ECONOMIC MISSION: PROMOTE PROSPEROUS AND STABLE AMERICAN AND WORLD ECONOMIES

Economic Mission: Promote Prosperous and Stable American and World Economies

The Secretary of the Treasury, as a principal economic advisor to the President, formulates and recommends domestic and international economic, financial and tax policies. Treasury policy offices work to achieve strategic domestic and international economic goals by analyzing, evaluating, and reporting to the Secretary on a wide range of developments that have consequences for the U.S. and global economies and through their leadership in developing and implementing Administration policy.

Economic Strategic Goals

E1: Promote Domestic Economic Growth

E2: Maintain U.S. Leadership on Global Economic Issues

E1: Promote Domestic Economic Growth

RESULTS

The past year presented a particularly challenging policy environment as growth of U.S. real gross domestic product (GDP) slowed sharply in the second half of 2000, followed by the U.S. economy entering a recession in March 2001. The September 11 attacks clearly made the contraction worse. The Secretary and the Offices of Economic Policy and Tax Policy played important roles in developing and implementing the Administration's policy proposals for economic recovery through stimulus and tax relief. Other efforts focused on real-time analyses to better monitor performance of the U.S. economy and on Social Security reform to modernize and restore fiscal soundness to the system.

The Office of Domestic Finance closely watched financial institutions and markets to assess U.S. financial system health and stability and to ensure that financial disturbances in any part of the system did not ultimately threaten the health of the economy. Two financial issues highlighted by the September 11 events were terrorism risk insurance and critical infrastructure protection. Treasury began working with Congress on a short-term federal intervention to reduce costs of insurance coverage while ensuring that terrorism risk insurance remained available to all property and casualty insurance policyholders. Treasury became chair of the Banking and Finance Committee of the Critical Infrastructure Protection Board established by the President to address physical and cyber threats to critical sectors of the economy.

KEY STRATEGIES – ECONOMIC AND TAX POLICIES

The Administration's economic and tax policy strategies were directed at meeting three key objectives:

1. Growth-enhancing policies, including tax relief and economic stimulus, to promote short-run and long run economic growth.
2. Real-time analyses and estimates to better monitor the performance of the U.S. economy.
3. Social Security reform efforts to modernize and restore fiscal soundness to the system.

Growth-Enhancing Policies

Monetary and Fiscal Policy. Faced with evidence of the slowing economy, both monetary and fiscal policy actions were taken to stimulate the economy. During the course of the year, the Federal Reserve undertook an aggressive effort to lower interest rates, cutting the Federal funds rate by 475 basis points from January to December. As always, the Administration and Treasury respect the independence of the Federal Reserve in making decisions about our nation's monetary policy and share the Federal Reserve's goals of maintaining healthy economic growth while preserving low inflation.

As a supplement to monetary policy, Federal fiscal policy also contributed to the stimulus. The adoption of tax relief in June 2001 not only boosted short-run growth, but will also promote intermediate-run and long-run growth. Later in the year, Treasury also participated in the development of Administration and legislative proposals for additional economic stimulus.

Tax Relief Enacted. The Economic Growth and Tax Relief Reconciliation Act of 2001 was signed into law by President Bush on June 7, 2001. Treasury played a key role in the development, enactment and implementation of this tax relief legislation that serves to boost short-run and long-run economic growth. By 2010, provisions of this law will double the $500 child tax credit, provide relief from the marriage penalty, reduce marginal tax rates, and eliminate the estate tax. Of particular note, the legislation creates a new 10 percent tax bracket, providing an estimated $421 billion in tax relief during the next ten years. The new bracket was retroactively effective to December 31, 2000. Treasury also distributed the advance payment checks -- maximum $600 per family.

Economic Recovery and Stimulus. The September 11 attacks and the associated disruption of economic activity and declines in consumer and business confidence presented a significant challenge to Treasury and the Administration. Treasury played an important role in the development of policies as the President and Congress moved quickly to provide immediate funding for rebuilding and recovery and immediate aid for the airline industry. Treasury also participated in the development of proposals for economic stimulus. Early in October 2001, the President called on Congress to pass additional stimulus, with a focus on investment and business tax incentives, tax relief for lower income workers, and extended unemployment benefits.

