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OVERSIGHT OF THE INTERNATIONAL MONETARY FUND AND WORLD BANK

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

ON

PROPOSALS TO REFORM THE INTERNATIONAL MONETARY FUND AND WORLD BANK, INCLUDING THE COSTS AND BUDGETARY TREATMENT OF MULTILATERAL FINANCIAL INSTITUTIONS' ACTIVITIES

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OVERSIGHT OF THE INTERNATIONAL MONETARY FUND AND WORLD BANK

WEDNESDAY, MAY 19, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

This morning the Committee meets to examine the role of the International Monetary Fund and the World Bank. It has been several years since the Full Committee has examined these Bretton Woods Institutions which are critically important to the architecture of the international financial system. Congress has a responsibility to monitor their work closely and seek to influence effective policy. After all, the United States is the single largest shareholder in almost all of these multilateral financial institutions.

Building on reform initiatives instituted after the Mexican and Asian financial crises, the IMF and the World Bank have implemented initiatives to better anticipate, prevent, and resolve sovereign financial crises, but obvious challenges still remain.

With the recent attention, debt restructuring battles, and financial resources attributed to Brazil and Argentina, opportunities exist to focus on the strengths and weaknesses of these institutions and what steps can be taken to make them more worthwhile.

For our first panel today, we welcome Under Secretary John Taylor of the U.S. Treasury. Under Secretary Taylor is the principle adviser to the Secretary of the Treasury on international economic and financial issues. Prior to serving this Administration, Under Secretary Taylor was the Roberts Professor of Economics at Stanford University. He is a globally recognized expert on international monetary and financial issues.

Our second panel will include three witnesses: Dr. Allan Meltzer, Distinguished Professor of Political Economy at Carnegie Mellon University; Dr. C. Fred Bergsten, Director of the Institute of International Economics here in Washington, DC; and Dr. Douglas Holtz-Eakin, Director of the Congressional Budget Office. Drs. Meltzer and Bergsten have extensive experience with regard to these multilateral financial institutions. In November 1998, as part of the legislation authorizing $18 billion of additional U.S. funding for the IMF, Congress established the International Financial In-

stitutions Advisory Commission to recommend future U.S. policy toward these institutions. Commonly referred to as the "Meltzer Commission," in reference to its Chairman, Dr. Meltzer. Dr. Bergsten has also served on this Commission and co-authored the dissenting opinion.

Dr. Holtz-Eakin's testimony will summarize CBO's ongoing study analyzing the Long-Term Economic Costs of U.S. Federal Budget Obligations. While this CBO study has yet to be completed, we are very interested in any preliminary findings Dr. Holtz-Eakin can share with us.

I want to thank all the witnesses for appearing before the Committee today. And, Dr. Taylor, we welcome you back from your trip to Asia and look forward to hearing your testimony. I am hoping we will be joined by some other members of the panel.

Your written testimony will be made part of the record in its entirety. You proceed as you wish.

STATEMENT OF JOHN B. TAYLOR
UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
U.S. DEPARTMENT OF THE TREASURY

Mr. TAYLOR. Thank you very much, Mr. Chairman.

Chairman SHELBY. By the way, you are no stranger to the Banking Committee.

Mr. TAYLOR. No, sir. It is good to be back, and thank you for inviting me to testify here on the efforts of the Administration to put forth its reform agenda at the Bretton Woods Institutions, the IMF and the World Bank. Reform of these institutions has been a high priority of the Bush Administration since its beginning.

During the first year of the Administration, we presented our reform agenda. President Bush, in an important speech at the World Bank, laid out some of the key principles and proposals, and then in testimony in the Congress and in speeches various places, we described some of the technical details on the political and economic rationale. I must say we worked together with our fellow shareholders in these institutions, which was very important, and with the staffs of the institutions as well to carry out the reforms.

In April 2002, there was an important international agreement between the United States, France, Germany, the United Kingdom, Canada, Japan, and Italy on how some of these reforms would be implemented in the so-called G–7 Action Plan of 2002.

Mr. Chairman, I am happy to report that an enormous amount of progress on this reform agenda has been made, especially in the last year and a half. Key reforms that have been implemented—and I will list five of them here—are the implementation of collective action clauses in sovereign debt; the creation of clear limits and criteria for exceptional borrowing from the IMF; the use of grants in replacement of loans from the World Bank; the introduction of a rigorous system for measuring results at the World Bank; and the focus of both institutions on their core expertise, with a better emphasis on division of labor between them.

As is true of many reform movements, many of these ideas have been discussed and debated for years. The work of this Committee, in fact, has been very much part of that discussion and debate. But, in my view, in the last few years we have gone well beyond

discussion and debate. What is different now is that these reforms have actually been adopted. Any one of these reforms, in my view, would represent a significant accomplishment. Taking them all together as a whole, I think they represent a fundamental shift in the way the international financial institutions are operating.

The goals of these institutions, simply put, are to increase economic and financial stability, number one; and, number two, to increase economic growth and thereby reduce poverty around the world. These are good goals. There is no reason to change these goals. But the world economy and financial markets have changed dramatically since the institutions were founded 60 years ago. So in order to fulfill these goals, the institutions must reform. Just, for example, consider some of the changes just in the last 15 years.

Securities, as distinct from bank loans, are a much bigger percentage of cross-border financial flows. Private capital flows have increased dramatically and are much larger than official flows from the international financial institutions. There has been a particular emphasis on remittances in recent years. As we get more and more data, we see that remittances alone from immigrants back home are much larger than the transfer of resources from the international institutions and other aid agencies. Then, finally, financial markets have become much more interconnected, and flows have become more volatile.

I believe that these changes in cross-border financial flows have, by themselves, led emerging markets to become more crisis-prone. And, in fact, the number and severity of crises in the 1990's was up significantly compared to the 1980's.

The initial responses to these crises by the official community in the 1990's were understandable. As in the case of Mexico, the responses had to be developed from scratch in a very short period of time, and they had to be implemented immediately. But the point I would emphasize in discussion of these crises is that they represented and provided very clear evidence that the systemic changes in the world's financial markets, as I just summarized, were taking place, and systematic changes in the operation of the institutions had to take place in order for them to fulfill their goals.

A related problem was that loans from the IMF and the World Bank to the poorest countries in the world—the poorest countries in Latin America, Africa, and Asia—were building up to clearly unsustainable levels, and this led to understandable calls for debt relief. And, again, in our view, the responses at this time were more tactical than strategic, dealing with the problem at hand rather than developing a strategy to deal with the overall problem. They dealt with the current serious need for debt relief, but not with the expectations effects and the incentive problems that would continue to cause the international institutions to lend too much to the very poor countries.

My written testimony, Mr. Chairman, provides the details of how the reforms I mentioned at the beginning deal with these problems, how it makes the institutions better able to deal with the current world environment in order to fulfill their goals. But I think that clear progress has been made and is substantial. Our review indicates that there is still more work to be done to lock in the reforms that I mentioned and to even expand on them.

In our view, now is an opportune time to move ahead to do more. Why? Well, there are three reasons I would emphasize here. First, the recent progress in these reforms, in our view, working internationally with other countries, has generated a new enthusiasm or a new momentum for reform. There is a positive feeling that by working together we can actually get something done to change the international institutions in an important way. This gives us an opportunity to make further changes, the kind of changes that have been on people's minds since the 50th anniversary of the institutions, but actually make them take place on the 60th anniversary.

The second reason to pursue these reforms now and to continue with what we are doing is that we currently are in a period where there are no major financial crises around the world. This gives us, the relevant participants, time to consider these longer-term reforms more thoroughly, and again, it seems to us that locking in and expanding on the five points I mentioned are the important things to do.

The third reason is simply this is the 60th anniversary of the institutions. It is a time to look back and to make sure we got it right.

For these reasons and others, Secretary John Snow, as this year's Chairman of the G–7 Ministers and Central Bank Governors, has called for a strategic review of the institutions with the aim of defining new directions for them to take that build on the five reforms I mentioned at the beginning. There has already been a very positive response to Secretary Snow's initiative from the developed world, from emerging market countries, and from the developing countries alike. Broad consultation is under way, so it is still too early for me to tell what the new directions will be over and above what has been accomplished in the last year and a half. But I will mention some examples of the ideas that are being well received.

One is the possibility of developing a new nonborrowing program from the IMF, a program that exploits the expertise at the IMF but does not burden countries with loans.

Another idea is to develop a new surveillance system with the IMF which would entail reorganization at the IMF and the encouragement of ownership and country-led proposals from the countries that pursue such programs.

And, finally, to further increase the amount of grants going to the very poor countries, as distinguished from loans, in an effort to further improve their debt sustainability in conjunction with additional debt relief.

The issues I have discussed here and more thoroughly in my written testimony, Mr. Chairman, are actually quite technical. Some people would consider them somewhat arcane. But they are deeply important to financial stability and economic growth. And I think, thanks to the very successful effort in the last year and a half as well as the actual improvement in the world economy, there is a willingness to consider further reform and to spend the time needed to get it right. Indeed, this is what Secretary Snow has urged us to do in the G–7 and his strategic review and new directions initiative.

Thank you, Mr. Chairman. I will be happy to answer any questions you may have.

Chairman SHELBY. Thank you, and thank you for your written testimony. You are absolutely right. It is very technical, but very important.

In October 2003, this Committee heard from Treasury Secretary Snow on the Chinese Exchange Rate Policy. At that time Secretary Snow was hopeful that significant concrete steps would be made toward a more flexible exchange rate policy in weeks and months to come. Now, 7 months later, you recently returned from Asia and reported that talks were very candid, very productive concerning the current economic conditions of China and that you remain confident that the Chinese Exchange Rate Policy is being addressed. Chinese leaders still have not announced a timetable.

My question is this: What specific steps, Dr. Taylor, have the Chinese taken to address the exchange rate situation? For example, what have Chinese leaders done to address the problems in the Chinese banking system, which has been very weak and could become even more so in the event of a currency peg or if it were precipitously removed?

Mr. TAYLOR. Thank you, Mr. Chairman. Just very specifically, the Chinese have injected some additional capital into two of the largest state banks, and that is in an effort to begin to deal with some of the nonperforming loans that they have to make the banks more resilient.

More directly related to the exchange rate, they have begun to relax some of the capital controls on both inflows and outflows. They have begun to work on developing markets, better spot markets, but, more importantly, more futures markets which are needed for a good, flexible exchange rate system.

My assessment is there is really not a debate about whether China will move to a flexible exchange rate. They have indicated they want to do that. They want to do it in a way that will work for them.

One of the things that we emphasized in this recent trip is that the current inflationary pressures in China are another reason to move toward flexibility because those inflationary pressures are being caused to some degree by the increase in money growth. As always, money growth will lead to higher inflation. And the flexibility of the exchange rate will enable them to contain the money growth more than they are able to do now. Now, as they buy securities in the international markets to defend the peg, they cannot offset it completely to sterilize it, is the technical word, and, therefore, money growth is stronger than it otherwise would be.

I think there are many reasons for them to move toward a flexible rate. They said they would. We are working with them on a technical level to make it happen as smoothly, as soon as possible.

Chairman SHELBY. Should we be more aggressive working with some of the others in the international market to help them shore up China's financial system as a preview of going toward a flexible exchange rate? Or is that something they have to do?

Mr. TAYLOR. Well, we can be very helpful with our expertise in the United States, not only from the Government side, the regulators, but also from the private market side, to develop some of

these futures markets. Markets that are for futures markets or forward markets are something that they are very much interested in. We sent a technical cooperation team to China in the winter. We are going to send a second team in June. And those discussions I would describe as quite technical, of course, but they are ones which are aimed toward creating these markets where a flexible exchange rate could work and where you have the price discovery, the ability to determine what the exchange rate will be in a full market system.

So, I think it is important to be active on this, not passive, and to share the information we have with them and encourage others. A very important development internationally is that the G–7 countries called for more flexibility in exchange rates in countries that do not have such flexibility. That was reiterated now three times—in the Dubai meeting, in the meeting in Florida, and in the meeting that just occurred in Washington. It is a multilateral effort at this point to help China move to a flexible exchange rate.

Chairman SHELBY. How do they deal with the situation they have, basically state-owned banks making loans to failing state-owned industries, you know, just eating it up, nonperforming loans? I mean, it seems like it is a merry-go-round.

Mr. TAYLOR. It is a problem. They know as they move toward a market economy that they have to get the banks to operate more in a market environment rather than have directed loans, which is what they are used to. They are opening their financial sector to foreign banks. I visited some of the foreign banks that are investing in China. That is a good way to begin to move more toward a market system. But they now have very large state-owned banks which they have to begin to think about how they are going to have more business-oriented type of lending, more lending that is based on accurate risk assessments. And it is difficult. I believe they are trying to do the right thing in this regard.

Chairman SHELBY. We will have other rounds.

Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. I again want to thank you for not only this hearing but also this series of hearings which you have held on issues critical to the financial industries in the United States.

I am going to make a couple of statements and maybe just toss out some issues that I would like to see the witnesses discuss. But I have to go to a markup in about 5 minutes in another Committee, and so I apologize for that.

I do want to reiterate my extreme interest in these issues, and I want to follow up just briefly on the line of questioning that you raised, Mr. Chairman, with regard to the exchange rate, and Mr. Taylor and the other witnesses.

It seems to me that while we wait for China to stabilize its banking system and move to a floating currency, the United States continues to suffer from the impacts of China's actions in Asia on other countries as well as on the United States of its exchange rate. And it seems to me that there is something more that we can and should be doing. I am not sure what that something is.

I note that Mr. Bergsten in his testimony suggests that China should go to an immediate one-time revaluation of 20 to 25 percent. I personally think that would be a good idea. I am not sure how we would cause that to occur. But I think what I am asking is: Is there not something more that we can do to try to address this issue than simply hope and work together as best we can to help strengthen China's banking system and encourage them to move at some distant date to a floating exchange?

Mr. TAYLOR. Senator, I think we are being quite active with them, and it is more than simply talking. It is doing. They have done a number of things to begin to open their capital account to allow more foreign investment in the financial sector. Those are all good things for us and for them. And in terms of the flexible exchange rate, that is what we have argued very precisely about. We have gotten lots of support from other countries around the world. We have emphasized it is a global issue. It has to be addressed, and it has to be addressed soon.

I think our strategy is one that emphasizes the flexibility of the exchange rate, and that will bring about the needed adjustment when it occurs. At this point it seems to me it is the right approach and it is working.

Senator CRAPO. Are you familiar with Mr. Bergsten's recommendation of an immediate revaluation?

Mr. TAYLOR. Yes, I am.

Senator CRAPO. What do you think of that?

Mr. TAYLOR. What we have argued is that the flexibility itself is important, not just the revaluation. Flexibility is important. Now, that may or may not bring about a revaluation. Right now the central bank is buying foreign-denominated securities which suggests upward pressure on the RMB. So in most people's estimation, more flexibility would indeed bring about an appreciation of the currency and that may be what the Chinese want to do eventually. But if it is simply a revaluation, then it is a revaluation to another fixed exchange rate, which brings about a lot of the same difficulties that are being created by the current fixed exchange rate.

So the flexibility is important, and that is the key globally to get the benefit from China's strong growth, which is benefiting the world economy, without the disadvantages and the distortions that a fixed exchange rate causes.

Senator CRAPO. Thank you.

Mr. Chairman, as I indicated, I have to go to a markup right now, but I just wanted to conclude with a statement.

Chairman SHELBY. Absolutely.

Senator CRAPO. Several years ago, we had some pretty intensive hearings with regard to the recommendations of the International Financial Institutions Advisory Commission with regard to the World Bank, and Mr. Meltzer was at those hearings, Mr. Bergsten was at those hearings.

I am concerned that we have not made very good progress in terms of implementing the recommendations of that Commission. And at the time I was very convinced that the Commission was on the right track in getting us the kinds of recommendations that we needed to follow in terms of getting more accountability and, frankly, more understanding of what is happening inside the World

Bank in particular, but the International Monetary Fund as well. Mr. Meltzer, I note that, in your testimony today you are going to discuss that. Unfortunately, I will not be here to listen to that, but I have staff here and I have read your written testimony, and I will be following very carefully what you say.

I just wanted to say to all the witnesses and to the Chairman and the other Members here that I am very concerned that we have not, either as a Congress or as the Administration, taken the necessary steps to be aggressive enough in the reforms with regard to the recommendations that we have already received that to me seem to be very evident in terms of their need. And I for one am going to be focused very closely on learning how much progress we have made and what progress we need to make in the future. I am very interested in Mr. Meltzer's recommendation that we need to have an independent performance audit or create some type of an entity in the World Bank, like the GAO or otherwise, that can perform its own audits to give us the kind of information that we need in order to maintain this pressure for reform and to understand the reforms that we need to implement.

I know that was not a question. It was more of a statement. But, Mr. Chairman, I believe that these are very critical issues, and I appreciate you bringing them before us.

Chairman SHELBY. Thank you, Senator Crapo.

Senator Allard.

Mr. TAYLOR. Senator, could I just respond?

Chairman SHELBY. Dr. Taylor, go ahead, if you want to respond to him.

Mr. TAYLOR. I think if you look at my testimony, I think you will find a lot of significant movement in the direction of the reforms that the Meltzer Commission and others have suggested.

For example, we do have right now independent audit of our new measurable results system at the World Bank. It was just approved by the board. So that is a very significant development. It is an independent audit of a particular issue.

We have moved substantially in the direction of grants. That was another part of the recommendation of many people, and we got international agreement to do that. I just went on a trip to Africa to observe how the grants are doing. They are very popular. It is a real significant accomplishment.

Conditionality has been narrowed substantially at the IMF. They do not have hundreds of thousands or even thousands or hundreds of conditions now. They have narrowed their focus. They should narrow it further.

There has been a lot of progress and a lot of international agreement, and I think that should be recognized. It does not mean we are done. It does not mean we are not going to go forward. Secretary Snow wants us to move ahead more. But let us recognize what has been done, sir.

Senator CRAPO. I appreciate that, and I do want to understand where we are. And I appreciate the fact that we have been moving in the right direction. That will help us to determine what we need to take as the next steps.

Thank you.

Chairman SHELBY. Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I have a statement I would like to have made part of the record.

Chairman SHELBY. Without objection.

Senator ALLARD. I am particularly interested in the difference between IMF's Independent Evaluation Office and the World Bank's Operations Evaluation Department. I understand that the IEO is much more independent and also seeks more outside information and evaluation of the IMF than the OED seeks on the World Bank. Would you agree with that understanding?

Mr. TAYLOR. Both of these entities are just beginning. The IEO, from what I have seen so far, is consulting broadly in its reviews. It has not done very much yet, has just begun. They have a good person in charge. I have spoken to him many times. We will have to see. We are watching it closely, but I think it is very important that they do thorough evaluations of the subjects that they look.

The OED, basically it is the same idea. We have, as I just mentioned a minute ago, asked for some of the things be done by an independent audit, and maybe we can do a comparison of the independent audit on this issue and the OED. I think that will give us some information. Right now I would not say that characterization that one is working better than another is correct. I think we have to look at how both of them are working, and be diligent in making sure they are working well.

Senator ALLARD. But the IEO seems to be consulting more out and around. Was that your initial statement?

Mr. TAYLOR. I have observed myself more consultation with the IEO. I cannot say whether they have been more consultative than the other group, no.

Senator ALLARD. I see. Do you believe that the current relationship between the World Bank and the OED is more appropriate for ensuring accountability and transparency or overseeing such a large financial institution with such a huge amount of risk?

