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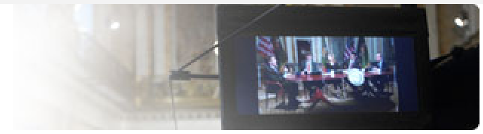

Remarks by Treasury Under Secretary for International Affairs David H. McCormick

2/25/2008

HP-838

At the Peter G. Peterson Institute for International Economics IMF Reform:

Meeting the Challenges of Today's Global Economy

Washington, D.C. – Thank you Fred, for that warm introduction, and thank you for inviting me here today. It's a pleasure to speak at the Peterson Institute for International Economics, which over some 27 years has gained a well-earned reputation as a source of cutting edge ideas on the key international economic issues of the day. The Peterson Institute is a particularly appropriate site for discussing the IMF's future. I am delighted to have the opportunity to add my voice to those of scholars and practitioners such as Fred Bergsten, Ted Truman, Mike Mussa, and Morris Goldstein, among others, who have offered important insights into the Fund and the global environment in which it functions.

Thank you Fred, for that warm introduction, and thank you for inviting me here today. It's a pleasure to speak at the Peterson Institute for International Economics, which over some 27 years has gained a well-earned reputation as a source of cutting edge ideas on the key international economic issues of the day. The Peterson Institute is a particularly appropriate site for discussing the IMF's future. I am delighted to have the opportunity to add my voice to those of scholars and practitioners such as Fred Bergsten, Ted Truman, Mike Mussa, and Morris Goldstein, among others, who have offered important insights into the Fund and the global environment in which it functions.

My argument today is straightforward. The IMF must reform to remain relevant. The world economy is constantly changing, and the IMF must now change with it, as it has successfully done in the past. At the highest level, the IMF's core mission remains promoting an open and growing world economy and the smooth functioning of the international monetary and financial system. It must adapt how it performs this mission, to a world marked by rapid technological transformation, the rising economic weight of emerging markets, and the increasing internationalization of financial markets. To remain relevant, the IMF must take three important steps:

First, the IMF needs to evolve how it performs its mission to meet the forward-looking challenges of the international monetary system.

Second, it needs to reform its governance structure to reflect the growing weight of dynamic emerging markets in the global economy.

Third, the IMF needs to change its operating model to reflect its new mission, ensure ongoing budget discipline, and put in place sustainable sources of income.

As it acts in these ways to meet the challenges of today and tomorrow, the IMF will find in the United States a constructive and committed partner.

A Changing Mission for a Changing World

The IMF was founded on the realization that international monetary cooperation and multilateralism were essential to promoting economic growth in the post-World War II world. The IMF and its sister institutions were also created to prevent a return to the insular policies of the 1930s in which countries erected barriers and engaged in competitive devaluations in ill-fated efforts to gain an edge in world trade.

In the following decades, the IMF assisted economic liberalization in Europe in the 1950s and 1960s, tackled financial crises in Latin America and Asia in the 1980s and 1990s, and helped transform the economies of Central Europe and the former Soviet Union following the fall of the Iron Curtain. More recently, it has been instrumental in assisting emerging market countries adopt sound economic policies and institutions. This is a legacy of success and significance.

Today, however, the IMF faces a very different world where many emerging market countries are able to tap the private capital markets and where the Fund's large lending role in emerging markets is in decline. It must operate at a time when misaligned currencies create excessive build-ups of foreign exchange reserves; when the investment of those reserves abroad risks stoking the fires of protectionism; when financial market turmoil can spread rapidly and without warning; and, when international cooperation is the key – perhaps more so now than ever – to meeting these challenges.

It is against this backdrop that we believe that the IMF must build on its strong multilateral and bilateral surveillance capabilities and rapidly strengthen its focus on three core priorities: exercising firm exchange rate surveillance, maintaining openness to international investment, and supporting global financial market stability.

First and foremost, the IMF should strengthen its surveillance over members' exchange rate policies. Today, we see many countries rigidly managing their exchange rates, resulting in some cases in trade distortions and excess reserve accumulation. Such policies may appear attractive on the surface, but they have the perverse effect of putting the accumulating countries' own domestic economic objectives at risk, while fostering imbalances and protectionist sentiment throughout the world economy.

