Support Alternative Energy Department Proposal and Offer As Alternative To Senator Bingaman.

__________ Do NOT Support Either Proposal.

__________ Discuss.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:29-JUL-1998 11:26:46.00

SUBJECT: first (partial) draft of Qs and As

TO: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
---------------------- Forwarded by Janet L. Yellen/CEA/EOP on 07/29/98
11:26 AM ---------------------------

Joseph E. Aldy
07/28/98 06:48:58 PM
Record Type: Record

To: See the distribution list at the bottom of this message
cc:
Subject: first (partial) draft of Qs and As

Please find attached a WP file with Qs and As (more Qs than As right now). I would like comments on the As as well as other Qs you might have. Thanks,

Joe

Message Sent
To:____
Janet L. Yellen/CEA/EOP
Jeffrey A. Frankel/CEA/EOP
Alan S. Polasky/CEA/EOP
Todd Stern/WHO/EOP
William J. Antholis/OPD/EOP

==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D89]MAIL43632451J.226 to ASCII,
The following is a HEX DUMP:

What portion of reductions does your analysis anticipate will be made in the U.S.?

This report does not present an assessment of the location of emissions reductions. As a part of the Adminsitration's assessment that the costs of reducing greenhouse gas emissions could be modest, we used a model that provides an illustration of the potential costs given effective implementation. This model, SGM, like other large energy-economy models of the world, can only adequately account for some kinds of policies. For example, a system of domestic and international emissions trading can be modeled well with SGM. However, other domestic initiatives, such as funding for R&D and voluntary industry commitments, cannot be modeled with SGM. All models require simplifying assumptions, so while SGM is very well designed to assess international emissions trading, it is not equipped to handle these kinds of domestic policies. Moreover, SGM does not have a land use module, so it cannot assess carbon sinks. While the permit prices we have provided reflect an output of the model where emissions reductions are allocated across regions through the tradable permit scheme, this output should not be considered the Administration's estimate of its efforts to abate emissions domestically. As the unaccounted for domestic initiatives reduce emissions, the permit price and cost associated with the tradable permit system that would be implemented for the first commitment period would fall. The reported permit prices illustrate what we mean by modest costs, and given the equivalent environmental effect of a ton of emissions regardless of its location, the modeling analysis reflects a cost-effective tradable emissions regime that attempts to achieve the goal of Kyoto at least cost.

How much money would be sent abroad? Isn't this a tax on American business and government transfers to Russia?

There will be no taxes on Americans or government trasnfers to Russia. However, U.S. firms -- not the U.S. government --- may choose to purchase international emissions permits if they so desire to meet their emissions obligations -- from Russia or other countires or through the CDM. As with any market transaction, purchases of these pemrits will have to comply with all U.S. legal and regulatory requirements. U.S. firms interested in international investmnent and emissions credits will have an incentive to ensure that other countries meet the international stanbdards for adequately monitoring and reporting their emissions of greenhouse gases. Russia will have a significant incentive to use the revenues to invest in mdern, climate-friendly plants and equipments so that as its economy recovers, it continues to produce emissions reductions for sale on international markets.

If your model does not account for key factors like domestic initiatives, carbon sinks, or electricity restructuring, why did you use that model?

No one model can handle all characteristics of the Kyoto Protocol and the President's policies to reduce greenhouse gas emissions. Indeed, as we have said previously, no one model is capable of providing definitive answers on climate change. However, models can aid our understanding of some of the key policy parameters. As we have seen, both with SGM, and through our review of the literature, including modeling exercises through the Energy Modeling Forum, flexible, market-based mechanisms for reducing emissions are critical to lowering the cost of meeting our target. Because of this insight, we employed a model to illustrate the cost-savings opportunities to trade across space and to trade across types of greenhouse gases. However, while SGM provides a solid understanding of the benefits of trading and the potential permit price under an international trading system, it does not assess other kinds of policies, like our domestic initiatives. This is another reason why we have portrayed our modeling results in the economic analysis as illustrative.

Why didn't you devise some way to factor those elements into your analysis, rather than putting them aside?

The Administration has not included quantitative estimates of emissions reductions associated with electricity restructuring, the CCTI, industry consultations, or the Federal energy program in the illustrative modeling analysis. First, the model can not assess these programs directly. Second, there is uncertainty in calculating the payoffs from funding research and development. Third, the industry consultations are still at an early stage, so it would be premature and difficult to quantify and incorporate emissions reductions from consultations into the illustrative modeling analysis. Fourth, we have attempted to err on the conservative side when accounting for technology diffusion in our analysis. This is somewhat analgous to the Administration's rationale for employing mainstream economic assumptions in our budget forecasts: in the presence of uncertainty, we are conservative in our estimates of the speed with which the economy will grow, tax receipts will rise, and the budget will improve. That way, any revisions or surprises that occur are likely to be in the pleasant direction. In this instance, we prudently and conservatively assume that there will be substantial delays between investments in new technology or the diffusion of existing technology, and the returns to such investments.

Is this CEA's analysis or the Administration's analysis? If it's the Administration's analysis, why does it not reflect any of the bottom-up perspective that DOE has used in the past?

This is the Administration's analysis. It reflects the work by many Administration agencies to evaluate the costs and benefits of mitigating climate change. The report provides the results from one model as an illustration that the costs could be modest. This conclusion that the costs could be modest is not based solely on this one model, but on a much larger review of the available climate change literature. Thus, the conclusion reflects the results from many different modeling efforts, including both economic work by the Energy Modeling Forum as well as the engineering-based approach reflected in the DOE Laboratories work.

Why is there only one scenario? Didn't you think it appropriate at least to represent other views?

The Administration's analysis presents the economic implications of the scenarios that best reflect the U.S. government's position on international trading and global participation.

Why are you so optimistic about international traidng but conservative about technology?

Our conservative approach is to avoid rosy scenarios as in budgeting. I am optimistic about trading because it is in our control to get it and make it work. We know that there are big differences in mitigation costs across countries that can lower overall costs and we will work to insure effective trading arrangements. Technology is out of our control. We can work to promote it, but there is an element of unpredictability.

Why don't you present a view that does not include the optimistic assumption that China, India, and other developing countries assume emissions targets?

That is a hypothetical scenario that is not consistent with our policies. This report illustrates, among other things, how developing countries can maintain sustainable growth while participating in an international system of emissions reductions and trading. By participating in international trading, developing countries could attract investment for cleaner energy and technologies while generating cost-effective abate opportunities for firms in industrialized countries.

You have essentially assumed an international trading system that operates as seamlessly as the New York Stock Exchange. Have you found a single outside validator to support an assumption that is this extraordinarily optimistic?

Because we are still engaged internationally on trading rules, we have the opportunity to develop a system that would promote active private sector participation with minimal transaction costs. Given the interest in climate change by such major actors like the World Bank, the Chicago Board of Trade, and the International Petroleum Exchange in London, and the efforts we have undertaken to learn from traders in other markets, we believe the potential exists to transform the concept of international trading into a practical, workable system.

Has this been peer-reviewed? Why not?

This has not been peer-reviewed. As a document that serves as a technical appendix to the testimony of the Chair of the Council of Economic Advisers, the document fell under the peer review policy of CEA. Simply put, CEA does not submit its reports for peer review. It never has, and it never will.

How did you model "meaningful participation by key developing countries"?

As the Administration has noted on numerous occasions, meaningful participation varies according to the circumstances of each developing country. (Insert standard response)

In this analysis, the $14 to $23/ton scenarios reflect an assumption that some developing countries take on emissions targets and participate in trading. While emissions targets in the first commitment period would surely constitute meaningful participation, that is not a necessary prerequisite for meaningful participation.

Your analysis includes "key developing countries" with emissions targets. Are China, India, Mexico, and Korea the only key developing countries?

These countries should not be considered the only key developing countries. In fact, the Administration does not have an official list of key developing countries. In the illustrative analysis, we used these countries as examples of the effects developing countries could have on an international trading system. In the Second Generation Model, these 4 developing countries are distinct regions from the "Rest of the World" region which encompasses all other Non-Annex I countries. The use of the model with these as "key developing countries" reflects the disaggregation of developing countries in the model rather than explicit policy decisions.

Your analysis assumes that "key developing countries" take on targets at their 2010 BAU emissions level -- this implies that they do not have to undertake any emissions reductions to comply with their targets. Is this consistent with Byrd-Hagel? Is this "meaningful participation"?

As we have said previously, there is no one-size-fits-all for meaningful participation. We have used targets set at 2010 BAU simply for illustrative purposes. It should not be construed as a statement on either Byrd-Hagel or meaningful participation, but simply as an illustration.

How much will it cost if you don't get "key developing countries" to take on targets?

That is a hypothetical that does not reflect our policy. We believe that the costs will be modest with developing countries taking on targets. Further, we believe with some kinds of emissions targets, developing countries could even benefit from adopting targets and participating in trading. Moreover, reducing emissions in these developing countries could generate substantial ancillary public health benefits, such as those related to reduced particulate matter and sulfur dioxide emissions. In these cases, it could be in the economic interest of these developing countries to take on targets.

How much will it cost if their are restrictions on international trading?

The U.S. position is to secure effective trading rules to promote low-cost emissions reductions. We have stated repeatedly our opposition to trading restrictions as both inefficient and infeasible. Since a ton of CO_2 emitted in New York has the same environmental effect as a ton emitted in Moscow, we see no environmental justification for placing restrictions on trading. Since we will not accept trading restrictions, it is unnecessary to discuss this hypothetical scenario.

Costs in other studies are more than 10 times yours. Why should we believe your estimates?

Many of the other studies that have been conducted with much higher costs do not appropriately reflect the achievements our negotiators secured in the Kyoto Protocol nor the Administration's policies for future action. For example, these studies, some which even claim to be analyses of Kyoto, do not include many of the important flexibility mechanisms in the Kyoto Protocol, such as international emissions trading, the Clean Development Mechanism, as well as the potential to trade across greenhouse gases. Further, these analyses do not not account for the Administration's position on developing country participation. The flexibility measures were included in the Administration's analysis. As I have said before, we can do it dumb, or we can do it smart. Doing it dumb means that we would ignore many of the cost-effective opportunities to reduce emissions. Doing it smart implies that we would take advantage of cost-effective options, and that is why the Administration was a strong advocate in Kyoto for flexibility measures, and we will continue to serve as an advocate in subsequent negotiations.

You have provided direct costs. The economic literature indicates that total costs of a policy like this should be 2 - 4 times the direct costs. What are the total costs of your policy?

What are the benefits of Kyoto?

Would a less stringent alternative capture most of the benefits of this approach? Why didn't you assess any such alternatives?

In your analysis, you modeled a tradable permit scheme. Isn't such a scheme modeled the same way as a carbon tax? Doesn't this mean that a tradable permit scheme is just a euphemism for higher energy taxes?

In the model, aren't permits auctioned? Does the Administration intend to auction permits?

The Protocol includes a provision on banking. Did you assess the effect of banking on costs in the first commitment period? Why not?

Why can't you estimate sinks? You agreed to something in Kyoto, and you don't understand its implications 6 months later?

