JEC STATEMENTS BEFORE THE INTERNATIONAL FINANCIAL INSTITUTION ADVISORY COMMISSION

Joint Economic Committee
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STATEMENT OF CHRISTOPHER FRENZE
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Chairman Meltzer and Members of the Commission, thank you for the opportunity to appear before you today to discuss some of the financial issues related to the Joint Economic Committee's (JEC) review of the International Monetary Fund (IMF). I am accompanied today by Robert Keleher, Chief Macroeconomist to the Vice Chairman, who will make the second half of our presentation before the question period. As you know, the work of the JEC in this area was initiated two years ago by Congressman Jim Saxton, who was the JEC Chairman in the last Congress and continues as Vice Chairman in the current Congress.

We do not have all the answers to questions about the IMF and its financial operations, but we have asked some of the right questions and these have produced much useful information. The public record shows that two years ago there was relatively little clear and current data on total IMF usable contributions and resources, the division of usable and nonusable resources, the U.S. contribution as a share of total usable resources, certain IMF reserves, and other data needed to adequately understand the financial operations of the IMF.

The JEC tried to change this situation by gaining more public release of IMF financial information and thus reducing incentives for excessive secrecy. Over a year ago Mr. Saxton asked the General Accounting Office (GAO) to obtain much of this information from the IMF's operational budget and other sensitive documents, and the results were presented to the Joint Economic Committee in hearings in 1998 and 1999. Shortly after the first of these two hearings, the IMF began posting much more detailed financial information on its web site.

This JEC effort to obtain increased transparency was quite successful, but much more remains to be done. The GAO has been extremely helpful, and has folded some of our additional questions about IMF lending into a new report to be released in the near future that will provide yet more detailed information. However, this commission could also be extremely effective in fostering more IMF financial transparency and facilitating the publication of additional information. The commission could direct detailed questions on IMF finances directly to the IMF to provide needed historical and current information on many aspects of IMF activities including time series of annual quota levels, lending, usable contributions, loan rollovers, interest charges, loan conditions, and so forth.

The absence of much of this information in the public domain reflects a lack of IMF transparency that is not consistent with the IMF's own transparency standards it applies to member countries. Some of this information is publicly available, but only in a fragmentary or partial form that is not readily accessible given the confusing nature of IMF financial statements.

I would like to turn to a review of part of the IMF's public financial statements and explain their format. It is our view that the IMF's financial statements were designed for use in an institutional and economic environment that no longer exists. In the current context these financial statements can be confusing and they are not fully transparent, as conceded by a member of the IMF Executive Board in congressional testimony last year. For example, the IMF does not consider its loans from its central account to be loans, so the term loan does not appear, but instead the IMF uses the term "currency purchases."

The widespread use of such obtuse concepts contributes significantly to a lack of transparency. Even so, the quarterly IMF financial statements and the IMF booklet called *Financial Organization and Operations of the IMF,* although very difficult and obtuse, are useful in reviewing IMF finances.

When new quota contributions are made 25 percent is typically paid in international reserve assets and the remaining 75 percent normally in promissory notes or letters of credit denominated in the members own currency. The reserve asset portion of the new quota subscription is added to what the fund calls the 'reserve tranche position" of the individual member. In addition, the IMF can encash the notes and letters of credit on demand to support its lending and other financial activities. These notes are reflected in a category called "IMF holdings of currencies." The quotas are part of the General Resources Account (GRA), the central account of the IMF.

The IMF is sometimes described as a cooperative or compared to a credit union, suggesting a broad-based support for lending. However, as a practical matter, the IMF is largely financed by a relatively small group of countries. In addition to their reserve positions, the IMF tends to encash the promissory notes of some countries much more heavily than others.

On the other hand, many other nations withdraw their reserve position, leaving all of their quota essentially in promissory notes. Nations can even borrow their reserve payments under quota increases, and then immediately withdraw these borrowed funds and repay borrowers. In this way they technically comply with IMF membership requirements but provide little or no usable resources to the IMF. Incidentally, the Exchange Stabilization Fund (ESF) has apparently been used to facilitate such borrowing.