This problem calls for the type of international attention that the Fund is ideally positioned to provide, and the IMF has already taken important first steps. Last summer, it overhauled a 30-year-old Executive Board decision on exchange rate surveillance and opened the way for the Fund to play a more productive role. The new decision rightfully places greater emphasis on the impact of country policies on external stability. It defines key concepts such as "manipulation" and "fundamental misalignment." The decision clarifies policies and outcomes which would trigger closer examination of country exchange rate policies and sets forth technical guidelines to help the IMF navigate through this critical but politically charged territory. The IMF must now step fully through the door it has opened and make exchange rate issues the priority they deserve to be. The Fund staff needs to hone its analytics on exchange rates, provide far better and more transparent coverage of exchange rate issues in its work, and offer clearer judgments and perspectives.

This step is fundamental to the IMF's future. If the Fund does not act now by providing a strong multilateral voice for addressing exchange rate issues, we risk countries developing their own bilateral responses. That would mark a major step backward for the IMF and the multilateralism it embodies. In addition, if the IMF fails to shoulder this fundamental responsibility, all other reforms will be called into question.

A second core priority for the IMF involves maintaining openness to international investment. In the current environment, meeting the unique policy challenges posed by sovereign wealth funds is the central issue in this area. We are all familiar with sovereign wealth funds, so I won't go into the details of what they are or how they have grown. For the IMF, the key point is that the rapid growth in the number and size of sovereign wealth funds has important implications for the international financial system. Sovereign wealth funds historically have had a strong track record of making long-term, commercially-driven investments, but they have the potential to be a force for instability or politically driven investments. We believe that a multilateral approach to sovereign wealth funds that maintains openness to investment while allaying these concerns is in the best interest of the countries that operate such funds as well as those in which they invest.

While I am focused on the IMF today, let me be clear that we in the United States understand our own obligation to protect the openness of our markets to all parties, including sovereign wealth funds. That said, the IMF is uniquely positioned to help ensure that sovereign wealth funds continue to be a positive force in the world economy. In response to these funds, the IMF is coordinating the development of voluntary best practices for sovereign wealth funds, which will help push back against the calls for increased restrictions on sovereign investment. The IMF has a mandate to promote financial stability, along with expertise in the fiscal, monetary and external policies that are tightly linked to the growth of these funds. Its members have a common interest in the maintenance of openness to trade and investment. The IMF also has existing Guidelines for Foreign Exchange Reserve Management, which can provide a foundation to build on. For these reasons, sovereign wealth funds are precisely the type of cross-cutting issue of systemic importance that the IMF is well-placed to address.

The IMF has already started down this path. Last November, it hosted a roundtable meeting for sovereign asset and reserve managers to discuss their common challenges and how to tackle them. Next month, the IMF Board will discuss the key areas that will comprise the sovereign wealth funds best practices work. We are committed to working with our partners in the Fund to bring this exercise to a meaningful conclusion by the annual meetings of the Fund and Bank if not sooner.

The current financial market turmoil brings to the front pages the third core priority for the IMF – its essential role in promoting global financial stability. Financial turmoil and instability is a global problem that requires a multilateral response using the full range of institutions, forums, and dialogues that we have at our disposal.

The IMF has an important contribution to make in forging a response to the current global financial market turmoil and developing enhanced means to prevent future crises. A pivotal part of this effort is its Financial Sector Assessment Program, or FSAP. As many of you know, an FSAP is a comprehensive assessment of a country's compliance with key internationally agreed upon standards and codes and can also be used to "stress test" a financial system against a variety of shocks to ensure its strength and viability. Over 115 countries have undertaken voluntary FSAPs, and this program deserves our strong continued support for the benefits it brings to the individual countries and the global economy. The United States reached understandings with the IMF in late 2006 and early 2007 about undertaking a U.S. FSAP. I am pleased to announce that our FSAP evaluation will begin next year.

Another IMF product, the semi-annual "Global Financial Stability Report" also contributes to financial early warning and stability by alerting policy-makers and the public to emerging risks and financial market trends. Recent reports have highlighted risks stemming from increasingly complex interactions between financial market developments and the broader global economy. This report in turn feeds into the work of the Financial Stability Forum (FSF), which typically draws on this analysis in its surveillance discussions.