Battelle has recently released a draft paper of its assessment of Kyoto. It indicates that the permit price with full global trading would be $25/ton. Why is their estimate higher than yours with the same model?

You used only 1 model. With all the same assumptions, what would the likely permit prices be using other models?

Last summer, you said that relying on 3 models would be futile. Yet, now you deliver an economic analysis relying on just 1 of the 3. What has happened since then that allows you to more comfortably rely on SGM?

The report indicates that electricity restructuring will lower carbon emissions by up to 40 MMTCE. How can making electricity cheaper result in lower emissions? Won't people consume more electricity if the price falls?

These additional provisions in the Administration's proposal on electricity restructuring result in some emissions reductions. Do you have an estimate of their costs? If so, do you know what the cost per ton (average and marginal) is for those emissions reductions?

The report indicates a range of ancillary benefits. Why the large range?

Isn't the upper bound of the ancillary benefits estimate derived from EPA's 812 report methodology? Isn't it true that the Administration's economic agencies do not accept that methodology as legitimate? Why then is it in the report?

The testimony presented on March 4 before House Commerce and at several hearings since indicated that, in addition to improved air quality, the ancillary benefits include reduced congestion and traffic fatalities. However, there is no mention of these benefits in the report. Why not? Further, why would congestion and traffic fatalities decrease with a tradable permit system?

Isn't it true that the permit price without trading would be \$193/ton? Wouldn't this be about \$0.50 per gallon in higher gasoline taxes?

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Thomas A. Kalil (CN=Thomas A. Kalil/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME:29-JUL-1998 13:32:37.00

SUBJECT: Privacy Policy

TO: Mary L. Smith (CN=Mary L. Smith/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TO: Peter G. Jacoby (CN=Peter G. Jacoby/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: William H. White Jr. (CN=William H. White Jr./OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: Michael Waldman (CN=Michael Waldman/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: Robert N. Weiner (CN=Robert N. Weiner/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: Jim Kohlenberger (CN=Jim Kohlenberger/O=OVP @ OVP [UNKNOWN])
READ:UNKNOWN

TO: Linda Ricci (CN=Linda Ricci/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

TO: Jacob J. Lew (CN=Jacob J. Lew/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

TO: Bruce N. Reed (CN=Bruce N. Reed/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Christopher C. Jennings (CN=Christopher C. Jennings/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TO: Lawrence J. Stein (CN=Lawrence J. Stein/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: Mickey Ibarra (CN=Mickey Ibarra/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: Dawn L. Smalls (CN=Dawn L. Smalls/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: Charles F. Ruff (CN=Charles F. Ruff/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: David W. Beier (CN=David W. Beier/O=OVP @ OVP [UNKNOWN])
READ:UNKNOWN

TO: Joshua Gotbaum (CN=Joshua Gotbaum/OU=OMB/O=EOP @ EOP [OMB])
READ:UNKNOWN

TO: Thomas L. Freedman (CN=Thomas L. Freedman/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TO: Ira C. Magaziner (CN=Ira C. Magaziner/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TO: Rebecca M. Blank (CN=Rebecca M. Blank/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

Kaplan_jon (Kaplan_jon [UNKNOWN])
READ:UNKNOWN

Jake Siewert (CN=Jake Siewert/OU=OPD/O=EOP [OPD])
READ:UNKNOWN

TEXT:
Attached is the privacy paper that has been revised
to take into account the discussion at the NEC/DPC
principals meeting on July 20th.

It will not be released to the public, but
will be used for the speech and press release
for the VP's privacy announcement this
Friday.

Please let me know by COB today if you have any
comments or concerns.
=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D61]MAIL40584551K.226 to ASCII,
The following is a HEX DUMP:

Draft July 27, 1998

FEDERAL PRIVACY COORDINATION RESPONSIBILITY

Concerns about privacy are shared across agencies. Some privacy activities are undertaken by many; others by no one. Early in the Administration, the President's Information Infrastructure Task Force (IITF) solicited and received public comments on whether there should be an entity within the executive branch to serve as a focal point for public and private sector privacy issues. The IITF reached no conclusion. This proposal concludes that work and responds in part to the July 1997 Presidential direction to develop recommendations as to the appropriate role of government in privacy.

Proposal

The President could assign coordination responsibility of privacy issues to the Administrator of the Office of Information and Regulatory Affairs (OIRA) of OMB. This assignment would strengthen the ability of the Administration to develop and implement effective privacy policy.

OMB recognizes that many agencies have expertise and responsibility for privacy in various areas, however, additional focus on privacy across the executive branch would be useful. This increased focus would be accomplished by the performance of four functions by OMB:

- *Coordination* - Assure that agencies address emerging privacy issues in their programs and policies, and promote greater consistency of Administration positions and policies.

- *Advice* - Drawing on agency expertise, provide advice on privacy policy questions to government agencies and the private sector.

- *Representation* - Explain and promote the Administration's privacy policy domestically and internationally.

- *Consumer Information* - Increase public awareness of privacy issues and the rights and responsibilities of consumers, industry, and government. Use the "bully pulpit" to encourage best practices and criticize bad actors.

Rather than create a new privacy office or entity, it is more appropriate to assign these functions to the Administrator of OIRA. Privacy concerns must usually be balanced with competing values, such as prosecution of criminals, identifying "deadbeat" parents, free speech, and the economic and commercial benefits that come from the free flow of information. OMB is the traditional coordinator of policy, regulatory and organizational issues, while OIRA is already responsible for other information policy matters and has expertise and authority in privacy under the Privacy Act. OIRA, therefore, is a logical place to assign the new responsibilities. To be an effective coordinator, additional resources would be required, however, minimal resources are necessary since the proposed role is primarily coordination, not operations. Decisions on major privacy policy issues would still be made under the auspices of the appropriate White House policy councils.

ONLINE COLLECTION OF INFORMATION

Protection of privacy in the online environment was addressed in the *Framework for Global Electronic Commerce* released by the President on July 1, 1997. In that document, the Administration reaffirmed the importance of "assur[ing] personal privacy in the networked environment" and endorsed the Privacy Principles adopted in June 1995. The Administration "support[ed] private sector efforts now underway to implement meaningful, consumer-friendly, self-regulatory privacy regimes." It cautioned that "[i]f privacy concerns are not addressed by industry through self-regulation and technology, the Administration will face increasing pressure to play a more direct role in safeguarding consumer choice regarding privacy online."

In the year since the issuance of the *Framework*, the privacy issue has garnered significant public attention. The Administration has undertaken broad outreach efforts to urge industry to take up the challenge of self-regulation. Numerous media stories have addressed the threat to privacy in the online environment. And the Federal Trade Commission's net survey demonstrated that -- as of March 1998 -- online enterprises were devoting insufficient attention to privacy concerns.

At the same time, there has been significant progress on industry self-regulation. On June 22, 1998 a group of 50 businesses and trade associations announced the formation of the Online Privacy Alliance. The Alliance adopted well-received guidelines for fair information practices applicable across a range of industries, including the marketing industry. The Direct Marketing Association, which represents over 3700 direct marketers, has endorsed the Alliance guidelines, and committed to require DMA members to comply with the guidelines as a condition of membership in the association.

The Alliance guidelines require members to adopt and implement a policy for protecting the privacy of individually identifiable information. An organization's privacy policy must be easy to find and understand and must state clearly what information is being collected; the use of that information; possible third party distribution of that information; the choices available to an individual regarding collection, use and distribution of the collected information, as well as the consequences, if any, of an individual's refusal to provide information. The policy should also include a clear statement of the organization's accountability mechanism and information about how to contact the organization if a problem or complaint arises. At a minimum, individuals should be given the opportunity to opt out of uses that are unrelated to the purpose for which the information was collected. The Alliance guidelines also require data collectors to take appropriate steps to ensure the security, reliability and accuracy of personally identifiable information.

The Direct Marketing Association has imposed additional requirements specific to marketing activities. These include a mandatory participation in the "Telephone Preference Service" and the "Mail Preference Service" through which consumers can have their names placed on a national "do not solicit" list.

The Alliance has committed itself to announce its approach to enforcement -- the final element of its privacy protection program -- within the next ten days. Based on our understanding of the likely ingredients of the enforcement approach, we believe the Alliance plan will satisfy the Administration's privacy principles. The Alliance's membership constitutes between 80 and 90 percent of online traffic.

In addition, the Council of Better Business Bureaus (CBBB) announced on June 22, 1998, that it will develop and implement a major privacy program through its subsidiary, BBBOnLine. According to the CBBB press release, the online privacy program will feature: privacy standard-setting, verification, monitoring and review, consumer dispute resolution, compliance "seal", and educational components. The program is expected to "go live" in the fourth quarter of 1998.

TRUSTe is a not-for-profit organization based in the Silicon Valley. The TRUSTe program provides notice by Web sites of their information practices, verification and oversight of the claims made in the site's notice, and consumer recourse through which consumer complaints will be resolved. TRUSTe has been criticized for its failure to require adherence to fair information practices -- any practice is permitted, as long as it is disclosed. On June 24, 1998, however, TRUSTe announced that it would require all new and renewing licensees to adhere to the privacy guidelines announced by the Online Privacy Alliance.

<u>Proposal</u>

The Administration should commend the members of the Online Privacy Alliance and other groups for the progress on self-regulation. We should, however, make clear that substantial challenges lie ahead. First, the privacy protections promised by these organizations must be redeemed -- these new organizations must become functioning entities. Second, the private sector must work to expand membership in self-regulatory organizations so that privacy protection becomes ubiquitous in the online environment. Obviously the Administration will also play an important role in this effort. We should repeat the caveat in the *Framework* that the absence of continued real progress will cause the Administration to advocate a more direct role for government in privacy protection.

ON-LINE INFORMATION ABOUT CHILDREN

The solicitation of information from children presents a unique problem. Unlike adults, children generally lack the ability to provide legally binding consent and may not be cognitively capable of understanding the consequences of giving out personally identifiable information online. Many companies presently collect information from children for a variety of reasons -- to contact a child to verify that they may have won a prize, to monitor children in chat rooms, for statistical purposes or for direct marketing purposes.

On June 4,1998, the Federal Trade Commission released a report to Congress, *Privacy Online*, which surveyed 1,400 Web sites. Eighty-nine percent of children's sites surveyed collect personal information from children. Although 54% of children's sites provide some form of disclosure of their information practices, the Commission found that few sites take any steps to provide for meaningful parental involvement in the process. They found that only 23% of sites even direct children to seek parental permission before providing personal information. Only 7% of the sites said they would notify parents of their information practices, and less than 10 % provide for parental control over the collection and/or use of information from children. The Commission recommended that Congress adopt legislation protecting children's privacy online.

Best Practices Model – Online Privacy Alliance

On June 22, 1998 the Online Privacy Alliance issued specific guidelines for the protection of children's' privacy online.

