

**THE INTERNATIONAL MONETARY FUND
AND INTERNATIONAL ECONOMIC POLICY**

HEARING

before the

**JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES**

ONE HUNDRED FIFTH CONGRESS

SECOND SESSION

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Tuesday, May 5, 1998

HOUSE OF REPRESENTATIVES,
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D.C.

The Committee met, pursuant to notice, at 10:02 a.m., in Room 2237, the Rayburn House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton, Doolittle, McCreery, Hamilton, and Hinchey; Senators Grams and Sarbanes.

Also Present: Representatives Arney, Cox, Campbell, and Bachus.

Staff Present: Christopher Frenze, Robert Keleher, Juanita Morgan, Colleen Healy, Mary Hewitt, Joseph Cwiklinski, Dan Lara, Shelley Hymes, Robert Stein, Howard Rosen, Bettie Landauer-Menchik, and Tami Ohler.

OPENING STATEMENT OF

REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. The hearing will come to order.

I am pleased to welcome the prominent economic experts testifying before the Committee this morning. The combined experience and knowledge of these witnesses ensure a very serious discussion on the policy issues related to the International Monetary Fund (IMF). George Shultz, William Niskanen, Paul Volcker, and Larry Lindsey have been involved in some of the most important economic policy decisions made during the past three decades. And we appreciate their appearance before the Joint Economic Committee (JEC) today.

During the last eight months, the Joint Economic Committee has been analyzing the IMF and its operations, practices and procedures. This research has identified several key economic issues on which reasonable people can disagree, but we cannot ignore these issues. These issues include IMF transparency, moral hazard, subsidized interest rates, taxpayer exposure, and IMF loan conditions that can be counter-productive.

Although my call for IMF transparency last fall was not greeted with universal agreement, a great deal of progress has been made in recent months in acknowledging the need for change in this area. We now have a broad consensus for a much more transparent and open IMF, although the best means for accomplishing these objectives is still under debate.

In the course of researching the transparency issue, the lack of transparency in the IMF financial statements became evident. Recently I have had the opportunity to question a member of the IMF Executive Board about IMF finances. My questions elicited the admission that IMF finances are not fully transparent, even to a member of the IMF Executive Board.

I would submit that if even high IMF officials do not understand IMF financial statements, then probably not many outside the IMF do either. But how can Congress and the public evaluate the performance and funding of an agency whose finances confuse even its own officials? The fault is not with the officials, but with an arcane and confusing presentation of financial information.

Recently, the IMF released a code of principles for member countries that very well expresses the meaning of financial transparency. For example, one principle states, budget estimates should be classified and presented in a way that facilitates policy and analysis and promotes accountability. I would suggest that the IMF should apply its general sound transparency principles to its own accounts as well as to member nations.

More facts concerning the IMF are needed before Congress can make an informed decision on the IMF appropriation. That is why I have recently requested that the General Accounting Office (GAO) do an evaluation of the transparency and content of IMF finances.

Another major issue is moral hazard and its amplification through the use of below cost or subsidized interest rates. Currently, the standard IMF loan rate is about 4.5 percent. This is much lower interest than those available for U.S. mortgages, consumer loans or business loans. The use of subsidized interest rates can only deepen the already serious problem of moral hazard, the encouragement of risky ventures and activities by the prospect of a bailout.

The bottom line is that the net effect of the IMF lending is to subsidize risk and socialize at least some of the resulting losses. The IMF reform legislation I have introduced would end this practice of

subsidized interest rates and also require more transparency of the IMF. Meaningful structural reform of the IMF is needed whether or not the IMF expansion is financed by the Congress this year.

We are fortunate to have such a distinguished set of witnesses to discuss the major issues related to the IMF here with us this morning. Secretary Shultz, particularly, we want to welcome you here this morning. I am aware of your time constraints, and so we will try to move through your testimony in an expeditious fashion.

Is there an opening statement from—

**OPENING STATEMENT OF
REPRESENTATIVE LEE H. HAMILTON**

Representative Hamilton. I have no opening statement. I do want to express a word of personal appreciation that Secretary Shultz was willing to testify. It is wonderful to see him back on Capitol Hill again. And I want to extend my best greetings to him. I came in the room a moment ago. I also see Mr. Volcker there. I apologize for not greeting him. But we are delighted to have him as well, and Mr. Niskanen.

Thank you very much, gentlemen. We look forward to your testimony.

Representative Saxton. I think Mr. Hinchey may have a statement.

**OPENING STATEMENT OF
REPRESENTATIVE MAURICE D. HINCHEY**

Representative Hinchey. Mr. Chairman. Thank you very much, Mr. Chairman. And let me say also what a pleasure it is to have the opportunity to meet Mr. Shultz in person. I have long admired your service to our country, and for that, I want to express my gratitude and appreciation.

Our focus on the IMF today occurs as a result of the recent financial crisis in East Asia. If it were not for the East Asian financial crisis, the International Monetary Fund would not be receiving the attention that it is under these conditions.

I recently, Mr. Chairman, had the opportunity to be part of a small delegation led by the Chairman of the House Committee on Banking and Financial Services to the Far East. On that occasion, we visited Hong Kong, Beijing, Seoul, and Tokyo. The trip did not allow us to visit Thailand and Indonesia, but I think it gave us a good indication of what was going on in that part of the world.

We had the opportunity to meet with a number of Americans on the scene, including representatives from the American Chamber of Commerce in both Hong Kong and Tokyo, as well as a number of other American business interests, as well as indigenous business interests and local officials.

It was apparent to me that the financial crisis in East Asia is a supply side debacle. It results in part, as a result of too much money in the hands of too few people chasing too few good loans. As a result, we are experiencing a dramatic oversupply of production in that part of the world of everything from computer chips to automobiles, and that oversupply and those bad loans are beginning to have an effect on our economy as well.

It has been estimated by the Chairman of the Federal Reserve, for example, that the crisis in East Asia will cost us perhaps between 1 and 2 percent in economic growth over the course of the year.

We have also seen an oversupply in our own markets of a number of products, including automobiles and other durable goods. So the attention that the IMF is getting in this present context is very appropriate, Mr. Chairman.

I want to express my appreciation to you for conducting this hearing and giving us an opportunity to listen to some people who undoubtedly will have something very important to say on the subject.

I thank you very much.

Representative Saxton. Mr. Hinchey, thank you very much. I would just like to say to my other colleagues that Secretary Shultz is due for the dedication of the Ronald Reagan Facility Justice Center at 10:00 a.m. to which he has agreed to be late. However, with your indulgence, we will proceed with the Secretary's testimony at this point.

Representative Campbell. Okay.

Representative Saxton. Mr. Secretary.

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

Mr. Shultz. Thank you, Mr. Chairman, and Members of the Committee. It is a privilege for me to be testifying once more before a congressional committee, and particularly since I see so many familiar faces and even some friendly faces. And it is a privilege always to be part of the outstanding group you have assembled, Mr. Lindsey, Mr.

Niskanen, who I know very well, but specially Paul Volcker with whom I have worked closely over many years, and who has given such distinguished service to our country.

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

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

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

So you have an organization that now has lots of money. From the figures that I have seen right now, it has on hand, after deducting for what they have committed in the Asian crisis, on the order of \$47 to \$48 billion, so it has got a lot of money on hand. It is seeking what amounts to another \$85 billion, including what other countries would contribute beyond the amount that the U.S. would contribute.

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

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

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

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

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

I think it is fair to say that Administrations have tended to use the IMF often to get things done that they could not get done through the Congress. The very large scale aid to Russia is an example. The Nunn-Lugar money, with solid congressional support, does a good job aimed at the nuclear problem. But I doubt that the Congress would have gone on with the large scale general budget support for Russia, particularly since the general budget supports whatever is going on. And I think, gentlemen, that through the IMF loans to Russia, we have, in effect, supported atrocities in Chechnya, and I don't know why we should want to do that.

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

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

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

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

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

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

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

And I think the system of collective bargaining was transformed by that decision into one in which people had to assume responsibility

themselves for what they did, rather than always passing it on to the government to intervene and tell them what to do. So the crisis that was declared by the President and the Supreme Court turned out not to be a national emergency.

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

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

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

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

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

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

bankrupt. And it was the same pressures for the Governor to intervene somehow and bail out Orange County.

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

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

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

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

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

seen what has happened in centrally planned economies. People can make wrong judgments. So those are two principles.

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

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

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

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

Then we turn to the recent Mexican bailout, and as we know, suddenly the scale is up in the \$40 billion range. Breathtaking. And

nowadays you see people thinking you have got to have that kind of money around. But it wasn't around before. This was an innovation based on questionable governance. But all of a sudden, we are in a different ballgame.

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

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

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

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

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

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

I was in Argentina recently. They had been telling Argentina that you have to curb your labor unions and that you ought to devalue your

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

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

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

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

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

Second, I think that it is wise to point out the fact, and I think Mr. Hinchey was saying this in some of his comments, that a lot of the things that have gone wrong have nothing to do with the new information age and all that. They have to do with classical errors, with people getting too much debt in comparison with equity, with people having short-term

borrowing on one side of a transaction and long-term commitments on the other side of the transaction, with people relying on a peg to the dollar when the policies being followed don't match the U.S. policies and, therefore, strain the peg, and with an overreaching notion that somehow devaluation is an answer and is going to produce more exports, when we know through our experience that unless you accompany devaluation with a very strongly disciplined economic policy, all it does is produce inflation, and you are right back where you started from.

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

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

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

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

Thank you, Mr. Chairman.

Representative Saxton. Mr. Secretary, thank you very much for the extremely thoughtful testimony.

Before I - before I ask a question, let me just take care of one little piece of housekeeping, if I may. There are obviously a number of Members here who are interested. In view of your limited time, we are going to proceed according to what we call a five-minute rule. That means the little lights in front of you will flash on and off green and red.

Also, I would just like to take this opportunity to publicly welcome Mrs. Shultz, Mrs. Shultz who is accompanying the Secretary this morning. I understand the Secretary was born in New Jersey, which is my home State, but then he moved to California and met Mrs. Shultz. And I think perhaps you got the better end of the deal.

Representative Campbell. No question.

Representative Saxton. Mr. Secretary, let me begin with I think the question which to me at least goes to the root of the matter and is in line with much of what you have said this morning. We have done some research here on the Joint Economic Committee, and we have come across lots of work that has been done in evaluating what it is that perhaps has gone awry in the international economic system, inasmuch as there has been a noted increase, as you have pointed out, sir, of many more problems than we would like to see, particularly in the last decade or two, relative to financial stability of financial institutions around the world; in fact, others have noted the same thing.

One writer writes, banking crises have become increasingly common, especially in the developing world, and that is Morris Goldstein and Philip Turner, who in their writings in 1996 made that observation.

Another writer wrote, there has been a global pandemic of bank insolvencies in the last 15 years. That is Gerard Caprio and Berry Wilson in their writings, *On Not Putting All the Eggs in One Basket*.

And then a review, another writer writes, a review of experiences in the 1980s of 181 current fund – meaning IMF fund members – member countries reveals that 133 have experienced significant banking sector problems. That is Lindgren and Garcia in their writings, Bank Soundness and Macroeconomic Policy.

And going along with that, I am sorry that I didn't have time to get this little chart blown up, but it is a chart which demonstrates the increase, particularly since in the decade of the 80s and 90s, of the number of banking problems and instability – issues of instability around the world.

[The chart, entitled, “Number of financial crises in developing countries” appears in the Submissions for the Record.]

And I suspect that based on your testimony which you began to summarize with words about expectation and bailout mentality, I suspect that there is a strong suggestion here on your part, as you recently wrote in the *Wall Street Journal* article, the problem that banks – the problem that banks make riskier loans when they are expected to be bailed out if

such loans go sour, several researchers, as I just pointed out, have noted that financial crisis in emerging markets have not only become more frequent, they have also become more severe.

Doesn't this suggest that there is a problem involving the bailout mentality or the expectation that somehow somebody like the IMF is there with a large pot of money? We refer to this issue as an issue involving something called moral hazard.

Do you believe, and I believe you do, that this is a serious problem, and specifically what is it that the Congress might be able to do if it is a problem, which I believe it is, to work to mitigate this problem?

Mr. Shultz. One thing you should do is something you shouldn't do; namely, vote this additional money. I do think that there are problems of bank regulation around the world. Countries vary quite a lot, but there are many countries where you have a big problem in that government, and finance and business are all sort of locked in together. And there is kind of a black box in there, nobody knows what is going on in that black box, and it is not regulated.

I suppose you would have to say that a lender who lends money into that black box knowing what you know is in some jeopardy. And so countries that don't have decent regulation ought to be caused to pay a very high risk premium to get money and in that way be encouraged to regulate themselves more fully. And there is no dearth of people or organizations around that can suggest ways of regulating banks in some appropriate manner. That kind of advice is easy to get.

Representative Saxton. Mr. Secretary, do you see a problem with the practices of the IMF with regard to the prevailing rate of interest that is normally charged on loans, which I understand is about 4.5 percent?

Mr. Shultz. The IMF is kind of a consultant to countries; it goes and gives its advice. And most consultants get paid for their advice, and the act of somebody paying you for your advice is in a way giving a market test to the advice. The IMF is a peculiar kind of a consultant. It pays you to take its advice, and it pays you in a form of a very heavy subsidy in the rate you have to pay on the loan.

And one of the things that ought to be researched, if you are able to get at the IMF records, is what is the total amount of subsidy, in effect, foreign aid, that there is a transfer of wealth from contributors to the IMF funds to those who have drawn. What is the total amount of subsidy?

It is a little hard to calculate it precisely. But in some cases, they make loans to countries that couldn't borrow it at any interest rate. But

even if you take some generous criterion like Libor plus 5 percent or something like that and compare it, it is a very heavy subsidy. Because, as you say, most of the loans are in the 4.5 or 4.7 range, but I think there are others that are even much lower than that in these programs they work out.

As I understand it, right now the IMF has programs with some 58 countries. And we have – all the publicity has been about the crisis countries, but they have regular programs, and they go around and tell people how they should run their economies. And much of the advice, I am sure, is useful, but I think some of it is not so useful. In my opinion, they are far too predisposed to raising taxes. They seem to have a formula that says you have to have austerity, raise taxes, that will help restrict imports. And devalue to promote exports, and that will give you foreign exchange to pay debts off with. I am sure I am oversimplifying it, but there is a lot of that kind of formula thinking, I believe, that is, to my way of thinking, wrong.

But, anyway, their scale is pretty big. And the loans, as you point out, are given at highly concessional rates. We debate a lot in this country, and you do in the Congress, about, for instance, the replenishments to IDA, the World Bank, the soft loan window. Well, the IMF is kind of a soft loan window, but you don't vote on that.

Representative Saxton. Mr. Secretary, let me just ask one further question. There are some who believe that if we don't fund this request for an expansion of IMF funds, that we will be abrogating our position of U.S. leadership. I guess I would take quite an opposite view and suggest that we would be abrogating our U.S. position of leadership if we didn't point out problems that are inherent in what we see as the IMF process.

Mr. Shultz. I agree with you. And it seems to me it ought to be possible to talk to other countries who are key contributors to the IMF and say to them, don't you think we ought to know more about what is going on here? Because, really, you don't know very much. I don't know all the ins and outs; you can't find out. And if there is a real examination, and one that isn't just the U.S., but all the contributors saying we are – that the IMF is trying to step up into a new league, up into the \$160 billion or so league, and they are aspiring to manage economies and change economic policies in broad, deep ways.

So their ambitions are growing rapidly. And under those circumstances shouldn't we know a little bit more about how they operate and what their thinking is and what their track record is.

**OPENING STATEMENT OF
REPRESENTATIVE RICHARD K. ARMEY,
HOUSE MAJORITY LEADER**

Representative Arme. Mr. Chairman, may I - if I may ask the indulgence of the panel and our guests. It has come to that time in my day when I must, as so often is the case, pull up my stakes and move on. But I did want to thank you for holding this hearing. I want to thank all of your guests this morning. And I appreciate the opportunity to be here, and if I could, to just make a few observations here.

We have had, I think, a pretty good revelation already of Secretary Shultz, and we will certainly have more revelations. But it seems to me we have some very critical questions to ask: What is or should be the role of the IMF in the changing world economy, where in fact it may have had its traditional or charter role made obsolete by the disconnect from the gold standard in the early '70's? I think we need to explore that.

I think we need to explore the extent to which it is open and, therefore, subject to evaluation by way of the manner in which they do business and the extent to which we can or cannot, support them.

I think we also need to get some sense of the relative weight of fears we might have regarding moral hazard as over and against the fears that we may in fact contribute to an epidemic of distress in world economies for lack of action through the IMF.

But the one thing I am very clear of, and the one point I want to make and emphasize here, is this : We are not talking about the question of whether or not. This nation is fulfilling its responsibilities in the world economy or not, this is not a question of a choice between internationalism or isolationism. It is a question about what is the prudent and responsible leadership the United States should make.

And I think these hearings will make a great contribution of that. I will not be able to stay, but I will, in fact, review the testimony as I have tried to stay in touch with all of the information on this. And I want to thank the Committee and the committee staff for putting together what I believe will be an excellent hearing and record for us to continue our work in the House.

I thank you.

Representative Saxton. I would like to thank the Majority Leader for his comments and observations. And at this point I would like to turn to Mr. Hamilton.

Representative Hamilton. Thank you very much, Mr. Chairman.

Mr. Secretary, I was impressed with your remarks on the problems of governance in the IMF, and your basic point about looking at the charter and asking questions about it getting more accountability and responsibility. That makes a lot of sense to me. I think it probably has application beyond the IMF. I think there are a number of world organizations, and regional organizations where that needs to be done.

I read some weeks ago your article in the *Wall Street Journal*, and, as you probably know, that article had quite an impact here in the Congress. I was impressed by several things about the article, but the last sentence impressed me, and you may or may not recall it. But it was that once the Asian crisis is over, we should abolish the IMF. And I was intrigued by that sentence. I don't know exactly what you mean by it.

And so one question is, Is it your position that we keep the IMF for the time being, but once this Asian crisis is over, then we can get rid of it but don't get rid of it right now?

And I guess the second question would be, Who would have stepped in if you did not have the IMF here? You had exchange rates plummeting. You had financial systems that were very fragile and were beginning to unravel, and the IMF has stepped in.

Who would there have been if you had not had the IMF here? Would they have come to the United States? Would we have had to step in under those circumstances?

Mr. Shultz. Well, you wouldn't have had the IMF advising competitive devaluations. You wouldn't have this, the IMF stepping into Indonesia and, without any real preparation, inducing the closure of 16 banks and thereby causing panic throughout Indonesia. Indonesia has never gotten up off the floor since they did that.

