

S. HRG. 106-657

**THE MELTZER COMMISSION: THE FUTURE OF
THE IMF AND WORLD BANK**

HEARING
BEFORE THE
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE
ONE HUNDRED SIXTH CONGRESS
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TUESDAY, MAY 23, 2000

U.S. SENATE,
COMMITTEE ON FOREIGN RELATIONS,
Washington, DC.

The committee met at 3:05 p.m., in room SD-419, Dirksen Senate Office Building, Hon. Chuck Hagel, presiding.

Present: Senators Hagel, Chafee, and Wellstone.

Senator HAGEL. Good afternoon. This afternoon, the Foreign Relations Committee will continue to exercise its oversight authority over U.S. participation in various international financial institutions. We will hear from three members of the International Financial Institution Advisory Commission, which recently issued majority and minority reports on what kinds of reforms should be made in these international financial institutions.

In October 1998, Congress voted an \$18 billion replenishment for the International Monetary Fund. The money was predicated on reforms of the IMF that included, among other provisions, improved fund transparency and market-based lending rates for borrowing nations. Congress also decided to commission a thorough review of the world's international financial institutions.

The International Financial Institution Advisory Commission was tasked with studying seven international financial institutions: the International Monetary Fund, the World Bank, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the World Trade Organization, and the Bank for International Settlements.

The Commission was chaired by our first witness, Professor Allan Meltzer. He is the Allan H. Meltzer Professor of Political Economy at Carnegie Mellon University and is a visiting scholar at the American Enterprise Institute. From 1988 to 1989, Dr. Meltzer served as an acting member of the President's Council of Economic Advisers. He was also a member of the President's Economic Policy Advisory Board and has advised and consulted for central banks, governments, and international financial institutions. Welcome, Doctor.

Dr. MELTZER. Thank you.

Senator HAGEL. Our second witness is Professor Charles Calomiris. Dr. Calomiris is a Professor of Finance and Economics at the Columbia University Graduate School of Business, and also teaches at Columbia University School of International and Public Affairs. He co-directs the Project on Financial Deregulation at the American Enterprise Institute and is a research associate of the

National Bureau of Economic Research. Doctor, we welcome you as well.

Dr. CALOMIRIS. Thank you.

Senator HAGEL. Our third witness is Professor Jerome Levinson. Dr. Levinson is one of the authors¹ of the three-person minority report that disagreed with the major recommendations contained in the majority report. Dr. Levinson is presently the Distinguished Lawyer in Residence at American University's Washington College of Law, where he has been for the last 5 years. Professor Levinson has a long, distinguished public service career. He served as chief counsel to Senator Church's subcommittee on the Senate Foreign Relations Committee and was general counsel to the Inter-American Development Bank. Sir, welcome to you as well.

Dr. LEVINSON. Thank you.

Senator HAGEL. As policymakers and in concert with our fellow members of these organizations that were included in the study, it is Congress' responsibility to translate the Commission's thoughtful recommendations into appropriate policies and procedures.

There were certain basic reforms that received consensus support on the Commission. These included a sharp distinction between lending programs of the IMF and World Bank, greater transparency in the programs of the international financial institutions, the need for stronger banking systems in developing countries, and support for debt relief for highly indebted poor countries [HIPC]. These are the kinds of reforms that have broad support both in the Congress and in the administration.

However, the Commission was sharply split on several more controversial recommendations. The Commission's majority report also called for changes in the most basic structure and programs of the IMF and the World Bank. These included turning all IMF loans into extremely short-term loans with maturities of no longer than 240 days. It called for permitting the IMF to lend only to countries that prequalified, no matter what kind of financial crisis the world was facing. Finally, it called for getting the World Bank out of the lending business and transforming it into a grant-making institution.

The committee looks forward to a discussion of these recommendations and gaining a better understanding of what reforms are achievable, what are relevant and could gain consensus support within the United States and among our G-7 country allies.

Before turning to our panel, I want to again thank each of you for taking your time, for your service to this country, and especially for the time that you all devoted in this study. We on this committee, as you know, have primary jurisdiction over most of these issues and we work in conjunction with the Senate Banking Committee and other tangential, sequential jurisdiction committees, but it is the primary responsibility for this committee to understand better what these recommendations are and how we might, in fact, benefit in actually implementing what you have done and what you are suggesting and take the time required, working with Treasury and other important parts of our Government, to in fact weave into

¹Dr. C. Fred Bergsten, a co-author of the minority report, was scheduled to testify but was unable to attend due to personal reasons. His prepared statement, which includes the full dissenting statement, begins on page 47.

the IMF these kinds of important and relevant recommendations based on the relevant challenges of our time.

I have said, when we have had oversight committee hearings before, that international financial institutions should be, in fact, relevant to the challenges of our day, and what has occurred in this amazing world of ours over the last 50 years, since the days of Bretton Woods and the institution of IMF and the World Bank, have brought us to a point where we have come to ask people who have spent lifetimes in your business how best we can use these institutions and how best we can apply the infrastructure, the resources to these new challenges of this new dynamic world.

So, that in essence is something that I think this committee is primarily interested in hearing from you. Most of us on this committee and our staffs have had an opportunity to get through those recommendations. I would hope that the effort that your Commission made will not end up like so many efforts of so many commissions around here: We have two or three more hearings and then we never hear from it again. I think it is more important than that, and I would hope that you could dwell and focus on that practical aspect of what you have come forward with and how it could be incorporated and woven into this realistic pursuit of helping nations.

So, again, thank you all, and Dr. Meltzer, I would ask you to begin.

STATEMENT OF DR. ALLAN H. MELTZER, CHAIRMAN, INTERNATIONAL FINANCIAL INSTITUTION ADVISORY COMMISSION; PROFESSOR OF POLITICAL ECONOMY, CARNEGIE MELLON UNIVERSITY; AND VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. MELTZER. Thank you very much. Of course, the last part of your remarks, Senator, are dear to our hearts. Having done this work, we certainly hope that it will have some impact on the way in which these organizations function, not just because we did the work, but because we believe so many of these recommendations are in the interest of the United States, as well as the broader interest of the United States in its role in the global community.

It is a privilege to testify before this distinguished committee on the report of the International Financial Institution Advisory Commission. Although the Commission was charged with making recommendations on seven different institutions, I will confine my remarks to two, the IMF and the World Bank, although I will be glad to answer questions about the others.

The Commission's report became available almost 3 months ago. It has been discussed and appraised extensively in the press both here and abroad, by the U.S. Treasury Department, foreign governments, and central banks, in public discussion and in the Congress. I believe this is the fifth hearing that Congress has held on the report, a recognition not only of the importance of the issues but the widespread recognition that reforms are needed.

I have followed discussion of the Commission's report closely. While there are many counter-currents, I believe it is fair to say that there is a very broad agreement that the IMF and the World Bank should be reformed and that the Commission's report is a proper starting point for such reform. The same bipartisan ap-

proach that was present within the Commission now characterizes many discussions of our conclusions.

The two most important problems that the Commission faced were, one, how to make the world economy more stable, less subject to the frequent, deep, and widespread economic crises that the world economy experienced in the 1980's and 1990's, and two, how to make more effective development aid to impoverished people while improving their opportunities and living standards. A subsidiary but important issue was reform of the institutions to make them more transparent, more accountable, and more efficient.

I will spend most of my time on the IMF. The main questions about the IMF are: Why have crises become more frequent and deeper, affecting many more countries in the last 20 years? What could a restructured IMF do to make crises less frequent, less severe, and less widespread? Before answering these questions, I will comment on why these questions are important to Americans and why the Congress, the administration, and the public have a major stake in the answers.

Many commentators talk about the IMF's successful performance. The Latin American debt crisis took most of a decade to resolve. Asia recovered much faster. Does the IMF deserve full credit for the speedy recovery in Asia?

I submit that the answer is no. The United States played a major role. We became, once again, the importer of first resort in a crisis. U.S. imports of goods soared; our exports fell in 1998 and grew very slowly in 1999. The U.S. current account deficit rose from about \$150 billion in 1997 to a current annual rate of \$400 billion. That \$250 billion swing is a key way we helped to strengthen the world economy.

I have distributed a chart,² that is in my paper, which shows what happened to the current account deficit. It looks as though someone tied a rock to the bottom of the line with a heavy weight and pulled it down. The chart shows what happened to net exports of goods and services. Unwinding this swing will be a major challenge to the U.S. and other economies in the next few years.

Let me leave no doubt. I believe that running the extraordinary trade deficit and allowing the dollar to appreciate against other currencies was the proper policy under the circumstances we faced then. Preventing or restricting imports would have been counter to both our narrow interest and our broader interest in general prosperity.

For some Americans, this policy was costly, however. Farmers are an example. Sugar and soybeans, wheat, and other commodities are priced worldwide in dollars. When Brazil devalued against the dollar, Brazilian soybeans and sugar became cheap temporarily compared to the U.S. produced sugar and soybeans. Canadian, Australian and other growers of wheat gained a temporary advantage over U.S. farmers growing wheat when their currencies depreciated against the dollar. The same is true for industrial producers. Appreciation of the dollar permits U.S. manufacturers to buy components or assemblies more cheaply from foreign suppliers, reducing their cost, but it also reduces sales by domestic manufacturers of

²The chart referred to is in Dr. Meltzer's prepared statement on page 9.

these same inputs. U.S. exporters face tougher competition when selling abroad, while foreign producers increase their share of the U.S. market.

To reduce the U.S. role as importer of first resort in a crisis, we must change the role of the IMF. It must go from managing crises to preventing them or, since complete prevention is unlikely, making them less virulent, less widespread, less harmful, and less frequent.

The commission addressed this problem by proposing an incentive-based system that encourages and rewards countries with good behavior. It began by identifying three major causes of deep and prolonged crises. They are, one, the collapse of the exchange rate, requiring substantial devaluation; second, collapse of the financial system, requiring large loans to shore up the remnants; and three, the long-term delay, often months, before the IMF and the desperate country agree on the many conditions that the country must accept to get assistance. Since the agreed conditions are often not met in practice, replacing the long negotiation with preconditions is an improvement.

The commission proposed four preconditions, reforms that countries must complete to qualify for immediate assistance in crises. The four preconditions require countries to strengthen their financial systems, improve their fiscal or budget policies, and provide timely information about their outstanding sovereign debt. Countries would have 5 years to phase in the conditions. Countries that met the preconditions would be less subject to crises.

I must admit that I am disappointed and disheartened by the Treasury's initial response. On the positive side, they have agreed that the preconditions are desirable. But they have spoken repeatedly about how only a small number of countries would adopt the conditions. They fail to notice that 50 countries, nearly a third of the IMF's membership and many of its larger members, already meet or accept one of the politically most difficult conditions, requiring full access of foreign financial institutions to the country's markets.

Equally disturbing, the Treasury's position would keep the U.S. as importer of first resort. It fails to protect the U.S. economy from the temporary losses to U.S.-based producers from the flood of imports and the loss of exports during the adjustment to exchange rate changes. This neglect or oversight is particularly surprising because in the last 2 years the Congress has given substantial assistance to affected groups, such as farmers and most recently sugar producers. This assistance compensates for some of the losses these groups sustained during this most recent crisis.

Further, the Treasury fails to recognize the improved incentives that countries and lenders would face under the proposed reforms. Once the preconditions have been phased in, the IMF would list the countries that met the conditions and those that did not. Countries meeting the conditions would have much greater opportunities to borrow in the capital markets and, because they would be less risky, they would borrow on more favorable terms. Countries that failed to meet the preconditions would receive less capital and would have to pay higher rates of return to compensate for their higher risk. In this way, markets would work to encourage reform.

All countries would not meet the standards. Let me suggest some examples of countries that are unlikely to do so. Ecuador and Pakistan have not been able to maintain a stable government. They have not had sufficient political stability to enact reforms like the preconditions. Some governments are venal and corrupt. It is unfortunate but true. They promise the IMF that they will make changes, but they are either unwilling or unable to do so. Ukraine and Russia are examples, but they are not alone.

Under the Commission's proposals, the IMF would not bail out countries like Ecuador, Pakistan, Russia, and Ukraine until they put in place reforms that strengthen their financial and fiscal systems. The acceptance and implementation of reform, not the promise of reform, works to increase economic stability and reduce crises. After the 5-year phase-in has passed, lenders to highly risky countries should expect to take the losses their positions imposed on them. That is why they received high returns. There is no problem of bailing them in. They are bailed in. The question is should they be bailed out? The answer of the Commission is no. They took the risk. They should be allowed to suffer the consequences. In a crisis, however, the IMF would lend, as needed, to countries affected by the crisis, but it would not generally lend to the crisis country if it has not met the preconditions. In a system-wide crisis, the Commission proposes to suspend the rules, lending as needed to stem the crisis.

Under Secretary Geithner, testifying before the Senate Banking Committee, said that the last process, permitting the IMF to waive the rules, would mean that the Commission's proposals might not differ from current practice. This statement is remarkable for two reasons. First, it fails to recognize that the U.S., the IMF, and the G-7 cannot force countries to reform. Reforms may be imposed, but they do not last unless the country chooses to maintain them and works to do so. Second, it fails to recognize that many countries would choose reform so as to attract foreign lenders and investors. Foreign lenders are the principal suppliers of capital. A country that fails to reform, and knowledge that the lender truly bears the risk of loss, would reduce a country's access to capital. Very little capital flows to sub-Saharan Africa. Very little, if any, went to Peru prior to the reforms instituted by the first Fujimori government. Lenders make mistakes, but they do not fail to recognize risk or fail to charge a premium for bearing it.

We, the United States, have a major interest in global stability. We must insist on reform of the international financial system. I note quickly that the Commission made other recommendations for changes at the IMF. It should improve the quantity, quality, and timeliness of information about member countries. It should improve transparency about its own operations. An ordinary person should be able to read the amount of loans it has outstanding, how much it has available in usable currencies to lend, and how much it costs to operate the institution. Further, the Commission agreed unanimously that the IMF should stop long-term lending and close the Poverty Reduction and Growth Facility, as you mentioned earlier.

I have reviewed the draft of S. 2382, the Technical Assistance, Trade Promotion, and Anti-Corruption Act of 2000. I find few of the

needed reforms. S. 2382 would do little to reduce the risk of financial and economic crises or the role of the United States as importer of first resort in a crisis, or the cost of crises to American farmers, manufacturers, and workers.

Let me turn to the World Bank. Long-term loans for emerging market economies should be the responsibility of the development banks. The Commission shares the World Bank's view that its mission and the mission of other development banks should be reduction of poverty in developing countries.

The Commission report asks four major reforms of these banks because they are ineffective and greatly overstaffed. Many of the professionals are dedicated to their tasks. The problem is to change the incentives under which they operate to improve their performance. In his testimony before the Commission, President Wolfensohn agreed on the need for improved performance.

The Commission proposed three main tasks for the development banks: one, to supply global public goods such as elimination of tropical diseases or improvements in tropical agriculture; two, promote economic and social development using an incentive-based system that subsidizes institutional reform and gives incentives for implementing and maintaining reforms—and I want to emphasize maintaining reforms—and three, use grants instead of loans to improve the quality of life in the poorest countries by inoculating children, providing sanitary sewers, bringing potable water to the villages, and in other ways.

The Commission proposed that the grants would be paid directly to service providers, on evidence of completion furnished by independent auditors. Grants would bypass corrupt governments; auditing results would improve performance. This is a much more effective mechanism for reform than is proposed in S. 2382.

The Commission believes that a very important first step toward reform of the bank would be an independent audit of the bank's performance. The bank provides almost no information about the success or failure of its projects after final disbursement of its loans. S. 2382 calls for a financial audit. This is a good first step, but it is not enough. Although the Commission did not propose an independent performance audit of the development bank's operations, I urge the Congress to require such an audit as a condition for additional U.S. assistance.

Finally, the Commission agreed unanimously that the present HIPC debts be written off completely in all countries that adopt and implement effective development programs.

Thank you.

[The prepared statement of Dr. Meltzer follows:]

PREPARED STATEMENT OF DR. ALLAN H. MELTZER

It is a privilege to testify before this distinguished committee on the report of the International Financial Institution Advisory Commission. Although the Commission was charged with making recommendations on seven different institutions, I will confine my remarks to two—the IMF and the World Bank.

The Commission's report became available almost three months ago. It has been discussed and appraised extensively in the press both here and abroad, by the U.S. Treasury Department, foreign governments and central banks, in public discussion, and in the Congress. I believe this is the fifth hearing that Congress has held on the report, a recognition not only of the importance of the issues but the widespread recognition that reforms are needed.

The IMF and the Bank are now more than fifty years old. They have evolved and changed in response to events, without any systematic thinking about what they do well, what needs to be done, what should be left to private sector institutions, and what governments or multinational institutions can and should do.

I have followed discussion of the Commission's report closely. While there are many counter-currents, I believe it is fair to say that there is very broad agreement that the IMF and the Bank should be reformed and that the Commission's report is a proper starting point for such reform. The same bipartisan approach that was present within the Commission now characterizes many discussions of our conclusions.

The two most important problems that the Commission faced were: (1) how to make the world economy more stable, less subject to the frequent, deep and widespread economic crises that the world economy experienced in the 1980s and 1990s, and (2) how to make more effective the development of aid to impoverished people while improving their opportunities and living standards. A subsidiary but important issue was reform of the institutions to make them more transparent, more accountable, and more efficient.

IMF

I will spend most of my time on the IMF. The main questions about the IMF are: why have crises become more frequent and deeper, affecting many more countries in the last twenty years? What could a restructured IMF do to make crises less frequent, less severe, and less widespread? Before answering these questions, I will comment on why these questions are important to Americans and why the Congress, the administration, and the public have a major stake in the answers.

Many commentators talk about the IMF's successful performance. The Latin American debt crisis took most of a decade to resolve. Asia recovered much faster. Does the IMF deserve full credit for the speedy recovery in Asia?