Alliance members that operate sites directed at children under 13 have agreed (1) not to collect online contact information from a child under 13 without prior parental consent or direct parental notification of the nature and intended use of this information, including an option for the parent to prevent the use of the information and participation in the activity; (2) to assure that information collected will only be used to directly respond to the child's request and will not be used to recontact the child for other purposes without prior parental consent; (3) not to collect individually identifiable offline contact information from children under 13 without prior parental consent; (4) not to distribute to third parties any personally identifiable information collected from a child under 13 without prior parental consent; (5) not to give children under 13 the ability to post or otherwise distribute individually identifiable contact information without prior parental consent – sites directed to children under 13 must take best efforts to prohibit a child from posting contact information; and (6) not to entice a child under 13 by the prospect of a special game, prize or other activity, to divulge more information than is needed to participate in that activity.

Proposal

The Administration already has endorsed the FTC's call for legislation with respect to protection of children's privacy in the online environment. The Administration should specify that this legislation should set forth the fair information practices applicable to the collection of information from children and grant the FTC authority to promulgate rules to implement these standards. The grant of authority to the FTC could include a safe harbor provision -- data collectors that belong to a self-regulatory organization that contains standards for collection of data from children acceptable to the FTC and can demonstrate full compliance with the statutory requirements would have a defense to any enforcement action by the FTC for violations of the statute.

GOVERNMENT INFORMATION

Public records are a rich store of personal information. Federal, state and local governments require individuals to provide various types of information and are usually required to make such records available for public inspection. Public records include, but are not limited to real property records, marriage and divorce records, birth and death certificates, driving records, driver's licences, vehicle titles and registrations, civil and criminal court records, parole records, postal service change-of-address records, voter registration records, bankruptcy and lien records, incorporation records, worker's compensation claims, political contributions records, firearm permits, occupational and recreational licenses, filings pursuant to the Uniform Commercial Code and filings with the Securities and Exchange Commission.

These public records contain extensive and detailed information (e.g., race, gender, Social Security numbers, addresses, dates of birth, marriage, and divorce.) Social Security numbers, for example, are available from the records kept by dozens of government entities, such as motor vehicle bureaus -- many driver's license records make the individual's SSN, as well as their name, address, height, weight, eye color, gender, and date of birth available in one place. Dates of birth may be available from birth certificate and voter registration records, and land records typically include dates of sales, prices, size of mortgage amounts, and the property address and description, as well as the seller's and purchaser's names.

The U.S. Privacy Act, 5 U.S.C. Section 552a (1988) protects individuals from non-consensual government disclosure of confidential information. The Memorandum for Heads of Executive Departments and Agencies, signed by the President on May 14, 1998, directs agency heads to take specific action to assure that use of new information technologies sustain privacy protections provided by applicable statutes and that the information is handled in full compliance with the Privacy Act.

While the U.S. Privacy Act restricts the disclosure of personal information collected and maintained by the Federal government, many States do not have analogous privacy laws. Not only is the protection of information collected and maintained by State governments governed by an uneven patchwork of laws, but State freedom of information and public record laws, enacted before powerful information technology made collection and dissemination of information easy and efficient, allow many States to sell personal information. State records are the source of much of the personal information that, when disseminated, generates the greatest concern about privacy protection.

Issues around the collection, sharing and sale of personal information gathered by States are complicated by requirements under Federal law that States collect and provide certain information to the Federal government. These laws include transfer of information for tax purposes, to locate parents delinquent in their child support payments, and to determine food stamp and welfare eligibility.

Any effort to restrict State collection and sharing of personal information will raise significant federalism questions. For example, two states have successfully challenged the Drivers Privacy Protection Act on federalism grounds.

The Administration has already begun to address the issue of sharing of data by Federal agencies with State, local, and tribal governments in the President's Memorandum to Heads of Executive Departments and Agencies, signed on May 14, 1998.

Proposal

The Administration should create a Federal-State Task Force to initiate a "privacy dialogue" to analyze the privacy of personal information collected by governments. The dialogue could include a study of the State laws that require the collection of personal information and the Federal laws that require States to collect personal information and consider the desirability of:

1. State enactment of laws similar to the Privacy Act.

2. Extension of the Privacy Act protections to Social Security numbers collected by State governments.

3. Re-evaluation of the meaning of "public records" in light of new technology.

4. A requirement that States redact Social Security numbers and other personally identifiable information from documents before they are placed in the public domain.

5. An Executive Memorandum to State attorneys general reiterating obligations imposed by §7 of the Privacy Act with regard to the protections afforded the collection of Social Security numbers and the requisite notice requirements.

MEDICAL RECORDS/HEALTH INFORMATION

The confidentiality of health information is a matter of widespread national concern, and the protection of this information has been a priority of the Administration. On September 11, 1997, Secretary of Health and Human Services Donna Shalala recommended that Congress enact

Federal legislation to protect the confidentiality of health information by imposing duties on those who hold such information and by providing rights to the subjects of the information. She proposed that the Federal law provide a floor of protection, and that States be permitted to, in addition, provide stronger protections.

Under the recommended legislation, health care providers, those who pay for health care, and those who get information from those entities would have to permit patients to see their own records, to keep records of disclosures and let patients know who has seen their records, and to permit patients to file proposals for correction of erroneous records. All entities collecting or maintaining information would have to advise patients clearly of their confidentiality practices and of the patients' rights.

Disclosures would be limited to those authorized by the patient, or those specifically permitted in the legislation, including disclosures for important public purposes, such as treatment and payment, research, public health, oversight of the health care system, and use in law enforcement or other legal proceedings if permitted by other law. There would be strict limitations on further disclosure in many of these instances. Within an organization, information could be used only for purposes reasonably related to the purposes for which it was gathered, and all disclosures would have to be limited to the minimum necessary to accomplish the purpose of the disclosure.

Entities receiving information pursuant to patient authorization would have to give patients a statement of their intended use of the information, and would be civilly liable for uses in violation of that statement.

There would be civil and criminal sanctions for violations, such as improper disclosure and obtaining information under false pretenses.

Congress is now considering the recommendations.

Proposal

The Administration will continue to issue to call for comprehensive medical records privacy legislation. HHS will also issue regulations that will propose standards for the security of individual health information by health plans, health care clearinghouses, and health care providers. These organizations would be required to use the security standards to develop and maintain the security of all electronic health information about individuals.

FINANCIAL INFORMATION

The recent increase in cross-industry corporate mergers raise important privacy concerns with regard to the treatment of consumer information shared by affiliated companies. Such mergers may allow detailed and sometimes sensitive information about consumers, including medical and financial data, to be shared among newly related companies with relatively few restrictions. In the case of the recent merger of Citicorp and Travelers, for example, consumers might not anticipate that providing information for insurance underwriting purposes to one entity might later be used by the financial institution that is or becomes an affiliate.

Each of the nations' largest 25 banks has a securities affiliate, and banks of all sizes sell insurance. Affiliate information sharing already includes not only sharing of information for marketing purposes (e.g., a credit card bank soliciting an affiliate broker-dealer's best customers for a new platinum card) but also for security purposes (e.g., tracking a credit card holder's spending patterns in order to detect immediately any unusual activity that might indicate fraud or theft) and increasingly for risk-management purposes (e.g., a customer's record of payment on a credit card apparently is quite useful in determining whether that customer is a good risk for auto insurance). Such practices can be expected to continue, as the lines between various types of financial services firms continue to blur and the firms continue to merge.

The Fair Credit Reporting Act (FCRA) governs activities of agencies that furnish consumer information to consumer reporting agencies and credit or "consumer" reports to third parties. The FCRA defines a consumer reporting agency as a person or entity that regularly assembles or evaluates consumer credit information or other information on consumers for the purpose of furnishing consumer reports to third parties to be used as a factor in establishing the consumer's eligibility for credit, insurance, employment purposes, etc.

Companies that share consumer information with their affiliates are not subject generally to the controls of the FCRA. This exemption was created in the 1996 Amendments to the FCRA. The FTC raised concerns about exempting consumer information shared by affiliates from the protections of the FCRA. The banking industry was strongly opposed to extending the FCRA protections to consumer information shared by affiliates. In the end, affiliate sharing was permitted, but customers were granted an explicit right to opt out of affiliate information sharing of personal information other than "experience" or "transactional" information (which may be shared not only with affiliates but also third parties). For example, a customer can prevent personal information contained in an account application from being shared.

The 1996 Amendments to the FCRA also contains an odd provision prohibiting the banking agencies from examining for compliance with the Act; rather, they must await a complaint or other indication of trouble. The banking regulatory agencies also are prevented from issuing regulations under the Act, but the Federal Reserve may promulgate "interpretative" opinions in consultation with the other agencies. These provisions were included in 1996 because of banking industry concerns about regulatory burden, as part of the compromise that moved the bill forward. Banks see the prohibition on compliance examinations as putting them on the same footing as everyone else covered by the FCRA.

The OCC, which regulates national banks, has announced its intention to review the disclosure practices of national banks under the FCRA to ensure that the opt-out option is made evident to consumers. The Federal Reserve expects to issue an interpretation of the 1996 Amendments some time this summer that would clarify for all banks what information may be shared with affiliates and how specific and prominent each opt-out notice must be. Treasury has met with the Fed, FDIC and OTS to encourage joint action in this area, and they appeared receptive.

Proposals

a. The OCC, which regulates national banks, has announced its intention to review their disclosure practices under FCRA to ensure that the opt-out option is made evident to consumers, and the Federal Reserve expects to issue an interpretation some time this summer that would clarify for all banks what information may be shared with affiliates and how specific and prominent each opt-out notice must be. Treasury has met with the Fed, FDIC and OTS to encourage joint action in this area, and they appeared receptive. A public prodding from the Administration could be provided, however.

b. Authorize the Federal Reserve, in conjunction with other banking agencies, to write enforceable rules on provisions of the Fair Credit Reporting Act.

c. Give bank regulators the authority to examine financial institutions for compliance with the Fair Credit Reporting Act.

Study Proposals

a. As more databases are available directly to companies, and companies themselves share information directly, there is some concern that the FCRA may become outdated and obsolete. Companies, for example, will no longer purchase credit reports from a central bureau, but rather will obtain information directly from the individual sources and create their own internal credit reports. In the absence of traditional credit reporting agencies, the protections of the FCRA would evaporate. The Administration could undertake a study to determine whether the FCRA contains the protections needed in the electronic age.

PROFILING

Commercial "profilers" build dossiers about individuals by aggregating information from a variety of database sources, including public and non-public records. Individual reference services, sometimes called look-up services, represent a sub-set of the profiling industry. These services provide information that assists users in identifying individuals, locating individuals, and verifying identities.

Although profiling plainly has legitimate purposes, the public also has legitimate concerns about the compilation of -- and access to -- dossiers that may contain a great deal of personal information about a given individual.

Best Practices Model – Individual Reference Services Group

On December 17, 1997, a group of 14 Individual Reference Services (the Individual Reference Services Group, IRSG) entered into a agreement on privacy practices which was submitted to the Federal Trade Commission. The IRSG program is based on compliance with certain principles, including notice, disclosure, choice, security, and public education. IRSG members agreed to acquire personal information only from reputable sources, to exclude marketing information as a source, to take reasonable steps to assure that data collected is accurate, complete and timely for the purpose for which it will be used, to correct non-public records when appropriate, and to limit distribution of non-public information to subscribers with appropriate intended uses.

