2014-0011-F

FOIA MARKER

This is not a textual record. This is used as an administrative marker by the Presidential Materials Division.

Collection:	Cheney Vice Presidential records
Office of Origin:	Staff Secretary
Series:	
Subseries:	Misc. Outbox, 2006
OA/ID Number:	00552
Folder Title: February 13, 2006	

Stack:	Row:	Section:	Shelf:	Position:
20W4	4	3	5	1

FOIAed Under:

Withdrawal/Redaction Sheet

Presidential Materials Division

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001a. letter	Sam Marler to Vice President Cheney (5 pages)	02/13/2006	PRM
001b. letter	Sam Marler to Vice President Cheney (photocopy) (2 pages)	02/13/2006	PRM
002a. letter	Kay McMillan to Vice President Cheney (1 page)	02/13/2006	PRM
002b. letter	Kay McMillan to Vice President Cheney (photocopy) (1 page)	02/13/2006	PRM
003a. letter	Harry A. Inman to Vice President Cheney (1 page)	02/13/2006	PRM
003b. letter	Harry A. Inman to Vice President Cheney (photocopy) (1 page)	02/13/2006	PRM
004a. letter	Dudley H. Bowen, Jr. to Vice President Cheney (1 page)	02/13/2006	PRM
004b. letter	Dudley H. Bowen, Jr. to Vice President Cheney (photocopy) (1 page)	02/13/2006	PRM
005. email	Lucy Tutwiler to Charles Durkin [redaction of cell phone number] (1 page)	02/13/2006	P6/(b)(6)
006. letter	Nelson L. Levy to Vice President Cheney (1 page)	02/15/2006	PRM

COLLECTION:
Cheney Vice Presidential Records
Office of the Staff Secretary
Miscellaneous Outbox, 2006
OA/Box Number: 00552

FOLDER TITLE:
February 13, 2006

2014-0011-F
AYM10

RESTRICTION CODES

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PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

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Barcode Scanning Sheet

Collection Code:	**VTRACK**
Staff Name:	
Document Date:	**2/13/2006**
Correspondent:	
Subject/Description:	**2006 MISCELLANEOUS OUT BOX MATERIALS (UNCLASSIFIED) -- LETTER OF SUPPORT AND ENCOURAGEMENT AFTER HUNTING ACCIDENT FROM SAM MARLER -- HANDWRITTEN NOTE OF SUPPORT AND ENCOURAGEMENT AFTER HUNTING ACCIDENT FROM KAY MCMILLAN -- LETTER OF SUPPORT AND ENCOURAGEMENT AFTER HUNTING ACCIDENT FROM HARRY ...**

Withdrawal/Redaction Marker

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001a. letter	Sam Marler to Vice President Cheney (5 pages)	02/13/2006	PRM

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002a. letter	Kay McMillan to Vice President Cheney (1 page)	02/13/2006	PRM

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002b. letter	Kay McMillan to Vice President Cheney (photocopy) (1 page)	02/13/2006	PRM

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Why The Economy Is a Lot Stronger Than You Think

In a knowledge-based world, the traditional measures don't tell the story

BY MICHAEL MANDEL

YOU READ THIS MAGAZINE RELIGIOUSLY, WATCH CNBC WHILE DRESSING FOR WORK, scan the Web for economic reports. You've heard, over and over, about the underlying problems with the U.S. economy—the paltry investment rate, the yawning current account deficit, the pathetic amount Americans salt away. And you know what the experts are saying: that the U.S. faces a perilous economic future unless we cut back on spending and change our profligate ways.

But what if we told you that the doomsayers, while not definitively wrong, aren't seeing the whole picture? What if we told you that businesses are investing about $1 trillion a year more than the official numbers show? Or that the savings rate, far from being negative, is actually positive? Or, for that matter, that our deficit with the rest of the world is much smaller than advertised, and that gross domestic product may be growing faster than the latest gloomy numbers show? You'd be pretty surprised, wouldn't you?

Well, don't be. Because the economy you thought you knew—the one all those government statistics purport to measure and make rational and understandable—actually may be on a stronger footing than you think. Then again, it could be much more volatile than before, with bigger booms and deeper busts. If true, that has major implications for policymakers—not least Ben Bernanke, who on Feb. 1 succeeded Alan Greenspan as chairman of the Federal Reserve.

Everyone knows the U.S. is well down the road to becoming a knowledge economy, one driven by ideas and innovation. What you may not realize is that the government's decades-old system of number collection and crunching captures investments in equipment, buildings, and software, but for the most part misses the growing portion of GDP that is generating the cool, game-changing ideas. "As we've become a more knowledge-

DAN PAGE

based economy," says University of Maryland economist Charles R. Hulten, "our statistics have not shifted to capture the effects."

The statistical wizards at the Bureau of Economic Analysis in Washington can whip up a spreadsheet showing how much the railroads spend on furniture ($39 million in 2004, to be exact). But they have no way of tracking the billions of dollars companies spend each year on innovation and product design, brand-building, employee training, or any of the other intangible investments required to compete in today's global economy. That means that the resources put into creating such world-beating innovations as the anticancer drug Avastin, inhaled insulin, Starbuck's, exchange-traded funds, and yes, even the iPod, don't show up in the official numbers.

Now, a generation of economists who came of professional age watching the dot-com boom and bust are trying to get a grip on this shadow economy: People like Carol A. Corrado and Daniel E. Sichel of the Federal Reserve Board, who, along with Hulten, figured out that businesses are spending much more on future-oriented investments than widely believed. In a way, these economists are disciples of Greenspan, who understood earlier than most that the conventional numbers don't capture the emerging knowledge economy.

Greenspan was continually digging into arcane factoids he hoped would give him a better insight into what was going on under the hood of the U.S. economy. And Bernanke seems to understand the importance of doing the same. In a speech last year, he said that intangible investments "appear to be quantitatively important." As a result, Bernanke noted, "aggregate saving and investment may be significantly understated in the U.S. official statistics."

BEYOND WIDGETS

AS GREENSPAN WOULD BE the first to tell you, it's a lot easier counting how many widgets the nation produces in a year than quantifying the creation and marketing of knowledge. After all, we're talking about intangibles: brand equity, the development of talent, the export of best practices.

This stuff is hard to measure, but to ignore it is to miss what the economy is telling us. And to miss that is to increase the likelihood of committing policy blunders. Including these intangible investments could provide a better picture of the economy, one that offers more advance warning of recessions, slippage in our ability to innovate, and other nasty surprises.

To understand why the government measures the economy the way it does, it helps to go back in time to the 1930s. The Great Depression had the nation in a death grip, and government planners and politicians lacked the tools to answer the big question of the day: Was the economy getting better or worse? To find out, the Commerce Dept. brought in economist Simon Kuznets, then at the National Bureau of Economic Research, to calculate for the first time the nation's income and output—the purchasing power and production of the U.S. economy. Setting such a benchmark would allow the government to figure out if the economy was growing or shrinking.

Working with handwritten data, Kuznets and a small group of

ILLUSTRATIONS BY DAN PAGE

The Shadow Economy

Intangibles such as R&D, training, education, and exports of knowledge are poorly tracked by today's statistics. Here's how better counting of intangibles would change our picture of the economy:

FEDERAL GOVERNMENT

Data: Office of Management and Budget, Congressional Budget Office

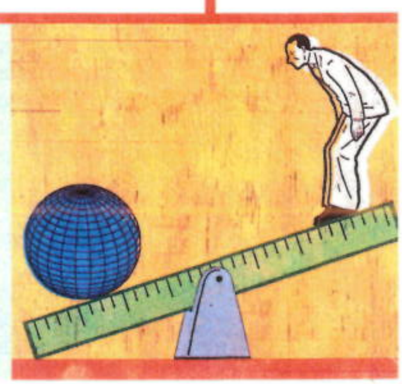
BUSINESS

Business investment in intangibles such as product development and training is critical for long-term profitability, but it doesn't get counted in GDP.

Unmeasured intangibles	$978
Physical capital and software	1139

Billions of dollars: Average for 2000-2003
Data: Corrado, Hulten, Sichel

THE REST OF THE WORLD



Government outlays for education and R&D are incorrectly labeled as current consumption, rather than future-oriented investment.

Education/research and development	$215
Physical capital	181
Surplus of rest of federal budget	78

*Billions of dollars; estimates for fiscal year 2005

- Investment is rising as a share of the economy, rather than falling.
- The current account deficit is considerably smaller.
- The personal savings rate in 2005 was positive, not negative.
- The part of the federal budget devoted to current spending is in balance.
- The 2001 recession was deeper than we thought. Current growth, however, may be stronger.

FAMILY

Household outlays for education, the most important investment in the future of the next generation, are improperly counted as consumption in the published data.

Education	$224
Personal savings, as officially measured	-42

Billions of dollars, 2005
Data: Bureau of Economic Analysis

The foreign trade statistics do not reflect the human capital being brought into the country by skilled immigrants. The official numbers also do not show the flows of knowhow that enable U.S. multinationals to reap high returns on their overseas operations.

Unmeasured inflows of human capital	$50-$200*
Unmeasured exports of knowhow	$25-$100*

*Billions of dollars; Annual average for 2000-2004

Data: BusinessWeek

fellow economists began counting tangible things like machines and buildings as long-term investments. It made sense, since this was still the Industrial Age. And such calculations came in handy during World War II, when the Roosevelt Administration needed a fix on the nation's capacity to grind out tanks, ships, and planes.

A BREAK WITH THE PAST

KUZNETS' WORK SET THE TONE for the rest of the century, not to mention helping win him the Nobel prize in Economics in 1971. Machines and buildings were counted as future-oriented investment, but spending on education, training, and R&D was not. No attempt was made to judge the social utility of expenditures. For example, the $6 million cost of building the Flamingo Hotel, the Las Vegas casino opened by Bugsy Siegel in 1946, was tallied as an investment. But AT&T's funding of Bell Labs, where the transistor was invented around the same time, wasn't even included in GDP. Kuznets himself acknowledged the limitations of his system, yet it stayed basically the same for most of the postwar period.

By the early '90s, Greenspan was becoming increasingly frustrated by the official numbers' inability to explain a rapidly evolving economy. In 1996 and 1997 he refused to accept conventional data telling him that productivity growth was falling in much of the service sector, noting—correctly, as it turns out—that "this pattern is highly unlikely." He also pointed out that the official numbers for consumer inflation were too high.

At the Washington offices of the BEA, J. Steven Landefeld, who became director in 1995, felt pressure to include numbers that better reflected the knowledge economy. Landefeld isn't a rash fellow, and the pace of change at the BEA, while quick for a statistical agency, would be called deliberate by most. But in 1999—six decades after Kuznets laid the groundwork for calculating GDP—Landefeld and the BEA decided to break with the past.

The BEA started treating business spending on software as a long-lived investment. The decision was overdue. Companies were spending more than $150 billion annually on software, far more than the $100 billion for computer hardware. And the software often stayed in use longer than the hardware. The fact that economists could go into stores and see software in brightly colored boxes reassured them that it was real. "Prepackaged software is a lot easier" to count, recalls Landefeld.

Silly as it may seem now, it was a revolutionary change at the time. But over the past seven years the economy has continued to evolve while the numbers we use to capture it have remained the same. Globalization, outsourcing, and the emphasis on innovation and creativity are forcing businesses to shift at a dramatic rate from tangible to intangible investments.

According to *BusinessWeek*'s calculations, the top 10 biggest U.S. corporations that report their R&D outlays—a list that includes ExxonMobil, Procter & Gamble, General Electric, Microsoft, and Intel—have boosted R&D spending by 42%, or almost $11 billion, since 2000. Yet over the same period, they have only increased capital spending by a meager 2%, or less than $1 billion. So all together, these giants have actually increased their future-oriented investment by roughly $12 billion—most of which doesn't show up in the BEA numbers.

This shift to intangibles looks all the more remarkable when we look a bit further back. P&G, for example, has boosted its spending on R&D, which doesn't count as investment in the GDP statistics, by 39% since 1996. By contrast, the company's capital budget, which does factor into GDP, is no bigger today than it was back then. The same is true at spicemaker McCormick & Co., where capital spending is basically flat compared to 1996 but R&D outlays to create new products have tripled over the same period.