Recently, British Prime Minister Gordon Brown called for strengthening "early warning" of potential financial turbulence and enhanced collaboration between the FSF and the IMF. Strong collaboration between the IMF and FSF is certainly desirable and improved early warning a laudable goal. Yet, we must also be realistic about our ability to predict crises. Indeed, our foremost challenge must remain developing effective policies and regulatory responses that institute sounder financial market frameworks able to withstand risks and losses should crises arise. As we learn more about the details of the Prime Minister's proposal, and others that may emerge, the international community can assess how to strengthen its capabilities in this area. Regardless of whatever other steps it might take, the IMF needs to improve its understanding of complex financial market dynamics and their interactions with the real economy and integrate this analysis into the mainstream of core IMF work.

By focusing its efforts more intensively in these three areas – exchange rate surveillance, maintaining openness to international investment, and financial sector analysis – the IMF can adapt its mission to the needs of the day. And to ensure the success of this policy reform agenda, these priorities should receive a significant allocation of management focus, resources, and talent.

However, even as the IMF shifts its core focus, it cannot lose sight of the need to maintain other key capabilities and longstanding responsibilities. The IMF will need to continue its role as a balance of payments lender to countries in crisis and as an institution promoting macroeconomic stability in developing economies. It must sustain its readiness to provide appropriate financial support in times of crisis, even if its role in this area will be less prominent than in the past. Additionally, the Fund has an important role in promoting macroeconomic stability in countries that are struggling to emerge from poverty through its policy advice, surveillance, technical assistance, and short-term balance of payments lending. In performing this function, however, the IMF must avoid "mission creep" and respect the primacy of the World Bank and regional development banks in working with reform-minded governments to promote longer-term structural reforms.

Governance and Reform

To accomplish this ambitious agenda, the IMF must also reform the way it is governed. I earlier referred to the changing relative economic weights of countries in the global economy. The rise of dynamic emerging markets, especially in Asia, is a remarkable and welcome development. These countries have accounted for more than half of the growth in the world economy in the past five years, and they have increasingly become creditors to the international system.

The IMF must now adapt to accommodate the increasing weight and responsibilities of these emerging economies. That means updating the IMF's outmoded governance structure, which reflects more the economic realities of the 1970s than the global economy of today. As a result, as many countries have seen their relative weight in the world economy rise sharply, they have also seen their voting weight in the IMF fail to keep pace.

If the IMF is to remain influential with these countries and relevant to the global economy, it must increase their stake in the institution. It must increase the shares of under-represented countries and cut the weight of over-represented nations. If the IMF – and we collectively – fail in this challenge, we risk the possibility that those nations who believe they are not being sufficiently recognized will drift away from the IMF and the cause of multilateralism altogether.

The zero-sum nature of this dilemma ensures it will be a difficult political nut to crack. It means taking incremental but meaningful steps to build on the 2006 Singapore quota reforms, and it will require political will at the highest levels in many of our countries. For our part, the United States is prepared to work flexibly and constructively with the IMF membership on further quota reform. As it has been, our position in this debate will remain consistent with four principles:

First and foremost, quota reform must significantly boost the weight of dynamic emerging market economies. It must achieve a meaningful shift in relative weights. To accomplish this, we will support a significant increase in the size of the second stage of quota reform.

Second, any new formula for determining quotas must give more prominence to GDP, the most robust measure of relative economic weight. While measuring GDP at market exchange rates is optimal for the purposes of the Fund, the United States is prepared also to accept an important role for purchasing power parity in the new quota formula if that helps to build consensus.

Third, calculations using potential new quota formulas result in a dramatic rise in the U.S. share in the Fund. However, the United States will only seek to maintain its voting share, prior to the autumn 2006 adjustment, and will forgo any additional increase in its weight at the institution in order to help provide space for a shift in weight to dynamic emerging markets.

Fourth and finally, the voices of the poorest must be protected during quota reform. To this end, the United States supports significantly increasing basic votes.

IMF quota shares are only one part of the Fund's governance structure. The other key component is the IMF Executive Board. Like the Fund's quota shares, Board representation has failed to keep pace with change. For the IMF to be a truly representative and effective multilateral institution, we believe that the Board too must change.

