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THE INTERNATIONAL MONETARY FUND AND INTERNATIONAL POLICY

HEARING

before the

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

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THE INTERNATIONAL MONETARY FUND AND INTERNATIONAL POLICY

Tuesday, February, 24, 1998

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

The Committee met, pursuant to notice, at 9:36 a.m., in Room 311, Cannon House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton, Ewing, Thornberry, McCrery and Stark; Senators Sessions and Bingaman.

Also Present: Representative Ganske.

Staff Present: Christopher Frenze, Mary Hewitt, Robert Keleher, Dan Lara, Juanita Morgan, Howard Rosen, Joseph Cwiklinski, and Caroline Buerkle.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. Good morning. The hearing of the Joint Economic Committee (JEC) to deal with the International Monetary Fund (IMF) and the issues surrounding it will come to order.

I am pleased to welcome the distinguished economic experts testifying before the Committee this morning. This hearing has been called to review the Administration's request for almost $18 billion for the International Monetary Fund. During the past several weeks there have been a number of hearings on the Asian crisis and the International Monetary Fund. Much of the focus has been on Asia instead of the fundamental issues regarding the IMF itself.

This is understandable given the circumstances, but more facts concerning the IMF are needed before Congress can make an informed decision about the IMF appropriation. For example, in presenting the case for increased resources for the IMF, little Administration testimony to date has presented basic financial information, such as the current level of quotas, amount of outstanding loans, the interest rate paid on quotas, and cost of overhead, and related expenses. Furthermore, the Administration case relies heavily on the Asian crisis, even though the IMF has sufficient funds to complete the announced Asian bailouts.

This hearing was called to focus on the IMF, its financing procedures, administration, and economic impact. This is entirely appropriate in light of the Government Performance and Results Act. Under the bipartisan legislation, which was supported by Members of both parties, Congress is to review programs based on measurable and objective performance criteria. This act fundamentally changes the way Congress and the Administration evaluate programs. Even if it is argued that the act does not technically apply to IMF, the IMF appropriation should be evaluated in the same spirit. This will require more transparency and responsiveness to Congress from the IMF in the future.

Sabastian Edwards, a former chief economist of the World Bank, has said the pervasive secrecy of the IMF makes evaluating its performance extremely difficult, if not impossible. I can attest to that, during the last couple of weeks in trying to figure out for myself, with the help of my able staff, many of the issues surrounding this subject.

The key question before Congress is whether the IMF should be significantly expanded into the future. Again, the IMF appears to have sufficient funds to cover its current obligations. We are now talking about whether the IMF should be significantly expanded and given more reach.

The current quota increase before Congress is somewhat smaller than that favored by the IMF. The IMF has signaled that the United States should be prepared for an additional quota increase fairly soon, apparently even after this appropriation. This indicates that the IMF expects rapid growth in its operation in coming years. The desirability of such permanent structural increase in the size and reach of the IMF is the key issue before Congress.

However, a convincing case for such IMF expansion is not clear to all and, in fact, has not been made. The IMF budget projections are not available because apparently the IMF does not produce such projections, even for their own internal use. Thus, a case for future IMF growth cannot be sustained by quantitative estimates of future IMF activities. Measurable and objective criteria for IMF functions are not available. Presumably the growth of the international capital flows in recent years might be used to justify an expansion of the IMF, but an alternative expansion might be a growing moral hazard problem, which we will get into later in the question and answer period, that is associated with the bailouts of recent years.

Aside from the specifics of the budget request, there are several major problems with existing IMF lending policies and practices. These include moral hazard, the lack of IMF transparency, excessive taxpayer exposure in the sending and the receiving countries, subsidized interest rates, and counterproductive conditions attached to the IMF loans. These are issues that reasonable people may disagree with, but they cannot be ignored. Meaningful structural reform of the IMF is needed whether an IMF expansion is financed in 1998.

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

At this time, I will ask the Ranking Member, Senator Bingaman, for any comments he may have.

OPENING STATEMENT OF SENATOR JEFF BINGAMAN, RANKING MINORITY MEMBER

Senator Bingaman. Thank you, Mr. Chairman. I do not have an opening statement. Let me welcome Assistant Secretary Geithner and the other witnesses. I look forward to your testimonies. This is an extremely important issue and we are going to live with its consequences for the foreseeable future. I commend you, Mr. Chairman, for having the hearing.

Representative Saxton. Thank you very much, Senator Bingaman. Do other Members have short opening statements, or shall we just move right ahead to the first witness if that is all right?

Mr. Geithner, thank you very much for being with us this morning to represent the position of the Treasury. We are anxious to hear your testimony. We have set aside 15 minutes for your opening statement, so if you would like to proceed?

OPENING STATEMENT OF TIMOTHY F. GEITHNER, ASSISTANT SECRETARY OF THE TREASURY

Mr. Geithner. Thanks. I will do a summary of my statement and ask that you include my full statement for the record.

I am very pleased to have the opportunity to come before you today to talk about the International Monetary Fund and why we believe it is so important to act now to strengthen its financial resources.

We think this is an important debate and an appropriate debate to have, and as a career civil servant at the Treasury, I am particularly pleased to have this opportunity to testify before the Joint Economic Committee.

The crisis that began this summer in Thailand and spread throughout southeast Asia and to Korea presents serious potential risks to American interests. Our economic interests are at stake because large and sustained depreciations in the currencies of our trading partners and deep recessions in their economies will reduce the competitiveness of American companies, reduce demand for American exports, reduce the earnings of American firms and reduce the value of pension funds across the country, all of which of course will affect American families, American workers, and American farmers.

Our security interests are at stake because economic instability, when it is acute and sustained, can threaten political stability. This risk is real not just in places where we now have American troops on the ground. It can be significant in any country where the basic institutions of the government are untested in crisis or where there does not exist a stable, established pattern for succession.

In response to these developments and in an effort to limit the risk they present, we have led a major international effort to help reestablish financial stability in Asia and to help strengthen the international financial architecture.

The IMF is at the center of these efforts and it will remain critical to any effective U.S. response to protect our interest in this crisis, as well as in future crises.

The centerpiece of our approach has been to support strong programs of reform. These programs are designed to address the specific causes of the crisis in each country, to create the conditions necessary for stronger, more stable exchange rates and for a quick return to rising living standards.

Although the specifics have varied across countries, the principal elements of each program include measures to strengthen the financial systems, structural reforms to make the economies more market oriented, the liberalization of restrictions on trade and investment, and true transparency and disclosure, measures to reduce the impact on the poorest segments of society of adjustment, and a supportive framework of monetary and fiscal policies.

These programs are essentially programs of growth-oriented structural reform. They are not austerity programs. It is the crisis, not the program, that induces economic distress, and it is the programs that help cushion declining growth in living standards and help create the conditions necessary for recovery.

Countries that have tried a different path of delayed adjustment and less comprehensive reform have normally found that by doing so, they simply lengthen the crisis into later recovery.

The other common element in these programs is that they can be adjusted in response to changing circumstances. When growth slows more sharply than expected, the IMF can move, as it has in each of the cases in Asia, to modify the fiscal targets in the program, so as not to impose excessive contraction and weaken economies; and when problems in the banking system become more acute than originally estimated, the IMF can act, as it has in Thailand and Indonesia, to strengthen the programs in response.

In support of these programs, we have mobilized temporary financial support, led by the IMF, to help rebuild reserves and provide confidence. This financial assistance is an essential part of the solution to these crises. It is necessary to induce stronger reform programs to provide some breathing space for the reforms to take hold, to supplement the countries' official reserves and to help ensure that these governments can meet their international obligations and can stand behind their financial systems.

There is no amount of official money, however, that can substitute for or compensate for a lack of commitment to reform. That said, even the most credible and most committed governments could not successfully confront problems of this scale without temporary financial assistance. It is useful to recall, although this is not a perfect analogy, it is useful to recall that the U.S.–this country–itself drew a substantial amount of our reserve deposit in the IMF in 1978 when we faced a major decline in the value of the dollar.

The IMF reform programs are structured carefully to help ensure they work to help limit the moral hazards that are inherent in any provision of official finance and to maximize burden sharing. Several of these features are worth highlighting:

Disbursements are tied to strict compliance with very detailed, concrete time-specified policy commitments. They are tranched or phased to induce up-front actions and to help sustain follow through. The money does not flow unless the policy commitments are carried out.

The assistance is provided in the form of temporary loans, not grants, at market-related interest rates and, in fact, after the establishment of a new IMF facility at our initiative last December, much of the assistance for Korea and for future cases will be made available for short maturities at a substantial premium to minimize use and maximize the incentive for countries to repay early.

The IMF's assistance comes with strict limitations on the use of the money, with restrictions on support to private corporations and with limitations and conditions on liquidity support to banks.

And the assistance is led by the international financial institutions, not by bilateral donors, which helps ensure conditionality is maintained and that we leverage substantial contributions from the international community.

Not providing this assistance, in our view, would risk more acute instability, a greater, more protracted loss of economic output, deeper, more sustained depreciations in the currencies of our trading partners, and greater contagion, all with much greater risk to the United States.

The IMF is essential to this effort. If it did not exist, we would have to invent it again. We have a huge stake, we believe, in making sure it has sufficient resources to respond to any intensification or spread of the current crisis.

Today, as much as when it was established with U.S. leadership more than 50 years ago, the IMF acts sort of as a forward defense for American interests. It has played a critical role in supporting reform and growth in the transition economies, helping bring Russia back from the brink of hyperinflation and pulling Poland from near collapse to one of the fastest growing economies in Europe. In Uganda it has helped underwrite 10 years of remarkable reforms which have generated average annual growth rates in real terms of 6 percent a year over the past decade. And in Argentina, to point out another example, the IMF has supported a successful transformation from a country characterized by hyper-inflation to one that enjoys strong growth, 7 percent in 1997, near zero inflation, declining deficits in a much more private-sector oriented economy.

The IMF has been successful in these cases and in many other cases because it promotes the core American economic values of sound money, respect for market forces and free trade.

I thought it would be useful for me to say a few words about the financial structure of the IMF. In some ways, the IMF operates like a credit union. That is not a perfect metaphor but it is a reasonably clear one. We extend a credit line for most of our quota subscription and for a GAB or NAB commitment. The IMF can draw on this credit line. Any drawing by the IMF gives us sort of a deposit in the IMF, which is of equal value, pays interest, is backed up by more than $30 billion in gold, and which we can withdraw essentially on demand if necessary. For these reasons, the U.S. participation in the IMF is treated as an exchange of financial assets. Our transfers are not scored as budgetary outlays and don't come at the expense of domestic programs.

Chairman Greenspan and Secretary Rubin have testified on a number of occasions over the past few months about the risks in the current crisis and about the importance of action by the Congress to strengthen the IMF resources.

As you know, the President's request has two components. The first component is to authorize U.S. participation in an expanded emergency reserve fund for the IMF, called the New Arrangements to Borrow. This was proposed in 1995, after the Mexican financial crisis, and it is modeled on the General Arrangements to Borrow, which was established by the U.S. in cooperation with the G-10 more than 30 years ago. The NAB would make available an additional $23 billion from some 25 countries to supplement the IMF's normal lending resources in the event of a serious threat to the stability of the international financial system. Just for reference, the GAB was last increased in 1983, in response to a request from President Reagan, and also in conjunction with a new alignment of quota increase. In the ensuing 15 years, the growth in the world economy trade, and most importantly perhaps, global capital flows, have left these arrangements too small to deal effectively with the challenges in today's capital markets.

Just to point out one fact that is useful, IMF resources as a percentage of private capital flows to developing countries are now one-twentieth as large as they were 15 years ago.

The second component of the President's request is to authorize our participation in the regular periodic increase in IMF quotas which are the normal lending resources of the institution. These resources have been increased on average every seven years to help ensure the IMF can keep up with the growth in the world economy and the global financial system, not fully keep up but keep up to some extent. This latest increase would increase the overall quotas by about 45 percent and provide roughly $65 billion in additional lendable resources. This was negotiated last year, really before the crisis took on its full dimensions, in consultation with the relevant congressional committees.

The IMF's recent reform programs in Asia have depleted its resources to levels approaching historic lows. Although the IMF has $45 billion now in uncommitted resources, only 10 to 15 billion of these resources, in our view, are available for lending for new programs because the IMF needs to reserve the remainder to accommodate possible withdrawals by Members. This is neither a sufficient cushion of resources to enable the IMF to perform its basic mission, nor is it sufficient to ensure the IMF could respond effectively if the Asian crisis deepens or spreads to other markets.

We believe it is extremely important that the Congress move quickly to approve both the NAB and the quota request so that the IMF has sufficient resources to help protect U.S. interests in what is a very delicate moment in the international financial system.

Now at the same time that we have worked to confront the immediate crisis in Asia, we have been working to help build consensus on reforms to strengthen the architecture of the international financial system. We have a very strong interest in trying to identify changes to the system that could help reduce the risk of and make the system more resilient in the event of future financial crises of this magnitude.

The President began this effort four years ago at the G-7 Summit in Naples and at the Summit that followed in Halifax, we launched a major effort to help make the financial architecture, in Secretary Rubin's words, "as modern as the markets."

Building on those steps, we have supported a number of changes over the past few months, and I will just list the most significant of these quickly:

We launched a new effort to strengthen transparency and disclosure standards, to help reinforce market discipline.

We have won support for a number of steps to improve transparency in the operations of the IMF, which I would like to review in detail for you during the question period.

We have changed the policies and operations of the IMF and the World Bank to make it possible for them, when necessary, to mobilize large-scale, front-loaded, more innovative programs of financial assistance that are more appropriate to today's capital markets.

We have established a new forum for surveillance and cooperation in Asia to help deal with risks that might precipitate future crises.

And we have encouraged greater participation by private financial institutions in the resolution of these crises, with a global effort by the major banks to refinance their short-term claims on Korean financial institutions.

We are now in a comprehensive review of changes to the system that we hope will help ensure we have effective institutions to manage the risks that accompany all the benefits of global capital market integration and to help us deal with the world in which we are all more directly affected by what happens in other economies and governments. But we don't have the capacity to induce sovereign states to take actions they do not yet perceive to be in their interest.

This is going to be a complicated and difficult process, with lots of interesting, compelling solutions to be explored. The temptation for some, I think, will be to try and stop the clock somehow to suspend the crisis while we try to figure out the best way forward, but we don't think that is a tenable approach given the risks we now face.

The U.S. role is critical because the IMF cannot strengthen its resources without us. If we do not act, the NAB will not come into force, the quota increase will not go into effect. We can't guarantee that by acting we can turn things around and successfully eliminate any fallout for the U.S. economy. Most of the solutions to these problems have to come from the countries themselves, but we have a responsibility to do what we can to help protect our interest in this crisis, and the strength of the IMF is essential to that objective. Thank you very much.

[The prepared statement of Mr. Geithner appears in the Submissions for the Record.]

Representative Saxton. Thank you very much. We want to thank you for your testimony. And let me just say at the outset that when Congress is asked to appropriate a sum of money that amounts to very close to $18 billion, obviously Members on both sides of the aisle take it very seriously. So we are sincerely looking for the information that we need to know how the money will be used, hopefully effectively, to solve problems that the IMF identifies.

Information to us is very important, therefore, relative to the operation of the IMF. And I must say that partly because the IMF has not been forthcoming, and partly because of the complicated nature of the information, it has been very difficult for us as Members of Congress to understand it.

Now as you know in recent months, there has been quite a bit of debate about these issues. One purpose of this hearing, therefore, is to try to elicit more facts about the IMF so Congress can make a more informed decision about the Administration's appropriations request. I would like to ask a series of questions relative to this information.

First of all, let me ask you about my request for three of the IMF reviews of the bailouts of Thailand, Indonesia, and Korea. Under the law, Congress must take the performance results and take the results of agency policies into account, in consideration of funding issues. We do that consistently. Yet the Treasury and the IMF refuse to release the IMF studies of the effects of its own policies for the use of public policy debate, even as it asks Congress for an $18 billion IMF appropriation.

This raises questions to me, at least, about the seriousness of Treasury's commitment to IMF transparency, something you mentioned several times in your opening statement. The failure of the IMF to even respond to my letters raises the same kind of questions. As I have publicly stated, I understand that classified and proprietary information may have to be deleted. I understand that and have no objection.

Let me ask you, have you read the IMF staff reviews I have mentioned, including one entitled "Indonesian Standby Agreement?"

Mr. Geithner. Yes.

Representative Saxton. Very good. Now, did the IMF study conclude that the IMF's recommended bank closures, far from improving public confidence in the banking system, have instead set off a renewed flight to safety?

Mr. Geithner. I think that is a slight mischaracterization of the conclusions reached in that report, and maybe it is worth reviewing those in more detail. As part of the initial program, the government of Indonesia decided to close 16 banks that were very weak, undercapitalized, essentially insolvent. That was, I think, an appropriate step in everyone's judgment. It is hard to imagine that they would be better off or the financial system would be better off by trying to keep afloat insolvent institutions longer than they should.

The result of that action was concern, quite inevitably, concern among depositors in other Indonesian banks that the situation was worse than people had previously expected. So there was a flight of deposits from the system as a whole and the flight to quality within the system as a whole, but that is a necessary, inevitable result of any situation like this. It has been true. It has happened in Japan. It has obviously happened before in the United States, and it has happened in a whole range of countries across the region.

I don't think it would be appropriate to conclude from that that the IMF or the Indonesians themselves were wrong to act to close. It is perfectly accurate to say the effect of that was heightened concern about the stability of the system as a whole, but that would have been unavoidable and would not have been made better by keeping these institutions open.

Representative Saxton. I thank you for that. But at the same time, did the IMF study say–you indicate that there was a run on other banks –as a matter of fact, that two-thirds of the country's banks had experienced runs on its deposits? Two-thirds?

