THE STATE OF THE INTERNATIONAL FINANCIAL SYSTEM

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

JUNE 20, 2007

Printed for the use of the Committee on Financial Services

Serial No. 110–42

U.S. GOVERNMENT PRINTING OFFICE

37–558 PDF WASHINGTON : 2007

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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THE STATE OF THE INTERNATIONAL FINANCIAL SYSTEM

Wednesday, June 20, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Present: Representatives Frank, Waters, Maloney, Gutierrez, Watt, Ackerman, Sherman, Moore of Kansas, Hinojosa, Lynch, Scott, Green, Cleaver, Moore of Wisconsin, Davis of Tennessee, Hodes, Ellison, Perlmutter, Donnelly; Bachus, Pryce, Royce, Paul, Gillmor, Manzullo, Biggert, Shays, Capito, Feeney, Hensarling, Garrett, Neugebauer, Price, Davis of Kentucky, Campbell, Bachmann, and Marchant.

The CHAIRMAN. The hearing of the Committee on Financial Services will come to order. This is our annual oversight hearing with the Secretary of the Treasury, and I am delighted to welcome Secretary Paulson. I think all members of the committee who have had dealings with him during his tenure will agree we have had a very constructive and cooperative relationship. We have made progress on a number of pieces of legislation in which the working relationship has been a good one. While there hasn't been complete agreement on things ranging from the bill for foreign investment in the United States, to the GSE legislation, through focusing on how we can better help the FINCEN to work in ways that are best both for law enforcement and for the ease of, the ability of the financial community to work, we have cooperated and look forward to this.

The Secretary obviously has major responsibilities, and the frustration all of us will have, of course, is that 5 minutes won't be enough to get into all of the issues. But I want to begin with what I think is a central issue, and I want to congratulate Secretary Paulson for helping to engage in public education.

Mr. Secretary, you said about a month ago, I read in the paper you were quoted as trying to explain to people for whom increased openness to the world economy and openness in trade was sort of obvious why there was resistance, and you noted, not personally as your view, but to report to people, that there is a degree of unhappiness that has become anger in many places among a lot of Americans about what they see as inequities in which growth goes forward aided greatly by globalization, but the average citizen does not get to participate. I believe that is one of our central problems.

This is a strong and growing economy. My own view, by the way, is that the economy is much less subject to some of the policy changes we make here at the margins than people might think. We have had a strong economy under two very different Administrations, that have pursued many different policies.

The American economy is a vigorous one. What has happened, however, is that there has been a growth in inequality. Inequality is, of course, not a bad thing, it is an essential element in a capitalist system, and the capitalist system is without question the best way ever stumbled upon, since no one specifically devised it, to promote the greater prosperity of the whole.

But there have been in recent years increasing trends towards inequality. There is a debate about what causes that. Some of it is the obvious result of trends in the economy, of globalization of technology, of the great advantages that capital has in terms of its mobility.

But we have in this country, from certainly the New Deal days forward, institutional mechanisms that retarded the growth in inequality. They were never aimed at doing away with inequality, but they were aimed at countering what could be tendencies for it to get out of hand.

I believe that inequality has clearly reached a dysfunctional stage in America, not yet economically, although there is one related aspect I hear from many of my friends in the financial community, concerns that the savings rate is too low, that Americans don't save enough. One prerequisite to be able to save is to have some money left over after paying your expenses so that you can save it. I believe that part of the problem we have seen is while people have not dropped their consumption yet, I think this is one of the reasons for the problems with the low savings rate on the part of the average citizen, which has consequences both for their retirements, but also for the economy's ability to generate capital today.

While it is not clear yet what the economic consequences are, it is clear what the political consequences are. I am in general agreement with the President's approach to immigration. The bill, you would have said, okay, here is the deal, it is going to be President Bush and most of the Democratic leadership and a lot of the Republican leadership, and the business community; looks like a good chance to get a bill.

Anger over increasing inequality, and I don't believe they are directly correlated, but people when they are angry don't always connect the dots in the straightest possible line. There is no question that the anger at a perceived unfairness in the distribution of our increased wealth is a contributing factor to the problems of the immigration bill.

Here in the House, Chairman Rangel of the Ways and Means Committee, and Chairman Levin of the Trade Subcommittee, have been working with you and others, the USTR in particular, to come up with an approach to trade that would accommodate the concerns many of us had about the rights of working people and of the environment with trade. We are not completely there yet, but their efforts have gotten opposition from some people who say, oh, no, the inequality situation is so bad here that nothing you can do can fix trade.

In area after area, we have a resistance to policies that I know you believe are in our overall economic interest. Many of them I agree with you on, some of them I would disagree, and we have to deal with the inequality. Now we have reached a point, and I appreciate your acknowledging it, when I think people understand we have more inequality than is necessary. Recent reports show the inequality by the common measure is greater than it has been since 1929. That means we are now back to being worse than it was under Hoover, not in absolute terms, but in inequality terms.

The question is, what do we do about it? And there are some who say, nothing. There are some who say, well, education will take care of it. I think education is an important potential way of dealing with it, but can't carry the weight people give. Part of it has to do with institution. One is government. And we are going to do 20 minutes on each side, and I am going to apportion the time appropriately.

One issue is government. I do not think it is possible for us to diminish the growth of inequality to an excessive point while simultaneously denouncing and demonizing government and always calling for it to shrink. Education is an example. Yes, I do believe that a better spread of education for the new kinds of work can help diminish inequality, but the way in which we finance particularly higher education in America today reinforces inequality. It does not undercut it. As State after State cuts funding for the public universities, we suffer.

Community colleges. Mr. Greenspan always cited community colleges as one of the best ways to get people the job training that will help them get the kind of jobs that aren't going to be outsourced, that are going to be good, solid, well-paying jobs. I have a community college in my district where we have a great need for nurses in the hospitals. A great nursing program, young people in the area who could do well as nurses, but they only have 42 slots, when they could use 3 or 4 times that many, because the funding has been cut. It is a State-funded institution.

You cannot simultaneously diminish government at all levels and fund higher education in an equitable way. There are other things we have to do that help.

So I do note that I very much agree with your emphasis on debt relief and on doing more to help the impoverished countries. But understand that in an era in which the budget is shrunk for the Department of Health and Human Services, in which we have to fight to get decent housing for older people, if you shrink all those programs in the United States, people shouldn't be surprised when there is resistance to putting more money into our international obligations. You can't shrink the pot and dip into it more deeply in some areas and not get that kind of resistance.

The other area is labor unions. As long as many in the business community and on the Republican side have as their goal a constant shrinking of the role of labor unions, we will not get the kind of social peace in this country that we need if we are going to be able to come together in a progrowth approach that diminishes inequality. That is true both domestically and internationally.

One of my problems is within the World Bank. For example, if you look at their rating systems on the way in which they allocate IDA funds, if you look at the World Bank and IFC, countries get credit for not treating the workers very well. They don't say it explicitly, but the more social network there is for the workers, the more workers have protections against arbitrary firing, the more there are vacation days, etc., literally then people get downgraded.

I want to continue to work together on this progrowth agenda. I think this committee on both sides has shown an understanding of the importance of the financial sector, in particular the intermediation function that the financial community performs of gathering up money from a large number of people and making it available for capital investment. But we have to do a better job of dealing with inequality.

While we now have an agreement that is a problem, as long as there is a view that government is a bad thing and unions are worse, we will not make the kind of progress towards social cohesion in this country that will allow us to substantially diminish inequality and go forward.

The gentleman from Alabama.

Mr. BACHUS. I thank the chairman, and I thank the Secretary for being here with us this morning. Let me start by commending the job you have done. You have done a wonderful job, you are a credit to the Administration, and I think that this committee on both sides is very pleased with your performance and your initiatives.

The chairman mentioned income and equity and worker rights and jobs, the quality of jobs. Let me say that we conservatives, or we Republicans or liberal Republicans, so I would say this side of the aisle, is also concerned about the income and equities. We are obviously concerned about worker rights, safety conditions on the job, and employment.

The good news is that Americans are making more, they are earning more, and they have more, and they are able to buy more with what they earn. Good-paying jobs are being created at a tremendous pace, and workers' safety is at historic rates, and most Americans face a choice of actually two or three jobs, choosing which job, not the fact they can't find a job. So our economy, as you said in your report, is very strong.

I want to address one thing, and that is China, and just ask you this: You said on page 3—and I am glad you said it, I wish the American people realized this when they talk about China and how the Chinese people save money—you said it is important to address the structural reasons why Chinese households save so much and consume so little.

They don't have Social Security, they don't have Medicaid, they don't have Medicare. They have to usually buy their children their first home, a lot of the middle class. Their educational costs, college educational costs, are tremendous. They have to save for that. So they have to save to simply exist.

I believe that addressing exchange imbalances, trade imbalances, can be a key to the United States and China having a mutually beneficial relationship, which is actually going to be key for our children and grandchildren, for these two strong countries which account for 40 to 50 percent of the growth across the globe to have a beneficial relationship.

In that regard I want to ask or just mention two or three things. The Industrial and Commercial Bank of China and other banks are wanting to do business here. They have approached the Federal regulators to allow them to open up. I see that as an occasion—you announced in your statement this morning that you have reached some financial agreements with the Chinese. I believe that you can use the occasion of Chinese banks wanting to set up here and operate here as a further opportunity for them to open their markets to U.S. banks.

I don't know what is going to happen, I don't know if we are going to open our markets. We are in an open economy, and I think that is very good, but in opening our economy, I think it is an opportunity for us to ask that they open their economies.

As I have said, the Chinese people have to save a lot of money. They have to try to provide for their retirement. Here in the United States we have something they don't have: We have great investment opportunities. They don't. That is why the Shanghai stock market today is—the P ratio is 46, 48 percent. You have heard the stories, you have been to China. I have talked to people in China where ordinary citizens are taking that nest egg, they are taking the money out of their mattresses and out of their bank accounts, and they are basically doing a crap shoot on their stock market. Now, if, which some people predict, that stock market tanks, you are going to have political and economic instability in China, which is very bad for the Chinese, and it is very bad for us.

I would ask, and if you would like to comment this morning, why the Chinese people cannot invest in the United States. Now, the government recently took their reserves, and they are investing their reserves around the world. But an excellent opportunity, a win-win situation would see instead of the Chinese bank overvalued and limited opportunities on the Shanghai exchange, are there any serious discussions about letting the Chinese people buy in the American markets?

Now, I am not talking about the Blackstone Group. We all read about how China is investing in the Blackstone Group. Those are not the Chinese people. That is not the middle-class Chinese.

I believe one answer to the Chinese people being able to provide for their retirement, and save for the future is their ability to invest in the United States. It is a win for us, and a win for them. I would like your comments maybe on that later on.

Let me conclude by saying this: We have all talked about their currency being undervalued to our currency; in fact, some government reports say 25 percent, other private reports say 28 percent, and I believe it is actually closer to 50 percent.

But the one thing that I think the American people miss is that there are detriments. Our goods are not as competitive in China, but there are advantages. We can buy goods from them very cheaply, and my concern is that if that currency revalues too quickly, it causes inflation in the United States, and it also drives up the costs for American households.

That is why, again, I believe a much more practical approach is for a gradual increase in their currency and at the same time allowing them to invest what is a tremendously growing amount not only of savings, but of reserves as the country has invested in the United States.

Thank you, Mr. Secretary.

The CHAIRMAN. The gentleman from Illinois is recognized for 5 minutes.

Mr. GUTIERREZ. Good morning, and thank you, Chairman Frank, for holding this timely hearing on the state of the international financial system. I want to use my few minutes to discuss what I believe is an ongoing currency misalignment and manipulation by China, the effect this practice has on the American economy, and what I and others perceive to be the lack of an effective response.

During my subcommittee hearing on the issue of Asia currency valuation in the Ways and Means Committee, Trade Subcommittee, together with the Energy and Commerce Committee, Trade and Consumer Protection Subcommittee, we framed this issue as one of Wall Street versus Main Street. To an economist on Wall Street, that may seem a little oversimplified, but I can tell you that for the American worker it certainly feels like they are being forced to battle Wall Street and both ends of Pennsylvania Avenue in addition to overseas competitors.

For the American economy, the American worker, currency undervaluation by China, in particular, is reaching critical mass. For over 10 years, China has fixed its exchange rate by intervening in currency markets. Economists estimate that the one is undervalued by at least 9.5 percent, and by as much as 54 percent. Many economists, including Federal Reserve Chairman Bernanke, characterize this undervaluation as a subsidy for exports from China.

Suffice it to say, we cannot compete with this kind of ongoing government subsidy, and we cannot continue down the current path with our second largest trading partner, because the imbalance hurts U.S. workers and businesses and threatens the long-term stability of our economy.

In 2006, the U.S. goods trade deficit with China rose by almost 15 percent in 1 year to nearly $233 billion. That is a record high. Meanwhile, because the Chinese Government must buy U.S. dollars to keep the value of their yuan low, China holds more in foreign currency reserve than any country in the world, or in history, for that matter.

Although there are other factors at play, the Chinese Government's daily intervention in the currency markets plays a key role in expanding U.S. trade deficits. It is not exclusive to that. That is why I was extremely disappointed last week when the Treasury Department, in its semiannual report to this committee on exchange rates, once again declined to find that China is engaging in currency manipulation.

I understand that under the current standards, the issue of intent may be an impediment to a finding of manipulation, and for that reason I believe that Congress should take a serious look at removing the intent requirement from the currency manipulation standard.

