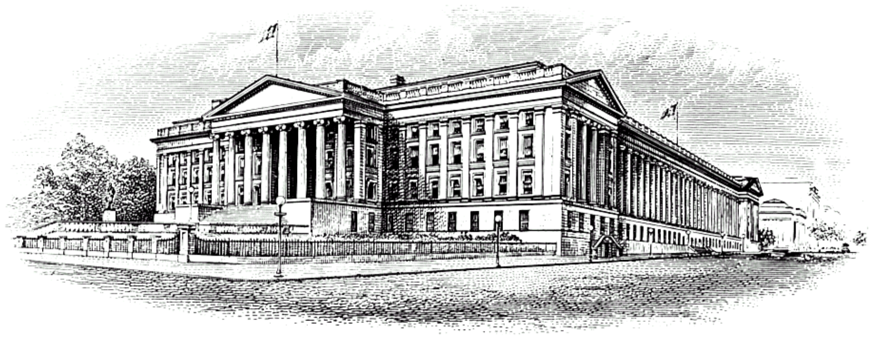

DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10:00AM **Contact** **Tony Fratto**
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TESTIMONY OF TREASURY SECRETARY JOHN W. SNOW BEFORE THE COMMITTEE ON FINANCIAL SERVICES U.S. HOUSE OF REPRESENTATIVES

STATE OF THE INTERNATIONAL FINANCIAL SYSTEM

Chairman Oxley, Representative Frank and Members of the Committee, thank you for inviting me here today. I welcome the opportunity to discuss the Administration's international economic agenda.

This is a time of opportunity. The global economic recovery has accelerated in the last six months. Economic stability is also improving, and risks have diminished. But we cannot be satisfied. The Administration's top priority is to achieve stronger and more lasting growth – in the United States and in the world economy as a whole. Our international economic policies are aimed at doing just that. Since the United States holds the chairmanship of the Group of Seven (G-7) this year, we have an important opportunity to lead change.

Promoting Strong, Sustained Growth in the Major Economies

Achieving growth in the major economies is fundamental to strengthening growth at home and worldwide. Indeed, the global economic recovery has accelerated in the last six months.

The United States is leading the way with a strengthening recovery. The President's tax cuts, passed by Congress, have worked. They have provided the stimulus that was necessary to turn the economy around, and they are now encouraging and allowing for the economic growth that is continuing into the future. The evidence is clear. Economic growth in the second half of 2003 was the fastest since 1984. New home construction in

2003 was the strongest in 25 years, and homeownership levels are at historic highs. Manufacturing activity is increasing. Inflation and interest rates are low. Jobs are coming back, and the unemployment rate is falling. Indeed, these facts all point to the same conclusion: We are on a path to sustained economic growth. However, there is more to do. We are not, by any means, satisfied. We will keep working until every American who wants to can find a job.

Beyond the United States, there are also promising signs. Japan's economy is recovering, with a strong contribution from domestic investment. Even in continental Europe, where growth is still lagging, the indicators are positive. And there is evidence that the momentum for growth continues to build, as financial markets strengthen, inventories fall, and investment picks up. More broadly, geopolitical uncertainties have eased, and economists see fewer downside risks.

Despite the positive outlook, we are convinced that action is needed to bring about stronger growth that is broad-based and sustainable – and less reliant on a single engine. Indeed, the need for stronger growth was at the top of the agenda when I hosted my G-7 colleagues in Boca Raton in February. This was the first Finance Ministerial convened by the United States during our chairmanship of the G-7 this year. I was extremely pleased with the consensus at this meeting about the importance of growth and that structural reforms – marginal tax rate reduction, labor market reform and regulatory reform – are needed to raise economic performance over the long term.

The strength of our shared commitment to follow through on structural reforms is reflected in the path-breaking Agenda for Growth initiative, which was launched by the G-7 last September. This initiative focuses on reforms to boost productivity and employment, and thereby increase economic growth. Strong fiscal and monetary policies are vital. But it is also essential that we implement structural reforms in the major economies to enhance the potential for sustained and strong growth.