Mr. TAYLOR. I think the OED is a step in the right direction, and as I say, I have spoken to them. We discussed their doing this work on the audit rather than have an independent audit. We chose the independent audit approach. That is something that the Congress requested as well. But my sense is the structure here allows for it to do the independent reviews and I think we are just going to have to see over time whether it needs to be adjusted or not, but I think the structure is fine at this point. But again, we have now established at least one independent audit of some significant things we are asking the World Bank to do, and I would like to compare that to what the OED does. That would be very useful.

Senator ALLARD. As you can probably tell by now, I am particularly interested in accountability and the transparency of financial institutions. One of the ways in which accountability and transparency can be evidenced is through practices like external audits. The GAO recommended in 2001 and 2003 that independent, external auditors conduct an audit at every multilateral development bank each year that would evaluate several aspects of bank operations that are not covered by the much simpler audits now conducted. For example, the GAO noted that the World Bank has several offices that function as internal control systems, but that to

date there is no way to know how effective they are in making sure bank funds are used for the assigned purposes, and that bank policies are obeyed. Congress agreed and recommended public summaries of such independent audits be published annually by June 2005.

The question is, has Treasury met with the GAO since January to review the terms of reference that apply here and to plan these audits, and can you share with us your outline for that work?

Mr. TAYLOR. Our staff has met with GAO regularly, Senator. On these particular issues, laying out a timeline, I will have to get back to you to see exactly what has been proposed.

Senator ALLARD. Can you get back for the record for the whole Committee, please?

Mr. TAYLOR. Yes, sir.

Senator ALLARD. Any further comment?

Mr. TAYLOR. I think just maybe a comment would be that based on the experience we just had with this independent audit initiative at the World Bank—we are one shareholder at the World Bank. There are many others. Every reform like this requires international consultation at a great degree of financial diplomacy if you like. This one was very hard to get through, and I think what is going to be important is for us to show in practice to our fellow shareholders whether or not this improves things. So to me it is a very important thing that we have this one example of an independent audit going through, and I think if we can show it is useful or if we find a better way to do it, then we can develop the international consensus that is needed to move the organization in a more productive way.

I just add that to your question, Senator.

Senator ALLARD. Mr. Chairman, I have just one other question, and if it has been addressed, I apologize, but this possible $100 billion from the World Bank that never was actually received by recipient countries, apparently that had been intercepted and privatized illegally, according to some testimony that was before the Senate Foreign Relations Committee, where they had held a hearing combatting corruption at the multilateral development banks. Apparently this was from Professor Jeffrey Winters' research. Has the Department of the Treasury come up with any official statement supporting or denying those claims? It would be interesting to hear your thoughts on those estimates in that matter.

Mr. TAYLOR. I believe this came up in a hearing last week at Senate Foreign Relations, and our representative at the World Bank responded, and if there is more information that you needed than that, we will be happy to give it to you, but the $100 billion is not something I find at all substantiated at this point. We will be happy to look further into it, but it does not sound plausible at this point. I will be happy to look into it more, Senator.

Senator ALLARD. I think we should. This is testimony that was given by an individual before the bank, and I would assume that the Senate Foreign Relations might be following up on it, but it is also something I think is of interest to this Committee, certainly of interest to me, because it gets to the very issue of accountability of dollars, and we have that responsibility as policymakers here to make sure that taxpayer dollars when they go to IMF or whatever

are handled in a responsible way and that things are making sure that we do not end up dealing with illegal activity in some way or another. If you can share with us in the record at some point in time, make it part of the written record here in this Committee, I think it would be helpful.

Mr. TAYLOR. Would be very happy to. Some of the things that we are doing at the World Bank to improve accountability is to have a system to measure the results of what they actually do with the money, the number of school books, for example, that are purchased, or the number of schools that are built or the number of inoculations that occur, and it is really improving a lot but we have to keep working at it. I very much applaud your efforts to help us look into it, Senator.

Senator ALLARD. You are talking about a performance-based evaluation.

Mr. TAYLOR. Yes, sir.

Senator ALLARD. I think that is really important. I want to see all the agencies in our Government do that, and I certainly think that the World Bank needs to do that and I appreciate your bringing that up without any of us having to bring it up.

Chairman SHELBY. Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I am pleased to join with you in welcoming Under Secretary of the Treasury John Taylor here this morning.

Secretary Taylor, I want to show a few charts just to set the context of the discussion that I want to have with you. This is the U.S. trade deficit beginning back in 1980 and coming across this is where we are today. If one thinks that a negative trade deficit matters, and I happen to think so, particularly when it gets to this order of magnitude, this is a chart that is a cause for great concern. I mean this is an incredible deterioration in our trade position. The current account position gives us that story.

I have to tell you, I spent a year working for Walter Heller, when he was the Chairman of the Council of Economic Advisors under President Kennedy, and he used to worry about these things. And then we were running positive balances, but even then he worried about them. Now we have this incredible position here, and this is what has happened to the U.S. net international investment position. We have gone from positive, and we are down here in a very significant negative posture.

The first question I want to ask, and I put it very simply, does this a change in position worry you?

Mr. TAYLOR. Senator, the first thing I would say is that the third chart, the net investment position, represents many people around the world investing in the United States, equity, lending, because it is such a good investment. It is a good place to invest.

Senator SARBANES. So the situation does not worry you? I mean your position, I take it, is they are all happy to take our debts so we build up this obligation to everybody, but that just shows that they have a lot of confidence in America; is that correct?

Mr. TAYLOR. It shows that they have a lot of confidence in America. The second thing I would say is that comparison to the early

1960's, we now have a flexible exchange rate. We are not trying to defend the Bretton Woods fixed exchange rate system, so that inconsistency or tension is gone. There is much more flexibility with respect to financial markets in the world, so it is possible to have flows of capital of that magnitude occur in ways that would be much more worrisome then. That is not to say it is not at all worrisome now. It is not to say that we do not need to be concerned with making growth higher elsewhere in the world because the number one way to reduce that deficit right now is to have other countries be attractive places to invest so that the funds can go elsewhere as well.

That is a major part of what we are trying to do internationally is to find ways to increase growth elsewhere because that will help the United States and help that problem.

Japan's economic growth in the last six quarters, for the first time in 12 years, is finally showing some signs of sustainability. That represents an important accomplishment with respect to our international economic policy. Right now, there is strong growth of much of Asia, and much of Latin America. So that will help that.

Senator SARBANES. Can I come back to my question? It does not worry you, is that right?

Mr. TAYLOR. There is aspects of it that are worrisome and that is why we are taking——

Senator SARBANES. Former Secretary of the Treasury Summers said in a recent speech, "There is surely something odd about the world's greatest power being the world's greatest debtor." He calls it troubling that the United States depends so much on inevitably political entities to finance its foreign debts. What do you think of that?

Mr. TAYLOR. I do not know what the context of former Secretary Sommers' comments are, Senator, but what I do know——

Senator SARBANES. Do you think it is odd that the world's greatest power is the world's greatest debtor?

Mr. TAYLOR. I think that what is important is that those investments are there because the United States is an attractive place to invest.

Senator SARBANES. Chairman Greenspan told the Senate Banking Committee, this very Committee, that the rate at which the United States is running current account deficits is unsustainable. He said countries that have gone down this path invariably have run into trouble, and so would we. What do you think of that?

Mr. TAYLOR. Again, I do not know the context of the Chairman's statement, but what I do know is that——

Senator SARBANES. I think it is in this context that we have set here.

Mr. TAYLOR. Right now, the efforts to deal with the problem are to raise economic growth other parts of the world, but we certainly do not want to make the United States a less attractive place to invest. Those investment flows create jobs in America. They create growth in our productivity and it is a very important thing to do. We would like to have more investment in the United States, not less investment in the United States. We would like to have more savings in the United States. But our emphasis here, rather than

just to say that there is a problem, is to do something about it, and that is what we are doing.

Senator SARBANES. You are kind of whistling past the graveyard, are you not? The IMF, in their World Economic Outlook, the most recent report released by the IMF, made reference to the deterioration in the U.S. fiscal position. Then they go on to say, "Moreover, today, the external position of the United States is weaker, involving record high current account deficits and rapidly growing net foreign liabilities, and so it is more vulnerable to changes in sentiment in exchange rate markets. The prospect of continuing large U.S. fiscal and external deficits and the implied external borrowing adds to concerns about international imbalances, increasing the changes of a disorderly resolution, including a rapid fall in the value of the dollar and a rise in U.S. long-term interest rates."

What is your reaction to that?

Mr. TAYLOR. I do not like everything the IMF writes, and that is an example which I do not think is very accurate.

Senator SARBANES. I see, all right.

Mr. TAYLOR. What we are emphasizing here is there is an important role for the United States in keeping our own economy strong. It is really one of the strongest economies in the world right now. We are trying to get other economies to grow more rapidly, so that can benefit the United States and create less imbalances.

Maybe what you could do is go further on in those reviews to see what they are suggesting. We have suggestions here and policies that we are following that are working. They are making the United States stronger and they are making the world stronger, stronger than it has been for a long time.

Senator SARBANES. What is your concern about the burden that is being placed on the future generation to pay on these claims that foreigners are building up against the United States? I mean what this will require is that we will have to have an outflow of payments to handle this international debt that we are accumulating. Is that not correct?

Mr. TAYLOR. Yes. When an investor makes an investment in the United States, they expect to get a rate of return. So those flows are the rate of returns. If a business invests in a foreign business or a foreign individual invests in the United States, they expect to get returns.

Senator SARBANES. We used to pride ourselves on the fact that we built up those investment positions abroad and were getting returns. Now it has just turned right around on us, has it not?

Mr. TAYLOR. What has turned around is the United States is one of the most attractive places for people to invest around the world. They are making those investments and they are getting returns.

Senator SARBANES. You think it is being done on a straight market basis.

Mr. TAYLOR. I have no reason to believe otherwise.

Senator SARBANES. You just came back from China and Japan, correct?

Mr. TAYLOR. Yes, sir.

Senator SARBANES. What do you think of the huge public decision that is being made in Japan, for example, to put money into the

American market? I would argue that it helps sustain their trade position. Are you at odds with that view?

Mr. TAYLOR. The Japanese have not been intervening in the market since March 16, sir. There have been no interventions. There were no interventions while I was in Japan.

Senator SARBANES. What was the magnitude of their interventions in the markets?

Mr. TAYLOR. It varied from day-to-day, and in 2003 and early 2004 it was very large, unprecedented in its magnitude. But it since then——

Senator SARBANES. I am sorry we do not have Fred Bergsten on a panel with you, but I am going to borrow from what he says in the——

Chairman SHELBY. Senator Sarbanes, he is coming next.

Senator SARBANES. Yes. But I am going to borrow from his statement which will come next.

The immediate issue is the massive intervention in the currency markets by China, Japan, Korea, Taiwan, and perhaps a couple of other countries to keep their exchange rates from rising against the dollar. China's intervention in 2003 exceeded the total increase in its GDP. Japan's intervention in the first quarter of this year exceeded the global total of the U.S. current account and budget deficits, that is, the Bank of Japan by itself more than financed all of our twin deficits. As a result of this intervention, all four countries cited here amassed foreign exchange reserves far in excess of any conceivable needs they might have—to levels of $850 billion for Japan, almost $500 billion for China, $200 billion for Taiwan, and $160 billion for Korea.

Now, what is happening? Here is Japan's stock of foreign reserves. Look at that beauty. I mean this is 1999 here and it is on a straight upward path, Japan's stock of foreign reserves. Here is China's stock of foreign reserves. You are the Under Secretary of the Treasury for International Affairs. This is China. Look at what is happening to their stock of foreign reserves. This is Taiwan. I mean it goes on and on. And you are telling me the market is working? This is South Korea. Look at that one.

Now, I have Europe, the market to some extent I think is working in Europe.

Senator ALLARD. Would the Senator from Maryland yield for a question here?

Senator SARBANES. Yes. Just let me finish these charts and orders. This is the EU stock of foreign reserves. And of course, I will not show it because I want to yield to my colleague, but I have a chart about where the currencies have gone. The EU currencies have adjusted and now you are telling me the market is working with Japan, China, Korea, and Taiwan? They are working the market. They are working the market. What is your response to what they are doing?

Mr. TAYLOR. Our response has been articulated in the G–7 statements on these topics, which is to call for greater exchange rate flexibility in countries that do not have such flexibility, and those are the ones that you have just held up there with the exception of the last one, which is the euro, which has had flexibility. So our approach here is internationally to ask for additional flexibility in the world economy. It is important to get it just for the reason you have your charts up there. But I would just make sure that my statement about working the markets is there, because we have a

amazing degree of good flexible markets in the United States. The United States is an attractive place to invest. We do not depend in any way—our markets are large and resilient. We do not depend in any way on the charts that you showed us right there. The market is working.

What we are doing now is emphasizing to all of the countries that you have just held up there the importance of moving to exchange rate flexibility.

Senator SARBANES. What is the key to doing that?

Mr. TAYLOR. To moving to flexibility?

Senator SARBANES. In the Asian markets. It is the China currency, is it not?

Mr. TAYLOR. That is a big part of it, yes.

Senator SARBANES. Yes. Now, they have it pegged, right?

Mr. TAYLOR. Yes, sir.

Senator SARBANES. Are you in favor that they go to flexible rates?

Mr. TAYLOR. Yes, I am.

Senator SARBANES. What would that do to their banking system in the short-run?

Mr. TAYLOR. They would go to a flexible exchange rate in a way that would make sure it does not harm their banking sector in the short-run or the long-run.

Senator SARBANES. My understanding is that most people think they just cannot go to flexible rates and what you should be seeking is that they repeg the rate at least in order to get this into more equilibrium and to allow these other countries, Japan, Korea, and Taiwan, which are staying in the wake of the Chinese currency because they do not want to disturb their own trade relationship with China, to allow adjustments to take place in their rate. Would that not be the case?

Mr. TAYLOR. I think the best way to do it is to have a flexible exchange rate, and that will let the market work even more.

Senator SARBANES. Meanwhile we are sitting here and getting these incredible deterioration of our positions. You apparently do not think it matters very much. I mean Greenspan tells us it matters. Summers tells us it matters. Bergsten is going to tell us that it matters in his testimony coming later this morning. I think you are just not coming to grips with the problem in my perception.

Mr. TAYLOR. I do not think I ever said it does not matter, Senator. What I said is what we are doing about it.

Senator ALLARD. Senator, would you clarify for me when you talk about the stock of foreign reserves, this is money that has been put in our banks here in America; is that what that is? What is that figure right there?

Senator SARBANES. No. These are their holdings.

Chairman SHELBY. Of our stock.

Senator ALLARD. These are their holdings of our stock.

Senator SARBANES. Yes. They have built up these currency reserves, very strong positions. And we owe it. We owe it. They are running it right up.

The Bank of Japan, as I said, Japan's intervention in the first quarter of this year exceeded the global total of the U.S. current account and budget deficits. That is, the Bank of Japan itself more

than financed all of our twin deficits. So they took these claims against the United States.

Now, the Secretary is arguing that it reflects confidence of investors overseas.

Chairman SHELBY. In the American——

Senator SARBANES. My understanding is these are public decisions, not private decisions; is that correct?

Mr. TAYLOR. Yes, sir.

Senator SARBANES. This was a decision by the Bank of Japan, the Government, not by private Japanese investors about the strength of the American economy. Now, why did the Bank of Japan make that decision?

Mr. TAYLOR. The Bank of Japan can probably best answer that question, Senator.

Senator SARBANES. I know, but you are the point person in the Government for this. What is going on here?

Mr. TAYLOR. The Bank of Japan is——

Senator SARBANES. Do you think they made that decision in order to sustain the currency position and gain a trade advantage from it?

Mr. TAYLOR. The Bank of Japan, in the last 6 months or a year or so, has improved the liquidity position of the Japanese economy in a way that the Japanese economy is now finally growing in a sustained way. The sustained way which can purchase U.S. goods and U.S. exports. That is the important thing to look at. The intervention has stopped. As of March 16, it is a figure that does not show up in your chart, so there has been none since then.

And I would say also, Senator, in terms of the overall flows of funds into the United States, you can make an intervention look big by comparing it to all types of things, but what is important is there is huge, gross flows coming into the United States, investing in our businesses, investing in our economy, and that is a good thing. If there were less investment by those countries in securities, I do not think that would change that picture much at all. Why they are doing it, we have indicated they should not be doing it. We indicated to the Chinese they should not be doing it. It is a major part of our initiative now with Japan.

Senator SARBANES. If it shows that we are strong, why are you telling them not to do it? I mean there is an obvious contradiction what you just said. You are telling me on the one hand, oh, this shows we are strong and they are putting it in, that is a good thing, and yet, you are going over there and telling them not to do it. You are telling them not to do it. Are you telling them that we are going to have a hearing before one of these Senate Committees, and someone is going to raise a little ruckus about it? Presumably not. Why are you telling them not to do it?

Mr. TAYLOR. Because it is in the interest of their economy and ours to have a more flexible exchange rate. Very simple. It does not mean that the United States should be a less attractive place to invest. We want to be more attractive to invest. We want to have our economy continue to grow. It is perfectly consistent. The United States is an attractive place to invest. The world would be a better place if there were more flexible exchange rates in China. There is no inconsistency whatsoever in those two statements.

Chairman SHELBY. Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Mr. Secretary, could you take a couple of minutes and give us a primer, if you will, on the financing of our budget deficit, and the financing of our trade deficit? My understanding is that our budget deficit for this fiscal year will be about $400 billion, and could you just talk a little bit about how that is being financed, please?

Mr. TAYLOR. It is financed by issuing Treasury securities, and the Treasury securities are auctioned and people of all sorts buy them. Most are bought by Americans. Some are bought by foreigners. Some are bought by foreign governments. So that is how it is financed, and it is going very well and works very well in the Treasury. The auctions are working just fine, and actually the amount of borrowing we have had to do recently is lower than what was expected. So that financing is working fine.

With respect to the current account, it is financed by all the people around the world who want to invest in the United States. They are private individuals and it is not just investing in Government securities, it is investing in our businesses and investing in real estate, investing in private bonds, so there is a wide range of investors in the United States just like Americans invest abroad in huge magnitudes. It goes both ways. Right now there are more people investing in the United States, and Americans are investing elsewhere around the world. That is why I was saying to Senator Sarbanes it represents the fact the United States' economy is a very attractive place for people to invest at this point.

Senator CARPER. Could you give us some idea of the magnitude with respect to the financing of our budget deficit, and the purchasing of Treasury securities? To what extent—and if you can quantify this for us it would be helpful—is the budget deficit being financed by individuals or banks within this country as compared to the individuals and businesses and governments from outside this country?

Mr. TAYLOR. I will get you the exact figures for you, Senator.

Senator CARPER. Just the rough magnitude.

Mr. TAYLOR. It would be about 80 percent domestic private individuals at this point in time, and there is a stock issue of how much in the past has been invested that way versus each month how much different it is, but what I could do is get you the statistics for the month or for the years, but that is a rough order of magnitude.

Senator CARPER. So we will just say our budget deficit is $400 billion this year. Are you suggesting that maybe 20 percent of that, maybe $80 billion, will be financed from people abroad?

Mr. TAYLOR. Approximately. I will have to get the exact figures for you.

Senator CARPER. Would most of that be by individuals? By banks? Would it be by foreign Governments? Do you have any idea how that breaks down?

Mr. TAYLOR. Most of it at this time would be by foreign governments, our own individual securities, yes. In the last, say, year or so it would be mostly governments.