You wouldn't have the picture that went all through Asia of the head of the IMF, Mr. Camdessus, with his arms folded standing over President Suharto as President Suharto signed a very intrusive program as to how Indonesia should be run. The humiliation. You don't cause people to do difficult things by starting with humiliating them, so we wouldn't have had that.

I think, in other words, that no doubt IMF money was helpful to some extent, but they did a lot of damage also; and the picture is at best

a mixed one. I think if you had not had the IMF, no doubt countries would have helped in one way or another, but in many cases people who made bad loans to private businesses in those countries would have had to sit down with their opposite numbers and work out the loans. It is fairly standard practice. It is not a new thing in our own country that people go bankrupt and they struggle and we have ups and downs and the marketplace takes care of it.

Representative Hamilton. And you would not have had this contagion that people talk about. In other words, your view is that the IMF made things worse rather than better?

Mr. Shultz. Well, I think you can certainly argue that. I don't think the picture is one that to say well, here is this Asian crisis, and thank God we had the IMF. Because it seems to me that a lot of it may have been induced by the IMF and the sense of a need for very large-scale money that has suddenly emerged in the world as a result of what was done in Mexico. People didn't have that idea before that.

Representative Hamilton. If you had not had the IMF, do you think the United States then would have been under a great deal of pressure to be the lender of last resort?

Mr. Shultz. Not necessarily the lender, but I think we certainly should have been trying to help countries work their way out of their problems; but to me, the burden needs to be on the country involved or on the borrowers or on the lenders. If they can produce a good program, then you can support it. Not the other way around.

I thought, for example, in the Mexican bailout case, one of the worst aspects was that it was signed in Washington. At a minimum, they should have signed it in Mexico City. If you are going to have a program, if I am going to make a difficult program work in my shop, it has to be my program. Then there is a chance of my working it from the inside out.

Representative Hamilton. Well, what was your point in waiting until after the crisis was over to eliminate the IMF?

Mr. Shultz. I guess it is just my having been in the arena a lot in various things and I see people, I mean there are genuine problems, and Secretary Rubin is a very capable professional person for whom I have a high esteem. He is struggling with these problems. I have been there, so I understand that he has difficulties.

I hesitated to write that article at all, but I thought things were just going way out of hand. I am on record four or five years ago in an

invited lecture to the American Economic Association as being in favor of ending the IMF and reviewing the charter of the World Bank, and trying to set the financial things there and perhaps assigning to the trade organizations some concerns about exchange rates. Their trade and exchange rates are two sides of the same coin.

I suppose I was just saying, the Secretary is enmeshed in this thing. Let us support him and when it gets over, then let us have an end to it. Who knows when it will be over.

Of course, the big question marks are what is going to happen in Japan and what is going to happen in Indonesia. Very different cases. And – but I don't think we need an IMF program for Japan. It is perfectly obvious what is needed in Japan.

Representative Hamilton. Mr. Chairman, I have lots of questions, but I know the Secretary's time is limited. Thank you very much.

Representative Saxton. Thank you, Mr. Hamilton. I would like to observe that even the IMF itself, with regard to the question of bank runs in Indonesia, even the IMF itself has a report that it will not publicly release that the IMF did prompt, in fact, the IMF activities did prompt the Indonesian bank runs. That is an IMF position review of its own policy.

Mr. Campbell?

OPENING STATEMENT OF REPRESENTATIVE TOM CAMPBELL

Representative Campbell. Thank you, Mr. Chairman. I would like to say what high regard I have for Secretary Shultz. He is a personal friend of long standing, and for Charlotte as well. Thank you for informing us and gracing our Committee once again.

Mr. Hamilton's question leads me to ask a different one than I was going to start out with. Pardon me for being a bit pedantic, but I really do need to know what your advice might be at this juncture. My worry is that the political support for ending U.S. involvement in the IMF is now because there is a crisis. Your second point in outlining the crisis mentality in Washington is correct, in that if we let this opportunity pass, as might have been suggested in your colloquy with Mr. Hamilton, or the last sentence in the coauthored article – by the way, I know that you wrote this with Simon and Wriston – that if you let it pass, we will never get to the reform. Another crisis will come along.

My predilection, my strong predilection is to seize the opportunity, and if it is not good economics for us to be in the IMF, to make that judgment now.

So that is my question. Knowing Washington so very well as you do, is it your advice that we terminate our participation in the IMF now, or is it your advice that we participate in this present tranche and then set about making the appropriate changes or withdrawing?

Mr. Shultz. My own opinion is that we should end the IMF now. That is just my opinion. I recognize that there are other people whose views I respect a lot who will disagree. Paul will speak for himself. There is nobody in the financial arena that I respect more than Paul Volcker. He has a different view. And his view, I believe he will speak for himself, is not the same as the Administration's view. There are a lot of different people whose views are entitled to be heard.

What I would suggest to you is that you do something like the following: Insist that before any of this tranche money that you have now before you, about \$18 billion, I guess, is contributed to the IMF, that there be a very thorough review of what the IMF has done. And that will require the IMF to provide information to the Congress, which they are reluctant to do. You may not get it. And I would stand there and say, well, until we get the information, you don't get the money. And cause there to be a real study of the subject.

And I think that if we know more, it may be that views will coalesce more. There are various ways of doing that; one that I have seen in a piece of legislation would vote the money, but with a condition that the Secretary of the Treasury cannot contribute it until he certifies to the Congress that all the conditions are being fulfilled and that the Congress votes affirmatively that they agree with the Secretary. So you can't run off with the money.

But nevertheless, the kind of condition I would put is that the basis be there for a thorough study, an informed study so that people know precisely what they are talking about. And we see, for example, that there is a lot of IMF money to countries that support terrorism. Do you know that? We ought to know that. How did that happen?

Representative Campbell. Mr. Secretary, the best argument I have heard the other way, which I would like to anticipate, because you won't be here to respond to it, is that the IMF serves an international FDIC kind of function, that one could make the same arguments about the free market in regard to our domestic banking institutions that you

persuasively make as to international banking, but that for the occasional crisis of confidence not justified by economic fundamentalists, which do occur in banking, hence, we have the FDIC. So, the argument runs, we need something like an IMF to defend currencies against the attacks on them that are not economically justified.

I would like to hear your response to that.

Mr. Shultz. Well, I don't know about the operations of these various funds with respect to small countries. They are not able to do very much with the larger countries. But I think the problem is way overestimated again, and I will give an example. George Soros' operations with respect to the pound in 1992, I believe, are often used, particularly since he boasted about all the billions of dollars he made speculating against the pound.

And to my way of thinking, you had a situation where the pound was linked to the deutschemark and the Germans were enmeshed and dominated in their thinking by the problems of integrating east and west Germany. And as it emerged, the Bundesbank felt – and if I were them, I think I probably would have felt – that they had to follow a very disciplined monetary policy that was not appropriate for Britain at the time. So that link was a bad link.

I remember being in London and saying to some of the British ministers, well, what are you going to do? And they said we are going to defend the pound, we are going to intervene. I said, well, what are you going to do after the intervention fails. They said it is not going to fail. I said, well, what are you going to do when it fails. We are going to raise interest rates. You are going to raise interest rates when unemployment is in double digits. Are you out of your mind?

Well, they did those things. They intervened heavily and it was like a gift to the so-called speculator. Then they raised interest rates and it was so ridiculous that it only lasted a day or so; and finally, the marketplace hammered the British into a decent economic policy, and now they are looking pretty good. Thanks to the marketplace. So I think most of these problems are of that nature.

Representative Campbell. Thank you, Mr. Chairman.

Representative Saxton. Mr. Hinchey.

Representative Hinchey. Thank you, Mr. Chairman. Thank you, Mr. Secretary. I very much appreciate having been here and having had the opportunity to listen to your very thoughtful comments on this subject.

I find myself agreeing with much of what you said, particularly with regard to the need for oversight of the IMF, the need to examine in depth the problems of governance of that institution, and the problem of transparency, which does not exist to a large degree with regard to the IMF. I think that as you have indicated, we ought to know a lot more about what goes on there. We ought to know a lot more about the decisions they make and about the kind of processes that the IMF staff engage in in reaching those decisions.

There are some things with your statement, which I found myself disagreeing, of course. I thought I heard you say that by supporting Russia economically and preventing their system from collapsing and providing particular support with regard to nuclear circumstances, that we were responsible in some way for the atrocities in Chechnya.

Mr. Shultz. What I was trying to say, perhaps I did not say it clearly enough, is that I thought the Nunn-Lugar money which was voted by the Congress had a specific objective, namely, to help the Russians get control of and reduce their nuclear stockpile according to the treaties that were signed. I thought that was a very good – that is an appropriate way to go about it. An objective was established to put before the Congress. The Congress authorizes and appropriates the money. Then it is used; it is being used effectively.

By contrast, I don't think the Congress would have voted for the large sum of money that has flowed to Russia from the IMF for general budget support. The IMF conditions it on certain economic matters which have mostly not been fulfilled. But when you give general budget support, particularly in a country where taxes are not being collected, where money is scarce, and they are involved, they get involved in a big operation like the Chechnya operation, you are in effect financing that; right?

Representative Hinchey. No, I don't think so. I don't think you are in effect financing it. I think what we are doing is financing a situation which is designed to prevent economic collapse of a very important country, and also financing a situation which is designed to prevent nuclear technology and nuclear hardware from falling into the hands of the wrong people.

I think that is what we were doing, it may be that doing so at the same time that the government of Russia was carrying out some activities with which we do not agree and to which we seriously object, but I think it is wrong to draw parallels between the two.

Mr. Shultz. Well, as I said, I think the Nunn-Lugar money, great, good decision. General budget support, money is fungible, and when suddenly you have big expenditures like those in Chechnya, that is where you are going. That is not the intent, I agree with you, but that is the effect.

Representative Hinchey. Okay, those things happened and there are things over which we have no control as we try to prevent circumstances from arising in the world which are going to have detrimental effects on our economy and on our security.

Mr. Shultz. We can have control.

Representative Hinchey. With regard to the Far East, the situation in Indonesia, I would agree with you, that some of the ways in which the IMF behaved with regard to Indonesia and some of the things they required were detrimental. But you had a circumstance of political instability in Indonesia that will have broad repercussions for American security in that part of the world, and that will also have some impacts on economic circumstances there which may spread, there is no doubt that the IMF had to intervene in some way.

There is a great concern, as you know, among many people that if the economic circumstances in the Far East are not stabilized – and they are not stabilized yet – that the instability there could spread. It could spread to South and Central America. It could spread to Russia. It could spread to Eastern Europe. And if it does so, then we would have on our hands a much more complex problem.

So while I find myself agreeing with you with regard to the governance of the IMF and some of the things that we need to do to increase the transparency of that institution, I just wonder what we would do to replace it. I think it has to be reformed. But with what would we replace it, and if it were not for the IMF and the kind of stability it can invoke—

Mr. Shultz. Or instability. I think, this is why I say, I think you really owe it to us taxpayers that you really have a careful examination of this. And take Indonesia as a case study if you would. What is the net impact of the IMF there? They are on their third program by way of saying the first one had something wrong with it, and the chairman mentioned this internal IMF report that I didn't know about that was critical itself, which they don't – is that a public document?

Representative Saxton. No, they have kept it very, very close to the vest.

Mr. Shultz. Why shouldn't it be a public document? Why is it so secret all the time? What is the reason why, there has to be all this mystery?

Representative Hinchey. On that point—

Mr. Shultz. Why do you want to give 160 billion to an organization, talk about black boxes.

Representative Hinchey. Thank you.

Representative Saxton. Just on that point, we began, I believe, in December requesting that these documents be made public; and they have been far less than forthcoming with regard to any information in a real public sense.

Senator Sarbanes. Does that include providing it to the Congress? I understood we received a number of internal memos and reports?

Representative Saxton. We were offered, I believe, two internal reports on the condition that we not talk about them publicly, which we declined to accept.

Mr. Cox?

OPENING STATEMENT OF

REPRESENTATIVE CHRISTOPHER COX

Representative Cox. Thank you very much, Mr. Chairman. Thank you, Mr. Secretary. When we refer to you as Mr. Secretary, we are referring to several cabinet departments simultaneously, I understand that. I appreciate, as do all the Members of the panel, your willingness to spend your time once again helping us work through this difficult problem.

I would like to in the interest of time ask you two questions at once and hope that you will address both of them. The first is, inasmuch as you mentioned currency devaluations as one of the staples of IMF advice which is used often if not always, as well as high tariffs and tax increases, recommended—

Mr. Shultz. I don't think they recommend high tariffs. I will excuse them on that.

Representative Cox. Well, I mentioned that because in Thailand last year IMF funds were made contingent on a 43 percent increase in their value-added tax or their national sales tax. The IMF also required that social spending not be reduced and that Thailand agree in the future to raise its import and export duties. So Thailand—

Mr. Shultz. I stand corrected.

Representative Cox. That is an example where they have urged higher tariffs. They have also recommended in more than one case freezing infrastructure projects and so on. In light of if not these specifics then those which you are familiar with, could you address the argument now being made by some that if we do not give this money to the IMF, it will hurt U.S. agriculture, and it will hurt our exports. It would seem to me on the basis of the policy of currency devaluations, that the contrary might just as easily be argued.

Second, you have suggested squarely that Congress should do better oversight of the IMF as the largest contributor to the IMF; one would expect, even though we represent only about 20 percent, that the U.S. would have significant leverage. I want to ask you whether or not the U.S. can successfully oversee the IMF, and whether anybody can successfully oversee the IMF. Since you are going over to dedicate the Reagan Building later on, one recalls the metaphor President Reagan used to use, that the closest thing to life on earth is a government bureaucracy; and maybe that is especially true for an international bureaucracy, because the IMF lacks in this case any effective oversight. The United States is not doing it. If the largest contributor is not doing it, and nobody is now doing it, can we ever effectively do it?

Those are my two questions, if you would.

Mr. Shultz. Well, I think fundamentally U.S. agriculture and other exporters are dependent on a healthy world economy. And I think a healthy world economy comes from trying to get people operating in a responsible and accountable way. And I believe the prospects for a healthy world economy are much better now than ever. Basically because – and I would claim particularly since I am going to the dedication of an international trade building honoring President Reagan – that his and Margaret Thatcher's and others' challenge to the then-conventional wisdom of the early '80s, to bring about more faith in the market forces and enterprise and such ways of running economies has changed things for the better. And so there are good prospects, and we should stick to responsibility and accountability.

And there are always ups and downs in your ability to export to a particular country. We need to have countries see that the more open they are, the better off they are going to be. It has been one of the reasons why we have been so healthy, that we are relatively open. It is not a favor to other countries. It has been a great thing for ourselves.

I was a director for a number of years of General Motors. I can tell you for sure if it hadn't been for the Japanese competition, that General Motors cars would not be the absolute first-class cars they are today. You can't buy a better car than a GM car today, but that is due to Japanese competition. The competition helps. So that is my answer to your first question.

As to governance, in a technical sense, I think our share is 17.77 or '8 or something like that. There are certain things that can't be done without a vote of 85 percent of the Members in weighted terms. So there are certain things we can veto, but they are fundamental things like a change in the articles of agreement or things of that kind. When it comes to making a loan, it is a majority vote.

I think if you were able to review the governance practices - and I know you did have the U.S. executive director, you mentioned, Mr. Chairman, that you had that person testifying here, and I don't know how far you were able to get into the governance of the IMF. But I think if you got into it, my guess is that you would find that like most of these things, it is a bureaucracy-run organization in all of its basically day-to-day operations. And when there is some big crisis like the Mexican crisis or the Asian thing, then the Secretary of the Treasury is in there with both feet and has a lot of influence.

But other than that, it is essentially a bureaucracy-run organization. But I think this is one of the things that you ought to find out, and have part of the study be exactly how does this organization that aspires to be so intrusive and aspires to have 160 billion or so to throw around, how does it operate? Why shouldn't we know that?

Representative Saxton. Mr. Secretary, Mr. Cox, one of the interesting things that occurred here a week or so ago as we had a hearing similar to this, actually Mr. Bachus, it was Mr. Bachus' hearing on the Committee on Banking and Financial Services. We asked the executive director of the United States delegation how this process worked and how many votes there were and how the United States participated.

And the answer was that, a rather lengthy period of time, there had only been about a dozen votes, but there had been something in the neighborhood of 900 decisions made which were made by consensus rather than through votes.

And so I suspect that the United States position and the influence of the United States exceeds the 17 or 18 percent that it would be in a direct way able to exert through the voting process.

I suspect the United States is called on quite often for our views and informing those opportunities for consensus.

Mr. Shultz. For a long time the amounts of money that people were dealing with were relatively small. Even through the 1980s period, the IMF sums were not large. Probably Paul can say what they were. But they were not large anyway. But now all of a sudden with the Mexican thing, we are in a new ballgame and suddenly you are talking about \$40 billion to a country and so on. That is real money.

Representative Saxton. There is another important point, and then we are going to Senator Sarbanes. The other point is, while it is true that our contribution amounts to something like 18 percent of the usable, of the funds that are declared or designated as usable by the IMF, our share is much larger, more in the neighborhood of 30 to 32 percent of the usable funds that are in the IMF; unusable funds are designated as those which are in the forms of currency which can't readily be used in the international marketplace. So of the usable funds that are available in the IMF, something in the neighborhood of 30 percent are a result of United States contribution.

Senator Sarbanes?

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator Sarbanes. Thank you, Mr. Chairman.

The first question I want to clear up just very quickly, if I can, is where you get the \$165 billion figure?

Mr. Shultz. Well, the amount of money now that the IMF has after deducting commitments in the Asia crisis is around \$48 billion right now.

Senator Sarbanes. Of which they have to hold 30.

Mr. Shultz. Incidentally, there is some very good testimony, I have it here, given by Ed Feulner. Two things that I found very rewarding to read were testimony of Ed Feulner before the General Oversight and Investigations Subcommittee of the Banking Committee of the House of Representatives, and then an article written by Martin Feldstein in Foreign Affairs that gets to this intrusiveness.

But in Ed Feulner's paper, he has a little table that says, "Reported Liquid Resources on April 30," this is from IMF sources apparently, April 30, 1997, were \$85.62 billion. Then estimated net change in outstanding credit during 1997, \$3.14 billion. So you deduct that. And then IMF commitments in Indonesia, Philippines, South Korea and Thailand, \$36.04 billion. You deduct that. He gets \$46.44 billion. Then

IMF anticipated income through 2000, the IMF has said this is what they expect just in their normal operations, \$28.32 billion, giving you \$74.76 billion.

Now, if you add to that roughly \$85 billion that is now being sought, that is, if the U.S. votes an \$18 billion tranche, other countries then come in and the total amount at their disposal rises by \$85 billion. If you add 85 and 75, you get to a large number.