Each G-7 country has taken concrete actions to advance these goals of the Agenda for Growth initiative. For example, Canada has fully implemented a five-year, $100 billion tax reduction plan. Germany has enacted key elements of a reform initiative to improve work incentives as well as to reduce taxes. And each of us has committed to going further to increase labor and product market flexibility, boost productivity and raise employment. The United Kingdom, for instance, is establishing a long-term strategy for funding innovation and scientific research, extending skills training programs, and proposing a collaborative initiative on regulatory reform across the EU. Japan will work on further fiscal expenditure and revenue reforms, including in the social security system, and will continue to address financial sector reforms. And France will continue its work to reduce labor market constraints, while also pursuing health care reform.

As for the United States, our contributions will be through the President's commitments to maximize growth and job creation. This includes: spurring saving through changes to the tax system; making health care more affordable; working to prevent frivolous lawsuits from diverting money from job creation; streamlining regulations; preparing

American workers for the demands of the 21st century job market; and working to make tax relief permanent, so that families and businesses alike can plan for the future.

The Agenda for Growth marks a fundamental change in the way the G-7 operates. I am truly hopeful that the commitments each country has made will translate into tangible results – in terms of improved prospects for our economies and the world economy as a whole. Combined with strong macroeconomic policies, including sound fiscal policies over the medium-term, this initiative is also an important step to addressing global current account imbalances.

Opening Markets and Reducing Barriers to Trade

Opening markets and reducing barriers to trade are key engines for domestic and global economic growth. Trade leads to more jobs, higher wages and increased productivity. It is through free trade that all nations can benefit from each other's prosperity. Free trade means new markets for exporters.

From the launch of the Doha negotiations in November 2001, the United States has consistently played a key leadership role in moving these negotiations forward and pressing for an ambitious outcome. We all missed an opportunity in Cancun to advance the cause of trade liberalization. Nonetheless, there are hopeful signs that we can get the Doha Development Agenda back on track again so that 2004 is not a lost year. The focus of the WTO negotiations should be the market access agenda – agriculture, industrial and consumer goods, and services. These areas have the greatest potential to promote economic growth. For developing countries to realize the benefits of trade, they too need to reduce their own trade barriers substantially. Developing countries collect most of their tariffs on trade with other developing countries. In particular, efficiency gains from trade liberalization in the financial services sector could be beneficial for many emerging markets.

But even as we ponder the next steps in the WTO, the United States continues to press an aggressive trade agenda to open markets regionally and bilaterally with willing partners. For example, we have recently concluded free trade agreements with Central America (CAFTA), Morocco and Australia, and we are negotiating additional free trade agreements in Africa, Asia, Latin America, and the Middle East. By moving forward on multiple fronts, we can exert leverage for openness and create a new competition for trade liberalization.

As I have made clear before, it is our strong view that the international trading system works best with free trade, free flow of capital and flexible market-based exchange rates. It is widely recognized throughout the world that free markets and market-determined prices are best able to allocate scarce resources to their most productive use. This is as true for domestic markets as it is for international markets. While the choice of an exchange rate regime is up to each country, we have been encouraging countries to use flexible exchange rates. Flexible exchange rates ease the adjustment to changing economic conditions in the international financial system. We recognize that, especially in the case of small open economies, there are benefits from a "hard" exchange rate peg, such as dollarization, joining a currency union, or using a credible currency board. Of course, a flexible exchange rate will not prevent the economic damage that is caused by a bad economic policy. A good flexible exchange rate regime requires a monetary policy with a focus on the goal of price stability, and with it a transparent, systematic procedure to adjust policy instruments in order to achieve that goal.

In Boca Raton, G-7 Finance Ministers and Central Bank Governors reinforced the importance of flexibility, stating:

> We reaffirm that exchange rates should reflect economic fundamentals. Excess volatility and disorderly movements in exchange rates are undesirable for economic growth. We continue to monitor exchange markets closely and cooperate as appropriate. In this context, we emphasize that more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms.

This statement is consistent with our strong dollar policy, which I have consistently reiterated since my confirmation hearing. A strong dollar is in the U.S. national interest.

