U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

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TESTIMONY OF TREASURY SECRETARY JOHN W. SNOW BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE ON THE INTERNATIONAL FINANCIAL SYSTEM AND THE GLOBAL ECONOMY

Chairman Oxley, Representative Frank and members of the Committee, thank you for inviting me here today. I welcome the opportunity to discuss global economic developments and the Administration's international economic policy priorities.

The Administration remains focused on achieving strong and durable economic growth in the United States and in the global economy. Our efforts within the G-7, the WTO, and the international financial institutions, as well as our bilateral and multilateral engagement with key economies around the world, are centered on this overarching objective.

While the global growth outlook is strong, the Treasury Department is focused on a number of priorities aimed at reducing risks and strengthening opportunities going forward. These include:

- Encouraging growth-enhancing reforms in key economies abroad to maintain global demand as imbalances are unwound;
- Promoting sustained economic reforms in emerging markets to reduce the chances that less benign financial conditions could lead to financial crises;
- Pressing for further opening of international trade and investment;
- Strengthening and modernizing the IMF's core functions and governance to maintain its relevance in the evolving international monetary system;
- Strengthening the integrity of the international financial system by rooting out money laundering, counterfeiting, and terrorist finance;
- Urging the Multilateral Development Banks (MDBs) to focus on policies that promote private sector-led growth, increase transparency, measure results and fight corruption; and
- Promoting long-term debt sustainability to end the decades-long lend-and-forgive cycle that has so clearly undermined growth and reform in poor countries.

U.S. Economy is Source of Strength and Stability for Global Economy

The United States has been a major driver of economic growth in the world economy for some years now, and I am pleased to report that, with our economy's outstanding health, we can likely expect the U.S. economy to continue to serve as a source of global strength and stability in the future.

Real GDP rose an impressive 4.8 percent at an annual rate in the first quarter of this year, reflecting a solid base of underlying strength in the economy. One component of strength is consumer spending. The Conference Board measure of consumer confidence rose smartly in April, reaching the highest level since May 2002. Solid consumer finances reinforce the stability of this spending; net worth is 563 percent of disposable personal income, the highest level since before the recession (2000:Q4).

I want to stress how broadly the benefits of this strong growth impact Americans.

- Average hourly earnings are picking up. We learned from this month's jobs report that average hourly earnings have risen 3.8 percent over the past 12 months – their largest increase in nearly five years. Comparing this point in the business cycle with the same point in the last business cycle, we're doing better during this recovery on wages.
- The unemployment rate is 4.7 percent – lower than the average for the 1960s, 1970s, 1980s or 1990s. The unemployment rate is dropping sharply for youths, African Americans, and for the last quarter, hit an all time low for Hispanic Americans.
- The U.S. homeownership rate reached a record 69.2 percent in 2005. The number of homeowners in the United States reached 73.4 million, the most ever. And for the first time, the majority of minority Americans own their own homes.

The strength of the economy is also visible at the Treasury, as we have seen strong revenue due to economic growth and rising employment. The Administration remains committed to cutting its fiscal deficit and meeting the President's goal of cutting the deficit in half by 2009 when it is projected to be about 1.4 percent of GDP. This will require determination, but revenue surprises are helpful. The budget deficit in fiscal year 2006 is on track to come in well below the estimate of $423 billion as projected in the FY 2007 Budget.

Global Economic Developments and Risks

The global economy is also enjoying a period of exceptional growth. The IMF projects global growth in 2006 of 4.8 percent overall and 6.9 percent for emerging markets and developing countries. Inflation remains contained, despite high oil prices, and the financial environment remains supportive of continued robust growth. This will be the fourth consecutive year of global economic growth above 4 percent – the strongest, sustained growth performance in 30 years. Global growth is particularly impressive in light of the bursting of the tech bubble, 9/11, the serious corporate governance scandals of a few years ago, and the sharp increase in energy prices. It is especially gratifying that developing economies have averaged growth of over 6 percent for the last six years.

But even in this strong growth climate we remain vigilant about potential risks. These include disruptive oil market developments, uneven economic growth amongst the advanced economies, the potential for rising protectionism, and emerging market vulnerability to potentially less benign financial conditions.

The continued rise in global imbalances – larger current account balances than were previously thought sustainable – is a development that particularly needs attending to by economies with weak growth rates, less attractive investment climates, or overly rigid exchange rate regimes. While there has been an intense focus on the U.S. current account deficit, it needs to be understood that our imbalance is a reflection of counterpart imbalances involving very high saving rates and export dependency elsewhere in the world. We believe that there will most likely be an orderly unwinding of these imbalances and we believe that the best contribution that the United States can make to this process is to continue growing at our full potential while continuing to reduce our fiscal deficit.

