

# U.S. DEPARTMENT OF THE TREASURY

## Press Center

### Assistant Secretary for International Affairs Clay Lowery Remarks

11/24/2008

HP-1288

#### *On International Financial Institution Reform at the Reinventing Bretton Woods Committee Conference on Building an International Monetary and Financial System for the 21st Century*

**New York - I want to thank the Reinventing Bretton Woods Committee for holding this conference on the International Financial System. Your timing couldn't be more impeccable. Just over a week ago, leaders from 20 of the world's largest advanced and emerging market countries – representing more than 85 percent of global economic output – met in Washington, D.C., to address the current crisis and lay the foundation for reforms that could help prevent a similar crisis in the future. The work plan that came out of the Summit on Financial Markets and the World Economy reflects strong consensus on three critical priorities:**

I want to thank the Reinventing Bretton Woods Committee for holding this conference on the International Financial System. Your timing couldn't be more impeccable. Just over a week ago, leaders from 20 of the world's largest advanced and emerging market countries – representing more than 85 percent of global economic output – met in Washington, D.C., to address the current crisis and lay the foundation for reforms that could help prevent a similar crisis in the future. The work plan that came out of the Summit on Financial Markets and the World Economy reflects strong consensus on three critical priorities:

- First, meaningful regulatory reforms are needed to address the root causes of the crisis. There is a growing recognition across major economies that global financial markets require national financial regulation to be as consistent as possible and not work at cross-purposes.
- Second, reform of the International Financial Institutions is needed to allow for greater participation of developing nations in order for these institutions to remain relevant.
- Third, we must avoid protectionism, push forward on further trade and investment liberalization, and implement other pro-growth policies.

In other words, we all must continue to take actions to stabilize our financial systems, promote economic growth, and assist each other and those less fortunate. I think of this as pragmatic as opposed to profound thinking, and I think of this as working on the plumbing and the carpentry as opposed to creating some grand international financial architecture that can grab a newspaper headline but can't be explained with any substance.

Given the sponsor and the context of this conference, I wanted to focus my comments on the reform and role of the International Financial Institutions, or "IFIs," in responding to the crisis. On the eve of a political transition in the United States, and amid a global financial crisis, it's worth evaluating the IFIs' abilities to respond to the current crisis and their roles going forward. I offer these remarks having been closely engaged with the IFIs from the time I first arrived at Treasury in 1994, and now having been part of two Presidential Administrations that prioritized work with the IFIs and periodically pushed for various reforms.

Instead of focusing on Bretton Woods II or some grand agenda, I thought it would be helpful to present a framework for these institutions in a world in which access to capital will be strained, private sector finance of trade and infrastructure will be lacking, and economic growth will deteriorate. In this Framework, I'll focus on some of the variables of reform that we have tried to implement over the last few years as well as the constant lessons that we simply need to continue to remember. I hope this will help in considering how we should think of the IFIs in the current storm and what the damage and implications we will likely need to face as that storm continues and as it subsides.

#### **Reform Variables**

Upon taking office, the Bush administration developed a set of priorities for IFI reform to preserve the institutions' relevance and improve their effectiveness. In particular, the United States insisted that the IFIs focus more clearly on their respective missions and demonstrate measurable efficacy in doing so. For instance, our reform agenda has taken these institutions to new frontiers on measuring and achieving development results, securing grant finance and debt relief for the poorest countries, enhancing accountability and transparency, and improving their identification of emerging vulnerabilities and macro-financial linkages.

At the International Monetary Fund (IMF) for example, the United States led the charge to improve country surveillance. Former Treasury Under Secretary for International Affairs Tim Adams made headlines when he charged the Fund with being "asleep at the wheel" when it came to IMF exchange rate surveillance. This emphasis was related to a growing vulnerability – global financial imbalances – that is one of the underlying causes of today's problems. Today, thanks to the efforts of Tim and others, the IMF is making progress toward more consistent and candid assessments of its members' exchange rate policies. However, more work remains to be done to ensure the Fund is willing to make tough judgments and increase its candor and clarity on external stability and exchange rate issues. This is not about pointing fingers, it is about calling the situation as you see it.

At the Multilateral Development Banks (MDBs) we have championed development effectiveness by urging the banks to provide resources to better performing countries, to monitor and measure the effectiveness of projects, and to expand the transparency of their operations. At the same time, we've pushed them to provide sustainable finance through grants and debt relief to the poorest countries, recognizing that high debt levels are a key obstacle to development. I think it is arguable that these initiatives in support of the more important efforts of many of the poorest countries to implement sounder economic policies has made the fallout from the past year's turmoil much better than it otherwise would have been.