The first entry in the briefing books we have provided is an overview of IMF finances from the quarter ending April 30, 1999. The last page of this overview contains a line item for the United States denominated in SDRs. As one can see, the quota of the U.S. is 37 billion SDRs, equal to about 50 billion dollars. The U.S. has 17 billion SDRs, or 46 percent, of its quota in its reserve position. The remaining 20 billion SDRs (54 percent) is in the column under IMF's holding of currencies. The amounts in this category are largely promissory notes and letters of credit.

Quotas, IMF's Holdings of Currencies, and Reserve Tranch Positions
As of April 30, 1999
(In Thousands of SDRs.)

	General Resources Account			
		IMF's Holdings of Currencies		
Member	**Quota**	**Total**	**Percent of Quota**	**Reserve Tranch Position**
United States	37,149,300	20,082,770	54.1	17,061,852
Ukraine	1,372,000	3,341,372	243.5	7
Turkemenistan	48,000	48,000	100	5

Source: International Monetary Fund

In other words, the sum of a *creditor* country's reserve position and IMF holdings of its currency is the amount of the quota. If the IMF were to encash more U.S. promissory notes this would raise the amount of the U.S. reserve tranche position and lower the amount of Fund holdings of currencies correspondingly.

The entry for Ukraine reflects the position of a net borrowing country. The Ukraine's quota is 1.4 billion SDRs, with virtually none of it in the reserve tranche position, but instead under IMF holdings of currencies. The Ukraine has provided what is essentially an IOU to the IMF equivalent to its borrowings of about 2 billion SDRs secured by its domestic currency provided to the Fund. This is reflected in the holdings of currencies; this amount is the sum of virtually all of the Ukraine's quota plus the value of its borrowing from the IMF. Borrowing countries typically have withdrawn most or all of their reserve positions so virtually all of their quota is in IMF holdings of currency. The amounts borrowed, reflected in domestic currency securing the loans, also are added in this category.

The case of Turkemenistan reflects the position of a member that is neither a creditor nor a borrower. This country has virtually no reserve tranche position and is not a borrower. Virtually all of its quota is in "holdings of currencies." This country currently is neither a creditor nor a borrower member.

This discussion may seem quite dry if not tedious, but provides a useful framework for review of the public IMF financial statements. As one scans through the statement of members' financial positions from the quarterly reports of the IMF, it is clear which countries maintain large reserve tranche positions providing support for IMF operations, and which on the other hand provide little or no support. The lower the percent of quota held in currencies, the higher the member's reserve position and relative degree of financial support for the IMF. On the other hand, it can be readily seen that many countries have all or nearly all of their quota in holdings of currency, meaning they have little or no reserve position to participate in the financing of IMF operations.

When the holding of currencies approaches or exceeds 100 percent, this typically means the member's reserve position is very low or zero. Nearly half of the IMF members currently maintain little or no reserve position, even after a recent quota increase. This suggests that the borrowing and immediate withdrawal of reserves required under a quota increase is quite widespread. The presence of these members does, however, provide a ready pool of current and potential future borrowers; about half the IMF's membership are current borrowers.

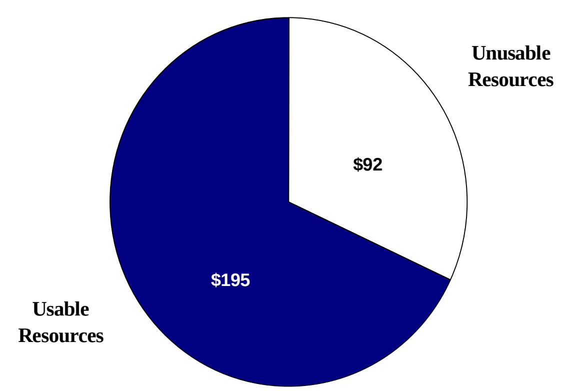
As previously noted, the reserve positions supply the funds for IMF lending. At the bottom of this statement from the IMF quarterly report, one can see the total of 63 billion SDRs in the reserve position, and 61 billion SDRs loaned from these contributions.