Mr. Geithner. Well, that may have been in the report and that may be true, but as I said, I think that is perfectly understandable in the context and probably unavoidable.

Representative Saxton. Did the IMF study state as a result that the central bank had to pump money into the banks equivalent to about 5 percent of GDP during the last two months?

Mr. Geithner. There is another report in front of me. I am reluctant to verify the specific numbers in there, and that may be true. I am a little uncomfortable, partly because I don't have it in front of me, walking through all the details of that report, and maybe it is worth talking a little bit about the concerns you raised about these reports as a whole.

We provide and are able to provide any document in the IMF, any staff report, any letter of intent, any program documentation, any analysis that the Congress requests, as long as we have appropriate protections in place to prevent the release of that information. We have also supported a whole range of policies in the IMF to make its prescriptions and its conclusions more transparent, and if you give me a chance, I would like to run through some of those policies.

Representative Saxton. If you can do it quickly, because I have a line of questions.

Mr. Geithner. Would you like me to wait, or should I run through that now?

Representative Saxton. Let me just back up to the question I just put to you relative to whether the central banks injected funds equivalent to about 5 percent of GDP during the last couple of months. Would you say that a significant amount of money was pumped back into the banks during the last two months?

Mr. Geithner. Absolutely.

Representative Saxton. And that 5 percent is probably within the realm of what it may have been.

Mr. Geithner. That–I want to look at the reports before I verify that.

Representative Saxton. That is fair enough. We appreciate that. Let's switch to Korea for just a minute. Does the IMF review of the Korean bailout examine the failure of the first Korean bailout to restore confidence?

Mr. Geithner. I'm sorry, does the–

Representative Saxton. Does IMF review of the Korean bailout examine the failure of the first Korean bailout to restore confidence?

Mr. Geithner. Absolutely.

Representative Saxton. Does it contain suggestions that additional steps might be needed, such as a second bailout during the Christmas holidays?

Mr. Geithner. I am not sure, actually, what the staff report at that point said about what was appropriate to the future to respond to the circumstances. I can tell you what we did that we thought was appropriate for a variety of reasons, many of which were political and had to do with credibility and a loss of credibility in the then- government. The initial program was not followed by an improvement in confidence; in fact, confidence deteriorated quite quickly after that.

In response to that, we thought it was necessary to work with the Korean authorities and the IMF to strengthen their program, to give them a chance to demonstrate through concrete actions that they were actually serious about trying to fix the problems that led to the crisis.

And supportive of that, we agreed to do two things which are very important to what has happened since. We agreed to pull forward some of the existing commitments–the disbursements in the pipeline from the IMF and World Bank, because at that point Korea was very short of reserves and was a day or two away from default.

We also agreed to make available part of what is called our "second line commitments," in the context of a broad agreement by the major international banks to refinance their existing claims on Korean financial institutions, and that process, as I think you know, has been quite successful in helping bring back a little confidence in Korea. And I think those steps were appropriate and have proven to be quite helpful.

Representative Saxton. Thank you. Now let's move to Thailand. Does the IMF review of the Thai bailout recognize that the IMF conditions on Thai fiscal policies were unnecessarily harsh and should be relaxed, as has been done in recent weeks?

Mr. Geithner. No, I don't think that is the correct characterization. I think people sort of tend to perceive these IMF programs as rigid, formulated prescriptions, that once applied never get adapted and changed. And in reality, they are quite flexible and they get adjusted in a rolling process as circumstances change.

In each of the cases, growth has proven to slow much more sharply than originally expected, and in response to that, the IMF has adjusted its fiscal targets in each case to make sure it was not imposing unnecessarily harsh adjustment, as the economy slowed further. But it wasn't the initial prescription that induced the declining growth; it was the sort of loss of confidence and credibility in the crisis that induced that.

Representative Saxton. Thank you. I know that you agree that we ought to address the issue of transparency, and unfortunately what we have to work with are your impressions of what is in the reports at this point.

Is there any doubt the IMF studies would be of great interest to Members of Congress in reaching informed decisions about the merits of IMF appropriations? Why should these documents not be publicly released after deletions of any classified or proprietary material?

Mr. Geithner. Well, I want to try to respond to that as well as I can. There are a variety of aspects to the transparency question and it is important we walk through those, I think.

The first is to make sure countries disclose to the markets better information, more comprehensive information about the quality–about the underlying financial condition of the country. That is something we supported very actively, the IMF has been very centrally involved in, we made some progress on, but we need to make more.

We also think it is important for the IMF to make available to the public more information about the contents of their programs and about the conclusions of their annual reviews of countries, called the Article 4 process. And we have, over the past several months, made important progress in those areas. For each of the major Asian programs, at our insistence, the IMF has released the letters of intent so the full details of the program are available to the markets, and that is critical to the effect of these programs, critical to credibility in our view.

We have also supported a more systematic external evaluation process at the IMF so that committees, ad hoc committees formed of external independent auditors and evaluators, can assess IMF programs in a number of areas and those results will be made public.

One more thing on the financial statements. We find the IMF financial statements hard to decipher too, and I think we share your frustration in trying to figure out what is actually behind them, but that is just because it is a complex institution, not because there is any mystery to the facts.

The IMF has a regular external audit every year of its financial statements and the conclusions of that review are made public. Now, just like in the Administration and I suspect in the Congress, we produce documents every day that have sensitive information in them or national security classified information that we are not prepared to make available to the public for lots of understandable reasons. The IMF has a number of documents that fall into that category, too. We make those documents available to the Congress upon request. You each have full access to that information and to those documents, but we do not have the capacity to release that information to the public; we don't have procedures in place that would allow us to release systematically redacted or modified versions of those documents to reduce classified information.

We are for more transparency in the IMF and we are very interested in working with you in the Congress to try and figure out ways to do that, and I would be happy to work with you and talk to your staff in more detail about things we might be able to do to respond to your concerns. We think it is very appropriate you have access to this information and you do have access to that information now.

We also think it is appropriate markets have access to more information and we have been supportive, quite successfully, in a number of steps in that direction, particularly over the last several months.

Representative Saxton. It is very difficult for us to understand why the Treasury and IMF cannot release declassified information to us. I understand that there is certain sensitive information that cannot be released. I understand there is classified information that cannot be released. Why can't the reports be released publicly on a declassified basis?

Mr. Geithner. Maybe the best explanation now is to say we are caught between the old and the new. This is an organization that has procedures in place to protect against the release of sensitive information, and we do not as members of that institution, under its current rules, have the capacity to make those public. And there are no procedures available now for us to systematically, as you put it, declassify or redact those documents. But as I said, I think you are making important points, and we share many of the objectives you have stated and we are prepared to work with you to see if we can accomplish those.

Representative Saxton. Congress deals with classified information all the time. We have an Intelligence Committee, and it deals with classified information on the third or fourth floor of the Capitol Building. I understand the walls are lined with lead, and the people who come out of those rooms never mention classified information, at least not on an authorized basis. We deal with those issues, and some of that information, from time to time, is declassified because we think the public has the right to know. The public ought to know that these issues are best decided when they are discussed publicly.

Is the real reason Treasury and IMF want to keep the study under wraps because it reflects badly on the IMF?

Mr. Geithner. Absolutely not. As I said, we think the programs are more likely to work if the markets have full information on the details of what is going on, and that is why we are providing more information to the markets. I think you are absolutely right about that case. But we have to be careful not to go–not to adopt changes that are going to make it impossible for the institution itself to function effectively in providing quite brutally candid assessments of what is going on in these countries and quite brutally candid prescriptions for what countries have to do to get back on track. And we have to find some way to balance the broad objectives of transparency with the same imperative which, as you acknowledge, leads the executive branch and the Congress to have procedures in place to prevent release of sensitive, classified information.

Representative Saxton. Let me ask one final question, and then we will move to Senator Bingaman. Is there any reason why the IMF financial statements should not be available in an understandable fashion to a typical economist or banker? Is there a useful purpose served by the opaque and confusing IMF accounting system that is currently used? And could you explain, for example, the accounting definition, "renumerable reserved tranche position," please?

Mr. Geithner. You know, I have been at the Treasury 10 years, and I am not an economist or an accountant, and I have found this stuff hard to figure out and understand.

Representative Saxton. We have had accountants and lawyers and economists working on it and trying to understand this stuff for weeks.

Mr. Geithner. You can take the balance sheet of any company in the United States and you may have a similar challenge.

Representative Saxton. Excuse me. You look at IMF documents –and it says here our quota is 26 billion, which is really $36 billion. You look at this and there is 13 billion. What is the term? The reserve tranche position is 13 billion, which is really not $13 billion. And CRS looks at all this stuff, and it comes back scratching its head. We cannot understand it, nobody will help us, and we are not going to appropriate money until we understand it. It is pretty simple.

Mr. Geithner. I think that is a perfectly reasonable concern, and we are happy to try to help the CRS understand. The GAO has conducted a number of studies of the IMF over time. They have a fair amount of expertise. We helped them walk through the accounts and explain them. They are hard to understand because of the institution, but there is no mystery to the facts and no mystery to the numbers and no mystery to the basic financial operations of the institution.

Representative Saxton. Just define for us the term "remunerated reserve tranche position."

Mr. Geithner. That is what I called in my testimony in simple terms, the claim we have in the institution that represents the IMF's drawing down of our credit line. That is an interest-bearing asset, and that is why it is sort of the offsetting claim to what they draw down on our credit line, and that is why our participation in the institution is not scored as requiring budget outlays.

I think the simplest answer is a deposit that pays interest that is liquid that we can withdraw.

Representative Saxton. Thank you.

Senator Bingaman.

Senator Bingaman. Thank you very much, Mr. Chairman.

I would like to begin by asking about the general way out of this financial crisis in Asia. A few weeks ago I read an article by Martin Feldstein, in which he said much of the cause of the crisis was due to policies which the Japanese government pursued in weakening the yen. He provided an explanation in the article, which I guess economists can argue about.

But when you get to the question of how Asia digs out of these circumstances, it seems that there is not much argument. The only way for most of these countries to dig out of the crisis is to export their way out, and the United States is the only market that is open and ready to accept those exports. The Japanese government, although we have urged them to stimulate their own economy and begin to accept more exports, don't seem to be willing to do that.

I guess I would ask, what specific actions are we urging the Japanese to undertake, other than just continued wringing of our hands. It seems to me, if the Japanese do not participate in the solution to the problem, the crisis is going to be much more protracted, and it is going to be much worse for U.S. workers and U.S. companies.

What specific things we are urging the Japanese government to do and what are the prospects for their implementation?

Mr. Geithner. Let me start by saying, we agree with your concerns and I certainly agree with much of what you said. There are three areas in which we think it is appropriate for the Japanese to take more forceful actions to deal with the challenges we now face.

The first is to use macroeconomic policy and fiscal policy with additional actions in the short-term to help strengthen domestic demand.

If you look at the trajectory of Japanese fiscal policy over the next fiscal year, it builds in significant additional contraction, and I would say the markets think that is a bit risky in the context of an economy this weak; and we suggested, as have the IMF and a number of other countries suggested, it would be more appropriate for the Japanese to act to stimulate demand with fiscal policy in the short term.

Senator Bingaman. That is a tax cut.

Mr. Geithner. There are a variety of ways they could do so. They are a sovereign country and we have been a little reluctant to prescribe in detail, certainly in public, the precise sets of policies they could take to meet that challenge. What is important to us is they do something that is going to work and work quickly.

The second area where we have been supportive of additional policies is in the financial system, where we want them both to stabilize, reduce systemic risks in the system and act to try and put the problem behind them more quickly. They have taken a number of steps recently in those directions, but they have not yet generated confidence in the markets. I think generally in Japan that they have got an effective medium-term plan for how to put this behind them.

The third area is just in the familiar area of opening their markets further. I think Japan would do Asia a great service if it was prepared to import more from the region, and so we have been actively promoting, generally in a variety of specific sectors, a more active market opening by the Japanese.

Senator Bingaman. Let me emphasize something you just referred to briefly. The Treasury Department has made apparently successful efforts in bringing together the foreign financial institutions which made large loans to Korea in order to restructure those loans. It seemed to me, the little bit I know about these circumstances, that that is an essential part and perhaps the most effective single thing that has been done so far in stabilizing the situation in Korea.

To what extent are you working in connection with the other countries in difficulty in the Far East in this restructuring effort. Second, are there plans to make this restructuring effort a normal part of the prescription or a normal part of the remedy that is put in place in these types of circumstances?

Mr. Geithner. I think we all want to find a way to make it possible for private investors to bear more responsibility for the risks they take in these investments and to be a greater part of the solution in resolving these crises. We don't have the capacity to force lenders to lend to countries in crisis if they don't think that they can do so, and it would be prudent to do so, or that their shareholders would be particularly enthusiastic to do so. We don't have the capacity to force them to take losses in these countries without assuming all the risks that come with a moratorium–the fear of sustained loss of access to the capital markets, the fear that banks would pull back from other markets around the world and that the crisis would be much more acute as a result.

Each of these circumstances is unique. What has happened in Korea has happened in part because the regime of the new government has been viewed as so credible and serious and, in part, because it was a very quick realization by the major international banks about the stake they had in trying to work this out. It is very hard to see whether those conditions would make it possible to adopt a similar solution in the other cases in Asia, much less in other cases elsewhere in the world, but one of the core features of what the Secretary and Chairman Greenspan have been trying to do, the process by which they tried to begin to strengthen the architecture, is to try and design mechanisms to help us do in the future what we tried to do in Korea.

Senator Bingaman. I recently received a letter from Mr. Dave Schlegel, who is the President and Chief Executive Officer of a company in Albuquerque, called Envirco Corporation. The company makes clean air equipment for use in semiconductor processing. The corporation employs about 100 people in my state, and it has been successful over the last several years in expanding its exports. By the end of last year, about 40 percent of their revenue came from exports.

They now face a situation where, as they put it, “overnight, the Asian crisis provided their Korean competitors a 50 percent cost reduction.” They also say that, "We should not allow the United States to soak up excess Asian production capacity so that Asian countries can export their way back to prosperity at the expense of American workers and jobs. Any ensuing American economic hardship must not solely fall on the American workers in industries vulnerable to Asian exporters using devalued currencies. Our export success," he is talking about his company, "has helped restore prosperity to the country, our people have worked hard, they have played by the rules, and they have succeeded. If they are now considered expendable to cure the Asian crisis, then their faith in American values and America's future is rightfully shaken." I may ask you to respond to this letter.

Do you have any response you could give us this morning as to what we tell this gentleman? It seems to me we have programs in place to increase assistance to large companies that do business internationally. What do we tell smaller companies of 100 employees? Do we just tell them, tough luck, all our efforts to encourage you to export were misguided?

Mr. Geithner. No, absolutely not. I think that is a terrific example of why we are doing what we are doing. It is useful to just review again why these programs are important.

They are important because unless we can put in place the conditions that are going to generate stronger, more stable currencies in these countries, and unless we can generate the conditions that can allow them to return to more rapid growth so there is a growing demand for U.S. exports again, we are going to face in companies across the United States a significant loss of exports and significant effects on their earnings.

The most effective thing we can do for companies like this one is try and shape an effective response that is going to bring the currencies back and bring stability and confidence and growth back to these countries. That is the most powerful solution to these problems, and it is exactly why we are acting.

Senator Bingaman. Thank you.

Representative Saxton. Thank you.

Before I move to my friend, Mr. Ewing, Senator Bingaman mentioned the interest of Martin Feldstein, who is the Chairman of the National Bureau of Economic Research, in this subject. I received a letter from him, which I would just like to read for the record. He says

"Dear Jim, I received your press release calling on the IMF to release documents relating to their programs in Asia. I support this request. I think the basic program documents should be available so they can be examined by a broader group of experts than just those in the IMF."

"The fund will no doubt," he continues, "reply that they can only do so with the permission of the countries themselves. I think it would help if Congress made it clear congressional support for IMF activities depends on getting these program agreements, and that it is therefore in the interest of the countries to agree to have these documents released."

That makes sense to me.

Mr. Geithner. Much of that makes sense to us, and that is why we pushed to accomplish what he described. Basic program documentation in each country was released to the public. He is absolutely right. It is perfectly appropriate for the broader community of investors and analysts and academics and economists to have access to information to allow them to assess the quality of that advice and the effectiveness of the program.

Representative Saxton. As well as the documents that we requested by this Committee.

Mr. Geithner. As I said, we are happy to try and work with you to figure out if we can design ways to facilitate greater release of those things and still protect sensitive, classified information. We don't have that right now, so I can't give the documents to you right now, but we are happy to work on that area.

Representative Saxton. Mr. Ewing, who got up at 3:00 a.m. to be here today, by the way.

OPENING STATEMENT OF REPRESENTATIVE THOMAS W. EWING

Representative Ewing. I am waiting for the Chairman to tell me it was all worth it.

I want to, if I can, Senator, follow up on your question for a minute. I think that is the real crux of some of our constituent concerns back home. If we do nothing and their economies plummet and the currencies are devaluated, our producers are–people who are trading overseas are going to be at a tremendous disadvantage, those markets are going to disappear or whatever. If we go in, as we have, and we try and stabilize the situation and there is tremendous devaluation in their money, we are still at a tremendous disadvantage in the trade issue with their currencies being devaluated. And we hear about this so much.

I am asking, what is the answer? I mean, either way, it is bad. Maybe we should just save our money if it is going to be bad either way. What would you say to that?

Mr. Geithner. I don't think I agree with that.

Representative Ewing. I didn't think you would agree, but how do you answer if it is going to be bad either way?