Long-Run Economic Growth. Treasury was actively engaged in the development and promotion of policies to enhance long-run growth in the U.S. economy, including promoting lower marginal income tax rates and discipline in Federal spending. Despite the short-run downturn, the long-run fundamentals of the U.S. economy remain strong. Inflation is at historically low rates and is expected to continue at low rates in the future, allowing macroeconomic policies to promote non-inflationary real growth. Treasury will continue to advocate spending discipline to assure that the recession-induced decline in the Federal budget position will be short-lived, with a return to an outlook for ongoing budget surpluses.

Real-Time Analysis of the Economy

Increased Monitoring of Real-Time Economic Data. As part of its advisory role on the performance of the economy and economic policy, Treasury focused on better analysis of the real-time information flow on short-run economic activity and the growth of real GDP. The most widely followed indicators of economic activity generally are available only monthly or quarterly. The lags involved inhibit the timely assessment of, and response to, the current economy. Information available on a high-frequency basis can be more reflective of emerging changes and thus enhance policymakers' ability to be at the forefront of breaking developments.

Treasury increased its efforts in monitoring high-frequency economic series on a regular basis to provide real-time estimates and analyses of the performance of the U.S. economy. The major strategy has been to search out existing public and proprietary high-frequency data that can be used to illuminate current economic developments. Such data include -- but are not limited to -- chain store sales, motor vehicle industry activity, and airline industry activity. In addition, weekly and biweekly tracking of current-quarter real GDP is desirable. These activities are particularly important at a time of business cycle turning points, such as has occurred this year.

Treasury began consideration of a number of previously unused private sources, which provide information related to individual industries. Taken together, these various data sources are useful in gaining an overall understanding of new economic trends that may be just in the formative stages. In addition, this activity puts Treasury analysts in touch with industry specialists who may have anecdotal reports of forthcoming developments not yet directly visible in the data.

New Approach to Forecast Current-Quarter Real GDP Growth. Treasury was actively involved in developing and maintaining a new statistical approach for forecasting a quarter's real GDP growth as it develops. Traditionally, forecasts of real GDP for the current quarter have been developed from the stream of monthly data by using one of two methods: (1) adding up components that directly enter GDP as they become available, or (2) using monthly indicators to inform judgments in an ad-hoc way about macroeconomic forecasts, including those for GDP. The new approach relies on statistical relationships for forecasting GDP growth from information that directly enters the GDP calculation as well as other indicators that are historically statistically related to GDP (interest rates, equity price indexes, etc). The system will allow Treasury analysts to develop and update GDP forecasts on a continuous basis as new data are released during each month and quarter.

Social Security Reform

Treasury continued to be actively involved in efforts to modernize and restore fiscal soundness to the Social Security system. Treasury worked to assure that any changes conformed to the President's principles for Social Security modernization and reform.

KEY STRATEGIES -- FINANCIAL SYSTEM STABILITY

A second key area of Treasury's policy focus centered on the U.S. financial system. The Under Secretary for Domestic Finance closely watched developments in financial markets and financial institutions in order to assess the health of the U.S. financial system and safeguard its stability. Treasury continued its efforts to avoid excessive risks building up in the system and to ensure that financial disturbances in any part of the system did not ultimately threaten the health of the economy. Two key issues highlighted by the events of September 11 were terrorism risk insurance and critical infrastructure protection. A third issue, which has been has been an on-going Treasury concern, was predatory lending practices.

Terrorism Risk Insurance

After September 11, the uncertainty of future terrorist acts left the insurance industry unable to assess and price risk. It was not just the insurance industry at risk, but the U.S. economy. Without insurance coverage for terrorism risk, the credit positions of all types of businesses would deteriorate, borrowing costs would be driven up and new construction difficult to finance, and sectors such as energy and transportation would be adversely affected, thus driving up prices and reducing production. Treasury began working closely with Congress on a short-term Federal intervention to help the economy by diminishing the cost increases for insurance coverage while ensuring that terrorism risk insurance remains available to all property and casualty insurance policyholders.

