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Senate Banking Committee

Subcommittee on International Trade and Finance

Scheduled: **June 7, 2005**

IMF Reform - Toward an Institution for the Future

Thank you Chairman Crapo, Ranking Member Bayh, and other members of the Subcommittee. I am pleased to be here today to talk about our agenda as a shareholder of the International Monetary Fund (IMF).

Reform of the IMF has been a high priority since the start of the first Bush Administration. Former Under Secretary John Taylor appeared before the full Committee last May and summarized our work to date in both the IMF and World Bank. He laid out the underlying rationale for our quest to update these institutions - noting the growing role of international debt securities, the increase in the volume of private capital flows, and the increasing interconnection between financial markets. As he said at the time, those factors, combined with the crises of the late 1990s, made abundantly clear that greater predictability, accountability and more systematic behavior on the part of the official sector were vital to enhance the international financial policy framework.

The Path of Reform

The International Financial Institutions Advisory Commission (IFIAC), chaired by Dr. Allan Meltzer, helped provide impetus for reform. The Commission's report in March 2000 provided important insights about how the IMF and other international financial institutions could better realize their goals. The Commission's recommendations contributed to a serious debate about IMF reform, in which this Committee was an active participant. With strong advocacy from Treasury, the IMF has acted on reform. Specific steps by the IMF have been detailed in a series of annual reports to Congress - most recently in October 2004. Let me summarize some of the highlights over the last five years:

- The international community has clarified the limits and criteria for large-scale official sector lending. Consistent with the Meltzer recommendations, there has been no quota increase in the IMF. With IMF liquidity at historic highs, there is no need to add to its resources. Further, we have encouraged the presumption that the IMF, rather than governments, is responsible for providing large scale loan financing in the face of crises. With IMF resources limited, this presumption provides an overall budget constraint and thereby an overall limit on loan assistance. Further, requests for large loans that represent exceptional access to IMF resources now face new procedures, including a higher burden of proof in the form of a special report that documents how IMF financing will support strong policies in the borrowing country.

- IMF programs are now more focused on its core macroeconomic areas of expertise. In work on lending programs, the IMF is more tightly focused on its core areas of monetary policy, fiscal policy, the balance of payments, exchange rates, and the financial sector. Further, the IMF relies more heavily on more robust analytical tools, particularly for risk assessment, enhancing its capacity to anticipate and deter financial crises.

    - We achieved changes to reorient IMF lending to focus more on short-term financing, discourage casual or excessive use, and provide incentives to repay as quickly as possible. This includes higher interest rates for higher levels of access to discourage excessive reliance on Fund resources. It also includes limited use of Extended Arrangements, to reinforce the focus on making resources available only for the short term. These changing incentives are having an effect.

    - The IMF is much more transparent than it was five years ago. Seventy-eight percent of staff reports for lending arrangements and Article IVs are made public. The IMF provides extensive information publicly about its financial operations. And the IMF has a permanent, independent evaluation office that has been producing high-quality reviews of specific IMF policies and activities.

- As part of the effort to correct incentives and prepare for more effective resolution of crises that occur, there has also been a major step forward on making the process of restructuring sovereign bonds more orderly. In that regard, the Administration worked closely with other countries to make routine the use of collective action clauses (CACs) in sovereign bond documentation to promote orderly restructuring and reduce disruption. One year after the launch of this initiative, Mexico responded by including CACs in its New York law governed bonds. Brazil, Korea, South Africa, and Turkey soon followed, and inclusion of CACs quickly became standard market practice.

These are major steps forward. Yet we are not prepared to relax our efforts. More needs to be done to ensure that the IMF is positioned for the challenges off the 21st century. In partnership with the G-7 and others, the United States has called for a strategic review to identify changes needed to make the IMF (and the World Bank) more responsive, relevant, and helpful to their members. The IMF has taken up this charge and is now undertaking a review of its role and strategy for the medium term.

Pushing the Next Wave of Reform - U.S. Priorities

Like any other institution, the IMF must continually examine itself to make sure that it is doing the best it can to achieve its core objectives. Fostering international monetary cooperation and balance of payments adjustment to support international financial stability and economic growth clearly remains its key aim. The purpose of this review is to make sure the institution is doing all it can to advance this goal.

As we engage in this review with other members of the IMF, the United States has several key priorities: strengthening IMF surveillance and crisis prevention; creating a more effective way for the IMF to actively support strong policies without lending; and realigning the IMF's role in low income countries to achieve better results. Let me explain what we have in mind in each of these areas.

Strengthening Surveillance and Crisis Prevention

The IMF's core mission is to oversee the international monetary system to ensure its effective operation, and for that purpose to exercise surveillance of the macroeconomic and exchange rate policies of its members. In this way the IMF should help prevent crises and foster adjustment in global imbalances.

