

# REFORM OF THE IMF AND WORLD BANK

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**HEARING**

**before the**

**JOINT ECONOMIC COMMITTEE  
CONGRESS OF THE UNITED STATES**

**ONE HUNDRED SEVENTH CONGRESS**

**FIRST SESSION**

—————  
**March 8, 2001**  
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# CONTENTS

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## OPENING STATEMENT OF MEMBERS

Representative Jim Saxton, Chairman . . . . .	1
Senator Jack Reed, Ranking Minority Member . . . . .	4
Senator Paul S. Sarbanes . . . . .	5

## WITNESSES

Statement of Allan H. Meltzer, Former Chairman, International Financial Institution Advisory Commission (IFIAC); American Enterprise Institute; Professor, Carnegie Mellon University . . . . .	7
Statement of Charles Calomiris, Member, IFIAC; Professor, Columbia University . . . . .	13
Statement of Adam Lerrick, Lerrick and Company Incorporated; Senior Advisor to the Chairman, IFIAC . . . . .	20
Statement of C. Fred Bergsten, Director, Institute for International Economics; Member IFIAC . . . . .	23

## SUBMISSIONS FOR THE RECORD

Prepared statement of Representative Jim Saxton, Chairman . . . . .	40
Prepared statement of Senator Jack Reed, Ranking Minority Member . . . . .	42
Prepared statement of Allan H. Meltzer together with “Recent Crisis in Post-Crisis Perspective” . . . . .	44
“Reforming the Sisters,” from <i>The Economist</i> . . . . .	75
Prepared statement of Charles Calomiris . . . . .	76
Prepared statement of Adam Lerrick . . . . .	94
Prepared statement of Representative Carolyn B. Maloney . . . . .	110
A written response from Allan H. Meltzer to Representative Carolyn B. Maloney . . . . .	111

# REFORM OF THE IMF AND WORLD BANK

Thursday, March 8, 2001

CONGRESS OF THE UNITED STATES,  
JOINT ECONOMIC COMMITTEE,  
WASHINGTON, D.C.

The Committee met, pursuant to notice, at 10:00 a.m. in Room 2360 of the Rayburn House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

**Present:** Representatives Saxton, English, and Maloney.  
Senators Sarbanes and Reed.

**Staff Present:** Chris Frenze, Bob Keleher, Darryl Evans, Colleen J. Healy, Corine Bradshaw, Daphne Clones-Federing, and Russell Comeau.

## OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

**Representative Saxton.** Good morning. It gives me great pleasure to welcome Dr. Meltzer and his fellow witnesses before the Joint Economic Committee (JEC) this morning. Dr. Meltzer served as Chairman of the International Financial Institution Advisory Commission (IFIAC), and the other witnesses before us were also associated with the Commission. I would like to take this opportunity to compliment Dr. Meltzer and the Commission once again for their fine work in addressing some of the most difficult issues in current economic policy.

In 1998, we began to look at the International Monetary Fund (IMF) as a result of a request from the Administration for an \$18 billion appropriation to add to, among other things, our portion of the IMF quota. As we began to look in terms of our oversight responsibility on this issue, in light of the U.S. expenditure or commitment of these extra dollars, we began to ask questions that seemed to have elusive answers.

We began to ask questions that in many instances went unanswered, either intentionally or unintentionally, and, as a result, three years ago began the process of learning about the International Monetary Fund and more about the World Bank and attempting to convey that to others, who are interested, both in the Congress and outside of the Congress.

Recently, *The Economist* magazine commended the Commission's report, which was a very important part of this process – noting that it commanded support across the ideological spectrum. That certainly was an appropriate comment.

[The article, “Reforming the Sisters” from the Economist appears in the Submissions for the Record on page 75.]

Over the last few years, there has been a remarkable shift in informed opinion regarding reform of the IMF and the World Bank, and the

Meltzer Commission has played a central role in bringing that about, along with Members of both parties on this Committee.

In retrospect, it is clear that the debate over the IMF appropriations a few years ago led to the much-needed examination of the role of the International Monetary Fund, as well as the World Bank.

In 1998, the proposed quota increase for the International Monetary Fund, which I mentioned a few minutes ago, sparked a major debate over the reform of the Institution in Congress. In the same year, this Committee held several hearings and issued a number of studies on various IMF reforms. This research identified a number of key problems with the IMF, including lack of transparency and excessive interest subsidies on loans that exacerbated moral hazard problems, increasing incentives for inappropriate economic behavior.

The lack of financial transparency also hindered Congressional and public understanding of how U.S. contributions are used. The current U.S. quota to the IMF is about \$50 billion, and so it seems to me and to others on this Committee that it is certainly important for us to know and understand, and, yes, approve of how those funds are used.

Recently, a former IMF research director validated these findings relating to the Fund's jerry-built structure of financial provisions, and suggested that almost nobody outside, and indeed few inside, the Fund understand how the organization really works.

Penetrating this obscurity required an extensive financial analysis of the Fund, supplemented with financial and other data requested from the General Accounting Office and made public through Committee hearings. The lack of IMF financial transparency is itself a problem, but also reflects a virtually unintelligible and archaic presentation of IMF financial statements.

To provide just one example, the IMF is a huge lending institution that does not classify most of its loans as loans. That is right, they don't classify most of their loans as loans. This lack of transparency also obscures the fact that most IMF funds used in operations come from a relatively small number of members, and that most IMF members do not provide such support.

It was also found that IMF loans exceeded prudent limits, had excessive maturities, that is, excessively long-term, and were not subject to adequate accounting controls or loan safeguards.

In addition, an IMF drift into development lending was noted as a serious concern, and a reflection of IMF mission creep. It was also concluded that IMF borrowing in capital markets was quite feasible and would be superior to continual quota increases, thereby relieving the pressure on the American taxpayer and other taxpayers.

Some of the research findings were later incorporated into legislation, including the *IMF Transparency and Efficiency Act*, which I sponsored in 1998. A version of the legislation became law, mandating increased

IMF transparency and reduction of IMF loan subsidies as a condition of the quota increase, which we finally granted.

Although some steps toward transparency have been made, it does not appear that the IMF has complied with interest rate reforms. This is most unfortunate, since it was hoped that these higher interest rates might encourage other needed reforms, such as shorter loan maturities and tighter loan caps. However, under Congressional pressure, including proposed legislation, the IMF did finally adopt some basic accounting controls and loan safeguards last summer, but their effectiveness remains to be seen.

In short, while some limited progress has been made, much more remains to be done. The Report of the Meltzer Commission last year provided a much-needed analysis of the IMF activities and their impact in regard to the recent financial crisis.

Its recommendations with regard to the IMF as well as the World Bank and development banks have framed the discussion about reform of these institutions ever since the report was issued. Policy changes recommended for the IMF include borrower preconditions, higher interest rates, shorter maturities, renewed focus on liquidity lending, and increased transparency.

A recent change in the IMF balance sheet – increasing its transparency somewhat – apparently was inspired by a recommendation of the Meltzer Commission. The Commission's proposal for grant financing of the World Bank activities has also been well received. The members of the Commission should be very pleased with the powerful impact of their work, and the Congress is in your debt for your contribution to the sound economy.

I want to thank you again for being here with us today. At this point, I would like to welcome my friend Senator Reed to the Committee this morning, and apologize for having started before you got here, but we are facing a series of votes upcoming, beginning in an estimated two minutes, and so I wanted to get started so that we can get opening statements out of the way before we leave for the votes.

At this time, if you would like to have an opportunity for your opening statement, and then we will begin to hear from our witnesses. I might add that any other opening statements will be submitted for the record. Thank you.

[The prepared statement of Representative Saxton appears in the Submissions for the Record on page 40.]

**OPENING STATEMENT OF  
SENATOR JACK REED, RANKING MINORITY MEMBER**

**Senator Reed.** Thank you very much, Mr. Chairman. Let me apologize simultaneously, which is the nature of life here in the Congress. We are conducting not only hearings, but a markup on the *Elementary and Secondary Education Act*. I apologize for my tardiness.

To my colleagues, Congresswoman Maloney and Senator Sarbanes and the witnesses, welcome. I also want to thank you, Mr. Chairman. I look forward to working with you in my capacity as Ranking Minority Member. The JEC has a long and distinguished history, dating back to its creation in the *Employment Act of 1946*, and it provides a unique opportunity for Members to explore some of the most difficult issues that confront our economy.

This year should be no exception. We have critical questions with respect to the Nation's future. We might disagree on the scope and size of tax cuts, of investments and budget policy, but this is a forum in which we can explore those differences, I hope, in a very rational and factual manner.

I believe, knowing you, Mr. Chairman, and my colleagues, that we can and will work constructively to advance critical issues that affect our country.

We understand that today our economy is in the midst of a pause. How long that pause will last and how deep that pause will be is a question that our analysts might be able to shed light upon. I think it is important for us to look at our changing economy, related issues of productivity, and integrating information technology. All of these issues are dramatically affecting our economy.

Turning to today's topic, let me first compliment you, Chairman Saxton, because you were more responsible than anyone for forming this Commission, looking at the operations of the IMF, and ensuring that that Institution is carefully scrutinized.

The International Financial Institution Advisory Commission has released its final Report. Now, several months later, we have another opportunity to look back at the Report, at its recommendations, and assess where we are going and where the IMF is going.

Again, let me conclude, Mr. Chairman, by saying how pleased I am to participate with you, to work with you on the Joint Economic Committee. I know you have a vote shortly. I will be rushing in and out to take votes as well. I am prepared to end my statement.

I just wonder if our colleagues might have a few words. Would it be appropriate now or should we go right to the witnesses?

[The prepared statement of Senator Reed appears in the Submissions for the Record on page 42.]

**Representative Saxton.** If I may just indulge the Members to submit their statements for the record, I would appreciate it. We are going to have votes, and the panel has a limited amount of time to be with us this morning.

**Senator Reed.** I know Senator Sarbanes has a very few moments here with us, and as my predecessor and as my Ranking Member on Banking, and, need I say more, I think it would be appropriate that he say a few words.

**Representative Saxton.** My friend from Maryland has in the past demonstrated his ability to give very comprehensive and short statements. So if my friend would give a comprehensive short statement for a minute or two, we would appreciate it.

### **OPENING STATEMENT OF SENATOR PAUL S. SARBANES**

**Senator Sarbanes.** Thank you very much, Mr. Chairman. We have Secretary Powell before the Committee this morning and I have to get over for that hearing.

I did want to in effect participate, even albeit briefly, in the first hearing of the Joint Economic Committee in the new Congress. I want to congratulate Representative Saxton, who will be the Chairman of the JEC in this Congress, and who has held this position in the past with distinction. And I want to say, Mr. Chairman, I think you are very fortunate to have Senator Reed as the Ranking Democratic Member on the Committee.

I look forward to the two of you working closely together and developing the Committee's agenda. I believe strongly in the role of the JEC in conducting oversight on the broad economic issues facing the country.