Senator CARPER. Just take a minute and explain why we have an interest in doing so.

Mr. TAYLOR. Because governments tend to hold government securities much more than they hold private-sector securities. It is the nature of reserves, international reserves are always invested in very safe kinds of assets, so they are looking for U.S. Government securities the invest in because they are very safe. So that is why governments tend to invest in our securities in a greater proportion than they invest in private securities.

Senator CARPER. In an earlier conversation that I had with Chairman Greenspan this year, when he sat in your seat, we talked about whether or not we eventually reach a point where people, businesses, banks, or Governments in other countries decided that they needed a high rate of return on our securities in order to continue to invest in those securities. Are those fears or concerns misplaced or not?

Mr. TAYLOR. I do not think any concern is necessarily misplaced. I think if the United States becomes a less-attractive place to invest, then investment in the United States will go down and will go elsewhere. We have no reason to think that that would be sudden. The charts that Senator Sarbanes presented, showed a steady movement over the years starting in the early 1990's. The United States' economy is very flexible. The international financial system is working very smoothly right now, a lot of orderly movements in the markets. There is no reason to think that things should be steady. But I do hope that the United States continues to be an attractive place to invest because that means our economy is working well, and our productivity growth is just astoundingly strong right now. The economy is working very well. So that is why people want to invest here.

But if other economies worked better, and I think that is the way to thin about it, we would like the rest of the world to do better than it is doing, we would like the United States to do better, too, creating more jobs, but the thing here is, if other economies become attractive places to invest, then you reverse some of this asymmetry that you mentioned, the Chairman himself mentioned.

But I think that our approach is to try to have stronger growth elsewhere around the world. We have something called the Agenda for Growth that the Secretary works through his G–7 counterparts, and I think that is the way you deal with these problems, not to try to make the United States a less-attractive place to invest, but to emphasize exchange markets should be flexible, ask the Chinese to have a more flexible exchange rate system, and they are saying they are moving in that direction, all of these things, it seems to me fit together in terms of a good international policy that is working quite well right now.

Senator CARPER. I read in the paper the other day that our trade deficit for I guess it was last month was pretty substantial. Do you recall what it was?

Mr. TAYLOR. I will have to get the exact number for the last month, sir, but it is about, it must be about $30 to $32 billion, I guess. I will have to look it up.

Senator SARBANES. What was that figure?

Mr. TAYLOR. For the month, it says $46 billion.

Senator SARBANES. Trade deficit, $46 billion in the last month, was it not?

Mr. TAYLOR. Forty-six, yes.

Senator SARBANES. Did you say $30 billion?

Mr. TAYLOR. I said $36 billion or something like that, yes. It is $46 billion.

Senator CARPER. I remember in a year, a whole year, where it was not that much, and I am sure you do, too. And if we go back to the 1970's, or the 1980's, it was probably $46 billion, somewhere along that in a given year. And what it seems to have done is to have increased through the 1980's, through the 1990's, and certainly into this decade. I just do not think we can continue to go on buying more from other countries, ever more from other countries than they purchase from us. It is maybe not a cause of alarm for you, but it is sure a cause of concern for me.

And one of the things that Senator Sarbanes is trying to get across is should we not be concerned about this? Should we not be doing something about it?

Mr. TAYLOR. We are doing something, Senator. And I cannot emphasize more that what we are doing is taking action. And whether we are more concerned or less concerned than other people, I cannot say. I know that we have a responsibility here is to put some policies into action, and they are working, and they are making a difference for the United States. Our economy is growing very strong. The economies in the rest of the world are beginning to grow more rapidly. It is working.

The focus on the trade flows is certainly important to do and look at. The current account deficit is certainly something to be concerned with, but I cannot measure whether I am more concerned or less concerned than anybody else. I know I am trying to take some actions working with the Secretary, and I think it is working. And I can just go through flexible exchange rates, the Agenda for Growth, structural reforms around the world. The world economy is in better shape now than it has been for a long time, and that shows what we are doing is working.

And you can always look for the bad parts of things and try to emphasize those. And as policymakers, we want to look and worry about things, and we do, but I think what you do want to emphasize here is how strong the United States' economy is, how we are creating jobs, how the policies are working, both domestically and are working with other countries, and it all wraps up to be a good picture. And you are pointing to some things that we all need to be concerned about, and we are, and we are taking action. That is the important thing is to take action.

Senator CARPER. Mr. Chairman, I would just say, in conclusion, I am one of those people, Mr. Secretary, who always sees the glass as half-full. I am an undying optimist, but I must say when I look at the trade deficit, which is $46 billion last month and is $552 billion in a year, and, boy, I find it hard to feel optimistic about that.

Thank you.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. I wanted to just, also, Mr. Chairman, put in the record a statement from the Monetary Policy Report to the

Congress by the Board of Governors of the Federal Reserve System in which they note,

> The financing counterpart of the current account deficit experienced a sizeable shift in 2003, as net private inflows fell while foreign official inflows increased. . . . Accordingly, net inflows through private securities transactions decreased markedly. In contrast, foreign official purchases of U.S. assets surged to record levels in 2003, with the accumulation of dollar reserves particularly high in China and Japan.

So this inflow is not coming from private decisionmakers judging the U.S. economy. In fact, they are going the other direction. It is coming from governmental decisions, and I am suggesting very strongly that they are making those governmental decisions in order to affect the trade relationship.

Senator SARBANES. I want to put one question to the Secretary on capital controls. I have a very strong concern about the Administration's approach in trade negotiations on the capital controls issue. It is my understanding that the goal of the Administration and the so-called "transfers provisions" dealing with capital controls in the proposed Free Trade Agreement is the absolute right to transfer capital with no exceptions, even for short-term portfolio investments in the event of a balance of payments crisis.

When resistance is met, such as was the case in the Singapore and Chile agreements, the goal is to craft only the narrowest and least-meaningful exception. In my view, this is a very shortsighted approach, both as a matter of policy and negotiating tactics.

Since the Asian financial crisis, most mainstream economists and financial efforts think that capital controls on short-term portfolio investments at least should be an option available to countries in the context of a balance of payments crisis. It is my understanding that the IMF no longer precludes such an option for countries with which it negotiates loan agreements.

I would ask the Administration to reconsider this approach on capital controls. Surely, in a balance of payments crisis, some exceptions, at least with respect to short-term portfolio investments, should be in order.

Have I accurately reflected the Administration's rigid positions on capital controls in the trade agreements? Is that the Administration's bargaining position?

Mr. TAYLOR. We have two very good Free Trade Agreements with Chile and with Singapore. And in those agreements, we asked for, and obtained, a great degree of security with respect to investments in those countries. One of the concerns that foreign investors have when they invest in countries is that their capital will be frozen or that we will not be able to get it back. So we have been very diligent in negotiating trade agreements which preserve the ability to transfer capital in and out of countries. It has been a major factor in all of our bilateral investment treaties for many years. We do not want to change that with our Free Trade Agreements. So we have been very insistent that this is a good thing to do.

The United States does not have such controls, and it is a vibrant economy. Many developing countries also do not have such controls. In the Central American Free Trade Agreement, this issue was not raised.

But what we did do for both Singapore and Chile is allow them to have an extension of the dispute resolution mechanism that oc-

curs with respect to all of our agreements. We would like investors, again, to invest in a country with the notion that they can have their money move around, they can get the profits back. That is what our investors would like to do, and that is what all foreign investors would like to do. That is how these economies are going to thrive if they get to foreign investments. So what we have been doing in these agreements is emphasizing the importance of the ability of free transfers of capital.

And when the countries, for one reason or another, do not want to do that, they have to go through the dispute resolution mechanism which is available in our Free Trade Agreements, and with respect to portfolio investment, they have a little longer period of time before the dispute resolution takes place. It is a fine approach, it is working, and the countries are quite happy about it.

Senator SARBANES. Is it your view that short-term capital flows constitute investments in the way you are just using the term? I take it, it is.

Mr. TAYLOR. Some of them certainly do. It could be a loan for inventories.

Senator SARBANES. In the NAFTA, there was a balance of payments exception included, and covered investments were defined so as to exclude debt securities and loans of less than 3 years original maturity. It seemed at least to address the short-term capital flow problem. You object even to that limitation; is that correct?

Mr. TAYLOR. There is some disagreement about how to interpret the North American Free Trade Agreement in this regard, Senator. But just to answer your question, I think that we should try to have as much ability for investors to move capital around. And short-term capital can sometimes be to finance inventories for a business. And frequently when countries try to limit that, they hurt the small businesses. There is evidence that in the capital controls that Chile had in the past, which they do not have any more, that it affected their small businesses, the worst part of society to hurt. That is where the jobs are created and where people come out of poverty.

Our feeling is that the more you could do to have a sensible treatment of these kinds of investment, which are investments. They are loans. They are helping businesses. Whether the maturity is long or short, we should try to encourage that, and that is what we do in these agreements, and I think they are good agreements.

Senator SARBANES. How does China's fixed rate impact this issue of short-term capital flows?

Mr. TAYLOR. Well, China's fixed rate is something that we hope goes away.

Senator SARBANES. I understand. But as it works now, how does it impact?

Mr. TAYLOR. They could have restrictions on capital flows whether or not they have a fixed exchange rate. So, directly, it does not impact, but one of the ways in which we have moved to have China be more willing to move to a flexible exchange rate is to have a greater degree of openness with respect to investments into China. So, if Americans want to invest in China, it is easier to do so, say, our financial sector, it is now easier to do so. There is an automobile loan program that Americans are able to participate in, but

also the Chinese can invest out of the country. For example, when a Chinese student comes to the United States, they can take more of their funds and put more of their money in dollars than they otherwise could.

We are looking for ways to remove some of the capital controls. That will help China, and they are trying to find a way to do that themselves. It is related to the flexible exchange rate in the sense that flexible exchange rates work better when there are not so many capital controls. And, in fact, one of the problems with fixed exchange rates is that in order to get monetary control in the economy, countries have to impose these capital controls. So flexible exchange rates allows the country, like the United States, to have a more open capital system and that is beneficial for any countries that choose to go in that direction.

So one of the reasons, again, to just repeat, for flexible exchange rates is that it allows countries to remove some of these controls, which generally do damage to the economy than help the economy.

Chairman SHELBY. Senator Allard.

Senator ALLARD. Mr. Chairman, I am probably the only real free-trader here sitting on this panel today, and I just feel like I have to say a few things.

You know, when you look at our trade deficits, and of course I do not think Senator Sarbanes' charts tell the whole story, but if you look at the Depression, if you look at the time in the late 1970's, when we had the misery index, the double-digit inflation, double-digit unemployment, and double-digit interest rates, our trade deficits were low, and they were low during the Depression. But what his charts reflect is the growth in our economy that has been happening since the middle 1980's and continued to grow, and it also reflects that we had a small dip in our trade deficit during the late 2000, 2001, and 2002 just as we were moving out of this recession. It was starting at the end of the Clinton Administration and then continued on for a short period of time the initial years of the Bush Administration.

But even though some people wanted to characterize it as a real severe downturn in our economy, in respect to other times, it was relatively modest, and our economy has continued to burn along. It has been doing that for a decade-and-a-half, and it just reflects the prosperity in this country. Americans are doing well, so they have money to spend. It increases demand on the dollar. So we see our dollar goes up. The dollar is like any commodity. It is like corn or wheat or anything else, and I do not share a concern. If somebody wants to hoard the dollar, if they want to somehow or the other manipulate the value of the dollar, I think eventually the commodity, looking at the dollar, will overwhelm them, and they are hurting their own economies in the long-run.

Now, short term, they may be able to gain some advantage, but in the long-run, and I look at what happens to our economy in relation to other countries. Our economy has been relatively stable. We have had our adjustments, which I happen to think are good, but other countries, if you look at what their economies will do, real exaggerated upturns and downturns. And I think we are doing things in here, and I hope that in trying to somehow or the other push trade restrictions, that we do not forget the lessons that we learned

at the turn of the 20th century when we had such high tariffs and so many trade restrictions, that our economy struggled in the 1900's to 2000 and even after that.

I believe we have a very good economy, and our economic policy is working well, and I just think that needs to be said.

Chairman SHELBY. I think a lot of things are working well, but we do have some concerns. Let us talk about the current account for just a minute. Senator Sarbanes brought it up. Chairman Greenspan, who comes to this Committee a lot, he has deep concerns about the current account. Tell me, Dr. Taylor, what are the big ingredients in our current account today, in other words the deficit there. A lot of it has to be oil, the importation of oil. I would like to know what percentage or roughly what percentage of our $500-billion deficit in the current account is made up of the importation of oil and gas petroleum products and what is manufactured goods. Can you do that for the record?

Mr. TAYLOR. I will submit for the record the precise number of months, and years, et cetera. But imports of oil are a significant thing. That is why it is important to——

Chairman SHELBY. Is it the majority?

Mr. TAYLOR. No.

Chairman SHELBY. It is not the majority of our——

Mr. TAYLOR. Imports.

Chairman SHELBY. —making up our $500-billion deficit in the current account.

Mr. TAYLOR. Well, the oil imports you want to measure relative to all of our other imports, and it certainly is not a majority of all of our other imports, which are many times the——

Chairman SHELBY. Is oil the number one single thing?

Mr. TAYLOR. I will have to look it up.

Chairman SHELBY. You do not know.

Mr. TAYLOR. I do not know. I guess it depends on whether you look at crude. If it is certainly just crude, I would imagine there are some other. Manufacturers, as a class, would probably be larger than just crude oil. So I think we should look at the whole table.

Chairman SHELBY. Now, you are——

Mr. TAYLOR. You want to look at automobiles versus all manufacturers.

Chairman SHELBY. You are a well-known economist now. You are not telling us today, are you, that our current account, as it is continuing, if it continues at $500 billion a year in deficit, in arrears, that that is good for the United States of America. You are not saying that, are you?

Mr. TAYLOR. No.

Chairman SHELBY. Does that concern you? It certainly concerns Chairman Greenspan. It certainly concerns a lot of us and others in the company.

Mr. TAYLOR. As I indicated, the fact that we are trying to do something about it I think shows the concern, and what I would always like to do is when people mention their concern is to try to say what are you going to do about it? And I am just trying to emphasize here what we are doing about it. We are not trying to restrict trade into the United States. We are not trying to be protectionist. We are trying to encourage other countries to grow more

rapidly, to take changes so that they are also attractive places to invest.

We are trying to find ways that our saving rate is higher because basically then Americans could invest more in the United States, as well as foreigners. That would reduce the gap between investment and savings. We are doing a lot of things that addresses the problem. And in that sense, you could say we are concerned.

Again, I do not know if I am more concerned or less concerned than other people. I have issues here that we are trying to address. I always try to emphasize what can you do about something rather than just say you are concerned. And what we are doing about it is the kind of things I have tried to list, and what we are not doing are the things I do not think we should be doing.

Chairman SHELBY. Doctor, are you concerned at all with the manipulation of the Japanese currency by the government that has gone on a long time and also the pegging of the Chinese currency at what we all consider less than value?

Mr. TAYLOR. Yes. That is why we have made such an effort to call for increased flexibility.

Chairman SHELBY. What does that do for the Chinese and Japanese and what harm does it do to us when they intervene like that?

Mr. TAYLOR. We have emphasized the flexibility of exchange rate because we think that is best for the United States. That way we can have a strong-growing economy. Chairman Greenspan and the Federal Reserve can concentrate on keeping the recovery strong and inflation low. Fiscal policy can be addressed to a strong economy of the United States. That is why the flexible exchange rate is so valuable for us, and that is why we emphasize it.

But if other countries are trying to peg their currencies to the dollar, especially if they are large countries like China and Japan, then that is a problem. So what we are doing is trying to emphasize this exchange rate flexibility, and I believe you are seeing flexibility, certainly seeing flexibility with respect to Europe.

Chairman SHELBY. Now, you are not telling us you have seen flexibility in the Japanese and Chinese, have you?

Mr. TAYLOR. I have seen no flexibility with respect to China whatsoever, yes.

So, I think that is the approach we are taking, Mr. Chairman. And I cannot emphasize enough it seems to us that it is working because the U.S. economy is strong and, yes, we are concerned about the degree to which large countries fix their exchange rates.

Chairman SHELBY. I have a number of questions. I am going to submit them for the record because we have got another panel, but one has to do with China. Why is China the World Bank's largest borrower, considering everything?

The other one—and we will do specifics for you, Doctor—the IMF's lending portfolio is heavily concentrated among three specific countries: Turkey, Brazil, and Argentina. Together, they account for approximately 70 percent of the IMF's portfolio exposure. Those are concerns to some of us, considering the credit risk.

Does the IMF have any role in the resolution of the large stocks of unpayable debt, particularly in crisis situations? Are there ways that creditors can be made to negotiate as a bloc or should the

countries simply announce what it will pay and so forth. These are concerns for me, and I will get those to you, for the record.

Mr. TAYLOR. I would be happy to.

Chairman SHELBY. We appreciate your appearance here this morning, and we know this is a difficult and very arcane situation, but very important.

Thank you very much, Dr. Taylor.

Mr. TAYLOR. Thank you.

Chairman SHELBY. We are going to call up our second panel, if we can at this time.

Our second panel is Dr. Allan Meltzer, Professor of Political Economy, Carnegie Mellon University; Dr. C. Fred Bergsten, Director of the Institute for International Economics; and Dr. Douglas Holtz-Eakin, Director, Congressional Budget Office.

All of your written testimony will be made part of the record of the hearing in its entirety.

Dr. Meltzer, we will start with you.

STATEMENT OF ALLAN H. MELTZER
THE ALLAN H. MELTZER UNIVERSITY PROFESSOR OF POLITICAL ECONOMY, CARNEGIE MELLON UNIVERSITY AND VISITING SCHOLAR
AMERICAN ENTERPRISE INSTITUTE

Mr. MELTZER. Thank you, Mr. Chairman. I have to apologize. I have to leave at 12:30.

Chairman SHELBY. That is okay. We will try to get you out before then. We might submit some questions for the record.

Mr. MELTZER. Thank you. I will be glad to answer them.

It is a pleasure to appear, yet again, before this Committee and to review the progress of international financial institutions. Today, I will briefly review IMF and World Bank programs to assess what has been done, what more needs to be done to make the world economy less risky and less prone to crises and to improve living standards in the poorest countries. These are big topics. I will limit my formal remarks to major changes that have occurred, or that should occur for these institutions to become more effective in realizing their objectives. I will discuss the IMF and the World Bank in that order.

Much of what the charters of the IMF and the World Bank say about purposes and objectives is out of date. The current mandate of the IMF should be to reduce global risk to an obtainable minimum. The current mandate of the World Bank should be to facilitate social and economic development as a means of reducing poverty.

How can the IMF reduce risk to an obtainable minimum? The IMF has two principal functions that can improve the markets' operations in ordinary times and in crises. One is to increase the quantity and quality of the information that the market has, and two, the IMF can do a significant job in trying to get that information and improve the quality and the timeliness.

Under pressure from the critics, the IMF has made much more information available about its activities, recommendations, and assessments. Important as is the improvement of information, the most important function of the IMF is to reduce the risk of severe

crises that spread internationally. Improved information contributes, but reform of IMF procedures is important also.

Prodded by its critics and its new management over the last 3 years, the IMF improved its operations and recommendations in several ways that Dr. Taylor described.

It now restricts the conditions attached to loans to a small number of macroeconomic and financial measures or objectives. It appears less willing to make massive loans than in the 1990's, and it pays more attention to avoiding crises and the determinant of debt sustainability in developing countries.