I would like to take this opportunity to applaud Secretary Paulson for making our economic relationship with China a priority and for launching the strategic economic dialogue between the two countries. I believe the dialogue will help make inroads when it comes to U.S. financial services firms gaining access to the Chinese market.

I am less confident, however, that the dialogue will help in getting the Chinese to allow their currency to fluctuate, and I think the difference is a matter of priorities from our side of the negotiating table.

I am looking forward to hearing from Secretary Paulson today on the issue of China currency valuation in general, the reasoning behind the Treasury Department's latest currency report on China, and its thoughts on the prospects of SED yielding any success on this issue.

In addition, several bills addressing currency valuation have been introduced in this Congress, and I would like to hear Mr. Paulson's thoughts on those bills, and in particular the idea of removing intent from the manipulation standard.

I thank you again, Mr. Chairman, and I thank Secretary Paulson for joining us this morning.

The CHAIRMAN. The gentleman from Texas, the ranking member of the Domestic and International Monetary Policy, Trade, and Technology Subcommittee, is recognized for 5 minutes.

Dr. PAUL. Thank you, Mr. Chairman.

Welcome, Mr. Secretary.

The recent sharp rise in interest rates may well be signaling the end to the painless, easy money decade that has allowed us to finance our extravagant welfare spending with minimal productive effort and no savings. Monetary inflation and foreign borrowing have allowed us to live far beyond our means, a type of monetary arrangement that always comes to a painful end. As our problems worsen, the blame game will certainly accelerate, claiming it is all due to China's manipulation of its currency, and demanding protectionist measures while unfortunately continuing to gain considerable attention.

Unfortunately, there is little concern for how our own policies, monetary, tax, and regulatory, have contributed to the problems we face. Too often officials ignore, and even distort, important economic information that could be beneficial in making market decisions.

Accurate money supply rates are vital in anticipating future price levels to the degree of malinvestment and the chances for financial bubbles to form. Since March of 2006, M3 reports have been discontinued. Private sources now report that M3 is increasing at a significantly high 13 percent rate. It is said that the CPI is now increasing at a rate of 2.5 percent, yet if we use the original method of calculation, we find that the CPI is growing at a rate of over 10 percent.

Since money growth statistics are key to calculating currency depreciation, it is interesting to note that in this era of global financial markets, in a world engulfed with fiat currencies, what the total world money supply is doing. Since 1997, the world money supply has doubled, and money growth is inflation, which is the enemy of the poor and the middle class, but a friend to the banks and Wall Street.

Monetary depreciation is clearly a sinister tax placed on the unsuspecting poor. Too many well-meaning individuals falsely believe that deficit finance assistance programs can help the poor, while instead the results are the opposite.

Welfare and warfare, guns and butter philosophy always leads to harmful inflation. We had severe problems in the 1960's and the 1970's, and we are doing the same thing once again. We have only started to pay for the extravagance of financing the current war and rapidly expanding the entitlement system by foreign borrowing and creating money and credit out of thin air.

There are reasons to believe that the conditions we have created will be much worse than they were in 1979 when interest rates of 21 percent were required to settle the markets and reverse the stagflation process. Congress, and especially the Financial Services Committee, must insist on total transparency and accuracy of all government financial statistics. Any market interference by government agencies must be done in full public view.

All meetings, decisions, and actions by the President's Working Group on Financial Markets must be open to public scrutiny. If our government is artificially propping up the dollar by directly manipulating gold prices or colluding with other central banks, it is information that belongs in the public domain.

The same is true about any interference in the stock, bond, or commodity markets. A free-market economy requires the government keeps its hands off and allows the consumers to exert their rightful control over the economy.

A strong case can be made that our economy is not nearly as robust as our government statistics claim. Unemployment numbers, inflation rates, tax revenues, and GDP growth all indicate that there is little to worry about, but in my estimation we should be much more concerned about the reality of the situation we face.

I yield back.

The CHAIRMAN. The Chair wants to apologize. I had forgotten there is a rule that says when a Cabinet officer or the Chairman of the Fed testifies, that we limit opening statements to the chairman and the ranking member of the committee. So I apologize to other members, but we are going to abide by the rule.

I am going to call on the chairwoman of the Financial Institutions Subcommittee for an introduction of the witness, since he is her constituent.

Mrs. MALONEY. I join my colleagues in welcoming you to the committee, and we thank you for your decision to serve our country as Secretary of the Treasury.

Secretary Paulson brings a lifetime of experience and leadership in financial institutions, capital markets, the head of Goldman Sachs, which is located in the district that I am honored to represent. He has been a leader not only at this fine institution, but a recognized and respected leader nationally and internationally in finance. His decision—although there were many offers for him to lead many organizations, he made the decision to serve our country, and we are very grateful.

As a New Yorker, Mr. Chairman, I have to thank him for recognizing that homeland security is part of financial security, and his leadership on TRIA and CFIUS are very greatly appreciated.

We look forward to your comments on how to keep America competing and winning, and keeping our competitive advantage. We thank you for your decision to be our Secretary of the Treasury. Thank you for being here.

The CHAIRMAN. Mr. Secretary, please go ahead.

STATEMENT OF THE HONORABLE HENRY M. PAULSON, JR., SECRETARY OF THE TREASURY

Secretary PAULSON. Thank you for, first of all, for making me feel so welcome. I thank you, Mr. Chairman, Ranking Member Bachus, Congressman Gutierrez, Congressman Paul, and Congressman Maloney, for that introduction. Thank you all very much. I am delighted to be here today to discuss the state of the international economy and financial system.

As you know, 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 with greater access to markets around the world, provided 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 to build a strong middle class.

A strong U.S. economy benefits the international economy, and the U.S. economy is strong. Most recent data showed 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.

Additionally, strong growth helped reduce the fiscal year 2006 fiscal deficit to 1.9 percent of GDP, from 3.6 percent of GDP in 2004. This is considerable progress, and we are on track to further reduce that deficit figure in 2007.

A strong international economy benefits the U.S. economy, and we see economic growth in nearly every corner of the world. It is especially positive that the world economy is growing significantly faster than in either the 1980's or the 1990's, and that developing economies are growing twice as fast as their recent 10-year average. I might also say they are growing 3 times as fast as industrial economies.

Growth in Europe and Japan has also accelerated, giving the global economy greater balance and more stability. However, Europe and Japan each need further structural reform and further, faster domestic-based growth on a sustained basis.

Rapid growth in China has helped power the global economy, and as a major global economic participant, China must also address the need for structural reform. China is taking the steps to transition from a planned economy to a market-driven one, and this process will continue for a number of years. While we agree with the Chinese on the direction of change in their economic reforms, we differ over pace. I believe there is more danger for the

Chinese in moving too slowly than in moving too quickly, and I advocate an increased pace of reform at every opportunity.

Our relationship with China is multifaceted, and we welcome China's growth and integration into the world economy. As our relationship with China matures, tensions will naturally emerge. Less than 1 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 stovepiping that 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.

We have pressed China to move beyond the minimal requirements of the WTO commitments, and to continue to open their economy to competition from foreign goods and services, and to move more quickly towards a market-determined currency.

You recently received a foreign exchange report which emphasizes the need for stronger action from China. Additionally, the Chinese need to accelerate the structural reform necessary to increase domestic consumption and reduce the reliance on investment and exports to drive growth.

I share your frustration about the pace of change in China. 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 so competitive. I share the Chairman's comments on this at the beginning.

In May, the President reaffirmed our commitment to an open economy and that our Nation welcomes direct foreign investment. Foreign investment strengthens the U.S. economy, improves productivity, creates jobs, and spurs healthy competition. It is a vote of confidence in our economy when other nations invest here.

I appreciate this committee's efforts to improve and strengthen the CFIUS process. Your legislation will contribute to this rigorous process for the assessment of national security risk in the very limited investment cases where it may arise. We have worked hard to open markets and liberalize trade in order to promote economic growth and development worldwide. The Administration is working hard to complete the Doha Round, which has the potential to lift hundreds of millions of people 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 unlock their important benefits.

We also have a strong stake in maintaining the relevance and the legitimacy of the international financial institutions including the IMF. The IFIs are indispensable to global prosperity, which is more effectively pursued through multilateral means.

The IMF is undergoing significant reforms, and we believe that successfully completing the reform process is critical to the IMF's future credibility. The Administration has pursued a proactive reform agenda on development. 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.

The United States seeks to preserve the gains made under recent historic debt relief initiatives and to end the lend-and-forgive cycle that has plagued many of the poorest countries in recent decades. Lifting unsustainable debt burdens from these countries allows a greater focus on economic growth and frees up resources that can be spent on poverty-reduction priorities.

Taken together, policies to embrace openness, promote trade, and assist developing economies will enhance economic security and prosperity for the American people and 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, Mr. Chairman, I now welcome your questions, and questions from your committee.

The CHAIRMAN. Thank you, Mr. Secretary.

[The prepared statement of Secretary Paulson can be found on page 56 of the appendix.]

The CHAIRMAN. The first question I want to address, I know we are going to be talking about this more, the Presidential Working Group will be coming to testify, but it deals in part with hedge funds, but the particular ownership form is not the issue, but I think what many, many of us agree is there was some concern about whether or not people are able to keep adequate track of the derivatives and the liabilities there.

Recently Assistant Secretary Ryan made a speech which surprised me a little bit because it seemed to express a little bit more concern about the potential systemic problems that we weren't fully on top of in that area before. Is there some greater concern than there was, say, 6 months ago?

Secretary PAULSON. No. Our thinking, Mr. Chairman, hasn't changed, but let me address this. As you know, our principles of regulation revolve around two primary tenets, investor protection and systemic risk. This is going to be very important as—

The CHAIRMAN. Let me say that I don't think investor protection is a great concern at this point. It is more the systemic risk potential.

Secretary PAULSON. I think it is.

Let me get then to hedge funds, because what we said at the President's Working Group is, looking at hedge funds and looking at derivatives, that by and large they have made the financial markets more competitive, more liquid, and more efficient. They have helped disperse risk.

The CHAIRMAN. We do have limited time, and I know you said that, but my question is whether Mr. Ryan's speech was somewhat of a move off that because it seemed somewhat different in tone.

Secretary PAULSON. No, because what Assistant Secretary Ryan's speech said is that we have never said there is no reason to have concerns, and we have never said that the guidelines and the frameworks that came out of the President's Working Group was an endorsement of the status quo. What we attempted to do there was to say we had all the regulators come together and speak with one voice and call for heightened vigilance, and what we said is that there are four groups that really need to be very vigilant. First of all, the regulators are looking very carefully at the risk, and looking at the relationships between the regulated entities and these private pools of capital, the managers of these private pools, looking at it from the investor side and from the prime broker side.

And so there has been a real focus on transparency, but transparency between the regulated entities, the big banks that provide credit to them.

The CHAIRMAN. Clearly we have an historic situation where securities transactions were regulated in the country in which they occurred by the country in which they occurred. That is decreasingly a description of reality. We are not sure now. The rapidity of movement, the hedge funds have increased.

Are we on an adequate path so that 10 years from now we will have in place a regulatory system that is adequate to this really much more transactional approach?

Secretary PAULSON. I think that is a great question because what we have seen is global financial flows that have dwarfed the trade in goods and services, and they are increasing at a very quick rate; that the global financial flows in 2005 were on a net basis over $6 trillion, and as a percentage of GDP they doubled since 2000. As part of that, we have seen global financial institutions—it used to be if you go back to 1995, we had roughly $20 trillion managed by institutions. It is now around $50 trillion, and it is managed very much on a global basis with diversity of investments from around the world.

The CHAIRMAN. My time is expiring.

Secretary PAULSON. So given that, I do think the way we need to think about these private pools of capital, hedge funds and so on, is to think about them increasingly on a global basis, and we are talking actively with regulators—the members of the President's Working Group are talking actively with regulators in Europe, in the U.K., and around the world, as to how to deal with these issues.

The CHAIRMAN. I appreciate it. Whatever dangers there are of not having a handle on it multiply almost geometrically when they are international.

I do mean to change to one other question, Mr. Secretary. I appreciate what you are doing on China. Now, some of the concerns have been here, well, the Chinese have been penetrating our economy too much, and we have to sort of defend against that, they have unfair advantages, some of which I agree with. But we had a hearing the other day on the reverse situation, the severe restrictions the Chinese continue to have on American financial institutions to prevent them from penetrating the Chinese economy on the grounds that we would be better at it.

To some extent it seems to me that the Chinese performed a great engineering feat and made the Pacific Ocean one way; that when they have a competitive advantage, the argument is let them benefit, but in areas where our financial institutions can have a competitive advantage, there are restrictions.

I would certainly think there would be strong sentiment here that the time has come for reciprocity. This is a pretty mature economy. And when Chinese financial institutions now come looking to be able to operate in the United States, if there are not reciprocal rights for Americans to do the same over there, I would hope we would be resistant.

Secretary PAULSON. Let me say that I agree with you on the need to open up their financial system. I actually went to Shanghai and gave a speech. By coincidence, it was about a week or 10 days after there was shakiness and volatility in their market.

I have argued that this is not only right out of fairness, but will be very important to them and to us because their economy is not going to develop the way they need it to develop in a balanced, structured way where there is domestic consumption. They are not going to be able to get to the point where they have a currency that is market determined unless they have competitive capital markets. And they won't have competitive capital markets unless they open up to competition.

