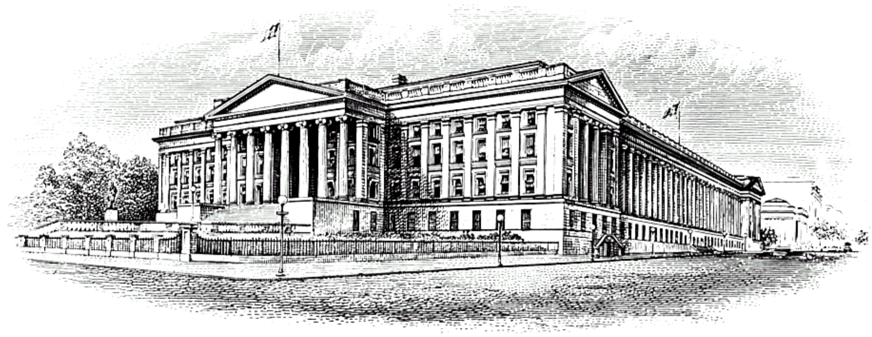

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The Bush Administration's Reform Agenda
At the Bretton Woods Institutions:
A Progress Report and Next Steps

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Testimony Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

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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 G8 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.

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[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.

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 G7 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 fifteen 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 1990s compared with the 1980s. By the late 1990s, 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 1990s 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 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 1990s 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. 75 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 decision-making, 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 non-sustainable 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 G7 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, advisors, 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, it 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 non-borrowing 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 two 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 G7 "strategic review and new directions" initiative.