The IRSG committed to implement a rigorous enforcement compliance method. The enforcement program has two prongs. First, signatories' practices are subject to review by a "reasonably qualified independent professional service." On the basis of established criteria, that entity determines whether a signatory is in compliance with IRSG principles. The results of the annual review are made public. Second, signatories who are information suppliers may not sell information to look-up services that do not comply with the IRSG principles.

The IRSG members agreed to provide individuals with access to information contained in services and products that specifically identify them, unless the information comes from a public record, in which case the companies will provide the individuals with guidance on how they can obtain the information from the original source. The FTC strongly disagreed with the limitation on the access provisions of the IRSG practices, and the Commission and IRSG agreed to allow 18 months before revisiting the access issue. On the basis of the IRSG program and the commitment to review access issues, the FTC advised the Congress that legislation on individual reference services was premature.

Proposal

The IRSG agreement is a good start, but it only covers one category of business involving the compilation of personal information -- traditional "look up" services like those offered by Lexis-Nexis. Other types of entities purchase information from one or more sources to create profiles. For example, some companies are in the business of compiling profiles and reselling them to industry users. Private investigation firms sell identifying and background information collected from public records, interviews, and other investigatory sources. Public records resellers sell public record information like driving and criminal records. List brokers like Metromail gather information in the aggregate from marketing transactions and rent the information typically used for marketing purposes.

The Administration should announce an effort, in conjunction with the FTC, to encourage these other types of entities to adopt self-regulatory principles that are tailored to their line of business. (Private sector entities that create profiles based on information they collect themselves may be covered by the online privacy self-regulatory initiative discussed above.) The Adminstration could point out that addressing this issue is important to give individuals the security they need to do business in both the off-line and the on-line environment. If the private sector fails to address the issue, the Administration would propose legislation to protect the privacy of Americans.

IDENTITY THEFT

The term Aidentity theft@ generally refers to the fraudulent use of another person's identity to facilitate the commission of a crime, such as credit card fraud. The criminal gathers information about a person and then uses the information to adopt the identity of a victim. The Secret Service reports that this type of offense is growing rapidly, and the victims have been the focus of intense media and Congressional interest.

Under existing law, identity theft offenses are clearly punishable to the extent that they include identification documents (i.e., forged or stolen documents) and an intent to defraud the United States. In other cases, however, there may be gaps in federal or state law that would permit or provide only minimal punishment for the practice.

Thus, it would be helpful to change the law to recognize the potential harm that could be done by offenders who commit identity theft with means of identification, and to address other problems that have emerged as a result of a dramatic increase in cases of identity theft. At the same time, legislation to criminalize identity theft must be carefully crafted to avoid problems that could arise from the federalization of a large new class of crimes.

Last week, Senator Kyl marked up his bill, S. 512, the Identity Theft and Assumption Deterrence Act of 1997. After raising initial concerns about the breadth of the bill, the Departments of Treasury and Justice worked with Kyl to produce a more narrowly focused bill.

Legislative Proposal

a. Assuming that the Kyl bill meets remaining Adminstration concerns, the Administration could endorse the Kyl bill, and work publicly with Senator Kyl and the banking industry (which strongly supports the bill) to see it enacted.

THEFT OF PERSONAL INFORMATION

Recent media reports and Chairman Leach have highlighted a problem related to identity theft, where an offender obtains information illegally but then uses it for a *legal* purpose --e.g., pretends to be a customer in order to trick confidential information out of a bank, and then sells that information to a private investigator or some other third party.

Option

Chairman Leach introduced the Financial Information Privacy Act on July 23rd. This legislation makes it a federal crime to obtain or attempt to obtain customer information from a financial institution through fraudulent means, such as by misrepresenting the identity of the person requesting the information or otherwise deceiving bank officers or employees into divulging it. The bill would also make it unlawful for someone to receive such customer information if that person knows or has reason to know that the information has been obtained fraudulently. Finally, the bill establishes an administrative remedy through the FTC.

The Administration could support the Leach bill and indicate a desire to work together toward passage.

PROTECTION OF NEW TYPES OF PERSONAL INFORMATION

The use of Social Security numbers by the private sector in connection with a variety of transactions allows profilers, marketers and others to combine discrete bits of information to create a portrait of an individual. These portraits have legitimate uses -- law enforcement, credit assessments, debt collection, etc. -- and we therefore must tread cautiously to avoid upsetting an information structure that is fairly well established. The FTC recently indicated to Congress that the use of a unique identifier like Social Security numbers may contribute significantly to the accuracy of these portraits. In addition, the FTC indicated that "the cat may be out of the bag" with respect to private sector use of social security numbers.

Section 7 of the Privacy Act makes it unlawful for any Federal, State or local government agency to deny to any individual any right, benefit, or privilege provided by law because of such individual's refusal to disclose his social security account number. The Act provides an exception that permits Federal, State or local governments to request disclosure of an individual's social security number. In such cases, the Act requires notice of whether the disclosure is mandatory or voluntary, by what statutory or other authority such number is solicited, and what uses will be made of it.

It seems unlikely that anything can be done with respect to limiting the use of social security numbers by the private sector -- they have become ubiquitous and any limitation could have significant economic implication. On the other hand, as technology provides new means of identification, such as biometrics, it is important to consider how to give individuals more control over these new categories of identifying information.

Proposal

The Administration could undertake a study (with or without public announcement) to determine whether any steps are necessary to allow individuals to exercise more control over the information that is relevant to new identification technologies.

PUBLIC EDUCATION

The U.S. approach to privacy focuses on choice – individuals should have the choice to protect or disclose most personal information. Many Americans are unaware of how their personal information is used, and they do not understand how to protect themselves or exercise their ability to choose. Likewise, many businesses are unaware of consumer concerns about privacy and have not thought through their information handling practices in light of this concern.

Proposal

The Administration could identify private sector partners to develop an advertising campaign to inform individuals about how to exercise choice with respect to the collection and dissemination of their personally identifiable information. Such a campaign could include all advertising mediums – radio, television, print, and electronic.

July 28, 1998

MEMORANDUM FOR NEC/DPC PRINCIPALS

FROM: GENE SPERLING

RE: PAPER ON PRIVACY POLICY

Attached is the privacy policy paper that has been revised to reflect the discussion at the July 20th NEC/DPC principals meeting. There is one additional issue that we may need to work with HHS to resolve, which is the issue of universal health identifiers.

The Vice President is scheduled to hold an event on privacy on Friday, July 31st. Although this paper will not be released to the public, it will serve as the basis for the Vice President's speech and press release.

If you have any concerns with the paper, please contact Tom Kalil at (202) 456-2801 by close of business today.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jonathan Orszag (CN=Jonathan Orszag/OU=OPD/O=EOP [OPD])

CREATION DATE/TIME:29-JUL-1998 10:25:25.00

SUBJECT:

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D15]MAIL46994351E.226 to ASCII,
The following is a HEX DUMP:

DRAFT #1 July 29, 1998

MEMORANDUM FOR THE PRESIDENT

FROM: GENE SPERLING

SUBJECT: Bingaman Proposal to Purchase Oil for Strategic Petroleum Reserve

Although oil prices have risen in recent weeks, they remain near a nine-year low. These low prices are adversely affecting some independent oil producers. In response, Senator Bingaman has proposed to replenish the Strategic Petroleum Reserve (SPR) to its Gulf War level by purchasing 24 million barrels of oil at a cost of $400 million. The purpose of this memorandum is to inform your decision on whether or not to support Senator Bingaman's proposal.

Today, the Senate is addressing the Treasury-Postal Appropriations bill. Senator Faircloth has an amendment on the Exchange Stabilization Fund (ESF) that Secretary Rubin strongly opposes. They need Senator Bingaman's help in defeating this measure. However, Senator Bingaman is looking for our help on his proposal. He currently believes that we are receptive to this idea because he has not heard anything negative about it. Because he may attach his proposal to the Treasury-Postal bill today, we need to convey our views to him as soon as possible.

Our analysis of the Senator's proposal suggests that it would have an uncertain effect on oil prices in the short run and little or no effect in the long run (six months or more). Whether this proposal affects oil prices in the short run depends in large part on whether producers liquidate some of their current oil inventories -- which are relatively high -- in response to the Federal government's purchase for the SPR. If producers reduce inventories to sell to the SPR, the transaction would merely shift inventories from producers to the Federal government with little or no effect on oil prices.

If, on the other hand, oil producers do <u>not</u> draw down their existing inventories or boost their production rates, Senator Bingaman's proposal could substantially drive up the price of oil and gas. It is unlikely that the SPR would be able to make a 24 million barrel purchase all at once; Energy would spread it out over several months. Regardless, past evidence suggests that the announcement of a SPR purchase this large could bump up oil prices. We estimate that oil prices could rise by as much as 10 percent or $1.40 per barrel. This would translate into a 3.4 cent increase in gas prices for all American drivers. We would expect, though, that any such increase would dissipate over a matter of a few months.

Pros:

- If we want to replenish the SPR, now is a good time because oil prices are cheap. Indeed, it is possible that the government will profit from a purchase today (if oil prices subsequently rebound). However, past experience suggests that it is generally dangerous for the government to try to game the market.

- If the SPR purchase increases the price of oil, it would help oil producers.

- Because oil prices are expected to rise over the next several months, this proposal could help smooth oil prices in the short term. The future markets suggest that the price of oil will rise from $14.20 per barrel today to about $15.10 per barrel in three months and $15.58 per barrel in six months. However, others could argue that the fact that oil prices are expected to rise is a reason <u>not</u> to intervene.

- A SPR purchase of $400 million may result in an acquistion of <u>more than</u> 24 million barrels because the quality (and price) of the oil offered to the SPR is lower than the quality (and price) of the benchmark crude.

<u>Cons:</u>

- To the extent the proposal benefits producers at all, it comes at the expense of either America's working families or other government programs.

- OMB thinks it is unlikely that it could receive an "emergency determination" for the SPR purchase. Therefore, the $400 million cost would have to be offset by cuts in other government programs. Your Administration has reserved the emergency determination for natural disasters (e.g., floods, earthquakes, droughts, etc.) and foreign conflicts.

- If the purchase has <u>no</u> effect on oil prices, some could argue we wasted $400 million and did not help oil producers.

- If the purchase has an effect on prices, gas prices could increase by up to 3.4 cents per gallon. Thus, some may argue that this proposal is a "tax increase" on working families. And if prices increase, industries such as airlines, railroads, and utilities would complain because their input costs would rise significantly. To the extent these industries pass through the increase in energy prices to consumers, American families will have to pay more for air travel, train travel, and their utility bills. Put simply, because we are a net importer of oil, any oil price increase costs American consumers more than it benefits American producers.

- Any increase in oil prices will tend to raise inflation and/or lower economic growth in the short run. A rough estimate suggests that a 10-percent increase in oil prices could either lower economic growth by 0.X percent and raise the inflation rate (CPI-U) by 0.3 percent.

- The SPR currently exceeds the minimum amount recommended by some experts. But others recommend a higher level in the SPR to maintain some import protections.

- Some may argue that by providing insurance to this industry, we will attract additional claimants for government help whenever an industry experiences a temporary downturn.

- If energy prices rise in the next several months as expected and we make an announcement today that we are buying oil, we may get the blame for the higher oil prices.

