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The State of the International Economy
Testimony Before the House Committee on Financial Services
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Secretary of the Treasury
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Thank you, Chairman Oxley, Ranking Member Frank, and other members of the Committee.

Let me begin with the goals of the Bush Administration's international economic policy. They are threefold:

- *Increasing economic growth,* because strong growth creates jobs, raises incomes, and reduces poverty over time,
- *Increasing economic stability,* because financial crises and recessions cause hardship and suffering, and impede economic progress,
- *Advancing U.S. foreign policy*—in coordination with our international political and security policy—because this will make America and the world safer and more secure.

Our international economic agenda includes opening markets and integrating the global economy, and the Treasury has a key role in formulating and implementing this agenda. That is why the Congress has required this annual testimony by the Secretary of the Treasury, and it is a pleasure to be here again today.

How are we doing in achieving these goals? I am happy to report that as a whole the global economy is performing very well:

- Global economic growth is as strong as it has been in thirty years, and, with inflation historically low, the expansion is expected to continue this year and beyond.
- The news about economic stability is equally good: there are no major recessions, no financial crises, and interest rate spreads, which measure risk, are historically low.

- And on the foreign policy front, our economic efforts are achieving important successes in combating terrorist financing, in the financial reconstruction in countries such as Afghanistan and Iraq, and in promoting economic freedom in the Broader Middle East and North Africa and other regions.

What are the reasons for this excellent economic performance? In my view good economic policies in the United States and other countries deserve much of the credit. To show this, I will highlight important events in three areas: (1) the developed economies, (2) the emerging market economies, and (3) the international financial system as a whole. In doing so it becomes clear that, despite the remarkable policy accomplishments of the last several years, this is no time to be complacent. There are challenges to address if we are to continue to see more growth, stability, and economic freedom around the world.

1. The Developed Economies

Among the large industrial economies, the United States is leading the way. Economic growth was 4.4 percent last year, the strongest in five years. The addition of 2.4 million jobs in the last twelve months alone attests to the continuing recovery from the slowdown of 2000-2001.

I believe that the first and most important part of an international economic policy is good policy at home, and here we have been successful. Well-timed fiscal policy changes—including the tax cuts of 2001 and 2003—and well-timed monetary policy changes restored stability, made the recession one of the shortest and mildest in United States history, and created the right incentives for strengthening the private sector led expansion. With inflation low, the expansion is expected to continue, even though oil prices remain a drag on the rate on economic growth. To make economic growth stronger, we must reduce the budget deficit, reform Social Security and the tax system, reduce the regulatory burden on business, and pass energy legislation—all high priorities of President Bush in his second term. Our efforts to reduce the fiscal deficit will be important for promoting greater stability of the international financial system.

The second largest economy, Japan, has also shown important improvements. The 1990s in Japan is frequently called the lost decade because of near zero economic growth, persistent deflation, and instability. Thus it is good news that Japan grew at about 2-1/2 percent on average in 2003 and 2004, and, despite the pause in the later part of last year, Japan's economic recovery appears to be continuing. As in the United States policy changes in Japan have been an important factor, including a monetary policy aimed at ending deflation and a large reduction in non-performing loans. Despite these improvements, however, Japan's longer-term economic growth is being held back by structural rigidities, which must be addressed if Japan is to reach its full potential

Unfortunately, economic recovery has not yet taken hold in the Euro area as a whole. Economic growth in the Euro area was less than 2 percent last year, close to the low average of the last ten years. While growth remains strong in the U.K. and the Scandinavian countries, it is very low in

Germany and Italy. These important industrial economies confront the task of generating economic growth in the face of changing demographics and structural impediments.

Current Account Imbalances

With the United States growing more rapidly than other industrial countries, exports have grown less rapidly than imports, and our *current account deficit* has therefore risen over the years. In 1990 it was 1 percent of GDP. By 2000 it had increased to 4 percent. And in 2004 it was about 6 percent. At its most fundamental level, the current account deficit reflects the excess of investment opportunities in the United States over the level of savings in our economy. Reducing the budget deficit in the United States—which, as I said, is a very high priority—will help reduce the current account deficit by reducing the gap between investment and saving. But reducing the *growth deficit* between the United States and other countries is also essential. And this brings me to our G7 Agenda for Growth initiative.