Mr. Geithner. Our view is that there is no way to avoid some of the effects of the crisis that has happened so far; that will affect us no matter what we do, going forward. But if we are not successful in trying to stabilize these countries and get them back to growth, then the loss of U.S. exports, the loss of earnings, the risk to U.S. companies would be far greater. That is not something we can prove to you, but we have lots of other past examples to illustrate why the effects would be much greater if we fail to succeed in helping these countries reestablish stability.

So I don't think it is fair to say that we have two outcomes here and that in both cases we have equal effects on the U.S. economy. I think in one case, the effects will be modest but significant. In the other case, it could be far greater.

Representative Ewing. This leads into a question I wanted to ask you dealing with agricultural products, because I think, since January, they have fallen about 5.8 percent in value, price, here in the United States. And that is probably because, again, of the depreciation or devaluation of the Asian currencies.

How fast do you see these currencies coming back in? Are they facing rather high inflation that will bring that currency a little more up to where it was, more rapidly than we are in this country?

Mr. Geithner. Well, I think that will be part of the mechanism that will help, over time, to limit the decline in their real effective exchange rates; but how fast they come back depends on how successful they are. It would be nice, but we can't will these exchange rates into higher levels and just keep them there through an active will. It only happens if you can generate confidence and confidence comes back; and as I said in my statement, once you lose confidence, it is hard to regain it. So it is hard to say how quickly the nominal exchange rates will come back.

Representative Saxton. You believe then that Members from agricultural areas should be very supportive of additional funding for the IMF?

Mr. Geithner. Well, they actually have been very supportive. In some ways, they have seen more graphically and more quickly the potential loss of exports. I think the estimates from the United States Department of Agriculture (USDA) now are that we could lose $2 billion in exports this year. Even if things stabilize here, that is a fairly substantial amount of money; and they have been very, very supportive in what we have been trying to do with the IMF in these cases.

Representative Ewing. We are talking about $18 billion in additional money. That was explained to me by Secretary Rubin and Chairman Greenspan, that this was to replace monies already obligated, kind of a standby in case there was a further worsening of the crisis; is that correct?

Mr. Geithner. Absolutely. As he put it, we feel it is important to have it to deal with any spread or intensification of the current crisis.

Representative Ewing. One last question. How do you get the most bang for your dollar when these economies have suffered hundreds of billions of dollars worth of loss from devaluation, and we are putting in a modest–how many billion–40 or 50 billion?

Mr. Geithner. Well, it doesn't seem very modest.

Representative Ewing. Compared to the estimated loss in those economies, it is modest. It certainly isn't a replacement.

Mr. Geithner. That is actually right. The amount of official assistance that has been made available and actually disbursed in these countries is very small in comparison to the scale of external liabilities, and that is why the programs work, if they work, only because they engender the confidence necessary to have savings stay in the country in foreign capital and private capital.

They don't work because the official money is there, although that is a necessary condition to make them work; they only work if private money will stay or come back in.

Representative Ewing. I guess it still isn't an answer to how a rather limited number of dollars, compared to what the loss is, replaces it and stabilizes the economy.

Mr. Geithner. You said it perhaps more clearly than I did. It is a relatively small amount of money in comparison to the losses experienced, and it is a relatively small amount of money in comparison to the losses that could be experienced.

Representative Ewing. My question is, how does that work?

Mr. Geithner. It works because–in some ways, it is like putting money in a loan window or augmenting the country's reserves. In association with these strong programs of reform, you give the people of the country and foreign investors more confidence that the country will be able to meet their obligations, that there will be enough time for the reforms to take hold, that they are going to believe they can have confidence they will earn a reasonable return on their investment as they bring it back in.

That is the theory of it, if it works.

Representative Ewing. Thank you.

Representative Saxton. Thank you.

Senator Sessions.

OPENING STATEMENT OF SENATOR JEFF SESSIONS

Senator Sessions. I would like to say, I do support you in your view that this Committee and all the Members of Congress ought to be able to understand the situation before we appropriate monies.

Let me ask you this. With regard to the amount of money needed, some have said there is sufficient money in the fund now. How certain are you that more money is needed at this time? Might it not be better for this Congress to sit back, make sure we get full information from the IMF, and see the kind of reforms we want to see, before we give the additional money?

Mr. Geithner. Let me start by saying, we think it is absolutely appropriate and necessary for you to have access to the information you need to make an informed judgment; and we think it is perfectly appropriate for you to have a thoughtful debate about the broad policy questions we face in the institution. We would not be up here if we did not think the risks in the current situation were serious enough to make the prudent act an act now to try to strengthen the IMF's financial resources. We would not put you through this or ourselves through this if we did not think it was important.

I think Chairman Greenspan has been eloquent in trying to describe that although the effects so far on the U.S. economy are going to be relatively modest, the potential risks to the U.S. economy are really quite significant; and there is a very small, but not negligible chance that this crisis could become a crisis of truly global scale.

In comparison to those risks, the existing financial cushion in the IMF, the $10 or $15 billion now available and the $23 billion now available in the GAB are very small in comparison to those potential risks. They are not just small in historical perspective, but they are very small in comparison to the magnitude of the risk we now face.

Just for comparison, the IMF's program in Korea is $20 billion, and the IMF normally lends, I think–and I might get the numbers a little bit wrong, but I can clarify them for you–I think the IMF normally lends $5 to $7 billion a year in times of much more common stability in the system.

So the existing cushion is quite low, and we think it would be prudent to act to strengthen the IMF so that we have the capacity to protect U.S. interests if this crisis were to deepen or to spread.

Senator Sessions. I just heard it had $85 billion in liquid resources in April–8.6 billion more than the previous April available to them. So, even if you took the whole proposed package, there would still be substantial reserves left, it would appear to me.

Mr. Geithner. A lot has happened in the world since April, and all that has happened in the world since April has left the IMF, as I said in my statement, with roughly $45 billion in uncommitted loanable resources now. But that overstates what they actually have available to lend to countries, because a substantial portion of that has to be kept to accommodate any possible withdrawal of–what we were discussing with the Chairman a few minutes ago–of our deposit in the institution, deposits other countries have in the institution.

So, in effect, we believe the IMF has roughly $10 to $15 billion available now and an additional 23 available that it could draw in some circumstances from the GAB. But these are historically low levels and imprudent levels, we believe, given the risks we now face in the system.

But we would be happy to walk you through, if you want, a little bit of how we got from April to where we are here and what existing commitments are outstanding, relative to the existing resources.

Senator Sessions. Let me ask this. I am concerned, ultimately, with how the IMF views itself and how we view the IMF. It is an institution that we expect to continue to grow, presumably to deal with crises continually, some of which are larger or smaller than this? Or is this, the Asian crisis, an extraordinary event that we don't expect to be duplicated anytime soon?

Mr. Geithner. Well, it is certainly an extraordinary event. I don't think any of us can say with confidence we are going to create a world in which the risks of these crises will fade away. I think the only way people know to prevent a crisis from just happening is for all countries to cut themselves off from the global capital market; and we think sacrifices–most countries believe the sacrifices and the forgone gains and growth in that would be inappropriate. So we are probably likely to live in a world for some time where there are some risks of crisis, and no matter how successful we are in strengthening the architecture of the system, the potential for crisis is likely to persist. It is also true that our interests are affected when a crisis happens, so the question we face is, what is the most cost-effective, prudent and effective way to protect our interests when the crises happen, if they happen in the future; and our view is, the most cost-effective way to deal with that is make sure the IMF is there with burden-sharing to help us respond.

Senator Sessions. Just briefly, with regard to the operating expenses of the IMF, how is that funded?

Mr. Geithner. The IMF charges its borrowers a little bit more than it pays its creditors, in a sense, and that margin funds the administrative budget of the IMF.

Senator Sessions. Thank you, Mr. Chairman.

Representative Saxton. Mr. Stark.

Thank you, Senator Sessions.

OPENING STATEMENT OF REPRESENTATIVE FORTNEY PETE STARK

Representative Stark. Thank you, Mr. Chairman.

Mr. Geithner, I heard you respond earlier to Senator Bingaman's concerns in suggesting that the Treasury does not support the idea of basically bailing out U.S. and European banks whose lending can charitably be described as "reckless," at best, in countries like Indonesia. But you say you don't think you could do anything about it. In other words–is that, in effect, what I heard you say?

Mr. Geithner. Well, if I did, I didn't do it well.

I think it is important to recognize that U.S. banks, foreign banks, Japanese banks, European banks have taken losses across the region, and I am sure there are more to come. They have not been insulated from the consequences of the loans they made.

Representative Stark. But they want to get bailed out, they want to get paid back with this IMF funding, don't they?

Mr. Geithner. Well, I think we all want to be in a situation where confidence and stability return to these countries.

Representative Stark. Wait a minute. They made bad loans, okay? By anybody's standards, they were, charitably, bad loans.

We have the experience of the 1980s in South America, we had it in Mexico; we have been up and down this hill a lot of times. They made bad loans.

If somebody was in the auto loan department of Chase, they would now be walking the streets had they loaned on Edsels at the rate these guys have loaned, with no protection for security devaluation, and lending short- against long-term obligations they knew they weren't going to get back. So, I mean, by any banking standards, they weren't good loans, and I think I heard Secretary Rubin say, when he addressed the Democratic Caucus, that he didn't think we should be bailing out our banks or Wall Street for their mistakes–let's say, their "zealousness." Did I hear him say something like that?

Mr. Geithner. To use his famous phrase, he said, "I wouldn't give a nickel to bail out investors in this context."

Representative Stark. Then did I just hear you say that is a difficult thing to do while you are trying to create stability in the region?

Mr. Geithner. Well, what is difficult to do is to force banks to lend to countries in crisis if the shareholders don't think it is prudent, and what is difficult to do is force them to take losses without, in effect, inducing default and without creating a situation where you are going to face the prospects of a much more acute crisis in these countries, and a more protracted loss–as the Latin American countries faced in the 1980s, a more protracted loss of access to the capital markets and to finance. Those are two things we can't do in the current situation. We may never be able to do.

But what the Secretary and Chairman Greenspan have said they would like to try to do is try to develop mechanisms that will ensure private investors bear more responsibility, more fully bear, to the extent practical, the consequences of the decisions they made in investing and making these loans.

Now, if you had them up here, they might have a different perspective on the prudence of the loans they made.

Representative Stark. If they think the loans are so good, why don't we just let them keep the loans and let them get what they can in the currencies they can get it in and say, that is it, guys? I mean, we don't do it around here for banks.

And I just want to come back–I think that I heard the Secretary say and I think I heard you say that we all agree we shouldn't be bailing out our banks. I mean, that isn't the purpose of this, is it? We are not trying to bail out Chase or Citicorp or BofA, for bad loans.

Mr. Geithner. That is right. We could care less about bailing out U.S. banks; we could care less about insulating the decisions they made. What we want to do is reestablish confidence and stability; and it is true, although–

Representative Stark. You know, I don't think these guys need any confidence and stability. They have made such stupid loans in the past, what the hell do they care, they just throw the money away because they know we are going to bail them out. I suspect that, yes, one of the problems would be, if we made them bear the consequences of bad business decisions–I mean, it is interesting.

When they make a profit overseas, we don't share in that, we don't collect any taxes, they keep that overseas, and we postpone the taxes so they can reinvest it overseas, right? That is a win-win-win. So when they make a lot of money overseas, none of us can use it to pave roads or support children's education or health care for the uninsured in this country; we do that in the name of increasing exports.

Now, when the situation is reversed, they don't want to pay any losses either; they want us to bail out their losses. Now I am just asking you, if we could figure out a way to help out the poor Indonesians– mostly that is the Suharto family–but if we could figure out a way to bail them out and not have any of that go to U.S. banks and investors, would you support that?

If I could just find that nice piece of legislation, and I suspect that would rest in the Tax Code, and we could work it out so Chase and Citicorp and all those guys didn't get any money, would you support that?

Mr. Geithner. Absolutely.

Representative Stark. That is all I wanted you to say. Thank you.

Thank you, Mr. Chairman.

Representative Saxton. I would just like to emphasize Mr. Stark's point. He said that these folks have not used the best discretion with some of these loans. It seems to me that if we continue to pump money into them as an encouragement to continue to make bad loans, then the bad loans are on our conscience as well.

Representative Stark. The Chair is correct.

Representative Saxton. Mr. Thornberry.

OPENING STATEMENT OF REPRESENTATIVE MAC THORNBERRY

Representative Thornberry. Thank you, Mr. Chairman.

Mr. Secretary, it is probably a mixed blessing that the current difficulties in Asia provide a number of us and the American people a time to really focus on the IMF as an institution. It is all bottled up in the same situation, and maybe that is not a good thing.

As you know, there have been a number of very knowledgeable and prominent people who believe the IMF has outlived its usefulness, that an institution set up after the war to help stabilize currencies at a time when we have so much of global economy where technology allows capital to move back and forth is, in its current form, at least, no longer useful.

I am trying to get the basics of your argument down, and it is somewhat related to Mr. Stark's line of questioning. As I understood your answers to a couple of previous questions, your belief is the IMF loans increase confidence in these countries and that increased confidence will result in investments being made that would not be made otherwise; is that true?

Mr. Geithner. Well, just to say it slightly differently, it is strong reform programs by credible governments with credible economic teams, backed by temporary financial assistance, that are essential to bring confidence back.

Representative Thornberry. Let me break that down. How much of the increased confidence comes from the conditions we impose on these countries and how much comes from the cash?

Mr. Geithner. I would say if these things work, it will be predominately because of the conditions.

Representative Thornberry. So we have to be smart enough to figure out what conditions will work in each of these countries and bring about economic growth; and if we mess up in putting those conditions on there, then it could actually be worse than otherwise?

Mr. Geithner. It could, but I think no one would disagree with the fact you need a change in policy to try and fix the cause of the crisis, and you need a change in policy to help improve the prospects for recovery.

That is a difficult job, and the country and the IMF together try to come up with what they think is the right way forward, and we play some role in trying to make sure they focus on the right things.

Representative Thornberry. Are you not concerned that by providing this safety net, if you will, for investors, that we are denying these economies the benefits of economic restructuring that may go with some defaults and bankruptcies? And, of course, as someone coming from Texas who went through a great deal of restructuring, if you would like to call it that, in the 1980s with the price of oil and so forth, it is a painful thing to go through, but perhaps you come out stronger economically at the end. And aren't we denying them that opportunity?

Mr. Geithner. Absolutely not, because these countries are going through wrenching adjustments right now, as a consequence of the crisis. They are not insulated from the wrenching adjustment they have to go through. There are already happening widespread bankruptcies across these countries, and it would not be appropriate to try to avoid that effect. To allay it, soften it, cushion it, that would not be appropriate for the reasons you said.

Representative Thornberry. Isn't that the effect of what we are doing? If we do not allow these defaults, then there are still some bankruptcies that are going to happen, but there are fewer than would otherwise happen.

Mr. Geithner. That is true, there are fewer than would otherwise happen, but there are corporations across the region that are overextended, which are now in the hundreds, going through bankruptcy and through workout, and that is only going to get worse before it gets better.

Representative Thornberry. Let me ask you this. A number of people have observed that investors perhaps in other parts of the world will see what the IMF does in this situation and condition their future behavior accordingly; the relationship between what happened to Mexico perhaps led to more risky investments in Asia is the example argued.

Do you agree that other investment decisions will be made, in part based upon how the IMF treats this situation today in Asia?

Mr. Geithner. They will. I think it is an important risk, the moral hazard risk you are referring to. It is something we worry quite a bit about. We design the programs to try to minimize it, but you can't eliminate it.

There are two types of risks in this context. One is the risk that countries will behave imprudently because of the expectation the IMF will be there. I think that is not as significant a risk because any country that watches what Mexico went through, or Korea and Thailand are going through, I think would be quite hesitant of following in their footsteps.

There is another risk, which is that investors will make imprudent investments in the hope IMF will be there to bail them out, and that is a more complicated issue. We think it is very important the IMF not be in the position where it is protecting private investors from the losses they took, and it generally does not. There is not remotely close to enough official money on the table to make investors whole.

The IMF is generally not making investors whole. People, banks, individuals are taking substantial losses across the region; we think that is necessary and appropriate. But I think you raise an important concern. We work in the context of these current programs, and we are going to be working in the future to try to figure out ways to minimize those risks.

I wanted to say one more final thing, which is that I think it is quite a popular view, but hard to support with the facts, the view what the IMF did in Mexico was somehow responsible for this crisis. I think that is hard to support with the facts. I think if you look at what has happened in interest rates in the United States and other countries across this period of time, what you have seen is a substantial compression in spreads, a significant narrowing in spreads across a whole range of asset classes, not just in emerging markets over this period of time; and that suggests there is something more at work than simply the existence of the IMF.

Investors took a lot of losses in Mexico, too, and it is very hard for any investor who went through that process to view what is happening now comfort for the future that they are going to be made whole if they go in.

Representative Saxton. Thank you very much.

Mr. McCrery.

OPENING STATEMENT OF REPRESENTATIVE JIM MCCRERY

Representative McCrery. I don't have any questions.

Representative Saxton. Mr. Ganske.

OPENING STATEMENT OF REPRESENTATIVE GREG GANSKE

Representative Ganske. Thank you, Mr. Chairman, for allowing me to join your panel today. I think this is important.

Representative Saxton. We are glad to have you.

Representative Ganske. I do come from a farm state, and there is a lot of interest in exports. I want to follow up on Congressman Thornberry's question. When we look at the Leach bill, okay, there are recommendations, basically there are a number of clauses in there that recommend that the U.S. representative advise the IMF on different policies. I want to know, specifically, how do you put teeth into that legislation to make sure that the IMF would follow the recommendations of Congress? What would you put in that bill to specifically put conditions on the IMF to make sure they are doing it right?