The hearing today, "Reform of the IMF and the World Bank," is obviously a very important matter, although I must confess with all due respect to the witnesses at the table, that as I look out at them, I have, as Yogi Berra put it, a certain feeling of *deja vu* all over again, because I believe we held a hearing with the same panel of witnesses, as I recall, last April, and the Banking Committee, of which I am the Ranking Member, held a full committee hearing and two subcommittee hearings last year on this report.

I just want to make this point: I think that we are fortunate to have, in addition to the work of this Commission, a number of other serious efforts to study this issue. In fact, Dr. Bergsten's Institute for International Economics issued a study last year entitled, "The Role of the IMF: A Guide to the Reports."

Three separate reports were issued in 1999. A task force of the Council on Foreign Relations, the International Center for Monetary and Banking Policies in Geneva, and the Center for Economic Policy Research in London issued a report on IMF reform, and the U.N. Conference on Trade and Development published a report. The Overseas Development Council issued a report in March of last year, and, of

course, the IMF itself has been trying to review its operations and implement reforms. Finally, the Treasury Department submitted a detailed report to Congress last year on IMF reforms.

So, I would hope that as we delve into this subject, that we would look at the views that were presented in these other major reports as well. I think there is a great deal of talent that has been invested in studying this important subject, the talent that is here at the table and their colleagues on this Commission, but these other reports to which I made reference as well, and I think we should get the benefit of the whole sweep of the analysis that has been made. So I hope if the Committee continues down this path with hearings, that we might consider doing that as well.

Mr. Chairman, I think a lot of this Committee, and I think this Committee has done extremely valuable work in the past, and I look forward to it continuing to do so in the future under your leadership. I am particularly encouraged in that view because of Jack Reed now assuming the position of the Ranking Minority Member on the Senate side, and I know he will bring a great deal of commitment and perception to this responsibility.

Thank you very much.

**Representative Saxton.** I thank the gentleman for his remarks and look forward to working with Senator Reed and other members of the Committee, including the former Chairman.

I would just like to remark that there is room for a difference of opinion on whether Yogi would think this is “deja vu all over again.” There are a lot of things that have transpired that have rolled us into a new chapter in IMF reform, not the least of which are the products that have been developed and disseminated by the Meltzer Commission, and, of course, not the least of which is a new administration which seems to show some indication of having appreciated very much the work of Dr. Meltzer and this group.

So, hopefully we will be able to move forward together in a way that will be productive for our economy, as well as the global economy.

Let me just introduce Dr. Meltzer at this point, who, of course, is the former Chairman of the International Financial Institutions Advisory Commission, that is the Meltzer Commission, and he is with the American Enterprise Institute.

Dr. Meltzer is a professor at the Carnegie Mellon University. He is joined by several other very well qualified individuals – Charles Calomiris, a member of the Commission and a professor at Columbia University, as well as Adam Lerrick, who served as senior advisor to the Chairman of the Commission, and by Fred Bergsten, who is Director of the Institute for International Economics as well as a member of the Commission. I would like to welcome you all.

**OPENING STATEMENT OF ALLAN H. MELTZER,  
FORMER CHAIRMAN, INTERNATIONAL FINANCIAL  
INSTITUTION ADVISORY COMMISSION (IFIAC);  
AMERICAN ENTERPRISE INSTITUTE; PROFESSOR,  
CARNEGIE MELLON UNIVERSITY**

**Dr. Meltzer.** Thank you very much, Mr. Chairman. The three of us, Professor Calomiris, Dr. Lerrick and I, have divided up the work on what we are going to say today. I will talk about the World Bank and they will talk about two other subjects of interest to the Committee.

The World Bank, including IDA, disbursed to its client countries \$24 billion in 1999 and \$18.5 billion in 2000. The budgeted costs for making and managing these disbursements are relatively high, almost \$1.5 billion or more than 7 percent of average disbursements. The cost to the donor countries is higher still, a multiple of the operating costs paid by the Bank. The Commission estimated the cost of the principal development banks to U.S. taxpayers at \$5 billion per annum.

Last year, the Commission described the bank as costly, inefficient, bureaucratic, ineffective, and lacking clear objectives. Its credo is "a world free of poverty." The Commission claimed it had no effective means of achieving its objective. The Bank's president and its officials publicly denied many of the Commission's statements.

The facts are clear and simple to relate: between 1987 and 1998, the number of people living on less than a dollar a day, the Bank's measure of extreme poverty, remained the same. The proportion of the population declined modestly, from 28 percent to 24 percent. This is not much of an accomplishment for an expenditure of about 200 billion current dollars.

Recently the Bank has started a reappraisal. The press has reported on a memo written by the staff of one of the Bank's major divisions in response to a request last December from President Wolfensohn for a discussion by all divisions of the Bank's problems. The memo is unsigned, but it states that it represents "consensus views that emerged from discussions among the managers and staffs of the divisions."

A reader of the internal Bank memo gets a picture of an ineffective organization with low morale and uncertain direction.

The memo lists five major problems at the Bank: the President's management and leadership style; an overload of institutional mandates and a lack of clear direction, problems at senior management levels; inadequate resources for the work; and the high degree of negativity among the staff.

To amplify these charges, the memo says that the President's proposals "while perhaps individually worthwhile, have tended to diffuse the Bank's focus. Their importance in individual countries is often unclear. The ideas have not been accompanied by adequate resources for implementation."

In other words, the Bank is not organized to assist countries to develop their economies and improve the quality of life for their citizens.

Further, the memo charges, "the Bank today has no focus and is driven by an ever-growing list of mandates imposed on it through a variety of means: President's favored subjects, board sentiments, public pressures, ideas generated by internal constituencies, and even fads. No initiative that starts as a pilot is ever considered a failure because of a lack of any honest an evaluation."

These are serious charges that go in the same direction but much beyond what the Commission said in its report. Better use of the \$20 billion to \$25 billion of annual disbursements should be an urgent concern of the Bank, its donors, the recipients, the Congress and the new administration. An effective response to these issues would neither accept them as entirely true, reject them as false, nor ignore them.

The donor countries should take two steps. First, they should require an independent management audit to appraise the organization. In a paper prepared last year for the Commission, Tom Faught concluded that the Bank's so-called matrix form of organization is inefficient and ineffective. Some of the Bank staff now reached the same conclusion. A thorough reorganization to develop effective incentives to reduce poverty, achieve development, establish market economies and democratic government appears necessary.

Second, the donors should require a performance audit of Bank lending and aid. The Commission, using tabulations made by the Bank's staff from the Bank's records, concluded that the Bank had an overall 55 to 60 percent failure rate to achieve sustainable results and a much higher failure rate, 70 percent, in the poorest countries.

Although these data came from tabulations supplied to the Commission by the Bank staff, bank spokesmen have disputed their accuracy. We have no independent way of measuring program results. We believe that an independent performance audit is an urgent necessity. The audit should show the Bank's successes and failures three to five years after projects are completed. They should be published.

The Bank does very limited amounts of post-project evaluation. Taxpayers, donors, recipients and the Bank's staff and management should welcome an independent evaluation of its successes and failures. This is an important step toward improvement.

**Representative Saxton.** Dr. Meltzer, I see that you are going to now move into some suggestions as to reforms that you think are necessary. Maybe this would be a good point for us to break before you start that. I will be back in 10 or 12 minutes.

[Recess.]

**Representative Saxton.** Dr. Meltzer, I believe you were about to begin to make some suggestions in your statement on some things that ought to be done to continue to reform the IMF, so you may proceed, sir.

**Dr. Meltzer.** The two most important reforms are, one, choose a consistent set of objectives based on known and accepted criteria for success, and, two, shift from the current command and control approach to reliance on incentives and monitoring. The Bank gives lip service to local autonomy, but chooses programs based mainly on the whims of non-elected non-governmental organizations (NGOs), the Bank's President, and in ways named in the internal memo quoted above. We will not achieve the paramount aim of improving living standards while spreading democratic government as long as programs are chosen by the Bank acting with the NGOs. Democratic accountability and sustained decisions require that local officials learn to make the hard decisions. That will not happen until they have the incentives to do so.

Incentives are one of the central threads that run through the Commission's report on the IMF and the development banks. The Bank should support and subsidize economic and social development and improvements in the quality of life, and should monitor results much more than it currently does.

The Commission proposed five broad sets of activities or changes. First is a grants program to improve the quality of life even in countries where governments are corrupt, venal, or unwilling to develop the necessary rules, laws and institutions that economic development requires. Countries would choose the program, but money would be disbursed to vendors only after a performance audit established that the work had been done.

Adam Lerrick, a member of the Commission's staff, who is here today, showed that the proposed grants program would be less costly than the current system of lending and could be done entirely from the resources that the development banks currently have. I am pleased to report that in a recently published memo, Michael Klein of the Bank's staff endorses a very similar program.

Klein writes, "Decades of aid provision have failed to support growth and to provide basic services to the poor. Not only that, foreign debt has slowly accumulated in many poor countries to the point that they cannot pay back."

The proposal is not a World Bank policy, but it is under consideration. Last week at the IDA 13-replenishment meeting in Paris, the task force proposed that "limited use of grants could be explored cautiously." Hardly a ringing endorsement, but a step in the right direction.

The second proposed change is to introduce incentives for undertaking and continuing institutional reforms. The Commission proposed to heavily subsidize interest rates and to delay repayment of loans for countries that undertake to establish and expand institutional reforms. To develop growing economies and political democracy, countries must be open to trade, expand property and personal rights, and

develop their institutions. The Bank has not made much progress on these critical changes.

Third, the development banks should encourage regional cooperation in solving the problems of disease, pollution, forestry and agriculture. The Bank now acknowledges that it has been slow to act on so-called global or regional public goods. It has accepted this criticism and begun to implement alleviation of AIDS in Africa. This is encouraging. Much more must than done across countries in disease, agriculture, forestry and the environment.

Fourth, over a 5-year period, development banks should phase out lending to countries that reach \$4,000 per capita income or an investment grade rating for their debt. Countries with capital market access can and should obtain desired loans from the market, a much larger supplier of capital. The development banks should continue to provide technical assistance, where invited to do so. They should reserve grants, lending and subsidies for the poorest countries.

Last year, the World Bank criticized this proposal mainly on the bogus grounds that loans to middle income countries provide resources that can be used in poorer countries. This claim is false. It is surprising and disconcerting that the Bank's President was not aware that his written statements to this effect, and published statements by his senior staff, are false.

Recently the Bank has started to reconsider its role in middle income countries with access to capital markets and has appointed a task force to reconsider its role. However, it has not introduced a policy of phasing out financial assistance to middle income countries.

Fifth, overlap between the World Bank and the regional development banks should be phased out. The World Bank should be a source of technical assistance to all countries and to other development banks. It should concentrate its financial assistance principally in the poorest African countries. Provision of grants and development lending in Asia and Latin America should be the sole responsibility of the regional development banks.

The World Bank's initial reaction to the report was hostile and obfuscating. The Bank's management has devoted much of its strategic effort to developing cliché-ridden, ambiguous statements such as the Comprehensive Development Program and, more recently, the Sustainable Framework Paper.

These statements contain many words about goals and directions that are attractive. Most of us share the main objective. Very little is said about how the Bank would motivate its own and other organizations to achieve these objectives by structuring incentives for client countries and within its own organization. The idea that performance and achievement depend on incentives and effort does not appear.