The example I use, which I think is getting some traction in China, is that they have $2 trillion in savings in banks getting a 2½ percent return in China, which is a negative return after adjusting for inflation.

The CHAIRMAN. Can we do anything about it, more than just talk?

Secretary PAULSON. I think we are making progress. They have taken some steps. I think they are going to keep taking additional steps, and we are going to be leaning on them because it is in their best interest as well as ours.

The CHAIRMAN. Thank you.

The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman.

I have discussed with the Chinese delegation, and I know the Secretary has, I believe, that the Chinese are beginning to realize that it is a win-win situation, and when we say open their markets, it is to their benefit, and their middle class desperately needs the investments that are open to America.

The ranking member of the subcommittee, Mr. Paul, and others have expressed concerns about leverage and about liquidity. We have tremendous liquidity and leverage in the international markets today, which can actually be a good thing, but they can be like a rubber band, and with the currency imbalances, and our trade deficits, it is a cause of concern.

With the markets becoming more international, and our ability to regulate those markets becoming more compromised, I will use that word, or ineffective in many cases, what can we do? Is there anything we can do we are not doing?

Secretary PAULSON. I think there is, because one of the things that we have emphasized is the need for competitive, transparent capital markets around the world. So when the concern about capital markets' competitiveness came up, I have always been very careful how I have defined it. I believe we should welcome strong, liquid, transparent, well-regulated capital markets everywhere in the world because they have a multiplier effect on economies. If our trading partners have stronger economies, we will do better, and there will be less risk.

My focus is on how do we make our markets stronger and better, and applaud the progress that others make. I do believe strong, efficient, competitive capital markets make a big difference in terms of economic growth and development. Also, Congressman, we will always have financial shocks from time to time. There is nothing we can do to make financial shocks go away.

Today we have a strong global economy. Inflation is relatively low. This is as strong an economy as I have ever seen globally. But there is always some risk that there will be financial shocks. We need to be prepared to deal with financial shocks by having good relationships with our counterparts around the world, and also by having a global financial system that is efficient, modern, and functions well.

I think that was part of what the chairman was also getting at with his question on dealing with hedge funds and private pools.

Mr. BACHUS. Let me go to a much smaller question as far as a very specific question. You are going to meet with FINCEN on Friday, I think it is. This committee has bipartisanly overwhelmingly passed legislation to reduce the cost of CTRs on seasoned customers, regular ordinary customers. Bill Fox, when he was FINCEN Director, embraced that, and the new Director is again taking a look at it.

The largest cost of regulation to the financial industry, banking industry, is the Bank Secrecy Act. It is a necessary act, but a lot of the regulation, quite frankly, is burdensome and unnecessary. How can we reduce the cost to both the customer, bank customers, and to the institutions by really taking a serious step on some of these unnecessary CTRs?

Secretary PAULSON. Well, thank you for that question.

First of all, one of my big focuses has been on keeping our financial system not just safe and sound, but secure and free of abuse, and we are also looking at regulatory burdens. Now, in many instances when we look at regulatory burdens, we say, how do we balance keeping the integrity of our markets versus having unnecessary burdens?

I do believe that in this particular area there may be ways in which we can make changes that will accomplish both, which will have us do a better job, and a more effective and more efficient job of law enforcement, while at the same time reducing some of the regulatory burdens.

And so our emphasis here is on how can we be more effective and efficient and do a better job of getting the bad guys and getting at abuse. In doing that, I think we may naturally drive toward some things that make a positive difference on the regulatory side.

Mr. BACHUS. I can tell you that the legislation this House passed by over 400 votes will reduce cost, and it will actually make things more clearly relevant to the law enforcement. It will basically assist them by eliminating millions of CTRs that have no law enforcement value whatsoever.

The CHAIRMAN. The gentleman from Illinois, chairman of the subcommittee.

Mr. GUTIERREZ. Thank you very much.

Secretary Paulson, could you talk to us a little bit about why you didn't find China manipulating its currency last week in your report?

Secretary PAULSON. First of all, thank you for the question.

We clearly found that the currency is undervalued. It doesn't reflect economic reality. We have been quite clear on that point, not only in the report, but also very clear publicly and privately with the Chinese.

Now, you need to recognize that in July of 2005, the Chinese began to reform their currency. They revalued the currency, and since then it has been appreciating. The currency has now appreciated about 8.6 percent, and over the last year, the pace of appreciation has accelerated. The Chinese have publicly said that they are going to continue to allow the currency to appreciate, and they have cited the reason for not moving quicker as the need to have stability.

Now, we disagree with the assessment. I think there is more risk in them moving too slowly, and it is dangerous for their own economy and for the world economy. But in terms of manipulation, that gets to intent. As a matter of fact, the way the law reads is if we had found them guilty of manipulation, what we would be asked to do would be to negotiate directly with them and press the case and work with them, through the IMF and on a multilateral basis.

We have also been negotiating directly with the Chinese and making the case as to why it is in their best interest. In terms of the IMF, I have personally, and the U.S. Government has worked very hard to get the IMF to come into the modern world, to recognize that the days of Bretton Woods have long since gone. I am very encouraged by what the IMF has just put in place, and I commend Director Rodrigo de Rato for the job that he has done.

Mr. GUTIERREZ. So we all agree, how undervalued is their currency, in your opinion?

Secretary PAULSON. I am not going to give you an opinion. Because, do I know? No. You gave a big range. I think the important thing is to have more appreciation in the short term and get to a point where we have a market-determined currency so we are not debating it anymore, and so therefore a big part of what we are doing is pushing for structural reforms, opening up their capital markets so they can in the intermediate term have their currency determined in a competitive marketplace.

Mr. GUTIERREZ. I understand. But, Mr. Secretary, you said that it is undervalued. You have a responsibility, Treasury has a responsibility. So if it is undervalued, you are saying yes, but, Congressman, they are moving to correct the imbalance. You said they are moving to correct it.

Secretary PAULSON. I said they are not moving quickly enough.

Mr. GUTIERREZ. Not moving quickly enough, but they are moving. So you are cognizant, I am cognizant, we are all realizing it is undervalued. Why don't we just say that they are manipulating it?

Secretary PAULSON. Because manipulation, as I said, gets to intent, and they have a clear policy, and they are moving. But, again, rather than focus on the term, what I would focus us on is what do we do about it?

Mr. GUTIERREZ. So you think it is accidental, the disparity? Either they did it intentionally, or it is accidental. Tell me how it happened or how you believe it happened.

Secretary PAULSON. Let me begin by saying that there are many, many countries in the world that don't have market-determined currencies. China just happens to be by far the biggest one. To me, it is an unnatural act to be as integrated as they are in terms of goods and services and not in terms of capital markets and currency.

Now, what I have said is that they made a decision to reform their currency. They said they were going to allow the currency to appreciate gradually, that they recognize the principle, but that they also place a big premium on stability.

Mr. GUTIERREZ. The chairman has been very kind, but I just want to suggest two things. Look, it hurts our workers, and the trade imbalance between our country is affected because of the very nature of this inequity in our currency, and we need to do more to fix it. It is not fair to American workers and our American economy.

Secretary PAULSON. We are in agreement on that. But the one thing I would just say very quickly: it is very important to deal with the currency, but even if the currency were dealt with, we would still have a very large trade deficit because there need to be major structural changes. A big part of our focus is then on those structural changes in addition to the currency.

The CHAIRMAN. Thank you.

I would say, Mr. Secretary, when you said the question was intent, and you said they agreed to raise it, but they decided to do it at a slow pace for stability, that sounds like intent to me.

The gentleman from Alabama has a request.

Mr. BACHUS. I have a unanimous consent request to introduce two studies on undervaluation and overvaluation. One is all the countries of the world. In fact, Iceland and Sweden are greatly overvalued. So we do have imbalances. I would introduce those two studies. One is a recent study.

The CHAIRMAN. Without objection they will be introduced. We could also pass them out during the hearing.

Mr. BACHUS. One is 26 percent undervalued, another is 55 percent.

The CHAIRMAN. 26 and 55 percent regarding China?

Mr. BACHUS. In China. The Chinese currency.

The CHAIRMAN. If there is no objection, they will be put in the record, and the gentleman from Texas is now recognized.

Dr. PAUL. Thank you, Mr. Chairman. There is a lot of concern in the Congress for the trade imbalances, and we talk about some currency problems, but I don't think we ever get to the bottom of that issue. There is a great deal of discussion about what China should do or shouldn't do, and I would like to concentrate more on what we should do for ourselves, because that is where our responsibilities are.

So often I think about how we have monetary problems here, we have tax problems here, and tax policy, regulatory policies, and also some of the things that we could do even in trade policies that could help. So I don't see how putting all the blame on China is necessarily helpful when so many are now calling for a solution such as putting tariffs on them. I think sometimes they forget a tariff is nothing more than a tax, and most likely a tax that would be borne by the poor who now are able to buy goods at a cheaper rate. So there is no easy solution there.

In the beginning of your statement, you mentioned that our policies are to encourage openness. I want to address that a little bit, and I have a question that has to do with the President's Working Group on Financial Markets. We have a program called the FDIC. It is not a free-market insurance program, but everybody knows about it, and there is reassurance, and so far the moral hazard has not been so bad that it hasn't been helpful at least to keep the old-fashioned run on banks from occurring.

In some ways I see the President's group as some type of an insurance program to look at the unruly markets that may or may not come, and yet we don't know a whole lot about it. I am interested in knowing more about this particular group and the meetings, whether there are minutes held, what are the discussions, have actions ever been taken; because if the group is truly an activist group, we as legislators and Members of Congress should have full knowledge of this because the four major departments and individuals who make up this group have a lot of influence over stock markets and bond markets and commodity markets and currency markets. And if we don't know what it does, it creates some speculation, and we do read articles in the paper about the speculation of what this group may or may not be able to do, and I think that that speculation can be harmful.

So could you let us know a little bit more about how this group works, and have you taken any precise actions to interfere in the market?

Secretary PAULSON. Well, thank you for your question. We have, I think, always tried to be very open about what this group is. I chair the President's Working Group on Financial Markets and its members consist of the Chairman of the Fed, the Chairman of the SEC, and the Chairman of the CFTC, and we have been asked on a number of occasions to come up with a study. There is a study on TRIA for Congress, I think it actually may have been for this committee.

But we talk about issues that are primarily related to the markets, and one of the things that we spend a fair amount of time on is looking at a systemic risk. There have been a lot of changes in the market, the markets continue to evolve, the global economy continues to evolve. One of the things we have said is that none of us is predicting a financial shock anytime soon. As a matter of fact, economic conditions would seem to indicate that it is not particularly likely, except financial shocks often come when they are not expected. They come from time to time, and the next time we do have a financial shock, it will be interesting because the United States is even more integrated into the global economy.

There has been an increase in derivatives and private pools of capital are playing a bigger role. So we have thought about it and are planning along those lines. The most recent thing we have done is to come out with guidelines and principles and a framework for dealing with some of the challenges posed by hedge funds and other private pools of capital.

And so this had the benefit. This was a forum where you could have the regulators come together and speak with one voice.

The CHAIRMAN. The gentlelady from California.

Ms. WATERS. Thank you very much, Mr. Chairman. Mr. Secretary, I thank you for being here today. And I would like very much to talk with you about the IMF or Bolter Funds or China, but I am not going to do that. I have decided that my work over the next few years will be focused on doing everything that I can to protect American citizens, to be a real advocate to correct the ills of government, or the private sector as it relates to schemes and rip-offs that our people have to endure in this Nation.

There are many people who are already forgetting Katrina, for example; we have just thousands upon thousands of people who were harmed, and still have not been made whole. But today while you are here, I am going to focus on Enron because you have a role to play in Enron. I have been following for some time now, after the biggest corporate crime in America was perpetrated on the people of this country and on the workers, what has happened to the victims. And I am very, very surprised to find out that our government, this Administration, and you have decided that you are more interested in protecting those with third party liability as relates to Enron and some other cases than you are in protecting the citizens who got ripped off with this corporate crime.

I was very disappointed to read that the solicitor general did not file an amicus brief in support of the defrauded investors in the Stoneridge investment part of this case currently pending before the Supreme Court. This is important because this would decide what happens to those Enron victims. Those Enron victims lost about $40 billion; about $7.3 billion of that has been recovered by the attorneys and lawyers.

However, I understand—and maybe you can answer this question. Why is it an apparent policy position of the Bush Administration to favor public enforcement of a private enforcement at all relevant to a case involving the interpretation of an SEC rule that governs both public and private litigation? The issue before the Supreme Court in Stoneridge involves who may be sued for participating in a scheme to defraud under Rule 10(b).5, not whether the private right of action should be scaled back. Why should the Administration view that our—as you have called it—overly litigious society is harming U.S. financial markets, whether valid or not, have any bearing on the correct interpretation of scheme liability in Rule 10(b).5 of the securities law? Isn't that a question for Congress, not the courts?

Now, I understand that Mr. Cox sides with the victims of Enron and that the SEC voted that they should be able to be sued and that they should be able to recover. And again, some of these banks have been forced to pay up. But you and the Administration are standing in the way. Can you explain that? Why would the government be against the people of Enron who were defrauded and those banks that literally were in collusion with Enron? Should banks be let off and not have to pay?