Senator Sarbanes. Well, I am not going to engage at length. Thirty of what the IMF holds of the 45 is not available to be used because they have to keep it as a currency reserve to meet the liquidity demands of its members. So they now have 10 to 15, which is a historically low level for quota resources. If you add to that the 23 and the 65, which are the two quota, well, one quota replenishment and the NAB, you come to just over 100 billion. But in any event, let me ask this question—

Mr. Shultz. Even 100 billion is a lot.

Senator Sarbanes. It is a lot of money, no question about it, but it is not 165 billion.

Mr. Shultz. Well, I am just relying on these numbers. We ought to have a good clear accounting.

Senator Sarbanes. I am very frank to say I think you are playing with fire. Actually, Secretary Rubin has talked of some of these things you have outlined. I want – I don't want to mix the changes that ought to be made in IMF procedures with a separate problem or the more basic problem of having the resources to meet a current crisis. In fact, Rubin just convened a meeting of finance secretaries here in Washington, he has given a major speech outlining his own concern about such issues as transparency, financial regulations, new mechanisms so creditors and investors bear the risk of financial judgments and so forth.

I think have a problem here of – I don't think you can modernize the emergency room at the same time that the patient is being wheeled in for surgery. Now, what do you think would have happened in Asia either if there had been no IMF or the IMF had done nothing. Let us assume the IMF had done nothing, and you had this Asian situation that was taking place in Thailand, Indonesia, South Korea and tangentially the Philippines, other countries sort of lined up to experience this, suppose there had been no rescue effort, which essentially I take it is the sort of – is that the approach you are suggesting?

Mr. Shultz. First of all, on the assumption that you posited, say assume there was no IMF, that would not have been this gigantic sum of money sitting there.

Senator Sarbanes. Since there was an IMF, what I am postulating is the IMF did nothing. This situation arose, it is your view that the IMF, that it is arguable that it made it worse, not better. Let us accept that as a working hypothesis for the moment. Let us then examine the situation in terms of what would have happened in the current situation if the IMF had done nothing?

Mr. Shultz. I don't think it is an option, when you have accumulated a vast sum of money and you have said that it was there in order to cope with problems of this kind, that you are not going to do anything. That is my way of expressing a problem. Namely, you put money there and situations arise to use the money.

Senator Sarbanes. So you think the IMF should have responded?

Mr. Shultz. No, I think – I wish that they didn't have that money and that expectation. That was created by what happened in Mexico and then the accumulation of this fund afterwards. Before Mexico there wasn't any expectation that anybody was going to come in with these vast sums.

Senator Sarbanes. I understand that, and I understand, but we kind of have to deal with the real world as it is out there. This situation occurs. What are we to do? In fact, the same factors that led to this situation exist elsewhere. If you want to do it prospectively, that may well be worth looking at. That is one of the things that Rubin is going to examine in terms of the financial architecture. But you have these buildups at the moment, not only in Asia but elsewhere as well. If we are not in a position to deal with them, what is going to happen? What would have happened in Asia if the IMF had withheld from the situation?

Mr. Shultz. Who knows? Suppose there had been no IMF.

Senator Sarbanes. No. There was an IMF. It was clearly there. I want to deal with a real situation. The IMF is there. The situation occurs. Would you have withheld the IMF from the scene?

Mr. Shultz. The reality is, if you want to deal with the real situation, that if you are an organization and you have a huge sum of money and it has been labeled as money to be used in situations like this, you really don't have an option. You are going to go and make that money available. And that is one of the reasons why the crisis arises in the first place.

Senator Sarbanes. Do you think the IMF should have made the money available?

Representative Saxton. Senator Sarbanes, your time has expired. If you would ask one final question, we will move on.

Senator Sarbanes. Do you think the IMF should have made the money available?

Mr. Shultz. The IMF was driven by the fact that the money was there. It was bound to intervene. But I think if there had been no IMF, probably the situation would be better than it is today.

In the Korean situation, for example, the initial IMF program was counterproductive, and it was only when the lenders and borrowers were caused to sit down together and work out rearrangements of their debt structure that the Korean situation started to stabilize. The Koreans, in my estimation, are very smart people. They played the IMF like a violin. And they got as much of these concessionary funds that the chairman was talking about as possible at low interest rates to help them finance themselves out of their problem. I think the Koreans could have managed very well without it.

The Philippines, you mentioned the Philippines, the Philippines really didn't have this problem. They did not accumulate the problem because their prosperity came too late to develop these excesses that have been elsewhere.

The Indonesian problem is of a different character altogether. But the problems the IMF is trying to get into, which involve very detailed management of the Indonesian economy, well, there are a lot of things wrong with Indonesia, but there are also a lot of things that were going right before this crisis got precipitated in part by what the IMF did.

But anyway, what I am saying to you is, I have given you my judgment and I have also said I recognize there are people who I respect who have other judgments. So it seems to me before this money is made available the Congress ought to know what is going on. And you don't. The fact is, you don't know. And they won't tell you. And I think you ought to stand there and say, until you let us know thoroughly what is going on, answer all our questions, we are not going to give you any more money.

Representative Saxton. Thank you very much.

Mr. McCrery?

**OPENING STATEMENT OF
REPRESENTATIVE JIM MCCRERY**

Representative McCrery. Thank you, Mr. Chairman. Mr. Secretary, I know that your time is short. I would not ask you a question but for the fact that you are a former Secretary of State. As such, you are in a particularly appropriate position to assess the impact, if any, of a change in the United States policy toward the IMF on the United States partners in the world.

How would it affect our standing in the international community in your opinion if we were to suddenly not support the IMF?

Mr. Shultz. Well, what I think should be done more comprehensively than I have just said is first of all, I think you ought to insist on knowing thoroughly what the IMF does before committing any more money to the IMF. Maybe when you know more you won't commit the money. That would be my suspicion.

However, the way I would go about it, if I were Secretary of the Treasury, if I were Secretary of State, is I would be trying to meet a lot with my counterparts around the world and assess the situation because everybody is in this boat together. And try to examine the situation thoroughly and see what together we can construct.

I thought the 50th anniversary of Bretton Woods was a time when this kind of review might take place. And there was an effort, and Paul Volcker led it and made some interesting suggestions, but it doesn't go anywhere unless it is done as a matter of government. Then there is some authority and power and stroke involved. And it seems to me it is time, and Secretary Rubin has been calling for an examination of what he calls the architecture. Well, so be it. I have read some of the things that he has suggested, and some I agree with, some I don't agree with.

But anyway, I think that is the right approach. What we ought to do is do it on a broad scale working with other countries, and know our own views, of course, but this is an international global economic system and other people are involved in it, and we need to respect that.

Representative McCrery. Thank you, Mr. Chairman.

Representative Saxton. Mr. Bachus.

**OPENING STATEMENT OF
REPRESENTATIVE SPENCER BACHUS**

Representative Bachus. Thank you, Mr. Chairman.

Mr. Shultz, I have expressed a lot of hesitation about IMF funding, but I will tell you that as a critic of that, the proponents have come up with some very good arguments and, I think they feel that you and I just don't get it. One of those arguments is that it doesn't cost anything. The Secretary of the Treasury said it is like money in the bank, said it doesn't cost us a dime.

Mr. Shultz. Well, are you familiar with the concept of opportunity costs? I will rest the argument on that.

Representative Bachus. But you are aware that they have—

Mr. Shultz. Yes, I am. I think it is a specious argument.

Representative Bachus. All right. We have - I sort of characterized the IMF as sort of a financial gadfly which goes all over the globe trying to bring financial nirvana, but I am told that this is absolutely necessary, that if we don't have an IMF, we are going to have trade wars. We are going to have depression and that we are going to go back to the - to a really dark age.

In fact, just an example of that argument, which really slows those of us up who - you just said a minute ago, we are all in the boat together. We are not on an island. We all understand whether we are for or against it, we all understand that what happens in Asia or Brazil affects us. Now, could it be that the IMF may not be perfect but it is the best we have, and that without it we would be a heck of a lot worse off?

David Rockefeller wrote an article May 1st in the *Wall Street Journal* and he said, "Without the IMF, the world economy would not become an idealized fantasy of perfectly liquid, completely informed, totally unregulated capital markets. This would be a serious, perhaps devastating defect. In fact, we get a good sense of life without the IMF in the 1920s and 1930s. The results included widespread competitive devaluation and trade wars in response to balance of payment problems, followed by a plunge into global depression and world war."

Could they be right?

Mr. Shultz. Well, I think the IMF is too big and trying to do too much, but I don't think it is able to cause the world to go into a total tailspin or get it out either. I think the right kind of behavior by sovereign governments is the key, and within that framework the right kind of behavior by the private borrowers, lenders, entrepreneurs, equity participants and so forth is the essential ingredient. What you want is people and countries that are accountable and responsible. That is what it takes to make the system work. And when you cause the

accountability and responsibility to be diluted, then the system starts misfiring and you start to get more and more crises.

Representative Bachus. My third question, one argument that I think is made by some of the opponents to this bailout has been that when we externally start imposing policies on sovereign countries, there is a backlash, both a political backlash and maybe labor unrest. In fact, you mention that in your article, that you fear a backlash.

What about the argument from the proponents that we are more likely to see this backlash if we do nothing and we allow these countries to – we don't come to their assistance? Could there be that same backlash, that same anti-American backlash if we do nothing?

Mr. Shultz. There could be. But I think the expectation, again, has been created, it is very recent, it has been created by what happened in Mexico. The expectation that if somebody gets in trouble there is \$40 billion lying there to do something about it. And that expectation ought to be removed from the system and returned to where we were, where people didn't think that way. And certainly when a friend gets in trouble, you try to help. And you help with advice and you help them get, try to get themselves back in decent shape, and if they do and they get on the right track, you try to encourage financial help.

But basically it seems to me you want to make sovereigns responsible for themselves and the private players responsible for themselves.

Representative Bachus. Let me ask just one quick question: Without the IMF in Mexico, for instance, might we have gone in totally as opposed to a part of a world organization, and then if something went wrong we would bear all the burden? Isn't there some sort of – do we not sort of spread the blame?

Mr. Shultz. I think the world views our Mexican intervention not as IMF but as U.S. The IMF did what we wanted it to do. I think if I had been President of Mexico, a hypothetical question like Senator Sarbanes asked, I will put it into the context of Mexico, if I had been President of Mexico, when the Congress declined, I would have said, okay, I am sorry I asked you in the first place. We made some mistakes and we know what they are and we understand how to correct them, and here are the programs that we are going to put into effect.

Now in the meantime there are these short-term debts that we incurred, perhaps unwisely. And I might say that while we were unwise to borrow the money, the people who loaned us the money also were

unwise. But at any rate, we can't honor those obligations right now, but we intend to as we make ourselves healthy, and we invite the holders of those short-term debts to come and meet with us and try to work out some sort of an arrangement where we share some of the misery. But in the meantime we are going to set our economy right, we are going to do it ourselves. We are in charge here in Mexico, not the IMF, not the U.S., we are in charge.

Representative Saxton. Thank you.

Mr. Shultz. Frankly, I think the international financial community would react well to that kind of thing, not adversely.

Representative Saxton. Senator Grams.

OPENING STATEMENT OF SENATOR ROD GRAMS

Senator Grams. Thank you very much, Mr. Chairman. Mr. Shultz, thank you for being here this morning. I just want to ask a couple of questions about the IMF. Do you believe that your concerns are with the IMF as an institution or is it with the structure and operations of the IMF? Do you think that there is a need for this type of international cooperation in financial crises and you just don't like the IMF or do you just want to restructure it, or both?

[The prepared statement of Senator Rod Grams appears in the Submissions for the Record.]

Mr. Shultz. We certainly need to have a sense of cooperativeness in the world economy. We need to be modest enough to realize that nobody is going to manage, in quotation marks, the "world economy" any more than some central planning agency in the Soviet Union was, as we now know, able to manage that economy. So you have to rely on market forces.

But nevertheless, a collaborative and cooperative feeling in the finance ministries and central banks is very important, and by and large those things do work pretty well. And so we want to have that. Whether there is – probably there is a role for a convener, as I said. I do think that having this large sum of money sitting there is an invitation and we would be better off without it. So that is why I have said what I have said here, but I recognize other people have different views, and people I respect, and I think what you ought to do is know better what you are dealing with before you provide more money. I think with all due respect, you do not know because they won't give you the information.

Senator Grams. The reforms that have been requested in many of the IMF packages are beneficial in some aspects, especially in opening markets, such as financial services, insurance services, and others, that have been closed. The IMF has been able to open some markets. Have some reform packages been good and others negative, such as in Indonesia, where the IMF may have been too tough?

Mr. Shultz. I think, let us take the case of Korea, I think the IMF's effort to get those markets open, financial markets and other markets, and to open up the possibility of ownership, foreign ownership in Korea, I am in favor of those things. And the U.S. policy has been banging on Korea for years to do those things and Korea has not wanted to do them. I respect Korea's sovereign right to decide that for themselves even though I wish they wouldn't, but that is their right. They are a sovereign country.

Now, what I fear is that they get in trouble and the IMF with its foot on their neck causes them to do something that they don't want to do but which we want to have them do. There is going to be resentment as a result. Even though I think if they did make those changes, they would really be better off, as well as we would. But there is I think a sense of respect for a sovereign country. How would we like it if we got in trouble and somebody put their foot on our neck and said change your entitlement systems right away, they are going to drag you down. We would say, get lost. We know we have problems, we are going to have to deal with them, but it is none of your business.

Senator Grams. Is during a crisis the time to throw the baby out with the bath water, so to speak?

Mr. Shultz. Well, you can get change at a time of crisis that you can't get otherwise if you know what you want to have done. And it would be the best thing to have the change come about as a result of the country itself.

Now, the new President of Korea, who is going to be in this country within a month, Kim Dae Jung, has advocated in his own policies a lot of these things that we want. In many respects he is a promising refreshing breeze on the scene. So why not put him in the leadership. Let it be his program, not our program. He just got elected President. And we have got – so we have got it wrong.

Senator Grams. Don't their programs have a big impact on our jobs or economy?

Mr. Shultz. They have some impact but not a big impact. Our economy is so big that it doesn't notice a lot of these things. And after

all, the conditions that we are trying to correct have been there a long time and our economy is a very prosperous economy.

Senator Grams. Thank you, Mr. Chairman.

Representative Saxton. Mr. Secretary, you have been extremely generous with your time this morning, and I want you to know how much we appreciate it. Everyone who is here on the panel, I noticed, listened intensely and engaged in very good conversation with you. Everyone may not have agreed with everything, but everyone benefitted by your being here, and we appreciate the amount of time and effort that you have expended on behalf of this issue with us this morning.

We look forward to further dialogue with you in the future. Thank you very much for being here and say hello to all our friends for us over at the Reagan Center.

Mr. Shultz. Thank you, Mr. Chairman.

Representative Saxton. Mr. Volcker, you are going to be the first to testify. If the next panel, including Paul Volcker, the former Chairman of the Fed who served from 1979 to 1987, Mr. William Niskanen, and Mr. Lawrence Lindsey would please come forward at this time.

Thank you for being with us this morning also. And, Mr. Volcker, please feel free to proceed at your pace.

**OPENING STATEMENT OF PAUL A. VOLCKER,
FORMER CHAIRMAN, BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM**

Mr. Volcker. Thank you. And I appreciate being here. I do have some appointments back in New York to which I must return. So I perhaps could give some reactions to what is been said here and take any immediate questions you will have.

I don't think there is any question that there are very large issues before the IMF and the world monetary system. I might say, I think the staff has distributed to you a speech I made on the subject recently, which expands on my views concerning the basic nature of the problems which go well beyond the IMF. But I certainly welcome this debate, because I have been encouraging a debate on these matters myself for some time.

There are obviously different perspectives established to advance that debate. I agree with much of what Mr. Shultz has raised. I disagree certainly with his conclusion as to how to best deal with these problems. And I don't agree with all of his diagnoses. I think we do have to

recognize that we are not the only country in the world. The IMF is an international institution.

We do not command that institution, but we do have a very large influence on it. The IMF was our creation. We created it, I think, because we recognize that we have to work in a world cooperatively with other countries. And this is the vehicle for doing so, but we certainly have a disproportionate influence on that organization, apart from our formal veto power, which certainly extends to this increasing in quotas.

As I listened to the concerns of some members of the committee and Secretary Shultz, I was struck by the fact that those concerns might better be directed toward the Secretary of the Treasury and the United States in general. The fund has not undertaken this program in Mexico a few years ago or the Indonesian program or the Korean program or the Thailand program because of a lot of faceless bureaucrats.

The people pushing those programs were Mr. Rubin and Mr. Summers, and who went down to Indonesia at the time the IMF programs were being revised to encourage, to use a mild word, Indonesia to cooperate with the IMF; it was Mr. Summers, Mr. Cohen, the former senator, not a faceless bureaucrat, who visited Djakarta to urge the Indonesians to work with the IMF.

The programs are no secret. The things that motivate the programs are no secret rightly or wrongfully. And I think as government officials they are perfectly equipped to testify and tell you the great proportion of the information that is relevant and needed.

I must say I do disagree with Secretary Shultz on one point. The mandate, the articles of agreement of IMF are not narrowly drawn to be concerned only with maintenance of the convertibility of the dollar and gold as was the case when the monetary system was organized. It speaks proudly of promoting international cooperation, international financial stability.

The amendments were specifically changed in 1967, I believe, to recognize the role of the IMF in a floating exchange rate world. And I don't think that role is obsolete. International cooperation is not obsolete. The IMF is the agreed international forum for discussion and for rulemaking in this area. It is a convener, that is to be sure, as Secretary Shultz suggested, but it is more than a convener. It is a rulemaker.

It also has to be provided with money. Money is often helpful in providing discipline, in providing incentives, and, in this case, money may be essential for dealing with financial crises.

Let me say these financial crises are not a rare event. Secretary Shultz emphasized they seem to be becoming more frequent. And I think there are reasons for that, apart from the moral hazard problem, although that is very important. We had international financial crises long before we had the IMF. The IMF was created to deal, help deal with financial crises.

We had a rather serious international financial crisis in 1929, in the early 1930s, which was the reason the IMF was created. Our inability to handle that crisis effectively, and the inability of the United States at that time to take leadership, was reflected in a very large world depression. It is that kind of event for which IMF was created to respond.

Nobody knows what the risks are in the future. I don't know what the risks are of another crisis that will need this particular amount of money in the next five years.

But I would remind you this IMF request for additional funds is not exactly unique. They have requested additional funds about every five years on the general theory that their resources should stay up with the advances in the world economy, and particularly the advances and enlargement of the world financial markets, which have certainly been increasing at an extremely rapid rate of speed. I don't think it is useful for me to try to debate what the odds are of a new crisis in the next few years that would need this money.

There is some risk. Whether it is worth taking that risk is a question for you to resolve. What I think is not at issue is this: like it or not, whatever you say, a refusal at this point to go ahead with an agreed quota increase will be interpreted as a retreat from multilateralism. This quota increase is in line roughly with past quota increases. It has been negotiated by the United States Administration, it doesn't come out of the blue. It was negotiated cooperatively by the United States Administration.