A separate issue regards the portion of quotas that can be used by the IMF for its lending. The public financial statements do not reflect the fact that many of the members have provided quota contributions, which are not regarded as usable by the IMF. In the IMF's confidential operational budget, the division is made between usable and nonusable resources. This is a critical distinction and has important implications for allocating the actual sources of funding for

IMF operations. This was one of the first pieces of information Mr. Saxton asked the GAO to obtain from the IMF through a review of the operational budget. The level of usable contributions is needed to know the amount of actual resources available to the IMF before lending, and also to gain a more accurate view of the financing burden borne by the donor nations.

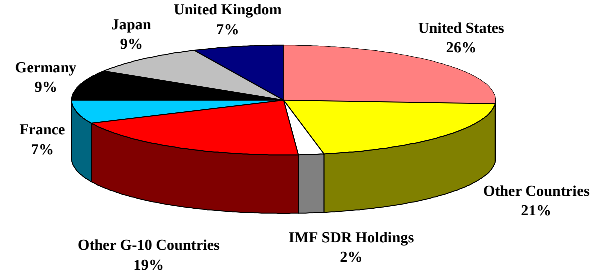
This graph presented shows the usable and nonusable contributions. Of $287 billion of total contributions, $195 billion is usable and $92 billion is unusable. As noted previously, nearly half of the IMF members do not have significant reserve positions, and many of these also would not have currencies that would be deemed usable by the IMF in the operational budget.

IMF Estimated Usable and Unusable Resources



Once the level of usable resources is determined, an accurate picture of the IMF's sources of funds can be provided. The second graph displayed shows the portion of usable resources contributed by the major creditor nations. As shown, the G-10 nations supply 77 percent of the IMF's usable funds in its main account. The other 171 member nations supply about 21 percent of the usable funds. This graph shows the actual burden of financing once the nonusable quota subscriptions of many members are set aside.

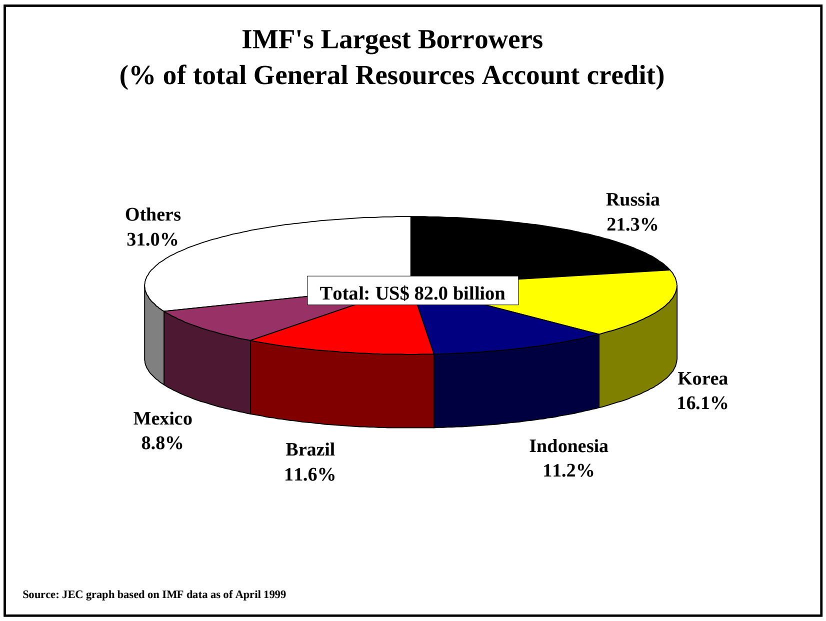
G-10 and Other IMF Members' Usable Resources



Source: General Accounting Office, Data as of April 30, 1999

The official line is that the U.S. provides 18 percent of the quotas, but the U.S. share of usable contributions is actually 26 percent. This relatively large U.S. position is reflected in the strong influence of the U.S. Treasury in IMF decision making. This graph illustrates the preeminent U.S. position, but also the high overall concentration in IMF financing, as opposed to the notion of broadly-shared financing often conveyed through the public quota statistics.