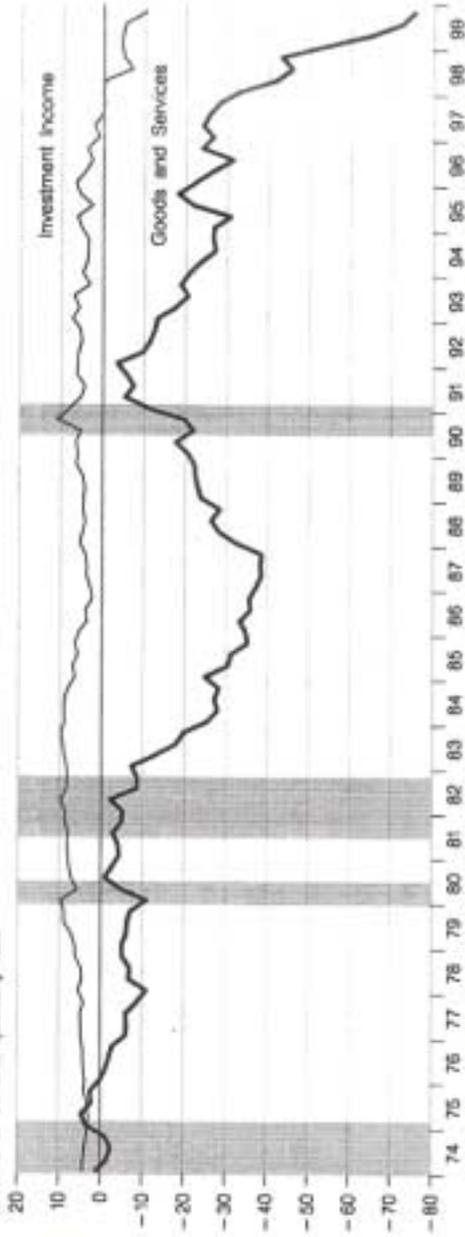
I submit that the answer is no. The United States played a major role. We became, once again, the importer of first resort in a crisis. U.S. imports of goods soared; our exports fell in 1998 and grew very slowly in 1999. The U.S. current account deficit rose from about \$150 billion in 1997 to a current annual rate of \$400 billion. That \$250 billion swing is a main way we helped to strengthen the world economy. The chart that I distributed [see following page] shows what happened to net exports of goods and services. Unwinding this swing will be a major challenge to the U.S. and other economies in the next few years.

The U.S. economy expanded rapidly during these years. Imports were cheap relative to the cost of domestic production, so, as a nation, we could help the world economy to recover while enjoying rapid growth with low inflation. Our rapidly growing economy, our innovative enterprises and rising worker productivity encouraged foreign investment in our plants, equipment, bonds and shares. The stock market soared, attracting foreign capital and bringing home as investment the extra dollars we spent for goods and services abroad. The capital inflow appreciated the dollar compared to other currencies. Devaluations and currency depreciation by many crisis countries, and others, also appreciated the dollar.

Let me leave no doubt. I believe that running the extraordinary trade deficit and allowing the dollar to appreciate against other currencies was the proper policy under the circumstances. Preventing or restricting imports would have been counter to both our narrow interest and our broader interest in general prosperity.

Trade and Investment Income Balances

Billions of dollars, quarterly rate



For some Americans, this policy was costly, however. Farmers are an example. Sugar and soybeans, wheat, and other commodities are priced worldwide in dollars. When Brazil devalued against the dollar, Brazilian soybeans and sugar became cheap compared to U.S. produced sugar and soybeans. Canadian, Australian and other growers gained a temporary advantage over U.S. farmers when their currencies depreciated against the dollar. The same is true for industrial producers. Appreciation of the dollar permits U.S. manufacturers to buy components or assemblies more cheaply from foreign suppliers, reducing cost, but also reduces sales by domestic manufacturers of these inputs. U.S. exporters face tougher competition when selling abroad, while foreign producers increase their share of the U.S. market.

To reduce the U.S. role as importer of first resort in a crisis, we must change the role of the IMF. It must go from managing crises to preventing them, or since complete prevention is unlikely, making them less virulent, less widespread, less harmful and less frequent.

The Commission addressed this problem by proposing an incentive-based system that encourages and rewards countries with good behavior. It began by identifying three major causes of deep and prolonged crises. They are (1) collapse of the exchange rate, requiring substantial devaluation, (2) collapse of the financial system, requiring large loans to shore up the remnants, and (3) the long-time, often months, before the IMF and the desperate country agree on conditions that the country must accept to get assistance. Since the agreed conditions are often not met in practice, replacing the long negotiation with pre-conditions is an improvement.

The Commission proposed four pre-conditions, reforms that countries must complete to qualify for immediate assistance in crises. The four pre-conditions require countries to strengthen their financial systems, improve their fiscal or budget policies, and provide timely information about their outstanding sovereign debt. Countries would have five years to phase-in the conditions. Countries that met the pre-conditions would be less subject to crises.

I must admit that I am disappointed and disheartened by the Treasury's initial response. On the positive side, they have agreed that the conditions are desirable. But, they have spoken repeatedly about how only a small number of countries would adopt the conditions. They fail to notice that 50 countries, nearly 1/3 of the IMF's membership and many of its larger members, already meet or accept one of the politically most difficult conditions, requiring full access of foreign financial institutions to the country's markets.

Equally disturbing, the Treasury's position would keep the U.S. as importer-of-first-resort. It fails to protect the U.S. economy from the temporary losses to U.S. based producers from the flood of imports and the loss of exports during the adjustment to exchange rate changes. This neglect or oversight is particularly surprising because, in the last two years, the Congress has given substantial assistance to affected groups, such as farmers and most recently sugar producers. This assistance compensates for some of the losses these groups sustained.

Further, the Treasury fails to recognize the improved incentives that countries and lenders would face under the proposed reforms. Once the preconditions have been phased-in, the IMF would list the countries that met the conditions and those that did not. Countries meeting the conditions would have much greater opportunities to borrow in the capital markets and, because they would be less risky, they would borrow on more favorable terms. Countries that failed to meet the pre-conditions would receive less capital and would have to pay higher rates of return to compensate for their higher risk. In this way, markets would work to encourage reform.

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We, the United States, have a major interest in global stability. We must insist on reform of the International Financial System. I note quickly that the Commission made other recommendations for changes at the IMF. It should improve the quantity, quality, and timeliness of information about member countries. It should improve transparency about its own operations. An ordinary person should be able to read the amount of loans it has outstanding, how much it has available in usable currencies to lend, and how much it costs to operate the institution. Further, the Commission agreed unanimously that the IMF should stop long-term lending and close the Poverty Reduction and Growth Facility.

I have reviewed the draft of S. 2382, the Technical Assistance, Trade Promotion, and Anti-Corruption Act of 2000, I find few of the needed reforms. S. 2382 would do little to reduce the risk of financial and economic crises or the role of the United States as importer of first resort in a crisis, or the cost of crises to American farmers, manufacturers, and workers.

THE WORLD BANK

Long-term loans for emerging market economies should be the responsibility of the development banks. The Commission shares the World Bank's view that its mission, and the mission of other development banks, should be reduction in poverty in developing countries.

The Commission report asks for major reform of these banks because they are ineffective and greatly overstuffed. Many of the professionals are dedicated to their tasks. The problem is to change the incentives under which they operate to improve their performance. In his testimony before the Commission, President Wolfensohn agreed on the need for improved performance.

The Commission proposed three main tasks for the development banks: (1) to supply global goods—such as—elimination of tropical diseases, or improvements in tropical agriculture; (2) promote economic and social development using an incentive-based system that subsidizes institutional reform and gives incentives for maintaining reforms; and (3) use grants instead of loans to improve the quality of life in the poorest countries by inoculating children, providing sanitary sewers, bringing potable water to the villages, and in other ways.

The Commission proposed that the grants would be paid directly to contractors, on evidence of completion furnished by independent auditors. Grants would bypass corrupt governments; auditing results would improve performance. This is a much more effective mechanism for reform than is proposed in S. 2382.

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Finally, the Commission agreed unanimously that the present HIPC debts be written off completely in all countries that adopt and implement effective development programs.

Senator HAGEL. Dr. Meltzer, thank you very much.
Dr. Calomiris, thank you.

STATEMENT OF DR. CHARLES W. CALOMIRIS, MEMBER, INTERNATIONAL FINANCIAL INSTITUTION ADVISORY COMMISSION; PAUL M. MONTRONE PROFESSOR OF FINANCE AND ECONOMICS, COLUMBIA UNIVERSITY'S GRADUATE SCHOOL OF BUSINESS; AND VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. CALOMIRIS. Thank you, Mr. Chairman. It is an honor and a pleasure to be here today to discuss the recommendations of the Meltzer Commission. I would like to summarize my written statement and ask that it be included in the record as well.

Senator HAGEL. It will be included.

Dr. CALOMIRIS. Since our report was published, it has become clear to me that two separate debates are being waged over the new so-called financial architecture—a narrow, visible debate over the technical aspects of specific proposals for designing mechanisms to achieve well-defined economic objectives, on the one hand, and on the other hand, a broader, less visible debate over whether the IMF, the World Bank, and other development banks should have narrowly defined economic objectives or alternatively should be used as tools of ad hoc diplomacy. Until we settle that second broader political debate, we cannot seriously even begin constructive dialog over how best to achieve economic objectives. Although open opposition to the Meltzer report generally focuses on its details, and much of that is sincere, behind closed doors many critics are candid about their primary reason for objecting to our proposals: “Forget economics; it’s the foreign policy, stupid.” For proposed reforms to succeed, they must face the challenges posed not only by economic logic, but by the political economy of foreign policy.

The Commission’s recommendations make sense as economics; that is, they were derived from evidence in a sensible way. Just as important, the principles on which they are based are valid ethically and politically, specifically, most importantly, our premise that the World Bank and the IMF should not and cannot continue to serve the ad hoc political purposes of broad foreign policy.

The Meltzer report begins with a well-defined set of economic objectives and political principles and suggests mechanisms that would accomplish those objectives within the confines of those principles. The economic objectives include: one, improving global capital market liquidity, two, alleviating poverty in the poorest countries; three, promoting effective institutional reforms in the legal and financial systems of developing countries which will spur development; and four, providing effective public goods, for example, through programs to deal with global problems of public health, particularly malaria and AIDS, and environmental risks in developing countries; and fifth, collecting and disseminating valuable economic data in a uniform and timely manner. The Commission viewed liquidity provision during crises, macroeconomic services, and data collection and dissemination to be appropriate missions of the IMF and saw poverty alleviation, the promotion of reform long term, the provision of global public goods, microeconomic data collection and dissemination, and related advisory services as the central missions of the development banks.

We also identified six principles that any credible reform strategy should satisfy and which underlie our proposals: one, respecting member countries' sovereignty; two, clearly separating tasks across institutions; three, setting credible boundaries on goals and discretionary actions by those institutions; four, judging policies not by their stated objectives alone but by their effectiveness; five, ensuring accountability of management through clear disclosure, accounting, internal governance rules, and independent evaluation of performance; and six, sharing the financial burden of aid through these institutions fairly among benefactor countries.

We began by evaluating the performance of the IMF, the World Bank, and the other development banks against the touchstone of these goals and principles and found these institutions quite deficient. They often failed to achieve their goals, even by their own internal measures.

Why is the IMF so ineffective? For one thing, the IMF's crisis lending mechanism is not designed to fulfill the role of providing effective liquidity assistance. Liquidity crises happen quickly. There is not time to enter into protracted negotiations or to demonstrate that one is an innocent victim of external shocks, as the IMF's stillborn contingent credit facility would mandate. If the IMF is to focus on liquidity assistance, and if the liquidity assistance is to be effective, there is no viable alternative to having countries prequalify for lines of credit. The current IMF formula of taking weeks or months to negotiate terms and conditions for liquidity assistance and then offering that assistance in stages over a long period of time simply is a non-starter if the goal is to mitigate or prevent liquidity crises.

IMF and development bank lending, which entails substantial subsidies to borrowing countries, does, however, manage to transfer resources to debtor countries during severe economic crises through the implied interest rate subsidies. But those transfers do not seem to improve securities markets in those countries or spur growth on average; rather, they are put to use for less laudable goals apparently, most notoriously, for shady transactions in Russia or the Ukraine. But it is the legitimate uses of IMF and development bank emergency loan subsidies that are even more troubling in my view, especially their use in facilitating the bailouts of insolvent domestic banks and firms and international lenders, which ultimately are financed mainly by taxes on domestic residents.

Consider the current IMF program being established with Ecuador. Ecuador has been suffering a deepening fiscal crisis for several years. As yet, there is no consensus for reform in Ecuador, and there is no reason to believe that reforms will be produced by a few hundreds of millions of IMF dollars. Why in the world is the IMF sending money to Ecuador? Some observers claim that IMF aid to Ecuador is best understood as a means of sending political payola to the Ecuadoran Government at a time when the United States wishes to ensure continuing use of its military bases there monitoring drug traffic. Will that sort of IMF policy be likely to produce the needed long-run reforms in fiscal and bank regulatory policy? Has the IMF not learned anything from the failure of its lending to Russia in 1997 and 1998?

Argentina, perhaps more than any other country, has depended on IMF conditional lending over the past several years to maintain its access to international markets. It is now widely perceived as possibly on the verge of a public finance meltdown, which many commentators blame, in part, on the IMF and the U.S. Treasury. IMF support, in retrospect, was counterproductive because it put the cart of cash ahead of the horse of reform. Now Argentina is faced with a growing and possibly an unsustainable debt service burden. Furthermore, at the IMF's behest, Argentina substantially raised its tax rates last year, choking off its nascent recovery. Instead, Argentina should have cut government expenditures. The notion that tax hikes are an effective substitute for expenditure cuts as a means of successful fiscal reform appears to be an article of faith at the IMF but, unfortunately, one that is simply at odds with the evidence. The chronology of policy failure in Argentina is aptly summarized in a recent financial markets newsletter that I would like to quote. "Between 1996 and 1999, the IMF and IDB all but led the marketing effort for Argentina bonds. The two institutions voiced strong endorsements each time that there was a confidence crisis in Argentina. The IDB went so far as to dispatch its most senior economist to New York last summer to recommend that U.S. portfolio managers buy Argentine bonds. At the same time, the Street," meaning Wall Street, "came to realize that the U.S. Treasury was the real force behind the IMF and IDB support for Argentina. It was never clear why there was such unwavering support. The motivation could have been geo-political. Argentina was a staunch supporter of U.S. political policies around the world and across the region. Argentina was also the poster-child of the so-called Washington Consensus. Therefore, the U.S. needed Argentina to succeed. At the beginning of the year, when the Machinea team traveled to Washington to seek a revised Standby Facility, the team met first with the U.S. Treasury before meeting with the IMF and the World Bank. These actions sent clear signals to the market that the country had an implicit guarantee from Washington. Otherwise, it would have been irrational for any creditor to lend so much money to such a leveraged country with such little flexibility."

Again, this is a newsletter from what I regard as the best Latin American bond market news daily.

How Argentina will extricate itself from its current debt trap is unclear. What is clear, however, is that the U.S. Treasury/IMF-sponsored debt inflows and tax hikes over the past several years have put Argentina into this risky position. More market discipline, less U.S. Treasury/IMF assistance and less debt at an earlier date would have encouraged the needed reforms of government expenditures and labor market regulations.

The World Bank's record and the records of the regional development banks in sponsoring successful programs are also poor. The World Bank's internal evaluations of performance, which are made shortly after the last disbursement of its funds, identify more than half of its projects as failing to achieve "satisfactory, sustainable" results.

The multilaterals do not follow the principle of separation either. The IMF's mission warrants short-term lending, yet the IMF typi-

cally makes long-term loans. Seventy-three IMF member countries have borrowed from the IMF in more than 90 percent of the years in which they have been members of the IMF. The development banks participate, on the other hand, in short-term emergency lending, despite the fact that this is not consistent with their long-term focus on development, and even though their managements sometimes privately complain about having to do so.

There is little disclosure of relevant information about accounting or decisionmaking within these institutions, too. In the case of the IMF, its own staff admits that its accounting system is an exercise in obfuscation. Quote. This is by an IMF staff member. "The cumulative weight of the Fund's jerry-built structure of financial provisions has meant that almost nobody outside, and, indeed, few inside, the Fund understand how the organization works, because relatively simple economic relations are buried under increasingly opaque layers of language. To cite one example, the Fund must be the only financial organization in the world for which the balance sheet contains no information whatsoever on the magnitudes of its outstanding credits or its liquid liabilities. More seriously, the Fund's outdated financial structure has been a handicap in its financial operations."

The Meltzer Commission's recommendations for reform follow directly from the perceived gap between actual performance of these institutions and the combination of bona fide objectives and principles that I summarized at the beginning. With respect to the IMF, the Commission unanimously voted to end long-term lending. The 8 to 3 majority went further, recommending that the IMF focus on maintaining liquidity for emerging economies. By providing lines of credit to countries in general, those that meet minimal, pre-established standards, and by lending to them as a senior creditor at a penalty rate, the IMF could prevent avoidable liquidity crises without sponsoring counterproductive bailouts of banks at taxpayers' expense.

With respect to the development banks, for poverty alleviation, we recommended relying on grants to service providers with independent verification of performance, rather than making subsidized loans earmarked to governments, as a mechanism more likely to deliver results.

With respect to promoting institutional reform, the Commission proposed making loans through the development banks to governments at highly subsidized rates, but only after they had passed laws establishing reforms. The maturity of those loans could be extended, and thus the subsidies implicit in them increased, conditional on the continuation of reforms, that is, only if independent verification indicates that promised reforms are continuing on track.

The Commission also voted unanimously that the IMF and the development banks should write off all claims against the highly indebted poor countries, once those countries have established credible development programs.

Treasury Secretary Summers testified before the House Banking Committee, while reserving the right to change his mind based on further reading of the report, and faulted the Commission on several specifics. In my formal comments, I review each of the Sec-

retary's concerns and explain why I believe they are misplaced. Let me just touch on a few.

With respect to our proposals for reforming the IMF, Mr. Summers expressed several concerns. He claims that "few if any of the countries that have suffered financial crises in recent years would have qualified for emergency IMF support." He goes on to recognize that the Commission recommended waiving prequalification standards in cases where global capital market stability was threatened, and that therefore, the Commission did not, in fact, recommend ruling out support to any country. Still the Secretary questioned, in light of our recommendation that prequalification could be waived, "how the rest of the report's proposals in this area are to be interpreted and applied." He questioned whether many countries would qualify for IMF support and whether lending even to prequalified countries might create moral hazard problems in comparison to the current practice of attaching conditionality, *ex post*.

These criticisms are misplaced. We envision a phase-in period of 5 years for the new prequalification standards, and we think most emerging market countries would prequalify. Most or all of the crisis countries in Latin America and Asia would face strong incentives to meet our proposed standards, particularly since failing to do so would likely reduce their access to and raise their costs of private market financing. If our proposed standards had been imposed, say, in 1990, the severe crises suffered by these countries, which largely reflected weaknesses in their banking systems and in the incentives of those weak banks to take on enormous exchange risks, may have been averted and certainly would have been far less severe.

