

Reform of the IMF and World Bank
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It is a great pleasure to appear before this committee to discuss the International Monetary Fund (IMF) and the International Financial Institutions. The Joint Economic Committee's leadership and its staff have done valuable and important work to increase understanding of the IMF's working. At the very start of the Commission's work, we turned to the JEC staff for help that they gave willingly. We are grateful to you, Mr. Vice-Chairman, to the Chairman, the members of the Committee and its staff.

Today, I will focus mainly on the IMF and the bipartisan, majority proposals for reform and change. These proposals have been publicly available for more than a month. I am pleased to note that they have attracted considerable attention including favorable editorials in many leading newspapers at home and abroad. Most writers and commentators have suggested that the bipartisan, majority proposals should serve as the basis for future discussion of reform. The opportunity for reforms that was ignored at the 50th anniversary of the IMF and the Bank has now been revived.

The majority is grateful that, in the month that followed release of the Commission report, discussion has not only remained active, but earlier vituperation and personal attack have ended. Discussion has been substantive and directed at the issues raised in the report. I hope that will remain true today. Once we moved to substance, differences and reasons for differences began to appear. But it also became clear that thoughtful commentators have found considerable common ground.

I can illustrate some broad agreements by referring to some of Treasury Secretary Summers's recent statements, namely his speech to the Council on Foreign Relations, his testimony to the House Banking Committee, and his recent column in the *Financial Times*.

Secretary Summers's statement of core principles for reform calls for: (1) clear delineation of responsibilities between the IMF and the multilateral development banks; (2) a refocused IMF that concentrates on short-term liquidity lending; (3) the establishment of pre-conditions to strengthen incentives that forestall crises; and (4) dissemination of information to markets.

These statements are entirely in accordance with the majority report.

Secretary Summers would assign the development banks responsibility for: (1) targeting financial resources to the poorest countries without access to private sector financing and (2) increasing production of global public goods. He asks for reforms that will provide substantial improvement in the effectiveness of development aid and debt relief for HIPC's that implement effective economic development strategies.

Again, he agrees with the majority report.

He agrees, also, that there is costly and wasteful duplication between the World Bank and the regional development banks. Although he does not go as far as the majority to eliminate duplication, the differences do not seem great. And, he agrees fully with the majority of the Commission on the need to avoid pegged exchange rates.

On other issues, we appear to be farther apart. I am at a loss to understand why he regards our recommendation, for pre-conditions on IMF lending at a penalty rate, as a potential source of instability. Countries that have not satisfied the conditions would borrow at a super penalty rate, under the majority proposal. But this distinction misses a point that we failed to emphasize sufficiently. Countries would have a powerful incentive to meet the pre-conditions, if not in five years then as quickly as they can.

The reason is that, once some countries have qualified, those that have not qualified would face difficulties borrowing in the capital markets. Private lenders would prefer to lend to countries that meet the new international standards. Some would charge a higher rate, but many would avoid lending to countries that do not meet the four pre-conditions for stability.

The pre-conditions the majority chose are not arbitrary. One is an extension of the type of standards for bank capital that developed countries have now adopted, based on the Basel agreement. Another is based on the WTO's protocol 5 that permits foreign banks to compete in the country's markets. More than fifty countries have accepted this protocol. The remaining conditions require reasonable fiscal policy and the timely release of information on the maturity

distribution of sovereign debt. These seem not only unobjectionable but necessary for stability. Experience in Latin America has shown how much economic and financial stability improved, locally and globally, when banks had adequate capital and foreign banks were permitted to compete in Argentina and Brazil.

While no one can guarantee that all crises would be avoided, crises would certainly be reduced in severity, frequency, and extent if the financial system and the fiscal system met standards that limited the possibility of financing overly expansive fiscal policies. Real shocks would still occur but financial expansion can not solve problems caused by real shocks. The IMF's job is to resolve short-term liquidity problems. Longer-lasting problems and poverty relief that require structural or institutional change should be financed by loans from development banks. These loans and poverty relief would be available from the development banks under the Commission's proposals.

Some critics of the majority report, including the authors of the minority dissent, claim that the majority wanted to weaken or destroy the IMF but, instead, settled for reducing its role. This is not only incorrect, it totally misses the point of the majority report.

The world has lived through a series of deep crises in the last twenty years. The majority (and many others) believe there are three major reasons for the depth and frequency of these crises: (1) the collapse of pegged exchange rates, (2) collapse of weak financial systems, and (3) the long delay between the time a crisis erupts and the time the IMF (or others) are ready to help. The delay is caused by the long negotiation over the conditions that the crisis country must accept before help becomes available.

The majority resolved the three problems by replacing ex post conditionality with pre-conditions that strengthen financial systems and avoid lengthy negotiation. The majority also favored an end to pegged exchange rates.

If future crises are less frequent and less virulent, the IMF's role would be smaller. It would still have a role as lender of last resort to developing countries and increased responsibility for marshalling information, increasing its quantity and improving its quality. This role is vital now that we rely principally on markets, not on governments or agencies, to allocate capital to developing countries. Better, more timely information is the enemy of financial crises.

Criticisms of the majority proposal for the development banks stress the number of poor people in middle income countries. The number of poor people is an attractive criterion only at

first glance. I am confident that, on further reflection, reasonable people will agree with the Commission majority that a better criterion is the number of people who lack adequate access to resources. China has many poor people. The majority wants the development banks to continue to give technical assistance and support to China. But China holds more than \$150 billion in foreign exchange reserves and receives private capital inflows that greatly exceed any amounts it receives, or is likely to receive, from the development banks. No less important, a reallocation of development bank lending from China to effective programs in the poorest countries would permit these agencies to increase aid to poor countries without alternative resources.

Some have argued that the market would not finance social services or education. The majority believes this is a misunderstanding of the Banks' practices. The development banks receive government guarantees when they lend. When private lenders have the same guarantees, they are not concerned if the loan finances social reform, education, or other projects with high social returns but low monetary returns.

Some have pointed to the recycling of loan repayments as a source of aid. The majority was aware of the need for additional funding for poverty and said so. It is important to recognize, however, that if a development bank agrees to continue subsidies, many countries, even poor countries, could borrow in the market place when they hold a guarantee of 90% of the project cost from the development banks. This would reduce the amounts that the Banks would show as outstanding loans (or pay as grants under our proposal) without lowering the resources made available to the poor countries and the programs that could be supported. There is, in short, little reason to believe that our proposals would harm the developing countries. The majority strongly supported increased assistance to the poorest countries if assistance becomes more effective through closer performance monitoring, use of grants, and other majority proposals.

Conclusion

I would like to end by raising one issue that is, or should be, one of the most important issues for the American people. That issue remains unspoken by the critics.

This administration, even more than previous administrations, has used the international financial institutions as sources of readily available funds to support its foreign policy. If it could not make heavily subsidized long-term loans through these institutions to Russia, China,

Mexico, Brazil and other countries whose policies the U.S. wishes to influence, the administration would have to change policy or ask Congress to appropriate the funds. Congress could better perform oversight, would question whether programs are successful and whether they benefit the American people.

This issue is sometimes described as a foreign policy issue. The Commission majority is accused of interfering with the conduct of foreign policy.

I do not agree with that characterization. The core issue is the constitutional responsibility of Congress to appropriate funds. Administrations for years circumvented the budget process to support Mobutu, Suharto, Marcos, and others. The majority believes, firmly, that final decisions about spending should remain with the Congress, not the administration acting through the international financial institutions. This reform is most basic because it deals with legislative responsibilities and constitutional prerogatives that, once sacrificed, are difficult to recover.