One country where we have been particularly active on the issue of exchange-rate flexibility is China. China has pegged its currency to the dollar for ten years. This Administration has stressed that China needs to move to float its currency as soon as possible. President Bush and I emphasized this point in all our China meetings late last year, and I will press it again when I meet with China's central bank governor tomorrow. China agrees that it needs a flexible rate, and we are making a lot of progress in that direction. To facilitate China's transition to a flexible regime, the Treasury Department and China's central bank have already begun a Technical Cooperation Program. China is also accelerating liberalization of its capital account and taking major actions to shore up its banking system.

We are stepping up our diplomatic efforts as well. Soon I expect to announce the appointment of a high-level emissary in Beijing who can start work in early spring, and China's cabinet is committed to a face-to-face dialogue with me on all these developments. I believe this broad-based full-scale diplomatic approach is the best path forward. It can also help address exchange-rate inflexibilities throughout the Asian region, consistent with the G-7 Boca Raton communiqué.

Fostering Growth and Stability in Emerging Market Economies

There is promising news among emerging markets as well. Many emerging market economies are experiencing higher growth rates, along with reduced interest rate spreads and improved equity markets. This is very good news, particularly after the frequent and severe crises that had become prevalent among such countries in recent years.

Stronger performance among emerging market economies is following concerted efforts to reform the international financial system to reduce the frequency of crises, support policy reforms by individual countries, and improve access of emerging market economies to private capital flows. Some of this work has focused on the International Monetary Fund – where reform is essential to our efforts to advance growth and stability.

I want to review for you some of the progress made in the last year – in particular through steps such as inclusion of collective action clauses in emerging market debt, limits on exceptional access to IMF lending, and improved IMF analysis of economic performance and vulnerabilities. (An account of reforms in the IMF is provided in Treasury's Report to Congress on Implementation of Legislative Provisions relating to the International Monetary Fund, October 2003.)

Two years ago, the United States took the initiative – in cooperation with other industrialized countries, emerging market issuers and the private sector – to advocate widespread inclusion of collective action clauses (CACs) in external sovereign debt. CACs are contractual provisions that can make debt restructurings more orderly and predictable in cases of unsustainable financial stress. Mexico included CACs for the first time in its New York law-governed bonds just about a year ago. And now CACs are on their way to becoming standard in internationally-issued sovereign bonds. A range of countries, including early CAC issuers Mexico, Brazil, Korea, South Africa and Turkey, have demonstrated that including these clauses in their issues has had no impact on pricing. And since the New Year, the Philippines, Panama, Colombia, Costa Rica, Venezuela, Indonesia and Israel have all included these clauses in their New York-issued bonds. Along with the IMF and others in the international financial community, Treasury continues to discuss the benefits of these clauses with potential sovereign issuers, as we work to build on this important trend in strengthening market practices.

To help prevent contagion as well as to provide the right incentives for strong policies, it is important to make clear that official resources are limited and are not endlessly available. We have indicated that the IMF must be the primary source of official resources for countries facing acute financial crises. And we have underscored the limits on the IMF's resources by making clear that there will be no quota increase in the foreseeable future. Within the IMF, we have worked to reinforce the limits on official finance by strengthening the guidelines for IMF lending. While reducing IMF exposure to current exceptional-access programs will take time, we have made important progress over the past year in narrowing and specifying the circumstances under which countries could access large scale IMF lending. Among other things, the IMF will prepare and publish a separate report evaluating the case for exceptional levels of lending whenever they are requested.

The United States clearly has a strong stake in helping countries recover from financial crises, and we have strongly supported the IMF's engagement with Argentina as it has worked to stabilize its economy. These efforts have been producing results. The Argentine economy has stabilized considerably since the crisis, with GDP growing 8.7% last year, inflation falling to 4%, the exchange rate appreciating by 14% and reserves growing by $3.5 billion. Argentina's current three-year IMF program launched in September provides the basis for Argentina to consolidate its recent macroeconomic progress and to adopt the reforms needed to lay the basis for sustained growth in the years ahead. The program also provides the broad policy framework to underpin a debt restructuring agreement between Argentina and its creditors by requiring Argentina to work in good faith with its creditors to reach a collaborative agreement that restores debt sustainability.