The G7 Agenda for Growth

From the start of his Administration, President Bush called for close economic engagement with our allies, emphasizing candid discussions based on mutual respect and cooperation rather than antagonism. Our successful economic engagement with Japan is an example. From the first Camp David meeting between President Bush and Prime Minister Koizumi in June 2001 to my frequent discussions with Finance Minister Tanigaki, we have discussed the key issues such as restoring health to the Japanese banking system and maintaining a macroeconomic policy stance to support Japanese growth and end deflation.

With the G-7 Agenda for Growth we brought this approach to all G7 industrial countries. The goal, of course, is increased economic growth among the G7, especially those where growth is lagging. The Agenda for Growth focuses on structural reforms needed to increase flexibility, raise productivity, and bolster job creation. This initiative is proving very fruitful. It has permanently expanded the traditional focus of the G7 beyond monetary and fiscal policies to supply-side policies. During the U.S. chairmanship last year, we delved into key areas for reform each time we met – including tax reform, labor market reform, and health care reform. At our final meeting in 2004, we agreed to make supply-side, structural reform issues a regular focus of the G7 meetings. And indeed this has continued as planned under the UK chairmanship.

Beyond the Agenda for Growth

As the Agenda for Growth has taken hold within the G-7, we have sought to extend the pro-growth focus to other multilateral fora. For example, a group of finance and central bank officials that Treasury Under Secretary for International Affairs John Taylor chairs at the OECD has significantly shifted its emphasis to pro-growth supply-side policies and their impact on the current account. Last year the G20 endorsed its analogous “G20 Accord for Sustained Growth”. And to help understand the divergence between U.S. and European productivity growth, the Treasury staff has been engaging with their counterparts at European Commission Presidency.

I believe that change is underway. Germany, for example, recently implemented labor market reforms that provide incentives for the unemployed to return to work. Italy passed a pension reform law in July, raising the retirement age. France has relaxed the 35-hour workweek restriction. The Japanese are working on privatizing mail delivery and its huge postal financial institutions

These are important achievements, but there is much more to do. Structural reform is difficult. Supply side policies take time to work. But as has been clearly demonstrated in Ireland, they work amazingly well. Last November I met in Warsaw with the Finance Ministers of Poland, Hungary, the Czech Republic, and Slovakia. I was greatly impressed with the speed and depth of their structural reforms, from lowering marginal tax rates to reducing barriers to investment. I am hopeful that these new members to the European Union will be a helpful force for change for the industrial countries, and our engagement with the EU will reflect that hope.

2. The Emerging Market Countries

As we all remember, the 1990s produced a series of damaging financial crises in emerging markets—from Mexico, to East Asia, to Russia, to Brazil. These crises rolled back hard-won economic gains, created profound social disruptions, and left many asking whether the international financial system was a source of instability rather than stability.

The most notable feature of emerging markets today is strong economic growth and the absence of financial crises. Economic growth in Latin America was 6 percent last year. In emerging market Asia it was 7-1/2 percent. In emerging market Europe it was 6-1/2 percent. In South Africa it was nearly 4 percent. Capital flows to emerging markets are again rising following the sudden stop after the Russia crisis in 1998.

Improved Policies and the Role of the United States

In my view these positive outcomes are primarily the result of better economic policies in emerging market countries themselves. Many countries have improved their fiscal policies and strengthened financial supervision. Many have adopted monetary policies that focus on price stability, and have moved from unsustainable fixed exchange rate pegs to flexible exchange rates, or have joined currency unions, or have adopted another country's currency. As a result emerging market inflation has been cut dramatically.

The United States has helped by assisting countries that are pursuing good policies. In fact, when the Bush Administration came into office, there was an urgent need for a comprehensive strategy to promote greater economic stability in emerging markets. This meant not only creating a policy environment that made financial crises less likely, but also setting out to ensure that international assistance, including from the International Monetary Fund (which I discuss later), was used to support countries with good policies, rather than provided in large amounts to countries with flawed policies. And we created new forms of U.S. engagement—such as the Group for Growth with Brazil and the Partnership for Prosperity with Mexico—to share experiences on how to tackle impediments to higher economic growth.

For example, when Brazil neared a full-blown financial crisis during its election in 2002, the United States supported a loan from the International Monetary Fund (IMF) to bolster the government's sound fiscal program, which was supported by the major candidates in the election. Then, when President Lula won the election and his government strengthened the fiscal program, risk spreads fell sharply. Brazil's economy grew more rapidly last year than it has in ten years.

