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Henry M. Paulson Jr.

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U.S. DEPARTMENT OF THE TREASURY

Press Center



Testimony of Treasury Secretary Henry M. Paulson, Jr. before the House Committee on Financial Services on the State of the International Financial System

6/20/2007

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Washington, DC -- Thank you, Chairman Frank, Ranking Member Bachus and Committee members, for the opportunity to appear today to discuss the state of the international financial system.

The Bush Administration is committed to strengthening U.S. and global economies by promoting domestic and international growth. Our policies encourage openness, competition, financial stability, and development, both at home and abroad.

As countries around the world have reformed and opened their economies, global integration has provided businesses greater access to markets around the world, more choices for consumers, and reduced the prices of goods and services, which is a real benefit, especially to those with lower incomes in the United States and abroad.

Our aim is to help ensure that more people share in the benefits created by economic growth and trade opportunities, to help every nation reduce poverty and build a strong middle class.

To further expand on these points, my testimony will touch on the following:

- The economic outlook for the U.S. and the global economy.
- Contributions that the U.S. and other economies have made toward global re-balancing and additional steps that are required.
- The vital importance of continued U.S. openness to foreign investment and trade, while ensuring national security, to keep our economy dynamic and competitive; and the imperative of addressing anxieties about globalization and successfully concluding the Doha trade round.
- Why the international financial institutions are key instruments through which to pursue U.S. economic interests abroad and what needs to be done to maintain their relevance and credibility. On the IMF side, this includes an overhaul of governance structure.
- The importance of multilateral debt and development initiatives, which serve U.S. interests – both moral and practical – by lifting people out of poverty, promoting private-sector led growth, helping rebuild war-torn societies.
- How the Treasury is working bilaterally and multilaterally to detect and disrupt financial networks related to money laundering, terrorism, WMD proliferation.
- How Treasury's international assistance program supports the achievement of many of these goals.

U.S. and Global Economic Developments

A strong U.S. economy benefits the international economy, and the U.S. economy is strong. Most recent data show that employers are hiring more than 100,000 people per month, businesses are starting to invest again and consumers are spending at a healthy pace.

The global economy continues to be very robust, with sustained strong growth from 2003 through 2006. In 2006, global GDP grew 5.4 percent, the highest rate of growth in over 30 years. The International Monetary Fund (IMF) projects continued strong growth, at about 5 percent, in 2007 and 2008. The U.S. and China are key engines of global growth, accounting for over 40 percent of world growth for the past 5 years. Emerging markets and developing countries have made a huge contribution to global growth, growing, on average, 4.8 percentage points faster than the advanced economies from 2003 through 2006. And with both Europe and Japan also experiencing faster growth, the global economy is now firing on all engines in a way that produces better balance, more sustained growth, and expanding opportunities.

At the same time there has been a substantial increase in the amounts of funds invested across borders, a near doubling in cross-border investment flows since 2000 to \$6 trillion annually. Not surprisingly, given the depth, liquidity and attractiveness of our financial markets, the U.S. has attracted international investment that has enabled us to achieve higher rates of growth, higher levels of capital formation, and greater job creation than would have been possible otherwise.

The issue of global imbalances remains on the international agenda. Some historical perspective is useful in this discussion. Global imbalances have evolved and developed over a long time period and are the result of a myriad of global forces, including the massive amounts of international investment mentioned earlier and the relative attractiveness of U.S. financial markets to foreign investors. Another reason is the consistently faster pace of demand growth in the United States relative to our foreign partners.

However, progress is being made, as suggested in last week's release of first quarter 2007 data showing the U.S. current account deficit has declined to 5.7 percent of U.S. GDP, down from a peak of 6.8 percent in the fourth quarter of 2005. Our partners are growing faster, particularly in Europe, where demand has strengthened. We continue to seek further re-balancing of global demand through stronger demand growth in Japan and Europe, as well as by oil exporting economies and China.

We are doing our part. The U.S. fiscal position continues to improve. The FY 2006 federal budget deficit was \$248 billion, \$70 billion less than in FY2005. This is considerable progress and we are on track to further reduce the deficit in 2007. As a share of GDP, the deficit amounted to 1.9 percent in FY 2006, down from a recent peak of 3.6 percent in FY 2004 and below the 40-year average of 2.3 percent. The U.S. labor market remains healthy with a low unemployment rate, steady job gains and solid real wage growth. Core measures of inflation appear to be contained, although energy and food price increases continue to boost the headline inflation figures.

In sum, global economic growth is widespread and moving at a faster pace than in the 1980s or the 1990s. Inflation is down, fiscal positions have improved, and vulnerabilities have been reduced. We still have work to do, however, to further re-balance global demand, expand global trade and open markets.