Mr. Geithner. Well, that is a question that preoccupies us quite a bit these days. We are 18 percent of the institution, an institution that has 182 members. Because we have 18 percent of the institution, we have the capacity to block some major policy decisions, but we don't have the capacity to force unilaterally on the institution a whole range of things, even those things we think might be appropriate. We don't have the capacity to force on the institution and we would not view kindly any attempt by other countries to force unilaterally those types of changes on the IMF.

Representative Ganske. Excuse me, Mr. Geithner, but if the U.S. doesn't appropriate these funds, the other countries aren't going to either.

Mr. Geithner. That is right.

Representative Ganske. So we do have the ability to effectively enforce some changes on the IMF.

Mr. Geithner. Well, let me say it a little differently. We have substantial influence in the institution. We have achieved substantial reforms in the institution, because of the efforts we have made, many in response to the objectives raised by Members of Congress. We are going to continue to promote the types of reforms in the institution. We think it will make it a more effective place. And it is true, if we do not act to approve the quota increase, it will not go into effect.

Representative Ganske. Well, give me some examples of specific things we should be asking the IMF to do, specifically. It is not just in the form of a recommendation from Congress for the appropriation. We recommend that the representative from the U.S. advise the IMF to make these changes. Things like funding will not come from Congress, unless the IMF does this. What would be your conditions?

Mr. Geithner. Our view is that would be inappropriate, because that would likely ensure that this quota increase will not happen and that would likely leave us with inadequate resources to deal with risks to the U.S. interest in the system.

Representative Ganske. You are saying if Congress would pass legislation that says "As we have looked over the effective policies of the IMF, they are contrary to their goals, and we feel that using U.S. taxpayer dollars going to the IMF are contingent upon these changes," that we shouldn't do that?

Mr. Geithner. That is not an approach we would support, because –actually, let me start somewhere else. I think if you look at the IMF and you invest the time necessary to look at what the IMF does in these places, you will find what the IMF does is quite consistent with core American economic values we think are appropriate for our country and for many other countries. We think it is perfectly appropriate for you to have a debate about whether that is the case and to look very carefully at what the IMF does in these cases and we think it is very appropriate for you to support our efforts in promoting reforms in the institutions that are going to make it more effective.

Representative Ganske. Your position is basically that there shouldn't be any more conditions than what are in the Leach bill, which is basically an advisory recommendation.

Mr. Geithner. No, I was trying carefully not to say that. What the Secretary said, in response to the Leach bill, been quite positive about the broad objectives of the bill and quite positive to see such an early demonstration of support for funding, both the quota increase and the NAB. But I just think it is important to recognize that we do not have the capacity to unilaterally impose on this institution a whole range of reforms as a condition for a quota increase, and to do so would risk not having it happen.

Representative Ganske. Let me go on to a different area then, and this goes back to what the Chairman was talking about in terms of getting the information from the IMF, basically their internal reports and the reports to the Treasury. Now, you mentioned that a Congressman can have access to that, so you could bring that over to my office.

Mr. Geithner. Absolutely.

Representative Ganske. Okay. Let me point out the problem with that. You bring that over to my office, and I review it. On the basis of my review, I decide that the IMF policies have actually been detrimental to solving this problem, okay, but now I cannot release the specifics of my review on that. Furthermore, I, as a Congressman–and I am a physician, I am not an economist–I am going to have to vote on this, okay; so my assessment is they are bad policies, detrimental; I am skeptical about the IMF actually being effective on this. I have looked at this, I can issue a press report saying I have reviewed this, my assessment is that their are not–I can't give out specifics, my assessment is the policies have not been effective, in fact in Indonesia have been detrimental; but I am not able then to get that out to the public to have people who are trained in this area, staffers from this staff, for instance, or independent analysis to back me up. That puts me in sort of an untenable position.

Mr. Geithner. I actually think you can do most of that now. The precise details of the policy commitments in these programs are now publicly available in each of these countries, and you can see on the ground now where they are working, where they are not, and there is a whole range of issues that affect that kind of judgment. That information is available to anybody who wants to look at it now, and I think you can make that judgment now.

Representative Ganske. Assistant Secretary, my time is up. I would just like to ask to set up an appointment with the Treasury Department to bring over to my office those reports, because I would like to review those.

Mr. Geithner. Absolutely.

Representative Ganske. Thank you.

Representative Saxton. Thank you, Mr. Ganske.

Mr. Geithner, I have a book full of questions that need answers, some of which you have touched on this morning. We have to move on to the next panel. And because we have a series of questions, I wonder if you would be kind enough to respond to them in writing.

Mr. Geithner. Absolutely.

Representative Saxton. They include a number of issues. Some are rather broad in scope. There is one that you just mentioned. I think I heard you say–my arithmetic shows an 18 percent figure–on monies that are actually loans through the IMF system at closer to 26 percent. I would like to get clarification on that.

Mr. Geithner. Absolutely.

Representative Saxton. Also issues involving what is generally referred to as the "moral hazard," which has to do with whether we are encouraging bad loans by standing behind these banks time after time. The issue of transparency or the lack thereof, which we have discussed some here this morning, but which I have more questions about. The issue of taxpayer exposure, both American taxpayer exposure and taxpayer exposure in the receiving countries as well. The issue of whether the interest rates should be subsidized or whether they should be driven more by the market. The issue of whether some of the conditions that you have mentioned here and in other answers are actually counterproductive in helping countries and institutions in some of the receiving countries to grow. The issue of whether these conditions that the IMF imposes are actually counterproductive.

So these are all issues that I have more questions than we can possibly go into today, and I would like to submit them in writing and hope that you will be able to answer them.

And I would also just like to mention that we may like to have you or one of your colleagues back, perhaps in the future, as we continue to try to educate ourselves on this series of issues, I should say.

Mr. Geithner. We would be happy to do that and we would be happy to spend a bit of time walking your staff, if you want, through the financial dimensions of the IMF in more detail so they can help read the numbers with a bit more perspective. Thank you very much.

Representative Saxton. And now we will hear from our next panel of witnesses, in the following order: Charles W. Calomiris, Paul M. Montrone Professor of Finance and Economics, Columbia Business School, and Director, American Enterprise Institute Project on Financial Deregulation; Lawrence B. Lindsey, Resident Scholar, The American Enterprise Institute; Allan H. Meltzer, The Allan H. Meltzer University Professor of Political Economy, Carnegie Mellon University, and Visiting Scholar, American Enterprise Institute; and C. Fred Bergsten, Director, Institute for International Economics.

Representative Saxton. Gentlemen, welcome. We are anxious to hear your testimony.

Mr. Calomiris, each of you will have about 12 minutes for your opening statement, and then we will move to questions. Mr. Calomiris.

OPENING STATEMENT OF CHARLES W. CALOMIRIS, PAUL M. MONTRONE PROFESSOR OF FINANCE AND ECONOMICS, COLUMBIA BUSINESS SCHOOL, AND DIRECTOR, AMERICAN ENTERPRISE INSTITUTE PROJECT ON FINANCIAL DEREGULATION

Mr. Calomiris. Thank you. I would like to ask that the full statement be entered into the record.

Representative Saxton. Without objection.

Mr. Calomiris. I will just summarize it briefly. The responses by the IMF and the U.S. Treasury to the Mexican crisis and the recent Asian crises have been shortsighted and counterproductive. The suggestion that the IMF's capital and facilities should be expanded to permit it to engage in more such activity in the future is troubling. The principal lesson of these bailouts managed by the IMF and the Treasury is the vital need to find a way credibly to commit not to sponsor them in the future.

Why are these bailouts so misguided? A guiding principal of a well-functioning market economy is that those who undertake risks should either lose or gain according to the outcomes produced by those decisions.

What have been the costs of violating that guiding principal through government absorption of financial losses? Three kinds of costs figure prominently. First, undesirable redistributions of wealth from taxpayers to the politically influential in developing economies. Second, the promotion of excessive risk taking and inefficient investment. And, third, the undermining of the natural process of deregulation and economic and political reform which global competition would otherwise promote.

While bailouts entail loans from the IMF and foreign governments at subsidized interest rates for developing country governments, taxpayers in the United States and other developed economies who pay the loan subsidies are not the biggest losers from the bailouts. The IMF and the U.S. Treasury in most cases are repaid, but these loans provide powerful justification for increased taxation to repay them. When the crisis has passed, the big winners are the wealthy, politically influential risk takers, and the biggest losers are taxpayers in countries like Mexico, Indonesia, or Korea.

The bailouts not only produce a one time wealth transfer, but encourage a repeat of the same problem in the future. If risk taking bankers know future gains from taking on risks will be private but losses will be borne by taxpayers again, that amounts to a government subsidy for risk which thereby encourages excessive risk taking, the so-called "moral hazard problem."

Studies by the World Bank and the IMF, independently, have documented some 90 episodes of severe banking crisis since 1982. In more than 20 of those cases, the bailout costs to developing country governments have exceeded 10 percent of their GDP. In roughly half of those cases, including the estimated losses of some of the current Asian countries, losses have been in the range of 25 percent of GDP. These losses are unprecedented. For example, in the United States during the Great Depression, banking losses were comparatively small, roughly 4 percent of GDP.

What can explain this epidemic? Not shocks of unprecedented magnitude like oil price hikes, wars or global downturns in demand, since such influences have been absent. The explanation is the roller coaster of risk produced by the choices of banks in developing economies, choices that are the by-product of government subsidies for risk taking.

Private business in many developing economies is dominated by conglomerates, often controlled by a small minority of wealthy, politically influential families or corporations. At the center of the unhealthy partnership between government and business is a new kind of bank, what I call the "quasi-public bank." Quasi-public banks are private institutions with an implicit claim to public resources which pay for their losses. They are a key instrument of economic control for conglomerates who own them, and a key vehicle for the transfer of political patronage from the government to these conglomerates. The key to understanding how quasi-public banks magnify economic risk is to consider how they respond to initial losses.

Normal private banks experiencing loan losses tend to reduce their portfolio risk to restore the confidence of their depositors and limit the risk of bank failure. But quasi-public banks need not concern themselves with the risk of failure, since bank depositors and stockholders are all insured against loss by taxpayers. In the wake of losses, these banks face opposite incentives, to channel ever riskier loans for their conglomerate owners.

Financial crises in these economies tend to go through three stages. First, initial loan losses are followed by purposeful increases in high-risk bank lending to conglomerates. Second, the fiscal problems created by the governments, off balance sheet obligations to bail out these weak banks, raises the likelihood of devaluation. Banks then undertake purposeful increases in their currency risk to take advantage of lower dollar-denominated interest rates, given this market perception of an increased probability of devaluation. And third, when large devaluation comes, it results in enormous losses to banks, and thus taxpayers, from the high bank exposures to credit risk and currency risk; again, purposeful exposures.

The consistency of this pattern is uncanny. It was first visible in the Chilean collapse of 1982 to 1983. The same pattern was followed in Mexico in 1994 and 1995 and in many other countries, and most recently in Thailand, Indonesia and Korea in the current crisis.

Domestic governments, as I have reviewed, have often been the most important source of perverse incentives for their banks. Where does the IMF fit in? The main influences of IMF and the U.S. Treasury in the 1990s have been to aggravate the problem in two ways, first, by lending legitimacy to domestic bailouts by calling for domestic taxation to repay loans from the IMF and the U.S. Treasury, thus making the wealth transfer within the developing countries much easier; and second, by insulating foreign creditors from losses during the crisis.

Insulating foreign investors from loss, (not foreign stockholders, but the banks who make short-term loans that aggravate the crisis) removes the incentive for those foreign investors to avoid lending to high-risk countries. That aggravates the moral hazard problem and magnifies the losses when the devaluation comes by promoting the flow of dollar-denominated hot money during the financial crisis.

What will foreign lenders learn from the Mexican crisis or the recent Asian crisis? I fear they are learning that they can lend without risk of default because of implicit protection of the IMF and the U.S. Treasury, and it does not help matters that the IMF and the Treasury are signaling their intent to provide ever-expanded bailouts by calling for ever-increasing amounts of IMF capital and new IMF lending facilities. That, of course, will add fuel to the fire of risk-taking in developing economies.

But the cost of ensuring foreign lenders against loss runs even deeper. The IMF and U.S. Government are undermining the natural process of reform in many emerging economies. If foreign investors are protected by the IMF, they will be less discriminating about where they place their funds and thus provide less of an incentive for reform in developing economies.

Some proponents of IMF bailouts, of course, argue that by intervening, the IMF is able to promote reform of domestic banking systems, which are really the centerpiece of the fragility, as I described it, and thus IMF intervention may reduce the likelihood of future bailouts. But the 1994-95 intervention in Mexico and, already, the recent Asian interventions are providing contrary evidence; and I can review some of that in the question-and-answer period.

So far, nothing substantive has been done to introduce market discipline into the Mexican banking system since its crisis, and there is no reason to believe anything will be done to limit the current system of subsidizing the risks of the industrial conglomerates and the banks they effectively own in Mexico. I expect similar results from the current conditions being attached to IMF assistance in Asia.

It is very hard to undermine the corrupt partnership between powerful industrialist bankers and their governments by giving them both money in exchange for promises to reform sometime in the future. That is not to say that IMF conditions of all kinds always fail. The IMF has been somewhat successful in getting countries to change tax or expenditure policies, foreign trade policies, and monetary policies.

Banking policy is fundamentally different for two reasons. First, real reform in the banking system takes years to accomplish, because it entails new ways of measuring and managing risk, new regulations and new supervisory procedures.

The time horizon necessary to implement successful reform is at least five years, in my experience. The horizon of IMF crisis assistance and conditionality, typically two years or less, is simply not suited to achieve true reform in these banking systems.

Second, banks are controlled by powerful and concentrated vested interests who are willing to fight hard to maintain their access to subsidized credit and to block these reforms. Thus, in practice, crisis countries tend to find it easy to promise, but never deliver, true banking reform. Instead, they tax quickly and deeply, pay back their loans to the IMF and the treasury, replenish the wealth of risk-loving conglomerates and their banks and return to business as usual.

Neither can IMF programs be justified by appeal to the threat of contagion or the need to prevent panics. In particular, there is no connection between current IMF bailouts of insolvent banks in Asia and appropriate historical interventions by central banks to stem banking crises. Historical lender-of-last-resort assistance during banking panics, in contrast to bank bailouts, was geared to prevent the failure of solvent banks which were temporarily in need of liquidity to prevent their unwarranted failure. That has nothing to do with what is currently going on in Asia.

Given some of the recent concerns of a threat from irrational contagion voiced by policymakers in the popular press, it is also worth emphasizing that random, irrational attacks on financial systems are simply not evident in financial history. Thus, concerns of irrational contagion, spreading all over the world, without any fundamental explanatory link are simply unwarranted. Such concerns should not be used to justify financial bailouts.

Let me close with some specific recommendations; I have four. First, stop the bailouts. The more the developing countries are forced to handle their own financial insolvencies and the more foreign investors are forced to bear the cost of their investment decisions, the more developing countries will be attracted by the benefits of true liberalization.

Second, there is no reason to expand the IMF's capital or develop the new proposed lending facility to provide fast-track bailouts to financial systems in distress. Indeed, an expansion of IMF capital or facilities would do real harm by signaling an intention to strengthen and expand the IMF's commitment to provide bailouts in the future. The U.S. Government should do all within its power to encourage the IMF to revert to pre-1994 goals of advising countries on their macroeconomic policy and serving as an international delegated monitor charged with tracking those policies.

Third, denying the IMF its desire to increase its capital and facilities and working to restrict its purview are not enough to stop the trend toward unwise expansion of global bailouts. Congress should abolish the exchange stabilization fund, a legacy of the Great Depression which has no legitimate role in U.S. monetary policy today. The World Bank should also be prevented from serving as a substitute vehicle for bailouts.

Fourth, IMF secrecy is contrary to its proper role as the source of independent, objective and informed opinion about the economic performance and financial risks of member countries. In pursuit of its appropriate mission, any policies or conditions for assistance advocated by the IMF should be revealed publicly. That will encourage a lively debate about their merits and permit critical evaluation about their effectiveness. Thank you.

Representative Saxton. Thank you very much.

[The prepared statement of Mr. Calomiris appears in the Submissions for the Record.]

Representative Saxton. Mr. Lindsey.

OPENING STATEMENT OF LAWRENCE B. LINDSEY, RESIDENT SCHOLAR, THE AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

Mr. Lindsey. Thank you, Mr. Chairman. I value the opportunity to be here today. I also ask that the entirety of my remarks be submitted for the record.

Representative Saxton. Without objection.

Mr. Lindsey. I think there are three salient points that have not been adequately addressed to date by the Administration in its request to the Congress for funds to support an IMF expansion. First, I think the prospective cost to the American taxpayer is greater than the Administration has suggested to date. It has been described as an essentially riskless investment, like putting money into a credit union. This is not the case.

Second, an expansion of the IMF has been described by the Administration as essential for our macroeconomic stability. It has been suggested, that millions of American jobs are at risk if the increased IMF funding is not approved. Again, I don't think this is the case.

Third, and I believe most important, an enlarged IMF is simply not the best way to advance a sound international economic policy for the 21st century. The IMF is a relic of the Cold War. It may have worked well in the last half of the 20th century, but it is not central to a sound global economic strategy for our country, going forward. Congress should use this opportunity to consider an alternative.

Let me begin with the nature of the U.S. contribution to the IMF. I believe it was three weeks ago, I was on a similar panel and I heard a senior Administration official liken American contributions to the IMF to deposits in a credit union. Consequently, this official argued, the money involved was not really an expenditure. He added the credit union was safe because a substantial portion of its assets were in gold and that no one had ever lost any money in the IMF. While this analogy demonstrates some superficial validity, I think it is an unfortunate comparison, and I hope and trust the Administration itself is not confused by its own analogy. I noted Mr. Geithner moved away a bit from that analogy this morning.