Critical Infrastructure Protection

The financial sector responded remarkably well to the events of September 11 partly as a result of earlier Treasury and financial industry efforts that focused on possible Y2K cyber threats and a 1997 Presidential commission report that had identified banking and finance as a critical sector vulnerable to cyber threats and other terrorist threats. In the aftermath of September 11, major financial institutions successfully activated their business continuity plans, banking and payment systems remained open for business, and regulators and financial institutions tested and reopened debt and equity markets quickly.

The President established the Critical Infrastructure Protection Board to address the broad range of physical and cyber threats to critical sectors or infrastructure. Treasury agreed to chair the Board's Banking and Finance Committee to recommend policies and coordinate programs for protecting the banking and finance infrastructure, including protection of information systems, emergency preparedness communications, and physical assets supporting the systems.

Predatory Lending

Treasury has been concerned for some time about predatory lending, where the lenders' terms and conditions are such that borrowers may not be able to repay their loans and, consequently might have their homes or other collateral repossessed. Treasury has tried to encourage lenders to offer loans and provide credit to borrowers who don't qualify for loans from traditional financial institutions because they are considered a higher risk. Responsible lenders charge these "subprime" borrowers more, but they do not engage in the abusive practices that are considered predatory lending. Predatory lenders' unfair and deceptive practices have most often affected the elderly, minorities, and low-income individuals borrowing for home mortgages.

Treasury continued to encourage the private sector to eliminate abusive lending practices and develop a set of industry best practices for subprime lending, and many key players in both the prime and subprime mortgage industry have announced mortgage purchase guidelines. National standards for good lending practices might provide a good model for the efforts of state and local leaders, who are also dealing with the problems of predatory lending. By working in partnership with lenders and consumer groups, Treasury has sought to help strike a balance between assuring widespread access to credit and avoiding unduly cumbersome requirements on legitimate subprime lenders, which might cause them to withdraw from providing credit to those who need it most.

KEY STRATEGIES -- COMMUNITY BANKING

Treasury has programs that help bridge the economic gap between low-income communities or distressed communities and the economic mainstream. The CDFI Fund provides investments in training and technical assistance to institutions that lend money to economically distressed markets, which may be low-and moderate-income borrowers or identified geographic areas. In FY 2001, the Fund made 285 program awards totaling $113 million, including assistance for small and emerging CDFIs, Native American training, and Bank Enterprise Awards for institutions insured by the Federal Deposit Insurance Corporation.

The Fund also designed the structure of a New Markets Tax Credit Program, which, beginning in 2002, will provide tax credits to private sector investors who invest in Community Development Entities (CDEs) which target economically distressed communities. The Community Tax Relief Act of 2000 will spur a projected $15 billion, over seven years, in private capital loans and investments in activities benefiting distressed markets. The fund will make the initial allocation of tax credits to selected CDEs by the end of calendar year 2002.

Another program, the Community Adjustment Investment Program (CAIP) helped create and preserve jobs in U.S. communities experiencing job dislocations resulting from the North American Free Trade Agreement. During FY 2001, CAIP funds for loans and loan guarantees totaled $78.5 million and hold the promise of creating and preserving about 2,200 jobs over the next two years. CAIP grant funds totaling $6.8 million were awarded in 21 communities. These grants are expected to create and preserve about 4,400 jobs over the next three years. In FY 2001, financial assistance awardees reported creation of over 1,000 private sector jobs.

MANAGEMENT CHALLENGES/HIGH-RISK AREAS

The economic downturn presented a challenge for Treasury's two bank regulatory agencies, OCC and OTS, which supervise a substantial number of U.S. commercial banks and thrift savings institutions. Treasury's Inspector General expressed concern that the downturn would pose added risks to the banking and thrift industries. The OIG stated that in the second quarter of 2000, the banking industry's earnings were the lowest since 1997. OCC and OTS pointed out that for the past decade, the banking industry experienced record profits, and the number of bank failures was minimal. Although the banking industry has experienced record profits and few failures over the last decade and is generally strongly capitalized, the OCC and OTS have recognized the challenge and responded through timely, effective examinations. OTS examiners are also emphasizing credit reviews and paying particular attention to business-related loans. OCC has emphasized the need for banks to maintain sound credit underwriting standards across all types of loans. The OCC's supervision is geared to focus its resources in the areas of greatest risk, and its recent structural changes are intended to improve its effectiveness in directing banks to address operational weaknesses.