The Strategic Framework Paper, however, recognizes the need to emphasize regional public goods, to reduce overlap with the IMF, to

integrate the group's private sector agency more fully into the Bank's work, and to harmonize activities with regional development banks. These steps, if taken, would move in directions the Commission advocated.

Also, we can hope that the current turmoil within the Bank may bring bona fide reform. I believe a performance audit and a management audit would improve information about the Bank, its ineffectiveness and inefficiencies, thereby making reform more likely. These audits would help the donor countries to understand why the Bank has been relatively ineffective in alleviating poverty in the poorest countries.

Real progress will not occur without organizational restructuring to increase performance incentives for the Bank's staff and within the client countries.

Poverty reduction is difficult and challenging. The Commission has no illusion that it will be done quickly. But we believe that very little will be achieved without major reforms of the type we proposed, reforms that introduce incentives for the countries to decide to make and maintain the necessary changes.

I would like to use my remaining few minutes to comment on the reception that the Commission's proposals have received outside the United States. In the past year, I have traveled and spoken about the report in Belgium, Canada, Central America, Germany, Japan, Switzerland and the U.K., in addition to the United States. I believe I can assure you that there is considerable support for many of the Commission's recommendations. The German Bundesbank and the Bank of Canada reached similar conclusions about the IMF by themselves.

A recent issue of *The Economist* magazine gives an assessment that accords with my experience. It wrote:

"It is also encouraging that a useful blueprint for reform, a starting point at any rate, is already at hand. Last year, making itself heard above the general racket, was a plan set out by the Meltzer Commission. The group did not achieve unanimity, but it did produce a report that commanded support from across the ideological spectrum, laid down some radical yet sensible basic principles."

The annual report of the U.K. Chancellor of the Exchequer states the need for "internationally agreed codes and standards, allowing financial markets to make informed investment decisions." Elsewhere the Chancellor's report discusses agreement by the G-7 Nations that "responsibility for negotiations with private creditors should rest with the debtor countries. No class of creditors should be considered inherently privileged."

The report also endorses "prequalification for assistance in a crisis. The aim is to create the right incentives for the adoption of strong policies and adherence to international recognized standards."

In September, the IMF adopted this statement as part of its reform proposal. These recommendations accord well with the Commission's

recommendations. I only hope that at some point they will begin to implement them.

In closing, I want to emphasize four points. First, we cannot afford and should not continue a system that generates expensive crises with extraordinary frequency. It must be reformed. Economic progress here and elsewhere requires a more stable system than the current IMF provides.

Second, we must rid ourselves of a system that imposes changes that countries do not want and will not enforce, that brings demonstrators to the streets protesting real and imagined wrongs, and that is ineffective.

Third, we must encourage the poorest countries and others to choose paths to economic and social development that are known to work. They must have incentives to do so.

Fourth, we must insist on performance and management audits to learn how effective these organizations are and to give them incentives to improve.

Mr. Chairman, you took leadership on issues of IMF accountability and effectiveness years ago. The new administration recognizes that global peace and stability requires blending economic, military and political programs. The best time for lasting reforms is when there are no crises. That time is now.

I welcome the opportunity to appear here today. I hope this is an additional step toward keeping reform of the IMF and the development banks moving forward by implementing the Commission's principal recommendations.

Thank you.

[The prepared statement of Dr. Meltzer appears in the Submissions for the Record on page 44.]

**Representative Saxton.** Thank you very much.

Dr. Calomiris, before I introduce you, I would like to welcome for the first time to our Committee, incoming Member Phil English from Pennsylvania. Phil and I have worked on many issues together and I have a great deal of respect for him. I was delighted when he requested to become a member of the Committee.

**Representative English.** Thank you, Mr. Chairman. A privilege.

**Representative Saxton.** Dr. Calomiris.

**OPENING STATEMENT OF  
CHARLES CALOMIRIS, MEMBER, IFIAC;  
PROFESSOR, COLUMBIA UNIVERSITY**

**Dr. Calomiris.** Mr. Chairman, it is an honor to appear here today to share my views on the progress to date on IMF reform.

I would like to ask permission to place the entire presentation I am going to make into the record, although I will not be able to present it all.

**Representative Saxton.** Without objection.

**Dr. Calomiris.** Thank you. I am going to address two main questions. First, are the reforms that have given rise to what people now refer to as the new IMF real, and what promise do they hold for solving the problems addressed by the Meltzer Commission and other critics; and, second, what additional steps should reformers take to ensure the continuation of the reform process?

Given time limitations, I am not going to be able to discuss in detail the first five pages of my statement, which includes a detailed discussion of disclosure, accounting and voting policy within the IMF. I will summarize it at the end of the statement, but I will refer to it just briefly to say that I think there has been significant progress at the IMF, and I think it is fair to say that they have been very responsive to criticisms in the areas of accounting and disclosure, and my statement goes through in detail the many changes that they have made. At the end, I will come back to talk about remaining needs for change.

I would like to turn, though, to the question of the reforms of the lending arrangements in the IMF. I am now on page six of my statement.

Over the last three years, the IMF has substantially changed the structure and terms of its lending arrangements. The main result has been an increase in the interest rate charged on, and a reduction in the maturity of large-scale loans to, countries facing financial crises. In December 1997, the IMF launched a new facility, the Supplemental Reserve Facility, or SRF, which provides financing for countries facing a sudden loss in market confidence. The SRF was used in lending to Korea in 1997 and in loans to Brazil, Argentina and Turkey.

As shown in Table 1 at the back of the paper, the SRF has higher interest and shorter maturity than other remaining IMF lending facilities. The interest rate of 300 to 500 basic points above the basic fund interest rate—that is close to the short-term Treasury bill rate—is in keeping with the mandate of the U.S. Congress in 1998 that IMF loans to countries experiencing sudden declines in market confidence be made at no less than 300 basic points above the basic IMF rate.

In April 1999, the Fund created a second new facility, the Contingent Credit Lines, or CCL. The CCL offers a precautionary line of credit to countries that prequalify by enacting sound economic policies. The CCL can be activated quickly to help counter financial crises.

While different in some important respects from the credit line envisioned in the Meltzer Report – and I will talk about that below – the CCL is similar to the credit line envisioned by the Commission in that it requires prequalification and that it permits rapid disbursement of funds in the event of a crisis. The CCL interest rate is the sum of the basic IMF rate plus a surcharge of between 150 and 350 basis points. This spread was established in November 2000. Previously, the CCL interest rate was identical to that of the SRF.

Two small points about that interest rate. First, it is unclear to me, since I am not an attorney, whether the 150 basis point surcharge on the

CCL meets the congressional mandate of at least 300 basis points above the basic rate for crisis assistance. Since the CCL is designed to assist countries during financial crises, it is hard for me to understand how the IMF could charge less than the 300 basis point surcharge mandated by Congress for access to the CCL.

Now, the second point is why is the IMF doing this? Well, the lower interest rate on the CCL relative to the SRF is meant to encourage countries to apply for the CCL. It is notable, however, that so far no country has applied for the CCL, much to the consternation of the Fund's staff.

In 2000, additional reforms were enacted by the Fund to the three other non-concessional lending facilities, standby arrangements, extended Fund facilities and compensatory financing facilities, to reduce the maturity and increase the interest rates paid under these facilities.

With respect to maturity, as shown in Table 1, "early repayment" would be expected under the SBA, EFF and CFF facilities, unless the IMF board agreed to make an exception and allow extended payment. For example, under early repayment, the EFF has a maximum maturity of 7 years rather than 10.

Interest rate surcharges for large amounts of borrowing under the SBA, EFF and CFF, have also been added in 2000. Those reforms would ensure that large loans financed through these facilities would bear higher interest rates, although the rates charged would still be less than under the SRF, and additionally in 2004 preexisting IMF facilities were phased out.

Those are all the non-concessional facilities. In addition to the five aforementioned facilities, the Fund maintains a concessional facility, the Poverty Reduction and Growth Facility, which lends to qualifying very poor member countries for a period of between 5.5 and 10 years at an interest rate of 0.5 percent.

Having reviewed all these reforms, the questions I want to ask are what do the lending reforms accomplish and how can they be improved?

The reduction in maturities and increases in interest costs for non-concessional loans are clearly a concrete movement in the right direction toward reducing the IMF's role in facilitating bailouts by reducing the subsidies these countries can extract from the IMF.

The creation of the CCL is another positive development, since it holds the promise of streamlining IMF conditionality via prequalification and encouraging countries to adopt reforms which should reduce the incidence of crises.

It is also worth noting that the IMF has developed in concert with the World Bank a newly expanded group of financial sector experts devoted to evaluating financial sector stability and regulatory performance. Thus, the IMF has recently come a long way toward being able to set prequalification standards for the regulation of domestic banking systems.

Despite all this progress, however, much more needs to be done. Four major problems remain under the current IMF lending rules.

Number one, countries may be able to get around the strict rules for gaining access to funds via the SRF during crises

Two, countries have little incentive to qualify for the CCL in the presence of the other non-concessional facilities.

Three, none of the lending facilities charges a true penalty rate as would be appropriate for a quasi-lender of last resort.

Four, the IMF continues to provide long-term concessional lending, which the Meltzer Commission argued should be the exclusive purview of the development banks.

With respect to the first problem, there is no rigid rule that specifies the circumstances under which a country may apply for one or the other of its facilities. As shown in Table 2, current management has placed crisis lending to Argentina and Turkey largely within the SRF rather than the EFF, and thus the higher interest rate and shorter maturity of the SRF currently does seem to be a real effective constraint on the cost and duration of bailout lending.

The details here are as follows: Argentina and Turkey together account for all \$7.9 billion outstanding of SRF commitments as of March 2, 2001. But not all of the crisis lending of the last year to Argentina and Turkey has been made through the SRF. In the case of Turkey, all of the increase in the standby arrangement from April 14, 2000, to March 2, 2001, that is the increase from \$2.9 billion to \$8.7 billion, was in the form of an SRF. But in Argentina, the increase in the standby over the same period was from \$5.4 billion to \$10.6 billion, a net increase of \$5.2 billion, but only \$2.1 billion of that increase was in the form of an SRF. Thus, one could argue that in the case of Argentina, the Fund did not meet the mandate set by Congress to lend at 300 basis points above the basic rate to countries that have experienced a sudden loss of market confidence. That is, unlike in Turkey, only part of the increased lending went through the SRF.

Now, of course, one could argue that there wasn't a sudden loss of market confidence in Argentina during this period. I don't think that is a sustainable argument, but I suppose one could say it. That illustrates the problem in having multiple non-concessional lines, one can parse words and therefore avoid the discipline of the reforms in the SRF.

Furthermore, in general, the existence of alternative facilities and the latitude of management to use different facilities at their discretion implies that IMF management could circumvent the stricter terms if they chose to do so. So the EFF is slated to be used to help countries with "long-term balance of payments needs." This is an ill-defined term which serves to promote latitude in IMF long-term involvement in member countries' policies through conditional subsidized lending.