Alternative Energy Department Proposal:

The Department of Energy recently invited oil companies to store oil in the SPR and pay for the storage space in oil. Currently, oil producers do not have excess storage space and with oil prices so low, they could benefit by building reserves now so that they can sell the oil later at higher prices. Since the SPR is currently 117 million barrels below full capacity, Energy proposes to lease 20 million barrels of space. Energy expects that the surcharge for storage would be 10 percent -- that is, if a oil producer stores 100,000 barrels, they would pay the government with 10,000 barrels. This proposal could have a similar, but much smaller, effect on the price of oil; by providing an incentive for businesses to build reserves, we would increase global demand, potentially raising the price of oil. It could also help restore up to two million barrels of our SPR.

We could potentially offer this proposal as an alternative to Senator Bingaman. Since the end result may be the same -- higher oil prices in the short run -- he may be willing to sign onto this approach. And since the Federal government would not be directly intervening in the oil market, many of the arguments against the Senator's proposal are not as relevant.

Recommendations:

The NEC, Treasury, CEA, OMB, and Energy are opposed to Senator Bingaman's proposal. There is unanimous agreement that this is a lose-lose proposal for the American people; it will either raise oil prices which would help oil producers at the expense of *all* American consumers or it will not raise oil prices which would mean we spent $400 million and did not help oil producers.

__________ Support Bingaman Proposal to Purchase Oil for Strategic Oil Reserves.

__________ Support Alternative Energy Department Proposal and Offer As Alternative To Senator Bingaman.

__________ Do NOT Support Either Proposal.

__________ Discuss.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:29-JUL-1998 20:29:31.00

SUBJECT: mtg.on Mexican IPR

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: Nouriel Roubini (CN=Nouriel Roubini/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Janet,

You will probably have a principals meeting Friday, on USTR's desire to list Mexico on July 31 as a "Priority Watch" case under Special301 on the subject of IPR. In the Deputies meeting, we supported State, along with Treasury, Justice and NSC, who are opposed. (It would produce a counterproductive backlash in Mexico.) Only Commerce supported USTR. But Richard Fisher insisted on a principals meeting.

Nouriel and/or I can give you further information.

JF

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:29-JUL-1998 09:52:53.00

SUBJECT: DRAFT Memo to the President on Strategic Petroleum Reserve

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
fyi
---------------------- Forwarded by Jeffrey A. Frankel/CEA/EOP on 07/29/98 09:52 AM ---------------------------

Jeffrey A. Frankel
07/29/98 09:39:43 AM
Record Type: Record

To: Jonathan Orszag/OPD/EOP
cc: Michele Jolin/CEA/EOP, Alan S. Polasky/CEA/EOP, Steven N. Braun/CEA/EOP,
Subject: DRAFT Memo to the President on Strategic Petroleum Reserve

Jon,
Very good memo.
Suggestions on your draft:

Para. 2. Change "ambiguous" to "uncertain". "Ambiguous" seems to imply that the purchase could drive the price of oil down as easily as up, which I don't think you mean.

I think you do a good job of reflecting the fact that the proposal would at best help one group at the expense of everyone else (and in fact the harm would outweigh the help); and that the argument for intervening to smooth out fluctuations in the oil market is no better than the argument for intervening to smooth out fluctuations in any other market.

Somewhere, perhaps added to your rebuttal at the end of the last "pro" point, you might mention that: the proposed action risks interfering with the natural market-equilibrating way of responding to oil prices that are thought to be temporarily low -- which is to create a futures premium and an incentive for firms to add to currently-held private inventories and other reserves, thereby moderating the decline in price relative to what it would otherwise be. This would be an example of the general point th at -- in general, and other things equal -- it is better to let private markets function without government interference.

Let us know if you want elaboration.

As you probably can guess CEA would be opposed to the Bingaman proposal.
JF

---------------------- Forwarded by Jeffrey A. Frankel/CEA/EOP on 07/29/98 09:26 AM ---------------------------

Michele Jolin
07/29/98 08:58:24 AM

Record Type: Record

To: Janet L. Yellen/CEA/EOP, Jeffrey A. Frankel/CEA/EOP, Joseph E. Aldy/CEA/EOP
cc:
Subject: DRAFT Memo to the President on Strategic Petroleum Reserve

Jon said he needs comments on this ASAP.
---------------------- Forwarded by Michele Jolin/CEA/EOP on 07/29/98 08:56 AM ---------------------------

Jonathan Orszag
07/29/98 12:34:43 AM
Record Type: Record

To: See the distribution list at the bottom of this message
cc:
Subject: DRAFT Memo to the President on Strategic Petroleum Reserve

Here's a draft of the memo to the President on Bingaman's SPR proposal.
We need to get sign off on this ASAP in the morning.

Forbes: Call me and I'll explain -- I'm also leaving a note to Gene to tell him to talk with Larry in the morning.

Steve B.: I have a question about some numbers in here. I will call you in the morning to discuss.

Message Sent
To:____
T J. Glauthier/OMB/EOP
Melissa G. Green/OPD/EOP
DAVID.WILCOX @ MS01.DO.treas.sprint.com@INET@LNGTWY
Jeffrey A. Forbes/WHO/EOP
Michele Jolin/CEA/EOP
Steven N. Braun/CEA/EOP

==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D97]MAIL426213516.226 to ASCII,
The following is a HEX DUMP:

DRAFT #1 July 29, 1998

MEMORANDUM FOR

FROM:

SUBJECT: Bingaman Proposal to Purchase Oil for Strategic Petroleum Reserve

Although oil prices have risen in recent weeks, they remain near a nine-year low. These low prices are adversely affecting some independent oil producers. In response, Senator Bingaman has proposed to replenish the Strategic Petroleum Reserve (SPR) to its Gulf War level by purchasing 24 million barrels of oil at a cost of $400 million. The purpose of this memorandum is to inform your decision on whether or not to support Senator Bingaman's proposal.

Our analysis of Senator Bingaman's proposal suggests that it would have an ambiguous effect on oil prices in the short run and little or no effect in the long run (six months or more). Whether this proposal affects oil prices in the short run depends in large part on whether producers liquidate some of their current oil inventories -- which are relatively high -- in response to the Federal government's purchase for the SPR. If producers reduce inventories to sell to the SPR, the transaction would merely shift inventories from producers to the Federal government with little or no effect on oil prices.

If, on the other hand, oil producers do <u>not</u> draw down their existing inventories or boost their production rates, Senator Bingaman's proposal could substantially drive up the price of oil and gas. We estimate that purchasing 24 million barrels of oil over one month would raise oil prices by about 10 percent or $1.40 per barrel. This would translate into a 3.4 cent increase in gas prices for all American drivers. We would expect, though, that any such increase would dissipate over a matter of a few months.

Pros:

- If we want to replenish the SPR, now is a good time because oil prices are cheap. Indeed, it is possible that the government will profit from a purchase today (if oil prices subsequently rebound). However, past experience suggests that it is generally dangerous for the government to try to game the market.

- If the SPR purchase increases the price of oil, it would help oil producers.

- This proposal could help smooth oil prices by raising them in the short term. The future markets suggest that the price of oil will rise from $14 per barrel today to about $14.75 per barrel in three months and $15.75 per barrel in six months. However, others could argue that the fact that oil prices are expected to rise is a reason not to intervene -- this could be viewed as the "market will correct itself."

Cons:

- To the extent the proposal benefits producers at all, it comes at the expense of either America's working families or other government programs.

- OMB thinks it is unlikely that it could receive an "emergency determination" for the SPR purchase. Therefore, the $400 million cost would have to be offset by cuts in other government programs. Your Administration has reserved the emergency determination for natural disasters (e.g., floods, earthquakes, droughts, etc.) and foreign conflicts.

- If the purchase has no effect on oil prices, some could argue we wasted $400 million and did not help oil producers.

- If the purchase has an effect on prices, gas prices could increase by up to 3.4 cents per gallon. Thus, some may argue that this proposal is a "tax increase" on working families. And if prices increase, industries such as airlines, railroads, and utilities would complain because their input costs would rise significantly. To the extent these industries pass through the increase in energy prices to consumers, American families will have to pay more for air travel, train travel, and their utility bills. Put simply, because we are a net importer of oil, any oil price increase costs American consumers more than it benefits American producers.

- Any increase in oil prices will tend to raise inflation and lower economic growth in the short run. A rough estimate suggests that a 10-percent increase in oil prices could lower economic growth by 0.X percent and raise the inflation rate by 0.X percent. [CHECK WITH STEVE BRAUN]

- The SPR currently exceeds the minimum amount recommended by experts.

- Some may argue that by providing insurance to this industry, we will attract additional claimants for government help whenever an industry experiences a temporary downturn.

Alternative Energy Department Proposal [CHECK]:

The Department of Energy has recently issued proposed guidelines that would invite oil companies to store oil in the SPR and pay for the storage space in oil. Oil producers do not have excess storage space and with oil prices so low, could benefit by building reserves now so that they can sell the oil later at higher prices. The SPR is currently 80 million barrels below capacity. Energy has proposed leasing 20 million barrels of space. This proposal could help

build our oil reserves back toward their previous levels and have a similar, but smaller, effect on the price of oil; by providing an incentive for businesses to build reserves, we would increase global demand today, raising the price.
[ADD MORE]

We could potentially offer this proposal as an alternative to Senator Bingaman. Since the end result may be the same -- higher oil prices in the short run -- he may be willing to sign onto this approach.

Recommendations:

NEC?
Treasury?
CEA?
OMB?
Energy?
White House Leg Affairs?
COS?

__________ Support Bingaman Proposal to Purchase Oil for Strategic Oil Reserves.

__________ Support Alternative Energy Department Proposal and Offer As Alternative To Senator Bingaman.

__________ Do NOT Support Either Proposal.

__________ Discuss.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:30-JUL-1998 18:36:55.00

SUBJECT: Janet's press statement

TO: Todd Stern (CN=Todd Stern/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: William J. Antholis (CN=William J. Antholis/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TO: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Please find attached the draft of Janet's press statement. All comments
should be sent to Michele. Have fun tomorrow!

=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D56]MAIL49289761W.226 to ASCII,
The following is a HEX DUMP:

I am pleased to have this opportunity to discuss the report of the Administration's economic analysis on the Kyoto Protocol and the President's policies to address climate change. This report elaborates on the testimony I presented in Congressional hearings this spring. It details how the United States can achieve its greenhouse gas reduction target under the Kyoto Protocol at a relatively modest cost. With the market-based, flexibility measures in the agreement, the participation of key developing countries, and smart policies at home, we can meet the challenge of climate change while maintaining a strong economy.

There is a powerful scientific rationale for taking action on global warming; taking action amounts to an insurance policy against a serious risk. Greenhouse gases are rapidly building up in the atmosphere and at current rates will reach levels not seen in 50 million years by 2100. The nine hottest years on record have occurred since 1987. Our leading scientists warn of serious consequences, like severe droughts and floods and health problems, if global warming is ignored. In 1992, the National Academy of Sciences said: "...even given the considerable uncertainties in our knowledge of the relevant phenomena, greenhouse warming poses a potential threat sufficient to merit prompt responses....Investment in mitigation measures acts as insurance protection against the great uncertainties and the possibility of dramatic surprises."

