Testimony of Secretary George P. Shultz

Excerpts From

THE INTERNATIONAL MONETARY FUND AND INTERNATIONAL ECONOMIC POLICY

HEARING

before the

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FIFTH CONGRESS

SECOND SESSION

MAY 5, 1998

OPENING STATEMENT OF SECRETARY GEORGE P. SHULTZ, DISTINGUISHED FELLOW, HOOVER INSTITUTION

Mr. Shultz. Thank you, Mr. Chairman, and Members of the Committee. It is a privilege for me to be testifying once more before a congressional committee, and particularly since I see so many familiar faces and even some friendly faces. And it is a privilege always to be part of the outstanding group you have assembled, Mr. Lindsey, Mr. Niskanen, who I know very well, but specially Paul Volcker with whom I have worked closely over many years, and who has given such distinguished service to our country.

I am going to address myself to some problems with the IMF as I see it, and I will state my own bottom line right at the beginning. I am very skeptical of what the IMF has done. I think, at a minimum, the Congress owes the American people a very close examination of its activities before you vote on this money. And I think, myself, when you take that close look, you will wind up not voting the money, at least that is my instinct. But let me go through some of my reasoning with you.

First of all, the problems of governance. The IMF was established with a charter way back right after World War II, and its job was basically to monitor the gold-based par value exchange rate system that was put in place. And I think it is fair to say that the brilliant thinkers of those days felt that you needed to establish a stable set of exchange rates in order to promote trade and investment. And also they had in mind the problems of the 1930s when you had protectionist policies arise that were very damaging, and competitive devaluations were kind of the other side of the coin of the protectionist trade policies. So that was fundamentally the IMF's role.

When it was necessary to close the gold window in 1971 and the par value system essentially went by the boards, we went into basically a floating rate system so that function of the IMF ceased. It is a very capable bureaucracy, and it has looked around for other things to do. And essentially it has taken up whatever seemed to be a problem of the moment without any real basis in a charter.

So you have an organization that now has lots of money. From the figures that I have seen right now, it has on hand, after deducting for what they have committed in the Asian crisis, on the order of $47 to $48 billion, so it has got a lot of money on hand. It is seeking what amounts to another

$85 billion, including what other countries would contribute beyond the amount that the U.S. would contribute.

So you have an organization without any real restrictions in a charter that says, here is what you are supposed to do, here is what you are not supposed to do. It nominates itself to do various things, which I will come to later, and it seems to me a real question whether we want to put in place an international bureaucracy with that much leeway and that much money just to do whatever it thinks is right, particularly when its track record shows that it has done a lot of things that are not right.

So you have real problems of governance. It is certainly the case historically that when the United States has wanted the IMF to do something, it has been able to get its way. And when you travel through Asia as you did, and I did recently as well, the Asians almost don't distinguish between the IMF and the United States. And so whatever resentments there are about whatever the IMF does, we get the blame for it. And there is going to be a considerable backlash, I am sure. But at any rate, we are able to promote policies of one kind or another. And you have problems of governance that arise from that.

And I use the recent Mexican crisis as an example. The administration, you recall, proposed a very large scale bailout. And they took that to Congress, and that proposal was debated around for several weeks and it became apparent that the Congress would not act on it. It was not in favor of it. So the Administration then took that proposal off the table, and in an unprecedented, let me underline unprecedented, move, used the Exchange Stabilization Fund that the Secretary of the Treasury has at his disposal. It had never been used like this before.

And then with I think about a $17.5 billion IMF commitment, the IMF had never operated on that scale before, put forward this very large Mexican bailout. Now aside from a legitimate debate about what that bailout did or did not do, it seems to me that there is a question of governance here: money that the Congress decided it did not wish to authorize and appropriate for an identified purpose was, through the IMF and through this fund in the Treasury, used in an unprecedented way by the Administration.

I was always taught that the Constitution said something like you cannot spend money unless it is authorized and appropriated. So there are some real issues of governance here.

I think it is fair to say that Administrations have tended to use the IMF often to get things done that they could not get done through the Congress. The very large scale aid to Russia is an example. The

Nunn-Lugar money, with solid Congressional support, does a good job aimed at the nuclear problem. But I doubt that the Congress would have gone on with the large scale general budget support for Russia, particularly since the general budget supports whatever is going on. And I think, gentlemen, that through the IMF loans to Russia, we have, in effect, supported atrocities in Chechnya, and I don't know why we should want to do that.