In discussions with key counterparts, I have emphasized that reducing global imbalances while maintaining global growth is a shared responsibility that will require contributions from Europe, Japan, developing Asia, particularly China, and energy exporters. The United States will do its part as well and remains committed to meeting the President's goal of cutting the fiscal deficit in half by 2009. But the United States cannot resolve the problem by itself. While Japan's recovery is broadening and Europe is in a cyclical upswing, the outlook for future growth remains modest and reforms to strengthen domestic demand-led growth and improve long-run growth potential are still needed. Emerging economies with current account surpluses also need to play a more active role in managing global imbalances by adopting policies that allow for greater exchange rate flexibility, promote sustained increases in domestic consumption, and accelerate the pace of financial sector reform. Greater growth-enhancing spending by energy exporters, and, where appropriate, exchange rate flexibility, is also needed.

Among emerging economies, China has a particularly important role to play in addressing global imbalances. Rapid growth in investment and exports has fueled external imbalances and heightened risk of boom/bust cycles in the Chinese economy. The Chinese authorities recognize the need to shift the sources of Chinese growth away from external demand and credit-fueled investment. In this regard, China has placed strong emphasis on consumption and rural development in its most recent Five-Year Plan. Increased exchange rate flexibility, which would give the authorities greater scope to use more market-based policy tools such as interest rates to manage the economy, is a necessary part of this internal and external rebalancing, as are reforms in the financial system and a host of policies to support reduced household and enterprise savings. We are intensively engaged with China in an effort to bring about greater exchange rate flexibility, balanced growth and financial sector modernization.

We are closely monitoring ongoing developments in emerging market economies, especially those having weaker fiscal positions, higher debt burdens, and/or dependence on commodity prices as they could be tested if financial conditions become less benign. We have encouraged emerging market finance officials to take advantage of present conditions to undertake fiscal consolidation and improve their debt structures, and we have encouraged the IMF to press for structural fiscal reforms in its emerging market surveillance. Low interest rates, favorable global liquidity conditions, and improvements in macroeconomic fundamentals and debt management capabilities have fueled capital inflows and reduced the borrowing costs for emerging markets. Emerging market spreads are unusually low, having fallen in recent weeks to record lows of around 170 basis points.

One of the Administration's international economic policy goals is to increase global financial stability. With this in mind, I want to emphasize the importance of reducing the vulnerability of the global financial system, including emerging economies, by fostering compliance with international financial standards. Countries where the institutional environment is well-regulated and transparent tend to demonstrate better economic performance and greater financial stability. Treasury promotes compliance with international standards in bilateral dialogues, in multilateral fora such as the Financial Stability Forum, and in the IMF and World Bank through support for financial sector assessment programs and integration of financial sector reform priorities identified by these programs into broader surveillance and country programs. Treasury is also actively engaged with the standard-setting bodies, international organizations, and other national authorities in the process of creating and revising the international financial standards themselves. The Treasury Department and U.S. financial regulators conduct bilateral dialogues with our counterparts from a number of key countries – including China, Japan, India and the EU – with the objective of encouraging movement toward more competitive, better regulated financial regimes and mitigating actual or potential cross-border frictions in the financial services realm, thereby contributing to a stronger economy.

Promoting International Trade and Investment

Free trade and the free flow of capital are key pillars of global prosperity and stability. The United States remains fully committed to achieving a very robust Doha package, with emphasis on real, additional market access in the core areas of negotiations – agriculture, manufactures, and services (including financial services) – which would boost growth and provide new economic opportunities domestically and globally. Given the Treasury Department's specific role in the financial services talks, we actively draw attention to the benefits of financial services opening in our bilateral discussions with governments around the world.

The potential benefits from these important trade reforms are enormous. The World Bank estimates that the global gains from full liberalization of merchandise trade would amount to $287 billion by 2015, including $142 billion in gains for developing countries. This would lift an estimated 66 million people out of poverty by 2015. Additional World Bank analysis also suggests that the benefits of services liberalization in developing countries could provide income gains more than four times greater than the gains from goods liberalization alone. Financial sector openness, in particular, has been shown to increase growth rates by over one percentage point in developing countries and to disproportionately help the poor, making commitments in the financial sector a win-win proposition. Of note, cross-country analysis shows that greater involvement by private and foreign banks leads to real benefits for consumers through more efficient lending and higher growth.

But the promise of Doha will not be realized unless we can break the current negotiating logjam. We are putting the full force of our policy efforts into finding a way forward. The door to a successful Round is agriculture, and the key to that door is a much more ambitious agriculture market access proposal from the EU. In addition, major developing countries such as China, India, and Brazil have to be willing to open up their markets in goods and services. We are very mindful that time is running short, with Trade Promotion Authority scheduled to expire in mid-2007.