The most important single change remains undone. The IMF should move from its command and control approach to one that relies on incentives. Historically, the IMF has attached conditions to its loans. The country agrees to the conditions to get the loan, but may be politically unpopular at home to enforce conditions such as expenditure reduction or tax increases or growth may be less than anticipated, requiring additional partial adjustment.

The IMF's Independent Evaluation Office found that countries achieved about one-half of the proposed change in fiscal balance, on average. About 60 percent of the programs underperform. This command and control approach has the unfortunate side effect of making the IMF appear responsible for imposing harsh measures under adverse circumstances. The country's government, of course, agrees as a condition of the loan. This does not remove the IMF's responsibility in the minds of the country's electorate, the protestors at international meetings, and much of the public.

I believe that a reform occurs when the country's leaders, a majority of its citizens or both want reform. Reform cannot be imposed successfully and has not been imposed successfully by external technocrats without local support. Local governments can, and do, frustrate reforms or ignore IMF or World Bank conditions. The reason Turkey, Brazil, Argentina, Ecuador, and others have repeated crises is that they do not reform enough to avoid them. They promise, but they do not reform. Command and control fails, as we should expect it will.

The main reform needed at the IMF is the development of an incentive system to replace command and control. Briefly, the IMF should establish a short list of policies or observable standards that countries should adopt to be assured of assistance in a crisis. It should use its surveillance to assure that a country meets the standards and publish the list of countries that do, and do not, get a guarantee of crisis assistance. The IMF would not help countries that do not meet the standard. To prevent crises from spreading, the IMF would assist countries that are victims of crises of neighbors or trading partners.

Countries that adopt the standard would be subject to less risk. Hence, they could borrow more capital at a lower interest rate spread over U.S. Treasuries. Other countries would get less capital and pay a higher interest rate. This would give the government and the public considerable incentives to adopt stabilizing policies. The capital markets, not the IMF, would impose discipline.

The IMF itself is at risk. As my colleague, Adam Lerrick, has shown, that risk is a cost to the United States and other countries, but does not appear in our budget. Lerrick estimates the hidden

annual cost of the IMF to U.S. taxpayers currently is $1.5 to $2 billion. The principal component is the risk of default by one of the major debtors; four countries—Argentina, Brazil, Indonesia, and Turkey—owe about 70 percent of the IMF's outstanding debt. The IMF avoids default by lending more money or, as in the case of Argentina, by extending the maturity of existing debt. As in the past, the IMF will come eventually to the Congress for a quota increase, either because of a default or because its resources are allocated to unpaid loans.

Reform of the system should be a priority. The Administration, to its credit, has made considerable progress getting collective action clauses into private debt contracts. Reform of debt repayment to international financial institutions and to lenders should be next on the agenda.

In the past few years, the Administration and the Congress have insisted on some of the reforms advocated by the majority report of the International Financial Institution Advisory Commission. Monitored grants replaced some of the lending to the poorest countries. The Administration has worked to set explicit conditions that can be monitored and has introduced incentives for countries to meet those conditions. In its most recent budget, Congress required an independent performance audit of some IDA programs and insisted on greater transparency at the World Bank. These steps are a good start, but only a start.

The central issue about the World Bank, with its many programs, is it spends or lends about $20 billion a year, but neither we, nor they, know which programs are effective and warrant expansion or retention and which are ineffective, and inefficient and should be abandoned.

The monitoring the Congress insisted upon for part of IDA should be extended to the entire bank and its facilities. We should know what is effective and what is not, where the money goes, and how it is used to improve the lot of the poor. There are two ways to gain the needed information: One is an independent performance audit by an outside agency. Another is development of an independent internal group similar to the GAO or the IMF's Independent Evaluation Office. The current arrangement at the Bank does not meet this standard. An example will bring out the problem.

We have considerable evidence that poverty has declined dramatically by the number of people living on a dollar per day or less in the world. The decline is most striking in Asia, especially in China and India. Market opening, private investment, protection of property rights, and the like contributed much to the improvement. Where these spurs to growth and development are largely absent, as in sub-Saharan Africa, poverty has increased. Did World Bank programs contribute to the reduction of poverty in Asia? Did these programs ameliorate worsening prospects in Africa? The Congress should want answers to these questions.

Further, the Bank should concentrate on the hard cases, the impoverished countries. The Banks should have an explicit program for graduation. Countries like China that can borrow in the capital markets with investment-grade ratings should not receive subsidized loans. Those loans can be better used to provide potable

water, sanitary sewers, disease control in the poorest countries and would encourage countries to adopt institutional reforms that have been effective in spurring development. These include the rule of law, open trading arrangements and protection of property rights and individual rights.

Finally, we should insist that the IMF and the Bank eliminate overlapping responsibilities. The World Bank should become a more effective development Bank. The Bank has estimated that a trillion dollars a year is paid in bribes to all countries. A large part is in the developing countries. Ridding the system of corruption is a major challenge.

The IMF's responsibility should remain the maintenance of global financial stability. As a result of experience in the Asian crisis, many Asian countries have accumulated substantial reserves to protect them against crises and to avoid being put under IMF supervision. They have also established a regional lending system outside the IMF. This, too, opens important questions about the future role of the IMF, particularly the role of the IMF in Asia. New leadership in the IMF and the end of James Wolfensohn's term at the Bank in 2005 provides an opportunity for new leadership, new approaches, and much needed reform.

Thank you, sir.

Chairman SHELBY. Dr. Bergsten.

STATEMENT OF C. FRED BERGSTEN
DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. Mr. Chairman, I would like to pick up from where Senator Sarbanes and you were having your discussion with Under Secretary Taylor a moment ago and just elaborate a few of the points that were focused there.

There is absolutely no doubt why the East Asian countries have been buying huge amounts of dollars. They have been doing so to keep their exchange rates undervalued to strengthen their trade competitive position as part of their own economic or development policies. They do not think of it as investments. They think of it as job creation. They keep the price of their currency low. That keeps the prices of their products low. That improves their market shares in world trade, and that adds to their economic development.

The impact on us is to preclude the necessary adjustment of our own exchange rate to reduce our own unsustainable trade and current account deficits, as you outlined, and that of course hurts our economy and reduces job creation in our own economy. It is that simple.

Senator Carper asked a very good question to Under Secretary Taylor: Well, why is it that the Japanese Government is buying U.S. Government paper? It is not as if the Japanese Government has to look around for investments. The Japanese Government is running a huge deficit—7 or 8 percent of their GDP. They are issuing huge amounts of paper themselves. The last thing in their mind is having financial assets that they have to look around to find a place to put. They are, in fact, taking huge amounts of money that they have to borrow from their own people in order to put them into Treasuries to keep the prices of their currency un-

dervalued to strengthen their trade and competitive position. In other words, it is even worse than was being said before.

The two big concerns: Japan and China. Senator Sarbanes picked up that line from my testimony which is just so stunning as to be worth repeating. In the first quarter of this year, Japan bought over $150 billion of U.S. dollars in the exchange markets and put the money in Treasuries. That is one quarter—multiplied by four, $600 billion annual rate. That is more than our entire budget deficit. It is more than our entire trade and current account deficit. So the Government of Japan, all by its little self, was doing this in order to protect its own competitive position and maintain its position in world trade.

Chairman SHELBY. Doctor, what can we do about it?

Mr. BERGSTEN. That was the final point, and I will just jump straight to it.

Under Secretary Taylor said, and is of course right, that we want other countries to grow faster, and that is helpful, but the truth is the fastest, conceivable growth rate, from all of the other countries he is talking about—the Japanese, the Europeans, et cetera—would have a very marginal impact in reducing our trade deficit. We have run the equations. Every 1 percentage point of faster world growth takes something like $10 billion a year off our trade and current account deficit. It helps, but it is tiny.

There is only one possible way to get our trade deficit down substantially within any reasonable period of time, and that is a lower exchange rate for the dollar. I am not calling for a weak dollar. The dollar rose in value by a trade-weighted average of 40 percent from the minimum in 1995 to early 2002. It produced a hugely overvalued dollar in the exchange markets; overvalued in the sense that our underlying competitive position cannot support the value of the dollar with that currency.

Over the 2 years, from early 2002 to early this year, the dollar came down by a trade-weighted average of about 10 percent—moving in the right direction. Incidently, it did so in a totally gradual and orderly way, no disruption to our own markets, the world economy, et cetera, but it only came down about a third to a half what is needed to restore any semblance of sustainability in our current account position over time.

I have sympathy for Under Secretary Taylor because I used to be in his job. He cannot sit here and say, like I just said, we need a lower exchange rate for the dollar. He did say we need more flexible exchange rates, by which he means the yen, the Chinese renminbi, and others need to go up against the dollar; for example, we need a lower exchange rate for the dollar. That is what he is saying.

The issue is have he and his colleagues done anything effectively to get it there, and there my answer is no; that both the Treasury and the IMF—and I document this in my statement—have failed to carry out the obligations of law, in the U.S. case, of the IMF statutes, in the IMF's case, to take significant action to bring those other currencies down. Indeed, the Chinese, by pegging to the dollar, have actually ridden the dollar down over the last 2 years, become more competitive, had a trade-weighted depreciation of their

currency of 8 percent, making the world's most competitive economy even more competitive.

Now, what can you do about it? You can bring lots of diplomatic and economic pressure. The United States has done it in previous episodes when we have had to play rough. But I had a simple suggestion for the Treasury Department a year ago when the Japanese intervention was at its height. I said you should simply call up the Japanese and tell them that for every dollar they buy in the exchange markets, you are going to sell a dollar. You are going to counter their movement in the exchange markets, which is so obviously counterproductive, to us, to them, I would argue in the long-run, and to the world economy. And, indeed, you would never even have to do it because, if you told them you were going to do it, they would cease and desist.

I was in Tokyo all last week. Under Secretary Taylor said the Japanese have not intervened for the last 2 months, and he is factually right. I was in Japan all last week. I talked to the officials that are most directly involved. I asked him if we could be assured that they had now ceased their intervention forever, and of course the answer was no. So, if the yen starts to rise again, and they become unhappy with the level to which it rises, you can be sure they will intervene again.

So we are going to have to take some serious action. I believe if we did the kind of suggestion that I indicated, that it would be enough to deter future action, but until we get serious and undertake action, not just words, the problem is going to continue.

Thank you.

Chairman SHELBY. Doctor, what would be the repercussions if we told them, and we have to mean what we say, "You buy. We are going to sell?"

Mr. BERGSTEN. Well, the markets would then realize that their intervention would be ineffective. The markets would therefore take the exchange rates to levels that the markets thought were right, which would be a considerably stronger exchange rate level——

Chairman SHELBY. Well, that is what we want, is it not?

Mr. BERGSTEN. And that is exactly what we want, and that would be the objective of the exercise. Secretary Taylor is right, conceptually, that we want these currencies where the markets would take them.

Chairman SHELBY. But how do you get there? Because we are no progress, are we?

Mr. BERGSTEN. Exactly.

Mr. MELTZER. May I comment?

Mr. BERGSTEN. So my suggestion, while seeming to some to be playing hard ball, would I think be both effective and unnecessary to actually implement because the threat would be so severe.

Chairman SHELBY. Dr. Meltzer.

Mr. MELTZER. There is an element missing in this discussion that is really quite critical, and that is, if a country has a fixed exchange rate, and its currency is truly undervalued, then it gets a big capital inflow, as China does, and that inflow produces either pressure to change the exchange rate or inflation. What matters is not the nominal exchange rate, the 8.25 renminbi to the dollar.

What matters is the real exchange rate adjusted for prices. Now, prices are starting to rise in China. That is a step in the direction of desirable changes.

The Chinese do not like inflation. That, more than any kind of pressure that the United States can put on them, is going to push them to do something about the problem that they see, which is to avoid the inflation and avoid the further depreciation or undervaluation of their real exchange rate. But it is the real exchange rate that matters, and countries can only control it for a certain length of time without running into problems of inflation or deflation. The Chinese have come from deflation, to modest inflation, and they headed toward higher inflation, and they understand that, and they need to do something.

Second, I would say it is a problem, as Members of the Committee have said, about the Chinese banking system. But the Chinese banking system could easily be improved by the huge stock of foreign exchange reserves that the Chinese have accumulated. They have the wherewithal to bail out the bad loans of their banking system, and that would be a step toward greater flexibility, and that is a pressure that the Administration should try to put on them, that is, to fix their banking system with the dollars that they have accumulated and then go on to a more flexible exchange——

Chairman SHELBY. Doctor, can they every really fix it, as long as they have state-owned industries, making bad loans to failing——

Mr. MELTZER. That is correct. They cannot permanently fix it because they use the banking system as really to do the fiscal policy operations of the government and to provide employment in the losing sectors of the economy, mainly the state-owned industries.

Chairman SHELBY. Dr. Bergsten.

Mr. BERGSTEN. Can I just say I fully agree with both of Dr. Meltzer's points, and I do agree that the rise of inflation and overheating of the Chinese economy, and further urgency from their standpoint to the desirability of the one-shot revaluation of the currency. Dr. Meltzer is right. They will wind up taking it one way or the other. But from their standpoint, it would be far more desirable to move the exchange rate preemptively rather than to let inflation and overheating build up. They could then suffer a hard landing of their economy, which would be bad for all of us. That is further reason why they should take the exchange rate action now.

Chairman SHELBY. Doctor, we appreciate your patience.

STATEMENT OF DOUGLAS HOLTZ-EAKIN
DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Well, it is a long way from this fascinating discussion to the arcana of the budget, but let me spend a couple of minutes summarizing the main points of the testimony that we submitted.

Chairman SHELBY. Yes, sir.

Mr. HOLTZ-EAKIN. As the Chairman is well aware, the multilateral financial institutions have an important function in international financial markets, mainly to enhance the flow of credit to borrowing countries to meet policy objectives. And in this way, they are similar to many domestic programs of the Federal Government,

such as direct student loans, student loan guarantees, Federal guarantees of mortgages, and a variety of other programs that the Congress has undertaken.

In my remarks today, I want to really focus on a few points:

As with those domestic programs corresponding to these policy objectives, there are costs, and unlike the domestic programs, the multilateral financial institutions operate as a collective effort. We have other nations involved in providing this policy objective, and they operate in an institutional setting that is quite different from domestic settings, making it more difficult to trace those costs back to the portion that resides in the United States.

Finally, they also operate in a world that has changed greatly. Recent developments in both international financial markets and the operation of these institutions make history less of a guide for those costs in the future.

In 1990, the Congress, in the Federal Credit Reform Act, sought to place domestic credit operations on a more even footing, from a budgetary point of view, taking things such as direct student loans, where there was a clear cash outflow, and guarantees, where there was no apparent cost, and trying to turn them into the equivalent of grants in each case—asking how much, in the way of economic resources, were being provided.

And with a decade of experience, a little bit more, the House Budget Committee has asked the House CBO to revisit the Credit Reform Act, and we are in the process of looking at a variety of activities: The provision of guarantees through things such as the Air Transportation Stabilization Board and the provision of pension guarantees through the PBGC; we also have some work in which we are looking at improving mortgage guarantees. And much like those activities, the activities of the multilateral financial institutions at their core involve an economic subsidy.

In the testimony, we lay out a ballpark calculation that suggests that relative to market borrowing. In 2003, the three multilateral financial institutions—the two windows of the World Bank and the IMF—provided economic subsidies that could be as large as $20 billion to the borrowers involved.

Now, we know that the United States really is responsible for only a portion of that subsidized lending. It may be the case that not all of the subsidy resides with the MFI's. It may be taken up by other lenders. It may be the case that the MFI's never pass back a demand for those resources to the Federal budget. However, the goal of the exercise in which we are engaged is to revisit the nature of these subsidies and look at them in the context of financial markets that are now characterized by large and much more rapid international capital flows, rising importance of private-sector bondholders as lenders in the international markets, and relatively diminished bilateral lending between two governments.

It is also the case that there have been some shifts in the legal and institutional setting for international workouts. And in that context, and with a broader desire by Congress and other settings to do forward-looking budgeting for costs that may be anticipated, we are undertaking our study. We have some preliminary results, which attempt to evaluate the magnitude of these subsidies, to assess the links between these subsidies and the Federal budget, and

to clarify the decisions that face Congress in issues and timing between the occurrence of the economic subsidies and the budgeting for them and when Congress wishes to treat them on the budget.

We look forward to working with this Committee, and with the Congress in general, to provide the budgetary treatment that will most illuminate the proper economic and budgetary incentives for the Congress.

Thank you.

Chairman SHELBY. Thank all of you. I have a few questions.

Dr. Meltzer, are we looking at a potential insolvency crisis among developing countries? And why do you believe developing countries rely so heavily on short-term funding, and what are the obstacles to a market for long-term developing country debt?

Mr. MELTZER. Let me start with the last one. We now have a lot of evidence on economic development, and China is a wonderful example, but India is also a wonderful example of recent progress, and we know what it takes to get long-term private capital into those countries.

It requires some kind of reasonable stability in application of the rule of law, where China is somewhat deficient, but moving in the right direction. It requires openness to trade. It requires some reasonable standards in the country for the protection of property rights, and human rights would be desirable, although often absent. Those are missing in many of these countries, and so they are left to borrow mostly in the short-term market, and a lot of their borrowing is from international financial institutions, especially among the poorest countries.

Is there a problem of a default to the international financial institutions? Unfortunately, the countries do not default to the international financial institutions because the international financial institutions do not let them. They lend them more money to pay the arrears on their debt, and they keep financing additionally by sending them more money.

There is something called the HIPC initiative to forgive some of those debts, but that is just a way of recognizing that they were not going to be paid.

Chairman SHELBY. Let me ask you this, Dr. Meltzer. In your testimony, you state that the IMF should not lend to countries that do not meet minimal standards.

Mr. MELTZER. That is correct. That was the main recommendation of a majority of the Commission.

Chairman SHELBY. Some of us are concerned that if the IMF said it would not lend to such countries, and then did so, the IMF would lose what little credibility it had left. How do you make such a commitment credible? Should exceptions be made for countries that would present a systemic risk to the international financial system? How do you work it? How do you balance it?

Mr. MELTZER. We want to group countries into three groups: Those that establish some reasonable standards of prudent financial behavior and some other conditions; second, those that do not; and, third, those that are at risk because of the imprudent countries or perhaps the prudent countries, but mainly the imprudent countries, we want to help the first and the third group; that is, we do not want international global instability. So we are going to

say we may have a country—Uruguay was a good example. It was hurt by developments in Argentina and, to a lesser extent, Brazil. The IMF came in, and it lent to Uruguay, and substantial amounts to Uruguay, relative to the size of its country. We think that is an appropriate thing for the IMF to do because it prevents the crisis from spreading to third countries.

We do not think it should be lending money to the countries like Argentina that do not meet those standards because, I believe—and I think there is good reason to believe—that if we told Argentina or Turkey that unless you develop these standards, you will not get more aid, there will be pressure in those countries to develop more standards because they will be able to get more capital at lower interest rates, and that will be in their interest, and they will be willing to make the changes that are necessary. They have no incentive.

Turkey has been in trouble periodically since the 1950's, and it knows that its friend, the United States, working through the IMF, will help it out in each one of those crises, so there is no reason to make substantial reforms. It now is making reforms. Why is it making those reforms? Not because of the IMF—because it wants to join the European Union, so it has an incentive to make the reforms that it has not made for the past 40 years.