Want to see how this works? Grab your iPod, flip it over, and read the script at the bottom. It says: "Designed by Apple in California. Assembled in China." Where the gizmo is made is immaterial to its popularity. It is great design, technical innovation, and savvy marketing that have helped Apple Computer sell more than 40 million iPods. Yet the folks at the BEA don't count what Apple spends on R&D and brand development, which totaled at least $800 million in 2005. Rather, they count each iPod twice: when it arrives from China, and when it sells. That, in effect, reduces Apple—one of the world's greatest innovators—to a reseller of imported goods.

That's why the new research from Corrado, Sichel, and Hulten is so important, and why building and improving upon it could become a key goal of economists in the coming years. Ultimately, we might end up with a "knowledge-adjusted" GDP, which would track the spending so crucial for global competitiveness.

Right now, though, rough calculations of these intangibles are all we have. To help come up with their $1 trillion number for unmeasured business investment, for example, Corrado, Sichel, and Hulten counted the portion of advertising designed to have long-lived effects on perception (that would include the sort of corporate image advertising seen in this magazine). They also estimated the value of new product development in the financial-services industry, which current R&D numbers miss. "We had to hunt around for bits and pieces of data," says Hulten.

Assessing how much bang for the buck companies get from their spending on intangibles is even harder, especially in the fast-changing knowledge economy. Take employee training. In the old days, that required flying people to a teaching facility, which cost companies a lot of time on top of the cost of the instructors and real estate. Now online learning and other innovations are driving down the cost of training. At IBM, the training budget fell by $10 million from 2003 to 2004, a 1.4% decline, while the number of classroom and e-learning hours rose by 29%. Are other companies seeing an equally dramatic decline in the cost of training? No one knows.

CHANGING PERCEPTIONS

THAT'S WHY THE BEA doesn't want to move too fast. It plans to publish supplementary accounts for R&D in the next few years, which will track R&D spending without adding it into the official GDP numbers. Other intangibles, though, remain below the radar. "No one disagrees with this conceptually," says BEA chief Landefeld. "The problem is in the empirical measurement."

But look at how our perception of the economy changes once you add in things like R&D and brand-building. The published data show that total investment—business, residential, and government—has been falling over the past three decades as a share of national spending, while consumption has been rising.

The numbers say growth slowed,

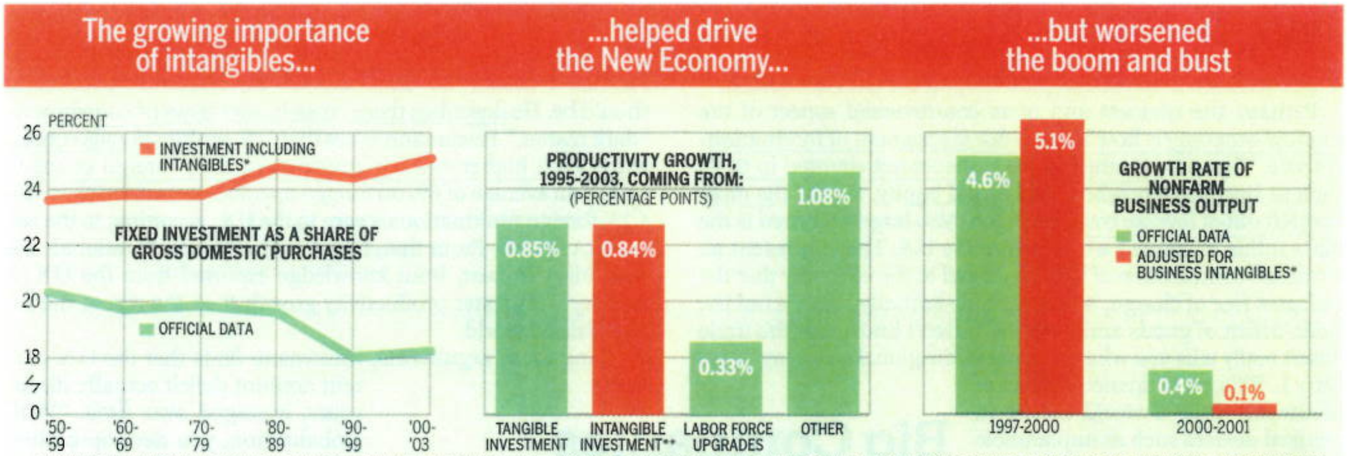
Add in the intangible investments provided by our three economists, and the picture changes completely.

Total investment rises, going from 23.8% of national spending in the 1970s to 25.1% in the early 2000s—much higher than the 18.3% the conventional numbers show. That helps explain why the economy has sustained strong productivity growth, and why foreign investors continue to pour money into the U.S.

Factoring in the knowledge economy also helps us understand why the recession of 2001 seemed worse than the official

Factoring in the Missing Pieces

Including R&D, training, and other intangibles in the numbers helps explain a decade of economic reality



*INCLUDES SPENDING ON R&D, PRODUCT DEVELOPMENT IN FINANCE AND INFORMATION INDUSTRIES, THE CREATION OF LONG-LIVED BRAND EQUITY, EMPLOYEE TRAINING, AND ORGANIZATIONAL CHANGE AND DEVELOPMENT
**INCLUDING SOFTWARE

Data: Corrado, Hulten, and Sichel; Bureau of Economic Analysis; National Science Foundation; Universal McCann; *BusinessWeek*

but jobs for designers jumped

statistics showed—and why the recovery was so slow. According to the published numbers, the six-month recession of 2001 was so mild the business sector actually grew at a modest 0.4% pace that year. By 2003, however, more than 3 million private sector jobs had disappeared.

One reason for this disconnect is simple: Corporations hacked back their budgets for R&D, advertising, training, and so forth. Yes, that canceled out a ton of high-paying jobs, but had no direct effect on GDP. Remember that R&D and other intangible business investments are not currently counted as national output. Therefore, when a company laid off an engineer doing long-term product development but kept selling the same number of its old products, GDP stayed the same. Productivity even went up, because fewer workers were producing the same amount of output. And if that laid-off engineer went to work, say, building houses? National output might even have risen.

ERIC HOFFMANN/BW

There's enough data available through 2003 to estimate how business intangibles would have changed the growth numbers. For our purposes, let's assume that overall intangible business investment followed the same path as industrial R&D and advertising, for which annual data are available. Crunch the numbers and it looks like the business sector really grew by only 0.1% in 2001, less than a quarter of the size of the official increase. Growth in 2002 now also looks slower than the published data.

By contrast, the conventional numbers may be understating the strength of the economy today. The BEA announced on Jan. 27 that growth in the fourth quarter of 2005 was only 1.1%. In part that was because of a smaller-than-expected increase in business capital spending. However, employment at design and management-consulting firms is up sharply in the quarter, suggesting that businesses may be spending on intangibles instead. Indeed, the consumer confidence number for January zoomed to the highest level since 2002, as Americans became more optimistic about finding jobs.

Then again, the economy may hit bigger bumps in the years ahead. When companies significantly trim their spending on R&D, design, training, and other knowledge-enhancing activities, as they did in 2001, the resulting pain in terms of job loss-

Trade stats miss a big chunk of the value-creating flow of knowledge

es and reduced innovation could deepen the next downturn.

Perhaps the trickiest and most controversial aspect of the shadow economy is how it alters our assessment of international trade. The same intangible investments not counted in GDP, such as business knowhow and brand equity, are for the most part left out of foreign trade stats, too. Also largely ignored is the mass influx of trained workers into the U.S. They represent an inmense contribution of human capital to the economy that the U.S. gets free of charge, which can substantially balance out the trade deficit of goods and services. "I don't know that the trade deficit really tells you where you are in the global economy," says Gary L. Ellis, chief financial officer of Medtronic Inc., a world leader in medical devices such as implantable defibrillators. "We're exporting a lot of knowledge."

Time for another real-world example. In December, Intel Corp. announced plans to build a new wafer-fabrication plant in Israel. To the statisticians, the value of that foreign investment is the book value of the plant—that is, the cost of erecting the building and installing the chipmaking machinery.

Not counted is the systematic export of knowhow to Israel that enables that factory to operate profitably. At the core is a program called Copy Exactly!, which requires that a new fab duplicate an existing one that is working well, down to how often the plant's pumps are serviced. All of this critical information is documented and transferred from the U.S. to the new plant, but it is not picked up by the trade statistics.

The numbers don't catch Intel's exhaustive training program either. To get its new plants running quickly, the chipmaker brings 800 or 900 employees from the new fab to spend a minimum of six months in Hillsboro, Ore., where Intel develops new production processes. By the time they return home, these people will have picked up not just the details of the process but also tribal knowledge—the unwritten lore of how Intel works. With that info in their heads, they're equipped to get the new factory up and running at high volume within a quarter, rather than taking a year or more. In economics speak, this is a classic transfer of human capital. So why isn't it called an export?

Ricardo Hausmann, director of Harvard's Center for International Development, believes it should be. He describes these cross-border flows of knowhow as "dark matter." Hausmann notes that U.S. multinationals consistently earn higher rates of return than their foreign counterparts—an average of 6% on foreign operations since 2000, vs. the 1.2% foreign multinationals earn in the U.S., according to the latest BEA figures. From that, he infers that the multinationals are benefiting, in part, from knowledge exported from the U.S., a country with faster productivity growth than the rest of the industrialized world.

Using these arguments, Hausmann finds that the U.S. current account deficit actually disappears, averaged over time. "With globalization, you develop a blueprint and sell it in all countries," he says. "Countries that are good at creating blueprints get more exports of dark matter."

Admittedly, most trade experts are hostile to Hausmann's conclusions. A recent report from Goldman, Sachs & Co. likened Hausmann's dark matter to cold fusion. And the economists at the BEA worry that adding knowledge exports to the trade stats would make published data less useful. "I have a problem putting fabricated flows into exports," says Ralph H. Kozlow, who oversees international accounts at the BEA. "You get into an impossible statistical maze when you try to value all of this at anything that anyone would believe."

But even if Hausmann is overstating his case, he's on the right track. There's no doubt that the statistical problems are formidable, but it's also certain that the conventional trade statistics are missing a big portion of the knowledge flows that create value these days. Suppose we assume that U.S. multinationals can earn an extra percentage point of return on their foreign investments by being able to use business intangibles exported from the U.S. Then a rough estimate of the value of the unmeasured exports of knowledge is anywhere from $25 billion to $100 billion per year, depending on what assumptions are used.

And let's not forget about immigrants. The workers who move to the U.S. each year bring with them a mother lode of education and skills—human capital—for free.

Big Companies Go Intangible

Companies are putting more emphasis on R&D and less on capital investment. Since 2000, the "intangibility index"—the ratio of R&D to capital spending, multiplied by 100—has risen for 9 of the 10 biggest U.S. companies that report R&D

COMPANY	INTANGIBILITY INDEX* 2000	LATEST**
EXXONMOBIL	5.1	4.4
GE***	73.6	100.7
MICROSOFT	429.1	761.6
PROCTER & GAMBLE	62.9	89.0
PFIZER	211.0	295.4
JOHNSON & JOHNSON	183.8	239.2
ALTRIA	32.0	42.3
CHEVRONTEXACO	2.2	2.9
INTEL	58.4	88.4
IBM	95.6	129.9
ALL 10	56.8	79.1

OVERALL	PERCENTAGE CHANGE 2000-LATEST**
R&D SPENDING	+42.1%
CAPITAL SPENDING	+2.1

*Capital spending for oil companies includes expenditures for exploration as well.
**Latest year for which R&D and capital spending are both available.
***Excluding GE Capital Services

Data: Company reports, *BusinessWeek*

One celebrated example is Jonathan Ive, the man who designed the iPod and iMac. Ive was born in England and educated at Newcastle Polytechnic University of Northumbria before joining Apple Computer Inc. in California in 1992.

Ive is not unique. Most of the workers who immigrate to the U.S. each year have at least a high school diploma, while about a third have a college education or better. Since it costs, on average, roughly $100,000 to provide 12 years of elementary and secondary education, and another $100,000 to pay for a college degree, immigrants are providing a subsidy of at least $50 billion annually to the U.S. economy in free human capital. Alternatively, valuing their contribution to the economy by the total wages they expect to earn during their lifetime would put the value of the human capital of new immigrants closer to $200 billion per year. Either the low or high estimate would make the current account deficit look smaller.