IMF lending is also highly concentrated. The next graph shows that the top 5 users of credit from the main IMF account for 70 percent of its outstanding credit. Russia and Indonesia together account for fully one third of these outstanding loans. The potential exposure of the IMF and its creditors from this high concentration of IMF lending is considerable. The relaxation of past IMF standards capping borrowing at 100 percent of member quota has led to the current situation. Borrowing can now be several hundred percent of quota contributions as more recent annual quota limits have also been further relaxed in recent years.



In summary, both IMF usable contributions and IMF lending are highly concentrated. A core group of advanced industrial nations is the primary source of funds. A distinct and much larger group of current and potential borrowers exist, most of who do not provide significant financial support for IMF activities. Even so, the IMF’s lending is highly concentrated, with politically and socially unstable borrowers currently accounting for a large share of outstanding credit.

I would like to close on a related issue that may be of interest. Our review of IMF procedures found last year no evidence of credible IMF procedures to monitor or track the use of IMF loan proceeds. Mr. Saxton took note of the lack of accounting safeguards a year ago in connection with the loans to Russia, now the subject of several inquires. A letter from Majority Leader Armey and Mr. Saxton last March to then Secretary Rubin in connection with the new Russian loan asked for a public disclosure and explanation of any such accounting controls, but none was forthcoming.

Thus it appears that when the IMF disburses funds to a member's central bank, it does not really have an independent way of knowing exactly what happens to it after that point. Perhaps such accounting safeguards would be difficult or unfeasible to administer, but their absence would seem to require a much higher degree of vigilance and effort to protect taxpayer funds from potential misuse. Clearly the loaning of billions of dollars to countries with pervasive corruption problems would run the risk that at least some of it would be misused. In the absence of such accounting controls, it is not clear what procedures the IMF has available to ensure that significant misuse of loan proceeds does not occur aside from simply not making a loan in such cases.

The second part of our presentation by Robert Keleher will focus on the costs of U.S. participation in the IMF, along with several related issues.

STATEMENT OF DR. ROBERT KELEHER
CHIEF MACROECONOMIST TO THE VICE CHAIRMAN
JOINT ECONOMIC COMMITTEE

INTRODUCTION

The Joint Economic Committee's (JEC) focus or interest in analyzing the International Monetary Fund (IMF) has *not* been to examine the specific details of loans or conditional loan programs in Russia, Indonesia, Thailand, Brazil, Korea or any other country. Rather, the JEC has focused on various aspects of the IMF *itself*.

In particular, we focused on the IMF's financial structure, the way the institution operates, and the costs of U.S. participation of the IMF. In our view, before Congressional policymakers can make sensible decisions about future IMF funding, IMF gold sales, or make constructive recommendations for reform, some essential, yet understandable information about how the IMF functions is required. In other words, information about, and some understanding of the institution is a prerequisite for sensible reform.