Chairman SHELBY. Dr. Holtz-Eakin, we are aware of CBO's ongoing study concerning the economic cost of long-term U.S. Federal Government obligations. In Dr. Meltzer's written testimony this morning, he cites that his colleague, Professor Adam Lerrick, estimates the hidden annual cost of the IMF to U.S. taxpayers currently as being $1.5 to $2 billion—I assume that is annually—the principal component being the risk of default by one of the major debtor countries.

How does this figure compare to the estimates arrived at in your current study? Are those numbers different, yours from Dr. Meltzer's?

Mr. HOLTZ-EAKIN. Well, ours are not yet complete, and I will stipulate that at the outset. But I will say that the Lerrick calculation is similar in concept to the starting point of our investigation, which is a comparison of the market's evaluation—what would you charge a risky borrower—with the terms actually charged in loans to these borrowers.

We choose not to look at the difference in interest rates, but rather look at the value of the loan versus a bond floated on private markets, which looks over the life of the loan. That is, the starting point of our investigation is exactly the same in character.

The issues that remain, from our point of view in tracing it back to budgetary treatment, are the degree to which those loans from, say, the IMF or the World Bank, remains, to some extent, senior to those of other lenders thus, more insulated, and then the degree to which they will, as a result, come back to the U.S. budget.

Chairman SHELBY. In your written testimony, you indicate that MFI's may not have enough resources to cover loan losses; that is, that the MFI's have a negative net worth. Can you give us some sense, this morning, of what the range of the size of what that negative net worth would be, what time frame should the magnitude of these losses play out, and what would the magnitude of the U.S.

commitment to cover the negative net worth of these in this—what would be——

Mr. HOLTZ-EAKIN. The numbers in the testimony looked at the portfolios of the IMF and then the two windows of the World Bank and pointed out the market value was about $203 billion below the book value. So that represents the losses on those portfolios. That is negative net worth from those entities viewed in isolation.

The share of the United States in those entities is difficult to pin down, but as it says in the testimony, we are somewhere between 15 and 20 percent for the group.

And the period over which that might play out is unknown, but if one were to go back to the beginning and cumulate all such losses, those are the kinds of calculations one would do.

Chairman SHELBY. You noted, at the beginning of your testimony, that the current budgetary treatment for multilateral financial institutions may fall short of the goal of recognizing the magnitude of U.S. commitments to the various multilateral financial institutions in a consistent fashion.

Based on the current treatment, could you elaborate on the examples of situations where Congress would have the incentive to pursue a particular policy response solely for budgetary purposes, rather than because it was the most effective policy.

Mr. HOLTZ-EAKIN. If you look back to the Credit Reform Act, an analogy I think is useful. Prior to Credit Reform, if the Government made a student loan, the entire value of the loan flowed out. To the extent that there was full repayment, it eventually flowed back in. It was entirely cashflow. If it guaranteed the exact same loan and got the exact same money to a student, it did not show up in the budget.

As a result, the idea was to make sure that Congress was well aware that these were equivalent economic transactions by turning them both into the cash equivalent grant to that student in terms of a subsidy.

In the international setting, you can imagine trying to get a particular loan amount in new dollars to a borrowing country. If done through a USAID loan, it would get Credit Reform treatment, and the value of the subsidy would appear in the budget. If it were done through the IDA, the Congress would have to provide the full budget authority for the loan, similar to the method for the original student loans. And if it were done through the IMF, there would not be a budgetary entry, but instead it would show up as a means of financing. As a result, the question is whether those differential treatments would lead Congress to misapprehend the relative costs of those different activities.

Chairman SHELBY. Dr. Meltzer, I think we know Dr. Bergsten's position regarding the revaluation of the Chinese currency. I would like your views as to the merits of the United States using its persuasive powers versus the strategy that you hinted at for using our influence to get the Chinese to shore up their financial system more quickly in order to facilitate a flexible exchange rate policy. In other words, what do we really get by just moving to another peg rate?

Mr. MELTZER. I think that first we want to look at the problem, Senator, from the standpoint not of what is in the United States'

interest but what is in the joint interest of the United States and China but certainly what is in the interest of China.

Chairman SHELBY. They are acting in the interest of China. Most nations will act in their best interest, will they not?

Mr. MELTZER. That is right. Now their best interest is changing because of the threat of inflation. We can help them, as Secretary Taylor said, with technical assistance, that is, by trying to show them how to shore up their banking system, how to get to a position. But we want to think about this problem somewhat more broadly. One of the problems that arises in the question of whether there will be a big revaluation of the Chinese currency or not is tied to the question of what the Chinese do with their internal controls on capital. The Chinese savers get virtually nothing for their savings, and they save a lot of money. If they opened that up, they would probably want to diversify. That would tend to weaken the currency, not strengthen it.

So if we think about the package, and yet it is in the long-term interest of us and the Chinese to see a more open capital market and a capital market that——

Chairman SHELBY. It would also have political repercussions because it weakens the central government, does it not?

Mr. MELTZER. Yes, it does, and it is probably the main reason——

Chairman SHELBY. Because people have choices, do they not?

Mr. MELTZER. Absolutely. And the control of finance is probably one of the major stumbling blocks on which the Communist Party is going to not want to give up control. But it is certainly in our interest, for that reason probably paramount, to see them do that.

Now, under the treaty under which they entered the WTO, they have to do something next year to admit foreign banks and give them more opportunity. And that is going to be a very important step in dealing with the whole package of issues that we have on the financial side with China. So the short answer to your question is I prefer to see a floating rate. But I prefer to see the floating rate under conditions with freer capital movements in China because I think that is a step in the direction that we want, geopolitically, China to take.

Chairman SHELBY. But as their economy or the part of their economy that is driven by market forces in a sense, and trade, as it continues to grow, there will be more pressure economically on the government, would it not, to reform the banking system for the economy?

Mr. MELTZER. Yes. But, of course, as you know surely better than I, pressures here and pressures there are not on the same order, are not on the same scale; that is, we have a lot more effective ways of bringing pressure on our Government than the Chinese do. And allocating capital is an area which is fundamental to the control of the Chinese. That is a big part of this issue.

We would like to see, ideally, much greater freedom of capital movements as well as much greater freedom of the exchange rate.

Chairman SHELBY. Capital will find its best investment.

Mr. MELTZER. That is correct, and not be under the control of the state.

Chairman SHELBY. By a political entity.

Doctor.

Mr. BERGSTEN. I would just add one point, an implication of something that Dr. Meltzer said and I addressed in my written statement, but it is important enough to flag orally. I argued in my statement that floating the Chinese currency and eliminating their capital controls are very good things as long-run objectives. But it will take quite a long time to get there given the weakness of the banking system and other problems.

Dr. Meltzer made the correct point that if the Chinese did eliminate their capital controls and go to a floating rate now, their currency might actually weaken in value because a lot of the money that is piled up in China as a result of their rapid growth and high saving right might go abroad in a one-time portfolio reallocation. That would make the trade problem worse.

If a lot of capital went out of China, weakened their currency, that would make them even more competitive and make the trade problem here an even greater one.

So that is a further reason why I believe the Administration is completely incorrect, as well as impractical, in seeking China to float the exchange rate now as their remedy to the problem. Do the one-time revaluation now, move toward floating and elimination of capital controls, but only over the longer-run.

Mr. MELTZER. May I add one other thing, Senator?

Chairman SHELBY. Yes, Dr. Meltzer.

Mr. MELTZER. One can get overly concerned about the trade deficit, and I think there are people who are overly concerned about the trade deficit. I do not believe it is a completely innocuous problem and that we should not pay any attention to it.

On the other hand, let us remember——

Chairman SHELBY. Do you consider it a serious problem but maybe not a crisis?

Mr. MELTZER. That is correct. Remember that people are selling us goods and services that are valuable, that keep down costs of production in the United States, that help us to grow and so on. And in exchange, they are taking pieces of paper that we can print up at fairly rapid rates and have found means to do that. They are earning 1 to 2 percent on those pieces of paper. Our firms are earning substantially more on the benefits that they get from being able to rationalize their production around the world.

Now, that has short-term costs to us that we all know in terms of job creation and factories moving, but it is not an action which is wholly harmful to us or that we should regard as a crisis that we need to do something about now.

Chairman SHELBY. But, Doctor, you cannot ignore long-term implications and long-term obligations and layer after layer of a current deficit year after year, though, can you?

Mr. MELTZER. No, we cannot. But let us recognize that there are two parts of this problem: How we got here, how we got from $150 billion annual trade deficit to $500 billion. We got there because of the committee to bail out the world. Was that a mistake? No, it was not a mistake. Now we are here with $500 billion, and we run into a lot of mercantilists, that is, countries that want to push out their exports to sell us goods and services more cheaply and take

our paper for it. And that is a very hard adjustment, and that is not going to be easy, but it is not a crisis for us.

If it continued for a long period of time and our productivity growth slowed, it would be a problem, a bigger problem than it is now. At the moment the problem comes from the thing that Dr. Bergsten has talked about.

What I worry about is how much of our foreign deficit is financed by governments and how much is financed by voluntary savings of people who want to invest here. I think we are moving from 2003, where it was of the kind that was harmful, to 2004, where it is more likely to be less harmful.

Chairman SHELBY. Sure. Dr. Bergsten, the last word.

Mr. BERGSTEN. I can only characterize what Dr. Meltzer said as it is fun while it lasts.

Chairman SHELBY. But it will not last forever.

Mr. BERGSTEN. But it will not last that long, and we know that from history. The dollar goes into a crash mode about once a decade. It has done so for the last 30 or 40 years. When it does so, the costs are very high. Even in the build-up period, the costs are very high. And, look, I think we all share that view here, that something much more effective has to be done about it.

Chairman SHELBY. An austerity program could——

Mr. MELTZER. Senator, every morning I get up, I genuflect and pray that I do not have to forecast long-term values of exchange rates.

Chairman SHELBY. Thank you.

I want to thank all of you for your patience and your contribution here today, and I am sure we will have you back here.

Senator Hagel is tied up in another Committee, but he asked that his full statement and some questions for the record be made part of the record. So, I hope you will respond.

Chairman SHELBY. The hearing is adjourned.

[Whereupon, at 12:09 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR WAYNE ALLARD

Thank you Chairman Shelby for convening this oversight hearing on the International Monetary Fund and the World Bank. The International Monetary Fund works toward a number of different goals through its 184 member countries which are integral in promoting international financial stability. Since it's creation in 1944, the mission of the World Bank has evolved from assisting with post-war reconstruction and development to fighting poverty and improving the living standards of people in the developing world today. Together, the World Bank and the International Monetary Fund have an important mission to assist in the economic well-being of all nations and provide stability to the international financial system.

As the Members of this Committee know, I always take great concern that strict and effective accountability and oversight of financial and other institutions are of the highest priority. I played an active role in seeing the creation of an Inspector General at the Export-Import Bank, and believe that new position has greatly added to the overall efficacy and fulfillment of their purpose and mission. I am particularly interested in exploring similar issues with specific regard to accountability and transparency of operations at the World Bank and the International Monetary Fund in today's discussion.

I would like to thank each of our witnesses for agreeing to testify before the Committee today. I look forward to your testimony.

PREPARED STATEMENT OF SENATOR CHUCK HAGEL

The Unted States has a significant stake in the International Monetary Fund (IMF) and the multilateral development banks (MDB's). Over the last 60 years, the United States has appropriated over $45.4 billion to all the MDB's and authorized an additional $69 billion in callable debt. Over that same period, the United States has also authorized a line of credit with the IMF that now totals $45 billion. The smooth and transparent operation of these institutions is critical not only to foreign nations and international investors but also to the American taxpayer.

The Mexican financial crisis of the early 1990's and the Asian financial crisis of the mid 1990's highlighted the need for IMF reform. In 1998, Congress increased the U.S. line of credit with the IMF by $18 billion, but before doing so, it mandated a series of reforms. The goal of these reforms was to have the IMF better anticipate, prevent, and resolve sovereign financial crises. We need to ask: Has this goal been achieved or is more reform necessary?

Earlier this year, I chaired a hearing at the Subcommittee on International Trade and Finance which examined the Argentine financial crisis. The hearing underscored the increasing number of private creditors today that invest in developing countries. In the case of Argentina, encouraging the capital flow of private investment is essential to ensuring Argentina's long-term economic growth. The Argentina crisis demands that we look at the IMF's role in protecting private investment when a foreign government defaults on its obligations.

Today's hearing will also look at issues surrounding the World Bank. Last week, the Senate Foreign Relations Committee, of which I am also a Member, looked at how MDB's are combating corruption. Here, too, Congress has a responsibility to ensure that American taxpayer dollars are spent responsibly and to examine whether reforms are necessary.

Investors from around the world look to the United States for leadership in institutions like the IMF and the World Bank. It is critical that we address reform when it is necessary and promote the right policies. America's economic security and prosperity cannot be separated from our leadership of the global economy. Thank you, Mr. Chairman. I look forward to hearing from today's witnesses.

PREPARED STATEMENT OF JOHN B. TAYLOR

UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
U.S. DEPARTMENT OF THE TREASURY

MAY 19, 2004

Chairman Shelby, Senator Sarbanes, other Members of the Committee, thank you very much for inviting me to discuss the Administration's reform agenda at the International Monetary Fund and the World Bank. Reform of these institutions—

founded 60 years ago at the now famous Bretton Woods Conference—has been a high priority since the start of the Bush Administration.

During the first year of the Administration we presented our reform agenda for the next few years. President Bush put forth key proposals in an important speech at the World Bank in the summer of 2001 just before going to his first G–8 Economic Summit. Then, in testimony before Congress, in speeches at universities, think tanks, and in the financial community,[1] we discussed the technical details and the economic and political rationale for the reforms. We worked together with our fellow shareholders and with the staffs of the Bretton Woods Institutions. The importance of the reforms was stressed in statements by the Secretary of the Treasury at the IMF/World Bank meetings, by the U.S. Executive Directors at the Board meetings, and by our representatives at the replenishment negotiations of the multilateral development banks. A path-breaking international agreement on reform implementation was put forth in the form of a G–7 Action Plan in April 2002.

I am happy to report that an enormous amount of rapid progress on this reform agenda has been made, especially in the last year and a half. The key reforms that have been implemented are:

- collective action clauses in external sovereign bonds;
- creation of clear limits and criteria for exceptional borrowing from the IMF;
- use of grants in partial replacement of loans from the World Bank;
- introduction of a system for measuring results at the World Bank;
- a focus on core expertise at the IMF and World Bank with division of labor.

As is true of many reform movements, people have discussed and recommended such reforms for years. The work of the Senate Banking Committee has added greatly to the discussion and debate. But in the last few years, we have gone well beyond discussion and debate. What is different now is that the reforms have actually been adopted. Taken as a whole and assuming they are locked-in, internalized, and expanded as described here, these reforms, in my view, represent a fundamental policy shift for the international financial institutions.

Goals, the Evolution of Markets, and the Rationale for Reform

Simply put, the goals of the international financial institutions are (1) to increase economic and financial stability and (2) to raise economic growth, thereby reducing poverty. These are good goals. There is no reason to change them. But the world economy and financial markets in which the institutions operate has changed dramatically since they were founded, and to achieve these same goals the institutions must reform. Consider some of the changes in the world's financial markets in just the past 15 years.

One important change is that securities represent a much bigger percentage of cross-border financial flows than in earlier years when bank loans were a larger percentage. An important implication of this change is that restructuring sovereign bonds—with literally hundreds of thousands of bondholders in many different countries—is perceived to be more difficult and uncertain than when debt was in the form of bank loans by a few banks or syndicates.

A second change is the increase in the volume of private capital flows. Private debt and equity flows grew to be much larger than official lending from the international financial institutions. Cross-border transfer payments are now predominantly private with remittances alone much larger than transfers of resources from the international financial institutions and other aid agencies.

A third change is that financial markets are more interconnected than in the past, which is one of the reasons for the concerns about contagion. The cross-border capital flows seemed to be more volatile as well.

I believe that these changes in the cross-border environment led the emerging markets to become more crisis-prone. In fact, both the number and severity of financial market crises increased in the 1990's compared with the 1980's. By the late 1990's, the emerging markets were perceived by investors as so crisis-prone that net private capital flows to emerging markets as a whole fell sharply.

The initial responses to these crises by the official community in the 1990's were understandable. As in the case of Mexico, the responses had to be developed from scratch in a very short period of time, and they had to be implemented immediately. In a number of cases, and in the Mexican case in particular, some argued that there should have been no special response by the international community, or that the

[1] Examples include testimony before the Joint Economic Committee, February 4, 2002, a speech at Harvard on November 29, 2001, a speech before the Bankers Association for Finance and Trade on February 7, 2002, and most recently a speech at the IMF on April 16, from which this testimony draws.

response was wrong. But the point I would emphasize is that these crises were providing clearer and clearer evidence that the systemic changes in the world's financial markets required systematic changes in the policy framework underlying the international financial system.

However, the responses of the international community to crises in the 1990's continued in roughly the same fashion as the response to Mexico. They tended to concentrate on short term tactics rather than strategy. They were designed around discretionary changes in the policy instruments rather than systematic changes in the policy regime. They tended to be government-focused rather than market-focused, emphasizing large loans by the official sector and later government-induced bail-ins by the private sector. Many observers became concerned that the increasing use of very large financial packages and the bail-ins were having adverse effects on expectations or incentives.

A related problem was that loans from the official sector—including from the IMF and the World Bank—to the very poor developing countries in Latin America, Africa, and Asia were building up to clearly unsustainable levels. This led to understandable calls for debt relief. Again the responses, in my view, were more tactical than strategic. They dealt with the current serious need for debt relief, but not with the expectations effects and the incentive problems that would continue to cause the international institutions to lend too much and the poor countries to borrow too much, leading to future debt sustainability problems.

In sum, something important was missing from the international financial policy framework, namely more predictability, more accountability, and more systematic behavior on the part of the official sector. More focus needed to be placed on what public sector actions were likely to be in a given circumstance, on what accountability there would be for those actions, and on what the strategy and the principles behind the actions were.

Collective Action Clauses

The very essence of these new clauses is to provide greater predictability and order to the resolution of sovereign debt. They do this by providing a new option for sovereigns to restructure their debt without having to obtain the unanimous consent of bondholders. Seventy-five percent has become the new threshold for amending key payment terms in sovereign bonds. I emphasize that the aim is not to make restructurings more desirable, but rather to make them more predictable and less vulnerable to "holdouts" in cases when a country has no real alternative. In the absence of such clauses, fears and uncertainties about what would happen if a country had to begin a restructuring of its debt can interfere with effective decisionmaking, especially in a charged political environment. Such clauses are a decentralized, market-based approach with a minimum of direction or discretion by the official sector. In this way too, the clauses reduce the uncertainty that accompanies a nonsustainable debt situation.

Importantly, the clauses also help the official sector to be more credible about the both the likelihood and likely size of its own response, and this in turn has favorable effects on market expectations, which can reduce the need for large responses by the official sector.

The Bush Administration has actively promoted these clauses. After intensive legal and economic research at the U.S. Treasury in late 2001 and early 2002, we concluded that these were the most promising and feasible way to introduce more predictability into the system. The official sector facilitated the development of proposals, but we emphasized that the market should work out the details and, ultimately, choose what language to adopt for the clauses. The clauses then became part of the April 2002 G–7 Action Plan.