In the meantime, we are continuing to press forward with an aggressive program of free trade agreements. The latest countries to be added to our FTA agenda are Korea and Malaysia. Overall, the Administration has completed FTA negotiations covering 15 countries, and implemented FTAs with eight countries thus far. The FTAs concluded by this Administration since 2001, combined with the three earlier accords, now cover roughly $925 billion in two-way trade – nearly 36 percent of total U.S. trade with the world and 45 percent of our exports. Where we have a FTA, our exports are growing a healthy 20 percent per year on average, more than twice the rate of growth for our exports where we do not have a FTA.

Greater openness to foreign investment also provides significant benefits to countries, whatever their level of development. The United States has concluded close to 50 Bilateral Investment Treaties that promote open and transparent investment climates abroad while ensuring that U.S. investors receive the same non-discriminatory treatment given to foreign investors in the United States. Our own country's openness to cross-border investment is one reason for the strong performance of the U.S. economy. U.S. affiliates of foreign companies employ about five million U.S. workers, account for about 20 percent of U.S. exports, and spend some $30 billion annually on research and development. It is critical that as we reform the process for reviewing foreign investment in the United States that we not unnecessarily harm this critical source of our economic strength.

Modernizing the IMF

The world economy is changing dramatically, and with it the environment in which the IMF operates. The global financial system is now dominated by private capital. Large emerging market countries account for much of the impetus for global growth. Payments imbalances unimaginable two decades ago now exist. A growing number of countries are building up foreign reserves as a form of self-insurance, and IMF credit outstanding is presently at a 25-year low, which represents a welcome decline in dependence on IMF lending. Despite these changes, the IMF's basic purposes – promoting growth, stability and monetary cooperation – are as important today as ever. The international monetary system needs a strong and central IMF, but, to continue to play a vital role the IMF needs fundamental reform – in its policies and its governance.

Partly in response to calls from the United States, the IMF Managing Director has set out a medium-term strategy that recognizes the need for fundamental reform. There is initial progress to report on several of the reforms we believe are of highest priority.

We have emphasized the need for greater attention to the Fund's core mandate of firm surveillance of exchange rate policies and their consistency with domestic policies and the international system. The IMF has followed our lead on this issue, and the Managing Director has stressed the need for the IMF to strengthen its focus on exchange rates. The Managing Director has also proposed new multilateral consultations, which can bring together the IMF, countries engaged in questionable currency policies, and countries most affected by those policies.

Critical to maintaining the Fund's legitimacy in many parts of the world is reforming its governance structure to reflect the growing importance of new economies. The United States strongly supports the effort to realign quotas and Board representation at the IMF in order to reflect changes in the global economy. Fundamental reform is needed if the IMF is to remain legitimate and relevant to its membership. We have agreed that a first step could consist of a limited ad hoc increase for the most under-represented members. But we have emphasized that an ad hoc quota increase by itself is inadequate to resolve the quota and representation issues that are steadily eroding the IMF's legitimacy and effectiveness. We are only willing to support a limited ad hoc quota increase at the IMF Annual Meeting in Singapore if it is credibly linked to a second step that delivers fundamental reform. This must include revising the IMF's quota formulas with GDP as the predominant variable, broadening the number of emerging market countries receiving increases in quota shares, and taking concrete actions to rationalize Executive Board representation.

There has been much discussion about the fall in the IMF's outstanding lending, to $35 billion from $107 billion at end-2003. The fall reflects early repayments by Brazil and Argentina, as well as more generally better emerging market policies and an exceptionally benign external environment. This is of course a welcome development – the appropriate measure of IMF effectiveness is how well it helps countries and the global system avert or recover from financial crises, not by the volume of Fund lending.

We are optimistic that a refocused IMF will strengthen market institutions and market discipline over financial decisions, helping to promote a stable and prosperous global economy. By doing so, over time markets and the private sector can supplant the need for the IMF to perform in its current role.

Supporting Economic Growth in Developing Countries

The private sector is the engine of growth in most countries and we continue to press for the adoption of policies which unleash the power of the private sector. This includes policies that improve the investment climate, increase access to finance for entrepreneurs, and facilitate business development. Over 70 percent of the population lacks access to financial services. Continued support for programs that support micro and SME lending as well as other financial services for the poor are critical to broadening and deepening economic growth.