The best way to ensure that loan facility arbitrage does not happen is to focus the IMF entirely on crisis lending and eliminate the SBA, EFF, and CCF, thereby precluding alternatives to the SRF and CCL. If you can

keep track of all these initials, the SRF and the CCL are for emergency lending during crises.

A second remaining problem is the absence of a strong incentive for countries to qualify for the CCL. The fact that no country has yet applied for the CCL should give pause to IMF management. The IMF seems to agree with the Meltzer Commission that it would be preferable for crisis assistance to be provided via the CCL rather than via the SRF, and they are trying to encourage countries to apply for the CCL. But member countries apparently believe they have adequate access to IMF resources via other channels.

The recent reduction in the CCL interest rate may provide something of an inducement for prequalification, but it is unclear whether the 150 basis point difference in spread between the CCL and the SRF by itself will be adequate to entice member countries. Furthermore, it is unclear whether the new rate on the CCL, as I said, violates the U.S. Congress's mandate that crisis lending occur at a premium of at least 300 basis points above the IMF's basic rate.

Clearly, the more the IMF can do to raise the relative cost and limit the maturity of SRF borrowing, the better it will be able to attract countries to the CCL, and the elimination of the SBA, EFF and CFF would also likely enhance interest in the CCL.

Third problem: Despite the recent increases in the IMF's lending rates, the interest rates are still not penalty rates. A penalty rate as first defined by Bagehot, is a rate in excess of the pre-crisis interest rate the borrower would pay but lower than the rates the borrower would have to pay during a bona fide liquidity crisis. By setting a penalty rate, the IMF would eliminate any incentive for a country to use the IMF to facilitate subsidies, bailouts, or otherwise gain access to subsidized loans.

During a period of transition to a pure CCL system, let's say over five years, the IMF could continue to offer both the SRF and the CCL with the CCL priced at the pre-crisis yield, plus, say, 100 basis points, and the SRF priced at the pre-crisis yield plus, say 200 to 300 basis points. That arrangement would encourage countries to qualify for the CCL, since lending under the SRF (with its *ex post* conditionality rather than prequalification) would be substantially more costly. Just as important, and I want to emphasize this, countries would be more likely to adopt the CCL and meet its prequalification standards, if it were clear that the SRF was being phased out, and I think that needs to be said in advance.

The main obstacle to reforming, as I have suggested they should, the IMF's interest rate policies to produce a real penalty rate in this way, is the equal treatment provision in the IMF's charter. Members under current practice are all entitled to borrow at the same interest rate. This rule does not make sense. The implied subsidies from the rule vary greatly across countries and in a way that rewards high-risk countries with higher subsidies. Repealing the equal treatment rule for the setting of interest rates on IMF facilities and replacing it with the rule that sets

borrowing rates as a function of pre-crisis sovereign debt yields would result in true equal treatment in the sense that the effective subsidy or penalty implicit in the rates charged would then be identical across countries.

Fourth, the IMF continues to lend on a concessional long-term basis under the PRGF facility. IMF staff argue that eliminating poverty, not crisis prevention, is the top priority for many of its member countries. They argue that in order to be engaged in these countries, the IMF must play a role in poverty reduction.

The Meltzer Commission strongly disagreed with this assessment. Indeed, we were unanimous in arguing that the IMF should focus on short-term crisis lending. Separation of functions between the development banks and the IMF is crucial for creating accountability on the part of all the multilateral organizations and for preventing competition among multilaterals in the provision of poverty assistance which could weaken the requirement set by multilaterals for countries seeking such assistance.

In Mr. Kohler's comments on the issue of poverty in his various speeches, one detects a bit of internal conflict. He seems to favor a refocusing of the IMF on liquidity provision and crises prevention, but he cannot quite bring himself to leave poverty reduction entirely to the development banks, at least not yet.

Now I want to turn to the recent IMF bailouts of Argentina and Turkey. The recent IMF programs in Argentina and Turkey have brought home once again the urgent need for the establishment of clear rules that limit IMF-sponsored bailouts. These bailouts demonstrate that despite all the recent improvements in IMF practices, the mind-set and practices of the old IMF continue to guide important policymaking.

In the case of Argentina, the IMF is repeating the same mistake it made in Latin America in the 1980s, namely the destructive postponement of sovereign debt restructuring. Argentina's debt service burden has ballooned in the past three years while its exports have stagnated. The result is an inability for Argentina to generate in the future enough foreign currency receipts via exports to service its debt.

International Monetary Fund support for Argentina postpones but does not resolve this problem. Indeed, it will make the problem worse in Argentina. As we learned in the 1980s, growth stalls and debt-to-GDP ratios climb in countries with an unsustainable sovereign debt problem because of the uncertainties that surround debt contracts and the unwillingness of new sources of capital to enter a country that has not resolved its unsustainable debt burden.

The IMF did postpone the restructuring of debt, and in the process it also postponed the uncomfortable period of financial and economic disruption that Argentina will face. But by coming to the assistance of Argentina in this way, effectively once again bailing out foreign debt

holders, the IMF has not only magnified the moral hazard problems and international capital markets, it has also postponed Argentina's recovery.

In the case of Turkey, a country that has \$20 billion of hard currency reserves currently, the IMF defensive intervention reflects the view among some within the IMF that crises provide windows of opportunity for the IMF to force countries to adopt painful reforms in exchange for bailout credit. It may very well be that this time in Turkey things will be different. The willingness of the Turkish government to accede to IMF demands for financial structuring, at least thus far, is one positive sign. But, if the past is any guide, Turkey will, once again, take the IMF's money and end up abandoning fiscal and monetary discipline in spite of IMF conditionality.

In the process, once again, G-7 politics has come to bear on the IMF, to weaken its stance vis-a-vis Turkey. Recent news stories suggest that the tide is already turning in this direction. Although by all accounts, the U.S. Treasury initially gave great latitude to the IMF in handling the Turkish crises, the State Department, Defense Department and National Security Council now seem to be exerting increasing pressure to ensure that Turkey be provided with as much subsidized IMF credit as possible.

Turkish officials are openly expressing their desire for access to funds with little interference in the management of their internal affairs. These crises and the IMF's reactions to them illustrate why it is so important to establish meaningful reforms of IMF lending practices that limit the use of the IMF as a means to bail out foreign investors, postpone inevitable sovereign debt workouts, or provide politically motivated access to IMF subsidies.

If the IMF could be established as a true crisis lender with funds available to prequalified countries as a true penalty rate, its role as a distributor of credit subsidies would end. It would cease to be a propagator of moral hazard and debt workout postponement, and it would be less of a target for political manipulation by the G-7.

In conclusion, I believe the IMF staff deserves substantial praise for their successful efforts at reform. But to make those reforms effective, I recommend the following additional policies:

With respect to disclosure and accounting reform, number 1, mandatory disclosure of Article IV consultations.

Number 2, disclosure, with a lag of the bargaining positions taken by the Fund's management in loan negotiations and the outcome of those negotiations.

Number 3, mandatory voting by the Fund board on all loan arrangements and recording and disclosure of all votes.

Number 4, the elimination of the SDR Department.

With respect to lending reforms, I would add the following reforms: Number 5, the immediate elimination of all non-concessional Fund

lending facilities other than the SRF and the CCL to permit an exclusive focus on crisis lending.

Number 6, the phasing out of the SRF to be fully replaced eventually by the CCL over a fixed period of time, say five years.

Number 7, the relaxation of the equal treatment constraint on interest rate charges and the establishment of true penalty interest rate charges based on pre-crisis sovereign yields plus spreads, with CCL borrowers enjoying lower spreads than SRF borrowers.

Number 8, the phasing out of the PRGF over a period of time with responsibility for poverty alleviation shifting to the World Bank and the regional development banks.

Thank you very much.

[The prepared statement of Dr. Calomiris appears in the Submissions for the Record on page 76.]

**Representative Saxton.** Thank you very much. Senator Reed is going to have to leave us, and I think he has a request he would like to make.

**Senator Reed.** Thank you, Mr. Chairman. I am going to leave to return to the markup on the educational bill. I don't know if I can return, or when I might return. If I could request that the witnesses respond to written questions that may be submitted to the record after the hearing.

**Representative Saxton.** Without objection.

[No questions submitted.]

**Senator Reed.** Gentleman, thank you.

**Representative Saxton.** Unfortunately, we are going to be running into another vote or perhaps a series of votes.

**Representative Saxton.** Some of us are trying to reduce taxes, and there are some folks in the Congress who don't think that is a really good idea, so there are certain procedural votes that are going to happen along the way to try to slow that down. So if you would try to summarize your statement for us in light of the fact that we are going to have some additional votes, it would probably be productive.

**Dr. Lerrick.** Mr. Chairman, first of all, how long would you like the testimony to last?

**Representative Saxton.** Five, ten minutes.

**OPENING STATEMENT OF  
ADAM LERRICK, LERRICK AND COMPANY  
INCORPORATED; SENIOR ADVISOR  
TO THE CHAIRMAN, IFIAC**

**Dr. Lerrick.** First of all, Mr. Chairman, thank you for inviting me to testify this morning. I would like to request that the entire written statement be put into the record.

**Representative Saxton.** Without objection.

**Dr. Lerrick.** When is a crisis not a crisis? When it occurs eight times within six years. Now both semantics and policies must alter.

A year ago the Meltzer Commission warned that a mechanism must be designed to avoid the abuse of IMF liquidity assistance to sponsor bailouts. Fine-tuning of the mechanics of present intervention won't accomplish the task, nor will convivial dialogue or earnest exhortation. We must focus instead on the incentives that motivate behavior. The view of crises has been static, and we must move to a dynamic approach that recognizes that an expedient response to one crisis can trigger a spiral of irresponsible borrowing and speculative investing

Thus far, every move that has been made has acted to create more crises. We have simply socialized the risk and privatized the return. Those who have set the precedent for bailouts have set aside the basics of market economics.

Fact one: Voluntary participation in crisis resolution is an oxymoron. No one voluntarily takes a loss.

Fact two: If a high return is offered without the attendant high risk, there will be excess demand.

Fact three: Only the credible prospect of default can enforce change in countries, write-downs in creditor holdings and caution in capitalists.

There has been no change in official conduct since bailouts entered the international consciousness in 1995 with Mexico. Then, the U.S. Treasury led an intervention effort to gather some \$50 billion for what they swore was a one-time event. Afterwards in 1996, the G-10 united to promise they would act to discourage expectations that large-scale official financing packages will be available to meet debt service obligations to the private sector.

There followed in swift succession: in 1997, Thailand for \$17 billion, Indonesia for \$34 billion, and Korea for \$57 billion; in 1998, Russia for \$16 billion, and Brazil for \$42 billion; and now Turkey for \$10 billion, and Argentina for \$20 billion. To date, a quarter trillion dollars in debt and risk has been shifted from the balance sheets of private creditors to official ledgers.

Loss has largely bypassed the private sector that, with the exception of Russia, has not written off a single dollar on sovereign lending to large emerging nations. When the international financial institutions move in and shore up the credit of faltering economies, private sector lending on terms the market sets after the bailout is simply an arm's-length decision. This cannot be confounded with the bona fide participation that implies a cooperative sharing of cost and of risk.