And at this point, after more than 50 years of the IMF and successive increases and quota increase, to say suddenly we don't have enough transparency, we don't have enough management, we don't have enough oversight, however valid those concerns, is going to be interpreted as a retreat from participation in the IMF. It is going to be interpreted as a retreat from multilateralism. I think it will be interpreted as an aggressive move by the United States that it no longer wants to be burdened with working towards a cooperative institution, it would rather work unilaterally.

Now, working unilaterally involves additional costs in my view. The IMF has been a very effective organization for sharing the burdens of intervention when those were deemed desirable by the United States itself. It is not a question to me whether we need reform of the international monetary system and the IMF, but a question of how we are going to approach it, and whether we are going to do it in a multilateral way or appear to be doing it or would like to do it unilaterally.

Now, there are lots of questions that arise. I think Secretary Shultz has raised some very valid questions. Let us look at the implications of having the IMF and not having the IMF, and let me go back to Mexico in the mid-'80s or the early '80s that he referred to, when he was Secretary of State. I happened to be Chairman of the Federal Reserve Board, and on the firing line both in economic policy and in cooperation with the IMF.

This was not a question of rescuing Indonesia, it wasn't a questioning of rescuing Korea or Thailand, or even, as he suggested, only a question of rescuing Mexico or Argentina or Brazil. We faced a situation where the international banking system was at risk for whatever reason, and U.S. banks were more exposed than other banks. They had more of their capital lent in Latin America than they had capital in most cases.

Is that a situation which we should have let go and decided those loans wouldn't be repaid, that we had no responsibility as a country or as an international organization to deal with? We decided there had to be some assistance or there should be some assistance. I was in the position of organizing that, frankly. And when we had to organize that assistance in a hurry, I called up my counterparts abroad and said, we face a large problem here, you face this problem, too, and we are going to have to deal with it together.

And their immediate response, quite naturally, was is the IMF going to support this program? Well, we had done enough homework to know the IMF was going to support the program, but other governments were not going to quickly respond to our request unless there was an international organization there that necessarily should have been involved. That international organization (the IMF) provided the international legitimacy that was necessary to deal with an international problem, a problem that was on our doorstep, but, to a considerable degree, affected other countries as well.

We did then precisely what Secretary Shultz was talking about. We called the creditors into a room, [you could do it then, it took a big room, but there were only a couple hundred creditors that amounted to anything]. The Mexicans said we are sorry, you can't be paid right now, you are going to have to wait, and not only that, you are going to have to provide some new money. The IMF agreed and said if you are going to have to lend some more money based on the exposure you have, then we will provide some marginal assistance and the aura and legitimacy of an international organization to encourage Mexico and these other countries to take the proper steps to repay you in time and to change their economic policies in ways that were more outward-looking in terms of basic American objectives.

You may recall that Mexico at that time was extremely insular. They were nationalizing their banks, rather than opening up their markets. They had closed markets. At the end of these programs, a very difficult time, they reprivatized the banks, they had opened the markets, they had joined the GATT, they had reduced and stabilized the economy, and at the end of the day the creditor banks took losses.

Now, I have problems with some of the more recent programs. We all have problems, and ranging from quibbles to more serious reservations. I agree with Secretary Shultz that the big Mexican program of a few years ago was a kind of watershed. But again, I repeat to you that was an American-sponsored program. Most of the \$40 billion we talked about was U.S. money directly. It wasn't fund money, it was U.S. money.

If you had problems with the Mexican Program, discuss it, and we ought to resolve some problems and decide what the future policy is. But where are we now? I think we agree we need review and reform. Some of that is referred to in this speech I gave, and I would be glad if you want to take the time to read that.

There are lots of little reforms, some of which have been mentioned here today. I call them the little reforms, because they are not going to affect the general direction of the world monetary system. They are not, in my opinion, going to affect the number of the crises we have in the future and how they are handled. They may be an improvement. You mentioned interest rates. You mentioned disclosure. You mentioned transparency. You mentioned bank supervision, all of the kinds of things that the Treasury has been emphasizing. They all broadly, in my mind, come all under the label of good housekeeping.

Good housekeeping is not going to prevent the next crisis and it is not going to deal with the new crisis when it arrives. I think something more basic is the matter: something systemic, something that goes far beyond the IMF as it is presently constituted or others to deal with. And I think it is, as I indicated earlier, related to what is a clash between global finance and small emerging economies.

There is an enormous amount of money that moves through these markets on short notice. It moves impelled by a variety of investors competing with each other to maximize their rates of return. It moves in volumes that in short periods of time can overwhelm the economies of small countries. As is often pointed out, the total banking system of Argentina, of Thailand, of Indonesia are about the size of one regional bank in the United States.

We are not dealing with huge economies that can ride with these waves. We are not dealing with a big steamship like the United States. We are dealing with canoes in the South Pacific that may be capsized and obviously are in danger of being capsized by ordinary and extraordinary turbulence, in international financial markets, which is not new.

I would suggest, in your thinking, you emphasize more some very key issues that I think arise. Secretary Shultz mentioned one, the apparent intrusiveness of IMF programs or the U.S. programs. When a crisis arises, can we expect an Indonesia or Korea to revise their internal policies, their institutions almost overnight?

The United States Congress has been struggling with banking reform in the United States for 20 years without having an effective piece of legislation. We want Korea to do it in three weeks or Indonesia to do it in three months? I mean, we have to have some rule of reason. I think the IMF stubbed their toe in Indonesia in demanding reforms before Indonesia was ready for it and aggravated the problem in the banking world.

We have questions of the proper boundaries between the IMF and the World Bank. To put it in its narrowest context, should the IMF be lending for long terms as repeatedly as it does to Russia, which borders at least on development credit, at the urging of the United States and other governments I might add. It is a question whether it should get in that business, whether it is the heart of the IMF business.

You, Mr. Chairman, have been concerned with moral hazard. I think that is a big issue. I don't think it is the cause of all of these problems. I don't think there is much moral hazard so far as the countries

are concerned, which suffer severely when these crises arise. But I think it may contribute to an insouciance on the part of lenders sometimes in dealing with these countries that magnifies problems and make them more difficult to deal with.

And I think that was an issue that arose as a result of the Mexican program. I don't doubt that. It is a very difficult issue to deal with, and I think there are ways of doing better than we have done in the past.

I would conclude by saying simply I think we have a major problem with the exchange rate system, which we don't want to face up to and have not wanted to face up to for years. But one of the complications, an important complication in Asia was the fact that the yen/dollar rate has gone up and down by 60 percent in the course of three or four years without any basic economic change that would suggest such a fluctuation between the two largest economies in the world. This 60 percent has no relationship to competitive realities. How can trade to respond to careful calculations of comparative advantage when exchange rates are moving by 60 percent over a period of time. This is a puzzle in itself.

But it becomes practically impossible for a small country in south-east Asia with diversified trade to have a sensible exchange rate when its two biggest trading partners own exchange rates deviate by 60 percent over the course of a year or two. There are a lot of disagreements on these issues, but I am suggesting that that problem is larger than the IMF.

The IMF has a problem, because the larger problems of the system are overwhelming its traditional approaches in my opinion, that requires a lot of rethinking. And I am delighted that the Congress wants to get into this area. But when I cite this kind of problem, it is also evident they are not going to be solved overnight. There is disagreement about it, and it is going to take an understanding among major countries and minor countries around the world.

The IMF is there as a forum to reach that agreement. And I would suggest to you that the evidence and the common sense of it is overwhelming that those discussions will go along more favorably and more productively if we appear to be engaged in the IMF effort, engaged in the IMF efforts as an ongoing institution and not in retreat. And that involves participating for, the sixth, seventh time in history, in an increase in quotas this time.

How do we explain that at this particular point in history, we step back and refuse to participate and refuse to permit other people to participate in an increase in IMF resources of the kind that we have

supported so many times in the past? Particularly when we recognize a need for change, a very healthy thing, let us support that debate, let's promote the debate, let's have you give due warning that you are not going to automatically accent another quota increase that hasn't yet been negotiated out in the future, pending a thorough debate of the fundamentals of this and where we want the IMF to go over a period of time. Taking the ball and going off and saying we are not playing right now until we get an agreement seems not to be the way to get the very kind of changes and fundamental reforms that you are looking for and should be looking for.

Thank you.

Representative Saxton. Thank you.

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

Representative Saxton. Mr. Niskanen, please. Mr. Niskanen?

**OPENING STATEMENT OF WILLIAM A. NISKANEN,
CHAIRMAN, CATO INSTITUTE**

Mr. Niskanen. Thank you, Mr. Chairman. My statement is brief, and so I will read it with your permission.

The case for the massive IMF/World Bank response to the recent Asian crisis reminds me of an all-too-frequent proposal to jump-start economic growth: The combination of massive demand stimulus and a solemn promise never to do it again. The problem with this type of policy, of course, is that the initial response undermines the credibility of the promise.

Secretary Rubin seems to understand the moral hazard problem caused by socializing the losses on international loans, but he claims not to know what to do about it. The young St. Augustine was rather more honest with himself; when faced by a similar problem, he prayed: Lord, make me chaste, but not quite yet.

For there should be no doubt about the nature of the choice that was made by the response to the recent Asian crisis: The international financial establishment committed over \$100 billion to reduce the near-term contagion effect of the recent Asian crisis without apparent regard for the longer term contagion effect that this bailout will probably increase the number of similar future crises in these and other countries.

The historical record is clear. Most of the less-developed nations funded by the IMF have later returned for more funds. Mexico, for

example, has had a financial crisis in each of the past four presidential election years. A total of 84 nations have been in debt to the IMF for 10 years or more, 43 nations for 20 years or more. And there is little doubt that the massive IMF and U.S. bailout of Mexico in 1995 contributed to the near doubling of capital flows to East Asia that same year.

Finance ministers and central bankers will commit almost any amount of our wealth to avoid a financial crisis on their watch, even when they recognize that the socialization of losses increases the probability of a crisis on some later watch. Rather than resolving the conditions that lead to financial crises, the IMF treats each successive crisis as a new event, indirectly assuring that there will always be a queue of new crises to address.

U.S. government membership in the IMF is like being a limited partner in a financial firm that makes high-risk loans, pays dividends at a rate lower than that on Treasury bills and then makes large periodic cash calls for additional funds.

The current Administration campaign to convince Congress to approve more funds for the IMF is also quite deceptive. To some groups, the officials suggest that more funds are necessary to help the poor starving children of Nameyourland. In fact, the IMF bailouts are a form of insurance for the foreign and domestic individuals, firms and banks that had made high-risk investments in the country subject to the crisis of the day. The 1995 Mexican bailout, for example, insured those generally wealthy Americans and Mexicans who had purchased the 28 day government bills, providing little help for the general Mexican population for whom the real per capita income is now lower than it was prior to the bailout.

Similarly, the Administration seems to have gained a support of the congressional Democratic leadership for new IMF funds on the premise that such funds would reduce the exchange rate effects and the resulting trade effects of future crises. In fact, the exchange rate of an IMF client generally stays weak for some years after a bailout. The dollar value of the Mexican peso, for example, is now less than half of that before the 1994 crisis, with the effect that Mexico has since had a trade surplus with the United States.

Finally, the Administration has gone around the world making a series of promises and then asserts that the congressional support of these promises is necessary to maintain U.S. leadership. The Clinton Administration did not invent this gambit, but it has been especially

consistent in using this argument to support its position on trade negotiations, global warming, NATO expansion, Iraq, and now the IMF.

For now, it looks like the bailout of Thailand, Indonesia and South Korea is history, a done deal for which the IMF does not need any more funds. So the current issue is whether the IMF should be refunded to prepare for the next round of financial crises. For now, I suggest, Congress should defer a decision to refund the IMF until it has a better understanding of the conditions that led to these financial crises, the moral hazard effects of socializing the losses on the international investment, the long term record of the IMF and feasible alternatives, including the implications of no multilateral governmental response to a financial crisis in any country.

It is especially important, for example, to understand the reasons why the recent Asian crisis was limited to Thailand, Indonesia and South Korea, but with much less effect, at least so far, in countries like Singapore, Hong Kong, Taiwan, and China. My initial judgment is that there are two patterns that are common to the problem countries in Asia, as well as with Mexico.

One, a record of state-directed credit allocation, either by a formal industrial policy or by crony capitalism, and, second, a futile attempt to maintain both a fixed exchange rate and a monetary policy responsive to domestic political pressure.

It is also important to understand why the frequency of magnitude of financial crises are increasing. Studies by the IMF and the World Bank have documented some 90 episodes of severe banking crisis over the past 15 years, a period of relatively stable world economic growth. For this condition, I suggest, the IMF and the World Bank bear substantial responsibility.

When a borrower is illiquid or insolvent, the only way to avoid a moral hazard problem is a financial workout in which both the borrower and the lender take a major hit; the borrower by giving up some or all control of the remaining firm or assets, and the lender by lengthening the maturity of the loans if the problem is only illiquidity or by trading the outstanding debt claims for lower ranked debt or for equity when the problem is basically insolvency.

Private bankers have handled such problems for generations long before the IMF and the World Bank muscled their way into this role with our taxes. I ask you to at least entertain the possibility that private bankers committing the assets of their own firms are likely to handle

such problems better than do public officials who play this game with other people's money.

As a rule, however, as documented in an important recent article by Charles Calomiris of Columbia University, recent IMF assistance has been, "designed to absorb the losses of insolvent banks and their borrowers in developing economies, and to insulate international lenders from the losses that they would otherwise suffer."

Calomiris goes on to document the three major consequences of this developing policy: First, "the main influences of the IMF and the U.S. government in the – the main influence of the IMF and the U.S. government in the 1990s have been to lend legitimacy to domestic bailouts by providing conditions that call for a taxation of the domestic middle class to repay these bridge loans from the IMF and the U.S. government and to insulate foreign creditors, especially banks, from losses during these crises."

Two, after the crisis is passed, "The big winners are the wealthy, politically influential risk takers, and the biggest losers are the taxpayers, middle income taxpayers in countries like Mexico and Indonesia."

The third is that this effect, thus, delays the necessary reforms. "If oligarchs can avoid true liberalization but still maintain access to foreign capital," Calomiris says, "where is the incentive for them to relinquish the rule of man in exchange for the rule of law, or to allow competition and democracy to flourish?"

Calomiris concludes that "The primary lesson of the recent bailout programs managed by the IMF and the U.S. government is for all parties to find a credible way to commit not to sponsor just counterproductive bailouts in the future."

The characteristic IMF response to this type of criticism, of course, is that the conditions for receiving IMF credit induce the type of reforms that are necessary to avoid future crisis. And in a few cases, this has been successful. The larger record, however, does not provide a basis for optimism. Most developing country governments, once the recipient of IMF subsidized credit, have become loan addicts.

As noted earlier, most of these governments have relied on IMF loans for more than two decades despite the conditions for receiving these loans and what is the usual two- to five-year maturity of these loans, which turn out to be rolled over again and again.

Maybe we don't need the IMF. That is now the judgment of former Treasury Secretaries Shultz and Simon and the former chairman of

Citicorp Walt Wriston. I am willing to defer judgment on that issue. In the meantime, Congress should not approve any additional funds for the IMF, at least until some of these broader questions are addressed.

Thank you for your attention.

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

Representative Saxton. Thank you. I feel like I should apologize. We have gone on here for a long time. And I know, Mr. Volcker you have a time problem. And I believe Mr. Niskanen also has a time problem. We would like to ask you all some questions and I hope you can bear with us, but we didn't expect 12 members of Congress to show up here loaded with questions, quite frankly. We thought we would be out of here long before this.

Mr. Lindsey, would you want to proceed with your testimony and then we will try to get back to you as quickly as we can with some questions?

Mr. Niskanen. If Paul has to leave, why don't you ask the questions to him first.

Mr. Volcker. I appreciate that courtesy.

Representative Saxton. Mr. Campbell would like to ask some questions.

Representative Campbell. If it is all right with Larry and Maurice.

Representative Saxton. Is that all right with you, Larry?

Mr. Lindsey. Sure.

Representative Campbell. Thanks, Mr. Chairman.

If you like, very quickly. Thank you, Chairman Volcker, I appreciate very much your testimony. A quick question, the alternatives, we have been talking about that a whole lot, it seems to me for developed economies you have got a question of the exchange rates are no longer fixed, if there is investment risk, you can handle it by edging in the future markets for those currencies. This is a premise, so you disagree with any premise you like, okay.

But for underdeveloped economies it may be that we need something like IMF. But then I would argue, call it what it is, assistance to underdeveloped economies and handle it through the World Bank. Your thoughts on that.

Mr. Volcker. Well, I think there is something to the thought that in today's system, with the fluidity of capital markets you are much less

likely to need IMF assistance programs for developed countries with sizable GNPs, and strong financial systems. But that still leaves the question of most of the world in terms of population, a great portion of the world.

I think you could combine the IMF and the World Bank. The risk is then you get the kind of blurring of functions and response that Secretary Shultz was talking about. And I think we should try to maintain a distinction between the short-term liquidity support, which has been blurred in practice, and what the World Bank does, which is more structural. It seems to me when you look at Indonesia, for instance, the kind of thing that the IMF is demanding is probably more suitable for the World Bank, when they are making loans, and that IMF should have been worried about shorter term liquidity.

Representative Campbell. And my thought about financial institutions is when you are dealing with the underdeveloped economy, that is probably far less important in the panoply of problems than it would be for developed economy. So toss it into the whole line of issues involved in an underdeveloped economy, as opposed to what seems to me a dangerous commitment, this is the moral hazard argument, that the dangerous commitment, we will defend this level of currency against another.

Mr. Volcker. I think we have a lot of dispute about this. I think the small countries are unable to live in a real floating rate system. There is too much uncertainty. The markets aren't broad enough. They don't have the financial strength, liquidity and economic depth to live with their currency freely floating. Their real preference is to not permit a float, going all the way to the Argentine fixed currency.

By the way, I don't think the IMF has been giving Argentina advice to devalue. I was a little surprised by Secretary Shultz saying that. If that is true, I am amazed, and it is, in my view, bad advice. But I do think – you know, they bounce around on an ocean. I like the metaphor of the world finance system being an ocean. You need oceans. They provide water, they are vital to life, but they have storms, and a storm that a big country can sail through capsizes a small canoe.

If I may just inject one other thought. This moral hazard issue, which I think is real. I think it is overplayed too, but it is real. We had a banking crisis in Finland. We have had a banking crisis in Sweden. We have had a banking crisis in Norway. We have had a sizable banking crisis in the United States. We have got a whopper in Japan.

I don't think any of those crises had anything to do with depositors in those banks thinking they were going to be bailed out by the IMF. I don't think that thought ever occurred to them. So I think this is rather independent of IMF moral hazard, that is I think something we want to deal with. I don't want to minimize it. I just don't want to make it the be-all and end-all.