Of course, the best outcome would be to avert crises before they occur. To help enhance crisis prevention, we have focused on strengthening the IMF's surveillance of its members' economies. In the last year, the IMF has also strengthened its analytics – through more systematic and transparent assessments of debt sustainability across emerging market countries and through more extensive consideration of balance sheet fragilities. And the IMF has taken a vital step forward to make its analyses widely available by establishing the presumption that country documents and lending program papers will be published.

The aim of our reform efforts has been to give greater clarity and accountability to IMF decisions. Doing so will provide greater predictability to markets. While important progress has been made, we are reviewing these reforms to determine whether we have done everything we can to ensure that we have a modern international policy framework appropriate for today's modern financial markets.

Protecting the integrity of the international financial system is fundamental to growth. In this context, we remain strongly committed to combating terrorist financing and money laundering. We are working closely with the IMF and World Bank and encouraging them to assess country compliance with the entire set of FATF Recommendations on a permanent, comprehensive and sustainable basis. Working with the international financial institutions is a key element of the broader effort, which focuses on helping countries identify and address shortcomings in their anti-money laundering and combating terrorist financing regimes – thereby bolstering the underpinnings of stronger, sustainable economic growth and development.

Fueling Growth and Better Living Standards in the Poorest Countries

In the poorest countries, the quest for growth provides the best hope for the future. Economic growth, led by the private sector, is the most effective means of promoting sustainable development and reducing poverty. Enhancing productivity is the key to progress and depends on sound national macroeconomic and governance frameworks.

The Millennium Challenge Corporation (MCC) aims to sharpen the incentives for countries to establish these conditions for growth. Ruling justly, promoting economic freedom and investing in people are the hallmarks of a strategy that can produce results. By allocating assistance based on objective indicators of performance in these key areas, the MCC aims to reinforce the efforts of countries working to improve their own prospects. President Bush signed the law creating the MCC on January 23, and the Board acted quickly to get the MCC operational, meeting for the first time on February 2. On March 5, 2004, the MCC sent to Congress a report describing the criteria and the methodology by which eligible countries will be selected from the list of candidate countries. The MCC will focus specifically on promoting sustained economic growth through investments in areas such as agriculture, education, private sector development, and capacity building. The MCC provides a tremendous opportunity to demonstrate how linking assistance to results can help bring success in achieving growth and development.

In the World Bank and the other multilateral development banks (MDBs), the United States has been promoting a set of key reforms to focus the institutions more centrally on their core missions and enable them to play a more effective role in promoting sustainable growth and poverty reduction. There have been significant achievements over the past year, and further improvements are expected, particularly in the context of ongoing negotiations to replenish the institutions that provide assistance to the poorest countries: the International Development Association (IDA), the African Development Fund (AFDF), and the Asian Development Fund (ADF).

President Bush's new grants initiative – first proposed in 2001 – is now well established in IDA and the AFDF, and the United States is in the process of negotiating a new grant program in the ADF, as well as seeking expansion of grant programs in IDA and the AFDF Grants have proven particularly useful to address the needs of countries with serious debt sustainability problems and for post conflict countries. Last week, Under Secretary Taylor led a mission to Africa to assess how the new grants were being received in the poorest countries, and found strong support and enthusiasm for this important new initiative.

In order to reinforce these reforms and strengthen the accountability of the MDBs, working with Congress we have set out ambitious goals to increase the transparency of the MDBs' decision-making processes. In particular, the United States has advocated greater availability of information on MDB projects, policies, Board meetings, fraud and corruption cases, and results indicators. We have also urged MDBs to make public the details of their internal systems for allocating assistance and establish a plan to conduct regular, independent audits of internal management controls.