Furthermore, it is hard to see how our proposed IMF lending arrangements would worsen moral hazard. Moral hazard depends on the expectation of receiving a subsidy. Under current IMF arrangements, countries borrow large amounts at highly subsidized rates. Under our proposals, there is no subsidy and therefore virtually no possibility of moral hazard.

Mr. Summers also criticizes our recommendations for reforming the development banks. He objects first to limiting emergency lending to the IMF; second, to our proposal to target country level assistance to the poorest countries only; and third, to the use of grants rather than loans for poverty alleviation.

Our proposal to limit emergency lending to the IMF follows directly from the principle that separating the functions of the various multilaterals promotes greater effectiveness and accountability. Nevertheless, the Commission report envisions loans or grants from development banks to poor countries that have experienced crisis-induced trauma. We recommend, however, that any assistance be channeled through appropriate long-term programs.

The Secretary also misunderstands the effect of our proposals on poor people who reside in developing countries with access to private capital markets or with per capita annual average incomes higher than \$4,000. He states, "the report would rule out MDB support for the majority of the world's poorest people." That is not true.

Similarly, the Secretary's statement that "the report's recommendations would drastically undercut the global role of the

World Bank by limiting it to the ‘knowledge’ business” indicates a serious misunderstanding of our recommendations. We envision a substantial continuing role for the World Bank in providing financial assistance.

Senator HAGEL. Dr. Calomiris, could I ask you to sum up your statement in the next minute because we want to leave time for questions and we have Dr. Levinson yet. So, I would appreciate that very much.

Dr. CALOMIRIS. I will try to move quickly.

Senator HAGEL. You have 1 minute.

Dr. CALOMIRIS. Rather than go through the rest of those specifics, let me talk about the second broader debate that I mentioned, the political debate.

Should the IMF or the World Bank not be hemmed in by too many requirements designed to make them effective as economic mechanisms because doing so prevents them from acting in a broad ad hoc foreign policy role? In my statement, I provide five reasons why I think it is desirable that the IMF and World Bank focus on economic objectives rather than pursue that broad role. Rather than list those for you, I will just mention one example right now.

I learned from a knowledgeable insider that the negotiations between the IMF and Pakistan right now are being held up by the U.S. insistence that Pakistan sign a nuclear nonproliferation treaty. Now, this is a laudable objective, but is the IMF the right tool for accomplishing that objective for the reasons I state in my opinion? I believe it is not.

In the interest of time, I will stop there and thank you for your attention.

[The prepared statement of Dr. Calomiris follows:]

PREPARED STATEMENT OF DR. CHARLES W. CALOMIRIS

WHEN WILL ECONOMICS GUIDE IMF AND WORLD BANK REFORMS?

The Meltzer Commission Report (a blueprint for reforming the IMF, the World Bank, and other multilateral development banks released in March, and signed by a bipartisan majority of 8 to 3) has generated its share of criticism from opponents in the Commission minority, the Administration, the labor unions, and the Congress.¹

Since our Report was published, it has become clear to me that two separate debates are being waged over the new “financial architecture”—a narrow (visible) debate over the technical aspects of specific proposals for designing mechanisms to achieve well-defined economic objectives, and a broader (less visible) debate over whether the IMF, the World Bank, and the other development banks should have narrowly defined economic objectives or alternatively, be used as tools of ad hoc diplomacy. Until we settle that second, broader political debate, we cannot seriously even begin the constructive dialogue over how best to achieve economic objectives. That dialogue is important; our proposals are a starting point for rebuilding these institutions, not the final word. But those who oppose the basic premises of the Meltzer Report don’t want to get to that constructive phase. They want the reformers to just go away. Although open opposition to the Meltzer Report generally focuses on its details, behind closed doors critics are candid about their primary reason for objecting to our proposals: “Forget economics; it’s the foreign policy, stupid.”

¹The Commission members who signed the Report include Allan Meltzer (Chairman), Tom Campbell, Edwin Feulner, Lee Hoskins, Richard Huber, Manuel Johnson, Jeffrey Sachs, and the author of this article. Fred Bergsten, Jerome Levinson, and Esteban Torres did not sign the Report. Mr. Huber, despite signing the Report, dissented on some points. The Report, Commission hearings, and background papers for the Commission (know formally as the International Financial Institution Advisory Commission) are available at the website <http://phantom-x.gsia.cmu.edu/IFIAC>.

For proposed reforms to succeed, then, they must face the challenges posed not only by economic logic, but by the political economy of foreign policy.

In this article, I summarize the recommendations of the Commission and respond to criticisms of our recommendations, both from the standpoint of their economic logic and their political economy. I argue not only that the Commission's recommendations make sense as economics, but defend the principles on which they are based, specifically, the premise that the World Bank and the IMF should not and cannot continue to serve the ad hoc political purposes of broad foreign policy.

First Principles

The Meltzer Report begins with a well-defined set of economic objectives and political principles, and suggests mechanisms that would accomplish those objectives within the confines of those principles. The economic objectives we envision for the multilateral financial institutions include: (1) improving global capital market liquidity, (2) alleviating poverty in the poorest countries, (3) promoting effective institutional reforms in the legal and financial systems of developing countries that spur development, (4) providing effective global public goods, e.g., through programs to deal with global problems of public health (particularly, malaria and AIDS), and environmental risks in developing countries, and (5) collecting and disseminating valuable economic data in a uniform and timely manner. The Commission viewed liquidity provision during crises, macroeconomic advisory services, and data collection and dissemination to be appropriate missions of the IMF, and saw poverty alleviation, the promotion of reform, the provision of global public goods, microeconomic data collection and dissemination, and related advisory services as the central missions of the development banks.

We identified six principles that any credible reform strategy should satisfy, and which underlie our proposals: (1) respecting member countries' sovereignty (that is, the desire to minimize the intrusiveness of membership requirements or conditions for receiving assistance), (2) clearly separating tasks across institutions (to avoid waste and counterproductive overlap, and to enhance accountability), (3) setting credible boundaries on goals and discretionary actions (to prevent undesirable mission creep and to promote accountability), (4) judging policies not by their stated objectives but by their effectiveness (i.e. ensuring that the mechanisms chosen to channel assistance are likely to succeed and to avoid waste), (5) ensuring accountability of management through clear disclosure, accounting, internal governance rules, and independent evaluation of performance, and (6) sharing the financial burden of aid fairly among benefactor countries.

The Record of IMF and Development Banks Performance

We began by evaluating the performance of the IMF, the World Bank, and the other development banks against the touchstone of these goals and principles and found these institutions quite deficient. They often failed to achieve their goals, even by their own internal measures. Studies of the extent to which the IMF succeeds in enforcing its lending conditions show a poor track record. Sebastian Edwards found that most of the time IMF lending conditions are not met.² And all three comprehensive studies of the average effects of IMF programs, which include the IMF staffs own study, failed to find evidence of a positive effect on economic activity or domestic securities prices from having received IMF assistance.³

Why is the IMF so ineffective? For one thing, the IMF's crisis lending mechanism is not designed to fulfill the role of providing effective liquidity assistance. Liquidity crises happen quickly. There isn't time to enter into protracted negotiations, or to demonstrate that one is an innocent victim of external shocks (as the IMF's stillborn contingent credit facility mandates). If the IMF is to focus on liquidity assistance, and if liquidity assistance is to be effective, there is no viable alternative to having countries pre-qualify for lines of credit. The testimony before our Commission of the IMF's acting managing director, Mr. Fischer, recognized the desirability of prequalification for providing liquidity assistance.⁴ The current IMF formula of taking weeks or months to negotiate terms and conditions for liquidity assistance, and

²"The International Monetary Fund and the Developing Countries: A Critical Evaluation," *Carnegie-Rochester Series on Public Policy*, 31, 1989, pp. 7-68.

³R.A. Brealey and E. Kaplanis, "The Impact of IMF Assistance on Asset Values," Working Paper, Bank of England, September 1999, N. Ul Haque and M.S. Khan, "Do IMF Supported Programs Work? A Survey of Cross Country Empirical Evidence," IMF Working Paper, November 1999, M.D. Bordo and A.J. Schwartz, "Measuring Real Economic Effects of Bailouts: Historical Perspectives on How Countries in Financial Distress Have Fared With and Without Bailouts," Working Paper, Rutgers University, November 1999.

⁴See the testimony of Stanley Fischer before the Commission on February 2, 2000.

then offering that assistance in stages over a long period of time, simply is a non-starter if the goal is to mitigate or prevent liquidity crises.

IMF and development bank lending—which entails substantial subsidies to borrowing countries—does, however, manage to transfer resources to debtor countries during severe economic crises. But those transfers do not seem to improve securities markets or spur growth; rather, they are put to use for less laudable goals—most notoriously, for shady transactions in Russia or the Ukraine. But it's the “legitimate” uses of IMF and development bank emergency loan subsidies that are even more troubling, especially their use in facilitating the bailouts of insolvent domestic banks and firms and international lenders, which ultimately are financed mainly by taxes on domestic residents.

In the cases of Mexico, Korea, Indonesia, and Thailand, those tax bills ranged from 20% to 55% of annual GDP, and averaged more than 30% of GDP. Not only do these bailouts transfer enormous wealth from average citizens to rich cronies, they undermine market discipline (by softening the penalties for unwise investing) and encourage reckless lending domestically and internationally. They also strengthen the hold that domestic cronies continue to exert on their countries' political systems.

Consider the current IMF program being established with Ecuador. Ecuador has been suffering a deepening fiscal crisis for several years caused by the combination of an unresolved internal political struggle, adverse economic shocks to its terms of trade, and a poorly regulated banking system (which encouraged enormous risk taking at taxpayers expense, and which has imposed a bailout cost of 40% of annual GDP on taxpayers). As yet, there is no consensus for reform in Ecuador, and there is no reason to believe that reforms will be produced by a few hundreds of millions of IMF dollars. Why in the world is the IMF sending money to Ecuador? Some observers claim that IMF aid to Ecuador is best understood as a means of sending political payola to the Ecuadoran government at a time when the United States wishes to ensure continuing use of its military bases there monitoring drug traffic. Will that sort of IMF policy be likely to produce the needed long-run reforms in fiscal and bank regulatory policy? Hasn't the IMF learned anything from the failure of its lending to Russia in 1997-1998?

Argentina, perhaps more than any other country, has depended on IMF conditional lending over the past several years to maintain its access to international markets. It is now widely perceived as possibly on the verge of a public finance meltdown, which many commentators blame, in part, on the IMF and U.S. Treasury. IMF support, in retrospect, was counterproductive because it put the cart of cash ahead of the horse of reform. Now Argentina is faced with a growing, and possibly an unsustainable, debt service burden. Furthermore, at the IMF's behest, Argentina substantially raised its tax rates last year, choking off its nascent recovery. Instead, Argentina should have cut government expenditures. The notion that tax hikes are an effective substitute for expenditure cuts as a means of successful fiscal reform is an article of faith at the IMF, but unfortunately, one that is at odds with the evidence. The chronology of policy failure in Argentina is aptly summarized in a recent financial markets newsletter:

Between 1996 and 1999, the IMF and IDB all but led the marketing effort for Argentina bonds. The two institutions voiced strong endorsements each time that there was a confidence crisis in Argentina. The IDB went so far as to dispatch its most senior economist to New York last summer to recommend that U.S. portfolio managers buy Argentine bonds. At the same time, the Street came to realize that the U.S. Treasury was the real force behind the IMF and IDB support for Argentina. It was never clear why there was such unwavering support. The motivation could have been geo-political. Argentina was a staunch supporter of U.S. political policies around the world and across the region. Argentina was also the poster-child of the so-called Washington Consensus. . . . Therefore, the U.S. needed Argentina to succeed. At the beginning of the year, when the Machinea team traveled to Washington to seek a revised Standby Facility, the team met first with the U.S. Treasury before meeting with the IMF and the World Bank. These actions sent clear signals to the market that the country had an implicit guarantee from Washington. Otherwise, it would have been irrational for any creditor to lend so much money to such a leveraged country with such little flexibility.⁵

⁵BCP's Molano Latin American Daily, May 15, 2000.

How Argentina will extricate itself from its current debt trap is unclear. What is clear, however, is that the U.S. Treasury/IMF-sponsored debt inflows and tax hikes of the past several years put Argentina into this risky position. More market discipline, less U.S. Treasury/IMF "assistance," and less debt, at an earlier date would have encouraged the needed reforms of government expenditures and labor market regulations.

The World Bank's record, and the records of the regional development banks, in sponsoring successful programs are also poor. The World Bank's internal evaluations of performance (which are made shortly after the last disbursement of funds) identify more than half of its projects as failing to achieve "satisfactory, sustainable" results. The World Bank earmarks subsidized loans to member countries, but does little to ensure that the funds are used for the stated purposes. And the allocation of funds is primarily to countries with easy access to private capital markets. Over the past decade, the World Bank has lent 70% of its funds to 11 countries. These countries are not among the poorest or those lacking access to markets. Indeed, for those countries, development bank loans average less than two percent of total capital inflows during that period.

The Commission found that development banks were ineffective as promoters of reform. As shown in the work of David Dollar and others at the World Bank, programs that subsidize institution building only work in countries that already have a commitment to reform.⁶ Reform-minded governments offer windows of opportunity for change, and under those circumstances constructive reforms can be hastened and broadened by appropriate external assistance, which can benefit not only the recipient but other countries as well (including the United States). But to be effective, subsidies have to reward bona fide efforts, not just lip service. There is a need to improve dramatically the way reform subsidization is delivered to ensure that it is channeled effectively where it can have the greatest positive impact.

The Meltzer Commission also found that the development banks are devoting far too little to alleviating global problems in the areas of public health, particularly the endemic problems of AIDS and malaria, which are important stumbling blocks to economic development in many of the poorest countries.

None of the international financial institutions clearly defines and limits its spheres of activity. The IMF's mission warrants short-term lending, yet the IMF typically makes long-term loans. Sixty-nine countries have borrowed from the IMF for a total of more than 20 years, and 24 of those countries have borrowed for more than 30 years. Seventy-three countries have borrowed from the IMF in more than 90% of the years they have been members of the IMF.⁷ The development banks participate in short-term emergency lending, despite the fact that this is not consistent with their long-term focus on development, and even though their managements sometimes privately complain about having to do so.

There is little disclosure of relevant information about accounting or decision making. In the case of the IMF, its own staff admits that its accounting system is an exercise in obfuscation:

The cumulative weight of the Fund's jerry-built structure of financial provisions has meant that almost nobody outside, and, indeed, few inside, the Fund understand how the organization works, because relatively simple economic relations are buried under increasingly opaque layers of language. To cite one example, the Fund must be the only financial organization in the world for which the balance sheet . . . contains no information whatever on the magnitudes of its outstanding credits or its liquid liabilities. More seriously, the Fund's outdated financial structure has been a handicap in its financial operations.⁸

With regard to the principle of respecting sovereignty, critics of all political persuasions seem to agree that the international institutions should reduce their intrusiveness. Labor union officials complain that conditions for assistance requiring labor market "flexibility" undermine the position of trade unions. Martin Feldstein has faulted the IMF for undermining debtor countries sovereignty through excessive micromanagement of the conditions attached to subsidized loans.⁹ George Schultz and others complain that the sovereignty and constitutional frameworks of creditor

⁶*Assessing Aid*. Oxford University Press for the World Bank, 1998.

⁷Ian Vasquez, "The International Monetary Fund: Challenges and Contradictions," Cato Institute, 1999.

⁸Jacques Polak, "Streamlining the Financial Structure of the International Monetary Fund" (Princeton: Essays in International Finance 216, September 1999), p. 2.

⁹"Refocusing the IMF," *Foreign Affairs*, March/April 1998, pp. 20-33.

members are also undermined, since loan subsidies often serve as an end-around the legislative oversight that should accompany foreign aid.

Proposals for Reform

The Meltzer Commission's recommendations for reform follow directly from the perceived gap between actual performance of these institutions and the combination of bona fide objectives and principles that we viewed as non-controversial. With respect to the IMF, the Commission *unanimously* voted to end long-term lending. The 8-3 majority went further, recommending that the IMF focus on maintaining liquidity for emerging economies. By providing lines of credit to countries that meet minimal pre-established standards, and lending to them as a senior creditor at a penalty rate, the IMF could prevent avoidable liquidity crises without sponsoring counter-productive bailouts of banks at taxpayers' expense. The terms under which the IMF would lend are crucial to our reform proposal. Under current practice the IMF lends at a markup over its cost of funds. That is not a penalty rate—for many countries it implies a substantial subsidy. Our proposed penalty rate removes that subsidy. Countries facing a bona fide liquidity crisis (including those with past fiscal problems that have decided to improve their fiscal discipline) would benefit by borrowing short-term at a penalty rate, since such borrowing would allow them to avoid unnecessary collapse. But countries seeking financial assistance for bailouts would get no benefit from senior IMF lending at a penalty rate. Countries facing both a liquidity crisis and a banking crisis would still likely access IMF lending, but doing so would discourage fiscally costly bailouts of banks. Borrowing on senior terms from the IMF at a penalty rate would not channel subsidies to a country that chose to expand its public deficit by bailing out its banks; indeed, it would hamper that country's ability to raise and retain private funds. Thus IMF complicity in bailouts would be avoided.

The proposed pre-qualification requirements for IMF lending are few. They include meeting IMF fiscal standards and prudential banking standards (that is, requiring that banks maintain adequate capital and liquid reserves). IMF discretion would be relied upon in setting and enforcing pre-qualification standards. Those standards reduce the likelihood that borrowing countries would access IMF lending to sponsor bailouts at their taxpayers' expense. We also recommend requiring that countries with access to IMF credit be required to permit free entry into their financial systems by foreign financial institutions. That requirement would go a long way toward ensuring competitive, stable banking in emerging markets, and in so doing would substantially reduce the likelihood and magnitude of bank bailouts. More than 50 countries already have agreed to this WTO provision. Over the five years that we envision for the transition to this new pre-qualification system virtually all emerging market countries would be able to meet these standards.

Our pre-qualification requirements are designed to avoid, rather than increase, intrusion by the IMF into the sovereignty of borrowing countries. IMF conditionality now is *ex post*, customized micromanagement (which is necessarily very intrusive). We suggest, instead, making IMF liquidity assistance available based on clearly specified rules which are the same for all countries. The requirement that countries allow free entry into financial services is not designed to force countries into greater free trade, *per se*, but to protect borrowing countries' citizens from bearing the costs of IMF-sponsored bailouts. The IMF's complicity in the bank bailouts in Mexico, Asia, and elsewhere—which the pre-qualification standards and penalty rate would avoid—has been a far more important invasion of sovereignty than our pre-qualification standards would be.