Let me put on my hat as a former regulator to examine the comparison. While the IMF is like a credit union in that it lends only to its members, the requirements for an IMF loan would not qualify it as a credit union under existing American practice. An American credit union does not loan to its members based on how much they contributed, but based on the assets or collateral they are going to purchase with the money. Most significantly, credit union loans are backed by an automobile or house; unsecured signature loans carry a very high interest rate and are ultimately backed by the bankruptcy statute for the borrower's state of residence.

By contrast, the IMF does not lend on collateral, but effectively makes only signature loans. There is no bankruptcy statute or right to attach assets in the event of default. Furthermore, there is no real assessment of creditworthiness; quite the contrary, an apparent requirement to get an IMF loan is that you not be creditworthy.

As far as the gold backing is concerned, I would find it somewhat troubling as a bank regulator if one of the banks I was supervising had an asset that was as volatile as gold backing up a substantial portion of my balance sheet. I note that gold has lost roughly 20 percent of its value in recent months; this is certainly not reassuring.

While I have not performed the analysis myself, I do know that at least one private-sector analysis, a group with a lot of money at stake in the issue looked at the IMF balance sheet as if it were a bank and concluded serious questions could be raised about the IMF's capital adequacy. Usually this would mean shrinking the size of the institution if you were a regulator looking at it, not enlarging it.

I would stress that the IMF is not a bank and shouldn't be treated as such, nor is it a credit union. The U.S. contribution should be viewed from a pragmatic point of view, not as a deposit, but as an expenditure.

It is also true that no one to this point has lost money in the IMF. Of course, if it were really such a great investment, the IMF would go directly to Wall Street to raise the money and not to the U.S. Congress to get the funds it needs.

I think the better comparison is that the IMF is like the FDIC in the late 1970s or early 1980s. At that time, taxpayers had not lost any money in the FDIC either. It was there to assist troubled members if they had a crisis. What we learned over time, however, was that a sufficiently large crisis would come along which would swamp the capacity of the fund to cover the losses of the large number of banks which were involved.

I really think that is the rationale behind the IMF request for a quota increase, and the observation you made, Mr. Chairman, that a further quota increase beyond this is likely in the foreseeable future. Due to a variety of reasons, not the least of which involves the concept of moral hazard, the IMF considers an ever larger quota necessary to cover the risks involved in ever larger international lending positions.

The question, therefore, is a good one. If this really is the equivalent of 1980, and we really are dealing with the equivalent of the FDIC, we desperately need to reflect on whether we want to make the institution even larger, or whether we want to contemplate new arrangements to cover the missions of the institution.

The second fundamental question I would like to address has to do with the supposed necessity of contributing to IMF for reasons of economic security. We are told that the economic consequences of not approving the $18 billion request will be dire for America. There are two separate arguments which support this claim. One has to do with trade, the other has to do with the banking system. Let me look at each one closely.

Let's consider the big picture for a moment. The same people who are warning of dire consequences if the IMF funding is not approved tell us in other venues that the U.S. economy is in better shape than ever. Now, it would be a truly unusual circumstance in economic history that a record-breaking economic recovery would be so fundamentally fragile that it relied on an appropriation equal to one-quarter of a percent of GDP for its continued success.

There is one possible link between record-setting expansion and economic fragility that needs to be considered. Is the United States economy really just resting on an economic bubble of excess credit expansion? Although I think the answer to this question is, on balance, no, I would feel more comfortable with the intellectual consistency of the advocates of this funding if they were to resolve the apparent paradox in their arguments.

But if the link between expansion and fragility were in fact the result of a financial bubble, an $18 billion appropriation for the IMF is, at best, irrelevant. There are other actions we should be taking and other questions we should be asking. Why are we effectively easing bank supervisory standards in the midst of a financial bubble? Why are we not gradually trying to deflate the bubble through a more restrictive monetary policy? Why is the Administration advocating $40 billion in new spending programs, rather than pursuing a more contractionary fiscal policy? Shouldn't public officials be trying to talk down the stock market if this is really a bubble?

Again, my own judgment is, the United States economy is not so fragile at this point in time that failure to approve this money would lead to an economic recession. However, I do believe we may be at risk of encouraging a future financial bubble to develop through actions now being proposed. Increasing the capacity of the IMF is not helpful in this regard, as it sends a signal to borrowers and lenders alike that a U.S. taxpayer-funded safety net is being expanded to rescue them.

Now, let's consider the two detailed mechanisms, which supposedly link our economic security to the IMF funding package. First, consider the trade argument. The Administration is pursuing a lobbying campaign, claiming jobs would be lost in various Members' districts if the IMF package is not approved. I can well understand the need for some form of political protection on this issue, but a careful examination of their claim suggests it is not well constructed.

My favorite trade story in this lobbying came from recent IMF hearings before a committee of the other House of Congress. There, one Senator from Nevada noted that the entertainment facilities in his State had been emptied since the Asian crisis began. State revenues were particularly threatened in Nevada. While the Senator was not explicit, the supposed logic followed that we needed to replenish the IMF so that we could bailout Asia, so Asian high rollers could return to Las Vegas and lose the money back to us.

While this might cause some to chuckle, I am sorry to say the fundamental logic of this argument is exactly the same, no matter what industry and no matter what State is involved. The notion that you can indirectly channel money to repay a bad debt and then expect the other guy to buy, on net, more goods from you than your initial gift is plainly fanciful. I do not believe that the act of creating jobs in one district should be the *sine qua non* of a Congressman's decisionmaking, but the Administration, by making this argument, is advancing a logic which is fundamentally false. The IMF quota increase will not be a net job creator in the United States economy, and Congressmen who base their vote on this argument alone are at best doing their constituents a disservice.

The other detailed link between the IMF package and the health of the American economy has substantially more merit. It falls on the well-being of the banking system. Chairman Greenspan has testified the risks from the current crisis pose, and I quote, “a small but not negligible probability” of placing the global banking system in jeopardy. I concur with Chairman Greenspan's evaluation. The question is what are the best ways to deal with that risk.

Chairman Saxton, as you pointed out in your opening remarks, the money for the IMF that we are now considering is not related to current commitments the IMF has made to Asia. Frankly, if approved, this additional funding would be used if events in Asia proved a bigger debt problem than the IMF now expects, possibly from other regions.

I don't believe that either the Fed or the IMF believes the Asian crisis, if contained to current levels, poses the kind of risk we are now talking about. But if that crisis were to worsen or financial problems were to spread to other regions, the IMF could be of only limited usefulness in stemming it.

Of much more importance are the actions we have already taken to protect the U.S. banking system. First, our Nation's regulators and its banks paid a high price in the early 1990s to build capital for our banks. Second, the Fed, under the leadership of Governor Phillips, worked closely with banks to develop highly sophisticated computer models of banks' balance sheets.

I disagree with Congressman Stark; I think our banks could easily lose this money. They are much less exposed than those of our major trading partners to any problems here, and it is thanks to the hard work we did in this country that that is the case.

And, finally, our monetary policy for the last 17 years has been used to build credibility. When we went to the IMF in 1978, we were in desperate shape; now we are not. I think it is our monetary policy in the end which will protect us from any problems.

In sum, Mr. Chairman, and I note the red light has come on, I do not think that we need to appropriate this money to save our economy, I think we have other protections in place, and I would also point out that I think the Administration is underestimating the cost to the U.S. taxpayer of the proposed bailout.

[The prepared statement of Mr. Lindsey appears in the Submissions for the Record.]

Representative Saxton. Thank you very much.

Mr. Meltzer?

OPENING STATEMENT OF ALLAN H. MELTZER, THE ALAN H. MELTZER PROFESSOR OF POLITICAL ECONOMY, CARNEGIE MELLON UNIVERSITY, AND VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. Meltzer. Thank you, Mr. Chairman. It is a privilege to appear once again before this distinguished Committee. It was as a part-time member of the staff many years ago that I first began the detailed study of domestic and international financial arrangements.

Between 1990 and 1996, capital inflows to emerging market countries rose from $60 billion to $194 billion. No one carefully monitored these flows. When problems developed in Asia last year, neither the International Monetary Fund nor the private lenders knew the magnitude of all of the countries' debts within a large range. The firms borrowed directly and through their subsidiaries. Often, the total was not shown on any balance sheet. Provisions of the IMF Articles of Agreement requiring surveillance, and the decision to strengthen surveillance at the Halifax meeting, following the Mexican problem, proved to be of little use.

Though important, the IMF's failures to monitor seem small beside the elementary mistakes of private lenders who ignored three principles of prudent behavior.

First, Asian banks and other borrowers used short-term renewable credits from foreign banks to finance long-term loans.

Second, Asian banks and corporations borrowed in foreign currencies and loaned in local currency. They accepted the exchange risk without hedging. The reasoning is appalling: Interest rates were lower abroad. None realized the difference in interest rates, after allowing for differences in inflation, included the risk of currency depreciation. I suspect this risk is now apparent.

Foreign lenders shared this myopia. They didn't show concern about making short-term dollar and yen loans to borrowers that financed long-term domestic assets.

U.S. and other bankers added a third elementary error. Many, perhaps most, did not ask to see consolidated balance sheets; they did not monitor total assets and liabilities of the borrowers. Try to borrow on your house or your car without showing your balance sheet. Yet tens of millions of dollars were loaned without any knowledge about what was being offered by the borrower.

The banks' behavior is evidence of the pervasive problem of moral hazard. The banks expected to be bailed out again, so they acted imprudently, without regard to elementary banking principles.

What has been the result? Equity investors, debt holders, and owners of claims denominated in foreign currency have taken large losses. By mid-January 1998, stock markets in Indonesia, Malaysia and Thailand had lost 75 percent of their value.

What about the U.S., Japanese and European banks? Their loans are in dollars, yen and other hard currencies. They want repayment in full. The IMF and the principal governments lend money to the Asian governments so they can pay the interest on their bank loans or repay the principal. It helps the Asian banks to avoid default, but the money goes to the foreign bankers.

Instead of taking losses like the holders of currency, stocks and bonds, the banks collect with relatively small losses. And in exchange for extending repayment, the banks collect fees for renegotiating the loans. They demand government guarantees of the loans they made to the banks, financial institutions and private corporations.

This policy is the fourth mistake. I believe it is the greatest mistake of all because it invites a larger financial crisis in the future. The Mexican bailout required $40 billion. This time the IMF and the developed country governments have promised three times as much.

Capitalism without failure is like religion without sin. It doesn't work. Bankruptcy and losses, even the threat of bankruptcy, concentrate the mind on prudent behavior. Prudence is the missing element in the Mexican and Asian problems. In its absence, bankers and other lenders have taken excessive risk.

The IMF's programs help governments to drive a large wedge between the social risk–the risk borne by the troubled country–and the private risk borne by bankers. This is one source of moral hazard, and one reason we have a crisis-generating system. A common argument in its defense is that Mexico repaid its loans to the U.S. Government and the IMF. That argument misses the point. If banks and financial institutions had taken losses in Mexico, they would have exercised elementary judgment about risks in Asia.

Some bankers and Treasury officials defend more money for the IMF by citing loans to Mexico as a success for U.S. Treasury-IMF intervention. This is an extraordinary claim. It looks only to the repayment of the loan, achieved mainly by borrowing abroad, at higher interest rates in most cases. It ignores the effects on the Mexican economy.

The results have been disastrous for the Mexican economy and its people. Despite enormous growth in the world economy for the past 20 years, Mexican real income in dollars was the same in 1996 as in 1974. You can see the chart following page 4 in my paper for a demonstration.

The Mexican people have been on a bumpy road but they have gone nowhere. In the same period, Mexican debt in constant dollars increased from $40 to $160 billion. That is shown in chart 2, following chart 1. Much of this is the price that Mexico paid for U.S. and IMF assistance. Without the IMF and the U.S. Treasury, Mexico would learn to run better policies, would have less debt and, I believe, would have made more progress.

Frequently the argument is made that moral hazard is not a problem because no government chooses to subject its economy and its people to the losses experienced in Latin America in the 1980s, Mexico in 1995, and Asia now. I believe this is true but irrelevant. The issue does not arise in that way.

A country may find it necessary to choose between offering guarantees to foreign lenders and facing large withdrawals of foreign loans. The government may choose to guarantee the loans by issuing dollar denominated securities, such as the Mexican tesobonos, or by promising to accept responsibility for private debts denominated in dollars, as in Korea or Thailand.

When the government offers the guarantee, it believes the default risk is manageable or bearable, just as the U.S. Government believed the risk in the savings and loan system was manageable. It is not necessary for the government to plan a debacle; the debacle is one possibility.

The opportunity to take a possibly small risk of a later crisis instead of a certain, smaller, current crisis is the second source of moral hazard. To reduce the risk of future crises, it is necessary to reduce the chances of a finance minister having to make the choice I just described.

The IMF and Treasury lending to Asian countries continues this dangerous system. The risk of a bigger, future crisis increases. Too much of the world has become "too big and too indebted to fail." Neither the IMF nor development banks, nor the U.S. and the Japanese governments can pay for all the errors, mistakes and imprudent actions they help to create.

Secretary Rubin was right when he said in September, "What we don't want to have is a situation where people can do unwise things and not pay a price," but that is the system Secretary Rubin and the IMF have created and sustained.

Many arguments are used to justify these policies. Some are misleading. Some are based on misunderstanding. Some are simply wrong.

One argument commonly made and repeated many times is that South Korea is a large country, the world's eleventh largest economy. It sounds impressive and, indeed, growth of the Korean economy since 1953 is a remarkable achievement. But the inference is that a financial collapse in South Korea would be a world-shaking event. In fact, Korea has a GDP about equal to the GDP of Los Angeles County. It may be the eleventh largest economy, but it is about 5 percent of the U.S. economy.

The role of the lender of last resort is not to bail out failed banks. Its job is to assure that solvent institutions do not fail for lack of liquidity. The Asian central banks have the power to stem a domestic liquidity crisis. The remaining problem is the need for foreign exchange to repay foreign currency loans.

The IMF offers two services. It lends currency on condition of reform, called conditional lending, and it acts as a consultant to troubled countries. Unlike most consultants, it pays the borrower to take its advice by offering favorable terms for its loans. With interest rates in Korea above 20 percent, the IMF lends at less than 5 percent.

Asian problems do not require international loans from the IMF and developed countries. The loans are more likely to delay than to provoke reform. The IMF may threaten to withhold payments, but as history shows, that threat is empty.

Many critics of the IMF oppose the policies of fiscal stringency and control of inflation. I do not share these criticisms in all cases. In countries with inflationary problems, control of spending is essential.

That is not the problem in Asia. The present predicament was not caused by imprudent spending policies, excessive demand and high inflation. Much of the problem arose because one of the principal markets for Asian products, Japan, has grown slowly, and because China increased its share of the Japanese market after devaluing in 1994.

The problem, then, for the IMF and for us is to get faster expansion of the Japanese economy. The longer term problem is to find a solution that avoids moral hazard.

If loans denominated in foreign currencies are withdrawn suddenly, solvent borrowers with excellent long-term prospects are unable to repay their short-term loans on demand. Neither they nor their local banks may be able to obtain sufficient foreign exchange to prevent default.

One solution is to have a true lender of last resort. Unlike the IMF, a true lender of last resort does not subsidize borrowers. It charges a penalty rate, a rate above the market rate, and it requires good collateral.

These requirements are not arbitrary. They are essential. The penalty rate means the lender of last resort will usually do no business at all. Borrowers will only come when they cannot get accommodation in the marketplace at market rates. Similarly, the requirement to offer good collateral induces banks and financial institutions to hold such assets. This reduces risk, and encourages safety and solvency. Unlike the IMF, a true lender of last resort does not create moral hazard.

My second proposal eliminates the main source of the problem. If banks were truly international in scope, they would operate in many countries. Local lending and local currency would be part of their mixed global portfolio. Banks would diversify currency risk within a global portfolio, lowering overall risk. This reform is not an idealized textbook solution. Citicorp in particular has tried to follow this strategy. The financial services agreement, accepted by members of the World Trade Organization last year, is an important move in this direction. In the proposed system, global banks would internalize the risk or hedge the risk if they chose to do so. The U.S. has strengthened its own financial system by letting banks branch regionally. European banks are beginning to merge transnationally and to operate branches in other countries.

The next step is to strengthen the global system. IMF bailouts and government-enforced restrictions on competition impede the solution. Financial crises in Latin America in the 1980s, Mexico in 1994 and 1995, and now in Asia, should alert governments to the need for fundamental reform. More money for the IMF delays reform of the international system, encourages moral hazard, and subsidizes risk. Fundamental reform begins with global banking and a true lender of last resort.

Representative Saxton. Thank you very much, Mr. Meltzer.

[The prepared statement of Mr. Meltzer appears in the Submissions for the Record.]

Mr. Bergsten.

OPENING STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. Bergsten. Thank you, Mr. Chairman. I too have provided a detailed statement. I hope you will put that in the record. Let me confine my oral remarks to three or four basic points and particularly respond to questions raised by other members of this panel.

First, let me try to dispose quickly of three fundamental points. The first is to emphasize that the proposed contributions to the IMF carry zero, repeat, zero cost to the taxpayer. With deference to Mr. Lindsey, I will not make an analogy to a credit union but I will point out that this is an exchange of assets. When the U.S. pledges dollars to the IMF, it can draw out the very next day an equivalent amount of deutsche marks, yen, or any other currency we may need for our purposes.

This is not theory. We have done it. When I was at the Treasury in the late 1970s, we drew in one fell swoop about $3 billion in marks and yen. We used them to defend the dollar, to defend U.S. interests.

So it is an exchange of assets. There is no net cost to the American taxpayer. That is an important point to keep in mind in talking about the cost-benefit ratio of the IMF contribution, because, if the cost is effectively zero, then you have to think the payoff is negative not to do it. So let's keep that in mind.