So, anyway, my first point is that there are issues of governance. And if there is going to be an IMF, it seems to me there ought to be a look at its basic charter, and there should be some statement about what this organization is for, and what it is not for. It is not an all-purpose organization, but it is operating that way.

The second point I want to make has to do with crises. Right now, as I have read the papers, the Administration is saying that there is a major crisis in Asia, and this money is needed. If it does not get voted, somehow the world is going to fall apart, and it is going to be your fault if you do not vote for the money. That kind of use of crisis is fairly typical.

I want to give you four brief examples of things that I have been involved in that are not IMF things, but are of the same sort.

Back in 1969 when I became Secretary of Labor, I inherited a strike on the Gulf and the East Coast: a longshore men's strike. It started the previous October. President Johnson had declared the strike to be a national emergency and had used the Taft-Hartley procedures to enjoin it.

The unions appealed and, on a fast track, it went to the Supreme Court. And the Supreme Court agreed with the President that it was a national emergency. But the Taft-Hartley injunction time ran out. And when I became Secretary of Labor, the strike was on and had been declared a national emergency, so what to do.

In my academic days, I had written a lot of things about how government was intervening too much and distorting the system of collective bargaining, taking away people's sense of responsibility and accountability for what they were doing in the Kennedy and Johnson years, and that government should do less.

So I was on the spot and I went to President Nixon with this problem. He was preoccupied with the Vietnam war. I said to him, Mr. President, your predecessor was wrong and the Supreme Court was wrong. This strike will cause a lot of disruption, and some people will be laid off and businesses won't like it, but it is not a national emergency. And if we will let the people know that we are not going to intervene beyond mediation, they will get it settled. In fact, the disruption is the kind of pressure that the market produces that causes people to settle. And we did that. And after about five weeks or so, the strike did get settled. And we had made a point, and we kept at it.

And I think the system of collective bargaining was transformed by that decision into one in which people had to assume responsibility themselves for what they did, rather than always passing it on to the government to intervene and tell them what to do. So the crisis that was declared by the President and the Supreme Court turned out not to be a national emergency.

When I became Budget Director in 1970, I had hardly been there, but there was a very large financial organization, and, Paul, you will remember this, because you and I were both involved in this problem. The Penn Central. Do you remember the Penn Central? It was a railroad, but it was far more than a railroad at this time, it was a big real estate and financial investor. And it was about to go bankrupt. It was a huge firm.

My mentor, Arthur Burns, a man that I had served and revered when I was at the Council of Economic Advisers, was Chairman of the Federal Reserve at the time. And he was in the Oval Office arguing that the government had to bail out the Penn Central, which could be done through a guaranteed loan from the Pentagon. And if it were not done, there were all these cards that would fall.

And I found myself uneasy and thought, who am I to argue with Arthur Burns that the financial system was stronger than that. That if you bailed out the Penn Central, you would send the wrong message: that you can get away with it, you can make mistakes and get bailed out. Furthermore, we would get enmeshed in this whole thing. I will never know how President Nixon would have come out on it, because at the crucial moment, Bryce Harlow, and some of you will remember Bryce, a wonderful Congressional relations and political adviser, walked in and said, Mr. President, in its wisdom the Penn Central has hired your old law firm to represent them in this matter, and under the circumstances, you can't touch this with a 10 foot pole.

So the Penn Central went down, and Arthur, in effect, did a masterful job of maintaining liquidity in the marketplace and nothing happened. So the crisis was overrated.

I won't go through the Lockheed story, unless somebody wants to. But I will take something more recent that I was involved in.

I am the Chairman of Governor Wilson's, California Governor Wilson’s Economic Policy Board, so I weigh in on things as they go along in California. And you may remember we had a bankruptcy in Orange County. And it came about because the high flying investment approach of the County, which the taxpayers loved when it was going great, suddenly ran into foul weather. And the County went – was going bankrupt. And it was the same pressures for the Governor to intervene somehow and bail out Orange County.

And people said the whole system of municipal finance in this country will go down because here is Orange County – Orange County’s gross product is bigger than Thailand, bigger than the Philippines, bigger than Indonesia I believe. It is a big place. And the Governor stayed out of it. And they kicked and they screamed and they sued people. But they had to face up to their problems, and rather than the system of municipal finance collapsing, I think, on the contrary, it caused people all over the country to look at their own investment policies more carefully and see that they were doing a sensible job.