What would happen if the stability of the global financial system were at stake because a large developing country in need of liquidity assistance had not pre-qualified? The report recognizes that the pre-qualification requirement could be waived in such a circumstance, but the lending limits, the IMF's senior status, the short maturity, and the penalty rate would still apply.

With respect to the development banks, for poverty alleviation, we recommended relying on grants to service providers with independent verification of performance, rather than loans earmarked to governments, as a mechanism more likely to deliver results. Development banks would share the burden of financing projects with recipient governments. For the poorest countries, the development banks would pay nearly all cost, but for those with higher per capita income the share of development bank support could be much lower. Grants would be paid to service providers, not governments, and those providers would compete for projects in open auctions. No grants would be paid out by development banks unless independent auditors had verified that the providers had actually achieved the stated objectives.

With respect to promoting institutional reform, the Commission proposed making loans to governments at highly subsidized rates, but only *after* they had passed laws establishing reforms. The maturity of those loans would be extended (and thus the

subsidies increased) conditional on the continuation of reforms—that is, only if independent verification indicates that promised reforms are continuing on track. For example, if a country passed a bankruptcy reform law, it would be eligible for a subsidized loan in support of implementing that new law (which can be a protracted and difficult process). Continuing progress after the law was passed (as indicated, for example, by an independent international group that rates the performance of countries' bankruptcy systems) would be a prerequisite to extending the duration of the loan.

We recommend focusing country-level poverty assistance and reform subsidies on the poorest countries, where it is needed most (a distinct departure from current practice). And we suggest devolving much of the authority over country-specific programs that combat poverty or support institutional reforms to regional development banks, leaving the World Bank to pursue neglected global public goods provision, for example, in the areas of health and the environment.

Are the existing resources of the international financial institutions adequate to meet these objectives? Yes and no. If the IMF refocused its efforts on emergency liquidity assistance, offered at a penalty rate, it could provide substantial benefits at little cost. So the IMF's capital is more than adequate. The resources currently available to the development banks could provide substantially greater and more effective assistance if the Commission's recommendations were adopted. However, the Meltzer Commission recommended substantial new appropriations for these institutions, if they can be reformed to improve their effectiveness.

The Commission also voted *unanimously* that the IMF and the development banks should write off all claims against the highly indebted poor countries (HIPC) once those countries have established credible development programs. The financial distress of the HIPC is as much an indictment of multilateral lenders (and the governments that control them) as it is of the leaders in the borrowing countries who often wasted those funds or used them for personal gain, leaving their impoverished citizens with an enormous debt burden. If the multilateral lenders can reform their policies so as not to produce these debt burdens again in the future, and if the HIPC can establish the basic foundations for growth, there is little point to continuing to punish the citizens in these countries for the mistakes of the policy makers of the past. However, without substantial reforms of the international financial institutions, debt relief will accomplish little in the long run; without reform, debt forgiveness would be a prelude to rebuilding the mountain of unpayable debt that now faces HIPC countries.

Reactions To the Report

The editorial pages of the New York Times, the Wall Street Journal, and the Financial Times have been favorably disposed to some or all of our recommendations, which has helped us to get a fair hearing. Some G-7 officials outside the United States (notably officials in Germany, the U.K., Canada, and the ECB) have expressed strong support for the thrust of our recommendations on IMF reform. The IMF, the U.S. Treasury, and the World Bank have each agreed with some of our criticisms and recommendations, and some of the reforms they are currently implementing move slightly in the directions we suggest (or at least appear to do so). Specifically, the IMF claims that it will improve its contingent credit line facility to attract more countries to sign on to it, and the Treasury Secretary has called for a scaling down of long-term IMF lending (although neither the IMF nor the Treasury has accepted the need to focus the IMF primarily or exclusively on liquidity assistance, as opposed to emergency aid broadly defined). While the World Bank has rejected our grant-based approach for providing assistance, and our call for HIPC debt forgiveness, in at least one recent case they seem to have accepted the essence of our argument for grant-based support. In late April, when considering the funding of the "Economic Recovery Project" to Burundi, the Bank's management conceded that:

Donors are concerned that any budget support, without appropriate controls, might be misused for military purposes. . . . It is for this reason that this ERC differs from normal Bank quick disbursing operations. Foreign exchange will be provided to the private sector, its distribution and value determined through auction.

Despite these small, encouraging signs, and the enthusiastic support the Report has gotten from some Members of Congress and some policy makers outside the United States, the thrust of the reaction to the Report from the Treasury Department, the World Bank, the IMF, and some other Members of Congress has been negative. Richard Gephardt referred to the Report as "isolationist." Pete Stark (who admitted publicly that he had not read the Report) nevertheless characterized our

proposals as “laughable.” Treasury Secretary Lawrence Summers, testifying before the House Banking Committee (while reserving the right to change his mind based on further reading of the Report) faulted the Commission on several specifics. Given the influence that Mr. Summers’ views may exert on the reform movement, it is worth addressing his criticisms in detail.¹⁰

At the hearings, Mr. Summers expressed concern that forgiving too much of the HIPC debt might hurt the HIPC countries themselves by making it harder for them to access capital markets in the future. It is important to stress that our report only spoke to the question of forgiving the debts owed to the multilaterals. In my view, it would not be necessary or constructive for the HIPC countries to default on, or seek forgiveness of, their private sector debt. So long as debt forgiveness is confined to the debts of the multilaterals, and the debts held by individual sovereign creditors, I see no reason why the HIPC countries would be penalized by the private capital markets. Furthermore, the historical literature on debt default indicates that “warranted” sovereign debt write downs (those which are practically unavoidable because of the high cost of debt service relative to available income) are not penalized very much by future creditors. Because the HIPC countries clearly fall into the category of warranted debt forgiveness, I think the Secretary’s concerns about the costs they would bear from debt forgiveness are misplaced.

With respect to our proposals for reforming the IMF, Mr. Summers expressed several concerns. He claims that “few if any of the countries that have suffered financial crises in recent years . . . would have qualified for emergency IMF support.” He goes on to recognize that the Commission recommended waiving prequalification standards in cases where global capital market stability was threatened, and that therefore, the Commission did not, in fact, recommend ruling out support to any country. Still the Secretary questioned, in light of our recommendation that prequalification could be waived, “how the rest of the Report’s proposals in this area are to be interpreted and applied.” He questioned whether many countries would prequalify for IMF support, and whether lending even to prequalified countries would create moral hazard problems (in comparison to the current practice of attaching “conditionality”).

The Secretary’s concerns again are misplaced. First, we envision a phase-in period of five years for the new prequalification standards, and we think most emerging market countries would prequalify. Most or all of the crisis countries in Latin America and Asia would face strong incentives to meet our proposed standards, particularly since failing to do so would likely reduce their access to, and raise their costs of, private finance. If our proposed standards had been imposed, say, in 1990, the severe crises suffered by these countries (which largely reflected weaknesses in their banking systems and the incentives of those weak banks to take on enormous exchange rate risks) may have been averted, and certainly would have been far less severe.

Furthermore, it is hard to see how our proposed IMF lending arrangements would worsen moral hazard. Moral hazard depends on the expectation of receiving a subsidy. Under current IMF arrangements, countries borrow large amounts at highly subsidized rates. The conditionality imposed on these countries (particularly in the area of financial sector reform) is not enforced and not effective, owing in part to the short disbursement time period of emergency lending and the long time period required for meaningful reform. Under our proposals, there is no subsidy, and therefore, virtually no moral hazard. Prequalifying countries would be able to borrow a limited amount on a short-term basis in the form of senior debt at a penalty rate; those that receive emergency assistance without having prequalified must borrow at a super-penalty rate, which provides further assurance that no subsidies would flow to those borrowers.

Another concern expressed by Mr. Summers is that the Commission’s report presumes “that crises emerge almost exclusively from flaws in the financial sector.” This is a significant misunderstanding of our report. According to our proposals, the role of the IMF would be to protect against liquidity problems in the markets for foreign exchange and sovereign debt that come from problems *other than* banking sector fragility. The point of the prequalification standards is to prevent the IMF from being misused as a mechanism for facilitating financial sector bailouts. Its main function lies elsewhere—specifically in providing protection against market illiquidity, either due to information problems that result in the temporary collapse of markets, or problems of self-fulfilling speculative attacks.

The Secretary criticizes our proposals for failing to provide IMF support to deal with “balance of payments problems.” I am not sure what the Secretary means by

¹⁰All references to statements by Secretary Summers are from his testimony before the House Banking Committee on March 23, 2000.

a “balance of payments problem.” Our proposals for IMF lending are designed to counter balance of payments outflows resulting from bona fide liquidity crises. Our proposals would not channel counter-cyclical subsidies to countries that suffer balance of payments outflows, per se. In our view it would be inappropriate to charge the IMF with the broad mandate of providing global counter-cyclical fiscal subsidies to its members.

Mr. Summers also criticizes our recommendations for reforming the development banks. He objects (1) to limiting emergency lending to the IMF, (2) to our proposal to target country-level assistance to the poorest countries, and (3) to the use of grants rather than loans for poverty alleviation.

Our proposal to limit emergency lending to the IMF follows directly from the principle that separating the functions of the various multilaterals promotes greater effectiveness and accountability. Under our proposals the IMF would have the capacity to deal with all bona fide liquidity problems that would arise. There is no need for the other multilaterals to assist it in providing short-term assistance.

Nevertheless, the Commission Report envisions loans or grants from development banks to poor countries that have experienced crisis-induced trauma. We recommend that any assistance to alleviate poverty or to spur reforms should be channeled through appropriate long-term programs, and that in the case of reform programs, these should be designed to ensure that the flow of aid is credibly linked to the implementation of reforms undertaken by recipients.

The Secretary also misunderstands the effect of our proposals on poor people who reside in developing countries with access to private capital markets or with per capita annual average incomes higher than \$4,000. He states that “the Report would rule out MDB support for the majority of the world’s poorest people.” That is not true. While we recommend that the MDBs focus their *country-level* poverty alleviation funding on the very poorest countries that lack access to private capital markets, we would have the World Bank *expand* its support to the poor *throughout the world* through two channels: financial assistance for supplying *global public goods*, particularly in the areas of public health and the environment, and technical assistance to all developing countries. Similarly, the Secretary’s statement that “the Report’s recommendations would drastically undercut the global role of the World Bank by limiting it to the ‘knowledge’ business” indicates a serious misunderstanding of our recommendations. We envision a substantial continuing role for the World Bank in providing financial assistance.

Finally, Mr. Summers’ statement that “the shift to grant-based funding would drastically reduce the total amount of official resources that can be brought to bear in these economies” confuses the dollar amount of *lending* that the development banks currently provide with the dollar amount of *assistance* implicit in that lending (the amount of interest subsidy). So long as the development banks retain their capital (as we recommend), under our proposals they will be able to channel *more* assistance using grants than using loan subsidies, and crowd in a *greater* flow of credit, to the world’s poorest countries than they do today. That is so even before taking into account our recommended increases in funding for the development banks. Current World Bank loans transfer money to borrowing countries in advance and require borrowing countries to guarantee repayment. Grant funding frees up additional resources by allowing countries to use their limited potential to guarantee repayment to support private market borrowing to finance their share of project costs. Also, unlike grant subsidies, the amount of subsidy transferred through a loan is limited by the fact that loans can’t bear an interest rate less than zero. Taking these advantages of grant-based assistance into account, Adam Lerrick of the Commission staff estimated that a grant-based program would support a volume of development projects for poverty alleviation and institutional reform 80% larger than that of the current loan-based programs.

I do not mean to suggest that there is no room for disagreement on the details of our recommendations. Indeed, it would be remarkable if that were so. Rather, in reviewing and responding to these arguments I hope to show that the reorganization of these institutions and the new policy mechanisms we suggest for them (e.g. IMF liquidity lending with prequalification, grant-based poverty alleviation, credible subsidization of long-run reforms, and HIPC debt relief) are quite reasonable and practical economic mechanisms.

“Forget Economics: It’s the Foreign Policy, Stupid!”

Dealing with these detailed concerns, however, is the easy part of responding to critics’ objections, and the less important part. Most critics of our proposals, including the Secretary, have a deeper problem with our Report. They do not agree with our goals and principles. Specifically, many critics do not share the goal of narrowing the latitude of the IMF and the World Bank. To some, the IMF and the de-

velopment banks should be used as cost-effective vehicles for “leveraging” U.S. foreign policy. From that perspective, any limits on the “flexibility” of these institutions are undesirable, as is transparency in accounting, open voting, independent evaluation of performance, and other procedural reforms we suggest, since they only get in the way of flexibility. Indeed, to those who view the multilaterals this way, their principal advantage is the absence of accountability. Aid can be delivered, and the embarrassing deals that lie behind it are not easily traced. Time-consuming parliamentary appropriation debates and justification for the use of taxpayer funds can be avoided. This point of view is not often voiced openly, but it is nevertheless a crucial element in the current debate over reform.

Consider, for example, the recent negotiations between Pakistan and the IMF. A knowledgeable insider informs me that the United States government has told Pakistan that its access to IMF subsidized lending depends on its willingness to sign a nuclear nonproliferation treaty. According to this person, unless Pakistan agrees, the U.S. will block its IMF program. In this case, the U.S. foreign policy objective seems laudable, but is the IMF the right tool for achieving it?

The view that the multilaterals should serve the broadly and flexibly defined goals of U.S. foreign policy is wrong for at least five reasons. First, the flexibility necessary to permit the multilaterals to serve as broad foreign policy devices undermines their effectiveness as economic mechanisms. When the objectives of poverty reduction and institutional reform take a back seat to ad hoc foreign policy it is no surprise that aid mainly flows to the richest and most powerful of the emerging market countries, or that the IMF and the development banks maintain so poor a track record, even by the standards of their own internal evaluations. In my view, there is no more important goal for American foreign policy than promoting stable economic development around the world. We should design multilateral institutions that are able to meet that challenge. Saddling those institutions with broader political mandates that weaken their ability to achieve bona fide economic objectives is counterproductive, even from the perspective of foreign policy.

Second, the use of multilaterals to pursue broad foreign policy objectives forces the management of these institutions to depart from clear rules and procedures in order to accommodate ad hoc political motivations. This undermines their integrity as economic institutions, makes it hard to establish norms for the conduct of management and mechanisms to ensure their accountability, and leads to erosion of popular support for funding the important economic goals on which they should be focused. It is ironic that some of the public officials who complain loudest about the reluctance of Congress to fund international organizations have done more than their share to produce the cynicism about these organizations that makes them so unpopular. The Meltzer Commission recommends substantial increases in the budgets of effective development banks. But the popular support necessary to raise new appropriations will not be forthcoming until these institutions regain their credibility.

Third, the subversion of the process of Congressional deliberation over foreign aid appropriations is no small cost to bear, even in the interest of pursuing desirable foreign policy objectives. It is beneath us as a democracy to sanction such behavior. If Congress wishes to delegate power over a limited amount of resources to a multilateral “political emergency fund” financed by the G-7 countries, then let it do so openly, establish the appropriate governance and oversight to accompany that delegation of authority, and keep the management and funding of that entity separate from the other multilateral institutions. I am not recommending that such a fund be established, but rather suggesting that if it were, it should be created by, and be made accountable to, the governments and taxpayers who authorize and finance its activities.

Fourth, it is worth considering the adverse impact that loans from multilateral lenders with non-economic objectives can have on emerging market countries. The debt burdens that plague the HIPC countries today are primarily the result of inter-governmental or multilateral loans that were politically motivated, not private or public lending made to finance credible investments.

Finally, it may not even be feasible for the United States to continue to use multilateral financial institutions as an extension of U.S. foreign policy. Progress in the global economy will make that approach to those institutions increasingly anachronistic. A decade from now the global economy will be much more polycentric. Europe and Japan are likely to enjoy a golden era of productivity growth over the next decade, as well as substantial improvements in the sophistication of their financial systems and increases in their living standards. Many emerging market countries outside of Europe—including Korea, Argentina, Brazil, and Mexico—will soon become full-fledged industrial nations, as well. Multilateral agencies focused on bona fide economic objectives, with a more decentralized administrative structure—one that

relies more on regional development banks in Asia and Latin America, financed by new benefactor countries as well as the G-7—will fit the global economy of the future better than the current structure, which is rooted in and subservient to the broad goals of U.S., or G-7, foreign policy. And a World Bank that can focus cooperative efforts among a growing number of benefactor countries to address global public health and environmental problems will be increasingly valuable for the same reason.

Sooner or later, global economic progress will mandate the kinds of reforms our Commission is recommending, and a number of senior members of Congress are considering. It is worth remembering that the independence of the Federal Reserve System from the Treasury Department—a precursor of sorts to the economic rationalization of IMF and World Bank policies advocated by the Meltzer Commission—that was achieved in 1951 resulted from a shift in economic power that made it impossible for the Treasury to continue to use monetary policy as a political and economic tool.

In 1935, then Treasury Secretary Morgenthau gloated that “the way the Federal Reserve Board is set up now they can suggest but have very little power to enforce their will . . . [The Treasury’s] power has been the Stabilization Fund plus the many other funds that I have at my disposal and this power has kept the open market committee in line and afraid of me.” Morgenthau felt no threat from the centralization of power at the Board of Governors in 1935 and the new structure of the Federal Open Market Committee because “I prophesy that . . . with the seven members of the Federal Reserve Board and the five governors of the Federal Reserve Banks forming an open market committee, that one group will be fighting the other . . . and that therefore if the financial situation should go sour the chances are that the public will blame them rather than the Treasury.”¹¹ The prospect of retaining power while escaping responsibility always appeals to government officials.

Why was Secretary Morgenthau able to control monetary policy in the 1930s, and why did that control lapse in the 1950s? In essence, Secretary Morgenthau had more funds at his disposal (with which to expand the money supply) than the Fed had on its balance sheet (with which to contract the money supply), so the Fed was simply too small to control the supply of money. By 1951, however, the size of the Fed had grown relative to the Treasury’s resources, and its independence, codified in the Treasury Fed Accord of 1951, was a forgone conclusion.

The growing strength of other industrial and emerging economies will increase the independence of the World Bank and the IMF from U.S. Treasury control in the next decade or two. In the post-World War II era the U.S. economy reigned supreme. Being an “internationalist” meant understanding the central importance of the strategic political struggle between the United States and the Soviet Union, and the need to make economic policy subservient to that struggle. But as the polycentric post-Cold War global polity and economy take hold, it will become increasingly apparent that the United States neither should, nor can, use the World Bank and the IMF as a tool of leveraged, “stealth” foreign policy.