The Strategic Economic Dialogue with China

Since becoming Secretary, I have emphasized the United States' economic relationship with China. Rapid growth in China has helped power the global economy. And, as a major global economic participant, China must address the need for structural reform.

Our relationship with China is multi-faceted, and we welcome China's growth and integration into the world economy. As our relationship with China matures, tensions will naturally emerge. Less than one year ago, President Bush and President Hu established the Strategic Economic Dialogue, which is a focused and effective framework for addressing issues of mutual concern. The first SED meeting was held in Beijing in December, and the second one was held last month here in Washington. We have tangible results to show for our work so far, such as agreements in civil aviation, energy, the environment and financial services.

Through the SED, which allows us to speak to senior Chinese officials with one voice, avoiding the stove-piping that had sometimes characterized past discussions, we can work to strengthen the U.S. – China economic relationship. It is very important to both of our countries that we get this right.

The United States supports a stable and prosperous China; a stable and prosperous China will be a growing market for U.S. goods and services, even if it will be an economic competitor at times. We are not afraid of the competition; we welcome it, because competition makes us stronger. It is in our interest to support China's continuing efforts to reform and open its economy. Our policy disagreements are not about the direction of change, but about the pace of change.

You recently received the foreign exchange report, which emphasizes the need for stronger, faster action from China. Treasury did not determine that China's exchange rate policy was carried out for the purpose of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade. But, Treasury continues to press the Chinese to increase the flexibility of their exchange rate.

Although they have taken some steps towards greater flexibility in the short term, they need to accelerate that movement and move more quickly to a market-determined exchange rate in the medium term. While currency reform is not going to eliminate our trade deficit, a market-determined exchange rate that reflects the underlying fundamentals of the Chinese economy is an important ingredient to sustainable, balanced economic growth in China, which is critical to continued stable growth around the world. The huge inflow of liquidity under the current exchange rate policy undermines the effectiveness of China's monetary policy and fuels excessive growth in credit, which itself poses significant risks for the Chinese economy's performance. The risk that China now faces is moving too slowly on exchange rate reform, rather than moving too quickly.

Rebalancing China's growth to be less dependent on exports is key to reducing China's trade surplus, and assuring that China can continue to grow in the future without generating large imbalances. Moving more quickly to embrace competition and market principles will also spread the benefits of China's growth to all of China's people. Just as important is addressing the structural reasons why Chinese households save so much and consume so little. Precautionary savings rates would likely decrease, and consumption increase, if there were a stronger social safety net. Competitive retail financial services would allow the Chinese public to insure against risk, finance major expenditures like education, and garner a higher return on their savings. Investments driven by market signals and expected profitability, rather than by administrative guidance, combined with a reduction in precautionary savings, would shift the economy from its infrastructure and export manufacturing focus and spread prosperity more widely. This can only be beneficial, and China's consumption and import level can only increase.

We will have our third SED meeting in December. Between now and then, we will continue to actively work on the trade agenda, on opening markets, increasing transparency and innovation, rebalancing growth and promoting energy efficiency and security, as well as environmental protection measures. We will continue our focus on financial services, moving at a faster pace towards a market-driven currency and expanding U.S. access in the services sector. We have room to be more creative and accomplish a good deal more.

Promoting Open Trade and Investment

A central U.S. policy priority is promoting further opening to international trade while addressing the sources of globalization anxieties. I have been and will continue to be an outspoken advocate for maintaining and extending open trade. This is fundamental to the long term competitiveness of the U.S. economy. As the world opens its doors, we must resist the sentiment that favors economic isolationism; this is not the time to retreat from the principles which have made America so strong and competitive.

We have worked hard to open markets and liberalize trade, in order to promote economic growth and development worldwide. Free trade agreements (FTAs) also bring significant benefits to Americans and the American economy as well as to our FTA partners. Over the last six years, the Administration has put free trade agreements into effect with ten countries. Agreements with the Dominican Republic, Costa Rica and Oman have passed Congress and await implementation.

The Administration is working hard to complete the Doha round, which has the potential to lift hundreds of millions out of poverty. Last month, congressional leaders and the Administration reached bipartisan agreement on labor, environmental and other issues related to pending free trade agreements with Peru, Panama, Colombia and Korea. We are hopeful that congressional approval of these agreements will soon unlock their important benefits.

Openness to trade and competition fuels economic dynamism, innovation, and deployment of new technologies that raise standard of living and productivity across the globe. Countries which have opened up to international competition have prospered, while others have been left behind. But a dynamic economy does create dislocations and change, and we must help workers succeed amidst this change. However, we cannot turn back the clock; the global economy is here to stay.