Political outcry in the industrialized world continues to demand that those who garner high returns must be compelled to contribute to emergency solutions. The paradox is that the private sector was already bailed in until we elected to bail them out.

The IMF response thus far has been long on subterfuge and short on substance. A case in point is Argentina, where the Fund is boasting private sector participation for half of the \$40 billion emergency package. In truth, it is nothing more than a bonus for bad lending decisions. Investors took no losses, assumed no risk and proffered no concessions on new funding.

All the evidence points to a new multilateral policy that has crystallized without legislative accord: A high flow of affordable funding to emerging economies, far beyond what official capability can provide, must be encouraged at all cost. The shadow of contagion has been stretched with each episode and now, with Turkey, to the view that default in any major emerging nation will shake investor confidence in all. Fear of global disruption provides an expedient bugaboo, but it is no longer the prime motive for intervention.

International Monetary Fund behavior implies a blanket guaranty backed by the G-7 governments that appears to eliminate virtually all investor risk and awaits the advent of the deluge to cry crisis and justify emergency aid. But there are consequences. Flows will become excessive as speculation escalates, governments become profligate, domestic entrepreneurs overextend and foreign investment is ill-considered. Without the stabilizing discipline of natural market forces, incentives for emerging nations to fulfill promises of reform are destroyed, economic growth is subverted, and the population at large is short-changed. Ahead lies the time when the totality of this new Ponzi scheme could entrain a worldwide crisis that engulfs the donors along with the recipients.

No one questions that growth and prosperity in developing countries are in the interest of every member of the system, but less reckless and less costly means must be explored. In times of calm, not in the midst of calamity, we must put in place a new framework and new tools that draw upon the skills and vast resources of the capital markets.

We must recognize that developing countries, with their violent political and economic swings, are sources of recurring disturbance. Undisciplined capital flows, emboldened by implicit IMF insurance, magnify this risk. The only unknowns are when and where instability will arise.

We must identify systemic economies whose weakness might spread beyond their borders. For the IMF, as lender-of-last-resort, true responsibility is to the system, not to individual borrowers. Today perhaps five economies in the emerging world would qualify: Argentina, Brazil, China, Korea and Mexico. For this critical universe, the IMF should subsidize the cost of stability as a global public good.

We must divorce the resolution of pre-crisis debt from the provision of new financing and direct these functions to different segments of the financial markets. The flow of emergency resources must not be

obstructed by the renegotiation of old claims, and new funds must be sequestered to forestall diversion into the payment of past obligations.

We must prepare reservoirs of liquidity for the times when credit weakens, but on terms negotiated before the event. Short maturity bridge funds offer breathing room that permits borrowers to restructure outstanding debt and to seek long-term financing from both the capital markets and the development banks for genuine structural reform.

There is a new direction to explore that addresses all these needs. It provides preparedness, liquidity for core economies, segregation of new funds and real private sector participation. A summary of this new structure follows, while a detailed outline is included as an appendix to this testimony.

The stand-by credit line to provide emergency liquidity is ubiquitous in the marketplace. But it can be transformed to become tradeable, securitized, subsidized by the IMF and protected by the Fund's endorsement of borrower policies. By this means, the IMF can enlist the private sector to assume the risk of threatened economies in advance and compensate the markets to provide an automatic first line of defense. The fund retains its traditional role of lender of last resort.

Options and notes, both publicly traded, are mechanisms that can modernize the classic stand-by line. Put options would give the IMF the ability to sell to private sector institutions at any time, over a predetermined medium-term period, floating rate notes issued by the core emerging governments.

Risk is diminished for the private sector by conditions on the exercise of the options and the release of the funds, either agreement to an IMF-sanctioned adjustment program or fulfillment of the preconditions of an IMF Contingent Credit Line. But the risk is not transferred to the taxpayers of the Fund's creditor members as occurs in classic IMF intervention.

A securitized, liquid marketplace will attract a spectrum of institutions beyond the traditional commercial bank universe that has dominated stand-by credit lines in the past. Every quarter, the IMF would buy, through competitive tender, 1-year put options covering \$1 billion principal amount of underlying notes for each country and 3-year put options covering \$500 million principal amount of underlying notes for each country. After three years, this new source of emergency financing would generate a sum equal to half the IMF's effective available resources, \$50 billion, or \$10 billion for each of the core emerging economies, reducing the demand for future quota increases.

The cost of the contingency structure will become ever more competitive as the market develops. Currently this amounts to 0.35 to 3 percent per annum depending on the borrowing country.

Since global financial stability is a prime public good, all members of the world economy should contribute. The cost of a \$50 billion program for the five core emerging economies would be approximately

\$750 million per annum, divided equally between an IMF subsidy and the protected country. To ensure a fair distribution of the Fund's share of costs among its creditor and debtor members, financing could be generated by raising the rate of charge on all loans and lowering the rate of remuneration on credit balances of donor nations. The effective annual cost to the creditor members would be \$187-1/2 million, of which the U.S. would bear \$50 to 60 million.

Today the IMF is engaged in a process of continuous intervention providing emergency resources to some 30 countries. Should market-based contingent financing expand to serve a broader spectrum of IMF members and grow to provision of \$100 billion or more of funds, there may come a time when IMF lending will become redundant. This would redefine the institution as a stalwart lender of last resort, ever vigilant but seldom in action.

Thank you, Mr. Chairman.

[The statement of Dr. Lerrick appears in the Submission for the Record on page 94.]

**Representative Saxton.** Thank you. Mr. Bergsten.

**OPENING STATEMENT OF  
C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR  
INTERNATIONAL ECONOMICS; MEMBER, IFIAC**

**Mr. Bergsten.** Mr. Chairman, I will be very brief out of respect both for your pending roll calls and my own, because I have to chair a luncheon session at my Institute at noon.

I would first applaud your continued focus on these issues. This Committee has a long and distinguished career of doing so. I have testified as far back as the mid-1960s, and the Committee has been crucial on these issues. I applaud you addressing them. I hope you will stick with it.

As you do, I would echo Senator Sarbanes' call to look at a broad array of proposals. I was a member of the Council on Foreign Relations Commission. Secretary O'Neill has said publicly that he has read and liked that report. Deputy Secretary of Treasury Ken Dam was a member of that Commission. I think that report in particular might commend itself to you as you go forward in this process.

You have heard a lot of details from the other panelists. Let me try to give broad overviews very briefly on three points. First, this is the first anniversary of the report of this Commission. So you might ask, how has it fared? Well, I was the leader of the dissenting minority, as you will probably recall, and we anticipated most of the subsequent criticisms. We pointed out that there were two core elements in the proposal for reform of the IMF, on which I will focus. One was that lending should go only to countries that met certain preconditions, thereby barring the fund from lending even to important countries if they had not qualified. The second was, once a country had pre-qualified, it got the money automatically,

whatever its policies – budget policies or anything else – because the majority felt that conditionality didn't work.

I am delighted to say that the world promptly and completely rejected the majority's proposals. When the Group of Seven and the old Interim Committee (now the International Monetary and Finance Committee), the decision-making body of the IMF, met a month later, they clearly reiterated their preference for other approaches. They rejected the central elements in the majority's proposals, and did the right thing by casting away the core of the proposals that had been made.

Probably more important than who struck John is what has actually happened by way of reform of the monetary system including the IMF. Here I would agree with Professor Calomiris: a number of important reforms have been occurring. He stressed the increased transparency of data in markets, and I agree with that. The IMF and other international institutions increasingly insist on implementation of the Basel Core Principles for Banking Standards and the special data dissemination standards. A whole series of steps being taken to improve transparency of country policy, of markets, and of the IMF itself. This, of course, reduces the risk of excessive lending and the onset of crises. This is one big reform; there is more to come, but it is happening.

Second, and the one on which I would put major emphasis, is that more and more countries have moved from adjustable peg exchange rate systems to managed flexibility of exchange rates. That is a huge reform, Mr. Chairman, which sharply reduces the crisis-prone risk of the system. Turkey has recently had a crisis but there is no contagion. One reason there is no contagion is that more and more countries have insulated themselves against it by moving to flexible exchange rate regimes.

I was in Mexico a week ago; what has happened there is fascinating. We have always thought of Mexico as one of the most crisis-prone countries in the world. Yet in the face of the East Asian crisis, in the face of the nearby Brazilian crisis, and in the face of recent Argentine trouble, Mexico has had no contagion. Why? They floated the exchange rate. When the Brazil crisis hit, the peso depreciated 20 percent. When the crisis settled down, the exchange rate moved right back. There was a little effect on inflation, but there was no crisis nor was there any contagion. So in that regard the system has been substantially improved.

The Deputy Managing Director of the IMF, Stanley Fischer, presented a very thoughtful paper on that issue at the recent meetings of the American Economic Association, documenting the huge shift in countries away from the old indefensible fixed pegs to floating exchange rates. That, to my mind, is a huge change.

A third and very important change is PSI, private sector involvement. There is now, in fact, a lot of bailing in of the private lenders. Almost every deal now requires bailing in of the private lenders. There is still a need for clear rules and guidelines. I don't think it has gone far enough

but that, too, is a very substantial reform that reduces the risk of moral hazard, reduces the risk of excessive lending, and the like.

So a lot has happened. Those who view reform as important, as I do, certainly should take some pleasure that not too much of it has been in the direction of the central proposals made by the majority of the commission.

The final point is: what remains to be done. Can you and others pack up and go home? The answer is obviously no because the system still has lots of problems. Lots more needs to be done.

I would focus on three elements. One I already mentioned: coming to clear policies and guidelines on private sector involvement to better share the risks with the private lenders.

Second, more explicit early warning systems of pending crises are needed. The IMF has so-called multilateral surveillance. It is demonstrably a failure because it fails to predict the crises and changes in market behavior, which are extremely important. We need more sophisticated systems of early warning indicators, that have now been developed at my Institute and other places, which could in fact help predict crises. They would enable us to go to countries and get them to take measures to head the crises off and that way, if they don't, start to go public about it and bring market pressures to bear even more.

The third and final needed reform is that this whole process has focused solely on emerging market countries. Nothing has been said about the big industrial countries. Indeed, the majority would have excluded them from IMF activities altogether.

That is like Hamlet without the prince. The biggest problems in the international monetary system are the huge fluctuations between dollar and yen, and dollar and euro, and the prolonged huge misalignments in these currencies. Incidentally these considerations are not irrelevant to the fact that we, the United States, are now running a trade deficit approaching \$500 billion, which threatens the stability of our own currency, but on which there is little comment, including in the tax cut debate.

The international financial architecture discussion has ignored the biggest players, and indeed the biggest players have a huge effect on the smaller players. When the dollar/yen exchange rate moves by 75 percent, as it did from early 1995 to early 1998, that was a major cause of the Asian financial crisis. So as you go forward, the agenda should be broadened and I hope you will pursue those issues as well. Thank you.

**Representative Saxton.** Thank you, Mr. Bergsten.

I know that you have to leave in a few minutes to get to your next event by noon, so in light of that, I would like to ask Ms. Maloney if she would like to ask you some questions before having to leave.