In addition to the general economic situation, the OIG saw additional regulatory and supervisory challenges stemming from the *Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (GLB)*, which lifted restrictions on affiliations of banks, securities firms and insurance companies. To deal with the new GLB challenges, OCC examiners have applied modern practices to the rapidly evolving financial products now offered by the banking industry and are using a wide array of tools to identify potential risks to individual banks and the banking system as a whole. OCC and OTS are committed to meeting these challenges and to ensuring the safety and soundness of the banking system.

PARTNERS

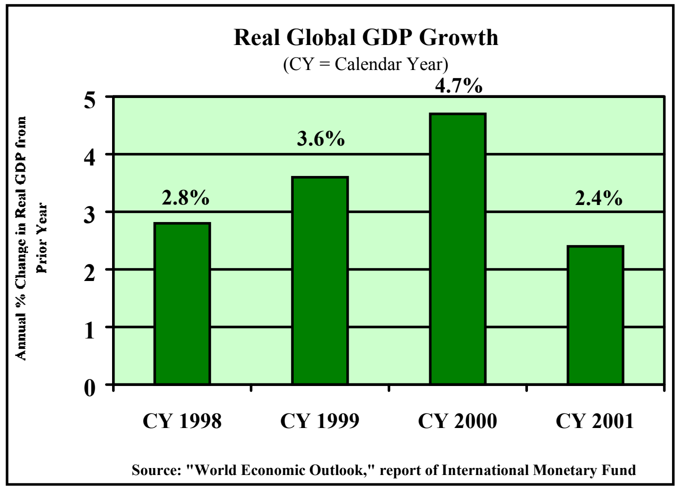
Treasury coordinates with Executive Office Councils such as the National Economic Council and other government organizations and agencies including the Federal Reserve Board, Federal Deposit Insurance Corporation, Securities and Exchange Commission, and the Departments of Commerce, Labor, and Health and Human Services.

NEXT STEPS

As discussed above, Treasury will continue to develop and implement domestic economic, fiscal and tax policies that promote short-run and long-run growth in the U.S. economy, including promoting lower marginal income tax rates and discipline in Federal spending. Despite the short-run economic downturn, the long-run fundamentals of the U.S. economy remain strong. Inflation is at historically low rates and is expected to continue at low rates in the future, allowing macroeconomic policies to promote non-inflationary real growth. Treasury will continue to advocate spending discipline to assure that the recession-induced decline in the Federal budget position will be short-lived, with a return to an outlook for ongoing budget surpluses.

E2: Maintain U.S. Leadership on Global Economic Issues

RESULTS



The U.S. economy is such a large part of the world economy, that as it started slowing significantly in the second half of 2000, the global economy also experienced a marked slowdown. Economic growth weakened sharply in most regions of the world, accompanied by a decline in trade growth and deteriorating financial conditions in emerging markets. Before the September 11 attacks, it appeared there was a reasonable prospect of recovery by late 2001; however, the decline in confidence at the time of the attacks delayed recovery in the United States. Europe and some emerging market economies in Asia and Latin America also grew slowly in 2001. Restoring strong global economic growth is a fundamental goal of the Administration's international efforts.

STRATEGIES/KEY MEASURES -- INTERNATIONAL LEADERSHIP

Treasury played a key role in maintaining U.S. leadership to strengthen the global economy. Four key strategies for achieving this goal were to:

1. Strengthen international economic cooperation and expand trade.
2. Enhance stability and growth through reform of the International Monetary Fund.
3. Raise economic growth and reduce poverty through reform of the multilateral development banks.
4. Combat the financing of terrorism.

Strengthen International Economic Cooperation

Restoring strong growth in the global economy is a key objective of the United States. Before the September 11 attacks, it appeared there was a reasonable prospect of recovery by late 2001. However, the decline in confidence at the time of the attacks delayed recovery in the United States. Europe and some emerging market economies in Asia and Latin America also grew slowly in 2001.