A successful Doha round would expand trade in agriculture, manufactured goods and services. The World Bank estimates that full liberalization of global merchandise trade alone would increase annual global income by \$287 billion (0.7 percent of global GDP) and lift 65 million people out of poverty by 2015. Agriculture in particular is crucial for developing countries, especially for the poorest ones. On average, agriculture represents 40 percent of GDP, 35 percent of exports, and 50–70 percent of total employment in the poorest developing countries

Financial services are particularly important for developing countries because they are linked to increased economic growth and development. A Doha Round without significant liberalization in these areas would be a missed development opportunity. Capital markets are the lifeblood of an economy. They connect those who need capital with those who invest or lend capital. They play a vital role in helping entrepreneurs implement new ideas and businesses expand operations, creating new jobs. Financial sector openness has been shown to increase growth rates by over one percentage point in developing countries and to help the poor disproportionately, making commitments in the financial sector a win-win proposition. Cross-country analysis shows that greater involvement by private and foreign banks leads to more efficient lending and higher growth.

Foreign Direct Investment

On May 10, 2007, President Bush reaffirmed our nation's commitment to "open economies that empower individuals, generate economic opportunity and prosperity for all, and provide the foundation for a free society." A free and open international investment regime is vital for a stable and growing economy, both here at home and throughout the world. Foreign investment in the United States strengthens our economy, improves productivity, creates jobs, and spurs healthy competition.

Thank you, Chairman Frank, Ranking Member Bachus and Committee members for your efforts to improve and strengthen the CFIUS process. Your bill will contribute to creating a sound process to assess national security risks in those limited investments where they may arise, while signaling to the rest of the world that the United States remains open for investment. The CFIUS process has historically applied to less than 10 percent of foreign acquisitions of U.S. firms and the vast majority of reviews take place without controversy.

Modernizing the International Financial Institutions

We have a strong stake in maintaining the credibility, relevance and legitimacy of the IFIs. The IFIs are indispensable to promoting the United States' global economic interests, which cannot be effectively pursued through bilateral means alone.

As you know, the President has nominated Ambassador Robert Zoellick to be World Bank President. Positive feedback from my extensive consultation with foreign ministers around the world reinforced our confidence in Ambassador Zoellick's ability to lead the Bank's vital mission of economic growth. I believe he will rightly keep Africa at the center of the Bank's focus and continue the vital campaign to fight corruption and reduce poverty.

At the IMF, we have reached an important moment for reform. Failure to follow through will undermine the credibility and legitimacy of the IMF. Within the past days, the IMF took action to update its operational framework for its surveillance over members' exchange rate policies. The U.S. has been a strong voice in favor of such reform.

The IMF's exchange rate surveillance framework was 30 years old and badly needed updating to reflect developments such as the tremendous rise in international capital flows and increased prevalence of freely floating exchange rates. The reform will permit firmer surveillance in areas such as insufficiently flexible exchange rate regimes or weak macroeconomic policies which do not adequately support the exchange rate regime. The U.S. will continue to emphasize that for the reform to be meaningful, it must be carried through in the day-to-day surveillance work undertaken by staff. Nothing is more important for the relevance of the IMF than rigorous execution of its most fundamental responsibility.

Firm, multilateral-based exchange rate surveillance has the potential to be a strong complement to bilateral diplomacy. A multilateral approach places exchange rate issues in a broader, less politically-charged context where the win-win aspects of reform can be more persuasively emphasized.

The United States has led the call for reforms of the IMF's governance structure so that it better reflects the world economy in which we live. The chief goal of governance reform must be to boost the voting share of dynamic emerging market economies. Major emerging market economies produce an increasing share of global output, and will increasingly drive global growth. Reform can and should be accomplished while protecting the voting share of the poorest countries. The U.S. has demonstrated its commitment to reform by offering to forego the additional quota which would otherwise be due to us. We continue to call on similarly situated countries to follow our lead.

Supporting Economic Growth in Developing Countries

This administration has pursued a proactive reform agenda on development. President Bush has made a strong case for why international development assistance is squarely in the U.S. interest. Treasury supports these international development objectives through active leadership in the multilateral development banks (MDBs) and international debt initiatives. Lifting unsustainable debt burdens from the poorest countries allows a greater focus on economic growth and frees up resources that can be spent on poverty-reduction priorities.