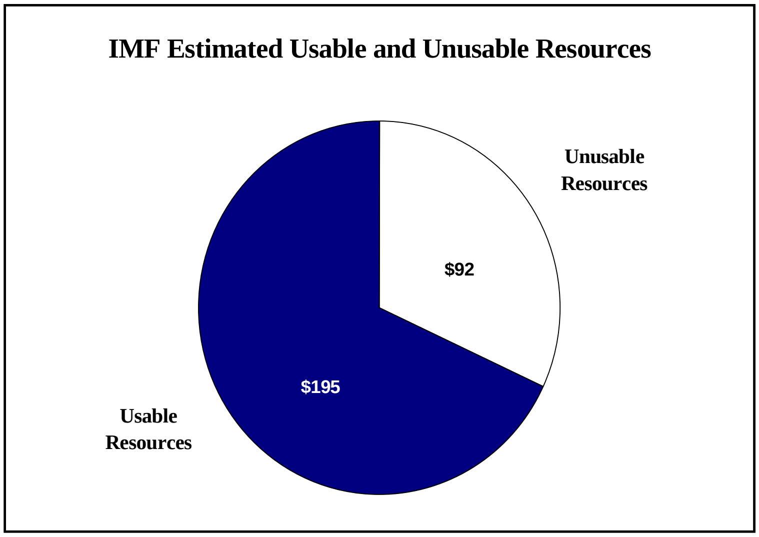
One of our goals was to highlight this relevant information; in a sense, to bring more transparency to the IMF. This has occurred in part through a series of JEC hearings, studies, and press releases. The JEC has used these vehicles of communication to highlight the resources available to the IMF, how the IMF's financial structure operates, and what is especially relevant to the Congress and the public, the costs of U.S. participation in the IMF.

On the other hand, we view our efforts as "work in progress" and as outsiders without access to confidential IMF information, do not pretend to have complete knowledge of the workings of the IMF.

With this in mind, I will quickly review IMF available resources (as requested by Chairman Meltzer); summarize some lessons we have learned about the costs of U.S. participation; and make some brief comments about the IMF's financial structure.

I. IMF AVAILABLE RESOURCES

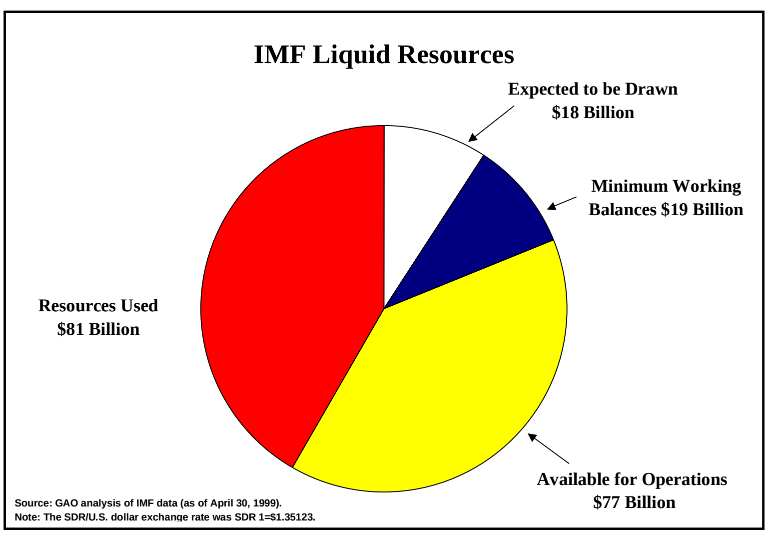
I have some charts I will be referring to in order to help illustrate my points. As my first chart demonstrates, the total resources available to the IMF are now about $287 billion. These are the total resources in the IMF's General Resources Account (GRA) obtained primarily from quotas.



The United States contributes 17.7% of the total, which is the largest share of all the IMF member countries. This percentage is the oft-cited contribution that importantly determines voting rights.

Of the total $287 billion, the IMF deems a sizable portion ($92 billion) to be unusable, leaving $195 billion as usable. This *unusable* portion is about 1/3 of the total and consists of the currencies of those contributions not sufficiently strong economically to permit their currencies to be used for IMF operations.

As the next chart illustrates, this leaves $195 billion as usable resources. Of the $195 billion, $81 billion is outstanding credit already extended (leaving $114 billion), $18 billion has been committed to countries needing assistance, and $19 billion is deemed necessary for minimum working balances. This leaves $77 billion available for additional credit to IMF members.



This $77 billion figure does *not* include three other possible funding sources. First, the IMF can borrow from members. The General Arrangements to Borrow (GAB) and the New Arrangements to Borrow (NAB) currently amount to $46 billion. Second, the IMF can borrow from credit markets which conservative estimates suggest could amount to $70 - $80 billion or more. Third, potential gold sales are an option which over the long term, could amount to about $26-$27 billion. Therefore, depending on how much of these additional resources are deemed (practically) obtainable, current usable IMF resources amount to anywhere from $77 billion to roughly in the neighborhood of $200 billion.