Secretary PAULSON. Thank you very much for that question. Let me begin by saying that I think you are referring to the Stoneridge case, and that is what you mentioned. The Stoneridge case is about a cable company, Charter Communications, and a couple of suppliers, one of which was Motorola. So that is what that case is about, Charter Communications and a couple of suppliers. Let me step back, before addressing that case and say that I am a strong advocate of the protections against security fraud. I think the SEC and the Justice Department have been particularly vigilant, and the hundreds of millions of dollars of fines that have been paid and recovered are very significant.

Now, I asked the Treasury Department to send a letter to the solicitor general on the Stoneridge case, which involves Charter Communications and Motorola, and some other suppliers. I did this because I thought it had enormous implications for the U.S. economy. And here's the reason, that when you are looking at the uncertainty of primary liability which could go to third parties—and as far as I am concerned this would create a very uncertain legal environment for all of the individuals and all of the public companies that deal with public companies, all of the parties that deal with public companies in the United States—I think that is ultimately harmful to our economy and to the—

Ms. WATERS. I am reclaiming my time for just one second, Mr. Secretary. Is it not true that the lawyers were able to recover $7.3 billion from three big banks—those banks are Citi, JP Morgan, and the Canadian bank—in the Enron case?

Secretary PAULSON. As I said, you are talking about Enron and the investors in those cases. I am talking about Stoneridge.

Ms. WATERS. No, but the relevance of Stoneridge to Enron raised in the Stoneridge case is whether those who participate in a scheme to defraud investors under Section 10(b) and Rule 10(b).5 of the U.S. securities laws can be held liable where the participants knowingly engaged in fraudulent financial transactions with the public cooperation to falsify its financial statements even though they did not themselves make a public statement. Isn't that the case?

Secretary PAULSON. I was going to say that the principle is important to me in terms of competitiveness and is important to people on both sides of the aisle. Senator Schumer and Mike Bloomberg did a study that looked at our capital markets and the impact on our economy. What did they cite? Excessive litigation risk is a big issue. I had a panel who looked at this, and Bob Rubin saw this as a big issue. My concern is that by exposing all sorts of third parties that happen to do business with a public company to primary liability, without clear lines is a risk to our economy, to our competitiveness, and to jobs. And as I said, I asked the Treasury to write a letter to the solicitor general on the Stoneridge case.

The CHAIRMAN. The gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman. I guess we are looking at some of the practical effects in the market today in terms of decisions that we have made in the past, but we have the outflow of capital from the U.S. markets, to London and to Hong Kong—Hong Kong, China, and it appears to be occurring at a pretty heavy pace. Only 2 of the 20 initial public offerings last year went public here in the United States, and if we looked back to 2000, there were 9, and there were 12 in 2001. So we have a trend that I think is a serious problem. And there is this argument that the current status of our legal system and the impact on an overly litigious society has been a factor in driving these decisions from entrepreneurs and investors not to take advantage of the capital markets of the United States.

You referenced the Bloomberg-Schumer report, and the conclusion of that report is that the prevalence, they say, of meritless securities lawsuits and settlements of the United States has driven up the apparent and the actual cost of business and driven away potential investors. It is not the only report that comes to that conclusion. But Mr. Secretary, with some recent developments regarding third party liability, it appears that this problem may only get worse.

And I would also just like to touch on Sarbanes-Oxley. Section 404 has frequently been cited as a likely cause of the outflow of capital. I would like to ask if you see a need to redress the burdensome regulatory environment facing our public companies on that front. And I would also just like your thoughts.

You mentioned the case of *Stoneridge* v. *Scientific Atlanta* concerning secondary liability. The question seems to be whether attorneys can sue not just a company that engages in wrongdoing, but any company that has done business with a wrongdoer. And if we went back to the 1996 case of Central Bank, the Court at that time said Congress never intended this language to cover secondary companies. At that point, the Court argued, trying to determine just who is liable in a civil setting is problematic here. And they warned of the excessive litigation that would come and the difficulties in costs that would be experienced by client companies and investors, the cost to investors under a case like that, the Central Bank case.

Do you think it is precisely that sort of case that could cause even more companies to decide that they are better off listing their shares over in London or in China? That is what I would like to ask you.

Secretary PAULSON. Well, I thank you very much for the question. Yes, there is no doubt that when you go around the world, and even here in the United States, one of the impediments to listing in the public capital markets in the United States is the question of executive litigation risk. And as I said, in the Stoneridge case what concerned me was exposing a wide range of individuals and businesses in the United States that happen to do business in some way with public companies to primary liability without bright lines. And so that was the case. Reasonable people disagree on this, but there are plenty of people on both sides of the aisle that share my concern there. And so that is a concern.

Now, in terms of your Sarbanes-Oxley question, I believe that Sarbanes-Oxley is by and large good legislation, and that the principles are all the right principles. Some of the issues have had to do with implementation. The biggest issue had to do with, as you said, Section 404. I think that there have already been major steps taken by Chairman Olson of the PCAOB and Chairman Cox to rewrite the auditing guidelines, and I am optimistic that you are going to see that we have to remain vigilant, but we are going to see that implemented in a more efficient and effective manner.

Mr. ROYCE. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. The gentlelady from New York.

Mrs. MALONEY. Thank you. First, I would like to thank the Secretary for working with this committee on the anti-terrorism risk insurance which we will be bringing up later on this week, and also for working with us on the legislation to strengthen the CFIUS process that reviews foreign direct investment for national security concerns. In the wake of the Dubai Ports World crisis, it occurred to us that we needed to strengthen the process and that we needed a certain and fair process to encourage safe foreign direct investment.

One of the first bills reported out of this committee was a CFIUS reform bill, and it passed the House 423 to 0. You don't see that with many pieces of legislation. I believe that this bipartisan bill really strikes that balance. It was reintroduced in the Senate this year and it followed most of the House versions on all the key points. One area where it differs from the Senate version is that it allows for the delegation of sign-off to the Assistant Secretary level, where the House had no official sign-off lower than the Under Secretary. It was the Secretary, the Deputy Secretary, then at the urging of Treasury we lowered it to the Under Secretary. And I am concerned about returning to the level of the Assistant Secretary. I want to note that it wasn't an Assistant Secretary who signed off on the Dubai Ports World transaction.

And my question is, do you support the Senate language to allow for sign-off at the Assistant Secretary level?

Secretary PAULSON. Thank you very much for that question. Let me begin by saying that I appreciate your leadership and the work of this committee, and that your bill is a strong bill. The Senate bill is a strong bill. You have highlighted one difference. I was not here at the time of Dubai Ports. I have heard various comments and I am not going to comment. I don't know where the sign-off occurred, but I will say to you that I have a strong, clear preference for sign-off at the Assistant Secretary level. It is a Senate confirmed level, and I believe this for a couple of reasons:

First of all, I think that this bill will give us a lot of changes and that it is going to make a big difference. And we are focused on national security in a very significant way. But the signal it sends to the rest of the world, which says that we are open for investment, but that it takes an Under Secretary or above to sign off on a CFIUS case, to me there is a bit of a disconnect there. And also, as someone who is trying to run a business, at the Department of the Treasury, we have one Under Secretary for International Affairs, and we have one Assistant Secretary for International Affairs, and just in terms of getting things done, it is not very efficient. I have talked about this before. There weren't very many areas we had of disagreement, but this is one of them, and on this I just respectfully disagree.

Mrs. MALONEY. But in your Department, you can structure it to the number of Under Secretaries who are there and the number of Assistant Secretaries. And considering the fact that the Dubai Ports World transaction was signed off at the Assistant Secretary level, aren't you concerned, as some of us are, that Assistant Secretaries don't reliably have the political and substantive judgment necessary to make these decisions? The biggest criticism of Dubai Ports World was the fact that no one of stature or great leadership in the Treasury Department signed off on it. It was a criticism of the level of sign-off, and to lower it to a lower level of sign-off really depletes the purpose of the bill to strengthen accountability in the process.

Secretary PAULSON. I think that would be a gross oversimplification of the Dubai Ports World case. And again, I can just tell you that I would be most comfortable having an Assistant Secretary be able to sign off. I take responsibility for my role in CFIUS and the Department does. And I think in terms of letting us operate efficiently and sending the right signal to the rest of the world an Assistant Secretary is a better route. You and I respectfully disagree. We agree on most things on this issue, and, I guess, why don't we just leave it at that.

Mrs. MALONEY. How many Assistant Secretaries are there at Treasury now?

Secretary PAULSON. We have one Assistant Secretary for International Affairs and we have one Under Secretary, and the idea of saying you could have—

The CHAIRMAN. We only have 5 minutes. That was a fairly simple question. How many Assistant Secretaries are there? It probably ought to be able to be answered fairly quickly.

Secretary PAULSON. Well, we have multiple Assistant Secretaries, but they—

The CHAIRMAN. I understand that. But again, we only have 5 minutes.

Secretary PAULSON. We have one Assistant Secretary in the international area.

Mrs. MALONEY. That is the total number?

Secretary PAULSON. Yes.

The CHAIRMAN. The gentleman from Connecticut.

Mr. SHAYS. Thank you, Mr. Chairman. I would think it would be a pretty exciting time to be a Secretary, and given how well the world economy is doing and the U.S. economy it would be a pretty heady business. Yet I get the sense from the American people that they don't feel the economic security that the indicators would seem to say they should feel. My sense is they don't feel that sense of comfort because the world is extraordinarily competitive and so they don't have a sense of job security. But when you talk about this among your colleagues, what is your conclusion for why public confidence doesn't match the statistics?

Secretary PAULSON. In terms of the way—

Mr. SHAYS. The strength of the economy, the fact that unemployment has gone down, very real growth in GDP. And yet there isn't this sense among the American people that their life is secure and their economy is doing well.

Secretary PAULSON. I think this is a feeling in the United States and in a number of other places around the world. I think part of it may be related to the point that the chairman made earlier on the widening income gap. Part of it may be related to the pace of change, part of it is related to the technological advancements which are continuing to force people to change and giving more of an advantage to those who know how to use technology.

Mr. SHAYS. So the future of our being able to compete is going to be based on how well our populace is educated and how willing we are to allow people with technical skills to immigrate into this country. Do you as Secretary of the Treasury get involved in those issues or are those issues that you have to punt to someone else?

Secretary PAULSON. Get involved in immigration issues?

Mr. SHAYS. Immigration and technology and making sure that Americans are keeping pace.

Secretary PAULSON. Those fall in other people's areas.

Mr. SHAYS. Let me ask you, with regard to what you refer to as a historic debt relief initiative, how are you able to make sure that it is not lend and forgive as you talk about this cycle?

Secretary PAULSON. Well, I have to say that is always a challenge. I think there is much more buy-in when you talk to people at the World Bank and to my counterparts from around the world at the G–7. I think there is a growing consensus and a structure for reducing the likelihood.

Mr. SHAYS. But is there anything concrete that your people talk about that say this is going to be different because we are going to not only—the debt relief is historic. It is larger than any time in past history and it is global. I mean, there is great participation. But is there anything that the United States is doing in a concrete way to make sure that we are not going to just see a repeat of this in a few years?

Secretary PAULSON. I think that is a good comment. I think a lot of this is not just going to be the structure that is put in place in the highly indebted countries—the poorer countries. There is going to have to be restraint and discipline from those that lend. There has been a lot of discussion about making sure that the developed countries and the multilateral institutions act in concert.

Mr. SHAYS. Let me put it in my own words. Is your basic point that whereas we have lent in the past, that countries are in a unified way going to be a lot stricter on how we give out credit?

Secretary PAULSON. Yes, and that there is a big focus on debt sustainability when we look at new lending. And there is a big focus on trying to discourage other nations from coming in and free-riding and following this forgiveness by making new loans.

Mr. SHAYS. Thank you.

Ms. WATERS. [presiding] Mr. Ackerman.

Mr. ACKERMAN. Thank you, Madam Chairwoman. Welcome, Mr. Secretary. Good to see you. I want to thank you first for the good work that you are doing, and especially including the section in your prepared comments, the issue of strengthening the international framework against illicit finance and how important your role is and the role of the Treasury in fighting terrorism. You possess tools that are very, very important to winning this war on terrorism and providing whatever transparency we can in the international community where people, players, companies, and sometimes countries are helping to finance terrorism and terrorist activities. Thank you for the good work that you are doing in the areas of nuclear proliferation, etc., specifically with regard to North Korea and Iran.

I have basically one question this morning, and that goes to the issue of the Iran Sanctions Act. This Act has been on the books. Unfortunately and regrettably, not one entity was sanctioned during the whole duration of the existence of this bill during the time of the Clinton presidency, and that wasn't a good thing. And in addition to that we have seen the same exact thing throughout the Bush presidency, which was greatly heralded, that if you harbor terrorists, it is just as bad as if you are a terrorist kind of approach, yet the Administration has not sanctioned anybody. And we know who some of these people are. We know what some of them are doing, and yet there are no sanctions.

It may be above your pay grade because you don't do the sanctioning; the President does that. So you may feel uncomfortable commenting on that as it might be above your pay grade.

Secretary PAULSON. Let me make a couple of comments. First of all, we have been, the Administration has been, and Treasury has been very active in terms of taking financial measures against a number of Iranian entities, including Bank Saderat, which has been active in financing terrorists, and then with Bank Sepah, which has been a big financer of proliferation and missiles, and weapon systems acquisitions. So we have been quite active there, and we have been quite active in engaging private sector banks from around the world.