Representative Campbell. I began with a distinction between developed and less developed with which you might have some disagreement, but at least it is a working way of dividing this up. In order to get from less developed to developed, I am thinking of Singapore, it is not numbers of population, but it does seem to be a reliable commitment to free market principles. That seems to me the key to get people from underdeveloped to developed, and not necessarily the size of the environment, the population or even the economy, but rather reliable commitment to free market principles, then capital flows in.

If I am not right, isn't an IMF guarantee counterproductive?

Mr. Volcker. Well, a commitment to free market principles may be basic and is basic, we all think, to the sustained growth of these countries over time. The interesting fact of the matter is, it also exposes them to the volatility of international financial markets. And one of the curious empirical observations is that the countries that have been most struck by these crises are the ones that the world in general thought were doing best in opening their markets and joining the world economy.

Mexico, the exemplar of Latin America, little Czechoslovakia, Vaclav Havel, you know, privatized everything in sight and said he didn't want any help from the IMF or the World Bank or anything else, welcomed foreign capital. In Eastern Europe they were considered to be doing best, but got dumped on first.

You know, the story of the favorable reports about Indonesia, Thailand, all these countries were doing fine, and I don't think this is a coincidence. Precisely because they were perceived to be doing fine, they attracted capital. And the market tends to go to excess. And it went to excess. They were willing to borrow, which is their fault, but it is also the fault of the people that were putting in more capital than they can handle. It is all great when it happens. You know, the economy grows, the exchange rate is strong, a lot of investment, a lot of real estate, specialties. You end up with a boom and a bust.

And Larry Lindsey taught me at one point it reminds you of Texas in 1980s, the same thing; good banking supervision, good banks, a lot of

attractive prospects, it attracted a lot of capital. Five years later they had no large, Texas owned banks left, they were all bankrupt. That was with the United States supervision, that was with my supervision, so it was obvious – it was obviously world-class.

Representative Saxton. Mr. Hinchey?

Representative Hinchey. I don't want to detain you. Do you have another couple of minutes? I want to apologize also. I am sorry that we didn't have the opportunity to listen to your views in contrast to Mr. Shultz. I think it would have been a good juxtaposition. But let me just ask you a couple of questions briefly.

What would have happened if the IMF had not provided liquidity to Thailand, Indonesia and Korea, and what are the implications for the United States economy if we do not provide the additional funding for the IMF?

Mr. Volcker. Well, on balance, despite what I perceive as mistakes, particularly in Indonesia, on balance I think the IMF has been helpful in stabilizing the situation. The Thai psychology and financial situation anyway has been somewhat stabilized and looks a little more promising than it did a few months ago.

I don't think there is any question that the economy of Korea, which is by far the biggest economy involved and the economy with the biggest impact on the rest of the world, has been stabilized by IMF intervention. I do not know, I don't understand why, at the first stage, instead of the second or third stage, they did not sponsor negotiation with the bank creditors. That was eventually done. And it was very helpful, as the Secretary suggested.

But let me say one of the complications, intellectually and otherwise, is the nature of the capital markets today. You have many more participants in international finance than you had 10 or 15 years ago. It was literally true, if you don't take these figures too literally, that in 1982, you could in a day or two invite and get all the significant bank creditors of Mexico in one room in the Federal Reserve Bank of New York. They don't have that big of a room, but it was maybe 150, 200 people, and you probably had representatives for 90 percent, of the short term, external credit of Mexico.

You can't do that today. There are money market operators. There are hedge funds. There are pension funds. There are college endowments. They are all over the place. You invite them to the room, and they say, what are you inviting me for? I am going to pull my money out of

Indonesia before I get to the room. A bank can't do that, because it has got a continuing commitment in a bank loan.

So you have a different type of problem. That was, I think, perceived to be the problem in Mexico in the 1995 and 1994 around. The banks were not much involved because they had been burned. What was big were mutual funds, pension funds, and they are not apt to be as cooperative as the banks, because they don't have a continuing interest in the country.

So you have got a different landscape, which I don't think we fully understand and which has nothing to do with failure to disclose. Most of the exposure - to the best of my knowledge, much of the exposure of American banks in Thailand, and particularly in Indonesia - is not in loans at all. They have been burned enough in loans. They stayed out. It is in derivatives, where they thought for complicated reasons they were hedged and protected. In a big crisis they discovered they weren't hedged and protected.

But it wasn't that they were bailed out of loans in Mexico and made a lot of loans in Thailand or Indonesia. They were getting exposure without understanding the nature of the exposure, as it turned out. Now these are big sophisticated banks. We are not talking about fringe operators who don't know what they are doing, who may not have known what they were doing. But in retrospect, they took on more risk than they realized.

It is a very big and complicated problem which is I think systemic, in the sense that we have a much larger, more fluid international capital market, much more complicated, many more interconnections through derivatives and otherwise than we had even 15 years ago in Mexico and Latin America. That was pretty much a straight bank loan problem, a few bond issues, no derivatives to speak of. It was straight bank lending by American and other banks. You knew about it, we had statistics, you might say it wasn't exactly hidden. The problem with more statistics is people will say, not "I will be cautious," but rather look, my, God, so many other people are lending in Indonesia, they must be smarter than hell, I better get in there, too."

Some markets operate like the U.S. stock market. The stock market may be high, but I don't want to be out if all of those other guys are in and it is rising and looking good.

Representative Saxton. Well, Mr. Chairman, thank you very much for being with us. I would like to compliment Mr. Hamilton and Mr.

Hinchey for having the forethought to invite you today, and your words have been most meaningful and thought-provoking and we appreciate you being here.

Mr. Volcker. I am sorry, but I have a previous engagement that I have to run to. I was here on short notice, and I really hope that you pursue this idea of looking at more fundamental reforms. But I honestly think that that will proceed in a more harmonious and productive way if you are not interpreted as turning your back on the existing institution that is, in some sense, following a policy that you have endorsed in the past in terms of increasing resources more or less in line with the growth of the economy.

Thank you.

Representative Saxton. Thank you.

Representative Hinchey. Thank you.

Representative Saxton. Mr. Lindsey, thank you for your forbearance. We appreciate your patience. And can we ask you for your testimony?

**OPENING STATEMENT OF
LAWRENCE B. LINDSEY, RESIDENT SCHOLAR,
AMERICAN ENTERPRISE INSTITUTE**

Mr. Lindsey. Sure. In the interest of time, what I would suggest is that I submit my written testimony for the record. And given what has transpired, I would like to briefly comment on what I have heard.

It is an honor for me to appear with two former colleagues, Mr. Niskanen and Mr. Volcker. And I think you will find my views somewhat between the two of them, maybe because I have respect for both of their opinions.

First of all, I do think that there are reasons to have an IMF. But I think we should think carefully about what they are.

The first thing needed is speedy action. Normally, I would say that I would prefer to have the United States Congress make an appropriation to carry out a specific mission, which is what Secretary Shultz said earlier.

With all respect to the Members present, Madison was very clever in designing the Congress to take deliberate amounts of time in considering things. And world financial markets don't often wait for the legislative pace. I have to say at the moment, though, that I don't find that argument compelling in the case of the IMF funding.

Consider Indonesia, for example, we are now nine months into negotiations with Indonesia in dispersing IMF funds, and even the greatest cynics of Congress would argue that Congress could have beaten the IMF in this case.

Second, with regard to speedy action, and I think this is in Mr. Volcker's speech, the real issue for speedy action is a question of liquidity versus solvency, whether or not the country in question can fundamentally repay its loans or whether it just simply is temporarily cash short.

Now, I have argued elsewhere, and I think it was true, it will turn out to be true in the case of Indonesia and Korea, the country is simply insolvent. It will never be able to repay its loans. You can do any kind of math you want on the South Korean balance sheet, and, for example, corporate debt payments, interest payments, just interest on corporate debt in South Korea amounts to 25 percent of GDP. Now there is no way, no way they are ever going to repay.

They are insolvent. They were not illiquid. Having the IMF rush in, in this case, and provide money was throwing good money after bad. The IMF should be there for the case of illiquidity for speedy action, not in the case of insolvency.

The second reason I think to have an IMF, but again I don't think it works in the current situation, is that they may have expertise which we don't have. And so we might want to subordinate U.S. interests to their interests. Again, I think the IMF has a very talented group of people working there and we should make good use of them. But, I really don't think that their expertise is being put to good use. I think the real problem involves what Secretary Shultz calls a confusion of missions. The IMF has to justify its existence. It wants you to take their money, along with their advice, and, therefore, it is not necessarily candid about the advice being given.

Let's compare, for example, the IMF estimates of performance in Indonesia, Korea, and Thailand made last October when we all knew the crisis was here, compared to what they just forecast in April. Last October, they said Indonesia was going to grow at 6.2 percent, now it is minus 5. Korea was going to grow at 6 percent, now it is minus 8/10. Thailand was going to grow 3-1/2 percent, now it is supposed to fall 3.1 percent.

Now, these rosy scenario assumptions I think are part and parcel of the problems that the IMF has in confusing its mission. It doesn't speak

accurately, because it is confused about what it is out there trying to do. I think related to that is an example of what they said about Japan. Last May, the IMF predicted that Japan was going to grow at 3 percent. I don't know of anyone, I don't know of any private forecaster – and I know lots of people in Japan, both in the government and out – who ever believed that Japan was going to grow at 3 percent.

Why did the IMF claim that it would? Well, the IMF is funded by the Japanese government, and the Japanese government thought they were going to grow 3 percent. So the fact that they are tied to receiving funds from member states that are a source of their information, and on the other hand, they want to lend to other member states, necessarily puts their information-providing business in league with their confusion about their funding and who they want to make loans to.

The second point I want to make is that lending is not costless. I think Secretary Shultz used the word "opportunity cost," and that is exactly right. If we believe, as the Administration claims, that this was costless, I would be the first to recommend that you don't stick to \$18 billion, why not make it \$18 trillion. It doesn't really make any difference.

The fact is that the U.S. government has to go out there and borrow money on the markets, money that otherwise would have gone to build houses, cars, plant and equipment, whatever, in order to provide this money to the IMF. It is a simple fact of life. It is not costless. We are foregoing other economic activities to do so.

The other piece of this Administration argument is to compare it to a credit union. Now, this is a completely specious argument. And I am just amazed that people like Deputy Secretary Summers would make it. A credit union does not make loans that are tied to the amount people put on deposit. That is what the IMF is doing. That is what quotas are all about.

Second, a credit union requires collateral. It makes home loans. It makes auto loans. All the IMF makes are signature loans. If you have collateral, you can go to the markets, you don't need the IMF.

And third, the credit union only makes loans to you if you are creditworthy. Now, the IMF only makes loans to you if you are not creditworthy. So the comparison that the IMF is some kind of a giant credit union to which we are a member, I think is an unfortunate contribution to this discussion.

Is the IMF riskless? Well, it is true that no one has lost money from the IMF, because no one has tried to withdraw it yet. If we did, we would have a test of that proposition. I would suggest that the IMF is something like the FDIC was in 1988 or 1989. We hadn't lost any money in the FDIC either. Of course, we had a \$200 billion FDIC bill coming due that we had accumulated when we actually tried to resolve the problems that were out there.

The final point I would like to make has to do with the issue of giving this money compared to what. One option is the issue of direct appropriation. And I think that that is really what you want to make a comparison to. Are you getting more or less with this \$18 billion channeled through the IMF than you would with \$18 billion to which the Congress attached the conditions that the Congress thinks are appropriate?

I think that there is - there would be great merit in us thinking about that approach, because it would reattach responsibility. Chairman Volcker was quite right in that what are being advanced in the name of IMF programs really are programs of the Administration. The Administration is largely responsible for what has happened over there.

Again with the problem with the exchange rate, the Administration talked down the dollar in 1993 and brought the yen up to 80. That was unsustainable. And now for other reasons, we have the yen at 130.

The Administration also followed a trade war. It, as of last October, for example, slapped Super 301 sanctions on South Korea just as that economy was going down. And in late October began a trade war with Japan that actually shut down oceangoing shipping between the two countries.

So having the IMF out there and saying we will let the IMF do it allows the people who are really calling the shots, I think, to duck responsibility. And I think when you duck responsibility, you end up squandering money.

The final point Chairman Volcker made with regard to capital adequacy for the banking sector, the reason that U.S. banks are not as exposed to Asia as are Japanese banks or European banks is that we have made reforms in this country with regard to banking supervision which have made it much more difficult for banks to become overexposed. Governor Phillips, my former colleague, chaired this effort of the Federal Reserve Board to develop complex modeling of bank lending. And I think it is something that we should take credit for.

We do not have to give money to the IMF because our banks are in trouble. Our banks will be able to weather this crisis without difficulty. They may have to reduce their dividends for a quarter or two at worst, but there will not be a fundamental banking crisis in the United States because of the prudent actions that our bank regulators have taken during the 1990s.

Thank you for allowing me to summarize those points based on what I heard. I would be happy to answer any of your questions.

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

Representative Saxton. Mr. Lindsey, thank you, and thank you also, Mr. Niskanen, for a very articulate testimony. We have talked a little bit about time constraints here this morning. Unfortunately, I am running into one as well. We have a Procurement Subcommittee markup which begins at 1:00 o'clock. We do this once a year and, unfortunately, I am going to have to be there at least shortly after 1:00 o'clock.

And so in the meantime, Mr. Campbell, why don't you proceed to ask your questions.

Representative Campbell. Thank you, Mr. Chairman.

Briefly to Mr. Niskanen, competitive devaluations, that is one thing we haven't talked about very much. It is argued as a reason for IMF, integral part of the GATT, of the World Trade Organization, if you have protections against tariffs but no protection against competitive devaluations you haven't accomplished anything. How valid do you think that argument is?

Mr. Niskanen. I think that generally does not arise when the exchange rate system is flexible by design. Now, you had a problem in September of 1992 in Europe in which Europe was subject to a quite differential shock as the consequence of the reintegration of Germany, and it led the exchange rates of a lot of the perimeter countries of Europe to be way out of line because they were at that time locked into the mark.

And what happened in September of 1992 is that all of those countries from Finland, around the perimeter to Italy and Greece, to devalue relative to the mark, and they have prospered substantially better than the countries that stayed with the market at that time.

That wasn't a competitive devaluation. I think it was a recognition of reality, and it was a consequence of trying to maintain the fixed exchange rate system in a region that is subject to differential shocks. The reintegration of Germany led Germany from being the second largest

net lender to the rest of the world, to put all of that new investment into East Germany instead of the rest of the world, and that was associated with a big increase in the exchange rate of the mark relative to the dollar and other currencies.

And that is what caused this. I don't see evidence of competitive devaluations if the basic exchange rate system in which they are operating is a flexible rate system. I think we have learned over the past 20 years, or we should have learned, that a pegged but adjustable exchange rate system is the worst of the three possible alternatives. We can live with an absolutely fixed exchange rate in a currency board like arrangement or with flexible rates.

But this attempt to maintain a pegged but ultimately adjustable exchange rates has proved to be an invitation to speculation because it is one-sided speculation.

Representative Campbell. In a completely floating exchange rate context, it seems to me possible to take Indonesia for an example that it can accomplish by devaluing its currency what it could not accomplish by increasing tariffs without violating GATT or WTO; why is that not right?

Mr. Niskanen. In a strict flexible exchange rate, the devaluation of the Rupiah is likely to be a consequence of letting their monetary policy get out of control. That does not necessarily increase their competitiveness, because it increases domestic inflation which is then reflected in the valuation of the exchange rate.

Representative Campbell. Do you have anything to add to that, Mr. Lindsey, then I am done? Thank you, Dr. Niskanen.

Representative Saxton. Mr. Hinchey?

Representative Hinchey. Mr. Lindsey, I thought I heard you say in your testimony that the Administration was responsible for the financial crisis in East Asia. I never heard that argument made before.

Mr. Lindsey. Well, I think Mr. Volcker was the one who said that the policies being carried out by the IMF were actually in part the policies of the Administration. The observation that I did make had to do with the exchange rate, which I do think our Administration has a substantial amount of responsibility for.

Representative Hinchey. The Administration made some mistakes with regard to the exchange rate, but the Administration is not responsible for the crisis in East Asia.

Mr. Lindsey. I don't believe I said that.

Representative Hinchey. Okay. The issue of moral hazard is one that interests me. Secretary Shultz, in his testimony this morning, made some points in that regard and cited some specific examples. The Penn Central bankruptcy was one, and he cited a number of others.

He didn't mention the savings and loan crisis. And I wondered at the time why he didn't mention that particular situation, because it seems that moral hazard exists in any government-backed insurance situation. The IMF is in essence a kind of an insurance policy.

Now, the underwriters of the insurance policy may not be behaving in quite the way we would if we were in their place, but the question is, do we want to throw out the insurance policy? The insurance policy certainly came in handy during the savings and loan crisis here in this country. And, in fact, the insurance policy of the IMF has come in handy in our own country, because we had to go to the IMF for some short-term financing back in the 1970s.

So it seems to me that some of the statements that have been made here today criticizing the IMF might go a bit too far. What would we do if there were no IMF, if the United States were just be left on its own to hand out \$18 billion in this particular case? Would that be enough? Would it be right? Is it appropriate for us to do that? What would happen if there were no IMF?

Mr. Lindsey. Oh, I think that is a good question. I asked that of Dr. Sakakibara in January when I was in Japan. And he said Japan would write a check. It is mostly Japanese banks that are asking – in the context of what if the U.S. did not appropriate the money – and he said Japan would be forthcoming with it. I think that probably would have taken care of at least part of the liquidity issue.

You raised, though, also in your opening statement, another piece of this, which I would like to tie together. It had to do with the excess supply of productive capital that is developed in Asia. And I think when you think of the insurance policy, it is really that excess supply of capital that you are bailing out.

When I was in Korea three weeks ago, for example, I talked with some people about Hanbo Steel, which is a big steel producer there, and they are world class steel producers. They borrowed lots and lots and lots of money in order to build state-of-the-art plants. Now, because of the IMF insurance policy, they don't have to pay interest on their debt, and as the saying goes, when you don't have to pay your bills, your gross is your net. And Hanbo is at the moment very, very profitable, and is

undercutting just about everyone in Asia. That is how the insurance policy works.

Now, if that is the type of insurance policy we have, then I think I would rather do without the insurance policy, because what we are insuring is, as you noted in your opening statement, an excess build up of productive capital that was entirely debt financed.

Representative Hinchey. Although we seem to agree on the problem of excess capital, what you are pointing out is the way the insurance policy is managed. And I would agree with you, that this insurance policy by these particular managers is not exemplary, and there are a lot of changes that need to be made. And we ought to do everything we can to insist on these changes, but that still doesn't mean that we ought to do away with the insurance policy completely.