So I am only making the point here that I think typically crises are overrated in prospect and used to justify things that have big, big downsides, and in which the downsides are not quite seen at the time the intervention is being proposed.

Third, I want to suggest to you two general principles that seem to me to be needed to govern thinking in approaching how this international financial system should be working in this day and age. There is a lot new in the financial system. It is very fast moving. The information age provides information quickly, but also the ability to move money around very fast, and so you have a very fast moving situation. And I think in such a fast moving situation, you must have players, countries, borrowers, lenders, who are responsible and accountable.

The more you deviate from responsibility and accountability, the more poorly the system will work because it is only when people do their due diligence carefully – don't loan money when there are questionable high risks, realize that you are going to be accountable if you make a mistake – that the system will work. And as soon as you get away from that principle, then the system will start misfiring, and you will start creating crises that would not have been created otherwise.

The second principle I would suggest is that the best insurer of responsibility and accountability is the marketplace, because it is relentless in its appraisal of how things are going with respect to a particular loan or economic proposition, and it makes its judgments. Certainly sometimes it swings a little more than perhaps is justified, but it comes back. And with all its pluses and its minuses, the marketplace is the best insurer of accountability and responsibility. And when you get away from the marketplace and its judgments and substitute the judgments of some managerial group, whether it is the IMF, we have all seen what has happened in centrally planned economies. People can make wrong judgments. So those are two principles.

I think what we are seeing in the IMF's behavior is a pattern of escalation. And I personally wonder where it is going, where does Mr. Camdessus think he is taking us. Go back just to the 1980s, not before that, the 1980s, we have the problems in Latin America. The U.S. government and the IMF were involved in trying to cope with those debt problems. The amounts of money used were very, very small in comparison with what is going on currently. The countries and those who had loaned the money basically were encouraged to interact together and roll over loans and extend and so on, and that is the way that worked.

I think, in retrospect, you can do a lot of second guessing of what took place, because what was on people's minds when I was present, I was kind of on the side lines, I had other things to do as Secretary of State, but I was watching. As I recall, people were very nervous about what would happen to major U.S. banks if the full dimensions of the bad loans were needed to be recognized. So to a considerable extent what was done was motivated by concern over the banks as distinct from concern over what was going to happen in Mexico, Argentina or wherever.

And it seems to me that you can argue that if the reality had been recognized earlier, maybe we wouldn't have had such a lost decade in Latin America. We do have one case study to compare with the IMF Latin American role, and that is Chile. Chile had Mr. Pinochet as its President. They got into similar troubles. They were pegged to the dollar, and the dollar got very strong in the early Reagan years, with Paul Volcker's wonderful work, the Fed, had the discipline necessary to take inflation out of the system, the dollar soared in value and Chile was pegged to the dollar. And it became untenable, and had a pattern very much like what we are seeing today, but because of Mr. Pinochet, Chile was an outcast. Nobody would help them.

The IMF wouldn't help them. We wouldn't help them. Nobody would help them. So they had to cope for themselves, which they did. They had a hard time. But by the mid-'80s, they had the only healthy economy in Latin America. So that is what you can do if you can stay away from the IMF. At any rate, that was intervention. But the scale was small compared with today.

Then we turn to the recent Mexican bailout, and as we know, suddenly the scale is up in the $40 billion range. Breathtaking. And nowadays you see people thinking you have got to have that kind of money around. But it wasn't around before. This was an innovation based on questionable governance. But all of a sudden, we are in a different ballgame.

And don't think that it isn't noticed. And don't think people didn't realize that one of the first things done in the big Mexican bailout was to take out the people who had loaned money, short-term money to Mexico at high rates, who were risky. In other words, they got returns commensurate with the risk, but then when the risk materialized, they were taken out, so Mexico didn't have to default on those loans. And that message becomes part of the atmosphere.

Following the Mexican bailout, with administration support, the IMF collected an additional fund of, I think, around $40 billion. And this was, as I read about it in the papers, to deal with, quote, future Mexicos. In other words, it was an invitation. Here is the big fund, it is an invitation. So now we are scaled up in a different way.