These numbers may also seem squishy. Still, if Fed chief Bernanke, corporate executives, and ordinary investors want to know where we've been, and where we're headed, tracking the creation and flow of knowledge is the only way to go.

–With Steve Hamm in New York and Christopher J. Farrell in St. Paul, Minn.

Tuition: It's Not Like An Ice Cream Cone

Forty-two grand a year. That's the going rate for tuition, room, and board at Vermont's pricey Middlebury College, where Donna Kelly's son and daughter go to school. "It's what we spend all our discretionary income on: education," says Kelly, who lives in St. Paul, Minn. "We look on it as an investment in their lives."

Government number crunchers don't see it that way, though. By their reckoning, the money households lay out for college and other levels of education—an eye-popping $224 billion in 2005—is consumption, no different than buying an ice cream cone or a new pair of sneakers. Ditto for money plowed into federal job programs, the National Science Foundation (NSF), and even the salary of the local public school teacher who helped your child learn to read.

Imagine if all the money you devote to education, plus the government's outlays for education, training, and R&D, went into the investment column instead. Suddenly, Americans would look a lot less profligate. The U.S. devotes more to education and R&D than most other industrialized countries. For example, America spends well over 7% of gross domestic product on education, compared with 4.6% for Japan. And if the money socked away by households and spent on education was counted as savings, then the U.S. personal savings rate for 2005 would be 2.0%, not the -0.5% the official numbers show.

So why aren't these outlays being categorized as investment? Supplementary accounts for government and business R&D are coming (page 62). But treating education as investment is much farther off, despite the obvious long-lasting nature of the "human capital" asset created by education. After all, the skills learned in school last a lot longer than the typical computer, which is counted as investment by the statisticians.

The reason is simple: There is no consensus, among economists, educators, or, for that matter, broader society on how to measure the value of a dollar spent on education. Should it be valued higher if it raises test scores or results in a higher wage down the road? Should it be valued lower if the kids are taught in a crowded classroom or if the college economics course is taught by a research assistant who speaks broken English? Are high school courses in art appreciation an essential part of the curriculum or a mere frill? These questions are not merely technical but matters of intense public and political debate, both at the national and local level.

Similar concerns complicate a more rational assessment of the federal budget. The government spends an enormous amount, $396 billion in fiscal 2005, on long-lived, intangible investment such as R&D and education, as well as such physical assets as computers and jet fighters. So why not take a page from the business world: Separate out investment spending from the day-to-day costs of running the government.

Calculating the budget that way would put the federal government's current operations into surplus, since the investment outlays exceed the total deficit of $318 billion. What's more, it would become clear that government borrowing was funding investments with a future payoff. In an ideal world, Congress would weigh whether boosting basic research, as President George W. Bush proposed in his State of the Union speech, was worth taking on more debt. Today, by comparison, the NSF is funded in the same appropriations bill as the Justice Dept., so that more money for long-term research may be competing against more dollars for the Federal Bureau of Investigation. That sort of choice encourages short-run thinking.

In the real world, even proposing a shift to operating and investment budgets would scare up a lot of opposition. One fear is that politicians would try to game the system. Says Joseph J. Minarik, research director for the Committee for Economic Development, a research organization in Washington: "One man's investment is another man's pork—pork being defined as spending that doesn't generate a broad return."

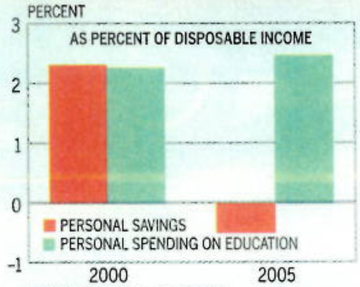
Still, calling things by their right names has clear advantages. Persisting in the fiction that government and household spending on R&D, training, and education is only consumption is to misunderstand the knowledge economy.

–By Michael Mandel in New York, with Christopher J. Farrell in St. Paul, Minn., and Howard Gleckman in Washington

Investing in The Kids

Households are spending more on education even as the savings rate falls

READING, WRITING, AND CHECKBOOKS



Data: Bureau of Economic Analysis

CHART BY ERIC HOFFMANN/BW

THE VICE PRESIDENT
HAS SEEN

Why The Economy Is a Lot Stronger Than You Think

In a knowledge-based world, the traditional measures don't tell the story

BY MICHAEL MANDEL

YOU READ THIS MAGAZINE RELIGIOUSLY, WATCH CNBC WHILE DRESSING FOR WORK, scan the Web for economic reports. You've heard, over and over, about the underlying problems with the U.S. economy—the paltry investment rate, the yawning current account deficit, the pathetic amount Americans salt away. And you know what the experts are saying: that the U.S. faces a perilous economic future unless we cut back on spending and change our profligate ways.

But what if we told you that the doomsayers, while not definitively wrong, aren't seeing the whole picture? What if we told you that businesses are investing about $1 trillion a year more than the official numbers show? Or that the savings rate, far from being negative, is actually positive? Or, for that matter, that our deficit with the rest of the world is much smaller than advertised, and that gross domestic product may be growing faster than the latest gloomy numbers show? You'd be pretty surprised, wouldn't you?

Well, don't be. Because the economy you thought you knew—the one all those government statistics purport to measure and make rational and understandable—actually may be on a stronger footing than you think. Then again, it could be much more volatile than before, with bigger booms and deeper busts. If true, that has major implications for policymakers—not least Ben Bernanke, who on Feb. 1 succeeded Alan Greenspan as chairman of the Federal Reserve.

Everyone knows the U.S. is well down the road to becoming a knowledge economy, one driven by ideas and innovation. What you may not realize is that the government's decades-old system of number collection and crunching captures investments in equipment, buildings, and software, but for the most part misses the growing portion of GDP that is generating the cool, game-changing ideas. "As we've become a more knowledge-

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based economy," says University of Maryland economist Charles R. Hulten, "our statistics have not shifted to capture the effects."

The statistical wizards at the Bureau of Economic Analysis in Washington can whip up a spreadsheet showing how much the railroads spend on furniture ($39 million in 2004, to be exact). But they have no way of tracking the billions of dollars companies spend each year on innovation and product design, brand-building, employee training, or any of the other intangible investments required to compete in today's global economy. That means that the resources put into creating such world-beating innovations as the anticancer drug Avastin, inhaled insulin, Starbuck's, exchange-traded funds, and yes, even the iPod, don't show up in the official numbers.

Now, a generation of economists who came of professional age watching the dot-com boom and bust are trying to get a grip on this shadow economy: People like Carol A. Corrado and Daniel E. Sichel of the Federal Reserve Board, who, along with Hulten, figured out that businesses are spending much more on future-oriented investments than widely believed. In a way, these economists are disciples of Greenspan, who understood earlier than most that the conventional numbers don't capture the emerging knowledge economy.

Greenspan was continually digging into arcane factoids he hoped would give him a better insight into what was going on under the hood of the U.S. economy. And Bernanke seems to understand the importance of doing the same. In a speech last year, he said that intangible investments "appear to be quantitatively important." As a result, Bernanke noted, "aggregate saving and investment may be significantly understated in the U.S. official statistics."

BEYOND WIDGETS

AS GREENSPAN WOULD BE the first to tell you, it's a lot easier counting how many widgets the nation produces in a year than quantifying the creation and marketing of knowledge. After all, we're talking about intangibles: brand equity, the development of talent, the export of best practices.

This stuff is hard to measure, but to ignore it is to miss what the economy is telling us. And to miss that is to increase the likelihood of committing policy blunders. Including these intangible investments could provide a better picture of the economy, one that offers more advance warning of recessions, slippage in our ability to innovate, and other nasty surprises.

To understand why the government measures the economy the way it does, it helps to go back in time to the 1930s. The Great Depression had the nation in a death grip, and government planners and politicians lacked the tools to answer the big question of the day: Was the economy getting better or worse? To find out, the Commerce Dept. brought in economist Simon Kuznets, then at the National Bureau of Economic Research, to calculate for the first time the nation's income and output—the purchasing power and production of the U.S. economy. Setting such a benchmark would allow the government to figure out if the economy was growing or shrinking.

Working with handwritten data, Kuznets and a small group of

The Shadow Economy

Intangibles such as R&D, training, education, and exports of knowledge are poorly tracked by today's statistics. Here's how better counting of intangibles would change our picture of the economy:

FEDERAL GOVERNMENT

Data: Office of Management and Budget, Congressional Budget Office

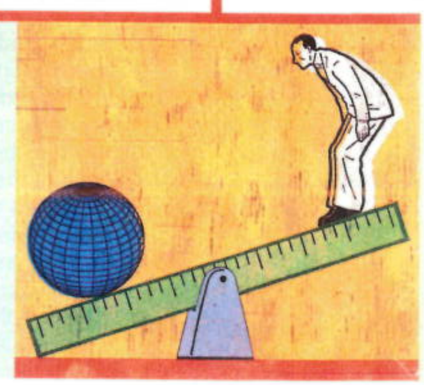
BUSINESS

Business investment in intangibles such as product development and training is critical for long-term profitability, but it doesn't get counted in GDP.

Unmeasured intangibles	$978
Physical capital and software	1139

Billions of dollars: Average for 2000-2003
Data: Corrado, Hulten, Sichel

THE REST OF THE WORLD



ILLUSTRATIONS BY DAN PAGE

Government outlays for education and R&D are incorrectly labeled as current consumption, rather than future-oriented investment.

Education/research and development	$215
Physical capital	181
Surplus of rest of federal budget	78

*Billions of dollars: estimates for fiscal year 2005

- Investment is rising as a share of the economy, rather than falling.
- The current account deficit is considerably smaller.
- The personal savings rate in 2005 was positive, not negative.
- The part of the federal budget devoted to current spending is in balance.
- The 2001 recession was deeper than we thought. Current growth, however, may be stronger.

FAMILY

Household outlays for education, the most important investment in the future of the next generation, are improperly counted as consumption in the published data.

Education	$224
Personal savings, as officially measured	-42

Billions of dollars, 2005
Data: Bureau of Economic Analysis

The foreign trade statistics do not reflect the human capital being brought into the country by skilled immigrants. The official numbers also do not show the flows of knowhow that enable U.S. multinationals to reap high returns on their overseas operations.

Unmeasured inflows of human capital	$50-$200*
Unmeasured exports of knowhow	$25-$100*

*Billions of dollars: Annual average for 2000-2004

Data: BusinessWeek

fellow economists began counting tangible things like machines and buildings as long-term investments. It made sense, since this was still the Industrial Age. And such calculations came in handy during World War II, when the Roosevelt Administration needed a fix on the nation's capacity to grind out tanks, ships, and planes.

A BREAK WITH THE PAST

KUZNETS' WORK SET THE TONE for the rest of the century, not to mention helping win him the Nobel prize in Economics in 1971. Machines and buildings were counted as future-oriented investment, but spending on education, training, and R&D was not. No attempt was made to judge the social utility of expenditures. For example, the $6 million cost of building the Flamingo Hotel, the Las Vegas casino opened by Bugsy Siegel in 1946, was tallied as an investment. But AT&T's funding of Bell Labs, where the transistor was invented around the same time, wasn't even included in GDP. Kuznets himself acknowledged the limitations of his system, yet it stayed basically the same for most of the postwar period.

By the early '90s, Greenspan was becoming increasingly frustrated by the official numbers' inability to explain a rapidly evolving economy. In 1996 and 1997 he refused to accept conventional data telling him that productivity growth was falling in much of the service sector, noting—correctly, as it turns out—that "this pattern is highly unlikely." He also pointed out that the official numbers for consumer inflation were too high.

At the Washington offices of the BEA, J. Steven Landefeld, who became director in 1995, felt pressure to include numbers that better reflected the knowledge economy. Landefeld isn't a rash fellow, and the pace of change at the BEA, while quick for a statistical agency, would be called deliberate by most. But in 1999—six decades after Kuznets laid the groundwork for calculating GDP—Landefeld and the BEA decided to break with the past.

The BEA started treating business spending on software as a long-lived investment. The decision was overdue. Companies were spending more than $150 billion annually on software, far more than the $100 billion for computer hardware. And the software often stayed in use longer than the hardware. The fact that economists could go into stores and see software in brightly colored boxes reassured them that it was real. "Prepackaged software is a lot easier" to count, recalls Landefeld.