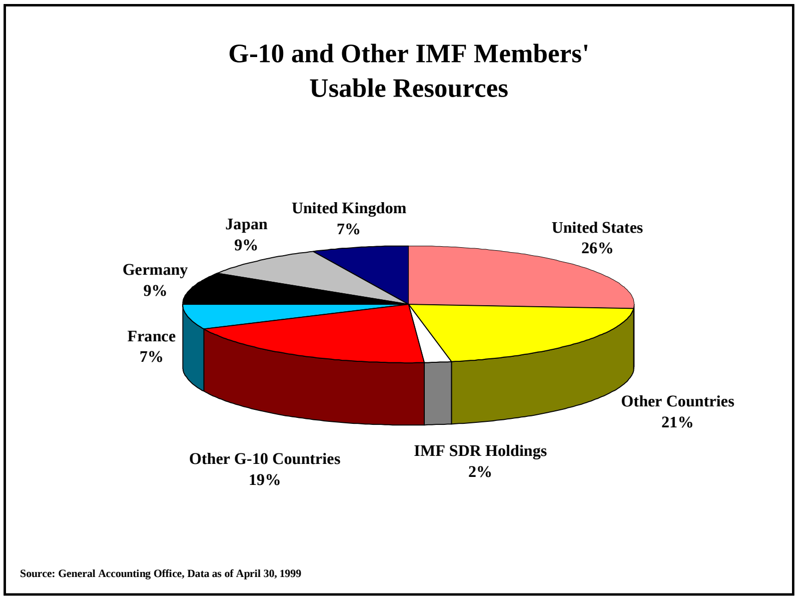
II. LESSONS ABOUT THE COSTS OF U.S. PARTICIPATION

As I mentioned earlier, another critical question for Congress and taxpayers relates to the cost of U.S. participation in the IMF. In examining this issue, we learned a number of lessons about these costs that I would like to briefly summarize for you this afternoon. As background, however, the U.S. contributes about 17.7 percent of total IMF quota subscriptions. It is this 17.7 percent figure that importantly determines the voting rights of IMF member countries and is often equated to, or identified as, the member country's official financial contribution.

However, the actual costs of U.S. participation in the IMF differ from this widely-cited 17.7 percent figure. In particular, evidence indicates that the U.S. is shouldering a larger burden than suggested by this figure. These additional costs are often inadvertently obscured by accounting practices and procedures as well as by difficulties in calculating various hidden costs, opportunity costs, subsidies, or risk factors.

Some of the lessons learned about the costs of U.S. participation in the IMF include the following: First, the U.S. contributes about 26 percent of *usable* financial resources to the IMF. As mentioned earlier, the IMF deems about 1/3 of member currency contributions to be "unusable" for IMF usage. Once you set aside these unusable currencies, the U.S. share of usable IMF quota contributions rises to about 26 percent, i.e., the U.S. contributes 26 percent of usable IMF quotas. Since this figure represents the proportion of those contributions that actually can be used for lending, it is economically more meaningful than the 17.7 percent figure. An implication is that the U.S. is contributing a higher percentage of usable resources than its voting shares would suggest.

The next chart shows the usable resource contributions of key IMF members. Of usable IMF resources, the U.S. contributes 26 percent, by far the largest contributed share. The next largest countries' contributed share are Germany's 9 percent and Japan's 9 percent. In other words, the United States' share is almost triple the size of the next largest member's share. It is also worthy to note that the G-10 countries' contributions to the IMF's usable resources clearly dominate all other sources. (The G-10 total is about 77 percent.) The implication is that IMF lending is largely being financed by a relatively small number of industrialized economies. As far as *usable* resources, then, the IMF does *not* have the broad-based support that is often suggested in the literature.