The gentlemen who suggested that the Japanese government could write a check is interesting to me, because that would mean a check by the admission of the Japanese government of \$600 billion and probably more realistically \$1 trillion, because that is the amount bad loans that the Japanese banks are sitting on. I don't frankly think that the Japanese government would write a check for that amount.

Mr. Lindsey. The question was what would happen if the IMF, if we didn't appropriate funds to the IMF. I don't think we are talking amounts of money of that magnitude in this case, in the IMF case. In fact, the—

Representative Hinchey. We are talking about the fact that the Japanese banks have bad loans in East Asia. Those bad loans amount to by their admission about \$600 billion, more realistically probably a trillion.

Mr. Lindsey. We will look into the future, but I think if we ask ourselves what happened to those loans, we will find five years from now that, in fact, the Japanese government will have written a check to cover them. But the more narrow question was what would happen if the U.S. did not appropriate the money, and the answer is Japan would have covered it.

And in fact, during 1997, early in 1997, Dr. Sakakibara recommended that Japan set up, vote a \$100 billion as an Asia-only IMF in order to take care of development problems in Thailand. The U.S. Administration vetoed that idea. So I think the offer was on the table. There was an alternative out there. It just wasn't suitable to the Administration.

Representative Hinchey. Well, the question is whether the alternative would have been acceptable in any case. The question was whether the alternative would have done the trick, and I think that was the question that the Administration was responding to.

They were responding to two things: First, would the offer have done the trick, would it have been sufficient to carry out the purpose and the objective; and second, does it make good sense to put the Japanese in charge of East Asia?

Mr. Lindsey. I would rather have their taxpayers at risk than my tax dollars, but that is a matter of debate.

Representative Hinchey. There are other issues besides tax dollars, and we haven't had any taxpayers lose any tax dollars yet, even though you raise some very important points about that which I think are accurate. Nevertheless, no taxpayers have lost any money yet, and the other consideration is a global policy consideration as to what extent we want to divorce ourselves from East Asia and turn over East Asia to Japanese government.

Representative Saxton. Thank you very much. Mr. Hinchey.

Mr. Bachus, you weren't here. Unfortunately, I am now the one with the time problems. So I am supposed to be at another meeting at 1:00 which is four minutes ago. So if you would proceed and use your 5 minutes expeditiously.

Representative Bachus. Thank you, I appreciate that.

First of all, Mr. Niskanen, is that how you pronounce it?

Mr. Niskanen. Yes.

Representative Bachus. I read your testimony and I found something new in it that sort of ought to cause all of us to pause, and that is we sometimes wonder why would people propose things that may not work long term. And the reason they do it is a short-term solution, but long term they are not there.

Mr. Niskanen. Right, it is a "not on my watch" syndrome. It is a problem of all government officials, including myself in several capacities - a terrible temptation to take actions now which make you look good at the moment without regard or concern about what happens in the future.

Representative Bachus. All right. And you know—

Mr. Niskanen. It is a reason, among other things, why Secretary Shultz says things differently now than he did when he was Secretary of the Treasury.

Representative Bachus. Oh, obviously. If you are in the Administration, what you want to do is you want to have – you are looking at two more years. You are not – and obviously a bailout does bring some temporary relief; the question is whether long term it is a negative or not. And, obviously, I suppose you ought to expect the Administration to act to be for a short-term solution, as you say, "not on my watch."

I want to ask both of you all, what does IMF want this money for? I know that may sound like an unusual question, but I have asked myself that, in that they already have the funds to do the bailouts they have agreed to do. They don't anticipate any other bailouts. Yet, we are assembling what will probably be over \$100 billion worth of reserves.

So, I mean, is the proof in the pudding? Do they really, while they are saying they don't anticipate more bailouts—

Mr. Niskanen. They didn't anticipate a bailout of Korea as late as November of 1997. And they claim to have anticipated the problem in Thailand, but did not take much action ahead of time. The fact that they say that they can't now anticipate a new bailout doesn't mean very much, because they have not anticipated the crisis in most of these countries in the past.

I think what they are saying is we can't anticipate crises, but we know they will happen, and the new Asian crisis has proven what magnitude of money they take, and we need to be refunded to finance a response to something like the recent Asian crisis. And before that happens, I think we should rethink through this whole issue as to whether that should be the role that they are in.

Let me respond briefly to a question that was raised by both Mr. Hinchey and Senator Sarbanes about what the IMF should have done in the Asian crisis. And I will respond, I think, in the same way that Secretary Shultz responded.

Once the expectations have been created, there is little option but to respond to the crisis that happens. Now, you can argue with some of the details, particularly with respect to Indonesia, although it may be in Korea as well, but that if you create a set of expectations by offering people to socialize the losses in their investments, I think you have to follow through on those expectations. The challenge now is that since

the Asian crisis for the most part is behind us for the moment, is to ask whether we should change the expectations in which both borrowers and lenders in the international capital market operate.

And I think that the answer to that is, yes, we should change those expectations in a way that says that you should not automatically count on an international governmental response to your getting into either illiquidity or insolvency problems, and now is the time to make that statement to the world. And the only way to do that is to start by deferring a decision on additional funding.

Mr. Volcker has made a statement that I find most implausible, that with all of the case for reforming the IMF you are more likely to get reform if you give them additional money than if you hold them hostage on that matter. And I think that is a violation of perspectives of anybody who has ever been close to the bureaucracy or a political system. I think you are much more likely to get a—

Representative Bachus. Or had a teenager.

Mr. Niskanen. — response from the IMF if you hold them hostage to additional funding, rather than if you give them money and then say, now let's talk about reform.

Mr. Lindsey. There is a second place that the money will go. As you said in your testimony, a lot of the members of the IMF simply borrow up to their quota, in fact, above 100 percent of their quota. They will contribute and they will borrow the money back. And that is where another portion of the money will go.

Representative Bachus. Could I make one final comment. Do you know what disturbs me most about this whole IMF thing, this just may be a brief response. I don't see we have an exit strategy.

Mr. Niskanen. It is because the Mexican bailout went ahead with no significant congressional comment, and that has created a whole new regime. The Mexican bailout should have been criticized very strongly, or at least strongly questioned at that time, and we wouldn't be in this new world. And now I think we have to change this new world that we have created largely in this building and downtown, by creating this expectation of somehow saying that massive governmental insurance policies are necessary for global capitalism or something, which I think is a travesty.

Mr. Niskanen. I must leave, I am sorry.

Representative Saxton. Let me thank both of you. We are going to draw this to a close. Let me thank both of you for being here and let

me particularly thank you for a forbearance. We had a long hearing, it lasted in excess of three hours. Thank you for being with us and thank you for understanding.

I would also like to thank my two colleagues who stuck with this for the entire time. And I would like to say how much I appreciate Mr. Hinchey being here and that I agree, he and I agree that we ought to look at what it is that we need to do differently vis-a-vis the IMF. And I look forward to working with you on that.

And let me just say that a week or two ago I contacted the General Accounting Office and asked them to get their hand in this in looking at the IMF so that when we get ready to make whatever changes we are going to try to make, at least we will have some good facts upon which to base the substance of those changes. So I look forward to working with you both as we move forward.

Representative Bachus. I am a CNBC junkie, so Mr. Lindsey is one of the shows I always watch. I see him about once or twice a month. I very much enjoyed, sort of like seeing one of my favorite movie stars.

Representative Saxton. Thank you very much.

[Whereupon, at 1:10 p.m., the hearing was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

I am pleased to welcome the prominent economic experts testifying before the Committee this morning. The combined experience and knowledge of these witnesses ensure a very serious discussion of the policy issues related to the International Monetary Fund (IMF). George Shultz, William Niskanen, Paul Volcker, and Lawrence Lindsey have been involved in some of the most important economic policy decisions made during the past three decades, and we appreciate their appearance before the Joint Economic Committee (JEC) today.

During the past eight months, the JEC has been analyzing the IMF and its operations, practices and procedures. This research has identified several key economic issues on which reasonable people can disagree, but they cannot ignore. These issues include IMF transparency, moral hazard, subsidized interest rates, taxpayer exposure, and IMF loan conditions that can be counterproductive.

Although my call for IMF transparency last fall was not greeted with universal agreement, a great deal of progress has been made in recent months in acknowledging the need for change in this area. We now have a broad consensus for a much more transparent and open IMF, although the best means for accomplishing this objective is still under debate.

In the course of researching the transparency issue, the lack of transparency in the IMF financial statements became evident. Recently I had the opportunity to question a member of the IMF Executive Board about IMF finances. My questions elicited the admission that IMF finances were not fully transparent even to a member of the IMF Executive Board. I would submit that if even high IMF officials do not understand IMF financial statements, then probably not many outside the IMF do either. But how can Congress and the public evaluate the performance and funding of an agency whose finances confuse even its own officials? The fault is not with these officials, but with an arcane and confusing presentation of financial information.

Recently the IMF released a code of principles for member countries that very well expresses the meaning of financial transparency. For example, one principle states, "Budget estimates should be classified

and presented in a way that facilitates policy analysis and promotes accountability." I would suggest that the IMF should apply its generally sound transparency principles to its own accounts as well as to member nations. More facts concerning the IMF are needed before Congress can make an informed decision on the IMF appropriation. This is why I have requested a General Accounting Office (GAO) evaluation of the transparency and content of IMF finances.

Another major issue is moral hazard and its amplification through the use of subsidized interest rates. Currently, the standard IMF loan rate is about 4.5 percent.

This is a much lower interest rate than those available in the United States for mortgages, consumer loans, and business loans. The use of subsidized interest rates can only deepen the already serious problem of moral hazard, the encouragement of risky ventures and activities by the prospect of a bailout. The bottom line is that the net effect of IMF lending is to subsidize risk and socialize at least some of the resulting losses. The IMF reform legislation I have introduced would end this practice of subsidized interest rates, and also require more transparency at the IMF. Meaningful structural reform of the IMF is needed whether or not an IMF expansion is financed in 1998.

We are fortunate to have such distinguished witnesses to discuss the major issues related to the IMF here with us this morning.

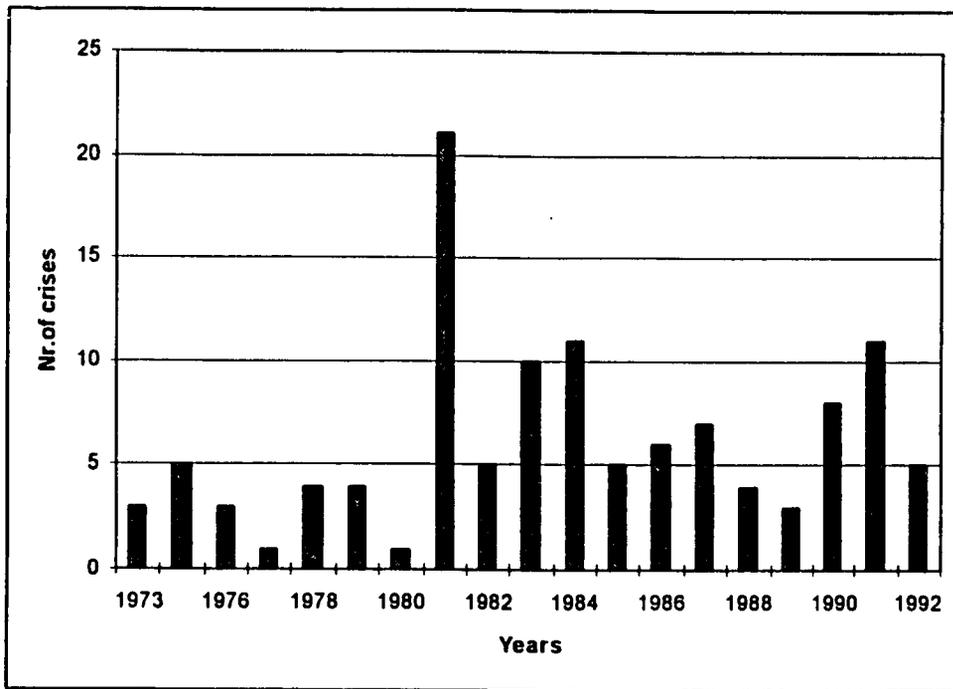


Figure 1. Number of financial crises in developing countries
Source: Frankel and Rose (1996)

PREPARED STATEMENT OF SENATOR ROD GRAMS

Mr. Chairman, thank you for holding this hearing today, although I must say I would have preferred it be a more balanced hearing.

As you may know, Senators Hagel, Roberts and I drafted a reform package that addresses many of the concerns most of us have about the IMF. We were able to attach this and the \$18 billion to the Emergency Supplemental along with the able leadership of Chairman Stevens. I was disappointed that the House chose to delay consideration of this funding. At this point it is difficult for me to see there is any intention of passing this funding on the House side, although clearly the US would suffer a blow to its leadership not just in East Asia, where it would be seen as US opposition to the Asian IMF packages, but globally as well. Most of all we would jeopardize our own important trade and security interests throughout the world.

Mr. Chairman, are we really willing to withdraw from this leadership or to impose conditions unilaterally that cannot be accepted by the other 181 members of the IMF or which would subvert the purpose of the IMF? Our own Majority Leader has indicated the reform package could be tougher. Right now it is tougher that I would have preferred. If it is any tougher, it will be a back-door way of ending US Participation in the IMF. This is a global market, where we depend on healthy economies throughout the world to expand opportunities for other nations, including our own. We cannot shut out the rest of the world, serving our own economy--we rely on global markets to grow our own economy. We also rely on healthy economies to maintain our security interests. It is hard for me to understand why some Members believe there is no consequence to the US if other economies are allowed to fail by their unsound fiscal and business practices. I would be pleased if we didn't need an IMF, but we do. We need a body that first of all tries to foresee and head off looming financial crises, but is also there to avert default through tough reform packages that actually accomplish needed structural reforms to a country's economy that prevent future crises and level the playing field for US exports.

Is the IMF perfect? No. Do its programs work 100%? Not always. Does it want to do better and has it improved? Yes. Any organization, including the US Congress and every department of our government, needs improvement--needs reform and oversight. The IMF isn't the only culprit here. The IMF has recently announced some improvements in its transparency, and the reforms in the Senate package were also necessary

to keep the pressure on for further reforms. The G-7 talks this month will also focus partly on improving the IMF.

But the US doesn't control the IMF--we can't get everything we want overnight. We have to work within the system, and even so, I think we can make some important progress by working with the IMF, not turning other member countries against us with strongarm tactics--by pushing for reforms that are unachievable. We can't submit a package of mandatory reforms to a multilateral body that changes the charter they have had for decades and that deny our share of the replenishment when those reforms cannot be achieved immediately. Yet, this is where I see the House moving.

If the Congress does not participate in the replenishment, the four Asian nations under IMF programs will see this as a US referendum on the Asian packages. Failure to act could actually halt progress in these countries and cause greater loss of US exports as well as risk sensitive security issues we have in these nations.

Right now, the wheat industry estimates \$39 million in losses--about a 5% total export reduction due to the Asian crisis. This reduction affects 1/3 of Minnesota's wheat exports in value. Asian markets buy 36% of the world soybean trade, and the US has 68% of this. Asia buys 40% of all US ag exports and has been our fastest growing market. Minnesota sends 22.5% of its total exports to Asia. If the IMF had not stepped in, the impact on US agricultures and industry interests would be far greater, and the crisis would have spread to other nations. Do we think a default in Japan would not have very serious consequences in the US? Does the Congress want to be blamed for impeding efforts to avert financial default in suffering nations, either in East Asia or elsewhere? Are we willing to ignore the impact here crisis have on our own economy? Are we willing to ignore the impact on strategic and political interests of the US?

To sum, I believe the US must maintain a leadership role in the IMF. We must work with the IMF to make it a better run, more transparent institution which designs loan packages that best address a country's financial crisis. Our efforts are designed to help other nations, but mostly they are to help ourselves. It is US exports and US jobs that are at stake. And we need to protect them.

**PREPARED STATEMENT OF PAUL A. VOLCKER,
FORMER CHAIRMAN, BOARD OF GOVERNORS,
FEDERAL RESERVE SYSTEM**

"Emerging Economies in a Sea of Global Finance"

I am told that, in its conception, the Charles Rostov Lecture Series was designed to focus on Asia. As time passed, there was a realization that a discussion of "Asian Affairs" isolated from "International Affairs" would be unduly confining and even sterile. That intellectual insight, it seems to me, applies with full force to the world of finance today. What has been labeled the "Asian financial crisis" has by now come to be broadly and rightly recognized as only the latest, and most dramatic, episode in a series of events that raise some basic questions about global finance and its implications for economic development.

Financial crises, national and international, have, of course, been a recurrent part of capitalism. But somehow they seem to be coming more frequently and with greater force these days, at least as they impact emerging economies. Not much more than a decade after the start of the severe Latin American debt crisis of the 1980's, Mexico found itself in renewed financial turmoil, with reverberations through South America. The international community, led by the United States and the International Monetary Fund, felt it necessary to respond with official credits that dwarfed amounts that had been lent, or even imagined, only a few years earlier.

Last year, what appeared at first to be a limited exchange rate problem in Thailand touched off a major financial crisis throughout Southeast Asia and then Korea. Massive new IMF programs could not stem the contagion, and the entire region -- with its vaunted Tiger economies -- is suffering a severe economic set-back. Almost overlooked in the midst of all that upset, the economically tiny Czech Republic, widely thought to be among the most promising of the transition economies, experienced its own financial crisis. Russia, chronically unsettled, narrowly escaped a new financial breakdown at the end of last year.

In searching for common ground in all this, one interesting point stands out. With the exception of Russia, the crisis countries had been characterized by exceptionally good economic growth and good progress toward price stability. Domestic savings were high, substantial progress had been made toward more open markets for both goods and capital, and investment has flourished. Virtually on the eve of some of those countries being engulfed by financial turmoil, no lesser authorities than

the World Bank and the IMF had acknowledged the effectiveness of their macroeconomic policies.

As the crisis spread, much attention centered on perceived structural defects in Asian emerging economies: Weak banking systems, governmental subsidies and favoritism, and crony capitalism. These are, of course, matters that have persisted over many years of remarkably rapid growth. At best, change will be uneven and slow and will bring uncertainties of its own.

Quite obviously, something has been lacking in our analyses and in our response. Emerging nations making good progress toward liberal policies and reforms have been hit hard. The problem is not regional, but international. And there is every indication that it is systemic -- systemic in the literal sense that it arises not from some *deus ex machina*, but from within the ordinary workings of the international financial system itself.

Conceptually and practically, open international capital markets should offer huge potential benefits in speeding and sustaining the economic growth of emerging and transitional economies. There are clear examples of those benefits in Asia and elsewhere. At the same time, the recurrent volatility of those global markets can impact with devastating force on inherently small and poorly-developed national markets and institutions.