Silly as it may seem now, it was a revolutionary change at the time. But over the past seven years the economy has continued to evolve while the numbers we use to capture it have remained the same. Globalization, outsourcing, and the emphasis on innovation and creativity are forcing businesses to shift at a dramatic rate from tangible to intangible investments.

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Unmasking the Economy

The Knowledge Economy and You: Advice for investors and workers

A GDP Primer: How the numbers are calculated

The Story Behind the Story: For a podcast interview with Chief Economist Michael Mandel by Executive Editor John A. Byrne, go to businessweek.com/search/podcasting.htm

The Blog: To discuss intangibles with Mandel, go to businessweek.com/the_thread/economicsunbound/

BusinessWeek online

www.businessweek.com/extras

than $1 billion. So all together, these giants have actually increased their future-oriented investment by roughly $12 billion—most of which doesn't show up in the BEA numbers.

This shift to intangibles looks all the more remarkable when we look a bit further back. P&G, for example, has boosted its spending on R&D, which doesn't count as investment in the GDP statistics, by 39% since 1996. By contrast, the company's capital budget, which does factor into GDP, is no bigger today than it was back then. The same is true at spicemaker McCormick & Co., where capital spending is basically flat compared to 1996 but R&D outlays to create new products have tripled over the same period.

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Right now, though, rough calculations of these intangibles are all we have. To help come up with their $1 trillion number for unmeasured business investment, for example, Corrado, Sichel, and Hulten counted the portion of advertising designed to have long-lived effects on perception (that would include the sort of corporate image advertising seen in this magazine). They also estimated the value of new product development in the financial-services industry, which current R&D numbers miss. "We had to hunt around for bits and pieces of data," says Hulten.

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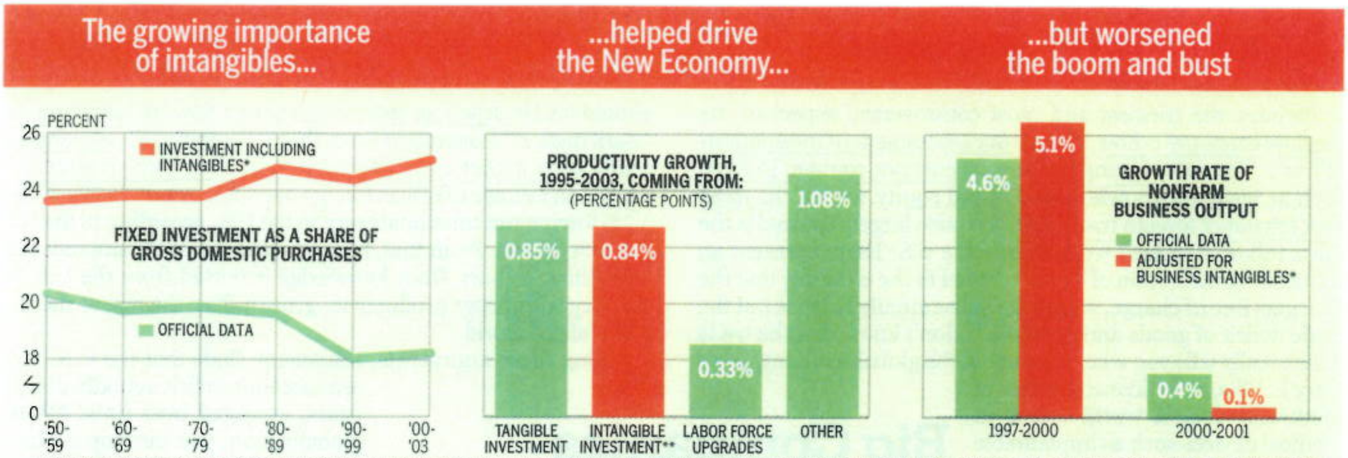
Including R&D, training, and other intangibles in the numbers helps explain a decade of economic reality



*INCLUDES SPENDING ON R&D, PRODUCT DEVELOPMENT IN FINANCE AND INFORMATION INDUSTRIES, THE CREATION OF LONG-LIVED BRAND EQUITY, EMPLOYEE TRAINING, AND ORGANIZATIONAL CHANGE AND DEVELOPMENT
**INCLUDING SOFTWARE

Data: Corrado, Hulten, and Sichel; Bureau of Economic Analysis; National Science Foundation; Universal McCann; *BusinessWeek*

statistics showed—and why the recovery was so slow. According to the published numbers, the six-month recession of 2001 was so mild the business sector actually grew at a modest 0.4% pace that year. By 2003, however, more than 3 million private sector jobs had disappeared.

One reason for this disconnect is simple: Corporations hacked back their budgets for R&D, advertising, training, and so forth. Yes, that canceled out a ton of high-paying jobs, but had

but jobs for designers jumped

no direct effect on GDP. Remember that R&D and other intangible business investments are not currently counted as national output. Therefore, when a company laid off an engineer doing long-term product development but kept selling the same number of its old products, GDP stayed the same. Productivity even went up, because fewer workers were producing the same amount of output. And if that laid-off engineer went to work, say, building houses? National output might even have risen.

ERIC HOFFMANN/BW

There's enough data available through 2003 to estimate how business intangibles would have changed the growth numbers. For our purposes, let's assume that overall intangible business investment followed the same path as industrial R&D and advertising, for which annual data are available. Crunch the numbers and it looks like the business sector really grew by only 0.1% in 2001, less than a quarter of the size of the official increase. Growth in 2002 now also looks slower than the published data.

By contrast, the conventional numbers may be understating the strength of the economy today. The BEA announced on Jan. 27 that growth in the fourth quarter of 2005 was only 1.1%. In part that was because of a smaller-than-expected increase in business capital spending. However, employment at design and management-consulting firms is up sharply in the quarter, suggesting that businesses may be spending on intangibles instead. Indeed, the consumer confidence number for January zoomed to the highest level since 2002, as Americans became more optimistic about finding jobs.

Then again, the economy may hit bigger bumps in the years ahead. When companies significantly trim their spending on R&D, design, training, and other knowledge-enhancing activities, as they did in 2001, the resulting pain in terms of job loss-

Trade stats miss a big chunk of the value-creating flow of knowledge

es and reduced innovation could deepen the next downturn.

Perhaps the trickiest and most controversial aspect of the shadow economy is how it alters our assessment of international trade. The same intangible investments not counted in GDP, such as business knowhow and brand equity, are for the most part left out of foreign trade stats, too. Also largely ignored is the mass influx of trained workers into the U.S. They represent an immense contribution of human capital to the economy that the U.S. gets free of charge, which can substantially balance out the trade deficit of goods and services. "I don't know that the trade deficit really tells you where you are in the global economy," says Gary L. Ellis, chief financial officer of Medtronic Inc., a world leader in medical devices such as implantable defibrillators. "We're exporting a lot of knowledge."

Time for another real-world example. In December, Intel Corp. announced plans to build a new wafer-fabrication plant in Israel. To the statisticians, the value of that foreign investment is the book value of the plant—that is, the cost of erecting the building and installing the chipmaking machinery.

Not counted is the systematic export of knowhow to Israel that enables that factory to operate profitably. At the core is a program called Copy Exactly!, which requires that a new fab duplicate an existing one that is working well, down to how often the plant's pumps are serviced. All of this critical information is documented and transferred from the U.S. to the new plant, but it is not picked up by the trade statistics.

The numbers don't catch Intel's exhaustive training program either. To get its new plants running quickly, the chipmaker brings 800 or 900 employees from the new fab to spend a minimum of six months in Hillsboro, Ore., where Intel develops new production processes. By the time they return home, these people will have picked up not just the details of the process but also tribal knowledge—the unwritten lore of how Intel works. With that info in their heads, they're equipped to get the new factory up and running at high volume within a quarter, rather than taking a year or more. In economics speak, this is a classic transfer of human capital. So why isn't it called an export?

Ricardo Hausmann, director of Harvard's Center for International Development, believes it should be. He describes these cross-border flows of knowhow as "dark matter." Hausmann notes that U.S. multinationals consistently earn higher rates of return than their foreign counterparts—an average of 6% on foreign operations since 2000, vs. the 1.2% foreign multinationals earn in the U.S., according to the latest BEA figures. From that, he infers that the multinationals are benefiting, in part, from knowledge exported from the U.S., a country with faster productivity growth than the rest of the industrialized world.

Using these arguments, Hausmann finds that the U.S. current account deficit actually disappears, averaged over time. "With globalization, you develop a blueprint and sell it in all countries," he says. "Countries that are good at creating blueprints get more exports of dark matter."

Admittedly, most trade experts are hostile to Hausmann's conclusions. A recent report from Goldman, Sachs & Co. likened Hausmann's dark matter to cold fusion. And the economists at the BEA worry that adding knowledge exports to the trade stats would make published data less useful. "I have a problem putting fabricated flows into exports," says Ralph H. Kozlow, who oversees international accounts at the BEA. "You get into an impossible statistical maze when you try to value all of this at anything that anyone would believe."

But even if Hausmann is overstating his case, he's on the right track. There's no doubt that the statistical problems are formidable, but it's also certain that the conventional trade statistics are missing a big portion of the knowledge flows that create value these days. Suppose we assume that U.S. multinationals can earn an extra percentage point of return on their foreign investments by being able to use business intangibles exported from the U.S. Then a rough estimate of the value of the unmeasured exports of knowledge is anywhere from \$25 billion to \$100 billion per year, depending on what assumptions are used.

And let's not forget about immigrants. The workers who move to the U.S. each year bring with them a mother lode of education and skills—human capital—for free.

Big Companies Go Intangible

Companies are putting more emphasis on R&D and less on capital investment. Since 2000, the "intangibility index"—the ratio of R&D to capital spending, multiplied by 100—has risen for 9 of the 10 biggest U.S. companies that report R&D

COMPANY	INTANGIBILITY INDEX* 2000	LATEST**
EXXONMOBIL	5.1	4.4
GE***	73.6	100.7
MICROSOFT	429.1	761.6
PROCTER & GAMBLE	62.9	89.0
PFIZER	211.0	295.4
JOHNSON & JOHNSON	183.8	239.2
ALTRIA	32.0	42.3
CHEVRONTEXACO	2.2	2.9
INTEL	58.4	88.4
IBM	95.6	129.9
ALL 10	56.8	79.1

OVERALL	PERCENTAGE CHANGE 2000-LATEST**
R&D SPENDING	+42.1%
CAPITAL SPENDING	+2.1

*Capital spending for oil companies includes expenditures for exploration as well.
**Latest year for which R&D and capital spending are both available.
***Excluding GE Capital Services

Data: Company reports, BusinessWeek

One celebrated example is Jonathan Ive, the man who designed the iPod and iMac. Ive was born in England and educated at Newcastle Polytechnic University of Northumbria before joining Apple Computer Inc. in California in 1992.

Ive is not unique. Most of the workers who immigrate to the U.S. each year have at least a high school diploma, while about a third have a college education or better. Since it costs, on average, roughly $100,000 to provide 12 years of elementary and secondary education, and another $100,000 to pay for a college degree, immigrants are providing a subsidy of at least $50 billion annually to the U.S. economy in free human capital. Alternatively, valuing their contribution to the economy by the total wages they expect to earn during their lifetime would put the value of the human capital of new immigrants closer to $200 billion per year. Either the low or high estimate would make the current account deficit look smaller.

These numbers may also seem squishy. Still, if Fed chief Bernanke, corporate executives, and ordinary investors want to know where we've been, and where we're headed, tracking the creation and flow of knowledge is the only way to go.

–With Steve Hamm in New York and Christopher J. Farrell in St. Paul, Minn.

Tuition: It's Not Like An Ice Cream Cone

Forty-two grand a year. That's the going rate for tuition, room, and board at Vermont's pricey Middlebury College, where Donna Kelly's son and daughter go to school. "It's what we spend all our discretionary income on: education," says Kelly, who lives in St. Paul, Minn. "We look on it as an investment in their lives."

Government number crunchers don't see it that way, though. By their reckoning, the money households lay out for college and other levels of education—an eye-popping $224 billion in 2005—is consumption, no different than buying an ice cream cone or a new pair of sneakers. Ditto for money plowed into federal job programs, the National Science Foundation (NSF), and even the salary of the local public school teacher who helped your child learn to read.