All of the MDBs are currently in the process of establishing results management systems that set monitorable and measurable results objectives at the project, sector, country and institution level. To provide a catalyst for this effort, the United States introduced an incentive as part of the United States' IDA-13 contribution, pledging an additional $300 million if the institution met specific performance and outcome targets. IDA achieved the initial targets set for last spring and is working on a new set of outcome objectives in the areas of private sector development, health and education. We have called for an independent audit to verify achievement of these goals.

The *private sector* plays a critical role in fighting global poverty and creating jobs in developing countries. This is why the successful initiative to allow a portion of IDA funds to be used to promote private sector development was so important. For the last several years, the United States has urged a greater emphasis on assistance to small businesses along the lines of the IDA/International Finance Corporation (IFC) initiative to promote SMEs in Africa which was approved this past year. There is strong evidence that small businesses are critical to employment generation in most developing countries, but there has been inadequate attention given to this critical sector by both multilateral and bilateral donors.

In February, we gained G-7 agreement to push the MDBs to work with governments to improve investment climates and provide more resources to support the private sector. In particular, to help countries establish the strong enabling environment needed for the private sector to flourish, we have called on the MDBs to prepare assessments of the impediments to private sector investment and action plans to address the key weaknesses in each country. We are also seeking ways to involve the private sector more closely in the development of MDB lending strategies.

Facilitating the flow of *remittances* is another promising avenue for promoting growth and development in the poorest countries. By far, the largest source of assistance to developing economies is not the governments of wealthy nations, or even the multilateral development institutions. It is family members who have gone abroad to work and send a portion of their incomes back home in the form of remittances.

Providing these remittances, which totaled more than $90 billion last year, often requires a huge sacrifice on the part of the immigrant worker. Many of these workers have incomes that are barely above the poverty line in their countries of residence, yet they send substantial shares of their pay home. For example, the average Latin American immigrant in the United States earns less than $25,000 annually, yet he or she sends, on average, $2,000 back home each year. And on top of this, the immigrant often pays high fees to send the funds. Once these flows arrive at their destination, limited access to or knowledge of financial services often constrains the recipients' options for saving or investing the funds – for example, for education expenses or for small business enterprises. Thus, tremendous potential for remittance flows to contribute to economic growth and development is lost.

The United States is taking the lead in addressing the cost and access issues related to remittances. The Administration has launched several initiatives with bilateral and multilateral partners since 2001. The bilateral work has focused on Mexico and the Philippines, where the objectives are to identify and address the physical and regulatory barriers that may exist and to promote competition among remittance service providers. Most recently, the United States secured G-7 agreement to identify problems in each of their countries and map out a strategy for addressing these barriers. By working together, bilaterally and multilaterally, we aim to enhance significantly the potential for recipients of these flows to invest in their future – and make a measurable contribution to growth and development in their native economy.

Supporting Economic Revival in Afghanistan and Iraq

I want to provide some details today on our work to support economic revival in Afghanistan and Iraq.

In February 2004, the G-7 Finance Ministers and Central Bank Governors issued an Action Plan on Afghanistan, the first such plan based on an individual country. In the Action Plan, the G-7 committed to producing visible and measurable results in Afghanistan by June, when the Afghan government is planning its first nationwide elections in over 20 years. To meet this deadline, the United States has set challenging targets in program areas, including the number of police trained and schools built. The G-7 and other donor countries are also deciding on goals that will advance their reconstruction programs in Afghanistan. The Afghan government has also set tough goals for itself in areas such as increasing domestic revenue collection by 50% in its next fiscal year.

In Afghanistan, Treasury has been focused on developing the government's ability to manage its financial accounts. Treasury provided a budget expert to the Ministry of Finance in February 2002, who helped the ministry manage and computerize expenditures and revenues. Treasury is working with the Afghan government to improve domestic revenue collection and coordinates with other donors to ensure that the government's operational expenditures (such as salaries) are covered. Recently, Treasury sent an expert to work in the Ministry of Finance on debt management. Treasury has also been closely monitoring the World Bank and Asian Development Bank programs in Afghanistan.