Coordination within the G-7. In the aftermath of September 11, the United States hosted a special meeting of the G-7 finance ministers to address the economic issues arising from the terrorist attacks. The October 6 meeting sent a strong signal of confidence at a time of widespread uncertainty in the global economy. The United States also used the G-7 process to focus on the steps needed to raise long-term growth in the global economy. The G-7 agreed to undertake a quantitative, fact-based study on how policy improvements in areas such as trade liberalization, education, and tax policy could increase long-run growth potential.

Economic Conditions of Major U.S. Trading Partners (rate of growth in GDP) CY = Calendar Year				
Trading Partner	**CY 1998**	**CY 1999**	**CY 2000**	**CY 2001**
Canada	3.9%	5.1%	4.4%	1.5%
European Union (Euro Area)	2.9%	2.6%	3.4%	1.5%
United Kingdom	3.0%	2.1%	3.0%	2.4%
Mexico	5.0%	3.7%	6.7%	0.0%
Japan	-1.0%	0.7%	2.2%	-0.4%
China	7.8%	7.1%	7.7%	7.3%
Source: "World Economic Outlook," report of International Monetary Fund				

Trade Promotion Authority (TPA). To restore confidence, expand trade, and open export markets, the Administration placed enactment of Trade Promotion Authority at the top of its trade agenda. Treasury worked with the White House and other agencies to urge the Congress to enact TPA, which will significantly strengthen the President's authority to negotiate trade agreements. The House passed TPA in 2001, and the Senate will consider it in 2002.

Enforcement of Trade Agreements. The U.S. Customs Service continued its work with international trade organizations to standardize trade and customs data. The Customs Service administered and enforced trade agreements to ensure that all goods and persons entering and exiting the United States comply with U.S. trade laws and regulations and expedited the movement of compliant cargo.

Reform of the International Monetary Fund (IMF)

Treasury continued its efforts to reform the IMF, a key international financial institution, so that it becomes an organization more consistently associated with success. Since the U.S. is a major shareholder in this institution, Treasury took the lead in pushing for changes in the way the IMF does business:

Crisis Prevention. The Administration called upon the IMF to improve its financial monitoring to sharpen its capacity to detect potential trouble and to take appropriate actions early to help prevent the occurrence of financial crises.

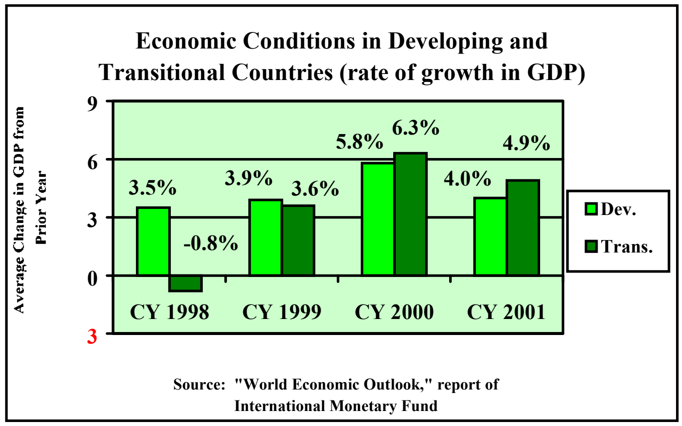
Greater Transparency. An important part of crisis prevention is increased transparency – both on the part of the IMF and its member countries. The United States encouraged countries to publish timely data on their performance and the IMF to be more transparent about its operations, so that markets can make informed decisions with respect to the potential risks of individual economies and the system as a whole.

Focus on Core Areas. The United States pressed the IMF to focus its efforts on promoting monetary, fiscal, exchange rate, and financial sector policies that provide the macroeconomic foundation for growth. In the past, the IMF strayed into matters outside of these core areas, diminishing its effectiveness in fulfilling this core mission.

Prior Actions. The United States was a strong advocate within the IMF of a greater use of prior actions, or conditions that countries must meet before a program is approved and IMF resources are disbursed. This approach helps ensure that needed reforms are implemented and provides an opportunity for countries to demonstrate their strong commitment to ownership of sound economic policies.