The Meltzer Commission Report has provided a credible starting point for reforming the multilateral financial institutions, and has persuasively argued that it is high time to begin that process. Before reform can begin, before these institutions can operate as effective economic mechanisms, they must narrow their focus, regain credibility as organizations, and recapture the trust of the taxpayers that finance their operations. And before any of that can happen, the developed countries, and especially the United States, must resolve the often unspoken controversy over whether these organizations should act as foreign policy slush funds or as bona fide economic institutions. That is the first step toward real reform.

¹¹ John Morton Blum, *From the Morgenthau Diaries: Years of Crisis, 1928-1938* (New York: Houghton Mifflin, 1959), p. 352.

Senator HAGEL. Doctor, thank you.
Dr. Levinson.

STATEMENT OF DR. JEROME LEVINSON, MEMBER, INTERNATIONAL FINANCIAL INSTITUTION ADVISORY COMMISSION; PROFESSOR, WASHINGTON COLLEGE OF LAW, AMERICAN UNIVERSITY, WASHINGTON, DC

Dr. LEVINSON. Mr. Chairman, I had to substitute for Fred Bergsten yesterday afternoon. I have submitted a brief statement.

I am not going to read it. I am just going to make a few points in the interest of your getting to the questions, which I think the members want to reach with respect to this.

Let me just say this. First, the majority report—there should be no illusions about it—basically eviscerates both the IMF and the World Bank. Let us not have any illusions about that. The IMF is converted into an international bank supervisory agency. Once a country is prequalified, its access to the resources is considered to be automatic. Essentially what you need at the IMF then is a high level clerk, two disbursing officers, and three lawyers to draw up the documentation.

They say that in a systemic crisis you suspend the rules, as if it is self-evident what a systemic crisis is. I want to remind you of the Tesebono crisis in Mexico in 1994 and 1995. You will recall that there was no agreement between the U.S. and the western European authorities as to whether the crisis was systemic. There was a substantial disagreement. So, it is not self-evident when a crisis is systemic. That is the first point.

The second point, with respect to the World Bank, the World Bank becomes converted into a super development bank for Africa because all financing terminates with respect to the member countries of Latin America and Asia. So, it becomes a super development bank for Africa until the African Development Bank can take over, and it then becomes what they call a provider of public goods, solving the malaria and public health problems of Africa. Why one believes that the World Bank is going to be more effective at this than the World Health Organization is a mystery to me. Why the World Bank is going to be a more effective coordinator of aid for NGO's than that United Nations development program, without financing that the World Bank provides, again is a mystery.

Now, I will not go into the details—I will be happy to address those issues in the question period—of the scheme that they propose for World Bank financing, the idea of grants, et cetera. But the criteria that they have set up means essentially that, for example, in Latin America, the only countries that would be eligible for borrowing from the IDB would be the Central American countries, less Costa Rica, and Bolivia, Paraguay, and Guyana. The Inter-American Development Bank does not survive as a regional development institution under that criteria. The point is to push the more advanced developing countries into exclusive reliance upon the private financial markets.

That brings us to the nub of the difference. Is there a legitimate role for development finance? We have had experience with the private financial markets for 25 years and we know how volatile they can be. We have seen the debt crisis of the 1980's. We have seen the Mexican Tesebono crisis. We have seen the East Asian short-term lending. We have seen the Russian crisis. We have seen the Brazilian crisis. So, the idea that you want to push the countries into exclusive reliance upon these volatile financial markets certainly should give one pause in light of the history.

Now, there is a legitimate issue which I think they raise and I think is at the heart of the dilemma. I think there is a compelling case for development finance in terms of the volatility of the markets. For instance, if you have the IDB with a self-sustaining lend-

ing program now of \$9 billion—by self-sustaining, I mean they do not need any further capital increases. They loan \$9 billion a year. The World Bank provides approximately \$7 billion. So, that is \$16 billion per annum for the Latin American countries, and that is complemented by another \$16 billion in counterpart funds by the countries. You have a base investment in the human capital of the region, if the resources are properly used, of approximately \$32 billion per annum. That gives you at least a secure baseline for investment. Whatever else occurs in terms of access to the markets, the countries know that they are going to be able to finance those key investments through long-term, assured capital lending from the international community through these institutions.

The basic difference between us, the minority and the majority, was that the majority said that only countries that are prequalified have access to IMF resources and there are no conditions that attach. We in the minority said that does not make any sense. You want the IMF to address with the country the underlying conditions that led to the crisis in the first place and to assure that those conditions are being addressed.

As I said, with respect to the World Bank and the development banks, we saw a continuing relevant complementary role for development finance as the private markets assume the primary financing role.

Neither the majority nor the joint minority really addressed the equity issue, and that is the reason I wrote a separate, rather lengthy dissent because I think this is the heart of the problem in areas like Latin America. They are trying to achieve two things at once: high growth rates and at the same time address historic inequities.

The basic problem we have with the World Bank and the IMF is that they are really pushing a neoclassical economic vision of the world; that is most evident in their labor market recommendations: in order to solve the unemployment problem that has accompanied the economic liberalization program, they want the countries and insist—in Argentina, for example—that the countries adopt labor market flexibility measures, which is a euphemism for measures which make it easier for firms to fire workers without substantial severance payments, to weaken the capacity of unions to negotiate, and to drive down urban unionized wages to make the country more competitive internationally.

I really find it astonishing to listen to Professor Calomiris' testimony with respect to Argentina and labor market reforms. No one was more dedicated than the Menem government to implementing this IMF, World Bank, and our own Treasury agenda with respect to the labor markets. And they tried. And that led in September 1996 to a general strike which brought the country to a halt and which had broad support in the middle class. So, the question of labor market reform is more than just a technical economic issue. It goes to the basic social compact in the society, and that compact has evolved as a result of negotiation within the society.

The present Argentine Government has accomplished something in reforming the labor market that the previous government was not able to, also accompanied by major labor unrest. Again, it is astonishing to listen to Professor Calomiris with respect to Argen-

tina's fiscal problem that they now face. They tried to cut. They have cut substantially. They have continuing riots in every one of the outlying provinces because they do not have an economic base in those provinces. When you cut the government expenditures, you are now having social riots in the interior provinces of Argentina. These are not simply a question of technical issues. This goes to the question of how you allocate the costs and the burdens of reform within a society.

Unfortunately, the approach of the IMF and the World Bank is to allocate that cost disproportionately to working people.

I want to refer you to an extraordinary report in the New York Times by Nick Kristof and David Sanger discussing the East Asia crisis, where they describe how the push for liberalization of the financial markets was a contributing cause to the East Asian crisis, and the push came from the United States. They say, "This is not to say that American officials are primarily to blame for the crisis. Responsibility can be assigned all around not only to Washington policymakers, but also to the officials and bankers in the emerging market countries who created the mess, the Western bankers and investors who blindly handed them money, the Western officials who hailed free capital flows and neglected to make them safer, the Western scholars and journalists who wrote paeans to emerging markets in the Asian century."

Absent from this rogues' gallery of culprits who are responsible are workers, workers in both Korea, the other East Asian countries, and the United States. As Professor Meltzer very rightly points out, they are the ones who pay the price disproportionately in the resolution of each of these crises. He refers to the United States as the importer of first resort, there is a social and political cost which underlies that importer of first resort function to which he refers to.

At the heart of the issue between myself and the other members of the Commission was they were unwilling to address the question of growing income inequality both between countries and within countries, and I think that is at the heart of the development issue. The dilemma we have, for those of us who support a continued role for development financing, is that the economic philosophy which these institutions bring to bear really fosters growing income inequality in the interest of this neoclassical economic model which places market efficiency above all other considerations. In my opinion, this is not sustainable politically and socially and that is what we are going to find out in the next couple of years.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Levinson follows:]

PREPARED STATEMENT OF DR. JEROME I. LEVINSON

THE INTERNATIONAL FINANCIAL INSTITUTIONS AND THEIR DISCONTENTS

Two events have highlighted the discontent with the IMF and the World Bank: first, the issuance of a report by the majority of an International Advisory Commission on International Financial Institutions, and accompanying dissenting statements. Second, high profile protest demonstrations in Washington at the April meetings of both institutions. Coming from opposite ends of the American political spectrum, the two events converge in evidencing a widespread discontent with the operations and priorities of both institutions.

Both the Commission and the protests, in my opinion, arise out of the evolution of the international trade, investment and finance system of the past two decades. That evolution has transformed domestic U.S. politics with respect to the international economy. The culminating event was the East Asian financial crisis in November 1997 and the request of the Administration for additional funding for the IMF to cope with the developing crisis.

That crisis served as a catalyst for two strains of criticism of the IMF: the center-left of the Democratic Party in the Congress, particularly in the House, demanded, as the price of their support, that the legislation include provisions that instructed the U.S. Executive Director in the IMF to use the "voice and vote" of the United States to (i) advance core worker rights as a part of IMF programs and (ii) to ensure that IMF programs that included labor market flexibility measures as a condition of financing are compatible with core worker rights. That demand reflected a widespread feeling among Democrats, and their labor allies, that IMF programs are biased in favor of capital and corporate interests. If the IMF legislation was to obtain Congressional passage, the Administration, Wall Street and the Congressional leadership, had to accept a provision in the legislation along the above lines.

For the first time, the legislation appropriating IMF funding included such a worker rights provision, but this approach did not question the existence of the IMF, or, its relevance. Nor did it impose conditions directly upon the IMF; rather, it respected the multilateral character of the institution by imposing the policy conditions upon the U.S. Executive Director (USED) in the IMF, and the U.S. Treasury Department, the principal agency responsible for U.S. policy relating to the IFIs. Understood in these terms, it represented a relatively conservative approach to policy reform in the IMF. It was a reformist rather than an abolitionist strategy.

At the same time, the Asian financial crisis catalyzed sentiment, in conservative U.S. academic and Congressional circles, that the IMF no longer served a useful purpose; on the contrary, it contributed to successive crises by increasing "moral hazard." The East Asia crisis, in this view, arose directly out of the 1994/95 bailout of Mexico: the resolution of the East Asia crisis should have been left to the private capital markets to sort out. This view received its most dramatic expression in a Wall Street Journal article by George Schultz, William Simon and Walter Wriston; Schultz and Simon, of course, had been Secretary of the Treasury in former Republican administrations and Wriston, was a former Chief Executive Officer of Citicorp. Because the article called into question the rationale for the very existence of an IMF, and because of the personal prestige of the authors, it caused something of a sensation.

The legislation approving additional funding for the IMF provided for a Congressional Advisory Commission on International Financial Institutions (IFIs), which was to examine U.S. policy with respect to these institutions, including the question of whether they ought to continue to exist. For purposes of the Commission, the World Trade Organization (WTO) was included in the definition of IFIs, indicating, in my view, that the Congress wanted the question of international finance examined within a broader context: trade, investment and finance, considered as an integrated whole.

The Advisory Commission consisted of eleven members, six appointed by the Republican Majority Leaders in the Senate and the House and five appointed by the Democratic Minority leaders in both Chambers. The Chairman (Professor Allan Meltzer of Carnegie-Mellon University) was drawn from among the majority members. I was one of the Democratic appointees. The various reports, a majority report (eight members), a joint dissent (three members), my own separate somewhat lengthy dissent, reflected the deep divisions within the Commission, and, in my opinion, within American society, concerning not only the institutions which are the subject of the Commission inquiry, but also the more general process in the international economy that we short-hand refer to as "globalization." (One member signed both the majority report and the joint dissent).

The Majority, consisting of the six Republican members and two Democratic appointees, Professor Jeffrey Sachs of Harvard University and Richard Huber, formerly Chief Executive Officer of the Aetna Corporation, recommended a highly constricted role for the IMF: only member countries of the IMF that are pre-qualified are eligible for IMF financing; that financing is at a penalty rate of interest for a maximum period of 120 days, with a one-time-only rollover for an additional 120 days. Initially, the Majority had a collateral requirement, an IMF preferential claim on tax revenues, specifically customs revenues, but in the final report this requirement was dropped.

The pre-qualification requirements relate to financial ratios for financial sector institutions; in the final meeting of the Commission, one dissenting member, Fred Bergsten, severely criticized the absence of macroeconomic criteria. In response to

this criticism, unspecified fiscal criteria were added. Program conditions attached to IMF financing are specifically barred. During a five-year transition period, non-qualifying countries would be enabled to borrow, but only at a super-penalty rate of interest.

Initially, the majority members of the Commission voted to have the IMF discontinue Article IV consultations, but at the same time, they proposed the IMF be a disseminator of best practices. The illogic of discontinuing Article IV consultations, the means by which the IMF informs itself of best practices, but expecting the Fund to disseminate such practices among the member countries finally dissuaded the Majority from recommending discontinuing Article IV consultations. Longer term lending facilities would be terminated.

The IMF, then, according to the Majority, has a highly restricted financing role as lender of last resort in a systemic crisis, or, when a country, through no fault of its own, finds itself in temporary dire financial straits, deprived of market access. It is a 19th century Bagehot conception of a central bank but without the money creation function; that conception assumed a single political entity in a country with basically solvent financial institutions operating within a market economy with relatively well developed financial markets. Any interruption of market access could be assumed to be an aberration and temporary in nature.

Countries which have problems which are structural in character are assigned by the Majority to the World Bank (and regional development banks). However, under the Majority proposal, the World Bank would be divested of financing responsibility in any of the countries of Latin America or Asia. It becomes a super-development bank for Africa, at least until the African Development Bank has matured sufficiently to assume exclusive responsibility for financing development in the region. To the extent there is a development financing function at all for the other regions, that function is to be carried out by the regional development banks. But the criteria for eligibility for financing from these institutions is set at such a high bar, that, for example, in Latin America, the only countries that would be eligible are the Central American countries, less Costa Rica, and Bolivia, Paraguay and Guyana. It is a proposal, which, in effect, says that for the more developed countries in Latin American and Asia, development financing is now irrelevant; they should rely, for development purposes, exclusively upon the private financial markets.

The World Bank becomes a source of "public goods," addressing such issues as tropical disease, for example, malaria, and AIDS, which are not now being adequately addressed. It also becomes a coordinator of other aid givers. In my view, neither the World Bank or the regional development banks, politically, can survive this proposal.

The joint dissent outlined a different conception: the IMF should continue to be a source of financing for countries which, for one reason or another, find themselves in balance of payments difficulties. The original conception of the Fund remains valid: it is desirable that countries in financial difficulty not resort to destructive policies that have the potential to set off a competitive cycle of policy choices that lead to harmful systemic problems. Such IMF financing should be accompanied by an agreement on program conditions that address the underlying causes that led to the balance of payments problem. That is a major difference with the Majority proposal: a continued role for programmatic content to accompany IMF financing.

The joint dissent, however, shared the view with the Majority that the IMF should not be a front-line permanent poverty fighting agency. It must assess the social impact of a specific program, but structural reform not proximately linked to the balance-of-payments problem, should be left to the World Bank and regional development banks. This conception, then, assumed a continued development financing role for the development banks, even for the more advanced developing countries. The increasing importance of the private financial markets as the primary source of development finance for the future, in the context of volatile private financial markets, must be complemented by public development finance.

Development financing provided an assured source of long-term finance for high value projects and programs, primarily related to human capital development but also for a limited number of high value physical infrastructure projects. That finance also, of course, has a policy content, that is not characteristic of private financing. In general terms, it is this conception that has been articulated by the Secretary of the Treasury, the Council on Foreign Relations and Institute for International Economics Task Force on International Finance, and a similar task force of the Overseas Development Council.

Neither the Majority report or the Joint Dissent, however, recognized the other source of discontent with the Bretton Woods institutions: the perception that they are critical elements in the development of a profoundly inequitable two track international trade, investment and finance system, a rule based system for the protec-

tion of corporate property rights and no protection for core worker rights and the environment. It is that perception, in my view, that fueled the demonstrations in Seattle and Washington. It is what is fundamentally at issue in the current intense debate in this country over granting permanent normal trade status to China. It is the issue that I address in my separate dissenting statement.

The issue arises most acutely in connection with the IMF/World Bank emphasis upon labor market flexibility measures, which is a code-word for measures that make it easier for companies to fire workers without significant severance payments, weaken the capacity of trade unions to negotiate on behalf of their members, and drive down urban union wages and benefits. Joseph Stiglitz, formerly Chief Economist of the World Bank, has noted, with respect to labor matters, it reflects an excessively economic view, through the even more narrow prism of neoclassical economics. This labor market intervention by the Bretton Woods institutions is contrasted with their indifference to the core worker rights of freedom of association and collective bargaining, where countries use the coercive power of the state to effectively deny workers these core worker rights, even where the country's own constitution and labor laws, at least, nominally, guarantee such rights.

Indeed, the World Bank is of the view that it cannot support freedom of association and collective bargaining; these rights have been deemed by the Bank to be political in nature; economic studies, according to the Bank, are inconclusive as to whether freedom of association and collective bargaining make a positive contribution to economic development. In contrast, according to the World Bank, labor market flexibility measures clearly contribute to economic development, and therefore are an integral part of the conditionality requirements of both World Bank and IMF programs.

Both institutions are, then, perceived as doing the dirty work for big capital, both domestic and foreign, to the disadvantage of workers, in both developed and developing countries. (Mr. Stanley Fischer, Acting Managing Director of the IMF, denies that IMF intervention is so one-sided, but that is the way it is perceived by trade unions, particularly in Latin America and Asia, and critics in the Congress).

That neo-classical economic model, promoted by the World Bank and IMF, is not confined to the labor market, but represents a more general approach to development: public sector intervention is suspect or worse; privatization, in any and all circumstances, is preferred. Growing income inequality within countries is of lesser consequence than economic efficiency considerations. So long as that perception continues, and I believe it is a perception based upon the reality of the policy priorities of these institutions, there is no possibility, in my view, of assembling a broad-based consensus within this country for support of the these institutions. On the contrary, I anticipate that public, although not elite, support will continue to weaken.

We run the risk of creating, in both the industrialized world and the borrowing member countries of the Bretton Woods institutions, an increasingly alienated and embittered working class, with incalculable social and political consequences. The apparent indifference of the Bretton Woods institutions to this tendency fuels the view that they are dominated by a one-dimensional, excessively technocratic economic ideology which is socially and politically tone-deaf.