This process offers the IMF a unique opportunity to assess risks, influence policy and help prevent crises. Indeed, surveillance has proven a very useful tool. Yet the execution of surveillance needs further enhancement. Action is needed, for instance, to further tighten the focus and selectivity of analysis. We also believe that the IMF needs to integrate more fully capital market and financial sector analysis into the daily life of the Fund. In addition, the IMF has a critical role to play in exercising firm surveillance over its members' exchange rate policies to promote international adjustment. In recent months the IMF has called for multilateral actions, including greater exchange rate flexibility in emerging Asia, and particularly in China.

Promoting Strong Policies without Lending

The IMF has traditionally had two levels of engagement with member countries - either the IMF reviews economic performance and policies annually through surveillance or, at the member's request, the IMF provides financial support conditioned on implementation of economic reforms that the IMF helps design and monitor. There is no middle ground between routine review and conditional finance.

The United States strongly believes that the IMF needs a new tool to provide for structured engagement in support of strong economic policies where there is no need for borrowing. We have proposed a new non-borrowing program to serve this role. Participation would be voluntary for member countries. The process of laying out an economic program would be led by each participating country, with the opportunity for country authorities to engage closely with IMF staff as they work to strengthen their country's macroeconomic policy framework and macroeconomic institutions.

The proposal now has the support of our partners in the G-7, and we expect it to be taken up by the IMF's Executive Board this summer. Demand for such an arrangement is already emerging from IMF member countries. We expect that some countries may actively seek to convert their borrowing relationship with the IMF to this basis and that others will welcome such a non-lending arrangement once their existing program expires, as a way of maintaining a signal from the IMF about the strength of their economic policies. This signal could be particularly useful to countries with strong macroeconomic foundations that nonetheless continue to depend on other donors for development financing or that are transitioning to market-based financing away from development finance. And it should help protect IMF resources for those countries with specific balance of payments needs.

Supporting Low Income Countries Effectively

Low-income countries face enormous economic and development challenges. Engaging with these countries to help them achieve macroeconomic stability - through policy advice, technical assistance, and financing when appropriate - is a vital part of the IMF's mission. Yet the Fund is not a development institution, and its financial operations should reflect its mission to provide short-term balance of payments financing rather than longer-term development aid.

While there is disagreement among economists about the impact of IMF assistance on economic growth in low income countries, the growth performance of many of these countries has been disappointing over the past two decades. A central challenge for the IMF is to improve the effectiveness of its own engagement in low income countries to help them achieve sustained improvement in economic outcomes.

Prolonged use of IMF resources is a serious problem, particularly for low-income borrowers, and is exacerbated by the Fund's practice of rolling-over existing exposure. Nearly all (30 of 32) countries with PRGF programs at the start of 2005 had at least two prior PRGF arrangements, each of which lasts three years. Prolonged reliance on IMF support can impede domestic ownership of economic policies and the development of institutions and can blur the IMF's short-term balance of payments role vs. the longer-term development finance role of the MDBs.

We have encouraged the IMF to undertake a close examination of its approach in low-income countries - with a view to helping these countries achieve better economic results. Good economic policies are fundamental to the efforts of low income countries to increase economic growth and improve the lives of their citizens. The IMF needs to find a way to support good policies more effectively, and in a way that is consistent with its role as providing temporary and short-term assistance in response to balance of payments shocks.

As a top priority, the IMF needs to establish and maintain high standards for its support for countries' economic programs. Weak or half-hearted policy efforts should not merit IMF financial support, in emerging markets or low-income cases.

When countries are pursuing strong policies, the PRGF should be flexible enough to respond to countries facing short-term adverse developments in their balance of payments. The PRGF also needs to be available to support needed macroeconomic reform over the medium term. It should not, however, be geared to provide long-term development finance. Indeed, we believe that the proposed non-borrowing program that I have described for you above would offer a particularly important tool for low-income countries that have progressed through stabilization and no longer need to rely on IMF financing.

And perhaps most important, helping low-income countries depends on ending the lend-and-forgive cycle, so that they can move into an era of sustainable debt. The IMF has recently implemented a new debt sustainability framework, which establishes new standards for determining whether countries can or should take on additional debt.

It is critical that the IMF and other lenders integrate this framework into their operations. This, along with increased use of grants in IDA and the AfDF, as well as further bilateral and multilateral debt relief in those institutions for the HIPC countries, can provide a clear path to end the cycle of repeat lending and debt problems holding back the poorest countries.

With respect to debt relief, the Bush Administration has put forward a bold proposal that would relieve the debt burdens of poor countries. The proposal calls for immediate action to provide up to 100 percent relief on IDA and AfDF loans to the Heavily Indebted Poor countries (HIPCs). Action on this debt is critical to putting these poor countries on a sustainable path.