The costs of meeting our Kyoto target should be modest. Even without counting the impact of domestic policies or the benefits of acting to mitigate climate change, estimates derived using the Second Generation Model (SGM) suggest an emissions price in the range of $14 to $23 per ton of greenhouse gases. In 2010, that would translate into an increase of $70-$110 per year for an average family's energy bill, although such increase would be substantially offset by the decline in electricity prices resulting from restructuring the electricity industry, as the Administration and others have proposed.

Domestic actions -- which are not factored into the SGM model -- can further reduce costs and substantially increase the amount of reductions made at home. These include federal electricity restructuring; efforts to increase the rate of technology improvement, such as the President's $6.3 billion budget package; forestry activities like tree planting, which can sequester carbon; industry consultations; and initiatives to reform federal energy use and procurement.

Doing it smart: The Kyoto Protocol is based upon flexibility measures that reduce costs. At U.S. insistence, the Kyoto Protocol allows emissions to be reduced where such reductions are cheapest. Key provisions include international trading of emissions permits as well as measures that allow our companies to share credit for emissions-reducing projects abroad.

The Second Generation Model as we have modified it has particular strengths in assessing the Kyoto Protocol, especially its flexibility measures. First, we model all 6 types of greenhouse gases. Second, we explicitly incorporate the flexibility mechanisms, such as international trading and the Clean Development Mechanism. Third, we use a computable general equilibrium model that appropriately depicts the way our dynamic economy works at horizons as long as a decade or more.

The benefits of acting to address climate change could be very large. Monetary estimates of damages from the environmental, health, and economic impacts of global warming projected to occur by the end of the next century have been estimated by noted economists to be in the range of 1% of GDP or more -- over $80 billion a year in today's terms. Moreover, in the short term, ancillary benefits of reducing greenhouse gas emissions -- such as reduced air pollution -- could produce savings equal to one quarter of the costs of meeting our Kyoto target.

I welcome any questions you may have about the Administration's economic analysis.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:30-JUL-1998 14:21:52.00

SUBJECT: econ fact sheet -- again

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
FYI. What do you think?
---------------------- Forwarded by Joseph E. Aldy/CEA/EOP on 07/30/98
02:21 PM ---------------------------

Todd Stern
07/30/98 02:15:06 PM
Record Type: Record

To: See the distribution list at the bottom of this message
cc:
Subject: econ fact sheet -- again

Joe -- the change from "which" to "that" fixes your problem in the third
bullet. If you have any doubt about that, call and I'll explain. Jake --
you ok with slightly edited top box?

Message Sent
To:____
Joseph E. Aldy/CEA/EOP
Jake Siewert/OPD/EOP
Elliot J. Diringer/CEQ/EOP
David B Sandalow/CEQ/EOP
William J. Antholis/OPD/EOP
Michele Jolin/CEA/EOP
Martha L. Wofford/WHCCTF/EOP
Roger S. Ballentine/WHO/EOP
Julie M. Anderson/WHCCTF/EOP
Dirk Forrister/WHCCTF/EOP

=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D18]MAIL42948561L.226 to ASCII,
The following is a HEX DUMP:

ADMINISTRATION ECONOMIC ANALYSIS:
MEETING THE CHALLENGE OF CLIMATE CHANGE AT A REASONABLE COST

The Administration's economic analysis of the Kyoto Protocol concludes that we can meet our Kyoto target for reducing greenhouse gases at modest cost; that taking action to address global warming amounts to an insurance policy against a serious threat; that there are real opportunities for low-cost reductions both at home and abroad; and that the benefits of averting climate change could be large.

July 31, 1998

There is a powerful scientific rationale for taking action on global warming; taking action amounts to an insurance policy against a serious risk. Greenhouse gases are rapidly building up in the atmosphere and at current rates will reach levels not seen in 50 million years by 2100. The nine hottest years on record have occurred since 1987, 1997 was the hottest year ever, and 1998 has been hotter still. Our leading scientists warn of serious consequences, like severe droughts and floods and health problems, if global warming is ignored. The National Academy of Sciences has said: "...even given the considerable uncertainties in our knowledge of the relevant phenomena, greenhouse warming poses a potential threat sufficient to merit prompt responses....Investment in mitigation measures acts as insurance protection against the great uncertainties and the possibility of dramatic surprises."

The costs of meeting our Kyoto target will be modest. Even without counting the impact of domestic policies or the benefits of mitigating climate change, estimates derived using the Second Generation Model (SGM) suggest an emissions price of $14 to $23 per ton of greenhouse gases. This would translate into an increase of $70-$110/year in 2010 for an average family's energy bill, although such increase would be substantially offset by the decline in electricity prices from restructuring the electricity industry, as the Administration and others have proposed.

Domestic actions that are <u>not</u> factored into the SGM model can lower costs even more and substantially enhance our ability to make reductions at home. These include federal electricity restructuring to increase competition and lower costs; efforts to increase the rate of technology improvement, such as the President's $6.3 billion budget and tax cut package; innovative practices, like forestry activities, which can sequester carbon; industry consultations; and initiatives to reform federal energy use and procurement.

Doing it smart: The Kyoto Protocol is based upon flexibility measures that reduce costs. At U.S. insistence, the Kyoto Protocol allows emissions to be reduced where and when such reductions are cheapest. Key provisions include international trading of emissions permits as well as measures that allow our companies to share credit for emissions reducing projects abroad.

The benefits of acting to address climate change could be very large. Noted economists have estimated the environmental, health, and economic costs of global warming projected to occur during the next century to be 1% of GDP or more -- over $80 billion a year in today's terms. In the short term, ancillary benefits of reducing greenhouse gas emissions -- such as reduced air pollution -- could produce savings equal to one quarter of the costs of meeting our Kyoto target.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:30-JUL-1998 09:19:31.00

SUBJECT: Re: press statement

TO: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: William J. Antholis (CN=William J. Antholis/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

CC: Jonathan H. Adashek (CN=Jonathan H. Adashek/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TEXT:
I have a concern. It comes from the following language, which is present in some form in the document but received more prominence in the current draft press statement:

...Even without counting the impact of domestic policies or the benefits of acting to mitigate climate change, estimates derived using the Second Generation Model suggest an emissions price in the range of $14 to $23 per ton of greenhouse gases....
Domestic actions -- which are not factored into the SGM model -- can further reduce costs and substantially increase the amount of reductions made at home. These include...

I know that Todd does not intend the words "domestic policies" to include the 2008-2012 tradable permit program that is the policy modeled along with international trading) with SGM. But, a reader may not realize that. The way the statement reads now could make it sound (incorrectly) like our results from the SGM model are based 100% on purchases from aborad, with no domestic actions at all. I know we wouldn't want to create that misimpression.
JF

Joseph E. Aldy
07/30/98 08:44:55 AM

Record Type: Record

To: Janet L. Yellen/CEA/EOP
cc: Jeffrey A. Frankel/CEA/EOP, Michele Jolin/CEA/EOP
Subject: press statement

Janet,

Last night, Todd and Bill both told me that your press statement should be short. Bill and Todd suggested that we go off of the talking points that have been written. So, as a good thief, I have plagiarized largely from the talking points. This is now 2 double-spaced pages. Let me know what you think, and I will then circulate it to Bill and Todd.

Regarding your press briefing, it appears that it might be primarily a conference call. Most of the enviro reporters at the papers they want to brief (NYT, WA Post, LA Times, WSJ) will be in North Carolina today for the naming of our Natural Heritage Rivers, so they would call in for the briefing. When I get more details, I'll let you know.

Joe

=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D72]MAIL448923612.226 to ASCII,
The following is a HEX DUMP:

I am pleased to have this opportunity to discuss the report of the Administration's economic analysis on the Kyoto Protocol and the President's policies to address climate change. This report elaborates on the testimony I presented in Congressional hearings this spring. It details how the United States can achieve its greenhouse gas reduction target under the Kyoto Protocol at a relatively modest cost. With the market-based, flexibility measures in the agreement, the participation of key developing countries, and smart policies at home, we can meet the challenge of climate change while maintaining a strong economy.

There is a powerful scientific rationale for taking action on global warming; taking action amounts to an insurance policy against a serious risk. Greenhouse gases are rapidly building up in the atmosphere and at current rates will reach levels not seen in 50 million years by 2100. The nine hottest years on record have occurred since 1987. Our leading scientists warn of serious consequences, like severe droughts and floods and health problems, if global warming is ignored. In 1992, the National Academy of Sciences said: "...even given the considerable uncertainties in our knowledge of the relevant phenomena, greenhouse warming poses a potential threat sufficient to merit prompt responses....Investment in mitigation measures acts as insurance protection against the great uncertainties and the possibility of dramatic surprises."

The costs of meeting our Kyoto target should be modest. Even without counting the impact of domestic policies or the benefits of acting to mitigate climate change, estimates derived using the Second Generation Model (SGM) suggest an emissions price in the range of $14 to $23 per ton of greenhouse gases. In 2010, that would translate into an increase of $70-$110 per year for an average family's energy bill, although such increase would be substantially offset by the decline in electricity prices resulting from restructuring the electricity industry, as the Administration and others have proposed.

Domestic actions -- which are not factored into the SGM model -- can further reduce costs and substantially increase the amount of reductions made at home. These include federal electricity restructuring; efforts to increase the rate of technology improvement, such as the President's $6.3 billion budget package; forestry activities like tree planting, which can sequester carbon; industry consultations; and initiatives to reform federal energy use and procurement.

Doing it smart: The Kyoto Protocol is based upon flexibility measures that reduce costs. At U.S. insistence, the Kyoto Protocol allows emissions to be reduced where such reductions are cheapest. Key provisions include international trading of emissions permits as well as measures that allow our companies to share credit for emissions-reducing projects abroad.

The benefits of acting to address climate change could be very large. Monetary estimates of damages from the environmental, health, and economic impacts of global warming projected to occur by the end of the next century have been estimated by noted economists to be in the range of 1% of GDP or more -- over $80 billion a year in today's terms. Moreover, in the short term, ancillary benefits of reducing greenhouse gas emissions -- such as reduced air pollution -- could produce savings equal to one quarter of the costs of meeting our Kyoto target.

I welcome any questions you may have about the Administration's economic analysis.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:30-JUL-1998 08:28:28.00

SUBJECT: new set of Qs and As

TO: David B Sandalow (CN=David B Sandalow/OU=CEQ/O=EOP @ EOP [CEQ])
READ:UNKNOWN

TO: William J. Antholis (CN=William J. Antholis/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Todd Stern (CN=Todd Stern/OU=WHO/O=EOP @ EOP [WHO])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Attached is a new version of the Qs and As, with answers to all questions in the draft I sent out the night before last, with 2 exceptions. Todd has rewritten the domestic reductions answer, and I am still trying to figure out how to answer one of the electricity questions. Are there other Qs that we need to be prepared for? (Note, since this is roughly the same as testimony, Janet already has a lot of Qs and As on these issues, so the new Qs should probably focus issues this report raises more clearly.)