The United States has been a leading voice on governance, making clear that these institutions must reform to remain relevant. Reform will not be easily accomplished, but as witnessed by the Summit, there is a growing recognition that governance issues are central to institutional legitimacy. Emerging markets must have a seat at the table to reflect more adequately the changing economic weights in the world economy. We fought hard to increase emerging markets' representation at the IMF, and while we supported the recent quota reform, it should have been even more ambitious. We've also strongly advocated a smaller and more focused IMF Board and called on other nations to work with us to reduce the number of chairs from 24 to 20 by 2012, with no loss in the number of emerging market or developing country chairs. And just last week, Secretary Paulson called on the IFIs to explore the possibilities of moving toward non-resident boards. However, governance reform extends beyond the board room and must include more transparency and accountability at these institutions and better efforts to fight corruption.

### "Constant" Lessons

We have been working on these initiatives for years, and I believe they have improved the way the IFIs do business. However, as the Summit underscored, there is more to do especially in the context of the current global financial crisis. Lessons are already emerging from the current crisis that will shape our approach and thinking going forward. As a policymaker, I'd suggest there are a few constant lessons that we need to keep reminding ourselves of:

- **Globalization is here to stay.** An increasingly globalized economy has fueled growth and opportunity all over the world; globalization cannot, and should not, be reversed. This is a constant lesson despite those who thought "global" imbalances were not really global or that economies had "decoupled" from each other. A reversion into protectionist barriers remains a call of the Sirens.
- **Always look around the corner.** I'd like to think that our focus on financial sector issues and on macro-financial linkages would have pointed out today's vulnerabilities before they happened. Instead, I now know that either because of lack of incentives or lack of creativity (or both), we failed to recognize and adequately address vulnerabilities in the global financial system. The lesson is that policymakers, regulators and the private sector have a responsibility to ask themselves what could go wrong, and to be receptive to warnings of potential vulnerabilities.
- **Finance is linked invariably to the human condition.** When financial systems don't work, individuals pay the price: whether it's the entrepreneur who can't get the start-up capital needed to open a business, the small business owner who can't get the working capital needed to meet payroll, or the student who can't get a loan to pay for college. The results can be the loss of wealth, loss of jobs, and even the loss of dignity. Make no mistake, a well-functioning financial system – here in the United States and throughout the world – is central to opportunity and prosperity.
- **Effective multilateral institutions are in our national interest.** The United States has a wide international reach; however, we can't do it alone. As the current crisis demonstrates, we need multilateral approaches. To use the words of a former boss, if they didn't exist, we would have to invent them. To support this lesson, we need to make sure the IFIs' remain focused on their respective roles, are equipped to fulfill those roles, and are well understood by their shareholders and the public.

An increasingly globalized economy has fueled growth and opportunity all over the world; globalization cannot, and should not, be reversed. This is a constant lesson despite those who thought "global" imbalances were not really global or that economies had "decoupled" from each other. A reversion into protectionist barriers remains a call of the Sirens. I'd like to think that our focus on financial sector issues and on macro-financial linkages would have pointed out today's vulnerabilities before they happened. Instead, I now know that either because of lack of incentives or lack of creativity (or both), we failed to recognize and adequately address vulnerabilities in the global financial system. The lesson is that policymakers, regulators and the private sector have a responsibility to ask themselves what could go wrong, and to be receptive to warnings of potential vulnerabilities. When financial systems don't work, individuals pay the price: whether it's the entrepreneur who can't get the start-up capital needed to open a business, the small business owner who can't get the working capital needed to meet payroll, or the student who can't get a loan to pay for college. The results can be the loss of wealth, loss of jobs, and even the loss of dignity. Make no mistake, a well-functioning financial system – here in the United States and throughout the world – is central to opportunity and prosperity. The United States has a wide international reach; however, we can't do it alone. As the current crisis demonstrates, we need multilateral approaches. To use the words of a former boss, if they didn't exist, we would have to invent them. To support this lesson, we need to make sure the IFIs' remain focused on their respective roles, are equipped to fulfill those roles, and are well understood by their shareholders and the public.

### Addressing the Current Global Economic Crisis

Knowing some of the variables of reform and the constants does not necessarily provide us a sound equation for how to think the IFIs should deal with today's crisis. In fact, we do not have the luxury of waiting for further reforms to take hold. The emerging market and low income countries are now facing the knock-on effects of a crisis that first metastasized in the industrialized world, and it is the IFIs that are the frontline responders to the fallout from the crisis. So while reform is critical, we need to think about how to best mobilize these institutions to address the current situation. With this backdrop, I offer a set of principles for IFI engagement in the current environment:

- **First, money can't fix problems that require changes in policy.** Determining the underlying cause of economic weakness, and the necessary corrective action to address the weakness, should be done in advance of sending money out the door. Lending large sums of money before assessing root causes and the appropriate policy responses can damage the IFIs by reducing the capital available to assist other countries in need and by undermining the institutions' credibility. It also damages the affected country in the long run by allowing it to delay needed policy reforms, only to deal with problems at a later date with potentially greater costs.
- **Second, countries must work better together and with multilateral institutions to deal with the current and future crises.** We've already seen effective action taken by a number of countries to deal with the current crisis, including coordinated central bank actions to support global liquidity and ensure the proper functioning of the global payments system. In just the last few weeks, balance of payments crises have required large bilateral support packages that are appropriate and individually unique (i.e., Iceland, Hungary). This model is likely to be more prevalent in the future. IFI lending cannot, and does not need to, keep up with global capital flows, but their programs should provide the framework for additional bilateral and official support in order to ensure that conditionality and policy messages are well coordinated. In addition, IFI engagement should be catalytic, contributing to greater stability and encouraging continued private sector activity.
- **Third, IFIs should be flexible and creative in using the existing capital and instruments at their disposal.** When financial assistance is the best response to address economic weakness, the IFIs should look first to their existing toolkit to determine if they already have adequate resources to respond. The IMF currently has over \$150 billion in available lending capacity to meet members' needs without resorting to another \$50 billion in contingent resources, while the World Bank has the

capacity to nearly triple current lending to \$35 billion per year for the next three. These resources are available now and it has been encouraging to see these institutions as well as the IDB and the EBRD demonstrate flexibility and step up their commitments. MDBs are also developing innovative ways to use existing tools to deliver assistance to countries in crisis, in particular by focusing on country financial sectors and potential shortfalls in trade finance. In addition, the IMF recently announced the establishment of the Short-Term Liquidity Facility, which is designed to help member countries that are facing temporary liquidity problems in the global capital markets.

Determining the underlying cause of economic weakness, and the necessary corrective action to address the weakness, should be done in advance of sending money out the door. Lending large sums of money before assessing root causes and the appropriate policy responses can damage the IFIs by reducing the capital available to assist other countries in need and by undermining the institutions' credibility. It also damages the affected country in the long run by allowing it to delay needed policy reforms, only to deal with problems at a later date with potentially greater costs.

### Looking Ahead: Taking the Long View

However, as past crises have shown, our policy response to the current crisis will have far ranging consequences in the distant and not-so-distant future. I see four implications of the principles just outlined:

- First, we cannot afford to repeat past lend-and-forgive cycles. To the extent additional IFI lending is the appropriate response to the crisis, and in some instances this will be the case, there will be implications: Is additional support consistent with a country's debt sustainability? Do we run the risk of undermining a country's long-term development by creating a dependence on external financing and technical expertise? Does additional IFI assistance run the risk of crowding out private sector activity? The answers to these questions are not static and will require constant re-evaluation and re-assessment of the effectiveness of IFI assistance.
- Second, we must remember the IFIs are taxpayer-supported institutions. Calls for capital increases – that is to say budgetary appropriations to enlarge IFI balance sheets – should be based on demonstrated needs and sound analysis, not fear and headlines. This is no small challenge, especially at a time when the focus is on domestic issues and when we face legitimate competing demands for resources.
- Third, don't let current efforts to stabilize the global economy detract from existing IFI priorities. The IFIs, and the MDBs in particular, have a mandate to promote poverty reduction and economic growth in all member countries, especially the poorest, and have a key role to play in the delivery of global public goods. That is why we cannot forget the importance of our support for financial windows such as IDA – the World Bank's financial arm for the poorest or the Clean Technology Fund, which is a new multilateral initiative housed at the World Bank to combat climate change by helping finance the deployment of commercially-available clean technology to the developing world.
- Fourth, make the case that functioning multilateral institutions are in the U.S. national interest. Skepticism of the IFIs, particularly in Congress, runs high. This administration has made a real effort to back up our words of support for the IFIs with deeds. The impressive track record of reforms is a credit to both our persistence and the ability of these institutions to adapt. This is not to say that the IFIs are perfect, rather it underscores the need to re-evaluate constantly their approaches to find out what works and what doesn't work. It does mean, however, that we need to fund them. Our arrears to almost all of these institutions have become ridiculous and it calls into question U.S. leadership. How can we add capital if we can't pay our existing bills? Why should the institutions accept U.S. led reforms if we don't financially support them? Will calls for multilateral solutions by the U.S. fall on deaf ears if we fail to make good on our commitments to these institutions?

### Conclusion

The United States must continue to lead on issues of institutional reform. This Administration has been a strong supporter of the IFIs, especially the concessional lending windows, as an effective tool for leveraging U.S. resources in promoting development and stability. And if you believe, as I strongly do, that our constructive engagement with the IFIs is in our own national interest, then we need to ensure that we are in a position to constructively support further reforms. This is no small challenge, but a challenge we must meet.

While I cannot speak the next administration I am confident they will continue to support and maintain U.S. credibility and influence at these institutions. This will require continued pressure on the institutions to make good on their commitments to enhance legitimacy, transparency and effectiveness. It will also require more prominent roles for emerging market economies (accompanied by emerging markets taking more responsibility within the global financial system). Finally, it will require that we are mindful that the actions we take today to address the crisis will have implications for the success of any future reforms.