In 2005 the G-8 agreed to support a multilateral debt relief agreement to cancel up to \$60 billion in debt obligations owed to the World Bank's International Development Association (IDA), the African Development Bank and the IMF by countries eligible for the Heavily Indebted Poor Countries (HIPC) Initiative. In response to U.S. leadership, the Inter-American Development Bank has followed suit, agreeing to provide additional debt reduction to its five most heavily-indebted borrowers: Bolivia, Guyana, Haiti, Honduras and Nicaragua, with debts totaling \$3.4 billion.

The U.S. seeks to preserve the gains made under these historic debt relief initiatives, and to end the "lend and forgive" cycle that has plagued many of the poorest countries in recent decades. This will require not only prudent debt management by borrowing countries, but greater attention by lenders to responsible lending policies and practices.

A key tool is the joint World Bank/IMF Debt Sustainability Framework, the DSF, for low-income countries, a forward-looking assessment of potential risk of debt distress. DSF must be put to use not only by borrowers to promote prudent management of new debt, but also by lenders, beyond the MDBs. It should include explicit guidance on recommended level of concessionality of lending.

We are concerned that some commercial creditors and non-OECD bilateral creditors have increased non-concessional lending to Low-Income Countries following the extension of debt relief, in effect "free riding" on the debt relief for these countries paid for by others. We are working within various forums, including the OECD Export Credit Group, to explore how use of the DSF might be expanded to other creditors. We are also working to engage the G-20 on a "Charter for Responsible Lending" to promote collaboration with emerging creditors. In this context, we are also working to help HIPC countries avoid costly litigation.

Largely through U.S. leadership, the MDBs have been making significant progress in support of our international policy priorities: promoting private sector-led growth, reducing poverty, fighting corruption, and assisting post-conflict countries in rebuilding their war-torn economies.

We are now engaged with our donor partners around the world in replenishment negotiations for the International Development Association, the concessional arm of the World Bank and the African Development Fund. Successful negotiations are particularly important for Africa, which receives half of the IDA's resources. U.S. leadership is essential to advance the following key objectives:

- Making sure the institutions measure, report and demonstrate results concretely and consistently; and continue to allocate more resources to countries that are reforming and performing well;
- Improved work in fragile states such as Afghanistan and Liberia;
- Increased transparency of the Bank's country operations;
- Greater attention to debt sustainability in poor, debt vulnerable countries;
- Continued efforts to fight against corruption.

The U.S. and the MDBs are strengthening their commitment to the financial sector in Africa, which is critically important for supporting sustainable economic growth. President Bush recently announced the Africa Financial Sector Initiative to provide financial and technical assistance to overcome barriers to capital markets development in Africa. This will complement work of the MDBs to strengthen Africa's financial markets.

The World Bank's new "Making Finance Work for Africa" initiative aims to increase efficiency of financial intermediation, provide greater access to finance for households and small business, and deepen financial markets. The IFC provides financial and technical assistance to help African financial institutions lend profitably to small and medium-sized enterprises. World Bank/IMF financial sector assessments help African countries develop financial sector reform strategies.

The MDBs also play a key role in addressing the needs of fragile states, which complements U.S. policy of helping to rebuild war-torn economies in countries like Afghanistan, Liberia, Haiti and Lebanon. Successfully addressing the special needs of fragile states is critical for advancing global economic and political stability. We are encouraging the MDBs to focus on the core issues of capacity and governance, since shortcomings in these areas often make it difficult for fragile states to effectively absorb aid. We also emphasize the need for the MDBs to achieve measurable results.

The Administration wants to continue to work with Congress on this proactive development agenda. In order for the United States to maintain its leadership in these important efforts, we must address the past payments due to these valuable institutions, as was requested in the President's FY 2008 budget.

Helping Small Businesses in Latin America

In March, President Bush asked the Treasury and State Departments to develop an initiative to "help U.S. and local banks improve their ability to extend good loans to small businesses" in Latin America and the Caribbean. On June 12, Treasury announced a three part program specifically designed to assist the estimated 90 percent of small businesses in the region that are often frozen out of the formal financial sector. The initiative is aimed at helping more people share in the benefits of economic freedom and growth that occur when small businesses thrive.

It is a three-part plan to catalyze market-based bank lending to small, profitable businesses with growth potential in Latin America and the Caribbean, that would be carried out in conjunction with in the Multilateral Investment Fund (MIF) of the Inter-American Development Bank, the Overseas Private Investment Corporation (OPIC) and the IDB Group's Inter-American Investment Corporation (IIC).

Household financial education is also vital to the success of this initiative. Many entrepreneurs get their start using their own savings or personal loans. Treasurer Anna Cabral will host a regional conference this fall to discuss ways we can enhance access to financial services, including financial service access of entrepreneurs in the region.