At the same time, the Administration acted quickly to head off the spread of crises. For example, when Uruguay experienced a bank run sparked by its neighbor Argentina's crisis, the United States mobilized an assistance package that included a $1.5 billion five-day bridge loan from the Exchange Stabilization Fund to a loan from the IMF to support a plan to back dollar deposits in the banking system. The strategy enabled Uruguay to end the bank run, restore economic growth, and repay the loan in four days.

Financial support worked in Brazil and Uruguay because it was used to bolster good policies. Large amounts of international assistance—such as from the IMF—cannot buy success or avoid crises in countries with poor economic policies. Too often in the past large assistance packages simply underwrote flawed economic policies and artificially shielded investors from reckless risks until it was too late to avoid a crisis.

China, the Exchange Rate, and the G7

Reform of the currency exchange regime in China is one of the highest priorities for our international economic policy. While many large emerging market countries have moved to more flexible exchange regimes, China has maintained an exchange rate peg for over a decade. This impairs adjustment throughout the international financial system and prevents China from using its monetary policy to control inflation as other central banks in the world do.

Along with our G7 partners we have urged China to move to a flexible exchange rate. We take this issue very seriously and have devoted considerable time and attention - at all levels - to working with the Chinese to prepare them for a change. During the past year we have seen progress. A very important development was when Chinese officials met with the G7 Finance Ministers and Central Bank Governors for the first time, and this has continued this year. Engagement with China contributes to global economic stability because of the size of China's economy, and its rapid growth means that it is now an essential participant in the international financial system.

China has not only indicated that it will introduce more flexibility, it has taken the practical steps needed to do so. As members of the G7 have recognized, the time has now come for China to introduce flexibility into its exchange rate. The Chinese are now ready to adopt a more flexible exchange rate, they have sufficiently prepared their financial system to live in a world of greater flexibility and need to take action now.

Economic Freedom in the Broader Middle East and North Africa

Another historically significant new engagement on economic policy has been among the countries of the Broader Middle East, North Africa, and the G8. In the economic sphere this new engagement began in September 2003 at a meeting I chaired in Dubai; we have met four additional times since that time, most recently last weekend in Washington.

This engagement brings together the finance ministers from Morocco to Pakistan, including Turkey, Afghanistan, and Iraq. Our discussions are about their home-grown economic reforms and how the G8 can help. The engagement has already spanned several initiatives, including a new IFC small business facility for the region. By joining with the foreign ministers as we did in the Forum for the Future meeting in Morocco, we hope to exploit the synergy between economic freedom and political freedom that we are seeing in the region.

3. Supporting Poverty-Reduction and Economic Growth in Developing Countries

The Bush Administration’s approach to developing countries is based on the principle that good economic policy in the countries is a prerequisite for economic growth and poverty reduction, and that we should work with countries to develop their policies. Official development assistance can be far more effective within such a good policy environment, and indeed it has frequently been wasted when such a policy environment is not in place.

Improving the overall investment climate is particularly important for promoting private sector development and job creation, and access to finance for small businesses is an important component of our development policy.

Based on this principle the Bush Administration launched several initiatives including our reform efforts in the World Bank (which I discuss below) and the Millennium Challenge Account, which will provide development assistance to countries that follow policies that lead to economic growth. The United States has nearly doubled development assistance since 2000. This increase -- which has raised our development assistance by about $10 billion annually -- represents roughly one-third of the increase in aid from all donor countries combined. U.S. annual assistance to sub-Saharan African countries alone has more than tripled since 2000, with over 30 sub-Saharan countries receiving increases of greater than 50 percent.

These new initiatives, combined with our existing activities, will further promote greater economic growth in developing countries. Given the truly astounding power of growth to reduce poverty, we remain fixated on promoting it. If sub-Saharan African economies expanded by 5 percent in 2005 and 2006, then nearly 30 million people would be lifted out of poverty. The Bush Administration will continue to work vigorously to achieve such ambitious results.

There have been important success stories where poor economies such as India and China have developed into fast growing emerging market countries, but many poor countries have failed to achieve sufficient growth on a sustained basis to lift their people out of poverty. For instance, in the 1990s sub-Saharan African economies grew by only about 2 percent annually, which is less than population growth, so per capita income declined.