Good governance and fighting corruption are fundamental to creating the investment climate necessary to sustain private sector-driven growth. It is imperative that development institutions attack corruption around the world that helps keep nations poor. We support World Bank President Wolfowitz's leadership on the anti-corruption agenda, and his commitment to develop a framework to address corruption systematically. We think such a framework should embody clear and strict criteria consistent with a zero-tolerance approach to corruption.

All MDBs need to be equipped to attack corruption in borrowing nations, and to demonstrate this leadership each MDB must have its own house in order. This requires MDB agreement on a common definition of fraud and corruption, work which is to be completed by the September World Bank Annual Meeting. It also requires that the MDBs increase the transparency of their own operations, strengthen procurement oversight, and implement appropriate incentive structures for staff.

In borrowing countries, strengthening public financial management is essential to improving governance and fighting corruption. We have encouraged the World Bank to expand the coverage of its Public Expenditure and Financial Accountability indicators so that they can provide a consistent benchmark of country strengths and weaknesses. MDB procurement must also adhere to the highest standards – such as those embodied in the World Bank's current policies – rather than rush to use local systems that do not yet meet such standards. Finally, we have advocated for increased transparency and accountability, including through the extractive industries transparency initiative which sets standards for accounting for natural resources revenues.

Deep debt relief through the enhanced Heavily Indebted Poor Countries initiative and the Multilateral Debt Relief Initiative (MDRI), along with the introduction of a non-borrowing policy support instrument at the IMF and the use of grants for poor, debt-vulnerable borrowers in the MDBs, offer prospects for ending the dysfunctional cycle of lend-and-forgive. But to make this happen, debt sustainability must become a central focus of international financial institution engagement in low-income countries. Otherwise, the push to help countries achieve the Millennium Development Goals could lead to another round of over-borrowing, leaving countries vulnerable once again to debt distress. To ensure that the hard-fought gains from debt relief are not squandered, it is essential for the World Bank and the IMF to remain vigilant on low-income country imprudent borrowing. We will continue to press the Bank and the IMF to improve their joint Debt Sustainability Framework for low-income countries. Toward this end, we have developed a proposal for IDA that would limit the pace of debt re-accumulation, and are discussing the proposal with our G-7 counterparts.

A particularly disturbing development is the emergence of new non-concessional lending that seeks to take advantage of realized or anticipated debt relief. This type of "free riding" behavior merits a firm international response. For example, the Chinese government is vigorously pursuing lending in Sudan and Mozambique, both of which are expecting eventual MDRI debt relief. In Sudan's case the lending terms are non-concessional; in Mozambique the terms are still being worked out, but based on the Sudan case we have serious concern. We have been working with our G-7 partners and in the Boards of the Fund and the Bank to push for a presumption of zero new non-concessional debt for countries which are candidates for debt relief. We are also working through the Paris Club and the international financial institutions and engaging directly with creditor countries to gain the adoption of more responsible lending practices.

Fighting Terrorist Finance

Continued terrorist attacks overseas remind us of the urgency of fighting terrorism and its illicit finance. We have been at the forefront of a concerted effort to collect, share, and analyze all available information to track and disrupt the financial activities of terrorists. Finance ministries and central banks play a key role in this effort, as financial intelligence is among our most valuable sources of data for waging this fight. Our goal is to draw upon all available financial information to detect and disrupt terrorist money flows.

Comprehensive integration of the IMF and the other international financial institutions as part of the global war on terrorism has been a consistent policy priority for the United States. We have encouraged close collaboration between the international financial institutions and the Financial Action Task Force (FATF) to assess global compliance with the anti-money laundering and counter-terrorist financing standards set by FATF.

As a result of U.S. leadership, in 2004 the IMF and World Bank Boards endorsed a common assessment methodology drafted by the FATF that provides a consistent framework for assessing compliance with FATF anti-money laundering and counter terrorist finance recommendations. The Boards reaffirmed this decision this May and have agreed that comprehensive anti-money laundering/combating the financing of terrorism assessments will be included as a regular part of all financial sector assessments and on-going surveillance. By the end of 2005, the IMF and World Bank conducted over 50 country assessments. The IMF and World Bank are also a key source of technical assistance for countries seeking to strengthen their counter-terrorist finance and anti-money laundering regimes, and the frequency of technical assistance missions has increased in recent years, partly due to U.S. leadership on this issue within the G-7 and the international financial institutions.

We will continue to emphasize that protecting the financial system from abuse is integral to international financial stability and to call on the international financial institutions to collaborate more closely with FATF toward this end.

Conclusion

Mr. Chairman, you can see that, while we have accomplished a great deal with respect to our international economic agenda, we remain cognizant of the risks and opportunities ahead and are focusing our efforts on addressing them.

I look forward to working with your committee and would be happy to answer any questions.

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