=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D39]MAIL41878261I.226 to ASCII,
The following is a HEX DUMP:

What portion of reductions does your analysis anticipate will be made in the U.S.?

New answer from Todd.

How much money would be sent abroad? Isn't this a tax on American business and government transfers to Russia?

There will be no taxes on Americans or government transfers to Russia. However, U.S. firms -- not the U.S. government --- may choose to purchase international emissions permits if they so desire to meet their emissions obligations -- from Russia or other countries or through the CDM. As with any market transaction, purchases of these permits will have to comply with all U.S. legal and regulatory requirements. U.S. firms interested in international investment and emissions credits will have an incentive to ensure that other countries meet the international standards for adequately monitoring and reporting their emissions of greenhouse gases. Russia will have a significant incentive to use the revenues to invest in modern, climate-friendly plants and equipments so that as its economy recovers, it continues to produce emissions reductions for sale on international markets.

If your model does not account for key factors like domestic initiatives, carbon sinks, or electricity restructuring, why did you use that model?

No one model can handle all characteristics of the Kyoto Protocol and the President's policies to reduce greenhouse gas emissions. Indeed, as we have said previously, no one model is capable of providing definitive answers on climate change. However, models can aid our understanding of some of the key policy parameters. As we have seen, both with SGM, and through our review of the literature, including modeling exercises through the Energy Modeling Forum, flexible, market-based mechanisms for reducing emissions are critical to lowering the cost of meeting our target. Because of this insight, we employed a model to illustrate the cost-savings opportunities to trade across space and to trade across types of greenhouse gases. However, while SGM provides a solid understanding of the benefits of trading and the potential permit price under an international trading system, it does not assess other kinds of policies, like our domestic initiatives. Indeed, none of the large, international models can assess our domestic initiatives. Given the international nature of the Kyoto Protocol, we decided it would be most valuable to employ an international model to assess the effects of trading. In this analysis, we attempted to be conservative in our assumptions, and while domestic initiatives will be quite important in meeting our target, their effects are still imprecise enough that we did not want to include them in the modeling.

Why didn't you devise some way to factor those elements into your analysis, rather than putting them aside?

The Administration has not included quantitative estimates of emissions reductions associated with electricity restructuring, the CCTI, industry consultations, or the Federal energy program in the illustrative modeling analysis. First, the model can not assess these programs directly. Second, there is uncertainty in calculating the payoffs from funding research and development. Third, the industry consultations are still at an early stage, so it would be premature and difficult to quantify and incorporate emissions reductions from consultations into the illustrative modeling analysis. Fourth, we have attempted to err on the conservative side when accounting for technology diffusion in our analysis. This is somewhat analogous to the Administration's rationale for employing mainstream economic assumptions in our budget forecasts: in the presence of uncertainty, we are conservative in our estimates of the speed with which the economy will grow, tax receipts will rise, and the budget will improve. That way, any revisions or surprises that occur are likely to be in the pleasant direction. In this instance, we prudently and conservatively assume that there will be substantial delays between investments in new technology or the diffusion of existing technology, and the returns to such investments.

Is this CEA's analysis or the Administration's analysis? If it's the Administration's analysis, why does it not reflect any of the bottom-up perspective that DOE has used in the past?

This is the Administration's analysis. It reflects the work by many Administration agencies to evaluate the costs and benefits of mitigating climate change. The report provides the results from one model as an illustration that the costs could be modest. This conclusion that the costs could be modest is not based solely on this one model, but on a much larger review of the available climate change literature. Thus, the conclusion reflects the results from many different modeling efforts, including both economic work by the Energy Modeling Forum as well as the engineering-based approach reflected in the DOE Laboratories work.

Why is there only one scenario? Didn't you think it appropriate at least to represent other views?

The Administration's analysis presents the economic implications of the scenarios that best reflect the U.S. government's position on international trading and global participation.

Why are you so optimistic about international trading but conservative about technology?

Our conservative approach is to avoid rosy scenarios as in budgeting. I am optimistic about trading because it is in our control to get it and make it work. We know that there are big differences in mitigation costs across countries that can lower overall costs and we will work to insure effective trading arrangements. Technology is out of our control. We can work to promote it, but there is an element of unpredictability.

Why don't you present a view that does not include the optimistic assumption that China, India, and other developing countries assume emissions targets?

That is a hypothetical scenario that is not consistent with our policies. This report illustrates, among other things, how developing countries can maintain sustainable growth while participating in an international system of emissions reductions and trading. By participating in international trading, developing countries could attract investment for cleaner energy and technologies while generating cost-effective abate opportunities for firms in industrialized countries.

You have essentially assumed an international trading system that operates as seamlessly as the New York Stock Exchange. Have you found a single outside validator to support an assumption that is this extraordinarily optimistic?

Because we are still engaged internationally on trading rules, we have the opportunity to develop a system that would promote active private sector participation with minimal transaction costs. Given the interest in climate change by such major actors like the World Bank, the Chicago Board of Trade, and the International Petroleum Exchange in London, and the efforts we have undertaken to learn from traders in other markets, we believe the potential exists to transform the concept of international trading into a practical, workable system.

Has this been peer-reviewed? Why not?

This has not been peer-reviewed. As a document that serves as a technical appendix to the testimony of the Chair of the Council of Economic Advisers, the document fell under the peer review policy of CEA. Simply put, CEA does not submit its reports for peer review.

How did you model "meaningful participation by key developing countries"?

In this analysis, the $14 to $23/ton scenarios reflect an assumption that some developing countries take on emissions targets and participate in trading. While emissions targets in the first commitment period would surely constitute meaningful participation, that is not a necessary prerequisite for meaningful participation.

As the Administration has noted on numerous occasions, meaningful participation varies according to the circumstances of each developing country. The term "developing country" encompasses a wide range of nations which are at various stages of industrialization and contribute differently to global emissions. Accordingly, there is no one-size-fits-all approach to measuring developing country participation. Clearly, a country with high GDP or one that emits a proportionally large share of global emissions should be expected to do more than one that is poor or whose emissions are negligible.

Your analysis includes "key developing countries" with emissions targets. Are China, India, Mexico, and Korea the only key developing countries?

These countries should not be considered the only key developing countries. In fact, the Administration does not have an official list of key developing countries. In the illustrative analysis, we used these countries as examples of the effects developing countries could have on an international trading system. In the Second Generation

Model, these 4 developing countries are distinct regions from the "Rest of the World" region which encompasses all other Non-Annex I countries. The use of the model with these as "key developing countries" reflects the disaggregation of developing countries in the model rather than explicit policy decisions.

Your analysis assumes that "key developing countries" take on targets at their 2010 BAU emissions level -- this implies that they do not have to undertake any emissions reductions to comply with their targets. Is this consistent with Byrd-Hagel? Is this "meaningful participation"?

As we have said previously, there is no one-size-fits-all for meaningful participation. We have used targets set at 2010 BAU simply for illustrative purposes. It should not be construed as a statement on either Byrd-Hagel or meaningful participation, but simply as an illustration.

How much will it cost if you don't get "key developing countries" to take on targets?

That is a hypothetical that does not reflect our policy. We believe that the costs will be modest with developing countries taking on targets. Further, we believe with some kinds of emissions targets, developing countries could even benefit from adopting targets and participating in trading. Moreover, reducing emissions in these developing countries could generate substantial ancillary public health benefits, such as those related to reduced particulate matter and sulfur dioxide emissions. In these cases, it could be in the economic interest of these developing countries to take on targets.

How much will it cost if their are restrictions on international trading?

The U.S. position is to secure effective trading rules to promote low-cost emissions reductions. We have stated repeatedly our opposition to trading restrictions as both inefficient and infeasible. Since a ton of CO2 emitted in New York has the same environmental effect as a ton emitted in Moscow, we see no environmental justification for placing restrictions on trading. Since we will not accept trading restrictions, it is unnecessary to discuss this hypothetical scenario.

Costs in other studies are more than 10 times yours. Why should we believe your estimates?

Many of the other studies that have been conducted with much higher costs do not appropriately reflect the achievements our negotiators secured in the Kyoto Protocol nor the Administration's policies for future action. For example, these studies, some which even claim to be analyses of Kyoto, do not include many of the important flexibility mechanisms in the Kyoto Protocol, such as international emissions trading, the Clean

Development Mechanism, as well as the potential to trade across greenhouse gases. Further, these analyses do not account for the Administration's position on developing country participation. The flexibility measures were included in the Administration's analysis. As I have said before, we can do it dumb, or we can do it smart. Doing it dumb means that we would ignore many of the cost-effective opportunities to reduce emissions. Doing it smart implies that we would take advantage of cost-effective options, and that is why the Administration was a strong advocate in Kyoto for flexibility measures, and we will continue to serve as an advocate in subsequent negotiations.

You have provided direct costs. The economic literature indicates that total costs of a policy like this should be 2 - 4 times the direct costs. What are the total costs of your policy?

Our approach follows the practice of the researchers who have developed the SGM model and is consistent with other uses of this model. This same approach is also used by researchers at the Massachusetts Institute of Technology. It reports costs as the sum of 1) the cost of emissions reductions achieved in the U.S., calculated to reflect only the incremental cost of each reduction, i.e., the minimum compensation that a profit-oriented firm would need as compensation for such reductions, and 2) the total value of payments to foreigners for emission permits acquired through international trading.

Although we have followed a practice accepted by many modelers the measurement of total costs in the computable general equilibrium models used to assess the economic impacts of mitigating climate change is an area of ongoing study. For example, researchers within the Energy Modeling Forum recognize that modelers need a better understanding of why the costs are so different across models and some way to decompose the many components contributing to the overall cost of mitigation. Differences in cost have not yet been decomposed into distinct components in a manner that lets independent researchers evaluate the validity of such claims.

What are the benefits of Kyoto?

Fully implementing the Kyoto Protocol would generate several kinds of benefits. First, it will be an important first step in seriously addressing the risks of climate change. Kyoto alone will not completely mitigate these risks, however, as the first step, it is essential to take the second, third, and further steps. As the report indicates, inaction on this issue could result in substantial economic costs in the next century. Second, abating greenhouse gas emissions would generate significant ancillary benefits, such as improved air quality and decreased reliance on imported oil.

Would a less stringent alternative capture most of the benefits of this approach? Why didn't you assess any such alternatives?

Some economic research does suggest that relative to the targets in the Kyoto Protocol, a more backloaded approach to emissions reductions could reduce the costs involved, even while resulting in the same ultimate concentration of carbon in the atmosphere. But the emissions paths called for under such a plan rely on very steep -- and perhaps implausible -- declines in the out-years to ensure that the same concentration goal is met. [If we had proposed such a path, we would undoubtedly have been criticized for proposing a plan that was too backloaded.]

The targets in the Kyoto Protocol strike the proper balance between those who wish to do more, at the possible risk of imposing significant costs on the economy, and those who wish to do less, at the possible risk of imposing significant costs on the environment.

In your analysis, you modeled a tradable permit scheme. Isn't such a scheme modeled the same way as a carbon tax? Doesn't this mean that a tradable permit scheme is just a euphemism for higher energy taxes?