Mr. ACKERMAN. I know indeed that—

Secretary PAULSON. To answer your question, I think that engaging in secondary boycotts, sanctioning companies in other nations, I think it is our collective judgment that this would work against what we are doing right now, which has the potential to be quite successful, building a multilateral consensus.

Mr. ACKERMAN. I understand that is your opinion.

Secretary PAULSON. Yes.

Mr. ACKERMAN. But you also, as we, are sworn to uphold your constitutional responsibilities and the Constitution and the laws. We passed a law and nobody is enforcing that law. Nobody has put anybody on this list. And whether you consider it a secondary or a tertiary or quaduciary boycott of a company that is participating in something that is going to result in destruction in the United States and want to observe the niceties of not doing that or not, that is your opinion. But I would suggest that the President should be, a President could and should have, this is a nonpartisan comment, should have some countries and some companies on that list. We do not.

But something that I think you can comment on, because indeed with both Bank Saderat and Bank Sepah you have been doing some good work, and you do have people from Treasury and different places in the world trying to convince them not to do business. Could you give us the names? That is something you can do.

Give us the names of some companies that are not cooperating with Treasury on this.

Secretary PAULSON. In terms of—

Mr. ACKERMAN. Which is the number one company that is not cooperating?

Secretary PAULSON. Well, in terms of—I will tell you this—

Mr. ACKERMAN. That is investing in Iran.

Secretary PAULSON. I would say in terms of the financial sector around the world—

Mr. ACKERMAN. Mr. Secretary, with all due respect, we each have only 5 minutes.

Secretary PAULSON. Right.

Mr. ACKERMAN. And you can run the clock on each of us if you would like. I would like you to give me three names, Mr. Chairman, if I might, I would like you to give me three names of companies anywhere in the world that you like that are not cooperating. You can do that. I know you can.

Secretary PAULSON. That are not cooperating?

Mr. ACKERMAN. Do you want me to repeat the whole thing? I know you understand me, so let's not run the clock and repeat the question again. Give me three companies that are not cooperating with us.

Secretary PAULSON. I am not prepared to single out three companies.

Mr. ACKERMAN. Would you get back to us in writing on that or you just don't want to?

Secretary PAULSON. I will get back to your question in writing, but I doubt, just to be very direct with you, that you will get a list from the Treasury Department of companies that aren't cooperating. If we find companies that are violating the law, we are going to take action against them.

Mr. ACKERMAN. And you have a reluctance to cooperate with the Congress and providing the companies that are not cooperating with U.S. law.

Secretary PAULSON. There are a variety of nations that we would like to get more support from, but we are getting support and we are building support.

Mr. ACKERMAN. We would like to help you with that, but—

The CHAIRMAN. The gentleman's time has expired. The gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman. Mr. Secretary, I don't think I have heard a discussion today about the patterns of entitlement spending within the Federal budget. Recently Chairman Bernanke of the Fed said that without early and meaningful action to address the rapid growth of entitlements the U.S. economy could be seriously weakened with future generations bearing much of the cost. He said that at a House Budget Committee hearing.

Recently Controller General Walker of GAO said that the rising cost of government entitlements are a fiscal cancer that threatens catastrophic consequences for our country and could bankrupt America. Most of the models I have seen from OMB and CBO and others, who slice and dice the numbers here, have us on a collision course over the next several decades of either having a Federal

Government consisting of a little more than Medicare, Medicaid, and Social Security or a doubling of taxes on the next generation just to balance the budget. So far I have seen no evidence in this Congress that there is an interest in attempting to reform these entitlement programs.

My question is, do you concur with the assessment of Controller General Walker and Chairman Bernanke and, if so, what could be the long-term implications for America's competitiveness in the international economy?

Secretary PAULSON. I do concur and I do believe that perhaps the two biggest intermediate to long-term structural economic issues we have are the need for entitlement reform and energy—those would be the two that I would cite. In the entitlement area we have a fiscal situation in the short term which is manageable and getting better. But if you look out a number of years, we have an entitlement issue which is driven by two factors—demographics and rising health care costs going up much quicker than the economy overall. This is frustrating because the sooner we deal with these as a country, the more flexibility we will have and the less onerous the penalty will be. Also, the price paid by the younger generation will be less.

So this is something—and I would tend to leave it with one positive comment—that I believe is a bipartisan issue. I do believe that people on both sides of the aisle understand it. I really do hope that sometime over the next several years we will all get together to solve it, because it is not going to go away, and the longer we wait, the more expensive it is going to be to solve the problem.

Mr. HENSARLING. Returning to the issue of Chinese currency, possible Chinese currency manipulation, I rarely have an opportunity to quote my mother at these hearings, but my mother once said that life is often full of lousy options, and it appears to me we may have a lousy option in dealing with Chinese currency. Isn't it true whether through market forces or through currency manipulation or through acts of divinity there will be winners or losers every time there are adjustments in the currency exchange rates? If you are in the export business or the import business, depending on which way the currency fluctuates there will be winners and losers. For those who are advocating various tariffs and sanctions won't that simply drive up the cost of many of our manufactured goods that could have a detrimental impact on the disposable income and the standard of living for low- and middle-income Americans?

Secretary PAULSON. If your question is do low-income American consumers benefit from low prices from cheaper imports, I think the answer to that is yes. As China moves toward a market determined currency, the winner will be the global system the world overall. It will benefit the United States and China. I believe we have a responsibility of fairness to press the Chinese toward getting to the point where they are not just partway integrated into the global system. The global system is not going to work over time unless those that play such a big role selling goods and services are truly integrated in terms of the financial markets and their currencies.

Mr. HENSARLING. Thank you.

The CHAIRMAN. Thank you. The gentleman from California.

Mr. SHERMAN. Thank you, Mr. Chairman. First I would like to thank you for the clarity of your answer to Mr. Ackerman. He asked you about the Iran Sanctions Act and why it did not apply to a single company, and your response was you thought it was bad public policy to sanction foreign companies. And I think that clarifies really the Administration view toward Congress, which is the laws that we pass are advisory and when they constitute bad public policy they will be ignored. Other than that you think it is terrible public policy, is there any reason at all legally, if you were just going to follow this statute, not opine on whether it is good public policy, that this Administration has not identified a single oil company that has invested more than $20 million in Iran?

Secretary PAULSON. Again, I take your point.

Mr. SHERMAN. Thank you. Sir, I am going to go on to the next question.

Secretary PAULSON. I will advise other people within the Administration. But the point that I was respectfully trying to make—

Mr. SHERMAN. Sir, I will reclaim my time. I think your answer is very clear.

Second, I would just like to clarify for the record the exchange of correspondence that I had with the Treasury Department over whether there should be an emergency plan for dealing with a 20 percent decline in the value of the dollar in any week or similar catastrophe or a 40 percent decline in a single month. The response from your Department has been that we don't need to worry about that.

I would urge you to work with my office if there is any legislation that you think would give you the tools necessary to deal with such a catastrophe, and I urge you again to work with the other Agencies of the Administration to put together an emergency plan. If, however, you don't think it is worth your time, that is fine. It is entirely up to you.

It has been widely reported the extraordinary efforts the Administration made to save Mr. Wolfowitz's job. You, yourself, made phone calls. When it comes to keeping the World Bank from making disbursements to Iran, the Administration voted against those loans, as you are required to by law, and in this case you actually followed the law. But how hard—can you describe, compare the extraordinary efforts that you made to save Mr. Wolfowitz's job with energy expended to try to prevent the World Bank from disbursing loans to Iran. Actually, I will ask that as a more specific question. Have you made any phone calls at the ministerial level urging that we stop making disbursements on the $1.3 billion of World Bank loans headed for Iran?

Secretary PAULSON. I have not made any personal phone calls on that.

Mr. SHERMAN. Did you make any personal phone calls to help keep Mr. Wolfowitz's job?

Secretary PAULSON. I made personal phone calls with regard to Mr. Wolfowitz to make sure that there was a fair process.

Mr. SHERMAN. I am glad that this is how we have allocated our chits in power in the World Bank. But let me move on to another question.

We have had two Iranian banks that you have prevented from doing business.

Mr. BACHUS. Mr. Chairman.

The CHAIRMAN. Yes.

Mr. BACHUS. I would ask in fairness—

The CHAIRMAN. We will stop the clock during this conversation.

Mr. BACHUS. I would ask in fairness that the Secretary, if he is asked a question, that he does have a chance to answer.

The CHAIRMAN. I would say the general rule is that the member controls the time. If the Secretary at the end wants to add something he can. I would say that I think the Secretary is having trouble adjusting to the 5-minute rule. In several cases, people have asked questions and the answers have been, it seems to be, more discursive.

Mr. BACHUS. Mr. Chairman.

The CHAIRMAN. I am sorry. It is not my time. I recognize the gentleman and I am trying to explain what is going on. The Secretary has on occasion been more discursive and has frankly repeated stuff that everybody knew. But if at the end he feels, the members control the time, that he wants to add, I would be glad to recognize him for that.

Mr. BACHUS. I thank the chairman. I think that in this case, the Secretary was asked a question, and after two words he was cut off.

The CHAIRMAN. Well, members control the time. And members do have a right, it seems to me, to ask a specific question and try to get a specific answer, particularly under the 5-minute rule.

The gentleman from California is recognized.

Mr. SHERMAN. Thank you. It is only in the Senate where you are allowed to filibuster. You have prohibited two Iranian banks from doing business with the U.S. Fed and U.S. banking system. Why not all of them?

Secretary PAULSON. We have a general prohibition against them doing business in the United States. We took action against the two banks because we had very hard intelligence and very strong evidence of clear wrongdoing. As a result, it was possible to go around the world, and with this conduct of clear misbehavior build a multilateral consensus. So we are looking at all of our options.

Mr. SHERMAN. I am reclaiming my time. You do need cooperation from the rest of the world on some things, but you could stop every bank that is of assistance to the Islamic Republic of Iran and is located in the Islamic Republic of Iran from doing business with the Fed without seeking international consensus.

Secretary PAULSON. They are excluded from the United States.

Mr. SHERMAN. They got the U-turn transactions.

Secretary PAULSON. They got the U-turn.

Mr. SHERMAN. And we could stop the U-turn without this lobbying effort?

Secretary PAULSON. That is one thing that we are considering. But as I said, and I spent a lot of time on this, Congressman, I believe that when we can show people that we have hard evidence, it is a lot easier to get the kind of support that we are currently getting from around the world, which I think is isolating Iran from the global financial system.

Mr. SHERMAN. Let me just point out that the centrifuges in Iran continue to turn and I wish we were as willing to inconvenience international corporations as we have inconvenienced American soldiers fighting in Iraq, and I yield back.

Secretary PAULSON. I have spent a lot of my time on this issue. It is very important to me, and we share the same objective here.

The CHAIRMAN. The gentleman from California, Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman. And thank you very much, Mr. Secretary. A few kind of relatively broad questions, unlike some of what you have been getting. What do you see as the greatest risks to business and capital formation in the United States? I mean some people will say Sarbanes-Oxley is a big one. I suspect from your previous answer you don't agree with that. Litigation risk perhaps. What do you see as the biggest impediments to people forming companies and capital in the capital markets in the United States?

Secretary PAULSON. Congressman, when people say Sarbanes-Oxley, I think they are using that as code for a lot of things. Not just the Sarbanes-Oxley Act, but the way it is implemented, all of the new listing rules that have come into place, the different changes in the boardroom, and the changes to the accounting system. Because the business scandals in this country were largely accounting scandals, and that is what Congresswoman Waters commented on with respect to Enron and others, there were big changes in accounting. And some of the secondary, and tertiary effects of those changes have not all been positive. We had, for instance, around 1,500 restatements last year in the accounting area.

I believe that all of these changes taken together have been a deterrent to public listing in the United States. At the Treasury Department, we focused on three things: First, the accounting industry and how that works and how the accountants relate to boards and to managements and to shareholders and how to deal with the restatements and the time and effort and money that is spent in that area, number one.

Second we are focused on regulatory structure. We have a regulatory system that has been built up in this country over many years. And so how we resolve some of those issues. And then the enforcement, legal system and getting at, again, the issues that we had an opportunity to discuss earlier with Stoneridge. And so I would say those are the three areas we focused on.

Mr. CAMPBELL. Okay. And litigation risk is kind of that third?

Secretary PAULSON. Yes.

Mr. CAMPBELL. There is a lot of talk around here about raising the tax rate on capital gains and dividends, either straight up or through on the higher income taxpayers, let us say, through the modifications in the Alternative Minimum Tax. What effect would that have, do you believe, on growth, capital formation, and job formation?

Secretary PAULSON. Well, I think it would be a negative. I think that the tax reform reducing the capital gains rate, equalizing it with dividends, was a major improvement. It was not only a reduction in taxes, but also a major reform that eliminated some of the biases that we have in our tax system. It has also helped drive jobs and growth, and I think it has been very positive. And, given where we are in our business expansion today, I wouldn't recommend increasing the dividend and capital gains rates.

Mr. CAMPBELL. And as a final question, we have a lot of angst about our savings rate, but yet globally there is a lot of global liquidity. Chairman Bernanke has called it a global savings glut. What does that mean for us, what does that mean for the economy, what does that mean going forward in this global savings glut?