**Representative Maloney.** Thank you. I appreciate all of the testimony, but I would like Mr. Bergsten to comment on one of the

statements that Secretary Summers made before the Banking Committee on the Meltzer Commission's report, and he said – he expressed concern that the pre-qualification would have tied the hands of the Administration to respond appropriately in financial crises in 1998, and I would like you to comment on that.

And also one of the recommendations of the Commission was that the World Bank should no longer make development loans, but should instead make grants, and my understanding is that this would require additional contributions from the U.S. and other countries. And is this the case, and is it possible that moving to a grant system would increase moral hazard?

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 110.]

**Mr. Bergsten.** I not only agree with Secretary Summers' statement but I made it long before he did. In the joint minority dissent we made exactly that point and I elaborated it in testimony before this Committee and elsewhere. Under the proposal of the majority, the IMF would have been unable to lend to any of the Asian crisis countries.

At the end of the day, hearing my criticism at the late stages of the formulation of the report, the majority put in a couple of sentences saying that in a systemic crisis the IMF could waive all of its proposals and do what it wants. But that was never spelled out and it was pretty clear it was not at the heart of what they had in mind. So their system as truly intended would have precluded the IMF from doing its job.

On your question about the World Bank, you should make an important distinction. There is currently the soft loan window of the World Bank (i.e., the International Development Association), which lends at a very long-term at a very low-interest rate. I think those credits, if you can call them that, should be converted to grants but that wouldn't be much of a change.

For the World Bank's hard window lending, its nonconcessional lending, however you are absolutely right. Changing that to grants would require enormous budgetary support from the industrial countries, notably the United States.

I applauded the sentiments behind the majority's desire to avoid new debt build up in developing countries but I must say I was not very enthusiastic about their sense of political legalism – their believing implicitly that there would be a huge burst of enthusiasm in this Congress and elsewhere to provide billions of dollars of grant monies for the World Bank to lend to client countries – on that basis. I don't think it would work. I don't even think it is desirable for those middle-income countries who can pay nonconcessional terms and therefore should be increasingly graduated and phased out over time as their income levels rise.

**Dr. Meltzer.** May I comment on that, please, on both of those comments, Mrs. Maloney?

**Representative Maloney.** Absolutely, but I know that he is supposed to be at another meeting right now. So I appreciate his testimony, and I would like to ask him one question that he mentioned in his – I am going to stay and listen to everything you have to say, Dr. Meltzer, but I know that he has to leave, and I just wanted to ask him.

You mentioned we aren't doing anything about the \$500 billion trade deficit. What should we be doing about it?

**Mr. Bergsten.** Well, there are a lot of things. First, we should not be cutting the budget of the Export-Import Bank and other agencies that try to support U.S. exports.

Second, we should be trying to encourage our major markets to adopt some of the new technologies, as we have done in the last few years, they can both grow faster and raise their potential rates of growth in the future – and thus be better markets for our exports. But we also have to face the fact that a reduction of our trade deficit – not an elimination, just a substantial reduction – will require a lower exchange rate for the dollar and that every time former Secretaries have espoused a strong dollar they have made the problem worse. I have always been surprised that they would never be called into question about that but, as the economy slows down and unemployment starts to rise, I suspect those issues will become serious.

There is another long-term prospect that relates to international trade negotiations. The U.S. has a huge comparative advantage in services exports. Despite our huge trade deficit, we run a large surplus of close to \$100 billion in services trade. If we can go into a new multilateral round of the WTO and induce other countries, particularly big developing countries, to liberalize their services sectors, we will then open potential markets for a surge of U.S. exports in areas where we are highly competitive. That would be, in fact, the most constructive, and least disruptive way to correct our trade deficit over time.

**Representative Saxton.** Ms. Maloney, in the interest of fairness, I permitted you to ask your questions of Mr. Bergsten, and I understand that he has to leave, but also in the interest of fairness, I would like to have Dr. Meltzer and Dr. Calomiris have an opportunity to respond in the context of your questions. Dr. Meltzer and then followed by Dr. Calomiris.

**Dr. Meltzer.** I would like to make two short points. First, the statement that Secretary Summers made is incorrect. It is incorrect because it doesn't ask the question had these reforms – we gave five years for the reforms to be phased in. Had the reforms been phased in, what would have happened in those circumstances? It just assumes that the crisis came. We agreed – I don't know where Mr. Bergsten gets his idea – we agreed that in a systemic crisis, there would be the need for action. So that is simply not a true statement about the report.

Second, and more important than who said what when and where, is the question about what has happened since. The IMF is desperately

trying to implement the CCL, the contingent credit line, which is based upon exactly the same principles as in the Meltzer Commission report; that is, they want to do that, they haven't quite found the mechanism for doing it, but they have testified and done it. And Secretary Summers has, in fact, supported the November movements toward the CCL. So in all those directions, there has been, I think, a change of views within the IMF and by Secretary Summers. So I think it is simply false to continue to take the position that Mr. Bergsten has taken here today.

On the question of grants, let me let Dr. Lerrick do that because he has worked out the question about grants.

**Dr. Lerrick.** I have sympathy for Senator Sarbanes who at the beginning of the session expressed the judgement that it seems like *deja vu* all over again. I can remember the discussion of grants a year ago, in fact, in front of this Committee. Whether grants are financeable and whether it would require an increase in contributions from the donor countries. At that time, testimony before this Committee showed that no increase in donor resources would be required to shift from a loan to a grant format at the World Bank. In fact, if you went to a grant format, you could increase development programs by 70 percent with existing resources.

Therefore, the issue of whether shifting to grants would require vast increases in donor contributions has been resolved. It does not require any increase in resources. This has now been analyzed and published in numerous places. It was presented at the American Economic Association annual meeting in January and has been reviewed with the finance staff of the World Bank. There is agreement that this proposal functions correctly as a financing mechanism.

**Dr. Calomiris.** Let me just add a little bit to this discussion. I want to point out that months before Mr. Bergsten joined the Commission, because he did come in toward the very end of it, when I first presented the outline of a plan for how to establish the IMF, it contained the feature that he just said we added at the last minute. Maybe he should go back and read the transcript of my presentation to the Commission, and he will discover if he does that that was part of the plan from the very beginning.

I want to emphasize some things about that. First of all, we never said that the IMF could not withdraw qualification from a country if it decided that that country didn't meet its qualification standards. So the idea that somehow the IMF would be stuck lending to a country that it didn't think met its standards is false.

Secondly, we never said that the IMF would be unable to lend to countries, even though those countries failed to meet pre-qualification standards.

How would the Asian crisis have played out? The first question you have to ask is whether Korea would have qualified. If these requirements had been phased in beginning in 1990, would it have pre-qualified? Let's assume it hadn't. Korea was the only global threat in term of its size as

an economy, in my judgment. So in my judgment, the IMF, if Korea had not pre-qualified, would have been right to lend to Korea at a superpenalty rate, which is what we envisioned, not what Mr. Bergsten said, namely that the IMF can do anything it wants. We didn't say that. We said that if a country hasn't pre-qualified, and if it is a systemic threat, then the IMF can lend only at a superpenalty rate.

So the answer would be the counterfactual has to begin with whether Korea would pre-qualify, and if not, whether it would probably still have received funding.

What about Thailand? Well, in my judgment of the way to interpret what the Commission report said, if Thailand hadn't pre-qualified, probably it would have not received funding because it wouldn't have been viewed as a systemic threat. This is just my interpretation of the meaning of our report to try to answer your question. It would have stopped the problem at Korea and probably not before, if those countries hadn't pre-qualified. Of course, they would have had very strong incentives to pre-qualify.

That is the answer to the direct question, but I think that this question is not very important anymore because people are now largely in agreement about the desirability of moving from the SRF to the CCL. As Professor Meltzer said, this is something that many people at the IMF agree to.

And so the question is how do you phase in a movement from SRF to a CCL? What is the difference in terms of conditionality or pre-qualification? Really it is not a black-and-white difference. The point really is that you want to make conditions simple and rules-based, and you want to make credit available quickly. Pre-qualification gets you there. It has to be somewhat flexible for the reasons that I said, which, as I said, were part of our proposal months before the report was finished.

Now, on the World Bank, I would say that it is also wrong to say that we get rid of World Bank lending or development bank lending. To be very specific, for encouraging good institution-building, what is now called structural lending, the World Bank and the development banks would continue to lend, but for poverty alleviation, assistance would be grants-based. So it's important to be very clear that we are not saying that we would get rid of lending, but we did say that we would add grants to the mix where appropriate.

I don't think there is a moral hazard problem from grants. There is accountability, and that was a key part of our proposal, that things be audited; that performance be evaluated by a credible third party; and that funds would not go to the country, but rather to service providers. It is hard to see how there is moral hazard in that case. So it wasn't just a proposal to throw money at a country, it was a proposal to use money in a way that is incentive-compatible to achieve your results.

**Representative Saxton.** Thank you very much.

Thank you, Mrs. Maloney.

Let me move on to some other items. Incidentally, I think it goes without saying that these issues are quite complex, and there is reason and room for differences of opinion.

**Representative Maloney.** Mr. Chairman, Mr. Bergsten apparently wants to make a statement before he leaves.

**Mr. Bergsten.** Could I give three one-sentence responses to what they said?

**Representative Saxton.** If you make them one sentence.

**Mr. Bergsten.** Literally.

First, I read the penultimate draft of the report and had no reference to a systemic takeout, whatever Mr. Calomiris may have written in an early submission to the Commission.

Second, I am stunned to hear Mr. Calomiris say that Thailand is not systemically significant since it was the Thai crisis that led the entire East Asian crisis to erupt and cause global harm.

Third, the majority says there is great incentive to pre-qualify under their system yet with a CCL that has offered pre-qualification now for over a year, there is not a single taker.

**Representative Saxton.** Thank you.

Dr. Meltzer, according to IMF figures, the top five IMF debtors account for about 70 percent of the outstanding IMF credit.

**Dr. Meltzer.** That is correct.

**Representative Saxton.** Indonesia and Russia account for about 40 percent of that.

**Dr. Meltzer.** I believe that is correct.

**Representative Saxton.** Is this lack of diversification of concern? Usually when we think about investing, which lending is a type of investing obviously, especially when considering the nature of the borrower, is this a reason for concern?

**Dr. Meltzer.** Well, concern that those loans will never be repaid fully, yes.

**Representative Saxton.** Dr. Calomiris, are the recently announced surcharges of 100 to 200 basis points for borrowing levels of 200 to 300 percent of quota likely to significantly change the current concentration of lending? Won't countries that want to borrow heavily still gladly pay one or two extra percentage points to do so if they are still receiving heavy credit subsidies?

**Dr. Calomiris.** My point earlier was that it will actually make that allocation worse potentially, too, because this kind of structure will discourage good countries, but encourage relatively bad countries; that is, if you have a markup of 300 basis points over the basic rate, then if your country, let's say, has a market yield of 200 basis points over the U.S. Treasury bill rate, then obviously you are not going to find these facilities attractive, but if you are Argentina and you have a 7 percent markup over

the U.S. Treasury rate, well, obviously you are going to find this very attractive. So Argentina, which currently accounts for a very large proportion of outstanding loans to the Fund, is likely under these kinds of rules to increase the concentration.