The Executive Board is simply too large, too inefficient, too costly, and too unrepresentative of the world in which we live. The crush of voluminous daily work means that Board members are not able to focus strategically on the big picture. This undermines the Fund's legitimacy and impedes its efficiency. For this reason, we call on other nations to work with us to reduce the number of chairs in the IMF Board from 24 to 22 seats in 2010, and to 20 seats in 2012. In doing so, the number of developing and emerging market country chairs should be preserved. To allow for greater voice of emerging markets and low-income countries, we also advocate an amendment to the Articles so that all Executive Board members are "elected," abolishing the current practice of "appointed seats" for the five largest shareholders.

We also believe that acknowledging this challenge, and committing to address it, can galvanize needed reforms in Board work practices and staffing levels. Facing reality in this way can help spur the Board to become more selective and strategic in its oversight role. A resident Board remains critical to the effectiveness of the institution, but that Board must adapt to changing global conditions. We look forward to working with other IMF members in developing proposals for streamlining the Board and improving its efficiency and strategic focus.

A New Operating Model

Finally, a refocused IMF requires a revised and sustainable operating model. The harsh fact is that as IMF lending has declined, the Fund's income has also fallen sharply at a time when it is still providing surveillance and other useful global public goods. As a result, a large medium-term financing gap has emerged on the order of $400 million per year. Managing Director Dominique Strauss-Kahn has proposed that $100 million of the gap be covered by reduction in IMF administrative expenses and the remainder through new income measures, principally the creation of an IMF endowment which could generate roughly $250 million in income per year. In examining financing options, the Fund has benefited enormously from the work of the Committee to Study Sustainable Long Term Financing of the IMF, headed by Sir Andrew Crockett and assisted by Alan Greenspan.

I'd like to commend the new Managing Director for the vigor with which he has tackled administrative cost cutting and also for instituting the budget discipline which the Fund has long recommended to others. Starting with $100 million in genuine cost savings in FY2009, this budget discipline must include transparent measures to ensure that these savings do not erode in future years. It is also important that the IMF Board demonstrate leadership by reducing expenses for the board more significantly, in percentage terms, than the cost cuts imposed on the IMF staff.

We recognize, however, that with the Fund's mission placing greater emphasis on surveillance and financial stability -- and less emphasis on lending -- the IMF will still require new sources of income. The United States will help ensure that the IMF has adequate resources to fulfill its vital global mission by seeking authority from Congress for a limited sale of IMF gold, consistent with this recommendation in the Crockett Report. We believe an endowment, financed through a limited gold sale, combined with continued budget discipline, will provide the basis for sound and sustainable IMF finances.

The Right Time for Reform

Ladies and gentlemen, in a changing world, we need to make full use of every tool we have available. The IMF has played an important role in supporting global growth and responding to global economic challenges for over six decades. The United States wants to see the IMF continue its record of success into the future. Our task is to ensure that it evolves how it performs its mission, its governance, and its operating model so that it can continue to play a central role in the global financial system.

The good news is that the IMF is already taking some important steps down the path I have outlined. Indeed, in Managing Director Dominique Strauss-Kahn, Treasury Secretary Hank Paulson, and others too numerous to mention, the IMF and the global economy have the leadership in place to address the challenges we face.

Some, however, perhaps even in this audience may have a less optimistic view. They argue that the IMF's progress to date and the reforms we advocate are too small, too incremental, and too slow to make a difference. I respectfully disagree. To reorient an organization's core mission and priorities, to adapt its governance structure, and to update its operating model is a major undertaking for any institution, private or public. In a large multinational organization like the IMF, that must accommodate competing national interests while fulfilling global responsibilities, it is all the more challenging. The reforms I have just described are significant, comprehensive, and achievable, and like compounding interest will deliver substantially increased benefits over time. These three areas of reform must be, in my view, the priority for all stakeholders who are committed to an effective, sustainable, and relevant IMF.

The birth of the IMF was not easy. In reading the accounts of the deliberations at Bretton Woods, I am always struck by the competing perspectives and interests of the participants. But the founders were guided by an overriding sense of mission, and that sense of mission led them to profoundly important results. Today, again fueled by a common sense of mission and a common commitment to multilateralism and reform, we can ensure that IMF continues to play an effective and significant role in the global economy. The United States will be flexible and practical. We will at times stand very firmly on principle, but I can assure you we will always be a constructive partner on this important journey.

Thank you.

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