Imagine if all the money you devote to education, plus the government's outlays for education, training, and R&D, went into the investment column instead. Suddenly, Americans would look a lot less profligate. The U.S. devotes more to education and R&D than most other industrialized countries. For example, America spends well over 7% of gross domestic product on education, compared with 4.6% for Japan. And if the money socked away by households and spent on education was counted as savings, then the U.S. personal savings rate for 2005 would be 2.0%, not the −0.5% the official numbers show.

So why aren't these outlays being categorized as investment? Supplementary accounts for government and business R&D are coming (page 62). But treating education as investment is much farther off, despite the obvious long-lasting nature of the "human capital" asset created by education. After all, the skills learned in school last a lot longer than the typical computer, which is counted as investment by the statisticians.

The reason is simple: There is no consensus, among economists, educators, or, for that matter, broader society on how to measure the value of a dollar spent on education. Should it be valued higher if it raises test scores or results in a higher wage down the road? Should it be valued lower if the kids are taught in a crowded classroom or if the college economics course is taught by a research assistant who speaks broken English? Are high school courses in art appreciation an essential part of the curriculum or a mere frill? These questions are not merely technical but matters of intense public and political debate, both at the national and local level.

Similar concerns complicate a more rational assessment of the federal budget. The government spends an enormous amount, $396 billion in fiscal 2005, on long-lived, intangible investment such as R&D and education, as well as such physical assets as computers and jet fighters. So why not take a page from the business world: Separate out investment spending from the day-to-day costs of running the government.

Calculating the budget that way would put the federal government's current operations into surplus, since the investment outlays exceed the total deficit of $318 billion. What's more, it would become clear that government borrowing was funding investments with a future payoff. In an ideal world, Congress would weigh whether boosting basic research, as President George W. Bush proposed in his State of the Union speech, was worth taking on more debt. Today, by comparison, the NSF is funded in the same appropriations bill as the Justice Dept., so that more money for long-term research may be competing against more dollars for the Federal Bureau of Investigation. That sort of choice encourages short-run thinking.

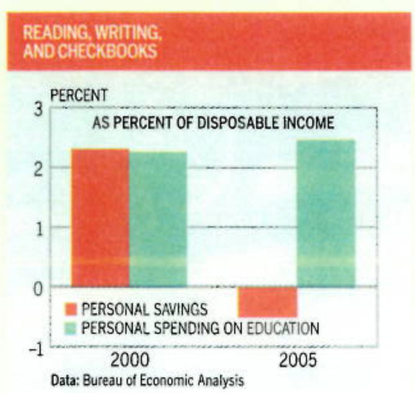
In the real world, even proposing a shift to operating and investment budgets would scare up a lot of opposition. One fear is that politicians would try to game the system. Says Joseph J. Minarik, research director for the Committee for Economic Development, a research organization in Washington: "One man's investment is another man's pork—pork being defined as spending that doesn't generate a broad return."

Still, calling things by their right names has clear advantages. Persisting in the fiction that government and household spending on R&D, training, and education is only consumption is to misunderstand the knowledge economy.

–By Michael Mandel in New York, with Christopher J. Farrell in St. Paul, Minn., and Howard Gleckman in Washington

Investing in The Kids

Households are spending more on education even as the savings rate falls



Data: Bureau of Economic Analysis

CHART BY ERIC HOFFMANN/BW

607529

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20502

THE VICE PRESIDENT HAS SEEN

February 13, 2006

MEMORANDUM FOR THE PRESIDENT

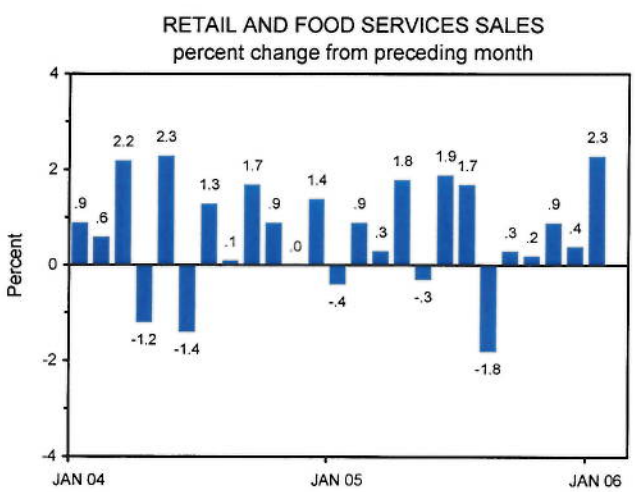
FROM: KEITH HALL

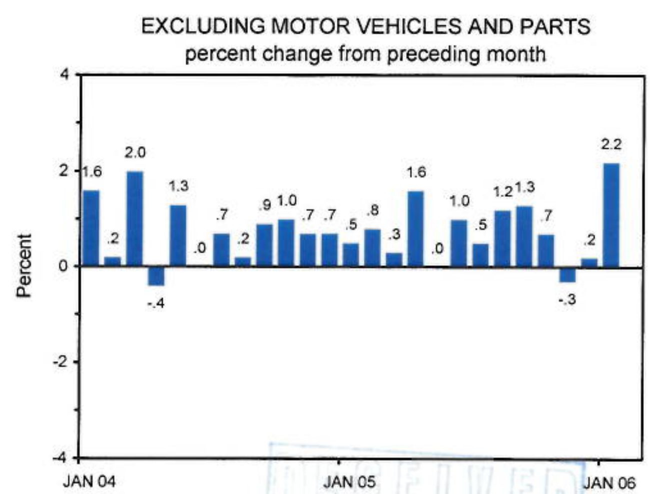
SUBJECT: **Retail and Food Services Sales in January** (★★★★)
Public Release: 8:30 am, Tuesday (Commerce Department)

Explosive growth in January retail sales

	Change in Retail Sales (nominal) from December to January	
	Actual	**Expected**
Total retail sales	2.3%	0.9%
Excluding motor vehicles	2.2%	0.8%

- **Nominal retail sales rose 2.3% in January**, well above market expectations of about 0.9%.
- **Sales of motor vehicles and parts increased 2.9% in January**, after a sizeable month-earlier gain. This increase had been foreshadowed by the automakers' report of an increase in unit sales from a 17.1 to a 17.6 million unit annual selling pace in January. Sales of light motor vehicles have been roughly flat at about 17 million units during the past 6 years.
- **Excluding motor vehicles, nominal retail sales rose 2.2%**, well above the roughly 0.8% increase expected by the market. A large rise in gasoline prices contributed to this increase. Even so, the real increase in January spending excluding motor vehicles is likely to be among the largest one-month increases on record (in a series that begins in 1990). The consumer price data needed to deflate retail spending arrives next week.
- **The January sales gain was distributed across a wide array of retail categories.**





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Today	Tue	Wed	Thu	Fri	Sat	Sun	Mon	Tue	Wed
Feb 13	Feb 14	Feb 15	Feb 16	Feb 17	Feb 18	Feb 19	Feb 20	Feb 21	Feb 22
Partly Cloudy	Snow Shower	Snow	Snow Shower	Snow Shower	Snow Shower	Snow Shower	Snow Shower	Partly Cloudy	Snow Shower
27°F	24°F	17°F	8°F	13°F	17°F	20°F	26°F	25°F	29°F
12°F	4°F	-8°F	-6°F	-8°F	-5°F	-2°F	3°F	5°F	5°F

Golf Index 0-Poor 10-Excellent

Do the conditions favor a low round?

0 - Poor Conditions, 10 - Excellent Conditions

0	0	0	0	0	0	0	0	0	0

Thunderstorm Maps | Golf Index Maps

Jackson Hole Golf & Tennis Club (est. 1963)

5000 Spring Gulch Rd
Jackson, WY
83001

Phone: (307) 733-3111
Toll-Free: --
Other: --
Fax: (307) 733-8473

GPS	Driving Range	Area Price
No	30 Tee Stations	$$$

Jackson Hole				Type: Public Course Opened: January 1963			
Architect: Robert Trent Jones, Jr., ASGCA					Fees (with cart)		
Holes	**Yards***	**Par**	**Slope**	**Rating**	**Weekday**	**Weekend**	**Twilight**
18	7168	72	123	72.5	$150	$150	$75

*Yardage measured from the back tees

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Health	Health Forecast, Allergies, Skin Protection, Air Quality, Aches & Pains, Cold & Flu, Fitness
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Driving	Driving Forecast, Interstate Forecast, Scenic Drives, Auto Advisor, Green Vehicles, Vehicle Safety Driving Safety Tips
Events	Events Forecast, Sporting Events, Special Events, Wedding Planner
Recreation	Recreation Forecast, Golf, Boat & Beach, Outdoors, Ski
Home & Garden	Home & Garden Forecast, Home Planner, Lawn & Garden, Schoolday, Pets, Your Holiday Helper
World	World Weather Forecasts & International Sites
News	News Center, National Forecast, Storm Watch, Hurricane Central, TWC Blog, Storm Stories, Road
Weather Tools	My Page, Desktop, Email, Pager, My Site, weather.com Gold, RSS Feeds
Interact	Photo Gallery, Boards & Forums, Contact Us
Education	Weather Classroom, Dave's Dictionary, Weather Encyclopedia, Glossary, SafeSide, SunReady
Multimedia	Video Forecasts
Shopping	The Weather Channel Store
TV - What's On	Storm Stories, Schedule, Road Crew, Personalities, Music, Forecast Earth, Channel Listings, Full F Could Happen Tomorrow
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Jackson Hole Mountain Resort, WY

Base Depth: 41-92"
New Snow: 0
Primary Surface: Packed Powder

Last Report: 02/13/06 06:00 AM

Trails Open: 96 of 111
Lifts Open: 11 of 12
Acres Open: 2500
Percent Open: 100
Status: Open

ResortCam® provided by RSN

Local Special Events | Local Sporting Events

Hours: Mon-Fri: 9a-4p; Sat/Sun: 9a-4p;

Snow Comments: Last snowfall: Feb 06/ 2 inches; Previous snowfall: Feb 04/ 4 inches;

Other Comments: Winds at base: calm; Visibility: excellent;

10-Day Forecast | Hourly | Details

Today	Tue	Wed	Thu	Fri	Sat	Sun	Mon	Tue	Wed
Feb 13	Feb 14	Feb 15	Feb 16	Feb 17	Feb 18	Feb 19	Feb 20	Feb 21	Feb 22
Partly Cloudy	Snow Shower	Snow	Snow Shower	Snow Shower	Few Snow Showers	Snow Shower	Snow Shower	Partly Cloudy	Snow Shower
26°F 11°F	23°F 3°F	15°F -9°F	7°F -6°F	12°F -9°F	15°F -6°F	19°F -3°F	24°F 2°F	23°F 4°F	27°F 4°F

Chance of Precipitation

Today	Tue	Wed	Thu	Fri	Sat	Sun	Mon	Tue	Wed
10%	60%	60%	50%	50%	30%	30%	40%	10%	60%

Wind Speed

Today	Tue	Wed	Thu	Fri	Sat	Sun	Mon	Tue	Wed
10 mph	7 mph	7 mph	5 mph	6 mph	6 mph	4 mph	5 mph	6 mph	8 mph

UV Index **0 Low** **10+ Extreme**

Today	Tue	Wed	Thu	Fri	Sat	Sun	Mon	Tue	Wed
3	2	2	2	2	3	2	3	3	2

Show this page in: English Units Metric Units

Snow Forecast Maps

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Travel	Travel Forecast, Business Travel, Vacation Planner, Aviation
Driving	Driving Forecast, Interstate Forecast, Scenic Drives, Auto Advisor, Green Vehicles, Vehicle Safety Driving Safety Tips
Events	Events Forecast, Sporting Events, Special Events, Wedding Planner
Recreation	Recreation Forecast, Golf, Boat & Beach, Outdoors, Ski
Home & Garden	Home & Garden Forecast, Home Planner, Lawn & Garden, Schoolday, Pets, Your Holiday Helper
World	World Weather Forecasts & International Sites
News	News Center, National Forecast, Storm Watch, Hurricane Central, TWC Blog, Storm Stories, Road
Weather Tools	My Page, Desktop, Email, Pager, My Site, weather.com Gold, RSS Feeds
Interact	Photo Gallery, Boards & Forums, Contact Us
Education	Weather Classroom, Dave's Dictionary, Weather Encyclopedia, Glossary, SafeSide, SunReady
Multimedia	Video Forecasts
Shopping	The Weather Channel Store
TV - What's On	Storm Stories, Schedule, Road Crew, Personalities, Music, Forecast Earth, Channel Listings, Full F Could Happen Tomorrow
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Withdrawal/Redaction Marker

Presidential Materials Division

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
005. email	Lucy Tutwiler to Charles Durkin [redaction of cell phone number] (1 page)	02/13/2006	P6/(b)(6)

This marker identifies the original location of the withdrawn item listed above. For a complete list of items withdrawn from this folder, see the Withdrawal/Redaction Sheet at the front of the folder.