We are very pleased with the dramatic progress that has been made in implementing these proposals in a very short period. Mexico included clauses for the first time in its New York law-governed bonds just about a year ago. And now clauses are well on their way to becoming standard in internationally issued sovereign bonds. A range of countries, including the early clause-issuers Mexico, Brazil, Korea, South Africa, and Turkey, have demonstrated that including these clauses in their issues has had no adverse impact on pricing. Just since January, the Philippines, Panama, Colombia, Costa Rica, Indonesia, and Israel have all included these clauses for the first time in their New York-issued bonds. Work continues to educate potential issuers about the benefits of these clauses, as we advance this important trend in strengthening market practices. The new clauses are now the market standard in New York.

Some argue that these clauses do not solve all the problems about the uncertainty surrounding debt restructurings, and they are right. Future crises may not be as closely associated with debt problems as past crises have been. But the clauses and

the debate surrounding them last year have helped to change perceptions about emerging market debt. The debt is now being held by a more diverse class of investors as an important part of their portfolios. Moreover, I believe that because the reform was implemented so successfully it has bolstered confidence in the reform process. People see that financial reform is possible even if it is very complex and involves changes in the policies for scores of countries and thousands of lawyers, advisers, investors, and financial institutions. For example, private creditors and borrowing countries now are working on a code of conduct, which could add more predictability and order into the system.

Clarifying Limits and Criteria for Large-Scale Official Sector Lending

There are several components of this reform.

First is the presumption—based on recent practice since the resolution of the Turkish financial crises of 2000–2001 and in particular the assistance package of early 2001—that the IMF rather than the official creditor governments is responsible for providing large scale loan financing. This provides an overall budget constraint and thereby an overall limit on loan assistance, recognizing that IMF resources are limited.

Second, within the context of this overall limit there has been an endeavor by IMF shareholders and management to signal in advance of a decision not to provide additional IMF loans when it appears that the limits of sustainability may be reached in the near future. Signaling policy changes in advance—even in broad outline—can lead to smoother adjustments and provide investors with time to obtain information about fundamentals. This reduces greatly the chances of contagion, because surprise increases or decreases in official financing can lead to runs for the exits and sudden stops. Also part of the principle of limiting funding when countries continue to follow unsustainable policies is to assist countries that are following good policies but may be hit by a crisis in the nearby country that is not following good policies. This too will help to reduce contagion in the event that the near-crisis country does in fact go into financial crisis. The clearest example of this is the case of Argentina where additional IMF resources were not suddenly stopped in 2001, but rather continued with signals—including restructuring funds built into the August 2001 program—that additional funding in the face of the ongoing debt sustainability problem would not continue. In addition, a financial assistance package was provided to Uruguay—which had been following good policies—to deal with the monetary crisis brought on by the bank runs of its close neighbor in 2002.

The third component of this reform adds specificity and accountability to the first two components. This is the agreement by the IMF Board in 2002 and 2003 on four specific criteria that should be met before large scale lending above certain limits can take place. The criteria are (1) balance of payments pressures on capital account, (2) high probability of debt sustainability, (3) good prospects of regaining access to private markets so that IMF financing provides a bridge, and (4) good economic policies in place. In addition, the IMF Board has adopted as a standard that, in cases of exceptional access, a new exceptional access report be prepared by the IMF management and published. The aim of the exceptional access report is to provide accountability in the same way that monetary policy reports or inflation reports provide some accountability at central banks.

Because these criteria must be interpreted in each case, it is clear that the limits themselves are not rigid. The reality of the market and policy environment is that the IMF management and the IMF member governments should use the criteria judiciously rather than rigidly. One cannot plan for all contingencies and so the criteria are closer to policy principles or guidelines. Nevertheless, the specific criteria represent a marked change in the direction of a more systematic and predictable policy regime.

The purpose is to reduce the uncertainty and the perverse disincentives in the markets due to lack of clarity about how much funding will be provided from the IMF and under what circumstances. The clearer limits help define the policy regime under which market participants and borrowing countries can operate. As part of the policy framework defined by the clearer access limits, the general presumption is that the official sector will avoid arm-twisting the private sector to do bail-ins, because this can lead to uncertainty about future applications and encourage early runs for the exits.

With these criteria in place, the question is frequently asked about how they were applied last year in the cases of Argentina and Brazil. In both of these cases, however, the countries were already in exceptional access territory and the goal is to exit from this exceptional access over time. The Argentina program is now focused on a complex debt restructuring. And a goal of the Brazil program is to exit from the exceptional access.

Grants Rather Than Loans to Very Poor Countries

Providing more grants to heavily indebted poor countries (HIPC) is necessary to deal with their long-run debt sustainability problems. Debt forgiveness through the HIPC process in a way that deals with their debts to the international financial institutions is essential for the countries with unsustainable debt situations. But if the international financial institutions return to their heavy emphasis on lending, then there are perverse incentives for these countries to get into an unsustainable situation again, which will lead to the debt relief cycle all over again.

This is more than a simple financial issue. Unsustainable sovereign debt not only requires a government to use new resources for repayment of such debt, but it also reduces private sector investment needed for economic growth and poverty reduction. Using grants rather than loans, therefore, avoids leading these countries down the path of heavy indebtedness.

Of course, this is a fundamental and difficult reform. Since their founding 60 years ago, the managements and shareholders of the Bretton Woods Institutions have thought of them primarily as lending institutions. Nevertheless, remarkably good progress has been made in implementing this reform. In 2002, an international agreement was reached to use up to 21 percent of the World Banks' International Development Association (IDA) window for grants. This allows substantially larger percentages in the heavily indebted IDA countries.

The grants have proved very popular in the countries that have received them thus far, but work needs to be done to further increase grant funding for the very poorest and heavily indebted countries and to integrate this more systematically into the debt relief process.

Measurable Results Systems with Accountability and Incentives

Another change in the world economy since the founding of the Bretton Woods Institutions is the mainstreaming of modern management techniques into private firms and the public sector. Effectiveness at these institutions requires that they also adopt such changes, including managing for results with clear accountability and incentives. Good progress has been made at the World Bank during 2003 in establishing a measurable results system for outcomes in countries as part of the new "measurable results incentive program" established in 2002 in the last replenishment IDA–13.

Nevertheless, there is a need to expand to more outcome indicators in the next replenishment IDA–14 and have more shareholders use such approaches. There is also a need to develop better systems for measuring outputs at the project level and include measurable outputs with timelines in loan/grant documents and in country assistance strategies for Board approval. There is also a need to develop a similar approach at the IMF.

Focus IMF and World Bank on Core Responsibilities Allowing for Division of Labor

The core responsibilities of the IMF are monetary policy, fiscal policy, financial markets, and exchange rates. Many IMF employees comparative advantage is in these highly technical areas. Focusing on these core issues makes IMF surveillance and crisis prevention more effective. In contrast, the World Bank's core responsibilities are structural policies that raise productivity growth, such as infrastructure, business climate, education, health, and governance.

As part of the focus on the core responsibilities the IMF should concentrate its programs on a small number of core issues and leave the other issues to the World Bank, thereby creating a useful division of labor. Good progress is being made here too, but many programs, especially in very poor countries, still have IMF structural conditions that should be left to the World Bank.

Strategic Review and New Directions

I think it is clear from this brief review that progress has been substantial. But it is also clear that more work can be done to lock-in and expand the reforms. Now seems to be an opportune time to move ahead. First, the recent progress has generated a new enthusiasm and momentum for reform—a positive feeling that by working together, the international community can make progress in fundamentally reforming the international institutions, a goal that has been on people's minds since their 50th anniversary. Second, we are currently in a period not preoccupied with an immediate and emerging financial crisis, which gives the relevant participants time to consider longer-term reforms. And, third, there is the occasion of the 60th anniversary.

For these reasons, Secretary John Snow, as this year's Chairman of the Group of 7 Finance Ministers and Central Bank Governors, has called for strategic review

with the aim of defining new directions that build on recent reforms and, if necessary, expand them. There has already been a very positive response to Secretary Snow's initiative from developed countries, emerging market countries, and developing countries. Broad consultation is under way, so it is still too early to tell what the new directions will be, but some examples of ideas that have already been well received are:

- A new nonborrowing program facility at the IMF with emphasis on strong country ownership in program design.
- A new surveillance system including a reorganization that ensures that debt sustainability analysis and other vulnerability analyses relevant to IMF lending is pursued independently from IMF lending decisions, publication of all IMF country reports, explicit allowance and encouragement of country-led development and presentation of policies for IMF assessment, and explicit focus on contagion by looking at connections between countries and assisting countries with good policies that are hit by crises in other countries.
- A further increase in the amount of grants going to poor countries from the World Bank and the other multilateral development banks in conjunction with additional debt relief in order to further improve debt sustainability, economic growth, and poverty reduction.

Conclusion

The reforms I have discussed in this testimony are technical, and may seem arcane to some. But they are deeply important for world economic growth and stability—the goal of the international financial institutions.

Thanks to the very successful implementation of reforms during the past 2 years as well as actual improvements in economic stability and growth in the world economy, I believe there is a willingness to consider further reform and to spend the time needed to get the technical details right as Secretary Snow has urged in his G–7 "strategic review and new directions" initiative.

PREPARED STATEMENT OF ALLAN H. MELTZER

THE ALLAN H. MELTZER UNIVERSITY PROFESSOR
OF POLITICAL ECONOMY, CARNEGIE MELLON UNIVERSITY
AND VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

MAY 19, 2004

Mr. Chairman and distinguished Members of the Senate Banking Committee. It is a pleasure to appear before you once again to review progress in reform of international financial institutions. Today, I will briefly review IMF and World Bank programs to assess what has been done, what more needs to be done to make the world economy less risky and less prone to crises, and to improve living standards in the poorest countries. These are big topics. I will limit my formal remarks to major changes that have occurred, or that should occur for these institutions to become more effective at realizing their objectives. I will discuss the IMF and the World Bank in that order.

Much of what the charters of the IMF and the World Bank say about purposes and objectives is out of date. The current mandate of the IMF should be to reduce global risk to an attainable minimum. The mandate of the World Bank should be to facilitate social and economic development as a means of reducing poverty.

How can the IMF reduce risk to an attainable minimum? The IMF has two principal functions that can improve the market's operations in ordinary times and in crises. One function is to increase the quantity and improve the quality of information available to private lenders. The other function is to reduce the risk of financial crises in a given country and the spread of crises to other countries, as in Latin America in the 1980's and Asia in the 1990's.

Under pressure from its critics, the IMF has made much more information available about its activities, recommendations, and assessments. This information can be used by private lenders to improve their assessment of risks in a given country. This is particularly important for making judgments in the ordinary course of lending. Many problems in developing economies arise or are exacerbated by the volume of short-term renewable loans used to finance risky, longer-term assets. Timely release of information about a country's debt structure and performance can reduce this type of lending.

Important as is the improvement of information, the most important function of the IMF is to reduce the risk of severe crises that spread internationally. Improved

information contributes, but reform of IMF procedures is important also. Prodded by its critics and its new management over the last 3 years, the IMF improved its operations and recommendations in several ways. It now restricts the conditions attached to its loans to a small number of macroeconomic and financial measures or objectives. It appears less willing to make massive loans than in the 1990's. And it pays more attention to avoiding crises and to determinants of debt sustainability in developing countries.

The most important single change remains undone. The IMF should move from its "command and control" approach to one that relies on incentives.

Historically, the IMF has attached conditions to its loans. The country agrees to the conditions to get the loan, but it may be politically unpopular at home to enforce conditions such as expenditure reduction or tax increases. Or, growth may be less than anticipated, requiring additional painful adjustment. The IMF's Independent Evaluation Office found that countries achieved about one-half of the proposed change in fiscal balance on average. About 60 percent of the programs underperformed.[1]

This command and control approach has the unfortunate side effect of making the IMF appear responsible for imposing harsh measures under adverse circumstances. The country's government, of course, agrees as a condition of the loan. This does not remove the IMF's responsibility in the minds of the country's electorate, the protestors at international meetings, and much of the public.

I believe that reform occurs when the country's leaders, a majority of its citizens, or both, want reform. Reform cannot be imposed successfully by external technocrats without local support. Local governments can, and do, frustrate reforms or ignore IMF (or World Bank) conditions. The reason Turkey, Brazil, Argentina, Ecuador, and others have repeated crises is that they do not reform enough to avoid them. They promise, but they do not reform. Command and control fails, as we expect it would.

The main reform needed at the IMF is development of an incentive system to replace command and control. Briefly, the IMF should establish a short list of policies or observable standards that countries should adopt to be assured of assistance in a crisis. It should use its surveillance to assure that a country meets the standards and publish the list of countries that do—and do not—get a guarantee of crisis assistance. The IMF would not help countries that do not meet the standard. To prevent crises from spreading, the IMF would assist countries that are victims of crises in their neighbors or trading partners.

Countries that adopt the standard would be subject to less risk. Hence, they could borrow more capital at a lower interest rate spread over U.S. Treasuries. Other countries would get less capital and pay a higher interest rate. This would give the government and the public considerable incentive to adopt stabilizing policies. The capital markets, not the IMF, would impose discipline.

The IMF itself is at risk. As my colleague Adam Lerrick has shown, that risk is a cost to the United States (and other countries) but does not appear in our budget. Lerrick estimates the hidden annual cost of the IMF to U.S. taxpayers currently as $1.5 to $2 billion. The principal component is the risk of default by one of the major debtors.

Four countries—Argentina, Brazil, Indonesia, and Turkey—owe about 70 percent of the IMF's outstanding debt. The IMF avoids default by lending more money or, as in the case of Argentina, by extending the maturity of the debt. As in the past, the IMF will come eventually to the Congress for a quota increase either because of a default or because its resources are allocated to unpaid loans.

Reform of this system should be a priority. The Administration, to its credit, has made considerable progress in getting collective action clauses into private debt contracts. Reform of debt repayment to international financial institutions and to lenders should be next on the agenda.

The World Bank

In the past few years, the Administration and the Congress have insisted on some of the reforms advocated by the majority report of the International Financial Institution Advisory Commission. Monitored grants replaced some of the lending to the poorest countries. The Administration has worked to set explicit conditions that can be monitored and has introduced incentives for countries to meet those conditions. In its most recent budget, Congress required an independent performance audit of some IDA programs and insisted on greater transparency at the World Bank.

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[1] "Fiscal Adjustment in IMF-Supported Programs," Independent Evaluation Office, IMF, September 2003, 7–8.

These steps are a good start, but only a start. The central issue about the World Bank with its many programs is: It spends or lends about $20 billion a year but neither we nor they know which programs are effective and warrant expansion or retention, and which are ineffective and inefficient and should be abandoned. The monitoring that Congress insisted upon for part of IDA should be extended to the entire bank and its affiliates.

There are two ways to gain the needed information. One is an independent performance audit by an outside agency. Another is development of an independent, internal group similar to the GAO or the IMF's Independent Evaluation Office. The current arrangement does not meet this standard.

An example will bring out the problem. We have considerable evidence that poverty has declined dramatically measured by the number of people living on $1 per day or less. The decline is most striking in Asia especially in China and India. Market opening, private investment, protection of property rights, and the like contributed much to the improvement. Where these spurs to growth and development are largely absent, as in Sub-Saharan Africa, poverty has increased. Did World Bank programs contribute to the reduction of poverty in Asia? Did these programs ameliorate worsening prospects in Africa? The Congress should require answers to these questions.

Further, the Bank should concentrate on the hard cases, the impoverished countries. The Bank should have an explicit program for graduation. Countries that can borrow in the capital markets with investment grade ratings should not receive subsidized loans. Those loans can be better used to provide potable water, sanitary sewers, disease control in the poorest countries, and to encourage countries to adopt institutional reforms that have been effective in spurring development. These include the rule of law, open trading arrangements, and protection of property rights and individual rights.

Finally, we should insist that the IMF and the Bank eliminate overlapping responsibilities. The World Bank should become a more effective development bank. The Bank has estimated that $1 trillion a year is paid in bribes in all countries. A large part is in the developing countries. Ridding the system of corruption is a major challenge. The IMF's responsibility should remain the maintenance of global financial stability. As a result of experience in the Asian crisis, many Asian countries have accumulated substantial reserves to protect them against crises and to avoid being put under IMF supervision. They have also established a regional lending system outside the IMF. This, too, opens questions about the future role of the IMF.

New leadership at the IMF and the end of James Wolfensohn's term at the Bank in 2005 provides an opportunity for new leadership, new approaches, and much needed reform.

PREPARED STATEMENT OF C. FRED BERGSTEN

DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

MAY 19, 2004

I want to focus my remarks today on the issue I believe is both most important to the functioning of the international monetary system and has been least satisfactorily addressed over the past 5 years of debate on the future of the international financial architecture: The exchange rate levels and exchange rate systems among the major economies of the world. This includes China and several other large economies in East Asia along with the United States, Euroland, and Japan. *I believe that the U.S. Treasury and the International Monetary Fund are violating their respective mandates concerning exchange-rate policy and that the Committee should address priority attention to this issue.*

Before addressing this major problem, I should note that there has been a considerable amount of good news on the exchange-rate front in recent years. A large majority of emerging market economies, and other developing countries, have shifted from fixed to flexible currency regimes and have thus insulated themselves from the types of crises that were so prevalent in the 1990's. In my view, this is in fact the central reform that has taken place in the international financial architecture and it will substantially reduce the systemic instability that was so prevalent in the recent past.

Paradoxically, the chief problem now relates to the currencies of the major countries. The immediate issue is the massive intervention in the currency markets by China, Japan, Korea, Taiwan, and perhaps a couple of other countries to keep their

exchange rates from rising against the dollar. *China's intervention in 2003 exceeded the total increase in its GDP. Japan's intervention in the first quarter of this year exceeded the global total of the U.S. current account and budget deficits, that is, the Bank of Japan by itself more than financed all of our twin deficits.* As a result of this intervention, all four countries cited here amassed foreign exchange reserves far in excess of any conceivable needs they might have—to levels of $850 billion for Japan, almost $500 billion for China, $200 billion for Taiwan, and $160 billion for Korea.

There are three very costly results of this process. First, much of the essential correction of the U.S. current account deficit is blocked. Despite the substantial (though gradual and orderly) fall of the dollar from early 2002 to early 2004 against the euro, Australian dollar, Canadian dollar, and a few other currencies, its trade-weighted average—which is what counts for purposes of trade adjustment—has only fallen by about 10 percent. This is largely because the Asian countries have resisted, partly or wholly, participating in the essential international adjustment.

Our external deficit has now largely leveled off as a result of the modest dollar decline and may fall by as much as $100 billion, though last week's record numbers for the deficit remind us of the severity of the problem. In any event, it will remain unsustainably high. I believe that we need to cut the deficit by at least one half, from its present level of $550 billion to $250–$300 billion, to achieve a sustainable position. This will require a dollar decline of 25–30 percent, from its highs of early 2002, 2½–3 times what has occurred to date.

Second, the distribution of the international currency (and thus economic) adjustment to date has been highly unbalanced. The euro and a few other currencies have risen by 40–50 percent against the dollar (and 10–25 percent on a trade-weighted basis). But the currencies of the Asian countries, which have been running the largest current account surpluses that are the primary counterparts of our deficits, have risen much less. In the key case of China, the currency has not increased at all because of its peg to the dollar. (Similar results obtain for Taiwan and a couple of the smaller countries.) This distorted distribution of currency movements has placed undue burdens on Europe, Australia, Canada, and several other countries. Since most of the Asian countries are growing rapidly and most of the Europeans are growing slowly, this distribution has dampened world growth. It has also understandably led the countries that have already appreciated to now resist significant additional appreciation until the Asians join the adjustment process, further truncating the necessary correction of the U.S. deficit.