In large international models like SGM, the model assesses the effects of tradable permits on emissions in a similar fashion as they do carbon taxes. However, there are several critical differences between a permit system and a tax. For example, a permit system provides insurance that a given quantitative target will be met, whereas a tax does not. Further, a tradable permit system allows for private sector participation in international trading, while a system of energy taxes would not. Finally, it should be noted that some increase in the relative price of energy will ultimately be necessary to address the critical issue of climate change. But it would be irresponsible not to explore all possible alternatives before resorting to a modest relative price change. The President has therefore proposed a graduated, three-stage approach to emissions reductions -- starting with a period of voluntary action, tax incentives, R&D, and Federal efficiency improvements, and then followed by the permit trading system a decade from now.

In the model, aren't permits auctioned? Does the Administration intend to auction permits?

In SGM, greenhouse gas permits are modeled as auctioned. However, it should be noted that the Administration has not decided to auction the permits. Further, just for the record, there are still several critical differences between such an auctioned permit system and a tax. For example, the permit system provides insurance that a given quantitative target will be met, whereas a tax does not. And any revenue from the auctions could be used to *reduce* other taxes -- so that the entire effort would be revenue-neutral.

The Protocol includes a provision on banking. Did you assess the effect of banking on costs in the first commitment period? Why not?

We did not assess the effects of banking on permit prices and costs because the Kyoto Protocol stipulates emissions targets for only the first target period. To analyze banking, we need to know the emissions targets for the second and subsequent periods. Without this information, it is impossible to assess the incentive for countries and private firms to bank emissions for use in later periods.

Why can't you estimate sinks? You agreed to something in Kyoto, and you don't understand its implications 6 months later?

There are ongoing international efforts through the UNFCCC and the IPCC to develop rules and methodologies for assessing sinks. Given that there is not an internationally agreed interpretation of Article 3.3, it would be premature to present an estimate of sinks for the United States. Moreover, we are still in the process of collecting data from other countries to better understand the extent of their sink potential.

Battelle has recently released a draft paper of its assessment of Kyoto. It indicates that the permit price with full global trading would be $25/ton. Why is their estimate higher than yours with the same model?

The permit price in the Battelle paper is close to the range presented in the Administration report. The Administration's range is lower for three reasons. First, we incorporated a cost curve for non-carbon dioxide greenhouse gases for the United States, which allows for more low-cost abatement opportunities. Second, we incorporated a 6 gas baseline for other countries as well. Third, our lower bound reflects a scenario with umbrella trading, which the Battelle paper did not assess. This umbrella trading with developing countries, which assumes that the E.U. decides not to participate in international trading, has lower costs because of fewer buyers in the international market.

You used only 1 model. With all the same assumptions, what would the likely permit prices be using other models?

This is somewhat of an unknown since the Administration modified the SGM model with the non-carbon dioxide cost curve and developed 6 gas baselines for all countries. However, based on results presented at previous Energy Modeling Forum (EMF) workshops, we know that SGM generates neither the highest nor the lowest permit prices among its class of models (computable general equilibrium, or CGE). Moreover, recent studies using bottom-up models have found much lower costs for reducing emissions than SGM or other top-down models.

Last summer, you said that relying on 3 models would be futile. Yet, now you deliver an economic analysis relying on just 1 of the 3. What has happened since then that allows you to more comfortably rely on SGM?

We are not relying on SGM. The model results we present from SGM are merely an illustration of our conclusion that costs could be modest. We assessed the economic literature on climate change mitigation, including the last three EMF exercises on climate change, in reaching our conclusion.

The report indicates that electricity restructuring will lower carbon emissions by up to 40 MMTCE. How can making electricity cheaper result in lower emissions? Won't people consume more electricity if the price falls?

Although competition will lower prices, which will tend to increase consumption, it will also provide a direct profit incentive for generators to produce more electricity with less fuel and improve energy efficiency as competitive sellers seek to maximize the value of their product offerings to buyers by bundling electricity with energy efficiency and management services. Specific provisions of the Administration's proposal that will yield additional emission reductions include a renewable portfolio standard, a public benefits fund that will support renewable energy and energy efficiency investments, "green" labeling to help consumers who value clean energy choose it, and a net metering provision encouraging the installation of small renewable systems.

These additional provisions in the Administration's proposal on electricity restructuring result in some emissions reductions. Do you have an estimate of their costs? If so, do you know what the cost per ton (average and marginal) is for those emissions reductions?

How do we answer this?

The report indicates a range of ancillary benefits. Why the large range?

The range reflects the 2 methodologies used in the NAAQS RIA (National Ambient Air Quality Standards Regulatory Impact Analysis) last summer. There is still uncertainty regarding several key variables in monetizing public health benefits associated with reducing particulate matter emissions. While the academic literature continues to debate these points, we have taken the conservative approach of providing a broad range. Note that the claim that ancillary benefits could offset 1/4 the compliance costs reflects the lower end of the range in the report.

Isn't the upper bound of the ancillary benefits estimate derived from EPA's 812 report methodology? Isn't it true that the Administration's economic agencies do not accept that methodology as legitimate? Why then is it in the report?

The ancillary benefits range reflects the 2 methodologies used in the NAAQS RIA (National Ambient Air Quality Standards Regulatory Impact Analysis) last summer.

This RIA enjoyed interagency agreement, so it is reasonable to use it in an Administration report.

The testimony presented on March 4 before House Commerce and at several hearings since indicated that, in addition to improved air quality, the ancillary benefits include reduced congestion and traffic fatalities. However, there is no mention of these benefits in the report. Why not? Further, why would congestion and traffic fatalities decrease with a tradable permit system?

The magnitude, and perhaps the direction, of the these benefits are very sensitive to the point in the energy system that the domestic cap and trade program is implemented. Since the Administration has not made developed the cap and trade policy yet, it would be premature to present estimates that would prejudge the policy. The magnitude of the ancillary air quality benefits is such that the conservative conclusion that ancillary benefits are equal to 1/4 of the resource costs of compliance still holds.

Isn't it true that the permit price without trading would be $193/ton? Wouldn't this be about $0.50 per gallon in higher gasoline taxes?

The permit price and gasoline price could be that high with that assumption, but this permit price reflects a hypothetical scenario which is neither Administration policy nor is it consistent with what was achieved in Kyoto. Only if part or all of Articles 3.1, 3.3, 3.4, 6, 12, and 17 were removed from the Kyoto Protocol would this even be conceivable.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:30-JUL-1998 15:09:26.00

SUBJECT: addition to press statement

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Todd would like us to add a paragraph (short) near the end of the press statement briefly describing SGM. Basically, he wants us to demonstrate that our model is different from others that have (or will) critique Kyoto (e.g., WEFA, EIA, etc.). It would read something like this:

"The Second Generation Model as we have modified it has particular strengths in assessing the Kyoto Protocol. First, we model all 6 types of greenhouse gases. Second, we explicitly incorporate the flexibility mechanisms, such as international trading and the Clean Development Mechanism. Third, we use a computable general equilibrium model that appropriately depicts the way our dynamic economy works over a decade or more."

Let me know how you think about this (especially the third point).

Joe

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:30-JUL-1998 21:11:36.00

SUBJECT: Capital Controls--some suggested revisions

TO: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Nouriel Roubini (CN=Nouriel Roubini/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

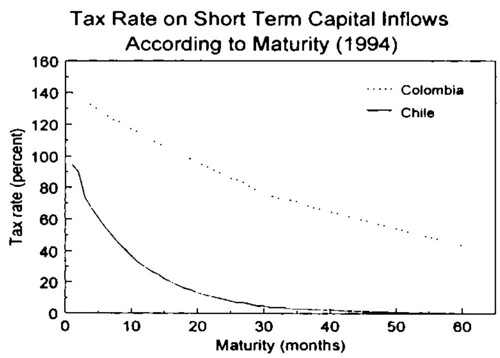
TEXT:
=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D65]MAIL43327071W.226 to ASCII,
The following is a HEX DUMP:

SPECIAL ANALYSIS

Controls on "Hot Money" Inflows in Chile and Colombia

The Asian currency and financial crisis has rekindled a broad debate over whether controls on short-term capital inflows, such as those implemented by Chile and Colombia in the 1990s, have helped them withstand international currency crises.



What are capital controls? Countries have adopted numerous methods to limit short-term capital inflows. Chile and Colombia placed a tax on capital inflows related to their maturity (see chart). Short-term inflows are taxed at very high rates, while long-term flows are taxed at progressively lower rates.

Why "hot money" can burn you. A (controversial) view is that large inflows of short-term capital, or "hot money," can be destabilizing. For example, large money inflows may cause a country's currency to appreciate, ultimately eroding competitiveness and causing a widening current account deficit. Growing reliance on foreign debt to finance a deficit can lead to crisis, especially if the liabilities are short-term, foreign-currency denominated and bank-related. When optimism about a country's economic prospects turns to pessimism, the money can quickly flee.

You should not play with fire if you are not a grown-up. Is there evidence that short-term debt can make a country more vulnerable to a crisis? Yes, but with an important caveat: fundamentals matter too. A number of recent studies suggest that it is in countries with weak economic fundamentals where a high level of short-term liabilities noticeably increases the probability or severity of a crisis. Such weaknesses include real appreciation and large current account deficits, excessive bank lending booms, and weak financial systems. In other words, strong economic fundamentals are the best protector against crises.

If it feels too hot, should you take a cold shower? In contrast to short-term portfolio flows, longer-term capital inflows (such as foreign direct investment, long-term bonds, and equities) are generally thought to be stabilizing. Chile and Colombia designed their controls precisely to avoid boom and bust cycles of capital flows. Their objective was to encourage long term inflows at the expense of short term inflows. Indeed, recent studies suggest that such controls affect the composition but not the overall level of capital inflows.

Banks. Instead of taxing all short term inflows, some have proposed penalizing only *banks*' short-term borrowing from abroad, potentially through imposing higher reserve requirements on their foreign-currency than on domestic borrowing. Such regulations fall well within the kind of enhanced prudential banking supervision that the United States and the IMF have for some time urged on developing countries.

The arguments for free capital flows. Although capital controls have garnered substantial attention since the Asian crisis, critics of such controls marshall several strong arguments against them. First, controls may raise domestic borrowing, diminishing investment and growth. Second, they may be unnecessary if a solid bank supervision system is in place. In fact, Chile and Colombia may have been sheltered from speculative attack due to the strength of their financial sectors and not as a result of their controls. Third, capital controls may become ineffective as investors find ways around them. Finally, approval of targeted restrictions could lead countries to use capital controls indiscriminately, thus insulating unsound policies from the discipline of the marketplace.

Can you turn the hot water on and off? The Asian flu has recently caught up with both countries. Their monetary authorities have been forced to defend falling currencies, by depleting foreign reserves and raising interest rates. Both countries have recently trimmed their controls on short-term inflows because they now need all the money they can get. Some make the argument that this policy reversal shows that the rationale for controls was weak to begin with. Others suggest that, if the controls are intended to address a problem of excessive short-term inflows at one stage of the cycle, followed by excessive reversal at another stage, the case for temporary controls is still there. In general, however, capital account liberalization should be the long-term goal; as suggested by the G-7, we should help "countries to prepare for integration in the global economy and for free global capital flows."