COLLECTION:

Cheney Vice Presidential Records
Office of the Staff Secretary
Miscellaneous Outbox, 2006
OA/Box Number: 00552

FOLDER TITLE:

February 13, 2006

2014-0011-F
AYM10

RESTRICTION CODES

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

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

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(b)(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
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(b)(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
(b)(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
(b)(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

607529

Durkin, Charles P.

THE VICE PRESIDENT
HAS SEEN

From: Tutwiler, Lucy A.
Sent: Monday, February 13, 2006 8:42 AM
To: Durkin, Charles P.
Subject: Catherine Armstrong's numbers

Office: (512) 478-1003
Cell: [redacted]

Withdrawal/Redaction Marker

Presidential Materials Division

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
006. letter	Nelson L. Levy to Vice President Cheney (1 page)	02/15/2006	PRM

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Cheney Vice Presidential Records
Office of the Staff Secretary
Miscellaneous Outbox, 2006
OA/Box Number: 00552

FOLDER TITLE:
February 13, 2006

2014-0011-F
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RESTRICTION CODES

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

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(b)(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

600329

JON KYL, United States Senator, ARIZONA

730 Hart Senate Office Building
Washington, DC
(202) 224-4521
FAX (202) 224-2207

FAX COVER SHEET

DATE: Feb. 13, 2006
PAGES(w/cover): ____

TO: Angie
OFFICE: ____
FAX: ____

FROM:

Jon Kyl____

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Corey Astill____	Sherry Reichel____
Ginny Balough____	Noah Silverman____
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Elizabeth Maier____	Lauren Weiner____
Matthew Mueller____	Andrew Wilder____
Lucy Murfitt____	Lisa Wolski____
	Other____

COMMENTS: For VP Cheney and Brenda Becker!
Thanks so much

The NSA Surveillance Program: An Indispensable Tool for Protecting America
Remarks by Senator Kyl at CSIS
February 13, 2006

Opening Story:
A story which intelligence historians continue to debate today concerns the German bombing of Coventry in the Fall of 1940, during the height of Hitler's efforts to bring England to her knees. It is claimed that Churchill received top secret intelligence, derived from the Anglo-American breaking of the German Enigma code, which indicated that Coventry would be hit later that day. Churchill faced a choice, evacuate Coventry and risk revealing that the Enigma code had been broken, or sit on the information at the cost of potentially thousands of lives. He decided to put the city's emergency services on alert and take no further action. Coventry was sacrificed, but the Germans had no hint that their code was compromised.

This story, while possibly apocryphal, is nevertheless telling, because it demonstrates the preeminent value of operational intelligence in war. Churchill was not criticized for his decision, illustrating the mindset that we expect wartime leaders to have.

I. Set the stage:
   - We are in a protracted struggle with an enemy whose ambition is simple: kill Americans by the millions and destroy our way of life.

   A. *DNI Negroponte*: Attacking the United States homeland, United States interests overseas and United States allies -- in that order -- are Al Qaeda's top operational priorities. <u>The group will attempt high-impact attacks for as long as its central command structure is functioning</u> and affiliated groups are capable of furthering its interests, because even modest operational capabilities can yield a deadly and damaging attack.[1]

   B. Enemy wears no uniform, and can hide among our population for years (as did the 9/11 hijackers); and coordinating and financing its mass casualty attacks like 9/11 requires contact with their sources of support abroad.

   C. The need for terrorists to communicate provides us with intelligence opportunities.

[1] Director of National Intelligence John Negroponte, testimony for SSCI "Hearing on the Worldwide Threat," February 2, 2006.

II. Our main weapon in fighting terrorism is good intelligence

- The NSA terrorist surveillance program is necessary, and Americans expect their government to protect them in this way.

A. *From AG Testimony:* It is hard to imagine a President who would not elect to use these tools in defense of the American people—in fact, it would be irresponsible to do otherwise. The terrorist surveillance program is both necessary and lawful.[2]

B. *FBI Director Mueller*: …leads from that program have been valuable in identifying would-be terrorists in the United States, individuals who were providing material support to terrorists.[3]

C. *DDNI Hayden*: …the 9/11 commission criticized our ability to link things happening in the United States with things that were happening elsewhere. In that light, there are no communications more important to the safety of this country than those affiliated with al Qaeda with one end in the United States.[4]

D. *DDNI Hayden*: Had this program been in effect prior to 9/11, it is my professional judgment that we would have detected some of the 9/11 al Qaeda operatives in the United States, and we would have identified them as such.

III. The program includes a number of key protections:

A. Intercepts only those communications where one end of the line is located outside the United States and one of the participants is a known or suspected member of Al Qaeda or an affiliate organization.

B. Closely targeted – it is not a driftnet to grab conversation and sort them by keyword searches. *From DDNI Hayden*

C. US identities are removed when they are not essential to understand intelligence reports. *From DDNI Hayden*

D. Presidential reauthorization is required every 45 days.

E. Leaders of the House, Senate, and the two intelligence committees have been continually briefed, and IG review is extensive.

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[2] Attorney General Alberto Gonzales, Prepared testimony before Judiciary Committee, February 6, 2006.

[3] FBI Director Robert Mueller, testimony for SSCI "Hearing on the Worldwide Threat," February 2, 2006.

[4] DDNI Gen. Michael Hayden, Speech at the National Press Club, January 23, 2006.

IV. 3 basic arguments currently being advanced by opponents of the program:

A. Argument 1: The program is illegal under current law
Not true: the legal arguments on behalf of the program are strong:

i. CONSTITUTIONAL AUTHORITY
Article II, Sec. 2: "The President shall be Commander in Chief of the Army and Navy of the United States, and of the Militia of the several States, when called into the actual Service of the United States..."

a. *From DOJ Letter to Congress*: **Under Article II of the Constitution, including in his capacity as Commander in Chief, the President has the responsibility to protect the Nation from further attacks, and the Constitution gives him all necessary authority to fulfill that duty. *See, e.g., Prize Cases*, 67 U.S. (2 Black) 635, 668 (1863) (stressing that if the Nation is invaded, "the President is not only authorized but bound to resist by force...without waiting for any** special legislative authority"); ***Campbell v. Clinton***, 203 F.3d 19, 27 (D.C. Cir. 2000) (Silberman, J., concurring)("[T]he Prize Cases...stand for the proposition that the President has independent authority to repel aggressive acts by third parties even without specific congressional authorization, and courts may not review the level of force selected."[5]

b. The fact that Congress passed FISA in 1978 does not erase the President's Constitutional authority.

- *From AG Testimony:* The FISA Court of Review, the special court of appeals charged with hearing appeals of decisions by the FISA court, stated in 2002 that "[w]e take for granted that the President does have that [inherent] authority" and, "assuming that is so, FISA could not encroach on the President's constitutional power."*Sealed Case*, 310 F.3d at 742.[6]

c. It has long been recognized that the President's constitutional powers include the authority to conduct warrantless surveillance aimed at detecting and preventing armed attacks on the United States. Presidents have repeatedly relied on their inherent power to gather foreign intelligence for reasons both diplomatic and military, and the federal courts have consistently upheld this

[5] William E. Moschella, Assistant Attorney General, Letter to Sen. Roberts, Sen. Rockefeller, Rep. Hoekstra, and Rep. Harman, December 22, 2005.

[6] Attorney General Alberto Gonzales, Prepared testimony before Judiciary Committee, February 6, 2006.

longstanding practice. *See In re Sealed Case*, 310 F.3d 717, 742 (Foreign Intel. Surv. Ct. of Rev. 2002).[7]

d. *From AG Testimony:* During the Clinton Administration, Deputy Attorney General Jamie Gorelick testified before Congress in 1994 that the President has inherent authority under the Constitution to conduct foreign intelligence searches <u>of the private homes of U.S. citizens in the United States without a warrant</u>, and that such warrantless searches are permissible under the Fourth Amendment. *See* Amending the Foreign Intelligence Surveillance Act: Hearings Before the HPSCI, 103d Cong. 2d Sess. 61, 64 (1994) (statement of Deputy Attorney General Jamie S. Gorelick). *See also In re Sealed Case*, 310 F.3d at 745-46.[8] (ames case)

e. *From AG Testimony:* ...the NSA's terrorist surveillance program fully complies with the Fourth Amendment, which prohibits unreasonable searches and seizures. <u>The Fourth Amendment has never been understood to require warrants in all circumstances</u>. The Supreme Court has upheld warrantless searches at the border and has allowed warrantless sobriety checkpoints. *See, e.g., Michigan v. Dept. of State Police v. Sitz*, 496 U.S. 444 (1990); *see also Indianapolis v. Edmond*, 531 U.S. 32, 44 (2000)...Moreover, although the Fourth Amendment does not require application of a probable cause standard in this context, the <u>"reasonable grounds to believe" standard employed in this program is the traditional Fourth Amendment probable cause standard.</u>[9]

ii. STATUTORY

The Congressional Authorization for Use of Military Force, Pub. L. No. 107-40, 115 Stat. 224 (Sept. 18, 2001) ("AUMF").

a. *From AG Testimony:* First, it expressly recognized the President's "authority under the Constitution to take action to deter and prevent acts of international terrorism against the United States." Second, it supplemented that authority by authorizing the President to "use all necessary and appropriate force against those nations, organizations, or persons he determines planned, authorized, committed, or aided the terrorist attacks" in order to prevent further attacks on the United States. <u>Accordingly, the President's authority to use military force against those terrorist</u>

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[7] Attorney General Alberto Gonzales, Prepared testimony before Judiciary Committee, February 6, 2006.

[8] Attorney General Alberto Gonzales, Prepared testimony before Judiciary Committee, February 6, 2006.

[9] Attorney General Alberto Gonzales, Prepared testimony before Judiciary Committee, February 6, 2006.

groups is at its maximum because he is acting with the express authorization of Congress.[10]

b. *From AG Testimony:* ...the language of the AUMF itself, calls on the President to protect Americans both "at home and abroad," to take action to prevent further terrorist attacks "against the United States," and directs him to determine who was responsible for the attacks.[11]

c. *From AG Testimony:* In 2004, the Supreme Court considered the scope of the AUMF in *Hamdi v. Rumsfeld*, 542 U.S. 507 (2004). There, the question was whether the President had the authority to detain an American citizen as an enemy combatant for the duration of the hostilities. The Supreme Court confirmed that the expansive language of the AUMF —"all necessary and appropriate force"—ensures that the congressional authorization extends to traditional incidents of waging war. And, just like the detention of enemy combatants approved in *Hamdi*, the use of communications intelligence to prevent enemy attacks is a fundamental and accepted incident of military force.[12]

d. Surely, collecting intelligence about the plans and intentions of the enemy in a time of armed conflict is an incident of war. History is replete with examples of President's using this authority.

- *From AG Testimony:* the day after the attack on Pearl Harbor, President Roosevelt authorized the interception of all communications traffic into and out of the United States. The terrorist surveillance program, of course, is far more focused, since it involves the interception only of international communications that are linked to al Qaeda.[13]

B. Argument 2: FISA is the sole authority for surveillance and must be used or amended
[Note: This argument rejects the constitutional authority claim]

i. FISA allows for changes "as authorized by statute", and the AUMF provides that authorization.

a. *From AG Testimony:* FISA allows Congress to respond to new threats through separate legislation. FISA prohibits persons from

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[10] Attorney General Alberto Gonzales, Prepared testimony before Judiciary Committee, February 6, 2006.