Clearly, a great deal is at stake in coming to some common understanding of that dilemma and how to deal with it. For that reason, I welcome the calls we are beginning to hear from both inside and outside official circles for a new look at the workings of the international financial system and its main institutions. But it is also my sense that we are still a long way from achieving a good understanding of, much less implementing, convincing new approaches.

In emphasizing so strongly the systemic nature of the financial problems this evening, I do not want to be misunderstood.

I abhor corruption, in finance or elsewhere.

I believe, over time, "crony capitalism", state ownership, and official industrial policies are all inherently less efficient than open competitive markets.

I have always favored strong banks, well-supervised and with experienced and prudent management. I have for many years fought against indiscriminately mingling banking with commerce in this country, and believe it is generally bad policy.

And I agree more information, widely disseminated, must almost always be better than less -- and in any case will be required in a modern democracy.

In varying degrees, all the countries caught up in the present financial crisis -- certainly those in Asia -- have had marked weaknesses in these respects. Over time, basic reforms will be needed to support sustained growth. In some cases, a strong political commitment to basic reform -- reforms extending beyond the economic -- has become necessary to restore confidence in government, and surely helpful in restoring financial stability. In that respect, both Korea and Thailand are fortunate in having in place new governments eager to embrace reform.

What I do not believe is that the timing, nature, and force of the Asian financial crisis (or, for instance, those in Mexico or the Czech Republic) can be explained in terms of those structural factors, important as they may be over time. None of them are new. None of them have been unknown nor, to the best of my knowledge, have they suddenly gotten worse.

There are basic reasons why growth among the Asian Tigers, old and new, has been sustained for decade at unprecedented rates.

There is a good supply of energetic and intelligent workers. A strong entrepreneurial spirit appears alive and well. There is a willingness to adopt and adapt to new technology and to maintain high rates of saving. All that means low cost and rapidly rising productivity, even in the face of what appear, by Western standards, flawed and weak institutional structures. That potential remains intact today. But clearly something has abruptly happened to disrupt that process. And, it seems to me that that something lies more in the financial area than in the structural flaws that have been at the center of so much attention.

Flows of funds and their valuation in free financial markets are influenced as much by perceptions as by objective reality -- or perhaps more precisely, the perception is the reality. The herd instinct is strong. Only in hindsight do episodes of strong "overshooting" or "undershooting" it become evident, and the reversals are typically sudden.

All that has always been true. The resulting volatility can ordinarily be accepted as a small price to pay for the immense benefits that broad and active financial markets can bring. That is certainly true for large and well-diversified economies, with sturdy financial structures. They typically have the resiliency to ride out the storm with limited and temporary damage.

The situation is more difficult for emerging economies. By definition, their economies and their financial institutions are tiny relative to the size of international markets. To put that in perspective, the entire banking systems of Indonesia or Thailand or Malaysia are comparable to one good-sized regional bank in the United States. Their entire Gross National Products are smaller than the funds controlled by our largest financial institutions, including large mutual fund families and other investors caught up in intense competition to out-perform their competitors.

I need not review in detail the enormous growth in the supply of financial capital nor the irreversible changes in technology that permit money to move around the world almost instantaneously with much smaller transaction costs. At the same time, the organization of the markets -- away from traditional commercial banks toward a variety of more transactionally-oriented institutions -- has made the markets both more impersonal and more fluid.

One result has been a capacity and willingness to reach out for more exotic high-yielding investments. The private sectors of emerging economies, with their strong growth potential, have become prime targets.

Those countries have in recent years become converts to the basic philosophy that more open markets for capital, as well as for goods, will bolster growth. One manifestation is their greater willingness to accept direct investment. Its longer-term orientation and technological and managerial components have been mutually beneficial. But there have been strong incentives to accept and encourage portfolio capital as well, where the benefits to the economy are more indirect and the potential risks greater. And much of that investment can be moved on very short notice -- at least until a crisis shuts down the market.

The process for a time is self-reinforcing. The inflow of foreign money helps to spur investment, to strengthen directly or indirectly export capabilities, and to sustain high rates of economic growth. By supporting a strong exchange rate, inflation is contained and a sense of stability reinforced. Profit opportunities for local banks and other financial institutions blossom as they intermediate the flow of funds. And the apparent success of the early investors encourages more to join, allocating amounts that from their individual perspectives may be marginal.

The difficulty is that what may be marginal to the increasing numbers of investment institutions with mobile money, can, in its totality,

be overpowering to the small receiving country. The possibility of simply sterilizing the inflows is expensive and self-limiting. With money so freely available from abroad, banks will lend aggressively. Sooner or later investment is likely to run ahead of needs and be misallocated by governments or private investors. In the circumstances, a real estate boom will be almost inevitable, and, whatever the particular exchange rate regime, the real exchange rate will appreciate, undercutting trade competitiveness.

Sooner or later, some event, internal or external, political or economic, will raise questions about the sustainability of it all. The capital inflows will slow or stop. The exchange rate will come under pressure, inducing capital flight. Reserves are depleted, the exchange rate sinks way below what was thought to be reasonable, inflationary forces rise, interest rates double and re-double, and the crisis is at hand.

In one sense the pattern is all too familiar. But there is a large difference from most earlier experience when the source of the crisis could be traced to irresponsible macroeconomic policies -- loose budgets, excessive monetary expansion, an escalating wage/price spiral --the kind of thing toward which IMF rescue programs have been typically and effectively directed in the past. The present situation is more complicated. It involves deep-seated questions about the operation of the global financial system, as well as macro-economic discipline. And it has become increasingly clear that simply providing escalating amounts of short-term financial resources cannot provide a satisfactory approach -- certainly not without providing creditors with a degree of assurance that would raise large questions of moral hazard.

The IMF and the official financial community have clearly been faced with difficult circumstances beyond the well-trodden approach of macro discipline and the provision of short-term credit. In the circumstances, one can empathize with the urge to deal aggressively with all those matters of internal reform to which I referred earlier. But there are limits and dangers to that approach as well, perceptual and political as well as economic.

One is the extreme difficulty of changing ingrained habits of government and business rooted in deep-seated cultural patterns. Ordinarily, it will be a slow process, and there can't be any assurance that radical change imposed in a crisis won't exacerbate uncertainty and dislocation; the contagious runs that followed the sudden closing of some Indonesian banks is one case in point. To the extent that "reforms" are,

or appear to be, imposed from abroad, the risk of a counter-productive backlash is increased.

The easy advice we give others about quick reform of their banking systems, I might point out, stands in stark contrast to our inability in the United States to pass legislation rationalizing competition among our banks and competing financial institutions -- an impasse that has lasted for more than 15 years amid entrenched private interests. It is ironic that one of the matters at issue in our Congress is the political pressure brought to bear to weaken our traditional barriers to combinations of commerce and banking, precisely the practice in Asia and elsewhere that we rail against as a major source of institutional weakness.

More important in the present context, we have to deal with the simple fact that countries with strong banks, honest and democratic governments, relatively transparent accounting systems, and experienced regulators have not been immune to banking crises. The list is long, and it includes the United States.

Others have aptly pointed to the situation in Texas to make the point. Once itself an independent country, Texas has economic mass -- a GNP about the size of Korea's and a large multiple of any of the smaller Asian economies. At the start of the 1980's it had among the most strongly-capitalized and profitable banks in the United States, and they were fiercely resistant to permitting any "foreign" ownership -- foreign defined as New York or other out-of-state banks. No doubt there is and was a certain amount of cronyism among Texans, and we later learned there was a good deal of corruption among poorly-supervised thrifts. But as one of the responsible commercial bank regulators at the time, I'd like to think that supervision was state-of-the-art. Certainly the bankers were experienced, accounting was in the hands of the Big Six applying GAAP standards, and SEC 10K reports and financial prospectuses were reviewed by the highest-paid analytic talent in the world. But none of that institutional strength insulated Texas financial institutions and the Texas economy from the financial excesses that accompanied the energy and real estate booms of the early 1980's.

Texas did and does have enormous advantages relative to a small emerging economy. It was part of the world's largest common currency area -- the United States. As such, there could be no loss of confidence in its currency and no inflationary impetus from depreciation. Its interest rates were those of the United States -- and they tended to fall rather than rise. Large companies were typically part of dispersed national and international operations. There was an effective lender of last resort and

credible deposit insurance -- and I might add a certain amount of regulatory forbearance.

Well, Indonesia and Thailand, Mexico and the Czech Republic, are not Texas. But I think there are lessons to be learned from all this experience.

The first and most important is that small and open economies are inherently vulnerable to the volatility of global capital markets. The visual image of a vast sea of liquid capital strikes me as apt -- the big and inevitable storms through which a great liner like the U.S.S. United States of America can safely sail will surely capsize even the sturdiest South Pacific canoe.

The natural defense is to seek the shelter of larger, inherently more diversified and stable ships. Texas is a case in point; by the end of the 1980's, every major bank in Texas, with the encouragement and support of the Federal Government, had become part of a much larger national banking organization. With heroic effort, Argentina has effectively adopted the dollar as a parallel currency and only one sizable private bank remains without substantial foreign ownership and interest. In Mexico, where resistance to foreign ownership of banks was a major issue only a few years ago in the NAFTA negotiations, four of the five largest banks today have important foreign capital. Thailand, strongly protective of its banks and finance companies before the crisis broke, now eagerly seeks foreign participation. On the other side of the world, in Eastern Europe, foreign ownership of banks is becoming commonplace.

In the non-financial world, there can't be much doubt that similar forces are at work. Distressed industrial and commercial firms will naturally look more favorably on injections of capital from abroad, whether by means of joint ventures or outright sale. Without doubt, to large and diversified international companies, this is a buying opportunity.

To put the point more generally, the economic logic of living in a world of global capital markets is much more integration, with the crisis force-feeding the existing tendency. The obvious counterpoint is a growing lack of autonomy in economic management, easily perceived as an affront to sovereignty. That potential for political resistance will be all the greater if the changes seem to be forced not by economic logic and national decision but by external forces with their own agenda.

One thing is sure. If a country wants to participate in open markets for goods and other services, it can't feasibly opt out of world financial

markets. The fact is finance is intertwined with trade and investment. There are so many ways for funds to flow, and so many incentives to circumvent controls, that effective insulation cannot be achieved without stifling growth.

So what can we do to better balance the opportunities and risks of global financial markets?

For one thing, justified skepticism about the efficacy of controls doesn't mean we need to frown on more limited efforts to restrain inflows of potentially "hot money". Some countries, with Chile the leading case in point, have developed techniques to restrain those flows that are broadly consistent with the basic desirability of encouraging prudence in banking practices. I am encouraged that the leading officials of the IMF have expressed some sympathy to that approach. I trust that in its zeal to incorporate freedom of capital movement into its basic charter, the Fund visualizes the prospect of maintaining surveillance over such measures rather than assuming they are, ipso facto, objectionable. Ideological purity rigidly applied is hardly appropriate to present circumstances.

A much more fundamental and difficult matter is exchange rate management. It is, it seems to me, an area of intellectual confusion.

Not so long ago, there was considerable sympathy for the use of a stable exchange rate for smaller, inflation-prone countries as a key policy objective and an anchor for expectations. In the aftermath of crises, criticism has mounted that exchange rates have been managed too rigidly, that something much closer to free-floating would have helped protect against volatile capital flows. The irony is that some of the fiercest critics of Thai or Indonesian exchange rate policy have also been among the most vociferous of those urging that the tiny economic area of Hong Kong and emerging China must, above all else, dedicate themselves to maintaining a strict peg against the dollar lest a new and devastating round of financial volatility break out in Asia.

Somehow we seem to be setting out a menu of exchange rate choices à la carte, without much sense of how those choices can meld together. The reality is that, left to the market, exchange rates of small and open economies are likely to be prone to wide and disturbing fluctuations. That is why the natural instinct is to seek shelter by maintaining a stable relationship with close trading partners or one of the major world currencies. In the industrialized world, the ultimate expression of that instinct is the drive toward a common currency in Europe. Another manifestation is the new interest in currency boards, accepting the loss of monetary sovereignty.

Much more common are compromise approaches formally or informally setting a range of values around a reference currency or a basket of currencies. Quite a few countries have managed such arrangements for considerable periods. There will, of course, be strains in the face of volatile capital markets and all the pressures and uncertainties in real economies. That is all the more true in Asia, where trading and financial patterns are so widely dispersed among North America, Japan and Europe. The choice of an appropriate anchor currency is not obvious.

Those difficulties are compounded when the major world currencies are themselves highly volatile. One precipitating factor in the Asia was the large depreciation of the yen. With its currency loosely linked to the dollar, Thailand's competitive position was sharply and unexpectedly undercut. But the solution is not so clear.

With fluctuations in the yen/dollar rate in a range of 50 percent or more over the space of a year or two, Thailand, or any similarly situated country, faces an insoluble dilemma. Both Japan and the United States are important markets and sources of finance. But stability against one currency is volatility against the other. Attempts to split the difference, even if practically feasible, can't escape competitive distortions.

I count it as one of the few constructive by-products of the Asian crisis that, finally, questions are again being asked about the design -- or, more accurately, the absence of design -- of the exchange rate system. For years, the "Big Three" (Germany, Japan and the United States) have been reassuring each other that the recurrent volatility among their exchange rates would settle down -- or if not, it didn't really matter much any way. Today, that air of insouciance is harder to maintain.

It's a frustrating time, analytically as well as practically, in dealing with the unprecedented problems of emerging Asia. Criticism and unhappiness about the role of the IMF and the other major players in international finance has been inevitable. What is encouraging is that the Fund itself appears to recognize the need for stepping back and for assessing with a fresh mind both the challenges posed by the new world of global finance. The fact is, new approaches are needed.

There should also be no doubt about what is at stake. If, a few years down the road as we get into the new millennium, the turbulence of markets persistently undercuts strong and consistent growth in emerging markets, then temptations to reject the ideology of open markets and multilateralism will increase. The kind of open, benign regionalism characteristic of much of today's trading world could turn malignantly

inwards, with all that implies for political conflict as well as economic tension.

Plainly, the United States is the single most influential actor in all of this. We are not a helpless giant. To the contrary, the danger lies in a certain arrogance -- a tendency in the Congress particularly to pull back from international economic leadership in the illusion we can be secure in our own strength, lulled by the performance of our economy and booming financial markets.

I do not need to emphasize that even the United States is not, and cannot be, on economic or political island. The simple fact is we need to work within and through international organizations -- organizations that we largely created -- if we want our vision of open markets and political consensus to prevail. One need not agree with every policy and every decision of the IMF to realize that it is the only vehicle we have -- and the appropriate vehicle -- to bring consensus and legitimacy to reform of the financial system on a global scale. To fail to support the proposal for additional IMF resources at this time, a proposal which burdens neither the budget nor the economy, could only be interpreted as a kind of abdication of leadership in the midst of crisis.

There is another imperative. In our insistence that the beleaguered economies of Asia take tough steps to reform their own economies, we need to recognize the need to keep our markets open. That happens to be in our immediate economic interest, helping to maintain price stability in the midst of vigorous growth. More fundamentally, we must not fail to demonstrate by our own actions that our advocacy of open trade is a lasting commitment, for fair weather and foul.

The turbulence in world financial markets strikes me as a test -- a test of our capacity to lead, and also to work imaginatively and cooperatively with others. I don't underestimate the difficulty of the challenge. But, happily, it comes at a time of great strength, and that strength can convert danger into opportunity.

**TESTIMONY BY WILLIAM A. NISKANEN,
CHAIRMAN, THE CATO INSTITUTE
"The IMF and U.S. International Policy"**

Mr. Chairman and members of the Joint Economic Committee: My thanks for this opportunity to testify on "The IMF and U.S. Economic Policy."

The case for the massive IMF/World Bank response to the recent Asian crisis reminds me of an all-too-frequent proposal to jump-start economic growth: the combination of massive demand stimulus and a solemn promise never to do it again. The problem of this type of policy, of course, is that the initial response undermines the credibility of the promise. Secretary Rubin seems to understand the moral hazard problem caused by socializing the losses on international loans, but he claims not to know what to do about it. The young St. Augustine was rather more honest with himself; when faced by a similar problem, he prayed: Lord, make me chaste, but not quite yet.

For there should be no doubt about the nature of the choice that was made by the response to the recent Asian crisis: the international financial establishment committed over \$100 billion to reduce the near-term contagion effect of the recent Asian crisis without apparent regard for a longer-term contagion effect that this bailout will probably increase the number of similar future crises in these and other countries. The historical record is clear: Most of the less-developed nations funded by the IMF have later returned for more funds. Mexico, for example, has had a financial crisis in each of the past four presidential-election years. A total of 84 nations have been in debt to the IMF for 10 years or more, 43 nations for 20 years or more. And there is little doubt that the massive IMF and U.S. bailout of Mexico in 1995 contributed to the near-doubling of capital flows to East Asia that same year.

Finance ministers and central bankers will commit almost any amount of our wealth to avoid a major financial crisis on their watch, even when they recognize that the socialization of losses increases the probability of a crisis on some later watch. Rather than resolving the conditions that lead to financial crises, the IMF treats each successive crisis as a new event, indirectly assuring that there will always be a queue of new crises to address. U.S. government membership in the IMF is like being a limited partner in a financial firm that makes high-risk loans, pays dividends at a rate lower than that on Treasury bills, and makes large periodic cash calls for additional funds.

The current administration campaign to convince Congress to approve more funds for the IMF is also quite deceptive. To some groups, the officials suggest that more funds are necessary to help the poor starving children of Nameyourland. In fact, the IMF bailouts are a form of insurance for the foreign and domestic individuals, firms, and banks that had made high-risk investments in the country subject to the crisis du jour. The 1995 Mexican bailout, for example, insured those who had purchased the 28 day government bills, providing little help for the general Mexican population for whom the real per capita income is now less than before the bailout. Similarly, the administration seems to have gained the support of the congressional Democratic leadership for new IMF funds on the premise that such funds would reduce the exchange rate effects and resulting trade effects of future crises. In fact, the exchange rate of an IMF client generally stays weak for some time after a bailout. The dollar value of the Mexican peso, for example, is now less than half that before the 1994 crisis, with the effect that Mexico has since had a trade surplus with the United States. Finally, the administration has gone around the world making a series of promises and then asserts that congressional support of these promises is necessary to maintain U.S. leadership. The Clinton administration did not invent this gambit but it has been especially consistent in using this argument to support its position on trade negotiations, global warming, NATO expansion, Iraq, and now the IMF.

For now, it looks like the bailout of Thailand, Indonesia, and South Korea is history, a done deal for which the IMF does not need any more funds. So the current issue is whether the IMF should be refunded to prepare for the next round of financial crises. For now, I suggest, Congress should *defer* a decision to refund the IMF until it has a better understanding of the conditions that lead to a financial crisis, the moral hazard effects of socializing the losses on international investment, the long-term record of the IMF, and the feasible alternatives -- including the implications of *no* multilateral governmental response to a financial crisis in any country.