Any debt relief in the IMF would need to be financed from existing resources in the IMF. We do not believe that gold sales - whether they were to be executed in the market or "off-market" - are necessary or warranted. I know that the issue of gold is of particular interest. Treasury has repeatedly voiced our opposition to a sale of IMF gold. Gold provides important underlying strength to the IMF's financial position. Selling IMF gold requires an 85 percent majority vote; since the United States has a 17.1 percent voting share in the IMF, our agreement is required before such a sale can go forward. Congressional approval is required for the U.S. Executive Director to vote in favor of such an IMF gold sale.

Modernizing the IMF's Governance

The IMF is accountable to its 184 member governments through a weighted voting structure aligned with countries' global economic standing. However, change in the world economy has outpaced that in the IMF's voting structure, particularly given fast-paced growth in emerging market economies and integration in Europe.

We feel strongly that the IMF is a financial and shareholder institution the governance of which should evolve along with the world economy. If countries are growing strongly and making increasing contributions to the global economy, then there should be a parallel enhancement of their position in the IMF. This is vital to maintaining the goodwill of members, on which the IMF relies to make its lending possible, and to preserving the centrality of the IMF in the global financial system.

Beginning in October 2004, Secretary Snow has emphasized that change is needed to address the growing disparity between the IMF's governance structure and the realities of the world economy. In April, he took a further step when he asserted that it is time to examine these issues now - and that progress should not, and indeed need not, be linked to an increase in the IMF's quota resources, which is not necessary given the current strength of the IMF's financial position. In particular, he has suggested that shifting quotas within the existing total could yield substantial progress. This could allow for quota shares to reflect the advent of monetary union in Europe and the increasing role of fast-growing emerging markets, especially in Asia.

Change will not come quickly or easily. The issues are complex, and extensive dialogue and cooperation will be needed to find a way forward. Yet we believe the effort is worthwhile - and indeed essential to the long-term effectiveness of the institution. An IMF for the future must be an IMF in which all have a stake.

Argentina

One of the important tasks that has faced the IMF over the last four years has been dealing with the situation in Argentina, so let me say a few words about Argentina's economy and engagement with the IMF.

The Argentine economy continues to recover from the sharp contraction that accompanied the 2001-2 financial crisis. Real GDP grew 9% in 2004, following growth of 8.8% in 2003. Inflation ended 2004 at 6% after spiking to 41% at the end of 2002. The exchange rate has been roughly stable since mid-2003 and reserves have grown $11.5 billion since the end of 2002.

These positive results have been underpinned by better macroeconomic policy since the crisis. The federal government increased its primary surplus to nearly 4% of GDP in 2004 from a zero balance in 2001. Monetary policy succeeded in limiting the growth of the money supply to prevent an upward inflationary spiral.

The United States has supported IMF engagement with Argentina through the transitional program launched in January 2003 and the three-year program launched in September 2003. The purpose of these programs was to lock in macroeconomic stability and attack impediments to growth. Essential reforms include addressing Argentina's chronic fiscal problems related to federal-provincial fiscal relations and weak tax administration, restoring the health of the banking sector, and improving the investment climate. The IMF program helped establish a basis for facilitating the normalization of Argentina's relations with its external creditors.

Argentina's performance under the three-year program has been mixed. Argentina has continued to perform strongly on its macroeconomic targets. However, we still have concerns regarding the implementation of its structural policy commitments under its IMF program. The IMF has not made any disbursements to Argentina since March 2004.

With respect to the debt restructuring, in January 2005 Argentina launched a debt exchange offer to restructure its $82 billion in principal claims of defaulted debt. Over 76% of creditors accepted Argentina's offer, while 24% (representing $20 billion in principal claims) did not.

With the recent settlement of the debt exchange, Argentina is now returning its focus to negotiating a new arrangement with the IMF. A key issue will be the development of an Argentine strategy to resolve the rest of the defaulted debt. There are a number of possible ways Argentina could do this, but it is important for Argentina to be clear about how it will proceed.

In addition to completing its debt restructuring, Argentina also needs an economic program that supports sustained growth so that it can continue to raise living standards and meet its financial obligations. Sustained growth requires improving the investment climate in order to attract private capital. Resolving the situation in the utilities sector will be an especially important signal to investors in this regard. Growth also requires locking-in fiscal improvements by fixing federal-provincial fiscal relations to prevent the provincial overborrowing that contributed to the 2001 financial crisis. Finally, continued strengthening of the banking sector will be important for providing the credit Argentina needs to grow. Key reforms in the banking sector include completing bank compensation, which Argentina has made further progress on in the past month, defining the role of public banks in the banking sector, and continuing with the defined path of regulatory reforms.

Conclusion

I appreciate the opportunity to reflect on the path of IMF reform and lay out for you the Administration's priorities as we continue to press change in this vital institution. I believe that important progress has been made. Yet there is more to be done to ensure that the IMF operates effectively in the 21st century. I hope my remarks today make clear our commitment to maintain the momentum of reform.

I welcome your questions.