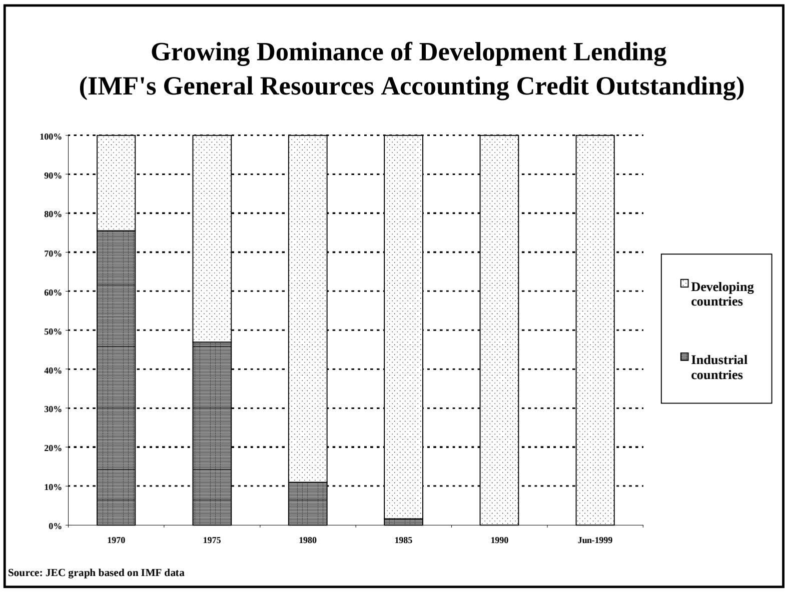
Second, the U.S. share of contributions to the GAB credit line is also significantly higher than its share of quota contributions: the U.S. share of this credit line commitment is about 25 percent. This commitment's share also *exceeds* the oft-cited quota-based, voting rights share (of 17.7 percent).

Third, the U.S. is remunerated for (part of) its reserve tranche position. This rate of remuneration, however, is at a rate of interest *below* that of comparable U.S. Treasury rates and therefore involves a subsidy. The current rate of interest remunerated on U.S. funds is about 3.4 percent. In other words, the U.S. government is lending at more favorable rates than the cost of money to the government. This subsidy should be recognized as a cost. In fact, the *President's Commission on Budget Concepts* defines the budget cost of an "exchange of assets" program as the difference between the Treasury's cost of funds for the term of the provision of resources and its rate of remuneration. (The Treasury rate minus the remuneration rate equals the cost.) Conservative estimates of this cost suggest it is not trivial; it could be as high as hundreds of millions of dollars per year.

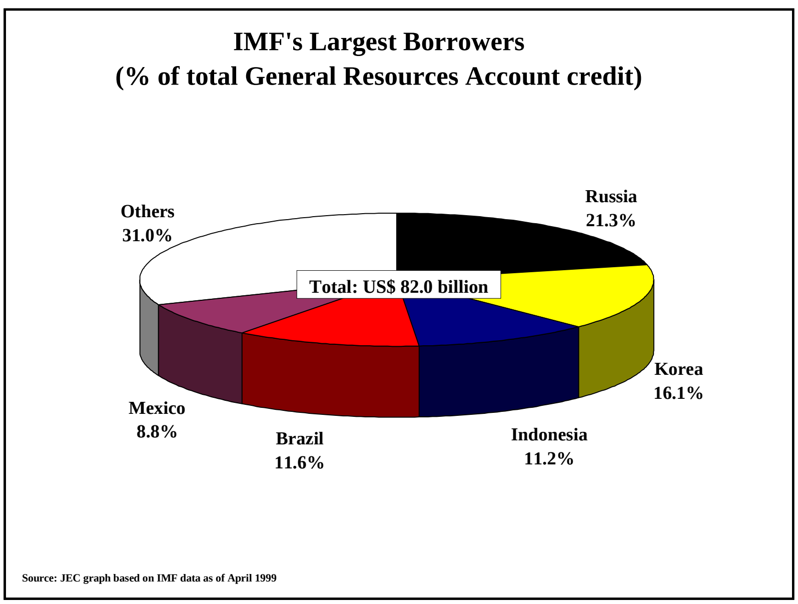
The United States also has a non-remunerated portion of its reserve position that (percentage-wise) involves an even larger subsidy. This unremunerated portion of the U.S. reserve position amounts to about $2.3 billion. The cumulative value of lost interest payments (from 1975-1999) may amount to several billion dollars. (A GAO witness estimated it to be $3.5 billion, but some private sources think it is even larger.) In any case, these costs are non-trivial and are not generally recognized by policymakers, the public, or taxpayers.