It is ironic that this neo-classical economic view now predominates in the Bretton Woods institutions: Lord Keynes and Harry Dexter White, the two men most responsible for the design of the Bretton Woods system, fought all of their professional lives against that same neo-classical model; the institutions they designed to insulate the world economy against the limitations of that economic philosophy have now become the means to impose it upon the borrowing member countries of the two institutions.

So there is a dilemma: there is a compelling case for development finance to complement the private financial markets, even with respect to the more advanced developing countries, but the Bretton Woods institutions, in promoting their neo-classical economic philosophy, have overreached: they are engaged in a project of remaking the economies of their borrowing member countries along lines that would never be accepted, politically, in their major non-borrowing member countries. In so doing, they are promoting an increasingly inequitable international economic system. They thus undermine support among groups in American society that should be their natural allies in what should be a noble enterprise: raising the standard of living for too many people that now cannot share in the global economy.

Senator HAGEL. Dr. Levinson, thank you, and to each of our three panelists, we are grateful you would spend some time here today.

Dr. MELTZER. Mr. Chairman, may I correct one statement?

Senator HAGEL. Dr. Meltzer.

Dr. MELTZER. Yes. If you look on page 88 of our report, there is the list of the countries. There are 11 countries in Latin America that would be eliminated from the list. What Mr. Levinson said is simply an overstatement of what would happen. There are only 11 countries in all of Central and South America and they are the richest countries or the countries which have access to financial markets.

Senator HAGEL. The record will reflect your comments, Dr. Meltzer.

I think the committee has developed some appreciation over the fact that we do have, indeed, a minority and a majority report.

Dr. LEVINSON. We have two minority reports.

Senator HAGEL. Two minority reports.

I would like to begin the questioning this afternoon with you, Dr. Calomiris. You have heard what your colleague and friend has said about the majority report, and we could spend days, I suspect, taking apart Dr. Levinson's analysis. But I want to focus on a point that he made, and you can take this any way you want to take it. His comment, I believe the quote was, "more than technical issues are involved here." First, do you believe that is true? And then would you amplify your answer? Should "more than technical issues" in fact be considered in determining the role of the IMF and other international institutions?

Dr. CALOMIRIS. I am going to ask for a little clarification. Do you mean, when you say more than technical issues—

Senator HAGEL. Well, Dr. Levinson laid out that we are dealing with real people's lives, social compacts as I think he referred to it. He seems to think the majority report defined the IMF, the World Bank, and the seven institutions that you studied in narrow, technical, economic terms only. Did you do it that way, or did you look at the reality of dealing with people's lives rather than a textbook framing of the issue?

Dr. CALOMIRIS. Let me respond. I think that we agree in our objectives. We disagree maybe about what the consequences of different policies would be to meet those objectives. Since we were talking about Argentina, let us use that as a case. I do not think the IMF or the World Bank should go to any country and tell them what their labor union laws should be, and I want to clarify that. I have said that in previous testimony. I do not think that is the proper role of those multilateral institutions and I do not think that it should be part of their conditionality for lending either. So, I think we agree on that.

Let me explain in Argentina where we may disagree, or at least how I view it. What I was suggesting is that the U.S. Treasury, IMF, IDB, and World Bank involvement in Argentina had made the size of the debt over the last 3 years very large. The major mistake was that it kept postponing private market discipline. Basically the arithmetic has not been working in Argentina. It is that simple. The amount of debt service required is getting very large. There are \$18 billion worth of Argentine debt that has to be either rolled over or new debt issued within the next year. The entire Argentine banking system only has a deposit base of \$80 billion. So,

that gives you a little bit of a sense of how big the shock is. I could go into the details.

The point is now we have a big problem, and the problem is a lot bigger as a result of the fact that the private market discipline that would have occurred 3 years ago, where the creditors would have said, we do not see the progress, we do not see the reforms, the money is not coming in, was postponed. If Argentina had been forced to choose 3 years ago between what I would call a reform agenda—that is, expenditure cuts, labor market reforms—then they could keep their currency board and they could maintain their payments on their foreign debt indefinitely. On the other hand, they might have learned 3 years ago that they did not desire or have the political will to maintain that policy stance.

I am not judging which of those they should do. That is up to Argentina. My point is now they have the worst of both worlds because now they are sitting on a powder keg. When they have to make that choice over the next year, it is going to be a much bigger cost either way. So, my point is not to disagree with Mr. Levinson about what the choice in Argentina should be. We do disagree about it, but that is really not the point of our recommendations. I think the spirit of our Commission was to say that should be up to the country. Let us not make their choice set worse. Let us not aggravate the risks and that is the sense on which I think we disagree.

Senator HAGEL. Dr. Levinson, what is wrong with that?

Dr. LEVINSON. I agree. I am delighted to hear that Dr. Calomiris agrees that it should be no part of the IMF, World Bank, or Treasury program to tell Argentina how it should resolve its labor market compact, which arose over the last 40 years, as we well know, in part as a consequence of the reaction against the oppressive conditions of the Argentine—what they called the *des camisados*, the ones who worked in meat packing.

But it is really astonishing to listen to this because it is as if when—Professor Calomiris, who I really admire because of his expertise in the history of international financial markets, talks about 3 years ago in Argentina. In order to meet the expenditure cuts that they had agreed with the IMF, the targets, they started cutting education. There was a middle class, an upper class, and a working class revolt in Argentina. They had to back off of those expenditure cuts. We talk about the labor market reform that the IMF and World Bank has been pressing for the last 5 years. As I said, in 1996 it brought the country to a halt. This year it led to riots before the Congress.

He is right when he says this has to be resolved by Argentina, but what he is not willing to acknowledge is that maybe the model that has been promoted for the last 10 years of radical labor market and liberalization of markets, without taking into account the employment consequences and the social consequences, is not sustainable in a place like Argentina.

Senator HAGEL. Thank you. My time is up for this one. But may I ask you for a quick response? You have something on your mind, I suspect. Then we will go to Senator Wellstone.

Dr. CALOMIRIS. I am trying to find a point of agreement. I have worked for the Argentine Government over the past 5 years. I

would guess that Mr. Levinson has probably worked for them, giving advice, saying what we think is right. I think we can agree maybe that Argentina should decide for itself, get a lot of different advice, and that there is no reason that the IMF or the World Bank needs to tell them what to do. I do not see any disagreement.

Dr. MELTZER. May I point out that that is why we tried to get rid of conditionality and impose preconditions, so that the IMF would not be in this position? I do not understand Mr. Levinson's position because he criticizes our report because we get rid of conditionality, and then he criticizes the conditions which they impose on the country. Now, perhaps he would like to impose different conditions on the country. Then other people would object to those. We got rid of those conditions for some of the reasons, and others, that he mentions.

Senator HAGEL. Well, thank you. I know we could continue this. It is an enlightening and didactic experience.

Senator Wellstone will get up and pour water on my head and leave if I do not call on him. Senator Wellstone.

Senator WELLSTONE. On my time, Dr. Levinson, why do you not respond to Dr. Meltzer.

Dr. LEVINSON. The problem is that Professors Meltzer and Calomiris and the majority throw the baby out with the bath water. They are right in terms of focusing and calling our attention to the degree of intrusiveness of the conditionality. They are right about that.

Senator WELLSTONE. And may I interrupt you for a moment? And the past history of that conditionality all too often, I gather, was imposing austerity measures, cutbacks, and basically trying to export countries exporting their way out of economic trouble. Would that be a summary?

Dr. LEVINSON. Yes. That is the basic philosophy that you have.

The difference is that I say—and Fred and myself agreed and the Treasury and the Council on Foreign Relations—that there is a legitimate role—if the international financial community is going to provide assistance, it is right to say, listen, you got into this mess, let us figure out a way together as to how you are going to avoid repeating it. So, you try and work out a program in which the conditions are most proximally related to the balance of payments crisis. But you do not try and remake the society. That is where I think the IMF and World Bank have overreached with the support of our own Government. So, it requires a degree of self-restraint.

Professor Meltzer is right to point out that once you accept conditionality, it is very hard to draw that bright line where you step over into that degree of intrusiveness that is really national sovereignty. The criticism I have is that they have stepped over that line and, with our support, are trying to remake not only the economies, but these societies in accordance with their prefixed model. Now, they would deny that, and the difference between us is I think there is a legitimate role for conditions proximally related to the problem.

Senator WELLSTONE. Let me ask you. Maybe this is a semantical problem here, but I am going to just read to you from your testimony that you submitted. You say: "Neither the majority report or the joint dissent, however, recognized the other source of discontent

with Bretton Woods institutions: the perception that they are critical elements in the development of a profoundly inequitable two track international trade, investment and finance system, a rule based system for the protection of corporate property rights and no protection for core worker rights and the environment.”

Now, it seems to me their argument would be that if you are now going to talk about some core protection for the environment and labor rights—I know Joe Stiglitz has also talked about this—that you are now talking about conditionality.

Now, let me ask you to sort of respond to that because I am trying to figure out exactly where you are at on this question.

Dr. LEVINSON. The problem I have is that they are pushing labor market flexibility, which as I said is—

Senator WELLSTONE. Right, which—

Dr. MELTZER. And that means the IMF, not me.

Dr. LEVINSON. No, I agree. Right, the IMF and World Bank.

And when you raise the question, wait a minute, that is an intervention on one side, what about labor market abuses where a country uses the coercive power of the state to deny workers the right of freedom of association and collective bargaining, they say, well, we cannot support freedom of association and collective bargaining because the economic studies are inconclusive.

I asked the World Bank for a statement on their policy. They said they were studying the matter, and then their studies concluded that they cannot support it. In the year 2000, the World Bank cannot bring itself to say freedom of association and collective bargaining are legitimate rights of workers. That is where I get off the boat.

Dr. CALOMIRIS. And if I can clarify my position and I think the majority's, it is simply we do not want the World Bank and the IMF setting conditions one way or the other on that point.

Dr. MELTZER. That is right. We want them to be neutral and simply not to lean either to protect—we certainly do not want them to protect the lenders, who have put their money in at risk and received rewards for doing it. That really is a major point. Nor do we believe that they should be involved in trying—and it is hard to know how they could succeed—in changing the political structure of a country. They have politics in those countries too and those countries are going to do what the balance of political decision in the country is. That is not the job of Washington. It is not the job of the IMF or the job of the World Bank.

Now, I would like to say one other thing, Senator Wellstone.

Senator WELLSTONE. Yes.

Dr. MELTZER. In fairness to the IMF, the fact that they come with austerity programs, they come in a crisis. There is going to be austerity because it is a crisis. No one is going to lend to them any more. There is going to be austerity because they have been borrowing more than they have been able to repay. So, there is going to be austerity.

What we would like to do and what we would like to get concentration on is instead of dealing with crises as they occur, deal with the conditions that create crises before they occur, establish some preconditions that countries will meet so as to limit the crises.

Senator WELLSTONE. This will be my final piece, Mr. Chairman, and Dr. Levinson can respond, but I would think, Dr. Meltzer, that you could argue that part of creating the conditions is the sort of building of community institutions in these countries.

Dr. MELTZER. Absolutely.

Senator WELLSTONE. And one of those institutions would have to do with the right of people to be able to organize and bargain collectively so that when people do so—you need people to consume in order to make the economy go. It can lead to a more stable class of people. And another might be sustainable environment. The commission tends to not call for more oversight or attention to environmental or social implications of structural adjustments. Is Dr. Levinson not trying to say that ought to be part of what is factored in here?

This is a great panel. They all want to speak. This is what happens when you get these professors together.

Dr. LEVINSON. There are some people, including my colleague, Fred Bergsten, who believed that the Commission should have simply ignored the World Trade Organization, which was defined as an international financial institution for purposes of this Commission. I do not believe that somebody put a mickey in the water system up here and that the WTO just slipped in while nobody was looking. There is a reason for that and I think it reflects the wisdom, if you will, of the Congress in terms of trying to see this problem as a whole, trade, finance, and investment.

What you have is a system which is developing where everything is directed to assure the security of capital and of corporate property rights and nothing is done to assure minimum, basic core worker rights, either in the WTO system or with the IFI's.

The Congress in the last IMF legislation accepted a provision with respect to core worker rights. We do not see it implemented in either the World Bank or the IMF. When I asked Wolfensohn, wait a minute, you are intervening in the labor market for purposes of labor market flexibility, you are intervening on the part of capital, what about the abuses, he said, look, I agree with you completely. He said, but if I take a measure to the board for labor market flexibility, I have no problem getting it through. If I raise the issue of labor market abuses in a country, I will not even get it on the agenda to be discussed.

There is something fundamentally wrong with that imbalance, and that is what I am saying. There is an imbalance both in the WTO and when the World Bank tells us in the year 2000 that they cannot support freedom of association and collective bargaining because the economic studies are inclusive, but they are enthusiastic about labor market flexibility, that is not neutrality. That is an intervention on the part of one party, and we should not stand for it and our executive director should not stand for it.

Dr. MELTZER. I realize the red light is on. May I just give a very brief answer to your question?

Senator WELLSTONE. Yes.

Dr. MELTZER. We separate crisis prevention, the role of the IMF, from structural reform. Questions like the environment are in our report and they are very prominent in our report as part of what we call world public goods, responsibility of the development banks.

So, we do not ignore the issue. We just do not think it should be on the list of conditions that are part of the reform. We think that the major problem that you are going to face is that the United States has run a huge payments deficit in order to finance the reform in Asia, and we are going to have to adjust to that and that is going to be painful and that is going to be a problem. And we need to build a system which does not require the United States to be the importer of first resort in a crisis, and this system is not doing it. And that, from the standpoint of the United States, is the single most important problem you have to solve because the rest will not follow unless we do that, that is, unless we do something to see that these problems do not all end up solved by exports to the United States.

Dr. CALOMIRIS. Senator Wellstone, I want to prove that I listened to your question. You asked about environmental and labor standards. In the report actually there is a fair amount of writing about environmental questions and there is a view in the report that I think was—I cannot say that it was a unanimous view, but that is my sense—that there really is a legitimate role for particularly the World Bank to play in promoting good solutions to global environmental problems.

What is the difference between environmental problems and labor standards? Why did we not talk about labor standards but we did talk about environment? The answer is very simple. Labor standards are something that each country should decide for itself, while environmental issues are intrinsically global. So, it makes sense, because of externalities across countries, for there to be some mechanism for helping countries to coordinate their approach to global environmental standards. At least that I think is the explanation.

Senator HAGEL. Doctor, thank you.

Let me call now upon Senator Chafee.

Senator WELLSTONE. I thought as a professor I get to get into this now. I had to listen to all that.

Senator HAGEL. No. We have to be out of here by midnight.

Senator WELLSTONE. I have to leave now. Thank you very much.

Senator CHAFEE. I have a quick question for Dr. Calomiris. You testified that the Commission voted unanimously to recommend that the IMF and the development banks write off all debts to highly indebted poor countries, and that the financial distress of the HIPC's is as much an indictment of the multilateral lenders as it is of the leaders in the borrowing countries who often wasted those funds or used them for personal gain. Despite these factors, the Commission voted unanimously that we should relieve them of their debt. Can you describe the debate on how the Commission came to that unanimous agreement, considering the scathing words in your testimony?

Dr. CALOMIRIS. Well, I will give my characterization of the discussion and then let the others, I suppose. I do not think that there was much of a hostile debate at all on this question within the Commission. I think that there was a consensus that it made sense to do HIPC debt forgiveness, largely because the people who had borrowed the money and the conditions under which the moneys had been borrowed really were very different from the current situ-

ations in those countries and the current people; that is, just as I say in the testimony, it is hard to fault the current citizens of those countries or even their current leaders for the bad judgment that went into those loans.

I think the disagreement in the Commission, was over how to set up the right criteria for debt forgiveness. How far do you want to push? Some members of the Commission, at least my recollection is, Mr. Huber felt that we should add more conditions, more preconditions, before forgiving debt. I think he mentioned particularly maybe privatizing all state-owned enterprises as a condition for forgiveness. He had some other ideas. Others had different ideas.

Because we could not come up with a clear list or a clear consensus on exactly what those conditions would be, I think we really just agreed on the principle that we saw no reason not to forgive the debt but that we did see a little bit of latitude for requiring some kind of bona fide development plan as a precondition. I think we were vague on this point because we did not reach full consensus on what that should be.

Dr. LEVINSON. May I elaborate just for a moment on that? I proposed that we should forgive the debt—period—because the majority themselves said in the report that the debt is not repayable. So, if you have an unrepayable debt, how are you conditioning the repayment of a debt which they themselves say is unrepayable? It does not make any sense. It is illogical.

Just let me finish please. So, what I suggested was, let us acknowledge that reality, which you yourselves have said. That the debt is unrepayable.

Therefore, you say to these countries, look, we all acknowledge that a good deal of this debt was contracted in cold war conditions. We are going to wipe that out. Your access to future resources will depend upon how well you use the space that we have given you by forgiving that debt. But we agreed that this debt cannot be repaid, and what is more, it was contracted for reasons which led to very little positive impact in your countries. So, let us start with a clean slate. But we've got to tell you, if you screw up in the use of this margin that we have given you, we are going to be very tough in terms of access to future capital. That position was rejected.

So, therefore, rather than vote against debt forgiveness, I went along with the majority in terms of saying it should be conditioned, but I do not see the logic of conditioning a debt which you say cannot be repaid upon A, B, C. You have already said it cannot be repaid. What are you conditioning the non-repayment on?

Dr. CALOMIRIS. If I may very quickly. We are not very far apart but instead of saying the debt cannot be repaid, I would add the word cannot be fully repaid. These debts do have a current market value. So, that means if you forgive it completely, that is, you take all of the debt away, you do have a little bit of leeway potentially to add a few conditions. But I agree with the thrust of what Mr. Levinson is saying, and I just want to say my feeling was that this was not a hotly contested issue. It was more that we really did not know exactly how to do it, and I think maybe his view went a little farther than others were willing to go.

Dr. LEVINSON. I think that is a fair statement.

Senator CHAFEE. And you are optimistic that they are different people than those that committed the abuses?

Dr. MELTZER. No, Senator Chafee, I do not believe that. I believe that they are certainly different people, but whether the institutions in those countries are sufficiently reformed is questionable.

I want to challenge this kind of semi-agreement. First, it was true that Mr. Levinson was alone on the issue of debt forgiveness without conditions.