[11] Attorney General Alberto Gonzales, Prepared testimony before Judiciary Committee, February 6, 2006.

[12] Attorney General Alberto Gonzales, Prepared testimony before Judiciary Committee, February 6, 2006.

[13] Attorney General Alberto Gonzales, Prepared testimony before Judiciary Committee, February 6, 2006.

intentionally "engag[ing] . . . in electronic surveillance under color of law except as authorized by statute." For the reasons I have already discussed, the AUMF provides the relevant statutory authorization for the terrorist surveillance program. Hamdi makes clear that the broad language in the AUMF can satisfy a requirement for specific statutory authorization set forth in another law.[14]

ii. The enhanced Terrorist Surveillance Program is necessary given the agility and resourcefulness of our terrorist enemy, which FISA cannot match. Actionable intelligence has a short shelf life.

a. PDDNI Hayden has testified that FISA is poorly suited to the carrying out of this kind of program.

- *PDDNI Hayden*: ...I don't think that anyone can make the claim that the FISA statute is optimized to deal with or prevent a 9/11 or to deal with a lethal enemy who likely already had combatants inside the United States... The president's authorization allows us to track this kind of call more comprehensively and more efficiently. The trigger is quicker and a bit softer than it is for a FISA warrant, but the intrusion into privacy is also limited: only international calls and only those we have a reasonable basis to believe involve al Qaeda or one of its affiliates.[15]

b. IT has been suggested that FISA's 72 hour provision allows for greater flexibility, but this is hardly the case.

- *From AG Testimony:* Some have pointed to the provision in FISA that allows for so-called "emergency authorizations" of surveillance for 72 hours without a court order. There is a serious misconception about these emergency authorizations. We do not and cannot approve emergency surveillance under FISA without knowing that we meet FISA's normal requirements. In order to authorize emergency surveillance under FISA, the Attorney General must personally "determine[] that . . . the factual basis for issuance of an order under [FISA] to approve such surveillance exists." ... Thus, to initiate surveillance under a FISA emergency authorization, it is not enough to rely on the best judgment of our intelligence officers. Those intelligence officers would have to get the sign-off of lawyers at the NSA, and then lawyers in the Department

[14] Attorney General Alberto Gonzales, Prepared testimony before Judiciary Committee, February 6, 2006.

[15] PDDNI Gen. Michael Hayden, Speech at the National Press Club, January 23, 2006.

of Justice would have to be satisfied that the statutory requirements for emergency authorization are met, and finally as Attorney General, I would have to be satisfied that the proposed surveillance meets the requirements of FISA. Finally, the emergency application must be filed "as soon as practicable," but within 72 hours.[16]

- Put simply, this is not standard wiretap activity. It is much different and the problem is that the Attorney General may not know what he is going to get out of a particular electronic surveillance until he gets it. FISA's 72-hour rule demands that the AG certify that he will be able to meet the FISA standard before the activity even happens. Hence, FISA limits the intelligence community's flexibility in an unacceptable way.

C. Argument 3: Oversight by Congress should be increased

- While there is some merit to this point, it is hard to guarantee the necessary operational secrecy in the current political atmosphere.

  i. There is a clear tension between the desire for more oversight and the potential for more unauthorized and harmful disclosure.

  ii. Those entrusted with knowledge of this program must be committed to its protection. Not all are. Opponents of the program openly celebrate the leaks while demanding that they be fully briefed on it.

    a. *Senator Leahy:* Mr. Attorney General, can you see why I have every reason to believe we never would have found out about this if the press hadn't? Now, there has been talk about, well let's go prosecute the press. Heavens. Thank God we have a press that at least tells us what the heck you guys are doing, because you are obviously not telling us.[17]

  iii. The leaders of our intelligence community believe that these leaks have been extremely damaging to our national security.

    a. *CIA Director Goss*: ...I'm sorry to tell you that the damage has been very severe to our capabilities to carry out our mission.[18]

    b. *DNI Negroponte*: ...any time sensitive sources and methods are revealed in the public domain, through press stories or otherwise,

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[16] Attorney General Alberto Gonzales, Prepared testimony before Judiciary Committee, February 6, 2006.

[17] Senator Patrick Leahy, Questioning of Attorney General Gonzales, Judiciary Committee, February 6, 2006.

[18] CIA Director Porter Goss, testimony for SSCI "Hearing on the Worldwide Threat," February 2, 2006.

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that this carries with it the grave danger of prejudicing, adversely affecting our intelligence operations, and in many instances lives can be directly at stake. And I must say that in the nine months that I've been in this job, one of the greatest disappointments that I personally have had is experiencing the degree to which people are willing to talk about classified matters to the public media. And we've got to bring that kind of activity to a stop.[19]

V. So what kind of oversight would be both helpful and workable?

A. Senator Specter FISA Court Proposal: Seeking an advisory opinion from the FISA Court would be both unprecedented and unwarranted. The U.S. Supreme Court would never review such a non-justiciable case. There is no case or controversy and quite probably a political question.

B. Amend FISA: There is simply no need to amend FISA, as the Attorney General testified. The President already has the authority to conduct the program under the Constitution, and the AUMF also meets the FISA requirement for "authorization by statute." Moreover, drafting an effective amendment would be difficult; it would likely be either too general or too specific.

C. Regular Briefing to SSCI and HPSCI: "after-action report" could cover enough relevant information to allow Congress to conduct meaningful oversight:

   i. Is the program being executed as it was intended, i.e., in accordance with the guidelines (without discussing the operational details of the guidelines)?

   ii. Have any U.S. persons been subject to surveillance who, under the guidelines, should not have been?

   iii. In any cases where this might have happened:

      a. Was there any damage from this occurrence?
      b. Are adequate measures being taken to ensure that it does not happen again?

   iv. The "gang of eight" should be provided with the guidelines governing the execution of this program as well as a general assessment of the results.

VI. CONCLUSION

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[19] Director of National Intelligence John Negroponte, testimony for SSCI "Hearing on the Worldwide Threat," February 2, 2006

From Testimony of 9/11 Commission Co-Chairmen:

"The American people must be prepared for a long and difficult struggle. We face a determined enemy who sees this as a war of attrition – indeed, as an epochal struggle. We expect further attacks. Against such an enemy, there can be no complacency. This is the challenge of our generation. As Americans we must step forward to accept that challenge."[20]

From the Attorney General's Testimony:

"In confronting this new and deadly enemy, President Bush promised that "[w]e will direct every resource at our command—every means of diplomacy, every tool of intelligence, every tool of law enforcement, every financial influence, and every weapon of war—to the disruption of and to the defeat of the global terror network." The terrorist surveillance program described by the President is one such tool and one indispensable aspect of this defense of our Nation."[21]

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[20] The Hon. Thomas H. Kean and the Hon. Lee H. Hamilton, Public Statement upon release of the 9/11 Commission Report, Jun 22, 2005

[21] Attorney General Alberto Gonzales, Prepared testimony before Judiciary Committee, February 6, 2006.

THE WHITE HOUSE

2/19/06

Assistant to the President for
National Security Affairs

Mr. President –

Catching up on my reading. Two very interesting articles and well worth a read if you have not already seen them.

Steve Hadley

cc. The Vice President
The Chief of Staff

607529 VP

THE VICE PRESIDENT HAS SEEN

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new art hed treatment

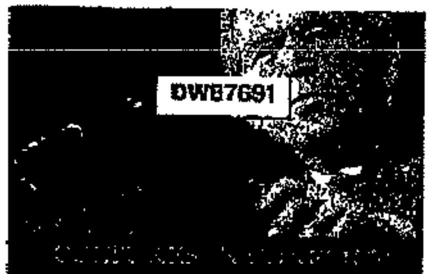
to spread democracy turning into a fiasco? It doesn't have to. But it does need to change.

Islam and Power

BY FAREED ZAKARIA

George W. Bush is not a man for second thoughts, but even he might have had some recently. Ever since 9/11, Bush has made the promotion of democracy in the Middle East the centerpiece of his foreign policy, and doggedly pushed the issue. Over the last few months, however, this approach has borne strange fruit, culminating in Hamas's victory in Gaza and the West Bank.

Before that, we have watched it strengthen Hizbullah in Lebanon, which (like Hamas) is often described in the West as a terrorist organization. In Iraq, the policy has brought into office conservative religious parties with their own private militias. In Egypt, it has bolstered the Muslim Brotherhood, one of the oldest fundamentalist organizations in the Arab world, from which Al Qaeda descends. "Democracies replace resentment with hope, respect the rights of their citizens and their neighbors, and join the fight against terror," Bush said last week in his State of the Union address. But is this true of the people coming to power in the Arab world today?



Palestinians burn the Danish flag to protest newspaper caricatures of the Prophet Muhammad; Bush in Nashville

This is an issue that deserves serious thought, well beyond pointing to the awkwardness of Bush's position. Bush's prescription is, after all, one accepted by many governments: it is also European policy to push for democratic reform in the Middle East. And in fact, little has happened over the last few months that makes the case for continued support of Muslim dictatorships. But recent events do powerfully suggest that if we don't better understand the history, culture and politics of the countries that we are "reforming," we will be in for an extremely rocky ride.

There is a tension in the Islamic world between the desire for democracy and a respect for liberty. (It is a tension that once raged in the West and still exists in pockets today.) This is most apparent in the ongoing fury over the publication of cartoons of the Prophet Muhammad in a small Danish newspaper. The cartoons were offensive and needlessly provocative. Had the paper published racist caricatures of other peoples or religions, it would also have been roundly condemned and perhaps boycotted. But the cartoonist and editors would not have feared for their lives. It is the violence of the response in some parts of the Muslim world that suggests a rejection of the ideas of tolerance and freedom of expression that are at the heart of modern Western societies.

Why are all these strains rising now? Islamic fundamentalism was supposed to be on the wane. Five years ago the best scholars of the phenomenon were writing books with titles like "The Failure of Political Islam." Observers pointed to the exhaustion of the Iranian revolution, the ebbing of support for radical groups from Algeria to Egypt to Saudi Arabia. And yet one sees political Islam on the march across the Middle East today. Were we all wrong? Has Islamic fundamentalism gotten a second wind?

There are those who argue that the collapse of the Arab-Israeli peace process, the war on terror, and the bloodshed in Afghanistan and Iraq have all contributed to the idea that Islam is under siege—providing radicals with fresh ammunition. This is not, however, a wholly convincing case. For one thing, opposition to the Iraq war is not a radical phenomenon in the Middle East, but rather an utterly mainstream one. Almost every government opposed it. Moreover, the rise and fall of Islamic fundamentalism was a broad and deep phenomenon, born over decades. It could hardly reverse itself on the basis of a year's news. Does anyone believe that if there had been no Iraq war, Hamas would have lost? Or that the Danish cartoons would have been published with no response?

The political Islamist movement has changed over the last 15 years. Through much of the 1980s and 1990s, Islamic fundamentalists had revolutionary aims. They sought the violent overthrow of Western-allied regimes to have them replaced with Islamic states. This desire for Islamic states and not Western-style democracies was at the core of their message. Often transnational in their objectives, they spoke in global terms. But it turned out that the appeal of this ideology was limited. People in Algeria, Egypt, Saudi Arabia

LEFT TO RIGHT: AHMAD MITMAN—AFP—GETTY IMAGES; PHOTOGRAPH BY DAVID T. LEE FOR NEWSWEEK

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and countless other places rejected it; in fact, they grudgingly accepted the dictatorships they lived under rather than support violent extremism. In this sense, political Islam did fail.