A second key question is whether the IMF actually needs the money. There was a lot of discussion earlier on how much the IMF has and how much might it have to use. Again, I think if one believes in the fundamental mission of the IMF, and that is an objective question to which I come back, then you want to have more money in the institution. Whether it has $10 or $15 billion available, or even $40 to $45 billion, and the truth is probably somewhere in between, one or two more major currency crises would require at least that much money. Brazil, Argentina, Russia, Malaysia, which has so far avoided the IMF but might need it, represent a very plausible series of additional country problems that might require more money than the IMF has available. That point too should be clear from the outset.

The third piece of debris, to get out of the way at the outset, is your question about transparency. You are absolutely right. The IMF should be more transparent. So should the World Trade Organization and most of the other international institutions. The U.S. has in fact been pushing that for about 20 years, again going back to my period in the Treasury.

What I think is most needed is for the IMF not only to make available the country data, as it is now doing, and try to expand that, but to make available its own appraisals. When the IMF reviews a country situation, it puts out a report. The first part of the report is analytical. That is now made available. The second part is judgmental, in which the IMF staff renders judgments as to whether the country is getting into trouble. That, I think, should be made public. If it were, it would alert the markets and there would be fewer of the crazy loans that everybody on the panel agrees have been made.

Markets can't function well without adequate information. The IMF analyzes country cases. It makes predictions. It did predict the Thai difficulties at least six months in advance. But those pieces of information were not widely available, and they should be.

Those are the kinds of things we should push. With some prodding, in fact, the IMF membership may agree. It is true that these are sovereign countries, many of which are reluctant to make data available. But I think, on this one, Congress is quite right to push. I think you will succeed. You should stay at it.

Let me then go to the fundamental question: Does the U.S. have a national interest in the kinds of programs that the IMF now carries out, and presumably would continue to carry out in the future?

It seems to me we have two central interests in the world economy. The first is the maintenance of maximum rates of economic growth and employment that are consistent with reasonable price stability. The second and related interest is the most widespread possible application of market-oriented policies rather than government controls and directives. These goals, incidentally, serve our foreign policy and national security interest as well as our economic interest.

My submission would be that the IMF plays a critical role in supporting both of those fundamental U.S. objectives. When a member country has a crisis and comes to the IMF for help, the Fund produces two things; financial assistance and policy requirements. It seems to me both are central to inducing and enabling the country to do two things: adjust gradually rather than precipitously to its crisis, and to adopt constructive market-oriented policy measures rather than draconian controls.

When a country faces a crisis and has to decide how to come out of it, it has two choices. It can either act immediately and with draconian controls, deep recessions and sharper currency depreciations, or it can have a more gradual phased in adjustment policy with more constructive, more sustainable policy, measures for the longer run. It seems to me our interest is clear, whether it is an agricultural interest in some states or a manufacturing interest in others, or our interests more broadly in a stable and successful world economy, in countries' doing it in a gradual, rather than precipitous way, and doing it with constructive, sustainable long-run measures rather than draconian controls. Those are the choices in the real world.

The IMF helps push the country in the constructive direction. It doesn't bail out banks. It requires, in the current Asian situation, banks to be closed. Indeed, some have criticized it for doing that too much in the Indonesian case. But the IMF does it; it pushes countries in a direction that will be constructive and sustainable for the longer run.

The basic question raised by other members of the panel today is whether the IMF hurts or helps. All three other members have the view that the IMF creates moral hazard. I think the analysis, while it raises some legitimate questions, is grossly overstated. Let me say why.

The members of the panel, particularly Professor Calomiris, argue that a very large part of the financial crises that have pervaded the world for the past couple of decades are due to the moral hazard problem, including the role of the IMF. I regard that as farfetched, without much evidence or proof. I would in fact like to hear some indication of why he thinks that is the case.

Let me suggest why it is not. The financial crises have not been limited to emerging market economies. They have pervaded industrial economies as well. What is the largest potential risk to the world economy and financial system right now? Not Korea, not Thailand, not Indonesia, not any developing country, but Japan. Is Professor Calomiris or anybody else on this panel going to say the reason Japan has a weak financial system–and could, if its NIKKEI index drops below 15000, face a globally significant financial crisis–is that the Japanese thought the IMF was going to bail them out? That is a farfetched thought; it is ridiculous. Did we get into the savings and loan crisis because we thought the IMF was going to bail us out? Of course not. There are much more fundamental factors that go to the nature of financial crises in country after country.

Timewise, the argument doesn't wash either. These crises have been going on for several decades. They have escalated over the last decade and a half, in periods and in countries where the IMF never had a role, was never even thought about, and can hardly be blamed with the crisis.

Let's take a look at what the IMF does in the actual country cases that we are talking about now. As I mentioned already, when the IMF has come into Asian countries, it has confronted an unusual situation. The rest of the panel seems to agree that the traditional IMF role of requiring more stable and effective macroeconomic policies–fiscal balance, and monetary policy stability–are correct. So maybe that is another issue we can put behind us and go to the point of dealing with financial systems.

The IMF, coming into these situations and finding weak financial systems as the basis of the current crisis, has not in any way sought to shore them up. To the contrary, it is requiring them to be reformed. Professor Calomiris is right that it takes a while. You can't reform fundamental structural elements of an economy overnight. My personal view is that the World Bank, with its experience in dealing with structural problems of this type, needs to be brought into the act in a much bigger way. It is probably a more appropriate instrument and institution to help deal with some of these problems than the IMF, with its more short-term focus.

But if one reads (and one can read) the programs in each of the Asian countries now, at the center of each of the programs is a requirement for fundamental reform of the financial system–new supervisory mechanisms, new regulatory requirements. Indeed, at the IMF's annual meeting in Hong Kong last October, there was an agreement on the creation of the Basel

Core Principles, a set of 25 principles deriving from work that my colleague, Morris Goldstein, did at our Institute for International Economics over the last year, calling for an international banking standard and putting into place on a worldwide basis a series of norms which each country is asked to adhere to in running its domestic financial system. It has to be voluntary, as you can't impose it on countries in this world, but you can certainly publicize those who do adhere to it and therefore are better credit risks and you can publicize those who ignore it and therefore should not get lending in the future. In short, steps have been taken in the direction required to help deal with it.

When the IMF goes into Korea, if you read the program as you can, it says in three different places that Korea must adopt the Basel Core Principles, which have to do with the whole range of sound supervisory and regulatory issues, reserve requirements, et cetera, that I know my colleagues on the panel believe should be implemented. Those are in the IMF programs. They made Indonesia close banks; they didn't bail them out and shore them up. So I am a bit mystified as to why it is that my colleagues on the panel see the IMF as hurting the situation rather than helping it.

Let me add one final concrete recommendation. We know, and it has been agreed earlier in the hearings this morning, that equity holders do take big hits. It should also be clear at least some of the banks have already recorded big hits. If you look at the fourth-quarter statements that have come out of Chase, Morgan, et cetera, several hundred million dollars of hits have been taken directly as a result of the Asian crisis. So they are already taking hits. It is not as if they have been let off.

But I fully agree that, as an integral part of all IMF programs now and in the future, it should be very explicit that the big lenders take haircuts. There is a very good precedent for doing so. The precedent was the second and final workout stage of the Third World debt crisis in the 1980s, which was the Brady bond portion of the response.

You remember, when the Latin American debt crisis began, the U.S. banks and some other industrial countries' banks were not in a position to take hits. Hence, the original Baker plan avoided hits on banks, in large part to keep our own banking system financially afloat. But then by the late 1980s, when our own banks had strengthened their positions, the Brady plan was put into effect and required the banks to take significant losses and provide significant debt relief to each of the debtor countries.

The amounts differed from country to country. The banks were given a series of options for how to do it. But it was an integral part of the program.

Under whose guidance were these Brady plans implemented? The IMF. They did it and they organized it. They had a lot of help–the Fed and the Treasury here, the G-7 and the G-10–but it was done by the international community as part of the eventual, final and successful workout of the Third World debt problem in the 1980s.

So we know how to do it. The new Basel Core Principles move it forward. The individual country programs in Asia are implementing that approach. It should be included systematically and structurally in each future country program where financial sector problems are a difficulty. I think those are the things Congress quite rightly should insist on, along with the transparency recommendations I advised.

[The prepared statement of Mr. Bergsten appears in the Submissions for the Record.]

Representative Saxton. Thank you very much, Mr. Bergsten.

Let me begin by asking Mr. Calomiris a question. I listened with great interest to Mr. Bergsten's analysis of the issue that we have been referring to as "moral hazard," and as a former businessman myself, I have difficulty not believing that there is an effect that we refer to as moral hazard.

In my previous life, I was involved with the sale and building of homes. You would buy a piece of land, and you would say we are going to make a substantial investment and hope to make a profit. Of course business people like to make as much profit as they can. I think one of the principles that you four will agree on, generally speaking, is the higher the risk, the greater the profit. Not always, but we hope that is the case most of the time.

So we decided how to make investments based on how much profit we can comfortably make with a comfortable amount of risk. If I got this investment that I am doing, and I got somebody standing behind me somewhere saying well, if you fail, we will loan you whatever it is that your failure amounts to, at an interest rate of about half what you can borrow from conventional sources. Dr. Bergsten, I respect your position. I am having trouble understanding it. So, Mr. Calomiris, if you would like to respond within this context, I would appreciate it.

Mr. Calomiris. Sure. There is an enormous amount of evidence, both case study analysis and also statistical evidence that clearly links this pattern of collapse since 1982 to the moral hazard problem. So it is not just your own very correct feeling that the logic must be true, it is also that we have studies, two excellent studies coming out of the World Bank that I would be happy to make available to anyone who wants to read them, one looking ex ante at bank risk taking and where bank risk lies on the Efficient Market Frontier (by Jerry Caprio)–and another very nice study by Asli Demanjuc-Kunt, looking at how ex ante differences across countries and safety net policies tend to affect risk. There are also lots of case studies. The interesting thing is some of the case studies are written by finance ministers or central bank presidents in these countries.

In my report, I go on at length about the Chilean experience. This is not someone looking from the outside in, this is the way people in these countries describe them. I have been involved in five countries outside the United States in financial reform, deeply. In Argentina, I have been working there four years. In Mexico, I was part of the advising that went on in 1995. I have also worked in El Salvador, China and Japan.

It is absolutely understood and accepted in Japan that "moral hazard" has played an enormous role in the financial collapse. No, it is probably not IMF-sponsored moral hazard in the Japanese case, but as I pointed out in my report, while the IMF has made matters worse, it didn't invent moral hazard. The domestic governments invented these policies, and it is often part of the way liberalization has taken place in many economies–freedom without responsibility. The IMF simply makes it worse.

If I can have one second to give a little bit of evidence about Asia that I came across yesterday. This is from the February 21st *The Economist* magazine, describing Indonesia. “In January, for example, Mr. Suharto promised to dismantle many of the monopolies and cartels which controlled trade in some products, but he seems to have forgotten to tell the monopolists. The plywood cartel, run by his golf partner, continues to issue instructions to its members. Restructuring of the financial system, a wash with red ink, has barely begun.”

Let me read about Korea from this week's *Business Week*, dated March 2nd, page 54. “Kim [that is the new president] wants the banks to stop lending to big companies at preferential rates, but just in the past 6 weeks, banks have provided nearly $1 billion in emergency relief flows to sickly chaebol, [those are the conglomerate companies.] The loans are offered at far below market rates and this is a distorted distribution of limited resources," says the head of research at Daiwa Securities in Seoul.

My experience in Latin America and the experience we are seeing illustrated here show that IMF reforms of banking systems can't work. The IMF conditions in other respects work very well, in fact too well. The IMF is very good at requiring the taxation to sponsor the bailouts of these banks, because tax policy is something it can enforce within a year or two. It is not very good at making sure the reforms in the financial system take place. By the time those reforms would occur, over any reasonable period it would take to implement those reforms, the IMF is already out. The countries drag their heels until the loans are repaid and they are no longer responsible to the IMF. I experienced that in Mexico personally, and I experienced the opposite in countries that have developed their own domestic will to actually reform. The IMF simply doesn't make a difference and in fact makes matters worse I believe.

Representative Saxton. Mr. Bergsten and Mr. Lindsey, if you would answer this question for me. One of the major problems that has been pointed to from time to time with regard to the IMF is that, as Mr. Calomiris and Mr. Meltzer just pointed out the IMF loans money and charges relatively low interest rates, subsidized interest rates, if you will. Is this acting in the best interest of the recovery of ailing countries, or should we be encouraging loans to be driven by market rates of interest?

Mr. Bergsten. I think the first question to clarify, Mr. Chairman, is what we mean in this context by a subsidized interest rate. The IMF lends at what it calls a market rate, by which it means its own cost of money, adding a slight margin to cover its own operating costs and the like. It is not concessional lending like foreign aid, the International Development Association of the IBRD, or anything like that. In that sense, it is a global market rate that the IMF is paying for its money and then charging to its borrowers.

Of course it is right that the market rate in any given borrowing country can well be higher at a given point in time. It is likely to be higher because the country, after all, is in a crisis. So what is the proper rate?

I think the policy implication, though, has been confused. The members of the panel, in addressing the moral hazard question have, properly focused on the risk that private lenders will be induced to make bad loans because of moral hazard. I think they agreed, however, that countries are not likely to be subject to moral hazard. No sovereign country is going to get itself into a financial crisis, throwing itself to the tender mercies of the IMF and putting itself through the wringer of an enormous adjustment problem, because it has money available from the IMF or anybody else, at whatever interest rate.

I think it would be farfetched to believe that any country was going to pursue profligate policies because it had IMF money, even at a subsidized interest rate, available to it. So I am not sure what the thrust of this particular point is. I am afraid it confuses the two kinds of moral hazard.

Representative Saxton. Dr. Lindsey, if you would respond, I have what I believe to be an accurate record of the interest rates that are generally charged by the IMF on a monthly basis, from October to February, and those interest rates seem to indicate that it's about 4.5 to 4.7 percent. That seems to me to be significantly below market rate. Is that correct?

Mr. Lindsey. I think that is a fair conclusion.

Representative Saxton. But what market rate?

Mr. Lindsey. Let me see if I can answer the question, Fred. As Mr. Bergsten said, the IMF lends at its cost of funds, plus a markup. Its cost of funds is not a market rate; that is why it is coming to you to give them the money. It also goes to the Bank of Japan, the Parliament of Japan, the Bundesbank, and everyone else. So the cost of funds to the IMF is a blended cost of funds to the national governments of the world. They are the best credit risks around because, literally, they can print the money to pay off the loan, so there is no credit risk at all.

So what is happening is the IMF is taking an essentially risk-free rate, tacking on a little administrative cost, and calling that a market rate. It really is not a market rate. None of us could borrow at it because we, as individuals, have higher risks than the United States Government, and certainly the Koreans have a higher risk. Any banker charges different rates to different people, depending on the perceived risk premium. So what the IMF is doing–I think the better phrase, rather than market rate, they are charging these countries a risk-free rate. To the extent there is risk in the system, it is not being reflected in what the countries are being asked to pay. With regard to–well, I should stop there. I had responses to Mr. Bergsten.

Representative Saxton. Let me follow up, if I may, Mr. Lindsey. I think you talked about a blended rate, which reminded me of something that I learned a while back on this issue. Isn't it true the IMF pays no interest on some of the money that comes through the quota?

Mr. Lindsey. I think the initial–the IMF was set up right after Bretton Woods and the initial contributions to it were contributions in gold, and I think that is the interest-free component. I admit I am not an expert on the minutia of IMF balance sheets.

Representative Saxton. It is hard to find an expert on that subject.

Mr. Lindsey. But I think that, yes, some of the blended rate is zero, but I think most of it, about 75 percent of the IMF balance sheet, is quota contributions.

Representative Saxton. In any event, it is below the true market rate.

Mr. Bergsten. Mr. Chairman, there has never been a default to the IMF. The IMF lends to sovereign governments. They always have repaid. So if you want to base the appropriateness of the lending rate on the credit history of the institution, there is some reason to lend at what Larry rightly says is a risk-free rate. They have never failed to be repaid.

Representative Saxton. Mr. Meltzer, would you like to respond?

Mr. Meltzer. That is really not the right criteria. For 150 years, we have had the principles of a lender of last resort written down. Those were written down by Bagehot, the editor of *The Economist*. What he said is, you want to lend at a penalty rate. Now, what is the penalty rate in this case? It is a rate which is higher than the rate on the assets that are used as collateral. That is to prevent people from getting subsidies, and it distinguishes, it tells you when there really is a liquidity crisis.

What is a liquidity crisis? It is when you hold an asset and there is no market for it. That doesn't happen very often, but it happened here, for example, in the Great Depression. No one would want to buy your asset because tomorrow they were afraid there would be a run on the bank and they would want the cash, so they wouldn't even invest in a Treasury bill under those circumstances.

Now Bagehot said, correctly, lend at the penalty rate; that will tell you the market isn't functioning, and that way there will be no risk to the organization, and there will be no excessive borrowing. That is a principle which has been established, and once it was established, it worked perfectly for the British banking system. There were no serious problems for the next hundred years. That is the principle we ought to install at the IMF.

And all of this talk about what is the cost of funds to the IMF is really irrelevant to the problem of what rate they should be charging. They should be charging a rate which discourages people from getting subsidized loans relative to the rate at which they, the borrower, could borrow elsewhere.

Representative Saxton. Thank you.

Mr. Ganske.

Representative Ganske. Thank you, Mr. Chairman.

Mr. Calomiris, I was interested in your statement on page five where you give the example–at the top of the page, it looks to me like you were working in this area and you say, after a day of lip service, the release of the funds, one of the Mexican officials in charge took me aside and expressed his appreciation for my efforts and then told me, quote, "Of course the banks won't let us do any of this," unquote.