Treasury is partnering with the government to promote private sector development in Afghanistan. I visited Afghanistan in September 2003, just two days after Afghan President Karzai signed the new banking law. This law allows foreign banks to operate, after several years of no formal banking services in Afghanistan at all. Treasury is also spearheading a U.S. government initiative to help establish industrial parks and encourage business growth in Afghanistan. Under Secretary John Taylor visited Afghanistan this February to assess progress on these initiatives.

Turning to Iraq, I want to emphasize that we continue to make meaningful progress on economic reform, despite a difficult security environment. For example, Iraq recently concluded the successful introduction of a new currency. Printing and delivering this currency on time was an enormous feat -- the equivalent of twenty-seven 747 plane loads of currency were delivered to Iraq and distributed to the public through approximately 240 exchange sites. By all accounts, the Iraqis have wholeheartedly embraced their new dinars, and confidence in the new currency remains strong.

At the G-7 Meetings in late February, we invited Iraq's Central Bank Governor, Sinan Shabibi, and Finance Minister, Kamel Gailani, to share their reform agenda. Both stressed their commitment to moving ahead with sound, market-oriented reforms that will underpin private sector-led growth, and described recent actions they have taken to demonstrate their commitment. For example, Governor Shabibi recently announced the selection of three foreign banks to receive a license to operate in Iraq – a significant departure from the previous regime, where only locally-owned banks were permitted to do business in Iraq.

In addition, Governor Shabibi has liberalized interest rates on all domestic financial instruments – loans, deposits and securities – enabling lenders and borrowers to make their own decisions rather than having them determined by fiat and top-down directives, which used to be standard practice. Finally, the Governor announced the imminent passage of a new Central Bank law. This law, which has since been approved, not only confirms the independence of the Central Bank, but also prevents the Central Bank from engaging in inflationary financing of the government. These steps follow the adoption of a modern banking law, approved last fall, which contains many provisions designed to support the development of a strong, robust banking sector.

Other priorities include addressing Iraq's substantial debt problem, which we will be working with the other creditors to resolve as quickly as possible and encouraging the IMF and World Bank to provide their full range of support – in line with their commitments at last October's Madrid donors' conference -- to the Iraqi people. The World Bank recently established a trust fund for Iraq, and has met several times with Iraqi authorities to identify priority programs and projects under this facility. The World Bank plans to begin making disbursements under this facility by July 2004. This fund – which has already attracted $1 billion -- will be financed by donors, and is in addition to the $3-$5 billion that the World Bank has committed to provide Iraq over a four year period once conditions for lending are met. The IMF is also laying the groundwork to provide financial and policy support for Iraq. At the Madrid donor conference, the IMF announced that total assistance could range from $2.5 billion to $4.25 billion over a three-year period. The IMF recently conducted initial policy discussions with senior Iraqi finance officials that begin the process for a financial and economic reform arrangement with the new government.

Authorization Requests

As part of the fiscal year 2005 budget, the Administration has requested $1,492.7 million for contributions to the MDBs, $200 million for debt reduction activities and $17.5 million for technical assistance programs. Related to these funding requests, the Administration will be making a number of authorization requests.

Authorization will be sought for further contributions to the HIPC Trust Fund. In 2002, President Bush committed to fund a share of the additional multilateral financing requirements of the HIPC Trust Fund. Subsequently, the Administration pledged $150 million to help meet the core financing requirements of the HIPC Trust Fund. Authorization is also requested to extend the authority for U.S. bilateral debt reduction under the HIPC initiative through FY2006. And reauthorization is sought for the Tropical Forest Conservation Act in order to continue providing debt relief for low and middle-income countries to support conservation of their tropical forests.

The Administration also has a pending request for Congressional authorization to implement two of the reforms of the North American Development Bank (NADBank) proposed by Presidents Bush and Fox. These reforms aim to enhance the performance of NADBank and its sister institution, the Border Environment Cooperation Commission (BECC). The proposed reforms requiring authorization are: (1) enabling NADBank to make grants and non-market loans out of its paid-in capital; and (2) extending the border region for NADBank/BECC operations on Mexico's side from 100 kilometers to 300 kilometers. We appreciate the quick action on this legislation in the House last year and hope for similarly swift action in the House this year on the newly-approved Senate bill.