Fortunately, during the last two years economic growth has picked up in many of the poorest countries. For example, in sub-Saharan Africa, growth is now estimated to have been about 4-1/2 percent in 2004. This increase clearly reflects the strong world economy overall, but it also is due to some improvements in economic policy especially greater inflation control in many countries. These higher rates of economic growth are raising per capita incomes and bringing tens of millions of people out of poverty in the poorest countries each year. But there are still billions in poverty and economic growth has to be increased further and be sustained if poverty is to be reduced significantly.

4. The International Financial System and Institutions

So far I have focused on the importance of economic policies undertaken by governments relating mainly to their own countries. Another important part of international policy relates to the international financial system and the international financial institutions. During the first term of the Bush Administration, important reforms were achieved at the IMF, the World Bank, and the other Multilateral Development Banks on which I serve as Governor. And we have made progress in the international financial services and tax areas. These changes are already being implemented and are factor in improved economic performance. And one of the key parts of U.S. foreign policy is our work on combating terrorist financing and supporting reconstruction efforts in Afghanistan, Iraq, and the Palestine Authority.

Reforms at the International Monetary Fund

These reforms set out to *clarify the limits on exceptional access* to IMF lending and to focus IMF programs and conditions on core macroeconomic areas of expertise. These reforms are now in place. Requests for exceptional access now face new procedures, including a higher burden of proof in the form of a special report that documents how IMF resources will support strong policies. The IMF's work—both with respect to its lending programs and surveillance—is more tightly focused and it now relies on more robust analytical tools.

A closely related achievement in the area of crisis prevention and resolution was the Administration's initiative to make the process of restructuring sovereign bonds more orderly through the use of *collective action clauses* (CACs) so that restructurings are less disruptive and more predictable. One year after the launch of this initiative, Mexico became the first country to include CACs in its New York-law governed bonds. Brazil, Korea, South Africa, and Turkey soon followed, as inclusion of CACs quickly became standard market practice.

Reforms at the World Bank and other Multilateral Development Banks (MDBs)

The MDBs serve a critical role in promoting global economic growth and stability, especially in countries and regions where poverty is most acute. From the outset, the Bush Administration has pursued an aggressive reform agenda in an effort to maximize the MDBs' effectiveness and achieve better results on the ground. These institutions were found by many to be lacking in: measurable results; institutional transparency and accountability; promotion of private sector-led growth; and lending policies that reflected debt sustainability problems in poor countries. As a result of recent reforms, considerable progress has been achieved in measuring results, increasing grants, focusing on private-sector led growth, fighting corruption, and improving transparency and accountability.

In 2001, President Bush called on the MDBs to provide 50 percent of their assistance to the poorest countries in the form of grants. Due to strong U.S. leadership in replenishment negotiations, IDA and the African Development Fund (AfDF) will provide approximately 45 percent of their assistance to the poorest countries in the form of grants. In addition, the Asian Development Fund (AsDF) agreed in 2004 to institute a 30 percent grants program for the poorest countries in Asia. Before President Bush's initiative, nearly all MDB assistance was provided as loans. These landmark achievements represent a crucial step toward ending the lend-and-forgive approach to multilateral assistance and ensuring long-term debt sustainability.

Because of its success in reforming the institutions to deliver assistance more effectively, the Bush Administration was able to justify a reversal of the trend in the 1990s of declining U.S. contributions to the MDBs. Displaying our strong commitment to these important institutions – based on their commitment to reform – during the Bush Administration the U.S. has delivered double-digit increases in funding for IDA, the AfDF and the AsDF, which provide consessional resources to the world's poorest countries.

Further Reforms at the IMF and World Bank

More also needs to be done to ensure that the IMF and World Bank are positioned to assist countries in taking on the economic challenges they face in the 21st century. The United States, in partnership with its G-7 partners and others, has called for a *Strategic Review* of the Bretton Woods institutions to identify the changes needed to make these organizations more responsive, relevant, and helpful to their members. The Bush Administration is committed to seeing this review through and working with the managements of the IMF and World Bank to implement the required reforms.

A bold debt proposal. The shift to greater use of grant financing will reduce unsustainable debt burdens over the long-term. However, debt will continue to act as a constraint on economic growth in the interim. To address this problem, the Bush Administration has put forth a bold debt proposal that would relieve the debt burdens of poor countries without additional cost. The proposal calls for immediate action to provide up to 100 percent relief on IDA and AfDF loans to the Heavily Indebted Poor Countries (HIPCs). These actions, combined with the new increases in grants going forward, will put these poor countries on a sustainable path.