Fourth, IMF remunerations do not adequately reflect the increased riskiness of IMF lending. IMF lending however, has become riskier over time. Earlier, the IMF made relatively safe, short-term (low-risk) loans to high-grade industrial countries (such as the UK, France, or Italy). Recently, it increasingly has made significantly higher-risk, longer-term loans to lower-rated countries such as Russia, Indonesia, Brazil, Mexico, or Korea.

The next chart shows how IMF lending has changed over time from industrialized to developing country lending. As you can see, in earlier periods, more loans were made to industrial countries than is now the case. Currently, almost all loans are made to developing countries.



The next chart shows the IMF's largest borrowers. At times, the IMF loan portfolio has become highly concentrated with loans to riskier developing countries like Russia, Indonesia, Brazil, Mexico, and Korea. This has occurred as lending limits have been raised substantially. Note that almost 70 percent of current IMF lending goes to only five countries and 1/3 of these loans go to Russia and Indonesia alone.



Note that these loans are not only riskier, lower-rated borrowers and highly concentrated, but also longer-term in nature. Since these higher risks expose the lender, lenders should be compensated for these higher risks. But this risk factor is generally not reflected in interest rates received by lenders to the IMF. This uncompensated risk factor is (in effect) another form of subsidy and cost borne by lenders such as the U.S. (and its taxpayers). This cost is yet another cost that is not generally recognized by Congress, the public, or taxpayers.

Fifth, I will simply mention that unrestituted gold sales can entail substantial costs to U.S. taxpayers.

In short, the sum of these costs can be substantial. There are several dimensions to the costs of U.S. participation in the IMF that policymakers, taxpayers, and the public should understand. These include a substantial shouldering of usable financial contributions and commitments to the IMF that exceed the oft-cited voting rights share, the costs of subsidized interest rates, the cost of the absorption of risk, and aspects of gold sales. Conservative estimates suggest that the costs of U.S. participation in the IMF are substantial, in the neighborhood of half a billion dollar per year. (Notably, the best quantitative estimates can be found in Adam Lerrick's study for the Bretton Woods Committee.)

All of this suggests that the United States is shouldering a significantly higher proportion of the IMF's financial resources than the oft-cited 17.7 percent quota share would suggest. Furthermore, these facts have not been transparent to policymakers, the public, or the taxpayer. These costs to the U.S. taxpayer too often have been understated, or obscured (perhaps inadvertently) by IMF accounting practices and procedures.

III. SOME BRIEF COMMENTS ON THE IMF'S FINANCIAL STRUCTURE

Finally, in addition to these costs, it is important to highlight the changing nature of the IMF financial structure. I have mentioned earlier about IMF lending and borrowing. IMF lending has become increasingly concentrated with longer-term, riskier borrowing from developing countries than was earlier the case. At the same time, usable resources of the IMF are largely provided by a relatively small group of industrialized countries. In fact, the IMF does not have broad-based financial support as is often reported. As much as 77 percent of IMF usable resources are supplied by the G-10 countries. In short, the IMF is a much different institution than was earlier the case: the IMF is using resources from a small number of industrialized countries and lending this money to a small number of risky developing countries at subsidized interest rates.

CONCLUSION

In conclusion, there are many dimensions to the costs of U.S. participation in the IMF that policymakers and the taxpaying public should understand. I have tried to summarize several important aspects of these costs this afternoon.