Then comes the Asian crisis, but we have been through all of that. And you now have very large amounts of money at play. I think it should be noted that the proposal now before the Congress was developed before the Asian crisis. So this proposal that you are dealing with was not as a result of the Asian crisis, it was in the works before and part of a pattern of escalation of the ambitions of the IMF.

As I understand it, they have around $47-, $48 billion on hand. They expect some income in the next year or so of around $20 billion. If you vote for the tranche now asked for and that is escalated up as other countries participate, they will also have an additional $85 billion or so. That will add up to around $160 billion. That is a lot of money to throw around without a charter.

So where are they going? I think that, as you see the pattern of intervention, it has gone far beyond what we saw in the 1980s, when essentially people were trying to restructure debt and in one way or another cope with the immediate balance of payments problems into an ambition to reform the way various countries run themselves.

Now, countries around the world probably could stand a lot of reform, and some people even think the United States has economic problems that should be faced up. But I wonder if this is the role of the IMF.

I was in Argentina recently. They had been telling Argentina that you have to curb your labor unions and that you ought to devalue your currency. Well, I don't know. I am sure there are a lot of managements cheering the idea of curbing the labor unions, but I don't know what business that is of the IMF really. And as for devaluing the currency, if I were in Argentina, given their history of inflation, and they have a currency board arrangement down there now that has served them well and they have got control of inflation. And it is still a question, this standard IMF advice to devalue. I think it is bad advice. But at any rate, in this ambition, we see scale and then we see intrusiveness.

If we – if we could say, stipulate that the IMF is always right, the IMF really knows what it is doing and sovereign governments really are really fallible, therefore, it is a good idea to substitute the IMF for economic policy decision of sovereign governance. Then maybe this would be a good idea, but I don't think the IMF's track record is that impressive. So when you appropriate or grant this money you are fueling these ambitions.

Now, in questions, I would be glad to try to respond on individual countries as what the IMF does and so on. But I am just trying to set out some general thoughts here. And let me set out some thoughts, saying, well, all right, if you are against this thrust, what are you for, what should be done as we have this fast moving world.

Well, I think, first of all, what needs to be done is to try to get the bailout expectations out of the system that are starting to run wild through the system. Those expectations undermine a sense of responsibility and accountability. As I have listened to people who are on the other side of this argument from me, they fundamentally agree with that point, but it is hard to know how you do it if you hold out a $100 billion fund and you are ready to intervene with it.

So you are in a dilemma. But I think back, just as in the collective bargaining example that I gave you, that if you are going to get people feeling responsible and accountable in the collective bargaining system, you have got to convince them that the government isn't going to be in there all the time telling them what to do. And, by the same token, if you are going to get the bailout mentality out of the system, you have got to remove this big overhanging amount of money.

Second, I think that it is wise to point out the fact, and I think Mr. Hinchey was saying this in some of his comments, that a lot of the things that have gone wrong have nothing to do with the new information age and all that. They have to do with classical errors, with people getting too much debt in comparison with equity, with people having short-term borrowing on one side of a transaction and long-term commitments on the other side of the transaction, with people relying on a peg to the dollar when the policies being followed don't match the U.S. policies and, therefore, strain the peg, and with an overreaching notion that somehow devaluation is an answer and is going to produce more exports, when we know through our experience that unless you accompany devaluation with a very strongly disciplined economic policy, all it does is produce inflation, and you are right back where you started from.

So there is nothing new about these problems. They are the old problems, and people need to, when they commit these sins, they need to pay for them.

I have talked to a lot of people around the world, people in the financial community. And, of course, a lot of them don't agree with what I am saying, but some do quietly. And I have heard some say, one thing we do need is some sort of a convener, because it is hard for an individual financial institution to be a convener. Sometimes it is hard for a country to be a convener. If you have an international agency that is competent, it can convene meetings and point to problems, as in the Korean situation, where lenders and borrowers were caused to come together and restructure debt and so on.

And I said, well, you mean an IMF without any money, and the guy said, yeah. I said, well, I would go for that. And there are some functions, but maybe there is a convening function for somebody to perform.

But I do also believe, especially at a time when we have the information age, when we have all of this fast moving money around, that sovereign nations are key players. And we need to respect the sovereign nations and cause them to feel that they are respected, but also are on the spot, and encourage them to regard themselves as responsible and accountable players.

Thank you, Mr. Chairman.