It is especially important, for example, to understand the reasons why the recent Asian crisis was limited to Thailand, Indonesia, and South Korea but with much less effect, at least so far, in Singapore, Hong Kong, Taiwan, and China. My initial judgement is that two patterns are common to the problem countries in Asia and also in Mexico:

1. A record of state-directed credit allocation, either by a formal industrial policy or by crony capitalism, and

2. A futile attempt to maintain both a fixed exchange rate and a monetary policy responsive to political pressure.

It is also important to understand why the frequency and magnitude of financial crises are increasing. Studies by the IMF and the World Bank have documented some 90 episodes of severe banking crisis over the past 15 years, a period of relatively stable economic growth. For this condition, I suggest, the IMF and the World Bank bear substantial responsibility. When a borrower is illiquid or insolvent, the only way to avoid the moral hazard problem is a financial workout in which *both* the borrower and the lender take a major hit:

1. The borrower, by giving up some or all control of the remaining firm or assets, and

2. The lender, by a lengthening of the maturity of the loans (when the problem is illiquidity) or by trading the outstanding debt claims for lower-ranked debt or for equity (when the problem is insolvency.)

Private bankers have handled such problems for generations, long before the IMF and the World Bank muscled their way into this role with our taxes. I ask you to at least entertain the possibility that private bankers, committing the assets of their own firms, are likely to handle such problems better than do public officials who play this game with other people's money.

As a rule, however, as documented in an important recent article by Prof. Charles Calomiris of Columbia University, recent IMF assistance has been "designed to absorb the losses of insolvent banks and their borrowers in developing economies, and to insulate international lenders from the losses that they would otherwise suffer." Calomiris goes on to document three major consequences of this developing policy:

1. "The main influences of the IMF and U.S. government in the 1990s have been ...to lend legitimacy to ...domestic bailouts by providing conditions that call for taxation of the domestic middle class to repay the bridge loans from the IMF and the U.S. government and ...to insulate foreign creditors (especially banks) from losses during these crises."

2. After the crisis has passed, "The big winners are the wealthy, politically influential risk takers, and the biggest losers are the taxpayers in countries like Mexico and Indonesia."

3. This effect, thus, *delays* the necessary reforms. "If oligarchs can avoid true liberalization but still maintain access to foreign capital," Calomiris asks, "where is the incentive for them to relinquish the rule of man in favor of the rule of law, or to allow competition and democracy to flourish?"

Calomiris concludes that "The principal lesson of the recent bailout programs managed by the IMF and the U.S. government...is for all parties...to find a credible way to commit *not* to sponsor such counterproductive bailouts."

The characteristic IMF response to this type of criticism, of course, is that the conditions for receiving IMF credit induce the type of reforms that are necessary to avoid a future crisis. In a few cases, this has been successful. The larger record, however, does not provide a basis for optimism. Most developing country governments, once the recipient of IMF's subsidized credit, have become loan addicts. As noted earlier, most of these governments have relied on IMF loans for more than two decades, despite the conditions for receiving these loans and the usual two-to-five year maturity of these loans.

Maybe we don't need the IMF -- that is now the judgement of former Treasury secretaries George Shultz and William Simon and the former chairman of Citicorp Walt Wriston. I am willing to defer judgement on this issue. In the meantime, Congress should not approve any *additional* funds for the IMF, at least until some of the broader questions are addressed.

Thank you for your attention.

**STATEMENT BY DR. LAWRENCE B. LINDSEY,
RESIDENT SCHOLAR,
THE AMERICAN ENTERPRISE INSTITUTE
“The Role of the IMF”**

Thank you Mr. Chairman. It is my pleasure to be here today to answer any questions you might have regarding the appropriate role of the International Monetary Fund in today's global economy. At the outset, I should indicate that these views are my own and do not necessarily represent the views of the American Enterprise Institute. I am particularly honored to be here on a panel with two former associates, Paul Volcker and Bill Niskanen, whose views I enormously respect. I believe that my views are likely to fall somewhere in between the views of these two distinguished individuals, perhaps reflecting the influence of both men on my thinking.

As a matter of fundamental principle, I believe that the elected representatives of the American people are the ones who should control the terms of assistance to foreign governments and institutions funded by the American taxpayer. Any exceptions to that basic principle must be subjected to a fairly rigorous standard.

Unlike many critics of the International Monetary Fund, I do believe that the IMF can play an important role in the international financial community. And I do believe that a limited quantity of U.S. taxpayer funds can be committed to that purpose. But let us be clear about why the Congress might want to delegate responsibility for the disbursement of funds to an international body like the IMF. I believe that there are two reasons which need to be considered.

First, in today's international market, events often move swiftly. Specifically, events might require a decision on the allocation of funds in a time frame too short for the standard legislative process. In such circumstances, an institution like the IMF might well play a role as a speedy provider of liquidity in a crisis. I should note that Congress has certainly created precedents for such a time sensitive delegation of decision making. In international security arrangements, the President is empowered to direct military forces to undertake warlike actions without a formal declaration of war. In financial matters, the Congress has granted the Treasury significant authority to intervene in foreign exchange markets with the exchange stabilization fund without ever consulting the Congress. In domestic banking circumstances, the Federal Reserve might similarly take significant steps which would, at least potentially, commit taxpayer funds without seeking congressional assent.

Second, it may be that international circumstances are such that a sum so vast is needed that the United States cannot prudently be expected to act on its own, or may find it advantageous to act with others. An international body might be more efficient, or might have expertise which we do not. Again, in the international security area we have long delegated decision making to international groups such as NATO, and recently we have established precedents of letting the United Nations act without congressional assent because we have judged it in the U.S. national interest to work through international bodies. In the area of foreign financial assistance, the U.S. Congress sometimes chooses to use international agencies such as the United Nations as well.

Thus, it is important that the Congress establish that these funds are going to either be used in so speedy a fashion that the normal legislative process would not work, or that the mission we are undertaking is of such a magnitude that we should subsume American interests in a larger international cause. I do not believe that either of these conditions has been demonstrated sufficiently.

Let us consider the "timeliness" argument. Although the Indonesian banking crisis happened more than 7 months ago, the IMF and the government of Indonesia are still negotiating the terms for an IMF disbursement of funds. While one must admit that our Founding Fathers designed the legislative process to be slow and deliberative, even the most extreme critic of the legislative process would have to concede that Congress could beat the IMF in the decision making process in Indonesia hands down.

Frankly, with regard to this issue of timeliness, the Congress has at its disposal much more effective means of allowing both speedy action and a more direct expression of the U.S. national interest. The Federal Reserve could be authorized to intervene in international currency markets and be granted an appropriation by Congress to do so. Unlike the IMF, Federal Reserve officials are regularly questioned by members of this Congress, including this committee. They are directly accountable, subject to audit and dismissal from their posts if Congress finds that they expended money in a manner which was not consistent with congressional intent. In my view, the Exchange Stabilization fund could be used in this manner, but actions by this Administration, in both the current crisis and the Mexican crisis, indicate that those funds were used to circumvent the congressional process, rather than to carry out congressional intent. So, I am sorry to say that the Administration's case for ever more money for the IMF cannot be justified under this time limitation argument. IMF behavior indicates that timeliness is not an

issue, but even if it were, a much better alternative already exists from the point of view of congressional supervision.

What about the argument that multilateral action is needed? Certainly the size of the funds being expended seems so large that prudent management would suggest that having a partner would be a good idea. But, is this expenditure of funds advancing a cause so noble that U.S. national interests should be subordinated to those of an international body?

Again, I think the reality is that this is not the case. I have just recently returned from two weeks in Asia and can tell you first hand that the IMF bailout has not had an effect which one could consider desirable. Let me focus particularly on the case of Korea. There, the giant Hanbo Steel has been effectively absolved for a year from paying any interest on the enormous amount of corporate debt which it has built up over many years. This gives the company an enormous competitive advantage over all other steel producers, American, Japanese, German, whatever. As the saying goes, when you don't have to pay your bills, your gross is your net.

The fact is, the great majority of the money the IMF disbursed in Korea and throughout Asia did not go to some noble cause such as feeding the hungry or housing the homeless. It went to helping specific companies which compete in the global marketplace get a reprieve on their debt service. This not only is not in the American national interest, it is not in the interest of the global economy either. Hanbo Steel is not outproducing its competitors because of some inherent cost advantage gained by greater efficiency. It is outproducing its competitors because it is being subsidized by the taxpayers of the United States and the other major countries of the world. The IMF action is making the global economy less efficient, not more efficient. Again, the Administration argument that we must subordinate U.S. national interest for a higher global interest carried out by the IMF does not wash in this circumstance.

There is certainly a foreign policy problem for the United States in the crisis now unfolding in East Asia. But, I cannot help but wonder how much more effective a direct appropriation of \$18 billion to the foreign policy operations of the United States would be in advancing the U.S. national interest than a similar appropriation to the IMF. Again, Congress could maximize its control over any such direct appropriation, targeting its use to those endeavors which do the most to enhance the economic and security interests of the United States. Indeed, I believe that an appropriation of smaller magnitude could actually have a far

greater effect in advancing U.S. interests than the \$18 billion now under consideration. I might add that in considering such an increase in foreign aid, Congress might also want to address the international monetary issues I discussed above by granting increased authority to the Federal Reserve, along with the necessary funding to carry out the stated objectives of Congress in the international monetary stabilization arena.

It is therefore clear to me that the IMF has not demonstrated that it has either a time advantage or a size advantage which would justify subordinating U.S. interests and control to that of a multilateral institution. But what of the argument that it has a qualitative advantage and is more efficient than an American governmental agency might be in carrying out its mission. There is no question in my mind that the staff of the International Monetary Fund includes some of the most competent and intelligent professionals available in the world. I also believe that they are well meaning. Certainly Stan Fischer, chief economist of the IMF, is one of the world's leading economists and a man for whom I have enormous respect.

Unfortunately, the competence of individuals can at times be overwhelmed by the bureaucratic demands of an institution. I believe that is the case today at the IMF. Otherwise competent individuals are caught up in a bureaucratic mission which is not making maximum use of their talents.

First, I do not believe that the IMF is hastening an economic recovery in Asia. It is simply not the case, as some claim, that creditors and debtors are incapable of resolving their own problems without the IMF. I would note that the stated reluctance of the congressional leadership to approving more funds for the IMF has actually helped force the banks and the debtor nations to sit down and negotiate. Had there been no IMF, this would have happened much sooner. Sadly, the efforts of the IMF and the Administration to create an early role for the IMF in this crisis had the effect of delaying negotiations between the parties directly involved.

This is a matter of straightforward self-interest. Both parties involved in the dispute -- the banks and the borrowers -- stood to lose money. Both are also aware that a protracted dispute simply increases the economic damage and increases the total losses which must be covered. But, both also saw the injection of IMF funds as a way of minimizing this loss. Thus, as long as it seemed as though the IMF was going to keep injecting funds, neither party had any incentive to resolve the dispute. It was only late in December, when it became clear that the

IMF was running out of money and would not be replenished in a timely manner, that an effective rollover of Korean debt occurred.

Thus, confronting the problem now before the Congress, I believe that an increase in the IMF quota would not be helpful to meeting the objective of a speedy recovery of Asian economies. Approval of the IMF quota increase would simply signal to those parties most directly involved that the world's taxpayers will cover a substantial portion of the losses brought about by their imprudent behavior. On the other hand, an actual rejection of a quota increase might destabilize Asian markets at a very delicate moment. Thus, the best course for the Congress is to defer consideration of the issue while studying the issue carefully and monitoring how events in Asia unfold.

Second, the expansion of the IMF into the role of lender of first resort has, in my view, detracted from its ability to carry out the functions for which it is well suited. The primary mission I have in mind is as an objective international provider of economic information and analysis. The predictive performance of the IMF in the current Asian crisis was dismal, to say the least.

In October, 1997, the IMF predicted that Indonesia would enjoy 6.2 percent growth in 1998. Its April forecast is for a decline of 5 percent. In Korea, a similar forecast last October of 6 percent growth has been marked down to a decline of 0.8 percent. In Thailand, growth of 3.5 percent has been revised to a contraction of 3.1 percent. Most alarmingly, expected growth of 2.1 percent in Japan has been adjusted down to a zero-growth scenario.

Yes, events change, and yes, private economists make errors too. But there are some differences. First, private economists with these error margins usually lose their jobs, as opposed to enjoying a massive increase in their operating budgets. Second, the problem with the IMF making these errors is that they largely result from biases created by the bureaucratic mission of the IMF, and thus undermine that institution's effectiveness. Third, these IMF induced errors create externalities with respect to the conduct of global economic policy, both in the affected nations, and among other nations and organizations of the world. To be specific, the IMF's self-described mission of being an aggressive lender causes it to fail in the mission for which it is most suited: providing objective economic advice.

In part, this results from the ownership of the IMF. It is owned by its voting members, the governments of the world who are its members. They provide its budget. They are also its customers. The IMF

bureaucracy must therefore remain on very good terms with these governments. That is why errors such as the Japanese economic forecast are made. Last May, the IMF forecast 3 percent growth for Japan in 1998, and even in October was forecasting 2.1 percent growth. The only other agency I know which advanced such optimistic numbers was the Japanese Cabinet. These numbers exceeded any private forecast of which I am aware, and especially in October, exceeded the best guesses of most government economists in Japan as well. The Japanese government is of course, the second biggest contributor to the IMF and has the second largest block of votes.

In the case of lending to nations in trouble, the need to close the deal causes the IMF to be unduly rosy about the effect of its prescriptions on the country receiving IMF assistance. Consider for example some calculations by David Malpass of Bear Stearns on the effect of the IMF on the dollar GDP of Asian nations. In Thailand, dollar GDP is expected to fall from \$184 billion in 1996 to \$156 billion in 1997 and \$121 billion in 1998. In Korea, the decline is likely to be from \$485 billion in 1996 to \$437 billion in 1997 and just \$300 billion in 1998. In Indonesia, the decline is likely to be from \$226 billion in 1996 to \$201 billion in 1997 and just \$100 billion in 1998. As a caveat, I should note that a major portion of these declines is the result of IMF prescribed devaluation, and it is certainly true that living standards will not fall by equal percentages.

What is key is that the IMF will not provide detailed estimates of the effect of its policies on the dollar GDP of recipient nations. If it did, it would surely not be able to close the deals with the participating governments as they would be shocked by the resulting effects. The IMF is also unlikely to want to provide such details to its major global constituency – global banking institutions – for they would quickly curtail their lending if they were aware of the magnitude of these effects.

I have no doubt that a limited sum of money, contributed by a variety of nations, could, if expended in emergencies, provide a much needed function in the modern global economy. The IMF should stick to this mission. It is one that the IMF can carry out with the ample financial resources and vast array of human talent and experience it has at its disposal. Its ability to function would be enhanced if it chose to cooperate with the world's central banks in carrying out its mission and if those central banks were empowered to cooperate. But this is not the case today.

Finally, let me turn to an issue which I believe to be of particular concern in the present environment. The pretense, advanced by the

Administration in recent congressional testimony, that this money is merely a “deposit” and the IMF is something like a “credit union” is plainly faulty. Further, the Administration argued, the U.S. contribution to the Fund was not really an expenditure and was costless to the American taxpayer. They added that the credit union was safe because a substantial portion of its assets were in gold, and that no one had ever lost any money in the IMF. While this analogy demonstrates some superficial validity, I think that it is an unfortunate comparison, and I hope and trust that the Administration itself is not confused by its own analogy.

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

By contrast, the IMF does not lend on collateral, but effectively makes only “signature” loans to member states. There is no bankruptcy statute or right to attach assets in the event of a default. Furthermore, there is no real assessment of credit worthiness. Quite the contrary, an apparent requirement to get an IMF loan is that the borrower is not creditworthy, in that the borrower could not obtain private sector financing.

As far as the gold backing is concerned, I would find it somewhat troubling as a bank regulator if one of the banks I were supervising had an asset that was as volatile as gold backing up a substantial portion of its balance sheet. I would note that gold has lost nearly 20 percent of its value in the last year or so. This is certainly not reassuring.

While I have not performed the analysis myself, I do know that at least one private sector analysis of the IMF balance sheet found that if it were a bank, serious questions could be raised about the IMF’s capital adequacy. Usually this would mean shrinking the size of the institution rather than enlarging it. I would stress that the IMF is not a bank and should not be treated as such. But, nor is it a credit union. The U.S. contribution should be viewed from a pragmatic point of view not as a deposit, but as an expenditure.

It is also true that no one has, to this point, lost money in the IMF. Of course, if it were such a great investment, the IMF would be going directly to Wall Street and not to the U.S. Congress to fund its needs. I think the better comparison is that the IMF is like the FDIC in the late 1970s or early 1980s. At that time, the taxpayers had not lost any money in the FDIC. It was there to assist troubled members if they had a crisis. What we learned over time, however, was that a sufficiently large crisis would come along which would swamp the capacity of the fund to cover the losses of the large number of banks which were involved.

In sum Mr. Chairman, I think that there are two ways in which the Congress can effectively influence the IMF. The first is to just say "no". A decision not to increase the American quota at the IMF would send a loud and highly effective signal regarding the operations of that body. It would indicate that the Congress would like to limit the growth of the IMF and, by so doing, try and limit its operations to those functions for which it is most suited: providing liquidity in times of global economic emergencies.

The second mechanism at the Congress' disposal is to require the IMF to take specific actions before any additional funds are provided. This is, in effect, what the IMF does to the countries which request its money. So-called "conditionality" requires that the country involved meets certain IMF conditions before any money is disbursed. I do not think that the hortatory language in the bill referred by the full committee accomplishes that end.

Some might suggest that the congressional deliberation process has had an effect on the IMF, regardless of what further actions are taken. I think that this argument holds some merit. In particular, I noted during December and January that the IMF would tend to strengthen its demands for market opening and greater transparency as objections emerged in the Congress and among opinion leaders to the increased funding of the IMF. But, I would argue that this is largely an argument which has its roots in the "just say 'no'" case I outlined above.

We should be clear that, by and large, the demands the IMF makes on recipient states are both reasonable and not contrary to U.S. national interests. Some would say that is sufficient. I disagree. Where U.S. taxpayer money is at stake, the Congress has the responsibility to choose that mechanism which maximizes its control over the funds disbursed and the conditions attached to any disbursement. The present Administration proposal does not rise to that standard.

As a practical matter, we should recognize that the IMF, like any bureaucracy, tends to operate in its own self interest. There is no doubt that the U.S. executive director and indirectly, the U.S. Treasury Department has a substantial influence in that body. While one may be content to simply let this influence take its course, I do not believe that Congress should be satisfied with letting its constitutional powers to control the purse strings be so easily circumscribed.

Thank you Mr. Chairman, and I would be pleased to answer any questions which you might have.

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