Secretary PAULSON. What has happened is that there has been a wall of money from around the world. Asia, Germany, Russia, something like $450 billion last year from the 10 oil exporting nations, $6 trillion in capital flows. Now, that money needs to find a home, and the U.S. economy is very attractive relative to other places, looked at historically or going forward. To me the key is to continue to keep our economy strong, to have policies that enhance confidence in our economy, to be open for investment, and to encourage foreign investment because we have attracted a lot. The U.S. economy is 25 percent of global GDP, but we have 40 percent of global financial assets here in this country, and that is very important.

Mr. CAMPBELL. Thank you, Mr. Secretary.

The CHAIRMAN. Mr. Secretary, we have a vote that is probably going to take about 30 minutes. We have some members here. Is it possible for you to take a break and come back at about say 12:40 and stay for another 40 minutes or so.

Secretary PAULSON. Okay.

The CHAIRMAN. I have to accommodate the members who are here. I will not allow any members who have not already been here.

Secretary PAULSON. I have a lunch and then I am supposed to speak to a group of international students at 1:45.

The CHAIRMAN. Where is that going to be?

Secretary PAULSON. That is going to be at the Executive Office Building. I am supposed to chair an economic principles lunch at 1:00, so the idea would be that I would come back at 12:45 and be here until 1:15.

The CHAIRMAN. If we can. We will try to accommodate as many members as possible. I appreciate it. We will finish some more questions now.

Secretary PAULSON. Could we do whatever we can to get me out of here by 1:15?

The CHAIRMAN. Yes.

The gentleman from Kansas.

Mr. MOORE OF KANSAS. Thank you, Mr. Secretary, for being here. Mr. Secretary, international currency policies, and particularly China's exchange rate policy, are a concern for American manufacturers and other folks as well. I would like to stay on the topic of currency policy, but I would like to draw focus to another side of the issue.

According to the most recent Treasury statistics, today foreign nations hold over $2.2 trillion, or 44 percent, of all publicly held U.S. debt, with China alone holding over $400 billion of our public debt. This makes China the largest foreign lender of the United States Government. I am concerned that we may be too reliant on foreign countries as creditors, some of whom may not have our best interests at heart. Add to this the Wall Street Journal and others have reported that China may be considering riskier investment strategies with its foreign currency reserves which could result in fewer purchases of investments like U.S. Treasury bonds and more buying of investments that are riskier but have better long-term returns.

Mr. Secretary, do you have any concerns, or are you concerned that China may be leaning towards a more aggressive investment strategy with our foreign reserves and what dangers, if any, does this pose to our country as a result of China's holding a substantial portion of our public debt?

Secretary PAULSON. Thank you very much, Congressman. I have spent a lot of time over my career looking at government bond markets, and I would begin by saying that roughly 50 percent of our treasury debt is held globally outside of the United States. That is very similar to many other governments. And in my judgment it is good to have a diversity of holders and to have people want to invest here. The Chinese, as you point out, own roughly $400 billion of our treasury debt. The Japanese own more than that, maybe another $200 billion.

U.S. treasuries trading volume is about $500 billion a day, so the Chinese own less than one day's trading volume. I believe they own our securities and invest in this country because it is in their best interest. They do so because they get the best return on a risk adjusted basis. In terms of what they are doing with their sovereign wealth funds, this is a trend we see around the world, and it is one you expect to see with countries that have a substantial amount of reserves, countries are going to want to invest their reserves in the way that makes the most sense for them. I see that as an opportunity, too, because I do believe they are going to want to make investments in the United States, foreign direct investments, which I think will be a good thing. But again, I am not alarmed by holdings of U.S. treasuries, whether they be in China, Japan, the Middle East or wherever. I think this is good for our country and it is not unusual.

Mr. MOORE OF KANSAS. Thank you, Mr. Secretary. What would you expect the result would be if for whatever reason China decided to sell off or not hold any more our debt? What would be the impact on interest rates in this country?

Secretary PAULSON. Interest rates are lower by virtue of the fact that U.S. treasuries are held around the world. If China decided to sell off U.S. treasuries slowly over time, which I don't expect because I am not quite sure where else they would want to invest their money, I don't think it would have a big impact. Because as I said, it is less than one day's trading volume.

Mr. MOORE OF KANSAS. If it wasn't sold off slowly what would be the impact, if it happened over just say a period of months?

Secretary PAULSON. I wouldn't speculate about that. I don't think it is a major concern or a major risk.

Mr. MOORE OF KANSAS. I hope you are right. Thank you.

The CHAIRMAN. The gentleman from New Jersey will be the last questioner in this period and we will resume at 12:45. The gentleman from New Jersey.

Mr. GARRETT. Thank you, Mr. Chairman. And my colleague from Texas, as he very rarely gets to quote his mother at these hearings, and I have never quoted his mother, but I am sure she has said to him at one time, son, always obey the rules. When it comes to small businesses in this country, specifically Sarbanes-Oxley, the rules that are about to be imposed upon them are pretty large and monumental. With regard to the entire Sarbanes-Oxley, some people have described it as being use of a sledgehammer to try to fix a problem when maybe just a little tap would have been more appropriate. We all agree accountability, transparency, they are laudable goals, but we are wondering whether we could have done it in a more competitive fashion. As you said before, and we all know we are in a global economy, but I often think that the burden we put on these companies, $4 million to $6 million per accelerated filer, 50 times what the original SEC estimates cost, are burdensome, but even more so on the small companies. The big ones we know what the outcome of Sarbanes-Oxley is. Some of the studies show that only 1 of 24 listings, over $1 billion, have been in the United States as opposed to foreign exchanges. I think the studies will show if we do go forward with some of these implementations on the small companies it is going to be even more detrimental.

Now, I will say this also, that I commend the SEC and the PCAOB, the work they are doing to try to revise this system, and the rules and what have you are good, but I think it may be a little unfair to the small guys because they being right in the middle of the year, calendar year so to speak, with the rules just coming forward and being enacted and implemented or asked to be implemented may be a burden on them.

So my first question is this: I just dropped in a piece of legislation, it is a bipartisan piece of legislation, that would extend for another year the current exemption for the small guys, for the smaller businesses, because the burden is greater on them. One study says, out of Nasdaq, it indicates that the burden of compliance as a percentage of revenues is 11 times greater for small companies, and there is probably a good reason for that. Again, in light of the fact that we are sort of in the middle of the game here and we are trying to throw that on to them, I want to know what your thoughts are of that idea of just giving a 1-year extension to allow them some breathing room.

Secretary PAULSON. I share your concern about small business, and it is very important that Sarbanes-Oxley be implemented in a much more efficient way that looks at the—section 404 should look at the costs versus benefits. Now, with regard to small businesses, they have a need also, if they are public, to have good control systems. And right now my understanding is that the earliest that these regulations would go into effect for the smallest businesses would be 2008.

Mr. GARRETT. Let's have a clarification for my benefit. That would mean for the filing of that period of time, correct?

Secretary PAULSON. Well, it would be for the filing which would, I think, be at the end of 2008. And so given the changes that have been made to section 404, and the changes that are being made, and given the fact that there is a delay, that I have been comfortable with the way—

Mr. GARRETT. For my benefit here, if that is the case, in which case the filing would be for 2009 or 2008, I would be in agreement with you.

Secretary PAULSON. I thought it is was going to go into effect for the 2008 year.

Mr. GARRETT. But if it is not, if it is for the filing—

Secretary PAULSON. If that would be the case, they would be filing the statement whenever they did, which would be early 2009. They would be living with the rules in 2008.

Mr. GARRETT. It is just for section B for that period of time, but for the others the management reports would be still for 2008 looking back towards where we are now?

Secretary PAULSON. That is right.

Mr. GARRETT. Which is the problem, that they would be looking for—basically we are right in the middle of 2007 with the regs still coming down and they will be looking to implement them. It is not as bad for the large guys who have already been basically implementing some system and we are just asking them to change it as we are going along, but for the small guys, isn't it an added burden because they haven't done it so far?

Secretary PAULSON. You and I are discussing something we are in agreement on. I wanted the burden to be less and less for the smaller firms. The large firms have been dealing with it for a number of years now, and as I understand it, the regulations have been greatly modified. Through the conversations I have had with the PCAOB and with Chairman Cox, I am comfortable with the current path, but I understand your point of view.

Mr. GARRETT. But are you comfortable with them having to implement it for the other provisions in filing 2008 or 2007 for regulations that are just now being implemented.

Secretary PAULSON. I think they will have time to transition, yes.

Mr. GARRETT. Okay.

Secretary PAULSON. I am sorry, I understand your concern but—

Mr. GARRETT. If the Chair lets me, where is their transition period if they are really just being thrown the regulations right now, because it is not just a filing in 2009, it is a filing in 2008?

Secretary PAULSON. The larger companies have been dealing with this now for a couple of years.

Mr. GARRETT. But the small guys haven't.

Secretary PAULSON. The small companies haven't and so there has been a modification. They have had a chance to look at what is going on. The rules are being modified. So, again, I would be happy to have some of our people talk with you about this off-line and I am sure that Chairman Cox would also.

Mr. GARRETT. Thanks.

The CHAIRMAN. We will recess. I thank the Secretary. We will start promptly at 12:45 p.m..

Mr. BACHUS. Mr. Chairman, I would like, and this is my personal opinion, but I would like to express to the Secretary my compliments. I think you were badgered, and your patience under fire was commendable.

Secretary PAULSON. I didn't look at it as badgering. It is my job to come up here and to respond. Thank you.

Mr. BACHUS. I did not mean Mr. Garrett. I meant earlier.

[Recess]

The CHAIRMAN. The committee will reconvene.

Mr. Scott.

Mr. SCOTT. Thank you, Mr. Secretary, for your patience and your generosity of time and staying with us for this session.

Let me first start off, Mr. Secretary, with a few questions. In your testimony you were very positive about the economy and our policies of international financial security around the world. Let me ask you, first of all, do you know the unemployment rate in the African American community?

Secretary PAULSON. Too high.

Mr. SCOTT. Do you know what it is?

Secretary PAULSON. I don't know the exact number. I have seen numbers getting way up there.

Mr. SCOTT. And specifically not just in the African American community but among African American males.

Secretary PAULSON. Yes.

Mr. SCOTT. It is catastrophic—over 40 percent, and in some areas even higher than that. That is not a good sign certainly for that community. I would like to ask you to take a close look at that.

As our top economist, as our Secretary of the Treasury, to have a segment of our constituency hovering at 40 or 50 percent unemployment is intolerable, and I would like to see us address that, find some reasons for that, particularly when you are so glowing with the soaring aspects of the economy otherwise, but for the African American community it is a serious case of extreme depression.

The other point I wanted to discuss with you is the squeeze on the middle class, another great area of concern. And if we look at how the middle class has contributed and has downsized, so to speak, we can almost see it in direct proportion to the loss of manufacturing jobs in this country.

So when we look at this economy I think, and the sector of African Americans especially and the squeeze on the middle class, the squeeze of middle class jobs, which are basically manufacturing jobs, and the loss of this has been directly tied to what I see as a very warped trade policy that in effect rewards companies and gives tax incentives for our companies to move overseas, to set up manufacturing plants overseas, and then if they make profits and keep those profits overseas, they are not taxed in our system. That is another area that we have to address.

And I agree with you, the world is too short, globalization is too important, the world economy is too important. We are so involved in it that isolationism is certainly not the answer. But perhaps some protectionism, something to realize now that we have to come home in so many measures, because America is suffering, America is not satisfied.

The polls for the President of the United States are devastatingly low, and for us in Congress, it is even lower: something in the area of 18 or 19 percent dissatisfaction of us in Congress, and around 20 percent as far as the President of the United States.

So America is upset about a few things. But there is no trade policy that exemplifies what is wrong with our trade policy, what is wrong with this country than the Korean Free Trade Agreement that is impending. Are you familiar with that, Mr. Secretary?

Secretary PAULSON. Yes, I am.

Mr. SCOTT. If you look at that, it shows what is wrong with our trade policies. Here we are with a country like South Korea. Are you aware, for example, that last year 700,000 automobiles were imported into this country from Korea and yet less than 5,000 United States automobiles were imported into Korea. Within this agreement, that is one thing, their tariffs, their complexities of them all are arranged in such a way to give this a terribly bad deal for the United States.

But the other point is as a part of these agreements they have what is known as these sort of economic industrial zones that are created—

The CHAIRMAN. If he is going to have time to answer.

Mr. SCOTT. My point is on that point—that are created basically to employ North Koreans who come in and work and take the money back into the North Korean economy. My bottom line is I would like to get your response on this agreement, your thoughts on it, would you, please?

Secretary PAULSON. Congressman, thank you for your comments. I very much share your concern with unemployment among young African Americans and males. Now with regard to the Korean Free Trade Agreement, I will pass on your comments to Ambassador Schwab and ask her to get back to you. But in terms of the auto sector, that is one that was focused on, so I am aware of the numbers you cited. I also am aware that Ambassador Schwab believes that there were a number of breakthroughs on this agreement that are going to make it much easier to import automobiles to Korea in the future.

Also with regard to manufacturing I would just have this to say to you, and it is very interesting. In 1950, we had 14 million manufacturing jobs in the U.S. economy; that was 30 percent of the employment. Today we have 14 million manufacturing jobs; that is 10 percent. Manufacturing has shrunk as a percentage of the U.S. economy. We have 7 times as much output as we did in 1950 and we are still the largest manufacturer in the world, 2½ times greater than China, bigger than Japan, a couple times bigger than Germany, but it has been automation.