This was not a surprise. Why would anyone want to give up a subsidy if they have political influence to maintain it? So far, nothing has been done to introduce market discipline into the Mexican banking system; there is no reason to believe anything will be done. And furthermore, I think on the previous page, you mentioned all deposits are 100 percent insured in Mexico.

Mr. Calomiris. All debts, basically, not just deposits, not just of banks, but of pension funds. It has been a virtually completely insured financial system.

Representative Ganske. So your point is that, regardless of what –and this ties in with what your statement was before on the plywood, which was recently reported in an issue of the *Wall Street Journal*, a lot of these countries will make an agreement with the IMF to do certain things to open up their markets, et cetera, but the leverage is only there as long as the IMF is giving the money and, many times, temporarily; and once that is over, then it is your opinion that there is a reversion back to practice as usual.

Mr. Calomiris. I think that is right, but I really want to make the distinction between macroeconomic reforms and microeconomic reforms. If the goal is to change something about the fiscal policy in a country, the IMF can sometimes be very successful. That doesn't entail a lot of money from the IMF, it entails advice, coordination, and it is something that can be done in fairly short order.

The reason the IMF is starting to get interested in banking reform is that their assistance has become microeconomic bailouts of banks. The problem is that IMF conditions for banking reform aren't going to work because you can't turn a banking system around on a dime the way you can change a fiscal policy around. It is that simple.

Representative Ganske. Let me ask the panel one question, then I think I will be done.

Recently it has been reported that Indonesia was looking at a currency board, and it has been reported that both the Administration and the IMF have been vehemently against that. Can you tell me why you think the IMF and the Administration have been against a currency board in Indonesia, when it seems to have worked effectively in other areas; and is, in fact, a currency board a legitimate idea for Indonesia to be looking at?

Mr. Calomiris. Having worked in Argentina with the central bank there for the last four years, I have become much more a fan of currency boards than I was prior to that. Still, I agree with the Administration, and with the IMF, that Indonesia, at this point, is not ready for a currency board.

Currency boards can work very well if, prior to instituting them, you have already put into place the fiscal reforms that will make the currency board feasible. I think there are very legitimate objections to Indonesia putting in place a currency board because it hasn't done that; and in fact, within the institutions–the World Bank, the IMF, the people I talked to –there are real concerns that the goals in Indonesia, of Suharto, to put a currency board into place, are potentially, let's just say, not goals that involve the best interest of his country.

Mr. Bergsten. We did a thorough study of currency boards at my Institute a couple of years ago that I would like to submit to you. It looks at all the historical cases and concludes there are two cases where they work. One is where you have very small countries that are heavily dependent on trade; they don't have really an autonomous exchange rate policy anyway. That is a case like Hong Kong. The second is where you are coming off hyperinflation and you need some kind of anchor to restabilize, and the public is willing to pay almost any price to do it such as high interest rates or high unemployment. That was the case of Argentina. Indonesia meets neither criteria.

In addition to the problems Professor Calomiris stated, I think Indonesia is more like Mexico. People who now want currency boards in Indonesia recommended them in Mexico three years ago. Mexico rejected it; it did not meet the criteria. It has done quite well with its recovery, under the guidance of the IMF, and Indonesia today is much more like Mexico three years ago than like Argentina or Hong Kong. I share the view it would be a bad mistake for Indonesia to go that route at this time.

Mr. Meltzer. May I just say one bit on that question.

I am not a great proponent of currency boards in Indonesia, but I think, in fairness to Mr. Suharto, there is another side to that problem. Food prices are going to go up three to four times. Every company that has debt in Indonesia is about to fail, because the debt now becomes extraordinarily burdensome when they have to pay four times or more the price at which they contracted the debt, just to keep the thing afloat. There is a real crisis. The IMF program failed in Indonesia.

Now, a currency board that could back an exchange rate at 5,500 rupiah is a risky gamble, but what is it to be compared to? Is it to be compared to the present crisis in which people are rioting in the street, where there is very great difficulty in buying food, where there is a real threat to the indigenous Chinese population in the country, where every company is about to fail? It is a gamble. If the IMF backed it with the $40 billion it has promised to Indonesia, I can't say it is a guarantee it is going to work, but it certainly is better than the program which is now there, which is doing nothing.

Mr. Lindsey. One of the fundamental criteria for a currency board would be that they actually have the money in the bank, the foreign currency in the bank, to back the rupiah.

Mr. Meltzer. The 40 billion?

Mr. Bergsten. $60 billion or more, according to most analyses.

Mr. Lindsey. Let me proceed. Okay, thanks, Fred.

What you have to do is, you have to take the Indonesian money supply, divide it by whatever number you want to have as the exchange rate, then you have to have that amount of money in the bank. There is no indication that Mr. Suharto did that before proposing the currency board. As a result, his actual proposal would be doomed to failure; it didn't meet the first prerequisite.

But I think Mr. Meltzer had an excellent point. The question is, compared to what? When countries choose different monetary regimes –and I think Fred Bergsten's book would point this out also–they often completely give up their own ability to run their monetary affairs, and so they say, well, let the Federal Reserve do it, which is what Hong Kong and Argentina have done, because there is no one indigenously who can. So I don't think you can necessarily condemn a currency board.

I agree with the IMF and the Administration that Mr. Suharto did not do his homework before proposing this one, but I think it depends on a case-by-case basis whether or not you really want to have one.

Representative Saxton. Let me change the subject. When we debate tax policy in this country, we try to be very careful not to make the rich richer and the poor poorer. Last night on the train as I was coming back to Washington, I was reading the testimony I had available. And Mr. Calomiris' testimony was one of the sets of papers that I had. I would like to read something from his testimony and then ask each of you, beginning with Mr. Calomiris and then going across the table, to respond to it.

Mr. Calomiris writes, "While bailouts entail loans from the IMF and foreign governments and subsidize interest rates to developing countries' governments, taxpayers in the United States and other developed economies who pay the subsidies associated with these loans are not the biggest losers in the bailouts. The IMF and the U.S. Treasury in most cases are repaid.

"Loans from the IMF and the U.S. Treasury, however, provide powerful justification for increased taxes to repay the loans. When the crisis is past, the big winners are the wealthy, politically influential risk-takers and the big losers of the taxpayers in countries like Mexico and Indonesia.

"Thus, in addition to bailing out foreign and domestic bankers who had lent funds to Mexican firms prior to the crisis, the likely result of the Mexican bailout will be the transfer of some $45 billion from Mexican taxpayers, collectively, to the country's wealthiest and most politically powerful enterprises and individuals."

Would you like to comment on that, Mr. Calomiris? I find that quite astounding.

Mr. Calomiris. I will only comment on it by clarifying where the $45 billion comes from.

When the Mexican government decided to bail out the banks, effectively using the assistance it was getting internationally to bail out the banks, it did it by purchasing $45 billion of bad debt from the banks with the statement that it would prosecute or sell those debts to get as much repayment as possible. And roughly 23 billion of those are corporate debts to the largest corporations, which are part of this whole conglomerate mechanism; they have done nothing to move in that direction. And the people that I talked to at the World Bank who are handling the Mexican economy tell me they currently have no expectation that will happen, so that is the basis for the discussion.

Mr. Lindsey. I think the analysis is a correct one, and I think the reason that it works that way is that you have to realize that the people who are doing the negotiating tend to represent themselves; and in a sense, the money was already lost when it was lent. The question is, who then makes up the money? Is it the lender, i.e., the bank, or is it the government? If the government chooses to make it up, the government is nothing more than the taxpayer; and that is the description Mr. Calomiris had in mind, and I think it is quite straightforward.

Mr. Meltzer. I agree with what Mr. Lindsey just said. Think back to our own experience with the savings and loan problem. We had all the bailed-out banks. We later sold off the assets that could be sold to the market, and the rest–the $150 approximately billion–is a charge to the taxpayers.

There are only two places you can go. You can sell the bank for whatever it is worth and get as much out of it as you can. The residual is what is guaranteed by FSLIC or the FDIC or the Mexican government; that is essentially what Mr. Calomiris' argument says.

Mr. Bergsten. I agree with Mr. Meltzer. But it is worth remembering that we all agree, I think, when you are faced with a financial crisis of that type, be it our S&L crisis or the Mexican position in 1995 or the Korean position today, you have to get the bad loans off the books in order to restabilize the financial system and enable it to go back to playing its role in the economy. That is going to require a big hit to the taxpayers of the country as a group.

Then comes the crucial question of how you distribute that tax burden. That is a question of the country's fiscal policy rather than anything directly related to the banking system per se.

Mr. Calomiris. Just a little addition.

The thing that is so different, though, from the way we think about this in the U.S. is that the owners of the banks are the borrowers from the banks; that is what makes it such a, if you like, "seedy proposition." What is really happening is the recapitalization of the banks is accomplished, and then the decision is made that the borrowers–who, by the way, just happen to be the owners of the bank–don't have to repay the debt that they had taken out from the bank. That is what makes it a little bit different.

Mr. Bergsten. It is not only seedy, but uneconomic and inefficient. One of those Basel core principles I talked about, that has now been agreed at the international level, is to put strict limits on connected lending by owners to themselves. That is an essential reform in any banking system in the world.

Mr. Meltzer. Let me just say, we don't need the IMF to do those things, and it wasn't the IMF that invented the Basel procedures. The principle began with Chile, which went through a wringer in the 1980s after it got rid of Allende. It had a lot of financial problems following that. It imposed a principle on the banking system: if you get bailed out, every dollar you got from the government you are going to pay back with interest out of future profits. The banks pay it back–that is essentially what we did with the RFC in the 1930s. We said, here is the money; we are going to salvage the banks, but the money has to be paid out of future profits of the bank.

Representative Saxton. Let me just move on to a couple other questions. We have to, unfortunately, finish up shortly because we have to clean the room for someone else who is coming in at 1:00.

Some proponents of additional IMF funding would like to preserve the flexibility of the U.S. Treasury and its access to the Exchange Stabilization Fund. Others have suggested placing limits on this fund. Could you comment on these alternative proposals? Do you have recommendations regarding the Exchange Stabilization Fund?

Mr. Lindsey.

Mr. Lindsey. In my opinion, the Congress would be better served to look at the intended purpose of the Exchange Stabilization Fund. Do you want the Treasury to have the ability to manipulate the U.S. dollar exchange rate on world markets? That is the fundamental issue.

My personal view on that, which I stated also when I was a governor, was that the answer was no; that is, it is a temptation to mischief. If I thought that the very able people we have in New York at our desk, who use the Exchange Stabilization Fund, were better than George Soros and the other hedge funds at taking money out of the foreign exchange market, I would recommend to you that you appropriate money for them to gamble with and enrich the taxpayer and lower our taxes as a result. Unfortunately, I don't think they are as good as Soros and they would end up losing the money.

So I tend to be a skeptic of the Exchange Stabilization Fund, but I would go back to its fundamental purpose. I don't think it is a useful tool to have.

Representative Saxton. Should it be liquidated?

Mr. Lindsey. Yes.

Mr. Meltzer. Yes. May I say two things about that?

The first is, when you talked about transparency, there is no transparency in the Exchange Stabilization Fund. Congress doesn't have a clue about what they do with the money. Once in a while you may be able to get some records from them.

Second, how does the fund finance itself? By a system, most of the time, called "warehousing," by which the Federal Reserve makes a loan directly to the Exchange Stabilization Fund, off the budget.

Now, it seems to me to be absolutely violating every principle we have of democratic government to say that administrative agencies can, between themselves, under whatever name or arrangement they make, allocate monies without the Congress voting for them. And that really is a fundamental principle which needs to be corrected–has needed to be corrected for a long time.

The Exchange Stabilization Fund started when we devalued the dollar; it was there to protect us against foreign predators who might try to appreciate the dollar. Now, it has been used for all sorts of purposes, like Mexico and other purposes, which have nothing to do with its original purpose and which constitute a direct violation of democratic principles–namely, using unappropriated funds for a purpose which Congress has not approved.

Representative Saxton. Dr. Bergsten, would you like to have a very quick response?

Mr. Bergsten. I believe we should maintain the Exchange Stabilization Fund. The fundamental reason is that private markets often diverge very sharply from underlying economic fundamentals. There are what economists call "externalities" to be taken into account by official entities like the Fed and the Treasury. The U.S. Government has to be in a position to deal with adverse effects on our national interest caused by excesses and errors of the markets, errors which everybody on the panel has agreed frequently happen and can be very large.

Representative Saxton. I'm sorry. Mr. Lindsey.

Mr. Lindsey. I'm sorry. I would take too long. I just get hot under the collar when I hear that.

I'm sorry. I will learn to be quiet.

Representative Saxton. As you know, the U. S. Government levies taxes to exact resources from the private sector and transfer them to the public sector. In the case of the IMF, some of these resources extracted from the U.S. may be transferred to the IMF and then loaned to others. We get a paper, an IOU, from the IMF that represents the value of resources transferred to the IMF.

In the foreseeable future, what is the probability that a significant amount of these IOUs will be cashed and returned to the United States?

Mr. Lindsey. I think this gets to the disagreement that Fred Bergsten and I have: Is this really a cost to the taxpayer? If it worked, then I would recommend not $18 billion, but $100 billion or a trillion or $2 trillion. I mean, $18 billion is not going to solve the problem. I don't think Fred would recommend that.

The reason that it is not costless to the taxpayer, I think is threefold. First, there is an opportunity cost involved to the U.S. economy. The money is being borrowed at the risk-free rate available to the U.S. Government. We are borrowing more than we would otherwise borrow. That money is therefore not available to other public sector uses. It goes from the U.S. Government, at the same rate to the IMF, at the same rate to the foreign borrower.

We agree the foreign borrower is paying too little, which means we are introducing a distortion into the system, so it is simply not costless because of the opportunity cost involved. A better test of whether this is costless or not would be the dissolution test.

If we were to announce that we were withdrawing from the IMF, would we actually get our money back? I don't believe so, but I think that would be the real test as to whether the loans to date have been costless.

Thirdly, prospectively, I again think the right comparison is with the FDIC or with FSLIC prior to the banking meltdown in the late 1980s. I think you can find statements by Treasury officials that the FDIC was a costless institution, that it never–that we never incurred a loss in all the bank resolutions we ever had. I am sure there was a date at which that was true, not in the last 10 years, but this is exactly the same.

When you have a major meltdown–and one will come at some point in time–the IMF and the resources available to it will be swamped; and we should face that and we should make sure we have other mechanisms in place to deal with that eventuality.

Mr. Bergsten. I would just add that there are dissolution provisions in the Articles of Agreement of the IMF. They do provide for the member countries to be repaid. I am confident they would be and could be.

May I add a point about the so-called subsidized interest rates? The reason why those interest rates are provided is because the IMF's purpose is to achieve a public good–less global recession, less competitive depreciation, less import controls and less deviations from market practices. Those are what economists call "externalities"; they justify submarket interest rates or prices for individual products that may deviate from a pure market consideration. That is the concept.

Since I happen to believe the IMF serves those public purposes effectively, I support the notion of the externality and, therefore, the submarket cost in the sense that it is being used here. Since my colleagues on the panel disagree that there are positive externalities, they quite logically want to see a pure market rate in terms of rates in the borrowing country.

But that is the difference. If you believe the IMF serves a public purpose, which is why it was created in the 1940s, which is why we supported it for so long and do now–and I believe that strongly as indicated in my statement–then you have a clear economic rationale for the interest rates they charge.

Mr. Lindsey. That is a little different than what you said initially, because what you just said I agree with, which is, it is a matter of cost-benefit analysis. There is a cost, but the benefit is higher. That is different than saying, this is a costless program that should only be rejected if the net benefits are below zero.

Representative Saxton. Mr. Calomiris.

Mr. Calomiris. That is exactly what I was going to say. It has been bothering me since I discovered that Secretary Rubin has been spreading it around. It bothered me in Mr. Bergsten's written testimony, the statement that the American taxpayer doesn't pay a penny.

Well, I worked at the IMF for a summer. I made a salary. Someone paid it. I don't think it was the tooth fairy; I think it was the taxpayers of the member states of the IMF who paid the salary. So there must be a gross cost involved in running the IMF. Borrowers don’t pay it. In fact they receive interest rate subsidies.

Another thing that is wrong with what I believe Mr. Bergsten said is, he said if it is just a credit cooperative, in some sense we all have this option to borrow, so we are all gaining; so even if there are interest rate subsidies, we all get subsidized, so in net there is no subsidy. That is not right because the probability of using it is not equivalent across the countries.

The IMF has become very different from what it was in the 1960s. In the 1960s or early 1970s, it was a fairly mutual arrangement where countries equivalently used it; now it has become a mechanism for transferring loan subsidies from the group of developed countries to the group of less developed countries.

So irrespective of whether you think that the benefits justify the costs, let's be honest; let's stop saying things like this doesn't cost us a penny, because if anyone believes that a loan subsidy doesn't cost him a penny, I would like to borrow some money from him at zero interest.

In fact, Fred, maybe we can meet outside.

Representative Saxton. Thank you very much. I thank all of you very much for being with us today. As you probably know, in Congress there are individuals who would like to have the Administration's proposal passed and the appropriation passed as proposed. There are others at the other end of the spectrum who would like us to withdraw from the IMF. Probably neither of those things is going to happen.

And so to the extent that we can understand these issues and perhaps in the future pass legislation which will address some of the concerns that many have and form a consensus among Members of Congress in both Houses and, obviously, the administration as well, then we will hopefully move forward to do, as Fred Bergsten suggests, make life a little better for some people around the world who do need it.

I want to thank all of you, for being here and for your written testimony, as well as your presence here today. Thank you, and the hearing stands adjourned.