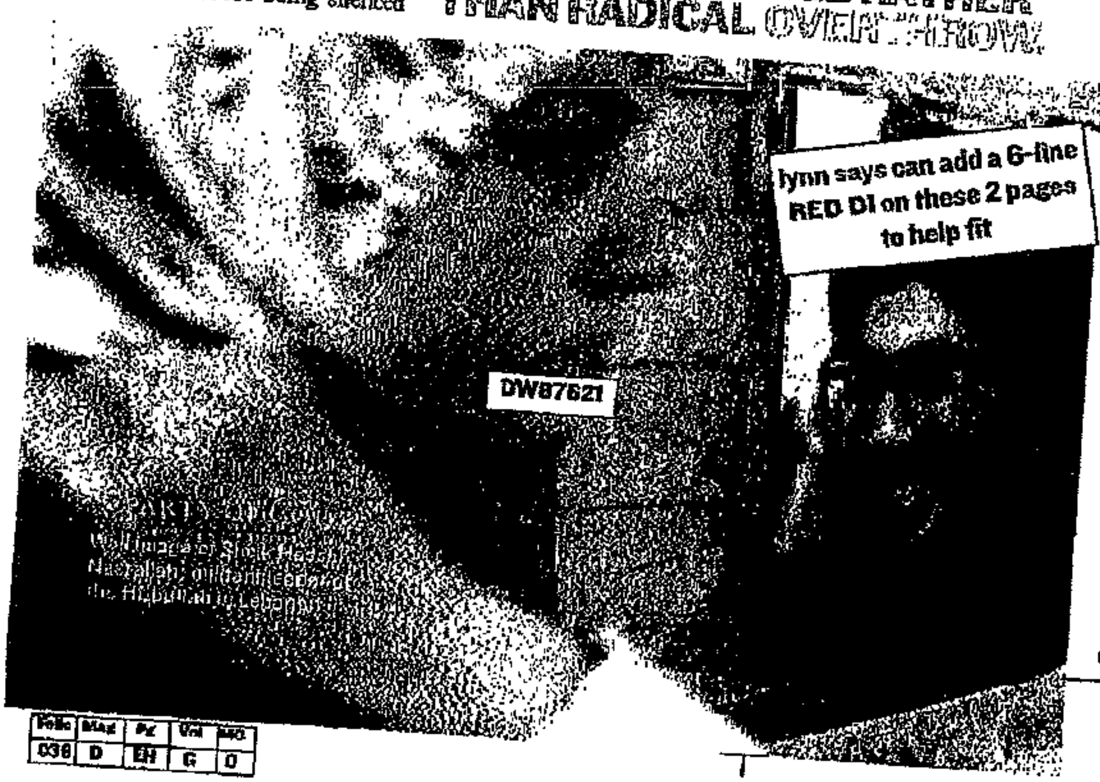
But over time, many of the Islamists recognized this reality and began changing their program. They came to realize that shorn of violent overthrow, revolution and social chaos, their ideas could actually gain considerable popular support. So they reinvented themselves, emphasizing not revolutionary overthrow but peaceful change, not transnational ideology but national reform. They were still protesting the dictators, but now they organized demonstrations in favor of democracy and honest politics.

There were extremist elements, of course, still holding true to the cause of the caliphate, and they broke off to create separate groups like Al Qaeda. (Some of this radicalism remains within the diaspora communities of Europe more strongly than in the Middle East itself.) But it is notable that well before 9/11, Egypt's Muslim Brotherhood condemned terrorism directed against the Mubarak regime, and it recently distanced itself even from the tactics of the Iraqi insurgency. It has sought instead to build support for its own social and political program in Egypt. For its part, not only did Hamas decide to participate in the elections—for the first time—but it campaigned almost entirely on a platform of anticorruption, social services and assertive nationalism. Only Al Qaeda and its ilk have condemned any participation in elections, whether by Iraqi Islamist groups or by Hamas.

This coming to terms with democracy, however, should not be mistaken for a coming to terms with Western values such as liberalism, tolerance and freedom. The program that most of these groups espouse is deeply illiberal, involving the reversal of women's rights, second-class citizenship for minorities and confrontation with the West and Israel. The most dramatic example of these trends is in southern Iraq, where Shiite religious parties rule without any checks. Reports abound that civil servants and professors are subjected to religious and political tests, women are placed under strictures never before enforced in Iraq, and all kinds of harmless entertainment are being silenced by vigilantes. When entering the office of Iraq's prime minister, Ibrahim Jaafari, one now sees women swaddled in veils and gloves, a level of zeal rarely seen elsewhere in the Muslim world.

Some of these forces have gained strength because of a lack of other alternatives. For decades the Middle East has been a political desert. In Iraq, the reason that there are no countervailing liberal parties is that Saddam Hussein destroyed them. He could not completely crush mosque-based groups and, by the end of his reign, he actually used them to shore up his own legitimacy. In much of the Muslim world Islam became the language of political opposition because it was the only language that could not be censored. This pattern, of dictators using religious groups to destroy the secular opposition, played itself out in virtually every Arab country, and often beyond. It was the method by which Pakistan's Gen. Zia ul-Haq maintained his own dictatorship in the 1980s, creating a far stronger fundamentalist movement than that country had ever known.

MANY ISLAMISTS REINVENTED THEMSELVES, EMPHASIZING PEACEFUL CHANGE RATHER THAN RADICAL OVERTHROW



THE BROADER REASON FOR THE RISE OF ISLAMIC politics has been the failure of secular politics. Secularism exists in the Middle East. It is embodied by Saddam Hussein and Muammar Kaddafi and Hosni Mubarak and Yasir Arafat. Arabs believe that they have tried Western-style politics and it has brought them tyranny and stagnation. They feel that they got a bastardized version of the West and that perhaps the West was not the right model for them anyway. Islamic fundamentalism plays deeply to these feelings. It evokes authenticity, pride, cultural assertiveness and defiance. These ideas have been powerful sources of national identity throughout history and remain so, especially in an age of globalized economics and American power. In face of the powerlessness, alienation and confusion that the modern world breeds, these groups say simply, "Islam is the solution."

Inevitably we have to ask ourselves what to do about these movements that are rising to power. The first task is surely to understand them—understand that they thrive on pride and a search for authenticity. These forces play themselves out in complex ways. It is obvious by now that the United States—and Europe as well—understand countries like Iraq and Iran very little. In Iraq, the United States overturned old social structures and governing patterns with little thought as to what would replace them. We believed that democracy and freedom would solve the problems of disorder, division and dysfunction.

Or consider Iran. Many Americans had become convinced that the vast majority of Iranians hated their regime and were trying desperately to overthrow it; all we needed to do was help them foment a revolution. There's little doubt that the regime is brutal and unpop-

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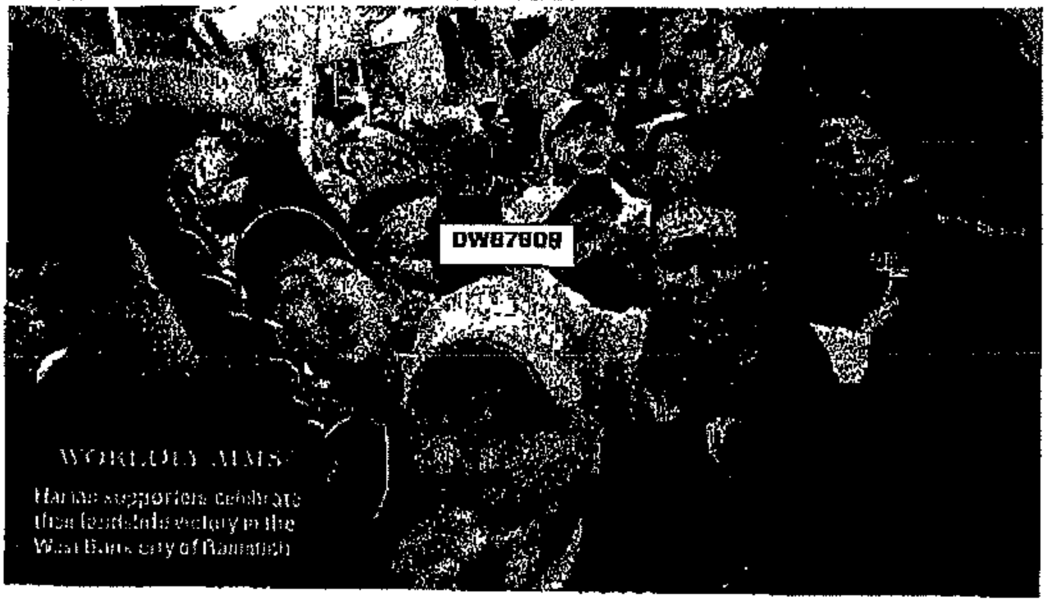

WORLDLY AIMS: Hamas supporters celebrate their landslide victory in the West Bank city of Ramallah

MUHAMMED MUHEISEN—AP

ular. But it also appears to have *some* basis of support, in mosques, patronage systems and poorer parts of the country. And those who do not support it are not automatically Western liberals. After all, there was an election in Iran and, despite low turnout, the eventual vote was free and secret. (Back when the winner of Iranian elections was a liberal, Mohammed Khatami, people often cited the vote as proof that the fundamentalists were failing.) Five candidates took part in the most recent race. The pro-Western liberal came in fifth; the conservative West-basher came in first.

RECENT EVENTS SHOW THAT PROMOTING DEMOCRACY AND PROMOTING LIBERTY ARE SEPARATE PROJECTS.

MY OWN GUESS, AND IT IS JUST A GUESS, IS that some Iranians—not a majority, but not a tiny minority, either—accept their current regime. This is partly because of its ideology and patronage politics, and partly because of general inertia. (We have only to look at Iraq to see that Shiite religious figures do have some hold on their populations.) Add to this an apparatus of repression and $60-a-barrel oil and you have a regime that has many ways to stay in power. President Ahmadinejad understands these forces. He emphasizes in his daily television appearances not Islamic dogma but poverty alleviation, subsidies, anti-corruption projects and, above all, nationalism in the form of the nuclear program. Ahmadinejad may be a mystic, but most of his actions are those of a populist, using the forces that will work to keep him in power. This picture of Iran, gray and complex, is much less satisfying than the black-and-white caricature. But it might be closer to the truth.

Elections have not created political Islam in the Middle East. They have codified a reality that existed anyway. Hamas was already a major player to be reckoned with in Gaza. The Muslim Brotherhood is popular in Egypt, whether or not Hosni Mubarak holds real elections. In fact, the more they are suppressed, the greater their appeal. If politics is more open, these groups may or may not moderate themselves, but they will surely lose some of that mystical allure they now have. The martyrs will become mayors, which is quite a fall in status.

But to accept these forces is not to celebrate them. It is important that religious intolerance and antimodern attitudes not be treated as cultural variations that must be respected. Whether it is Hindu intolerance in India, anti-Semitism in Europe or Muslim bigotry in Saudi Arabia, the modern world rightly condemns them all as violating universal values. Recent months have only highlighted that promoting democracy and promoting liberty in the Middle East are separate projects. Both have their place. But the latter—promoting the forces of political, economic and social liberty—is the more difficult and more important task. And unless we succeed at it, we will achieve a series of nasty democratic outcomes, as we are beginning to in so many of these places.

This fight is not one the fundamentalists are destined to win. The forces of liberalism have been stymied in the Middle East for decades. They need help. Recall that in Europe for much of the last 100 years, when liberal democrats were not given assistance, nationalists and communists often triumphed through the democratic processes.

Above all, the forces of moderation thrive in an atmosphere of success. Two Muslim societies in which there is little extremism are Turkey and Malaysia. Both are open politically and thriving economically. Compare Pakistan today—growing at 8 percent a year—with General Zia's country, and you can see why, for all the noise, fundamentalism there is waning. If you are comfortable with the modern world, you are less likely to want to blow it up.

There are better and worse ways to handle radical Islam. We should not feed the fury that helps them win adherents. The Bush administration's arrogance has been a great boon to the nastiest groups in the Middle East, which are seen as the only ones who can stand up to the imperial bully. We should recognize how varied these groups are: some violent, others not, some truly antimodern, others not—and work to divide rather than unite them. When, for example, Bush added Chechen brutalities to his list of crimes of "radical Islam," he made a mistake. Russia has waged a horrific war against Chechnya for two decades, killing more than 100,000 civilians. To speak of that conflict in the same breath as the London bombings, as Bush did, is to suggest that any time a Muslim kills, whatever the provocation, it's all the same to him.

Give Bush his due. He has correctly and powerfully argued that blind assistance to the dictatorships of the Middle East was a policy that was producing repression and instability. But he has not yet found a way to genuinely assist in the promotion of political, economic and social reforms in the region. A large part of the problem is that the United States—and the West in general—are not seen as genuine well-wishers and allies of the peoples of these countries in their aspirations for a better life. We have stopped partnering with repressive Middle Eastern regimes, but we have not yet managed to forge a real partnership with Middle Eastern societies. ■

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But we [illegible] in Iraq, in Afghanistan

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