Limits on Official Support and Development of a Sovereign Debt Restructuring Mechanism. The Administration made clear that there should be limits on official support to countries facing unsustainable situations. This is essential in order to avoid encouraging behavior by countries and investors that makes future financial crises more likely. Secretary O'Neill also called for the development of a sovereign debt restructuring mechanism that will provide a more predictable framework for debt workouts.

Reform of the Multilateral Development Banks (MDBs)



The multilateral development banks have a critical role to play in promoting economic growth and reducing poverty in the developing world. In order to achieve these goals, the MDBs must change their ways of doing business. The Administration has proposed a wide-ranging MDB growth agenda, which includes the following elements:

Productivity Growth. Rising productivity is the driving force behind higher economic growth, improved living standards, and sustained poverty reduction. Treasury helped shape the debate on MDB policies by pressing the MDBs to focus more intently on operations that raise productivity growth, especially activities that improve education and health; promote private enterprise; promote rule of law, effective public expenditure management, and anti-corruption; and encourage openness to trade.

Measurable Results. Secretary O'Neill emphasized the importance of measurable results in the development work of the MDBs. In response, the World Bank agreed to prepare a study of the "lessons learned" from operational successes and failures of the past several decades. The Administration has proposed linking the level of the U.S. contribution to the International Development Association (IDA) – the part of the World Bank that provides financing to the poorest countries – to concrete improvements in IDA's performance.

Private Sector Development. Investment by private firms is critical to increasing productivity, employment and economic growth in developing countries. Treasury encouraged the MDBs to ensure that private sector development is a core element of their lending operations and policy dialogue.

Grants. President Bush proposed that 50 percent of the World Bank and other MDB funds for the poorest countries be provided as grants rather than loans. Grants are the best way to help poor countries make productive investments without saddling them with ever-larger debt burdens. Treasury has been a forceful advocate for the President's proposal in negotiations for the IDA and African Development Fund replenishments, which remain ongoing.

Transparency. Treasury continued efforts to improve transparency and information disclosure at the World Bank. A large percent of institutional and borrower-country documents are now publicly available, including summaries of executive board discussions on major policies and programs -- allowing more opportunity for outside engagement.

Combat Terrorist Financing

The terrorist attacks of September 11 clearly identified the need to eliminate the international flow of funds that finance global terror. At the direction of the President, Treasury launched the financial front in the war on terrorism and took the lead in global efforts to combat the financing of terrorism.

Treasury successfully pursued international cooperation to combat terrorist financing on a global scale through a number of forums, including the United Nations, the G-7, the G-8, the G-20, and the international financial institutions. Treasury worked closely with the other members of the G-7 industrialized nations as they pledged to monitor terrorist assets by an improved mechanism similar to the Foreign Terrorist Asset Tracking Center established in Treasury's Office of Foreign Assets Control. The G-7 also asked the 31-member Financial Action Task Force (FATF) to focus on specific measures to block the financing of terrorist networks, freeze terrorist assets, and criminalize the collection of funds for terrorism. The United States hosted an extraordinary plenary session of the FATF, at which FATF members established eight special recommendations on terrorist financing, which quickly became the international standard for steps that countries can take to protect their financial systems from abuse by terrorist financiers.

Treasury established a Task Force on Terrorist Financing to keep track, account by account, dollar by dollar, of all countries' efforts. By the end of 2001, 196 countries or jurisdictions around the world had committed to combat terrorist financing, 143 countries had orders in place blocking terrorist assets, and over $68 million had been frozen globally between September 11 and the end of 2001.

PARTNERS

To achieve these U.S. international strategic goals, Treasury worked closely with the Department of State, the U.S. Trade Representative, Agency for International Development, other agencies and institutions including the International Monetary Fund, World Bank, and regional multilateral development banks. Treasury also worked with the finance ministers of other countries, both bilaterally and in multi-lateral groups such as the G-7 (Canada, France, Germany, Italy, Japan, UK, and the U.S.).

NEXT STEPS

In FY 2002, Treasury will work with the above-mentioned entities to increase the global economic growth, improve economic stability, strengthen bilateral and multilateral economic cooperation, promote productivity growth and poverty reduction, and cut off the flow of terrorist financing.