Third, China's peg to the dollar essentially blocks the participation of all of East Asia (even, to a partial extent, Japan) in the needed adjustment process. China is the world's most competitive major economy, and has become even more competitive as it has ridden the dollar down against virtually all other currencies, and its neighbors are understandably reluctant to let their currencies rise against the dollar because doing so would mean they would also rise against the renminbi. Thus Korea, Taiwan, and Japan have resisted fully participating in the global adjustment process along with China; their own trade-weighted exchange rates have either risen minimally (Japan and Korea) or declined (Taiwan).

The obvious question is what to do about all this? The Treasury Department reported to the Congress on April 15 that it is "encourag(ing) . . . policies for large economies that promote a flexible market-based exchange rate." However, the report concluded that "no major trading partner of the United States met the technical requirements for designation (for currency manipulation) under the Omnibus Trade and Competitiveness Act of 1988." Moreover, the International Monetary Fund "concur(red) with our conclusions" when Treasury consulted with them, as required by the statute.

These conclusions by both the Treasury and the IMF are patently incorrect. China's huge intervention, which has prevented any appreciation of its currency against the dollar, is clearly intended to maintain an undervalued exchange rate to strengthen the country's international competitive position. Japan's even larger intervention has not precluded some significant rise in the yen but that rise would clearly have been much greater in the absence of Japanese official action. Similar conclusions obtain, on a lesser scale from a global standpoint, for Korea and Taiwan. *Hence the Treasury Department by failing to act against this widespread manipulation is clearly violating both the letter and spirit of U.S. law.*

The IMF is likewise violating its own rules. Article IV, Section 1 (paragraph iii) of its Articles of Agreement stipulate that each member shall "avoid manipulating exchange rates . . . in order to prevent effective balance of payments adjustment or to gain unfair competitive advantage over other members." The Fund itself (Article IV, Section 3) is to "exercise firm surveillance over the exchange rate policies of members" and, under the principles and procedures adopted in 1977 (after the

initial advent of floating exchange rates), the first indicator of the need for such surveillance is "protracted, large-scale intervention in one direction in the exchange market." *This is exactly what is happening in all the East Asian countries cited yet no discernible Fund action has been taken.*

The problem is further compounded by the erroneous nature of the advice that has been offered by the U.S. Treasury Department and the Fund (and the G–7) in their discussions of the issue with the Chinese. *They have urged China to liberalize or dismantle its exchange controls, and float its currency, despite the totally unrealistic nature of any such move for at least a few more years* in light of the weakness of China's banking system. Such advice, if accepted, could even produce net capital outflows from China that would *weaken* the renminbi, and intensify the global adjustment problem. *China should instead retain its capital controls and fixed exchange rate, for a while longer, and deal with the immediate international problem (as well as its drastic domestic overheating) through a one-time revaluation of 20–25 percent.*

I conclude that the most urgent unresolved issue of the international financial architecture and the role of the IMF, at the current time, is how to get all major trading countries to participate fairly and effectively in the international adjustment process. Countries are never eager to adjust, so rules of the game have been developed at the national and international levels to assure that they do so. *Both the Treasury and the International Monetary Fund are violating their obligations to promote global adjustment, however, and I urge the Committee insist that they do so.*

PREPARED STATEMENT OF DOUGLAS HOLTZ-EAKIN

DIRECTOR, CONGRESSIONAL BUDGET OFFICE

MAY 19, 2004

Mr. Chairman and Members of the Committee, I appreciate the opportunity to appear today to discuss the costs and budgetary treatment of U.S. support for multilateral financial institutions (MFI's).[1] At the request of the House Budget Committee, the Congressional Budget Office (CBO) has been examining the budgetary presentation of a variety of the Federal Government's financial transactions. The preliminary analysis that I present today derives from that effort.

The United States supports MFI's to further its international economic and political policy objectives. In the process, it incurs costs. My focus today will not be the benefits of MFIs' operations but, instead, the economic measurement and budgetary presentation of the costs of MFIs' activities. I hope to convey the following key points:

- MFI's lend to countries that have often gone into arrears and sometimes defaulted on their debts to other lenders.
- The operations of MFI's embody subsidies to borrowing countries.
- Some of the features of world financial markets that protected MFI's from loan losses in the past may not do so in the future.
- Therefore, U.S. taxpayers may bear some portion of those costs in the future. The extent of that exposure will depend on the financial structure of the MFI and the laws and institutions that link it, the United States, and other relevant parties and the United States' decision about replenishing the MFI's resources.
- To support well-informed policy decisions, the Federal budget should recognize the magnitude of the United States' financial commitments in a consistent fashion, including those of the various MFI's.
- The current budgetary treatment of MFI's may fall short of that goal.

My statement does not attempt a comprehensive survey of MFI's, but rather focuses on three of the most important ones: The World Bank's International Development Association (IDA), which lends at "concessional" terms—providing loans at below-market rates and with very long terms; the International Bank for Reconstruction and Development (IBRD), which undertakes most of the World Bank's "nonconcessional" operations; and the International Monetary Fund (IMF). Each

[1] MFI's include the International Monetary Fund, multilateral development banks, and several other specialized financial institutions. Such banks include the World Bank, the Asian Development Bank, the Inter-American Development Bank, the African Development Bank, the North American Development Bank, and the European Bank for Reconstruction and Development. Other specialized organizations include the International Finance Corporation, the Inter-American Investment Corporation, and the Multilateral Insurance Guarantee Association.

MFI poses different economic risks and different conceptual issues for the presentation of U.S. commitments in the Federal budget.

The Economic Costs of MFIs' Operations

All loans present risks to the lender of nonrepayment (credit risk); and MFI's lend to particularly risky clients. Member countries that have borrowed from MFI's have often gone into arrears and sometimes defaulted on their debts to other lenders. They have restructured their debts, changed their future debt payment through rescheduling, and sometimes asked for debt forgiveness. For example, since 1990 borrowing members of the three MFI's have rescheduled about $270 billion of their loans from other governments—a figure that represented almost 60 percent of their nearly $450 billion in outstanding bilateral debt as of 2002. They have also rescheduled and reduced their debts to private banks. The resulting losses have been estimated at $61 billion between 1989 and 1995, or about one-third of the private-sector portfolio of $191 billion in loans to those borrowers.[2]

Reflecting their credit risk, the debts issued directly by the governments of borrowing member countries—sovereign bonds—trade at a discount below U.S. Treasury securities with similar maturities and coupons. For example, such discounts have reached as much as 35 percent for Brazil and 80 percent for Argentina, both important borrowers from MFI's.

MFIs' lending embodies subsidies to the borrowing countries. The economic magnitude of such subsidies can be gauged by comparing the book values of an MFI's loans—the dollar face value at the time the loans are made—with the corresponding market value. To estimate the market value, CBO used the market prices of borrowing countries' bonds with terms (maturities, coupon payments, and so forth) adjusted to be similar to those of MFI loans.

Several important caveats apply to those calculations. First, as discussed at length below, the use of market prices as a point of comparison assumes lenders have equal seniority—a level playing field where one lender will not be paid before the others. Second, as with all such valuation estimates, they represent a snapshot; one could choose to make a valuation at several points in time. Third, CBO relied on several simplifying assumptions and approximations, including the adjustments to bonds terms, that were not exact. The results of the calculations are, therefore, best considered as approximations of the relevant costs.

The International Development Association

Donor countries provide resources through capital subscriptions to IDA. It then lends that money to low-income countries that may have difficulty borrowing on international markets. The loans carry a zero interest rate, or, on occasion, IDA provides funds as grants. As of June 2003, its portfolio of outstanding loans had a book value of about $115 billion (see Table 1). In contrast, the market value of the loans was only about $20 billion.[3] Therefore, subsidies by IDA totaled about $95 billion. Of that amount, about $7.1 billion resulted from lending that occurred in the previous fiscal year.

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[2] William R. Cline, "International Debt Re-examined," in Federal Deposit Insurance Corporation, *An Examination of the Banking Crises of the 1980's and Early 1990's,* vol.1 of *History of the Eighties: Lessons for the Future* (1995), pp. 234–235.

[3] For many IDA borrowers, no sovereign debt is traded in public markets. However, even assuming optimistically that IDA's borrowing members could borrow on the same terms as the United States, the length of loans and repayment schedules yield subsidies over 80 percent. Therefore, the probability of defaults has little influence on the estimated value of the loans.

Table 1.

The International Development Association's Portfolio, June 2003

(Billions of dollars)

	Book Value	Market Value	Difference	Difference as a Percentage of Book Value
Total Portfolio	115.1	20.3	94.8	82.4
2003 Lending[a]	7.3	0.2	7.1	97.6

Sources: World Bank and preliminary estimates by the Congressional Budget Office.

a. Loans made during the World Bank's fiscal year ending June 30, 2003.

The International Bank of Reconstruction and Development

Member countries also pay in capital subscriptions to IBRD. Unlike IDA, however, IBRD increases its capacity to lend to developing countries by selling bonds in international capital markets.[4] In June 2003, IBRD had $11.5 billion in paid-in capital and $108.6 billion in outstanding debts. Those resources helped fund $116.2 billion in loans to developing countries.[5] In addition to paid-in capital, IBRD members have agreed to provide another $178 billion in callable capital. Of that total capital, about $110 billion is payable by high-income industrial countries.

In June 2003, IBRD's portfolio of all outstanding loans had a book value of $158 billion (see Table 2). The market value of the loans was considerably less—about $111 billion. Again, the gap between the book value and market value, or $47 billion, reflects the estimated costs of the subsidies inherent in IBRD's portfolio. Of that total, $7 billion in subsidies arose from IBRD's $11.2 billion in lending during the previous fiscal year. Those operations in 2003 give an indication of the economic subsidies in new loans. At the same time that IBRD originated about $11 billion in new loans, the market valued them at about $4 billion.

Table 2.

The International Bank of Reconstruction and Development's Portfolio, June 2003

(Billions of dollars)

	Book Value	Market Value	Difference	Difference as a Percentage of Book Value
Total Portfolio	157.8	110.8	47.0	29.8
2003 Lending[a]	11.2	4.3	7.0	62.1

Sources: World Bank and preliminary estimates by the Congressional Budget Office.

a. Loans made during the World Bank's fiscal year ending June 30, 2003.

The International Monetary Fund

IMF assigns member countries "quotas," or capital subscriptions. Members pay their quota in two components. First, about a quarter is in highly liquid currencies, easily converted to other similar currencies. The remainder is in notes denominated

[4] The World Bank also has $26.4 billion in retained earnings to buffer against defaults without calling for more capital. See World Bank, *Annual Report, 2003,* vol.1, table 1.

[5] World Bank, *Annual Report, 2003,* vol.1, table 11.

in the member's own currency. Altogether, IMF members have paid quotas totaling about $300 billion.[6] In exchange, member countries have the right to withdraw the highly liquid currencies that they paid in and to borrow such currencies beyond what they paid in.

When countries draw beyond their paid-in quotas, the terms for such loans vary, with repayment periods ranging from 2 years to 10 and interest rates starting from a basic rate (at present, about 2.7 percent) and adding as much as 800 basis points (8 percentage points) for loans that are large relative to a member's quota.[7]

For many member countries, the economic advantage arising from membership in IMF lies in being able to effectively exchange their own currency for highly liquid foreign currencies. Suppose, for example, that the Government of Argentina needed to make a payment on non-IMF international debts denominated in dollars. The government might perceive that buying the necessary dollars using Argentine pesos on international currency markets would adversely affect the dollar/peso exchange rate. If so, the government could borrow dollars from IMF, leaving the peso/dollar exchange rate unaffected, even as Argentina used those borrowed dollars to settle its debt obligation.

How does such a transaction entail an economic cost? The main potential for subsidy arises when IMF lends strong, liquid currencies, such as the dollar, and gets in exchange from the borrowing countries promissory notes for repayment 2 to 10 years in the future that they may be unable to fully honor.

In June 2003, IMF had a portfolio of outstanding loans with a book value of $121 billion. However, valued using the market prices of comparable private-sector bonds, the portfolio would be worth $60 billion. That is, IMF members lent $121 billion in exchange for assets with an estimated value of $60 billion and thereby provided subsidies of about $61 billion. Of that amount, $6.4 billion arose in the previous fiscal year, when IMF made loans of $41 billion that had a market value of roughly $35 billion.

Table 3.

The International Monetary Fund's Portfolio, June 2003

(Billions of dollars)

	Book Value	Market Value	Difference	Difference as a Percentage of Book Value
Total Portfolio	121.4	60.1	61.3	50.5
2003 Lending[a]	41.1	34.8	6.4	15.5

Sources: International Monetary Fund and preliminary estimates by the Congressional Budget Office.

a. Loans made during the International Monetary Fund's fiscal year ending June 30, 2003.

Estimating the U.S. Share in the MFI's

An important step in assessing the potential treatment of U.S. commitments in the Federal budget is gauging the magnitude of the country's role in MFI's. The size of the United States' share depends on its share of the capital or of the quotas of the MFI in question. Those shares are set out in MFIs' articles of agreement and in their boards of governors' resolutions.

For IDA, since all funds are actually paid in, the United States' share is a relatively unambiguous 21.7 percent.

For IBRD, the United States' nominal share of paid-in and callable capital is 14 percent. Alternatively, it may be the case that other countries are unable to absorb their full nominal share. If so, a more relevant indicator may be the market value. The U.S. share of the market value of that capital is about 22 percent. Thus, a rough estimate of the U.S. share lies in the range of 14 percent to 22 percent.

[6] International Monetary Fund, *Financial Statements of the International Monetary Fund, Quarter Ended January 31, 2004,* Balance Sheet, p. 3.

[7] *How Does the IMF Lend: A Factsheet* (April 2003), available at *http://www.imf.org/external/np/exr/facts/howlend.htm;* and SDR Interest Rate, Rate of Remuneration, Rate of Charge and Burden Sharing Adjustments, May 16, 2004, available at *http://www.imf.org/external/np/tre/sdr/burden/2004/051004.htm.*

For IMF, the United States' share is based on the amount of gold and currency that it has paid in over the years. Nominally, the U.S. share of the fund's resources and obligations is 17 percent. However, only part of IMF's resources can be used to settle accounts, the usable currencies—the U.S. share of which is about 22 percent. Thus, an estimate of the U.S. share lies between 17 percent and 22 percent.

Changes in Financial Markets Affecting MFIs' Prospects for Loan Losses

The preceding discussion contained estimates of the value of MFI portfolios—in particular, new lending—using market prices for publicly traded bonds and assuming that the debts owed to MFI's are on a level playing field with loans from other lenders. But if the claims of MFI's were senior to the claims of private bondholders, then MFI loans would be less risky. Accordingly, using prices of those sovereign bonds to estimate the value of MFIs' portfolios would underestimate the value of MFI loans because higher seniority would mean that the loans would be paid off first in the event of financial trouble in the borrowing country. Therefore, using market rates would overstate the costs of the subsidies arising from MFI loans.

Seniority, particularly the future treatment of new lending, therefore, bears critically on determining the potential future costs of U.S. participation in MFI's. According to both IMF and the World Bank, MFI's do not have seniority established by law or by the provisions of the loan agreements. But even without such legal standing, seniority can arise in practice. Determining such "practical seniority" is complex.

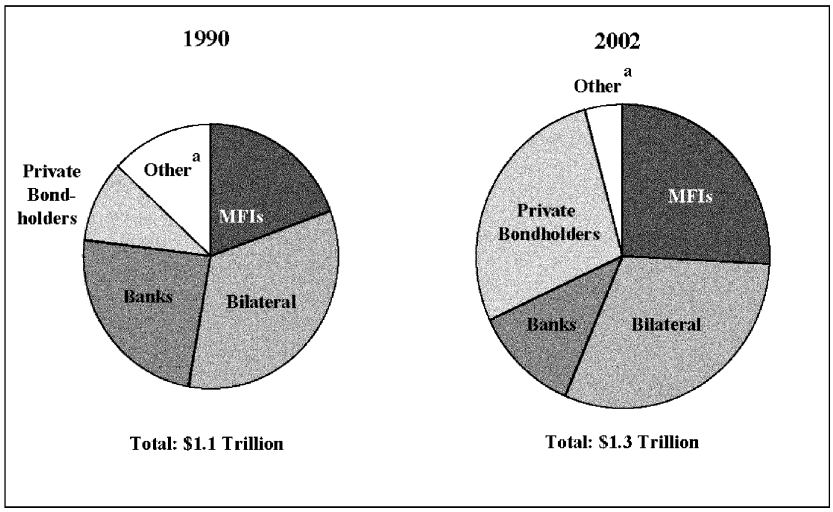
For the past 60 years, most borrowers have fully repaid their debts to MFI's, sometimes even as they were going into arrears, rescheduling, or requesting forgiveness on their debts to other lenders. From that record, one could conclude that the claims of MFI's are not subject to the same risk as the publicly traded bonds of borrowing countries.

However, some of the features of world financial markets that insulated MFI's from defaults in the past may not do so in the future. The effective seniority of MFI loans has been weakened by the reduced importance of bilateral (government-to-government) and commercial bank lending and by the increasing importance of private bondholders. Those changes in the sources of lending have reduced the flexibility of rescheduling debt payments to MFI's.

At the beginning of the 1990's, three groups had made substantial loans to MFI member countries. The MFI's themselves lent nearly exclusively to governments. Other countries, or bilateral lenders, organized for debt-negotiation purposes as the "Paris Club," provided loans or loan guarantees to borrowing governments. Finally, private international banks, organized for debt-negotiation purposes as the "London Club," made private loans to governments or to private agents who had guarantees from MFI borrowing members. Each group of lenders accounted for a sizable share of the debts of MFI borrowing members (see Figure 1). As I shall describe, IMF played a key role in coordinating the groups.

Figure 1.

Sources of MFI Borrowers' Public and Publicly Guaranteed Debts, 1990 and 2003



Source: World Bank, *Global Development Finance Online*.

a. "Other" consists of debts owed to other private creditors.

When a borrowing member of an MFI could not pay all of its loans, it would go to IMF and negotiate a plan for restructuring and rescheduling its debts, usually on the condition of changing its domestic economic policies. Negotiated agreements with IMF set out, among other terms, the maximum total debt repayment that a country would be expected to pay in each year.

The participation of the Paris Club, which would meet to consider debt forgiveness or rescheduling, was often crucial to success. In those negotiations, the Paris Club operated strictly in tandem with IMF. In particular, the Paris Club did not meet to consider rescheduling unless the debtor had negotiated a "program" with IMF.

Similarly, according to documentation by the Paris Club, a prerequisite for its own agreements was "burden sharing" with the commercial banks constituting the London Club. Consequently, IMF programs generally included payments to the London Club.

IMF programs provided for rescheduling debts owed to commercial banks and bilateral lenders and did not provide for rescheduling MFI debts; that is, MFI's were paid first. As a practical matter, then, IMF programs gave MFI's seniority over bilateral lenders and private banks.

Historically, the Paris Club's willingness and ability to make new financial resources available to MFI borrowers through rescheduling has been a key element in establishing MFIs' practical seniority. For the Paris Club to continue to protect MFIs' seniority in that way, though, the debts owed to Paris Club creditors must be sufficiently large in relation to the debts owed to MFI's. If the amounts owed to the Paris Club are smaller, rescheduling the debts will be less helpful in permitting the continued servicing of the MFI debts.