Strengthening the International Framework against Illicit Finance

In 2004, Treasury became the first finance ministry in the world to develop in-house intelligence and analytic expertise to use specific, current, and reliable intelligence to evaluate potential national security threats. We use reliable financial intelligence to build conduct-based cases, working to achieve a multilateral alignment of interests. Multilateral support is critical to the success of targeted financial measures; this support is also vital to bolstering the integrity of the international financial system and to underpinning sustainable growth and development.

Treasury continues an intensive effort to track and disrupt terrorist financing that has been effective on several levels. Perhaps the best example of a multilateral program of targeted financial measures is evidenced when the target provides support to al Qaida or the Taliban. In that case, a U.N. Security Council list requires all member states to freeze the assets of designated actors.

We are applying targeted financial measures against narcotics trafficking, terrorism threats and to counter the threat of proliferation, particularly the threats posed by Iran and North Korea. We have used our authorities to financially isolate entities central to the financing of terrorism and proliferation, such as Iran's Bank Sepah and Bank Saderat. We have worked to ensure that targeted financial measures are a central part of multilateral efforts to combat WMD proliferators; these measures are included in key UNSCRs related to North Korean and Iranian proliferation activities.

One of the greatest challenges of this century will be to keep the most dangerous weapons out of the hands of dangerous people. As I travel and meet with my colleagues in finance ministries around the world, everyone acknowledges that we must find effective ways to deal with these threats, short of military measures. Other nations can move more quickly to accomplish our shared goals of protecting the financial system and combating security threats by implementing the laws necessary to give their finance ministries the authority to access and use intelligence, and by integrating financial and security functions. This will enable further cooperation and multilateral action, which is in the world's best interest. And, these authorities must be available not only for use against terrorist financing and money laundering, but also for the dangerous, emerging practice of proliferation financing.

In conjunction with these targeted financial measures, Treasury has worked to enhance transparency across the international financial system and creating a dialogue with the international banking and financial service industries. Treasury is working with FATF to reinforce anti-money laundering/counter-terrorist financing framework to safeguard against threats such as WMD proliferation. FATF is a centerpiece of multilateral efforts, but cannot function effectively in isolation, the IFIs are major partners. Countering illicit finance promotes international financial stability and is therefore complementary to the missions of the IFIs.

The U.S. has been working very closely with the IMF and MDBs on anti-money laundering issues since 1999 and on terrorist financing issues since 2001. Our efforts have been very successful in gaining their commitment and engagement to combat terrorist financing and money laundering. A major step forward occurred in March 2004, when IMF and World Bank Executive Boards agreed to make countries' compliance with the FATF 40 + 9 recommendations, the anti-money laundering and terrorist financing standard, a regular part of their financial sector surveillance and diagnostic work, including in the Financial Sector Assessment Program.

The IMF and World Bank continue to undertake country assessments and provide technical assistance to help countries strengthen their AML/CFT regimes. They have performed 80 country assessments since 2002. The IMF has provided technical assistance to 158 countries; conducted 57 training workshops/seminars at national or regional level, involving 1,873 participants. And the World Bank has undertaken 196 outreach activities and 314 technical assistance missions, training approximately 2,200 officials in 140 countries.

Treasury Technical Assistance

Treasury seeks to advance the international economic agenda, and the specific goals that I have discussed today, in many ways, primarily through bilateral policy dialogue, through Treasury's participation in international organizations, and through specialized groupings such as the G-7/G-8.

Another, less visible, way is Treasury's international technical assistance program. It is a very small program that "punches above its weight" and merits your support. Let me give you a few specific examples that illustrate how Treasury assistance is supporting our efforts to combat illicit finance, to promote economic growth in developing countries, and to promote open trade and investment:

- In Afghanistan, Treasury advisors have assisted the Afghan Central Bank in a successful effort to license and regulate the vast network of informal currency changers, also known as "hawaladars." This was a major step forward in the effort to bring hawaladars into the formal financial system and thereby reduce vulnerability to money laundering and terrorist financing.
- In Zambia, Treasury advisors are helping the Finance Ministry to create a new Treasury Department that unifies and makes more transparent revenue and expenditure collection, and introduces new cash management tools.
- In Mauritius, Treasury advisors have provided critical assistance in advancing "aid for trade" initiatives. With Treasury's help, Mauritius has introduced more advanced budget techniques that will help the authorities plan for and mitigate the budgetary impact of steps to liberalize its trade regime.

Conclusion

Taken together, policies to embrace openness, promote trade and assist developing economies will enhance economic security and prosperity for people around the world. These goals reflect what is best in the American people, and I look forward to working with you to achieve them. Thank you and I welcome your questions.

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