I would just simply say to you, and I am not debating it, I understand the issue, but that there are many other industries that have taken their place, and that of the top industries, many are in service industries right now—engineering, computer sciences, we can just go through that long list.

But I think the name of the game is transitioning people from manufacturing jobs to other good jobs and finding good jobs, so we agree on that. I am not disagreeing with you, I am just saying that there have been changes all over the world that have been driven by automation.

The CHAIRMAN. The gentlewoman from Minnesota.

Mrs. BACHMANN. Thank you, Mr. Paulson, for your willingness to come back to this committee and speak to us this afternoon. I am the lone Republican holdout on this side. But thank you, Mr. Secretary, for coming back to this committee. I appreciate your time.

The question was asked of you earlier regarding entitlement spending, and that is an area of deep concern of mine as well. The untold story that so many Americans aren't talking about is really the great prosperity that we are enjoying right now, low unemployment, the markets are doing great, and the stock market is doing great. We have a great success story, but it is a very short window that we have before the great drawdown on entitlements will begin to occur, and I know members in this room may disagree on how we should address this situation, but I think there would be very little disagreement on the fact that we can't sustain what we are doing now.

I wonder if perhaps, and I have several questions I would like to ask you, but I first wonder if you would answer what would be your first suggestion for what at a minimum Congress should begin to do this session to address the entitlement looming crisis that we are looking at.

Secretary PAULSON. Okay. I think you are wise to say that the time to address these problems is during a time of economic strength. Now I don't want to sound like Don Quixote here, and even though I think it is unlikely, I still believe there is always a possibility we could get people on both sides of the aisle to come to the table and come with open minds to put forward their best ideas and come up with solutions.

There have also been budget proposals put forward by the Administration, including in the Medicare area, to slow down the rate of growth of spending and the trajectory of growth as it relates to things like program efficiency.

Mrs. BACHMANN. Reclaiming my time, the Federal budget is very misleading, and this is something I wonder if you can comment on. It encourages Congress to over commit to future entitlement spending because the true long-term costs are not properly accounted for. This is something that I am concerned about. It seems that we could benefit from a process that would incorporate present value calculations of our overall commitments under current law and not just over a limited time horizon, like maybe 75 years, an estimate of all future sources of revenues and outlays, then split into major spending categories, Medicare, Social Security, and the rest of government.

I am just wondering, Mr. Secretary, if you agree that that would be helpful or do you think that Treasury's annual financial report to the Federal Government would be a good place to include such an estimate? Because having good data to work off of helps us.

Secretary PAULSON. I agree with you, good data to work off of helps, but there are so many different reports and analyses. But as I talk to people, I don't find disagreement as to the problem. I don't have a lot of people in either party standing up saying there is no problem.

Mrs. BACHMANN. Right, I agree with that.

Secretary PAULSON. So I really do think it is more about political will than it is about economic analysis.

Mrs. BACHMANN. I agree absolutely. Mr. Secretary, that is why I am wondering, what would be your minimum goal for Congress this term in beginning to address this problem? If we agree there is a problem, what would be the minimum goal, in your estimation?

Secretary PAULSON. A minimum goal I had was to talk about this issue with as many people as I could, and depoliticize it in order to get agreement on both sides that there is a problem, so it would be easier whenever that time comes to come together to solve it.

Mrs. BACHMANN. I think we can get there. But what I am wondering is, on the solution side of the equation, Mr. Secretary, what would be your minimum goal on the solution side of the equation?

Secretary PAULSON. Other than what I have just suggested, which is to make progress toward understanding the problem and agreeing that it needs to be solved, the minimum would be to have people on both sides agree to come together and sit down with an eye towards solving the problem.

Mrs. BACHMANN. I guess we will end with that, Mr. Chairman.

The CHAIRMAN. I thank the "Lone Ranger" for her comments. And now the gentleman from Texas.

Mr. GREEN. Thank you, Mr. Chairman.

I thank you for the ocularity that you provided at the genesis of this hearing. You made some most important comments about equality and inequality, and I would like to just for a moment make a few additional comments and thank the Secretary of for being here today.

Mr. Secretary, you have indicated that you have concern for reducing poverty, building a strong middle class, and that you want to see people around the world, I suppose, share in the benefits of this economic growth. In this country, we have persons who work full time and live below the poverty line. We are the richest country in the world—1 out of every 110 persons is a millionaire—yet we still have people working full time and living in poverty.

We mentioned saving. Many times, much of the time what persons who are full-time workers are doing is not saving, they are postponing consumption, and there is a difference between saving and postponing consumption. They literally have things that they could consume that they forego so as to have some semblance of savings.

There is also the inequality of opportunity that the chairman talked about very briefly, and it has to do with, in my comment, earnings. We have CEOs who are making much, much more than the average worker, 500 times and even more in terms of increases in their salaries.

And then we have the inequality of the opportunity to learn. In my opinion, we are not putting enough into the institutions of higher education so that all persons can have equal access to education.

With that said, I now go to your statement wherein you indicate that you want to end the policy of lend and forgive, the policy that has to some extent benefited many of the nations of Africa. Given our history as it relates to Africa, our history in this country, it seems to me that we have a moral imperative to do more than anyone else on the planet when it comes to Africa.

My concern with ending the lend and forgive policy is in which direction will it take us if you do this? Will we cease to lend, or will we accord more grants? There are many directions that we can go in, and the phrase "end lend and forgive" causes me some degree of concern.

So I would like for you, if you would, to tell me, will we continue to lend? Is that a yes or no? If you would, I would beg you to begin by saying yes or no, because sometimes when people finish, I don't know whether they have said yes or no. If you could.

Secretary PAULSON. Congressman, you took a while to ask the question, and I would like just a minute or two to answer.

Mr. GREEN. I agree that you should say all that you desire, Mr. Secretary, after you just tell me whether you think we will continue to lend—

Secretary PAULSON. Obviously.

Mr. GREEN. I take that as a yes.

Secretary PAULSON. In terms of this Administration, I can't think of any Administration that has ever worked so hard or done so much to make a difference in Africa, and we could just tick off all of the various things in terms of what has been—

Mr. GREEN. Without ticking them off, let me mention one other thing. You indicated in your comment that you have made a call on behalf of Mr. Wolfowitz because you wanted to make sure there was a fair process. You did say this. My concern is this: Given that there has never been a female to head the World Bank, never in the history of World Bank, have you made any calls to indicate that it may be time for a capable, competent, qualified female to head the World Bank?

Secretary PAULSON. The last time I was asked the question, I was asked whether I made a call on lending to Iran. Now, there haven't been any votes to lend to Iran since I have been Secretary.

With regard to this situation, I worked to make sure the proper governance process was in place as it related to Paul Wolfowitz. Once that was done, I called around the world to listen to what leaders around the world wanted, and what I heard was they wanted someone—

Mr. GREEN. Do you agree that there are capable, competent, qualified females? Did you make any phone calls to assist any female, any female who is capable, competent, and qualified to hold this position?

Secretary PAULSON. I did not, and I think it would be a great day when a woman runs the World Bank.

Mr. GREEN. What have you done to accelerate the movement toward that great day? Things don't happen by accident; they usually happen by design. What have you done by design to assist in the process, since you were willing to assist Mr. Wolfowitz?

Secretary PAULSON. What I was doing with regard to Mr. Wolfowitz was working to assure a fair process, and then what I did after that was to make sure that we would get someone who was very well regarded and considered an expert around the world to lead the efforts for development and for lending to poor countries, and someone who has a big—

Mr. GREEN. Thank you, Mr. Chairman. I yield back the balance of my time.

Thank you, Mr. Secretary.

The CHAIRMAN. Mr. Secretary, may I ask you, we have been joined by one member who was not here at the close. I think we can fit them both in if you can do that.

Secretary PAULSON. I will be very brief.

The CHAIRMAN. We may have to cut the gentleman to 3 or 4 minutes. The gentlelady from Wisconsin under our agreement will go first and then finish with the gentleman from Illinois.

Ms. MOORE OF WISCONSIN. Thank you so much, Mr. Chairman, and thank you, Mr. Secretary, for sticking around.

I do have a question about vulture funds. As you know, vulture funds are specialized asset management companies that buy the distressed commercial debt of the poorest and most indebted countries, most notably in Africa, and knowing that the multilateral debt relief has put the governments in these countries in a better position to pay.

These companies are formed specifically to prey upon a particular country, and then they sort of disappear. They buy these debts at a deep discount and then go after them in courts of countries, particularly United States and Britain. We even have a couple of cases, the Elliott case, where they paid $11 million for the debt of Peru and recovered $55 million from a New York court. And, of course, the resident of Washington, D.C., Michael Sheehan, from Donagan International, which bought debt for $3.8 million from Zambia. I did that just as background information for those people who may be watching us here.

A third of the countries receiving this debt relief have been targeted by lawsuits and 38 litigating creditors with judgments awarded in 26 of these cases. And I say all this to say that I am very, very concerned that vulture funds didn't come up in the G8 meeting. Your testimony has perhaps some vague reference to those vulture funds on page 6, paragraph 4. I am not even sure you are referring to them.

You spent a lot of time answering questions of the gentleman from Texas Mr. Green, and Mr. Shays earlier, talking about placing more restraints on lenders, but you really didn't talk about what we could do with these vulture funds. The Department of the Treasury has been briefed by NGOs like the Debt Relief International, which has given you really a thorough briefing on what you can do, but yet in your testimony you say, oh, we are working with various fora, thinking about what we might do, exploring what we might do. And what you could be doing right now is providing some technical assistance and legal assistance to these countries like Liberia where the predators are just waiting to prey on them. You could be giving them advice about what to do before they come, during these lawsuits, and the Treasury is missing in action on this. Why?

Secretary PAULSON. I would just say to you, Congresswoman, that I have been asked not to overreact to some questions, but let me say when you say we could be doing more for Liberia, maybe we could always do more. But we have been so active and Treasury's Office of Financial—

Ms. MOORE OF WISCONSIN. Listen—reclaiming my time. Listen, I know that this Administration has done a lot for Africa. I want to stipulate to that, I want to acknowledge that. I am talking about why aren't we giving technical assistance to these countries to stave off these vulture funds?

Secretary PAULSON. I would say this: We are doing everything we can to help them, and I deplore what the vulture funds are doing, and we use moral solutions. But the vulture funds have the rule of law on their side. When countries enter into debt agreements, laws apply. And so the one thing I take some comfort in is that they haven't been overly successful. The judgments they have realized at the end have not been as high as they might have been.

But this is a problem, it is a difficult problem to deal with because of the way our legal system works, and it is one that we are focused on.

Ms. MOORE OF WISCONSIN. Why aren't you advising Congress about what we might do since these cases are being brought primarily in the United States? Why didn't you bring it up in the G8 where these nations could change their laws?

Secretary PAULSON. I wouldn't know how to change the law, because how could you change a law that says—

Ms. MOORE OF WISCONSIN. There is no transparency.

Secretary PAULSON. This is not about transparency. The law basically says if you borrow money, you have an obligation to pay it back.

Ms. MOORE OF WISCONSIN. We could define "odious debt." if there are illegitimate regimes that have changed, there are ways that we can define. You could use the forum of the G8 to define "odious debt."

The CHAIRMAN. The gentlewoman's time has expired. Now, 3 minutes for the gentleman from Illinois, and 3 minutes for the gentleman from Tennessee.

Mr. MANZULLO. Secretary Paulson, thank you for your service and your patience. I was disappointed that the Treasury Department once again did not label China as a currency manipulator—not disappointed in you, but disappointed in the decision. I think you are doing a great job over there.

In previous years, the excuse of Treasury was that China did not meet the two conditions required by law, that you needed a trade surplus with the United States, and with the rest of the world to be a currency manipulator. Now they have both, about $400 billion; 177 billion with the rest of the world, the rest with us.

In your prior testimony you said that we clearly found China has manipulated its currency. You also said it is an unnatural act. Then you also said you have to show intent. Well, I can't see how intent could be shown any more clearly than every day the Chinese intervening in the market.

I mean, we are just at the point now where we need Treasury to say, hey, we have given them enough rope, we are going to label them as a currency manipulator. Mr. Secretary, how much more evidence do you need before you find out that they are a currency manipulator?

Secretary PAULSON. We are not arguing over how the currency is valued, and we don't have a difference of opinion as to what China needs to do. And what the act in question says, that if we had found them a manipulator, which we didn't, the remedy would have been to do what we are doing right now, which is work to press them directly through negotiations and work with the IMF.

We have had big success with the IMF. Recently—I think it was on Friday—they had a successful vote which is going to allow them to approach their currency surveillance process in a different way, which I think will help us in our work to achieve—

Mr. MANZULLO. But when you make the official designation, that goes a long way nationally and internationally as a currency manipulator. That encourages them more to clean up their act.

Secretary PAULSON. There are many, many countries in the world that don't have market-determined currencies. There are many—

Mr. MANZULLO. But it is not killing our manufacturing base.

Secretary PAULSON. Here we have a country that has recognized the principle and is moving its currency. So to say they are manipulating to gain an unfair advantage in trade gets to motive.

Mr. MANZULLO. So it may be against their motive, but not against what they are doing, especially when you represent a highly industrialized manufacturing district and people that could compete, but they are getting killed because of the—

Secretary PAULSON. I appreciate your comments. I am certainly not here to defend China's currency practices. Any of the Chinese who have sat down across the table from me know that I am not patient.