[Whereupon, at 12:37 p.m., the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

It is a pleasure to welcome the distinguished economic experts testifying before the Committee this morning. This hearing has been called to review the Administration's request for $18 billion for the International Monetary Fund (IMF).

Over the last several weeks there have been a number of hearings on the Asian crisis and the IMF. Much of the focus has been on Asia instead of fundamental issues regarding the IMF itself. This is understandable given the circumstances, but more facts concerning the IMF are needed before Congress can make an informed decision on the IMF appropriation.

For example, in presenting a case for increased resources for the IMF, little Administration testimony to date has presented basic financial information such as the current level of quotas, amount of outstanding loans, the interest rate paid on the quotas, and cost of overhead and related expenses. Furthermore, the Administration case relies heavily on the Asia crisis even though the IMF has sufficient funds to complete the announced Asian bailouts.

This hearing has been called to focus on the IMF, its financing, procedures, administration, and economic impact. This is entirely appropriate in light of the Government Performance and Results Act. Under this bipartisan legislation, Congress is to review programs based on measurable and objective performance criteria.

This Act fundamentally changes the way Congress and the Administration evaluate programs. Even if it is argued that the Act does not technically apply to the IMF, the IMF appropriation should be evaluated in the same spirit. This will require more transparency and responsiveness to Congress from the IMF in the future. As Sabastian Edwards, a former Chief Economist of the World Bank, has said, the pervasive secrecy of the IMF makes evaluating its performance extremely difficult if not impossible.

The key question before Congress is whether the IMF should be significantly expanded into the future. The current quota increase before Congress is somewhat smaller than that favored by the IMF. The IMF has signaled that the U.S. should be prepared for an additional quota increase fairly soon. This indicates that the IMF expects rapid growth in its operations in coming years. The desirability of such a permanent structural increase in the IMF is the key issue before Congress.

However, a convincing case for such IMF expansion is not at all clear and, in fact, has not been made. The IMF budget projections are not available because apparently the IMF does not produce such projections even for internal use. Thus, a case for future IMF growth cannot be substantiated by quantitative estimates of future IMF activities. Measurable and objective criteria for IMF functions are not available. Presumably, the growth of international capital flows in recent years might be used to justify an expansion of the IMF, but an alternative explanation might be a growing moral hazard problem associated with the bailouts of recent years.

Aside from the specifics of the budget request, there are several major problems with existing IMF lending practices. These include moral hazard, lack of IMF transparency, excessive taxpayer exposure, subsidized interest rates, and counterproductive conditions attached to IMF loans. These are issues on which reasonable people may disagree, but they cannot be ignored. Meaningful structural reform of the IMF is needed whether or not an IMF expansion is financed in 1998.

PREPARED STATEMENT OF TIMOTHY F. GEITHNER, TREASURY ASSISTANT SECRETARY, DEPARTMENT OF THE TREASURY

Mr. Chairman, thank you for giving me the opportunity today to discuss the International Monetary Fund, its role in the world economy and financial system, and why we believe it is important to act now to strengthen its financial resources.

New Risks in the Global Financial System

This hearing today takes place in the context of two developments of great importance to the United States and to this debate over funding for the International Monetary Fund (IMF).

The first is the emergence of a global financial market that has brought significant benefits to the world economy, but also new risks. National financial systems are now more closely integrated than ever before. Capital now flows across markets on an extraordinarily large scale. And technological innovations in telecommunications and finance make it possible for finance to flow much more quickly in response to events.

These developments have made it possible for private capital to finance an extraordinary improvement in living standards across many countries. But they also have increased the scale, force, and speed with which financial crises can occur.

These risks are illustrated clearly in the financial crisis in Asia, and this is the second development which makes these hearings on the IMF so important. The crisis that began this summer in Thailand and then spread throughout Southeast Asia and to Korea presents serious potential risks to American interests.

Our economic interests are at stake because large and sustained depreciations in the currencies of our trading partners and deep recessions in their economies will reduce the competitiveness of American companies, reduce demand for American exports, reduce the earnings of American firms, and reduce the value of pension funds across the country, all of which, of course, will affect American families and American workers.

Even if the crisis is contained to its current dimensions, the impact on the U.S. economy could be significant. While it is too early to offer a precise assessment of the overall impact of the Asian crisis, preliminary assessments by the OECD and a number of private forecasts have estimated that the impact on the U.S. economy may be around half a percentage point (0.5%) of U.S. GDP. If the crisis is not contained, the impact could be significantly greater.

Our security interests are at stake because economic instability, when it is acute and sustained, can threaten political stability. This risk is real, not just in those places where we now have American troops on the ground. It can be significant in any country where the basic institutions of the state are untested in crisis or where there does not exist an established pattern for stable governmental successions.

U.S. Policy

In response to these developments and in an effort to limit the risks they present, we have led a major international response to help reestablish financial stability in Asia and to help strengthen the architecture of the international financial system. The International Monetary Fund is at the center of these efforts, and it will remain critical to any effective U.S. response to protect our interests in this crisis, as well as future international financial crises.

Our strategy to protect U.S. interests in the immediate crisis has the following major elements:

- First, we have worked to encourage the countries in crisis to put in place strong programs of reform, and supported these programs with temporary financial assistance from the international financial institutions.
- Second, we have encouraged countries in the region and outside the region to take preemptive policy actions to reduce their vulnerability to contagion from the crisis.
- Third, we have worked to encourage Japan and the other major industrial countries to pursue policies to strengthen growth and open their markets, and thereby contribute to recovery in Asia.
- And, finally, we have taken steps, led by the U.S. Eximbank, to protect U.S. exports to the region, by mobilizing trade finance for the countries in crisis.

Restoring Financial Stability in Asia

The centerpiece of our approach has been to support strong programs of reform, backed by temporary, highly conditioned financial assistance, led by the IMF, as a bridge to recovery.

Policy and Reform

These programs of economic reform are designed to address the specific causes of the crisis in each country and to create the conditions necessary for stronger and more stable exchange rates and for a quick return to rising living standards.

To accomplish this, the programs focus on the types of reforms necessary to restore confidence, so that the people of these countries are willing to keep their savings in the currency of the country concerned and so that new flows of private capital will be available to finance recovery.

Although the specifics have necessarily varied across countries, the principal elements of each program include:

- Measures to strengthen the financial systems by closing weaker institutions, reinforcing stronger ones, and improving the supervisory system.
- Structural reforms to make the economy more market-oriented, better able to allocate capital efficiently, and less vulnerable to corruption.
- The liberalization of restrictions on trade and investment.
- Improved transparency and disclosure in the financial accounts of the government and central bank, and in the balance sheets of private banks and corporations.
- Measures to reduce the impact on the poorest segments of society by protecting health and other social expenditures from budget cuts.
- A supportive framework of monetary policies to help stabilize the exchange rate and contain the inflationary effects of depreciation, and fiscal policies to promote the necessary reduction in external deficits and to finance the costs of financial sector restructuring.

These programs are essentially programs of growth-oriented structural reforms. They are not austerity programs. Despite popular perception, the degree of fiscal and monetary tightening in these programs in Asia has been modest by comparison with the stabilization programs the IMF has employed in different circumstances.

It may be unavoidable that the reform programs and their architects get associated with and blamed for the economic distress that comes with financial crisis. But it is the crisis–not the programs–that induces the distress. And it is the programs that help cushion the decline in growth and living standards and help create the conditions necessary for recovery. Countries that have tried a different path of delayed adjustment and less comprehensive reform have normally found that by doing so they simply lengthened the crisis and delayed recovery.

The other common element in these programs is that they can be adjusted in response to changing circumstances. When growth slows more sharply than expected, for example, the IMF can move, as it has in each of the cases in Asia, to modify the fiscal targets in the programs so as not to impose excessive contraction on weakened economies. And when problems in the banking system become more acute than originally estimated, the IMF can act, as it has in Thailand and Indonesia, to strengthen the programs in response.

Temporary Financial Assistance

In support of these programs of reform, we have mobilized temporary financial support, led by the IMF and other international financial institutions, to rebuild reserves and help provide confidence.

The U.S. has also joined with other countries in being prepared to provide contingent supplemental resources that could be made available to augment these programs. We have a moderate share of these supplemental lines, and have not yet disbursed any funds.

This financial assistance by the international community is an essential part of the solution to these crises and a necessary complement to the programs of reform. It is necessary to provide confidence, to induce stronger reform programs, to provide some breathing space for the reforms to take hold, to supplement the countries' official reserves, and to help ensure that these governments can meet their international obligations and can stand behind their financial systems.

There is no amount of official money available in the world that could substitute for or compensate for a lack of commitment to reform in these countries. But even the most virtuous, most credible, most committed government could not successfully confront problems of this scale without temporary financial assistance. It's useful to recall that the United States drew a substantial amount of our reserve deposits from the IMF in 1978–largely financed through the General Arrangements to Borrow (GAB)–when we faced a major decline in the value of the dollar.

The IMF reform programs are structured carefully to help ensure it works, to help limit the moral hazard risks that are inherent in any provision of official finance, and to maximize burden sharing. Several of these features are worth highlighting:

- Disbursements are tied to strict compliance with very detailed, concrete, time-specified policy commitments. They are tranched or phased to help induce both early up-front actions and sustained follow-through. The money does not flow unless and until the policy commitments are carried out.
- The assistance is in the form of temporary loans, not grants, at market-related interest rates. In fact, after the establishment of a new IMF facility at our initiative in December, much of the assistance for Korea is being made available for short maturities at a substantial premium to minimize use and to maximize the incentive to repay early.
- The assistance comes with strict limitations on the use of the money, with restrictions on support to private corporations, and with limits and conditions on liquidity support to banks.
- The assistance is led by the international financial institutions–the IMF, the World Bank, and the Asian Development Bank–which ensure that conditionality is maintained and that we leverage substantial contributions from the international community for any U.S. participation (direct or indirect).

Not providing this assistance, however appealing that might seem as an option, would risk more acute instability, with a greater and more protracted loss of economic output, deeper, more sustained depreciations in the currencies of our trading partners, and greater contagion, with all the attendant risks to the United States.

The Critical Role of the International Monetary Fund

The IMF is absolutely central to this effort. If it did not exist, we would have to invent it. We have a huge stake in making sure it has sufficient resources to respond to any intensification or spread of the current crisis and for any future crises.

- Without the IMF, there would be no multilateral mechanism for providing apolitical advice to shape strong reform programs.
- Without the IMF, at times of crisis, there would be greater depreciations in the currencies of our trading partners and sharper adverse impacts on the US and world economies.
- Without the IMF, at times of crisis, there would be greater pressure on the United States to act unilaterally with taxpayer resources to protect our interests without the global leverage the IMF provides.

Today, as much as when it was established with U.S. leadership more than 50 years ago, the IMF acts as a forward defense of American interests. It has played a critical role in supporting reform and growth in the transition economies, bringing Russia back from the brink of hyperinflation, and Poland from near collapse to one of the fastest growing economies of Europe. In Uganda it has helped underwrite ten years of remarkably successful economic reforms which have generated average annual growth rates, in real terms, of over six percent a year. And in Argentina, the IMF has supported–including during the 1995 "tequila crisis"–Argentina's deep economic transformation from a country characterized by anemic growth and hyperflation to one that enjoys strong growth (8% in 1997), near zero inflation, declining fiscal deficits, and a more private-sector oriented economy.

The IMF has been successful in so many cases because it promotes the core American economic values of sound money, respect for market forces, and free trade.

I thought that it may be helpful for me to say a few words about the financing structure of the IMF. In some ways, the IMF operates like a credit union. We extend a credit line– most of our quota subscription and for our GAB or NAB commitment–which the IMF can draw on. Any drawing by the IMF gives us a sort of deposit in the IMF, which is of equal value, pays interest, is supported by over $30 billion in gold, and which we can withdraw essentially on demand if necessary. For these reasons, U.S. participation in the IMF is treated as an exchange of financial assets. U.S. transfers to the IMF are not scored as budget outlays, and do not come at the expense of domestic programs.

Chairman Greenspan and Secretary Rubin have testified several times over the past few months about the risks in the current crisis and the importance of action by the Congress to strengthen the IMF's resources.

As you know, the President's request has two components:

- The first component is to authorize our participation in a facility to provide expanded emergency resources to the IMF called the New Arrangements to Borrow. Proposed after the Mexican financial crisis and modeled on the General Arrangements to Borrow (GAB) established by the G-10 more than three decades ago, these arrangements would make available an additional $23 billion from some 25 countries to supplement the IMF's normal lending resources in the event of a serious threat to the stability of the international financial system. The GAB was last increased in 1983 in response to a request from President Reagan, and also in conjunction with a normal quota increase. In the ensuing 15 years, the growth in the world economy, trade, and, most importantly, global capital flows have left these arrangements too small to deal effectively with the challenges of today's capital markets–for instance, IMF resources as a percentage of private capital flows to developing countries are now one-twentieth as large as they were 15 years ago.

- The second component is to authorize our participation in a normal periodic increase in IMF quotas, which are the normal lending resources of the institution. These resources have been increased on average every seven years in an attempt to keep up with the growth of the world economy and the global financial system. This latest proposal, which would increase the overall quotas of the IMF by about 45 percent and provide roughly $65 billion in additional loanable resources, was negotiated last year, in consultation with the relevant committees in the Congress.

The IMF's recent stabilization programs for Asian countries have depleted its resources to levels approaching historical lows. Although the IMF has $45 billion in uncommitted resources, only $10-15 billion are now available for lending, because the IMF needs to reserve the remainder in cash balances to accommodate possible unconditional withdrawals by members. This is neither a sufficient cushion of resources to enable the IMF to perform its basic mission nor is it sufficient to ensure the IMF could respond effectively if the Asian crisis deepens or spreads to other markets. We believe it is extremely important that the Congress move quickly to approve both the NAB and quota requests, so that the IMF has sufficient resources to help protect U.S. interests in the event of unforeseeable but potentially very damaging financial emergencies over the near term.

Strengthening the Architecture of the International Financial System

At the same time that we have worked to confront the immediate crisis in Asia, we have worked to build consensus on reforms to help strengthen the architecture of the international financial system. We have a strong interest in trying to identify changes to the system that could help reduce the risk of, and make the system more resilient in the event of, future financial crises of this magnitude.

President Clinton began this effort four years ago at the G-7 Summit in Naples. At the Summit that followed in Halifax in 1995, we launched a major international effort to help make the international financial architecture, in Secretary Rubin's words, "as modern as the markets."

This initiative produced an international program to strengthen transparency and disclosure, the development of core principles for banking supervision in emerging markets, the establishment of an "Emergency Financing Mechanism" to accelerate the IMF's capacity to respond in crisis, and an expanded emergency facility for the IMF, the New Arrangements to Borrow.

Building on these steps, we have supported a number of additional reforms over the past few months. The most significant of these are the following:

- We launched a new effort to strengthen transparency and disclosure standards to help reinforce market discipline, by improving the quality of information available to the markets on the liabilities of central banks, the balance sheets of the banking system, and the external debt of the government and private institutions.
- We have won support for a number of steps to improve transparency in the operations of the IMF, including the release of Letters of Intent with respect to each of the three large Asian programs and summaries of the IMF annual reviews of countries, and new efforts to use independent, external evaluators to gauge the effectiveness of IMF programs in a number of areas.
- We have changed the policies and operations of the IMF and the World Bank to make it possible for them, when necessary, to mobilize the types of large-scale, front-loaded, and more innovative programs of temporary financial assistance more appropriate to the challenges of today's capital markets. Most important among these changes is the establishment of a new facility in the IMF, the Supplemental Reserve Facility, which will result in much of the resources provided in exceptional circumstances being extended at shorter maturities and at a substantial premium over the IMF's normal lending rates.
- We established a new forum for mutual surveillance and cooperation in Asia, to help deal with risks that might precipitate future crises.
- And we have encouraged greater participation by private financial institutions in the resolution of these crises, with a global effort by the

major banks to refinance their short-term claims on Korean financial institutions.

We are now in the process of a more comprehensive review of changes to the international financial system that will help ensure we have effective institutions to manage the risks that accompany all the benefits of the global capital markets, and help deal with a world in which we are all more directly affected by the failures and successes of other economies and other governments. But we do not yet have solid and convincing means to induce sovereign states to take actions that would prevent a crisis, or to induce investors to make judgements about risk and return that overcome the more powerful forces of fear and self interest that drive markets.

These challenges will be the subject of a meeting of finance ministers and central bank governors from key countries around the world that we will convene later this year as a first step to try to build a global consensus on reforms to the architecture of the international financial system. We held a preparatory meeting of senior officials from the finance ministries and central banks of 22 countries in Washington last week. And the G-7 Finance Ministers and Central Bank Governors last weekend endorsed a framework of new initiatives in several areas.

This will be a complicated and difficult process, with lots of interesting, compelling solutions to be explored. The temptation will be to try to stop the clock somehow and suspend the reality of the global financial market while we try to figure out the best way forward, but that is not a tenable approach given the risks we now face.

Conclusion

The United States is central to this effort to contain and resolve the Asian crisis and to strengthen the architecture of the international financial system.

Our role is critical because the IMF cannot strengthen its financial position without us. If we do not act, the NAB will not come into force, and the quota increase will not go into effect. Our role is important because no other nation has the capacity to lead the global effort necessary to deal with a crisis of this magnitude. And our role is fundamental because our perceived willingness and capacity to support an effective international response is critical to confidence at what is a rather delicate moment for the global financial system.

We cannot guarantee that, by acting, we can turn things around and successfully limit any fallout for the U.S. economy and our strategic interests. Most of the solutions to these problems have to come from the countries themselves. But we have a responsibility to do what we can to protect our interests in this crisis. And strengthening the IMF is essential if we are to have the tools necessary to protect those interests.

Please visit www.house.gov/jec/hearings/02-24-8h.htm for the other statements.