So my answer would be that part of the advantage of moving to a true penalty rate structure, that is relaxing the equal treatment requirement and allowing the spread to be based on the countries' own pre-crisis yield, is that you get away from these bad incentives that are worrying you.

**Representative Saxton.** Let me ask another question. Currently Russia, Indonesia, Ukraine and Argentina comprise over half of the outstanding IMF credits. At the same time serious corruption issues have emerged in several of these countries. We have discussed, previously, the lack of adequate IMF accounting controls and safeguards that the IMF has belatedly, I might add, tried to address, but doesn't potential corruption also imply increased risks as perceived in the credit market.

**Dr. Meltzer.** Well, the IMF, I mean, the facts are really quite simple. When the IMF turns over the money to the central bank of the country, it has no control over what happens to the money after that. And it has very poor, if any, monitoring procedures for making sure what happens to the money. So the money goes to the central bank, and after that it goes wherever the central bank or the government of the country directs it to go, and that is a problem. It is a problem which we tried to address at least in part. It is a very difficult problem to solve because, of course, these are sovereign countries.

**Representative Saxton.** Were you ever able to get a handle on what happened to the IMF moneys that went to Russia?

**Dr. Meltzer.** No, I mean, in fairness, we did not try to pursue. We only had six months to cover seven organizations. We did not try to pursue the questions of legality, which at that time were being pursued, I think, through the court system.

**Representative Saxton.** When credibility of central banks are damaged by corruption or political manipulation, wouldn't the market take these risks into account?

**Dr. Meltzer.** Yes and no. That comes to really one of the parts that I would think is at the heart of these problems. If it believes that these loans are going to be bailed out, it doesn't really care. The market doesn't function very well as a guardian of where the money goes because they don't think that they are at risk substantially in any of these cases, and that is I think in Mr. Lerrick's testimony. He talks about how we have socialized the risk and continued the return. This is a system which bails out large financial lenders often at the expense of the people in the country. That is why people demonstrate against this organization. They don't understand why it continues to function that way. We don't understand why it continues to function that way.

So we would like to see a system get back to the core issues and away from the annoying details. There are too many crises, they are too deep,

and they affect too many people. That system is not working, and it needs reform.

Second, the system of aid and development also isn't working. It is inefficient and ineffective, and it is costly, and it is not working very well. So it needs to be reformed, and a great opportunity for reforming some of these will come when the World Bank comes for the IDA 13 appropriation, which should be coming along fairly soon.

**Representative Saxton.** In 1998, I introduced a bill to provide for IMF transparency and other reforms in the IMF. A version of that bill became law as part of the House appropriation. The legislation eventually enacted included a version of this legislation with regard to, first, transparency, complete with certain qualifications that we had provided, and second, it was followed by a section mandating risk adjusted interest rates, the second major issue addressed by the original bill. Both of these policy changes were conditions of Congressional approval of the IMF quota increase.

Would you discuss the IMF action which followed with regard to these changes, with regard to our portion of the quota?

**Dr. Meltzer.** I think Dr. Calomiris has looked into that more closely recently than I, so I prefer to let him answer that.

**Dr. Calomiris.** I think, again, I am not a lawyer, so I don't know whether the IMF has done something that is in violation in some strict sense, but I think I would say that there are a couple of questions that you could ask.

As I understand the language, it says that the IMF has to lend to countries that have suffered a sudden loss of market confidence at least 300 basis points above the basic rate. I think that is what the statute says. The SRF does have that 300 basis points over the basic rate requirement built into it.

The questions, though, are two things. First of all, the CCL, which is also to lend during crises, only has 150 basis points over the basic rate. That might be a problem from the standpoint of the law.

Secondly, only some of the lending to Argentina was done through the SRF. Other lending to Argentina since between April of 2000 and March of 2001, about half of it, occurred through a normal stand-by arrangement, which has a lower interest rate than what you are requiring.

Now, my proposed solution will solve this problem, because if they lent at spreads over their own pre-market yield, it would certainly be in almost all cases more than 300 basis points above the basic IMF rate.

**Representative Saxton.** One final question, and then I would like to turn to my friend from Pennsylvania. I am concerned that the IMF is not complying with the law's requirements that interest rates on emergency loans be adjusted for risk. The risk adjustment in the law is rooted in my legislation, and the intent was to reflect the market's perception of risk. In other words, the Congressional intent of this legislation that passed was

to eliminate pervasive IMF interest rate subsidies in this lending. However, according to a recent project of PricewaterhouseCoopers, the risk premia associated with many of these borrowing countries are far in excess of what the IMF is charging. Even the so-called interest rate premium associated with the Supplementary Reserve Facility, SRF, is a fraction of what a true risk adjustment would require.

Do IMF interest rates still include credit subsidies, and do they reflect true risk premia embodied in market interest rates?

**Dr. Calomiris.** The answer is yes, they still have subsidies, because countries, as I said, that have high market interest rates will find the 300 basis points over the U.S. Treasury rate to still be a very good deal.

Now, why is it that they didn't adopt your recommendation? As I understand it, the equal treatment requirement within the IMF's charter precludes them from charging different interest rates to different countries. So in fairness to the IMF, I think that there is some sympathy – I haven't done a poll, but I think there is a lot of sympathy in the IMF for your recommendation. The problem is that under the current charter, which, as I understand it, requires a very large supermajority to change, they can't get rid of equal treatment without that large supermajority vote. So we should all encourage the U.S. to push for exactly that change in the IMF's charter.

**Representative Saxton.** Let me just make two points, and then I will go to Mr. English. The first point is that the 300 basis point limit was a floor. And I think that is a very important distinction.

The second is that the provisions in our legislation made the appropriation conditional. They were not recommendations. They made the use of American dollars conditional upon the adoption of these provisions by the IMF. And what you are saying is that has not happened.

**Dr. Meltzer.** That is correct.

**Representative Saxton.** I understand you are not a lawyer.

**Dr. Calomiris.** Thank you. I appreciate the compliment.

**Dr. Lerrick.** Mr. Chairman, because it was your legislative intent that the 300 basis points over the base lending rate not be viewed as the benchmark but as a minimum. Very simply, as Dr. Calomiris has said, the interest rates, even with the three percent surcharge, are extraordinarily subsidized rates for these borrowers. Their alternative, were they to borrow in the market, would be somewhere between seven to ten percent above the IMF base interest rate.

Now, one issue that I will pose to you, because this would be, I believe, the Fund's response, is that there is zero risk on IMF loans; that no one has ever defaulted to the IMF. The IMF is a preferred creditor; no country will ever not repay the IMF, and therefore, if that premise is true, your legislative requirement has been met at each point in time because your 300 basis point floor is met and because there is no risk.

I don't agree with that point. I think there is substantial risk in IMF loans, and, therefore, there is still very large subsidization of IMF credit.

**Representative Saxton.** And our attention at the same time in adjusting IMF interest rates for risk was to approximate market rates.

**Dr. Lerrick.** That is right, and if you look at market rates on average, excluding crises – for when crises occur, of course, these rates rise dramatically, but if you exclude these times and look at pre-crisis rates and at long general averages, the average for emerging market bonds over any extended period of time is between 700 and 900 basis points above U.S. Treasury securities.

**Representative Saxton.** I am sorry, Mr. English. Let me just ask one final question. In light of what has transpired, or perhaps what hasn't transpired, have we addressed the issue of moral hazard to any significant degree?

**Dr. Lerrick.** In my opinion, absolutely not. There has not been a single major sovereign crisis except Russia, where any private sector investor has absorbed a loss or had to proffer new financing on concessional terms. Every single investor in major sovereign debt has been paid in full when due, and in fact, in Korea and Indonesia, not only were the investors who lent to the governments paid in full, the government expanded its guarantee to include \$33 billion of obligations of private sector commercial banks which were basically insolvent. So, as Dr. Meltzer said, we have a system in place where it doesn't matter how corrupt the central bank is, it doesn't matter how good the economic policies are, it doesn't matter how indebted the country is, as long as the markets believe that they will be bailed out in full, there is no incentive for them to pay any attention to credit risk because there is no reward for paying attention to credit risk. And, of course, this perception has been recently reinforced in Argentina and Turkey. It was reinforced that no one is going to take a loss, and therefore their investors can collect a risk premium without assuming a risk. That is where the moral hazard comes from.

Very simply, if you examine one of the key announcements of the Argentine rescue package, at the very beginning Argentina stood up and said no one is going to take a loss on our bonds. They said Argentina will not default, all investors will be paid in full, and the IMF stood beside them and agreed. Once you say that, the game is over. The investors know that they are not going to have losses and they are going to be paid in full, and, therefore, to get them to do anything else, buy new bonds, exchange old bonds, you have to give them a bonus on top of what they were promised. They will not have a penalty for making a bad lending decision. You are going to give them a bonus for having made a bad lending decision.

**Representative Saxton.** Thank you. Mr. English.

**Dr. Calomiris.** Just a very brief comment on Turkey.

**Representative Saxton.** Really brief.

**Dr. Calomiris.** I think it is important to mention that you cannot possibly construe Turkey's access of the IMF right now having to do with Turkey's requiring liquidity. Turkey, as I said in my comment, has \$20 billion of foreign reserves, which exceeds the total foreign exchange exposure of its financial system. In other words, there is no hard currency liquidity problem possible in Turkey.

The only way to understand Turkey's appeal to the IMF for funds, is as an appeal for effectively a fiscal transfer, a subsidy to Turkey from the IMF. There is no bona fide liquidity need.

**Representative Saxton.** Thank you. Mr. English.

**Representative English.** Thank you, Mr. Chairman. I will keep my remarks very brief in view of the pending vote.

Dr. Meltzer, given the small steps that the IMF has recently undertaken to address the corruption issue, an issue they think has even crept into the awareness of the general public, in your view, are these moves adequate; are there adequate corruption safeguards in place now in the IMF?

**Dr. Meltzer.** No. Corruption in these countries, in many of these countries, unfortunately, is endemic, and there is – the steps that have been taken simply don't meet the problem. Now, it isn't going to be easy to meet the problem, but the steps that have been taken do not meet the problem.

**Representative English.** Do the rest of you agree with that?

**Dr. Lerrick.** Yes.

**Dr. Calomiris.** Yes.

**Representative English.** Very good.

I have a number of other questions I would like to ask, and for Dr. Bergsten as well, so I will simply, I think, do those by correspondence.

[No questions submitted for the record.]

**Representative English.** But a final question for Dr. Meltzer. You had indicated at the close of your written statement that there was considerable international support for the Commission recommendations. Which recommendations have received the most international support?