The CHAIRMAN. The gentleman will suspend.

The gentleman from Tennessee.

Mr. DAVIS OF TENNESSEE. Mr. Chairman, thank you very much.

Secretary Paulson, it is good to see you here. I am glad that you spent the time that you have, and you certainly had several questions that have been asked of you, and I appreciate your engagement to answer some. And some I wonder if you have actually answered those, at least not to my satisfaction; others you may have.

I live in Tennessee. I represent an area where low-wage, low-skilled jobs have been leaving almost at a rate of—

Secretary PAULSON. I missed the industry.

Mr. DAVIS OF TENNESSEE. Lower-skilled, lower-wage industries have been leaving almost as if it is a rabbit fleeing with hounds behind him. There is a saying we have is that you have to be careful; you can eat corn out of the crib, but not the seed corn, because you will be hungry the next year.

My fear is that our economic policy is gradually chipping away at that sackful of seed corn, that we may ultimately destroy or at least have a significant impact on our industries in America. I look at China that has probably 20 percent of the world population and India with another 20 percent, being 40 percent from those two nations, and I would assume, and I believe I may be correct, that probably when you look at the production of those two countries, it is mainly for export, it appears to be.

In our country probably 90 percent of the people can actually purchase what we produce in this country, maybe 10 percent can't, but most, if it is a house, or an automobile. Most can afford clothing, things we can buy. But in India and China, 40 percent of the world's population cannot purchase what is being produced in their own country. I think that is a bad—you talk about globalization. I don't think that is a real plus to say we are in a globalized economy.

Number two, I look at this trade policy that we have, and I look at our debts that we are adding up, and I heard someone today talk about entitlements, is that really going to destroy our economy. I wonder if they realize in the budget is $2 billion a year in Iraq to no-bid contractors, which seems to be an entitlement to them, is also having a tremendous impact on our economy in this country and our ability to invest in our own country.

So we have had a lot of talk today that I believe tries to justify each person's positions rather than look at America itself.

The question I want to ask you—and there was an editorial in the New York Times today that discussed bipartisan legislation introduced in the Senate last week that calls for a gradual process of imposing economic and political pressure on China unless they move faster to increase the flexibility of their exchange rate.

I am inclined to agree with the legislation itself, but what the editorial suggests is that maybe we need to look at other areas of globalization rather than just China opening up.

The CHAIRMAN. If the gentleman wants an answer, we will have to wrap up that question soon.

Mr. DAVIS OF TENNESSEE. I would like your opinion on the legislation, if you are familiar with 1607; if not, the economic pros and cons of threatening China mildly or strongly to take more action in the immediate future.

Secretary PAULSON. Congressman, at the beginning of your statement you talked about the need for major structural reform in China, where most of their growth is exports, manufacturing for exports. We are going to have a big imbalance, a trade imbalance, until China engages in widespread structural reform, until they have the kinds of social safety nets where their citizens don't have to have precautionary savings, savings at the 50 percent level.

So I do believe that what it is going to take over time is direct engagement, but it is going to be more of a gradual process because it is difficult or impossible for us to mandate structural reform in China. So that would be my answer. Thank you.

Mr. DAVIS OF TENNESSEE. So that safety net you are talking about is an entitlement?

The CHAIRMAN. Mr. Secretary, thank you for coming. And the hearing is adjourned.

[Whereupon, at 1:17 p.m., the hearing was adjourned.]

A P P E N D I X

June 20, 2007

<u>REMARKS OF THE HONORABLE DONALD A. MANZULLO</u>
<u>BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES</u>

"THE STATE OF THE INTERNATIONAL FINANCIAL SYSTEM"

Wednesday, June 20, 2007 10:00AM in Room 2128

Mr. Chairman, thank you for holding this hearing today on the subject of the international financial system. I look forward to the comments by the Secretary of the Treasury, Henry Paulson, Jr., regarding the Administration's positions on reforming the International Monetary Fund (IMF), the World Bank, and his perspective on the general state of the international financial system. I appreciate the service of Secretary Paulson who brings a great depth of experience to the international financial portfolio of his responsibilities.

The world financial system has dramatically changed since the Bretton-Woods Agreement was first developed in the aftermath of World War II. The agreement established the IMF and the World Bank with the prime purpose to stabilize exchange rates and promote economic development in order to prevent despotic leaders from taking political advantage of future economic calamities.

To the great credit of the founders of the post-World War II international economic order, the mission of the IMF and the World Bank has been a success. However, times have changed. Initially, exchange rates were stabilized by the gold standard. By the late 1970's, the gold standard and fixed exchange rates were abandoned. Now, exchange rates are governed by market forces with periodic intervention by foreign governments or the IMF to insure that national economies do not collapse and cause political instability because of a weak currency.

However, one of the rules of free trade is that nations should not regularly manipulate their currency for a trade advantage. There are many nations of the world that regularly intervene in exchange markets to undermine the value of their local currency to boost the value of their exports. I was disappointed that the Treasury Department once again did not label the largest of these offenders – China – as a currency manipulator. In previous years, the excuse was that China did not meet the two conditions required by the law – a nation needs to have both a large trade surplus with the United States and the rest of the world in order for it to be considered as a currency manipulator. To respond to that problem, I introduced legislation in 2005 to give Treasury the flexibility to label a country as a currency manipulator even if the nation does not have a global trade surplus. This provision was included in the new version of *Fair Currency Act of 2007* (H.R. 782), authored by Representatives Tim Ryan and Duncan Hunter, which now has 107 bipartisan cosponsors.

However, this issue is now moot for China. In 2004, China had a relatively modest $32 billion global trade surplus when the U.S. experienced a trade deficit with

China totaling $162 billion. In 2006, China's trade surplus with every nation of the world ballooned to $177.5 billion and America's trade deficit with China reached $232.5 billion. It is obvious that China's undervalued currency influences global patterns of trade. Suffice it to say that I believe China meets the criteria of our law that enables the Treasury Department to label China as a currency manipulator. We cannot sustain a manufacturing base in this country when some of our Asian competitors can sell a product in this country less than the cost of the raw materials for our domestic producers.

The Wall Street Journal reported yesterday that under pressure from the United States, the "IMF has promised to identify countries that manipulate their currencies in ways that give them an edge in foreign trade." Obviously, having a multilateral international organization like the IMF take a more pro-active position on this issue is welcome. But any decision by the IMF should not preclude action that the U.S. government can take to offer our manufacturers concrete remedies to address the situation. As every day that passes without any significant appreciation of China's currency – especially after the limited success made at the recent Strategic Economic Dialogue with China – the lack of progress will only increase the chances that legislation such as S. 1607, which was introduced by Senate Finance Committee Chairman Max Baucus and Ranking Minority Member Chuck Grassley to require trade remedies to correct currency misalignments, will become law even over a presidential veto. With all due respect to the esteemed witness before the committee this morning, the Administration had better pay attention. The frustration level is building across the country. Thank you, Mr. Chairman.

Opening Remarks

Honorable Maxine Waters

House Committee on Financial Services

Hearing: "The State of the International Financial System"

The Honorable Henry M. Paulson, Jr., Secretary U.S. Department of Treasury

Room 2128 Rayburn House Office Building
10:00AM
June 20, 2007

Good morning ladies and gentlemen. I want to thank our distinguished guest, the Honorable Henry M. Paulson, Jr., Secretary of the Treasury for joining us today to provide his unique perspective on the State of the International Financial System. Mr. Secretary, you know that I have very specific interests related to debt cancellation, China and Dafur, and China's participation in the international financial system so I welcome you.

I am pleased to say that existing debt cancellation programs have freed up resources to reduce poverty in some of the world's poorest countries. I thank you for your work in this area. Uganda is using its savings of $57.9 million from debt cancellation in 2006 on primary education, malaria control, healthcare and infrastructure. Zambia is using its savings of $23.8 million to increase spending on agricultural projects and to eliminate fees for healthcare in rural areas. However, there are many needy and deserving poor countries that have yet to benefit from the cancellation of their debts.

I recently introduced the *Jubilee Act,* which will make 67 of the world's poorest countries eligible for complete debt cancellation by the United States, the World Bank, the

International Monetary Fund (IMF), and other bilateral and multilateral creditors. In order to receive debt cancellation, the governments of these countries will be required to allocate the savings from debt cancellation towards spending on poverty-reduction programs. They also will have to engage interested parties within their societies, including a broad cross-section of civil society groups, in the spending allocation process; produce an annual report on this spending; and make it publicly available.

The *Jubilee Act* also will establish a framework for responsible lending in order to preserve the benefits that debt cancellation has provided to poor countries and their people. As you may be aware, the *Jubilee Act* requires the Secretary of the Treasury to take action to end the predatory practices of "vulture funds," private investment funds that buy up the debts of poor countries at reduced prices just before these countries receive debt cancellation and then sue these countries to recover the original value of the debts plus interest. Finally, the *Jubilee Act* will require the Secretary of the Treasury to develop and promote policies to prevent bilateral, multilateral and private creditors from eroding the benefits of debt cancellation through irresponsible or exploitive lending.

The *Jubilee Act* will expand debt cancellation to all needy and deserving poor countries and preserve the benefits that debt cancellation has provided to impoverished people worldwide.

I am particularly concerned about debt cancellation for Haiti. According to the International Monetary Fund (IMF), Haiti owes over one billion dollars to multilateral financial institutions. Of this total, $21.4 million is owed to the IMF, $507.1 million to the World Bank, and $533.9 million to the Inter-American Development Bank. Much of this debt burden was accumulated during the oppressive rule of the Duvalier regimes, neither of which used the money to benefit the Haitian people.

I introduced House Resolution 241, which urges the IMF, the World Bank, the Inter-American Development Bank, and other multilateral financial institutions to cancel Haiti's debts. The Resolution also urges the Secretary of the Treasury to use the voice, vote and influence of the United States within these institutions to accomplish this goal. Cancellation of Haiti's debts will enable the democratically-elected government to improve needed social services --- health care, education as well other essential services. In addition, it will enable Haiti to invest in its infrastructure needs, while improving the lives of the Haitian people.

Similarly, Liberia's total debt stands at $3.7 billion, $1.6 billion of which is owed to multilateral financial institutions, including $740 million to the IMF, $530 million to the World Bank, and $255 million to the African Development Bank. A total of $358 million is owed to the United States. Much of Liberia's debt burden was accumulated during the oppressive and undemocratic regimes of Samuel Doe and Charles Taylor, who did not use the loan funds for the benefit of the Liberian people.

I am especially concerned that Liberia may be expected to pay off its arrears to multilateral financial institutions prior to obtaining new assistance in the form of grants, loans, or debt relief from the international community. This nation cannot afford additional delays and cannot reasonably be expected to drain such large amounts of money from its already fragile economy.

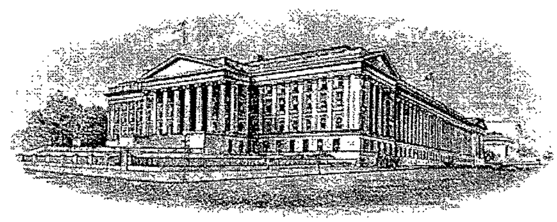
Of course, the ongoing genocide in the Darfur region of Sudan is a top priority for me. Genocide is believed to have caused the deaths of almost half-a-million people. More than 200,000 people have been killed by Sudanese government forces and armed militias since 2003, and another 200,000 people have died as a result of the deliberate destruction of homes, crops and water supplies and the resulting conditions of famine and disease. Over one-third of the population of Darfur has been displaced, and the United Nations estimated that almost 250,000 people have been displaced in the past six months alone, due primarily to government-sponsored militia attacks.

China, unlike most nations in the international financial community, has cultivated a close relationship with the government of Sudan. China maintains close military ties with Sudan and purchased almost $2 billion worth of Sudanese oil last year. China also has cancelled $100 million in Sudanese debt and provided an additional $20 million to finance the construction of a presidential palace in the capitol city. As a result, China is in a unique position to put pressure on the government of Sudan to stop the violence in Darfur. So far, it has failed or refused to do so. Secretary Paulson and other U.S. officials should urge China to acknowledge and condemn the atrocities in Darfur, cease all weapons sales to Sudan, and suspend economic cooperation with Sudan. U.S. officials should also urge China to use its leverage to influence the

Government of Sudan to stop the genocide.

Finally, I have paid close attention to the Strategic Dialogue in which the U.S. has been engaged with China on a host of trade, currency and economic issues. However, I have not seen any evidence that these talks have produced concrete results that will dramatically benefit the United States. The June 2007 Treasury International Economic and Exchange Rate Policies Report to Congress concluded that the Chinese currency is undervalued, and that the Chinese exchange rate regime is an issue. Are the Chinese concerned about the perception of their intractability on this issue?

We are also still prohibited from fully participating in the Chinese financial services sector, while China has unfettered access to U.S. financial services and our capital markets. As such, I hope that the Secretary will be able to shed light on what the Chinese believe will be accomplished to eliminate restrictions to their financial markets before the next round of talks. After all it has been a number of years since China joined the World Trade Organization (WTO), which operates on principles that seem inconsistent with China current policy towards the United Sates financial services firms. Thank you.



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10 a.m. (EDT), June 20, 2007
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TESTIMONY OF TREASURY SECRETARY HENRY M. PAULSON, JR. BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES ON THE STATE OF THE INTERNATIONAL FINANCIAL SYSTEM

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 HIPCs 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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