Second, there is nothing illogical about saying, one, we are going to forgive the debts because they cannot be paid, but we want to make sure, by imposing conditions which we want put in place, that the next set of debts will not be in the same position as these debts at the end of 10 or 15 years. So, the conditions are there looking forward to saying, look, we want reforms in these countries. We want the reforms to be in place, and we are going to use the leverage of debt forgiveness to get those reforms to be put in place. That does not seem to me—there is nothing illogical about that. It seems to me to be a sensible thing to do, to use the leverage we have to get the reforms we need.

Dr. CALOMIRIS. If I can just amplify what Professor Meltzer said. Conditions have two sides to them. Professor Levinson was talking about imposing very draconian conditions on the recipient, and his point was, well, if the recipient cannot repay it, you do not have a lot of leverage in imposing conditions.

But there is another set of conditions and those are the conditions on the institutions going forward, and that is, I think, the more important set of conditions to be thinking about when you forgive the debt.

Senator HAGEL. Senator Chafee, thank you.

Dr. Meltzer, has the IMF or World Bank responded to you in any way on your Commission's recommendations?

Dr. MELTZER. Not formally, but I have had any number of meetings with officials of the institution both here and abroad. I have talked to them. I think that they accept a great many of the proposals that we have made. They like the idea of preconditions. Dr. Fisher, the Deputy Managing Director of the Fund, testified to that in an open hearing of the Commission. They liked the idea of having a lender of last resort function. They have gone very far toward the idea of having either hard, fixed or fluctuating exchange rates.

Where do they differ with us? I do not want to speak for them, but let me say what my sense of where they come from is.

One is they do not like the idea of giving up long-term lending, which we want to move out of the Fund and into the bank. They think that there is something to do there. I will let them speak to that. But anyway, that is one.

The second is they would like to have conditions when there is a crisis in addition to the preconditions. Now, that is a strange issue. Let me say that I could see a compromise which said, yes, if those conditions are limited to the monetary, fiscal, and exchange rate policy of the country, that might be good.

The problem is not to get back into two boxes which we want to escape from. One is the box which says we spend a lot of time negotiating those conditions and then things get worse during that period, as in Mexico, as in Korea. The second is that if we say, look,

if you do not meet the preconditions, we will negotiate with you anyway and put on other conditions which you may or may not meet. Then we are right back into the present system, which is a system which generates crises and does not prevent them.

Those are, I think, the two major issues.

On transparency, I think the Fund is making substantial progress in that direction in collecting information and other things. I think that they are not very far apart from us. That is my interpretation, but there are some basic differences between us and those are two of them.

Dr. LEVINSON. I would only add two points. The Fund got into longer-term lending as a consequence of the oil crisis which followed upon the Arab oil embargo in 1973 and the countries had difficulties repaying. So, the various facilities provided for longer amortization periods. That was the origin of it.

The second thing is the basic difference comes down to the degree to which under the majority proposal, access to the Fund's fund would be automatic without conditions which address the underlying conditions which led to the crisis to begin with. What it really boils down to is whether or not you think it is legitimate for the Fund to enter into an agreement to address those issues with the country which seeks assistance. That is where I think the major area of disagreement is between the majority, the Fund, the Treasury, and Fred Bergsten and myself and Esteban Torres with respect to the Fund.

Dr. MELTZER. Let me address that a little bit. The Fund has tried to have something called the CCL, which is a way of moving in the direction in which we would like them to go, with preconditions and so on, certifying countries in advance. The problem is that they gave countries no incentive to take those preconditions because they did not gain anything. If they got into a crisis, the Fund was going to be there to bail them out anyway, so why should they agree to that. And that is a tricky issue.

So, it is important to try to get meaningful the idea that countries have to establish on their own, when there is not a crisis, conditions which are going to mitigate crises, prevent them. We cannot guarantee that there will be no crises. We can try to make them much less severe and much less burdensome to them and to us.

Dr. LEVINSON. The assumption which underlies the majority, it seems to me—it seems to me there are two. One, that access to the IMF is too easy and too desirable for the borrowing member countries. Well, this is so fantastic if you talk to the officials in the borrowing countries. To go to the IMF, it is like going to the dentist for root canal work. Nobody wants to go to the IMF.

Dr. MELTZER. But that is not our assumption.

Dr. LEVINSON. Please. That is the assumption, that the countries have easy access to the IMF. Therefore, they do not have to take the measures. If they are not taking the measures, it is because there are deep, internal social and political impasses. That is the problem with Ecuador. That is the problem they are going to have in Argentina as they try and figure out a way out of this mess. That is the problem which has held up fiscal reform in Brazil for all these years, although the present government is making progress.

The problem is, as I see it, Senator Hagel, that the majority just cannot face the fact that these are not simply financial issues. They reflect the historic impasses in these countries. So, what we have is two steps forward, one step back, in some cases one and a half steps back. It is a constant process of trying to nudge and help and pull and push as the countries themselves try and resolve their internal dilemmas. The question is, is the direction right? And I think that, on balance, a lot of progress has been made. But the assumption that countries do not undertake these reforms because they know they can go to the IMF just seems to me to be fantastic.

Senator HAGEL. I might point out in some of Dr. Calomiris' testimony, he recounts in some detail about how many nations over a period of how many years have drawn on the IMF like a bank account that is just there and available. Now, I am not passing judgment on that observation, but I did note that you made that point, and I suspect you are going to want to continue to further the point. Go ahead, Doctor.

Dr. CALOMIRIS. Mr. Chairman, you took the words out of mouth. There are 73 countries, who are members of the IMF, who have borrowed in 90 percent of the years that they have been members of the IMF. I think that that fact speaks for itself. Borrowing from the IMF is not an occasional thing that you do because you are absolutely up against the wall, and I cited the example of Pakistan as a country right now which, while it is having some problems with its debt crisis, it is much more of what I would call a subtle negotiation over of transfer of subsidy in exchange for some political favors. That is a better way to characterize that negotiation I think.

Senator HAGEL. Let me ask Dr. Meltzer if he has a response to this.

Dr. MELTZER. I have two.

The basic assumptions which operated in our Commission were not the ones that Mr. Levinson mentions. They are two in respect to the IMF. The crises are too frequent, too deep, and too burdensome, and we need to do something to stop it, that is, to slow that process down and make it less burdensome, less onerous.

The second is that the biggest incentive for reform in the country is the capital market, the fact that you can get access to the capital market. That will be the incentive to reform. It is not what somebody tells them what they have to do. It is the idea that if you do not do these things, you are either going to pay more for the capital and you are going to get less of it. Those are the important reforms. So, we are going to say to them, here are the reforms. If you have met those reforms, we are going to give you certification of a kind, and if you have not met those reforms, we are going to withhold it from you. And then we are going to say, anybody who lends to somebody who is on the list of countries that have not met the reforms, let them take the risk, but let them bear it also.

Senator HAGEL. Thank you.

Very briefly, Dr. Levinson.

Dr. LEVINSON. For every irresponsible borrower, there is an irresponsible lender. What we have had is the countries have been encouraged to recur to the financial markets. Our own Treasury has encouraged them. Listen to what Mr. Gartner, the former Under

Secretary of Commerce said, "I never went on a trip when my brief did not include either advice or congratulations on liberalization," referring to liberalization of the financial markets.

The fact of the matter is that this is not just a question of irresponsible countries and irresponsible officials. You have had an explosive growth in access to the financial markets. It has meant the democratization of the financial markets in terms of countries have been able to access those markets which have never had access. Entities within these countries have been able to access these markets. The problem is that we have gone too far too fast before institutions were in place with respect to bank regulatory authorities, et cetera. What is more, with respect to the Asian countries, remember the Asian countries followed the Japanese development model. It was directed credit. You did not have independent supervisory bank authorities because that would have interfered with the basic strategy of directing credit to strategic sectors.

So, now we are talking about restructuring not just the financial sector, because that was part of, again, what I referred to as a social compact. In Korea you had a commitment to lifetime employment. In return, the workers agreed that the enterprise could distribute the workers with flexibility. Now you are telling the workers, no, now you are going to be subject to the vicissitudes of the market. You have a whole different philosophy.

My problem with their approach is that it is really based, as I said at the beginning, upon the view that these are technical financial issues, and I see them as a part of a whole problem within a society of reconstituting and how to distribute the burdens and the costs of adjustment.

Senator HAGEL. And you have made that point extremely well. Doctor, thank you. I am going to move on to Senator Chafee.

Senator CHAFEE. I am done, Mr. Chairman.

Senator HAGEL. You wanted another point.

Dr. CALOMIRIS. I do not see our disagreement the same way. I think we share a lot of objectives, and I do not think I am a narrow-minded technocrat. I like to think about people's lives as much as Professor Levinson does. But I think we have a disagreement, and I would like to explain historically some evidence that I think is consistent with my point of view.

Senator HAGEL. Doctor, if you do not mind, I want to get maybe one more question in and let you all go home. I would be very interested and intrigued with your point. Maybe we can do it again, but let me just keep it rolling so we do not keep you all up here.

Dr. CALOMIRIS. OK.

Senator HAGEL. Let me ask each of you. With the recommendations for preconditions that the majority report came in with, how would those preconditions have affected Asia, Russia, Argentina, and Brazil over the last few years? Would we have made the world better, more dangerous, more unstable?

Dr. CALOMIRIS. May I take a crack at that?

Senator HAGEL. You can jump right in.

Dr. CALOMIRIS. Remember that we are talking about phasing in over a 5-year period the preconditions. So, the right way to pose the specific counter-factual question is suppose we had phased in—

Senator HAGEL. Now, wait a minute. The issue here is not the correct way to present the question. I presented the question based on reality. Asia went down. We all thought, or at least most of us, I guess, thought it was a currency blip in Thailand in the summer of 1997 or June 1997. Now, no theoretical framing here. What could we have done as that Asian financial crisis spread? That is reality, and we have got problems on our hands. So, we do not back it up and start at 5 years or 10 years. 1997 is now. What do we do?

Dr. CALOMIRIS. I was just trying to understand. Were you saying that our Commission would have met in 1996? Is that what you were saying?

Senator HAGEL. Well, if we were living with the preconditions that you have recommended, how would the IMF have responded? Would the IMF have responded?

Dr. CALOMIRIS. Let me try to answer it under those terms. If we had been living under those preconditions, then countries would have either qualified or not.

Senator HAGEL. If they would not have qualified, then what happens?

Dr. CALOMIRIS. If they would have not qualified, then the IMF would have made a determination whether global systemic stability required waiving the prequalification requirements to lend to them, which our report envisions their doing.

And I suspect they would have. If they had waived the prequalification requirements, however, they could not have waived the penalty rate or the fact that these would have been senior loans. Therefore, we would have at least avoided complicity in the bailout of the domestic financial institutions and the international lenders because no flows of subsidies would have gone to them. So, we would have provided liquidity but not bailout.

My view is that those countries would have, given a couple of years, prequalified and they would have acted very differently in the mid-1990's. And the real problem in Thailand and Korea and Indonesia was weak banking systems. Those were predicted crises. They were actually predicted in print in March and April 1997 in the Economist and in the Financial Times. And in fact, the Economist even said something like what took place in Mexico is about to happen in those countries, fully 3 to 6 months ahead of the actual crisis.

I know Dr. Meltzer wants to address this as well, but are we putting too much of a burden and too high an expectation on these international financial institutions?

Dr. MELTZER. Yes. We need to put much more of the burden and much more of the incentive on the country.

Let me answer your question because I think it is the right question to ask because what we are concerned about is how will all this work. And the answer is let us take Korea, which is the biggest one of the countries that failed.

Korea has had a bad banking system for years. When I first went to Korea in 1985, the question was, what do we do about the banking system? How can we open our capital markets with such a weak banking system? That is 12 years before this crisis occurred.

How did Korea get such a bad banking system? It got a bad banking system because it uses the banking system to subsidize the industries that it wants to create. It did it with the chemical industry. It turned out to be a bad idea. Not all their ideas are bad, but that one turned out to be bad. They did it with the construction industry, and they subsidized a lot of construction in the Gulf when the oil countries had a lot of money and were building a lot of things. So, they subsidized the development. They later subsidized the country going into automobiles and semiconductor chips. So, these are subsidies. They lend at very low rates.

The semiconductor market collapsed in 1996. The banking system took a big hit. So, with having negative net worth, it had even more negative net worth. It loaned as the banks did here or the savings and loans did here. It loaned at high risk loans. The Korean banks were lending money to Russia, buying GKO's in order to get the high returns that they could get and borrowing the money from the U.S. banks or from Japanese banks at very low rates and lending it in Russia to hold GKO's in order to earn the returns that they hoped would bail them out of some of the problems that they had. Now, if they had a strong banking system, they would not be doing that, or they certainly would be doing less of it.

Therefore, I cannot say that Korea would not have suffered a crisis in 1997. Neither I nor anyone else knows that, but I can tell you that the banking system would not have collapsed if it had been adequately capitalized, if there had been American banks and Japanese banks and European banks there. When people ran from the country, they would run to the American banks, which were safe and sound and so on, as they did in Japan, as they did in Brazil.

Now, how do I know that that is going to happen? Because look what happened in Brazil a few months later. In Brazil, everyone said there is going to be a big crisis. The exchange rate collapsed, but the banking system did not collapse.

Why is that? Because Citicorp, ABN-AMRO, Chase Bank have been there, First Bank of Boston—Bank of Boston—they have been there for years and they have a commitment. They have assets and liabilities in the country. They do not run, and therefore they stabilize the situation. And that is the kind of system that we are trying to build. We are trying to build a system in which banks will take up some of the risk, that the banks will be well capitalized and that they will be risk absorbers.

Now, what is the present system? The present system is Korea does not let in the U.S. banks or foreign banks. So, they lend to the Korean banks on 3-month notes. And those notes came renewable, and when the lenders see that a crisis is likely, they say the exchange rate is going to fall, there is no point to renew the loan, it is not going to appreciate, and so let us get out. And that exacerbates the crisis, and then the banking system goes down. And that is the nexus that we have to cut into by making the preconditions which say reform the financial system, reform the exchange rate system so that they do not spend \$30 billion or \$40 billion that they borrow in the world market in order to shore up the exchange rate system and then fail and then depreciate, and then of course,

become—push, get out of their crisis by exporting mainly to us. That is really the system we have to break into and change, and that is what the reforms are about.

Senator HAGEL. Just one moment, Dr. Levinson. Would you just quickly, Dr. Meltzer, address my followup question on the burden that we are placing on the IMF and these international financial institutions?

Dr. MELTZER. I think that is right. As I like to say, there are politics in those countries too. You cannot come in, as the IMF, in the midst of a crisis and clear away all the problems and make things all happy again by lending them some money in exchange for some commitment. There are many people in Asia who say the crisis did not go on long enough. Now, that does not mean that they like to see people suffer. What they meant was that as soon as the progress became clear, the reforms ended or slowed down a great deal.

So, yes, the IMF comes in in the midst of a crisis. We criticize them because we say that their conditions do not work, do not work very well on average. But it is not because I think I have better conditions that I can put on and say, if I were running this show, I would do a better job. That is not my criticism at all. My criticism is let us not put ourselves in the position where we are bailing out countries that have not done what they need to do. Let us give them the incentives to do it and make those incentives hard so that they will want to pay the tough political price, which you understand better than I do, the tough political price to make the tough judgments which are required to provide greater stability in the world. That is what this report is about.

Senator HAGEL. Thank you.

Dr. Levinson.

Dr. LEVINSON. I think your two questions really point up the issue. You asked what would have happened if the Commission's recommendations had been in place. Well, Professor Meltzer has referred to Brazil. Recently Brazil has imposed conditions upon the entry of foreign banks. Why? Because in Brazil, the historic situation has been that the Brazilian banking sector, Brazilian owned, has continued to loan to the government, even in times of crisis because in Brazil, the Pavlista industrialists and bankers believe in Brazil. They do not run. The money does not leave. It is very nationalistic. The foreign banks advise their clients not to buy government securities because it was too risky. So, the Brazilians say, wait a minute, it is not in our interest to have a presence of the foreign banks because look at what they did in times of crisis. We know Brazil better than they do. So, they impose conditions limiting foreign bank ownership.

If they impose conditions, under the majority criteria, they are not completely open to foreign capital. Therefore, they would not have been eligible for IMF financing. Brazil is large enough to have systemic consequences. You would have had to have a vote in the IMF as to whether they are large enough to have systemic crises.

Professor Meltzer complains that the IMF did not act quickly enough. Do you think you could have gotten a quick consensus in the IMF on that fundamental question? I doubt it. Just as in Mex-

ico, the United States and the Europeans disagreed as to whether the problem was systemic.

In your second question you went on to ask if we have placed too much of a burden upon the international financial institutions. Of course, we have. It is the Willy Sutton principle of international finance. Remember Willy Sutton, the bank robber who was arrested in the 1950's in Florida, and they said to him, well, why did you rob only banks? And he said, "because that is where the money is." Why do we turn to the IMF and the World Bank? Because that is where the easily accessible money is to address a systemic crisis or a crisis which at least is perceived as systemic.

So, the major industrialized countries have imposed upon the IMF and the World Bank to continually get into Russia, manage the transition in Russia, and to solve the East Asia crisis when the East Asia crisis has roots which are very different. Remember the World Bank World Development report—the East Asia miracle of 1993 which said Korea went from a country in 30 years with \$260 per capita income to the 11th largest industrial country in the world? Well, the banking system cannot be isolated from that strategy of development. So, when you are talking about revamping the banking system, you are talking about revamping the country's whole development approach which enabled it in 30 years to become the 11th largest industrial country in the world. That is going to be a wrenching change.

So, the question is, do you want the international community to have a role in terms of helping them to get through that or not and leave it to the private financial markets? In essence, you asked the two questions which are at the heart of the issue.

Senator HAGEL. Thank you.

Dr. Calomiris, would you like to respond in 60 seconds or less?

Dr. CALOMIRIS. I think I already responded to most of it, and I think I will just pass.

Senator HAGEL. Dr. Calomiris, thank you. Dr. Levinson, thank you, sir. Dr. Meltzer. You three have all added immeasurably to at least this weak-minded Senator's understanding of your contributions to our country through your time and effort on the Commission. So, we are grateful. The committee is grateful. Thank you.

Dr. MELTZER. Thank you, Mr. Chairman.

Dr. CALOMIRIS. Thank you, Mr. Chairman.

Dr. LEVINSON. Thank you, Mr. Chairman.

Senator HAGEL. The committee is adjourned.

[Whereupon, at 4:45 p.m., the committee was adjourned.]