**Dr. Meltzer.** These are based on my subjective judgments of conversations that I have had plus written statements that have been made by the Bundesbank and the Bank of Canada. I think the main source of agreement is to move toward a system which is less crisis-prone and, therefore, which gets the reforms up front. We can argue about whether conditionality is a good idea or not a good idea and so on with Mr. Bergsten. The fact is if we look around, we see that countries agree to do things at the time they get the money, and then during the period of the crisis they make some small steps, and then things improve, and that is the end of reform. So that you get a country – the most extreme example would be a country like Russia and Ukraine, or Ukraine where

they make the same promise over and over again and don't carry it through, and that has been true in Korea where privatization and all these things that the IMF insisted upon has gone very slowly.

What we need is a system which says that not all, but many of these crises occur when there is a weak banking system and a pegged exchange rate. There I agree with Dr. Bergsten. There has been improvement in the pegged exchange rate; much, much less in the weak banking system. So if we can get some structural reforms which will strengthen the financial system, stop using it as a slush fund, which is what happens – that is why the banking system is weak. The government wants to show that it has fiscal responsibility, so it uses the banking system to do the subsidies that it doesn't want to do through the tax and expenditure system, and then it gets into trouble. And the banks are doing part of the political process of subsidizing industries – in many cases subsidizing industries that compete with our industries, but they are subsidized, and those subsidies then come home to roost. The banks are illiquid, in many cases insolvent, and they continue to go on year after year. The IMF gets an agreement or the World Bank gets an agreement they are going to do something about it. There is no enforcement, and it is very difficult to enforce. That is why we want to move to a system of prequalification. You make the reforms first, and then you get the money.

**Representative English.** Thank you, Dr. Meltzer, and it is a privilege to have you down from western Pennsylvania.

**Dr. Meltzer.** Happy to see you.

**Representative Saxton.** In light of the fact we have a new administration, I happened to meet with Secretary O'Neill very briefly one day, and we talked about the IMF. I was surprised at the level of commitment that he seemed to have for IMF reform. I have not had a chance to talk to Larry Lindsey, but I know that from past hearings the President's new economic adviser is also predisposed to IMF reform.

I am curious. Any of you had an opportunity to chat with either of these gentlemen or people who work with them, and what are your impressions?

**Dr. Meltzer.** Well, Dr. Calomiris and I are colleagues or were colleagues of Dr. Lindsey at the American Enterprise Institute where we both spend a few days a week, so we know him very well, and we know that his views are supportive of the broad – not the detail necessarily, but the broad range of reforms that we have talked about, and I think that this is true. I think that *The Economist* article – leaving aside what Mr. Bergsten has said, or responding to it, *The Economist* article, I think, summarizes the state of the debate. Many people in many countries have now come to recognize that the Commission's proposals are not the blueprint for reform, but they are the basis for moving forward toward reforms, and that there has got to be some give and take. But that, I think, is now an accepted principle, and I hope that the administration will work along those lines.

[The article "Reforming the Sisters" from *The Economist* appears in the Submissions for the Record on page 75.]

**Representative Saxton.** Dr. Calomiris, very quickly.

**Dr. Calomiris.** One thing I just want to mention is that I think it was in February 1998 that a panel was convened here that you chaired that had Fred Bergsten, Allan Meltzer, myself, and Larry Lindsey. If you go back and look at what Mr. Lindsey said at that time, I think you would see that it is very consistent with the kinds of recommendations that we are making.

But I would go beyond that to emphasize what Allan said, that this is not an issue that I think is just the administration's point of view. We have now gotten to the point where I think there is strong bipartisan consensus, consensus even within the IMF and with the World Bank to some extent, that these kinds of reforms make sense. It may be that it won't end up looking exactly like what the Meltzer Commission proposed. So be it. But I think we really have got to the point where there is an opportunity, and I just hope I can work with anyone who is interested to make that opportunity realized.

**Representative Saxton.** Thank you. We are going to try to conclude before we go to vote. Mrs. Maloney, you really only have three or four minutes.

**Representative Maloney.** Yes. I would like to applaud all the panelists, and particularly, Dr. Meltzer, your report has really ignited a debate on a very serious subject and has led to some reforms, but certainly has raised questions that need to be debated and talked about.

I am going to ask a few questions. We have got to run to vote. If you decide to answer in writing, I would appreciate it.

I think the whole panel agrees with the statements of some of you on the risk; that there is something wrong with the system whereby you take a risk or a subsidy, and it works out fine, then you are applauded; you take a risk or a subsidy and you make a mistake, then everybody runs in. And you make the profit when you make this, and then you make a risk mistake, and you are losing money, then somebody runs in to bail you out.

**Dr. Meltzer.** One word answer: Absolutely.

**Representative Maloney.** But I have seen this in our own American banking system. I find it frightening the unprecedented bailout of long-term capital where the central bank came in and saved people with their Cayman banking accounts. Any comment on that, on our own banking system, I think would be incredibly helpful.

**Dr. Meltzer.** The same principle applies.

**Representative Maloney.** But no one is saying that. Everybody is applauding them like it is the most wonderful thing in the world.

**Dr. Meltzer.** We did not applaud.

**Representative Maloney.** Okay. Put it in writing. I would love to see it. I would raise it in hearings.

Secondly, what I am extremely concerned about is what has been raised by other side of the aisle, is the corruption factor whereby we lose credibility. We may undermine democracies by giving loans to, quote, a corrupt government that doesn't help the people. Russia is the biggest example. I would support a bipartisan effort, any hearings or commission reports, looking into what happened in Russia, and any ideas of how we can control this so that we are not giving money that may – you know, you may have a financial crisis, but we are not really looking at how it is being handled in a way that isn't corrupt and good for the people who live there.

And finally, this is a very important point, because I am a little confused about it, and it has come up over and over again. We are all in agreement that the majority reports suggest a systemic risk exception to the lender-of-last-resort of the IMF. We all agree on that, but I don't quite understand how it works and how it is different from current policy. I would appreciate that in writing.

[The written response from Dr. Meltzer appears in the Submissions for the Record on page 53.]

You heard Mr. Bergsten's response on the Thai thing, saying that that was systemic, others were saying it wasn't, and just related to it. Just take an example, what I think some people are concerned about and what Summers was concerned about is tying your hands and not being able to respond, and that there is a bureaucracy that says you can't help when you feel that you should, so exactly how that would work.

Let me give you an example, say, under the last resort proposal of the IMF functions, that we have an international community. Say a country is not pre-qualified, yet they elect a pro-reform government, and then it is suddenly hit with a monetary crisis. Should we not provide assistance to the country that is not pre-qualified, allowing the reform government to possibly die? Shouldn't we support them? I mean, these are some questions, and I think in a lot of minds is the flexibility of being able to respond, and I think it was raised very starkly by Dr. Bergsten.

**Dr. Meltzer.** May I respond quickly?

**Representative Saxton.** I am sorry, but we have got to go vote, and we are going to miss the vote. Would you like to request they respond to those questions? I think they are great questions.

**Representative Maloney.** I would love it in writing, and I would take it – you know, I am very concerned about the corruption issue, the whole risk issue, even our own banking system, and about this whole – the last item about the flexibility of the systemic exemption.

[The written response from Dr. Meltzer appears in Submissions for the Record on page 111.]

**Representative Saxton.** Before I thank you, I would just like to share one story with you. My friend Mr. Frenze and I joined the delegation to go to Russia in the week prior to Thanksgiving 1999 to try and explore with Russian parliamentarians what may have happened to the IMF funds. They agreed to hold a hearing – a public hearing with us chaired by a member of the Communist Party and highly dominated by members of the Russian party and spent two or three hours claiming that American banks stole the money. I thought you would find that interesting.

Thank you for being here. We appreciate very much the continuing degree of hard work and dedication that you are involved in, particularly with regard to the IMF and World Bank issues. You have been true leaders in getting us on the road to reform, and we look forward to working with you as we move down that road. Thank you very much.  
[Whereupon, at 12:22 p.m., the hearing was adjourned.]

## SUBMISSION FOR THE RECORD

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### PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

I would like to welcome Dr. Meltzer and fellow witnesses before the Committee this morning. Dr. Meltzer served as Chairman of the International Financial Institution Advisory Commission, and the other witnesses before us were also associated with the Commission as well. I would like to take this opportunity to compliment Dr. Meltzer and the Commission once again for their fine work addressing some of the most difficult issues in current economic policy.

Recently *The Economist* magazine commended the Commission's report, noting that it "commanded support across the ideological spectrum." Over the last few years, there has been a remarkable shift in informed opinion regarding reform of the IMF and the World Bank, and the Meltzer Commission has played a central role in bringing this about. In retrospect, it is clear that the debate over the IMF appropriation a few years ago led to a much needed examination of the role of the IMF and World Bank.

In 1998, the proposed quota increase for the International Monetary Fund (IMF) sparked a major debate over the reform of this institution in Congress. In the same year, this Committee held several hearings and issued a number of studies on various IMF reforms. This research identified a number of key problems with the IMF, including a lack of transparency and excessive interest subsidies on loans that exacerbated moral hazard problems.

The lack of financial transparency also hindered Congressional and public understanding of how U.S. contributions are used. Recently a former IMF research director validated these findings and said, "the Fund's jerry-built structure of financial provisions has meant that almost nobody outside, and indeed, few inside, the Fund understand how the organization works..." Penetrating this obscurity required an extensive financial analysis of the Fund, supplemented with financial and other data requested from the General Accounting Office (GAO) and made public through Committee hearings.

The lack of IMF financial transparency is a problem in itself, but also reflects a virtually unintelligible and archaic presentation of the IMF financial statements. To provide just one example, the IMF is a huge lending institution that does not classify most of its loans as loans. This lack of transparency also obscures the fact that most IMF funds used in operations come from a relatively small number of members, and that most members do not provide such support.

It was also found that IMF loans exceeded prudent limits, had excessive maturities, and were not subject to adequate accounting controls and loan safeguards. In addition, an IMF drift into development lending was noted as a serious concern and a reflection of IMF “mission creep.” It was also concluded that IMF borrowing in capital markets was quite feasible and would be superior to continual quota increases.

Some of these research findings were later incorporated in legislation, including the *IMF Transparency and Efficiency Act*.

In 1998 a version of this legislation became law, mandating increased IMF transparency and a reduction of IMF loans subsidies as a condition of the quota increase. Although some steps towards transparency have been made, it does not appear that the IMF has complied with the interest rate reforms. This is most unfortunate, since it was hoped that these higher interest rates might encourage other needed reforms, such as shorter loan maturities and tighter loan caps. However, under Congressional pressure, including proposed legislation, the IMF did finally adopt some basic accounting controls and loan safeguards last summer, but their effectiveness remains to be seen. In short, while some limited progress has been made, much more remains to be done.

The report of the Meltzer Commission last year provided a much-needed analysis of IMF activities and their impact in recent financial crises. Its recommendations with regard to the IMF as well as the World Bank and development banks have framed the discussion about reform of these institutions ever since the report was issued.

Policy changes recommended for the IMF include borrower preconditions, higher interest rates, short maturities, renewed focus on liquidity lending, and increased transparency. A recent change in the IMF balance sheet increasing its transparency somewhat apparently was inspired by a recommendation of the Meltzer Commission. The Commission’s proposal for grant financing of World Bank activities has also been well received. The members of the Commission should be very pleased with the powerful impact of their work, and the Congress is in your debt for your contribution to sound economic policy.