A new non-borrowing program. We are also focusing on how the IMF's work in the poorest countries can be more effective. We have proposed a new non-borrowing program for countries that don't need IMF loans but still can benefit from their IMF's macroeconomic policy advice.

Economic needs of the low-income countries are vast; we believe the IMF can play a constructive role in poor countries primarily through surveillance and policy advice and, when needed for balance of payments purposes, financial assistance. Last weekend, the G-7 Finance Ministers expressed their backing for the creation of a non-borrowing program.

These additional reforms will further the division of labor and exploit the comparative advantage of the IMF and the World Bank, with the IMF focusing on monetary, fiscal, exchange rate, and banking supervision issues, and the World Bank focusing on economic development.

International Trade, Financial Services, and Investment

Completion of the Doha Development Agenda is vital to spurring global economic growth, stability, and is an important part of U.S. foreign policy. As part of the Doha Agenda the United States has proposed the elimination of all global tariffs on consumer and industrial goods by 2015 and substantial cuts in farm tariffs and trade distorting subsidies. Trade liberalization on such a grand scale would deliver benefits of roughly $500 billion annually to the world's poor. This is more than double the size of current official development assistance flows to developing countries.

The Treasury has a particular responsibility in the financial services talks, which are an integral part of the broader Doha negotiation. We are working to draw greater attention to the services component of the Doha discussions and with other finance ministries on the financial services issues in particular.

Treasury is also active in the progress on free trade agreements (FTAs). The FTAs with Chile, Singapore and Australia entered into force in the past year, and we have concluded FTAs with Central America/Dominican Republic, Morocco, and Bahrain. In addition to liberalizing trade in goods and services, these FTAs provide protection for the free flow of capital, so that emerging markets can attract the funds they need to expand the productive potential of their economies. We plan to advance our negotiations on additional free trade agreements in Africa (Southern African Customs Union), Asia (Thailand), Latin America (Andean countries, Panama, Free Trade Area of the Americas), and the Middle East (United Arab Emirates, Oman).

Financial Regulatory Talks Between the United States, Japan, and the Europe

For the past three years, the United States and the European Commission have been discussing a range of financial regulatory issues. The agenda has included Europe's Financial Services Action Plan, the Sarbanes Oxley Act, the Basel II Capital Accord, and convergence of accounting standards. International issues arise because the United States and the European Union have different legal, cultural, and historical traditions. Actions by each may have unintended spillover effects for the other, which our discussions helped to manage. For similar reasons, we have also conducted annual meetings between Japanese and American financial regulators.

Progress on International Tax Treaties

Treasury has been very active pursuing tax treaties in the Bush Administration. This past year we fulfilled another long-standing goal with the conclusion of a new, modern tax treaty with Japan that entered into force on March 30, 2004. The new treaty provides for significantly reduced withholding rates on cross-border payments of dividends, interest and royalties as well as modernizing a number of other rules. The new treaty significantly reduced existing tax barriers to investment and trade in both directions, enhancing the global competitiveness of our businesses and creating new opportunities for international trade and investment.

The Global Fight Against Terrorist Financing

Since September 11, 2001 we have accomplished much in our global fight to disrupt the flow of funds that support terror – a critical component of the overall effort to keep America safe. Worldwide efforts have shut down channels terrorists and their sympathizers depended on to transfer funds, led to the capturing or killing of key terrorist facilitators and deterred donors from supporting al Qaida and other like-minded terrorist groups. We continue to work with our G7 and other international partners to coordinate these efforts. This past year Treasury was pleased to welcome Under Secretary Stuart Levey who oversees our new Office of Terrorism and Financial Intelligence, which is focused on safeguarding the financial system against illicit use and combating rogue nations, terrorist facilitators, money launderers, drug kingpins, and other national security threats.

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Mr. Chairman, I think you can see we have accomplished much in international economic policy during the first term of the Bush Administration from reform of the international financial institutions, to a major increase in development assistance, to new forms of cooperation with our allies. We are pleased that the world economy is performing so well, and that global economic growth and stability have both increased so much. But as I have indicated, we have an ambitious agenda for the second term. I look forward to working with your committee and would be happy to answer any questions.