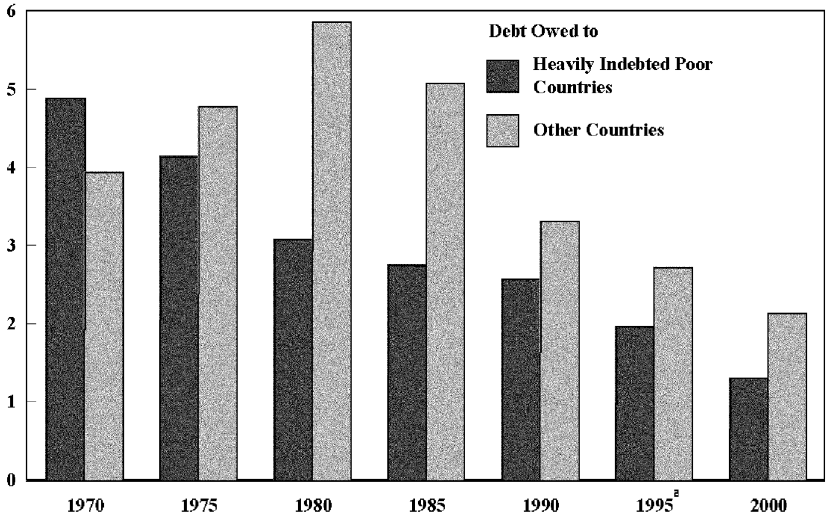
MFI lending members have experienced what happens when bilateral debts are not large enough to be rescheduled and, thereby, permit the servicing of MFI loans. For what are termed "heavily highly indebted poor countries," bilateral debts had declined steadily relative to the debts owed to MFI's. By 1995, there was only $2 in bilateral debt per dollar of MFI debt (see Figure 2). Rescheduling Paris Club debts could not provide enough additional resources to permit continuing the timely servicing of the debts owed to MFI's. In the fall of 1996, the World Bank and IMF proposed relief for those countries, which came in the form of additional grants by the United States and other wealthy countries, sales of gold by IMF, and grants

from the World Bank (drawing on its retained earnings).[8] So far, the relief provided to the heavily indebted poor countries has amounted to $31 billion.[9]

Figure 2.

Countries' Debt Owed to Bilateral Lenders and Banks per Dollar of Debt Owed to MFIs

(Dollars)



Source: World Bank, *Global Development Finance Online*.

a. For heavily indebted poor countries, restructuring debts owed to the bilateral lenders in the Paris Club and to private banks in the London Club stopped working in 1995 as a means of keeping the countries current in their payments. In 1996, lending members of the World Bank and International Monetary Fund began providing them additional resources.

For other countries borrowing from MFI's, too, bilateral and bank debt relative to MFI debt has fallen, from almost $6 per dollar of MFI debt in 1980 to about $2 in 2000. Argentina and Brazil, for example, have bilateral debts amounting to less than 10 percent of MFI debts, so any rescheduling of bilateral debts would have little relevance in facilitating the repayment of their MFI debts.

A second shift in financial markets that may have diminished MFIs' practical seniority is the increasing importance of private bondholders. In 1990, private bondholders held small amounts of sovereign debt, but in 2002, they held about one-fourth—more than that owed to MFI's (see Figure 1). MFI's do not have legal seniority over private bondholders, and the bondholders are subject to none of the institutional arrangements among the MFI's, the Paris Club, and the London Club that coordinated payments and fostered MFIs' practical seniority in the past.[10]

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[8] See World Bank, "The HIPC Debt Initiative," available at *http://www.worldbank.org/hipc/about/hipcbr/hipcbr.htm;* and International Monetary Fund, "Debt Relief Under the Heavily Indebted Poor Countries (HIPC) Initiative" (April 2004), available at *http://www.imf.org/external/np/exr/facts/hipc.htm.*

[9] International Monetary Fund, "Debt Relief Under the Heavily Indebted Poor Countries (HIPC) Initiative."

[10] In 2003, IMF proposed a "sovereign debt restructuring mechanism" (SDRM) that would provide it legal seniority over private bondholders. Those bondholders objected, and the U.S. Treasury did not support the change. Consequently, IMF dropped the proposal for the SDRM.

See International Monetary Fund, *Proposals for a Sovereign Debt Restructuring Mechanism (SDRM): A Factsheet,* available at *http://www.imf.org/external/np/exr/facts/sdrm.htm;* Paul Blustein, "Bankruptcy System for Nations Fails to Draw Support," *Washington Post,* April 2, 2003, available at *www.washingtonpost.com;* and Anne O. Krueger, First Deputy Managing Director, International Monetary Fund, address given at the International Monetary Seminar,

Moreover, as borrowing countries turn more toward lenders in the private sector, during times of distress they may be more willing to continue to service their private-sector debts in order to retain access to those lenders. That shift may further diminish the practical seniority that MFI's have held.[11]

The legal landscape, too, raises the possibility of diminishing practical seniority for MFI's. In a recent case, a private U.S. creditor did not accept Peru's restructuring of its foreign debt.[12] The creditor obtained a judgment against Peru in the Federal District Court for the Southern District of New York. However, the creditor was unable to attach assets in the United States but then obtained an order from a Brussels court enjoining the Euroclear System from processing Peru's payments on the restructured bonds. The creditor was successful in arguing that Peru could not pay one group of creditors before paying it because of the *"pari passu"* clause in the bond agreements requiring equal treatment in payments to creditors.

The argument accepted by the Brussels court is currently before the Federal District Court for the Southern District of New York in connection with the debt of Argentina. Concerned about the possibility that the private creditors would be successful in applying the Brussels decision, the Department of Justice submitted a "statement of interest" brief contending that any interpretation of the *pari passu* clause that would prevent nations from continuing to service their debts owed to MFI's in times of financial crisis was "contrary to U.S. interests."[13] The ongoing litigation leaves the future of MFIs' seniority unresolved.

To What Extent Could Losses by MFI's Accrue to the U.S. Budget?

As operating entities, MFI's have retained earnings, reserves, and precautionary balances that could cover some loan losses. Those resources might postpone calls on the U.S. budget. However, MFI's may not have enough resources to cover all such losses; in fact, to the extent that MFIs' assets are correctly valued at market prices, the institutions currently have a negative net worth. Moreover, as economic entities, MFI's have no independent source of resources beyond those contributed by their members or any earnings from those contributions that the MFI's retain (which remain the property of their members).

Under IDA's articles of agreement, no further call on U.S. resources may occur as a result of the association's activities. Furthermore, because IDA borrowers have been repaying their loans, the association has funds on hand. But the risk revealed by discounts on private-market bond prices and the long terms of the loans at a zero interest rate suggest a high probability of future credit losses, the potential exhaustion of IDA's capital, and the need for additional resources. In those circumstances, if the Congress followed past practice, it might choose to appropriate additional funds to IDA. However, IDA's articles of agreement do not compel the United States to honor any of the association's commitments over and above the money paid in.

IBRD's articles of agreement provide for no automatic call on U.S. resources as a result of the bank's activities. In the event that the developing countries borrowing from IBRD did not pay their loans and the defaults exceeded IBRD's retained earnings, it would have to call for capital to repay the outstanding debts held by its bondholders. Over and above the $2 billion in capital that the United States has already paid in, the country has agreed to pay in another $30 billion in callable capital should such an event materialize.[14]

In addition to its paid-in capital of about $11 billion, IBRD has $26 billion in retained earnings from its previous operations. It could use those funds to cover loan losses before calling for additional capital. Because the U.S. share of IBRD's resources is between 14 percent and 22 percent, the loss of those resources would represent a substantial cost to the United States. If defaults exceeded retained earnings and paid-in capital, IBRD would have to call for capital, including from the United States. The Congress has appropriated about $7.4 billion for that purpose, so the Treasury could provide up to that amount without additional Congressional action.

Banque de France, May 13, 2003, available at *http://www.imf.org/external/np/speeches/2003/051303a.htm.*

[11] A U.S. Treasury official recently noted the rising importance of private-sector lending and its potential for further growth. See John B. Taylor, Under Secretary of Treasury for International Affairs, address given at the IMF conference in honor of Guillermo Calvo, April 16, 2004, available at *http://www.treas.gov/press/releases/js1473.htm.*

[12] *Elliott Assocs., L.P.,* v. *Banco de la Nacion,* 194 F.R.D. 116 (S.D.N.Y. 2000).

[13] See David N. Kelley, U.S. Attorney for the Southern District of New York, Statement of Interest of the United States before the United States District Court, Southern District of New York, *Macrotecnic International Corp.* v. *Republic of Argentina,* 02 CV 5932 (TPG), and EM, Ltd., v. Republic of Argentina, 03 CV 2507 (TPG).

[14] World Bank, *Annual Report, 2003,* vol.1, table 11.

IMF, like IDA, has no claim under its articles of agreement to more funds from the United States. Its holdings of gold, amounting to $41.3 billion, cannot be used to finance its lending operations, but it has been building precautionary balances over the past several years; in 2003, those balances amounted to about $8.4 billion.[15] Any defaults would reduce the balances but would not automatically lead to a call on U.S. resources.

The Budgetary Treatment of MFI's

The budgetary treatment of the costs associated with MFI's has changed over time and is not uniform among them.

Since 1960, for multilateral development banks (MDB's), including the World Bank and other banks not discussed in this statement, the budget has recorded $4.6 billion in paid-in capital and $39.5 billion in direct contributions. The budget reflected those transactions in the traditional manner, as both budget authority and outlays provided to the MDB's.

Over that period, the United States has made about $62 billion in commitments of callable capital to the MDB's. Before 1981, the Congress appropriated budget authority to the U.S. Treasury to back the commitments. Those appropriations totaled slightly more than $12 billion through 1980, and all of those funds remain as unspent, unobligated balances at the Treasury. In 1981, the approach of specifically appropriating budget authority for callable capital was dropped. The Congress has continued to provide new limitations on callable capital, bringing the total commitment level since 1960 up to about $60 billion, with about $22 billion provided in the 1980's and $34 billion in the 1990's (only about $1 billion in callable capital has been provided in the past 5 years). No budgetary resources have been specifically appropriated to cover those additional commitments.

For IMF over the past 40 years, the budget has recorded $42.4 billion in quota payments and $9.7 billion in other special-purpose payments. Dating back to the 1967 President's Commission on Budget Concepts, transactions with IMF have been recorded as a means of financing because the United States receives special drawing rights equal to the amounts paid in (and therefore the transaction has been viewed as an exchange of assets of equal value).

However, there are other financial activities associated with the United States' membership in IMF. When the U.S. Treasury sends money to IMF, it gets a reserve position with the fund that forms a portion of the Treasury's monetary assets. IMF pays interest to the Treasury on most of its reserve position. Those interest collections are recorded in the budget as net interest receipts. The amount of interest received by the U.S. Government is net of the charges (burden sharing) that IMF levies on creditor countries to cover the estimated risk of IMF loans. In contrast to those earnings, however, the Treasury has realized interest costs because the money on deposit with IMF increases the requirement for the Treasury's borrowing from the public.

As with any foreign exchange asset, the dollar value of the reserve position rises or falls with the exchange rate. The changes in that valuation are recorded in the budget as outlays. If the dollar strengthens, the value of other currencies and thus the reserve position decreases, and that change is recorded as a positive outlay. If the dollar falls in value, the value of the reserve position in dollars increases, and the change is recorded as a negative outlay. Those valuation adjustments are recorded in the budget under the international affairs area.

The current budgetary treatment does not fully reflect the U.S. share of the credit risk associated with the lending and other transactions of MFI's. However, the budget records actual cashflows to and from MFI's, and resources remain in the Treasury to cover a portion (about one-fifth) of the United States' commitments for calls for capital.

When considering how to display in the budget the costs associated with MFI's, three important questions stand out:

- Should the budget record primarily the cashflows to and from MFI's, as it does today, or should it seek to also record and provide resources for potential future risks associated with MFIs' lending and other transactions?
- If the latter, after the funds are first provided, should the estimates of costs be updated and the differences recorded in the budget on a regular (for example, annual) basis?

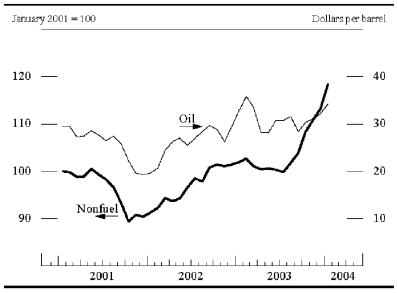
[15] See International Monetary Fund, *Financial Risk in the Fund and the Level of Precautionary Balances,* February 3, 2004, table 4, as of October 2003, available at *http://www.imf.org/external/np/tre/risk/2004/020304.pdf.*

- Should the budget attempt to record the credit risk associated with the United States' past investment and commitments to MFI's or only the risks associated with the new resources provided?

CBO's work on these issues is not yet complete. The analysis will be more fully developed and subject to CBO's formal review process, which includes review by outside experts. The completed analysis will be presented in a forthcoming paper.

Mr. Chairman, that concludes my statement today. I welcome any questions that you or Members of the Committee may have.

Prices of oil and of nonfuel commodities

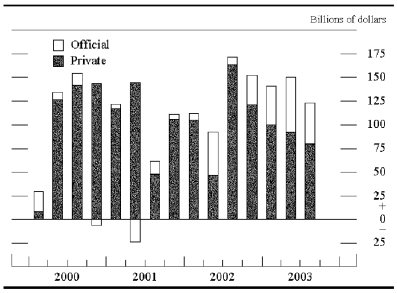


NOTE. The data are monthly and extend through January 2004. The oil price is the spot price of West Texas intermediate crude oil. The price of nonfuel commodities is a weighted average of thirty-nine primary-commodity prices from the International Monetary Fund.

of the dollar and strong global demand, particularly from China.

In 2003, the spot price of West Texas intermediate (WTI) crude oil averaged more than $31 per barrel—the highest annual average since the early 1980s. The spot price of oil began to rise at the end of 2002 when ethnic unrest in Nigeria and a nationwide strike in Venezuela sharply limited oil supplies from those two countries. In the first quarter of 2003, geopolitical uncertainty in the period leading up to the war in Iraq also added upward pressure on oil prices. On March 12, the spot price of WTI closed at $37.83 per barrel, the highest level since the Gulf War in 1990. When the main Iraqi oil fields had been secured and it became apparent that the risks to oil supplies had subsided, the spot price of WTI fell sharply to a low of $25.23 per barrel on April 29. However, oil prices began rising again when, because of difficult security conditions, the recovery of oil exports from Iraq was slower than expected. Prices also were boosted in September by the surprise reduction in OPEC's production target. In the fourth quarter of 2003 and early 2004, strengthening economic activity, falling oil inventories, and the continued depreciation of the dollar contributed to a further run-up in oil prices.

U.S. net financial inflows

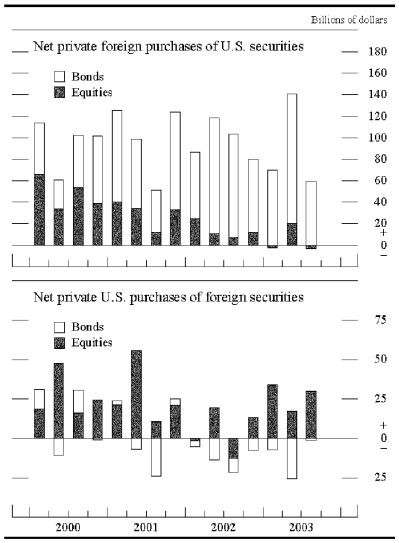


SOURCE. Department of Commerce.

The Financial Account

The financing counterpart to the current account deficit experienced a sizable shift in 2003, as net private inflows fell while foreign official inflows increased. Private foreign purchases of U.S. securities were at an annual rate of about $350 billion through November, about $50 billion lower than in the previous year. Private foreign purchases of U.S. equities continued to recede, and, although the level of bond purchases was little changed in the aggregate, foreign purchases shifted somewhat away from agency bonds and toward corporate bonds. Over the same period, purchases by private U.S. investors of foreign securities increased nearly $80 billion. Accordingly, net inflows through private securities transactions decreased

U.S. net international securities transactions



SOURCE. Department of Commerce and the Federal Reserve Board.

markedly. In contrast, foreign official purchases of U.S. assets surged to record levels in 2003, with the accumulation of dollar reserves particularly high in China and Japan.

Compared with the pace in 2002, foreign direct investment in the United States increased, as merger activity picked up and corporate profits improved. U.S. direct investment abroad held relatively steady at a high level that was largely the result of continued retained earnings. On net, foreign direct investment outflows fell about $50 billion through the first three quarters of 2003.

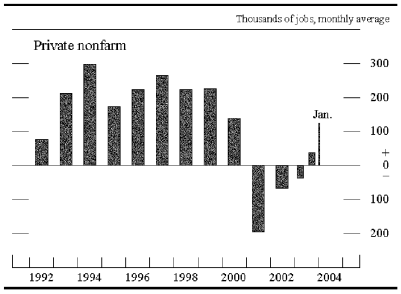
The Labor Market

Employment and Unemployment

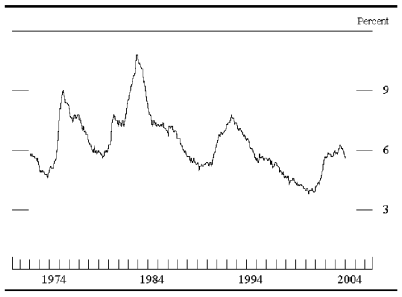
With economic activity still sluggish during the first half of 2003, the labor market continued to weaken. Over the first eight months of the year, private nonfarm payroll employment fell, on average, more than 35,000 per month, extending the prolonged period of cutbacks that began in early 2001. The civilian unemployment rate, which had hovered around 5¾ percent for much of 2002, moved up to 6¼ percent by June. However, by late in the summer, the labor market began to recover slowly. Declines in private payrolls gave way to moderate increases in employment; over the five months ending in January, private nonfarm establishments added, on average, about 85,000 jobs per month. By January, the unemployment rate moved back down to 5.6 percent.

During the late summer and early fall, prospects for business sales and production brightened, and firms began to lay off fewer workers. Initial claims for unemployment insurance dropped back, and the monthly Current Population Survey (CPS) of households reported a decline in the number of workers who had lost their last job. However, for many unemployed workers, jobs continued to be difficult to find, and the number of unemployed who had been out of work for twenty-seven weeks or more remained persistently high. The labor force participation rate, which tends to be sensitive to workers' perceptions of the strength of labor demand, drifted lower. Although the CPS indicated a somewhat greater improvement in employment than the payroll report—even after adjusting for conceptual differences between the two measures—the increase in household employment lagged the rise in the working-age population, and the ratio of employment to population fell further during 2003.

Net change in payroll employment



Civilian unemployment rate



NOTE. The data are monthly and extend through January 2004.

The modest upturn in private payroll employment that began in September was marked by a step-up in hiring at businesses supplying professional, business, and education services, and medical services continued to add jobs. Employment in both the construction industry and the real estate industry rose further, although the number of jobs in related financial services dropped back a bit as mortgage refinancing activity slackened. At the same time, although manufacturers were still laying off workers, the monthly declines in factory employment became smaller and less widespread than earlier. Employment stabilized in many industries that produce durable goods, such as metals, furniture, and wood products, as well as in a number of related industries that store and transport goods. In several other areas, employment remained weak. Manufacturers of nondurables, such as chemicals, paper, apparel, and textiles, continued to cut jobs. Employment in retail trade remained, on net, little changed.

Productivity and Labor Costs

Business efforts to increase efficiency and control costs led to another impressive gain in labor productivity last