STATEMENT SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF C. FRED BERGSTEN,¹ DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

REFORMING THE INTERNATIONAL FINANCIAL INSTITUTIONS: A DISSENTING VIEW

It was a privilege and pleasure to be appointed to the International Financial Institutions Advisory Committee in January to replace Paul Volcker, who had to re-

¹C. Fred Bergsten is Director of the Institute for International Economics, the only major research institution in the United States devoted to international economic issues. He was Assist-

Continued

sign due to heavy commitments elsewhere. I enjoyed working with the group and appreciate this opportunity to spell out the views of the four commissioners who dissented from the recommendations of the majority. (Mr. Richard Huber signed both the report and the dissent, and explained his rationale for doing so in a statement of his additional views.)

I and my fellow dissenters share the view that reform of the international financial institutions (IFIs) is desirable. We agree with a number of the proposals of the majority, in particular the need to clearly delineate the responsibilities of the IMF and the World Bank. But there are four central issues on which we disagree; I will summarize them briefly here and append the full dissenting statement signed by myself, Mr. Huber, Mr. Jerome Levinson and former Congressman Esteban Torres.

First, the *report paints a very misleading picture of the impact of the IFIs over the past fifty years*. The economic record of that period is a success unparalleled in human history, both for the advanced industrial countries and for most of the developing nations. The severe monetary crises of recent years have been overcome quickly. Hundreds of millions of the poorest people on earth have been lifted out of poverty. The IFIs have contributed substantially to this record. The “bottom line” is unambiguously positive but the majority portrays a negative tone that badly distorts reality.

Second, the *recommendations of the majority would totally undermine the ability of the IMF to deal with financial crises and hence would promote global instability*. The majority would authorize the Fund, when facing a crisis, to lend only to countries that had prequalified for its assistance by meeting a series of criteria related to the stability of their domestic financial systems. This approach has two fatal flaws:

- *it would permit Fund support for countries with runaway budget deficits and profligate monetary policies* (because the majority believes that IMF conditionality does not work); this would enable the countries to perpetuate the very policies that triggered the crisis in the first place, squandering public resources and eliminating any prospect of resolving the crisis² and
- *it would prohibit support for countries that were of systemic importance but had not prequalified, again running a severe risk of bringing on global economic disorder*.³

As Paul Krugman put it in his op-ed on the report in the New York Times on March 8, the majority “suggested restrictions that would in effect make even emergency lending impossible.”

Third, *the recommendations of the majority might well undercut the fight against global poverty* despite their avowed intent to have the opposite effects:

- *they would shut down two major sources of funding for the poor*, the regular lending program of the World Bank (\$20-25 billion per year) and the Poverty Reduction and Growth Facility at the IMF (\$1-2 billion per year). The majority in fact proposes a program of “reverse aid” to the world’s richest countries, returning capital to them from both the World Bank and the International Finance Corporation (which they would also shut down).
- *they would terminate lending to even the poorest countries if they had obtained access to the private capital markets*, which we should obviously be encouraging rather than discouraging;

ant Secretary of the Treasury for International Affairs during 1977-1987 and functioned as Under Secretary for Monetary Affairs in 1980-81. He was also Assistant for International Economic Affairs to Dr. Henry Kissinger at the National Security Council during 1969-71. He has written 27 books on international economic and financial issues including *The Dilemmas of the Dollar: The Economics and Politics of United States International Monetary Policy* (2d edition, 1996). He chaired the Competitiveness Policy Council created by Congress from 1991 to 1997.

²The final version of the report added a sentence including a “proper fiscal requirement” to the prequalification list. No rationale for that addition is stated, however, and the term is not even defined. If the “fiscal requirement” were intended to be a quantified level of permissible budget deficits, it would represent an international equivalent of the Maastricht criteria that have been extremely difficult to implement in relatively homogenous Europe and would be impossible globally. If it were simply a qualitative notion, the Fund would be back in the business of conditionality which the report rejects—and would face the prospect of dequalifying and requalifying countries as their policy stance shifted, adding an important new element of destabilization to the picture.

³The report again made a last-minute addition suggesting a takeout from these requirements “in unusual circumstances, where the crisis poses a threat to the global economy.” But the concept is never explained or defended so it cannot be taken seriously.

- *they want the more advanced developing countries, even those which still include tens of millions of the world's poorest people (e.g., Brazil and Mexico), to rely wholly on the volatile private capital markets; and*
- *most importantly, they would in the future rely wholly on grant aid appropriated by rich-country governments when we know that this Congress, and parliaments in many other countries, are highly unlikely to support sharp increases in such funding even if the majority's reforms were to produce much more efficient aid programs.*

Third, the report makes a series of sweeping and radical proposals without a shred of supporting evidence or analytical support: closure of the International Finance Corporation and the Multilateral Investment Guarantee Agency, shifting all non-concessional lending to Latin America from the World Bank to the Inter-American Development Bank and shifting all nonconcessional lending to Asia from the World Bank to the Asian Development Bank. Some of these proposals may have some merit but the report fails to make a case for any of them.

Further, the report misses most of the central trade issues in its chapter on the World Trade Organization. This is not surprising since it is a report of the International Financial Institutions Advisory Commission and the members were not chosen for their knowledge of trade. The legislation authorizing the commission did not even ask it to review the statutes relevant to trade and we believe that the Congress should simply ignore this component of the report.

We believe that there are a number of other important errors of both commission and omission in the report but that the four cited are the most critical. At the same time, we reiterate that there are numerous recommendations that merit serious attention. We hope that the Congress will focus on those and ignore the several damaging ideas highlighted in this statement and in the attached joint dissent.

DISSENTING STATEMENT

There are numerous constructive proposals in the report. We agree that reform is needed at the international financial institutions (IFIs) and support a number of the report's most important recommendations: to clearly delineate the responsibilities of the International Monetary Fund and the World Bank, to promote stronger banking systems in emerging market economies, to publish the IMF's annual appraisals of its member countries, to avoid any use of the IMF as a "political slush fund" by its donor members, to fully write off the debt of the highly indebted poor countries (HIPCs) to the IFIs, to increasingly redirect World Bank support to the poorest countries and to the "production of global public goods," and to provide that assistance on grant rather than loan terms.

But some of the central proposals in the report are fundamentally flawed and/or unsubstantiated. They rest on misinterpretations of history and faulty analysis. They would greatly increase the risk of global instability. They would be inimical to the interests of the United States. We reject them totally and unequivocally.

Misreading History

Most importantly, the report presents a misleading impression of the impact of the IFIs over the past fifty years. A visitor from Mars, reading the report, could be excused for concluding that the world economy must be in sorry shape. But we all know that the postwar period has been an era of unprecedented prosperity and alleviation of poverty throughout the world. *The bottom line of the "era of the IFIs," despite obvious shortcomings, has been an unambiguous success of historic proportions in both economic and social terms. The United States has benefited enormously as a result.*

Even a somewhat narrower "bottom line" evaluation would be much more favorable to the IFIs than is the report. Almost all of the crisis countries of the past few years, ranging from Mexico through East Asia to Brazil, have experienced rapid "V-shaped" recoveries. All of the East Asians except Indonesia, for example, have already regained output levels higher than they enjoyed before the crisis. Even Indonesia and Russia, the two laggards with deep political problems, are now growing again. The world economy as a whole rebounded quickly and smoothly from what President Clinton called "the greatest financial challenge facing the world in the last half century." Whatever the difficulties along the way, the IMF strategy has clearly produced positive results.

The history of successful development over the postwar period is even more dramatic. Never in human history have so many people advanced so rapidly out of abject poverty. The World Bank and the regional development banks contributed significantly to those outcomes. The report itself notes, at the outset of Chapter 1, that "in more than fifty postwar years, more people in more countries have experienced

greater improvements in living standards than at any previous time.” It ignores that reality for the remainder of the text, however, and the tone throughout is so critical as to convey the message that very little progress has occurred.

The other great success story of the postwar period is democratization. More than half of the world’s population now lives under democratic governments—a dramatic shift over the past decade or so. Yet the report repeatedly argues that the IFIs undermine democracy by somehow precluding local governments from pursuing autonomous economic policies. The report is particularly critical of the Fund’s role in Latin America, where virtually every country has become democratic during the very period when the IMF has been most active there. IMF conditionality is obviously not a roadblock to democracy. The allegations of the report simply fail to square with the facts of history.

Promoting Financial Instability

Turning to the specific recommendations, the most damaging relate to the central responsibility of the International Monetary Fund for preventing and responding to international monetary crises. The report would limit the Fund to supporting countries that prequalified for its assistance by meeting a series of criteria related to the stability of their domestic financial systems. This approach has two fatal flaws.

First, *the majority* would have the IMF totally ignore the macroeconomic policy stance of the crisis country—“the IMF would not be authorized to negotiate policy reform.” Hence they *would sanction Fund support for countries with runaway budget deficits and profligate monetary policies*. This would virtually eliminate any prospect of overcoming the crisis; it would instead enable the country to perpetuate the very policies that likely triggered the crisis in the first place and thus greatly increase the risk of global instability. It would also provide international public resources for countries whose own policies were likely to squander them in short order, without any assurance of their even being able to repay the Fund. No reputable international institution would adopt such an approach.

The proposal for adding an undefined “proper fiscal requirement” to the prequalification list smacks of an international equivalent to the Maastricht criteria, which have been extremely difficult to apply in the relatively homogenous European Union and would be totally unrealistic at the global level. If the “fiscal requirement” were left open as to content, it would require Fund negotiation (“conditionality”) of precisely the type that the majority rejects—as well as the strong likelihood of periodic dequalifications and requalifications of countries that would be immensely destabilizing. Hence the prequalification list would in practice be limited to financial sector considerations, as clearly intended by the majority in any event, and fiscal as well as monetary policy would be completely ignored.

Second, *limiting Fund activity to any set of prequalifying criteria would almost certainly preclude its supporting countries of great systemic importance and thereby substantially increase the risk of global economic disorder*. Whatever criteria might be selected, it is totally unrealistic to think that all systemically important countries will fulfill them even after a generous transition period. The Fund would then be barred from helping such countries and financial crises in them would carry a much greater risk of producing a severe adverse impact on the world economy. No reform of the Fund should block it from fulfilling its central responsibility as the defender of global financial stability through providing emergency support for all countries which could generate systemic threats. (The Executive Summary suggests a takeout from these requirements “in unusual circumstances, where the crisis poses a threat to the global economy” but Chapter 2 on the IMF calls only for “extraordinary events” to be handled by “vehicles other than the IMF.”)

These proposals apparently derive from five faulty lines of analysis in the report:

- that the overwhelming systemic problem that needs to be addressed is moral hazard, despite a dearth of empirical evidence that this phenomenon had much to do with any of the three sets of crises in the 1990s (except for Russia, where the market’s “moral hazard play” was related primarily to that country’s being “too nuclear to fail” rather than to its economy or to prior IMF policies);
- that countries will be deterred from getting into crises, and hence having to borrow from the Fund, by according senior status to the IMF’s claims on the country and by charging them “penalty interest rates;” the Fund already has de facto senior status and has already sharply increased its lending rates, however, and a crisis country in any event is motivated primarily by acquiring additional liquidity rather than by the terms thereof;
- that the IMF fails to require banking reform in borrowing countries, whereas it has done so in every crisis case in recent years;

- a misrepresentation of the extensive literature that assesses IMF conditionality, which reaches agnostic conclusions concerning its effectiveness rather than the negative verdict claimed in the report; and, closely related,
- a failure to compare actual outcomes in crisis countries with what would have happened in the absence of IMF programs; crisis countries obviously experience losses of output and other negative developments but the issue is whether they would have fared even worse without IMF help and the report, while noting the need to consider the “counterfactual,” does not even attempt to address that central issue.

Much more desirable proposals for reforming the International Monetary Fund can be found in the recent report “Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture” by an Independent Task Force sponsored by the Council on Foreign Relations. That group, unlike the current Commission, reached unanimous agreement. Its members included Paul Volcker, George Soros, several corporate CEOs, former Secretaries of Labor and Defense, former members of Congress Lee Hamilton and Vin Weber, President Reagan’s former Chief of Staff Kenneth Duberstein, and top economists including Martin Feldstein and Paul Krugman.

For example, the Independent Task Force suggested that the IMF should offer better terms on its credits to countries that have adopted the Basel Core Principles to strengthen their domestic banking systems in order to provide incentives for such constructive steps; this is far superior to the report’s all-or-nothing approach, which would have the deleterious effects outlined above. That group also offers constructive and realistic reform proposals on how to alter the IMF’s lending policies so as to reduce moral hazard without jeopardizing global financial stability, through better burden sharing with private creditors, and on how to shift the composition of international capital flows in longer-term and therefore less crisis-prone directions.

Undercutting the Fight Against Poverty

The second major problem with the report is that *its recommendations might well undercut the fight against global poverty*, despite its stated intention to push the world in the opposite direction. In particular, its proposal to eliminate the nonconcessional lending program of the World Bank represents another reckless idea based on faulty analysis.

First, *the report would totally shut down two major sources of funding for the poor*—the World Bank’s nonconcessional lending program and the IMF’s Poverty Reduction and Growth Facility. These programs help hundreds of millions of the world’s poorest people, many of whom live in the poorest countries but many of whom also live in countries (e.g., Brazil and Mexico) whose average per capita income now exceeds the global poverty line.

The report would in fact return substantial amounts of World Bank capital and more than \$5 billion of IFC capital to the donor countries. *This proposal would amount to massive “reverse aid” to the richest people in the world!* It would be financed through sizable repayments of prior World Bank loans, draining real resources from some of the poorest people in the world (e.g., in Africa and India). The proposal belies the avowed intent of the report to improve the lot of the poor.

Second, the report would bar World Bank lending even to the poorest countries if those countries had obtained access to the private capital markets. Why penalize countries like China and Thailand for doing precisely what the majority says it wants them to do—qualify for market credits?! This proposal would create negative incentives for a large number of key developing countries.

Third, and most critically, *the report would rely wholly on appropriated grant funds from rich-country governments for future assistance to the poor*. Callable capital that was no longer needed at the World Bank because of the shutdown in its lending programs could not simply be given to IDA; an entirely new authorization and appropriation process would be required in our own Congress and other legislatures around the world. Indeed, IDA would lose the funds now transferred to it from World Bank profits (and, under another of the report’s proposals, the repayments of earlier IDA credits as well). This proposal comes at a time when Official Development Assistance, as measured annually by the OECD, has declined enormously—especially, as a share of total income, in the United States. Even if the report’s proposals were to promote dramatic improvements in aid effectiveness, the results would take many years to show up *and it takes a great leap of faith to believe that donor governments would provide substantially increased funds even then*—let alone in the longish transition period when the changes were being implemented.

Fourth, the report wants the more advanced developing countries to henceforth rely wholly on the private capital markets for external finance. But those markets are enormously volatile as we have seen in the crises of both the 1980s and 1990s;

the private money can flow back out, deepening crisis conditions, even faster than it came in. Moreover, the markets do not care if their funds are used for developmental purposes, especially poverty alleviation.

Unsubstantiated Proposals

The third major problem with the report is its cavalier recommendations for several sweeping institutional changes without any analytical foundation at all. While there may be legitimate reasons for some of these proposals, the rationale for pursuing them has not been established:

- elimination of the World Bank's Multilateral Investment Guarantee Agency on the basis of three lines of assertions;
- elimination of the International Finance Corporation, one of the most successful components of the World Bank family, and the parallel entities at the regional development banks, without a shred of evidence that such actions would be desirable (and without acknowledging that such a step, along with the elimination of MIGA, would undercut the report's stated goal of increasing the flow of private sector resources to the poor countries);
- a shift of funding for all country and regional programs for Latin America and Asia from the World Bank to the Inter-American and Asian Development Banks, respectively, solely on the basis of cryptic assertions that the latter would do a superior job—which run counter to the judgments of most observers.

The fourth major problem is the chapter on the World Trade Organization. The global trading system, and U.S. policy toward it, is an enormously complex and important issue at this point in time. The Congress will indeed shortly be considering a vote on whether the United States should maintain its membership in the WTO. The chapter is totally inadequate and indeed full of errors in dealing with the issue, understandably so because the Commission members were not chosen for their expertise on trade topics.

For example, the chapter suggests that “there is considerable risk that WTO rulings will override national legislation” when there is no such risk. It believes that WTO rulings “should not supplant legislative decisions” when there is no risk of their doing so. It recommends that “WTO rulings . . . should (have) no direct effect on U.S. law” when they neither do so now nor ever could do so. The group's title is the International *Financial* Institutions Advisory Commission and the report admits that “the Commission had neither the time nor the expertise to evaluate all the changes that have occurred or the many proposals for future changes.”

Additional Problems

There are numerous other flaws in the report:

- there is no reason to preclude the IMF from future assistance to high-income countries, which might need its help in future crises if global consequences are to be minimized;
- there is no reason to bar it from pushing member countries to adopt more stable exchange rate systems;
- there is no reason to propose a new set of ideas for strengthening banking systems in emerging market economies when the Basel Core Principles have already been agreed and the correct priority is to promote their adoption and effective implementation;
- it ignores the fact that the dozen countries which receive the bulk of the World Bank's loans also have the bulk of the world's population, and hence deserve substantial official funding;
- it ignores the valuable role of the Bank in strengthening the hand of reformers in developing countries and thereby tilting national policies in constructive directions; and
- it ignores central issues such as sustainable development and core labor standards that must be addressed by all of the IFIs.

The report also fails to address some of the central issues that must be part of any serious reform of the IMF. It should advocate, for example, much more effective “early warning” and “early action” systems to head off future crises. It should offer a formula for “private sector involvement” in crisis support operations, to assure sharing their financial burden between private creditors and official leaders (including the IMF), rather than simply “leaving that issue for participants.” It should address the cardinal practical issue of *how* emerging market economies will manage their floating exchange rates, rather than simply reiterating that these countries should either fix rigidly or float freely—which very few now or ever will do. It should promote more stable exchange-rate arrangements among the major indus-

trial countries, which are crucial for global stability and without which the emerging markets will continue to have severe problems whatever their own policies.

To conclude where we started: reform is needed at the IFIs and there are a number of constructive proposals in the report. But its recommendations on some of the most critical issues would heighten global instability, intensify rather than alleviate poverty throughout the world, and thereby surely undermine the national interests of the United States. These recommendations must be rejected and their presence requires us to dissent from the report in the strongest possible terms.

C. Fred Bergsten, Director, Institute for International Economics.

Richard Huber, Former Chairman, President and CEO, Aetna, Inc.

Jerome Levinson, Former General Counsel, Inter-American Development Bank.

Esteban Edward Torres, U.S. House of Representatives, 1983-99.

